194 – 11 September 2023

How Sick?

- We take a hard look at Germany's headwinds and policy set-up.
- We still see a marginally higher-than-even probability of an ECB rate hike this week.

After the Economist cover on 19 August on Germany being the "sick man of Europe" again, an article in Der Spiegel on "France being a better Germany" is making the rounds. We look into some of the German headwinds, in comparison with France and other large Euro area economies.

To some extent, it is the higher weight of some sectors which are struggling all across Europe – the car industry, or energy-intensive manufacturing – which explains Germany's underperformance. Yet, energy prices are an undeniable specific hindrance, and beyond the sectoral issues, the whole German industry is struggling. The country is losing market shares abroad, a painful issue for such an export-driven economy and evidence that slower China is not the only source of softness. The steep acceleration in unit labour costs does not help, but this is a common feature across the Euro area. Maybe more worryingly, the specific deterioration in survey-based "perceived competitiveness" by German companies suggests that, beyond the impact of higher energy and labour costs, there may be a decline in the non-price attractiveness of German products.

Policy implications are different from the last time, 20 years ago, that Germany was dubbed "Europe's sick man". Wage moderation this time again would be welcome, to help deal with the Euro area's inflation issue, but it is unlikely to bring a comprehensive solution to the difficulties on the export side. Reducing energy costs would be a key step, as well as boosting further investment in R&D and spurring innovation, but the solutions currently discussed look difficult to square with the political balance of the coalition. Germany has the fiscal space to address its issues, but the political conditions are not met.

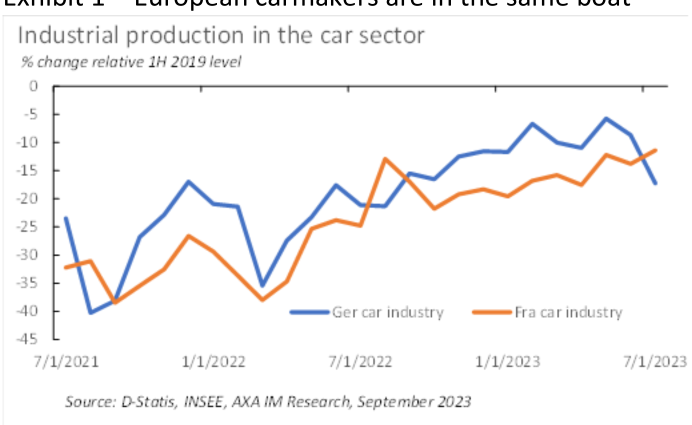
Markets will likely focus this week on the ECB meeting. We review here why we still see a marginally higher than even probability that the central bank hikes again on Thursday – for the last time in this sequence.

What's the source of Germany's weakness?

GDP for Q2 was revised down in the Euro area from an initial print at 0.3% to 0.1% quarter-on-quarter, converging back to the same mediocre pace as in Q1. This was essentially driven by another erratic Irish figure, but the new number is easier to reconcile with the message of the soft data, with surveys barely rebounding in the spring. Surveys fell further into Q3, as we discussed last week, leaving little hope for a recovery in GDP this summer. While in our view a new source of concern is the recent extension of softness to countries such as France which so far had been performing well, the weakness of the German economy, given its size and its importance for the other member states, remains the main drag on the Euro area. Last week's hard data confirmed what the Purchasing Managers' Index (PMI) and the IFO survey suggested: industrial production fell for the third month in a row in Germany, posting a cumulated decline of 2.8% since April. In France meanwhile industrial production rose by 0.9%. This latest Franco-German gap is of course adding credibility to the view now popularized by Der Spiegel, hailing France's economic model against Germany's.

