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Securing Europe's medical supply chains against future shocks

by Sam Lowe

European policy-makers should not give in to the temptation to use the COVID-19 pandemic to justify the forced onshoring of medical supply chains. Better options are available.

The COVID-19 pandemic severely disrupted medical supply chains, leading some politicians to question Europe's reliance on imports, particularly from China. To them, the solution is obvious: companies should be forced to make vital medical products in the EU rather than abroad. However, this is easier said than done, and pulling production into the EU does not necessarily leave the Union any less vulnerable to supply shocks. Being overly reliant on one location for vital products is a risk, whether the source is China or Europe.

If the EU is to build up resilience against future crises, its efforts now should be focused on gathering more data on supply chain risks and embedding deeper regulatory co-operation with key countries. Only in specific instances should it consider providing financial incentives for companies to diversify production and sourcing.

COVID-19 demonstrated that member-states, and the systems they rely on, were unable to respond to a global pandemic. There have been notable problems obtaining ventilators from China and paracetamol from India. Countries have even had to contend with being outbid for personal protective equipment (PPE) by the US. Since the beginning of the pandemic, Global Trade Alert, a group that monitors global protectionism, estimates that across 86 jurisdictions, 157 export controls on medical supplies and medicines have been implemented.

But how big is the problem for Europe? The EU is already one of the biggest global producers of medical products, and the biggest exporter. When it comes to imported medical products, particularly pharmaceuticals, it sources the vast majority not from Asia, but from the US ($47 billion) and Switzerland ($35 billion). However, it does import the majority of its PPE from China.

Yet a focus on the value of imports can be misleading. While the US and Switzerland tend to produce expensive and innovative drugs, cheaper generic medicines and active ingredients imported from elsewhere are also important. When accounting for the quantity of pharmaceuticals imported by the EU, rather than their value, India shifts from being the EU's sixth biggest provider to second.

The trade-off the EU is facing is that if it does onshore the production of generics, active ingredients and PPE, in order to reduce its reliance on India and China, higher wage costs will lead to these products becoming noticeably more expensive. From a purely financial point of view, it remains sensible to produce low innovation medicinal products in countries with relatively low labour costs. But as the COVID-19 crisis has shown, Europe risks being left exposed when production of certain essential medical products is overly concentrated in one place.

Before it decides what action to take to avoid future problems, the EU must first establish exactly where the vulnerabilities in medical supply chains lie. To do so, it must work closely with producers to ensure any response is based on accurate data. The European Medicines Agency (EMA) has already begun this process, by monitoring shortages of pharmaceuticals, but coverage needs to be expanded to include other medical products. The EMA may need more funding for the task.

Where tariffs have recently been removed to facilitate the import of vital medical products, they should not be reinstated. Trade economists Simon Evenett and Alan Winters propose a multilateral bargain whereby tariffs are not reinstated and in exchange exporter countries make binding commitments not to implement export curbs in a crisis. This is a sensible approach. As such, the EU should support the trade initiative launched by New Zealand and Singapore to ensure the free flow of essential goods, which commits to the removal of tariffs and the avoidance of export curbs on 120 medical products.

However, tariffs are not the biggest issue: they are zero-rated for most medical products anyway. The EU's main priority should be increasing regulatory co-operation with its trade partners, so that products imported during an emergency meet EU safety standards. Many Chinese-made ventilators and masks failed to do so. The EU should build on existing engagement with Chinese and Indian regulators, with the ultimate prize being a mutual recognition agreement covering good manufacturing practice for pharmaceuticals and medical products.

After Brexit, the EU cannot ignore the UK's role in its medical supply chains. After the current transition period, Britain will compete with China to be the third-biggest supplier of medical products to the EU, even if new trade frictions between the EU and UK reduce trade to some degree. It is in the EU's interest to engage with the UK's request for a free trade agreement that would include enhanced provisions allowing for mutual recognition of good manufacturing practice in pharmaceuticals and medical equipment, batch certification, good clinical practice and information-sharing arrangements.

