Euro Area Economy: Under Pressure, But More Resilient Than Perceived

- The rigidities of a unified currency and single central bank within the euro area means that ECB policy cannot simultaneously satisfy the different needs of all member nations. This causes economic divergences in every cycle, which can persist until they become secular trends and result in significant imbalances, and eventually trigger a crisis.

- It is encouraging that the ***cyclically*** vulnerable parts of the region from the last decade are now those that have the strongest structural supports. This provides a long runway before ***structural*** forces will again dominate over cyclical dynamics. It also provides more stability for the regional economy and a substantial firewall to fend off recessionary forces.

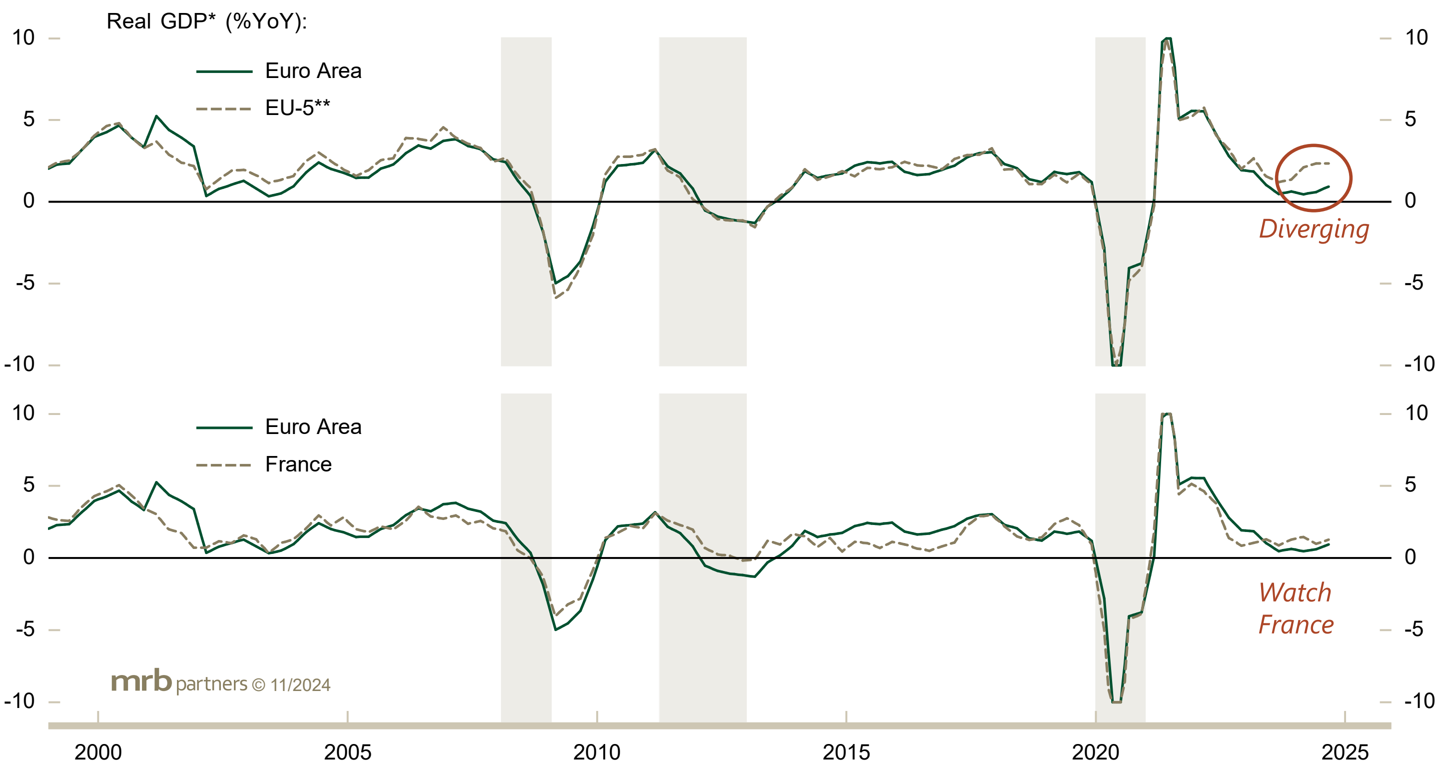
- Many of the southern euro area members' economies faced stiff household deleveraging last decade, which was painful but eventually reduced structural imbalances. Deleveraging has now tapered off, and these economies are experiencing a more vibrant cyclical economic expansion, supported by consumer spending.

- Germany has the current weakest cyclical growth backdrop in the region due to drags from its large manufacturing sector that is struggling with a lack of global competitiveness and a weak overall demand backdrop. However, Germany has among the strongest structural foundations in terms of household and government sector balance sheets, and has accumulated the greatest degree of household excess savings since the pandemic, which mutes contractionary forces.