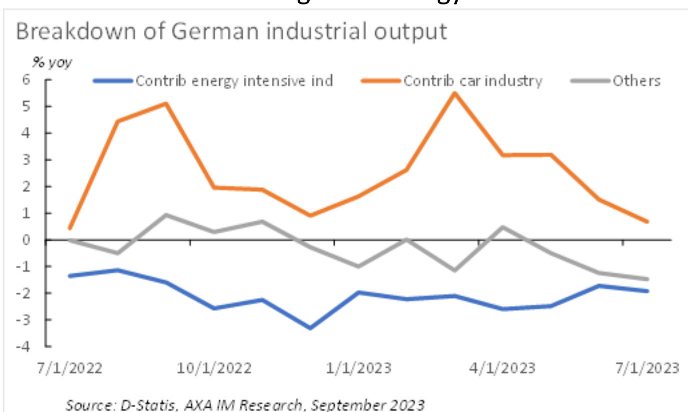
A popular explanation of the German underperformance lies in **the headwinds blowing against the country's car industry**. Indeed, output in July 2023 was in this sector still 17% below the level reached in the first half of 2019, but **this is by no means an exception in Europe**: the gap in French car production relative to the pre-Covid level until May 2023 was even larger. What is striking is actually how similar the trajectory of the car industry has been over the last two years in the two countries (see Exhibit 1), at least until July when output rebounded nicely in France while it continued to decelerate on the other side of the Rhine. While the adaptation of the German car industry to a decarbonizing world and the growing competition from Asian producers is undoubtedly a structural challenge – more on this later - in the short run, it's more the *size* of this industry (14.2% of the industrial production index, against 4.6% in France) than its idiosyncratic recent dynamics which explains the underperformance of aggregate German output.

Exhibit 1 – European carmakers are in the same boat



Source: D-Statis, INSEE, AXA IM Research, September 2023

Exhibit 2 – Sustained drag from energy-intensive sectors



Source: D-Statis, AXA IM Research, September 2023

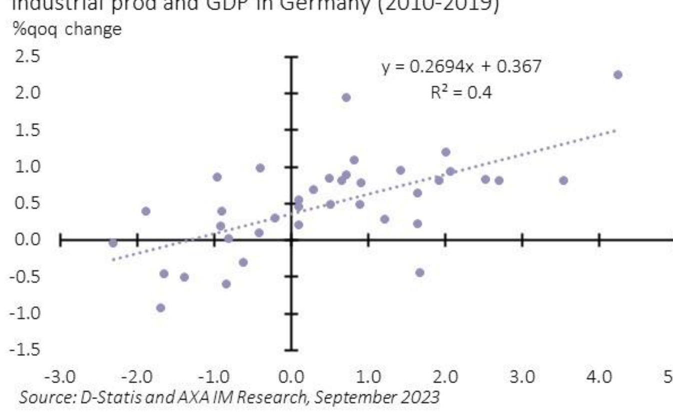
Another key issue is of course **the sensitivity of Germany's industry to energy prices**. We computed in Exhibit 2 the contribution of the 5 energy-intensive sectors (see here for D-Statis methodology) and that of the car industry to the year-on-year change in the overall industrial production index. Despite the improvement in energy costs, **German industrial output continues to be plagued by a negative contribution of c.2% from energy-intensive industries on a year-on-year basis.**

Germany is specifically hit through this channel for two reasons. First, the price of electricity for industrial clients is much higher there than in many other European Union (EU) countries (between 16 and 25 cents/KwH depending on the consumption level in June 2022, at the peak of the energy shock, against a range of 9 to 12 cents/Kwh in France, (see here on page 41-42 for more details). Second, **the economic weight of those industries ultra-sensitive to the cost of energy is particularly high in Germany.** The 5 sectors identified by D-Statis (manufacturing of chemical products, metal products, coking and refining, glass and ceramics, paper), which account for a bit more than three-quarters of the overall energy consumption of industry, stand for 17% of industrial value added, e.g., more than car-making. The biggest industrial energy consumer is by far the chemical sector (30% of the consumption of the whole German industry). It accounts for 12% of manufacturing output in Germany against 8% in France.

Still, the specific role of energy does not suffice to explain all the recent underperformance of the German industry. Indeed, what is also obvious in Exhibit 2 is the fact that **the re-deceleration of the car sector combined with the continued drag from the energy-intensive sector would not have driven the overall index in contraction territory without the deterioration of the "rest" of the German industry** (the "others" line in Exhibit 2). This raises the possibility that beyond the sectoral issues, the German economy is dealing with a more pervasive and comprehensive set of problems.

