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Shift happens: Will the EU-CEE automotive industry benefit or suffer from the industrial reshuffling?

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The transition to electric vehicles is a major industrial challenge for the European Union, with consequences for all manufacturers, despite differences between Member States; as well as the subject of major debates within the Green Deal. Michal Hruby's blog post opens up an essential debate on the definition of European industrial policy between East and West, and provides a very clear position from the so-called Visegrad countries on the differentiations, complementarities and convergences between these national contexts. It also calls for consideration of the reconfiguration of automotive industry value chains between Member States within the internal market, but also with external partners. On the basis of this position, it will be essential to structure an in-depth debate on the key issues of industrial employment and competitiveness in the short and long term.

"We need a European industrial policy. Not a national fragmentation."

Enrico Letta (President of the Jacques Delors Institute, former Italian Prime Minister) for Politico on preparing an official report on the state of the EU Single Market for the European Commission.

Bigger picture

More than ever, stakeholders realise that industrial policies are back in the mainstream of economic policymaking and can make a difference in achieving a competitive advantage. One can easily witness the surging amount of unilateral policy interventions, be it through trade, investment, research, innovation, or the labor market, seemingly falling outside the scope of industrial policy yet well aligned with it. Not surprisingly, traditional industries, including automobile production, are integral to the targeted manufacturing sector worldwide, primarily due to the change in today's perception of tomorrow's competition with China.

The 2023 EU Green Deal Industrial Plan and its proposed building block, the Net Zero Industry Act, are but an answer from the EU, steering the industrial development and green transition towards 2030 and beyond within the EU borders—this time with a pinch of dirigisme. Not only are these new strategies crucial for the timely delivery of the ultimate goals of the 2019 EU Green Deal, but also for maintaining and strengthening the resilience and competitiveness of the EU businesses in a changing geopolitical environment.

However, as I argue in this blog post, Czechia and its like partners in the EU automotive industry face not only the risk of extra-EU competition in the transition to electromobility, but also an intra-EU risk of the EU Single Market decay under the beggar-thy-neighbor national industrial policies. I conclude that EU policymakers should limit the internal damage to product and labor markets from the double-edged sword of industrial policies and focus on the external dimension of competitiveness. Yet, Czechia and the like countries must be equipped with a flexible and just strategy to cope with possible automotive production scale-down and a threat of "stranded" people, a soft-landing plan.

Pride goes before a fall

The automotive fellows from the Central and Eastern EU Member States (EU-CEE, including Czechia, Hungary, Poland, Romania, Slovakia, and Slovenia) have experienced a transformation into a solid manufacturing base over the last decades. Their economic convergence and integration into the EU Single Market have been led mainly by foreign direct investments, which for economists seems evident as the integration process opened new opportunities for foreign investors and capital movement. It boosted local short-term growth, albeit with mid- and long-term challenges of this growth model flagged in advance given the high reliance on exports in the hands of foreign companies and possibly a lower labor productivity growth compared to the advanced EU economies.

The then-increasing economic complexity and growing automotive industry in the "integrated periphery" saw a sign of a slowdown after the global financial crisis and before the pandemic outburst. The countries have long benefitted (and still benefit) from various EU finance tools, from common EU industrial and cohesion policies, national contributions, and state aid. Although this has been a much-needed booster for large energy and transport infrastructure projects for most converging and energy-intensive EU-CEE regions, it could not change the economic fundamentals of the EU-CEE countries in such a short period. The region is still only beginning to transform in many areas of its infrastructure.

The functional specialisation of EU Member States remains persistent over time, and the EU-CEE countries mostly build their specialisation in fabrication and technical support. While the slowdown of convergence due to the "factory economy" model was worrying mostly for economists, the pre-COVID decade has been fantastic for many automotive employees. In Czechia, for example, the labor market witnessed a prolonged period of high job vacancy rates in manufacturing, including the automotive industry (above the EU average), compared to a very low unemployment rate (below the EU average), helping to achieve a real wage growth across multiple years.

