THE SUPPLY CHAIN IMPACT OF EUROPE'S NEW COMPETITIVENESS STRATEGY

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A new report commissioned by the European Commission calls for urgent action to reverse Europe's loss of competitiveness. Professor John Manners-Bell, Ti's Chief Executive and Founder of the Foundation for Future Supply Chain, writes that the proposed roadmap has major implications for the region's supply chain and logistics industry.

EUROPE'S COMPETITIVENESS PROBLEM

The foundations upon which the European Union's economy is based are being shaken and it quickly needs to identify and implement new growth strategies to avoid becoming marginalised. This is a summary of the long-awaited report into Europe's competitiveness by former Italian Prime Minister, Mario Draghi commissioned by European Commission President, Ursula von der Leyen. His report will have significant implications for the development of Europe's supply chain and logistics industry.

In his words, he summed up the predicament. 'If Europe cannot become more productive, we will be forced to choose. We will not be able to become, at once, a leader in new technologies, a beacon of climate responsibility and an independent player on the world stage. We will not be able to finance our social model. We will have to scale back some, if not all, of our ambitions.'

The problems, he believes, are deep-rooted. Europe spends less on R&D than its US counterparts and often fails to translate innovation into commercialisation. The region suffers from high energy costs, a lack of natural resources and has issues with a Common Energy Market. Rising geopolitical risks have dampened investment and the region is highly dependent on strategic competitors – sometimes adversarial - for critical raw materials (CRMs) and semiconductor chip technology. At the same time, historic reliance on the US defence umbrella has left its ability to respond to global security events compromised, its defence industry fragmented.

The changing global economic paradigm is at the heart of the EU's problems. He recognises that much of the bloc's economic growth has in the past come from international trade. But, as he puts it, '[the] multilateral trading order is now in deep crisis' with growth rates for international trade forecast to be much lower in the medium term than in the past twenty years. European manufacturing is finding itself squeezed –

hammered by Chinese competitors offloading their surplus capacity on Europe and unable to rely on China as an export market due to the country's economic weakness. This has combined with the end of geopolitical stability caused by Russia's invasion of Ukraine and with it the cessation of cheap and abundant supplies of energy.

The EU's problems are exemplified by the challenge it faces in the green energy transition. Presently it is seeing a sharp deterioration in its trade balance in clean tech products with China – photovoltaic panels, batteries and electric vehicles (EVs) in particular. If it chooses to put up barriers to Chinese imports the energy transition would be set back and EU exporters exposed to retaliatory measures. Should it ignore the problem, EU jobs will be at risk from Chinese exporters 'dumping' goods on the market due to weak domestic demand and over-capacity.

The report also acknowledged some of the internal tensions which have resulted in the recent political upheaval seen in many European countries. 'Globalisation brought many benefits for the European economy as well as lifting hundreds of millions out of poverty around the world. But policymakers were arguably too insensitive to its perceived social consequences, especially its apparent effect on labour income.' In other words, off-shoring strategies pursued by manufacturers may have led to the loss of good quality jobs to other parts of the world, although the report went on to say this was more the result of automation than open trade. Still, '…the notion that globalisation had exacerbated inequality infiltrated public perceptions, while governments were seen as indifferent'.

WHAT ARE THE SOLUTIONS?

So far, so bad. Whilst Europe's problems are well documented, it is Draghi's recommendations which are of real interest, given that his document is likely to provide a roadmap for future European Commission policy.

Eschewing the dirigiste tendencies of many European politicians, he asserted that attempts to improve competitiveness should be made by increasing productivity, not by creating national champions or raising trade surpluses. This should be achieved by developing knowledge and skills, not by focusing on labour costs.

However, he is certainly not a proponent of a total 'laissez faire' approach. At the heart of his response to the competitiveness crisis is the development of a new industrial policy comprised of multiple strategies: fiscal, trade and 'foreign economic' policy to secure supply chains in critical sectors. It will involve closing the 'innovation gap' with strategic rivals, developing a plan for decarbonisation, increasing security and reducing trade dependencies.

The latter has been caused by Europe's commitment to what Draghi calls 'high trade openness'. To cope with the demands of a new and complex political landscape, the report recommends deploying policies which:

1. Provide an open market to mass produced, non-strategic imports even if they are highly subsidised by the producing country. He believes it is better for the EU consumer and inflation, if, say, the Chinese taxpayer bears the cost of supplying the EU market. At the same time sourcing must be diversified to limit dependency on any one country;
2. Encourage Foreign Direct Investment (FDI) in the EU to stimulate jobs, where the technology is not seen as strategic, but impose tariffs to 'level the playing field' when faced with competitors supported by foreign subsidies;
3. Require local-content in situations when technology is critically important to ensure technological sovereignty (through insisting on joint ventures, for example); and
4. Support infant industries through subsidy and protection.

Regarding this last point, Draghi warns against falling back into the trap of previous generations, when politicians tried to pick winners or 'national champions' as they were called. Instead, there should be a focus on stimulating competition by increasing productivity, investment and innovation. He also believes that addressing issues of fragmentation – especially pools of capital - would naturally lead to the development of larger businesses that would be better able to challenge US or Chinese competitors.