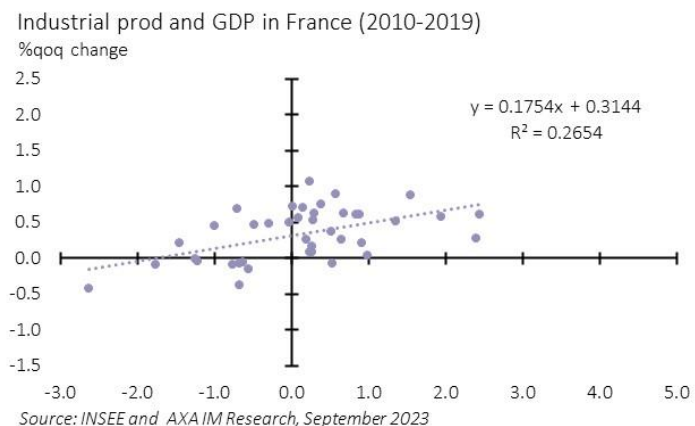
But before we get there, we need to take the measure of the ramifications of this industrial weakness for the rest of the economy. **The correlation between industrial production and GDP growth is higher in Germany than in France** (see Exhibit 3 and 4 – we've looked at the period between the end of the Great Financial Crisis and Covid to get a sense of the pattern when the economy is at or close to "cruise speed"). This is the product of another "size effect": with a higher weight of manufacturing in total value added, Germany's economy remains more driven by this sector's cycle.

Exhibit 3 – German GDP tightly correlated with IP



Source: D-Statis and AXA IM Research, September 2023

Exhibit 4 – Less so in France



Source: INSEE and AXA IM Research, September 2023

Another lesson we can draw from the comparison of exhibits 3 and 4 is that output (industrial production on the x-axis and GDP on the y-axis) is "noisier" in Germany than in France, with a more scattered pattern (we have on purpose kept the same scale across the two graphs). The standard deviation of the quarterly change in industrial production is 1.5 times higher in Germany than in France, and that of GDP is nearly twice as large. Some of this may pertain to different national accounting practices – your humble servant is always baffled by how German GDP is frequently affected by "exceptional factors" – but fundamentally this may also be the product of the country's industrial specialization in highly cyclical products. With the dominance of the capital goods and intermediate goods sectors, the German economy reacts more sharply to the gyrations of the global cycle than economies more focused on consumer goods – such as France. The somewhat "erratic" nature of the German data should be kept in mind: the materialisation of isolated upside risks in the future data flow should be taken with a pinch of salt before asserting that Germany's "bad patch" is over.

Lamenting – or secretly enjoying, since Schadenfreude is often prevalent in the foreign commentariat when it comes to the German economy – the demise of the country's growth model is becoming a cottage industry. We would however argue that the usual focus on China as a source of traction for German production – Berlin's "bad bet", beside the choice of Russia as the main source of gas - is not necessarily the "end of the story". Of course, the fact that demand is weak in China is no good news for German producers. But Exhibit 5 suggest **that soft demand for German products is unfortunately quite widely spread geographically.** Indeed, there has been no marked difference between "intra Euro area" and "extra Euro area" orders in the recent deterioration observed by the Bundesbank. Comparing actual exports to world demand allows to control for the effect of lower external traction. We use in Exhibit 6 the "world markets volume" data computed by the Organisation for Economic Co-operation and Development (OECD) for each country (in practice the sum of import volume from client countries weighted according to their share in each exporting country's shipments). The difference between actual export growth and the change in world markets' volume returns the change in each exporter country's market share. In the Euro area, **two "clubs" appear. Spain and Italy have managed to bring their market share back to its pre-Covid level, while there remains a gap of about 5% for Germany and France**. This should dampen enthusiasm for

the French growth model, but in truth, in the short run at least it is less an issue for France given the lower share of exports in GDP there (c.30% against more than 40% in Germany).

