

Stuck in a low gear

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The term “the sick man of Europe” was first used to refer to the faltering Ottoman Empire in the mid-19th century, possibly by the Russian Tsar Nicholas. Since then, various countries and regions have held this unfortunate title while both the Russian and Ottoman empires have long disappeared.

In the 1960s and 1970s, the dubious honour fell to the UK, which having also lost its empire, was struggling to integrate into the larger European economy. It suffered from disruptive strikes and cost-of-living shocks and required an International Monetary Fund (IMF) bailout in 1976.

The IMF also had to get involved in the early 2010s, when Ireland and Greece were bailed out, the latter as part of the largest debt restructuring in the world up to that point. Italy, Portugal and Spain were also lumped into this unfortunate grouping, and all suffered a second deep contraction, coming soon after the 2008 global financial crisis. The Greek economy is still 20% smaller than in early 2008, while Italy has only barely returned to its pre-2008 level of real GDP.

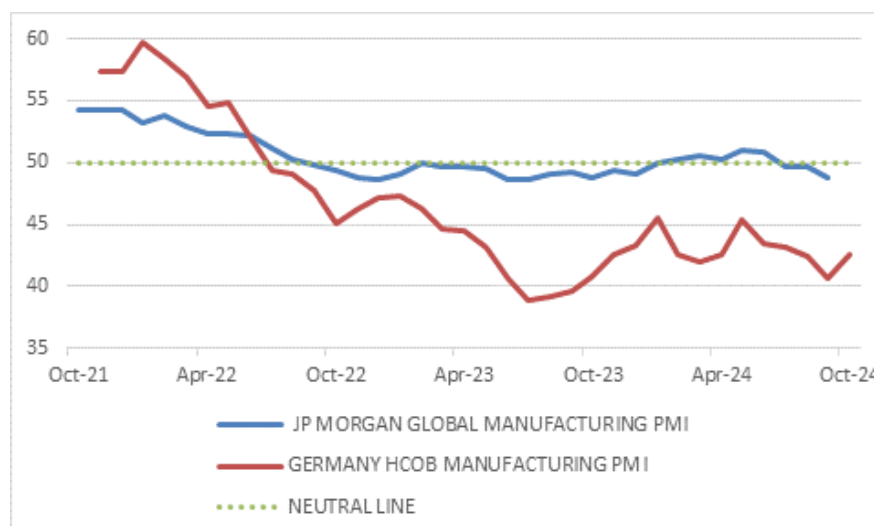
Recently, the Southern European economies are doing much better, partly because of the post-Covid tourism boom. In fact, the crowds have been so big that there is increasing talk of actively restricting tourism in places.

Today, it is Germany’s turn to be the sick man of Europe. This is ironic because when its economy outperformed the Southern Europeans in the early 2010s, German politicians rarely held back in lecturing them on fiscal and economic policy.

Schadenfreude

While leaders in Greece, Spain and Portugal are no doubt enjoying a spot of quiet schadenfreude, weakness in Germany drags down growth for the broader European economy. The IMF’s latest forecasts suggest that Germany will not grow this year, meaning no rebound from 2023’s 0.7% decline. This implies that the German economy will end this year barely any larger than on the eve of the pandemic.

Chart 1: Manufacturing Purchasing Managers’ Indices



Source: LSEG Datastream

In any country, economic success or failure is a complex matter but there are a few key issues. Germany's economy is skewed towards manufacturing – it is an industrial powerhouse – but globally manufacturing is under pressure. Germany was also too dependent on cheap Russian pipeline gas from which it is now largely cut off. Even though the energy crisis of 2022 has mostly passed, German manufacturing volumes have not recovered. Some production might be lost for good, as it is not globally competitive at current energy costs. BASF, the largest chemicals company in Europe, has for instance announced that it is moving 11 plants from Germany to the US and China.

