

Eurozone industry outlook: the perfect storm continues

While no turnaround is expected in the immediate future, there are some green shoots visible for industry in 2025. However structural factors are weighing on the manufacturing sector, which will limit the scope of any rebound



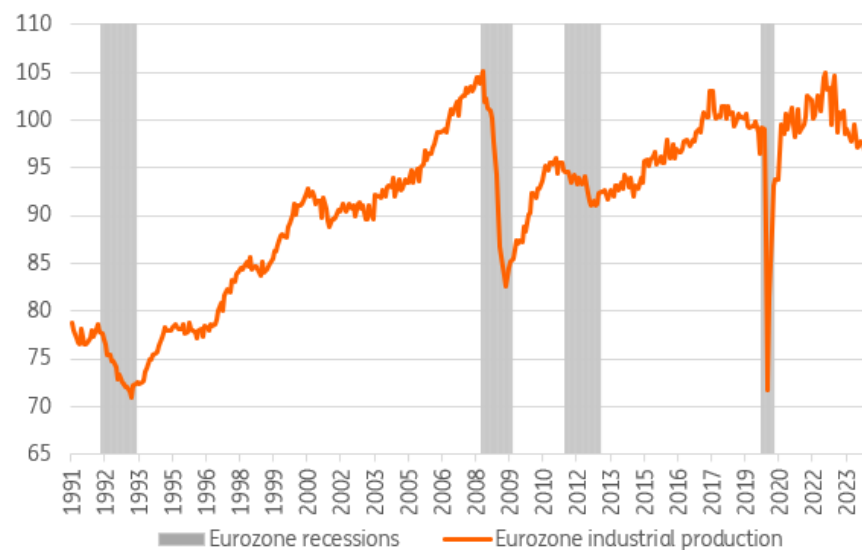
Germany has struggled with weak manufacturing this year but it's not alone

Industrial production continues to contract

There is no sugarcoating it. European industry is going through a deep correction, and it does not look like the end is here yet. Since mid-2022, industrial production has been in steady decline. This represents the strongest downturn in production in more than 30 years without the eurozone economy entering a recession. A strong service sector is keeping the economy afloat, while the manufacturing sector is shrinking.

There is little light at the end of the tunnel right now. Looking at recent data, we hardly find any evidence that a rebound is imminent. Inventories built up during times of high demand and supply-chain disruptions have barely come down. And new orders are not yet picking up, with demand both from within the eurozone and without remaining weak.

This is the strongest downturn in eurozone manufacturing without recession since 1991



Source: Eurostat, ING Research

Multiple drivers cause weakness in manufacturing

The perfect storm for manufacturing has multiple drivers. Over the past few years, we have seen that supply-side problems have faded and that (the lack of) demand has quickly become the largest worry for European manufacturers (see chart below).

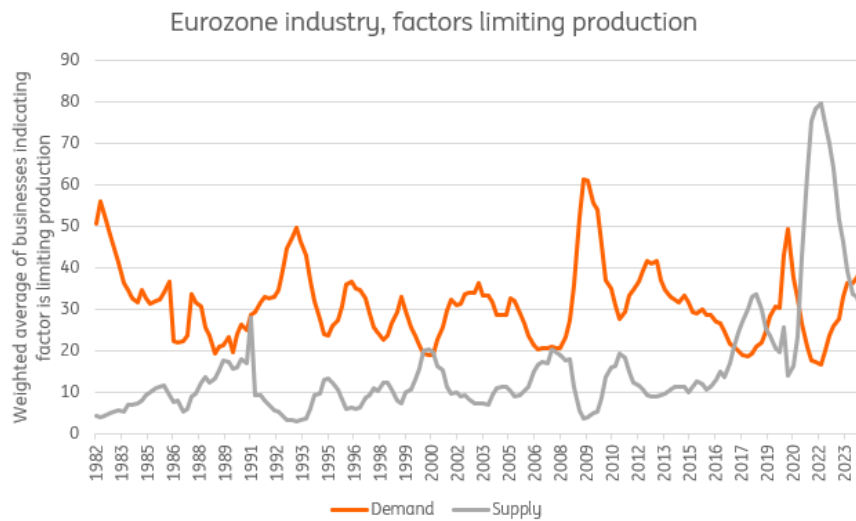
Going through the drivers of weakness, we find that consumer demand for goods remains sluggish due to the real income shock that Europeans experienced when inflation surged. And the economy seems to be stuck in a weak growth environment, which limits the outlook for consumer demand despite a decent recovery in real wages.

Furthermore, weak fixed investment plans are impacting manufacturing significantly. In the eurozone, investment is well below its pre-pandemic trend. This is due to weak domestic demand as well as high interest rates after years of negative rates. And policy uncertainty plays a major role, too.

More structurally perhaps, the energy shock is still keeping energy-intensive production muted, while weak demand outside of the eurozone – think of China for example – is impacting new orders in the manufacturing sector. Chinese export growth to the eurozone, meanwhile, is a sign of additional competition for local producers.

