Letter n°70

The new faces of globalization (2): Europe, the obstacles to overcome.

"Europe visibly aspires to be governed by an American commission. Its entire policy is directed to that end.”
Paul Valéry in 1930.

Europe has long proved Paul Valéry's words right in many areas, but with its internal dynamics and the pressure of world events, it is deepening its integration.

Since the signing of the Treaty of Rome in 1957 and even more so since the entry of Great Britain in 1973, the European Union has been above all a free trade area and, with the exception of agriculture, a large market open to the world.

In recent years, faced with five phenomena, the EU has taken on a completely different face:

- Brexit has paved the way, previously refused by the British, to the definition of common policies. Inconceivable before the UK’s exit, the adoption of the €750 billion European recovery plan, with the mutualization of a common debt, is a convincing example.

- Secondly, the Covid crisis illustrated the value of pooling resources for the supply of vaccines to the Union, a prelude to other common actions.

- Also, the Chinese takeover of a German technology company, the belated awareness of the effects of Chinese control over the Greek port of Piraeus and the Chinese decision to boycott products from Lithuania after it supported Taiwan were all incentives to define a common policy in relations with China at the end of 2021.

- At the same time, the Ukrainian crisis and the inflation of energy prices prompted the Europeans to agree to set a target price for Russian oil at $60/barrel and gas at €180/MWh, and to accelerate the implementation of a carbon tax at the borders.

- Finally, the Americans’ adoption of the $370 billion IRA plan in August (see our Letter 69) is pushing Europeans to consider the implementation of comparable measures to help reindustrialize the continent, encourage relocations and facilitate the energy transition, perhaps in the form of a "Buy European Act" like the "Buy American Act" created by Roosevelt in 1933.

In history, there are many examples of nations or unions formed in reaction to external pressures. What we are witnessing is not a revival of the EU on the international scene but an awakening, not a resurgence but an emergence of Europe.

Opposed to Russia since the invasion of Ukraine, indisposed by the upcoming implementation of the IRA in the United States and irritated by China’s attitude, the EU is becoming more aware of the attractiveness of its large market, of the leverage power thus available in international negotiations and so it intends to carry more weight in the face of China, Russia and even the United States.

At the same time, if Brussels is learning to find a response to the Hungarian reticence regarding sanctions against Russia, and to Hungary’s and Poland’s infringement of the independence of the judiciary and the media in their countries, a lot remains to be done. But without being naïve, this Letter is optimistic about the future of Europe and the attractiveness of its stock market.

To address this issue, we will analyse successively the three challenges to be overcome and the six policies that were recently implemented.

- **The three challenges to overcome**: American competition, energy costs and Chinese competition.

  - ***American competition***:

The United States is an economic, political and military partner for Europe, and at the same time, even if the ties are close and long-standing, it is a commercial rival.

US companies employ 4.9 million people in the EU and Europeans employ 5 million Americans in the US. Sales of US subsidiaries in Europe reached $3.4 trillion, more than total US exports. In terms of flow, US investments in Europe have increased by 10% this year and has reached $4 trillion cumulatively. European investments in the US rose by nearly 15% to $3.2 trillion.

In the relationship between Europe and the US, Biden has put an end to the conflicts initiated by Trump, on Airbus, aluminum and steel, but now the debate is about energy prices and the IRA.

US oil and gas companies benefit from the high gas prices and additional demand from the EU. Overall, in Europe, gas-dependent sectors such as paper, chemicals and steel generate €600 billion in turnover and employ 8 million people.

No battery factory development is conceivable without competitive energy. The fact that BMW is investing $1.7 billion to expand its South Carolina plant, and the fact that Northvolt, Europe's leading supplier of batteries notably to VW, BMW and Volvo, is abandoning its plant project in Germany in favor of an investment in the US for which, according to the Financial Times, it would benefit from a subsidy ($600 to $800 million), are important issues.

Examples can also be seen in other sectors, with the Italian company Enel's solar components subsidiary and, conversely, American companies preferring to invest in America rather than in Europe.

Enticed by the IRA, Saint Gobain recently made three acquisitions in the US for €4.5 billion, in plasterboard and in construction chemicals to strengthen its positions in construction, renovation, decarbonization and building insulation with electrochromic glazing, a glass that reduces air-conditioning needs by coloring. Thus, by 2030, the group expects Europe's share of its sales to fall from 67% to 50% and North America's to grow from 13% to 25%.

Germany, with an industrial sector accounting for more than 20% of GDP, is one of the countries most affected by the rise in hydrocarbon prices. The energy-consuming sectors account for a quarter of the country's industrial jobs and chemicals alone account for 400,000 employees. According to German forecasts, one in four German SMEs in industry is considering relocation and it is estimated that, despite the €200 billion plan, 10% of these jobs have already been lost.