- France has comparatively high household and government sector debt levels relative to GDP (thereby increasing its longer-term vulnerabilities). However, households in France also have underspent since the pandemic, providing some cyclical firepower. France's economic expansion is also broadly in line with the aggregate euro area, making this member nation and its consumer sector (rather than German manufacturing) the key in tilting the entire regional economic growth profile.

- On balance, as the ECB tries to shore up activity in the currently sick German economy, it should provide a boost for France (and the healthy economies). Better growth in France would meaningfully improve the growth prospects for the aggregate euro area.

Chart 1 Euro Area: France Holds The Key To Unlock Growth



* Truncated at 10 and -10; source: National Source
** GDP-weighted aggregate of Germany, Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

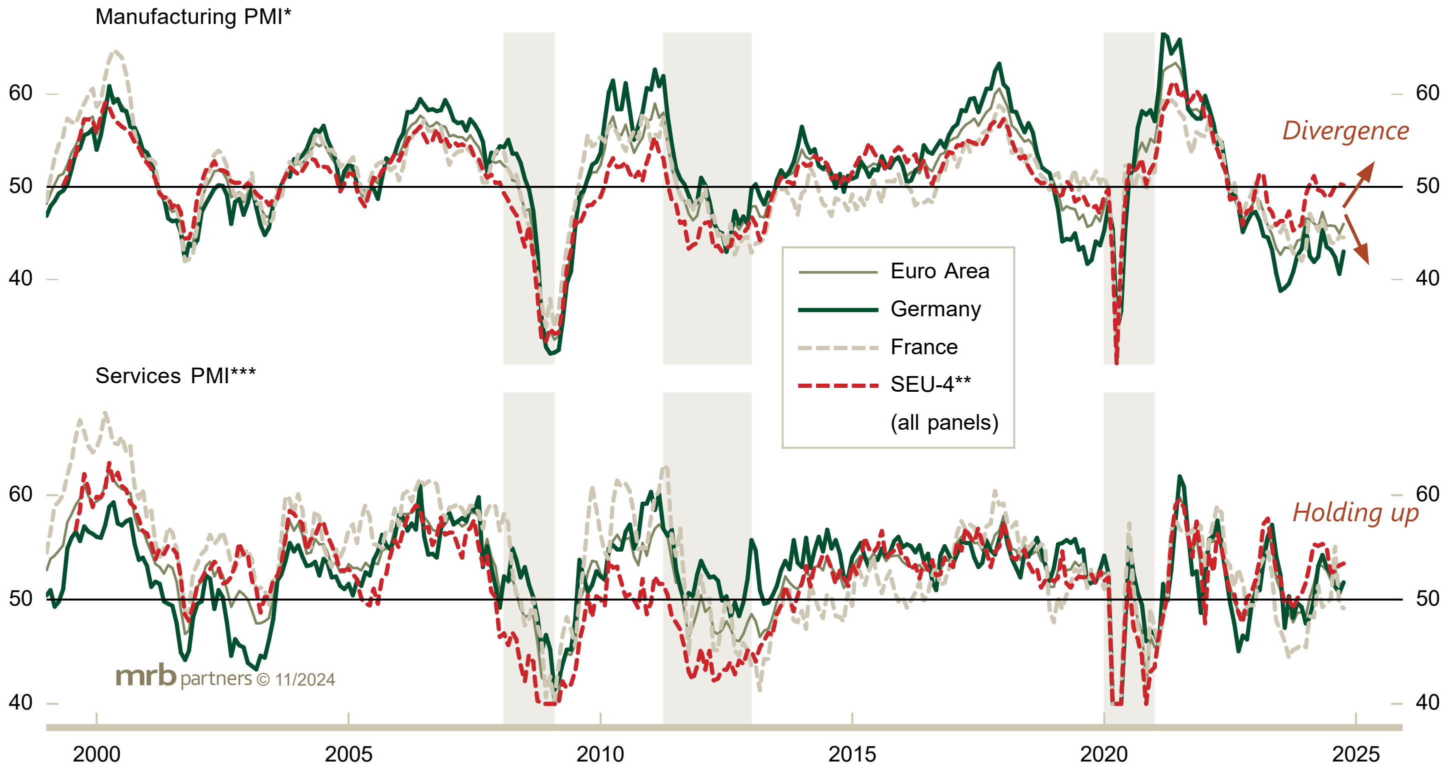
Our recent **MRB *Research Highlight*** flagged the growing ***cyclical*** divergence within the euro area[1]. Our research concluded that aggregate euro area economic activity has been dragged down by a currently sick and stagnating German economy. However, four southern euro area countries (SEU-4, which includes Greece, Italy, Portugal and Spain), which together have roughly the same economic importance as Germany, are enjoying a much more vibrant expansion of nearly 5% real GDP growth. In fact, when aggregating the real GDP growth of Germany with the SEU-4 (i.e. EU-5) the growth rate is about 2.5%. (**charts 1** and **2**). France's economy is in between and currently sluggish, largely due to a household sector that is reluctant to spend.

