

Strategic Autonomy in Post-Covid Trade Policy: How Far Should We Politicise Supply Chains?

by Elvire Fabry and Andreas Veskoukis



ABSTRACT

The resilience of supply chain (SC) is a key nexus in the debate over the European Union's strategic autonomy that continues to divide member states. To reduce critical dependencies on external supply, both diversification of supply and the reshoring of production have their limits. Moreover, the growing rivalry between the United States and China calls for the development of a systemic approach to SCs' resilience that takes into account all levels of subcontracting beyond the first tier of supply. This calls for going beyond the traditional positioning of EU member states in favour of free market or public intervention, to work on a close coordination of an industrial policy that relies on a stronger attractiveness of the Single Market and a trade policy that aims less at protecting strategic industries from foreign competition than at applying precautionary measures that protect populations from supply shortages.

European Union | China | Foreign trade | Supply chains

keywords

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Introduction

The covid crisis has showcased the kind of turmoil and instability that arises when global supply chains (GSCs) are disrupted. As supply shortages were hitting hard across many industries in the early months of the pandemic, much focus was put on the national vulnerabilities created by complex GSCs. The European Commission announced its aim to invest in strengthening the EU's resilience and strategic autonomy as a way of coping with current and future crises. The 2021 trade policy review described the resilience of supply chains (SCs)¹ as "a pillar of the European Union's drive towards open strategic autonomy".²

However, the oxymoron "open strategic autonomy" continues to generate debate among Europeans. The concept suggests that market openness is not at stake. Yet it does not rule out that increasing the resilience of SCs – defined as the ability to swiftly recover from unexpected disruptions – may require more public intervention. Some caution is advisable regarding any objective of full resilience, which could justify more political control over SCs. However, there is a legitimate

¹ The supply chain represents all the steps required to get the product to the customer, while the value chain is a process in which a company adds value to its raw materials to produce products eventually sold to consumers.

² European Commission, *Trade Policy Review - An Open, Sustainable and Assertive Trade Policy* (COM/2021/66), 18 February 2021, p. 6, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0066>.

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concern about the development of global interdependence supported by economic actors which have limited national allegiance. Rebuilding confidence in GSCs and open markets thus requires a closer look at the potential contribution of public support. What, then, are the main options for reducing excessive dependence on foreign supply? Who is in the driving seat to adjust SC strategies: businesses or the state? How far can we politicise the management of SCs?

Any strategy to increase the resilience of supply chains requires first to assess the reality of reliance on foreign supply and to question the limits of both diversification and reshoring as the main options to reduce the critical dependencies, to finally focus on the support that the EU can provide to business to develop a systemic monitoring of SC resilience.

1. Resilience of SCs as a structural challenge for strategic autonomy

“Strategic autonomy” was first included in the European Council conclusions in December 2013 as an objective to develop European defence, technological and industrial capacities.³ It was subsequently considered an important element in the EU’s global strategy of 2016 as a way of protecting European principles, values and interests.⁴ Brexit, Donald Trump’s aggressive trade policy and China’s state capitalism have since then provoked a more defensive European attitude and awareness that Europeans need to stand up for their interests within the realm of international trade and investment. “Open strategic autonomy” was introduced by the European Commission in its latest trade policy review and corresponds to the perceived need to strengthen “the EU’s ability to make its own choices and shape the world around it through leadership and engagement, reflecting [its] strategic interests and values”.⁵ However, Europeans’ reluctance to consider the EU as a global power makes it hard at this stage to reach a consensus on what the concept concretely entails. EU member states remain divided on the strategy required to increase the resilience of SCs.

The Commission’s Directorate General for Trade calls for an assertive EU that is able to increase the resilience of its SCs by combining market openness, level playing field with trade partners and a capacity to defend itself with autonomous tools in order to rebalance interdependence. Yet *member states team up in various groups with different understandings of what “openness” entails.*

³ European Council, *Conclusions* (EUCO 217/13), 19/20 December 2013, <http://data.consilium.europa.eu/doc/document/ST-217-2013-INIT/en/pdf>.

⁴ European External Action Service, *Shared Vision, Common Action: A Stronger Europe. A Global Strategy for the European Union’s Foreign and Security Policy*, June 2016, <https://europa.eu/!Tr66qx>.

⁵ European Commission, *Commission Sets Course for an Open, Sustainable and Assertive EU Trade Policy*, 18 February 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_21_644. See also European Commission, *2020 Strategic Foresight Report. Charting the Course towards a More Resilient Europe* (COM/2020/493), 9 September 2020, p. 2, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0493>.

On 1 March 2021, Germany, Denmark, Estonia and Finland sent a joint letter to the President of the European Commission, Ursula von der Leyen, calling for EU digital sovereignty and a reduction in the economic and strategic dependence of Europeans.⁶ Despite these countries' commitment to "open markets and open supply chains", their joint letter received a reply from eight other member states (Belgium, Ireland, Latvia, Lithuania, Luxembourg, Poland, Sweden and the Czech Republic) which voiced fears that calls for sovereignty could spur a form of protectionism.⁷ In their own letter dated 8 March 2021 the latter group of countries insisted on opening up the European economy. France supported neither of the letters: the French position consists of prioritising the development of industrial capabilities while preserving an open market. Finally, close to the group of eight, the Netherlands and Spain presented a non-paper on 25 March 2021 rejecting economic protectionism and setting out detailed proposals for pragmatic sovereignty, viewed as a means of acting and not as an end in itself.⁸

The debate is not specifically European. Following the review of American SCs launched on 24 February 2021 across four sectors (pharmaceuticals, computer chips, advanced batteries and critical minerals),⁹ the Biden Administration is preparing a comprehensive strategy for federal agencies to shore up production and delivery. Six additional broader sectors will be reviewed by the end of the year: defence, public health, information technology, transportation, energy and food production. China itself adopted its 14th five-year plan in March, restating its "dual circulation" strategy to reduce dependence on foreign energy, technology and investment.¹⁰ All large countries that are deeply integrated into the global economy are undertaking similar reviews.

2. Dependency on foreign supply: Current state of play

At the macro-level, *GSCs are somehow already becoming shorter, reinforcing a regionalisation of supply*. Domestic sourcing continues to play a far greater role than foreign sourcing. Yet closeness to supply does not result in increased resilience and robustness per se. A supply chain is as strong as its weakest link.

⁶ Finnish Government, *Finland, Germany, Denmark and Estonia Call on EU to Accelerate Digital Transformation*, 2 March 2021, <https://vnk.fi/en/-/finland-germany-denmark-and-estonia-call-on-eu-to-accelerate-digital-transformation>.

