HOLDING UP WELL, BUT TO WHAT EXTENT?

Growth in the Eurozone is expected to stabilise at 0.3% q/q in the second half of 2024, before picking up slightly in 2025, supported by the cycle of interest rate cuts. However, the difficulties in industry, highlighted by the deterioration in PMI indices in September, and the uncertainty about the Chinese economy, increase the downside risks to our forecasts. A more adverse scenario, in which the manufacturing sector drags the rest of the economy along with it, is not the preferred one at the time of writing. Although less pronounced, the differences in dynamism between countries and sectors are expected to continue into 2025.

Thus far, imported disinflation in manufactured goods has enabled headline inflation to fall back towards the ECB's 2% target, but this effect is set to fade. This increase would offset some of the disinflation that we foresee in services, which is expected to pick up next year, enabling headline inflation to stabilise at around 2% by the second half of 2025. With two further cuts expected in October and December, followed by two more in the first half of 2025, the ECB's terminal rate would be reached next spring. As a result, activity in the Eurozone is expected to strengthen in 2025, supported by a rebound in the German economy and a more favourable carry-over effect than in 2024.

THE CHINESE DILEMMA

Some sectors of European industry are currently caught between sluggish domestic consumption and Chinese overproduction, which is ultimately aiming to increase the country's market share by squeezing out local producers through lower price. With corporate margins falling in the second quarter and PMI employment indices for the manufacturing sector showing a clear deterioration in September (standing at 45.8, the lowest post-Covid level), a tipping point in the Eurozone labour market, which has so far held up remarkably well, is possible. The European Commission's quarterly survey of production constraints is also illuminating. While recruitment problems were, up until the end of 2022, the main constraint on activity, the lack of demand has since become the main factor again. It should be noted that this indicator has been fairly reliable in the past for indicating reversals in the economic cycle[1].

Responding to Chinese competition in a unified manner within the EU-27 remains a tricky task. The October 4th vote to ratify the increase in tariffs on Chinese electric vehicle imports highlighted the deep divisions between member countries, with only ten countries voting in favor of the measure, while five opposed it (including Germany), and twelve abstained (including Spain). Countries with strong links to the world's second largest economy (Germany, Slovakia, Hungary) are more reluctant to raise tariffs out of fear that Beijing will introduce tougher and more far-reaching retaliatory measures. As part of the transition to electric vehicles, some political leaders are also looking to attract Chinese car plants to their countries.

Furthermore, while a genuine decoupling in trade between the United States and China is seemingly well underway, a break between the EU and Beijing is yet to materialise, and, in some respects, trade dependencies have even deepened in recent years[2].

GROWTH AND INFLATION

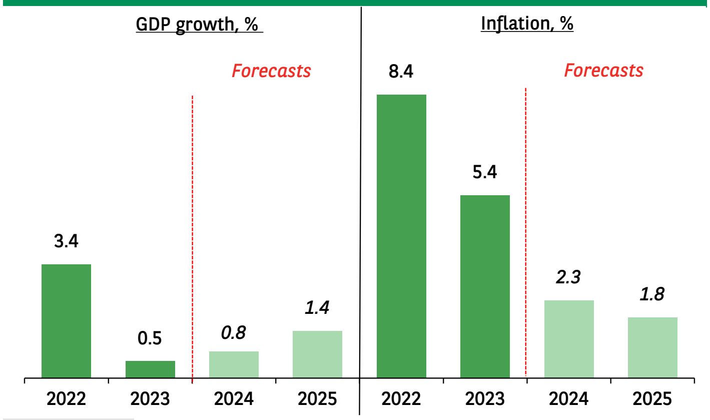

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Therefore, the current levelling-off of trade between the two blocs is primarily a reflection of the general decline in demand, rather than a shift in trade from the EU to other countries. The share of EU (extra-EU) imports from China has in fact remained stable over the last two years at over 20%[3].

A LARGE BUDGETARY GAP

As was the case in 2023, 2024 will see the fiscal position of the countries at the epicentre of the European debt crisis in the 2010s holding up very well. Greece, Portugal and Ireland are set to achieve primary surpluses close to or even above 2% of their GDP, while the deficit in Spain is expected to fall back below 3%. Against a backdrop of falling inflation across the Eurozone, the narrowing of spreads between the German Bund and Greek, Spanish and, above all, Portuguese yields reflects a significant fall in the risk premium assigned to these countries. Conversely, the budgetary adjustments to be made by the five countries[4] subject to the EU's excessive deficit procedure will act as a brake on activity, but are nonetheless essential for limiting tensions on the bond market.

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1 According to the survey for Q3 2024, 39.7% of companies surveyed cited demand as a production constraint, while 19.3% cited recruitment problems. It should be noted that, in this survey, companies are able to choose multiple answers.
2 See for example, *While the US and China decouple, the EU and China deepen trade dependencies*, PIIE Blog, 27th August 2024.
3 Source: Eurostat. 12-month moving average.
4 Belgium, France, Italy, Malta, Slovakia, plus Romania, Hungary and Poland outside the Eurozone.