For historical reasons, investors place a disproportionate amount of attention on the German economy and its manufacturing sector, which is currently weak and will lag any cyclical improvement in the region. Instead, the SEU-4 is leading the expansion, and France likely will provide a better barometer for the ***aggregate*** euro area economy. Indeed, France's consumer sector likely holds the key to titling the aggregate euro area ***cyclical*** growth profile in a more encouraging direction.

France's consumer sector holds the key to titling the aggregate euro area cyclical growth profile in a more encouraging direction

[1] **MRB:** ***Euro Area: Member Divergences Provide Opportunities***, October 23 2024

Chart 2 **Be Careful Using German PMI Manufacturing As A Go-To Indicator**



* Source: Markit Economics; excludes Portugal
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at 40; excludes Greece and Portugal; source: Markit Economics
Note: Shaded for Center of Economic Policy Research-designated euro area recessions

Today's report complements our previous research by focusing on the ***structural*** outlook for the euro area. We conclude that:

- Germany is cyclically weak, but the economy has a strong structural foundation due to solid household and government sector balance sheets. Although this may not encourage greater consumer or fiscal spending to boost the cyclical expansion, it does provide a substantial firewall to fend off contractionary forces. Indeed, widespread concerns about recession in Germany (and the aggregate euro area) are exaggerated, given that there are few imbalances in Germany to be cleansed. Ok, but there is no growth, so the recession concerns are valid. Maybe say "deepening recession" or something.

- The SEU-4 economies do not have the same degree of structural resilience as Germany, but they have gone through a decade of household deleveraging and now have a much stronger footing than previously. Government debt-to-GDP remains elevated for many of these economies, but a solid consumer-led cyclical expansion is currently underway and fiscal stimulus in not required. Lower ECB rates will help sustain, and more likely augment, underlying growth in the heathier economies.

Germany is cyclically weak, but the economy has a strong structural foundation due to solid household and government sector balance sheets

- France has comparatively high household and government sector debt-to-GDP ratios (which increases its longer-term vulnerabilities). However, households in France also have materially underspent since the pandemic, providing some "excess savings" to serve as cyclical firepower.

One of our key frameworks over the past 15-years has been that the rigid nature of the common currency and single central bank means that policy will inevitably be too restrictive for some member nations, while too accommodative for others[2]. This causes cyclical divergences to persist for a long time and frequently leads to structural imbalances.

In the current environment this means that attempts by the ECB to shore up activity in the relatively weak aggregate euro area by cutting interest rates to encourage greater consumption, will fuel economic activity in the healthier SEU-4 and provide opportunities for investors. Fortunately, the SEU-4 have considerably fewer private sector imbalances than a decade ago, which provides a long runway before they again become a risk for regional stability. Likewise, if the ECB fails to provide enough support for the German economy, the government has ample latitude to help fill in the economic growth gap without causing fiscal strains, ***should it choose to do so***. In short, structural fragilities should not shift to the forefront again anytime soon and derail cyclical investment opportunities.

