Council of the
European Union

Brussels, 24 July 2017
(OR. en)

10957/17

COMPET 528

NOTE

From:	Presidency
To:	The High Level Working Group on Competitiveness and Growth
Subject:	Competitiveness check-up on global value chains: The external dimension of the Single Market and the importance of globalisation

Delegations will find in Annex a Presidency discussion paper on the competitiveness check-up on global value chains: The external dimension of the Single Market and the importance of globalisation, in view of the meeting of the High Level Working Group on Competitiveness and Growth on 7 September 2017.

THE EXTERNAL DIMENSION OF THE SINGLE MARKET AND THE IMPORTANCE OF GLOBALISATION

In the previous HLG meeting we discussed how Value Added accounting provided a different view of the international position of the EU economy and the Single Market. It helped us to understand better the relative importance of services and manufacturing for EU competitiveness.

The objective of this second session is to get an insight to EU external competitiveness and then open a wider discussion on impact of globalisation[1] on EU economy and future of industrial policy, outlining strategic views for its future development. The outcome of the discussion will be summarised by the Estonian Presidency in a Presidency report about the EU industrial strategy. The Report will reflect Member States expectations and proposals for the strategy on topics discussed in the HLG and the Industry Working Party during the second semester of 2017.

The Value Added approach offers an intuitive and useful way to analyse the evolution of competitiveness and the drivers behind it. We argue that the EU becomes more (or less) competitive in one market if the share of value added coming from the EU to meet demand in that market has increased (or decreased).

The development in global value chains (GVC) impacts the European economy and leads to changes in structure of the global economy. Given this change in the global balance of economic power, Europe needs to identify its competitive advantages and those sectors (production and services) where efforts should be bundled in order to improve European competitiveness.

[1] Based on Reflection Paper on Harnessing Globalisation

The competitiveness of EU manufacturing

If we consider the total demand for manufactured products in the world, we can see that the share of value added coming from the EU in that total demand has fallen considerably between 2004 and 2014: for every euro of final demand of manufactured goods in the global market, the share of EU value added is 11 cents lower in 2014 than in 2004.

This indicator suggests a considerable loss of competitiveness, but there are some caveats:

– First, the loss in value added is also driven by the catching up process of major emerging markets. The current trend within globalisation reflects a deepening in GVCs, leading to a more diversified global production network considering regional strengths in the production process. Hence, dynamic emerging markets are more and more integrated within these networks, resulting in the observed increase in their value added market share.

– Secondly, demographic changes in Europe differ substantially from emerging regions. According to UN-Statistics, the population in Europe will decline by 4.3% until 2050, whereas in Africa the population will more than double and increase by about 20% in Asia.

– Thirdly, this loss is much lower (about half) if we consider the market for industrial products including business services.

– Fourthly, the situation varies considerably across Member States: the share of the Member States that joined the Union after 2004 has actually increased (4.4 cents).

– Finally, there seems to have been some changes in recent years as the share of EU value added meeting global demand has not declined significantly after 2011. However, this period (2011-2014) is too short to draw definitive conclusions.

The fall in competitiveness in global manufacturing markets is mainly explained by demand factors (60%) but 40% of the loss can be attributed to a deterioration in productivity and competitive stance of EU producers. The loss of competitiveness has been particularly important in low-tech sectors (e.g. textiles) but also in some high-tech sectors (e.g. computers), while competitiveness in the mid-tech sectors of the EU 28 remains more resilient.

There are significant structural changes in the composition of the value added of our manufacturing sector that traditional statistics could not show:

1. First, EU services are particularly important as inputs for manufacturing in the EU.

2. There is an increasing volume of non-EU Value Added in EU manufacturing production and exports.

3. The growth of EU value added in manufacturing is increasingly driven by non-EU manufacturing value chains: there is an increasing share of EU manufacturing value added incorporated in the final production of the rest of the world.

The linkages between manufacturing and services are particularly interesting. EU manufacturing relies heavily on European services as inputs: for every euro of total Value Added generated by EU manufacturing, 52 cents have been originated in services sectors and then incorporated in manufacturing value added. Non-EU services suppliers have a much smaller role (6.5 cents).

Business services are a major source of value added for manufacturing but the role of this sector is just second to logistics, wholesale and other forms of business to business intermediation services. Other services sectors play a significant role as well. Real estate, retail distribution and infrastructure related services also make significant contributions.

