Issue Brief

July 17, 2023

EU-Japan-Taiwan Cooperation: Building a Blue Supply Chain[1]

Niklas Swanström and Lwanga Egbewatt Arrey

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The COVID-19 pandemic, the escalating trade war between the United States and China, and Russia's invasion of Ukraine have exposed vulnerabilities and weaknesses in the global China-centric economic supply chain as democratic states have experienced significant economic pressures stemming from these external geopolitical occurrences. In this context, democratic states are increasingly falling victim to Chinese economic coercion and trade weaponization as the geopolitical stakes increase. This issue brief discusses the need to reduce dependence on the China-centric global supply chain and explores avenues and challenges that key democratic stakeholders like the EU, Japan, and Taiwan must acknowledge and consider to build a blue supply chain as an alternative to the authoritarian-centered red supply chain.

The outbreak of the COVID-19 pandemic in 2020, the ongoing trade war between the United States (U.S.) and China, as well as the full-scale Russian invasion of Ukraine, have heightened concerns about over-dependence on supply chains originating in China and Russia.[2] Beijing's implementation of restrictions on foreign investments and technology for access act in 2017 and other legal restrictions on foreign trade, as well as its use of the economy as a political weapon towards South Korea, Norway, and Sweden, to mention a few, are developments that brought increased attention to the need to reduce supply chain dependence on China. The ongoing challenges are not new and they have necessitated a long process of voluntarily reasserting control over an increasingly complex and vulnerable supply chain, with political measures from China and Russia intended to disrupt the chain.

China accounts for almost 30 percent of global manufacturing, equal to the combined manufacturing shares of the U.S., Japan, and Germany.[3] Testament to its strong dominance in the downstream sector of the global supply chain, China also accounts for 14 percent of all global exports, while making up only 5 percent of global equity markets.[4] But the challenge is not that China controls so much of the world economy, but in the manner in which it attained this position and how it continues to wield this economic power. The politicization and militarization of the economic supply chain has been notable, not least in its attempt to economically isolate states such as Lithuania and Australia during and after the COVID-19 pandemic. Beijing's approach appears to be to defend Chinese interests at the cost of others, hence further weaponizing its control of the supply chain. To reinforce this trend, big firms, both private and public, are required to do the Chinese state's bidding and serve as policy instruments in Beijing's ongoing trade war with the U.S. Despite some recent improvements in Chinese transparency and protection of foreign business interests, the National Intelligence Law of 2017,[5] Cryptology Law of 2020[6] and the Data Security Law of 2020[7] state that all Chinese companies have to share data with the Chinese Communist Party—this has been and will continue to be an obstacle to trust and reliance on the Chinese supply chain. Chinese policy hardly encompasses the values of a globalized liberal economy—values many Western economists and politicians espouse. China's attempts to punish Australia and Lithuania for having independent views, and potentially different opinions on the origin of the pandemic exemplifies how quickly China can weaponize its economy against anyone who displeases Beijing. The growing geopolitical tension makes it increasingly difficult to utilize a strategy that seeks to take advantage of economic opportunities with China. Following the political manipulation of the market as well as the overextension of the global supply chain, changes must occur to safeguard the economies of democratic states and restart a process to establish a Blue Supply Chain that could be the foundation of a free economy 2.0.

Following the COVID-19 pandemic and other disruptions tied to geopolitical and geo-economic competition between Washington and Beijing, several business entities have adopted a China Plus One Strategy.[8] This enables multinational companies to maintain manufacturing hubs within China to secure the benefits of access to the lucrative Chinese market, while setting up operations in other countries in the Indo-Pacific region such as Vietnam, Thailand, and India, in a bid to reduce their reliance on the Chinese manufacturing base—diversifying and de-risking their supply chains. While the China Plus One Strategy is largely based on the incentive to limit economic risk from over-reliance on a single production hub and supply chain, the EU, Japan, and Taiwan can go a step further to safeguard their economic prosperity from unpredictable interruptions to supply chains based on unforeseeable and apolitical shocks like pandemics or economic recessions. All three actors need to secure their economic independence and build resilience to interruptions originating from coercive trade practices, intellectual property theft, and geopolitical competition between China and the U.S. and like-minded states in the region and beyond.

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Objectives of a Blue Supply Chain

It is apparent that the U.S. is and will continue to be a critical partner for all three actors, but creating an independent and open structure could not only strengthen the national security of these three actors, but also reinforce cooperation with the U.S. It is neither in the interest nor practically possible for Taiwan, EU, and Japan to hedge between the U.S. and China in the new geopolitical environment. It is also not possible to ignore potential political changes within the U.S. that could complicate relations. Following the Biden administration's imposition of export controls and restrictions towards supplying technology to Chinese semi-conductor manufacturers as part of the U.S. effort to reduce dependence on China's supply chain, some European companies have been negatively affected. This situation highlights the unpredictable exposure to geopolitical risk that European, Taiwanese, and Japanese companies face as a result of trade and supply dependencies on China.