⁷ Philip Stephens, "Supply Chain 'Sovereignty' Will Undo Globalisation's Gains", in *Financial Times*, 18 March 2021, <https://www.ft.com/content/b5f72f88-814f-4697-8b83-e7d120c81fdc>.

⁸ Spain and Netherlands, *Non-Paper on Strategic Autonomy while Preserving an Open Economy*, 24 March 2021, <https://www.rijksoverheid.nl/documenten/publicaties/2021/03/25/spain-netherlands-non-paper-on-strategic-autonomy-while-preserving-an-open-economy>.

⁹ White House, *Executive Order on America's Supply Chains*, 24 February 2021, <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/02/24/executive-order-on-americas-supply-chains>.

¹⁰ People's Republic of China, *14th Five-Year Plan for Economic and Social Development (2021-2025) and Long-Range Objectives Through the Year 2035* (in Chinese), 12 March 2020, http://www.gov.cn/xinwen/2021-03/13/content_5592681.htm.

It is thus necessary to accurately map and identify excessive dependencies and consider whether these might create national vulnerabilities.

2.1 The regionalisation of foreign sourcing

The benefits of GSCs are obvious to the extent that they lead to firms and countries specialising in the production stages in which they have comparative advantages, resulting in economies of scale and significant optimisation of costs. GSCs have thus developed with ever more numerous stages of production located across different countries and regions for a final product. The use of ever more complex products has also required a larger diversity of know-how and thus further fragmentation of production. Yet *the benefits of ever lengthier SCs may already have been exhausted*. It is not unlikely that the rising cost of labour in developing countries, notably in China, alongside other structural factors in the economy, has led to this reshuffling of SCs.

A shortening of VCs was well under way before the covid-19 pandemic. An analysis of the global average share of foreign value-added content in gross exports, which is a way to measure backward participation in global value chains, has allowed Sébastien Miroudot and Håkan Nordström to highlight that *this shortening of value chains started in 2012 for goods and in 2016 for services*.¹¹ The average distance of intermediate inputs sourcing (i.e. the distance between producer and consumer) has decreased by 9 per cent, from 2,308 km to 2,099 km since 2012.¹²

“Proximity sourcing” (i.e. production located closer to consumers) is indeed benefiting from the digital transformation, the “servicification” of goods (i.e. higher content of services in goods), the development of 3D printing allowing the production of customised goods and sustainability constraints. Further improvements in technology such as robotics, artificial intelligence, 5G, as well as the development of more capital-intensive production should continue to bring production closer to the consumer and lead to a “slowbalisation” (i.e. shortening of SCs and a reduced contribution of trade to economic growth).

Europe is itself the area with the most regional value chains.¹³ From the perspective of an individual EU member state, the share of European value added in gross exports (i.e. foreign value added from another EU country) is about twice the share of foreign value added from non-EU countries. *According to the 2018 TiVA database of the Organisation for Economic Co-operation and Development (OECD), the EU’s total share of foreign value-added content in gross exports is limited to*

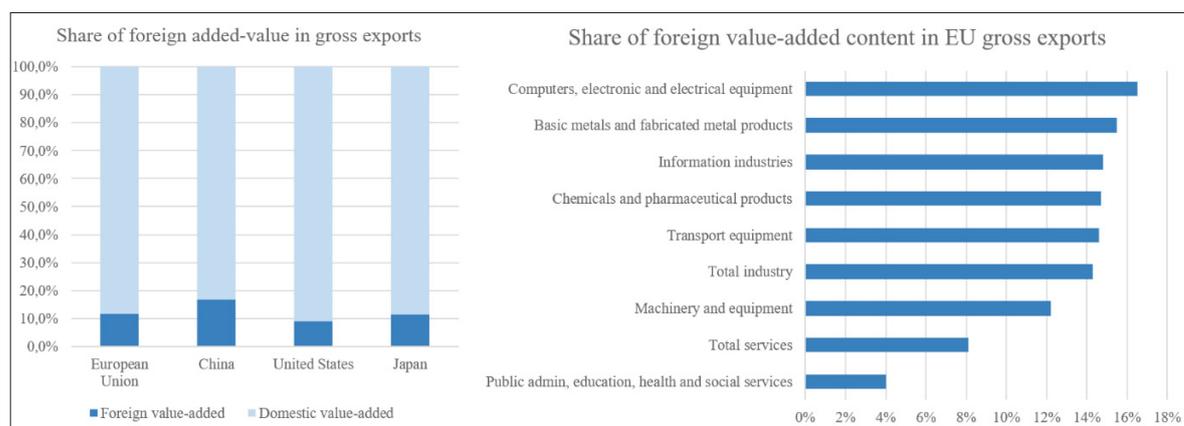
¹¹ For goods, the peak was reached in 2011 with 23.5 per cent of foreign value-added content in gross exports and has since then declined. Sébastien Miroudot and Håkan Nordström, “Made in the World? Global Value Chains in the Midst of Rising Protectionism”, in *Review of Industrial Organization*, Vol. 57, No. 2 (September 2020), p.195-222 at p. 205.

¹² Ibid., p. 218.

¹³ Ibid., p. 215.

11.6 per cent, while the world average is around 20 per cent. Figure 1 shows that the EU average is higher than the US level, similar to the Japanese level and lower than the Chinese equivalent of 16.7 per cent. European manufacturing sectors (with computers, electronic and electrical equipment at the top) are generally more reliant on foreign value-added content than service sectors, even if domestic sourcing is the norm for both.

Figure 1 | Share of foreign value added in gross exports



Source: OECD TiVA database, 2018, <http://oe.cd/tiva>.

Although the evidence above suggests that dependence on foreign value-added content remains limited, it can still be argued that a small disruption can cause negative externalities in all downstream stages of production. The complexity of GSCs makes the repercussions on a global scale or a given country difficult to predict.¹⁴ Any meaningful mapping of dependencies on imports thus requires a detailed multilevel approach to identify critical dependencies.

