GEAR 2030 DISCUSSION PAPER

Trade, international harmonisation and global competitiveness

Scene setter
Competitiveness of the EU automotive industry is very important for the growth of the EU economy. The EU automotive industry employs around 12 million people, has strong economic links with many industrial sectors and has socio-economic importance\(^1\).

The continued process of global economic integration means there is great potential for EU automotive manufacturers in emerging markets. Given that up to 80% of growth in the next decade is expected to come from outside of Europe, the EU automotive industry is likely to concentrate on accessing third country markets and tapping into the rationale of exploiting the economies of scale. The European Union is already a net exporter of cars and light commercial vehicles, and the trade surplus is increasing over time (€95 billion in 2014 and €120 billion including the trade in parts and components).

At the same time, road transport emissions continue to represent an important source of air pollution and green-house emissions, and the EU automotive industry remains largely dependent on energy imports for conventional (i.e. fossil) fuel engines.

Similarly, safety standards, quality and utility of vehicles are constituents that are increasingly shaping modern consumers’ choices and preferences.

In terms of emissions’ reduction and environmental protection the EU can no longer boast that it is an absolute leader, with the US, Japan, Korea, and also China moving ahead aggressively.

In terms of safety, the gap is also starting to widen in some cases (e.g. requirements for rollover, rear impact, armrests, auxiliary braking for heavy vehicles, electric vehicles test).

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\(^1\) Inter alia reducing the environmental footprint and global warming and maintaining high standards of safety and quality.
Figure 1. Emissions Standards for Selected Pollutants in the United States and the EU

Source: CRS Report 2014

Figure 2. International Fuel Economy and GHG Standards Comparison

Source: CRS Report 2014
Car makers can generally choose to serve a market by a) producing the cars locally or b) importing cars from plants outside the market. This choice of serving the market through local production or imports depends on a range of factors including business strategy, market size, trade costs associated with transportation and tariffs as well as non-tariff and regulatory barriers such as local content requirements, and market specific technical requirements.

Likewise, economic fundamentals of production costs (e.g. labour costs\(^2\), tax incentives and R&D) and market size are important determinants for car manufacturers in choosing the mode of supplying a specific market. Another important factor determining the location of production is the availability of local supply chains.

Currently, most of the cars that are sold in Europe are also produced in Europe and the larger original equipment manufacturers (OEMs) of non-European origin have production plants in Europe. Local production accounts for 86% of sales in the EU, while imports account for only 14% of sales in the EU (2012 figures).

In many large overseas markets, local production accounts for most of the total sales in Brazil it accounts for almost 100% of European OEM sales. In Japan and Korea, on the other hand, imports play an important role in meeting local demand for European vehicles.

Projecting growth, and considering only the Chinese, EU, US, Indian, Brazilian, Russia, Korean and Japanese markets, 115.5 million EU passenger cars are expected to be released onto the market between 2016 and 2020\(^3\) according to the available market data. However, all major markets with the exception of China are projected to stall in the future; Russia may return to growth in a couple of years resuming the pre-crisis levels by 2020.

**Figure 3. The Potential of China’s Vehicle market – International Vehicle Penetration Comparison, number of vehicles per 1000 people**

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Vehicles per 1000 people</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>800</td>
</tr>
<tr>
<td>Japan</td>
<td>600</td>
</tr>
<tr>
<td>Germany</td>
<td>500</td>
</tr>
<tr>
<td>Korea</td>
<td>400</td>
</tr>
<tr>
<td>China</td>
<td>100</td>
</tr>
</tbody>
</table>

Sources: JTC

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\(^2\) Labour cost in China and other developing countries is on average 6 times inferior to that of the EU or the US.

\(^3\) Working with an assumption that market shares of the EU industry remain stable.
Vehicle penetration in China and India is much lower than in the EU, the US and Japan for example, so there is a potential for significant growth over the next five to 10 years. It is expected that the Chinese market will reach 600 vehicles per 1,000 people by 2030. If the EU industry is not ready to tap into that potential the size of its market share could decrease progressively. The EU automotive industry business case, given its vehicle production profile, could be particularly strong for China. Over half of China’s urban households will be “upper middle class” by 2020, versus 14% in 2012, with an income of €15000 to €32000 a year\(^4\). Profits derived from operations in China already today represent an important source of revenue for European OEMs.

**Figure 4. China’s Rising Personal Incomes Mean Rising Vehicle Sales**

The EU automotive industry has been initially successful in gaining market shares in both mature and emerging markets outside the EU\(^5\), and many European car makers have invested substantially in overseas markets. EU manufactures have benefitted from these opportunities and the growing and positive trade surplus in passenger cars is demonstrating these achievements.

