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ADAPTING TO A NEW TRADE ORDER

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Like globalization itself, global trade is changing. The reasons why and the ways in which companies and countries engage in trade are evolving, partly of their own accord and partly as a result of larger shifts in the global economic, business, and political landscapes. The question is, are countries and companies keeping up? Are the top executives, business decision makers, and policymakers adapting to new trade realities?

New Patterns of Globalization and Trade

The global economy is sending conflicting signals. Protectionism is enjoying a resurgence, multilateral trade agreements are under attack, and global trade institutions are declining in influence. At the same time, customers, data, services, devices, processes, and businesses continue to integrate digitally. Meanwhile, trade growth is slowing. From 2000 through 2015, global trade increased only 2% per year, according to the World Bank, and 2016 data is expected to show that global exports have grown at a slower rate than GDP for the first time in 15 years.

These seemingly contradictory forces are ushering in a radically new model of globalization—and changing how people view issues such as trade. (See "The New Globalization: Going Beyond the Rhetoric," BCG article, April 2017.) Those who focus on the narrative of retreat may miss important growth opportunities in the decades ahead. And those who concentrate on the trade-versus-jobs argument, the developed-versus-developing-markets debate, or the significance (or lack thereof) of trade deficits risk overlooking much more important developments that are shaping the future direction of trade.

The Rise of Protectionism. Trade, particularly "unfair trade," is frequently invoked as a scapegoat for countries' economic ills (a particular industry is declining, for instance, or manufacturing jobs are disappearing), especially in developed markets. Critics argue that because they are unable to change other countries' unfair approach-

es, they must implement more protectionist policies to balance the playing field.

While trade has always had naysayers, protectionist rhetoric has become much more commonplace among national leaders, and many of these leaders are pursuing policies to halt or roll back global economic integration. Examples include the US withdrawal from the Trans-Pacific Partnership (TPP), the proposed renegotiation of the North American Free Trade Agreement (NAFTA), and the UK's decision to leave the European Union. According to the World Trade Organization (WTO), the number of trade-restrictive measures in force in the G20 continues to rise, jumping 16% to 1,263 from October 2015 to October 2016.

The Rise of Emerging-Market Consumers. A frequent trade narrative in recent decades focuses on companies shifting manufacturing to low-cost developing countries and selling the finished products in affluent developed markets. While this model makes up a highly visible portion of global trade, the world is changing fast as emerging markets flex their economic muscle.

China's consumer economy is expected to reach $6.1 trillion in 2021 (even if GDP growth slows to 5.5%), which is bigger than the consumer economies of Germany, the UK, and France combined. India's nominal year-over-year expenditure growth of 12% is more than double the anticipated global rate of 5% and will make India the third-largest consumer market by 2025. Africa will have more than 1.1 billion consumers by 2020—and twice as many affluent consumers as the UK. Private consumption has helped power solid growth in Peru over the past 15 years, including straight through the period following the 2008 global recession.

(See *Five Profiles That Explain China's Consumer Economy,* BCG Focus, June 2017; *The New Indian: The Many Facets of a Changing Consumer,* BCG Focus, March 2017; *Africa Consumer Sentiment 2016: The Promise of New Markets,* BCG Focus, June 2016; and *Peru: Climbing the Andean Heights of Wealth and Well-Being,* BCG report, October 2016.)

Continued economic and consumption growth in these countries is leading to changes in global trade patterns. Goods no longer flow primarily east to west or south to north. Intraregional trade is growing in the developing world, and many goods are sold where they are produced. New trade patterns involve countries in new roles, both as consumers and as producers, which has big implications for both companies and countries. WTO data from 2015 shows that the US share of global merchandise imports was actually the same in 2014 as it was in 1948 (13%); it climbed only as high as 17% in the intervening 65 years. Europe's share shrank from 45% to 36% while Asia's share more than doubled from 14% to 32%. One starts to think about trade quite differently if a few large markets for end demand give way to a much more "multipolar" universe of countries.

The Rise of Digital Trade. While trade in goods is stagnating, trade in global services—especially digitally enabled services—is growing fast. In 2014, services constituted 25% of total exports from Organisation for Economic Co-operation and Development (OECD) countries—up from 17% in 1980. This shift reflects the growing value of services in many industries and the fact that digital technologies are blurring the boundaries between products and services. Cross-border B2C e-commerce transactions are expected to jump from $530 billion in 2017 to almost $1 trillion in 2020, and the volume of B2B e-commerce is estimated at many multiples of B2C by the UN Conference of Trade and Development, among others.

The rapid growth of digital platforms has started to make national borders and traditional country-based business models redundant. Today, goods worth $700 billion are traded through Alibaba and Amazon—an amount that represents a compound annual growth rate of more than 33% since 2012.

While digitization will not supplant old technologies, it will transform competitive

rules and supply chains for companies, and it has big implications for industries, such as logistics and international banks, that have built significant businesses funding global trade. (See "What You Need to Know About Globalization's Radical New Phase," BCG article, July 2016.)

