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Policy Position

Conditional support: How the EU can solve the geo-economics dilemma of the Green Deal

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#GreenDealAgenda
#SupplyChains
#Diversification

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A European Green Deal that can withstand external shocks and navigate the twists and turns of geo-politics rests on diversified sources of critical imports. However, diversification is a matter for corporate decisions on where to find supplies and place investment and European firms, grappling with cost-push inflation, are reluctant to bear the costs these entail. In this policy position, Francesco Findeisen makes three suggestions about how the EU can help its firms achieve economic resilience through conditional industrial policy support and public procurement.

As the European Union gradually puts its green industrial strategy into legislation this winter, it must grapple with a geo-economics dilemma: how to get firms to diversify their supply chains and shoulder the necessary costs, given the challenges posed by cost-push inflation. With the twin proposals for a Net-Zero Industry and a Critical Raw Materials Act, the Commission has now outlined how it envisages fortifying the Green Deal against external shocks and geo-politics. However, without greater direct intervention, the strategy will fail to deliver diversification.

The challenge is no small task: European firms in green industries heavily depend on a handful of countries, particularly China, for critical inputs and sales. Therefore, aggravated trade tensions could drive up the prices of critical inputs further. In a downward scenario, this could sever European firms' access to Chinese imports and export markets. And an external shock comparable to COVID-19 could once again compromise essential supply chains. Europe's interdependence with China is hard to overstate. In 2023, the People's Republic was the EU's largest trading partner by volume, while the EU's trade deficit with China has increased to its highest yet. This same year has seen European firms source the raw materials necessary for green innovations and manufacturing predominantly from China and, to a lesser extent, from the Democratic Republic of Congo and Chile. For rare earths and graphite, the dependency has been close to 100%. Of course, this dependence varies across EU member states, sectors, and firms.

Germany's big car companies, for example, achieve 30% or more of their sales in China, with electric vehicles becoming more important. They push back against interventionist EU policy as they fear that retaliatory trade measures might compromise their market access and impose substantial costs.

At the heart of the geo-economics dilemma lies a simple truth: reconfiguring supply chains costs a lot of money. To diversify, firms must alter entrenched business practices and make substantial investments. They must gather information about the geography of their supply chains and the associated risks. They must seek suppliers from different countries for resources and products that are difficult to substitute. And where necessary, they need to relocate foreign direct investments and production facilities outside 'countries of concern'. All these steps entail uncertainties and costs, which may undermine the competitiveness of European firms both domestically and in global markets.

Resilience requires not just political strategy but also keen alignment of corporate supply and investment decisions. It can be promoted externally by diversifying supply chains and export markets, and internally through investments in domestic value chains. Market diversification is a thorny issue beyond the scope of this discussion. Rather, this paper develops three ideas for how the EU can surmount the geo-economics dilemma. First, the European Commission should invest real money that's conditional on diversification to support firm-level action. It should tailor both support and conditions to the structure of trade relations in relevant sectors and the size of firms. Diversification, after all, is in many ways a European public good. Firms, the European public, and public authorities all benefit from resilient supply. Second, the Commission should leverage public procurement to steer corporate decisions toward diversification. Third, it should create an institutional mechanism that enables dynamic collaboration with the private sector all the while safeguarding against corporate capture.

Reappraising corporate supply and investment decisions

Over the past 30 years, European firms have offshored supply stages to third-party countries and companies and developed select export markets to remain competitive within the EU's macroeconomic regime. These business decisions forged fragmented supply chains with geographically concentrated nodes. With notable variations across member states and sectors, companies exported high-value-added goods produced from relatively inexpensive inputs from a few countries into strategic markets and expanded market share through foreign direct investments. Part of this strategy was to leave concentration risks with policymakers. Many companies acted as if they were ‚too big to fail'.

But COVID-19 and Russia's war against Ukraine have forced a U-turn in the EU's foreign economic policy. These two events caused shortages in intermediate goods and raw materials, as well as spikes in the prices of critical inputs for European manufacturing and innovation processes. Export restrictions on critical raw materials have reached all-time highs since then, and the Chinese economy and consumer markets are cooling, further increasing challenges for Europe's exports. Simultaneously, the global race to net-zero is escalating the demand and competition for critical raw materials worldwide, maintaining upward pressures on prices. In response, the EU initiated a paradigm shift, prioritizing supply chain diversification strategically, and is now seeking to put the goal of economic resilience at the heart of corporate decision-making.

