ODDO BHF
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Economy

Europe: no contagion, no recession

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In the slowdown of the Eurozone initiated at the start of 2018, sectors, countries and economic agents were hit in very disparate ways. The weight of industry, openness to trade, employment trends, fiscal choices, political shocks in some instances, are all explanatory factors. At this stage, Germany and Italy are the most weakened economies, France is the most resilient. Excluding industry, the trend in European real GDP has slowed only slightly. Even so, without tangible signs of a stabilisation of industrial activity, which are too scarce for the time being, growth prospects are unlikely to pick up.

Non-industrial sectors resilient to the manufacturing gloom

At the end of 2017, at the height of the recovery that began in 2013, the Eurozone had a growth rate approaching 3%. The annual trend fell to around 1% in mid-2019, and the latest business climate surveys at the beginning of Q4 predict a rate of between 0.5% and 1% in the second half of 2019. The PMI-composite index of activity, at 50.2pts in October, is just above the theoretical threshold between the expansion zone and the recession zone. The Eurozone slowdown is far from homogeneous. It is characterised by significant discrepancies between sectors, which also explain, to a large extent, the differences between countries (table). This note examines the situation of the four major countries in the Eurozone.

	Real GDP growth *		Jobless rate		Share of value added (%)			Trade (% GDP)	
	2015-17	H1 19	5Y ago	last	Manufacturing	Construction	Administration	Exports	Imports
EMU	2.2	1.2	11.5	7.4	16.5	5.4	18.9	49.2	45.5
Germany	2.1	0.6	5.0	3.1	21.7	5.5	18.6	48.4	42.7
France	1.5	1.3	10.3	8.5	10.9	5.7	22.0	32.2	33.4
Italy	1.3	0.4	12.3	9.5	16.7	4.3	16.5	32.3	29.4
Spain	3.3	1.9	24.2	13.8	12.2	6.5	18.1	34.1	29.1

* annual rate

First, some general remarks on the Eurozone as a whole. The most striking feature of this cycle is the disparity between the manufacturing sector and the rest of the economy. Industry, a globalised sector *par excellence* and therefore exposed to various external risks, is in recession; but excluding industry, real GDP was on a 1.8% growth trend recently in the Eurozone, which is only marginally lower than in recent years. The resilience of the rest of the economy comes from non-cyclical sectors, such as administrative services, or cyclical sectors such as construction. Construction activity, which was in crisis until 2013, is benefiting from improved employment trends (higher disposable income) and credit conditions (monetary easing) and can therefore extend its catch up. **A possible contagion from industry to the rest of the economy could occur if employment were to falter, but this risk remains moderate to date[1]. Moreover, there is no sign of a tightening of credit conditions.**

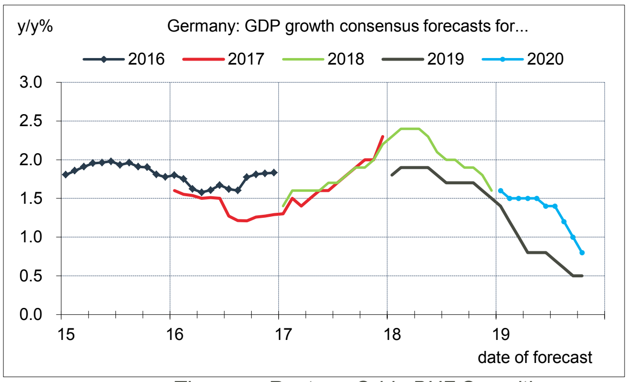
GERMANY

In less than two years, the German economic situation has changed radically. Germany was a key contributor to the recovery of the Eurozone, and today it is a drag. Over this period, growth forecasts have been lowered month after month (chart lhs, p. 2). **Such an upheaval cannot be understood without considering the automotive sector[2], whose weight is oversized and which has seen bad news accumulate one piece after another**: weakening external demand linked to the global/Chinese slowdown, introduction of new environmental standards, electrification, trade tariff threats, risk of a