Finally, geopolitical tensions in the Middle East have contributed to longer-than-expected disruption in shipping. As a result, input costs for producers have started to increase again. This makes production more challenging in a weak demand environment in the eurozone.

Supply-side problems have faded as demand concerns returned



Source: European Commission DG ECFIN, ING Research calculations

Note: the supply category consists of industrial businesses indicating labour and equipment are a factor limiting production.

This is not a global problem, it's just us...

The eurozone is quite alone in this. Other major economies are not experiencing a similar downturn. Looking at China and the US for example, we see that the US has experienced flatlining production over the past 18 months, while China saw production grow by about 6%. The eurozone saw production decline by a similar amount. With weak domestic demand in China, it is no surprise that exports surged by 15% over the same period. For the eurozone, exports contracted by close to 5%. So, China has been able to mask weak domestic demand by producing for the rest of the world, which has gained a lot of attention recently as Western economies struggle with China's excess capacity.

Germany is most often described as the sick man of Europe in terms of manufacturing. But the reality is that while Germany may have experienced a larger contraction in industrial production than most other markets, there are very few shining lights within the eurozone. None of the major eurozone economies now produce more than at the start of 2023. France has performed best but is down 0.4%, while Germany has experienced a downturn of 8.4% based on comparable data from Eurostat.

Other big blocs are surging ahead despite local concerns

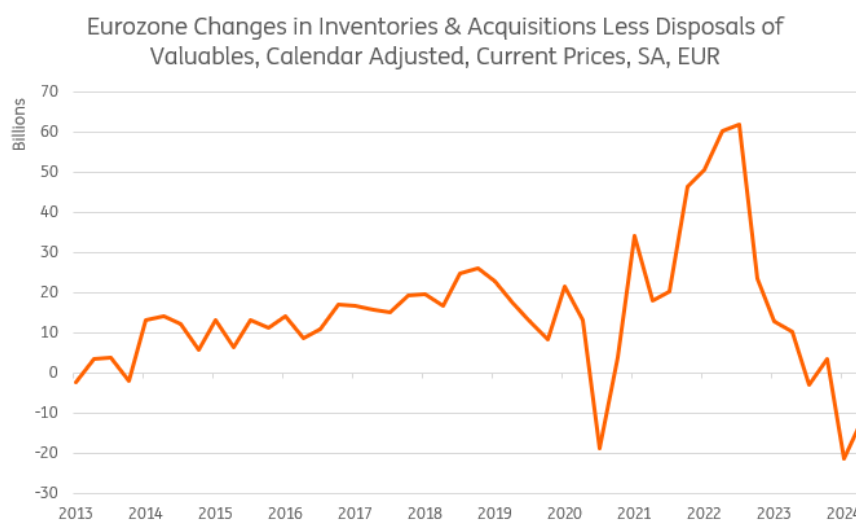


Source: CPB World Trade Monitor, ING Research calculations

Green shoots are apparent when looking at inventories though

The inventory cycle is key to the recovery in production. National accounts data has shown a sharp inventory reduction in the first and second quarters of this year. But this comes on the back of far greater increases in the years before. The large buildups raise doubts about how much stocks will have to fall before production picks back up. It could very well be that some sectors will simply maintain higher inventory levels than in the past as a result of supply chain disruptions during the pandemic and the first phase of the war in Ukraine. Currently, a large number of eurozone businesses are still indicating that the stock of finished products is continuing to rise though, leaving us sceptical about an imminent turnaround.

Destocking has started, but after a massive buildup



Source: Eurostat

Some sectors are showing more progress than others, and these could be bellwethers for

the overall recovery in 2025. Taking the European Commission industry survey question on the stock of finished products as a proxy for inventories by sector, we note significant declines in inventories for some of the more energy-intensive sectors and for transport equipment outside of motor vehicles.

Before the summer, the destocking seemed to coincide with an increase in new orders but since then, overall order books have been deteriorating and that has also been the case for some of the sectors that already dealt with destocking. The transport equipment sector stands out as a prime example of an industry that has not experienced rapid destocking and is seeing a rise in new orders. This is a sector that includes defence equipment.

A move from just-in-time to just-in-case could spark an early recovery

As already suggested above, the question is whether inventories really need to decline as much as in the past before a meaningful pickup in production can be expected. If the past years have brought anything, it is doubts about the just-in-time production model. Previous years have been characterised by uncertainty about delivery times, outright shortages of products and volatile transportation costs. Most recently, the Middle East conflict has resulted in longer delivery times and soaring transport costs. A lot of companies have reassessed their supply-chain vulnerabilities.

A logical result of this is that businesses could hold onto larger inventories in order to be less vulnerable to supply-chain shocks. This could also imply that the typical inventory cycle, where a surge in production is expected once inventories are depleted, may not apply in the current uncertain climate of globalised production.

