

Strategy Bulletin (No. 341)

**In a Tight spot? German Companies' Strategy toward China and the impact on EU**

**~Mitsubishi Motor's Withdrawal from China vs. German Companies Double-Down Investment on China**

The world economy is facing a mountain of difficulties, including Russia's invasion of Ukraine, the confrontation between the U.S. and China and the possibility of an invasion of Taiwan, the bursting of the real estate bubble in China, fragmentation and the rise of right-wing populism in advanced Western countries, a review of the zero-carbon policy and the failure of environmental idealism, and more. All of these are serious problems, but almost all of them highlight the relative advantage of Japanese equities. In the previous issue, we analyzed the bursting of the Chinese bubble and the coming decline of the Chinese economy. In this issue, we will explore the strategic confusion and economic stagnation over the European economy by reviewing its strategy toward China.

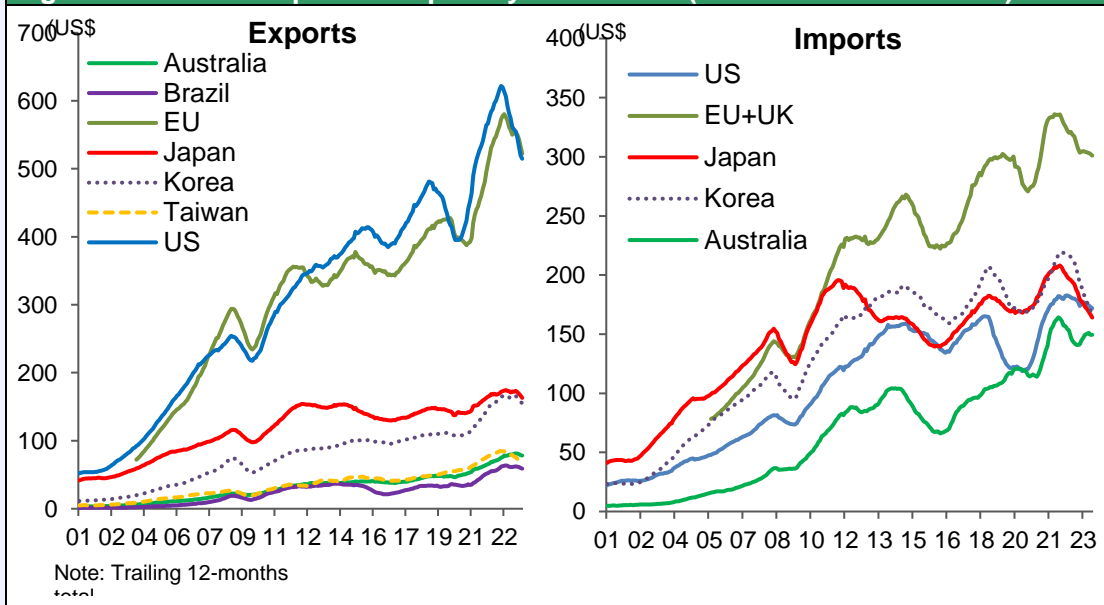
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**(1) Europe's Trade Deficit with China is Growing Rapidly, and Political Leadership is Increasingly Defending Against China**

To date, the eurozone has benefited more than other countries, such as the U.S., Japan, and South Korea, in its business with China. Chart 1 shows China's imports by country. Over the past decade or so, while imports from Japan, South Korea, and the U.S. have hardly grown, only imports from the eurozone have increased by 60-70%. However, Chinese firms have been steadily catching up in technology and strengthening their competitiveness, and they have been cutting into the ground of European firms. China's exports to Europe have expanded faster than its imports from Europe, and the EU trade deficit with China doubled to 39.6 billion euros in 2022 from 2019, the year before the Corona pandemic (Figure 2).