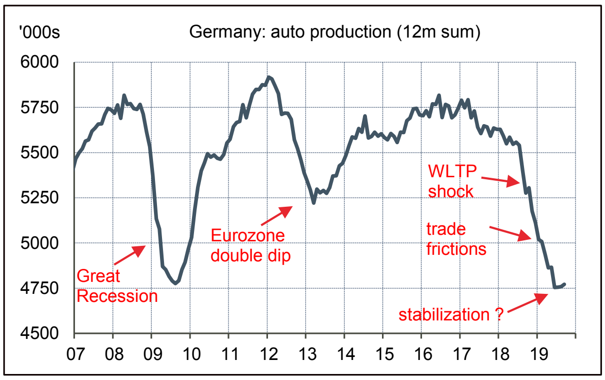
[1] *See our* Economic Note *dated 3 October 2019: "European labour market health check".*
[2] *See our* Economic Note *dated 25 April 2019: What's Germany worth without the automotive industry?*

hard Brexit, closure of the Turkish market after the financial crisis in 2018. After a collapse almost as severe as during the Great Recession, automotive production is now showing signs of stabilisation at a very low level (chart rhs). **This suggests that the correction of industrial activity has passed its most acute point**[3].

Germany: growth forecasts (consensus)



Germany: automotive production (units, 12 month-sum)



Sources: consensus, Thomson Reuters, Oddo BHF Securities

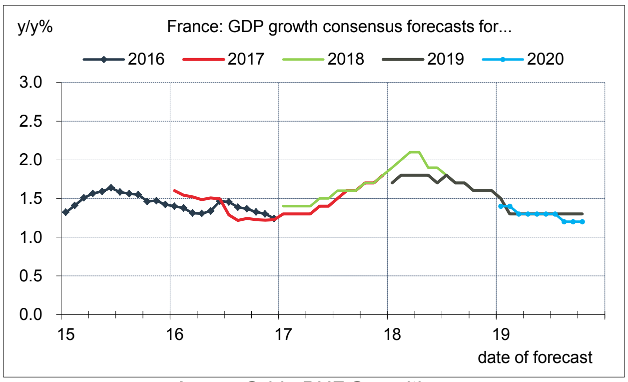
The activity indicators for Q3 point to a total activity that is stable at best. According to the Bundesbank, there is a risk of a modest decline in real GDP, which would push the economy into a so-called technical recession (two consecutive quarters of contraction). The outlook for Q4 remains weak as business climate indicators have not yet rebounded. They are also stabilised at a low level.

In recent months, the pace of job creation has slowed significantly and the number of jobless claimants has stopped falling. However, there is no decline in total employment. **Except in industry, what is restricting the labour market is not companies' reticence to hire, but rather the lack of skilled workers**. There is therefore no reason for household income to suddenly weaken, and domestic demand seems well protected. **Among the risk factors, recent developments raise some hope**, with the apparent easing of tariff tensions (including threats of tariffs on cars) and the possibility of an orderly Brexit in the next three months. If this progress is confirmed, it could justify a rebound in the business climate and the beginning of a strengthening of growth. Returning to an average growth of 1% does not seem unreasonable in 2020.

FRANCE

A year ago exactly, the sudden bursting onto the scene of the "Yellow Vests" movement saw France's economy enter a period of turbulence which lasted for a few months This may have contributed to reducing the growth prospects, albeit modestly (chart lhs). Household moral declined sharply in Q4 2018, but it has since more than corrected this contraction. The business climate remained relatively unaffected; it is clearly still in the expansion zone. Even more significantly, employment conditions continued to firm in recent quarters (chart rhs).