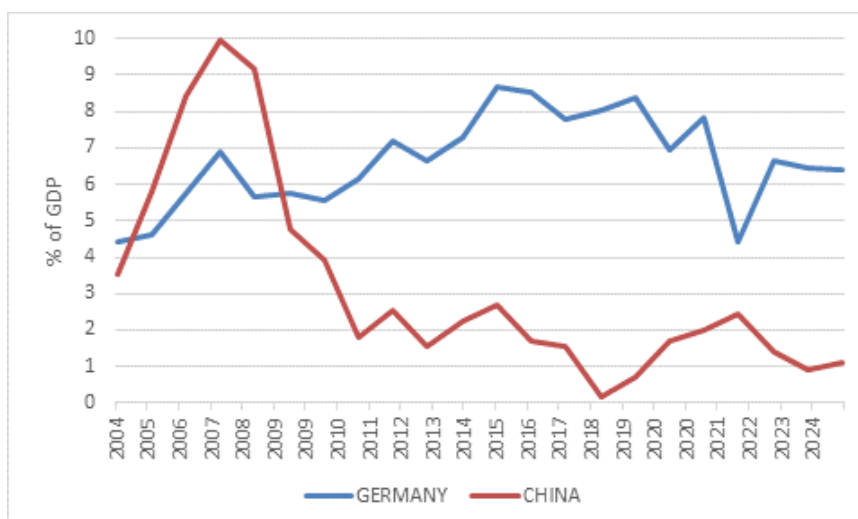
Germany has also scored a few own goals, including the decision to shut nuclear plants in the wake of the 2011 Fukushima disaster in Japan, as well as the reluctance to use the period of negative interest rates between 2015 and 2021 to borrow and upgrade its increasingly creaky infrastructure. To South African visitors, for instance, Germany's railway system seems out of this world, but regular users are frustrated with consistent delays and cancellations.

Overexposure to the automotive industry is also a problem. Germany is synonymous with cars, particularly high-performance internal-combustion vehicles, where it has long been a dominant player. But the global auto industry is in the midst of a sea change. Not only are electric and hybrid vehicles becoming mainstream, but China has turned out to be a formidable competitor. Not only are Chinese motorists buying fewer German cars in favour of homegrown brands, but Chinese car companies are competing head-on with German marques in other countries. It now exports more vehicles than any other country, having overtaken Japan in the past year.

We see this on South African roads too, with several new Chinese brands recently introduced at very attractive price points.

There is another irony here, namely that China and Germany share an export-focused economic model that depresses domestic demand. Both countries run large surpluses with the rest of the world, though China's is not as large relative to the size of its own economy as it used to be.

Chart 2: China and Germany current account surpluses



Source: LSEG Datastream

Nonetheless, both rely on demand from the rest of the world to make up for a lack of demand at home. In the case of Germany, that manifests in underinvestment, as noted.

China, on the other hand, overinvests and under-consumes. As an example, despite the impressive growth in vehicle production, domestic car sales seemed to have reached a plateau in 2017 already. This is one of the reasons Chinese cars are flooding global markets. There is excess production and not enough domestic buyers.

