DP WORLD

TRADE IN TRANSITION

REGIONAL REPORT: EUROPE

WRITTEN BY The Economist INTELLIGENCE UNIT

About this research

Trade in Transition is a global research programme led by The Economist Intelligence Unit, sponsored by DP World, which presents private-sector sentiment on international trade. In this year's report, we specifically explore the impact of covid-19 on companies' trade operations and the resulting shift in approach to international trade by private-sector firms.

The research is based on two global surveys of senior executives involved in their firms' day-to-day international trade decisions and transactions. The first survey of 3,000 respondents was conducted between January and March 2020 and the second survey of 800 respondents was conducted between October and November 2020. Both surveys captured perspectives of executives across six regions (North America, South America, Europe, Middle East, Africa and Asia-Pacific). The survey findings were supplemented with in-depth interviews with trade experts and senior executives across regions and sectors.

This report focuses on the key findings from Europe, in the period just before the end of the Brexit transition.

We would like to thank the following experts for their time and insight:

Anna Stellinger, director of global trade and EU affairs, the Confederation of SwedishEnterprise

Peter Gerber, chief executive, Lufthansa Cargo AG

Stephane Piat, senior vice president for quality and supply chain, Schneider Electric

Paolo Garzotti, head of trade unit, European Commission

We would like to acknowledge the research contribution of Adam Green. This report was edited by Melanie Noronha.

Executive summary

Prospects for European trade in 2020 appeared gloomy as exports fell sharply by 24% in the second quarter of the year, as pandemic-related restrictions disrupted supply chains. Nevertheless, our survey of global executives finds European corporate leaders in an upbeat mood. They have traded well through the pandemic and are ready to launch a strong defence of global supply chains, albeit with contracts that allow for more flexibility and the use of technology to give early warning signs of future disruption.

KEY FINDINGS

- **European companies have largely weathered the storm:** Forty-six percent and 48% of executives surveyed in October-November 2020 reported an increase in international sales and purchases, respectively, in the first half of 2020 compared with the first half of 2019, despite the pandemic. On international sales, the share of respondents in Europe reporting an increase was higher than in North America, Asia-Pacific, the Middle East and Africa.
- **Uncertain demand was a far greater threat to European companies' international revenues than supply disruption:** Forty-six percent of respondents in Europe stated that demand shocks had the largest negative impact on international sales compared with just 22% who cited supply shocks.
- **European companies are less likely to be restructuring critical supply chains than their peers:** Seventy-three percent of European companies are re-organising their most critical supply chains, but that is significantly less than the global average of 83%. This may be due to the backdrop of uncertainty against which they are planning their supply chain strategies. Meanwhile, 40% of European executives said uncertainty about pandemic-related lockdowns is the greatest obstacle to reconfiguring their supply chains.
- **Agility is a common theme in European companies' approach to future trade transactions:** Seventeen percent of European executives said introducing flexibility into supply contracts will be the most important principle of future trade arrangements, a higher percentage than for any other region. The second most popular strategy for European executives is to deploy technology to yield real time analytics, so they can spot supply and demand shifts within their supply chain faster.

Healthy companies, lacklustre economies

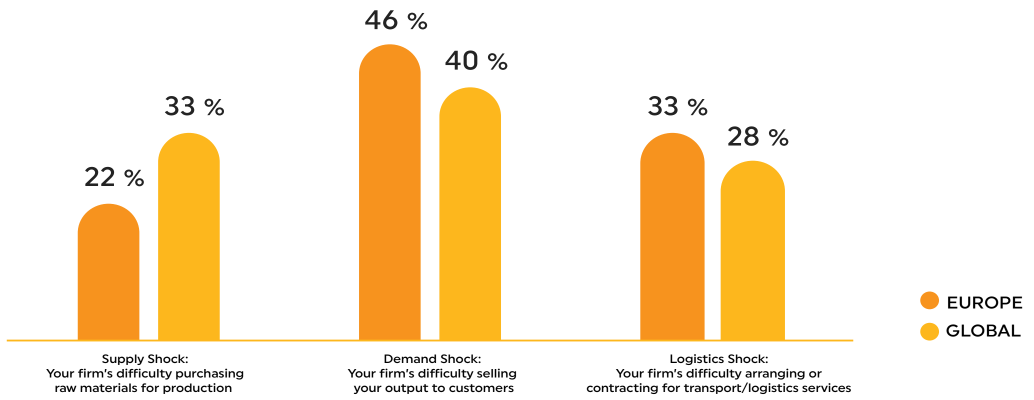
Even before the coronavirus pandemic struck, there was a slowdown in European trade. The value of trade in merchandise—exports and imports of physical goods—dropped by 3.1% in 2019, compared with the previous year.[1] The region was also mired in trade negotiations surrounding Brexit, which have concluded with the EU-UK Trade and Cooperation Agreement, but will result in significant changes to trade dynamics within Europe. The economic shocks induced by the pandemic only compounded these challenges.

