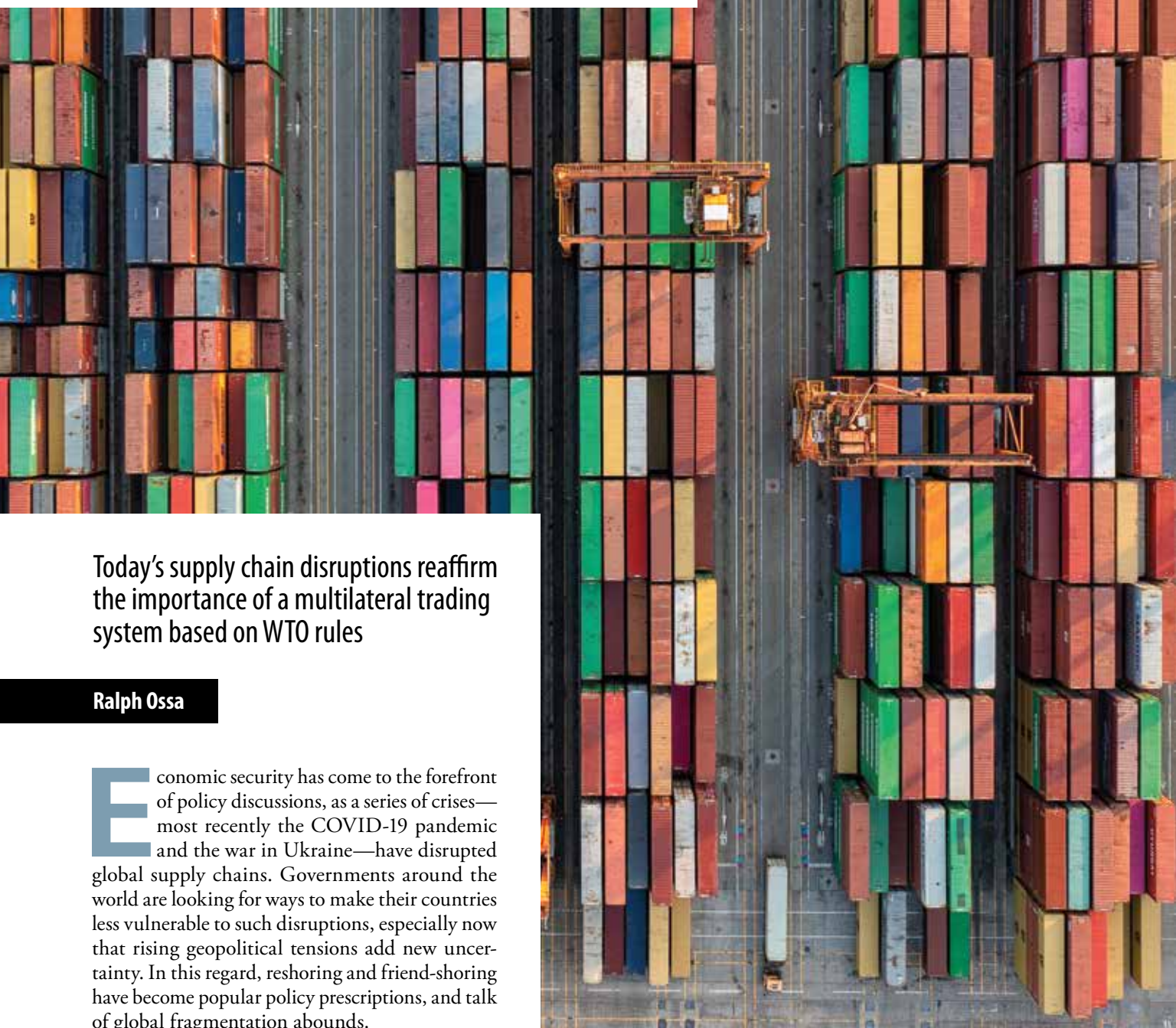


PILLAR OF ECONOMIC SECURITY



Today's supply chain disruptions reaffirm the importance of a multilateral trading system based on WTO rules

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Economic security has come to the forefront of policy discussions, as a series of crises—most recently the COVID-19 pandemic and the war in Ukraine—have disrupted global supply chains. Governments around the world are looking for ways to make their countries less vulnerable to such disruptions, especially now that rising geopolitical tensions add new uncertainty. In this regard, reshoring and friend-shoring have become popular policy prescriptions, and talk of global fragmentation abounds.

In this article, I offer a different perspective, emphasizing the benefits of a strong multilateral trading system based on the rules of the World Trade Organization (WTO). I argue that such a system is the best guarantor of economic security because it provides households and firms affected by supply shortages with unparalleled flexibility. It is difficult to predict where supply shortages will arise and who has the capacity to step in, so access to a broad range of outside options is key.

Evidence is mounting that this “flexicurity” offered by the multilateral trading system is highly effective at mitigating supply shortages. Ethiopia’s adjustment to the tragic war in Ukraine is a striking example of this point. As highlighted in a recent WTO report on the trade effects of the war, Ethiopia imported 45 percent of its wheat from Russia and Ukraine before the war and then saw these imports plunge dramatically—by 75 percent in the case of Russia and even 99.9 percent in the case of Ukraine. However, it was able to respond to these disruptions by sharply increasing its wheat imports from the United States and Argentina, even though it had not imported any wheat from Argentina before. Clearly, such swift substitution among alternative suppliers would have been much harder in a fragmented world economy.

