

# ECOWEEK

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## Eurozone: when manufacturing sneezes, do services catch a cold?

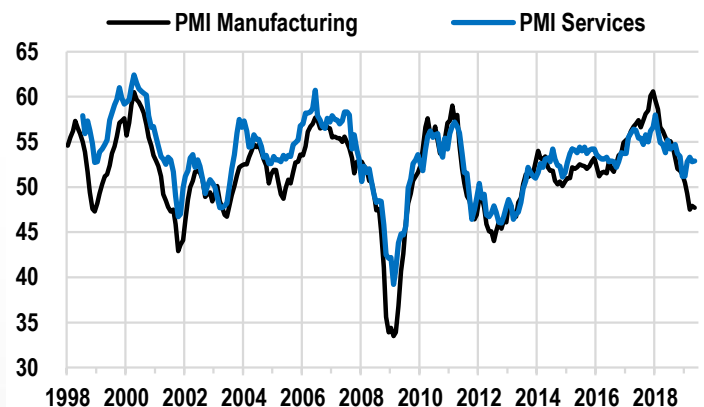
■ According to Mario Draghi, a key question is how long the rest of the economy can remain insulated from the weakness in the manufacturing sector ■ Historically, the purchasing manager indices for manufacturing and services have been highly correlated, which can be partly attributed to the important role of services in the value chain of the manufacturing sector ■ The future resilience of the services sector in the eurozone will very much depend on what happens in Germany where the gap between the PMIs of the two sectors is abnormally high

*"The key issue is: how long can the rest of the economy be insulated from a manufacturing sector that keeps on being weak?"*<sup>i</sup> The answer to the question asked by Mario Draghi during his recent press conference is important for future Governing Council decisions but also for business and household spending behaviour going forward. Judging by the purchasing manager indices, historically, manufacturing and services have tended to move in lockstep. The first half of 2005 was an exception and in recent months a gap has opened up between the two sectors. It is this observation which has triggered the comment of the ECB President.

What drives this, generally speaking, high correlation? One factor is the cause of the slowdown. If the shock is global, like in 2008-2009, or economy-wide, like the eurozone sovereign debt crisis in 2011-2012, one would expect that manufacturing and services suffer simultaneously from a drop in confidence, income, access to financing, etc. If the shock is sector specific, which to a large degree has been the case since early 2018, the extent of the spillover effect from manufacturing to services will depend on the degree in which both sectors are intertwined. In a study in 2014, the ECSIP Consortium<sup>ii</sup> noted that *"as services are used in the production processes of a manufactured product, the value of a final manufacturing product embodies directly and indirectly value added created in services to a large extent."* Based on data for 2011, in the EU-27, *"services account for slightly less than 40% in the value of a final manufacturing product"*.<sup>iii</sup> This implies that a drop in the demand for manufactured goods has a considerable impact throughout the value chain and hence on services.<sup>iv</sup> Confidence effects may also play a role: companies in the services sector may end up becoming concerned about their business prospects when they observe that the manufacturing sector is in a dire situation with no end in sight. This may weigh on their recruitment and investment plans.

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EUROZONE PMI: MANUFACTURING VS SERVICES



Source: IHS Markit, BNP Paribas

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Economic scenario

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To explore these relationships, the charts below show, on the horizontal axis, the 12-month change in the manufacturing PMI and on the vertical axis, the equivalent for services. In France, Italy and Spain, the correlations are very high but this is less the case in Germany. In that country, the slope of the regression line is also less steep, which suggests that services are more insulated from what's happening in manufacturing or depend on other factors. What is striking however is the degree in which the latest observation of the 12-month change of the German services PMI diverges from the expectation based on the historical relationship between the two sectors and given the huge drop in the manufacturing PMI. One would

expect that, eventually, this outlier would correct itself, either because manufacturing rebounds, or because services weaken significantly or a mixture of these two. Considering that for the other countries both indices are well in line, when gauging the resilience of services in the eurozone to the worsening international business climate hitting manufacturing, the analysis has to focus on Germany. Clearly, absence of a pick-up in manufacturing sentiment would end up weighing on confidence, not only in Germany, but, given its weight, also in the rest of the eurozone.

