Supply Chain Diversification

DIHK Impulse

German Chamber of Commerce and Industry

Imprint

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Impulse – Supply chain diversification

Geopolitical challenges, supply chain disruptions during the coronavirus pandemic and the Russian war against Ukraine fostered discussions about strategic dependencies and resilient supply chains in foreign trade debates. The focus is on diversifying procurement and sales markets as well as production sites.. By presenting this paper, DIHK provides an impulse to improve conditions for an easier diversification of supply chains.

Critical interdependencies - How dependent is the German economy?

In terms of its trading partners, Germany has a broad global base. No single trading partner has a share of more than 10 percent. However, according to the EU Commission[1] , six percent (137 products) of EU imports are strategically dependent. For 34 key products, such as rare earths, electronic products, semiconductors and chemicals, the dependency is classified as particularly critical. There are also critical dependencies for the German economy in these areas.

Diversification is companies' daily business

Risk management is part of the daily business for entrepreneurs. As a response to disruptions in supply chains at the beginning of the covid pandemic, German companies increased their stock levels, switching from just-in-time to just-in-case. To make their supply chains more resilient even after the pandemic, many companies have increased their stock levels in recent years and are expanding their supplier networks. [2]

Against the backdrop of geopolitical tensions, German companies are actively de-risking and increasing diversification efforts, particularly in China. According to a survey conducted by the AHK Greater China, many German companies operating in China are planning to set up additional locations outside China (China +1) or are planning to establish China independent supply chains.[3]

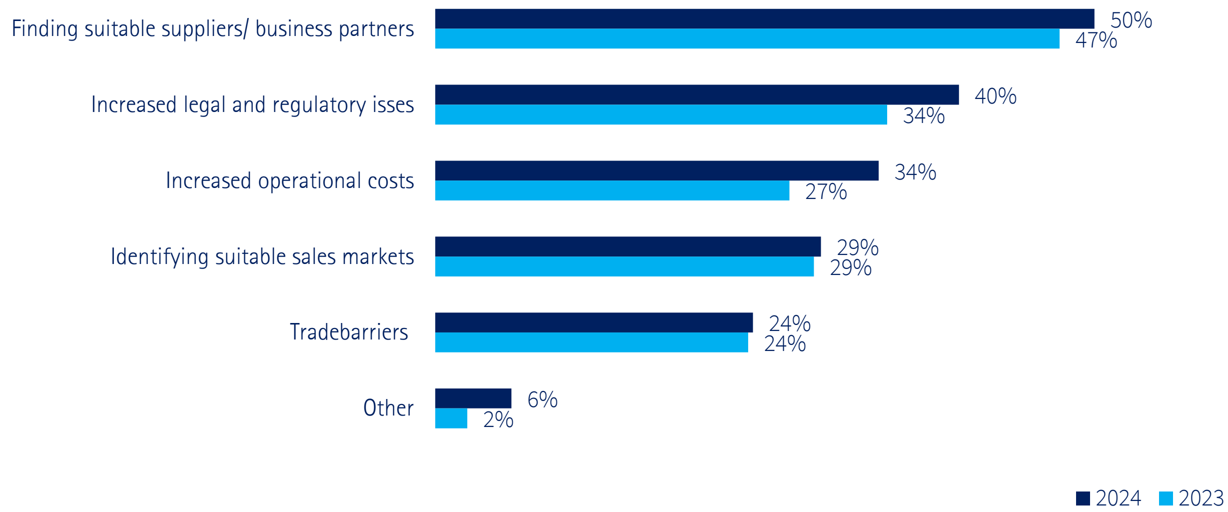
Companies are also adjusting their investment intentions. In the AHK World Business Outlook (WBO) from fall 2023, for example, one in five German companies in China stated that they intended to reduce their investments in China. In the Asia-Pacific region, on the other hand, German companies are more optimistic and are planning further investments on-site.[4]

Challenges to diversification

In order to limit risks and build resilience, many German companies are diversifying their supply chains. However, according to figures from the yet to be published WBO Spring 2024, 85% of companies face challenges when it comes to diversification. For half of these companies, the search for suitable suppliers continues to be one of the main difficulties in diversification. In addition, evermore companies are facing higher costs due to the diversification of their supply chains. In spring 2024, one in three companies that reported challenges encountered such higher costs.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=SWD:2021:352:FIN
[2] https://www.dihk.de/de/themen-und-positionen/internationales/ahk-world-business-outlook-herbst-22/zwei-drittel-der-deutschen-unternehmen-passen-lieferketten-wegen-krisen-an--88374
[3] https://china.ahk.de/publications/business-confidence-survey
[4] https://www.dihk.de/de/themen-und-positionen/internationales/licht-und-schatten-im-internationalen-geschaeft--105926

Challenges in diversification (in percent, multiple answers possible)



Source: AHK World Business Outlook, spring 2023, as well as data from the yet to be published AHK World Business Outlook spring 2024

Diversification ties up capital

The diversification of supply chains means greater security and increased resilience for companies, but at least in short term, it also means higher operational costs. According to the AHK World Business Outlook Spring 2024, every third company facing challenges in diversification was confronted with increased costs. Transitioning to strategies such as "multi-sourcing" and associated market analyses and quality controls for new suppliers not only takes time but also creates costs. Especially the reduction of quantity discounts due to lower order quantities and distribution among multiple suppliers often increases costs.

