How much longer can the Eurozone rely on Germany for growth?

At a glance...

Over-reliance on Germany is becoming an issue

In the aftermath of the financial crisis, the Eurozone relied on Germany to push up its economic growth rate. However, in the absence of a pick-up of growth in France, Italy and the periphery, this over-reliance on Germany is starting to become an issue. This is because:

- even with reasonably strong growth rates in Germany in recent years, the Eurozone hasn't managed to grow faster than 1% since 2011 and as a result its GDP remains smaller than immediately before the financial crisis (see Figure 1);
- Germany has itself slowed recently and faces longer term demographic and economic challenges that could drag down its potential growth rate starting from around 2020.

Political risk impacting short-term outlook

Focusing on Germany, we have downgraded our main scenario GDP growth projection from 1.5% to 1.2% for 2014 as there are tangible signs that external shocks (notably the Ukraine-Russia situation) have affected its short-term outlook. In October, for example, the ZEW Indicator of Economic Sentiment slumped into negative territory for the first time since November 2012. This is expected to have wider implications on the Q3 Eurozone GDP figure which will be announced on 14th November.

Germany faces long-term challenges

We think that, in the long-run, Germany has three main challenges it needs to overcome to maintain robust economic growth rates. These are:

1. Unfavourable demographics: Germany's working-age population is expected to shrink by around 8 million people between 2010 and 2030;
2. Low investment to GDP ratio with its public investment rates below those of the other core countries; and
3. Poor labour productivity in the services sector compared to France and the UK (which is, however, offset by Germany's international excellence in the manufacturing sector).

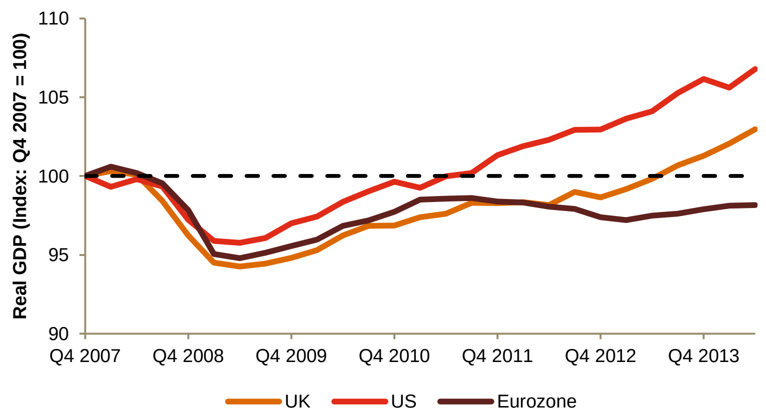
So where is growth in the Eurozone going to come from?

In the short-term, the outlook for the other core economies, which make up close to 40% of Eurozone GDP, is looking weak:

- Italy has fallen into its third recession since 2008, although we expect it to grow modestly in 2015 in our main scenario; and
- France has stagnated for the first two quarters of 2014 and, in the absence of substantial reforms to its product and labour markets, its outlook remains poor.

In fact, we calculate that, in a downside scenario where France and Italy fail to grow next year, Eurozone growth could average just 0.8% as compared to our current main scenario projection of just over 1%.

Fig 1: The Eurozone economy is smaller now than it was at the beginning of 2012 and still hasn't regained its pre-crisis level



Source: Datastream

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Economic update: One step at a time for Italy's reform agenda

Italy's labour market is struggling but reforms are on the way

One of the historic features of the Italian labour market was that it was 'two speed': permanent employees enjoyed significantly greater benefits, including a high level of protection from redundancy, compared to those on temporary contracts.

This helped create a relatively inflexible labour market. As a side-effect, Italian labour productivity stagnated. Figure 2 shows that this trend is in contrast to the experience of its competitors like France, Germany and Spain.

