Euro area: The manufacturing slump may be drawing to a close

HENRY COOK
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1591
E: henry.cook@uk.mufg.jp

MUFG Bank, Ltd.
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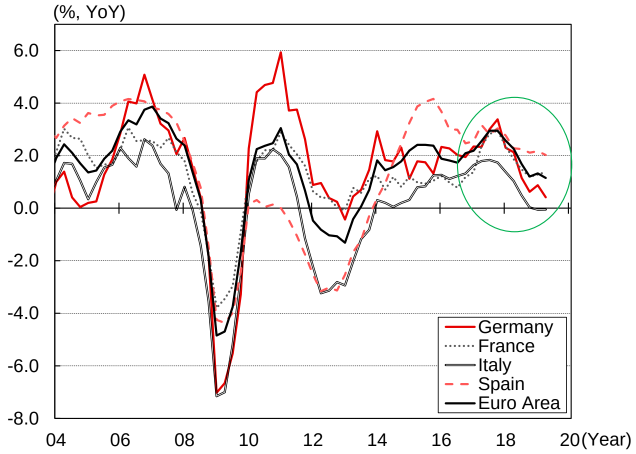
A manufacturing-led downturn

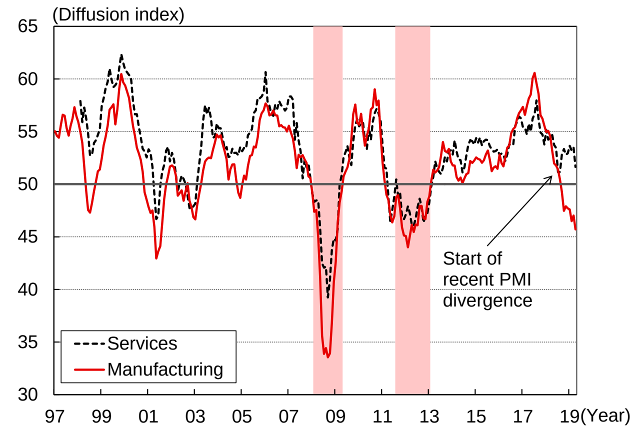
After the synchronised upswing of mid-2016 to late-2017, euro area real GDP growth has slowed sharply to just 1.2% YoY in Q2. This downturn has been led by the industrial sector, with the manufacturing and services PMIs diverging sharply since the turn of the year. The causes for this weakness in industrial output are hard to disentangle. Slower growth in China, the trend of increasing global trade protectionism, Brexit uncertainty (and distortions from precautionary stockpiling), and changing auto-industry regulation are likely to have all been factors. In terms of sequencing, the ECB has estimated that the slowdown in euro area industrial production was originally caused by weakness in international trade in the first half of 2018.[1] After then, euro area-specific factors also became a drag. Car manufacturers have been particularly affected by new vehicle emission testing regulation, as well as a wider shift away from diesel engines. Externally, the threat of US tariffs on EU-produced cars continues to weigh on sentiment, as does the ongoing slowdown in Chinese economic activity.

1. Euro Area Real GDP Growth Rates



Source: National sources, MUFG Bank Economic Research Office

2. Euro Area PMIs



Note: Shaded areas indicate euro area recessions.
Source: IHS Markit, Macrobond, MUFG Bank Economic Research Office

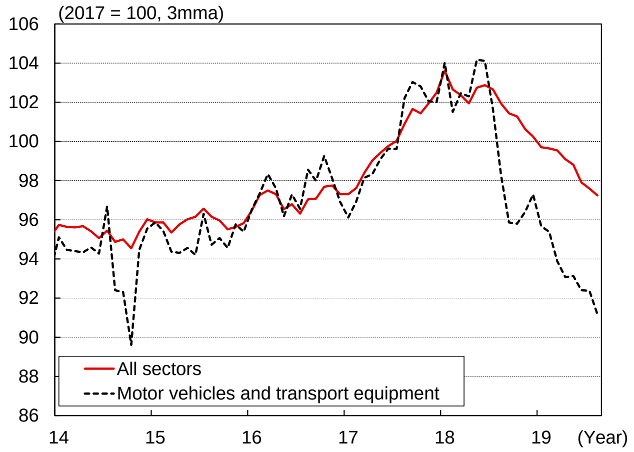
[1] See here: www.ecb.europa.eu/pub/pdf/ecbu/eb201906.en.pdf

