

The European Union's Covid-19 incentive and its impact on exports

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In mid-July 2020 European Union leaders approved the most aggressive climate change plan in history.¹ This was contained as part of the European Commission's recovery plan in the wake of the Covid-19 pandemic, wherein European Union (EU) leaders, after a four day summit, agreed to a \$2 trillion deal² which included the establishment of a carbon border tax and a commitment that 30% of their total expenditure from the recovery fund would be used to address climate concerns and accordingly, roughly \$600 billion would be dedicated to green measures.³

Operating as a single market with 27 countries, the EU is a major world trading power and in terms of the total value of all goods and services produced (GDP), it is bigger than the US economy. Recent estimates puts the EU's GDP at €15.3 trillion.⁴ With just 6.9 % of the world's population, EU trade with the rest of the world accounts for some 15.6 % of global imports and exports and together with the United States and China, it is one of the 3 largest global players in international trade, therefore any trade linked pronouncements and incentives will reverberate far and wide.

The European Union's recent Economic Recovery Plan has, due to its focus on climate action, sustainable investments, and a just transition fund, reignited the debate on the relationship between economic growth, resilience and sustainability. The backdrop to this is that the rapid rise of wind and solar power has priced coal out of many markets and in 2020 renewable sources of power generated 40% of European Union electricity while fossil fuels generated 34%⁵. In Spain, coal generation fell 58% in the first six months of the year and it is predicted that 69% of that country's entire coal fleet will be shuttered between 2020 and 2021. Furthermore, the COVID-19 outbreak has severely depressed power demand, further reducing coal consumption. By June 2020 countries like Portugal saw coal generation fall by 95% while the Netherlands, Austria and France all experienced reductions of more than 50%. Possibly the best illustration of the end of Europe's love affair with coal and the increasingly uncompetitive

¹ <https://www.technologyreview.com/2020/07/31/1005819/how-an-eu-tax-could-slash-emissions-far-beyond-its-borders/#:~:text=The%20text%20of%20the%20242,are%20allowed%20by%20EU%20manufacturers>

² <https://www.cnn.com/2020/07/21/eu-leaders-reach-a-breakthrough-on-the-regions-recovery-fund.html>

³ <https://www.cnn.com/2020/07/21/eu-leaders-reach-a-breakthrough-on-the-regions-recovery-fund.html>

⁴ https://europa.eu/european-union/about-eu/figures/economy_en

⁵ <https://www.reuters.com/article/us-europe-climatechange-coal/europe-steams-towards-coal-exit-research>

economics of coal power is to found in Sweden and Austria which closed their last coal plant plants in March.

In late 2019 members of the new European Commission produced the European Green Deal, an ambitious set of initiatives that aimed at making Europe the world's first climate-neutral continent.⁶ According to Ursula von der Leyen, the new President of the European Commission, the European Green Deal would be at the centre of the EU's economic strategy to "bounce forward" from the COVID-19 crisis and assist in achieving its 2030 emissions-reduction target which are enshrined in EU law. The carbon border tax will commence in 2023 and the level at which imported goods are taxed will depend on the carbon emissions associated with producing these goods.⁷ Since imports represent approximately 25% of the emissions of all goods consumed or processed in the EU, placing a carbon tax on imports could go a long way towards meeting its carbon reduction targets. Of the 44 sectors that the EU regards as high priorities for new carbon measures, 85% are related to materials, energy, and those sectors that provide raw ingredients for industrial processes. Sectors such as chemical products, basic metals, paper products, and non-metallic mineral products, despite being less dependent on trade, would be directly affected because of their high carbon intensity. Quite evidently, this will create huge challenges for companies with a large carbon footprint.

Those companies that export to the EU and that are in carbon-intensive industries, would need to adapt quickly by reducing their carbon footprints, or risk losing their market share either to EU-based competitors or to other nations that are more carbon efficient. To assess the potential impact of the carbon border tax, a recent study looked at a selection of carbon-intensive industrial sectors to see how they would be affected by the implementation of the tax, with the assumption being that the tax was calculated based on \$30 per metric ton of CO₂ and for the purposes of this paper, just two principal KZN exporting sectors have been considered. In 2018 EU-based paper product manufacturers imported roughly \$200 million in wood pulp that was produced by either mechanical or chemical processes in 2018, yielding a profit pool of \$20 million to \$60 million. It was estimated that once implemented, the carbon border tax would cost this sector \$17 million to \$20 million, and in the process, profits would be

⁶ <https://www.bcg.com/publications/2020/how-an-eu-carbon-border-tax-could-jolt-world-trade>

⁷ <https://www.technologyreview.com/2020/07/27/1005641/carbon-border-taxes-eu-climate-change-opinion/>

slashed by an average of 65%.⁸ The impact of this would be felt indirectly by producers of goods such as recorded media, pharmaceuticals, and consumer packaged goods that use paper products.

