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Navigating 21st century industrial policy

by
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The COVID-19 pandemic highlighted the vulnerabilities of supply chains established entirely on minimizing costs. Sourcing networks were shown to be too rigid and dependent on a small number of offshore locations, most notably China. Making strategic supply chains more resilient was a core goal in the Biden administration's 100-day supply-chain review that focused on semiconductors, batteries for electric vehicles (EVs), active ingredients for essential medicines, and critical minerals. However, global value chain (GVC) research shows that "resilience" has diverse meanings at different levels: individual firms (operational efficiency); global industries (managing company participation in geographically shifting and organizationally complex supply chains); and countries (national security).

In response to medical-supply and other product shortages caused by COVID-19, the rise of economic nationalism and geopolitical tensions such as the Russian invasion of Ukraine and concerns over Taiwan, many governments made strengthening their supply chains of strategic goods a national-security priority. Thus, even countries such as the US that had avoided, at least, the appearance of having industrial policies resorted to them.

The Biden administration advanced a bold "modern American industrial strategy" that consolidated the push to rebuild strategic US supply chains in three major legislative bills, each targeting key industries:

- The CHIPS and Science Act (CHIPS Act), Aug. 9, 2022; US$53 billion.
- The Inflation Reduction Act (IRA), Aug. 16, 2022; US$738 billion.

- The Bipartisan Infrastructure Law (BIL), Nov. 26, 2021; US$840 billion.

The ambitious 2020 Industrial Strategy for Europe supports the transition to a green and digital economy, makes EU industries more competitive globally and enhances Europe's autonomy by promoting a series of "strategic value chains", including clean vehicles, smart health, low-carbon-emission industries, the industrial internet of things, and cybersecurity.

In Asia, China launched its quest to become a technological superpower nearly a decade ago through explicit state-sponsored strategies such as Made in China 2025 (adopted in 2015), the Belt and Road Initiative and the Dual Circulation model to promote national security by emphasizing advanced manufacturing, electric vehicles, clean energy, digital technologies, and using selective access to its large domestic market to lessen China's dependence on the global economy.

Several novel features of 21st century industrial policies shape their impact on FDI:

- *A broad and evolving range of industrial sectors are affected*. All the major economies pursuing new industrial development strategies highlight intermediate goods like semiconductors in their plans, as well as emerging digital technologies such as artificial intelligence and quantum computing. These products touch a wide range of other industries.

- *GVC-oriented policies link trade and production in multiple ways*. In integrated supply chains, trade policies affect investment and production decisions—and vice versa. In semiconductors, for example, the global shortage of chips began in July 2018 when the Trump administration imposed a 25% tariff on chips imported from China, followed by export controls intended to starve the Chinese telecommunications giant Huawei of inputs, especially semiconductors. This "weaponized trade" was only partially effective because Huawei was able to replace US chips used in its 5G equipment with those from Japan, the Republic of Korea, Taiwan, or Europe.

- *Policy coordination and international partnerships among like-minded countries are essential*. Given the similar goals of industrial policies in major economies, unintended consequences and trade conflicts are inevitable. Policy dialogue and flexibility are needed. For example, the IRA included "Buy American" (local content) provisions for EVs assembled in North America that were considered discriminatory by the EU and other US trade partners. To accommodate these pressures, IRA adjustments were added to make more EVs eligible for consumer tax credits, such as removing the Buy American provision for "leased" EV vehicles.

To navigate 21st century industrial policy, MNEs and their host countries must be both nimble and strategic.

- *MNEs can address policy uncertainties in GVCs with two main types of strategies: switching and upgrading*. Companies can increase the resilience of GVCs and circumvent trade restrictions by switching their location of production, end markets or suppliers (e.g., making their supply chains more domestic, more regional or more diversified). In addition, they can upgrade the activities or tasks they perform in a given location via functional diversification in GVCs to foster innovation and increase resilience vis-à-vis domestic and external shocks.

- *Derisking, rather than decoupling, may be a more viable approach*. Decoupling from China, or dismantling the complex supply chains that tie the two countries together, has been popular in some policy circles. This is an impractical task that would not advance US, European or Chinese security and prosperity. A more suitable strategy for the US and its allies may be "derisking" which aims to lower US and EU reliance on China without eliminating potential collaboration on broader objectives like climate change or sustainable development. However, whether derisking versus decoupling is a meaningful distinction has been questioned, with derisking seen by some as narrowly targeting China.

The goal of 21st century industrial policy should not be national self-sufficiency, which carries a heavy economic cost. A better approach is a hybrid industrial policy that reflects security needs and reasonable costs linked to a mix of domestic production and foreign supply chains, particularly with trusted suppliers in like-minded countries.

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