GLOBAL ECONOMICS UPDATE

Strong auto sector rebound probably largely in the past

- **The rebound in global auto production and sales over the past year has been partly responsible for the better-than-expected activity data over the past several months. And with auto sales in most advanced economies still well below pre-virus levels, there is still some scope for a further recovery as pent-up demand is met. But several indicators suggest that demand has weakened amid the sharp rise in borrowing costs, meaning that the auto sector may not provide a boost to GDP for much longer.**

- Motor vehicle production fell sharply for most of 2021 and into the start of 2022, as virus outbreaks and corresponding containment measures led to widespread factory closures and bottlenecks all along the production and distribution supply chains. This led to acute shortages of some key auto parts such as semi-conductors, which weighed heavily on production, and in turn sales of autos. Meanwhile, in some countries like Germany, the surge in energy costs following Russia's invasion of Ukraine curbed production further.

- **But product shortages have eased significantly over the past year or so, meaning that they no longer seem to be a major constraint on production.** This has paved the way for a recovery in the auto sector. Indeed, despite a bumpy year due to various virus disruptions in China, global auto production and sales have risen by around 35% and 28%, respectively, since April 2022. (See Chart 1.) Globally, motor vehicle output only accounts for around 1.5% of total value added, but the surge in auto production since last April means that it has been responsible for about 0.5%-pts – or around one fifth – of the total rise in world GDP since then.

- Production has risen across the board, and is now back above pre-virus levels in several major automobile producing countries, especially those in Emerging Asia. (See Chart 2.) Meanwhile, pent-up demand has meant that vehicle sales have also risen sharply. **But the recovery in sales has been weaker than that in production.** Globally, sales are still below their pre-virus level, with the gap between production and sales at its largest since at least 2005. (See Chart 1 again.) **In fact, sales are still lagging production in most major auto producing economies, and remain particularly depressed in the US and Germany.** (See Chart 3.)

- The main question now is whether sales will catch up and support further growth in production going forwards. On the one hand, sales could rise further as backlogs of orders are cleared and residual pent-up demand is met. **However, there are several reasons to believe that demand will weaken from here.**

- **For one thing, vehicle sales tend to be one of the spending categories which are most sensitive to higher interest rates.** The sharp rise in policy rates over the past year has caused borrowing costs to surge and financial conditions to tighten. And although pent-up demand probably explains why sales have held up better in DMs than the loose historical relationship between our Financial Conditions Indices and vehicle sales would normally suggest, sales look set to weaken soon. (See Chart 4.)

- Various other indicators also point to a weaker outlook for auto demand. In the latest S&P global sector PMI, the output and new orders components for the auto and parts sector fell back below the 50 no-change mark, suggesting that activity and orders fell in April. Meanwhile, the latest surveys in the US and euro-zone revealed that consumers still viewed conditions for purchasing a vehicle as being historically poor. (See Chart 5.) What's more, the most common reasons for this cited in the US survey were high prices and interest rates, whereas mentions of inadequate supply have fallen sharply. And the 5% fall in the Nasdaq Global Automobile Index over the past year also points to a pretty lacklustre outlook for the sector.

- **At least the combination of better supply and weaker demand means new vehicle inflation is now falling (see Chart 6), and should fall further over the coming months.** Given it only accounts for about 2.5% of the CPI basket on average in major DMs, the impact on inflation will be small. But in the US – where prices rose the most and its CPI weight is the largest – it has already knocked about 0.3%-pts off headline inflation.

- **The upshot is that although easing supply shortages and pent-up demand provided a significant boost to auto sectors globally at the start of this year, high interest rates and a weak global economic backdrop mean that weak demand may soon become a major headwind for the sector. This suggests that the recent resilience of activity in Germany and the US in particular is unlikely to last.**

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Chart 1: Global* Motor Vehicle Sales and Production (Millions)

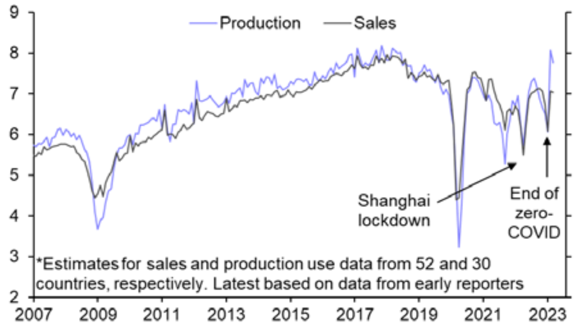


Chart 2: Motor Vehicle Production (Dec. 2019 = 100)

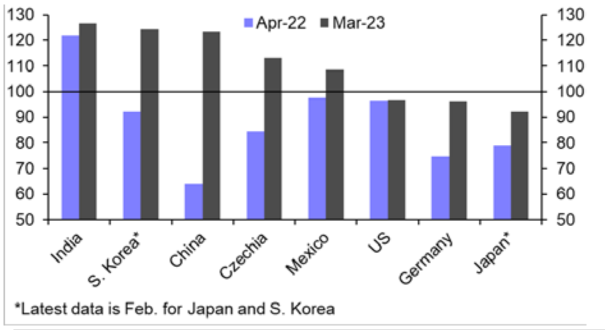


Chart 3: Motor Vehicle Sales (Dec. 2019 = 100)

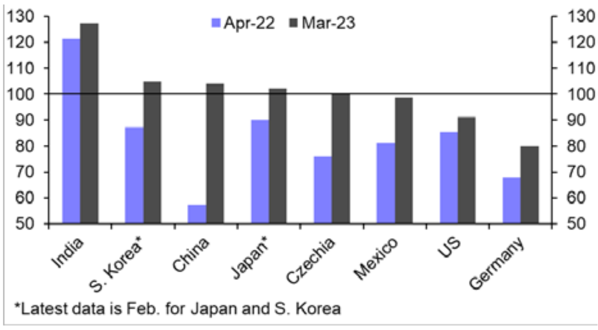


Chart 4: DM Broad FCI & Auto Sales

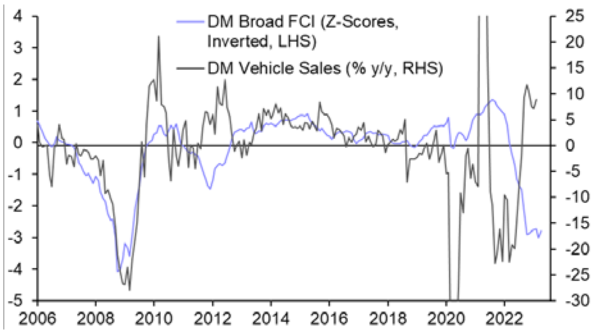
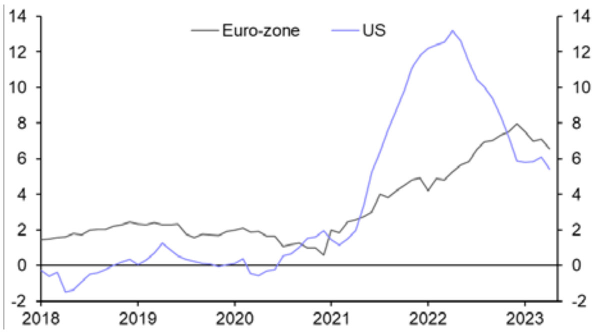


Chart 5: Consumer Survey Indices Of Intentions/Good Time To Buy A Car In The Next 12 months (Z-Scores)

Chart 6: New Vehicle CPI (% y/y)



Sources: Refinitiv, Umich, Capital Economics

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