Globally, the first half of 2020 saw a historic retreat from international trade, as measures to stem the covid-19 pandemic disrupted supply chains, and demand for many goods and services cratered. According to the World Trade Organisation (WTO), the value of global exports and imports fell by 21% year on year in the second quarter of 2020.[2] In the same period, Europe was among the regions that experienced the sharpest fall in trade activity – with exports and imports falling by 24% and 22%, respectively.

In Europe, the fall in exports resulted primarily from a demand shock, according to executives in a global survey conducted by The Economist Intelligence Unit in October-November 2020 (see Figure 1). Just under half of European executives surveyed (46%) reported that demand shocks—that is, difficulty in selling goods to customers—had the greatest negative impact on their international sales in the first half of 2020. As pandemic-related restrictions on movement of people curtailed business activity around the world, a wave of job and wage cuts resulted in an overall slump in demand. The Economist Intelligence Unit estimates that quarterly GDP in Germany, France and the UK—Europe's largest economies—fell by 9.7%, 13.7% and 19.8%, respectively, in the second quarter of 2020. Given that intra-European exports contribute 50-75% of total exports for most EU countries,[3] the fall in economic activity in the continent's major economies would have had an adverse impact on companies' international sales.

For 33% of executives surveyed in Europe, the logistics shock (defined as the difficulty in

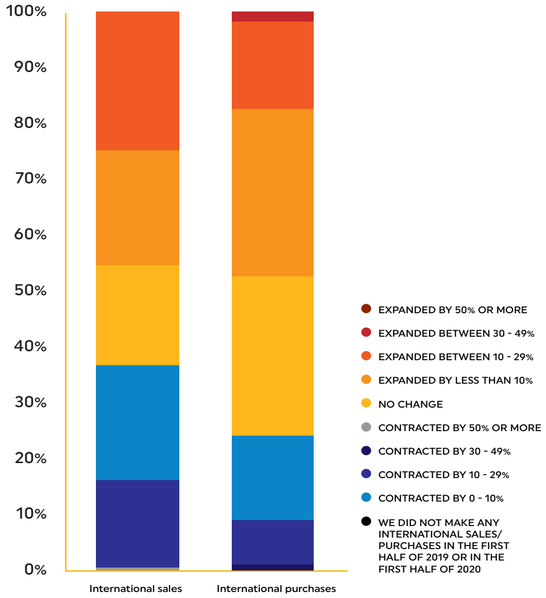
FIGURE 1
Which shock had the greatest negative impact on your firm's company-wide international revenues in H1 2020?



Source: EIU survey October-November 2020

[1] Chapter II: Highlights of world trade in 2019. World Trade Organization. 2020. Available online at https://www.wto.org/english/res_e/statis_e/wts2020_e/wts2020chapter02_e.pdf
[2] Third Quarter 2020 Merchandise Trade Value. World Trade Organization. Updated on 4 December 2020. Available online at https://www.wto.org/english/res_e/statis_e/daily_update_e/merch_value_latest.pdf
[3] Intra-EU trade in goods – main features. Eurostat. Last modified on 10 September 2020. Available online at https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Intra-EU_trade_in_goods_-_main_features#Intra-EU_trade_in_goods_compared_with_extra-EU_trade_in_goods

FIGURE 2
International trade performance (sales and purchases) in H1 2020 vs H1 2019



Source: EIU survey October-November 2020

transporting raw materials or finished products) had a greater negative impact on international sales than demand shocks, while just 22% blamed supply shocks (defined as the difficulty in purchasing materials for production). In this respect, Europe differs significantly from other regions—supply shocks had the greatest negative impact in South America (cited by 46% of respondents) and Asia-Pacific (40%).