**Figure 1: Chinese Exprt and Import by destination (BBG. Musha Research)**



Germany, in particular, has made the most progress in strengthening relations with China among developed countries, with Chancellor Merkel visiting China 12 times during her 16-year tenure. However, modulation has emerged, with the trade balance with China turning into a deficit in 2022. The main reason for the trade modulation is the rapid increase in batteries, mainly for EVs, and semiconductors (solar panels, power semiconductors, etc.). China's battery exports to Germany were \$1.6 billion in 2020, \$3.7 billion in 2021, and \$8 billion in 2022, while its semiconductor exports to Germany were \$1.4 billion in 2020, \$1.8 billion in 2021, and \$3.1 billion (JETRO "Regional Analysis Report"). There is a built-in mechanism that automatically increases the deficit with China as EU shifts to clean energy and EVs.

In addition, the rapid expansion of Chinese EVs in Europe is increasing the risk of European auto companies losing market share locally. European automakers such as VW, which have enjoyed high growth in the Chinese market, are now on the defensive positions (Figure 3).

In the first half of 2023, China exported 2.14 million automobiles (+76% YoY), surpassing Japan to become the world's largest exporter driven by EVs and exports to Russia, which is embargoed by the democracies. The share of Chinese vehicles in Russia is expected to increase from 9% in 2021 to 37% in 2022, and to exceed 50% in 2023, approaching 1 million units (Toyo Keizai Online).

Global EV (BEV+PHEV) sales in the first half of 2023 reached 6.16 million units, up 41% from the previous year, of which 60% are believed to be vehicles produced in China. Leading the pack was BYD with 1.25 million units (up 96% from the previous year), followed by Tesla with 890,000 units (up 57%), VW Group (430,000 units), Jilin Volvo Group (360,000 units), and SAIC Group (320,000 units), all of which are mainly produced in China.

In response to this offensive by Chinese EVs, the U.S. has put a block on the IRA (Inflation-Reduction Act) by exempting Chinese-produced vehicles from subsidies. In addition, Ford's plan to build an EV battery plant in Michigan in cooperation with China's CATL, the world's largest battery maker, was temporarily halted due to pressure from Washington. Belatedly, the EU has also announced that it will investigate whether unfair subsidies are being provided to the Chinese auto industry. It is also said to be considering including cumulative carbon emission history (utilizing the Carbon Border Adjustment Mechanism) in its regulations. France has included cumulative carbon emission history in subsidy eligibility, effectively putting in place a mechanism to subsidize only European-made EVs.

Figure 2: Trade deficit of EU with China (FT)

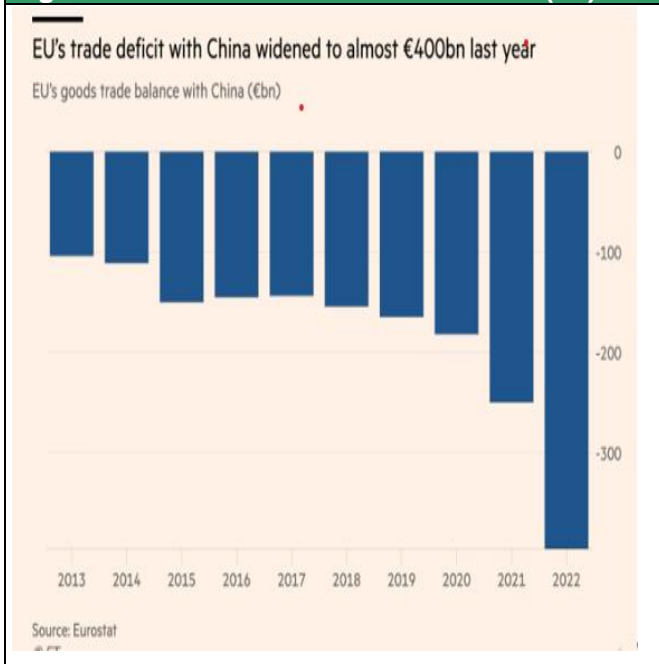
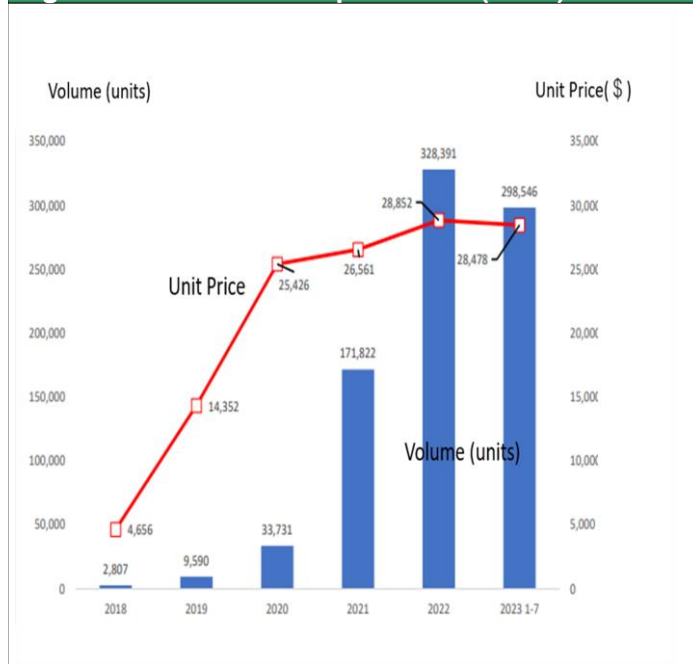


