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CHINA HELPS GERMANY - AND THE EU - THROUGH THE WINTER OF THE SECOND WAVE

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Earlier this year we looked at the myriad implications for the EU, and particularly for Germany, of the recently agreed investment deal with China. Much to the chagrin of the U.S., [the Comprehensive Agreement on Investment \(CAI\)](#) strengthens the ties between the world's second and third largest economies. And although it is not expected to come into effect until 2022, the importance of this relationship is already on full display as Europe continues to struggle under a second wave of the coronavirus and slow vaccine rollout. Until herd immunity is achieved through a mass vaccination programme, social distancing restrictions - and the associated economic impacts - will likely remain a significant drag on the EU with a disproportionate burden on the services sector. Yet, preliminary Q4 GDP numbers surprised to the upside in the Euro Area, likely driven by strength in the manufacturing sector. China's continued recovery is providing a much-needed source of external demand, a vital offset to self-imposed Euro Area domestic weakness via strict lockdown measures. This boost, alongside committed European monetary and fiscal policy support, will help export oriented economies, such as Germany's, and indeed the wider EU weather the economic effects over the challenging winter period and beyond.

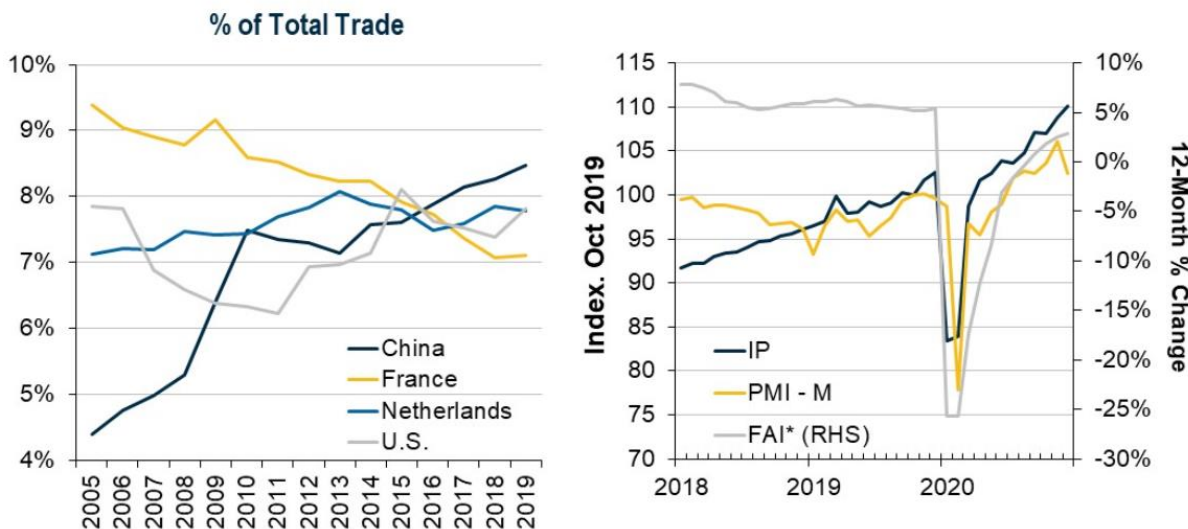
The Importance of China's Recovery to Germany and the EU

As the world's third largest economy, the EU is markedly more open than the U.S., with exports accounting for nearly 30% of Euro area GDP compared to just 10% for the U.S. ¹ Within the EU, the German economy is the largest and one of the most open, with exports accounting for nearly 50% of GDP and with important trade linkages to the rest of the region. **Thus, it was a trade milestone when China became Germany's largest trading partner by volume in 2016 (Figure 1), and the relationship has only strengthened since then.** A breakdown of 2019 trade data reveals that Germany specialties in exporting capital intensive goods to China, particularly machinery and transportation goods, which have existing supply chains across the EU. Therefore, China's economic recovery from the pandemic carries important implications throughout Europe.