German industry has been most affected

Some euro area economies have been relatively immune to the slowdown in industry so far (the French manufacturing PMI has continued to hover above the 'breakeven' mark of 50). However, Germany, the euro area's largest manufacturer, has borne the brunt of it. The latest German manufacturing PMI was a dismal 41.7. This **German manufacturing weakness has been led by the automotive sector**. While total industrial output has fallen by 5.5% since June 2018, car production has fallen by 12.4% over the same period (Chart 3).

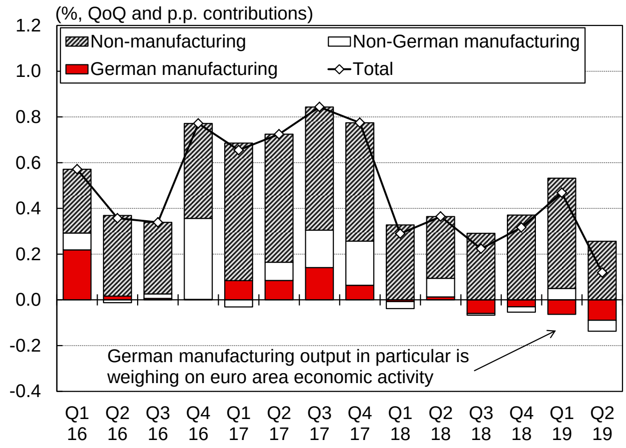
Plainly, this slowdown is not good news for Germany (industrial production accounts for around 25% of German output). Indeed, the most recent data, -0.1% QoQ real GDP growth in Q2, indicates the country is teetering on the edge of a technical recession. Nor is it good news for the wider euro area economy. **German manufacturing has exerted a drag on total euro area output since Q3 2018**, with an average contribution of -0.06, vs -0.01 from non-Germany manufacturing.

3. German Manufacturing Output



Source: Statistisches Bundesamt, MUFG Bank Economic Research Office

4. Euro area GVA Growth and Contributions



Source: Eurostat, MUFG Bank Economic Research Office

There are more signs of increased pass-through to services but the consumer outlook remains firm

We also note the persistent weakness in total domestic new orders, as well as the European Commission's business survey which suggests that weak demand is limiting production. **The longer that the weakness in manufacturing persists, the greater the risk of pass-through from the manufacturing sector to the wider economy**. While the divergence between the manufacturing and services PMI remains stark, the latter has also now started to trend lower. The services PMI declined to 51.4 in Germany, the lowest for three years (and to 52.0 in the wider euro area, an eight-month low).

Such signs of contagion were probably inevitable after such a pronounced slump in manufacturing, but the persistent divergence and limited contagion effect thus far does point to resilience in the services sector – and the economy as a whole. This can largely be attributed to a healthy consumer environment as **robust household spending has partly offset the drag from investment, inventories and net exports**. Euro area unemployment has consistently fallen from 12.1% in 2013 to 7.4% in August this year. Nominal wages are increasing by around 2.5% YoY while, despite the ECB's best efforts, inflation remains stubbornly muted (0.9% YoY in September). Against that background, retail sales are averaging over 2% YoY in real terms over the last six months. In Germany, where the industrial downturn has been strongest, sales growth has actually been even stronger on average.

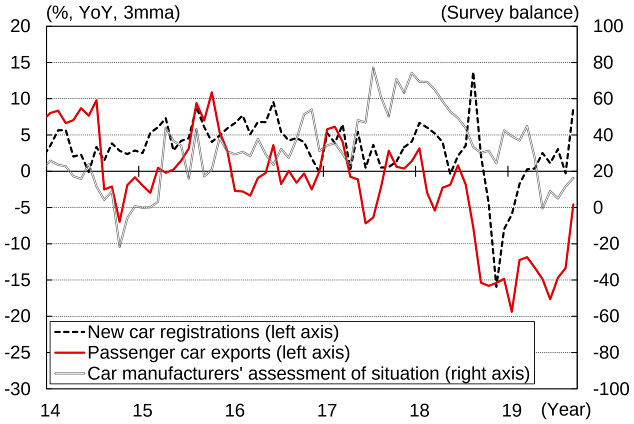
Is the euro area economy approaching a turning point?