As a result, new production could return to the eurozone even if inventories remain higher than in previous times. This is because the production process is changing from a “just in time” to a “just in case” model where businesses hold onto larger amounts of inventory than in the 2010s when the world was much more predictable. This could result in a quicker turnaround for eurozone manufacturing than currently expected.

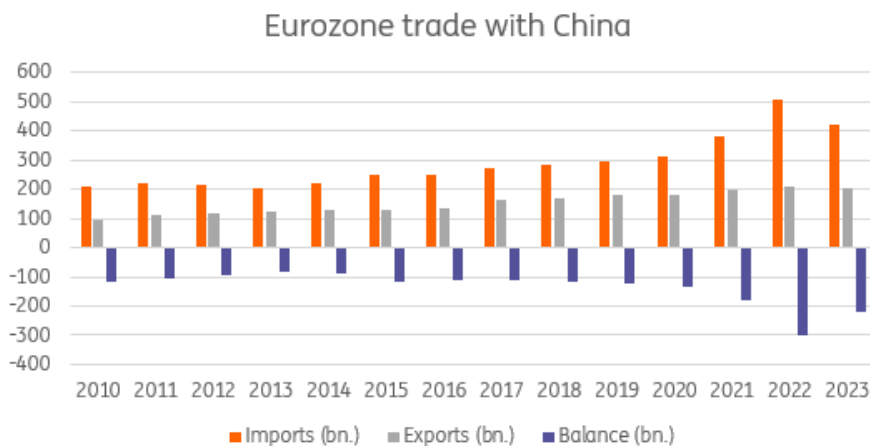
Structural problems continue to weigh on production, leading us to expect a subdued recovery in 2025

For 2025, we do expect that some recovery will come for the manufacturing sector. An easing of inventories, strengthening purchasing power of the consumer and somewhat easing of interest rates all add to an environment that warrants a careful turnaround of production in the eurozone. However, the expected soft landing in the US economy and continued growth problems in China should keep foreign demand suppressed. Add to this the ongoing structural worries with investment reluctance and policy uncertainty, and it is almost impossible to see a vigorous rebound of eurozone industry.

The changing growth model in China is adding to concerns about a structural decline of European industry in certain markets. Exports from China have soared as domestic demand disappoints and production capacity is large. This puts pressure on certain industrial sectors in Europe, the car sector most notably. It is too early to draw conclusions about how much of an existential threat this poses to European industry, because of possible European policy responses or a recovery of Chinese domestic demand for example. But for the foreseeable future, this is piling pressure on

eurozone industry.

Since the pandemic, the trade deficit with China has deepened

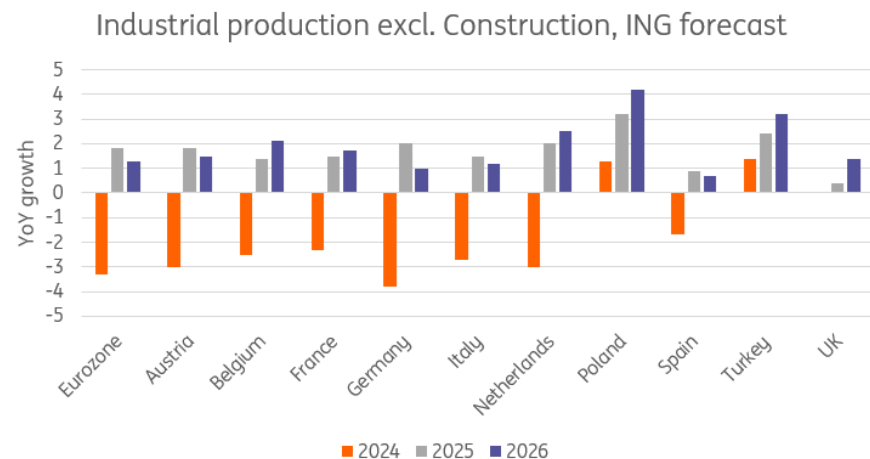


But also think of energy-intensive industries. The eurozone is currently seeing some tentative recovery in production from the most energy-intensive sectors, but energy prices have become more volatile and uncertain than before the energy crisis. More competition in the global LNG market or a cold winter could bring back higher prices than before. This limits the recovery that can be expected from energy-intensive sectors.

Locally, production is also still facing supply challenges despite sluggish demand. Labour shortages continue to be among the top concerns of manufacturers even if output has been declining. The availability of skilled labour is a concern that is likely to remain, especially as a lot of occupations are facing an ageing workforce, on the blue-collar side in particular.

All in all, it looks like green shoots in the manufacturing outlook are emerging. But eurozone industry continues to be plagued by enough longer-lasting concerns that it would be too optimistic to expect a vibrant recovery in 2025. There is light at the end of the tunnel, but it is very faint right now.

ING forecasts for industrial production



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