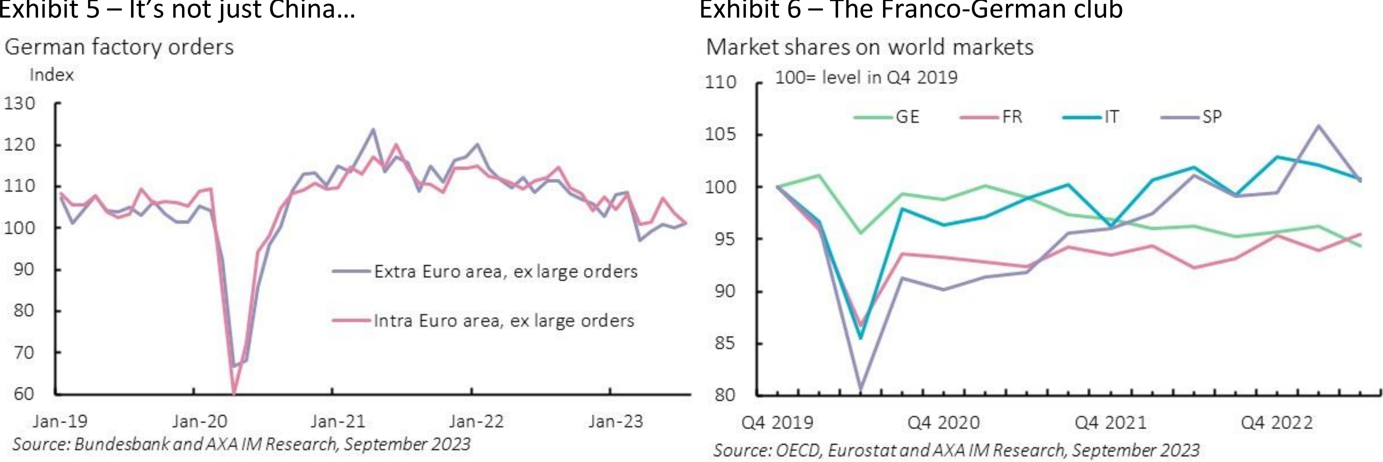


Exhibit 5 – It's not just China…

Exhibit 6 – The Franco-German club

A decline in market share is the very definition of a loss of competitiveness, but it's an "ex post" indicator, which does not say much about *why* exports underperform world demand. Looking at the behaviour of unit labour costs (compensation deflated by productivity) is the first port of call. As can be seen in Exhibit 7, all European countries have had to deal with a significant increase in unit labour costs since the start of the pandemic, with one exception (Italy). Germany does not stand out in the pack, with a cumulated rise of 12%, between France and Spain. This may become a headwind in the near future, as wage growth in Germany is likely to exceed the pace seen in the Euro area as an average in the coming quarters, judging by the recent pay deals, but for now, this can't be the "smoking gun" explaining the country's export underperformance.

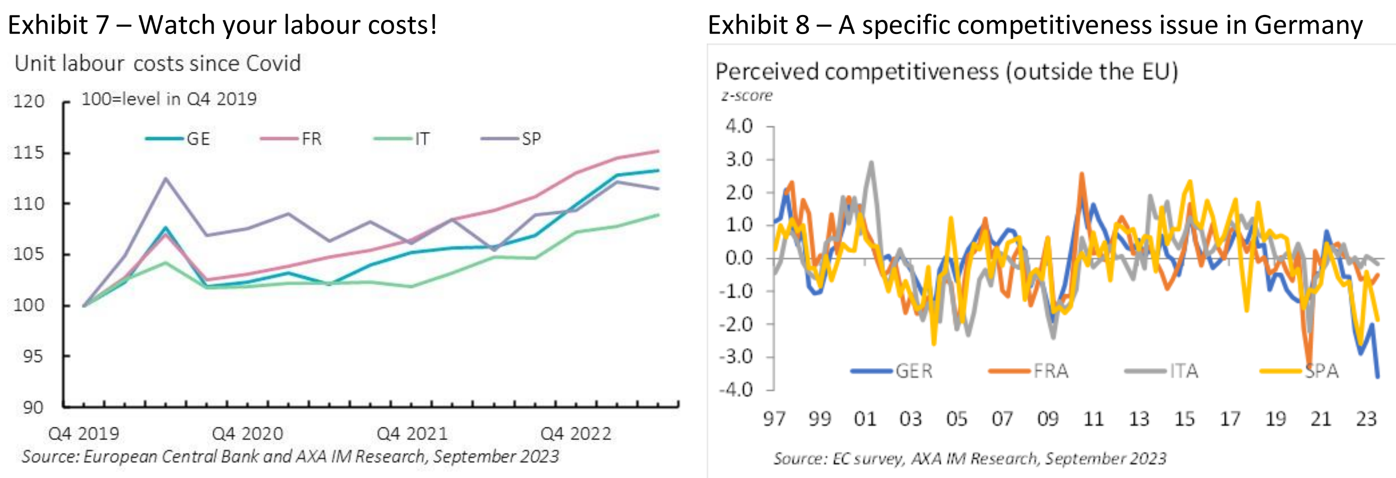


Exhibit 7 – Watch your labour costs!

