Overt optimism cannot hide the facts

The latest book in our Bite-Size Brexit range is now published! 'Carmageddon?: Brexit & Beyond for UK Auto' looks at the manufacturing industry at the heart of the issues around Brexit, with the industry's sophisticated just in time and other major logistical challenges.

The book, edited by Professor David Bailey, Professor Alex De Ruyter, Neil Fowler and John Mair, brings together a wide spectrum of industry experts and world-renowned auto industry figures, providing a real perspective on Brexit at the raw edge. Contributors include leading auto analysts, top automotive journalists, politicians and academics.

Today, we are delighted to share Justin Cox and David Oakley of LMC Automotive's contribution to the book.

Enjoy…

2020 vision? The macro impact on the auto sector could still be devastating, say Justin Cox and David Oakley of LMC Automotive

As we write, the terms of the UK's future relationship with the EU post-2020 are still highly uncertain. With the UK formally leaving the EU on January 31 this year and entering a transition period until the end of the year, the nature of the longer-term trading relationship is not yet known.

The possibilities include the UK reverting to trading on World Trade Organisation (WTO) rules if no trade deal can be struck this year – henceforth referred to as a no-deal Brexit – and a 'bare bones' trade deal, eliminating tariffs. There is the possibility of an extended transition period beyond December 2020, with the aim of a comprehensive free-trade agreement following, though any delay would be something of a U-turn by prime minister Boris Johnson. The Conservative government, now bolstered by a strong majority in parliament, has indicated that it is keen to diverge from EU standards in some areas, raising the possibility that the future arrangements will be somewhat closer to the 'harder' Brexit scenarios, even if a trade deal is agreed in a timely manner.

As ever with Brexit, though, it is difficult to be certain how much of the debate on all sides is intended as a negotiating tactic rather than a serious long-term strategy. Remarkably then, as we head towards the four-year anniversary of the referendum, the UK's future trading relationship with the EU is still unclear. As the transition period extends all current trade arrangements to the end of 2020, we assume no macroeconomic impact at the time of the technical Brexit date of January 31.

Beyond 2020

The likelihood of the UK government achieving its aim of completing a freetrade agreement with the EU by the end of 2020 looks ambitious and a transition period extending to the end of 2022 appears more realistic, despite UK government insistence this can be wrapped up sooner. Our partner Oxford Economics (OE) sees UK GDP growth at an average of 1.5 per cent in 2020-22. The relatively positive medium-term forecast reflects fiscal loosening from the Treasury as well as a boost from pent-up demand due to the uncertainty created by Brexit.

Away from the base case, the risk of no deal still looms. Under a no-deal scenario, OE is not forecasting that the UK enters a prolonged recession, although two consecutive quarters of negative growth can be expected, with no deal acting as a drag to the tune of up to 1-1.5 percentage points

per year. The worst potential effects of no deal would be mitigated, OE assumes, by higher government spending – and therefore a greater tolerance for a higher deficit, at least temporarily – as well as a cut in interest rates, to 0.25 per cent. This interest rate cut would be delivered despite a spike in CPI inflation.

The impact on sales

UK light vehicle (LV) sales – which include both personal vehicles and light commercial vehicles – totalled 2.73m units in 2018 and 2.68m in 2019. While these represent ongoing falls year-on-year, it should be noted that the UK market is receding from an all-time record of 3.08m units in 2016, and a cyclical slowdown would anyway be expected. In addition, Brexit is certainly not the only factor that has been affecting sales in recent times, although uncertainty around the future of the economy is seen as a cause of slowing sales as 2018 and 2019 progressed.

The introduction of a new emissions testing procedure, known as WLTP, disrupted sales across Europe back in 2018, with sales still struggling to fully recover by year-end. Furthermore, diesel sales have declined severely amidst a spate of negative publicity for the fuel type, linked to harmful emissions and therefore potential bans in the future. With some, more modest, WLTP disruption in 2019 and continuing low levels of consumer and business confidence, vehicle sales contracted once again.

Under our baseline outlook, we assume an orderly exit from the EU with a trade deal post-2022 in place. LV sales are on a weak footing and with GDP slowing once again in 2020, we forecast sales falling a little over 1 per cent this year, before returning to modest growth of circa 2 per cent in 2021, by which time LV sales will be 2.7m.

However, under a no-deal scenario, a number of macroeconomic factors would conspire to put downward pressure on sales. As well as a reduction in GDP growth, the pound would depreciate sharply, by – OE expects – almost 15 per cent on a trade-weighted basis. This would increase the cost of vehicles in the UK, given that most cars sold in the UK are imported (predominantly from the EU), and even those that are locally manufactured rely on international supply chains. Add to this, a 10 per cent WTO tariff to be applied on the imported vehicles, and the pressure on prices begins to really accumulate.

Supply chains would also be affected by 10 per cent tariffs in the event of a no deal, as well as non-tariff barriers such as increased customs checks at the border, all of which will increase cost pressures on manufacturers.

The effect of sterling's fall

After sterling's depreciation in the wake of the 2016 referendum, automakers absorbed some of the costs stemming from the weaker pound, but would surely struggle to do so much further were the currency to slip to the levels predicted by OE, and tariffs were applied. For example, it was recently reported that Brexit disclaimers are being applied to invoices for imported vehicles such that the customer absorbs any tariff-related price increase prior to vehicle delivery, thereby protecting company margins.

