The Conference Board of Canada

Defining Friendshoring

Another Paradigm in a Protectionist World

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The Global Commerce Centre

Working with policy-makers and businesses, the Global Commerce Centre helps Canada realize its global potential in a multipolar world.

The success of Canada's trade sector is critical to its economic growth and development. As a country with abundant resources and innovation, Canada is well positioned to be a global leader in trade.

But there's a long way to go.

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We aim to achieve this objective alongside our Funding Members by exploring how Canadian businesses can leverage emerging opportunities, including new markets, digital trade, and green trade.

Through GCC's research agenda, we will identify barriers to trade and investment, such as protectionism, and provide recommendations on improving the resiliency of Canada's trade system.

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Key findings

- Geopolitical tensions and protectionist policies are forcing a rethink of what we trade and with whom we trade.
- The conversation is moving from reshoring to friendshoring—the idea that trade should shift to trusted economies, rather than be open—but it's not clear what friendshoring hopes to achieve.
- We identify three possible objectives of friendshoring:
  - If friendshoring is meant to reduce security risks, we need to understand and prioritize what products are critical and with which countries trade is vulnerable to disruption or protectionist actions.
  - If friendshoring is meant to promote ties with friendly nations, then Canada is already on a path of growing free trade agreements, but change will happen very slowly.
  - If friendshoring is meant to economically hurt "unfriendly" countries, then Canada should tread carefully. Friendshoring should be rules-based and not a cover for protectionism, as doing so could lead to trade wars and an erosion in the purchasing power of Canadians.
- More clarity is needed about what traded products are critical to Canada if we plan to implement friendshoring policies.

Rising political tensions and protectionism

In recent years, Canada has felt the real economic impacts of rising protectionism, with much of the tension coming from our two biggest trade partners—the United States and China.

In 2017, the Trump administration re-negotiated the North American Free Trade Agreement (NAFTA), claiming that NAFTA was creating disadvantages to U.S. industries. And despite the successful re-negotiation of a new trade deal, the United States went on to impose stiff tariffs on Canadian softwood lumber, steel, and aluminium. Steel and aluminum tariffs were lifted in 2019 but tariffs on softwood lumber remain today.

The Biden administration also imposed protectionist measures that affect Canada, including cancelling the Keystone XL pipeline and applying "Made in America"[1] policies for subsidies and government procurement. Tensions and trade restrictions between Canada and China have also been rising, especially since the arrest of Huawei's Chief Financial Officer, Meng Wanzhou, in December 2018. In 2019, China imposed trade restrictions on imports of Canadian canola, sending canola prices plummeting in that year. Restrictions on red meat imports from Canada were also imposed in 2019. And both Canada and China imposed travel warnings and restrictions, even before the COVID-19 breakout.

Canada is not alone in feeling the pinch of rising protectionism. According to Global Trade Alert (GTA), a university-backed organization that tracks government policies that affect trade, protectionist trends are strongly on the rise.[2] Globally, the number of state interventions restricting trade are running at over four-fold higher than they were in the decade before the pandemic. (See Chart 1.) The GTA data also point to an increased share, since the pandemic, in the use of subsidies and trade protective measures, rather than tariffs, to restrict trade flows.

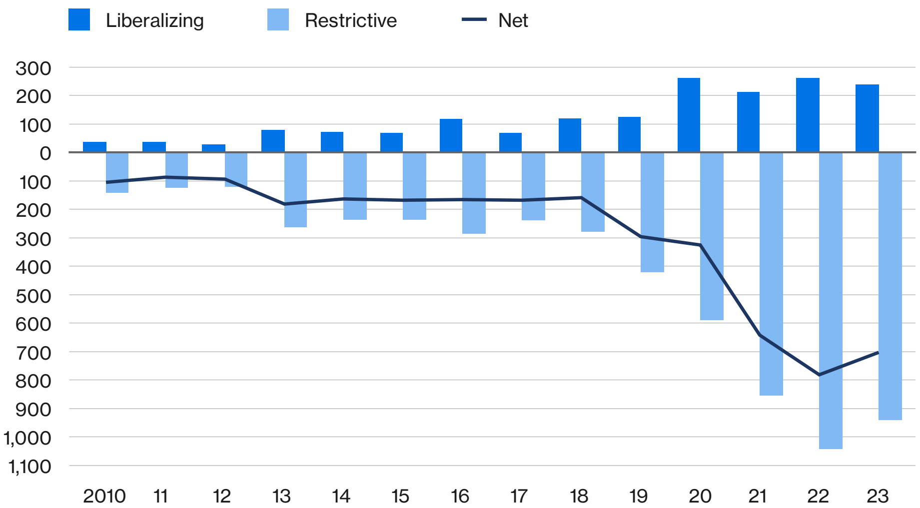
We've argued previously[3] that the pandemic stressed global supply chains and is partly responsible for the change in attitude toward global trade but, more recently, Russia's invasion of Ukraine and growing tensions between China and many western countries over Taiwan are adding heavy political tension to the trade discussion. It is from these events the term "friendshoring" has emerged.