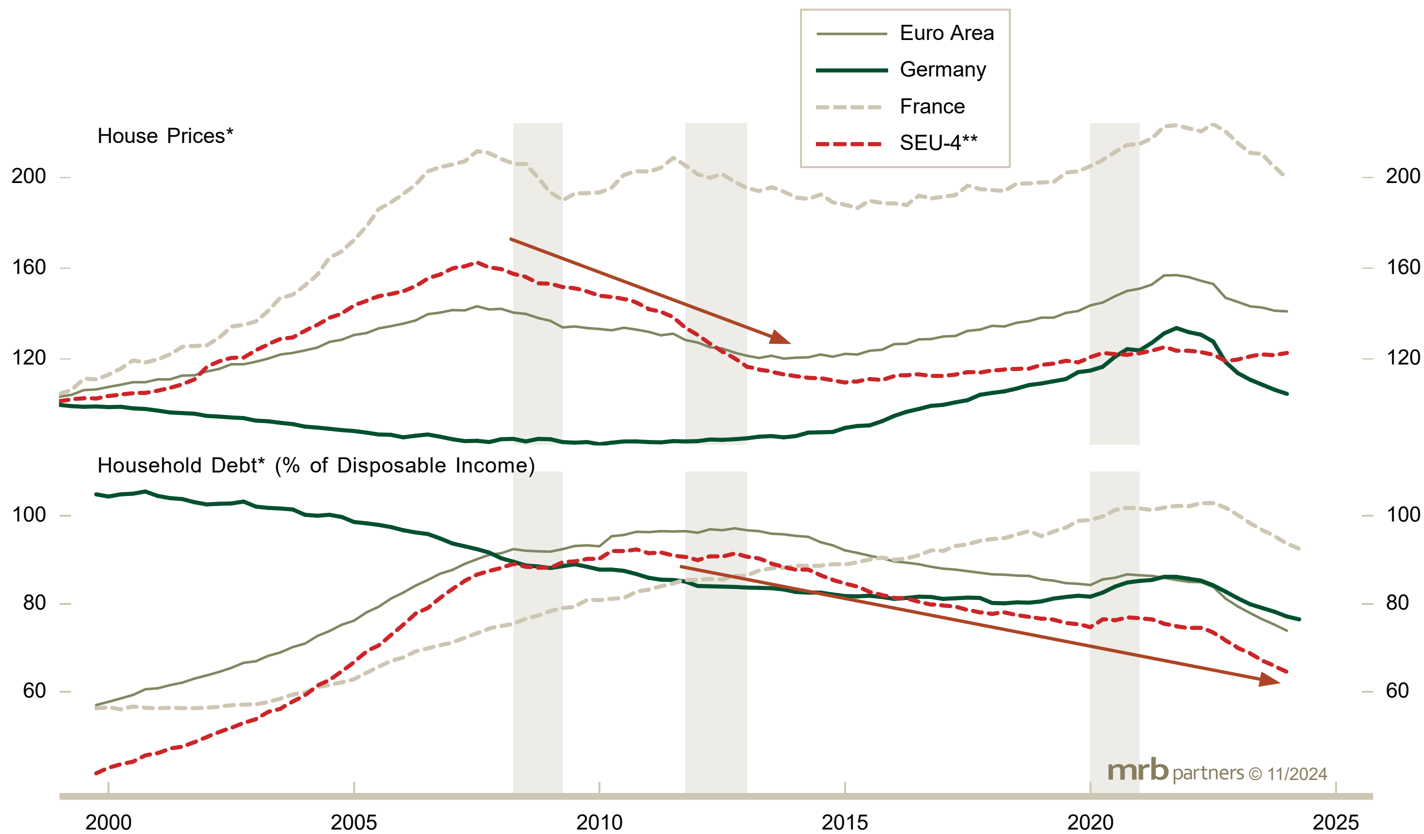
The SEU-4 have considerably fewer private sector imbalances than a decade ago, which provides a long runway before they again become a risk for regional stability

Past Deleveraging Has Put The Region On A Much Stronger Footing (chart 3, 4 and 5)

- At the beginning of the last decade, the household sectors in the periphery euro area (including the SEU-4 members) were saddled with huge debt burdens and began what would be a prolonged and painful deleveraging adjustment in the aftermath of their housing busts. Their housing fallout ended by the mid-2010s. Deleveraging continued but has tapered off this decade, and these economies are now enjoying a healthy cyclical expansion, supported by greater consumer spending.
- While household debt-to-disposable income continues to erode for most euro area countries (including the SEU-4), the driver of the downtrend has shifted, and

[2] **MRB:** ***Euro Area Crosscurrents (Part II): Structurally Flawed***, June 11 2018
MRB: ***European Monetary Union: Designed To Fail?***, May 26, 2015
MRB: ***Can The European Monetary Union Be Salvaged?***, February 27, 2013

Chart 3 The SEU-4 Economies Have Develered Over The Past Decade



* Source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

it is now mostly due to strong income gains rather than reduced leverage. This is constructive for both the structural and cyclical outlook.