Changes in Manufacturing and Cost Structures. Wages are rising in many emerging markets, and when combined with other manufacturing and shipping costs, they are tilting some production advantage back to developed markets. As we reported recently, in terms of direct costs, the US is increasingly competitive with China. (See "Honing US Manufacturing's Competitive Edge," BCG article, January 2017.)

At the same time, the rising use of automation and robotics and the application of other advanced technologies, such as additive manufacturing (3D printing) and the Internet of Things, are forever altering the factory floor—wherever it may be located. We estimate that the adoption of digital technology in manufacturing will decrease labor costs by as much as 30% over the medium term in countries including South Korea, Germany, the US, and China. The future is less about big vertically integrated supply chains and much more about multilocal manufacturing that is closer to the consumer and involves much smaller facilities. Again, this kind of sea change has big implications for trade.

The Decline in Status Quo Trade Institutions. Long-standing global trade institutions are declining in impact and importance as digital trade grows. The rise of bilateral and regional trade agreements and the 20-year failure of the global trade community to update multilateral rules have reduced the role of global trade organizations such as the WTO. Many of the rules that purport to govern multilateral agreements are out of date: cloud computing didn't exist and Amazon was a nascent online bookstore when the WTO was established in 1995. In addition, processes such as the WTO's dispute resolution procedures have come under criticism for being too slow and cumbersome to be effective. One result is that bilateral and multilateral trade agreements are supplanting WTO-led multilateral trade negotiations, which have been stalled since the start of the Doha Round. The number of bilateral and multilateral trade agreements has been rising steadily—there are almost 300 in force today, up from about 50 in 1995. In addition, national and regional lenders and development institutions are playing big roles, supplanting some of the impact of global institutions such as the World Bank and the International Monetary Fund (IMF). The China Development Bank and the Export-Import Bank of China already lend more than all other multilateral development-financing institutions combined, according to the Economist Intelligence Unit. China's One Belt, One Road initiative contemplates $1 trillion in infrastructure and other spending across 60 countries.

New Strategies for Countries

Countries need to change the way they think about trade. Too much of the current policy debate centers on job creation and largely ignores other important considerations, such as national security, the fragmentation of purchasing power and the rise of a more multipolar world, and the impact of advanced technologies. Market access and attracting investment have become as important as trade terms. Moreover, the relationship between jobs and trade is changing. Policymakers need to delink unrelated issues, such as trade deficit reduction and domestic employment, and focus on what their goals in a changing world should be and the levers they can pull to achieve them.

One of the most important considerations for countries is to clarify the impact of the technological changes taking place on jobs. Robotics and artificial intelligence will do more to shape the labor markets of the future than trade. A 2016 report by Australia's Commonwealth Scientific and Industrial Research Organisation (CSIRO) projects that almost three-quarters of all full-time positions in Australia will be affected by technological changes over the next two decades—and about a third of all current

work fully automated—which means those jobs will disappear. (See *Tomorrow's Digitally Enabled Workforce,* CSIRO report, January 2016.) While Australia is only one midsize economy, it is far from unique in terms of the macro forces at work.

New technologies do offer the prospect of greater growth and productivity for companies and economies worldwide. But their near-term impact is likely to be counter to the efforts of policymakers and others concerned with labor markets in both developed economies that are seeking to bring back "lost jobs" and emerging markets that are trying to create new jobs for the hundreds of millions of people entering the workforce. A changing game calls for players to rethink their strategies. For countries, this means at least three things in the near term.

Resist protectionism and prepare for a changing workforce. Rather than putting up barriers that are unlikely to deliver what policymakers intend, smart countries will adopt more open trade and investment policies that make them attractive to businesses. They will also move now to position themselves and their workforces for future jobs. New job categories will require new skills and qualifications, with a big emphasis on technical abilities and "soft skills." Policymakers need to think about a comprehensive set of interventions, including catalyzing new ecosystems by removing structural barriers to entrepreneurship, rebalancing the taxation mix to encourage investment and training, stimulating skilled immigration, and, yes, fostering increased international trade. Longer-term solutions will involve retraining workers, increasing scientific research, and reorienting the education system. Tariffs or other trade barriers, no matter how well intentioned, will not help workers adapt to rapid economic change.

Equip business (especially small business) to succeed through trade. We have argued many times before that growth in nations' digital economies can have a substantial impact on countries' GDP and jobs. (See, for example, *Which Wheels to Grease? Reducing Friction in the Internet Economy,* BCG Focus, April 2015, and *The Mobile Revolution: How Mobile Technologies Drive a Trillion-Dollar Impact,* BCG report, January 2015.) A big part of this impact is trade-related because the internet connects local businesses with international customers, markets, and supply chain partners. Today, world trade represents about 30% of global GDP, an increase of 20% since the early days of the internet and three times the level of 50 years ago. While businesses of all sizes benefit, some of the biggest beneficiaries are small and medium-sized enterprises (SMEs), the same companies that are growth engines for most economies.