The state of global supply chains

The evidence points to considerable concentration in global supply chains. For instance, only a small minority of US firms have diversified supply chains in the sense of importing the same product from more than one source country (Antràs, Fort, and Tintelnot 2017). Looking at macroeconomic data, WTO economists estimate that 19 percent of global exports are in “bottleneck” products, defined as products that have few suppliers but a large market share (Majune and Stolzenburg, forthcoming). Interestingly, this share has doubled over the past two decades, suggesting that global supply chains have become less diversified over time.

While it is tempting to interpret these facts as prima facie evidence of underdiversification, it is more plausible that they reflect simply the presence of large sunk costs in forming global value chains. It is costly for firms to identify a suitable foreign supplier, coordinate production processes, and build a trusting relationship, so they are forced to rationalize their global sourcing strategies. What is more, firms also have considerable self-interest in avoiding

supply chain disruptions since they directly affect their bottom line. McKinsey estimates that supply chain disruptions cost firms more than 40 percent of a year’s profit every decade on average.

The slow adjustment of global supply chains to the trade tensions between China and the US also speaks to the presence of large sunk costs. True, it is possible to detect first signs of decoupling in certain highly exposed products, as Chad Bown has recently shown. However, it is still striking that bilateral trade between China and the US was at a record high in 2022, despite the large and persistent tariffs that are in place.

At the macroeconomic level, it is worth recalling that country-level specialization is a natural outcome of the forces of comparative advantage and a classic source of gains from trade. Indeed, I have argued elsewhere that trade is beneficial precisely because it provides access to critical products for which domestic substitutes are hard to find, based on a calculation that the 10 percent most critical products account for 90 percent of the gains from trade (Ossa 2015). This suggests that diversifying the production of the above-mentioned bottleneck products would likely come at high welfare costs.

WTO economists estimate that fragmentation of the global economy into two rival blocs would reduce real incomes by 5.4 percent on average. A revival of multilateralism could instead increase real incomes by 3.2 percent, so the opportunity cost of forgoing international cooperation and instead moving to geopolitical rivalry is 8.6 percent. Importantly, the opportunity costs vary from 6.4 percent for developed economies to 10.2 percent for developing economies to 11.3 percent for least developed economies. The stakes are highest for low-income countries because they stand to benefit most from the positive technology spillovers associated with international trade.

The case for policy intervention

A recent paper more formally analyzes the case for policy intervention in the face of potential supply chain disruptions (Grossman, Helpman, and Lhuillier 2023). The authors identify two opposing market failures that policy could potentially correct. On one hand, firms have an incentive to underinvest in supply chain resilience, because some costs of supply chain disruptions are incurred by consumers. On the other hand, firms have an incentive to overinvest in supply chain resilience, because this might





allow them to benefit from the extraordinary profit opportunities supply chain disruptions present. The bottom line is that the case for policy intervention is rather subtle, and governments may wish to push for reshoring, offshoring, nothing, or both.

For all practical purposes, this means that the case for policy intervention in global supply chains is weak. Resilience is desirable but also costly, and there is no reason to believe that firms are systematically under- or overexposed to supply chain risks. That said, it is important to recognize that this analysis abstracts from some of the national security considerations in the current policy debate. There may be circumstances in which it could be argued that firms do not internalize the security externalities of their commercial activities—which could then justify limited interventions in global supply chains designed to internalize these externalities.

These theoretical considerations are broadly consistent with the evidence. After all, global trade has been remarkably resilient—and also an important source of resilience—during the pandemic and the war in Ukraine. Following the COVID-19 outbreak, trade recovered within just three quarters of the downturn in the second quarter of 2020. It supplied households with the masks, vaccines, and home office equipment they needed to cope with the public health emergency. One year into the war in Ukraine, trade is also performing above expectations, after some initial slumps in products such as wheat. This helped ensure that food shortages could be largely avoided, even in heavily exposed countries such as Egypt, Ethiopia, and Türkiye.

The value of a strong multilateral trading system

These considerations suggest that the main role for policy is to provide an economic framework in which resilient supply chains can thrive. Paramount to this role is defending the multilateral trading system, which keeps trade barriers low, nondiscriminatory, and predictable. It is worth remembering that the multilateral trading system is a historic achievement of the international community and not the natural state of international commercial policy. It was created in a constitutional moment after World War II following three disastrous decades of deglobalization.

The rules-based nature of the multilateral trading system is particularly important for supply chain security. It not only reduces the risk of policy-induced supply chain disruptions but also

increases the likelihood that markets will stay open when access to alternative sources of supply is needed most. These advantages would be lost in a power-based trading system in which countries were free to adjust their trade policies as they saw fit.

It is well documented how detrimental trade policy uncertainty is for trade flows. For example, Handley (2014) has shown that a reduction in bound tariffs increases trade flows even if applied tariffs remain unchanged. This is because a reduction in bound tariffs reduces trade policy uncertainty by limiting the extent to which applied tariffs can be changed. Countries sometimes apply lower tariffs than they are bound to by their WTO commitments, which results in so-called tariff overhang.

A broader implication of this is that preserving the credibility of the multilateral trading system is crucial. It not only matters what policies countries commit to but also how credible these commitments are perceived to be. This means that any violation of WTO rules comes with significant collateral damage, undermining the functioning of the multilateral trading system as a whole. The WTO's challenge of preserving the credibility of the multilateral trading system is not unlike central banks' challenge of anchoring inflation expectations.

All this does not mean that the economic framework in which global trade is conducted cannot be improved. If the goal is to strengthen the resilience of global supply chains, what the WTO calls “reglobalization” suggests itself as a natural guiding principle. The idea is to work toward more inclusive globalization that allows a broader range of countries to participate in global value chains. **FD**

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