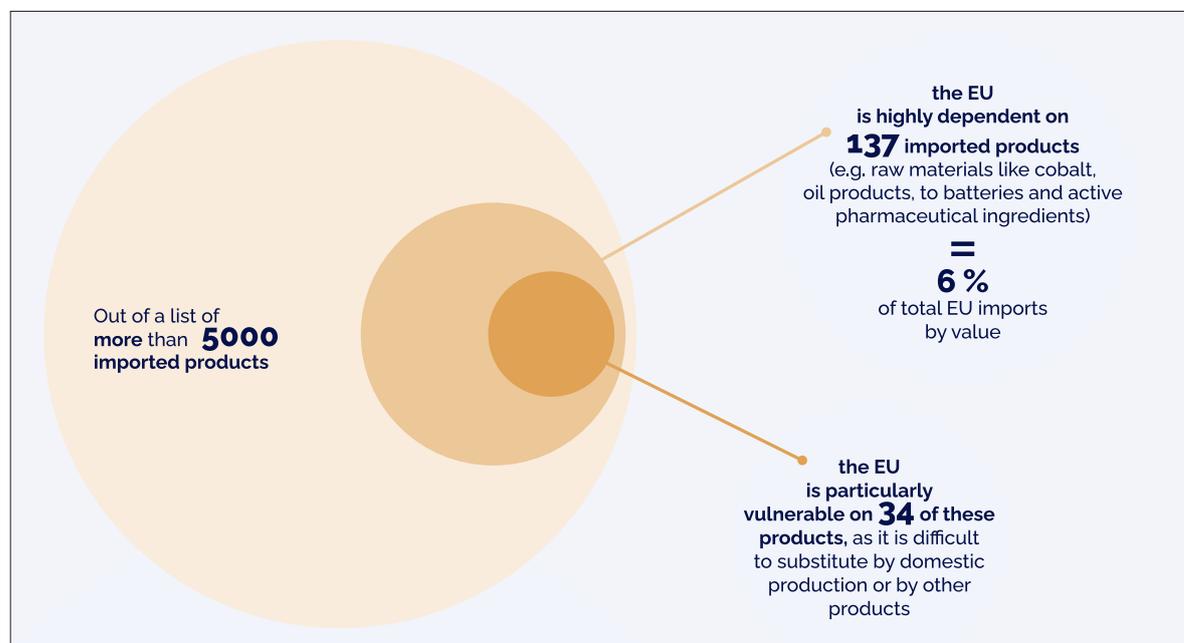
2.2 A complex mapping of dependencies on imports

The assessment of the EU's strategic dependencies and capacities published by the European Commission already provides a broad overview of critical dependencies in four strategic ecosystems (defence and aerospace; energy intensive industries; renewables, digital and electronics; and health).¹⁵

¹⁴ Isabelle Mejean, Alejandra Martinez and Elie Gerschel, "How Global Value Chains Became Victims of Covid-19", in *The European Financial Review*, April-May 2020, p. 41-45, <https://www.europeanfinancialreview.com/?p=36467>.

¹⁵ The dependence is measured by using three key indicators: concentration of production, importance in EU demand and EU capacity to substitute imports. European Commission, *Strategic Dependencies and Capacities* (SWD/2021/352), 5 May 2021, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021SC0352>.

Figure 2 | A first assessment of the EU's strategic dependencies by the European Commission



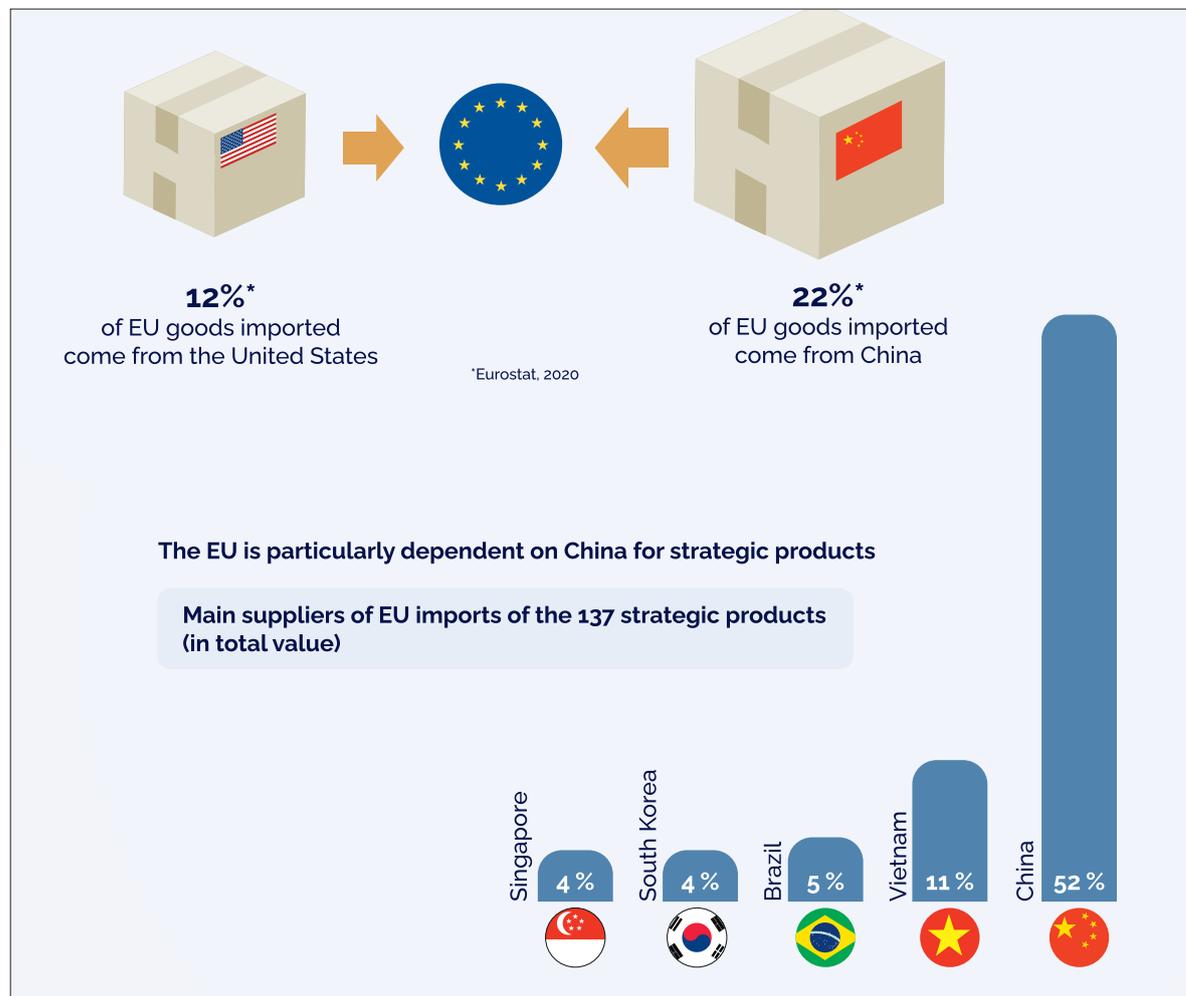
Source: Elvire Fabry and Giovanni Butelli, *Reducing the EU's Strategic Dependence*, Paris, Jacques Delors Institute, 31 May 2021, <https://institutdelors.eu/en/publications/reduire-les-dependances-strategiques-de-lue>.

