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The European Automotive Supplier Report

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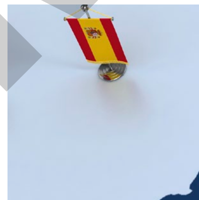

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REGIONAL REPORT

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CHAPTER ONE

Economics of the automotive industry in Europe

- The region's recovery from the great financial crisis proves challenging as periods of economic growth have been followed by recession in recent years.
- Various factors are supporting a tepid economic recovery, including the weakness of the Euro, the expansive monetary policy of the European Central bank as well as low energy prices.
- Major differences are emerging within the region, with periphery economies still attempting to fully recover to 2008 GDP levels, while Germany and other Baltic economies are well above their 2008 GDP levels.
- Potential headwinds are linked to the strength of the Chinese economy and the ongoing risk of Greece exiting the Eurozone. Implementation of structural reforms to labour markets remains fundamental in creating a sustainable long-term economic recovery, especially in Southern Europe.

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This report focuses on Europe; defined as the European Union countries plus Russia. Different definitions of Europe exist, which reflect the intricacies of a region which has a diverse economic and social fabric and several entangled layers of collaboration among its members. Such complexities have an impact on the economic and social development of the region, therefore also on vehicle and component sourcing patterns of OEMs and suppliers which operate in Europe. Among the main classifications used in this report:

- **Euro-zone countries**: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain. These 17 countries represent the economic core of the region with 12.5 trillion USD of combined GDP. They share a currency, the euro. The Euro is also used in smaller states like Andorra, San Marino, Monaco and Vatican City, while Kosovo and Montenegro use the Euro even though they are not officially part of the Eurozone. The European Central Bank (ECB) sets the monetary policies, therefore interest rates, for the Eurozone, while fiscal consolidation measures are delegated to the individual members of the monetary union. Financial ministers from Eurozone countries meet at the Eurogroup, which is the only form of collective oversight on individual members' fiscal policies together with the ECB.

- **European Union**: Eurozone countries plus Sweden, Croatia, United Kingdom, Poland, Lithuania, Latvia, Hungary, Denmark and Czech Republic form this economic and political area, which was designed to enhance trade, by forming a 28 country-strong single market. Other than Sweden, Denmark and the UK, which have negotiated an opt-out, all European Union countries are obliged to eventually join the Euro once they meet the "convergence criteria" (inflation target, budget deficit target, debt to GDP target, exchange rate vs. Euro and long-term interest rates). Membership to the European Union is regulated by the Copenhagen criteria, which monitor aspects like democratic governance, human rights and the country's economy. The eastwards enlargement of the union is an ongoing issue for the EU, with several countries having applied for membership and currently in the process of implementing measures to meet EU requirements. Among these Albania, Serbia, Kosovo, Macedonia and Montenegro. Other countries like Turkey and Iceland have witnessed in recent years some interest in joining the Union, however their chances of joining appear slim in the near future.

- **European Economic Area (EEA)**: including European Union countries (ex. Croatia) plus Iceland, Liechtenstein and Norway. This group of countries grants Iceland, Liechtenstein and Norway access to the European Union's market without subscribing to all of its regulations. Major exclusions are regulations on agriculture and fishing.

- **European Free Trade Association (EFTA)**: Switzerland joins Iceland, Liechtenstein and Norway in this free trade association. Switzerland decided not to join the EEA and has access to European Union's internal market through a bilateral agreement.

- **EU Customs Union**: Monaco, Turkey, San Marino and Moldova have an agreement in place with the European Union, which allows goods to travel without incurring any customs duty. This is not a free trade union, and therefore the 31 countries have agreed to impose a common tariff for goods imported from outside the Customs Union.

- **Central European Free Trade Agreement (CEFTA)**: This free trade agreement area involves Albania, Bosnia-Herzegovina, Macedonia, Moldova, Montenegro, Serbia and Kosovo. It does not have a free trade agreement with the EU and countries that join the EU automatically lose their affiliation to the CEFTA upon joining.

- Countries like Russia, Kazakhstan, Georgia, Ukraine, and Belarus tend to remain outside some of the wider European central economic pacts, but are however considered under the European region.

Economic Review

The European Union is the world's largest economy since 2014 with a global gross domestic product in nominal terms of 18.4 trillion USD in 2014 according to International Monetary fund data. The EU, which accounts for only about 7% of the global population, has overtaken the US in the ranking of the economic areas and now represents about 24% of the global GDP as of 2014. The Eurozone represents the core of the European Union from an economic standpoint, accounting for about three quarters of the overall GDP produced in the European Union.