The report also highlights that the use of subsidies could lead to tensions within the EU. Without coordination at a European level, the richest countries in the Single Market would be able to provide more support for their own companies, distorting the market. This was seen throughout Covid-19 pandemic when Germany and France came in for criticism from smaller countries for the way in which they were able to support their own businesses. Draghi believes that the European Commission should play an enhanced role in coordinating how sectors and companies are supported by national governments.

SMARTER TRADE POLICIES ARE NEEDED

The report recommended that trade policy should be more flexible, nuanced, applied on a case-by-case basis and avoid generic stances. Smarter use of trade measures, such as tariffs, would encourage trade with markets supplying key technologies (such as US) and also be used to guarantee critical supplies by allowing preferential market access (for example, in the clean tech sector). At the same time, administrators should not be afraid to use tariffs to 'level the playing field' with global competitors. Even so, Draghi warns against ill-judged trade measures saying, 'Imposing tariffs on imports of raw materials or

intermediate goods, but not on final goods that use those materials intensively, could lead to de-localisation'.

In order to protect EU consumers from higher prices, EU manufacturing should not be protected if it is highly uncompetitive, even if imports are supported by foreign subsidies. The EU should be prepared to relinquish ground on low value added manufacturing and, in effect, allow foreign taxpayers to fund EU consumption.

Implicit in the policy paper is an admission that the EU lacks confidence in the World Trade Organisation's ability to structure and police international trade as it once did. Instead, the EU has chosen to negotiate bilateral trade deals and arm itself with the ability to respond to trade disputes. 'In June 2023, the EU adopted a new Economic Security Strategy furnishing itself with a range of instruments to deal with dumping, respond to coercion and address distortions caused by foreign subsidies within the EU, as well as adopting tools to address technology leakage and enforce sanctions.'

The report states that 40% of EU imports are sourced from a small number of countries, goods which, in many cases, are hard to substitute. About half of these imports originate from countries with which it is not 'strategically aligned' or in other words, fall into the category of strategic adversaries, China being the most obvious. However, Draghi is not concerned that there will be a sudden shock to trade from a geopolitical conflagration. In the case of China, he believes that trade dependency is mutual, that is, whilst the EU relies on China for a large proportion of its imports, China in turn relies on the EU to soak up its manufacturing over-capacity. Therefore, any residual risk stems from the opportunity for China to use the trade imbalance to coerce some of the EU's smaller member states, undermining common policy objectives.

This assessment may downplay the risks of potential trade disruption and seems dangerously complacent seemingly ignoring the prospect of an invasion of Taiwan by the Chinese military. In contrast, many in the US feel that a conflict in the region is probable if not inevitable. Whilst the EU seems to believe that the Chinese government would not take such a step due, not least, to its economic ramifications, its analysis may be mistaken. Achieving its longstanding objective of unification may be deemed by the Chinese government as worth more than any impact on its economy, especially if it judges that any repercussions would only be short term. Europe's dependency on Chinese trade would inevitably weaken its foreign policy response and the impact on the European economy of critical shortages and inflation would make it impossible to sustain a robust position for any length of time. After all, high levels of trade between the EU and Russia did nothing to prevent Putin's invasion of Ukraine.

DELIVERING DECARBONISATION

The paper deals at length with the problems – and opportunities – which the EU faces in terms of meeting its Net Zero Carbon Emissions goals. As already highlighted, the risks of losing leadership in clean technologies to China and the US are already very evident. In particular, the report highlighted a number of challenges:

- Scaling up alternative fuel production – the EU needs to put in place plans to build out a supply chain.
- Lack of EU wide planning which is compromising the ability to build multi-modal solutions.
- Car makers and corporate logistics companies have been given targets which will increase demand for EVs and charging infrastructure but there are no similar plans to supply the grid.
- The EU needs to make agreements with 'like-minded' neighbours which will allow access to low cost renewable energy sources.
- Avoiding delocalisation of clean tech production and acquisition of EU manufacturers by state-subsidised foreign producers.

Draghi also mentioned that there was, 'a risk of carbon leakage and business diversion from transport hubs in the EU to those in the EU's neighbourhood, unless effective solutions for ensuring a level playing field are found at the international level.' No doubt he had the UK in mind given that extra-EU flights and sea journeys are partly excluded from the EU's Emissions Trading System (ETS). As a result, some shipping lines have already added the UK to their calls in order to reduce costs.

In the automotive ecosystem, he recommends that 'an industrial roadmap' should be established to deliver horizontal convergence (i.e. electrification, digitalisation and circularity) and vertical convergence (i.e. critical raw materials, batteries, transport and charging infrastructure) of value chains.