Germany, the country most affected by US competition from the IRA plan, is advocating for a similar plan in Europe with the same aim of promoting a low-carbon economy.

  - ***Energy costs***:

European governments complain that gas prices in the US are 3 to 4 times lower, a handicap for industrialists in sectors such as chemicals. According to ***Thierry Bros***, American gas is produced at $6/mBtu, or $9.90/mBtu after liquefaction and $13/mBtu after transport costs to Europe. The problem is the selling price to European manufacturers, $37/mBtu, is four times higher than the American price. At issue are the pricing formulas in long-term contracts.

Europe thus faces the highest energy costs in the world and the cost of this increase is equivalent to three percentage points of GDP.

As a result of the energy price differential between the EU and the US, particularly in gas which is an important factor for the German chemical industry, the European chemical industry recorded a trade deficit for the first time. Not only did European production fall by 2.1% in the first eight months, but also investments by large European firms in the US, such as Solvay in Wyoming, are increasing while the share of turnover generated in Europe by European companies is falling. The BASF Group has stated it wants to reduce its production capacity in Europe as quickly as possible and also permanently because its gas bill has increased by more than €2 billion since the beginning of the year and the company is thus in a loss in the 3rd quarter.

To help the sectors in difficulty - chemicals, paper, metallurgy - the 27 agreed on a tax on the superprofits of companies in the oil sector. It could bring in nearly €150 billion, but this is not enough.

- ***Chinese competition***:

For a long time, Europe has been angelic in the face of Chinese competitors who do not hesitate to subsidize their production.

Thus, between 2011 and 2021, European imports from China almost doubled and the EU's dependence on Chinese strategic components such as rare earths, IT or telecommunications equipment, was aggravated.

At the same time, the Chinese have increased their holdings in European companies.

- **The six means implemented**:

There is nothing like an electric shock to incite a wake-up call and to define a common industrial policy. We are therefore witnessing the definition of a less liberal and more interventionist policy, a desire to relaunch Franco-German cooperation, a search for ways to circumvent the unanimity rule in order to facilitate the decision-making process within the EU, a quest for a common policy in energy and industry, a firm policy towards China and finally a desire to move towards a European defence.

- ***A more interventionist approach***:

Since 2019, public spending has increased by four points to 51% of GDP against 37% of GDP in the US.

In parallel, the EU budget rules, budget deficit below 3% of GDP and public debt below 60% of GDP, remain suspended.

On the tax front, the EU has finally agreed to the minimum tax of 15% on companies from January 2024 to eliminate competition between countries, an agreement endorsed by 140 countries but not yet ratified by the US.

- ***A desire to deepen the Franco-German union:***

The Franco-German partnership has been the subject of many questions and doubts but all this seems excessive and lacking in memory.

Even at the time of General De Gaulle and at the time of the rapprochement with Chancellor Adenauer, Germany's Atlantic tropism was causing tensions. In its first version, the Elysée Treaty of 1963 provided for the development of joint armaments programs. The Americans had sent Jean Monnet to the Bundestag to have a preamble added reminding them of the primacy of the Atlantic alliance. It was a slap in the face for General De Gaulle and Chancellor Adenauer.

Then, the Georges Pompidou-Willy Brandt duo was not exemplary because the German pushed the French to welcome the UK into the EEC.

Relations between Giscard d'Estaing and Helmut Schmidt and then between François Mitterrand and Kohl were close but there were differences: a reluctance towards Jacques Chirac's plan to revive the economy after the first oil crisis, an initial resistance to Greece's entry into the EEC desired by Giscard d'Estaing, and François Mitterrand's discomfort with German reunification which was overcome by the creation of the single currency. Finally, the Mediterranean Union desired by Nicolas Sarkozy was not to Angela Merkel's liking.

So many examples to highlight the differences in sensitivity between the two countries but they did not prevent the Franco-German partnership from functioning.

Today, France wishes to deepen the European Union to 27 members and, with the Balkan countries or Ukraine, prefers the project outlined by Mitterrand in the early 90s of a second circle. Germany, referring to Chancellor Olaf Scholz's Prague speech, favors an enlargement of the EU towards the East, the six Balkan States (Serbia, Montenegro, Bosnia, North Macedonia, Albania, Kosovo) on the one hand, and Ukraine on the other. The decision is delicate because the original balance of Europe, in the West, would be shifted to the East and the differences in living standards are gaping. Some suspect a desire to counterbalance France but we do not believe it. We do not see any potential for Germany in this strategy. The conservative government of Poland, with a population of 44 million, has not had very friendly relations with Germany for a long time. The agreement with Hungary is impossible and the other countries in the region are small.

