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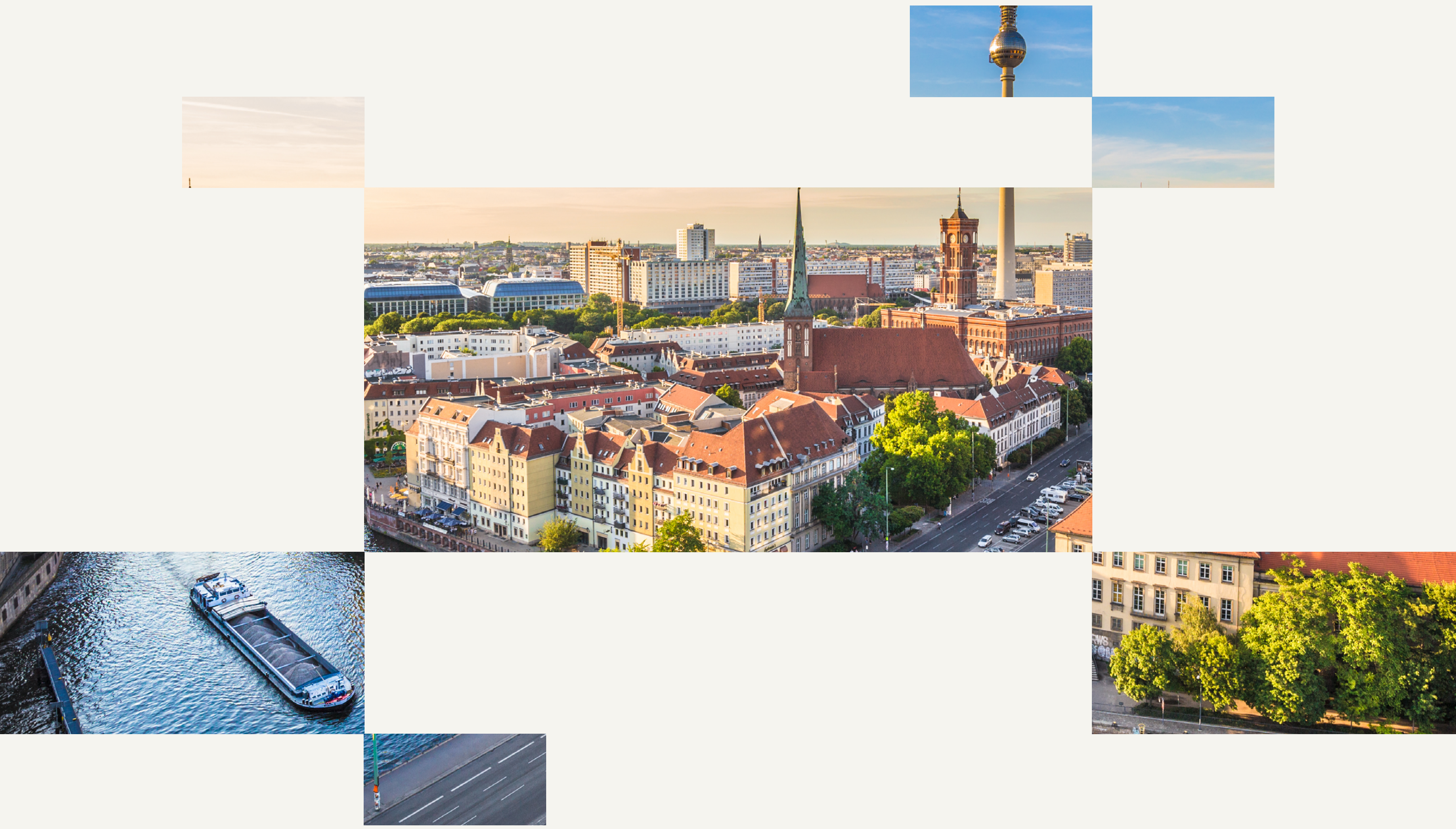
Europe outlook 2023

The threats to Europe's industrial competitiveness



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Contact us

LONDON

Economist Intelligence
The Adelphi
1-11 John Adam Street, London, WC2N 6HT
United Kingdom
Tel: +44 (0)20 7576 8000
e-mail: london@eiu.com

NEW YORK

Economist Intelligence
750 Third Ave, 5th Floor,
New York NY 10017, United States
Tel: +1 212 541 0500
e-mail: americas@eiu.com