Without more direct intervention, however, the Commission's twin proposal will not buttress the Green Deal against external shocks and geo-politics. It aims at deepening access to public and private finance for firms that invest in net-zero industries and resilience,

as well as speeding up permitting procedures. It establishes benchmarks for the shares of economic activity that should occur within the borders of the EU and for the proportion of critical supplies that can be sourced from any one country. And it envisions the strategic use of public procurement, in which sustainability and resilience complement 'value-for-money' selection criteria. Yet, these measures will not suffice to steer diversification in the right direction.

Towards a resilient Green Deal: conditional support and strategic procurement

First, the Commission should use its green industrial policy entrepreneurially, as argued by Mariana Mazzucato and Dani Rodrik, and mobilize substantial public funding support conditional on firm-level diversification. In contrast, the twin proposal foresees hardly any new funds and any support mostly in the form of national state aid and information management. However, substituting for imports is costly because relevant industrial capacities in the EU have been eroded, and European firms will not fundamentally change their business practices without an external lever. This lever can take the form of regulations or financial support. Yet, relying on regulations alone risks backlash from European firms and could compromise their competitiveness. Moreover, national state aids will further fragment the single market. Therefore, the Commission should tie grants, loans, and guarantees to recipients' commitments to diversify supply and apply sanctions ex-post, such as clawing back financial support, if these fail to comply over time. Additionally, it should coordinate the inclusion of resilience criteria in the pricing of national export guarantees. If concentration is not firm-specific but at the level of the sector, the Commission should subsidize corporate diversification based on their contribution to enhancing resilience. This approach allows the Commission to share the risks associated with diversification investments, rather than shouldering them, thereby maximizing the public value of its support.

There is much to learn here from Japan's success at diversification. When, in 2010, China temporarily cut Japan off from critical raw material imports, the country began investing in corporate supply chain diversification. It made it a cornerstone of its National Economic Security Strategy to monitor supply and value chains in strategic sectors and use public funds to steer corporate diversification.

Second, the European Commission should use public procurement strategically to guide corporate decisions toward diversification. Public procurement constitutes approximately 20% of EU GDP, promising an effective steer. The Net-Zero Industry Act recognizes this potential and envisions resilience and sustainability criteria to count toward bid scores. However, the Act allows procurement authorities to disregard these criteria when they inflate bid prices by 10% or more and opt for lower, non-resilience-promoting offers. Moreover, it does not foresee offsetting cost increases at the EU level, further undermining national incentives to tie procurement to greater resilience. Therefore, the Commission should compensate procurement authorities for the cost differential, where plausible diversification measures inflate bid prices by 10% or more. Simultaneously, it should make diversification a requirement in public calls for tenders that exceed the average contract value by a factor of one and assign meaningful weight to resilience criteria in technical evaluations.

However, conditionality should be tailored to the size of business, as small and medium-sized enterprises (SMEs) cannot bear the costs of resilience while staying profitable. With more than 99%, the lion's share of the EU's non-financial firms are SMEs, collectively contributing to roughly half of value added. Thus, the Commission should calibrate conditionality and procurement to the size and capacity of firms. The smaller the firm, the greater the support.

Third, the Commission should institutionalize resilience governance to avoid capture and adapt conditionality to evolving geo-political and macroeconomic circumstances. On the one hand, the Commission must define diversification criteria and targets and provide commensurate support independently of corporate interests. On the other hand, it must work closely with firms to access information, including commercially sensitive contracts and investment decisions, and design realistic conditionalities and support. Toward these ends, the Commission should create an institutional setup that enables dynamic collaboration with firms while simultaneously preserving its autonomy from corporate interests.

Towards a resilient Green Deal

In a nutshell: a resilient Green Deal requires active intervention. The Commission should mobilize real money and make disbursements conditional on corporate diversification, while strategically using public procurement toward the same objectives. And it should create an institutional mechanism that strikes the right balance between collaboration and regulation of the private sector in resilience governance.

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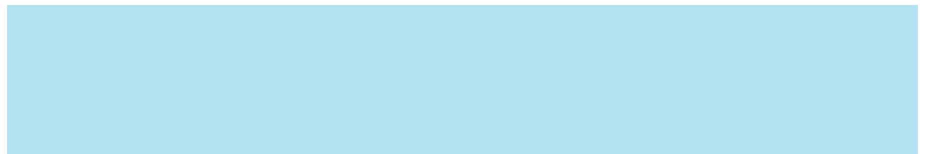

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