No light at the end of the production line

'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 Vicky Pryce's contribution to the book.

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Brexit causes numerous and complex problems for the UK automotive sector, says Vicky Pryce, and there appears to be no easy answer to whatever happens

The UK automotive sector has been one of the great successes of the last decade. In 2016 it accounted for some 4 per cent of the economy, employed just under 900,000 workers, had an annual turnover of some £82bn and was one of the UK's main exports with some 80 per cent of its output destined for abroad.

It is one of the most productive sectors of the economy, traditionally investing some £3.6bn annually though this has fallen sharply since the Brexit referendum of June 2016. And it has been a success story overall. Output had picked up after the serious slowdown during the financial crisis with competitiveness bolstered by a weaker exchange rate and annual production rose to 1.7m cars in 2016, the highest number since the record year of 1972 when 1.9m cars left UK factories. There were some 2.7m engines built in the UK that year.

Following the EU referendum however car production fell back by 3 per cent in 2017 and by over 9 per cent in 2018 as a whole to just 1.52m passenger vehicles, with UK car exports dropping despite the devalued Brexit pound. However the Brexit uncertainty and the threat of a no-deal scenario continued through 2019 taking its toll on the economy and on the automotive sector.

It is not surprising that the sector would suffer given the impact on both supply and demand of the Brexit vote. According to calculations by the Bank of England, the National Institute for Economic and Social Research (NIESR) and also the Centre For European Reform (CER), output in the UK economy since the referendum grew some 2.5-3 per cent less than it would have done had the referendum result gone the other way if one took into account the UK's comparative position, previous trends and world trade and GDP growth over the period.

What basically happened is that as investment was held back, indicating increased uncertainty in the economy, productivity and competitiveness suffered as did overall prosperity and real living standards of the UK population. And demand generally remained subdued despite substantial monetary easing by the Bank of England since mid 2016. Following the referendum households saw a further fall in real disposable incomes for a while as inflation rose temporarily, reflecting the fall in sterling that followed the shock result.

Of course there were external factors too. The most recent period has witnessed a slowdown in the world economy as trade disputes between China and the US escalated and trade relations between the EU and the US worsened, while Germany's industrial production machinery seems to have ground to a halt. The regulatory environment on cars is evolving with much uncertainty still on what the future for diesels and electric cars might look like as environmental concerns rise.

Business and consumer optimism low

In such an environment it would indeed be expected that demand for and production of cars in the UK would be adversely affected. But Brexit can still be seen to have had a direct negative impact on the sector. The Society of Motor Manufacturers and Traders (SMMT) has referred to Brexit as ‘the most significant threat to the competitiveness of the UK automotive sector in a generation’.

While some of the political uncertainty has now gone following the decisive Tory victory in the general election of December 2019, concern about the length of the transition period, due to end in December 2020, and the new terms of whatever trade agreement is reached with the EU may well see the demand weakness remain for some time to come – both from individual consumers and from businesses.

Investment worries

Since the referendum, and with various Brexit deadlines approaching threatening a no-deal and then being postponed, there has hardly been enough stability or confidence to invest or produce. Business investment across all sectors has fallen in many quarters.

The latest Office for National Statistics’ (ONS) estimates for the third quarter of 2019 showed stagnant growth in business capital expenditure in the three months from June to September, although it was up 0.5per cent from a year earlier. And business optimism has been in general decline for some time – the Q4 2018 CBI survey suggested a further sharp drop with investment intentions on buildings, new plant and machinery and also on training showing the worst quarterly performance since the financial crisis.

This lack of confidence was bound to also be reflected in the car industry too. Investment in the sector has been on a declining trend in the last few years. Latest data suggest that it halved in 2018 alone with the result that car manufacturers invested just £589m in the UK compared to £2.5bn in 20155. In the six months to June 2019 investment pledges fell by a further 70 per cent compared to the already poor first half of 2018.

Not surprisingly, relocating activities seems to have started already. SMMT research has been suggesting for some time that a significant percentage of firms are already moving operations out of the UK and reducing headcount, as well as reviewing and actually altering logistics and other arrangements such as warehousing and stock adjustments, to be able to cope with Brexit.

The reason to worry of course is that the shape of the sector has changed drastically over the past few decades. All the large manufacturers producing in the UK are foreign owned. with only smaller specialists and luxury producers still mainly in British hands. The big overseas companies, producing partly for the domestic market but also massively for export, can more easily adjust and move operations due to changes in the competitive environment. Their investment plans are being followed closely and Nissan UK (Japanese owned with an annual production of 500,000 units) was one of the first companies to be visited by Theresa May to reassure it on Brexit when she became Prime Minister after the referendum.

Despite the reassurances given so far, the company has shelved its investment plans for building the new X-Trail in the UK8, partly blaming the Brexit uncertainty for its decision. Honda announced its intention to close Swindon, which was already running at half capacity, at the end of 2021 and consolidate production in Japan.

