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FOCAL POINT

Is euro area economic resilience overrated?

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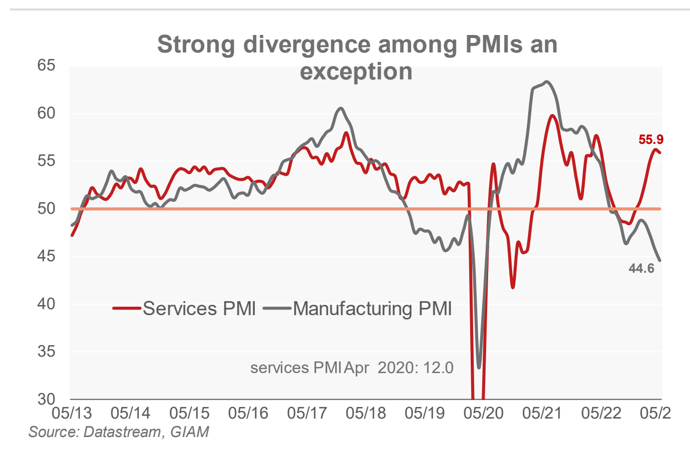
Our Focal Point series explores topical issues on macro, markets and investment

- **Services and manufacturing PMIs have diverged sharply recently, with recovering services contrasting contracting manufacturing. This global divergence is particularly striking in the euro area, especially in the light of diminishing real income.**
- **Post-Covid effects on employment, a normalisation of savings and pent-up demand for services account for most of the divergence. Our analysis shows that the euro area services PMI may have somewhat overshot but is unlikely to signal contraction as we expect the labour market to stay strong and headline inflation to recede.**
- **By contrast, the manufacturing PMI will remain exposed to the drag from trade and tighter monetary policy, pointing to persistent weakness. But given the much higher weight of services, we still think that the euro area will avoid a recession.**
- **Major downside risks are further significant tightening of credit standards, an inflation shock and an even much weaker global economy. That said, with underlying inflation entrenched, the bar for the ECB to stop tightening or even loosen its policy stance remains high for now.**

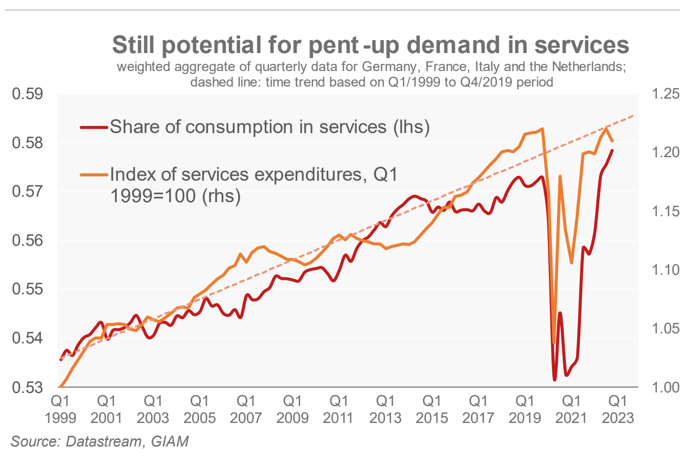
In contrast to expectations, the euro area avoided a winter recession. A key reason probably was strong domestic demand heralded in a rise of the services PMI (sPMI) from 49.8 in December to currently 55.9 thereby more than offsetting the deterioration of the manufacturing PMI (mPMI) that is much more exposed to the global economy. This dichotomy is not confined to the euro area but also holds globally, including China and the US. Post-Covid recovery effects play a role. Yet historically divergence between both indicators is an exception (see rh-chart for the euro area). We think that this divergence may persist still for longer and the euro area will avoid a recession. In what follows we therefore take a closer look at the drivers of both indices.



Source: Datastream, GIAM

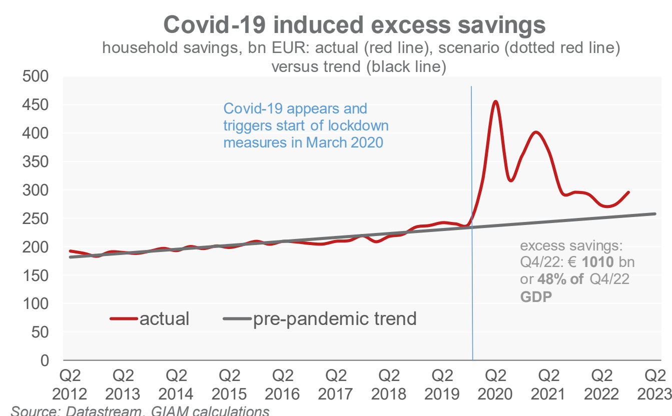
Services PMI: excess savings and strong labour market

Services can be traded to a much lesser degree than goods so that its dynamics are mainly determined by domestic demand and consumption and the state of the labour market. The latter stayed in the euro area – thanks to generous government support measures – in good shape over the past years. The unemployment rate has currently come down to a low of 6.5%, employment growth even accelerated to 0.6% qoq in Q1/2023 while nominal wage growth (compensation per employee +5.0% yoy in Q4/2022) has gained momentum. Still, the sPMI of 55.9 in May looks stretched based on these factors.