HONG KONG

Economist Intelligence
1301 Cityplaza Four 12 Taikoo Wan Road Taikoo
Shing, Hong Kong
Tel: + 852 2585 3888
e-mail: asia@eiu.com

GURGAON

Economist Intelligence
Skootr Spaces, Unit No. 1 12th Floor, Tower B,
Building No. 9 DLF Cyber City, Phase - III Gurgaon -
122002 Haryana,
India
Tel: +91 124 6409486
e-mail: asia@eiu.com

DUBAI

Economist Intelligence
PO Box No - 450056, Office No - 1301A Aurora
Tower Dubai Media City Dubai,
United Arab Emirates
Tel: +971 4 4463 147
e-mail: mea@eiu.com

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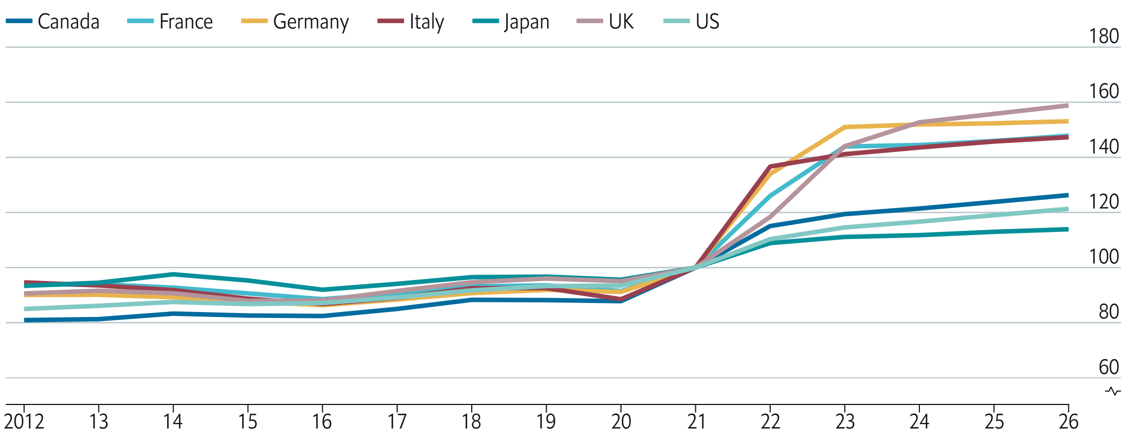
The threats to Europe's industrial competitiveness

- **Energy market dynamics for Europe in 2023 will be as challenging as in 2022. Natural gas storage in Europe is likely to be completely depleted by the spring, while little new import capacity will yet be available.**
- **High energy costs and falling demand are forcing industry across Europe to idle. Input costs will remain elevated for several years, making some European industrial sectors uncompetitive, and resulting in a loss of global market share.**
- **Chemicals and base metals will be the worst affected owing to their high reliance on natural gas as an input, but downstream industries such as the automotive sector will also suffer.**
- **China is set to benefit at the global level. Within the region, we expect a shift towards production in southern Europe from central Europe, with services holding up better than goods production.**

The stark increase in energy costs for the European industrial sector in 2023 and beyond will have a significant impact on the competitiveness of European industry. In addition, the coming recession will reduce domestic demand for industrial products; with global freight costs now declining as pandemic-related supply-chain disruption eases, import substitution is becoming more attractive. European industry already had a higher cost base than other advanced economies. A further increase will make producing in Europe an unprofitable business strategy for many energy-intensive firms.

Increases in European input costs outpace other advanced economies
(producer price index; 2021=100)



Source: EIU.
*EIU forecasts from 2023.

Given increasing geopolitical uncertainty and the size and expense of moving capital-intensive processes to Asia, we do not expect a trend of relocation. Instead, we expect firms to shut down some European production (possibly permanently) and replace it over time by increasing production elsewhere. However, these dynamics will be felt differently across industries. In this article, we examine four key sectors in which the impact will be particularly acute.

Energy: the transition accelerates

The push towards renewables will support European firms involved in the energy transition, with streamlined regulatory arrangements and greater subsidies. However, China will remain the global leader in overall production, with 76% of all photovoltaic cells produced there (compared with less than 14% in Germany). Even on new installations, 2020 data show the EU falling further behind China, and drawing level with the US. Wind energy faces similar dynamics.

Despite the gas crunch, hydrocarbon production in Europe will not significantly increase, with the exception of North Sea drilling in Norway and the UK. Increased nuclear power is planned in France, Sweden and the UK, as well as in central Europe, but all those initiatives will take several years to come online. On the corporate level, major energy firms—including Uniper, EDF and others—are facing significant strain as they scramble to replace Russian supplies, limiting their potential to be major investors in global projects.

