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Europe should prepare for a bumpy ride

Automotive sector will face fierce competition

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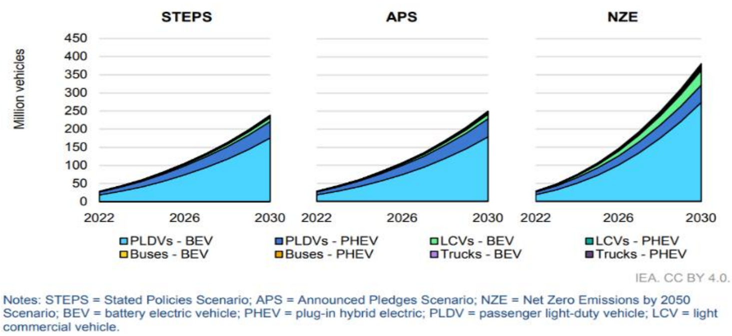
Summary

- The EU recently launched a probe investigating Chinese state subsidies for its electric vehicle sector.
- This probe is likely to show that China has indeed subsidized its automotive sector and as such the EU could take counter measures to ensure a more level playing field.
- We consider several scenarios that could unfold in case the EU would conclude that China has subsidized its electric vehicle sector.
- We think that the most likely scenario is a negotiated settlement that would either result in some protective measures and/or entails Chinese investments in Europe in either the car or the battery sector.

Into a higher gear

Governments around the world, particularly in the West, are incentivizing consumers and businesses to wean themselves off fossil fuels as soon as possible. And it is effective. The IEA even brought forward their forecast for peak fossil fuel demand. One of the primary reasons is that electric vehicles are being adopted faster than expected (Figure 1), particularly by Chinese consumers. Over a third of new cars sold in the last year were battery electric vehicles (BEVs) or plug-in hybrid electric vehicles (PHEVs), and this share is expected to grow.

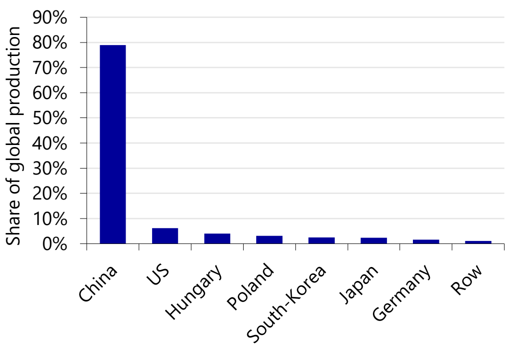
Figure 1: "All gas, no brakes" for electric vehicles according to the IEA



Source: IEA

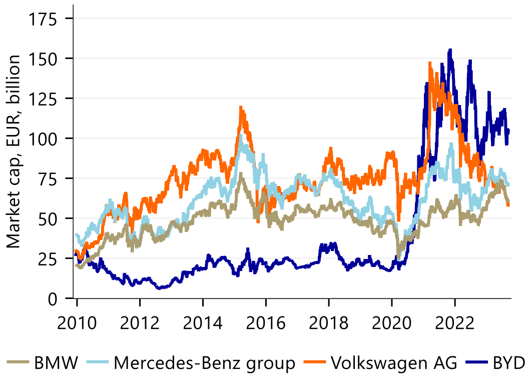
It should come as no surprise that electric vehicle adoption is particularly high in China. For more than a decade, new energy technologies such as batteries and solar panels have been at the forefront of China's industrial strategic agenda. As a result, China now controls the entire value chain, including mining and processing of rare earth metals, battery production, and car production and is home to the world's largest battery manufacturers (such as CATL and BYD), which have decades of experience in battery manufacturing. Because these companies control the entire battery value chain they can sell cars at attractive prices while maintaining similar operating margins as more established brands.

Figure 2: Guess who dominates the production of lithium-ion batteries (2021)



Source: [S&P]

Figure 3: Are German brands soon in the rear view mirror?



Source: Macrobond, Bloomberg

These policies are now starting to bear fruit. There is currently a glut of overproduction in China (some estimates put it at [20 million cars per year], double the amount of cars sold in the EU), which has led homegrown brands to aggressively cut prices in order to gain market share. As a result, after years of dominating the market, BYD recently dethroned Volkswagen as China's top brand. BYD has even surpassed Volkswagen in the top three most valuable car brands (Tesla, Toyota, BYD).