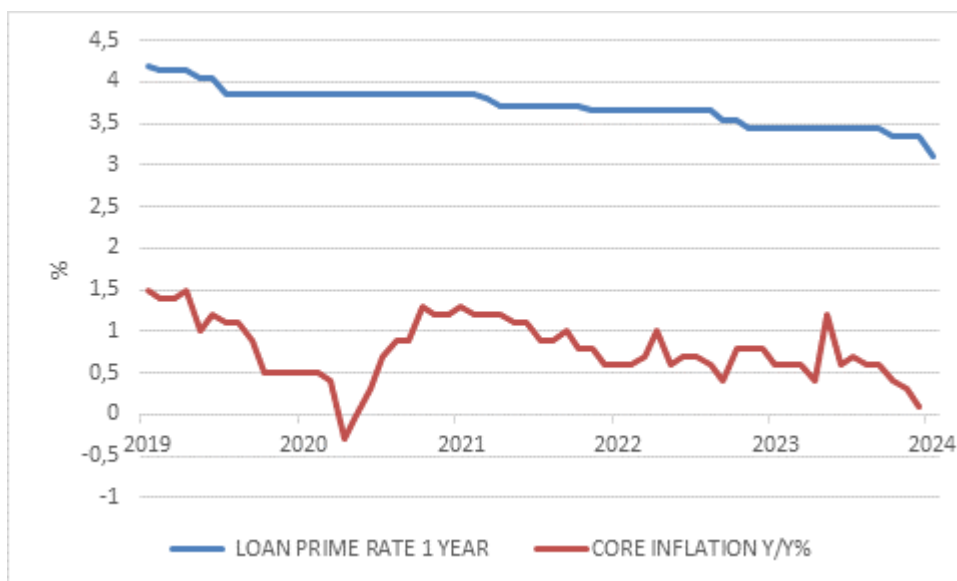
Household consumption has grown strongly over the years in yuan terms but remains extremely low as a share of national income (or GDP). In most countries the number is 60% plus; in China it is around 40%. Conversely, the investment share of national income has been sustained around 40% for several years, a feat no other country in modern history has achieved. This has given China its world-class infrastructure and top-of-the-range factories, but also an oversupply of apartments and excess industrial capacity. High investment levels made sense when the economy was underdeveloped 20 years ago; today all this investment can no longer earn a decent return.

Action

Unlike German authorities (arguably), Beijing has finally sprung into action to address cyclical economic weakness and deflation fears.

In recent weeks, the People’s Bank of China (PBOC) has cut interest rates and launched initiatives to boost bank lending. Perhaps the most eye-catching was setting up a facility to lend to asset managers, banks and insurance companies to purchase shares, and to listed companies to buy back their own undervalued shares. This resulted in a massive market jump, probably much more than authorities expected, since their goal is to attract long-term capital to the market, not to boost speculative interest. Other important measures aim to support developers to complete sold but unfinished units and easing of some of the restrictions put in place to deflate the property bubble.

Chart 3: China inflation and interest rates



Source: LSEG Datastream

Lower interest rates and more bank lending can help on the margin, but the biggest problem is not the cost or availability of credit, but the willingness to deploy it. In the West after the 2008 crisis, low interest rates were mostly used to pay down debt, not to increase borrowing. Moreover, the banking system is probably so clogged up with bad loans that its ability to be the conduit for looser monetary policy is questionable. Lower interest rates can in fact hurt bank profitability and therefore further gum up credit channels, probably explaining why the PBOC's rate cuts have been rather modest.

Fiscal policy has a better chance of kickstarting the economy, since the money can be directly injected into projects and initiatives that can deliver growth, while the central government can also help along the deleveraging process by absorbing debt held elsewhere in the economy, notably by local governments. The Minister of Finance has promised more fiscal spending, but investors await details.

Fiscal and monetary policy can help stabilise the cyclical downturn. Addressing the structural problems will require reforms that still appear to be lacking. As a result, longer-term trajectory for Chinese growth rates still points lower.

