Inventory adjustment could explain persistent weakness in the Eurozone's manufacturing sector

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Difficulties persist in the Eurozone's manufacturing sector. Both industrial production and new orders are down on last year, and sentiment remains weak with July's manufacturing PMI below the 50 no-change mark for a sixth consecutive month. Private consumption on the other hand, which is the largest 'final demand' component of GDP, is currently robust on the back of healthy income and employment conditions and elevated consumer sentiment. Though growth is currently slowing, external demand is now looking stable after weakening in response to the economic slowdown outside the Eurozone that started in mid-2018. Capital expenditure is also robust in the context of high capacity utilisation (Chart 1), meaning that overall, final demand is generally solid.

Though final demand is solid, the ongoing slump in the manufacturing sector can be viewed in the context of large scale inventory adjustment. In fact, changes in inventories made a negative contribution to GDP growth for two consecutive quarters in Q4 2018 and Q1 2019. The diffusion index for stocks of finished goods is currently higher than during the European Debt Crisis, which indicates a major adjustment in reaction to the upswing in production which lasted until early 2018. The economic slowdown in Europe is often attributed to political uncertainty, for example to Brexit. However cyclical adjustment could also be a key factor here.

It is difficult to predict exactly when this inventory adjustment will end. Looking at previous diffusion index data for stocks of finished products, inventory expansion tends to last around 1-2 years. Based on the fact that the most recent 'low' was in February last year, it seems likely that the effects of the current adjustment will start to fade around the end of this year.

At its 25 July meeting, the Governing Council of the European Central Bank (ECB) updated its forward guidance, stating that 'The Governing Council expects the key ECB interest rates to remain at their present or lower levels at least through the first half of 2020', hinting at future rate cuts and additional monetary stimulus measures. The extent to which additional monetary stimulus measures will affect hard data like industrial production is unclear. However, despite risks like Brexit and US-China trade conflict, we expect manufacturing to be supported to some extent, at least in terms of sentiment. This means that it may be possible to avoid sustained deterioration in corporate sentiment.

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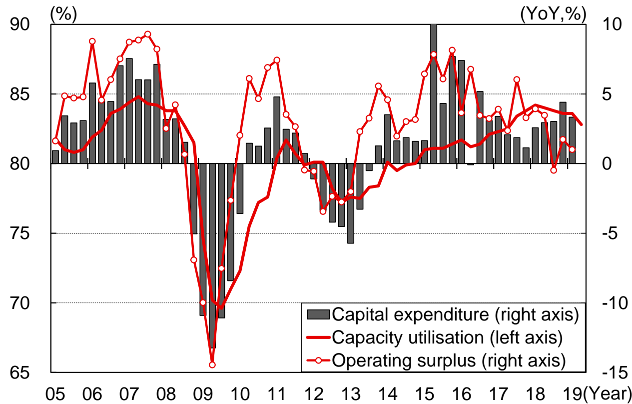
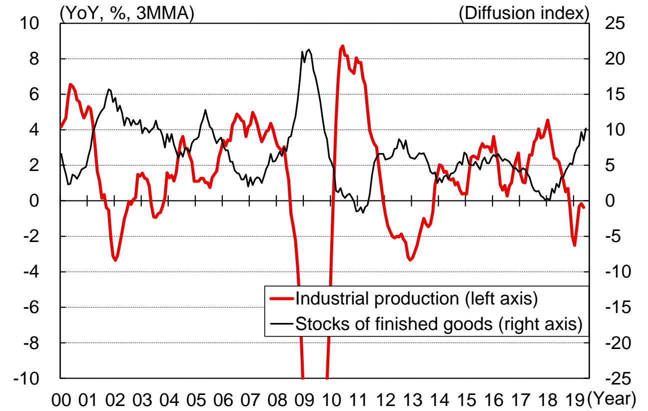


Source: Eurostat, European Commission, MUFG Bank Economic Research Office



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

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