Regional and Global Value Chains and their impact on structural changes

In our previous discussion we looked into the relative position of the EU in an internationally segmented production and distribution landscape adopting the value added perspective. However, we still have not zoomed into trade in "full international value chains" as such. A narrower and more precise approach to trade in international value chains is helpful to understand the linkages in production and trade in regional or global value chains. This is essential to identify structural changes in the international organisation of production. It is also important to see the implications of Single Market integration as an integrated production area, not just as a market.

But what do we mean by international value chains? If we are just producing intermediate or final goods to be exported to another country to be consumed there or to be re-elaborated and consumed there, we are still in a fairly traditional world with trade in final and intermediate goods.

The situation changes qualitatively when the segmentation of production is more advanced and the organisation of production is geographically dispersed further. This happens when the production process requires at least two border crossings. For instance, this would happen when an intermediate input is produced in country A and is sent to country B where it is elaborated further and then it is sent to a third country C for final elaboration, distribution and consumption. This does not require three countries necessarily: we would also have an international value chain if the intermediate product finalised in B is shipped back to A instead of C for the same purposes. What really matters is the level of segmentation and geographic dispersion in production.

This narrower approach calls for a more restricted focus of the economic activities considered. Until here, we have considered the value added produced and exported. Now we will only focus on the re-exported domestic value added, i.e. the domestic value added embodied in a country's intermediate exports that crosses borders at least twice. In quantitative terms this is a significant reduction: while vale added is 67% of EU gross exports, the re-exported value added is just 17,4 % of the total value of exports.

This concept is important to help us understand the importance of the Single Market in configuring Europe as an economic area, not just as a market but also, as what some people have called "Factory Europe".

For that purpose we can define regional value-chains as those international value chains where production takes place across (at least three) borders within a geographic area, e.g. the EU. The EU can therefore be identified as a Regional Value Chain (RVC). Likewise we could define NAFTA or MERCOSUR as other RVC. Then we can also define global value-chains when production involves countries beyond those regional areas.

This approach also confirms the loss of EU competitiveness in manufacturing but the situation is more nuanced and we get some new insights:

1. First, the relative fall in manufacturing has been rather smaller, especially if we consider manufacturing and business services together.

2. Secondly, the sharp increase in the intensity of value chain (VC) trade seems to have flattened out after the crisis.

3. Between 2000 and 2014, the loss of market share in VC trade has been of 4% in manufacturing (and just 1% in manufacturing and business services). This compares to 7,8%for the USA, and 5,5% for Japan.

4. While the Single Market framework available at EU level has been the same for all 28 Member States, some have been able of attracting a growing share of manufacturing activities.

5. At least for the period 2011-2014, the EU has been capturing an increasing share of the value added embodied in exports because the value added exported has been growing faster than the total value of exports. This applies in particular to VC trade while it is not present in GVC. This suggests that at least for this part of the EU exports (i.e. those included in VCs), Europe is capable of capturing an increasing share of value added included in exports.

6. Although the trading activity in VCs within "Factory Europe" has established since the recovery and despite the growth of demand in emerging economies, EU RVC have consolidated *vis a vis* GVC. Roughly speaking 50% of all VC trade still takes place within European RVCs. These percentages are high in manufacturing VCs. In that sense we cannot say that "Factory Europe" is going global.

7. From a producer perspective, the EU RVC is not an evenly integrated area. Germany has a more prominent role in the RVC. Other Member States have seen their integration in the RVC increasing (e.g.PL and NL) while other countries have reduced their relative level of integration.

8. The consolidation of production linkages within "Factory Europe" is confirmed by the close relationships between EU producers integrating the EU RVC. All EU Member States tend to have significantly more joint production with other Member States than the world average when their value added is finally absorbed by the Single Market. This shows a high degree of integration of the EU as a production base and as a market.

9. Geography matters for economic relations but comparisons between the relative level of integration of countries such as Switzerland and Austria with the rest of the EU show a clear positive impact of the Single Market in the consolidation of the EU production base.

10. The importance and strength of these production linkages becomes very clear when we compare NAFTA, EU28 and the Asian Regional Value Chains.

Questions for discussion:

1. How do our industries need to adapt in order to be globally successful and move up the value chain? What are the possible choices?

2. What actions are needed on EU and national level?