Figure 3: Chinese EV export to EU (Jetro)



## (2) German companies in DOUBLE DOWN investment in China

Despite these moves from the political world to block investment in China, German industry has a different view. German automakers criticize the policy, fearing that an EU investigation could lead to retaliation by the Chinese government.

What is troubling is the concentration of EVs and other clean energy ecosystems in China. China has created an environment favorable to domestic companies through massive subsidies, corporate support, and restraint of foreign companies. To win in the high-tech industry, it is essential to continue to make huge initial investments, and China has been knocking out competitors one after another in LCDs, telecommunications base stations, solar panels, wind power generation components (nacelles, plaid, towers), and so on. Now, the company has also acquired a global share of over 60% in EVs and batteries for EVs.

The company also holds a majority share in upstream areas such as the securing of resources and refining of battery material metal. VW stated, "The distance between the Western countries and China's ecosystem is widening, and we need to adapt to this situation." VW has increased the ratio of locally procured parts and materials for vehicles produced in China to over 90% in the past few years.

BASF has also announced that it will invest up to 10 billion euros in China by 2030 and has begun construction of plants to produce synthetic gas and hydrogen. According to the research firm Rhodium Group, Germany's share of EU+UK FDI in China in 2022 was 52%, up from 46% in 2021. The automotive industry accounted for 68% of that total, up significantly from 50% the year before. German companies seem to be caught in a dilemma in which the short-term gain in the Chinese market is more important than the geopolitical and long-term perspective. (WSJ 9.22.23).

## (3) The key is future Chinese domestic demand; contraction is inevitable

Whether German companies' strategy of sticking to a pro-China line will be successful or not depends primarily on future domestic demand in China. For three reasons, it will be difficult for China to maintain robust domestic demand. First, the history of the bubble bursts in the U.S. and Japan foreshadows a bleak future for domestic demand in China. Second, consumer confidence is deteriorating in China, and if the bubble burst is not halted, it could trigger a serious consumption contraction spiral. Third, China's excess supply capacity will cause severe deflation and starving exports, which the world will not tolerate.