In addition, following disruptions in manufacturing and supplies from China during the COVID-19 pandemic, there is now an urgent need for Taiwan, EU, and Japan to blue-shore production and sourcing in other countries in the Indo-Pacific such as India, Vietnam, and Taiwan. Taiwan has been taking the lead in risk diversification with a reduction of 10.4 percent of its investments in China in the first quarter of 2023 alone, following a 14 percent decrease in 2022.[9] This is despite a surge of 240 percent in Taiwan's overseas investments to $6.9 billion in the first quarter of 2023.

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While complete reshoring and decoupling from China is not feasible, or even in the interest of any state in the foreseeable future, the EU, Japan, and Taiwan can establish the building blocks of a blue supply chain of democratic and like-minded states by incentivizing their respective business sectors to adopt a "China for China" policy, i.e. local production in China for the Chinese market only.[10] This policy will allow EU, Japanese, and Taiwanese companies and firms to reduce their reliance on Chinese manufacturing for exports, whilst simultaneously maintaining a local supply chain to cater to the Chinese market. Some of the most critical and sensitive manufacturing has to be home-shored, but others could either be blue-shored or near-shored.

One of the strengths of a partnership between Japan, EU, and Taiwan lies in the institutions that hold the foundation of their economies. Democracy, transparency, legal norms, and shared values both in the business sector and in politics guarantees some stability and predictability of the system. This is not to say that all work perfectly, but there is a fundamental difference between authoritarian states and state-controlled business practices. The U.S., South Korea, Australia, Canada and to some extent India, to mention a few, have the same institutional likeness and can merge to form the largest supply chain in the international economy.

Challenges and Obstacles

Having identified the need and urgency of diversifying their supply chains and production bases away from Chinese control, the EU, Japan, and Taiwan must realize that home-shoring, near-shoring and/or blue-shoring come with a set of challenges and obstacles. The obvious challenge is to home-shore to economies where the labor force is expensive and to some degree in shortage, and to production sites that today are not in existence. Vietnam, India, Thailand, and Indonesia are typically mentioned as potential new manufacturing hubs through which European, Japanese, and Taiwanese companies can diversify production and sourcing to reduce reliance on the red supply chain. These potential new manufacturing hubs have advantages with an educated labor force at a competitive cost, but they also come with some structural challenges which have to be addressed for the blue supply chain to emerge as a competitive alternative to the red supply chain. Much remains to be improved in terms of the institutions, infrastructure, and educational attainment of the labor force in many of the aforementioned alternative production hubs. For instance, Vietnam is reputed to have more of an assembly line capacity, rather than a production capacity.[11] It also has poorly developed energy and transport infrastructure with only 20 percent of roads paved, and with a young working-age population that may be more inclined towards work in the service sector rather than manufacturing. In addition, there is an increasing demand for more skilled employees in the manufacturing sector owing to greater digitalization and automation—something that China has developed over decades. Similar challenges are present in the Middle East, Africa and Latin America. More importantly, what assurances are there that states in these regions will be committed to a blue supply chain, and are not trying to hedge the two alternatives?

Furthermore, despite efforts to provide incentives and reforms to attract investment from multinational companies by countries like India, Vietnam, and Thailand, the availability of skilled labor, and the scale of developed infrastructure in China is still much more desirable, especially for those involved in producing high-end technology products.[12] The difficulty in quickly diversifying manufacturing and sourcing is understandable given that many big multinational corporations and companies have carried out decades-long investments in building their manufacturing ecosystems based on product assembly, raw material supplies, and manufacturing in China.[13] Thus, diversifying away from the Chinese supply chain will cost significant amounts of time and financial resources. Diversifying will be necessary though, so long as the economic weaponization and politicization continues.

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The EU, Japan, and Taiwan need to be aware that Chinese companies are not only beginning to base their supply chains and facilities in Europe and its surroundings, but also in Asia, as a mitigating strategy to the near-shoring trend.[14] Also, the sheer size of the Chinese market continues to be a major pull factor for multinational companies. For instance, the Chinese market continues to account for a large proportion of Taiwan's semiconductor exports, approximately 44 percent in 2020.[15]

Getting the House in Order

While recognizing that the threat to economic security and supply chains posed by China's coercive trade policies, intellectual property theft, dual-use technology acquisitions, and geopolitical competition with the U.S. are objectively extrinsic, it is important to point out that some precipitants to Japanese, Taiwanese, and European economic vulnerability are of internal origin and not necessarily China-related. These countries need to get their house in order. There are major internal drawbacks independent of China, due to the relative lack of innovation, resources, and deregulation. The Japanese and European economies, in particular, have been sluggish and have not been developing as rapidly as the Indo-Pacific economies generally.[16] This is partly due to the dependency on China, but more importantly on excessive regulations and lack of easy access to capital for innovative industries, something that has been present in many other economies as seen by the much higher number of patents and innovative research in key industries. Increased investments in high-tech industries have been initiated and would need to be further strengthened, while cutting-edge innovation mini-laterals would greatly benefit the participants.