In addition, in the new geopolitical context of global trade, a dependence on one country becomes even more critical, whether it is *on a product basis* (e.g. 72.5 per cent of nickel supply, used notably in batteries, comes only from Russia) or *for all imports*.¹⁶ While overall EU dependence on goods imported from China is significant compared to products imported from the US, it is particularly high for the 137 strategic products identified by the European Commission.

In addition, any assessment of the dependence on one country remains limited if it is based on a classification of final products without pointing at dependence on intermediate goods (raw materials and components) used by other importers. From this point of view, the EU dependence on Chinese intermediate goods is rapidly growing, as imports coming from other countries include Chinese intermediate goods.

¹⁶ Daniel Fiott and Vassily Theodosopoulos, "Sovereignty over Supply? The EU's Ability to Manage Critical Dependences while Engaging with the World", in *EUISS Briefs*, No. 21 (December 2020), p. 3, <https://www.iss.europa.eu/node/2510>.

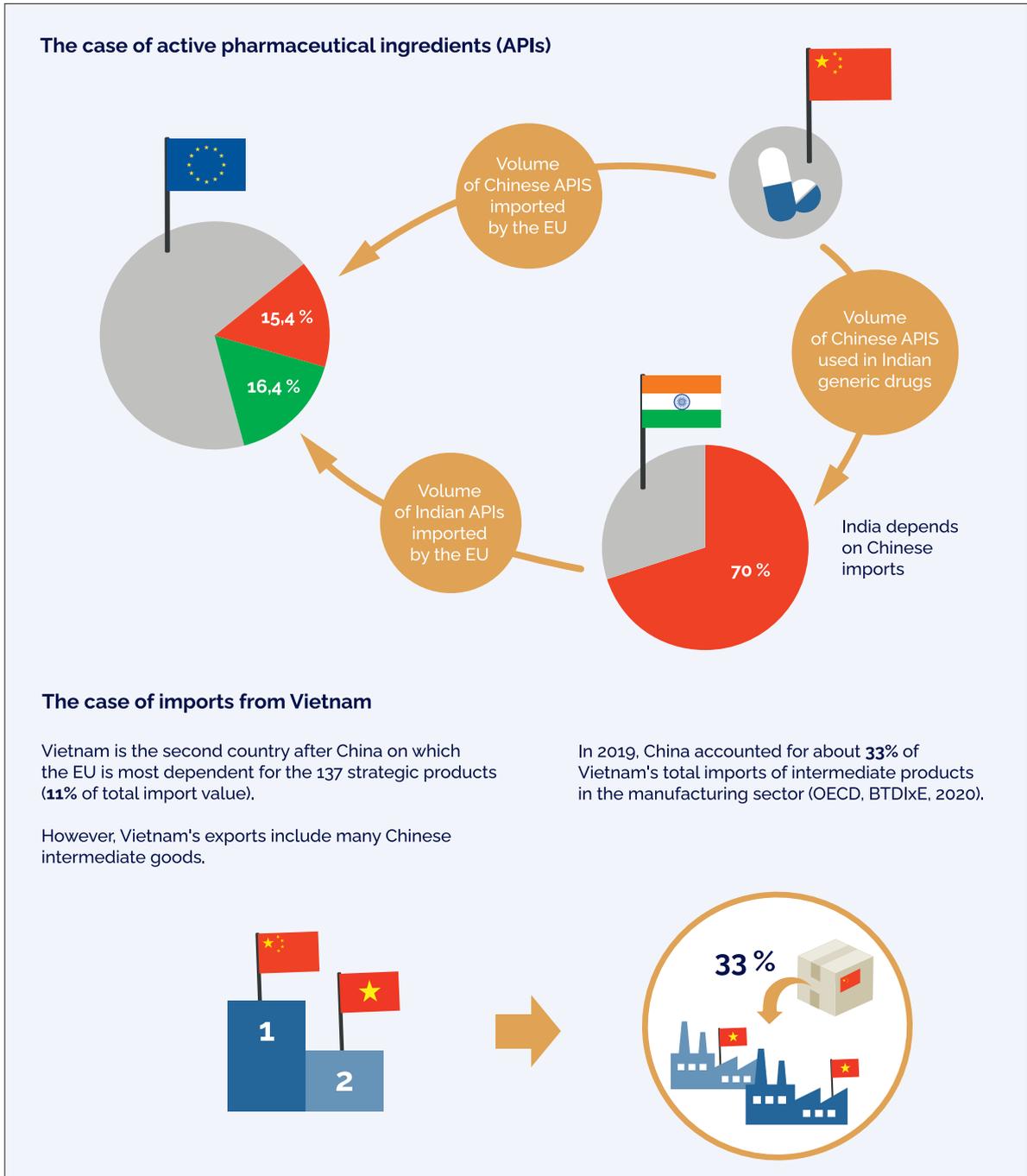
Figure 3 | EU's dependency on imports coming from key trade partners



Source: Elvire Fabry and Giovanni Butelli, *Reducing the EU's Strategic Dependence*, cit.

Beyond the available data based on current consumption, future needs made possible by innovation should also be anticipated. Despite GSCs having shown considerable resilience to the disruption caused by the pandemic, the latter is a wake-up call to acquire more knowledge on these complex strategic dependencies.

Figure 4 | The complex assessment of EU dependence on Chinese intermediate goods

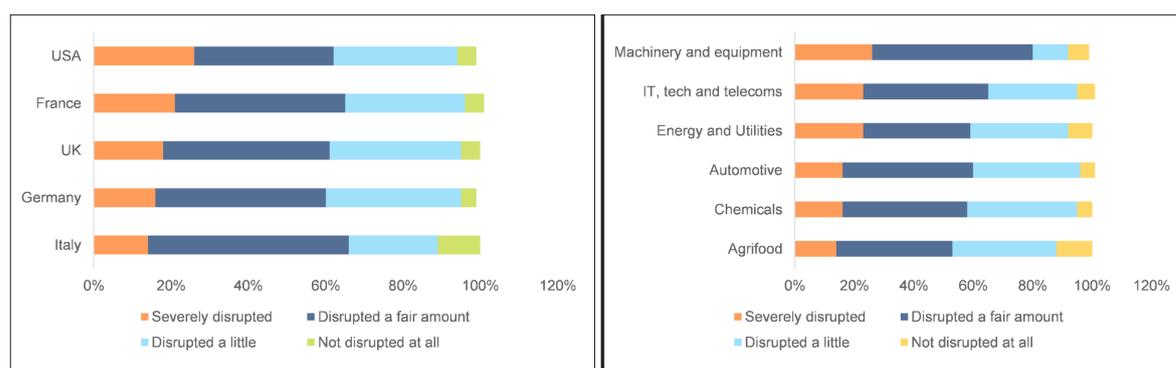


Source: Elvire Fabry and Giovanni Butelli, *Reducing the EU's Strategic Dependence*, cit.