However, the positive trend reversed with the advent of the economic crisis in 2007. Europe’s well-developed automotive industry that suffers from fierce competition has since not fully captured the growth in car ownership outside Europe. As a result, EU sales

\(^4\) Forbes, March 2015.

\(^5\) For example, extra-EU exports, used a simple proxy for growth, increased from €65 billion in 2005 to €73 billion in 2008.
of passenger cars relative to global sales have decreased from 34 per cent before the crisis to 20 per cent today.

With a view to helping the EU industry to recapture this potential, and in order to grow strongly, the EU automotive industry will have to optimise its production and development cycles in a given broader policy constellation, i.e. climate and energy targets, changing mobility concepts and modifying demographics ecosystem. In this regard, EU Industry could benefit from effective public policy support.

In the latest trade and investment strategy Communication "Trade for All", the Commission considers trade policy should continue to place the emphasis on removing tariff and non-tariff barriers in the process of negotiating and implementing key free trade agreements. Evidence suggests that the degree of trade protection and the potential for reducing the impact of trade barriers in the automotive sector varies from country to country, but is consistently higher for final cars than for parts and components. According to Copenhagen Economics the impact of tariff elimination and the reduction of non-tariff barriers would, via the implementation of FTAs, lead to reductions in total (i.e. landed) marginal costs of cars of up to 12 per cent in the EU, and between 5 per cent (e.g. Japan) and up to 35 per cent (e.g. India) in the partner countries.

Another key element to remove non-tariff/regulatory barriers remains reinforced international regulatory cooperation, including the acceptance of international regulations under the 1958 UNECE Agreement. Global technical harmonisation is a key factor in strengthening the competitiveness of a traditionally highly export-intensive EU automotive industry. Common technical requirements, like those under the UNECE framework, reduce development costs and avoid duplication of administrative procedures.

While, striking a good bilateral trade deal can be very beneficial for industry, implementation and enforcement, which are key to realising the benefits, can be challenging.

In the context of rapid technological developments, mobility concepts and growing environmental concerns, it is expected that the automotive industry will recognise these constraints and will further improve its performance.

Implementation of stricter regulatory requirements that will provide a benchmark for the industry will require major investment and represent a significant financial burden. However, if spread across a long term horizon, regulatory requirements might create an environment that will provide incentives for fresh capital, helping the automotive sector to sustain their level of innovation, gain a leaner structure, and adapt to the challenges of the future, including those ensuing from the EU's 2030 and 2050 climate energy-objectives. The expectation is that the ambitious regulatory agenda will permit the EU

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6 The Commission more than doubled the funds for cooperative research and innovation in the automotive sector in the period 2014-2020, to support a faster transition of the EU industry towards the green vehicles, decarbonisation of conventional engines, improved safety and automation.


8 Copenhagen Economics (2014) "The impact of trade liberalisation on the EU automotive industry: trends and prospects" study produced for the European Commission, DG Trade, under framework contract (TRADE/07/A2).
automotive industry to continue accessing markets where the core growth value is being created⁹.

**Trade policy**

EU trade policy is an essential and highly effective instrument to facilitate exports to third countries.

In this context, as outlined in the Communication "Trade for All", important priorities for 2016 will include making significant progress in the negotiations with the US and Japan. One of the priorities in any FTA negotiation will be to address regulatory issues.

Given the importance of the automotive sector, the Commission tries to incorporate a sector-specific annex in FTAs under negotiation, wherever useful. As a general rule they will be adapted to the characteristics and market conditions of the EU's partners. They will attempt to resolve existing barriers, establish disciplines to avoid new trade barriers arising and promote harmonisation regulations covering technical requirements, conformity assessment and marking schemes. According to Copenhagen Economics, in 2012 the potential FTA partners¹⁰ represented more than 60% of total EU export of cars and 75% of total car import measured by value.

Furthermore, the trade Communication also acknowledges the increased significance of the global value chains and underlines the importance of imports of inputs, including energy and raw materials, for the competitiveness of the EU's production and exports. The role of SMEs, which are in particular important in the supply of components, is also recognised and all future FTAs shall include dedicated provisions to enable SMEs to better benefit from these agreements.

In addition, under "Trade for All", the Commission will also put increased emphasis on implementation and enforcement of FTAs already in place (such as that with Korea). To that effect, the Commission proposes enhanced partnership with Member States, the European Parliament and stakeholders which all share the responsibility to facilitate the implementation of the FTAs. This partnership will build on the existing co-operation (such as the Market Access Partnership, Civil Society Dialogues etc.), will enhance it and go beyond in particular with regard to awareness raising about the opportunities offered by the FTAs, co-operation at customs, regular reporting, monitoring and feedback gathering and so on.