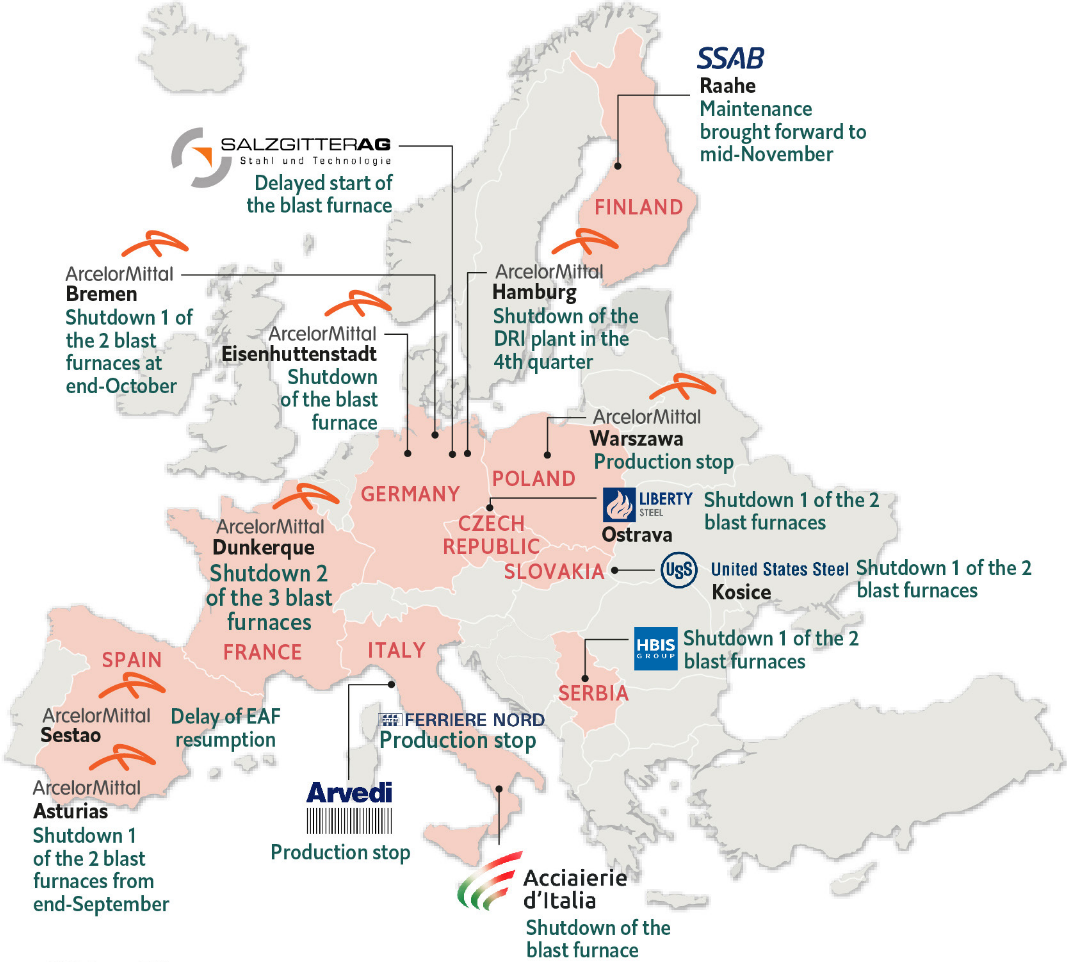
The construction of new gas infrastructure is designed to be dual-use with hydrogen to future-proof the infrastructure investment. **This will result in governments looking increasingly favourably on hydrogen projects, which can make use of the infrastructure.** However, the widespread take-up of hydrogen is still several years away and likely to be concentrated in sectors making the higher upfront initial investment.