To avoid being caught empty-handed in future, the EU should expand its recently established stockpile of medical equipment. The European Commission should be responsible for releasing supplies to the countries with most need. That would reduce the incentive for member-states to put in place restrictions on exports of medical products to each other, as happened when the coronavirus initially reached Europe.

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An EU-wide stockpile will also create an opportunity for targeted intervention. Diversifying supply chains is expensive for companies, and the cost of reconfiguring them will either fall on consumers or governments. Japan has set aside $2 billion of its COVID-19 stimulus package to help its companies move the production of vital products out of China and into Japan and the wider ASEAN region, but the response from business has been muted. An alternative approach could see the EU only buy medical products for its stockpile from companies that are able to demonstrate that their supply chain is resilient to a variety of shocks, including by not being overly exposed to one country or region. The EU should be prepared to pay a premium for such a service.

Ultimately, when considering how to strengthen medical supply chains, the EU needs to be acutely aware of the role it wants to play in the world. It cannot hold itself up as an advocate of openness and multilateral co-operation if it chooses to look inwards and rely on its own resources in a crisis. Pursuing self-sufficiency through the forced onshoring of medical supply chains is not a solution to the problems identified by the current pandemic, but there is still much that can be done to ensure Europe does not get caught out again in the future.

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The recovery fund faces a tricky passage

by Christian Odendahl and John Springford

The Commission's proposed recovery fund is macroeconomically meaningful. The 'frugals' should focus less on negotiating away the transfers to harder-hit countries, and more on how the money is spent.

The European Commission has turned the €500 billion EU recovery fund proposed by Angela Merkel, the German chancellor, and Emmanuel Macron, the French president, into a €750 billion front-loaded grant and loan programme integrated into the EU budget. This could be a historic step forward for the EU. For the first time, the EU is likely to agree a common fiscal response to a severe economic shock that goes beyond the pre-existing EU budget, which takes no account of the economic cycle; and the response is based on EU-issued debt, rather than immediate payments by member-states. The plan recognises the pain that COVID-19 has imposed on some parts of Europe, especially in the south. But the forthcoming negotiations will be tricky: it is unclear how much spending will be allocated to hard-hit regions and sectors, and how much will benefit increasingly authoritarian governments in Hungary and Poland.

There is a big risk that the gap between northern and southern Europe will widen as a result of the COVID-19 crisis. Further divergence would undermine the single market, bolster anti-EU sentiment in some countries, notably Italy, and make the EU even harder to govern than it is now. Designing the recovery fund to avoid further divergence is the key challenge for the Commission.

Ursula von der Leyen announced the Commission's proposal on May 27th. The Commission wants sizeable grants for countries that are poorer and hardest hit by COVID-19. These grants would be paid out in the first four years of the next EU budget period, between 2021 and 2024. Under the Commission's plan, the EU would borrow collectively at very long maturities (with bonds maturing between 2028 and 2058). Member-states' share of repayments would be determined by their national income per capita a long time in the future.

Frontloaded grants of €500 billion – roughly 3.5 per cent of 2019 EU-27 GDP – are economically significant. Italy would receive around 1 per cent of GDP per year to spend between 2021 and 2024, complementing its own national stimulus. But it would not add to Italy's public debt, as the repayment would be a collective responsibility. The recovery fund will not turn the EU into a fiscal union, but if member-states agree to the Commission's proposal, investors will be more confident that the EU will stand together in a severe crisis, both now and in the future.

As we explained in a recent research paper, there are several reasons why COVID-19 will be more damaging to the economies of southern Europe. Italy and Spain were hit first by the pandemic. Other countries saw the severity of the outbreaks in Spain and Italy, and had the chance to lock down more quickly, thereby limiting the outbreak. They will be able to open their economies more rapidly, while it will take several more weeks before France, Italy, Spain and Belgium have reduced infections to a manageable level.

The lockdowns – and continued social distancing measures when they are lifted – are especially bad for the many regions in Greece, Spain, Italy and Portugal that have large tourism or manufacturing sectors. Office workers can work more easily from home, whereas those in factories or leisure sectors must work together or in proximity to customers. Moreover, tourism is far more seasonal in Mediterranean resorts than northern cities, and tourists may stay away during the summer peak.

