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The European Union's proposed duties on Chinese electric vehicles and their implications

The European Commission can take a better route than imposing countervailing duties on Chinese electric vehicles

Uri Dadush, Conor McCaffrey

European Union countervailing duties (CVD) on certain types of electric vehicles (EVs) from China went into effect provisionally on 5 July[1] . The duties are being imposed based on a European Commission finding that China's EV subsidies represent potential injury to EU industry as it transitions away from the internal combustion engine. EU imports of EVs from China are surging, but still represent a small share of EU car sales. Most imports from China originate from joint ventures of EU and Chinese manufacturers, and from Tesla, which is the largest importer.

In the meantime, China is starting its own investigation into some EU exports, such as cognac[2] . The EU has initiated consultations with the government of China to resolve the dispute, as it must do under the World Trade Organisation Subsidies and Countervailing Measures Agreement. Under WTO rules, China cannot retaliate unless it challenges the EU measure and a dispute settlement panel rules in its favour.

The CVDs range from 17.4 percent to 37.6 percent of the import price, on top of the EU's 10 percent tariff on imported vehicles. They represent a formidable barrier in an industry where average profit margins are typically in the range of 4 percent to 8 percent. The CVDs will affect all EVs imported from China regardless of whether the original equipment manufacturer (OEM) is Chinese, American or European. Here, we offer an economic and political (as opposed to legal) analysis of the CVDs.

Methodology behind the CVDs

The Commission methodology for identifying subsidies and countervailing them is well established. Reflecting the importance of the EV sector, the regulation implementing the CVDs[3] is the result of a comprehensive investigation, encompassing extensive consultations with Chinese firms, EU firms, the Chinese government and Chinese trade associations. Identifying subsidisation in China's opaque system is challenging, especially since, as the regulation documents repeatedly, the Chinese government and several of the Chinese entities covered were uncooperative.

The regulation details how the Chinese government has prioritised the EV value chain (materials, batteries, vehicles) since 2010. Of course, the EU and the US are also prioritising EVs in their quest for decarbonisation. However, the Chinese state and Communist Party hold large sway over the Chinese economy, including state-owned and private corporations and powerful industry associations. Thus, the Chinese government adopts a 'whole of society' deployment of plans and instruments, including subsidies, as part of its industrial policy.

To determine whether imports from China are subsidised, the Commission chose a sample of three Chinese OEMs to conduct its investigation, namely BYD, Geely and SAIC. It set the CVD for all other cooperating firms at the average of the three. Curiously, Tesla, the largest exporter from China to the EU, was not chosen and has asked for a separate investigation.

For each of the sampled companies, the Regulation identifies and quantifies various sources of subsidies (Table 1).

Table 1: Types of subsidies granted to Chinese EV producers (% of revenues)

Company	Preferential financing	Grants	Land use rights	Batteries/battery inputs	Tax exemption/reduction
BYD Group	3.76	2.79	1.20	7.35	2.30
Geely Group	4.11	4.45	0.84	10.32	0.25
SAIC Group	9.65	10.84	0.67	13.24	2.62

Source: Bruegel based on Regulation (EU) 2024/1866 (see footnote 3). Note: The categories 'Land use rights' and 'Batteries/battery inputs' refers to the Chinese government provision of these for less than adequate remuneration.

We assess how the four main sources of countervailable duties –below market supply, preferential financing, grants and land usage – are calculated. Though it is evident that that various forms of non-market incentives in the Chinese EV sector exist, they may be significantly less than suggested by the Commission's methodology.