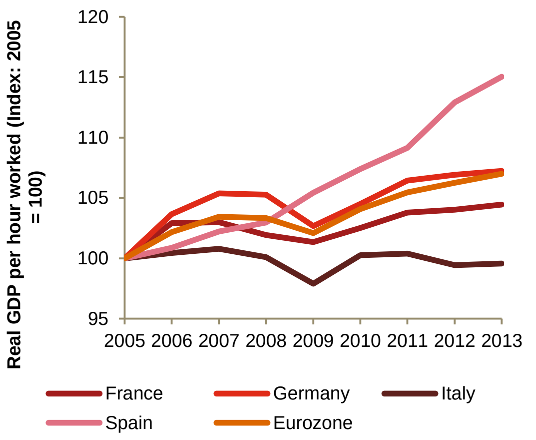
However, recently, policymakers in Italy have been discussing reforms aimed at reducing the disparities between permanent employees and those on open-ended temporary contracts.

What are the implications if these reforms go ahead?

These reforms are expected to encourage the mobility of labour from stagnating sectors to those that are growing and, as such, should have a positive impact on productivity in the long-run. At a more granular level these reforms should also help to reduce the reliance that Italian businesses have on temporary workers, so encouraging them to invest more resources in their human capital.

However, there is still a long way to go before these reforms are officially implemented, so for now it's very much a case of one step at a time.

Fig 2: Italian labour productivity has not kept up with its competitors in the European Union



Source: OECD

South Korea seeks to empower its female population

Northern Europe tops our Women in Work Index

PwC's Women in Work Index gives an overview of the level of economic empowerment of women in OECD countries. In our March 2014 update, Northern European countries like Norway and Denmark ranked at the top while Japan and South Korea were near the bottom. Policymakers in Japan and South Korea have recognised their weaknesses in this area and are at different stages of implementing reforms aimed at empowering women by making it easier to join, and remain, in the workforce.

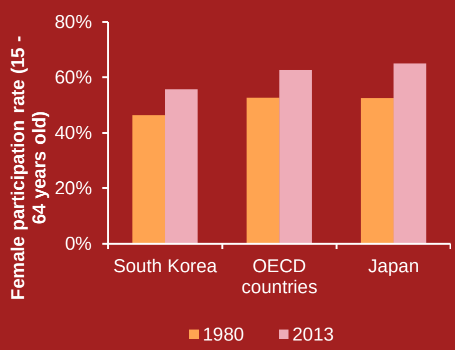
Japan is tapping into its most underutilised resource

In Japan, for example, increasing the number of women in work forms part of the structural reform arrow of 'Abenomics'. Figure 3 shows that Japan already has high female participation rates (relative to the OECD average), but it falls short in other areas like equality of earnings with men and the gap in the participation rates between men and women. However in our latest update of the Index, Japan moved up a place and it could continue to move up the rankings if the government's policy has its desired impact.

South Korea still has a long way to go to catch-up to OECD levels

For South Korea things are not looking so bright as it comes bottom among OECD countries in our Women in Work Index. This is because it had the worst ranking in two out of the five components which make up the Index: equality of earnings with men and the shortfall in female labour market participation rates compared to men. Focusing on the latter, Figure 3 shows that female participation rates in South Korea have been historically low compared to the OECD average and neighbouring Japan. Specifically, in 2013, the female participation rate stood at just 55.6%, which was more than 9 percentage points below that of Japan.

Fig 3:South Korea's female participation rate is lower than across OECD countries



Source: OECD

What if South Korea increased its female participation rate?

The South Korean economy is expected to grow at around 3.5% per annum in the short-run. Robust demand in the economy has meant that its unemployment rate has decreased from around 3.7% in 2010 to around 3.1% in 2013. This signals that labour demand is outstripping supply. If this trend continues, it could result in higher wage inflation, which in turn could erode South Korea's competitiveness.