1 A long list of examples is available from The White House, "Build America, Buy America Act—Federal Financial Assistance."

2 Global Trade Alert, Global Dynamics database, lag-adjusted statistics.

3 The Conference Board of Canada, "Shoring Up."

Chart 1
Number of trade restrictions rising swiftly
(new interventions per year, adjusted for annual comparability)



Source: Global Trade Alert.

Friendshoring was first used in a speech by U.S. Treasury Secretary Janet Yellen in April 2022, shortly following Russia's invasion of Ukraine. In her speech, Yellen suggested that trade should be "free but secure" and supply chains should be "friend-shored" to trusted countries. In that same speech, Yellen had strong words of warning to China: "The world's attitude towards China and its willingness to embrace further economic integration may well be affected by China's reaction to our call for resolute action on Russia."[4]

In March 2023, during his address to the Canadian Parliament, U.S. President Biden spoke of secure and reliable supply chains that create value "at every step right here in North America"[5] – perhaps broadening his view that "the supply chain for America begins in America"[6] from his earlier State of the Union address in February.

It is clear that in the United States, both Democrats and Republicans are leaning away from open trade, and friendshoring has become the latest term in the protectionists' quiver.

Canada, too, is pulling the friendshoring arrow from the quiver. In the 2023 federal budget, friendshoring is discussed as an opportunity in which Canada can become a more trusted supplier for countries that are themselves friendshoring supply chains:

> **"At the same time, the pandemic and Russia's illegal invasion of Ukraine exposed strategic economic vulnerabilities among many of the world's democracies. Our allies are moving at speed to limit their dependence on dictatorships by building their critical supply chains through democracies like our own. This shift, often referred to as "friendshoring," represents a significant economic opportunity for Canada and Canadian workers. As a stable democracy with a skilled workforce and a rich endowment of natural resources, Canada can reap the benefits of becoming a reliable supplier of critical goods for our democratic allies."**[7]

4 U.S. Department of the Treasury, "Remarks by Secretary of the Treasury Janet L. Yellen on Way Forward for the Global Economy."

5 The White House, "Remarks by President Biden in Address to the Canadian Parliament."
6 The White House, "State of the Union Address."
7 Department of Finance Canada, *Budget 2023: A Made-in-Canada Plan*, 70.

The federal budget also refers to friendshoring as a way to secure delivery of critical products and to limit the economic benefits of our supply chains to ourselves and our friends:

> **"In the years to come, Canada will contend with two intertwined global economic shifts: first, the accelerating global race to build net-zero economies and the industries of tomorrow; and second, a realignment of global trade patterns as democracies move to friendshore their economies by limiting their strategic economic dependence on countries like Russia and China."**[8]

While the term "friendshoring" is popping up more often, there is very little understanding or consistency among policy-makers (and others) about what it really means and what market failure it is intended to address. More so, there is little or no rationalization from policy-makers about what countries are considered friends, what policies can be implemented to friendshore, or even what products should be friendshored.

8 Ibid., 4.

Defining friendshoring

We offer up the following possible definition. Friendshoring involves relocating production and supply chains to countries that share a strong bond or alliance with the home country, regardless of their geographical location or comparative advantage in delivering the said product. Friendshoring differs from reshoring in that it is not intended to make supply chains more resilient, nor bring value-added production or jobs back to the home country.

There are three distinct political strategies or goals associated with friendshoring.

Goal 1: Reduce security risks

Reducing security risks—to secure critical imports away from countries that could hurt our economy or our ability to deliver products or services should relations turn sour—is not a new objective. The concept of safeguarding supply chains for national security has evolved to encompass a broad range of industries and goods. Initially, the focus was primarily on ensuring a stable supply of essential resources like food and energy. Ensuring the integrity of the supply chains for aerospace and defence is another obvious concern. However, as nations have become increasingly interconnected and dependent on global trade, the scope of supply chain security has also expanded to include medications and medical equipment, critical technology components, and cybersecurity.