Metals: eye-watering costs

Extremely high energy usage in the smelting process, as well as falling prices for metals such as aluminium and zinc, is eroding profitability in the metals sector. Average monthly wholesale electricity prices in key countries reached about €375/MWh in September, a tenfold annual increase. For aluminium, the most energy-intensive metal to smelt (at 14 MWh/tonne of primary production), this implies a power input costing US$5,200/tonne, more than double the spot price of aluminium (less than US$2,300/tonne). Other metals such as steel, although less energy intensive, are seeing similarly unviable cost dynamics. **Operating smelters under such conditions is not sustainable, even for short periods of time, and over half of productive capacity in Europe is now idle.**

Even plants with long-term power contracts will be at risk as these come up for renewal. The longer wholesale prices remain above €100/MWh—they were at about €200/MWh in early November—the more challenging it will be to renew at affordable rates. Even firms with access to power under preferential tariffs have had to cut production. Some smelters have maintained some production by avoiding peak usage times; but many cells can only remain without power for a few hours without risking a costly metal freeze. **Given these extreme operating conditions, the risk of further smelter closures remains high.**

Energy crisis is forcing the steel sector to idle
(EU steel plants; planned stoppages and closures as at Nov 2nd 2022)



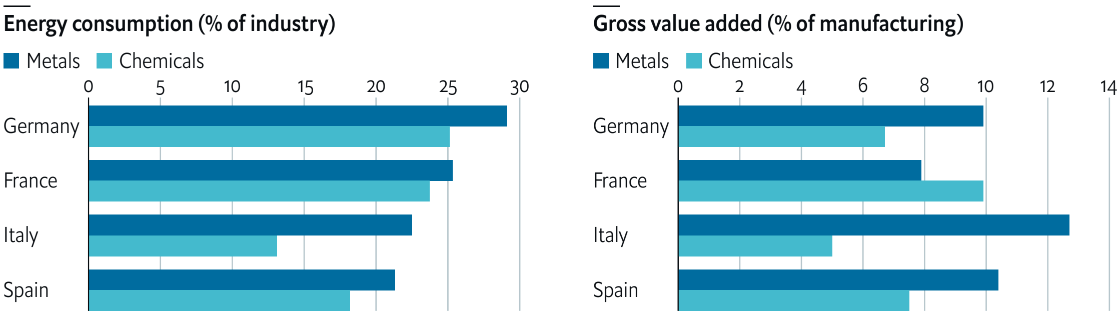
Sources: GMK Center; EIU.

Chemicals: no substitute for gas

The chemicals sector is second only to metals in terms of energy intensity, with natural gas being a feedstock for many chemicals as well as a source of heat generation, making substitution particularly difficult. Production of ammonia (of which natural gas is a feedstock) is particularly uncompetitive at present, and about 70% of Europe's fertiliser production capacity has been halted. Most will not be restarted, raising risks for crop yields in the short term and a loss of market share in the longer term.

BASF, Germany's largest chemical firm, uses as much energy annually as the energy usage of Denmark. With the European cost base already higher than in other developed markets even before the crisis, and set to remain at this elevated level throughout our forecast period (2023-27), this is no longer a profitable business model, and the company plans to permanently downsize its operations in the region. **Europe is therefore set to lose global market share for the chemical industry, with China (already the largest player) poised to benefit.**

European energy consumption for metals and chemicals is huge
(2019)



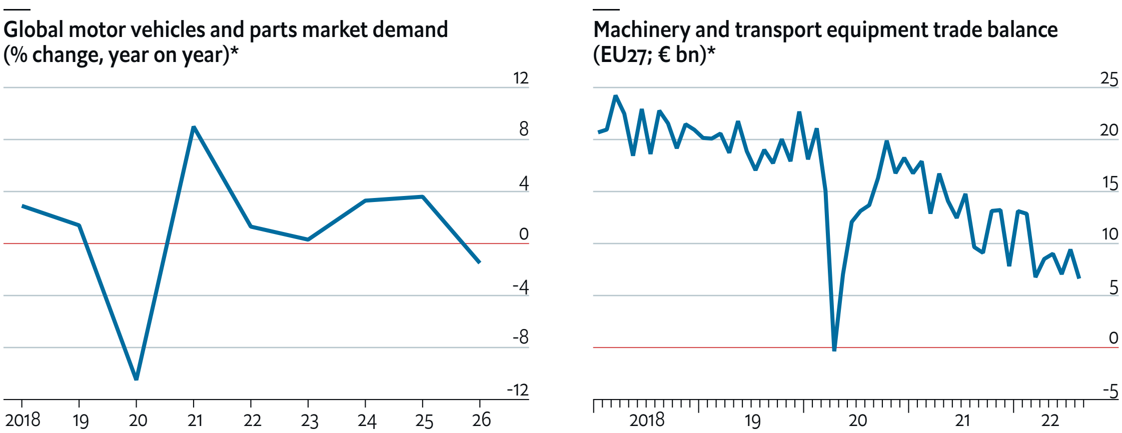
Sources: International Energy Agency; UNIDO; EIU.