The experience of small businesses seeking to do more online illustrates how the internet is shaping the future of world trade and contributing to its growth. For example, our research among 3,500 SMEs in multiple countries has found that over the past three years, the leaders in adopting mobile technologies have increased revenue up to two times faster and added jobs up to eight times faster than laggards. Heavy-web-using SMEs are almost 50% more likely than medium or light web users to sell products and services outside their immediate region and 63% more likely to source products and services from farther afield. We also found that SMEs in economies with high barriers to digital adoption generally lag SMEs in economies with low barriers in the level of internet adoption and use. A recent report by the B20 recommended that G20 members would find it in their own interests to develop and implement "country-specific initiatives to improve e-commerce readiness and digital literacy of developing countries and [SMEs]." (See *Creating Benefits for All: Driving Inclusive Growth through Trade and Investment,* B20 Taskforce Trade and Investment Policy Paper, March 2017.)

Improve collaboration with other countries. Even as countries compete on the global trade and investment playing field, there are plenty of areas in which closer cooperation can help establish, clarify, and harmonize the rules of the game, which benefits all players. The digital age, with new types of trade and new categories of

threat, adds to the need for multilateral collaboration.

Cybercrime, which is a growing danger to everyone, is one such area; others include consumer protection, payments, border taxation, and the use of digital IDs. As the B20 pointed out in its March 2017 policy paper, "The current global structure of incompatible and partly discriminatory national standards and regulations creates many barriers for the further expansion of cross border e-commerce. Interoperable and nondiscriminatory standards are critical for aspects of e-commerce."

One case in point is how Singapore's government is preparing to take its economy forward with the seven recommendations provided by the nation's Committee on the Future Economy, which include deepening and diversifying international connections, acquiring and utilizing deep skills, and building strong digital capabilities.

New Strategies for Companies, Too

Companies need to respond to a changing trade environment at two levels: taking concrete near-term steps that can help address the current uncertain times and developing strategies and business models to address long-term structural changes in the global economy.

Near-Term Changes. In an uncertain and sometimes volatile world, companies can benefit from developing a playbook to guide their responses to changes in trade rules and relationships. (See "How to Thrive in an Era of Shifting Trade Policy," BCG article, June 2017.) The first step is establishing a framework for evaluating the impact of such changes as rewritten trade agreements or the erection of new trade barriers. This framework should take into account the impacts in three areas: the company's supplier ecosystem, its manufacturing network (if it has one), and its distribution and retail channels and end users.

Several factors determine each company's degree of exposure. They include the degree to which supply chain networks are concentrated in countries where trading relationships are at risk, whether the company is financially healthy enough to postpone major sourcing changes in response to new trade and tax policies, and the ability of operations to offset higher trade costs by shifting suppliers or production. Companies also need to determine whether their position in the marketplace allows them to pass added costs to customers.

Having mapped the risks, companies can generate potential actions in response to changes in trade rules under various scenarios and identify the trigger points for putting plans into action. They should estimate how much these actions will affect future exposure to trade policy changes and anticipate the likely response from competitors. Actions fall into three areas:

- **Preventive actions** that the company can take before the new policy agenda has been set, when details may still be influenced; these include arming itself with data to educate lawmakers on the effects that different policy options will have on their companies, employees, customers, and communities

- **Preemptive actions** to take when the policy direction clarifies, such as identifying and prequalifying suppliers in new locations or exploring global pricing agreements with suppliers that manufacture in multiple countries; companies may also look at regionalizing, localizing supply chains or migrating production closer to demand

- **Reactive responses** that can be taken after decisions have been made; companies should decide whether it is better to take short-term actions to mitigate risk or whether opportunity exists for bolder moves that could capitalize on the new environment to gain competitive advantage

Long-Term Changes. Companies taking a long-term view will overlay new trade costs with other trends likely to redefine their optimal footprint in the years ahead. The

rapid advance of robotics, for example, can be expected to flatten some cost differences between countries. Companies may also decide that the time has come to accelerate plans to add new capacity and modernize its manufacturing approach at the same time.

In our April 2017 article "The New Globalization: Going Beyond the Rhetoric," we identified three fundamental questions relating to a changing trade order that global companies will need to answer in the longer term:

- How and where do they find global opportunities in the new environment of fragmented low to moderate global growth and economic divergence among emerging economies?
- What kinds of business models will be most effective in a global economy that is shaped by evolving technologies and trade policies and is likely to be more physically localized but more digitally integrated?
- What organizational philosophy and model should companies adopt to succeed in the new global economic and business environment?

Despite nationalistic calls for simplistic populist "solutions" and claims that certain policies will be "easy," the world is only getting more complex. A variety of uncertainties could result in radically different directions for the global economy. It's all but certain that the environment for commerce and trade will look quite different in a few years' time. There will be strong temptations to wait and see how events play out. But the biggest risk for countries and companies alike is inaction. It's hard to win at a new game when you play by old rules.

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