Southern European countries also have less fiscal room to support businesses and workers, and put together sizeable stimulus packages to aid a recovery. The European Commission is already asking questions about Germany's vast support programme for its companies – including the recently agreed bailout of the Lufthansa airline – which might undermine the single market.

In the future, the increased debt burden caused by the COVID-19 crisis will hit the south harder, even if the increase in debt is the same across Europe. The reason is that borrowing costs tend to rise as debt piles up. By our calculations, Italy and Spain will have to spend an additional half a percentage point of GDP on debt service if their stock of debt jumps by 20 percentage points, whereas Germany's debt service costs will not change at all (because Germany starts from a lower base). In addition, the EU's fiscal rules – which are in urgent need of reform – mandate countries with high debt to cut it to 60 per cent of GDP. Less supportive fiscal policies in southern Europe would sap growth for many years.

The recovery fund, which requires the unanimous agreement of the 27 member-states, is intended to counteract these forces. That is why the Commission wants most of the €500 billion to be transferred to Southern and Central and Eastern Europe. Northern European countries, bar Germany, have already signalled their opposition, and are likely to press for as much money as possible to be recycled back to their own regions and businesses.

To gain their support for a recovery fund that will have a macroeconomic impact, the rules governing how money is spent will be important. The Commission proposes that most of the funding should be for investment projects, based on grants and loans. The money should be spent in line with EU priorities: the digital and green transitions. The EU also hopes to develop its own funding sources from carbon allowances and border taxes on greenhouse gas emissions, a tax on tech giants, and a tax on non-recycled plastics. This approach is reasonable in part, as it focuses on common European goods such as preventing climate change.

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But an investment spurt would be risky: projects have long lead times, and public investment is prone to corruption and waste. That is why fiscal stimulus is usually enacted through welfare and tax systems: such measures boost spending quickly. While EU investment funding will give national governments more room to support the economy, keeping the quality of investment high will also be important, especially in Hungary and other member-states where too much EU money flows to people who are close to the government. The Commission is considering making EU funding more contingent on the rule of law, to prevent corruption, and to stop Hungary and Poland slipping further towards autocracy. Rather than obsessing about 'structural reforms', such as liberalising labour markets, as a pre-condition for fiscal integration, now is the time to impose stricter rules on what EU money is spent on and who benefits from it. The Council is yet to pass a Commission proposal to make EU funding conditional on upholding the rule of law. Without it, Hungary and Poland would stand to receive sizeable additional transfers that might provide political benefits to increasingly autocratic governments.

With Germany, France, Spain, Italy and the Commission all behind the recovery fund, the EU looks likely to take a much-needed step towards greater fiscal integration. But if the strings attached to the fund are well-designed, the money will do more to improve prosperity and democracy across the EU.

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Trump's COVID-19 response is deepening the transatlantic rift

by Luigi Scazzieri

Relations between Europe and the US were already in a poor condition before the coronavirus pandemic. Trump's response will make tensions worse.

President Donald Trump's 'America First' approach and his hostility towards the European Union have led the US and Europe to clash over many issues in recent years. These have ranged from trade and climate change, to China, the Middle East and defence spending within NATO. Trump's response to the coronavirus pandemic will lead to a widening of transatlantic differences.

In previous crises, such as the 2008-09 financial crash, the US was at the forefront of the international response. Trump's approach could not be more different. Instead of co-ordinating with allies in the fight against COVID-19, the US imposed a ban on travel from Europe without notice, and reportedly attempted to buy CureVac, a German vaccine company, to try to ensure Americans would be inoculated first. The US was caught unprepared after Trump ignored early warnings about the dangers of the new disease sweeping across the globe. Europeans have looked on in disbelief as US state governors fought with each other over medical supplies. Trump's announcement that he is taking hydroxychloroquine as a preventative measure, despite the fact that it can lead to fatal complications and has not been shown to be effective, is likely to add to Europe's sense that it no longer has a reliable partner in Washington.