Governments have become more proactive in assessing potential risks related to specific countries or regions and implementing measures to protect sensitive technologies, trade secrets, and critical infrastructure.[9] Geopolitical considerations and concerns over intellectual property theft and cybersecurity are shaping the approach to securing supply chains. This has led to increased scrutiny of foreign investments, export controls, and the development of regulations to safeguard national security interests.

9 The United States, Canada, and many other countries imposed restrictions on the use of Huawei telecommunications technology. See, for example, Che, "Huawei, Pummeled by U.S. Sanctions, Reports Plunge in Profit."

Goal 2: Strengthen our diplomatic ties between Canada and like-minded countries

If friendshoring is meant to strengthen and expand our trade and diplomatic ties with some countries, then Canada is well on its way. The Canadian government has already forged a multitude of bilateral and multilateral trade agreements with many countries and regions around the globe. These Free Trade Agreements (FTAs) seek to eliminate or reduce trade barriers, enhance market access for goods and services, protect intellectual property rights, promote investment, and facilitate regulatory cooperation. Currently, Canada is party to 15 FTAs with 51 countries encompassing 1.5 billion consumers.[10] Whether or not our FTAs are fully aligned with what are considered friendly nations remains to be clarified. But of course, it is very unlikely, and politically tricky, for our government to establish such a list. Moreover, as we've seen in recent years, a friendly nation today can easily slip out of favour tomorrow, simply due to a change of government.

The likely strategy will be to play it safe. Canada can continue to promote trade and trade agreements with friendly nations, without having to identify those that we consider unfriendly. In addition to FTAs, Canada promotes trade with other countries through diplomatic efforts, organizing trade missions and trade promotion events, and providing export development and other business support. These efforts are meant to enhance market opportunities, attract foreign investment, and support Canadian businesses in expanding their presence in global markets.

10 Trade Commissioner Service, "Canada's Free Trade Agreements."

Goal 3: Hurt the economies of countries we consider unfriendly

Applying trade and other sanctions to punish unfriendly nations is also not new. In recent years, Canada has imposed sanctions on some countries, often in concert with the United States, Europe, or under the directives of the United Nations. Iran, North Korea, Venezuela, and Russia are just a few examples of countries hit with widespread sanctions for reasons that include national security, human rights concerns, or geopolitical disputes.

Most recently, Canada, the United States, the European Union, and other countries imposed heavy and ongoing rounds of sanctions on Russia after its illegal invasion of Ukraine in late February 2022. These sanctions targeted key sectors such as energy, finance, and defence, and imposed restrictions on specific individuals, entities, and trade activities. The sanctions have had a notable impact on Russia's economy, but the negative impact is smaller than initially expected.

The effectiveness of sanctions is subject to geopolitical dynamics, the size of the domestic economy relative to trade, and the targeted country's adaptation strategies. Russia maintained trade ties with many large consumers of its energy and natural resource exports, such that global markets for oil and resources have rebalanced since the spring of last year when global commodity prices surged. Russia is also circumventing its exclusion from SWIFT, an international transactions system that facilitates cross-border payments, by importing and exporting goods through third countries such as Kyrgyzstan, Armenia, and Georgia.[11]

And irrespective of their effectiveness, the pain of sanctions goes both ways. Canada had immaterial trade ties with Russia before 2022 but many European countries depended heavily on Russian energy exports, especially natural gas. Because of the sanctions, Europe faced energy restrictions and high inflation over the past year, putting several European countries at, or near, recession.

If Canada looks to friendshoring to slow or hurt the economic progression of another country, especially if that country is an important trade partner, then we should be prepared to incur costs for our own economy.

11 Sauvage, "Why Is the Russian Economy Holding Up Against Western Sanctions?"

The carrot and the stick of the friendshoring agenda

The federal government made clear in Budget 2023 that Canada should not source critical goods from countries with authoritarian regimes, namely Russia and China. It also suggests that China's dominance in clean tech is problematic:

> **"Simultaneously, Canada must navigate a fundamental shift in the patterns of global trade. For much of the past three decades, the global economy has become increasingly interconnected. While economic integration lowered costs for many goods, it also built a system of global trade that was vulnerable to the disruption of critical supply chains. For Canada and our democratic partners, the vulnerability created by dependence on authoritarian regimes for critical goods is no longer tenable. Russia's weaponization of energy exports has forced the world's democracies to fundamentally rethink their supply chain vulnerabilities. China currently dominates key portions of supply chains for clean technologies, including batteries."**[12]

While Canada has not announced a friendshoring agenda, we can consider some potential policy levers to achieve the friendshoring goals alluded to in Budget 2023.