Source: Datastream, GIAM

We think that the current strength in sentiment is mostly driven by pent-up demand from the pandemic. As a result of lockdowns services demand fell sharply, both in terms of share in consumption as well as in absolute terms (see graph above). Related to the lockdown is involuntary savings as people were not able to spend the money in the way they wanted too. Before the pandemic household savings broadly followed a time trend while during the pandemic huge excess savings – defined as deviations from this trend – built up (see graph below). In fact, there is a strong negative correlation (of -0.75) between excess savings and the deviation of consumers' share in services expenditures from the pre-pandemic trend. With the end of lockdowns the household savings rate came down (from a max of 25.4% in Q2/2020) but with the latest reading of 14.2% as of Q4/2022 it is still above the long-term pre-pandemic average of 12.9%. With an estimated volume of about € 1 tr, the deployment excess savings is a potential booster for euro area domestic demand.

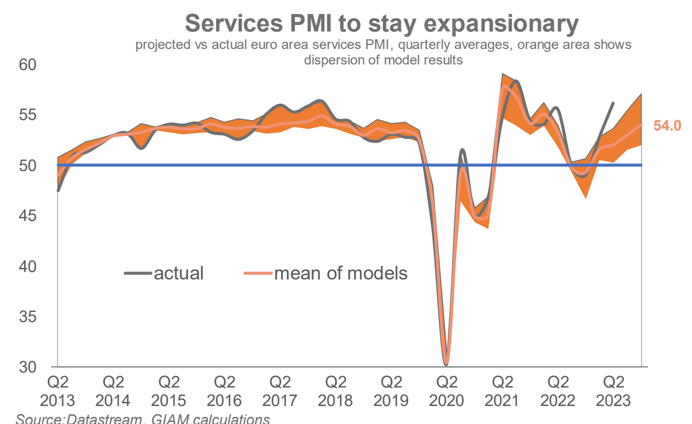


Source: Datastream, GIAM calculations

Pent-up demand played an important role in strengthening domestic activity over the past quarters and it becomes clear that and this boost is likely to last for some more time. However, the effect on the sPMI will in the end crucially hinge on whether consumers are willing to use the savings and to spent them for services demand as we would conjecture.

When looking at the determinants of the sPMI econometrically we find that savings behaviour (comprising the savings rate and excess savings) and employment growth are the most important factors, followed by wage development (compensation per employee), the past tightening of credit standards for firms and government consumption expenditures. Looking ahead, we deem it reasonable to assume that employment growth slows somewhat (to 0.2% qoq) but stays in the current situation positive, helped by retiring baby boomers. Real wage growth will be supported by receding headline inflation (we look for around 3% yoy by Q4/2022 largely due to a more favourable energy price development) amid at least unabated nominal income growth. Amid good labour market prospects we see the savings rate coming down further by year-end which should lift consumption by about ½ % of GDP compared to the end of last year, General government consumption expenditures will likely be scaled back and credit standards for firms are set to be tightened somewhat more. In this environment the current reading of the sPMI looks clearly too high. But looking ahead, its fundamentals sPMI should improve and its reading stay above the crucial threshold of 50 separating expansion from contraction.

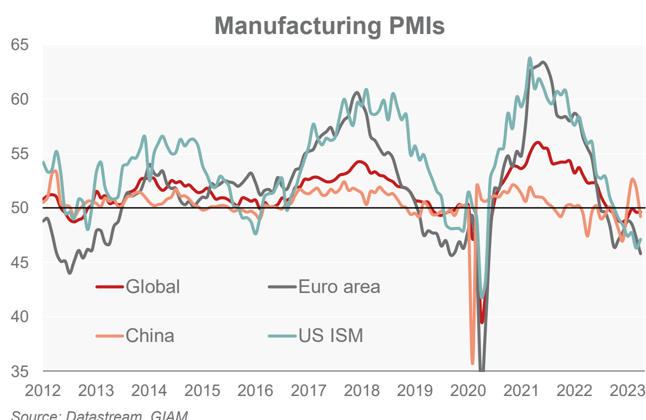
Crucial to this outcome are the stability of the labour market and our expectation of receding inflation. Under these conditions our assessment of ongoing services sector expansion is quite robust. Our various specifications see the Q4/23 sPMI in the range of 52.0 to 57.1 with a mean of 54.0. The risk of a services sector recession is also mitigated by the potential deployment of the huge stock of excess savings that we did not consider in our scenarios.



Source:Datastream, GIAM calculations

Manufacturing sector

The downturn in the manufacturing sector has largely been a worldwide phenomenon with the global manufacturing PMI in slightly contractionary territory since September 2022. In the euro area, the mPMI shrank of late to 44.6 index point while in the US, the manufacturing ISM (47.1) and mPMI (50.2) (compiled by two different data suppliers) currently diverge. However, even in China both mPMIs returned to below the 50 points threshold despite the reopening rebound in demand.