More generally, the report concludes that Europe must shift to a circular economy as an alternative to relying on Chinese clean tech and EVs. This shift must be supported by an industrial policy which will encourage domestic production and an economic foreign policy to assure access to critical raw materials (CRMs). However, for the time being, China remains the single largest processor of nickel, copper, lithium and cobalt, all essential to the green transition. Draghi recognises that there is a global race to secure CRMs, one which Europe is losing. Whilst China has its Belt & Road Initiative (BRI) which has effectively channelled raw materials from Africa and Latin America to its domestic manufacturing sector and the US is using its Inflation Reduction Act (IRA) to develop scale

domestic processing, refining and recycling capacity, the EU has yet to prepare its own response.

HOW WILL THE POLICY IMPACT ON SUPPLY CHAINS?

Draghi recognises that any diversion from the present open trade policy will have cost implications. Supply chains will inevitably become less efficient, whether this is as a result of diversifying supply base, investing in domestic chip manufacturing capabilities or sourcing CRMs from new markets.

In terms of semiconductor chips, EU needs a foreign economic policy covering the entire supply chain, aggregating the procurement and stockpiling of CRM at a European level. He recommends that the EU's 'Global Gateway' initiative (Europe's answer to the BRI) should be used to finance projects and source critical materials from strategically aligned countries.

Draghi's approach to increasing the EU's competitiveness will have subtle but important impact on Europe's logistics and supply chain industry.

- Circular supply chains will develop as products which enter the market from overseas are reused or recycled. This will provide a headwind to the growth of inter-continental movements of goods (both finished goods and virgin materials) as demand is satisfied from within the EU.
- Manufacturers will be encouraged to diversify their supplier base geographically in order to reduce dependence on China, a trend already underway.
- In contrast, the policy will encourage trans-Atlantic trade with the US, related to key technologies.
- Trade in mass market, low value products from Asia is likely to be unaffected as the EU focuses on developing a manufacturing base for higher value, strategic goods.
- Near-sourcing of goods from neighbouring countries will benefit trade and transport services, as the EU looks for more reliable suppliers of critical raw materials and goods.
- Trade measures will be implemented in a more precise way to prevent the unintended consequence of de-localising manufacturing.
- Efforts and resources will be focused on building robust supply chains with strategically-aligned trading partners for critical materials ('friend-sourcing').
- Political efforts will be made to facilitate the development of greener multi-modal solutions across the continent.
- There will be EU-level efforts to provide a charging grid to support the uptake of electric vehicles and trucks. Likewise, there must be greater focus on building end-to-end supply chains for alternative fuels.

- Supply chains will become less efficient overall from a cost perspective as the EU adopts policies which increase resilience and reduce dependence from a strategic risk perspective.
- The recycling of materials from EVs, turbines and other green tech should be encouraged to create a single circular market by enforcing regulations on waste. This in turn will drive logistics intensity and more regional land-based transport solutions.

CONCLUSION

The Draghi report contains no real surprises, but it sets out what many will see as a sensible roadmap, navigating the perils and pitfalls of the complex global economic and political landscape. It recognises the problems the EU faces and highlights the reasons why the region has been ill-prepared to meet the challenges, not least due to over-regulation, fragmentation of capital and an over-reliance on adversarial trading partners. It also acknowledges that it has lost or is rapidly losing leadership in key sectors – especially clean technology - and sets out an approach of how to deal proportionately with Chinese government-supported competitors.

Draghi urges that action must be taken urgently to reverse the loss of competitiveness. As he puts it, 'We should abandon the illusion that only procrastination can preserve consensus.' However, with France and Germany in political limbo given the rise of populist parties (caused in part by a resentment of globalisation) this may be difficult to achieve. Increased centralisation of decision-making at a European Commission level may not be very popular with many of the EU's members.

In terms of logistics and supply chains, regional solutions will become more important over the coming years. Circularity will result in product life being extended, components re-used and materials recycled, creating more demand for logistics intensive services within Europe. Linear supply chains, originating in Asia and ending in Europe will become relatively less important with implications for global shipping.

New relationships will be developed with neighbouring countries to enable near-sourcing opportunities, reducing dependencies on non-strategically aligned countries. At the same time, Europe will be encouraging trade with its strategic allies, the US and UK for example, in critical sectors such as technology, whilst protecting and supporting industries which it sees as important for its future development. Tariffs will only be used as a political lever in the last resort or when productive European businesses are threatened by unfair foreign competition.

Draghi's recommendations for increasing the EU's competitiveness are based on a smarter approach to global trade, building resilience by deploying a range of supply chain strategies backed up by policy which encourages, supports and sometimes protects European businesses. In terms of positioning, it strikes the middle ground, calling for:

- more de-regulation of industry;
- more centralisation of decision-making in Brussels;
- consolidation of national European defence industries;
- consolidation of European banking sector;
- the sparing use of protectionist trade measures to 'level the playing field';
- government support for strategic sectors;
- a rejection of a return to business subsidies; and
- a focus on high value adding industries, especially clean tech.

It certainly does not call for an isolationist Europe in a de-globalised world, recognising that this would be self-harming given the extent to which it is still dependent on off-shored markets, especially China. However, unless action is taken quickly, Europe will fall further behind its major competitors with implications for economic growth, standards of living and a loss of economic leverage on the world stage. It will become ever more vulnerable to coercion and unable to respond effectively to geopolitical events.

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