2.3 The stress test of the pandemic reveals good resilience of GSCs

A large majority of firms and sectors have experienced temporary disruption during the covid-19 pandemic due to lockdown measures to contain the virus (figure 5). But, overall, as the Commission's trade policy review concludes: "The first lesson to be drawn from the crisis is that most supply chains have shown remarkable resilience."¹⁷ Even the fear of food shortages did not materialise, and most companies were able to resume production once lockdowns were lifted. There is little evidence to argue for any correlation between the level of fragmentation of production and the severity of the economic impact of covid-19. The rupture of supply that happened for specific products like personal protective equipment was due to an *unprecedented shock of global demand, rather than to weaknesses in SCs*.

Figure 5 | Covid-19 disruption of supply chains by country and by sector



Source: Euler Hermes, *Global Supply Chain Survey: In Search of Post-Covid-19 Resilience*, Munich/Paris, Allianz/Euler Hermes, 10 December 2020, p. 4, https://www.eulerhermes.com/en_global/news-insights/economic-insights/Global-Supply-Chain-Survey-In-search-of-post-Covid-19-resilience.html.

Yet all products are not exposed to foreign shocks in the same way. For some highly strategic goods such as, once again, in the health sector, resilience is not enough. They require robustness: an ability to maintain operations during a disruption rather than to recover following an unexpected disruption.¹⁸ Some strategies to achieve resilience or robustness can be mutually exclusive. Sourcing exclusively from one single supplier, thus relying on a critical dependency, may lead to a stronger customer–supplier relationship and by extension to additional commitments on behalf of the supplier for a faster recovery, and therefore to resilience rather than robustness. There is, however, no clear alternative when choosing a strategy for either resilience or robustness, since decisions made by one firm create externalities for trade partners localised downstream in the SC.

¹⁷ European Commission, *Trade Policy Review*, cit., p. 7.

¹⁸ Isabelle Mejean, Alejandra Martinez and Elie Gerschel, "How Global Value Chains Became Victims of Covid-19", cit.

In the absence of any macro-prudential regulation that aims to manage systemic risk, firms do not have any incentive to consider the impact of their decisions on third parties, making the systemic resilience and robustness of SCs difficult to manage.¹⁹ In order to address this, two main options are currently discussed to anticipate future disruption of supply: diversification of suppliers and reshoring of production.

3. Relocalisation of production: The limits of diversification and reshoring

The robustness and resilience of SCs cannot be summarised as a binary choice between foreign and domestic production. Diversification works well to avoid interruptions of supply, thus leading to robustness, but it is costly, and companies may also lack the necessary capacity to assess risks in the SC. Considering the fact that overall reliance on foreign value added is low, reshoring has little economic rationale. However, when considered as a solution to geopolitical concerns, it has attracted political attention for certain strategic products or as a mean to reverse the trend of increased dependence on certain countries.

3.1 The challenge of diversification

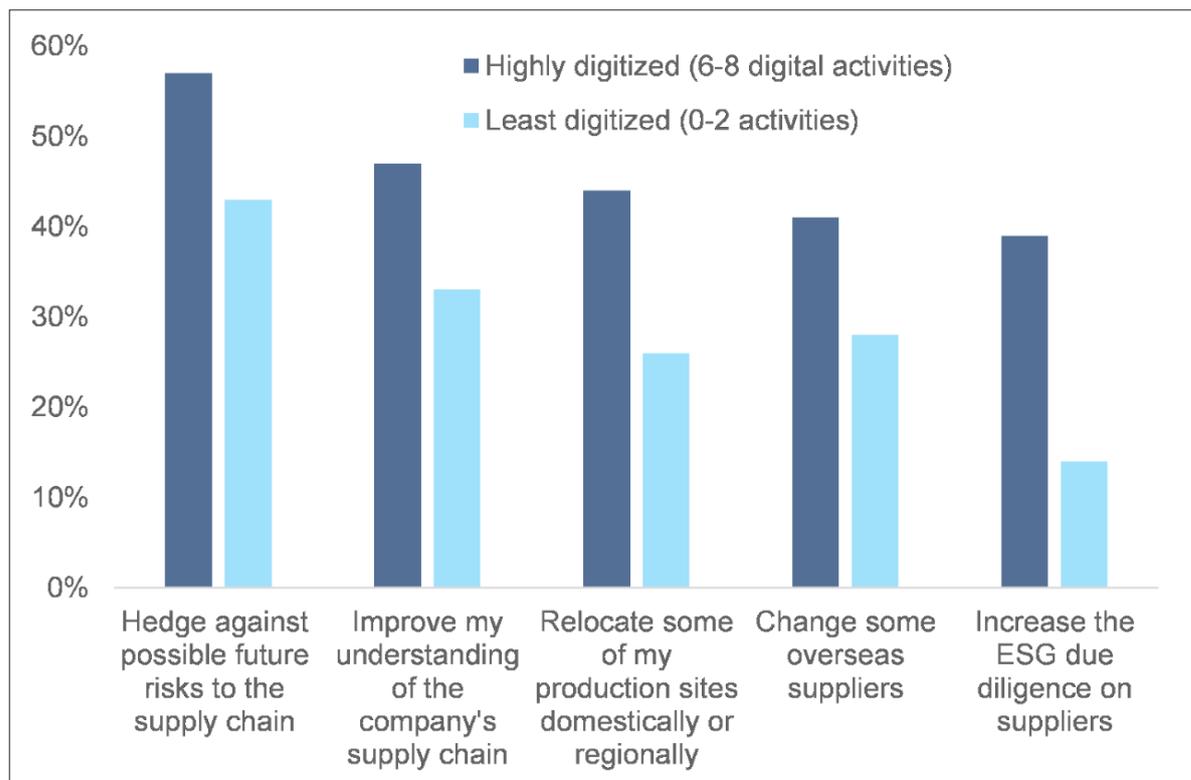
The need to diversify supply is nothing new to business. Companies have always had to consider the broader framework of a supplier, and have diversified based on the assessment of the risk with which a country is associated according to various criteria (political instability, social unrest, economic recession, climate change...). The lesson drawn from the pandemic upon excessive supply dependencies is to contract at least one additional supplier, as suggested by the so-called China+1 (additional supplier) strategy.