The region is a hub in the global trade network, being the largest exporter and the second largest importer. The US are the main export destination of European-made items and services, while China is its main import partner, representing about 17% of the overall imports into the region. While Europe is among the most advanced economies in the world, it has been facing major challenges over the last seven years since the global financial crisis in 2008.

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On the economic side, the region's economic recovery from the great financial crisis has had much less momentum than the US. It has taken the Eurozone three years to achieve the economic levels of 2008 again, with GDP of about 13 trillion Euros. However, following two years of economic recovery like that of 2010 and 2011, associated with GDP growths of 2.1% and 1.7% respectively at the European Union level, the momentum has stalled in 2012. The slowdown has been perceived more boldly in the core Eurozone region with a reduction of GDP by 0.9% compared to 0.5% to the entire European Union. In 2013 the economy of the Eurozone contracted again, while the overall European Union GDP expanded, further highlighting the issues in the core Eurozone. This trend was also recorded in 2014 when a mild recovery took place in the Eurozone region (0.8% increase of GDP) vs. 1.3% at the European Union level. The recent mild improvement of the economic momentum and consensus about the fortunes of the Eurozone has several drivers, including the sharp decline in oil prices, the depreciation of the Euro, fewer fiscal headwinds and the further easing of monetary conditions via quantitative easing that the ECB has granted to deal with Eurozone periphery countries' financial woes. In November 2014 a new EU investment plan was announced by the newly installed European Commission with the intent of boosting the European economy through electrical, telecommunication and transport infrastructure investments.

The labour market has been improving, but slowly, with unemployment rates in the EU dropping below the 10% threshold for the first time in three years in November 2014 and remaining in the 9% territory in 2015. The US in the same period recorded a drop in unemployment rates from 9% to 5.5%. High unemployment has been a major dampener of consumer spending in Europe and shows how the recovery is still subdued. In the core Eurozone unemployment remained above 11% in the first half of 2015. Confidence indexes in the region show that consumer confidence remains low as well as that of the industrial business, which remains one of the core economic engines of the region. On the other hand, the services sector tends to record stronger confidence levels. While various regional-level metrics are showing that a fragile recovery is taking place in the region as a whole, the geographical footprint of the recovery remains non-homogenous. Of particular concern are the high unemployment rates recorded among young people in Southern European countries (over 40% in Spain, Greece and Italy), as well as statistics about long-term unemployment.

While Germany, the economic engine of the region accounting for about 20% of the region's GDP, is coping with unemployment of 4.7%, Spain, the region's fourth largest powerhouse, is coping with unemployment rates in excess of 22%. For example, Spain and Greece are clocking 26% and 27% unemployment respectively. The resulting imbalance of economic growth is evident as Germany expanded by 1.6% in 2014 compared to 2013, while Italy went through its third year of economic contraction as GDP shrank by 0.4% in 2014; Eastern European countries have performed much better with Poland expanding by 3.8% in 2014.

The broader challenges that the region is facing are not only economic. One political challenge with an econ0mic impact is linked to the expansion of the Union, which causes increasing friction with Russia, as proven by the military confrontation east of the European Union in Ukraine. Such confrontation has brought the issue of a common defence system back on the agenda of the European Union, with most of the advocates for such a system among Eastern European member states which are closer to Russia's historical influence area. In a bid to reduce Russia's assertive attitude in the Ukrainian civil war, the European Union has implemented sanctions on Russia's financial, arms and energy sectors in September 2014. The sanctions have exacerbated a difficult economic situation for Russia, linked to a substantial drop in oil prices, upon which about half of Russia's federal budget relies. Russia's main trade partners in the European Union like Germany, Italy, France and Poland, have also been hurt by Russia's retaliation against the US and European Union's sanctions; for example, by imposing an embargo on food imports. Another critical challenge for the Union is fine-tuning its immigration policy to deal with the inflow of immigrants from Middle East and Africa, mostly linked to the unstable political situation in Syria and the rest of the Middle Eastern region.

Economic outlook

The above mentioned drivers of economic growth are going to support the Eurozone through a phase of mild economic expansion in the next few years, however probably a disappointing one if we consider the temporary nature of the stimuli that the economy is receiving. The ECB is not expected to withdraw its quantitative easing measures before 2017 as the region attempts to gain further economic momentum, and the health of the financial sector has further improved, especially in periphery economies of the region. Inflation has been lower than one percent in 2014 and is not expected to increase substantially before 2017, supported by lower energy costs. Oil prices are also expected to stay subdued in the next couple of years as a consequence of a slowdown