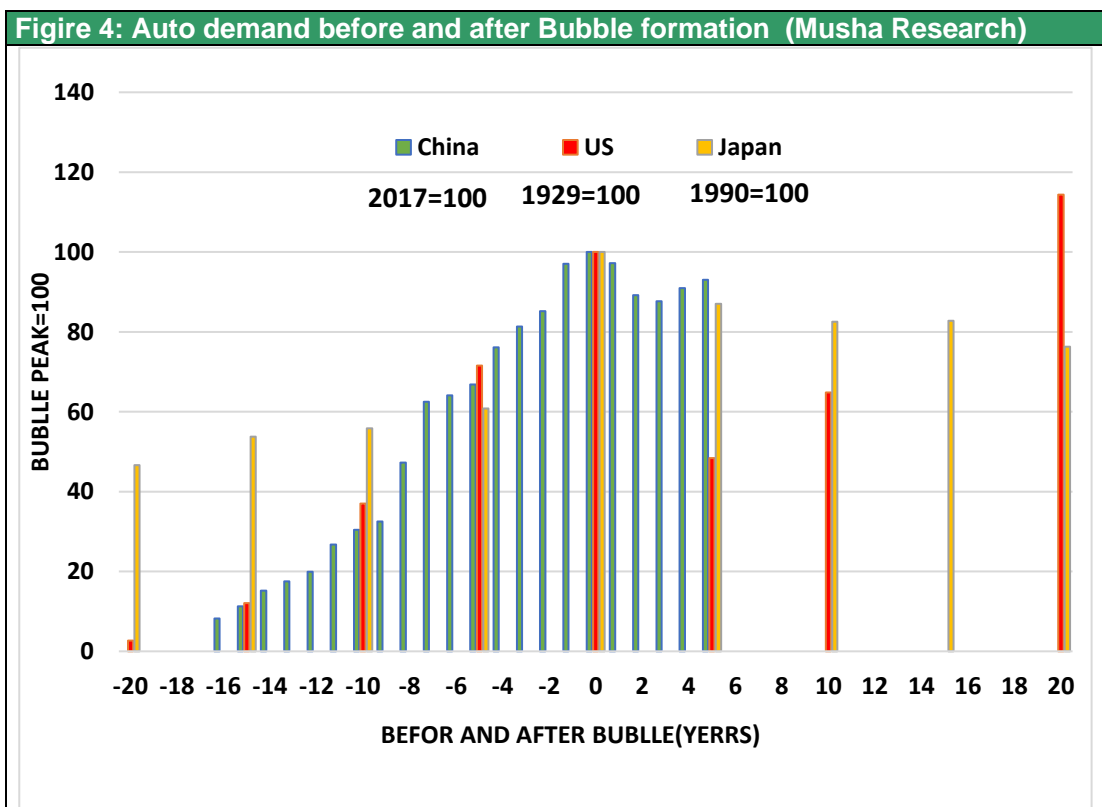
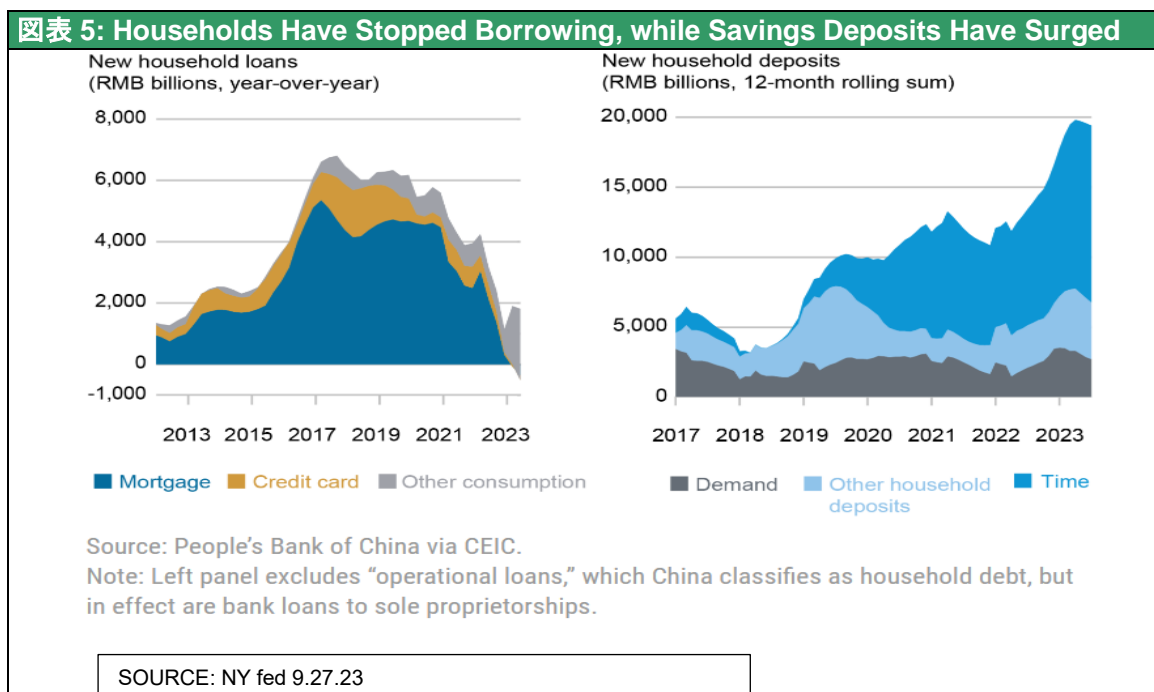