Diversification is nevertheless costly and time-consuming. It may not be the priority for firms if the probability associated with a risk is difficult to assess. Given the significant investment and operating costs of diversification, companies' incentives are mixed. They might instead prefer to adopt a piecemeal approach. *Potential for diversification can also be limited by the concentration of suppliers (either in specific countries or in particular firms).* The effects of agglomeration, economies of scale and comparative advantage have led to certain SCs being highly concentrated to the point that there are only two or three suppliers of a certain component worldwide (e.g. the world is highly dependent on Taiwan Semiconductor Manufacturing Co -TSMC).

¹⁹ Sébastien Miroudot, "Resilience versus Robustness in Global Value Chains: Some Policy Implications", in Richard E. Baldwin and Simon J. Evenett (eds), *COVID-19 and Trade Policy: Why Turning Inward Won't Work*, London, CEPR Press, 2020, p. 117-130, <https://voxeu.org/node/65536>.

Furthermore, diversification may not be sufficient. *It might have to be combined with a "reasonable" effort at stockpiling, which the "just-in-time" approach aimed to reduce. But "reasonable" is a very abstract criterion. Extensive use of digital tech to equip SCs with stress tests and monitoring is also required.* This enables transparency, traceability and due diligence across the entire SC. Highly digitised companies have thus been able to cope more easily with the disruption caused by the pandemic than less digitised ones (figure 3).

Figure 6 | Coping mechanisms, by level of digitisation



Source: Euler Hermes, *Global Supply Chain Survey: In Search of Post-Covid-19 Resilience*, cit. p. 5.

In any case, keeping markets open to allow for diversification is something widely advocated by businesses: when switching to alternative sources of supply, fewer than 15 per cent of companies support reshoring of GSCs, and around a third favour some degree of nearshoring (i.e. relocating in the neighbourhood).²⁰

3.2 The limited contribution of reshoring to resilience

Rather than an economic rationale, geopolitical realities seem to be more decisive for reshoring. Dependency of supply becomes a major global concern because of the power acquired by China, economically and demographically.

²⁰ Euler Hermes, *Global Supply Chain Survey: In Search of Post-Covid-19 Resilience*, cit., p. 7.

While the Chinese system of state-owned enterprises and unlimited subsidies is insufficiently disciplined by WTO rules, the prospect of increasing Chinese power generates asymmetries in interdependence. This Chinese challenge to the US leadership, now translating into a *geopolitical rivalry*, increases the perceived need for reshoring. The US-Chinese leadership contest in the technological sector is already resulting in a progressive unbundling of the production of semiconductors. If this were to extend to other technological products, this so-called “decoupling scenario” would have more spillover impact on GSCs. Trade partners, such as the EU, would be pressured to remain in one sphere of influence or the other by relying on American or Chinese SCs.²¹ Preserving strategic autonomy would thus mean securing more domestic capability. This has led to a new political discourse on the reindustrialisation of the domestic economy, which has support from public opinion. In France, notably, 76 per cent of public opinion supports reshoring,²² despite less dependence on foreign supply and demand than notably Germany.²³ However, building domestic/European capabilities for future needs should be distinguished from the relocation of production in the home country.

Reshoring should not be a matter of relying exclusively on domestic sourcing. The OECD METRO model shows that *trade regimes that fully rely on localised sourcing are less resilient and robust than GSCs*.²⁴ Despite reducing the exposure to foreign risk, fully domestic production results in local shocks being magnified and not cushioned through trade. *Reshoring should thus rather be considered as an insurance remedy to secure supply during short-term shortages if there is a surge in global demand or if export restrictions are imposed by third countries. It would allow to preserve a minimum level of EU manufacturing capacities that could be ramped up if needed.*

There are other limits to reshoring. If the remedy can be meaningful for targeted strategic products, it cannot be generalised to address all meaningful dependencies. Beyond the most obvious strategic products like electric batteries required for hybrid and electric cars, it remains challenging, as seen above, to determine what the main risks and potential shortages of critical products are. Nor does reshoring resolve the problem of dependencies on critical raw materials.²⁵ Reshoring

²¹ Robin Harding, “Japan Under Pressure from US to Decouple Supply Chains”, in *Financial Times*, 20 April 2021.

²² Marion Sollety, “Most French People Don’t Trust the EU to Bring Manufacturing Back to Europe: Poll”, in *POLITICO*, 2 April 2021, <https://www.politico.eu/?p=1662497>.

²³ Ariell Reshef and Gianluca Santoni, “Chaînes de valeur mondiales et dépendances de la production française”, in *La Lettre du CEPII*, No. 409 (June 2020), <http://www.cepii.fr/CEPII/en/publications/lettre/abstract.asp?NoDoc=12689>.

²⁴ Organisation for Economic Co-operation and Development (OECD), *Shocks, Risks, and Global Value Chains: Insights from the OECD METRO Model*, June 2020, <https://www.oecd.org/trade/documents/shocks-risks-gvc-insights-oecd-metro-model.pdf>.

²⁵ As soon as in 2011, the European Commission established a list of 14 raw materials of high importance to the EU economy and of high risk associated with their supply because of low substitutability and low recycling rates. Nine were supplied by China, one by Russia, two by the Democratic Republic of the Congo and two by Brazil. The list has now been updated to 27 materials,

would also lead to less diversity of inputs and more expensive ones. Building the necessary capabilities for domestic production is very costly, especially if the know-how is lacking. If the additional cost is not absorbed by companies, it is passed on to the consumer. *Whether European consumers are ready and able to pay for this higher price remains an open question.* The financial capacity to invest in research and innovation and to build the necessary domestic infrastructure also requires preserving and increasing access to the remote consumers of emerging economies, as 85 per cent of the world's GDP growth is expected to come in 2024 from outside the EU.²⁶

Reshoring should not be advocated as a solution to create jobs domestically. Reshoring to the Single market could still allow European firms to benefit from the different comparative advantages resulting from different labour costs within the EU. But reshoring to developed countries is associated with the increased use of robotics and other automation technologies.²⁷ Any job created would rather be highly skilled one.