While the Federal Reserve has opened emergency currency swap lines with other countries to help stabilise their economies by allowing them to obtain dollars, the US government has shown little interest in international health or economic co-operation. In a late March call between G7 foreign ministers, US insistence on referring to coronavirus as the "Wuhan virus" meant they failed to agree on a joint statement. Similarly, the US did not participate in an EU-led effort in early May to pledge €7.4 billion in funding for a coronavirus vaccine. Trump suspended US funding for the World Health Organization (WHO) in mid-April, accusing it of mismanaging the original outbreak in Wuhan and covering up for China. He is now threatening to quit the WHO altogether. In contrast, Europeans have strongly criticised Trump's decision to freeze contributions to the organisation, arguing that its work is essential.

The pandemic is likely to widen transatlantic differences over China. Trump has taken a hostile stance towards Beijing, accusing it of a cover-up, claiming that coronavirus originated in a Chinese lab and threatening to "cut off the whole relationship". European countries broadly agree with the US analysis that China mismanaged the initial phase of the crisis, and the EU has led calls to launch an international investigation into the handling of the pandemic. Europeans also agree on the need to build more resilient supply chains that depend less on China. Even before the pandemic they had moved to protect strategic economic assets by scrutinising Chinese investments in Europe more closely. Now they are concerned that China will take advantage of Europe's economic woes to buy up European firms at bargain-basement prices. But Europe will be reluctant to back a much harder US stance towards Beijing. Europeans are aware that Europe cannot completely cut itself off from China, and they can still benefit from trade and health co-operation with Beijing. Moreover, the lack of US and EU leadership has allowed Beijing to present itself in a positive light in many member-states such as Italy, providing them with medical equipment (even if some of it has been faulty). Most Europeans do not see China as a serious threat: for example a recent poll by Pew Research Center and Körber-Stiftung found that Germans were just as keen on having close relations with China as they were with the US.

Both the US and Europe are likely to become more protectionist as a result of the pandemic. Moves to reshore essential industrial supply chains, combined with greater use of subsidies, would lead to increased trade tensions. The economic fallout of the pandemic will also fuel the transatlantic spat over defence spending within NATO. The recession caused by lockdowns will probably lead to cuts in European defence budgets. Making the case for military spending will be difficult when countries are faced with competing demands to pump billions into healthcare and the economy to save businesses and jobs. And, as in the aftermath of the 2009 financial crisis, the impact of defence spending cuts will be deeper if European countries fail to co-ordinate. New EU initiatives such as the European Defence Fund, which could lessen the impact of cuts by promoting greater co-operation, were already being scaled back before the pandemic, and are at risk of being further reduced. This would remove a bone of contention with the US, which dislikes the initiatives, but worsen the impact of spending cuts.

If Trump loses the election to Democratic candidate Joe Biden later this year, there would still be differences between the EU and the US on trade, China, and defence spending – but tensions would ease. Europe and the US would be much more likely to come to an understanding on trade, and disagreements over NATO burden sharing would also soften. The chances of a joint, and therefore more effective, approach towards China would also improve, although Democrats are taking a harder line towards Beijing than Europe is, pressing for allies to exclude Chinese firm Huawei from building next generation 5G mobile networks. Above all, however, a Democrat administration would not be hostile to the EU itself, and would recommit the US to upholding multilateralism: Biden has already stated he would re-join the Paris climate agreement and seek to revive the nuclear deal with Iran. Together, the EU and the US could launch a programme of economic and medical assistance to help developing countries counter the pandemic, collaborate to address the climate emergency and work together in the Middle East.

"The economic fallout of the pandemic will also fuel the transatlantic spat over defence spending within NATO."

A second Trump presidency, however, would be a defining event for the transatlantic relationship and for the multilateral world order. Trump would have few reasons to be restrained in pursuing his nationalist approach in what would be his final term. Under one scenario, the US and Europe would increasingly diverge, with European leaders concluding that the US could no longer be seen as a partner, and trying to build a more assertive and autonomous Europe, including by investing much more in its own defence capabilities.