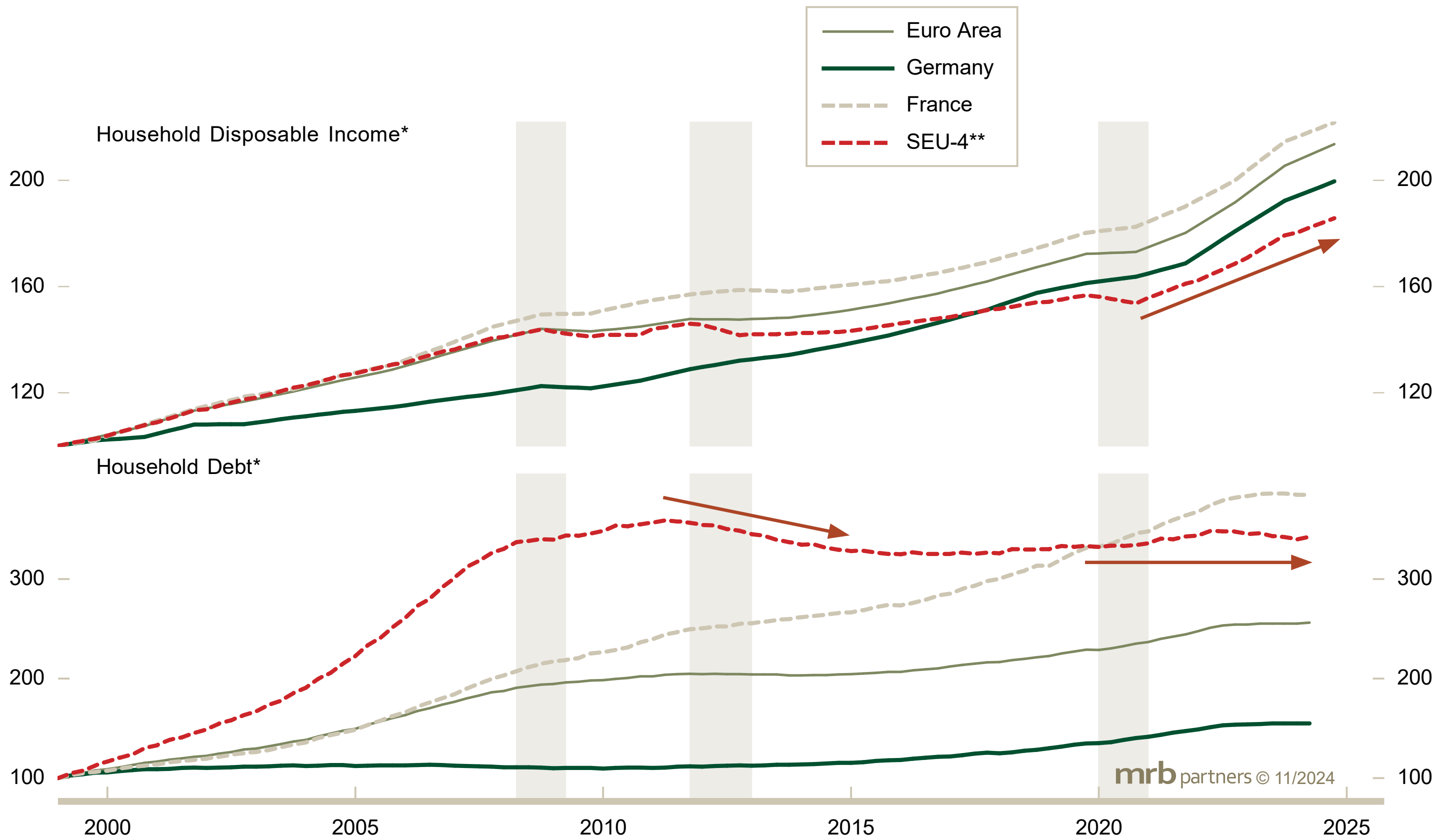
SEU-4 deleveraging is over...

...strong income gains rather than reduced leverage is improving household balance sheets,which is constructive for both the structural and cyclical outlook

- Germany never had the same level of household debt and house prices did not reach the same frothy extremes as in the SEU-4 economies. However, home prices have fallen in Germany over the past couple of years, undoubtedly adding to the reluctance of the household sector to spend. Private sector credit growth is also mildly contracting in Germany, compared with stagnant to lackluster in the rest of the region.

- France does not face the same competitiveness challenges as the German economy and its manufacturing sector, but it has among the highest household debt as a percent of disposable income. France also has elevated and eroding home prices that are weighing on consumer sentiment. Indeed, France is now one of the most interest rate sensitive countries in the euro area, although this means it could also respond more positively to ongoing ECB rate cuts.

