MACROECONOMIC *view*

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Europe desperately seeking growth

KEY HIGHLIGHTS:

- After a decent start to the year, the European economy is showing signs of weakness.
- The recovery is being threatened by difficulties in Germany and France.
- Germany has massive trade surpluses, but its cumulative growth over five years is null.
- After decades of denial, France can no longer ignore its enormous public debt wall.
- In a context of disinflation, the ECB should further loosen its monetary grip.

In 2022 and 2023, The European economy has weathered the triple shock of the gas crisis, soaring consumer prices and an unprecedented rise in interest rates. At the start of this year, the pieces seemed to be falling into place for the eurozone to finally kick-start a recovery. Despite the ongoing war in Ukraine, the energy markets had largely returned to normal. As a result, inflation fears were receding. The ECB could consider easing monetary policy once price increases had returned to normal. Overall, the three negative shocks were fading.

What happened to these hopes of recovery? Until the beginning of Summer 2024, the economic data were moving in the desired direction. Over the first half of the year, real GDP in the eurozone grew at an annual rate of 1%. After eighteen months of virtual stagnation, that is a sensible improvement. However, this pace is still far from the trend seen before the pandemic (1.9%). It also pales in comparison to the United States over the same period (2.2%). (chart 1)

A closer look reveals that the foundations of this nascent recovery are not very solid. First, the business climate indicators show major disparities across sectors. The industrial sector, which is normally at the forefront of the cycle, is still struggling, while services continue to be buoyed by the end of the post-pandemic recovery. By definition, a catch-up after an exogenous shock cannot last forever.

Second, it should be noted that the components of the nascent recovery are unbalanced. In the first half of the year, growth was mainly driven by strong exports, while household and business demand fell. Consumers have been feeling a little more confident for several quarters now, but this has not translated into increased spending. On the contrary, according to Eurostat data, the household savings rate has been rising since the spring of 2022 and reached 15.7% of disposable income in mid-2024, around three points higher than normal. As for their investment rate, i.e. their property purchases, it has fallen by more than one point in two years.

A third cause of fragility is the growing divergence between countries. Europe is not made up of countries with the same production base, nor the same areas of specialization. Differences are inevitable and usually without major consequences. Beyond a certain point however, this raises questions on the calibration of the economic policy as well as the cohesion of the zone. More than ten years ago, the weaknesses were concentrated in the southern countries, suffocating under the weight of their public and private debt.

The euro currency could have disappeared without the decisive intervention of the ECB. But this time, the problem is quite different. Southern Europe (Italy, Spain, Portugal, and Greece) records robust growth (graph 2). Weakness is instead affecting the largest economies of the European Union, Germany, and France. Let's say a few words about these two countries.

In Germany, the level of economic activity is exactly the same today as it was five years ago. That's half a decade lost. The German 'model', which was so successful in the 2000s and 2010s thanks to its integration into world trade, is showing its limits. Production costs have risen, largely as a result of the energy crisis, which has highlighted the vulnerability of the chosen mix (excessive exposure to Russian gas). At the same time, China, which was driving demand for manufactured goods, has become a major competitor. The electric vehicle sector is a case in point. That said, Germany's budgetary situation is solid, which in theory gives it plenty of room for manoeuvre.