The wider recession will reduce demand in Europe, further eroding the chemicals sector. Demand for industrial fibres, polymers and plastics used in construction and car manufacturing is falling, and inputs for (now idled) industrial processes, such as caustic soda, vital for aluminium smelting, are no longer in demand.

Automotive: less affected, but already in a slump

Although less directly energy intensive than other sectors, the automotive industry represents about 7% of EU economic output and supports vast upstream and downstream supply-chain networks throughout Europe. In addition to firms' direct energy use, which now costs more, input prices have risen for energy-intensive metals, glass, semi-manufactured input goods (especially electrical wiring from Ukraine and mineral goods from Russia) and critical inputs for electric vehicles.

A weak global automotive outlook is hurting European exports



Sources: Eurostat; EIU.

*EIU forecasts from 2023.

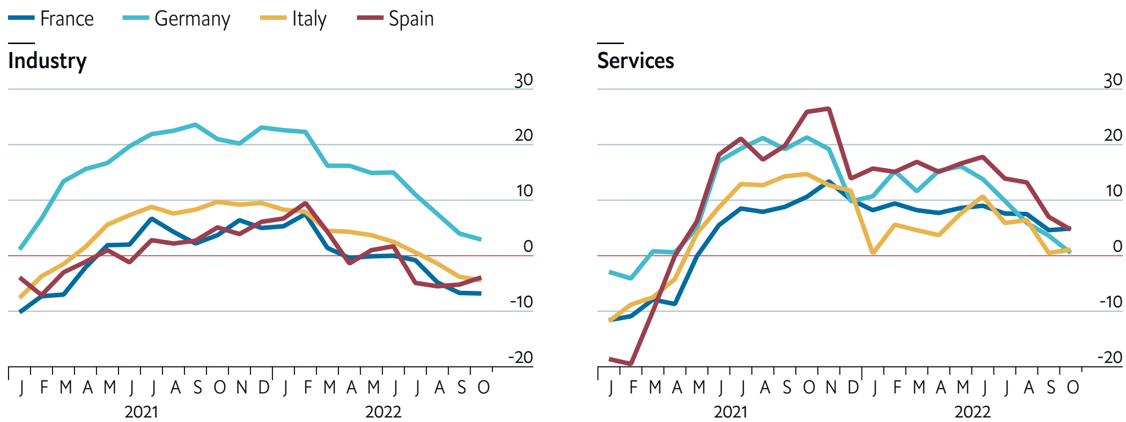
Automotive facilities in Europe were already grappling with over-capacity even before the pandemic; the recession will further reduce demand both within and outside Europe. **We expect that this will lead automakers to cut back investment and production in the region as it becomes unprofitable amid higher energy and labour costs.** However, weaker price inflation in southern

Europe presents an opportunity for automakers to nearshore some energy-intensive production processes southwards to Mediterranean countries, where liquefied natural gas (LNG) terminals are already functional and keeping energy costs contained.

Conclusion: what to watch out for

The increase in European industry's already high cost base will be a net loss for the continent. **Within the industrial sector, the impact will be most keenly felt in chemicals and fertilisers, sectors in which natural gas is a direct input to the final product**, whereas sectors such as automotive, which use gas for energy, but with possible alternative power sources, will see significant substitution and, as a consequence, less lasting scarring. The gas crunch also creates opportunities for firms that can provide effective substitutes for gas in industrial processes, which may also drive innovation in the energy and materials spaces. **Pressure on heavy industries is likely to see the less energy-intensive service sector hold up better through the recession and be more likely to drive future growth.**

Business confidence for industry has fallen further than for services
(seasonally adjusted; % balance of responses)



Sources: European Commission; EIU.

Globally, **China is well positioned to benefit,** with pre-existing cost base and scale advantages in metals, chemicals, and solar and wind installations. Regionally, **southern Europe will see its competitiveness within Europe increase,** as it has more installed LNG and pipeline capacity, **at the expense of central and eastern Europe**. Southern Europe also benefits from milder winter climates and greater reliance on services to begin with.

Firms active in the green transition stand to benefit, as subsidies and new forms of energy generation will raise profitability in the medium to long term. **One issue to watch out for is the introduction of the EU Carbon Border adjustment mechanism in 2026.** This may present a competitive advantage for chemicals producers in Europe, which already score well on green metrics, and will be an important consideration for European firms currently expanding production in non-EU markets but planning on importing to the EU.

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