Exhibit 8 – A specific competitiveness issue in Germany

Yet, where conversely Germany stands out, it is when looking at the firms' own perceptions, through the prism of the balance of opinion of industrial firms on their competitiveness on foreign and domestic markets (see Exhibit 8). Perceived competitiveness tends to move in a synchronised way across the Euro area's main economies, which is hardly surprising since they share the same exchange rate. Recent developments have been remarkable though: German firms' balance of opinion on this issue is today 4 standard deviations below its long-term average, well below the other countries.

This would suggest that t**he German industry is facing difficulties on foreign markets which cannot be easily reduced to the usual quantitative measures of competitiveness.** Unit labour costs do not directly integrate the impact of energy prices, and this may be an explanation. Yet, we also need to mention the possibility that German products are losing

some of their “intrinsic attractiveness”. The car industry would provide an example. The issue may not be primarily that German cars are getting more expensive, but that they no longer differentiate enough from competitors’ products to justify the price difference, in particular on new segments such as Electric Vehicles (EV).

Policy space versus policy hesitations

Our exploration of the German data gets us to a complicated picture laid out in front of policymakers in Berlin. Some of the current softness is cyclical, but as much as the German economy is specifically hit by the deterioration in the global manufacturing cycle – because of its sectorial specialisation and the sheer weight of industry in GDP – **there are clearly some structural forces at play which cannot be addressed by merely waiting for some better times in the global economy.**

Yet, **Germany’s current predicament probably calls for a very different set of policies as the ones the country pursued 20 years ago after it was dubbed the “sick man of Europe” for the first time.** In the 1990s, at least the diagnosis was easy: Germany had squandered its competitiveness in the unification shock, while the public welfare system was not conducive to the expansion in the participation rate which the demographic changes called for. A long phase of wage moderation - coupled with the end of the crawling appreciation of the currency thanks to the euro - helped rebuild competitiveness while the (measured) deregulation pushed through by the Schroeder administration at the beginning of the century helped with labour supply.

The same prescriptions would probably fail to fully address today’s issues. **Attaining some wage moderation is necessary to bring inflation back under control and lift the European Central Bank (ECB)’s burden, but as we argued in the previous section, the drift in unit labour costs is unlikely to be the sole driver of Germany’s market share loss**. If this reflects more a decline in the “intrinsic” attractiveness of German products, policy recommendations would rather focus on more efforts on investment spending – in the broad sense of the meaning, i.e., including R&D – to speed up the renewal of the current flagship industries and prepare for a shift towards a different sectoral specialisation. Labour supply remains a problem, with businesses reporting massive labour shortages and a general skills mismatch, but it’s unclear how much higher the participation rate could be raised within the limits of the current social consensus in Germany. Arguably, **there should be more focus on working time than on the number of workers**. According to Eurostat, in 2022 full-time employees worked on average 34.6 hours a week in Germany against 36.2 in France and 36.4 in Spain.

Getting the price of energy down on a sustainable basis is clearly one of the key structural issues which need to be tackled. There are (at least) two different ways to achieve this: either changing the energy mix itself to make it less expensive or mitigating the cost with subsidies – beyond the emergency packages Berlin put in place just like everyone else in Europe last year – to protect the country’s competitiveness. There seems to be little to no appetite right now for a proper debate on the energy choices. Chancellor Scholtz was remarkably clear on his refusal to discuss the shift away from nuclear power (calling the possibility to re-start recently mothballed plants “a dead horse”). Subsidizing is thus the hotly debated issue, but without any conclusion for now.

Economy Minister Habeck (from the Greens) proposed a cap on electricity price for a “limited set of energy-intensive” industries at 6 cents/Kwh on 80% of their consumption (thus still maintaining an incentive to seek the cheapest provider for the remaining 20%) until 2030. The idea would be to give these businesses some visibility on their energy cost while the country expands further its renewable energy capacity. This is the sort of arrangements which rarely come down well in the economic profession, since blurring the price signal would strongly reduce the firms’ incentive to transform their production process and reduce their energy consumption. Besides, from a technical point of view, it is debatable whether a further development of renewable sources would necessarily trigger a sustained decline in average prices if no lasting solution were found for “baseload”, i.e., the energy source which can be relied upon when renewables do not produce enough irrespective of the overall installed capacity (today this is provided in Germany by gas and lignite). While the cost of renewables has been falling and can be expected to fall further, businesses could still be faced with painful “flares” in electricity costs. It could not be ruled out that the subsidy would have to be maintained beyond 2030.