The impact of these economic shocks is evident in the gap between expectations and reality for trade growth in 2020, captured in our surveys from January-March 2020 and October-November 2020. At the start of the year, 77% of executives surveyed in Europe expected international sales revenue for 2020 to expand over the previous year, with nearly half of respondents (47%) expecting growth of more than 10%. Respondents to our second survey revealed that only 46% of respondents expanded international sales in the first half of the year and only 25% experienced a growth above 10%.

But importantly, our survey data indicate that the trade picture is not as bleak as expected early in the pandemic (the pessimistic scenario developed by the WTO had European exports and imports falling by 33% and 29%, respectively, in 2020[4]). In our survey, a higher share of respondents in Europe experienced an expansion (46%) in international sales than a contraction (37%), with 18% experiencing no change in the first six months of 2020 compared with the same period in 2019. In the first half of 2020, exports of cereals and pharmaceutical products from the continent increased by 23% and 12% respectively.[5] Also in the same period, twice as many respondents saw international purchases expand rather than contract (48% v 24%). Since then, there has been a recovery in trade: exports fell only by 2% in the third quarter of 2020 year on year (compared with a fall of 24% in the second quarter of 2020).

These results reveal the remarkable agility in corporate responses to the pandemic. After the initial disruption, many companies in Europe moved rapidly to reconfigure their supply chains, switching or adding new suppliers, using different logistics partners or targeting new markets for sales. Companies are also using advanced technologies to optimise trade operations, enabling them to be more responsive to market changes.

The extent to which these strategies are used will determine how regional and global trade patterns will shift in the coming months and years. In the next section, we explore how companies in Europe have responded to pandemic-related trade disruptions and the challenges they face as they continue to source from and distribute to international markets. The final section concludes with our assessment of how companies' experiences during the pandemic have shifted their approach to international trade.

[4] Trade set to plunge as COVID-19 pandemic upends global economy. World Trade Organization. 8 April 2020. Available online at https://www.wto.org/english/news_e/pres20_e/pr855_e.htm

[5] ITC Trade Map. Available online at https://www.trademap.org/

Trading through the pandemic – agility amid uncertainty

In response to the various economic shocks (demand, supply and logistics) experienced during the pandemic, companies began to reconfigure their supply chains, a move that interviewees tell us had been under consideration at many firms for years. Seventy-three percent of executives surveyed in Europe were in the process of reconfiguring their supply chains in October-November 2020, lower than the global average (83%), but still representing a vast majority of respondents in the region.

Through interviews with executives at private-sector companies and trade organisations, we have identified how companies in Europe have approached their supply chain reconfiguration. Examples discussed below show that companies are diversifying their supplier base, commonly known as "multi-sourcing", and using advanced technologies to optimise trade operations. To assess how these strategies will impact regional and global trade flows, we also explore the average time to reconfigure supply chains, how much companies are investing in this effort and the barriers they face during the transition.

SUPPLIER DIVERSIFICATION

Pandemic-related disruptions revealed weaknesses in companies' supply chain management strategies including, for some companies, an overreliance on a single or limited number of sources for raw materials and other key inputs. Such concentration, buried deep within a web of subcontractors, can potentially derail an entire manufacturing process if a specific country or firm faces sudden duress.

Companies have responded by diversifying their supplier base. "From a manufacturing standpoint, we want to guarantee that if it's critical to business, we ideally [have to source] from two different regions," says Stephane Piat, senior vice president for quality and supply chain at Schneider Electric, which provides energy and automation digital solutions.

A part of this is ensuring that components are compatible for manufacturing facilities in different geographies. "We want to [adhere to] global standards in every factory we have," Mr Piat adds. Schneider Electric aims that, over the next two years, more than 70% of its raw materials will be sourced from multiple locations, up from 40% currently. Such a strategy may do more to accelerate harmonisation of production standards than ongoing negotiations between countries and regions.

THE VERDICT ON REGIONALISATION?

Disruptions caused by national lockdowns during the pandemic have triggered discussions on the regionalisation of supply chains. While executives we interviewed were quick to dismiss calls for reshoring (the process of bringing manufacturing operations back to a company's home country), they emphasised the need for greater diversity of partners within a regional hub. "We have a global supply chain, but with regional footprints," Mr Piat says. "The intention is that these regional footprints can backup each other with additional buffer capacity that provides support in case a factory shuts down in one of the other zones."