Chart 7 superimposes the historical automobile sales trends in the U.S. (1929 peak) and Japan (1990 peak), where historical bubbles were formed and then collapsed, on the current Chinese automobile sales. Based on the experiences of the U.S. and Japan, we can conclude that (1) the peak of the real estate bubble coincided with the peak of automobile sales, (2) demand remained sluggish for 20 years after the bubble burst, and (3) the rapid increase in automobile sales in China prior to the bubble coincided with the rapid increase in automobile sales during the U.S. Great Depression. When automobile sales fell by more than half after the bubble burst in the United States, China may need to be prepared to follow a similar path. In the case of the U.S. at the time of the Great Depression, the population had increased by 10% in 10 years, which is also a pessimistic factor for the future of China.

Second, people are becoming convinced that the real estate bubble is about to burst in China, and extreme defensive behavior is beginning to spread, with household savings surging and new debt plummeting (see Figure 5 by NY Fed). This risk aversion in the face of continued monetary easing by central bank is uncanny and differs from the bubble bursts in Japan in 1990 and in the U.S. in 1929. In both Japan and the U.S., the bubble burst was triggered by rapid monetary tightening, and private-sector debt shrank rapidly in the process of the bubble burst, while at the same time household savings and deposits also plummeted.



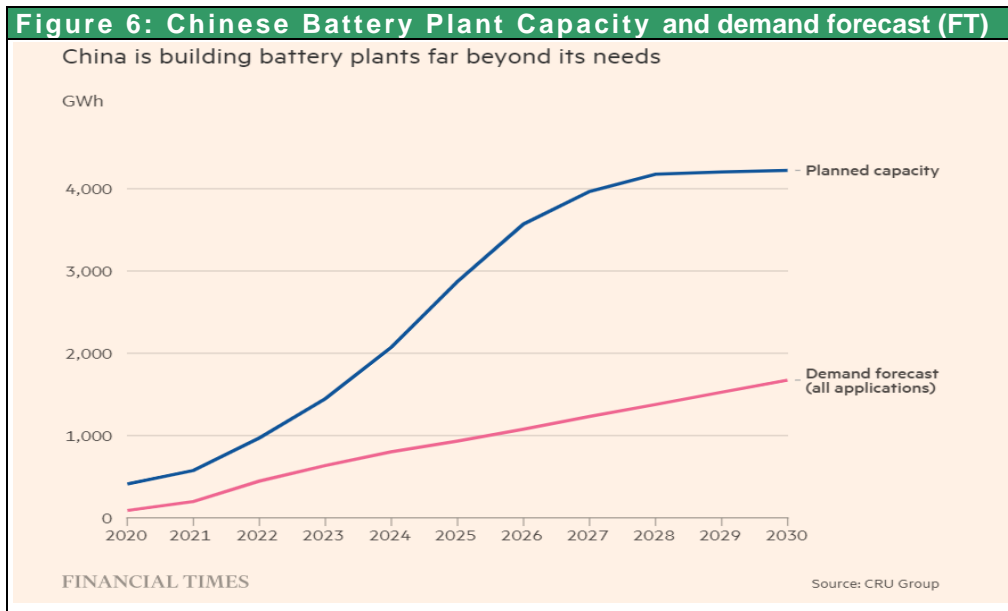
Third, the excess supply capacity in China and the expected cooling of domestic demand could lead to dumping exports, but the U.S.-China confrontation and the countries promoting China's decoupling will not allow this. For example, the FT reports, "Chinese manufacturers are building battery factories that far exceed domestic demand, thanks to huge state subsidies and unlimited bank loans. They have 1500 gigawatts of battery production capacity this year, enough for 22 million cars (equivalent to three times demand)." (9.4.23) and warns that it risks spurring geopolitical tensions between China and the West.