William De Vijlder

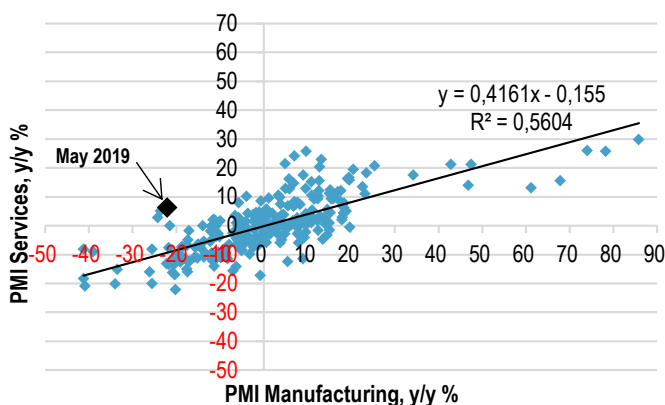
<sup>i</sup> ECB, Introductory statement to the press conference of Mario Draghi, President of the ECB and Luis de Guindos, Vice-President of the ECB, Vilnius, 6 June 2019

<sup>ii</sup> Study on the relation between industry and services in terms of productivity and value creation, 2014. The report was written for the DG Enterprise and Industry of the European Commission by the partners of the ECSIP Consortium: WIIW (The Vienna Institute for International Economic Studies), Ifo and Ecorys

<sup>iii</sup> In France this percentage was even higher (48.5%) and the opposite holds for Germany (35.9%). Italy (40%) and Spain (39.4%) are in line with the EU average.

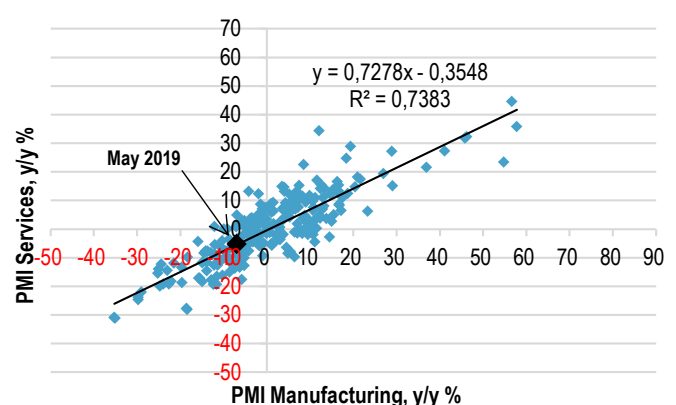
<sup>iv</sup> The authors make a distinction between upstream (development) services (R&D, design), core (production) services (supply management, production and process engineering, other technical services) and downstream (market) services.

GERMANY (SINCE JUNE 1998)



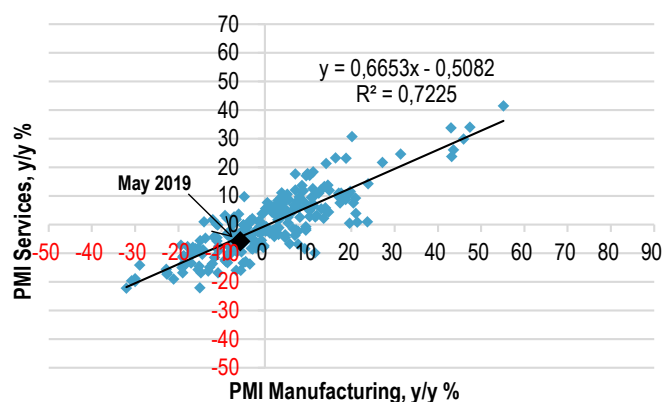
Source: IHS Markit, BNP Paribas

FRANCE (SINCE MAY 1999)



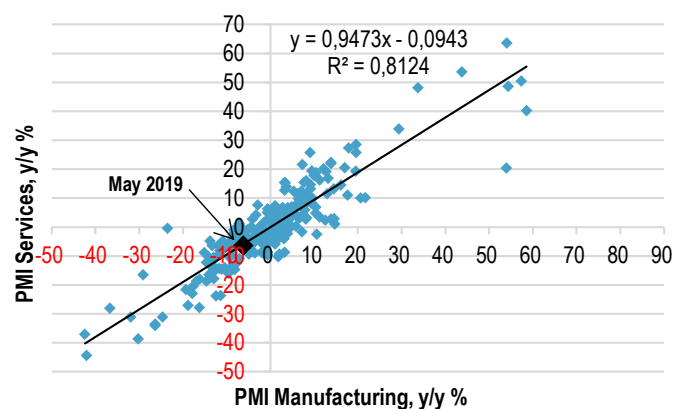
Source: IHS Markit, BNP Paribas

ITALY (SINCE JANUARY 1999)



Source: IHS Markit, BNP Paribas

SPAIN (SINCE AUGUST 2000)



Source: IHS Markit, BNP Paribas



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