Anna Stellinger, director of global trade and EU affairs at the Confederation of Swedish Enterprise, echoes this sentiment, describing the approach taken by both SMEs and multinationals in Sweden. "They have made the necessary arrangements through either diversification or stockpiling," she says. "But there is absolutely no call for any kind of policy going towards reshoring." A recent survey conducted by the Confederation showed that only 2% of Swedish companies wished to re-shore production to Sweden.

For some companies, being closer to the customer is also an important consideration in supply chain reconfiguration. Although parts from Asia are cheaper, Schneider Electric is undertaking a massive programme

> **"We have a global supply chain, but with regional footprints. The intention is that these regional footprints can backup each other with additional buffer capacity that provides support in case a factory shuts down in one of the other zones."**

Stephane Piat, senior vice president for quality and supply chain, Schneider Electric

to develop a new supply base in Eastern Europe in order to source affordable parts. Already, 80-90% of the parts for products sold in Europe are sourced from the continent itself. "We need to have a short supply chain as much as possible, closer to customers, not only on the manufacturing but also on the supply [side]," says Mr Piat.

For Schneider Electric, the plan to source raw materials closer to production facilities in Europe is also being implemented in anticipation of punitive trade measures against China taken by the EU. "We anticipate some tariff barriers or custom barriers," says Mr Piat. "We know that even though [Asia] is very cost competitive today, it may not last in the long run, so we are trying to build a kind of supplier base of the future in eastern Europe."

Together, building buffers for regional operations, moving production closer to the customer and preparing for potential tariffs may strengthen intra-regional trade flows for European companies.

(REAL TIME) KNOWLEDGE IS POWER

Our survey conducted in October-November 2020 shows that executives across the world are betting on the same handful of technologies to optimise trade operations. Respondents globally stated that their companies relied on cloud computing (40%), Internet of Things (IoT) (39%) and big data analytics (34%) to respond to the pandemic crisis, with an unusual degree of alignment in the survey responses across geographies. In Europe, the three technologies were cited almost evenly by roughly 36% of respondents.

Our earlier survey conducted in January-March 2020 offers clues on why these were the technologies of choice. Their ability to improve access to information was cited as the biggest positive impact on a company's ability to trade across borders. Among the three technologies, the highest share of respondents (44%) expected cloud computing to improve access to information the most, followed by IoT (41%) and big data analytics (39%).

Integrating these technologies into their systems has made companies more responsive to continually evolving market trends. Germany's national airline Lufthansa deployed software to manage demand for passenger flights so that it could quote spot rates to cargo customers. With supply and demand changing rapidly, such price flexibility was essential to clear the market. The company is now seeing high-capacity utilisation rates of its cargo aircraft and has seen its order flow grow much faster than the company had forecast. As a result, Lufthansa not only pulled retired cargo planes back into service but also repurposed passenger planes to fly goods only.

At Johnson and Johnson, which produces medical devices, pharmaceuticals and consumer goods, data scientists have employed algorithms to identify sudden changes in order patterns, so the company can get ahead of demand changes. It has also deployed IoT sensors to provide real-time insights into the location and condition of products already dispatched to consumers.[6] Similarly, Schneider Electric is feeding real-time supply chain information to assist with more accurate forecasts and risk modelling, using a digital twin of their supply chain.

6 4 High-Tech Tools Johnson & Johnson Is Using to Get Products to You During the Pandemic. Johnson & Johnson. 10 September 2020. Available online at https://www.jnj.com/innovation/johnson-johnson-supply-chain-technology-during-coronavirus

In this way, the use of advanced technologies has been vital to providing executives with insights to drive agility and optimise trade operations.