However, the glut of electric vehicles is not just meant for the Chinese market. China expressly states in its 'Made in China 2025' plan that it wishes to be a high-tech exporter. And as a result, Chinese automakers are now making their way to Europe, where they are rapidly flooding the market with low-cost, high-quality electric vehicles. According to the European Commission, China's share of EVs sold in Europe has risen to 8% and could reach 15% by 2025. This is especially painful for German automakers, who are losing market share in both China and Europe.

Cars, cars, cars

For Europe, and especially Germany, the automotive sector is very much at the heart of the economy. So before we dive into the ramifications of this threat to Europe’s industry, we would like to spend a few words on the importance of the automotive industry, since the latter, which operates in long, complex and optimized value chains, has an enormous impact on other sectors of the economy as well. First, through providing an income for workers (the automotive industry employs approximately [6%] of Europeans, and it is deeply ingrained in the self-image of countries such as Germany), but also because there are a lot of specialized companies that supply the automotive sector with sensors, steel and rubber, just to name a few things.

Figure 4: The automotive sector is very central to Germany, Italy and Spain

	Germany	*France*	*Italy*	*Spain*
Manufacture of motor vehicles, trailers and semi-trailers	0.84	0.04	0.14	0.18
Manufacture of machinery and equipment n.e.c.	0.37	0.03	0.27	0.06
Manufacture of food products	0.24	0.16	0.50	1.00
Manufacture of fabricated metal products, except machinery	0.24	0.05	0.24	0.13
Manufacture of basic metals	0.15	0.02	0.13	0.11
Manufacture of rubber and plastics products	0.15	0.03	0.11	0.09
Manufacture of chemicals and chemical products	0.15	0.05	0.11	0.16
Manufacture of electrical equipment	0.12	0.01	0.08	0.06
Manufacture of furniture, other manufacturing, repair and installation	0.11	0.05	0.14	0.07
Manufacture of other non-metallic mineral products	0.10	0.04	0.09	0.11
Manufacture of paper and printing products	0.09	0.04	0.10	0.09
Manufacture of computer, electronic and optical products	0.08	0.02	0.04	0.01
Manufacture of coke and refined petroleum products	0.07	0.02	0.08	0.07
Manufacture of basic pharmaceutical products	0.06	0.02	0.05	0.04
Manufacture of other transport equipment	0.04	0.04	0.06	0.04
Manufacture of wood and products of wood and cork	0.03	0.01	0.04	0.03
Manufacture of textiles	0.02	0.01	0.18	0.05

Source: RaboResearch, Eurostat

To visualize how central the automotive sector is, we have conducted a network analysis for the European manufacturing sector. A relative score between 0 and 1 is assigned to each sector in the economy using eigenvector centrality. This score is based on the connection that each sector has with other parts of the economy and how important these other parts of the economy are, with 0 being the least and connected and 1 being the most connected sector. From figure 4 it is immediately clear that the automotive sector is a really central sector for the German economy, whilst it is also one of the most central sectors in Italy and Spain.

Will Europe hit the gas or the brakes?

Given the importance of the automotive industry, it was no surprise that Ursula von Der Leyen stated in her 'State of the Union' speech on September 13 that Europe will do "*whatever it takes to keep its competitive edge*." This time, Europe should not repeat the mistake of a few years ago, when China flooded the European market with cheap solar panels, driving European manufacturers out of business. Particularly since, this time around, the stakes for the European economy are much higher.

As a result, Von der Leyen announced that the Commission will conduct an anti-subsidy investigation into state subsidies for Chinese vehicles. China initially reacted angrily to Von der Leyen's proposal, claiming that it would harm relations and that automakers who fail to keep up with technological advances are protected in this way. China summarized the probe as a 'naked protectionist act' on electric cars.