Following the United Kingdom's (UK) vote to leave the EU in 2016, several trade barriers came into existence between the UK and the EU, further plaguing a European economy already suffering from labor shortages and a business sector unprepared to overcome disruptions and lacking the capacity to diversify supplies and production.[17] The EU can remedy some of these internal challenges to its economic and supply chain security by putting in place measures and incentives that enable companies to "in-source" as a step towards taking control of their supply chains.[18] In addition, given that the Russian invasion of Ukraine has reduced the EU's dependence on Russian energy, the EU needs to find ways to reduce energy costs and increase the use of renewable power sources in response. Also, the EU can learn from India and Japan's examples to make themselves more attractive for companies willing to diversify their manufacturing units and production lines from China to the extent that the European economy can absorb home-shoring.[19]

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Reflecting on the semiconductor sector, while Taiwan currently accounts for over 70 percent of the manufacturing base of advanced semiconductors, Japan's semiconductor industry has experienced neglect and gradually declined since the 1990s.[20] Currently, Japan does not have the capacity to design and plan advanced logic semiconductors, and its production capacity is low. In light of these weaknesses, Tokyo has adopted a clear three-pillar strategy to revive its semiconductor industry,[21] a strategy which can prove useful for the EU to coordinate with through the European Chips Act[22] and take a place as an indispensable player in the construction of an EU-Japan-Taiwan blue supply chain partnership.

Integrating the Supply Chains

In September 2020, Taiwan, the EU, Japan, and the U.S. hosted a "supply chain restructuring forum" where they announced their commitment to secure key industries in the post-pandemic world following the disruption of supply chains.[23] While expressing in no uncertain terms that supply chain security is part and parcel of national security, the Taiwanese Ministry of Foreign Affairs stated its intention to establish industrial ties with like-minded partners based on shared values and freedom from political coercion. The forum also identified the development of supply chains in Association of Southeast Asian Nations (ASEAN) member-states, India and the Visegrad Group as a priority.

While there exist differences in the degree to which Taiwan, EU, and Japan are willing to associate trade with national security, with Japan reflecting Taiwan's direct association between the two areas, and the EU more reluctant to make direct connections owing to its strong adherence to free trade principles, these three players have to find ways to realize their economic and supply chain security agenda in concert.[24] To that end, Japan, India, and Australia's September 2020 Supply Chain Resilience Initiative (SCRI) in the Indo-Pacific aimed at reducing trade dependence on China stands as a model that the EU, Japan, and Taiwan can learn from.[25] Like the SCRI, in addition to semiconductor production, the EU-Japan-Taiwan blue supply chain partnership should focus on securing a stable supply chain in the following sectors: Petroleum and petrochemicals; automobiles; steel; pharmaceuticals; textiles and garments; marine products; financial services; IT services; tourism and travel services; and skill development. In addition, the EU's engagement with Japan and Taiwan as well as its designation of key sectors can be further strengthened under the proposed Critical Raw Materials Act.[26] As aforementioned, given that there are significant differences between the EU and Japan on how far a national security logic should be applicable in the economic and trade milieu, the EU should initially set out to consolidate consensus on areas of convergence with Tokyo and Taipei, such as on supply chain security, anti-coercion, and restrictions over technology transfers.[27]

Like the U.S.-led Chip 4 Alliance[28] of which the EU is not a participant, the five key European countries involved in the semiconductor sector — Belgium, France, Germany, Italy, and the Netherlands — can initiate a strategic semiconductor supply chain network with Japan and Taiwan in conjunction with the EU's European Chips Act.[29] This facet of EU-Japan-Taiwan economic security cooperation will serve two key purposes necessary to closing gaps in their blue supply chain partnership. First, it will further strengthen the increasingly robust Japan-Taiwan cooperation in building resilient semi-conductor supply chains;[30] and second, it will close a gap in EU-Japan economic security cooperation by having the EU join a minilateral economic framework of which Japan is a participant, perhaps even seeing EU ascension into the Indo-Pacific Economic Framework for Prosperity (IPEF).[31] Enhancing EU-Japan cooperation by realizing EU membership in the IPEF or another minilateralist economic framework with Japan can potentially address some of the fundamental differences between the EU and Japan over the extent to which national security logics can be applied to trade and economics, whilst also strengthening consensus and cooperation on four key areas: Supply chain security; complementarity of industrial policies; cooperation on anti-coercion; and, cooperation on controlling technology transfers.[32]

Authors –

Dr. Niklas Swanström *is the Director of the Institute for Security and Development Policy, and one of its co-founders. He is a Fellow at the Foreign Policy Institute of the Paul H. Nitze School of Advanced International Studies (SAIS) and a Senior Associate Research Fellow at the Italian Institute for International Political Studies (ISPI).*

Lwanga Egbewatt Arrey *was an intern at the ISDP Asia Program and was enrolled in the master's program in Political Science at Uppsala University.*

Endnotes

1 The supply chain here refers to the whole supply chain from the idea to the consumer. Blue stands in contrast to the supply chain that has increasingly been dominated by China, and other authoritarian states such as Russia, i.e. a Red Supply Chain.
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