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## COVID-19 and European Industry: Global Shocks, Local Shocks and Value-Chain Restructuring

Coronavirus and its Societal Impact - Highlights from WZB Research

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## COVID-19 and European Industry: Global Shocks, Local Shocks and Value-Chain Restructuring

**By John Humphrey and Grzegorz Lechowski**

Over the past decades, the world economy has seen an increasing geographical and organizational fragmentation of manufacturing production. Activities have been divided up across different locations and firms, creating new global economic interdependencies. In the early weeks of the COVID-19 epidemic, these linkages led to a rapid transmission of the economic shock from East Asia to Europe, disrupting work and production in many large and small local businesses.

But how will the complex value-chain structures in European manufacturing sectors absorb the current wave of economic disruption arising from the spread of the COVID-19 epidemic to the West? And how will existing network arrangements change? Future scenarios are uncertain and will depend, among others, on the pace of recovery and the policy measures taken to mitigate the economic downturn.

### *From a supply- to a demand-side shock*

When COVID-19 first spread in China, many saw it as a regional issue. But as lockdowns in East Asia led to sharp falls in industrial output and exports, firms in the West using Chinese parts faced a “supply shock” that disrupted their own production. The electronics industry – with its manufacturing base dependent on Chinese labor, and its supply chains reliant on thin, “just-in-time” inventories – was badly affected. Even for the leading Western producers, the shock arrived fast and left little room for maneuver.

By March, COVID-19 had become a global pandemic, and its most dire health and societal impacts started affecting key Western economies. As two prominent European economists observed: [“What was widely viewed as a ‘Chinese problem,’ and then an ‘Italian problem’ has become an ‘everybody problem’”](#). And importantly, the pandemic has brought into play different kinds of mechanisms disrupting European manufacturing sectors.

One example is the German car industry – a [sector already challenged](#) by the ongoing transition to electromobility and trade conflict with the USA. Following the February supply shock from China, as well as a collapse in demand in Asian markets, the industry has been hit by a severe “demand shock” resulting from containment measures in Europe. These have reduced local consumer incomes, created uncertainty and closed not only factories but also car dealerships. In Germany, [car sales fell](#) by 38% in March 2020 (compared to March 2019) – in Italy, France and Spain the falls were even greater ([85%, 72% and 69% respectively](#)).

### *Value-chain restructuring*

While it is still too early to predict the severity of these shocks and their impacts on the car industry, two structural effects seem possible. First, some writers have predicted that the supply-side shock might reverse the trend to global offshoring towards more

sustainable, perhaps regional, industrial arrangements (see e.g. [Gertz, Butollo](#)). But here, a nuanced and sector-specific assessment will be needed. A long period of offshoring and outsourcing – that was slowed but not reversed by the 2008 global crisis – has left the German car industry more reliant on foreign inputs. This dependency arose mostly from the integration of low-cost Eastern European labor into a coordinated regional production system – and less so from outsourcing to Asia. And the COVID-19 crisis may affect this particular value-chain arrangement in various ways: on the one hand, it can make the industry more risk-averse, and less willing to “externalize” production; on the other, the growing cost pressures may force German firms to further reduce their reliance on the high-wage, Western locations.

Second, the demand shock will hit German firms directly, but possibly unevenly. Larger firms (such as assemblers or global suppliers) may use their market power to extract concessions from less powerful ones – with domestic small suppliers particularly at risk. Some may go bankrupt before the epidemic ends; and those that survived may suffer financial harm undermining their productive and innovative capabilities. This could radically change the structure of the German domestic car industry and affect its global competitiveness – in particular, compared to countries that may come through the crisis faster and with less damage.

#### *What happens next*

We are in uncharted territory, and further, unexpected impacts may occur. Some regions and countries may experience a quick, V-shaped recession. In China, the dramatic fall in car sales in early February was partly reversed in March, and South Korea showed a similar trend. Equally, there are grounds for pessimism – with [some leading analysts predicting a recession and financial stress similar to, or greater than, the 2008 crisis](#).

At present, the pandemic has not yet played itself out. Large parts of Asia, Africa, or Latin America are still in the early stages of the outbreak, and these economies also matter for global value chains in manufacturing. In addition, measures taken by governments – individually and collectively, both during and after the health crisis – will influence the long-term economic impact of the pandemic. The extent of policy cooperation, or competition, between nations will be critical for the post-crisis trajectory of industrial globalization.

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