However more recently, matters seem to have cooled down, or at least a bit. During Valdis Dombrowskis' recent visit to Beijing no public criticism was voiced regarding the recently announced probe. This all despite Dombrowskis' clear criticism on China's stance on the war in Ukraine and his message that the EU could become more assertive if the trade and investment relationship would not become more mutual beneficial.

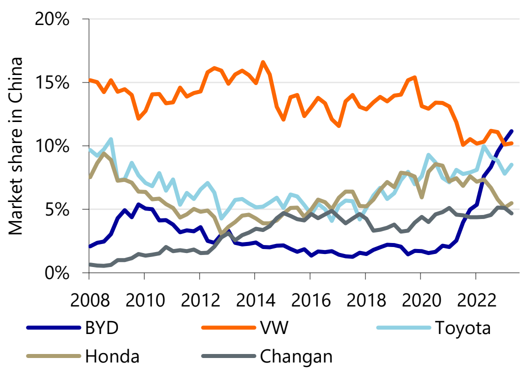
The EU is currently researching the matter, but before the results are in, we would like to sketch a few scenarios on how this might unfold.

Scenario 1: Unilateral Protectionism

Since the Chinese government supported its battery sector, and, by extension, its automotive sector, with low-interest loans, capped energy costs, and tax breaks, they may potentially find plenty of evidence of Chinese subsidies. As a result, we believe that the European Union will have no trouble finding some legal basis to impose tariffs if they so desire. Currently, the bloc's tariffs on imported cars are relatively low (only 10% compared to 27.5% in the US), and governments frequently subsidize electric vehicles, regardless of whether they are imported or produced within the Eurozone. Changing the latter, as France intends to do, appears to be a simple way to create a more level playing field without imposing direct tariffs. Indeed, France seems to be the more hawkish country within the EU when it comes to protecting its industry, which is also evident by the fact that France is actively trying reduce its dependence on China.

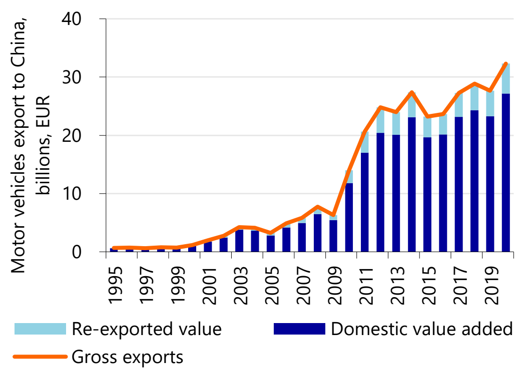
We believe that in case of unilaterally imposed trade restrictions by the EU - regardless of the type of trade barrier - China is likely to retaliate, albeit perhaps reluctantly. China has no interest in fighting a trade war on two fronts, but simply cannot let this go unchecked, as it would undermine China's new-gained status of a global superpower. Since trade barriers are unable to protect Europe's interests in China, it is almost guaranteed that Europe's exports to China will be affected by the retaliatory measures. While German car makers, for example, are already rapidly losing market share in the Chinese market (Figure 5), China could easily speed up that process. This would be particularly painful for Germany, but would also heavily impact European exports to China in general. Over the past years motor vehicle exports accounted for EUR25bln or roughly 11% of the domestic value added in European exports to China (Figure 6).

Figure 5: Has VW been asleep at the wheel?



Source: China Automotive Technology and Research Centre

Figure 6: The Chinese need for European speed



Source: OECD Trade in Value Added

Disadvantageous treatment of European brands in China is just one example. One could argue that, given the current trend, European automakers are bound to lose market share in China regardless of such measures. Perhaps more concerning is retaliation by denying Europe critical minerals and products for domestic car production (as China did for gallium and germanium exports), something China is capable of given its dominant position in the battery value chain and several other clean-tech inputs. This would stall the development and production of European cars, as it would take years for domestic extraction and processing of minerals, as well as battery production, to be sufficient to meet European demand.

Even though France seems eager to confront China, Germany seems a lot more reserved to go down this path. As recent as the 25th of September, Germany's minister of transport was quoted "*in principal, I don't think much of erecting market barriers*" continuing that these measures could spark a chain reaction that would massively damage the German economy. With France and Germany being at odds over which path to follow, China could also try to sow division in the EU. But next to fractures in the EU, a second scenario comes into play.