China's Recovery Gains Momentum...

As China contained further significant COVID-19 outbreaks since the early part of 2020, several economic activity indicators, such as Industrial Production, manufacturing PMIs, and Fixed-Asset Investment, recovered their Q4 2019 levels by the end of the year (Figure 2). The initial rebound in industrial production - notwithstanding the recent dip likely reflecting a temporary impact of the Chinese New Year - has continued, and the sustained recovery points to gathering economic momentum.

FIGURE 1 AND 2: GERMANY'S MAJOR TRADING PARTNERS AND CHINA'S MANUFACTURING RECOVERY



Source: Destatis and Haver Analytics, respectively. *Year-to-date fixed-asset investment.

China's recovery bodes well for its key trading partners, especially Germany. Due to the slowing in the global economy in the years just prior to the global pandemic - in part reflecting heightened trade tensions between the U.S. and China - growth in exports of German goods slowed in 2018-2019, and they slumped sharply during the initial stages of the pandemic. **However, since then, exports have recovered with German exports to China now exceeding levels recorded 12 months ago.**

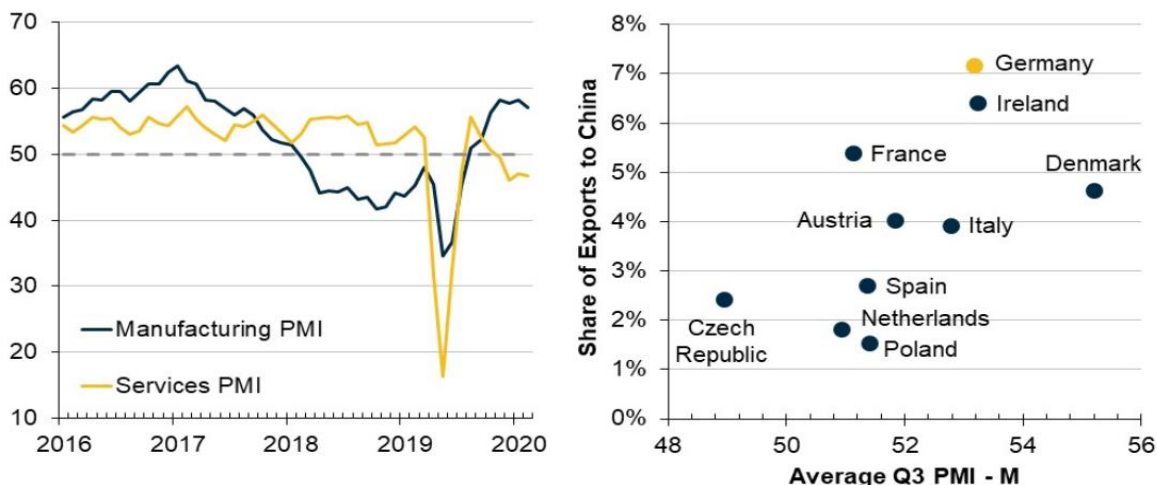
---Boosting German and EU Manufacturing

German manufacturing PMIs fell markedly in early 2020 before rebounding to exceed their Q4 2019 level by the end of the year, and they subsequently reached an expansionary pace not seen since early 2018 (Figure 3). This softer activity indicator suggests further recovery in German industrial production, which maps directly into GDP and supports economic activity while its services sector remains subdued. This is reflected in the latest estimates for German GDP in 2020 at -5.3% - a less pronounced contraction than in the global financial crisis - and our 2021 forecast, which calls for growth to recover to around 4.0%.

Moreover, statistical analysis shows that a 1 percentage point increase in Chinese manufacturing PMI is associated with an increase of nearly 3 percentage points in German exports to China five months later. For example, that would suggest that the 1.3 percentage point increase in Chinese manufacturing PMI between October and November will boost German export growth to China by 3.7 percentage points by April. So, past momentum in Chinese manufacturing should continue to benefit the German economy, partially offsetting the weakness in services that will likely continue in the coming months given the social distancing measures in place.