France: growth forecasts (consensus)



France: new hirings in long-term contracts

Sources: consensus, Acoss, Oddo BHF Securities

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[3] Even if the automotive sector, due to its weight, largely explains the German industrial recession, other segments of the industry have also experienced negative shocks over the past year. This was the case of the chemicals activity at end-2018 (disruption of the supply chain due to the level of the Rhine) and energy production in Q2-Q3 2019 (closure of coal-fired power plants).

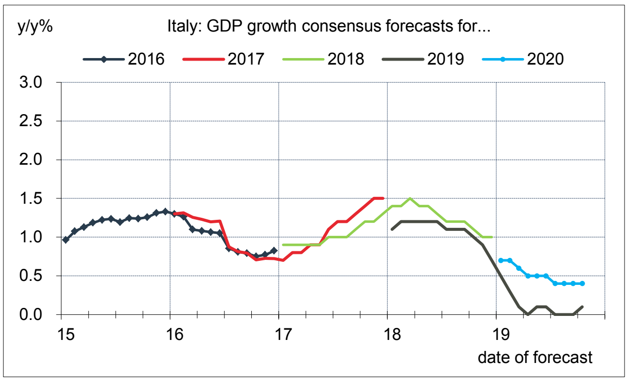
Compared with other European countries, France's economy is looking fairly good in 2019. As elsewhere, there is a discrepancy between the situation in industry (in stagnation, not in deep recession) and that of services. The low weight of industry in value-added is an advantage here, but this would not be enough if domestic demand were not supported by favourable fundamentals (employment, credit) and a more stimulating policy-mix. **The "Yellow Vests" movement pushed the government to take early action to support disposable income. Note that households have so far been quite cautious (increased savings).**

France being France, the social climate is never entirely peaceful. The pension reform project is a red flag for unions that are not very representative but hold symbolic strongholds in public companies. Strikes have taken place and others are planned in transport. Unless there is a mass social movement (as in 1995), these disruptions should not derail the French economy. **With the further decline in unemployment, we can expect household consumption to strengthen in 2020, raising the growth prospects to between 1.5% and 2% per year.** These levels are consistent with recent business climate indices.

ITALY

In the cold spell that Europe is experiencing, Italy shares with Germany the twin disadvantage of having a large industrial sector and high exposure to global demand (the country has foreign trade surpluses). **In addition, Italy is the only major European country in which activity in the non-industrial sectors has also slowed. The cause and effect relationship is difficult to prove but the sequence of events suggests that the rise in political uncertainty has had a significant impact**. It is no coincidence that the growth outlook quickly fell to zero *after* the M5S-Lega[4] government was formed mid-2018 (chart lhs). The anti-EU position of the government was quickly sanctioned by the bond market, weighing on the business climate and perception of bank risk. In contrast, the Italian spread significantly narrowed this summer following the failed attempt by Matteo Salvini to trigger a snap election. **All in all, there can be no pick-up in activity in Italy as long as there is the looming danger of fiscal questions taking an alarming turn, or indeed as long as the threat of an exit from the Eurozone is occasionally brandished. It would be dangerous to think that the new government is rock solid, but at least relations between Rome and Brussels have become less conflictual**. This can do no harm. We are certain that fiscal policy will not take a restrictive turn in 2020. The savings made on the sovereign debt burden – stemming from the monetary easing by the ECB – have prevented the budget deficit from deepening in 2019. Note also that the Lega's leader, who is now the leader of the opposition, acknowledged that leaving the euro was not a realistic option.

Italy: growth forecasts (consensus)



Italy: industrial investment survey

Sources: consensus, Bank of Italy, Oddo BHF Securities

There are reasons to infer that the abating political and fiscal uncertainty will have a positive impact on the business climate. But at present, we do not have enough data since the new government's formation to confirm this. The PMI-composite has not collapsed in recent months, but remains weak. A survey on the investment outlook in industry shows a fairly clear rebound compared with the low point hit end-2018 (chart rhs). The Bank of Italy is expecting a stagnation in real GDP in Q3 which, in light of a fresh drop in industrial production, sends out a moderately positive signal to the rest of the economy. In the short term, as in Germany, the outlook will primarily depend on the signals from industry. Manufacturing activity must stabilise before a rebound in growth rates becomes a possibility.