Another scenario is equally possible, however, if Europe does not behave as one coherent entity. EU member-states might be unwilling to agree to deeper co-operation, torn apart by increasingly bitter disagreements over issues ranging from financing the economic recovery, to the rule of law, migration and climate change. In that case, some states might turn towards Beijing in search of economic opportunities, while others could latch onto the US for protection, fearing Russian aggression or instability in the Middle East. In either case, a second Trump term risks permanently damaging the transatlantic relationship, and weakening the West as a whole.

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CER in the press

Politico
13th May
Ian Bond, a former British diplomat who is director of foreign policy at the **CER**, said it would be hard for the EEAS to take a firmer line on China – given that foreign policy decisions need unanimous agreement at EU level. "You're always going to be stuck with the lowest common denominator," said Bond.

Express
12th May
Charles Grant, director of the **CER**, said: "I think the EU will set three conditions for this [an FTA], which will be very very hard for Boris Johnson's government to comply with. "The first condition is a so-called level-playing field – the EU will insist that our rules on social and environmental standards, state aid, taxation are automatically updated to follow EU rules."

Politico
5th May
Sam Lowe, a senior research fellow at the **CER**, noted that Britain would struggle to get anything significant from the US on financial services, as Washington does not historically address financial regulation in its trade agreements. However a deal could lead to closer working on financial services regulation in future, he added.

Bloomberg
29th April
"If the EU does not provide the solidarity and insurance in such a crisis, parts of the EU may then question what the EU is for," said Christian Odendahl, chief economist at the **CER**. "That's why countries like Germany have been willing to debate the matter of aid – and even transfers to the south."

Financial Times
15th April
John Springford, deputy director of the **CER**, thinks tracing technologies are a prerequisite for post-lockdown life but warns that without mass testing in member-states, they may still prove ineffective: "To avoid further mass outbreaks, member-states must first continue to build testing capacity and develop contact tracing systems."

BBC News
2nd April
"This €100 billion [proposed EU coronavirus jobless scheme] strikes me as rather small given the number of unemployed that are expected in light of the huge economic shock facing not only Italy but the eurozone as a whole" the **CER**'s Luigi Scazzieri told BBC News.

Financial Times
31st March
Agata Gostyńska-Jakubowska, a senior research fellow at the **CER** said the EU needed to make up for an initial "chaotic and unco-ordinated" pandemic response in which some member-states "showed a lack of solidarity with Italy", Europe's worst-affected country. "This has created an opportunity for eurosceptics to reinforce their narrative of the EU doing too little too late," she said.

Recent events

28 May
Daimler Forum webinar on strategic issues co-organised with SWP and the Brookings Institution with Stephen Biegun, Philippe Errera, Richard Moore and Matthew Pottinger.

27 May
Webinar on 'What place for an ambitious European Green Deal?' with Philippe Lamberts

18 May
Webinar launch of 'Stars with stripes: The essential partnership between the European Union and the United States' by Anthony Luzzatto Gardner with Stephanie Flanders

13 May
Webinar on '5G: The next European frontier' with Hosuk Lee-Makiyama, Phillippe Lefebvre and Janka Oertel

29 April
Webinar on 'Where is Brexit going?' with Charles Grant, Sam Lowe and Georgina Wright

21 April
CER/Kreab webinar on 'Rebuilding the European way of life after the coronavirus: Time for resilience' with Margaritis Schinas

17 April
Webinar on 'How to relax lockdown measures' with Luca Ferretti and Clemens Fuest

31 March
CER/Clifford Chance webinar on 'Is the EU's trade policy fit for the 21st century?' with Alan Beattie, Beata Javorcik and Sabine Weyand

26 March
Webinar on 'The implications of the COVID-19 pandemic' with Sophia Besch, Ian Bond and John Springford

Forthcoming publications

Europe, the US and China: A love/hate triangle?
Sophia Besch, Ian Bond and Leonard Schuette

The future of EU development policy
Khrystyna Parandii

What would an effective UK trade policy look like?
Sam Lowe