Consequently, reshoring and diversification are limited and do not offer clear-cut solutions to reduce dependence on foreign supply. A close coordination of industrial policy and trade policy is needed to adjust domestic capacities and foreign supply. *As the world's largest trading power, the EU may have a specific approach to resilience.* So far it has resisted what is now seen as a structural global trend towards protectionism,²⁸ with 8.7 per cent of world trade covered by import restriction measures in 2019, compared to 0.6 per cent in 2009.²⁹ The EU's ban on covid vaccine exports could be an indication that Europeans are moving towards more public intervention in the management of SCs.³⁰ But the debate is not solely about whether it is up to companies or the state/EU institutions to reduce critical supply dependencies. Rebalancing economic interdependence rather requires a strong partnership between the two.

to reflect production, market and technological developments, but it does not reflect potential risks that the geopolitical framework calls to consider.

²⁶ European Commission, *Trade Policy Review*, cit., p. 3.

²⁷ Fernanda Bárcia de Mattos et al., *Robotics and Reshoring. Employment Implications for Developing Countries*, Geneva, International Labour Organization, 2020, p. v, https://www.ilo.org/emppolicy/pubs/WCMS_751599/lang--en.

²⁸ "Protectionism has structurally become part of the very fabric of international trade relations". See European Commission, *On Trade and Investment Barriers: 1 January 2019-31 December 2019* (COM/2020/236), 15 June 2020, p. 7, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0236>.

²⁹ World Trade Organization (WTO), *Report of the TPRB from the Director-General on Trade-Related Developments, Mid-October 2019 to Mid-May 2020*, 10 July 2020, p. 6, <https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/TPR/OVW14.pdf>.

³⁰ Henry Farrell and Abraham Newman, "The New Age of Protectionism", in *Foreign Affairs*, 5 April 2021.

4. Towards a systemic approach to SC resilience

Private firms make their own independent decisions. They can assess the vulnerability of their direct supplier upstream and direct client downstream. But few companies extend resiliency planning further upstream to their second- or third-tier suppliers. *They lack visibility on their overall SCs and are not able to manage overall resilience.*

The lack of macro-prudential management of risks along SCs therefore serves as an incentive for a political debate on a new form of sovereignty: a SC sovereignty, which suggests state control over supply. More precisely, should countries give private companies a mandate to secure the supply of targeted strategic products? Such methods would entail protectionism, which would to a certain degree imply reverting to a world that is less efficient and cooperative. Rather than controlling private companies' supply, *the state or EU institutions should provide support for diversification of supply through its trade policy and simultaneously increase the attractiveness of the domestic market to develop domestic production and avoid further offshoring caused by digitisation.* While the size of the market is a key factor of resilience of supply, facilitating business within the EU therefore remains a priority.

4.1 The siren song of SC sovereignty

Companies have no mandate to secure the supply of the population of a given country. The increase of foreign investment flows has also contributed to diversifying the ownership of private firms, diluting any meaningful characterisation of the national identity of a company.

The direct control of states over GSCs, and thus the aforementioned risk–return trade-off, is limited. A state can try to increase domestic production by using a wide range of tools intended to limit imports (tariffs, technical barriers to trade and Sanitary & Phytosanitary Measures, conformity assessment procedures, adoption of subsidies and import substitution programmes etc.).³¹ *But a reduction of imports has a boomerang effect with reduced access to foreign markets for exports, and thus requires a capacity to sustain autarky.*

A state might also be tempted to use *restriction of exports* to prioritise national or regional supply.³² *Export bans are broadly prohibited by the World Trade Organisation (WTO) (article XI of the General Agreement on Tariffs and Trade or GATT) because it is difficult to prevent their negative spillover effects on GSCs.* Export restrictions always come at the expense of the supply of other countries

³¹ Pablo Quiles, "Legal and Policy Implications of COVID-19-Related Export Restrictions", in *International Economics Insights*, 12 May 2020, <https://www.tradeeconomics.com/?p=6658>.

³² Washington can rely on the Defense Production Act (which allows the government to force private companies to prioritise domestic needs) to impose *de facto* bans on vaccine exports.

and have a domino effect by spurring reflexes of economic protectionism. *The WTO only allows members to temporarily apply non-discriminatory export bans to prevent or relieve critical shortages of food or other essential products.* It is then rather seen as a matter of precautionism than protectionism. As early as April 2020, eighty countries had already introduced export prohibitions or restrictions as a result of the covid-19 pandemic, including seventy-two WTO members (with EU member states counted individually).³³

Nevertheless, the broad carve-out for “security exceptions” allowed by article XXI of the GATT has led to a “*weaponisation*” of economic interdependence aimed at limiting the autonomy of other states (e.g. the Trump Administration’s export ban of US semiconductors to China).³⁴ Retaliation could easily lead to an escalation of bilateral aggressive measures with a broad impact on GSCs. If the Biden Administration continues engaging in decoupling technological SCs in China, it will have a disruptive impact on GSCs. Trump’s tariffs on Chinese imports have already affected trade globally and led to diversification of supply. Any reduction in market access caused by this rivalry requires careful anticipation, as much for the United States and China as for the rest of the world. There is thus an ongoing debate at the Bureau of Industry and Security in Washington on the negative impact of export restrictions: less access to the Chinese market would also entail fewer dividends to invest in research and development in the US tech sector.³⁵

For Europeans, rebalancing interdependence calls for a twofold strategy: increasing public support to help business diversify while actively increasing the attractiveness of the European ecosystem/single market by ensuring a more level playing field with competitors. *This suggests that, complementary to the indirect role of member states, the EU has a strategic role to play.*

4.2 Priorities for the EU to help business increase resilience of SCs

*First, the update of the WTO rulebook prioritised by the European trade policy review is key for the stability of global trade and GSCs as well as the resilience of European.*³⁶ By playing the role of the broker who tries to bring the United States and China to the negotiating table, the EU endorses a strategic role to limit global imbalances and potential disruption in SCs. Common regulation is required in expanding sectors (e.g. e-commerce, response to climate change, investment). New rules for

³³ WTO, *Export Prohibitions and Restrictions*, 23 April 2020, <https://doi.org/10.30875/827540bd-en>.

³⁴ Henry Farrell and Abraham Newman, “Weaponized Interdependence: How Global Economic Networks Shape State Coercion”, in *International Security*, Vol. 44, No. 1 (Summer 2019), p. 42-79, https://doi.org/10.1162/isec_a_00351.

³⁵ Ana Swanson, “The Agency at the Center of America’s Tech Fight with China”, in *The New York Times*, 26 March 2021.

³⁶ European Commission, *Reforming the WTO: Towards a Sustainable and Effective Multilateral Trading System*, Annex to the *Trade Policy Review - An Open, Sustainable and Assertive Trade Policy* (COM/2021/66), 18 February 2021, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0066>.

subsidies are needed to avoid major distortions of competition in the post-covid era.³⁷ Access to critical raw material should be addressed at the multilateral level. The modernisation in November 2020 of the European export control regulation on sensitive dual-use goods and technologies could also provide a good basis to support more convergence for export controls at the global level.