Chart 4 **Strong Income Gains Is Now Driving Deleveraging For The SEU-4**



* Rebased; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

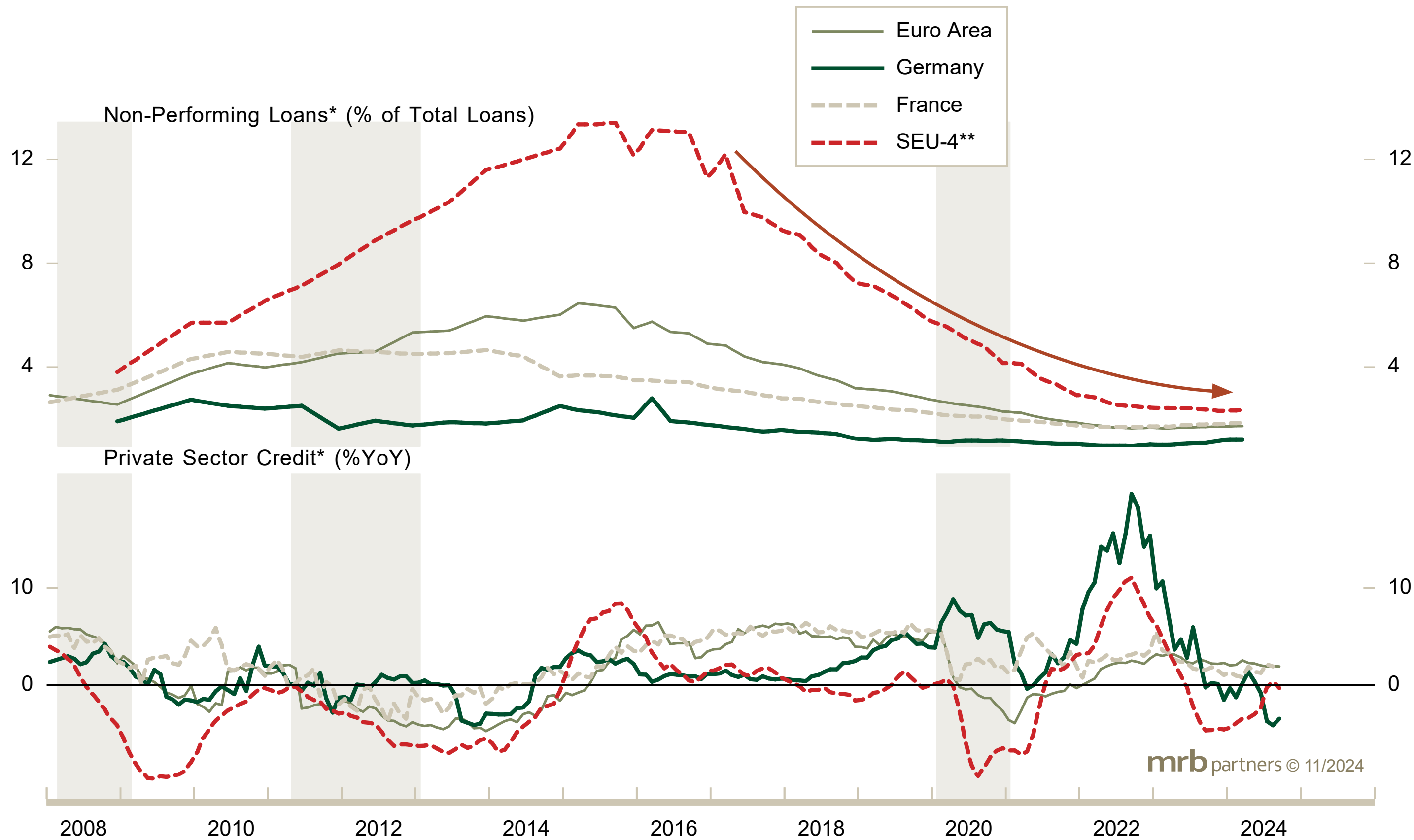
- In aggregate, the finances of the euro area household sector are much healthier compared to last decade, which provides a greater foundation to support spending and the overall economy. The financial sector also underwent a prolonged balance sheet adjustment and is now at a much healthier starting point. Non-performing bank loans (which were largely associated with the SEU-4) tapered off at very low levels earlier this decade.

The finances of the euro area household sector are much healthier compared to last decade

- In turn, reduced household debt burdens for the aggregate region means that the consumer sector is now less sensitive to rising interest rates. In turn, consumer spending could be supported by increased credit ***if*** necessary. For now, private sector credit remains subdued, while solid wage gains are supporting household consumption.

- Note that the increased resilience of the euro area household sector was probably best demonstrated in 2022 when demand held up despite confidence being crushed by heightened uncertainty related to the Russia-Ukraine war and the related surge in energy prices.

Chart 5 The Health Of The Euro Area Banking Sector Has Improved Materially



* Source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Excess Savings Offer Firepower For The Region (chart 6)