The EU-Korea FTA has so far been beneficial for the car industry in terms of increased exports. In the fourth year of the FTA, EU exports of motor vehicles to Korea had increased by 206%, from €2 billion in the year preceding the FTA to €6.1 billion. However, non-tariff barriers remain an issue for the industry and some important lessons can be drawn from the implementation of the FTA. Though progress can be noted in terms of reducing the existing import barriers over the last four years, various technical and regulatory barriers continue to hamper effective market access. These are to a large extent due to different ways of regulating and in many cases the FTA does not provide a

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⁹ This is not an isolated rationale. For an example, the Australian 2013 report of the Parliament considers the following "... if the aim is to maximize Australia’s opportunities to export Australian-made vehicles it would, of course, be to Australia’s advantage to impose the strictest standards at home to ensure that all international standards are met and Australian-made vehicles are suitable to export to all international markets”.

¹⁰ 20 main trade partners for Europe.
legal basis to remove them. However, the annual working group established under the FTA to implement the Annex, provides an effective forum to discuss solutions to the market access concerns of both parties and to engage in closer regulatory cooperation. EU industry continues to have high expectations about the impact trade policy can have. However, a fundamental question is to what extent FTAs can be expected to tackle all regulatory barriers.

While FTAs provide improved market access for industry, the extent of the benefits can vary depending inter alia, on the compatibility of the existing regulatory frameworks and the state of the domestic industry of the trading partner concerned. In certain cases, regulatory alignment can be relatively limited or tariff reduction staging can be lengthy\textsuperscript{11}, which reduces or slows the anticipated benefits. In terms of incompatibility of regulatory regimes, the US is of course the biggest challenge. Reducing or overcoming over time this divide could potentially provide a significant economic benefit for both partners.

In "Trade for All" the Commission also pledges to continue its efforts to eliminate non-tariff barriers through regulatory co-operation. This is particularly pertinent in cases where FTAs are not an option and the policy continues to rely on bilateral regulatory dialogues with a view to ensuring at least common approaches or the equivalence of the existing and future automotive regulations and standards between the EU and the most important third country markets. For example, with China our main efforts up until now, have concentrated on promoting a common approach to measures of energy saving and to emissions' reduction, as well as reducing the impact of burdensome domestic certification measures. With India, if a bilateral dialogue could be developed this might provide a channel for regulatory co-operation. The EU has previously proposed provisions to address regulatory issues in the framework of the EU-India FTA negotiations.

**International harmonisation**

The Commission has been actively campaigning, both internally and externally, for a revision of the existing rules in the context of the UNECE 1958 Agreement with an objective to accommodate for the needs of emerging economies and to enable the mutual recognition of international whole vehicle type approval (IWVTA). This, together with the enhancement of the voting procedures to ensure that new contracting parties feel more fairly represented, is expected to further promote the efficiency of international regulatory harmonisation, as it will render the adoption and implementation of international regulations more attractive for third countries, whilst at the same time ensuring continued reliability and robustness.

The objective for 2016 is that the contracting parties finalise their respective national processes, and once the possibility of obtaining agreement has been verified, the proposals for the revision of the Agreement will be put to vote in WP.29 (tentatively in March 2016).

The IWVTA Regulation, even though partial in the first phase, will substantially reduce the administrative burden related to the type-approval and introduction of the same vehicle model in countries which are contracting parties to the 1958 Agreement and will apply this new UN Regulation.

\textsuperscript{11} For example the trade balance turned into a surplus only in a third year of the implementation of the Korea-EU FTA, and this is applicable for the sales of motor vehicles only.
The Commission will also continue to work in view of extending the recognition by trade partners of the 1958 UNECE Agreement as the forum for international standardisation and rule-setting in the area of motor vehicles, both at multilateral level in the WTO TBT Committee and in the context of bilateral agreements.

The EU-Japan FTA would further establish the UNECE 1958 Agreement as the forum for international harmonisation of motor vehicle regulation. The recently concluded FTA with Vietnam sets an example on how this policy should be implemented in the ASEAN region. There are also signs that the South American continent has started moving to better alignment with these international standards.

However, the evidence suggests there is a margin of discretion for transposition of international requirements into the national regulatory systems by the contracting parties. Furthermore, the risk is that the contracting parties, at one point in time, start withdrawing from applying the UNECE Regulations.

Within the framework of the 1998 UNECE Agreement the most promising areas of work are breakthrough technologies, focusing in particular on safety and emissions requirements for Electric Vehicles, with the impending work on the 2nd phase of GTR on hydrogen fuel cell vehicles.