We expect that the combined impact of these effects (sterling falling, tariffs, macroeconomic weakness) would be to reduce UK LV sales by around 12 per cent compared to the baseline scenario for 2021, with a market outturn of 2.38m against the base case of 2.70m sales. Over the 2020 to 2024 period, we forecast that a cumulative 1m UK sales could be lost in a no-deal scenario, versus the base case.

The impact on production

Although the effect on other countries would be much less significant, we still see global sales being reduced by some 300,000 units per year in the near-term, in addition to those lost in the UK, if no deal is agreed.

The auto industries in the UK and Europe are closely integrated. Common regulatory EU-wide frameworks have evolved to facilitate the development of highly complex automotive supply chains, which now underpin a business model that relies on just-in-time and just-in-sequence delivery and production.

This business model will be affected by Brexit, but the scale of impact depends on which scenario is pursued: our base transitional Brexit or the no-deal scenario. The UK is estimated to have produced 1.42m light vehicles in 2019 and, of this total, almost 80 per cent were exported globally, with the EU receiving more than 55 per cent of this volume. However, it is important to appreciate the complexity of automotive manufacturing with each finished vehicle consisting of thousands of components, which in turn are processed and traded across multiple borders. For UK production, 44 per cent of a vehicle's content is sourced locally, with almost 80 per cent of the remaining non-domestic content coming from the EU.

In a no-deal Brexit, barrier-free access to the EU market is expected to end with the UK withdrawing from the EU on WTO terms. Under these terms, a 10 per cent tariff would be applied to all traded goods. Coupled with regulatory requirements, these new customs procedures will inevitably add barriers to trade, increase red-tape and ultimately cost. Border checks in particular will cause delays and undermine the efficiency of the just-in-time model.

Although the threat of an imminent no-deal Brexit has dissipated following the UK government's agreement to enter the transitional EU-withdrawal phase, the shape of Brexit beyond 2020, at the end of transition, remains unclear. Indeed, without sufficient trade negotiation progress being made, the automotive industry may well still face another cliff-edge moment at the end of 2020 as the prospects of a no-deal Brexit reappear.

In this situation, we could see year-end contingency stock-building provide a modest 1.5 per cent boost to the UK's 2020 LV production outlook, when measured against our current base-case view. However, the impact of a nodeal Brexit would begin to fall heavily in 2021 as unwinding of stocks,

weaker competitiveness and a falling domestic market combine to undermine the UK's LV production volume: we expect output could fall below 1.4m units – 10 per cent lower than our current base-case view.

Investment may go to the EU

Longer term, continuing obstacles to trade associated with a no-deal Brexit may encourage an increase in UK component manufacturing onshoring. However, fears persist that UK domestic original equipment manufacturers (OEMs) lack the required local market scale to attract investment by key volume component suppliers – very simply, large capacity investment decisions are more likely to gravitate to the EU where the combined potential of the single market offers the greatest volume opportunity and manufacturing economies. This is particularly relevant for an industry which is facing such technological change as all automakers grapple with huge new investment decisions required to accommodate the evolution of electrification and autonomous driving.

For UK-based OEMs, a no-deal Brexit might even threaten the existence of certain assembly facilities. Indeed, the fear of a no-deal scenario may have contributed to the announcements by Nissan to cancel the expansion plans of its Sunderland plant, and Honda, which has confirmed that it will close its UK manufacturing operation in Swindon from 2021.

Admittedly, much of these decisions are based upon the new EU-Japan trading accord. In force since February 2019, this new trade agreement ensures that the EU's 10 per cent tariff on Japanese auto imports will be tapered to zero over the next ten years. Increasingly Japanese OEMs may choose to import new models rather than invest and continue to localise production in their European transplants.

For the UK, whose access to the EU's single market originally attracted Japanese automakers, Brexit adds another dimension. Should the UK leave without a deal and WTO tariffs are applied to UK vehicle exports, the same cars made in Japan may well end up costing less to import into the EU27 than those produced just across the Channel in Britain.

With the UK's Japanese transplants collectively producing almost half of the UK's LV output in 2019, and Toyota and Nissan respectively exporting 79 per cent and 60 per cent of their production to the EU, risks for further industrial shrinkage are significant. For PSA Group, which is battling with overcapacity, the Opel/Vauxhall Ellesmere Port plant may be tough to justify after 2021, when the current- generation Astra compact model produced there is slated for replacement.

Peugeot has already issued a clear warning on possibly shifting Astra production to southern Europe in the event of no deal. Jaguar Land Rover, meanwhile, could divert more production to a new facility in Slovakia and/or increase contract production with Magna in Austria.

As a result, it would be overly optimistic to assume that manufacturers which export large portions of their UK output to the EU would continue to do so indefinitely under persistently unprofitable operating conditions.

Indeed, should more of these currently UK-produced models fail to be renewed in Britain, annual UK car production could be over 500,000 units lower in the second half of the next decade when compared with our base view.

‘Carmageddon?: Brexit & Beyond for UK Auto’ is available NOW, in paperback and digitally, here.