The positive spillovers from China's recovery are visible elsewhere in Europe too. Figure 4 compares a country's Q3 rebound in manufacturing PMIs to its share of exports to China. Clearly, some of the manufacturing rebound likely also reflects the recovery seen elsewhere, such as in the U.S. and its elevated demand for goods, since the depths of the crisis in Q2 2020. Nevertheless, the relationship shows that those countries that reported a higher share of exports to China also experienced a greater expansion in their Q3 manufacturing PMIs. With an estimate for a GDP contraction of -6.8% in 2020, we anticipate Euro Area growth will reach 5.0% in 2021, up from a prior estimate of 4.0%.

FIGURE 3 AND 4: GERMANY’S MANUFACTURING, SERVICES PMIS AND A COMPARISON OF EUROPEAN COUNTRIES’ MANUFACTURING PMIS TO SHARE OF EXPORTS TO CHINA



Source: IHS Markit/Haver Analytics and Haver Analytics, respectively. As of January 2021 and Q3 2020, respectively.

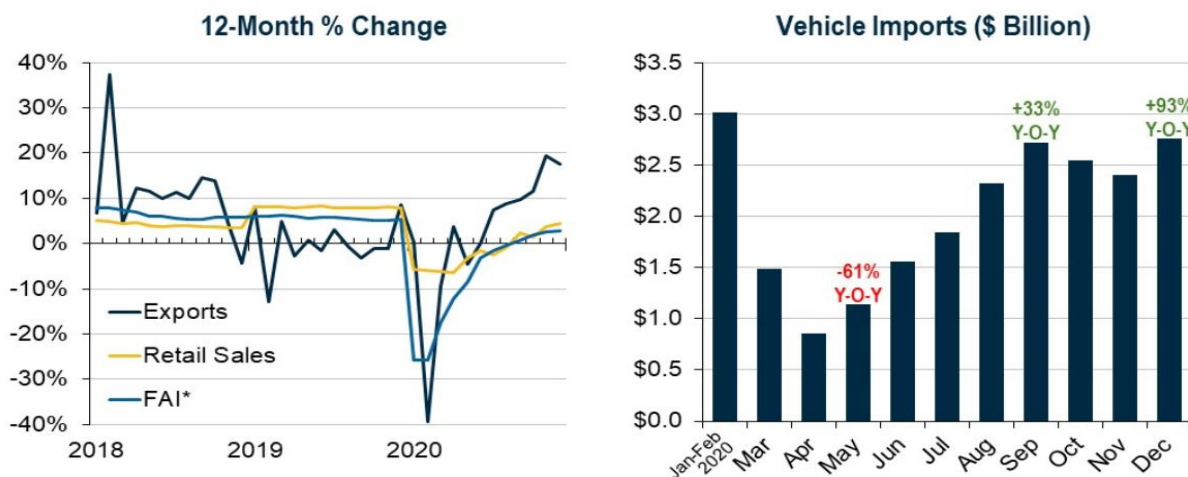
China’s Recovery Pivots Towards the Consumer...

The latest Chinese PMI data for December suggest that the pace of production expansion may have peaked. However, China’s recovery now appears to be showing signs of broadening out to the Chinese consumer. This is a very different pattern to what was observed in the U.S. and Euro Area. ² Figure 5 shows that retail sales in China - used as a proxy for consumption - lagged exports following the worst of the pandemic, perhaps reflecting consumer caution in light of the limited social safety net. The slow recovery in retail sales to the Q4 2019 level is also reflected in measures of Chinese consumer confidence.