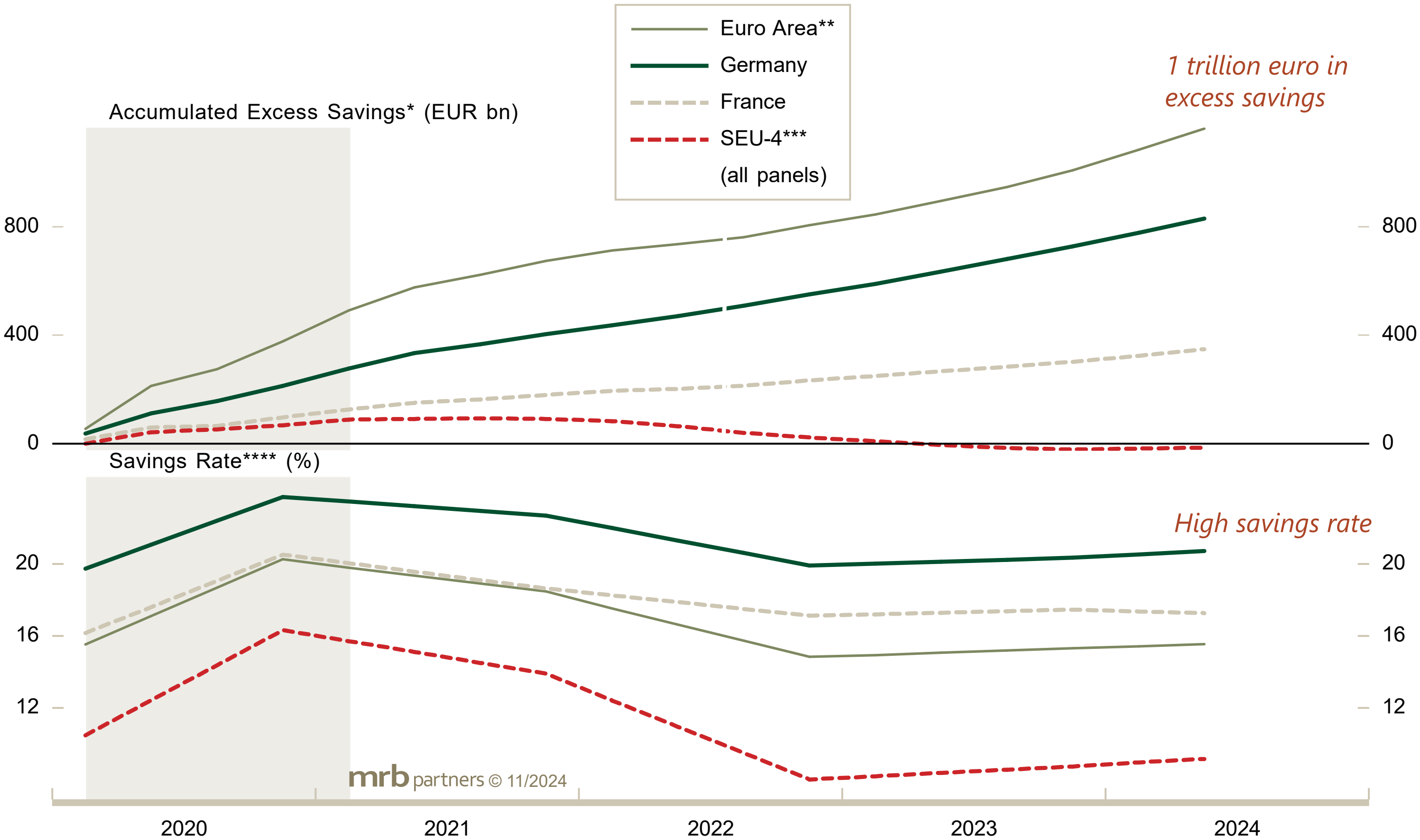
- In aggregate, euro area households have continued to accumulate excess savings since the pandemic (i.e. savings in excess of the pre-pandemic trend). These savings are estimated at over EUR 1 trillion, which provides a significant cushion for households and could provide a boost to consumption heading forward now that consumer confidence is steadily improving.

- Euro area households have saved around 15% of their income on average over the past four years, which is the highest the average savings rate has been since the formation of the monetary union. Higher than usual household savings is being supported by solid income gains and a reluctance (so far) to spend.

- The majority of these household excess savings are in Germany, amounting to over EUR 800 billion as of Q2 of this year. Germany also has the highest savings rate in the region, at roughly 20%.

German and French households have continued to accumulate excess savings since the pandemic

Chart 6 Ample Excess Savings From Germany And France Offers Firepower To Stimulate Growth



* Source: MRB Calculation
** Aggregate of France, Germany, Italy, Portugal and Spain
*** Aggregate of Italy, Portugal and Spain
**** Source: European Commission
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