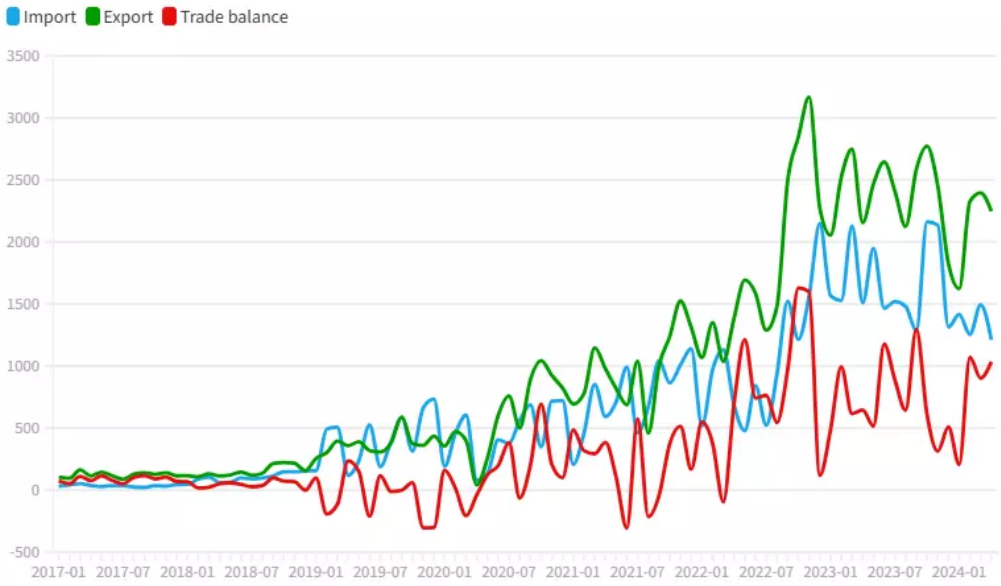
- *Below market provision of batteries and their inputs*. The reference used to compute the subsidy are the differences between the export and domestic prices of batteries (for SAIC and Geely) and of lithium iron phosphate (a key battery input, relevant for BYD which produces its own batteries). But many exporting firms price to market (Parker, 2016), and the fact that the export price of these inputs is higher than the domestic price is not necessarily because of subsidies. The markets for EVs, batteries and minerals in China are known to be exceptionally competitive[4] and in a price war[5], while in the EU car prices and consumer purchasing power are much higher.
- *Preferential financing*. Using its standard methods to try to establish a market-based rate as a counterfactual to the preferential financing received, the Commission assigned a credit rating of B to the three sampled Chinese firms and attributed a correspondingly higher spread compared to prevailing market rates to their borrowing and equity. The B rating, far below investment grade, is extremely low for large, modestly profitable firms, such as the sampled Chinese OEMs. For example, almost no firm in the S&P 500 is rated B or below. Moreover, credit ratings are available for Geely from the major international agencies, and they are higher than B[6].
- *Grants.* The government of China provides a subsidy to manufacturers for each vehicle sold. In economic terms, both consumer and producer subsidies have the effect of increasing the incentive to produce[7]. However, the Chinese subsidy, unlike the EU subsidy, is not available to importers and the Commission is correct in arguing that it is countervailable for that reason. Still, the scheme was discontinued as of December 2022, and even though some benefits continue to accrue to Chinese producers because payments are staggered, its distortive effects are fading by now. The Commission Regulation states that some Chinese provinces are introducing their own schemes but does not provide evidence of this.
- *Land use.* Land in China is owned by the state. Provinces subsidise EV producers by allowing them use of land at below market price. The Commission uses the price of land use – rent – in Taiwan as the reference point. However, Taiwan is far more densely populated than China and its income *per capita* is three times higher. Land

prices tend to be correlated with income and density, so the reference price appears too high.

The risk of injury

Adopting a kind of 'infant industry' argument normally associated with developing countries, the Commission Regulation argues that the EU EV sector is too young to withstand Chinese competition. But while some of the key success factors in EVs (eg battery technology) are different from the combustion-engine vehicle sector, the value chains of the two sectors have many common elements. This is most evident in the popularity of various types of hybrid vehicles. It is well known, of course, that the EU's OEMs are among the world's most successful. As shown in Figure 1, the EU runs a global trade surplus in EVs.

Figure 1: EU27 new EV car trade (extra-EU, monthly, € millions)



Source: Bruegel based on Eurostat (ds-045409). Note: Product code for new battery electric vehicle car is 87038010.