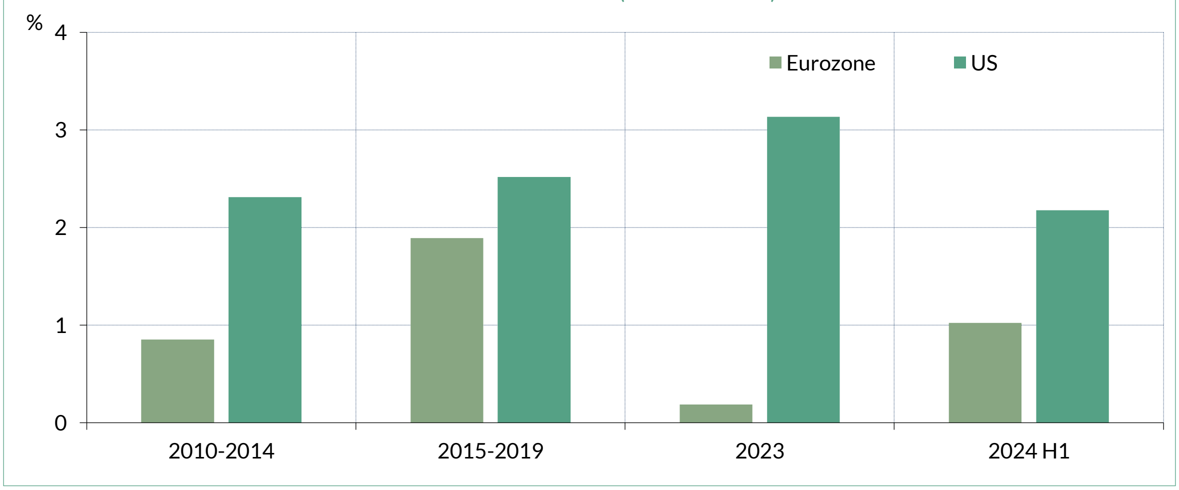
The same cannot be said for France. Weak public finances are nothing new, since the last budget surplus was recorded in the 1970s. But an unexpected worsening occurred in 2024. Initially, the government was aiming for a budget deficit of 4.4% of GDP. In reality, the figure will exceed 6%. The political turmoil caused by the early elections and the absence of any real government for several months did not help, but the problem is deeper than that. It reflects a natural inclination towards public spending. As a result, the tax burden is excessive. The government has presented a restrictive budget for 2025 (mainly through tax increases), which will have a negative impact on French growth prospects.

So what hope is left for recovery?

Firstly, it is notable that disinflation is proceeding faster than the central bank had anticipated. The inflation rate has fallen back below the critical threshold of 2% in the eurozone (1.8% in September). The outlook for corporate sales prices has returned to its normal pre-shock trend. Disinflation is a powerful factor in restoring household spending capacity after several years of compression. If households are no longer (or are less) worried about their purchasing power, it is not unreasonable to expect a fall in the savings rate.

In this environment, the ECB has good reasons to revise its monetary policy. Policy was made very restrictive last year at a time when disinflation was not assured. Now, policy rates should be much lower. The ECB has already eased its policy several times this year. It must continue to do so, so as to consolidate and strengthen the initial signs of recovery in the credit market.

REAL GDP GROWTH (ANNUAL RATE)



Source : Bloomberg, ODDO BHF

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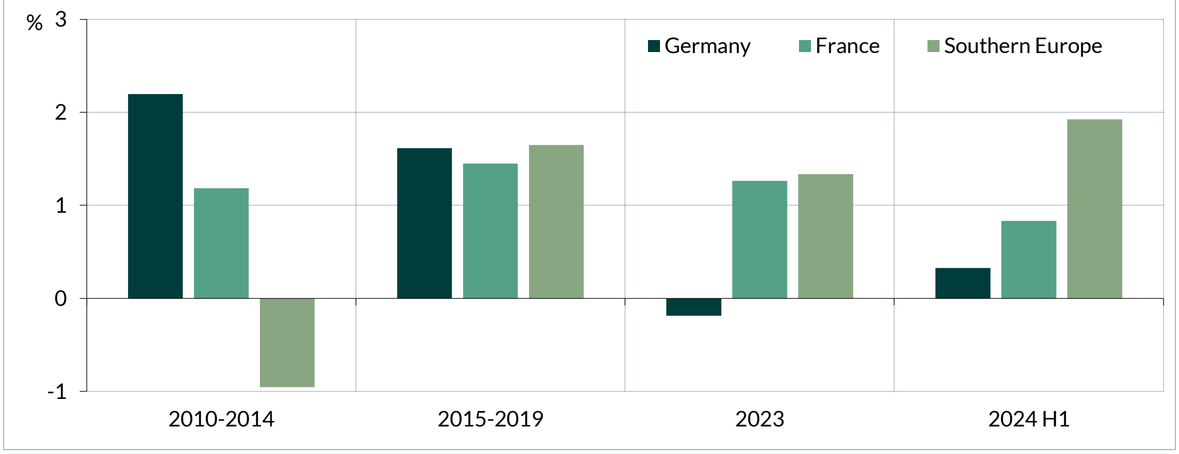

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