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MACRO UPDATE: US-EU TRADE CONFLICT, EUROZONE ECONOMY

Berenberg Macro Flash

WTO to authorise US tariffs on EU imports

Call it a little irony. Today, the World Trade Organization (WTO) warned that trade conflicts pose the biggest risk to an already very muted outlook for global trade. Nonetheless, the WTO looks set to add some fuel to the fire shortly. In the next few days, the WTO will likely announce the maximum amount of countervailing duties which the US will be allowed to impose on imports from the EU in response to EU subsidies for Airbus. According to some media reports, the WTO could authorise duties of up to $7.5 bn, which would set a new record for the WTO.

In separate cases that have been running for some 15 years, the WTO found in the past that both the US and the EU have subsidised their major airplane makers too much. As both sides have failed to fully redress the situation, WTO rules allow the US and EU to impose countervailing duties against each other once the WTO has determined how extensive these tariffs could be. The US has a head start in this particular stage of the dispute. The EU will reportedly have to wait some 3-6 months before the WTO sets a limit for the penalties the EU can levy on the US over the Boeing issue in return. The duties need not be all related to the aircraft sector. The US has already published a list of imports from the EU worth $25bn from which it will choose. The list includes some foodstuffs and luxury goods.

Logic suggests that the US and EU should reach a negotiated settlement. Both are at fault according to the WTO, both would lose from imposing tariffs on each other. Some US airlines have already warned that import tariffs on Airbus planes they have already ordered may potentially lead to lay-offs. However, the Trump administration seems inclined to go ahead with tariffs to score a point and to put additional pressure on the EU ahead of the start of serious US-EU trade talks once the new EU Commission has taken office in November.

Being a global trade power on par with the US, the EU seems unlikely to budge. US-EU trade talks are fraught with problems anyway as the US wants to use the threat of car tariffs to prise open EU agricultural markets. For the EU, this is a political no go. Fortunately, we find little political support in the US for a trade war against the EU. Unlike China, the EU is not seen as a geopolitical rival steeling commercial secrets. EU car makers are widely seen as creating rather than destroying jobs in the US. Our base case thus remains that the US-EU trade conflict will not lead to serious new US car import tariffs. As long as the transatlantic tit-for tat remains well below this threshold, it should not hurt business confidence and investment much. In the Boeing-Airbus case, the US is at least playing by the accepted global rules instead of undermining the system. While the Airbus/Boeing cases will make headlines, they pose no major risk to the economic outlook on their own.

Eurozone economy: manufacturing down, inflation subdued, labour market still resilient

The downturn in Eurozone **manufacturing** looks set to deepen further until the end of the year. Roughly in line with the flash estimates published last week, Markit reported today that its purchasing managers' index for Eurozone manufacturing fell further to 45.7 in September from 47.0 in August, hitting the lowest level since October 2012. The sharpest contraction in orders in almost seven years points to a further drop in manufacturing output in coming months beyond the 1.8% yoy decline in industrial output (ex construction) recorded in July.

Much of the weakness in the Eurozone is focussed on Germany. With its outsized share of manufacturing in GDP (23% versus 15.8% elsewhere in the Eurozone) and its focus on highly cyclical goods such as cars, machine tools and base chemicals, Germany is much more exposed to the downturn in global trade and investment than other advanced countries. Generic problems of the German car sector add to that. Whereas the German manufacturing PMI hit a 10-year low of 41.7 in September after 43.5 in August, the average for the remainder of the Eurozone receded only to 47.4 in September after 48.5 in the month before.

The PMI data suit our call that German real GDP is contracting slightly by 0.1% qoq in Q3 and Q4 while the Eurozone economy continues to hover just above stagnation with qoq gains in GDP of 0.1%. It will take some resolution of trade tensions to turn global manufacturing and trade around and thus to end the recession in Germany and the near-stagnation in the Eurozone. A hard Brexit could briefly deepen the woes.

Unsurprisingly, **inflation** remains subdued in the Eurozone. An uptick in some volatile service prices raised core inflation (ex energy and food) to 1.0% yoy in September from 0.9% in August. The core rate has oscillated around this level since 2013. While an updrift in wage inflation to 2.6% yoy in 1H 2019 from 2.1% last year and an average of 1.7% in 2015-2017 should feed through into slightly faster service price inflation, the current economic downturn will keep a firm lid on price pressures. For the time being, headline inflation (0.9% yoy in September after 1.0% in August) will be driven mostly by oil price gyrations. Base effects from the oil price spike last autumn could reduce headline inflation further in the next two months before the fall in oil prices that started at the very end of 2018 will show up in headline inflation of just above 1% yoy early next year.

Although the manufacturing downturn has started to spread to some services and is showing up in a lower number of job vacancies in Germany (down to 763k in September from a peak of 808k a year ago), the Eurozone **labour market** has so far remained surprisingly resilient. Eurozone unemployment fell to 7.4% in August, the lowest rate since May 2008. Unemployment is now back to where it was before the Lehman and euro crises. It has come within striking distance of the record low of 7.3% which the currency area had hit in late 2007.

Of course, the labour market is a backward-looking indicator. The PMI data point to some job losses in manufacturing to come. However, as labour-intensive services have remained on a growth track so far, although at a significantly reduced pace, we do not expect the near-stagnation in the Eurozone economy to show up in a notable rise in unemployment. Even in Germany, where many sectors such as public services, healthcare and construction still face a severe shortage of skilled labour, the likely rise in unemployment in coming months will likely remain muted. This limits the downside risks to consumer confidence and domestic demand for Germany and the Eurozone as a whole.

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