Euro Area Outlook

Fragile recovery

Supply disruptions hit European manufacturing just as the energy crunch took another turn for the worse. France has announced an additional €30bn of public investment in industry while the SPD, the Greens, and the FDP have agreed to begin formal negotiations for the traffic light coalition.

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Services left to drive growth Q3 growth alone

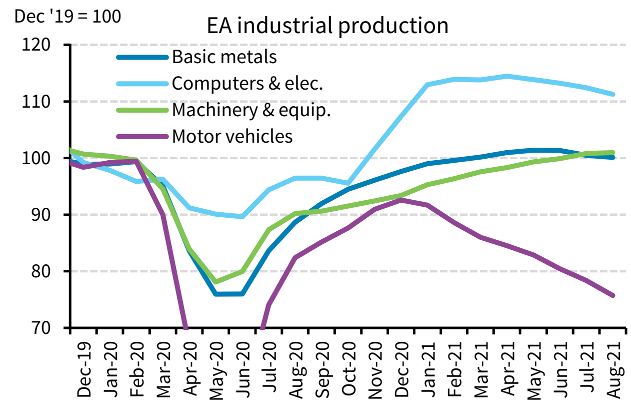
This week's release of industrial production (IP) data for August signals that supply disruptions are a larger and more persistent drag on output than we had previously expected. While the bulk of the damage is in the German auto sector, the to-date-strongly-outperforming computer and electronics industry is also exposed (Figure 1). Adding to this, the demand side also looks to be weakening, both due to delivery delays as well as a broader slowing in global demand. As a result, the carry over in IP for Q3 currently stands at 0.0%, suggesting services alone will drive growth in Q3, with meaningful improvement in industry unlikely before well into 2022. Even so, we think the August data also demonstrates the high monthly volatility caused by supply strains and thus both good and bad IP readings should be be interpreted with caution (see EA Industrial Production: Bad, better, worse). Next week's PMIs will provide insight about momentum at the beginning of Q4 (Barclays forecast: 55.1).

Meanwhile, the energy crunch threatens to add to production headwinds as natural gas prices rose again this week (Figure 2). Recognising the damaging effects this unprecedented surge in energy prices could have on household consumption and industrial production just as economies are recovering, the European Commission this week presented a toolbox of measures which the EU and its member states can use to address the crisis. These include tools from tax breaks to aid to households and business, but not any new EU-level solutions. More information about the EU's response may come from the EU leaders summit next Thursday and Friday as well as the EU's energy ministers extraordinary meeting on 26 October.

On a positive note, gas supply shortages in Europe may start to ease with Russia's President Putin expressing readiness (Bloomberg, 14 October 2021) to supply as much gas as Europe needs. However, the offer likely comes with an embedded conditionality of an approval of a controversial Nord Stream 2 (NS2) pipeline. The pipeline, operational since September, awaits certification from Germany and EC regulators which may take another 3-6 months (Reuters, 15 October 2021). A relatively small fine (EUR1mn) gives Russia an incentive to start supplying gas to the EU via a non-certified NS2, in our view, while enabling it to earning political points for helping to ease the energy crisis while also benefiting from record-high spot market prices.

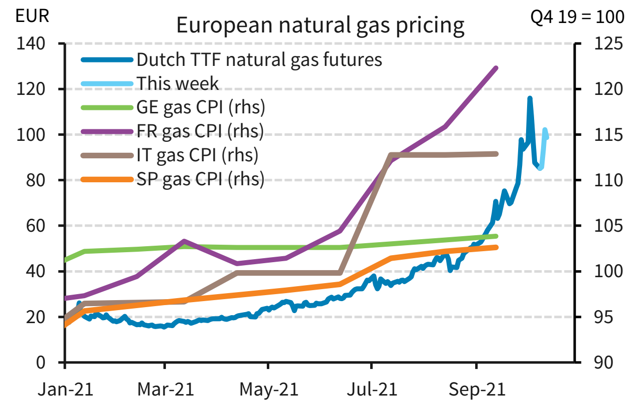
On inflation, the September Big-4 prints show surging wholesale gas prices being passed onto consumers in France (Figure 2). Headline prints were unrevised for Germany (4.1% y/y), France (2.7% y/y), and Spain (4.0% y/y), but revised down for Italy by 10bp (to 2.9% y/y).

FIGURE 1. Disruptions and slower growth are not limited to auto manufacturing...



Source: Eurostat, Haver Analytics, Barclays Research

FIGURE 2. ...with the continued energy crisis adding to the headwinds



Source: Bloomberg, Eurostat, Barclays Research

October ECB meeting a likely bridge to the December meeting

We expect no major news from the October ECB meeting (28 October) but will look for any discussion on the future of QE ahead of the December announcement and on the effect of supply disruptions and the energy crisis on the recovery and inflation. We will pay particularly close attention to any narrative on the effects of temporarily higher price growth on wages, especially in light of ECB Chief Economist Philip Lane's comments this week that wages may experience a one-off shift higher that does not imply faster trend wage growth. We still expect the ECB to end the PEPP in March, but expand the APP so that it can still buy a sizable amount of assets (c.EUR700bn in 2022 cumulatively from PEPP and APP, with the flow of purchases declining from c.EUR80bn a month in March 2021 to c.EUR40bn a month in December 2022, see All eyes on future ECB QE).

France announces new public investment in industry

In France, President Macron presented his 2030 plan, with €30bn (1.2% of GDP) of investment for the next five years to promote industrial competitiveness and technologies of the future. The focus is on decarbonisation (€8bn), semiconductors (€6bn), transportation (€4bn), and health (€3bn). Starting with a planned €3-4bn envelope next year, the plan will pursue, but with more limited amounts, investments highlighted in the €100bn France Relance recovery plan ending in 2022. Pending at the time of the 2022 budget announcement (see A transition budget), this package will add fiscal stimulus to enhance medium-term growth, in line with our positive outlook (see France: Springing towards elections). It also lays out President Macron's economic priorities, taking him a step closer to the electoral campaign.

In Germany, the SPD, the Greens, and the FDP successfully concluded their exploratory talks, agreeing to move to formal coalition negotiations. The latter could now take months, although the SPD leader and most likely future Chancellor Olaf Scholz, vowed this week to take office by Christmas. During this time, the parties will determine their plans for policy once the new government is in place, with today's announcement signalling significant emphasis on environmental issues, including exiting coal by 2030, a one-off increase in the minimum wage from €9.5 to €12.0/hour, no new taxes, and a return to the constitutional debt brake (Bloomberg, 15 October 2021).