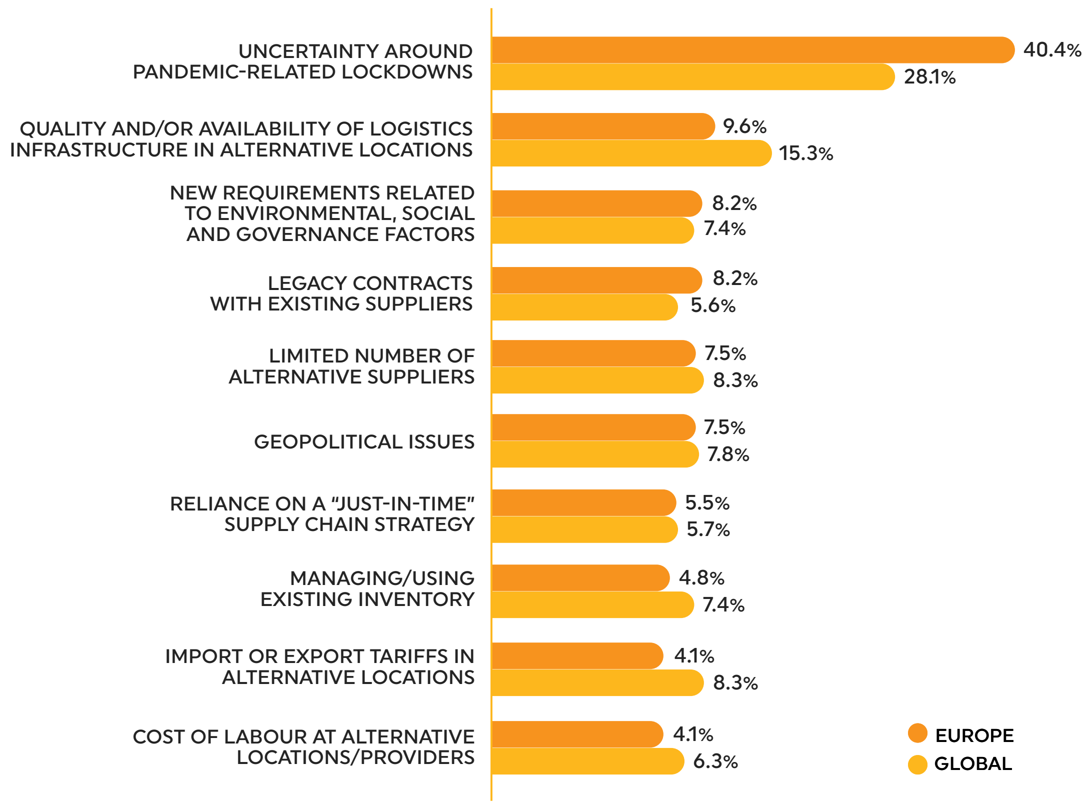
BARRIERS TO RECONFIGURING SUPPLY CHAINS

The interventions described above, which companies implemented in response to supply chain disruptions, have needed a significant amount of time and investment. In Europe, respondents to our survey anticipate that their companies will take, on average, about 8.5 months to complete their supply chain reconfiguration, in line with the global average. The highest share of respondents (37%) estimate that it will take between 6 and 12 months to reconfigure their supply chains.

But European companies surveyed are investing less money in the process than peers elsewhere. Just 5% of European executives say they reallocated more than half their revenues from the first half of 2020 to reconfigure their supply chains. This is far lower than all other regions: the figure was 10% in Asia-Pacific and 15% in North America.

One reason for the lower level of investment may be the backdrop of uncertainty against which executives are reorganising their trade operations. In our survey, over 40% of respondents based in Europe cited uncertainty around pandemic-related lockdowns as the single largest barrier to reconfiguring critical supply chains. This was significantly higher than in other regions, barring South America: the figure was just 23% and 21% in Asia-Pacific and North America, respectively. One reason for this could be that when the survey was conducted (in October-November 2020), countries

FIGURE 3
Barriers to supply chain reconfiguration in Europe v globally



Source: EIU survey September 2020

across Europe were experiencing a spike in covid-19 cases and were about to or had already commenced another round of national lockdowns.[7] "A big challenge up to now with the pandemic is that there are new rules every day [on countries reopening or going into lockdown]," explains Peter Gerber, CEO of Lufthansa Cargo. "So, this [has] meant that we had to be very, very flexible in our day-to-day operations."

This higher level of concern over the uncertainty of lockdowns could also explain why European companies are less likely to be reconfiguring global supply chains than peers in other regions, possibly as they are unsure what future they are preparing for. Nevertheless, that a vast majority of companies are committed to adapting their supply chains (73% of respondents in Europe) indicates a commitment to maintain global supply and distribution networks, despite the challenges endured during the pandemic. But there are new priorities in the European corporate approach to international trade, our survey results reveal. In the final section, we present these priorities and the outlook for international trade.