This suggests that the strategy of German companies to double down on their investment in China is a dangerous choice. The WSJ reports that German companies are trying to justify their increased investment in China with a "local for local strategy" and "insulation of Chinese business," but this logic is difficult. As mentioned above, China's auto market is no longer growing, and any increase in production in China will only increase pressure on exports. Also, at the time of World War II, U.S. companies had overseas subsidiaries in enemy countries, such as German Ford and German GM (Opel).

GM (Opel), for example, were kept alive by separating their management from that of their home country and allowing them to cooperate with Hitler in the war while maintaining capital ties with parent company. Following the experience of these U.S. companies, the strategy of separating the Chinese business from

the home country makes little sense. There is a possibility that the Communist regime, which has no respect for property rights, will act harder. In the first place, there is no guarantee that China will be able to remit profits out of the country.

China's auto exports are booming, but the country will eventually run into geopolitical obstacles. If this is the case, German automakers that are ramping up production in China could be digging their own graves. The answer is not simple: Which is wiser, Mitsubishi Motors' strategy of cutting its losses by shutting down Chinese factory or the German automakers' double down strategy?



#### (4) Global Position of Japanese Companies Not a Bad Thing

The WSJ editorial praised Akio Toyoda's assertion in its editorial that "Toyota needs to reconsider the West's relentless shift to EVs" as a courageous and sound argument. Toyota is promoting HVs and plug-in hybrid vehicles (PHEVs) as alternatives to BEVs (battery powered EVs) because PHEVs have internal combustion engines that can run when the battery runs low, reducing concerns about range. They are also cheaper than EVs. The problems with a hasty shift to full EVs are significant: (1) 1.2 million public charging facilities will be needed in the U.S. by 2030, and about 400 new charging facilities will need to be built every day, but that goal is far from being achieved. (2) More than 300 new lithium, cobalt, nickel, and graphite mines will be needed to meet the anticipated battery demand by 2035, which will take decades to develop. (3) The amount of raw materials in one long-range battery electric vehicle could instead be used to make 6 plug-in hybrid electric vehicles or 90 hybrid electric vehicles. (4) The overall carbon reduction of those 90 hybrids over their lifetimes is 37 times as much as a single battery electric vehicle. These inconvenient truths undermine the climate religion and government mandates. (WSJ June 4)

According to a Pew Research Center poll conducted in the U.S. in June, opposition to a policy banning the sale of new internal combustion engine vehicles starting in 2035 has risen to 59% from 51% in April 2021. The position of Japanese companies such as Toyota, which are regarded as being behind in the shift to EVs, may not necessarily be bad.