Increasing the female participation rate could be one answer to the labour market pressures that South Korea is experiencing. Our analysis suggests that a five percentage points increase in the 2013 working-age female participation rate could also raise the amount of wages earned in the economy by about $26 billion (in 2013 constant prices and exchange rates).

South Korean government is taking action

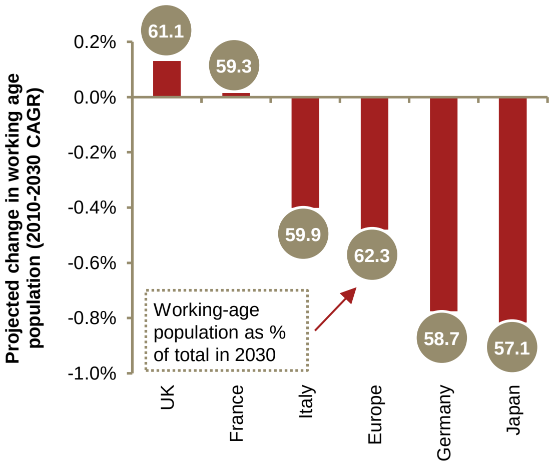
Like Japan, the government in South Korea is in the early stages of addressing the gender imbalance in its workforce. It has set up a three-year plan for economic innovation, which aims to raise the female employment rate to 62% by 2017 primarily through the adoption of measures aimed at making it easier to balance working with being a parent.

We think this could have a series of positive effects on businesses. Specifically:

- a more diverse workforce could come up with better business ideas and so deliver better results;
- raising female employment could boost household disposable incomes, thus pushing up demand in price-sensitive sectors like consumer products; and
- businesses that do more to help women integrate better into their workplaces are likely to attract the most highly skilled recruits.

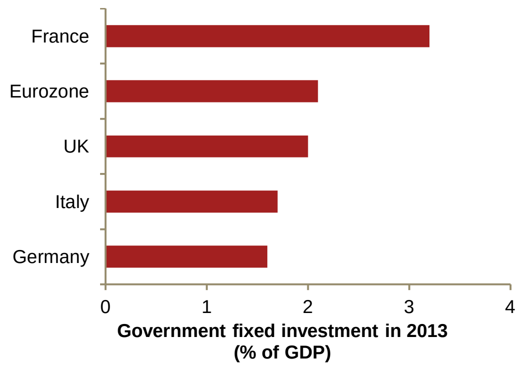
The Eurozone's reliance on Germany for growth looks shaky

Fig 4: Germany's working-age population is expected to shrink quicker than in wider Europe



Sources: UN World Population Prospects, PwC analysis
Note: Europe category is as defined by the UN

Fig 5: Government investment in Germany is the lowest in the core and is below that of the Eurozone



Source: Eurostat

Fig 6: The only service sector where German workers are the most productive is real estate

Source: Eurostat
*Note: *Compared to France and the UK, 2011 data*

Eurozone growth has stalled again

Eurozone growth is stuck in neutral. The bloc has not grown in net terms since the first quarter of 2012 and economic output remains below its pre-crisis level (which we've defined as the fourth quarter of 2007). As a comparison, the US has grown by around 7% over the same time period (see Figure 1).

Much attention has been centred on the poor performance of the peripheral economies – Ireland, Spain, Portugal, Greece and Cyprus – which have shrunk by around 1.8% per annum on average since 2009 in GDP-weighted terms. However, they make up less than 20% of Eurozone GDP. So, how have the three largest economies of the Eurozone – Germany, France and Italy – been performing?