7 COVID-19: tracking the pandemic. The Economist Intelligence Unit. 18 January 2021. Available online at https://eiuperspectives.economist.com/healthcare/covid-19-tracking-pandemic

Shifting gears

European executives are unlikely to forget the first half of 2020 when their supply chains were stretched in ways beyond their anticipation, and lockdowns generated unprecedented demand shocks. Even so, they remain cautiously optimistic about a recovery in global trade to pre-pandemic levels.

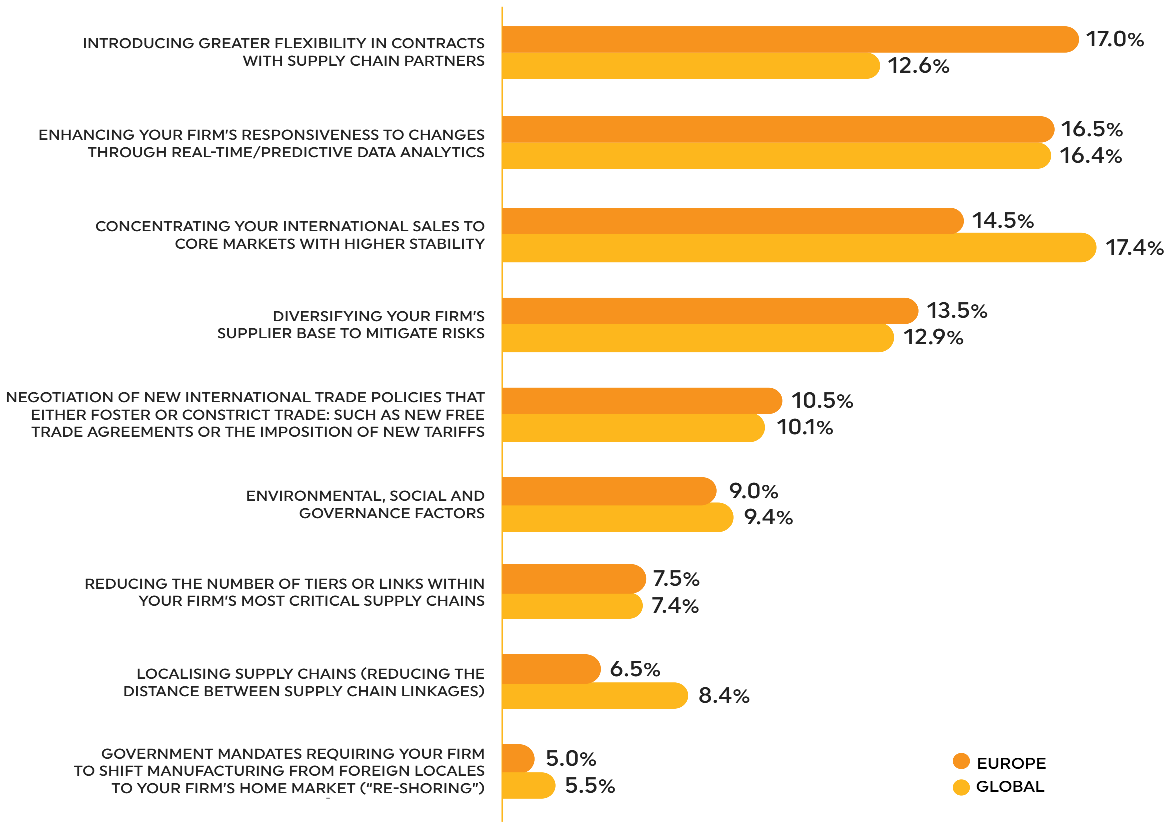
In October-November 2020, a plurality of respondents in the region (46%) expected trade to recover within 1-2 years, with less than a quarter (23%) expecting a recovery in less than a year. "There is a feeling that even if we have [another] wave, many larger firms say that, the orders are coming in, and the necessary rearrangements on the cost side have been made," says Ms Stellinger.

As a group, European companies have responded to the covid-19 pandemic by renewing their faith in globalisation. There is little interest in reshoring or shrinking supply chains. When asked about the most important factors in determining future international trade transactions, government-mandated reshoring was bottom of the list, cited by only 5% of respondents in Europe (see Figure 4). "I believe the covid crisis has shown that globalisation is necessary," says Mr Gerber, "because we flew masks around the globe; we got them from Asia to Europe, or vice versa, and we will see the same with the vaccines. It is an increasingly interwoven world, and this is necessary."

