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Dragoman Digest

EU unveils subsidy package to counter the US' IRA

Action follows fruitless efforts to mitigate 'discriminatory' effects of the IRA

In response to the **US**' landmark *Inflation Reduction Act* (IRA), the **EU** earlier this month laid out its *Green Deal Industrial Plan (GDIP)*. The GDIP aims to discourage industry shifts to the US by streamlining permitting for projects, expediting access to finance and deepening efforts to access raw materials crucial for the energy transition. The EU has argued that the IRA's steep domestic content requirements for access to large tax credits unfairly promote US-based manufacturers.

The EU has committed at least 250 billion euros (US$265 billion) to its plan, markedly less than the US$374 billion promised under the IRA. Rather than providing new funding, the EU has repurposed funds from existing schemes, including the NextGenerationEU plan and the Just Transition Fund. A core focus of GDIP will be ensuring that funding supports green manufacturing and activities like hydrogen production. So far, most funding has benefited R&D projects.

The EU's response follows unsuccessful efforts to convince the US to change tack. The only tangible breakthrough of a bilateral task force set up to resolve EU grievances has been a guarantee that EU-made electric vehicles (EVs) will benefit from tax credits for commercial vehicles. The two countries have also expressed interest in creating a "critical minerals buyers club" that aims to strengthen critical mineral supply chains. Aside from this, the US has doubled down, unveiling last week a further US$24.5 billion subsidy package for EV chargers, batteries, and green transportation with steep domestic content requirements. As early as next month, the US federal tax statutory body, the Internal Revenue Service, is set to explain how provisions of the IRA will work in practice, including what counts as a "free trade" agreement and a "US-made" product. The EU must be hoping for a liberal interpretation.

US chip export throws growth spanner in the works of Chinese expansion plans

Restrictions may inhibit rather than accelerate China's self-sufficiency ambitions

The effects of US' semiconductor manufacturing equipment export controls are beginning to be felt. Imposed last October, the controls ban the export of equipment to **China** used to make DRAM memory chips smaller than 18 nanometres (nm), logic chips smaller than 14/16 nm, and NAND memory chips with more than 128-layers. US citizens must obtain a licence to work at Chinese semiconductor companies.

Restrictions on US nationals working at Chinese chipmakers have had a tangible impact. Leading Chinese NAND chip manufacturer YMTC has been rapidly expanding its presence in the NAND memory chip market since 2016 and was even on the cusp of securing a major purchase order from Apple. However, following US restrictions, it has now been forced to cut 10 percent of its workforce. YMTC's CEO, who holds a US passport, was also compelled to step down last September. ChangXin, which specialises in DRAM chips, has delayed the opening of its second plant by at least a year and cut its workforce by five to seven percent.

Most have suggested that by depriving China of US technology, the curbs will inevitably accelerate China's semiconductor self-sufficiency drive. This may be a case of conflating ambition with ability, at least for the medium term. Some industry insiders are now forecasting that China's self-sufficiency rate for semiconductor manufacturing will plateau by 30 percent by 2030. This is up for 24 percent now but well short of China's target of 70 percent by 2025.

This 30 percent figure is likely to be considerably lower if foreign chip manufacturers with operations in China are excluded from the final count.

Japan appoints academic as new central bank governor

Ueda faces a particularly difficult task

Japan has nominated 71-year old economist Kazuo Ueda as the new governor of the Bank of Japan (BOJ). Ueda was put forward after the leading candidate, Masayoshi Amamiya, said that he could not review objectively the monetary easing policy that he implemented. Ueda's appointment marks a break from the past practice of employing career bureaucrats. Ueda comes from a mostly academic background, though he sat on the BOJ's policy board from 1998 to 2005. A notable decision during that stint was his votes against the BOJ's zero interest rate policy and its aggressive use of quantitative easing.

Ueda's appointment comes at an inflection point for the BOJ. Since the early 2000s, to revive Japan's stagnant economy and avoid deflation, the BOJ has expanded its unorthodox quantitative easing programme. The BOJ has maintained ultra-low interest rates that, at one point, became negative. Whilst having some success in boosting growth, aspects of these policies are now coming home to roost. The decision to go it alone in sticking to ultra-low rates has led to a rapidly depreciating yen. The price of imported food and energy has soared, and Japan has seen its first meaningful inflation in decades, almost all of it imported.

Ueda is widely expected to move to gradually normalise Japan's interest rates. Japan's public debt currently stands at 246 percent of GDP. Domestic companies have long become used to ultra-cheap finance. Rising interest rates will make the cost of debt servicing much more expensive. Ueda faces the herculean task of balancing these competing interests with the imperative to reduce inflation.

The EU finally defines 'renewable hydrogen'

France wins the inclusion of nuclear-derived, low-carbon hydrogen under new rules

Last week, the **EU** officially defined 'renewable hydrogen,' a decision which will shape the deployment of billions of dollars of capital over the next few decades. In defining green hydrogen, the EU has sought to ensure that investment in hydrogen does not detract from renewables investment. From 2028, for hydrogen to be considered renewable, electrolysers must be connected to renewable capacity installed no more than 36 months before the project commences operations. This 'additionality' requirement will also apply to export projects in other jurisdictions, although it will not apply where renewable energy already dominates the energy mix. Additionality requirements will be introduced gradually and become more stringent over time, factoring in a transition period for electrolysers to scale up.

The rules end months of negotiations among member states over what qualifies as clean hydrogen. A key sticking point was whether hydrogen produced with nuclear could be classified as renewable. After intense lobbying from **France**, nuclear-derived hydrogen is a notable (at least partial) inclusion under the new EU rules. This means hydrogen produced with France's nuclear-powered grid will be classified as 'low carbon' hydrogen instead of 'green' under EU legislation.

The definition is welcome news for investors and hydrogen producers, providing regulatory certainty on the requirements for subsidies and tax credits. The logical next step for policymakers is a 'Guarantee of Origin' scheme to track and verify project attributes.

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US capital flows into China's VC market fall off a cliff

Private player exodus raises concerns of increasing state dominance

US investment in **China**'s startup and venture capital ecosystem decreased by nearly 75 percent in the past year from US$95 billion to US$14 billion. Beijing's regulatory crackdown on tech, zero-COVID restrictions, and the escalating US-China tech war have severely dampened investor confidence. US lawmakers have called on the Biden administration to establish greater oversight of outgoing US investments into China. China's most successful and established private venture capital funds have had a torrid year. In October 2022, reports emerged that Alibaba founder Jack Ma's Yunfeng Capital was struggling to attract investors. Chinese tech giant Tencent felt the need in September 2022 to divest over US$14.8 billion from its US$88 billion listed equity portfolio.

The retreat of private and international capital will lead to more influence for state-run "government guidance funds". These funds are explicitly designed to direct capital to state-prioritised sectors. Theoretically, guidance funds are meant to establish sub-funds managed by professional asset managers. This has mostly been the case in more developed areas like Shanghai but does not appear to be the case in the country's disparate provinces. In the case of Shandong, individuals managing the sub-funds often lack sufficient professional experience. Funds appear to have been directed to favoured provincial firms. A more state-dominated VC sector may see funds being deployed more based on political connections rather than commercial bona fides.