As we noted in our most recent global outlook[2], we believe that the slump in manufacturing is unlikely to lead to a serious downturn – and **there may be a global recovery from as early as H1 2020**. This also applies to the euro area. Broadly, we suspect that **recent weakness in output is a small slowdown within a wider expansion rather than the end of the cycle**. A natural return towards the potential growth rate was always likely after the unsustainable pace of expansion in 2016-17. Additional factors (slowing Chinese economy, Brexit, auto-sector regulation, protectionism) have intensified the deceleration, with the manufacturing sector most affected.

However, there are signs that the auto industry downturn is bottoming out, which may be key for the health of the German manufacturing sector and the wider euro area economy. New car registrations were muted following the large swings around the introduction of the Worldwide Harmonised Light Vehicle Test Procedure (WLTP) on 1 September 2018, but increased sharply last month (22% YoY). The slump in vehicle exports also seems to have troughed. Taking a wider view, Germany's 0.3% MoM increase in industrial production (0.7% excluding energy and construction) in August was encouraging as well.

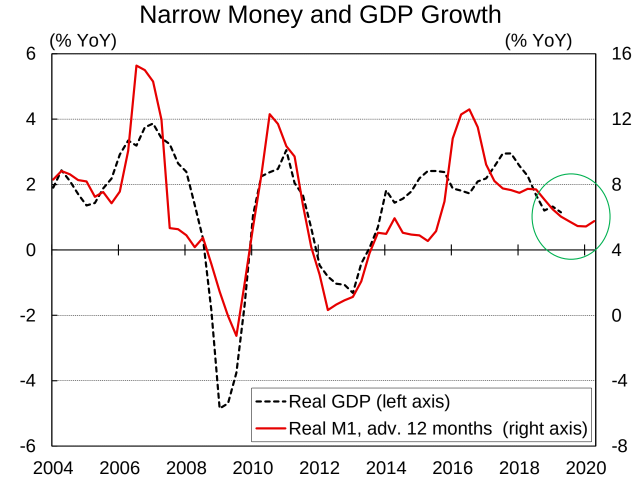
On a wider scale, **we are encouraged by the recent uptick in real narrow money growth**. This tends to lead economic activity by around 12 months and the latest data bolsters our view that the euro area downturn may now be close to bottoming out.

5. German Car Exports, Registrations and Sentiment



Source: Ifo, KBA, Statistisches Bundesamt, MUFG Bank Economic Research Office

Narrow Money and GDP Growth



Source: ECB, Eurostat, MUFG Bank Economic Research Office

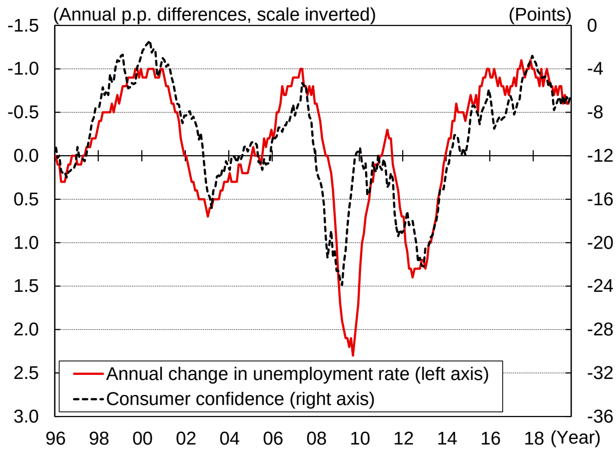
Meanwhile, we expect services sector's relative resilience to continue. The European Commission's gauge of consumer confidence has fallen slightly as the pace of labour market

[2] See here: www.bk.mufg.jp/report/ecoglb2019e/outlook_global20190830e.pdf

gains has slowed, but it does remain buoyant at 0.7 standard deviations above its long-term average. The euro area share of employment in the services sector has increased markedly over the last two decades, which suggests that consumer-led growth is now more durable in the face of a manufacturing-led slowdown. The services PMI employment index stood at 53.0 in September, well above its long-term average. While further labour market gains might be limited, there is little survey evidence suggesting that companies are rushing to reduce headcounts and wages, so **household income conditions should remain firm**.