12 Department of Finance Canada, Budget 2023: A Made-in-Canada Plan, 17.

Goal 1: Using the stick to reduce security risks

Under international trade rules, Canada can impose trade restrictions to reduce security risks. There are provisions under the rules of the World Trade Organization (WTO) that allow for this. Article XXI of the General Agreement on Tariffs and Trade (GATT), a foundational agreement of the WTO, includes provisions that allow member countries to deviate from their trade obligations. Article XXI states that nothing in the GATT shall prevent any member country from taking any action that it considers necessary for the protection of its essential security interests.[13]

It's important to note that the precise scope and limits of these exceptions have not been precisely defined within the GATT. As such, the application of national security exceptions has been subject to debate and interpretation, resulting in disagreements and disputes between member countries. However, it seems implausible that we can justify moving supply chains or restraining trade for batteries, battery components, or other green initiatives under the guise of national security.

Indeed, greening the economy is an important national and global objective, but it may not be considered a national security issue like food, medicine, energy, or defence. It is true that the global push toward clean energy has pushed countries to secure supply chains

13 World Trade Organization, GATT Article XXI, 1.

for rare earth elements, critical minerals, and renewable energy technologies. And much of the recent friendshoring discussion has been focussed on critical minerals, in particular those deemed essential for the green transition. If others are applying unfair trade measures for commercial interests, then Canada could counter legally under international trade rules.

According to the Organisation for Economic Co-operation and Development:

> **“China, India, Argentina, Russia, Viet Nam and Kazakhstan issued the most new export restrictions over the 2009 to 2020 period for critical raw materials, and also account for the highest shares of import dependencies of OECD countries. The OECD finds that the trend toward increasing export restrictions may be playing a role in key international markets, with potentially sizable effects on both availability and prices of these materials.”**[14]

Budget 2023 highlights that China is a dominant producer of rare earth elements and other critical components of batteries, but how to address this challenge is not discussed.

There is a case to be made if we are countering protectionist measures initiated by the Chinese government. According to some reports, China is looking to ban exports of rare earth metals to maintain an advantage in high-tech production.[15] Tit-for-tat trade restrictions or tariffs are common and can be justified under WTO rules.[16] Much of China’s success over the past 30 years is due to its ascension as a trade and manufacturing powerhouse achieved under WTO rules. For it to now move away from those rules to protect its competitiveness seems unfair, and countering with our own restrictions could be justified.

14 Organisation for Economic Co-operation and Development, “Supply of Critical Raw Materials Risks Jeopardising the Green Transition.”

15 Newcomb, Tim. “Why China Is Banning Rare Earth Metal Exports.”

16 World Trade Organization, ”Understanding on Rules and Procedures Governing the Settlement of Disputes.”

However, China is an important trade partner to Canada, and some of our key exports, including canola, red meat products, and other agriculture products, have been hit hard by protectionist measures implemented in recent years. Moreover, Canada imported over $100 billion worth of products from China in 2022, much of them electronic products and components intended directly for consumers or feeding our manufacturing supply chain. A careful review to assess if these inputs feed strategic products is needed if we are concerned about escalating trade tensions. Regardless, initiating, or countering trade restrictions with China will undoubtedly be met with additional tit-for-tat measures. The implications could be costly.

Goal 2: Using the carrot to strengthen ties with other countries

If our strategy is to diversify supply chains to other nations by promoting trade, then the motor is already running. In addition to our multitude of FTAs, Budget 2023 references and commits sizable additional funding to Canada’s Indo-Pacific strategy, aimed at diversifying trade and investment away from a heavy reliance on China. At the core of the strategy is a commitment to strengthen partnerships with like-minded countries in the region, including Australia, Japan, India, and ASEAN (Association of Southeast Asian Nations), and others. Canada aims to foster cooperation in areas such as trade, investment, security, and sustainable development.

However, the extent of success at limiting trade with China simply by expanding trade with other countries will take time, and likely have at most a modest impact. There is little indication in the trade data available that firms have moved supply chains away from China. Moving supply chains can be costly, especially if moving to new suppliers results in a permanent lift to input costs. Businesses will not be motivated to move supply chains easily.