Second, the European Commission has a central role to play in monitoring the needs for diversification by developing knowledge of external dependencies. Businesses could better anticipate critical dependencies if they had access to a broader overview of SCs at the regional, European and global level. We have seen above how complex it is to identify critical dependencies and notably to decide what countries and companies will need from others in the future. In line with the first analysis of EU *strategic dependencies presented by the European Commission*, a systemic approach to dependencies requires the Commission's bird's-eye view. Aggregated data provided by member states would have to be complemented with business data to reach the necessary accurate level of analysis ensuring traceability of risks. Identifying which type of information is required and building confidence in sensitive data sharing systems will be challenging – it might entail more support for the use of block chains. All economic actors belonging to a common industrial ecosystem (large companies, subcontractors, research laboratories, universities or others) could be encouraged to send alarm signals. Further due diligence on the monitoring of dependencies could also be requested from lead firms.

In addition, the EU should continue *negotiating free trade agreements (FTAs) to address critical import dependencies with more diversification.* The EU is the trade power which has signed the highest number of FTAs worldwide.³⁸ EU companies benefit from this comparative advantage to diversify supply. Now, after two decades of active negotiations, the European Commission intends to focus on the ratification and implementation of agreements that have already been signed. However, preferential access to critical raw materials is even more important when there are few alternatives for diversification (like for cobalt, a key component in lithium-ion batteries, with China already broadly controlling the resources of the Democratic Republic of the Congo, which represents 70 per cent of global cobalt resources). Access to critical raw materials need to be addressed in new trade partnerships.

Third, the agenda of a level playing field built by the Directorate General for Trade of the European Commission is a major contribution to rebalancing interdependence, as asymmetries in market access increase one-sided dependencies. The foreign direct investment screening mechanism implemented in October 2020 was a first step. The list of sectors that are subject to control is based on criteria of "public

³⁷ Elvire Fabry, "Industrial Subsidies are at the Heart of the Trade War", in *Jacques Delors Institute Blog*, 27 January 2020, <https://institutdelors.eu/en/publications/les-subventions-au-coeur-de-la-guerre-commerciale-2>.

³⁸ The EU has signed more than 40 FTAs versus 14 for the US.

policy, public security and public health". The pandemic has already pushed various member states to extend this list.³⁹ New industrial sectors playing a key role in the security and competitiveness of a country are considered as more strategic. In addition, *the European Commission could suggest expanding the coordination of member state screening with a focus on the resilience of SCs, starting with the protection of critical logistic infrastructures like ports.*⁴⁰ Industrial ecosystems promoted by the European Commission will also be useful to identify at an early stage the threats caused by foreign direct investment projects to an entire SC.

The instruments proposed by the Commission to autonomously control the use of foreign subsidies in the single market and the reciprocity of access to public procurement will also contribute to making the single market more attractive and to prevent a weaponisation of dependencies.⁴¹ *Public procurement could also be adapted to promote preferential sourcing from suppliers who commit to due diligence requirements aimed at increasing the resilience and robustness of their SCs, and/or commit to using domestic production capacities and sourcing from regional suppliers.*

Fourth, the trade policy review has rightly emphasised that trade policy is designed to support internal policies aimed at protecting European interests and values. Priority is given to the green and digital transitions of the EU. But the industrial policy, aimed at developing European capabilities, requires as well a close coordination with trade policy, without using the later as an instrument of protectionism to rebalance asymmetries that originate from failures in domestic policies.

In addition, *the Commission should anticipate and prevent the risk of service offshoring caused by the digitisation of the economy. While the digital transformation of the EU's economy is key for the attractiveness of the single market, progress in information and communication technologies will also provide access to a more remote labour force in the production of services. After the initial competitiveness shock, which caused supply dependencies in the manufacturing sector, the increasing opportunities to offshore labour in the service sector might well cause a second shock of competitiveness and new forms of dependencies. To avoid this headlong rush, the European Commission must carefully anticipate what strategic autonomy will require in a digital global economy. It will, first of all, require a strong initiative for the completion of the single market for services*

³⁹ Elvire Fabry and Micol Bertolini, "Covid-19: The Urgent Need for Stricter Foreign Investment Controls", in *Jacques Delors Institute Policy Papers*, No. 253 (April 2020), <https://institutdelors.eu/en/publications/covid-19-lurgence-dun-controle-renforce-des-investissements-etranagers>.

⁴⁰ Elvire Fabry and Jacopo Maria D'Andria, "The Challenges of Chinese Investment Control in Europe", in *Jacques Delors Institute Briefs*, 11 February 2019, <https://institutdelors.eu/en/publications/les-enjeux-du-controle-des-investissements-chinois-en-europe>.

⁴¹ European Commission, *Proposal for a Regulation on Foreign Subsidies Distorting the Internal Market* (COM/2021/223), 5 May 2021, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0223>.

in order to avoid remaining obstacles between the 27 member states to be an incentive for offshoring.

The debate concerning the resilience and robustness of SCs and its contribution to the strategic autonomy of the EU is framed by the new geopolitical landscape. There is a need for a *realistic forward-looking approach that recognises the fact that reshoring cannot be oversold, that diversification has its limits and that companies will incur additional costs to increase resilience and robustness of their SCs*. This calls for overcoming the confrontation between a free-market approach and state interventionism, which continues to split EU member states according to their traditional positions, and the adoption instead of a pragmatic and more complex approach: a close coordination between firms and states with the common goal of increasing the resilience and robustness of SCs.

The capacity to identify critical dependencies by sector, goods or components will be decisive. This requires a strong partnership to share knowledge about dependencies in order to develop a systemic knowledge-based approach to resilience. As Paul Krugman has pointed out, "strategic trade policies could be recommended, if at all, only on the basis of detailed quantitative knowledge of the relevant industries",⁴² and strategic trade policies should focus less on protecting domestic industries from foreign competition and rather on applying precautionary measures to strategic industries to protect people from shortage of supply risks. While reshoring and diversification do not represent clear-cut solutions, a more ad hoc fine-tuned strategy requires a trade policy that supports diversification of supply and an industrial policy that increases European capabilities according to sectorial needs.

Updated 26 July 2021

⁴² Paul R. Krugman, "The Current Case for Industrial Policy", in Dominick Salvatore (ed.), *Protectionism and World Welfare*, Cambridge, Cambridge University Press, 1993, p. 160-179 at p. 164.

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