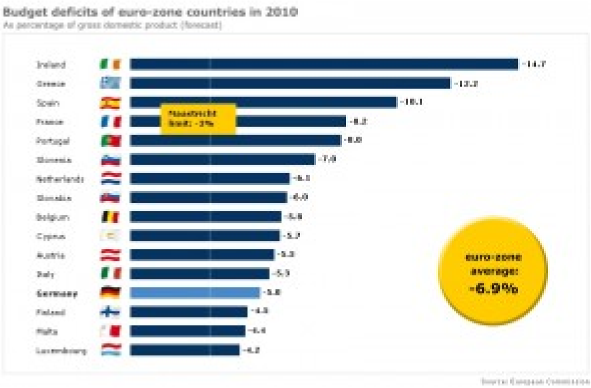
The Euro Crisis and the European Motor Industry

Is the sovereign debt of the so-called European ‘PIIGS’ the new “sub-prime mortgage”? The money markets think so. They know that the most important banks in Europe – i.e. the German and French banks – own a mountain of unsupportable government debt from Portugal, Italy, Ireland, Greece and Spain. Consequently, they only want to lend more at very high interest rates and with extensive guarantees. The Euro went into freefall in May 2010 because the bail-out package for Greece left the rest of the debt even more exposed. The Italians say that the only way out of the Euro crisis is for the ECB to guarantee all of Europe’s sovereign debt – and to print money in order to buy it. The Germans are saying ‘No!’

How did they get into this mess?

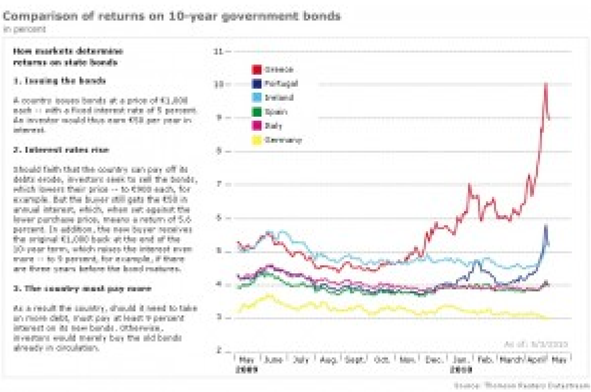
The orthodox view is that, in the late 1990’s, France and Germany relaxed the stringent rules on maximum and annual growth levels of government debt within the Eurozone. That sparked a construction and property binge in the ‘Club Med’ founded on low global interest rates. Coupled with that, the ‘Club Med’ states in particular increased their social costs – and spending – until net government income couldn’t support the borrowings.



Beyond allegations of financial profligacy and creative national accounting, the root problem for ‘Club Med’ is its low real-terms growth. All of these economies have lost competitiveness since joining the Euro, either to lower-cost Eastern Europe or better developed Western Europe. For example Portuguese unit labour costs increased 20% vis-à-vis Germany over the last decade, and Greek unit labour costs increased a whopping 11.2% in Q4 2009 alone compared with a 0.5% drop in Germany. Unemployment in the ‘PIIGS’ averages 6 – 15% in 2009.

What are the Options?

There are four. The weak countries could leave the Eurozone. While the vot ersin Germany and France might be in favour, their political masters are not. It may still happen, but not yet.



Option 2 is severe government austerity measures – wage freezes, tax hikes and mothballed spending projects – until the net income is great enough to service the debt. This is the IMF preferred option. Option 3 is to devalue the currency – by design or default – so that in effect the debt burden is eroded. This is the Italian solution, but it only works as long as other currencies don't follow suit.

Option 4 is to increase productivity, so that income rises faster than taxes. This may be reachable for most of the 'PIIGS' in the long term – 10 to 15 years. It won't help now.

Some forecast that the route to a Eurozone 'double-dip' recession will look like this: Banks won't lend to other banks because they don't know who is creditworthy given their (unknown) holdings of 'Club Med' sovereign debt. Banks then stop lending to businesses again, so the real economy slows, unemployment rises and government income (taxes) decline. Because government have less income, they need to borrow more, but their riskiness increases, so government bonds will fall in value; in turn money markets will turn further against the Euro. As a result, even more investment money will flow away from the Euro. The recession will enter another severe phase.

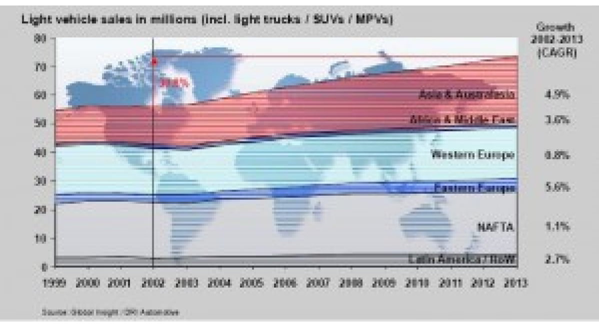
The ECB will have to buy the sovereign debt of all the Eurozone countries. No one doubts it. The question is will it be 'sterilized' or 'un-sterilized'. Sterilized means that for every Euro spent, the ECB will buy back another – the money supply will not rise. So, there should be no inflationary effect.