Germany must be given time to adapt its model. Cut off from Russian energy, it cannot cut itself off from the Chinese market. The accusation that Germany is playing a lone hand in the relationship with China is excessive because, firstly, all countries are doing the same and, secondly, unlike Angela Merkel, Olaf Scholz has been to China with a small delegation as well as to Vietnam, Singapore and Japan.

It is difficult for France to blame Germany for a €200 billion plan to limit the effects of rising energy prices because France is behind a similar €100 billion plan.

Germany and France, together accounting for over 40% of European GDP, are calling on the EU to support emerging industries essential to the energy transition and will go to the US in January to plead the European cause and to try to obtain exceptions to IRA measures.

In January 2023, it will be the 60th anniversary of the Elysée Treaty signed by General de Gaulle and Chancellor Adenauer and we can expect joint progress.

- ***Towards abandoning the unanimity rule***:

The primacy of European law does not date from 1957 but from the Treaty on the Constitution of the EU in 2005 and the 2007 Lisbon Treaty. Each member was free to enter the EU but must be committed to respecting Article 2 of the Lisbon Treaty, namely the rule of law, freedom, democracy and the separation of powers. These documents, signed by governments and ratified by their parliaments, organize a Europe of nations, not a federal one, and allow the possibility of leaving the EU with Article 50. European law is voted by the Council, then the European Parliament and finally the national parliaments. European directives are validated by national parliaments.

To strengthen the EU, the unanimity rule must be abolished. In the face of Poland and Hungary, pusillanimity cannot persist because these two countries trample on freedom of the press, the independence of the judiciary, the rights of minorities and allow corruption to develop. The money paid by the EU must not be hijacked, as in Hungary, or used to keep power.

Hungary has been ostracized by Europe and even abandoned by its Polish ally. It faces a difficult economic situation, with high inflation that has forced it to raise rates to more than 11%, and is unable to do without Community funds. In seeking to obtain the payment of €5.8 billion in aid plan from Brussels, Hungary has had to lift its veto on €18 billion aid to Ukraine, accept the OECD directive on the minimum 15% tax rate on multinationals, commit itself to reforms to restore the rule of law, fight corruption and restore the independence of the judiciary. If no agreement is reached by 31 December, Hungary will lose 70% of these subsidies.

Other positive points for the EU are that Meloni in Italy is not questioning the membership of the EU and Sunak, the British Prime Minister, is seeking to reduce disputes with the Union.

- ***Deepening cooperation in energy and industry***:

The EU emits 2.4 times less CO2 per capita than the US and these emissions are decreasing faster. As a result of this and its social policies, the EU has a longer life expectancy, 81 years compared to 79 in the US and 77 in China.

There is a breakthrough in the "Europe of energy" and the idea of strategic autonomy. Europe is stopping Russian coal purchases, €4 billion/year, and oil purchases and, if it maintains gas deliveries, an agreement has been reached on a gas price cap of €180/MWh, with the current price coming down from €340/MWh to the present €110/MWh.

In response to the IRA, it would be difficult for the Europeans to sanction the Americans by taxing their products on import and a complaint to the WTO would be ineffective because it would lead to retaliation. Similarly, one can conjecture a suspension of the tax on digital services directed against mainly American groups.

Trying to obtain exemptions from the IRA for European companies would be better. Launching a European equivalent of the IRA would be preferable. Considering the creation of a European sovereign wealth fund through a community loan and contributions from member states to finance the industries of the future, such as biotech, AI, semiconductors and hydrogen, is an interesting option defended by the European Commission.

The European ambition to reindustrialize and stengthen strategic independence should be accompanied by budgets or even a legal framework, a sort of "Buy European Act", a replica of the 1933 "Buy American Act". On this condition, Europe will be able to compete on an equal footing with the US.

For the time being, the EU accepts aid for the development of green hydrogen, just over €5 billion, but European aid to these industries of the future comes from a reallocation of EU budgets. Van der Leyen's idea of a sovereign wealth fund or EU debt is not yet accepted by Germany, but progress in this direction is likely in 2023.

Inevitably, there will be job losses, in paper or ceramics, but the card to play is that of the sectors of the future. The EU must, for example, be careful as the head of Airbus stressed not to be left behind by the Americans on the hydrogen aircraft of the future.