To make a historical analogy, in the 1970s and 1980s, Japanese and then Korean OEMs appeared to threaten the European automotive industry, but they became established in the EU market only over decades and after large investments. European OEMs adjusted to them by greatly increasing productivity and quality and by adding innovative features. Chinese OEMs still have a minuscule share of the EU automobile market, while EU OEMs are in the process of rapidly developing their

own lower priced EVs and investing in battery technology and manufacture, often in joint ventures with Chinese producers.

Some implications of the CVDs

The CVDs apply to about €10 billion in annual imports (in 2023), a minuscule amount relative to the €17 trillion EU economy, implying that their macroeconomic effect will be imperceptible. However, if approved, the CVDs, which apply for five years and will be difficult to reverse, will have significant consequences for the automobile industry. Because of the large price difference between similar or identical models in China and the EU, where prices can be 50 percent higher, the CVDs will capture a large part of the profit made by firms exporting from China. EU OEMs and Tesla account for the lion's share of these profits since, unlike Chinese suppliers, they have already established distribution networks and brands. EU OEMs will see profits decline sharply as CVDs are applied, but their imports from China may remain marginally profitable (Barkin et al, 2024). In contrast, Chinese OEMs may well be deterred completely, causing their exports from China to the EU to drop sharply[8].

Both sets of exporters are likely to react by raising prices. The biggest effects of tariffs are to raise consumer prices (Fajgelbaum et al, 2019) and, over time, to divert imports to more expensive third-party suppliers. In this case, higher prices for EVs will cause additional damage by directly slowing the green transition and by garbling the Commission's message about its urgency and overwhelming importance. Lower-income EU consumers who need a car and are already struggling with high prices will be especially affected.

The CVDs will reduce pressure on EU OEMs to increase productivity and innovate. They will also reduce the incentive to operate value chains that span the EU and China, which is by far the largest producer and consumer of EVs and batteries. China has established a clear technological lead across the EV value chain[9], one that may no longer depend on subsidies.

Chinese OEMs may respond to the CVDs by establishing production in the EU, but that option will also entail higher costs and prices, and in any event will only be open to the biggest producers. Some Chinese producers of EVs and batteries may prefer instead to establish their largest facilities in lower-cost locations with access to the EU market, as is already happening in Morocco and Turkey[10]. Within the EU, Hungary – which maintains close relations with China – may turn out to be the

preferred EU location for Chinese OEM investment, which some EU capitals will see as an undesirable outcome.

The Commission Regulation adheres to WTO procedures and internal EU due process, in sharp contrast to the United States's unilateral approach to the issue under its Section 301 ('unfair trade') provisions. However, the CVDs are bound to be seen as another sign that world trade is fragmenting into hostile blocs, adding to the trade policy uncertainty across the world and heightening geopolitical tensions. Steps that are seen to directly or indirectly weaken the open trading system on which the EU relies endanger all the EU's largest export sectors.

Policy

While CVDs at some level may be appropriate, the benchmarks and methods applied to calculate them may lead to levies that are too high. More importantly, better policy alternatives are available.

A first-best solution is to deal with the underlying problem of Chinese subsidies. We believe it is possible in this case, considering the importance of the EV sector for the green transition and the pressure exerted by the United States' own prohibitive tariffs on Chinese EVs. The EU and China may be able to reach agreement as follows: a) the domestic price of batteries and lithium in China should be allowed to rise nearer to the world market price (assuming of course that it is being artificially depressed now); b) the interest rate charged to Chinese OEMs should reflect international credit ratings; c) China's producer subsidy for EVs should be definitively terminated and not replaced at the national or provincial level; and d) land use will be allowed at a market price established in each province. Closing such a deal would probably require a critical examination of the EU's own subsidy schemes[11] and whether and to what extent they are distortive of trade.