Scenario 1b: Mediated settlement

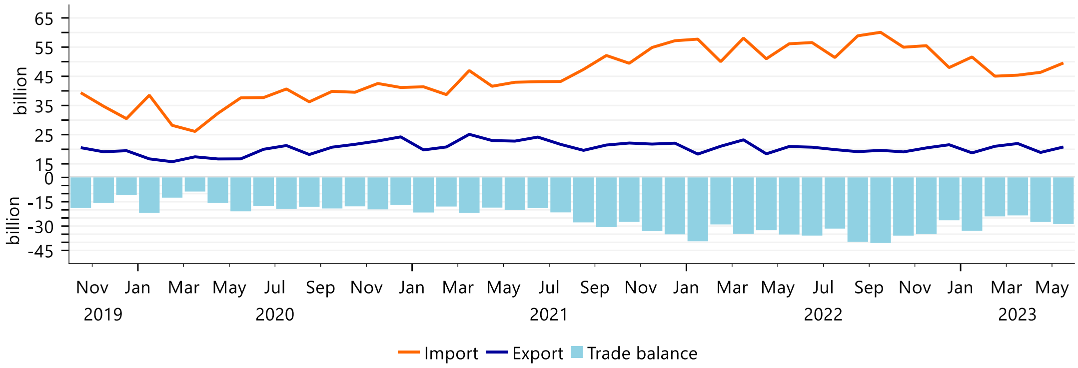
The second scenario that we envision is a milder version of the previous scenario. Remember that during the early eighties a trade dispute between the US and Japan was nipped in the bud after Japan – pressured by the US – imposed voluntary export restraints on itself. This scenario would boil down to a bilaterally negotiated agreement that would regulate China's access to the European market for electric vehicles. This agreement could take on many shapes and forms.

First, China could agree with a quota that would limit the amount of cars sold on the European market. Secondly, China and the EU could agree upon a share of Chinese cars and/or batteries being produced within the EU. In both cases this could go together with measures that, for example, include the transfer of certain technologies by Chinese car- or battery producers.

We don't think an arbitrage via the WTO is likely. First, because these cases are very time consuming. Whilst the case drags on, Chinese brands could already secure a foothold in the European market. Moreover, a resolution is unlikely, since the US continues to block the appointment of new members of the WTO body that is responsible for reviewing appeals. This basically means that the WTO has become a paper tiger.

Finally, China's growing trade surplus with the EU –which last year reached more than 400 billion, has become a growing concern for the EU. It seems clear that the current unbalanced trade relationship is up for renewal. China seems to realize very well that it is better to negotiate a new trade relationship with the EU than to passively await unilateral decisions from the EU that could further deteriorate China's access to the European market.

Figure 7: The EU's trade deficit with China has widened quite a bit, mostly due to higher imports



Source: Macrobond, IMF

Scenario 2: Free trade

For decades, Europe has been a proponent of free trade, which is understandable given the position of European firms in the global value chain. Europe became wealthy by exporting high-tech, high-value-added goods around the world. Given the unrivalled quality of many of their products, free trade was preferable because they would be the global leader. However, with Chinese manufacturers taking the lead from European car manufacturers, the roles have shifted. Rather than Volkswagen building factories in China, BYD, for example, is now planning to construct factories in Europe. If the current trend continues, European automakers will lose a significant portion of their market share in Europe.

This trend is bolstered by the fact that the European car fleet is rapidly electrifying, a market niche in which China excels. Currently, electric and plug-in hybrid vehicles account for 28% of new car registrations in Europe, but this figure is expected to rise to 65% by 2030, and close to 100% by 2035, when all cars sold in the European Union must be zero-emission vehicles. Assuming that Chinese brands can secure a solid position in this market, as von der Leyen suggested, the share of Chinese vehicles could rise from 2% now to 15% by 2035.

We therefore think that, of the scenarios presented, this is the least likely one. First, the EU is clearly worried about the threat to the European automotive sector, and given its importance it must act. Second, given that the probe is almost certainly going to show that China is subsidising its EV sector, inaction i.e. the business as usual option, would make the EU look like a toothless trade tiger. Finally, inaction from the EU would risk that member states would independently find ways to protect their automotive industry, much like France has already done by denying consumers subsidies for most Asian cars.