It still plans to keep its European headquarters in Bracknell in the UK and the company did not attribute this decision directly to Brexit. Nevertheless uncertainty as to the final deal cannot have helped. This means losses of 3,500 direct jobs and a possible further loss of an equal number again down the supply chain. Swindon workers are already blaming Brexit as a reason. And it is worth bearing in mind that some 40 per cent of all components in Swindon come from the EU.

In mid 2019 JLR, although seeing an improvement and return to profit towards the end of its financial year, announced a record loss in its history for 2018 as a whole13, and had already announced plans to cut 4.500 jobs, many in the UK. It had earlier worried that a no-deal Brexit would cost it an extra £1.2bn in lost profits per annum and had implemented a series of cost-cutting measures14.

More recently however JLR, helped by the promise it seems of a £500m loan guarantee from the government, has announced plans to assemble new electric cars in the UK and the intention to produce a new Range Rover model in Solihull. Mini intends to base its new electric hatchback at its plant in Oxford.

Output impacts

But smaller component manufactures down the supply chain will remain worried, concern about the supply chain identified by the British Chambers of Commerce (BCC) as big firms adapt to Brexit is likely if anything to intensify through the coming year.

In this environment it would be expected that car production would also be affected, and this is precisely what has been seen. In response to the prevailing uncertainty a number of the large car companies shut down output for a few weeks in April 2019 to coincide with the original deadline of March 29 – which of course came and went – and that certainly affected production early on in the year.

Honda had earlier announced plans to shut Swindon, anyway, for six days after the Brexit date of March 29 in 2019 to ensure it could handle any issues with exports to the EU and also to address any concerns in relation to its imports of components post Brexit. As a result in April 2019 car production was 44 per cent down on the previous year. Toyota, BMW and Jaguar Land Rover (JLR) all implemented further planned temporary closures in November 2019 to coincide with yet another, as it happens, missed Brexit deadline, this time under new Prime Minister Boris Johnson. Output fell by 16.5 per cent that month from the levels a year earlier.

The result is that production in the sector contracted by 14.5 per cent in the 11 months to November, having shown monthly falls for 17 out of the last 18 months. This has made it the worst period of decline since 2001.

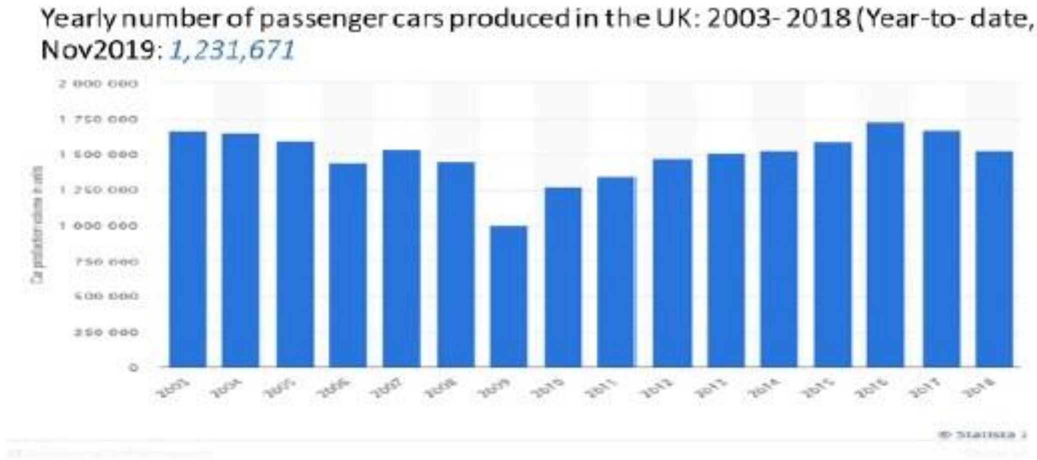

Figure 1: Car production in the UK: November 2013-2018 and October 2019 (SMMT)