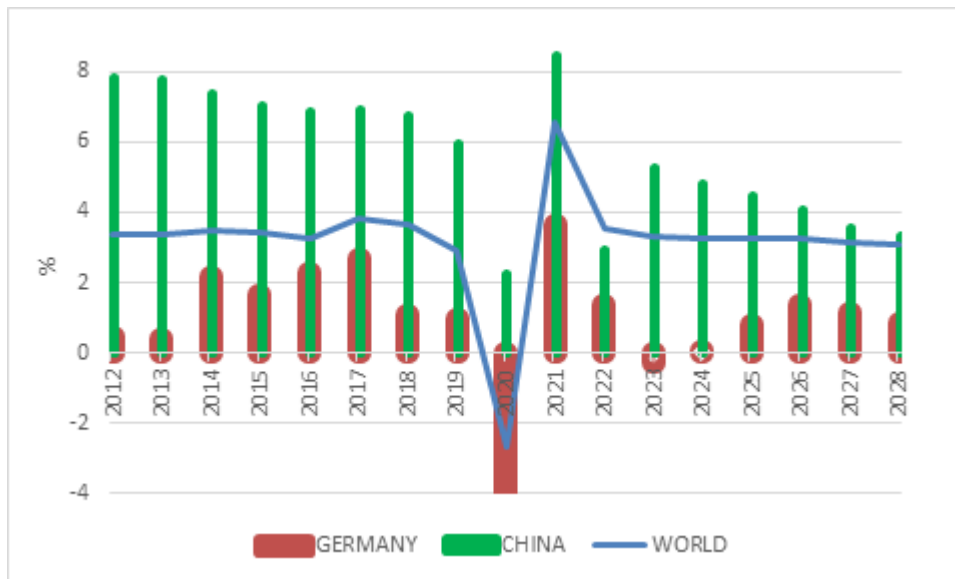
As many commentators have pointed out, Chinese households spend much less than their counterparts elsewhere because they receive a smaller slice of the economic pie, and because they save a large portion of what they end up getting. Saving for a rainy day is always a good idea for an individual household, but if all households save a lot, it can hold back the economy. The high savings levels are often ascribed to the lack of a solid society-wide safety net, unexpectedly for a communist country. Better social protection, including removing *hukou* system restrictions that limit migrant workers' access to social services should help. Giving households a larger share of national income could be achieved through a combination of more transfers from the government, higher wages and a more progressive tax system. Getting there faces institutional and ideological and perhaps cultural obstacles, however, seem unlikely any time soon.

Instead, the focus of policymakers – with guidance right from the top, no doubt – has been on high-tech manufacturing (such as electric vehicles and semiconductors), not economic rebalancing. This has delivered successes but has also contributed to oversupply as noted above.

The bottom-line is that, like Germany, China's very successful growth model seems to have run its course. Germany still seems stuck in navel-gazing mode, while China's leadership seems to have at least correctly diagnosed its problems. So far, however, it's largely only treating the symptoms.

Nothing is inevitable though. It is not Germany's first time wearing the "sick man" mantle. After reunification in the 1990s, it similarly stagnated until far-reaching reforms were introduced. China made even greater changes to economic policy in the 1980s and 1990s and reaped the immense benefits. It can be done, in other words, but deep reforms usually require a sense of crisis. As we've experienced in South Africa, things have to get really bad before politically difficult choices are made.

Chart 4: Real economic growth, forecasts after 2024



Source: International Monetary Fund

Where does this leave the global economy and markets, given that China is the second largest economy in the world, and Germany number four?

The IMF projects real global growth slightly above 3% per year over the medium term. If realised, it will be a solid but unspectacular pace, somewhat below the historic average. The expected decline in Chinese growth from 4.8% this year to 3.3% by 2028 is part of the reason. German growth is projected to rebound somewhat next year.

From the point of view of global financial markets, the main driver will remain the state of the United States. The US dominates global debt and equity markets, and the dollar is by far the most widely used currency in forex markets and in the real economy. In the MSCI All Country World Equity Index, US shares account for 63%, while the weights of China and Germany are 3% and 2% respectively. German and Chinese shares already trade at average to below-average valuations, suggesting that economic weakness is priced in.

At the moment, the US economy is ticking over nicely, but the looming election is a source of uncertainty. Markets seem to increasingly price in a Donald Trump victory, which at least means it won't be a shock if he wins. But it will worry policymakers in Germany and China since it could ramp up the threat to export-led growth models. The US economy is likely to slow from current perky levels over the next year or so. However, the main thing for investors is if it can do so in an orderly way that avoids a recession, allows for lower inflation and ongoing interest rate cuts. Trump's policies might throw an inflationary spanner in the works in terms of the latter two.

From a South African point of view, China is our largest single-country export partner. The JSE is also correlated with Chinese markets. As China's growth profile shifts, it is likely to become more service-oriented and less commodity-intensive over time. This creates potential headwinds for South African commodity exporters, but opportunities in other sectors, for instance in attracting more Chinese tourists to our shores.

This last point is of course true in a much broader sense. As the global economic and political environment evolves, there will be uncertainty for investors, but also new

opportunities. The challenge as always is to stick to an investment strategy and be able to look through the noise.