While there was a permanent need for a new workforce, the Czech automotive industry's productivity was still relatively low compared to the Western European neighbors. Although one could find great EU-CEE examples of automotive industry manufacturers or suppliers operating near the technology frontier, the sum of these companies could still hardly be called an industrial frontrunner. To be clear, the final automobile producers and a large share of suppliers are foreign-owned by their mother companies, with a possibility of significant positive spillovers. However, they operate primarily on fabrication tasks, and these spillovers do not fully materialise. In contrast, most suppliers are small to medium enterprises under the pressure of the oligopolistic final producers exerting considerable market power.

Overall, a large workforce and capital are tied to a traditional manufacturing industry that many people feel proud of. It has been facing the most significant transformation in the last decades, with possibly large and unequal impacts on regional prosperity. Although the industrial leaders, i.e., the final producers, agree on the need for a green transition towards electromobility (they already invested heavily), it might not fully translate into actions when short-term losses start to add up in the face of aggressive competition in electromobility for masses from Asia. The recent anecdotes of lobbying for a weak EURO 7¹ and a possible postponement of the market introduction of affordable electric vehicles raise awareness of the strong state capture by automobile producers, presumably led by the German and French carmakers.

Friends and foes

Fast forward, we went through major economic shocks in the last four years, including the global pandemic outburst, supply chain shortages, and Russia-induced war in Ukraine, and woke up to a new foreign and industrial policies paradigm, especially given the perception of economic vulnerability and dependence on foreign essential goods. The EU-CEE region stands alongside the other EU Member State fellows between giants, the US and China. Yet, the eastern EU bloc countries must also pay special attention to the happenings within the EU.

First, the most obvious risk for the automotive industry across the EU countries is the incoming Chinese (or, generally Asian) competition in electromobility—pushing the technology frontier of electric vehicles, achieving larger effects of economies of scale, accumulating faster the knowledge in mass battery production, and already reaching the design, quality and taste of the EU customers; yet also relying on large financial and non-financial subsidies by the Chinese government, currently under an anti-subsidy probe of the European Commission, setting lower environmental, social, and governance standards and values compared to the EU Single Market, and relying on overseas and long-distance product exports so far.

However, one can expect a quick rise and local market penetration, including new Chinese greenfield investments into electric vehicle factories and battery production based in the EU, which will slowly add pressure on the legacy EU automobile producers before they can fully materialise on the innovations and new product diffusion of domestic origin. Shift happens, and the reshuffle on the EU market could also lead to changes, both scale-ups and scale-downs, in the regional production and employment levels in the EU-CEE countries, where the high share of the automotive industry on the gross domestic product now poses a bigger-than-ever threat should the industry slowly start to vanish.

Second, the risk of an intra-EU race-to-the-bottom and beggar-thy-neighbor industrial strategies has been slowly creeping up through the last four years, culminating in serious debates over the future of the EU Single Market and its State aid rules. While there is a consensus that we all as EU Member States need to benefit from a robust economic partnership with Germany and France, a pillar of the EU economy, it must not come at the cost of diverting investments from the EU-CEE region, artificially increasing barriers for EU-CEE exporters reaching the western markets, or generally postponing the process of the economic convergence.

Unfortunately, the EU took steps towards loosening the State aid rules not only for the crisis period but also beyond, especially through the Temporary Crisis and Transition Framework. In its “first” and the actual crisis period, the framework allowed for a disproportionate support in favor of the German and French businesses. The “second” period is scheduled to mobilise the transition part of the framework for projects aligned with the green manufacturing goals of the Net Zero Industry Act. Hence, voices appear for preventing the EU Single Market's fragmentation, especially when the EU-CEE supply chains might continue facing higher risks in connection to regional war-related consequences, low availability of clean and cheap energy, and generally feeling the tight fiscal room relative to the deep-pocketed EU Member States.