Source: Datastream, GIAM

This strongly suggests that global and not only regional forces are at work. Accordingly, we analysed not only on the euro area but also the global level and find that the explanatory drivers are almost identical. The statistical analysis identifies world GDP growth, CPI inflation, monetary policy and international trade as the most influential factors for the mPMI. In fact, global short-term interest rates have the strongest impact. They work with a time lag which, depending on the specification, varies between three and seven quarters. This is in line with the proposition that monetary policy (represented by the 3-month global interest rate) works with lengthy and also variable time lags, which add to the challenges of central banks. The ECB for instance expects its past tightening measures to exert substantial downward pressure on activity over the 2023 to 25 period. Long-term finance (the 10-year global government bond yield) turned out to be to a lesser extent relevant in the euro area and even played statistically (was insignificant) no role on the global level. Another dampening factor is CPI inflation, which looks economically plausible as rising prices cut into demand. Interestingly, we were not able to identify energy or oil prices as direct, significant drivers. This may technically be due to the fact that oil prices are strongly politically influenced and not only the result of the global business cycle only. Lastly, world GDP growth and expanding trade elicit a positive impact on euro and global manufacturing PMIs.

Looking ahead, given the strong and lasting impact of tightening monetary policy mPMIs are bound to stay soft for a while. The impact of monetary policy will be mitigated by receding inflation and the cycle-dampening effects of higher stability in domestic demand. Moreover, even with bottlenecks in the manufacturing sector having largely run their course, output did not recover and in the car industry pent-up demand past peak. With the US set to fall into recession we see no substantial improvement ahead. All in all, we expect the euro area mPMI to stay in contractionary territory over the remaining course of 2023 and to average in the range of 45 to 48 by Q4/2023.

EA recession likely to be avoided

For the euro area economic activity outlook, the ultimate question is: Who is right, the sPMI signaling ongoing expansion or the mPMI suggesting that contraction might be ahead. Given that services account for about 70% of GDP the correlation of the sPMI with quarterly GDP growth (from 1999 to 2022) is 0.55 (mPMI 0.43) and with the notable exception of Q2/2008 quarterly output growth only receded when the sPMI's average was below the threshold of 50 in that quarter. However, the usual suspicion is that the more volatile export-oriented manufacturing sector triggers swings in economic activity. Indeed, there is some empirical underpinning for this. With a lag of three quarters manufacturing sentiment (Granger causes) services sentiment before as well as after the pandemic (see table below).

That said, since 2020 - namely in the pandemic and post-pandemic period – the finding that the mPMI leads the sPMI is on the verge of statistical insignificance suggesting that it lost statistical importance to explain swings in services sentiment in the post-pandemic recovery. We conjecture that just because the mPMI is set to stay in recession the sPMI must not necessarily follow in the current situation. Instead, it might also be the case that the sPMI leads the way this time.

Who leads the way: mPMI or sPMI?

	Lag in quarters					
	1	2	3	4	5	6
			period 1999 to 2019			
mPMI leads sPMI	no	yes	yes	yes	no	no
sPMI leads mPMI	no	no	no	yes	no	no
			period 2020 to 2023/Q1			
mPMI leads sPMI	yes	yes	yes	no	no	n.a.
sPMI leads mPMI	yes	yes	no	no	no	n.a.
			period 1999 to 2023/Q1			
mPMI leads sPMI	yes	yes	yes	yes	no	no
sPMI leads mPMI	yes	yes	no	no	no	no

Source: Derived from Granger causailty tests for quarterly averages for the respective period. Green fields confirm the lead of the man. PMI, red fields indicate impact in both directions and blue fields show no statistically significant impact in either direction

The quarterly average of the mPMI is below 50 since Q3/2022 but that did not lead the sPMI down so far. In contrast it continued to surge. We think this is due to the fact that the current environment still characterised by the post-pandemic recovery in services, incl. hospitality, traffic and tourism. Together with ongoing labour market strength resulting from government support measures during the pandemic and demographically induced labour shortage the domestic part of the economy is shielded against shocks from the global economy more than usual. As a result the dichotomy between both sectors can still persist in our view. Assuming that in a

conservative scenario the sPMI recedes to 52.2 while the mPMI stabilizes at 45, activity would stagnate (and the composite PMI be close to the threshold of 50) but a recession would be avoided in 2023.

Conclusions

Clearly, there are risks to our constructive no-recession view. A significant further worsening of credit standards, a shock that drives inflation up again and hence prevents it from receding or an even weaker global economy than pencilled in are key risks we have on our radar screen. But unless there are signs for such risks to materialise, we see no reason for the ECB to turn more dovish or even to pivot. In our scenario underlying inflation will still remain underpinned at levels well above the 2% target and we do not expect the hawks to become more relaxed. In contrast, we see the risk that the ECB continues to hike even beyond the June meeting.

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Imprint

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