The proposal has not been accepted by the other parties of the ruling coalition – despite a policy paper by Chancellor Scholtz' own Social Democratic Party (SPD) arguing in favour of a similar scheme. The economic incentives arguments played a role, but also, we suspect, the cost of the cap for public coffers (estimated at EUR 30bn) at a time when Berlin is re-instating the "debt brake. The proposal was not well-received outside Germany either. It was viewed as a way for Germany to use its fiscal capacity to regain competitiveness against its European peers which do not benefit from the same room for manoeuvre, without addressing the country's underlying structural problem. Habeck had pre-emptively addressed this by mentioning the possibility to create an EU-wide financial facility to allow all member states to pursue the same approach. Still, such facility at the EU level could not exist without a German backstop, which the country is unlikely to agree on, given its reluctance to increase its contingent commitments.

While the Spiegel article triggered a torrent of comments in France which, unusually, may boost the country's morale – beating the All Blacks might however prove more decisive in the short run - there remains an undeniable, formidable asset on the German side: the state of its public finances. While France's fiscal capacity is stretched, Berlin retains a wide room for manoeuvre to "spend its way" out of its current cyclical and structural predicament. The "only" issue is that the country is not in the right political set-up to make full use of this capacity. We do not expect sweeping reform measures anytime soon.

Difficult decision for the ECB

The outcome of the ECB's Governing Council meeting this Thursday is unusually uncertain. We have been discussing this last week. The doves have a stronger hand than anytime so far in this cycle, with tangible signs that the ECB's tightening is making its way through the economy and that patience should be warranted as the weakness in the real economy should gradually percolate to firms' margin behaviour and dampen wage growth. We would expect this to be reflected in the new batch of forecasts, with softer growth weighing on core inflation, which we see at 2.2% in 2025 (from 2.3% in the June batch). Yet, we would be surprised to see the ECB revise its inflation forecasts in 2024 and 2025 enough to be fully consistent with their target – which they said should be attained "in a timely manner". Moreover, if the central bank wants to focus on the consistency of its own message – which so far has been more interested in the observed behaviour of costs than in forward-looking probing – then there is little reason for a pause: the 0.2 percentage point improvement in core inflation in August can hardly be seen as an inflexion point (it stood at the same pace in May), and unit labour costs have accelerated again in Q2. The recent slight uptick in consumer and market-based inflation expectations would give the ECB an easy justification for "one last hike".

The main reason why we still see a marginally higher probability of a 25bps hike rather than the status quo is of a tactical nature. While keeping the policy rates unchanged in September could still be presented as a mere "skip", with a maintained tightening bias, offering chances for the central bank to react later if indeed inflationary pressure were too stubborn in the months ahead, in reality **the hawks probably sense that not moving this month will seriously impair the chances to hike again**. Indeed, it is highly likely that the real economy data flow will deteriorate further, while base effects should push inflation more decisively down. Note that such deceleration would not necessarily mean that the central bank has tightened "enough". This will be ascertained only if and when inflation returns to 2%. But tightening further amid soft – and possibly hard – data pointing to a recession, while inflation falls, albeit from a pace still significantly above target, would be very difficult to negotiate and communicate. We thus expect the hawks to go "all in" to try to win the case this week, but we fully accept that political arguments are fickle by nature.