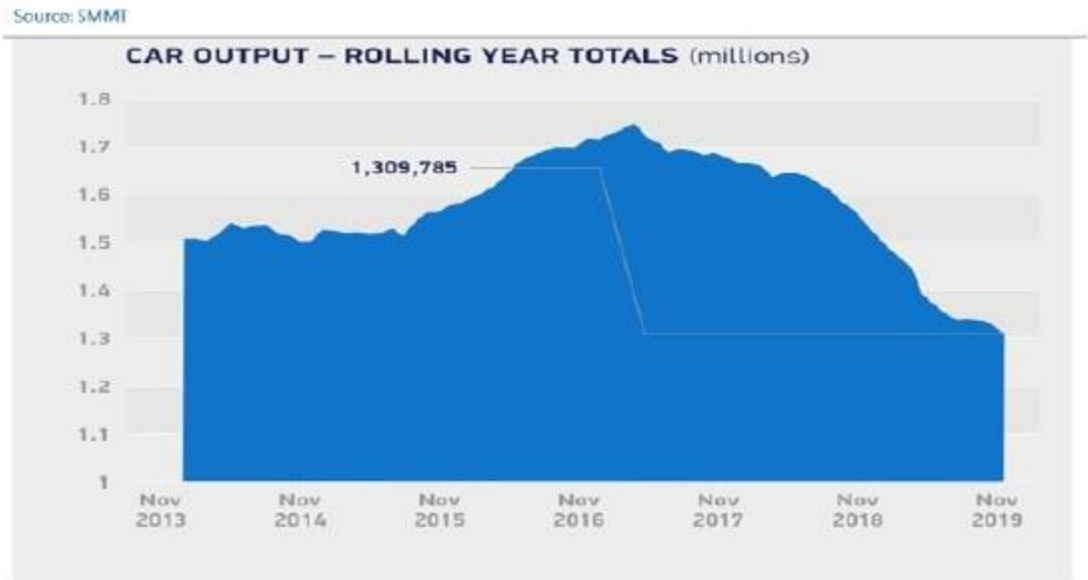

Figure 2: Rolling car output in the UK: November 2013- 2019 (SMMT)

But optimism in the sector hit the lowest in 27 years during the past year as uncertainty took its toll. And trying to cover itself against the possibility of no deal is estimated to have cost the sector some £330m in extra costs, such as extra warehousing space, stockpiling, new logistics solutions and staff training to deal with new expected customs procedures18.

Consumer confidence

The consumer, now over-indebted again after being incentivised to borrow at record low interest, has been a major part in this slowdown.

So despite high employment rates, the fact that real wages though improving are only just getting back to the levels seen before the financial crisis, Brexit uncertainty and the lack of clarity regarding how the UK government will proceed on diesel cars have negatively affected consumer confidence in the sector impacting on car registrations.

Figure 3: New car registrations in the UK: 2013- 2019 (SMMT)

New cars registered in the UK fell by some 6 per cent in 2017 and by a further 7 per cent in 2018. Vehicle registrations in 2019 were down by a further 2.4 per cent over the whole of the year according to SMMT. Diesel car registrations were down 22 per cent, while petrol cars rose by 2 per
cent. At the same time sales of new battery powered cars rose by 144

per cent but their share remains at only 1.6 per cent of the total market. It will take a lot more for that share to rise, including greater price incentives and many more charging points across the country. But businesses were also cautious overall with new fleet registrations rising by just 0.8 per cent in 2019 as a whole. In parallel the BCC has been reporting the development of serious skills shortages in many sectors including the car industry where EU workers make up at least 10 per cent of the UK automotive manufacturing sector labour force.

With many EU citizens deciding to leave since the referendum those still arriving from the EU to work are not sufficient to stop a serious drop in net EU migration, which was just 48,000 in the year to June 2019, the lowest since 2003. And yet the sector remains a vital part of the economy and of UK manufacturing, accounting for 12 per cent of all exports23. With 57 per cent of UK car production going to the EU it is no surprise that developments on the Brexit front are worrying the UK car industry, perhaps more than any other sector.

Indeed, in his letter to Nicky Morgan, former chair of the House of Commons Treasury Select Committee (and now in the Lords) on the implications of a no-deal Brexit, the then Chancellor Philip Hammond singled out the car industry for mention among the sectors most likely to be affected by a no-deal Brexit. In a report of their Annual Executive Survey in early January 2019, the Engineering Employers' Federation (EEF), the manufacturing association, and AIG Insurance found that Brexit was affecting manufacturing confidence negatively with the most feared issue being delays at the border.

What next?

As the next deadline of January 31 for exiting the EU approaches, the sector will have to brace itself for what is to come. The outcome of the forthcoming trade negotiations with the EU will be critical. Tariff-free trade would be welcome, but the issue is more one of the extra costs and disruption associated with the ending of frictionless trade with the EU, which would severely undermine the just-in-time manufacturing that has served the sector well.

More than half of car components used in car assembly in the UK are produced elsewhere and a part can move multiple times between the UK and the rest of the EU to be improved/added to before it forms part of the final assembly over here27. Any end to this cooperation with continental suppliers – and their cooperation in turn with the 2,500 UK suppliers – would eat away at the UK sector's competitiveness, and with it the attraction of the UK to foreign investment.

And the regional implications would be severe. Work by Dennis Novy at the University of Warwick has calculated the unintended consequences for inflation of the Brexit vote as a result of sterling's depreciation since June 2016; it concluded that the North of England, Scotland, Wales and Northern Ireland – all areas with above average import content – suffered most in terms of that inflation that followed.