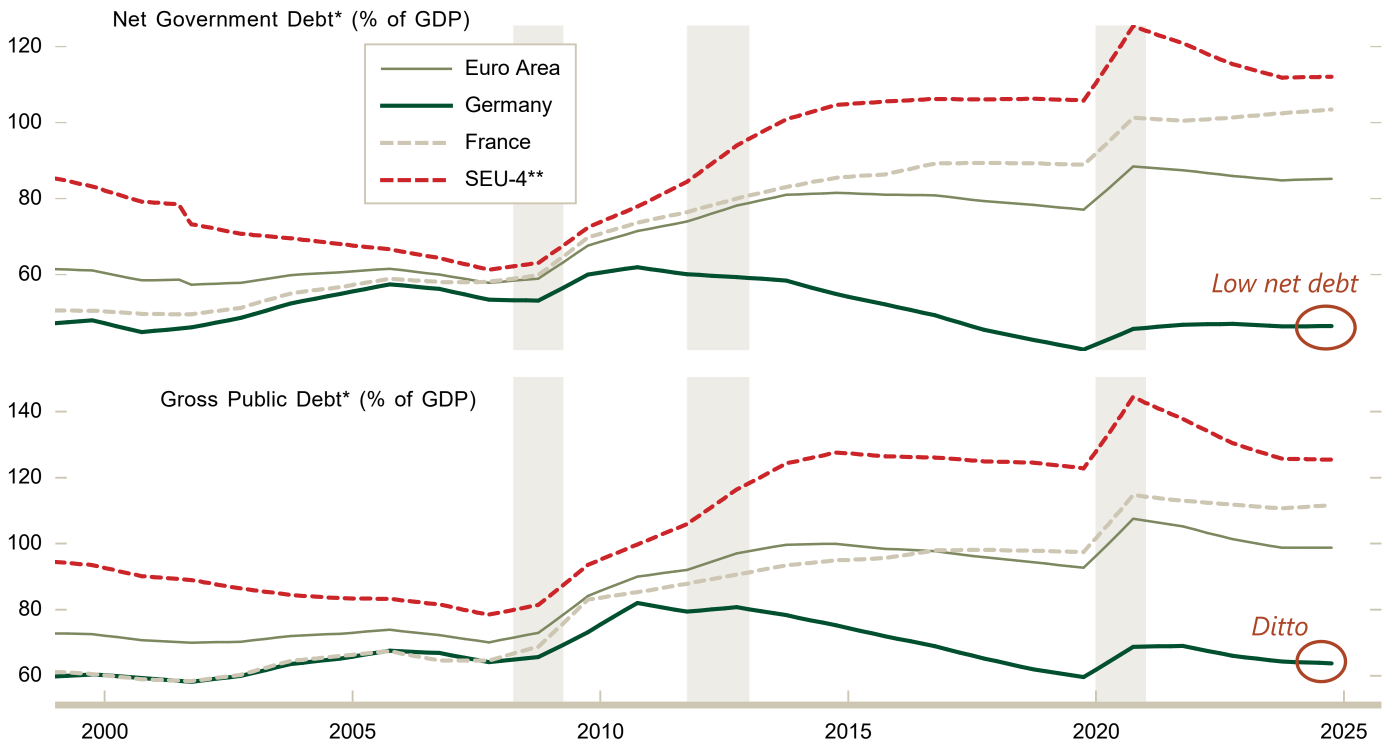
- French households have contributed to aggregate excess savings, amounting to roughly EUR 300 billion. France has had an average savings rate over the past four years of 17%.

- In contrast, the SEU-4 economies have been a mild drag on excess savings and have a much lower average savings rate of 9% over the past four years.

- On balance, the aggregate euro area has ample unspent excess savings to boost consumption if households choose to spend it. At a minimum, the pool of savings will eliminate the need for households to retrench further (even if employment conditions were to soften), which curtails contractionary forces within the region. This warns against investors analyzing the current ***cyclical*** weakness in the region through the lens of the past 10-15 years when ***structural*** deleveraging drags frequently dominated.

The aggregate pool of savings in the euro area could eliminate the need for households to retrench if employment conditions were to soften

Chart 7 **Germany Has The Fiscal Pockets To Stimulate Growth**



* Source: IMF
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

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Government Debt Burdens Have Not Improved, But Germany Has Ample Latitude (chart 7)

- The current ECB policy framework relies heavily on member nations to use fiscal policy to offset the shortcomings of unified monetary policy within the region. Member nations need to use fiscal stimulus (run deficits) when aggregate monetary policy is too restrictive for their economy, while demonstrating discipline and using fiscal restraint (run surpluses) when ECB policy is too accommodative. The latter frequently does ***not*** occur, and this leaves significant room for government debt imbalances to develop, which has been the case since the euro area was formed.

- Put another way, without individual currencies or central banks, member nations are left with only one of three major policy levers. In turn, government finances and thus fiscal latitude become paramount for member nations to reflate in periods when their local economy is struggling, and aggregate regional monetary conditions are too restrictive.

- Using fiscal policy as a reflation tool requires nations to rebuild public coffers and a rainy-day fund during good times. Germany is probably the best example

Germany has among the healthiest public coffers in the developed world, and material fiscal latitude to stimulate domestic growth conditions

of a fiscally responsible nation, albeit critically it often places its own structural stability over cyclical growth and regional stability. Nonetheless, Germany has among the healthiest public coffers in the developed world, and material fiscal latitude to stimulate domestic growth conditions should it choose to do so.

- The pandemic became a substantial headwind for tourism and overall economic growth, particularly in the SEU-4. This put further pressure on government debt imbalances in these economies during that period. However, both gross and net government debt have mildly eroded relative to GDP in the years since. Also, the SEU-4 economies are currently enjoying an economic expansion that is being supported by solid consumer spending and is not reliant on fiscal stimulus. Indeed, these governments can and should continue to reduce their leverage.

- France also stands out as having limited fiscal latitude compared to Germany, with gross and net government debt above 100% of GDP. However, reengaging the consumer sector is the key to unlock greater cyclical vibrance in France, rather than the need for fiscal stimulus.

The current ECB policy framework relies heavily on member nations using fiscal policy to offset the shortcomings of unified monetary policy within the region

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