If the ECB does not hike, the market is likely to take this as a strong sign that the central bank is "done", which we don't think the Governing Council would be happy with, even if it would also be our conclusion. If only to win over the hawks, a significant "tightening threat" would need to be maintained. **Keeping the current forward guidance might be difficult.** Indeed, the market would consider that rates are already "*sufficiently restrictive*" since the ECB chose not to hike this time. So logically it would take a further drift upward in inflationary pressure to warrant a subsequent additional hike. We would then expect the ECB to change its messaging to something like "interest rates will be kept at current or higher levels" long enough to bring inflation back to target. If the ECB does hike, then maintaining the current wording will be easier.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• ISM non-mfg (Aug) 54.5 vs 52.7 prior. Often echoing retail activity, defied early signs of August sales drop • Jobless claims 216k from 229k, the lowest since February. Indeed, vacancy measure also rose in Aug. • Mortgage applications fell 2.9% in latest week, continue to suggest slowing US housing activity • Fed comments start to coalesce on pause in September, but still more mixed beyond	• CPI inflation (Aug) - rose to 3.3% last on base effect, gas costs set to drive further gain, but core to fall • Retail sales (Aug) preliminary sell-side research points to retracement from strong July • Empire mfg survey (Sep), weak in Aug but volatile • U MIch consumer sentiment (Sep, p) headline likely to fall on gas, inflation expect's watched • Jobless claims for signs of persistent strength
	• Final EMU Q2 GDP came at 0.1%qoq (-0.2pp below 1st estimate). Employment unchanged at +0.2%qoq • Final service August PMIs revised lower to 47.9 • 3 years consumers inflation expectations (Jul) increased to 2.4% (+0.1pp) probably reflecting higher oil prices • Final ECB speeches did not point to a clear commitment. This is really a 50/50 call	• ECB monetary policy meeting. We think the GC will make a last 25bps hike. Inflation outlook has not changed since June and proofs of deceleration are insufficient yet • Final HICP data (Aug) to dig further into the first deceleration signal of core • ZEW survey • Industrial production (Jul)
	• BRC retail sales (Aug) up 4.3% indicating that July drop in Retail sales (-1.2%) should reverse • PMIs (Aug) suggest economy in contraction territory for the first time since Jan. • KPMG/REC employment survey points to steepest drop in permanent placements in three years	• Labour market data (Jul/Aug) expected to show slack growing with u/rate likely to rise from 4.2% • GDP (Jul) likely to fall back following BH impacted 0.5% June rise alongside poor weather and strikes • Trade balance (Jul) • RICS survey (Aug) to reflect weakness in housing
	• Per capita wages slow +1.3% (Jul) from 2.3% (Jun) due to weakness in overtime payments • Trade balance (Jul) rose to surplus of ¥68.2bn, amid declining fuel prices and inbound tourism recovery • GDP (Q2) 2nd est revised down to still strong 1.2% from 1.5% driven by revisions to private capex	• M2 money supply (Aug) • Reuters Tankan Indices (Sep) • PPI inflation (Aug) • Machinery orders (Aug)
	• Declines in trade narrowed in Aug, exports (-8.8%yoy vs. -14.5% in Jul), imports (-7.3%yoy vs. -12.4% in Jul) • After the easing policy in the property market, tier one cities saw improvement in property sales (in floor area) by 20.5%wow	• Sat (9 Sep): CPI (Aug), PPI (Aug) • Over the next week: TSF (Aug), New Yuan Loan (Aug), FDI (Aug) • Fri (15 Sep): main data release for Aug (IP, FAI, retail sales, unemployment rate)
EMERGING MARKETS	• CB: Both Chile & Poland cut rates by 75bps to 9.5% & 6.0%, respectively. Malaysia stood on hold at 3.0% • Q2 GDP (yoy%) grew 0.9% in Korea, 1.6% in South Africa & 1.1% in Romania • Aug inflation (yoy%) declined in Colombia, Hungary & Mexico. It rose in Taiwan & Turkey	• CB: Peru (7.75%) & Russia (12.0%) are expected to stay on hold • Aug CPI: Brazil, Czechia, India & Romania • July industrial production: Colombia, India, Malaysia, Mexico, Hungary, Romania, South Africa & Turkey • July retail sales: Brazil & Colombia

Upcoming events		
	US:	Wed: CPI (Aug); Thu: PPI (Aug), Retail sales (Aug), Weekly jobless claims (9 Sep); Fri: Empire state survey (Sep), Industrial production (Aug), Michigan consumer sentiment (Sep)
	Euro Area:	Mon: EA summer forecasts, It Industrial production (Jul); Tue: Ge ZEW survey (Sep), Sp HICP (Aug); Wed: EA Industrial production (Jul); Thu: ECB announcement & press conference; Fri: Fr, It HICP (Aug)
	UK:	Tue: Labour market report (Jul); Wed: Monthly GDP (Jul), Construction & manf output (Jul), Index of services (Jul), Industrial production (Jul), Total trade balance (Jul); Thu: RICS Housing survey (Aug)
	Japan:	Thu: Industrial production (Jul)
	China:	Fri: 1Y MLF, Fixed asset investment (Aug), Industrial production (Aug), Retail sales (Aug), New home prices (Aug), New yuan loans (Aug), Total social financing (Aug), M2 supply (Aug)

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