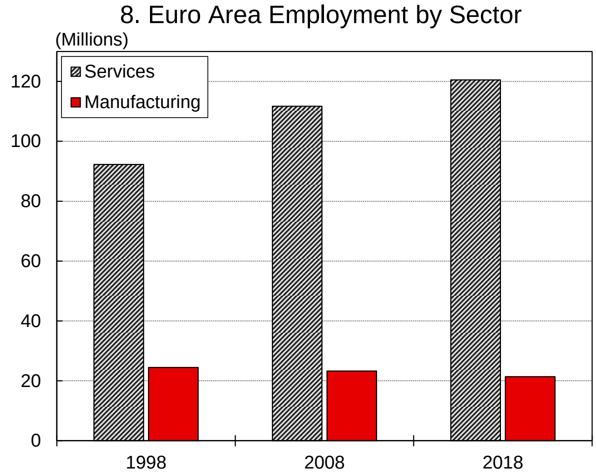
With that in mind, the main risk for household demand might stem from higher saving. Various surveys are suggesting that consumers are looking to set aside more money rather than spend it. However, the gross saving rate moved above its long-term average in Q2, so any further increase in saving may be limited.

7. Euro Area Consumer Confidence and Unemployment



Source: Eurostat, MUFG Bank Economic Research Office

8. Euro Area Employment by Sector



Source: Eurostat, MUFG Bank Economic Research Office

Any rebound is likely to be muted

The industrial slowdown may be close to turning but there is unlikely to be a swift recovery for the euro area. The clouds hanging over the economy (a slowing Chinese economy and tariff troubles in particular) are likely to remain, meaning that **any rebound might be muted**. The possibility of US tariffs on EU cars is a sword of Damocles hanging over German industry and will continue to suppress business sentiment, even if there is a recovery in output. A stronger euro after any signs of stronger economic activity would be unhelpful for exporters. With these factors in mind, the pace of growth in late 2017 (approaching 3% YoY) remains a distant memory. **Our baseline is for euro area real GDP growth to average 1.4% in 2020** (close to its potential rate).

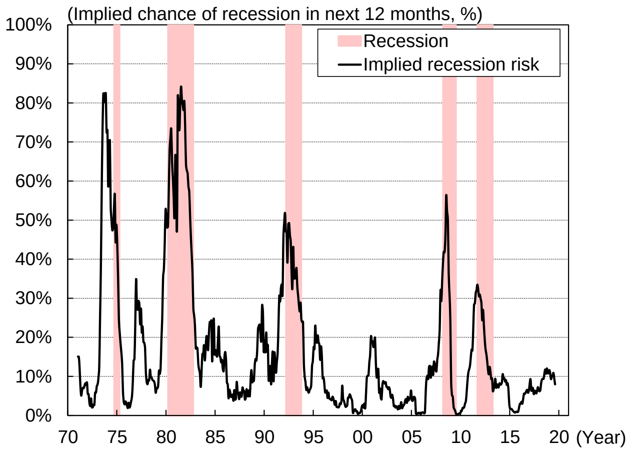
Over the short-term, our models suggest that the euro area PMIs are consistent with reasonable Q3 GDP growth of around 0.2% QoQ (the same approach, applied to the manufacturing PMIs alone, suggests growth of -0.2%, which highlights the extent of the divergence between services and industry). However, while the euro area economy as a whole is likely to have expanded in Q3, we suspect that **Germany will be unable to escape a technical recession**. The August industrial production release was positive, but a sharp drop in construction output is likely to be a drag on total output. Despite signs of green shoots mentioned above, confirmation of a German recession may well add to the sense of gloom around the euro area economy in the second half of 2019.