- **Italy**, the 3rd largest Eurozone economy, has fallen back to recession for the third time since 2008 and is projected to remain a drag on Eurozone growth for the rest of the year. Recently there has been some more positive news on structural reforms, but these are unlikely to drastically change the short-term outlook (see Economic Update on page 2);
- **France,** the 2nd largest economy, is at a cross-roads and is trying to convince its EU partners of the merits of a relaxed fiscal stance compared to implementing structural reforms, which are usually painful but have long-term benefits; and
- **Germany**, the largest economy of the bloc, has had a much stronger growth profile until recently, but lately it has been facing some pressure from the Ukraine-Russia situation and the gradual slowdown in one of its key export markets, China. The August industrial production figures (down 4% month-on-month) have already taken the shine off its previously good economic performance (although some of this effect was due to one-off factors) and forward looking surveys (e.g. ZEW and Ifo) suggest the short-term economic outlook has turned sour. On the flip-side though, two out of Germany's three key export markets (the US and UK) are growing at relatively fast rates which could help offset some of the effects described above. Based on this analysis we have revised down our main scenario for German GDP growth from around 1.5% to around 1.2% per annum for 2014-15.

On the whole, despite its recent slowdown, the picture in the Eurozone has still been one of excessive reliance on Germany. In fact our analysis suggests that Eurozone output would have been smaller by around 2.7% compared to its pre-crisis level had Germany not grown at all since 2008.

So while Germany is still expected to achieve positive, if relatively modest, growth for the next two years and remain a key driver of Eurozone growth in the short-term, it does beg the question, how long is this going to last?

The long-term German picture is different

In our view, Germany faces three main challenges in the longer term. These are:

- **Poor demographics:** Figure 4 shows that Germany's working-age population is projected to shrink by almost 8 million people between 2010 and 2030. The knock on effect of this will be to drag down the potential average growth rate of its economy to only around 1%[1] in the 2020-2030 period, compared to actual average growth of 1.2% from 2000-2010 even including the deep recession of 2008-9. One way German policymakers can counter this is by tapping into the excess labour supply the peripheral economies have, though the resulting increase in immigration could run into some political opposition.
- **Low investment to GDP ratio:** The German private sector channels much of its savings abroad rather than into investment in the domestic economy. As a result, Germany has an investment to GDP ratio of only around 17%, lower than the average for the Eurozone (17.8%), and an abnormally large current account surplus. Public sector investment is also lower than in the other core countries (see Figure 5). The IMF has already called on economies with sound public finances, like Germany, to boost infrastructure spending, which would make sense at a time when long-term German bond yields are so low.
- **Low productivity in the services sector:** When compared with the UK and France, workers in Germany are the least productive in 4 out of the 7 main services sub-sectors (see Figure 6). Even though this effect is offset by Germany's international excellence in the manufacturing sector, we think this is an area where policymakers will need to focus their attention as countries like China move up the value-chain into high value added manufacturing and so Germany needs to switch more into tradable services in the long-run to sustain its growth.

In the short-term, Germany may be able to keep propping up the rest of the Eurozone, but with long-term challenges on the horizon, this is unlikely to be able to continue.

[1]This analysis is from our World in 2050 modelling which we will be updating in the first quarter of next year when these numbers might change.