The European Commission has been more measured, talking of "strategic autonomy". What this entails has yet to be properly defined, but it is geared towards improving the EU's self-sufficiency and could include an array of strategies from on-shoring or near-shoring to diversifying the supplier base and shortening supply chains.[8]

FIGURE 4

Factors that will determine how companies will conduct international trade transactions up to 2025



Source: EIU survey September 2020

[8] Europe wants 'strategic autonomy' – it just has to decide what that means. Politico. 15 October 2020. Available online at https://www.politico.eu/article/europe-trade-wants-strategic-autonomy-decide-what-means

European executives are nevertheless worried about more protectionist policies. "A great concern is that we do see protectionism is still on the rise," says Ms Stellinger. "We don't have the usual tariff-based protectionism that we had in the last century, but we do have many non-tariff barriers." These include limitations on data transfers across borders, restrictions on participation in public procurement, stringent rules on local hiring and local ownership of companies, among others. "So of course, there's a great concern from Swedish companies that other countries, in general, are becoming slightly more closed and slightly more nationalistic and slightly more protectionist." Our survey conducted in January-March 2020 showed that rising protectionism was among the top two reasons for pessimism about trade in 2020-2021 (cited by 22% of respondents based in Europe).

For private-sector companies though, diversification of the supplier base is the order of the day—ensuring sources in more countries, rather than fewer—as well as occasionally holding buffer inventories. "Of course, we see a diversification of the supply chains in order to get more security or reliability," says Mr Gerber. "Not at home, but sourcing in other parts of the world."

The diversification of their supplier base appears to be well underway for companies in Europe, based on insights from experts we interviewed, so this is not a top priority in the short to medium term (see Figure 4). Up to 2025, as executives engage in international trade transactions, introducing greater flexibility in contracts with supply chain partners —such as order quantity or delivery lead time flexibility— will be the most important factor. This was the top factor chosen by executives in Europe (cited by 17% of respondents), whereas globally it ranks fourth.

Enhancing their firms' responsiveness to changes through real-time/ predictive analytics was the second most important factor, cited by nearly 17% of respondents in Europe.[9] As we have seen from examples presented in the previous chapter, they are betting on new technologies—including IoT, cloud computing and big data analytics—to garner real-time insights. Indeed, one of the standout findings from our research was how much European executives are focused on increasing visibility within their supply chains and responding quickly when changes are detected.

Among these changes will be those required in EU countries' trade with the UK. With the EU-UK Trade and Cooperation Agreement provisionally in effect since January 1st, businesses are starting to adjust to the post-Brexit era. Businesses in the UK are already grappling with administrative challenges, particularly around certification and rules of origin.[10] The UK's automotive sector will be among those most affected: much production is based in the country as a gateway to EU markets; in addition, rules of origin will limit the extent to which UK firms can globalise their supply chains.[11] The broader impact on trade dynamics in Europe will be clearer once the teething issues have been resolved.

Ultimately, from their choice to introduce more flexibility in contracts and use more advanced technologies, executives in Europe seem to understand that the 2020 pandemic was just one more example of growing structural uncertainty in business, with the potential for shocks that come in many shapes – from geopolitical tension to major weather events. Although a recovery in European trade is expected in 2021—exports and imports are projected to grow by 8.2% and 8.7%, respectively—these challenges imply a need for a general state of readiness to deal with a variety of unpredictable risks. European companies seem up for the challenge, ready to leverage all the tools available to help them respond with agility to perpetual change.

[9] The use of advanced technologies for greater responsiveness was a trend emerging even before the pandemic. Our survey conducted in January-March 2020, just as the pandemic was spreading around the world, showed that new technologies for improving the ability to trade was the top reason Europe-based executives were optimistic about trade in 2020-2021 (cited by 53% of respondents).

[10] https://www.economist.com/britain/2021/01/30/absurdities-on-the-border-between-great-britain-and-northern-ireland

[11] http://www.eiu.com/Handlers/WhitepaperHandler.ashx?fi=Brexit-risk-and-resilience-for-business.pdf&mode=wp&campaignid=brexit21

DP WORLD