The risk of a recession in the next 12 months is elevated

While our baseline scenario is a recovery in euro area output, risks are tilted to the downside. There are various indicators which can be used to gauge near-term recession risk. In the US, the predictive power of the yield curve (the difference between long-term and short-term yields) is well-known for its strong track record in predicting recessions but in the euro area, where there have been significant structural changes, it does not have such a strong signalling power. Instead, the best single variable predictor of euro area recessions is real money growth (as used above in Chart 6). Our M1 model, which is similar to one used by the ECB[3], suggests that the risk of a euro area recession in the next 12 months is currently around 10%.

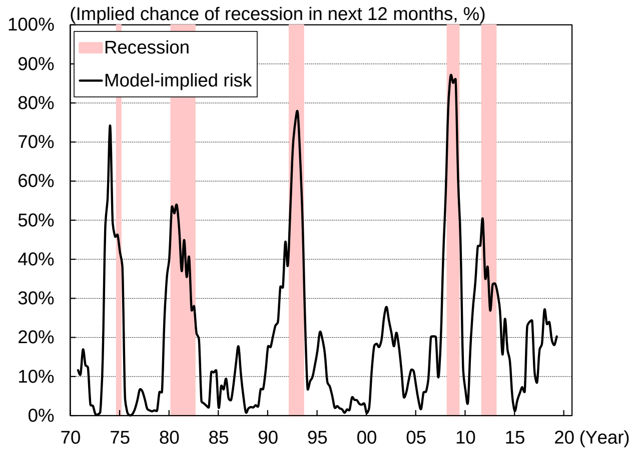
Instinctively, that feels a little low as the single currency area's largest economy teeters on the brink of a technical recession and there is evidence of slower global growth. Our broader factor model, which is based on over 35 variables covering the euro area economy and beyond, suggests that **the recession risk for the euro area is close to 20% over the next year**. To our minds, this seems more realistic. Note that the model has been estimated using quarterly data up to Q2. Recent data suggest that the risk may well have increased in H2 2019.

9. Euro Area Recession Risk (using adv. real M1)



Source: ECB, MUFG Bank Economic Research Office

10. Euro Area Recession Risk (broad factor model)



Source: EABCN, National sources, MUFG Bank Economic Research Office

A large part of the recent uptick can be attributed to a factor that is best-described as the 'open economy' (the strongest weights are on variables related to trade and international economies). This chimes with our view that, despite its size, **the euro area is more responsive to developments in other major economies** than might be expected. This is probably due to its composition of 19 small, open national economies, as well as the fact that the largest member has a sizeable manufacturing sector and is therefore more vulnerable to any downturn in the global cycle. Even though the industrial slowdown in the euro area may be close to bottoming out, the risk of recession in the next 12 months remains elevated. In particular, the euro area is very vulnerable to a slowdown in the US, both due to the risk for financial conditions and business confidence, and for external demand (it is the euro area's largest goods export

3 See here: www.ecb.europa.eu/pub/economic-bulletin/focus/2019/html/ecb.ebbox201903_04~eba5677b27.en.html

market). This means that **the overall risk of recession in the euro area may well hinge on the health of the US economy**.

On the other hand, if the US expansion continues, trade protectionism fears dissipate and a 'no deal' Brexit is avoided then **there may actually be upside risks for the euro area**. As a whole, the euro area fiscal stance is (slowly) becoming expansionary. Confirmation of a technical recession in Germany (Q3 GDP is due to be released on 14 November) would put more pressure on policymakers there to implement further fiscal stimulus, as we have discussed before.[4] In the absence of a severe shock to business confidence then this may result in a lagged, pro-cyclical response as the industrial slump bottoms out. Meanwhile, the ECB's move in September to push the deposit rate further into negative territory (with mitigating measures for the banking sector) and restart net monthly asset purchases will provide further monetary policy support for the euro area economy.

[4] See here: www.bk.mufg.jp/report/ecoeu2019e/MUFG-Economic-Brief-20190905.pdf