...And German and EU Auto Supply Chains Benefit from the Rebound in Chinese Auto Sales

Although auto sales in China were already slowing into the pandemic, their rebound—likely supported by government purchase incentives as part of its pandemic response - provided the clearest sign of a consumer recovery. **Given that one third of German cars are sold in China ³, a recovery in this corner of the Chinese economy brings significant benefits for Germany and other EU countries with important auto supply chains.** Indeed, the rebound in China’s auto sales has coincided with a 93% year-over-year increase in Germany’s auto exports (Figure 6).

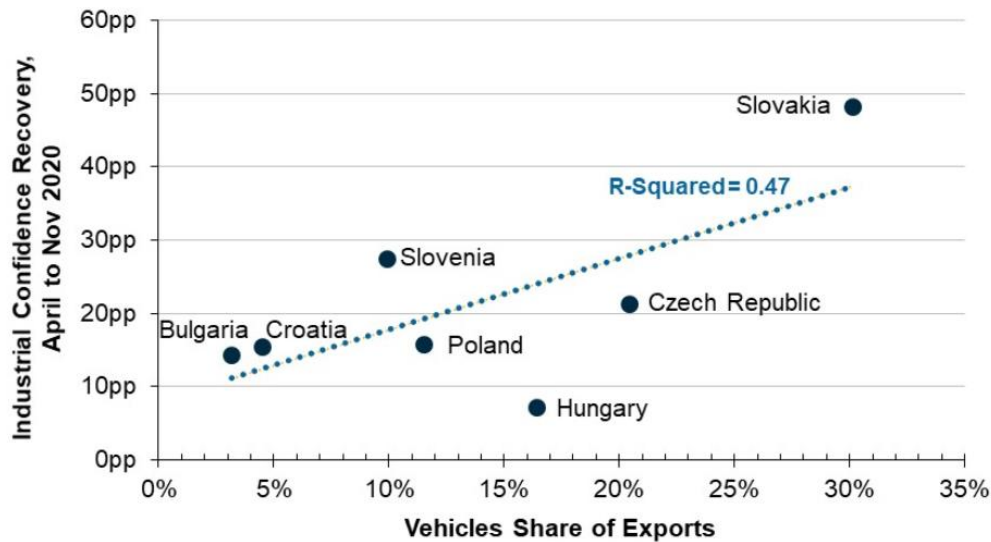
FIGURE 5 AND 6: CHINA’S RETAIL SALES LAGGED IN THEIR RETURN TO Q4 2019 LEVELS AND CHINA’S VEHICLE IMPORTS FROM GERMANY



Source: Haver Analytics and Chinese Customs, respectively. *Year-to-date fixed-asset investment. As of December 2020.

Several Central and Eastern European Economies with important auto-related supply chains in vehicles and related parts have similarly experienced a boost in terms of improved industrial confidence (Figure 7).

FIGURE 7: COMPARISON OF SHARE OF VEHICLE AND RELATED PARTS EXPORTS AND INDUSTRIAL CONFIDENCE IN CERTAIN EUROPEAN ECONOMIES



Source: Haver Analytics. As of November 2020.

China Will Remain Strategically Important for the EU

Even prior to the pandemic, Europe's fortunes were closely tied to economic activity in China. As Europe continues to struggle to contain a second wave of the virus and the logistics of rolling out vaccines, it's particularly beneficial that a key trading partner is showing signs of a durable recovery. The demand from China will help Europe - and particularly Germany with its strong manufacturing and transport trade links to its biggest trading partner - to at least partially offset the impact of strict lockdowns on the services sector. Looking ahead, while the CAI is only expected to be ratified and implemented in 2022, it suggests that China will remain strategically important for the region in the post-COVID recovery phase in the years to come.

¹ See the May 2020 Eurostat release for the latest data on the International Comparison Program.

² See "A Visual Tour of China's Strong—Yet Unsettled Recovery from the Great Lockdown," on the Bond Blog @ PGIM Fixed Income.

³ <https://www.dw.com/en/are-german-carmakers-too-dependent-on-china/a-55400204>

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