Goal 3: Inflicting economic pain may require a carrot-and-stick approach

Canada is a rules-based trading nation, and setting trade restrictions with the specific objective of limiting economic gains in China would be difficult, and undoubtedly come with retaliatory measures that would be hurtful to Canada. Instead, the U.S. and Canada seem to be relying on industrial policy to move supply chains home.

The U.S. *CHIPS Act of 2022* (Creating Helpful Incentives to Produce Semiconductors) is an initiative aimed at bolstering the domestic semiconductor industry in the United States. Incentives under the CHIPS Act are estimated at US$52.7 billion, with funds intended to support semiconductor research, development, and manufacturing capabilities within the United States. And shortly after the enactment of the CHIPS Act, President Biden signed into law the *Inflation Reduction Act* (IRA), which put forth an estimated US$369 billion of tax credits and other incentives to support green manufacturing, green technology and renewables, critical minerals, and electric vehicles within the United States (and friendly nations).[17]

In response to these incentives, Canada too is relying on incentives to lure investment home. Chapter 3 of Budget 2023 is entitled "A Made in Canada Plan," with significant funding coming in the form of investment tax credits and other funding for clean technology manufacturing, battery manufacturing, and critical minerals mining. Budget 2023 had set aside funds to cover the deal with PowerCo, Volkswagen's subsidiary company that is to build a large battery plant in St. Thomas, Ontario. The deal struck is priced at over $13 billion in investments and tax credits, mostly disbursed in line with production.[18] Shortly after the Volkswagen deal details were announced, Stellantis NV threatened to halt construction of its battery plant in Windsor, Ontario, saying that it wanted incentives that would match up with those it would receive under the IRA should it opt to built its plant in the United States instead. A deal with Stellantis seems forthcoming but the costs could be sizable.[19]

Budget 2023 discusses the federal government's concern with China's dominance in the battery supply chain, but the incentives being offered for battery manufacturing have likely displaced investment from the United States to Canada. Other green incentives in Budget 2023 could succeed in displacing investment from China to Canada but it's a long shot. These incentives are meant to encourage investment at home but will not necessarily draw that investment from what might occur in unfriendly countries.

There could be an alternate approach to moving supply chains away from China. Canada is exploring the use of carbon border adjustments, and this may provide a rules-based approach to countering China's dominance in green production and other industries.[20] Carbon border adjustments are meant to help achieve greenhouse gas emissions reductions internationally by costing out the carbon intensity of production across different jurisdictions. China is still heavily dependent on coal for energy, such that much of its production is carbon intensive. Applying a carbon border adjustment, in the form of a carbon import tax for instance, would add to the cost of importing products from China, and perhaps incent supply chains to move.

17 Harput, *What Policy Initiatives Advance Friend-Shoring?*

18 Austen, "Canada Lands Volkswagen Battery Plant With Billions in Subsidies."

19 Platt and Coppola, "Stellantis EV Battery Plant Could Cost Canada $19 Billion in Subsidies."

20 Department of Finance Canada, "Exploring Border Carbon Adjustments for Canada."

Conclusion

While the use of the term “friendshoring” is new and, arguably, on the rise, the policy objectives behind friendshoring are not.

Under existing trade rules, Canada has the right to protect and friendshore its supply chains if the objective is to reduce national security risks. However, securing supply chains for critical minerals, batteries, or green technologies could come under scrutiny by our trade partners, if they consider that this has more to do with commercial rather than security interests. This could make it difficult to impose restrictions on private sector investment and supply chain location decisions. The use of the “stick” to encourage moving supply chains may be limited.

The “carrot” can be used by encouraging trade with friendly nations and with subsidies and other incentives to enhance investment and production at home. Canada seems to be working effectively on these fronts, but progress will be slow. Companies will weigh the risks and costs of moving supply chains, especially if doing so results in increases in production costs.

To complicate matters, what is considered a friendly nation today may not be the case tomorrow—certainly this was the case with our relationship with China.

If Canada wishes to pursue a friendshoring agenda, more research is required to identify what traded goods are critical to our national interest and economic success. In addition, similarly to the research often produced when assessing the economic impact of free trade agreements, we should also assess the economic impact of friendshoring policies; this would provide better insights into the potential benefits and costs. Finally, an assessment of the geopolitical risks associated with our trade partners is needed to support policy-making.

Canada will need to tread carefully with a friendshoring agenda. A carrot-and-stick approach will likely be needed, depending on our objectives. But no matter what policies are implemented, friendshoring will likely result in tit-for-tat trade wars, higher production costs, and an erosion in the purchasing power of Canadian households.

Appendix A

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