#### (5) European stagflation, lack of optimism, and the failed Russian Chinese biased European economic strategy

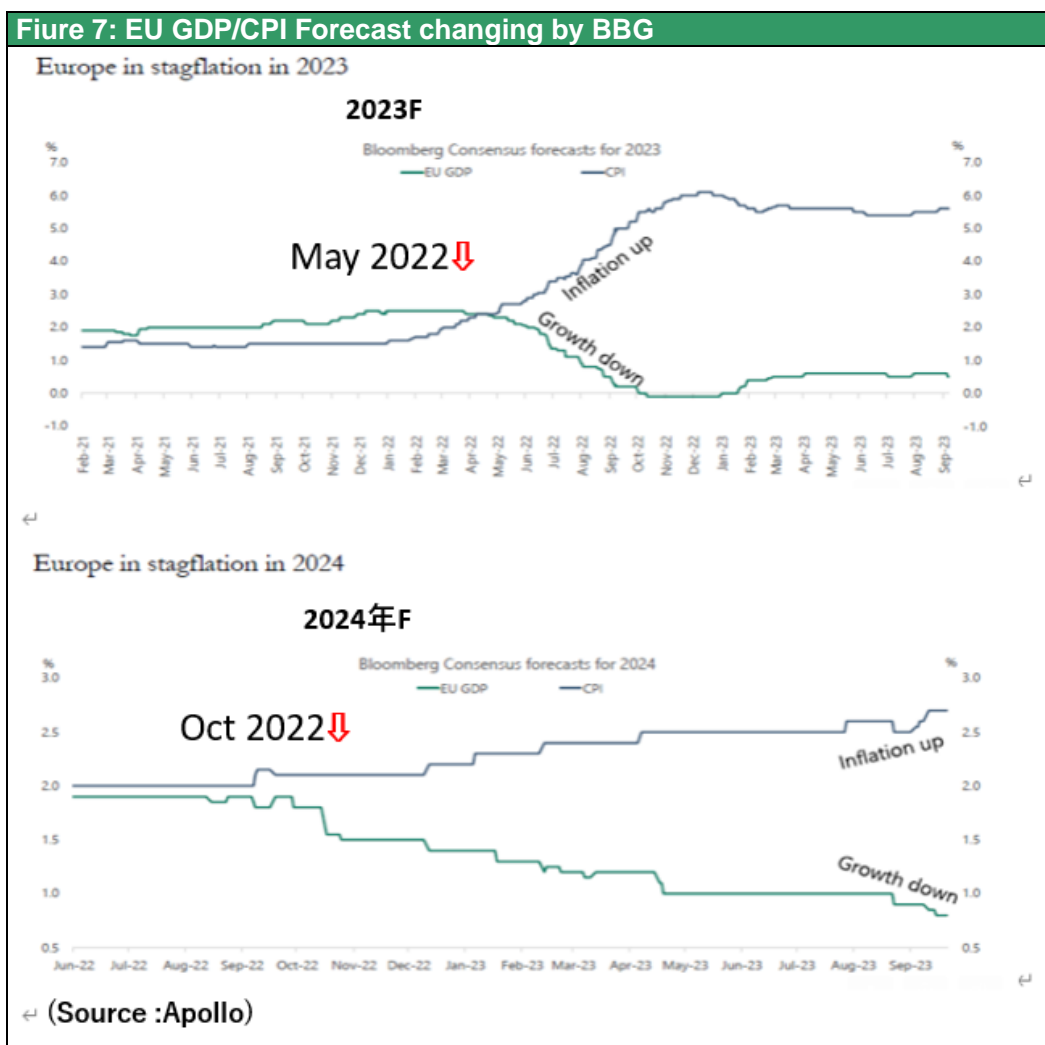
The European economy is emerging as a difficult one among the U.S., Japanese, European, and other advanced economies, with the IMF's most recent national GDP forecasts (for 2023) averaging 0.9% for the eurozone compared to 1.8% for the U.S. and 1.4% for Japan, with the eurozone stagnating at an

outstandingly low rate. In particular, Germany, which accounts for one-third of the eurozone GDP, is the only G7 country with a negative growth outlook at -0.3%. The German economy has remained almost flat since the start of the war in Ukraine in the 2Q of 2022 until today, and since the beginning of 2023, it has been stagnating at -0.2% y/y in both the 1Q and 2Q, showing increasing signs of stagnation.

While high inflation is a common global difficulty, the marked slowdown in economic growth and resulting stagflation is an economic situation unique to Europe. According to the Bloomberg consensus forecast, the market expects stagflation to intensify in Europe in 2023 and 2024 (noted by Apollo Chief Economist Torsten Slock).