Projections: November 2014

	Share of 2013 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2013	2014p	2015p	2016-2020p	2013	2014p	2015p	2016-2020p
Global (Market Exchange Rates)		100%	2.6	2.8	3.2	3.2	2.4	2.7	2.8	2.6
Global (PPP rates)	100%		3.3	3.4	3.8	3.9				
United States	16.4%	22.4%	2.2	2.3	3.2	2.4	1.5	1.8	2.1	1.9
China	15.8%	12.7%	7.7	7.4	7.3	7.0	2.6	2.3	3.0	3.4
Japan	4.6%	6.6%	1.5	1.3	1.2	1.2	0.4	2.5	1.7	1.5
United Kingdom	2.3%	3.4%	1.7	3.0	2.5	2.3	2.6	1.6	1.7	2.0
Eurozone	12.3%	17.1%	-0.5	0.7	1.1	1.5	1.4	0.5	1.0	1.5
France	2.5%	3.8%	0.1	0.4	0.9	1.7	1.0	0.7	1.0	1.5
Germany	3.4%	4.9%	0.2	1.2	1.2	1.3	1.6	0.9	1.5	1.7
Greece	0.3%	0.3%	-3.9	0.2	1.8	3.0	-0.9	-1.2	-0.3	1.3
Ireland	0.2%	0.3%	0.2	3.9	2.5	2.5	0.5	0.4	1.4	1.5
Italy	2.0%	2.8%	-1.8	-0.3	0.6	1.0	1.3	0.3	0.5	1.4
Netherlands	0.8%	1.1%	-0.7	0.8	1.5	2.0	2.6	0.9	1.2	1.4
Portugal	0.3%	0.3%	-1.0	0.9	1.4	1.8	0.4	0.0	0.6	1.5
Spain	1.5%	1.8%	-1.2	1.2	1.7	1.5	1.5	0.1	0.8	1.0
Poland	0.9%	0.7%	1.6	3.2	3.3	3.5	1.2	0.4	1.8	2.5
Russia	3.4%	2.8%	1.3	0.1	0.3	2.0	6.8	7.2	6.3	5.0
Turkey	1.4%	1.1%	4.1	2.8	3.4	4.5	7.5	8.8	7.0	4.8
Australia	1.0%	2.0%	2.4	3.2	2.8	3.1	2.2	2.6	2.6	2.7
India	6.6%	2.5%	4.7	5.2	6.5	6.5	6.3	5.6	5.9	6.0
Indonesia	2.3%	1.2%	5.8	5.2	5.8	6.3	6.4	6.2	5.9	5.1
South Korea	1.7%	1.7%	3.0	3.5	3.6	3.8	1.3	1.7	2.2	2.9
Argentina	0.9%	0.8%	2.9	-0.6	0.8	3.3	-	25.0	25.0	-
Brazil	3.0%	3.0%	2.3	0.5	1.0	4.0	6.2	6.3	5.5	4.8
Canada	1.5%	2.4%	2.0	2.2	2.5	2.2	1.0	2.0	1.8	2.1
Mexico	2.0%	1.7%	1.3	2.6	3.7	3.6	3.8	3.9	3.7	3.6
South Africa	0.7%	0.5%	1.9	1.4	2.3	3.8	5.8	6.2	5.6	4.8
Nigeria	1.0%	0.7%	5.5	6.2	6.2	5.7	8.5	8.4	8.6	7.3
Saudi Arabia	1.5%	1.0%	4.0	4.3	4.4	4.3	3.5	2.9	3.2	4.0

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index released by INDEC which is based in the fourth quarter of 2013 (therefore we do not provide a 2013 estimate). We will provide a 2016-2020 inflation projection once a longer time series of data is available. GDP projections for Argentina use the 2004 base year national account data (previously base year 1993). Our Nigeria GDP projections relate to the new rebased GDP figures but are subject to high margins of error. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise during the second half of 2015	16-17 December
European Central Bank	0.05% (September 2014)	Rates on hold following decrease in September	6 November
Bank of England	0.5% (March 2009)	Rate to start rising gradually during 2015	6 November

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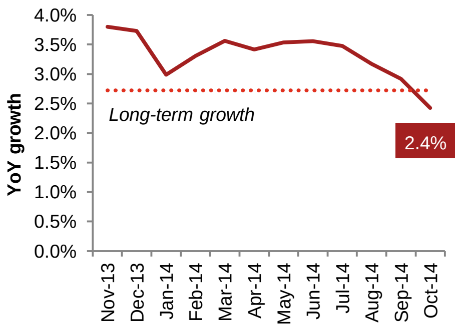
PwC's Global Consumer Index

Global consumer spending growth falls to 2.4% this month, the first time it has fallen below the long-term average since June last year.

Consumer confidence and money supply growth have fallen while industrial production figures have improved slightly. However, stock markets have experienced jitters due to weak global economic news that could affect future consumption.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

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