For now, while the US is subsidizing decarbonisation, Europe aims to penalise fossil fuels with a carbon tax at the borders to protect EU companies from cheaper imports from countries with less demanding climate policies. Concretely, companies exporting to the EU will have to buy pollution rights at European market rates if their productions cause emissions above European standards. The idea is to encourage the rest of the world to adopt European standards, to mitigate the risk of ecological dumping, i.e. to make an industrialist who has relocated his polluting production pay. But while it is easy to tax intermediate products, it is difficult to tax finished products such as cars.

This is not protectionism because European and non-European producers will pay the same tax, but the US administration has expressed its concern and other countries are opposed to it.

The European Commission wants to reduce emissions by 55% from 1990 levels by 2030, but much of the investments needed to accelerate the energy transition are unfunded. It is hard to imagine the installation of six wind turbines per day. It will require a substantial increase in EU subsidies.

In renewable energies, the Europeans, already killed off by Chinese competition in solar panels, should favour the major European players in wind energy such as Vestas, Siemens-Gamesa and Nordex, but they are losing out, suffering from Chinese competition and rising steel costs, and cannot access the Chinese market.

The European Union is reviving the exploitation of rare metals and there are countless of lithium mining projects in France with Imerys, in Austria, in Finland, in Portugal or in the Czech Republic, all with the aim of achieving greater independence from China. This is essential if the European Union wants to achieve its objective of a 25% market share in the global production of electric batteries in 2030, compared with only 2% in 2020.

- ***A tougher policy against China***:

The EU's critical dependence covers only 5% of imports. Of the two partners, the EU has understood that China has more to lose if relations between the two blocs sour. Therefore, at the end of 2021, Europe decided to join forces to speak to China with a firm voice and to submit to Brussels' control any attempt to take control of a company in a sector deemed strategic. In return, China obtained the possibility of investing in renewable energies in Europe within the limit of a 5% market share in each country.

But the implementation of the International Labour Organization's convention on forced labour is not yet effective, there is no court of arbitration and, if Europeans can more easily access the Chinese market in finance or chemicals, in some sectors the restrictions are undeniable: for example, telecommunications because Internet networks and e-commerce remain closed to European investors. For example, in the automotive sector but VW does not plan to withdraw from the Chinese market because it makes 50% of its profits there.

Germany has blocked the sale of a factory of the German semiconductor group Elmos to a Swedish company, a subsidiary of a Chinese company SIA Microelectronics and the EU has decided to take China to the World Trade Organization against sanctions imposed on Lithuania. But the Dutch government has told the Americans that it will not follow the measures against China to the fullest, leaving the door open to ASML exports in semiconductors.

- ***European defense projects***:

The war in Ukraine favors a resurgence of NATO, a reaffirmation of American influence and an increase in US arms sales.

But the American return is temporary because the eye of the United States is riveted on Asia in general and Taiwan in particular and therefore the EU must think about its defense and emancipate itself.

The strategic differences between France and Germany in the field of defense are long-standing. France has always believed in strategic independence, Germany has always thought that there was no alternative to an Atlantic Alliance, but the two countries are trying to move closer together.

Under Mitterrand's presidency, the Franco-German brigade was created, but thirty years later, Germany would like to develop the combat tank of the future on its own. On the other hand, Germany's recent purchase of American F-35s corresponded to the need to replace the Tornado fighter aircraft, but does not compromise the development of a European fighter aircraft. In association with Airbus in Germany, Dassault will start studies on the prototype that will replace the Rafale and Eurofighter in the 2040s, a project worth some €100 billion. The aircraft will be under the responsibility of Dassault, the engines under that of Safran, the drones and the combat cloud under that of Airbus. A competing project involving Japan, the UK and Italy is expected to be launched.

Conclusion: "***In a world full of carnivores, the herbivores among which the Europeans were counted do not have an easy life." Sigmar Gabriel***, former German Foreign Minister.

Crises can be opportunities and Europe offers examples of this: the energy transition is being accelerated by the rise in hydrocarbon prices, reflection on European defence is reinforced by the war in Ukraine, and industrial policy in favor of the energies of the future is stimulated by American competition from the IRA.

Among European countries, there is not necessarily recourse to protectionism but rather enhanced cooperation in order to compensate for the lack of R&D, the small number of large groups in new technologies, the delays in semiconductors and the weak structural growth.

To encourage reindustrialization, facilitate relocations and raise growth potential, an equivalent of the €750 billion European recovery plan, a "European sovereign wealth fund", could be an answer to the IRA. A partial recourse to Europe debt financing would be an option supported by France and the countries of the South. To date, this project has clashed with the Netherlands' concern for orthodoxy and divided the German government but progress is expected in 2023 and we therefore remain optimistic about the future and the attractiveness of the European market.

Geneva, 28th December 2022

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