Un-sterilized is just the opposite. The ECB will be forced to print money – in the UK it was called 'quantitative easing' and in the US 'TARP'. It will be the only buyer of 'PIIGS' bonds. The sting in the tail is that, if the purchases are sterilized, the 'PIIGS' will have to face a long and painful period of re-structuring while they regain competitiveness. Sadly, as Greece has shown, the public are unlikely to endure higher prices and lower wages for long. The alternative – unpalatable to Germany – is inflation, effectively devaluing the debt.

So far, it appears the forces of common interest are triumphing over the national political backlash in countries like Germany. All of Europe's economic recovery, including Britain's, is at risk if big trading partners such as Spain are dragged into lasting recession by overly severe austerity measures. Big banks in France and Germany would be devastated if there was widespread default in Greece or Portugal, since they have done most of the lending.

The Euro optimists hope the way to save the eurozone will be to complete the project by agreeing much closer fiscal and political union between the single currency members. In future, the hope is Germany would no more allow Greece to get into this mess than it would Bavaria.

What will be the impact on business in general and the motor industry in particular?



A continued Euro Crisis could drive three effects: a second bout of demand destruction aross Europe, price and cost inflation and – possibly – a secondary wave of devaluations by other currencies – primarily the US$ and sterling – whose competitive position is undermined by a weak Euro.

The effect on individual auto makers depends greatly on their level of diversification. VW, for example, derives 71% of its revenues from Europe, but is well placed to benefit from a stronger US Dollar, Chinese Yuan and Brazilian Real. At the other extreme, Toyota only derives 14% of its sales from Europe. It should be able to offset a fall in Eurozone markets with growth elsewhere.

The table below lists the key exchange rate-related factors for four of the main European players. However, a strong position related to the Euro exchange rate doesn't help with inflation, whether its imported, or home grown.

	VW	Daimler	Toyota	Renault
Manufacture outside Eurozone	Yes	Yes	Yes	No
Source components outside Eurozone	Yes	Yes	Yes	No
Sell vehicles outside Eurozone	Yes	Yes	Yes	No
Sell value for money cars in Eurozone	Yes	No	Yes	Yes
Sell cars with high brand equity in Eurozone	Yes	Yes	No	No

Collectively, global automakers have already weathered a catastrophic destruction of demand. Between 2005 and 2009 global passenger car sales fell 24%, Trucks dropped 46% and vans slumped by 38%. The result has been the break-up of 'Daimler-Chrysler', and Chrysler's subsequent alliance with Fiat, the bankruptcy of GM and swallowing of Porsche by VW. Smaller players, such as Perodua have been sidelined and the centre of gravity of the European market switched towards budget and value-for-money brands and offers.

The Euro Crisis could trigger further demand shrinkage in 2010 and 2011.

Volswagen

Arguably, the automaker with the greatest dependency on Western Europe is Volkswagen Group, where 75.2% of their sales were in Europe in FY2009, around €76BN. Profits were almost halved – €1.3BN – but cash flow at €18BN should enable them to weather the economic storm in the short term. Their brand portfolio, which includes Volkswagen, Škoda and Seat, gives them a range of access routes to the budget segment, although they failed to exploit this as well as some of their competitors in 2009.

VW Group derives 9% of group revenues from the Asia-Pacific region but optimism about the region should be tempered for three reasons. First, VW's own recent reports caution that car prices in China are down 50% in 2010 compared to their 2002 level. To compensate, VW cut car material costs by 40% between 2004 and 2008. Since then, their Asia-Pacific sales performance has 'flat-lined' due to the global recession. However, the 15% appreciation of the Chinese Yuan against the Euro has helped. Second, while the official China inflation rate to April 2010 was 2.8%, the true rate is much higher. Honda's operation in southern China was closed in June when employees rejected a 24% wage rise! Productivity is unlikely to match wage increases of this magnitude, so prices will rise and margins will be eroded in 2010. Thirdly, China is under pressure to allow its currency to 'float'. Their authorities are reluctant because the Yuan would almost certainly strengthen, potentially hurting China's exports.

Another 9.6% of VW revenue derives from South America, primarily Brazil, where it's the No.3 brand, selling almost 380,000 units in 2009 in a falling market. Only China is a more important ‘BRIC’ market. Since January 2009, the Brazilian Real has appreciated 38% against the Euro, providing a major windfall for VW as much of its production is locally sourced and manufactured. Inflation is a worry here too. At 5.4%, Brazil’s central bank has raised its base rate to 9.4%. Inflation is worse in Russia (6%) and much worse in India (the CPI is up 14.5%0. In FY2009 VW Group posted currency gains of €190 MN (FY2008 –E113).