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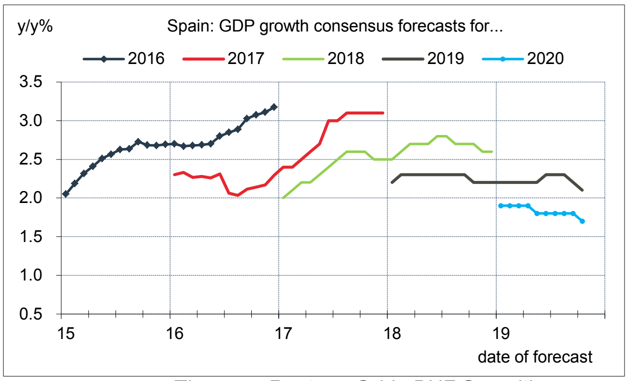
[4] *See our* Economic Note *dated 7 November 2018: "Di Maio and Salvini are pushing Italy towards a triple dip"*

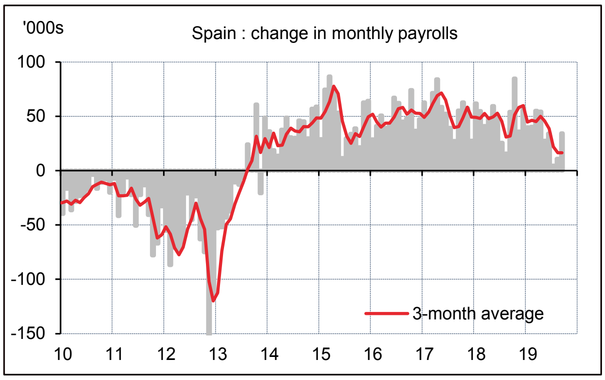
SPAIN

Since 2014, Spain's economy has been the most dynamic in the region, benefiting from the end of financial fragmentation, the clean-up of banks' balance sheets and the rapid improvement in labour market conditions (unemployment rate dropping by two points per year). The tourism sector was also buoyed by the decline in popularity of certain Mediterranean destinations deemed riskier after the Arab spring of 2011 and the migrant crisis of 2015. There is room for further improvement in the labour market, but the contribution to activity is steadily decreasing, which explains the gradual moderation in growth forecasts (chart lhs). As a result, Spain's growth rate declined from above 3% in 2015 and 2016 to 2% for 2019. Expectations for 2020 are a shade lower than 2%.

Spain: growth forecasts (consensus)



Spain: rate of job creation



Sources: consensus, Thomson Reuters, Oddo BHF Securities

For the past few months, the Spanish economy has been showing signs of weakness, with the clearest signal coming from the rate of job creation (chart rhs). The business climate has also weakened, and as is the case in the rest of the Eurozone, it is industry that is dragging sentiment down. Foreign demand is having a negative impact but the political situation is probably contributing to the uncertainty. **The traditional two-party system (PSOE/PP) is a thing of the past with the emergence of new parties from the far-left (Podemos), the centre (Ciudadanos) and far-right (Vox). For the past two years, Prime Minister Sanchez has not succeeded in obtaining a stable majority, which has delayed or complicated talks about the budget**. April's elections were not conclusive so new elections are scheduled for 10 November. The situation in Catalonia, one of the most prosperous Spanish regions, is still tense, but is nevertheless less explosive than at the time of the 2017 referendum (which had had a negative impact on the business climate).

Given the margins for a fall in unemployment, we have every reason to expect Spain to continue outperforming the Eurozone in the short term. According to the Bank of Spain and the financial regulator, GDP growth is expected at between 1.5% and 2% in the second half of 2019. **A clarification of the political situation would probably help to dispel the wait-and-see attitude and improve this outlook a little**.

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