WITH THE EU ENERGY SECTOR UNDER UNPRECEDENTED PRESSURE, THE US SUBSIDIES FOR ELECTRIC VEHICLES HAVE EMERGED AS A SOURCE OF TRANSATLANTIC FRICTION

The war in Ukraine has cast a long shadow over European business and industry. There are various drivers of the high levels of pessimism and discomfort on the continent, but none more potent than the weaponization of energy by the Kremlin. I describe below the concerns of European policymakers and business leaders that the landmark Inflation Reduction Act ("IRA") (*see* my previous briefing note, available here) will exacerbate the pressures on European industry, as investments in new green technology operations and R&D head to the United States. The potential shift in new investments to the United States was characterized this past Monday by EU Internal Market Commissioner Thierry Breton as a potential "wave of de-industrialization" posing an "existential challenge to a significant portion of industrial activity in Europe."

Bleak Business Sentiment

A report issued by The Conference Board and the European Round Table for Industry (ERT), "Measure of CEO Confidence"™ for Europe paints a bleak picture of business confidence, largely as a result of double-digit inflation linked to record-high energy costs. Among the key findings of the report:

- The confidence measure for Europe fell in H2 2022 to a record low of 24, down from 37 in H1 2022 and 63 in H2 2021 (a measure below 50 indicates more negative than positive responses).
- As for the H1 2023 outlook, 87% expect the economic outlook to worsen.
- A third (34%) plans to temporarily pause or decrease investments in existing businesses due to high energy prices, and 15% plan to do so on a permanent basis.
- A third (32%) said they intend to temporarily downsize operations or cease production in the region, while 15% plan to do so indefinitely.
- One in five (22%) respondents do not expect energy prices to return to 2019 levels before 2024, with another 22% not expecting this to happen in 2025, either. A further 38% do not expect energy prices to ever return to 2019 levels.
- The principal drivers of inflation are energy costs, far ahead of supply chain shortages and wage growth.

Increasing green investments is seen as the most popular way to safeguard businesses from future energy crises. A surprising 91% intend to either increase their investments in green energy or make no changes to current investment plans in Europe. A majority (59%) expects to permanently increase their investments in green energy technology, which exceeds the 48% that are planning to do so only on a temporary basis.

Confirming the downward trends, the S&P Global Eurozone Manufacturing purchasing manager index (PMI) released in October highlighted that the downturn in manufacturing in the eurozone had accelerated, falling to a 27-month low. This reflects declines in both output and new orders. Demand for eurozone goods feel sharply as high inflation and economic uncertainty took their toll.

Transatlantic Tensions

European business leaders and government officials have been sounding the alarm over the $369 billion of tax credits, subsidies and other incentives directed to supporting domestic clean energy initiatives embedded in the IRA. The provisions are seen as hugely disadvantageous to Europe, largely because of the potential diversion of investment in green technology away from Europe. The key concern is the EV subsidy. For example, EV buyers in the United States will be eligible for tax credits for vehicles the final assembly of which is in North America, and running on batteries manufactured or built in North America, with minerals mined in the United States or in a country with which the United States has a free trade agreement or recycled in North America.

While European leaders are raising concerns, they also are coming to the realization that they will need to reorient EU policy to protect EU-based manufacturing as the world gears up for the transition to net-zero. Their challenge: how to create a competitive EU ecosystem for the design and manufacture of batteries, solar panels and other green technologies, and how to do so without breaching WTO rules. The French, in particular, have long called for strategic independence from both the United States and China, which can only mean starting at home.

A US-EU task force was launched in late October to discuss Europe's concerns related to the IRA. Reportedly the European Commission had raised concerns in early November, followed by a meeting of EU finance ministers at which similar concerns were highlighted. European trade ministers met yesterday on the issue as well, hoping to come up with an agreed position before the December 5th meeting of the TTC (*see* below).

On the US side, the law is, as Treasury Secretary has said, according to a Bloomberg report, "what it is." On the other side of the Atlantic, the tools available are likely limited, particularly since subsidies would have to be funded, either at the EU level (perhaps funded from the European Sovereignty Fund first proposed by EU Commission President Ursula von der Leyen in September) or at the member state level (the latter creating its own internal market distortions). The proposed and pending EU Foreign Subsidies Regulation, allowing the European Commission to review m&a transactions affected by foreign subsidies that distort the EU single market, would only impact those US companies undertaking acquisitions or public procurement bids in the European Union.

The fears of EU policymakers are by no means misplaced, particularly in the context of the sentiments expressed by European business leaders noted above. There is an obvious risk that companies will cut back or cease investments in Europe in favor of investments in the United States or China to get ahead of the wave of investments that can be expected to drive transitions to net-zero economies.

French and German Responses

French President Emmanuel Macron will be meeting in Washington with President Biden this coming week where the agenda is likely to be dominated by concerns that the IRA could prove fatal to already weakened European industries. Also this coming week, the EU-US

Trade and Tech Council (TTC), chaired by senior US and EU officials will meet, but that meeting too is likely to be overshadowed by the EV subsidy issue.[1]

President Macron reportedly will raise exemptions for European companies along the line of those enjoyed by Canada and Mexico. Germany, and to a lesser extent France, fear that their automotive exports to the US (cars, in the case of Germany, and automotive parts, in the case of France) will suffer from the IRA subsidies provided to US-made EVs.

In a sign of cooling tensions between France and Germany, prompted perhaps by the commonality of interest vis-à-vis the Americans on this trade issue, earlier this week, Minister of the Economy, Finance and industrial and digital Sovereignty of France, Bruno Le Maire, met with his German counterpart Robert Habeck to consider responses to the IRA, including a more-subsidy based industrial policy for the European Union. (Incidentally, this was part of a multiple visits by German ministers to Paris and French ministers to Berlin – *see* reporting yesterday in Le Monde.)

The Le Maire – Habeck joint declaration

> "call[s] for an EU industrial policy that enables our companies to thrive in the global competition especially through technological leadership. We want to coordinate closely a European approach to challenges such as the United States Inflation Reduction Act. We will explore industrial policy possibilities to prevent downside effects of protectionist measures by third countries and will ensure that WTO rules are respected by all. Therefore we will build a European platform of transformation technologies."

On Thursday, Minister Le Maire and the German Finance Minister, Christian Lindner, called for the swift approval of REPowerEU, as well as movement on other initiatives, to provide much needed funding to support energy transition.

Concluding Thoughts

While Europe would have rejoiced at the passage of the IRA and the implications for the global battle against the climate crisis, there is now talk of a trade war. A trade war with just six weeks to go before the relevant IRA provisions largely enter into force on January 1 would serve no one's interests, other than perhaps Vladimir Putin's. We should hope that this issue will not derail the much needed consolidation of transatlantic defense, security and trade cooperation. Maintaining that cooperation is all the more important as the war in Ukraine drags on and that unified front against Russia remains ever so critical, while Europe faces its worst economic crisis in decades and energy prices continue to spiral upwards. And

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1 The TTC is intended to avoid transatlantic trade disputes and generate cooperation across key issues, with a stated focus on sustainable development, environmental protection and urgent action to confront the climate crisis." One area of progress has been developing a common standard for EV charging infrastructure.

then, of course, there is the multi-faceted strategic competition with China (against whom, incidentally, the "buy American" provisions initially were directed).

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