Secondly, EU automakers, machinery and equipment manufacturers and construction companies consumed \$20 billion of imported flat-rolled steel in 2018. This generated profits of as much as \$2 billion and it is estimated that the carbon tax would range from \$250 million to \$1.3 billion in this sector, thereby reducing the profit pool on average by roughly 40%. The flat-rolled steel industry is currently facing a surplus and consequently, the most carbon-inefficient producers may struggle to pass these costs on to customers or through the supply chain. Steel makers that use electric arc furnaces to produce steel from a high percentage of scrap metal produce less emissions than those from steel makers using blast furnaces or basic oxygen furnaces. As an example, the carbon intensity of commodity steel makers in China and the Ukraine that primarily use blast furnaces emit about 2 metric tons of CO₂ equivalents for every metric ton of steel produced. Other countries such as India and Turkey, are generally more carbon efficient and they would accordingly pay significantly less tax, and if they build partnerships with European customers, would be able to take crude steel share from China, Russia, and the Ukraine.

To get a better sense of how swiftly the competitive dynamics of the global trade could change, one need only look at oil. Russia, due to its proximity, is the biggest oil supplier to the EU and accounts for more than one-quarter of its imports. Despite this, Russia's petroleum has twice the carbon footprint of petroleum from Saudi Arabia since their oil reserves are deeper in the ground than those in Saudi Arabia. In addition, the steep decline in global demand for crude oil since the onset of the COVID-19 crisis has pushed spot-market and futures contract prices so low that they already are well below the cost of recovery in many countries. The new policy could prompt EU importers to switch more of their sourcing to Saudi Arabia, whose producers would pay 30% to 50% less in carbon border tax than most competitors.⁹

⁸ <https://www.bcg.com/publications/2020/how-an-eu-carbon-border-tax-could-jolt-world-trade>

⁹ <https://www.bcg.com/publications/2020/how-an-eu-carbon-border-tax-could-jolt-world-trade>

Those companies that export to Europe and who would be (in)directly affected by the carbon border tax could pursue several basic options in order to retain their competitiveness. In some instances, they could shift to input suppliers that produce within the EU or to input suppliers with a lower carbon intensity, or to a country with an equivalent mechanism for pricing carbon. If these alternatives are limited, they could instead absorb the additional cost and try to pass it on through the rest of the value chain. The size and strategic importance of the EU market means its action could transform the fundamentals of global advantage. Companies around the world will be compelled to manage their carbon footprints with greater urgency. The EU carbon border tax would have implications for companies in every sector, whether they would be paying the tax directly or indirectly and whether they are European or non-European. Not only is South Africa the EU's largest trading partner in Africa but its exports to the EU have moved from mainly commodity-based products to a more diversified export profile that includes manufactured products.

It is now abundantly clear that those companies which rely on the EU as an important export market will experience a dramatic change in terms of competition. Due to the fact they have already borne the high capital cost of adopting more eco-friendly production technology and have more than a decade's worth of experience in managing their carbon footprints, many European companies could be stronger competitors in their home markets. In effect those technologies, processes, and strategies aimed at minimizing greenhouse gas emissions and which previously may have seemed like onerous burdens, will now provide strategic advantage to those companies that adopted them. Non-European companies that had been under little regulatory pressure to map, report, and control their emissions would have to build these capabilities quickly in order to remain competitive in Europe. This may be particularly important for those companies in emerging markets that based their competitiveness primarily on a combination of low labour and environmental compliance costs, as the former advantage would now be effectively neutralized by the carbon tax.

There is merit in the argument that that it is fundamentally unfair for Europe, which has produced nearly 25% of the world's cumulative historical emissions, to suddenly begin penalising poorer nations that have polluted far less over time and who still have considerably lower emissions on a per capita basis. Despite this though the idea of a carbon border is gaining

traction amongst the powerful developed nations and even the US Democratic Party in the run up to the November election has argued for “carbon adjustment fee” on products from countries that aren’t meeting their commitments under the Paris agreement. The indications are that a carbon border tax could invariably result in a global market fragmented between one group of low-carbon nations and another of high-carbon ones that continue to trade amongst each other. Where South Africa and KwaZulu-Natal stand in this depends on steps that are taken by local companies and the different organs of state within the next few months.