Scenario 2b: Free trade and subsidies

In order to bring the European automotive and battery sectors up to speed, the EU could try to counter Chinese subsidies by increasing European subsidies. Earlier this year, the EU passed legislation allowing member countries to match foreign subsidies for specific sectors critical to the green and digital transition. While subsidies would certainly help to close the gap, we do not believe they will be sufficient.

First, as previously stated, China can sell EVs at a discount because it controls the entire value chain. Because critical minerals are hardly extracted and refined in Europe, the EU would remain reliant on China in this regard. The question is whether Europe can truly scale production to the point where it is competitive with China without first securing the necessary inputs.

The second issue is financing. As a result of sharply rising interest rates, European governments are already struggling to balance their budgets (as we showed in this report). When budgets need to be cut, long-term investments are usually the first to go. Direct subsidies from the European Union would necessitate a larger EU budget, which would necessitate higher contributions from individual member states or increased tax revenues. Both options require unanimity in the European Council and are likely to be opposed by the more fiscally hawkish countries such as the Netherlands.

But the most important factor is the fact that it will take time to catch up with Chinese firms, which are likely to secure a foothold in the European market in the meantime. Regaining the market share from Chinese brands in Europe will be hard once they have established a firm position.

The most likely road ahead

We think that the European Union's probe into Chinese state subsidies is unlikely to result in a full-blown trade war, but it seems just as unlikely that the probe will not result in some significant changes with regard to the current largely uncontrolled EU market access for the Chinese automotive sector.

One of the most key factors mitigating the risk of a full-blown trade conflict is the simple fact that both China and the EU already have more economic challenges than they wish for. Risking their $900bln trade relationship may seem rather unattractive to both parties.

Furthermore, both economic power houses have an economic model that is very reliant on exports and thus thrive in a 'free' trade environment. A full-blown trade war would go very much against what both countries have been preaching for decades. Moreover, at this moment China and the EU are still too much mutually dependent to be able to deal with a fall out from such a trade conflict.

This may explain why China recently seemed to adopt a more conciliatory approach vis-a-vis Europe. For example, as Italy said it would withdraw from the Belt and Road Initiative, president Xi Jinping pledged to his counterpart Mattarella to promote a *"healthy and stable"* relationship. China is realising that Western firms are in the process of de-risking and slowly turning away from China (as we argued in this report). By showing good faith, China may be hoping to slow this process.

Finally, while the EU and the US do agree that the current trade- and investment relationship with China needs a serious revision, the EU's desire for more strategic autonomy will likely imply that the EU will largely determine its own course when it comes to their overall relationship with China. With this in the back of our mind we can get to our conclusion.

Conclusion

Future technologies are knocking on the door, but Europe does not appear to be fully prepared. Given the automotive industry's economic and cultural importance, we believe Europe will act to protect its industry. Consequently, we do expect the EU to take measures to slow down the import of Chinese cars, but we would argue that the EU is more likely to take the route of trying to achieve this in an amical way rather than through unilateral tariffs. Indeed, Dombrowskis' recent visit to Beijing seems to be just about that.

Regardless of the outcome of the tariff dispute, we believe European automakers will lose their dominant position in the Chinese market. Because Chinese manufacturers have a significant head start in battery technology and economies of scale, the European Union simply cannot protect European automakers' positions in foreign markets. A decline in comparison to the previous golden years, when European brands dominated the Chinese market, appears to be unavoidable.

However, this does not imply that Europe’s automotive industry is in inevitable demise. European companies have repeatedly demonstrated their ability to innovate, and policymakers have made it a top priority. While this should have been done years ago, it might help to soften the blow.

Furthermore, battery and EV technology is still evolving at lightning speed, implying that it is no given that Chinese firms will continue to dominate the field. Having to rely on an exogenous technological shock, however, is not a position of strength. Ongoing concerns about the European automotive sector could also fuel fears of slower growth, higher inflation from import tariffs, and a potentially weaker currency (as we argued earlier).

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