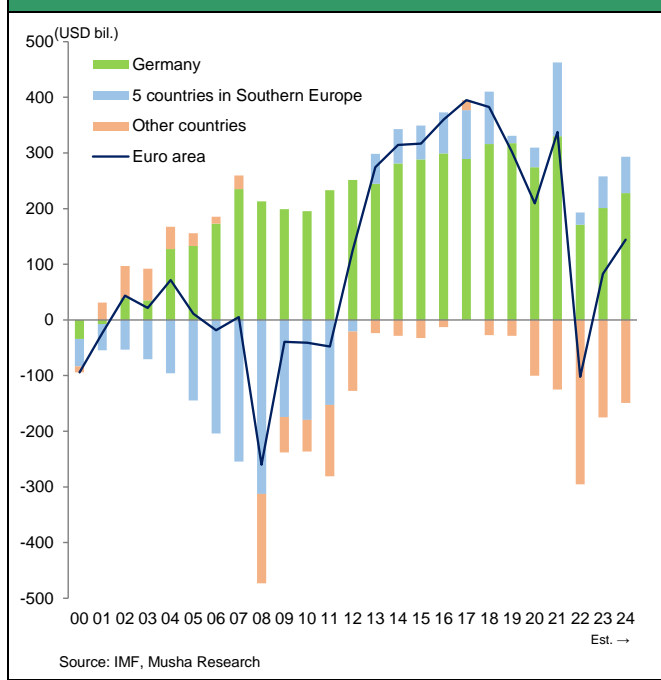
At the root of the Eurozone's difficulties is a failed economic strategy that is overly dependent on Russia and China. In response to the complete cessation of natural gas imports from Russia, switching to other sources of supply became expensive. Germany's strategy of relying on Russia for 55% of its natural gas imports during the German-Russian honeymoon failed. In addition, the complete shutdown of nuclear power plants and other problems with Germany's hasty zero-carbon policy have been exposed. This has triggered fears of inflation turning malignant, including a sharp rise in electricity prices. Add to this the worsening trade with China. Germany's golden age of enjoying large current account surpluses for a long time may become a thing of the past.

The basis for the stability of the eurozone to date has been the financial strength of Germany, supported by its large current account surpluses. There are concerns about the sustainability of a system in which southern European countries such as Italy and Spain are fully dependent on Germany's financial strength. The economic difficulties of Germany may turn into a problem for the entire eurozone. Stagflation in the eurozone could be prolonged.

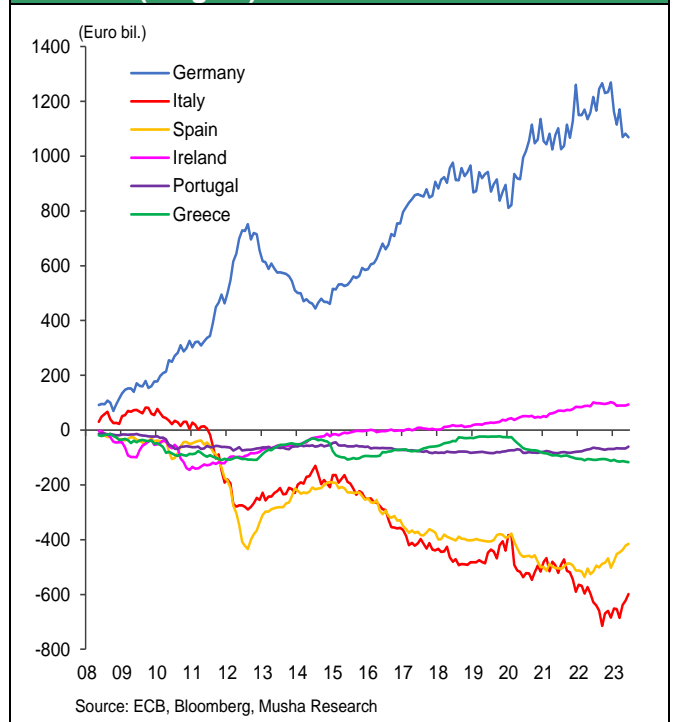




**Figure 8: Declining Current Account in Euro area**



**Figure9: Intra-Euro System claims and liabilities(Target2)**



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