Renault

Renault, with 66% of its FY2009 €33.7BN sales in Western Europe – down 10% – is similarly vulnerable to a Eurozone crisis that reduces demand. In 2009 France alone still supplied 30% of its sales, Germany 10% and Italy and Spain together another 10%. The volatile global market led to a FY2009 loss of €396 MN and Renault reported that currency effects – appreciating Euro – accounted for around 25% of their revenue loss. Even if the currency effects reverse in 2010 they may suffer significant deterioration in revenue from the key European markets. Unlike VW or Daimler, Renault only has significant sales to two of the ‘BRIC’ economies – Russia (72K) and Brazil (117k) both vulnerable to cost inflation in the 5 – 6% range. It is very weak in the growing Asian markets – China, India and SE Asia.

Daimler

With fingers in many pies – cars, financial services, trucks and buses and vans – Daimler benefits from wide product diversity. However, 55% of its income comes from cars, 22% from trucks and the rest from vans, buses and other activities.

The most likely inflationary impact is that EU made vehicles will cost more to build and will be priced higher. Assuming EU incomes rise slower than prices, domestic sales will falter. Export sales are less predictable as prices are a function of exchange rates and price rises. Against the US$ and the Chinese Yuan, the Euro has depreciated by 20% since December 2009. Over the same period, it has fallen 9% against Sterling and the Rouble and 16% against the Japanese Yen.

Leaving aside imported inflation, this is not to say that Euro-denominated prices could rise by these amounts in each market without an impact. In the US, the Euro has been appreciating for most of the last 10 years, making European cars more expensive. Even at its current low the Euro is 25% higher than it was in 2000. Over the same period, it’s up 30% on sterling, 10% against the Yen and the Rouble (since 2005). Only in China is the Euro lower in value (-20%) than it was 5 years ago.

Toyota

With only 14% of their revenue from Europe, Toyota is the least exposed to the Euro Crisis. However, it is exposed to exchange rate volatility and lost €2.45BN on Forex in FY2010 – around 1.6% of total revenue. The Japanese Yen has been steadily appreciating since January 2009 against both the US$ (+13%) and the Euro (+23%). Toyota reported that adverse Forex rates were the most significant factor depressing net income in FY2010.

For FY2011 Toyota forecast there would be 125Yen to the Euro. As at 15 June 2010, it was

112, an appreciation of 11%. At this rate their forecast Forex loss of €640 MN appears optimistic. So too does their forecast rise in CKD and foreign sales of 620,000 units.

Vehicle Production Input Factor Prices

The short and medium term outlook for vehicle input factor prices is not encouraging either. All of the major items are up in price significantly, as demand outstrips existing capacity. The summaries below illustrate the situation as at 2nd Quarter 2010 for each of the most important production inputs.

Steel:

According to Vale, the world's largest iron ore producer, the recession is already over for mining and metals. Based on January 2009 prices, April 2010 iron ore prices are up 80% and the London Metal Exchange Index is up 140%, fuelled primarily by demand from China. The shift towards an index based pricing model by major producers will also push up contract prices. Global carbon steel output in December 2009 matched pre-recession 2007 levels.

Oil:

Since January 2009 prices have moved from the $45 to the $75 per barrel range in June 2010. With 6 and 12 month oil futures trading in the $93 range the market outlook is for higher prices. However, a prolonged downturn in Europe could trigger a softening of spot prices if demand deteriorates.

Plastics:

Auto-makers use a wide variety of plastics in vehicle construction and, as all plastic feed stocks is a by-product of oil, their prices move with the oil price, but with greater volatility. Using February 2009 as a base, PVC is up 25%, polypropylene has risen 39% and a basket of styrene and ABS by 125%. Once again, as with steel, the mothballing of capacity between 2007 and 2009 has led to excess demand.

Where will it end?

The initial analysis by Western European taxpayers, as they realized that the 'single currency' meant joint responsibility, was to cry 'foul!' and point to profligate spending. The 'Club Med' retorted that the Euro was a Franco-German project which simply impoverished them, by allowing the French and German corporations to penetrate European markets. The proof is a growing German surplus, fuelled by expanding 'Club Med' debt.

They go on to say that IMF-inspired deflationary economic policies will tip them – and the rest of the EU – into long term decline and political instability. Ireland, Spain and Portugal are already in outright deflation. Others could follow. If they follow the IMF route, it leads to unemployment, insolvencies and a race to the bottom.

My guess is that the tipping point will be when one or two of the large 'Club Med' members threaten to leave. At that point, real quantitative easing will start and inflation will follow or the Eurozone will shrink. My money is on the former.