Tinkering the new industrial strategies

First and foremost, the EU-CEE automotive fellows need not the fragmentation of the EU Single Market through run on State aid, potentially damaging the product and labor market. They should instead strive for a genuinely EU-wide industrial policy adhering to and complementing the cohesion policy. The external dimension of the EU industrial policy should be prioritised, maintaining competitiveness abroad. There are, however, three other areas I consider essential for tinkering with the national level of industrial strategies, and I show them in the example of Czechia:

First, **we need to be ready to let go**. Czechia and similar countries must be prepared for a possible scale-down in the automotive industry, potentially affecting the least productive companies and having unequal regional impacts. Although the country tends to balance capitalist behavior in good times and socialist behavior in bad times, there should be a clear signal that the government cannot keep fighting for struggling businesses and artificially keep those parts of economies alive. With record-like low unemployment levels but also relatively low productivity rates, Czechia should instead focus on the quality of the labor and incentives for upskilling and reskilling according to the needs of future industrial development, pursuing the goal of becoming a knowledge-based and innovation-driven economy.

Second, **no industrial policy is ever perfect**. Although some vertical industrial policies could make sense after close monitoring of the Czech economy, we should not readily hand easy money to big businesses in selected industries, including the final automobile or battery producers, as we are a too small economy for such types of incentives. The government could pursue horizontal industrial policies and focus on the structural reforms and institutional framework, which was already due years ago, including a bottom-up approach to increasing social dialogue and labor market conditions, including labor quality and less restrictive bureaucracy for small and medium enterprises and the construction sector. A better institutional framework could be a positive factor in considering reinvestments by foreign-owned automotive companies. It makes sense to scale up bottom-up activities like regional innovation and industrial strategies focusing on investment promotion.

Third, **we need to be ready to absorb the funds**. After amending the ongoing multiannual financial framework and the Recovery and Resilience Facility (RRF) due to its new REPowerEU chapter, what conceptually lies ahead is the post-RRF green transition, including an alignment with the soon-to-be-enacted Net Zero Industry Act on the way to 2030 and beyond. Czechia needs to continue benefitting from an incredible pot of money, including the EU industrial and cohesion funds, yet conditional on those key structural reforms already due ten years too late. The country should be able to absorb the funds for value-adding projects. The institutional capacities and overall legislative framework should be amended to enable tailor-made interventions on the industry- and firm-level (if necessary), primarily to support small and medium enterprises and new emerging companies.

Policy recommendations

If I could lay out recommendations in the hope of inspiring any policymaker in Czechia or the like automotive-based fellow countries in the EU-CEE, although undoubtedly some of these pieces of advice are already considered at the national level, I would sketch these three basic recommendations as follows:

One. In Brussels, Czechia should clearly communicate the need for an EU industrial policy that adheres to cohesion policy, including just transition, incentivises private rather than public spending, and the urgency to monitor and limit any adverse side effects of loosening the state aid rules for the green transition.

Two. The country should prioritize creating the enabling conditions for businesses and entrepreneurship and limiting the excessive domestic bureaucracy that limits many industries and deteriorates the prospects of reinvestment of foreign companies in Czechia. This, however, must be different from the possible state capture by large businesses.

Three. The government should elaborate an industrial strategy, including increasing its analytical and regional capacity, and lay the foundations for the upcoming EU multiannual financial framework programs and the post-RRF green transition. A soft-landing “what-if” social plan for the automotive industry is necessary in case of adverse development and could be considered at the national and EU levels.

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[1 https://www.europarl.europa.eu/news/en/press-room/20231009IPR06746/euro-7-meps-back-new-rules-to-reduce-road-transport-emissions](https://www.europarl.europa.eu/news/en/press-room/20231009IPR06746/euro-7-meps-back-new-rules-to-reduce-road-transport-emissions)

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