Another preferable approach would be to impose a WTO-compatible temporary safeguard tariff on all EU imports of EVs (not just Chinese imports), but only when and if it becomes evident that EV imports are big enough and rising rapidly enough to endanger the overall viability of EU OEMs (Dadush, 2024). We believe this is not the case at present.

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Endnotes

1 See European Commission press release of 4 July 2024, 'Commission imposes provisional countervailing duties on imports of battery electric vehicles from China while discussions with China continue', https://ec.europa.eu/commission/presscorner/detail/en/ip_24_3630. The duties are subject to approval by EU countries, expected in November. The vehicles affected are new battery electric vehicles designed for the transport of nine or fewer persons. In general, hybrids, including plug-in hybrids, are not affected, but range-extender hybrids (ie EVs with an internal combustion range extender) are included (see Article 1 of European Commission, 2024).

2 Jack Simpson, 'China to hold hearing into brandy imports as tension grows with EU over tariffs on EVs', The Guardian, 5 July 2024, https://www.theguardian.com/world/article/2024/jul/05/china-to-hold-hearing-into-brandy-imports-as-tension-grows-with-eu-over-tariffs-on-evs.

3 Full detail of the CVDs is set out in Commission Implementing Regulation (EU) 2024/1866 of 3 July 2024 imposing a provisional countervailing duty on imports of new battery electric vehicles designed for the transport of persons originating in the People's Republic of China, available at http://data.europa.eu/eli/reg_impl/2024/1866/oj.

4 See for example Laura He, 'A brutal elimination round is reshaping the world's biggest market for electric cars', CNN, 24 April 2024, https://www.cnn.com/2024/04/24/business/china-ev-industry-competition-analysis-intl-hnk/index.html.

5 Jiahui Huang and Sherry Qin, 'China's EV Price War Is Just Getting Started', The Wall Street Journal, 24 April 2024, https://www.wsj.com/business/autos/chinas-ev-price-war-is-just-getting-started-f8bfb198.

6 For instance, in June 2024, Moody's rated Geely Ba1, which is equivalent to BB+ by Standard and Poor's; see Bondblox, 'Geely Auto Downgraded to HY Status of Ba1 by Moody's', Bond Market News, 3 April 2024, https://bondblox.com/news/geely-auto-downgraded-to-hy-status-of-ba1-by-moodys.

7 In a simple demand and supply framework, a consumer subsidy increases demand and price, and indirectly raises profit. A producer subsidy increases profit directly, increases supply and lowers price.

8 See model simulations in Kiel Institute News of 31 May 2024, 'EU tariffs against China redirect trade of EVs worth almost USD 4 billion', https://www.ifw-kiel.de/publications/news/eu-tariffs-against-china-redirect-trade-of-evs-worth-almost-usd-4-billion/.

9 See for example Chengyi Lin, '3 Drivers of China's Booming Electric Vehicle Market', Harvard Business Review, 3 January 2024, https://hbr.org/2024/01/3-drivers-of-chinas-booming-electric-vehicle-market.

10 Peter Hoskins, 'China Tesla rival BYD signs $1bn Turkey plant deal', BBC, 9 July 2024, https://www.bbc.com/news/articles/cp08d1nq1y3o; Sam Metz, 'Chinese firms eye Morocco as way to cash in on US electric vehicle subsidies', Associated Press, 3 July 2024, https://apnews.com/article/china-morocco-electric-vehicles-batteries-subsidies-ea055ee37c5da66d30a38df80e4d198e.

11 Such as Important Projects of Common European Interest (IPCEIs), which are state-aid exemptions granted by the Commission to allow EU countries to help fund large cross-border infrastructure and innovation projects, including the industrial deployment of innovative technologies. Over €6 billion has been approved for two battery IPCEIs, with EV manufacturers among the beneficiaries.
See https://competition-policy.ec.europa.eu/state-aid/ipcei/approved-ipceis/batteries-value-chain_en.

Bruegel
Rue de la Charité 33,
B-1210 Brussels
(+32) 2 227 4210
info@bruegel.org

Bruegel.org