Increased negative legal and regulatory impact

In addition to increased operational costs, 40 percent of companies facing challenges are reporting increased legal and regulatory issues. In 2023, it was only 34 percent. Tariffs and non-tariff trade barriers, such as local certifications, drive up costs and planning efforts for companies. But increasing challenges are also posed by the German and European side. The majority of German companies affected by the Supply Chain Due Diligence Act (LkSG) complain about increased levels of bureaucracy. Moreover, the LkSG could even counteract supply chain diversification. According to a special survey by the DIHK on the LkSG in early 2023, almost a quarter of companies with more than 3,000 employees that are planning measures to minimize human rights and environmental risks in the supply chain, are considering withdrawing from risky markets and terminating trade relationships. [5]

Diversification requires time

Supply chains are structures that have grown over decades and can only be partially restructured in short term. The search for new or alternative business partners for a successful diversification takes time. Identifying suitable sales markets continues to pose challenges for almost every third company. Additionally, the search for suitable suppliers is becoming an increasing obstacle for many companies in their efforts to diversify. While in 2023, 47 percent of respondents found the search for new and suitable suppliers difficult, now half of the companies face significant challenges.

[5] https://www.dihk.de/de/aktuelles-und-presse/aktuelle-informationen/nachhaltigkeit-sollte-nicht-auf-kosten-der-diversifizierung-gehen-97880

What do companies need for successful diversification?

More trade - diversification through trade agreements

A resilient German economy requires diverse and close partnerships. Comprehensive and ambitious EU trade agreements to eliminate trade and investment barriers with partners such as Mercosur and Mexico, as well as with trading partners in the Asia-Pacific region, the Gulf states, and Africa, are necessary for diversifying supply chains. It is important that these agreements achieve ambitious progress, particularly in areas such as tariff reduction, services, public procurement, intellectual property, and investments. In order for companies to benefit from tariff reduction, straightforwardly applicable preferential rules are necessary within the framework of these agreements. Trade agreements open new markets for diversification and enable expansion of trade.

No managed trade – resilience by decree is short-sighted

Since the experiences of the COVID-19 pandemic, companies are aware of the fragility of international supply chains and the increasing geopolitical risks. Many have already taken steps to minimize risks and diversify their supply chains. Such adjustments should remain entrepreneurial decisions. Measures that move towards "managed trade" – state control of trade – are rejected by the German economy.

Global investment flows are crucial for the internationally interconnected German economy. State interventions in capital movement freedom and the fundamental right to property generally take place in an economic policy tension field. In matters of national security, politics takes precedence. The majority of the German businesses warn that overregulation and an overly strict emphasis on economic security endanger capital inflows, economic growth, and jobs. The introduction of state examinations even for German foreign investments in the form of direct investments (a so-called Outbound Investment Screening) would be another intervention in entrepreneurial freedom and a step towards state-controlled foreign trade. The majority of the German economy is critical of this. At the same time, individual companies suggest that particularly in value chains, which are considered sensitive for the long-term success of the German economy, protective measures should be weighed. It is important to coordinate and pursue monitoring, measures, and support paths together with European partners.

Raw material partnerships – strengthening cooperation

Critical dependencies exist for Germany and Europe, especially in resource supply. Companies depend on imports for procurement, especially raw materials and downstream intermediate products. Shortages lead to rising prices and thus to a lack of competitiveness. In addition to expanding domestic raw material extraction, closer cooperation with third countries such as Australia, Indonesia, Brazil, Chile, and the DR Congo is needed. The initiatives of the German Mineral Resources Agency, such as raw material monitoring, should be utilized and expanded. Through new and modernized resource partnerships, sources of supply can be diversified, and supply can be sustainably secured. In order to improve access, availability, and extraction conditions for raw materials, Germany should also coordinate more closely with our European and global partners.

Reduce foreign trade bureaucracy

In foreign trade, companies complain about steadily increasing bureaucracy. In order not to further complicate the diversification efforts of German companies, it is important to reduce reporting requirements and bureaucracy. This includes, among other things, regulations such as the LkSG, plans for an EU supply chain directive (CSDDD), the European

CO2 Border Adjustment Mechanism (CBAM), taxonomy, and sustainability reporting (CSRD), the EU regulation on deforestation-free supply chains, or the planned ban on products from forced labor. New regulations must be evaluated on practicality and feasibility, especially for SMEs. But existing regulations should also be monitored in this regard. Practical regulations around legal and environmental monitoring enable companies to remain active in markets with particular challenges in terms of human rights and environmental factors. Harmonizing reporting requirements is essential to relieve companies and strengthen diversification.

Creating incentives - instruments for diversification

Successful diversification requires incentives. The federal government's guarantee instruments can provide support. The companies welcome the improved conditions for federal investment guarantees for 34 countries introduced in 2023. This is an important first step, but sustainable diversification requires more. Procedures for export credit guarantees (Hermes guarantees) and investment guarantees should be digitized, streamlined, and simplified, not only in the application phase but also in the event of damages, so that companies can better utilize the instruments. To open up export credit guarantees for more companies, it is important to increase the threshold for foreign value-added share for all product groups and not just for particularly sustainable exports in the "green" category to 70 percent. This would enable more companies to use export credit guarantees to secure their exports and further advance market diversification.
The network of chambers of commerce abroad (AHKs) with more than 150 locations in 93 countries and the regionally anchored 79 chambers of commerce (IHKs) actively advise companies and actively support diversification by assisting in entering new markets and by facilitating the mediation of suitable business partners on-site.