The study warns that even if sterling falls no further – in fact it has recently been rising as political uncertainty at least has been lifted and the chances of another referendum have disappeared – any tariffs imposed on EU imports after Brexit would exacerbate the inflationary impact felt so far, while non-tariff barriers such as customs checks and red tape would ultimately also be damaging as they would feed into higher prices for British consumers.

This would be particularly pronounced in areas where pan-European supply chains have been well established and end up being disrupted. According to SMMT calculations, a no-deal shift to the 10 per cent EU tariffs that would apply to UK cars as a third country, and 4.5 per cent tariffs on exports of components, would add some £1.8bn to the cost of exports and affect competitiveness adversely. Imports of cars from the EU would bear an extra cost of some £2.7bn, which would be hard for the sector to absorb at a time when consumers remain under pressure in their personal finances.

Looking at this analysis it is obvious that the car industry is likely to be one of the most affected by this – both in terms of costs and also consumer demand.

Multinational businesses already moving

Michael MacMahon from Oxford University30 has looked at the impact of uncertainty over Brexit on business decisions. He concludes that "because the UK is so interconnected with other EU nations, uncertainty over Brexit has likely affected every aspect of firms' business environment”. Worryingly, as he points out, a large number of companies appear to have only just realised the extent of the exposure of their business to membership of the EU – which allows them participation in global supply chains, access to labour across all skills levels, and access to all the services they need. Hence the recent rush to stockpile goods and components reported in the UK at the turn of the year.

In his piece for the 2019 Centre for Competitive Advantage in the Global Economy (Cage) report MacMahon ends up lamenting the fact that firms are in fact facing what he terms ‘policy-generated uncertainty’ (Brexit, one would argue, being one) as government objectives often look completely undeliverable. But though hard-line Brexit – a no deal – was feared most because of the rules of origin, customs controls, and delays, all Brexit scenarios would make the UK production more difficult and less competitive.

Reflecting these concerns the EEF, in its briefings, has recommended that to ensure some continuity and minimise costs, if and when the UK leaves the single market, the manufacturing sector should be allowed to continue to participate in developing ‘harmonised’ product standards.

Again, on behalf of manufacturers as a whole, it also pleaded for the current health and safety landscape to be maintained after leaving the EU so as to avoid creating extra costs and disrupting business. That is of course in direct contrast to how some people interpret ‘taking back control’, the slogan that contributed to winning the election of December 12 for the Conservatives and finally ushering in Brexit.

That interpretation says that on exiting the EU the UK is given licence to diverge its regulatory base and take advantage of that freedom to compete more aggressively with the rest of the world – and the EU. Were that view to dominate then the chances of a deal being agreed, which allows trade to be as frictionless as possible which is what the industry would ideally want, diminishes considerably.

So uncertainty will remain. And Brexit arguments will not go away. Most economists therefore looking at the difficulties ahead expect the economy overall, to stay subdued in 2020 growing by no more than 1-1.5per cent with investment rising very slowly at best.

Cost-free Brexit for the car sector is a dream

So what is in prospect? As Mike Hawkes, chief executive of SMMT has pointed out: “Frictionless trade as part of the EU single market and customs union has driven the success of the UK automotive industry so the fact we are leaving is already painful, and already causing damage.” Moreover any free-trade deal with other countries, such as the one mooted with the US, would necessitate a fall in import tariffs for cars coming to the UK from the US and that could mean the loss of tens of thousands of car manufacturing and service jobs here.

A cost-free Brexit is a dream. Any added friction that augments costs to producers in what is a very tight-margin sector that has to meet tough emissions regulations and other safety standards will be affected by this. The automotive sector is therefore braced for quite a rough time ahead. A longer transition period beyond December 2020 would help, but there is no guarantee that this will be on the table. What will emerge after the UK leaves remains unclear. And then there is the question of financial support.

Will the sums of money that are currently earmarked for transport, including the automotive sector, under the Horizon 2020 budget agreement and the Horizon Europe that succeeds it, still flow to UK car manufacturing?

High levels of cross border research and development have been important in assisting competitiveness in the sector. In early January 2020 it was suggested that the new government’s appetite to spend more supporting industry, R&D and the regions on the back of relaxed fiscal rules, while borrowing costs remained at their current near record low levels, might provide some relief.

But for the sector in the end much will depend on what type of trade agreement we strike with the EU. Will we get there? And what is more, will we get there in a year which seems to be the new deadline when the transition period is due to come to an end? Don’t hold your breath.

Notes:

1. https://www.smmt.co.uk/industry-topics/uk-automotive/

2. https://www.bbc.co.uk/news/business-47055188

3. https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/busi

nessinvestment/julytoseptember2019revisedresults

4. https://tradingeconomics.com/united-kingdom/business-confidence