TTIP would strive to enhance the regulatory relevance of the UNECE 1998 Agreement. A major challenge is to increase the transposition of GTRs by the contracting parties to the 1998 Agreement.

A deeper reflection on how GTRs are developed in terms of good regulatory practices, transparency and stakeholder involvement may be warranted.

**Global competitiveness**

In the automotive sector, a major forward looking challenge is to maintain or increase the share of high-quality and high-technology vehicles on third markets with an impressive growth potential.

Emerging emissions gaps, emissions measurement discrepancies, diverging consumer information standards, difficulties with the enforcement of existing regulations, as well as a growing number of FTA implementation/negotiation issues speak in favour of a domestic (EU) regulatory strategy that is more future-proof and ambitious.

In the absence of the necessary level of ambition, the EU automotive industry risks starting rapidly and irreversibly losing its market share, in particular on its most strategic markets, such as China and the US.

One important challenge to be considered is the future regulatory approach of China, in regard to the fuel efficiency/CO2 and pollutants standards, but also with respect to future test-cycles. What is equally worrying is the Chinese ambivalence towards global harmonisation. More concretely, China is weighing up the idea of dropping its historical approach of following the EU regulations (Euro 5, Euro 6) and adopting the US approach (LEV III), with even shorter phase-in periods than in the US. These plans complement another set of Chinese efforts to address CO2 emissions and energy efficiency.

Another, more immediate, challenge is related to the difficulties with the implementation of the existing EU regulatory framework (e.g. diesel emissions scandal), which
undermines the credibility of the EU policy and weakens its negotiating position vis-a-vis third country partners. Moreover, it has important ramifications not only for the entire EU automotive value chain, but also more broadly including the financial markets. Investors are becoming increasingly concerned about the risks posed by the scandal, fearing that the automotive sector has been destroying shareholder value, in particular as the risk rating agencies can easily start downgrading the automakers’ credit ratings. Many of these companies have already now credit ratings that are below the investment grade. Importantly, the competitiveness of the automakers will have direct effect on the other parts of the value chain, suppliers in particular, and could erode important value in those segments too.

The EU automotive industry should be prepared for these challenges well in advance, and one of the key prerogatives is a continued private and public investment\textsuperscript{12} in research, development and innovation which should help the EU automotive industry, in particular small and medium sized players to adapt to rapid production cycles and mitigate the weight of high capital expenditure, thereby seizing the opportunities supporting highly skilled jobs and growth.

\textbf{What is being proposed}

Taking the above considerations into account, the GEAR 2030 group may like to explore the way forward with a view to formulating certain policy recommendations, which while remaining WTO compatible and non-protectionist, may enhance global competitiveness of the EU automotive in the run up to 2030. In this context it would be in particular opportune to assess the potential of the existing EU level policy instruments promoting cross-border trade and evaluate the tools and actions that ensure more predictability and can continue generating value for the EU economy and society.

The following questions will permit to facilitate and steer the discussion.

\textbf{1.} To what extent has the market access landscape changed over the course of five years? Do trade barriers remain the main obstacle depressing the growth opportunities for the EU automotive industry? Similarly, does the EU’s own tariffs and regulatory environment discourage investment of foreign companies in the European market?

\textbf{2.} Negotiating trade agreements is a complex process, and experience shows that implementing FTAs is also a very challenging exercise. How can this be improved? What enhanced role could be foreseen for the industry in the proposed partnership for implementation?

\textbf{3.} How could trade policy, including the Market Access Strategy assist the sector further? What other instruments should there be at the disposal of the Commission to deal with external trade barriers?

\textbf{4.} What are the sector’s priorities which the Group would like the Commission to consider when negotiating FTAs and when engaging in bilateral regulatory dialogues?

\textsuperscript{12} For example, the Commission has been for years actively supporting car automation, vehicle connectivity and development of Intelligent Transport System (e.g. pre-empting traffic lights, parking management reducing congestion in urban areas, automated tolling systems and congestion information delivered to drivers) and will identify research pathways facilitating decarbonisation and fostering the uptake of clean industry in an Integrated Energy Union Research, Innovation, and Competitiveness Strategy, to be adopted in 2016.
5. To what extent can the EU automotive sector commit/adapt to stricter EU (and global) emissions and safety standards, in order to remain competitive on the world stage? Can the EU automotive industry adapt to the recent developments in the energy policy and societal challenges? How could those responsible for public policy contribute? Will this address a growing number of issues related to the implementation/negotiation of free trade agreements?

6. How to strike the right balance between a more ambitious and future-proof regulatory strategy and a gradual regulatory approach? What are the benefits/limits to being a leader and first adopter of new technological benchmarks? Can we in this context talk about the effective regulatory paradigm shift?