

Article | 27 January 2025

Why manufacturing continues to weigh on eurozone growth: it's the inventory cycle, stupid!

We continue to believe that the winter months will see eurozone GDP stagnating on the back of the ongoing crisis in manufacturing



Maintaining a comfortable level of inventory and avoiding excessive levels is a delicate balance

Inventories gone wild

Admittedly, inventories may not seem like the most exciting topic at first glance. However, the past few years have been marked by multiple shocks, distorting the traditional inventory management model. After decades of reducing inventory-to-sales ratios in an increasingly integrated world economy ("The world is flat," remember that one?), the post-pandemic supply chain shocks led to the realisation that too low a level of inventories can cause major disruptions.

Increased geopolitical tensions have undoubtedly contributed to this sentiment. At the same time, inventories are costly. Thus, it remains a delicate balance between maintaining a comfortable level of inventory and avoiding excessive levels.

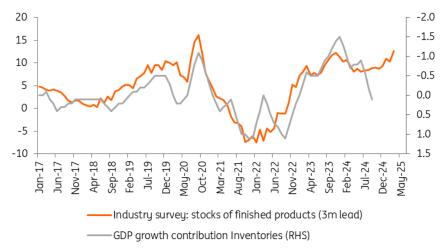
Manufacturing remains a major drag on growth

Where it becomes interesting for a macroeconomist is that inventory cycles can have a significant impact on GDP growth. Since the start of the Monetary Union, inventory changes have added between -1.4 and 0.9 percentage points to year-on-year GDP growth on a quarterly basis.

A lot depends of course on the mood in the manufacturing sector. Is there increased optimism, leading to more rapid stock building or does pessimism prevail, causing inventory reductions?

The eurozone manufacturing sector is going through a very difficult period, to put it mildly. Relatively high energy prices, the Inflation Reduction Act in the US (which has attracted investments to the US), insufficient domestic demand, and China exporting its excess capacity to the rest of the world, are weighing on sentiment. Since the last quarter of 2022, the added value in eurozone manufacturing has fallen by more than 7%. The uncertainty regarding potential import tariffs in the United States is not helping to reverse the situation rapidly.

High inventories are likely to impact GDP negatively



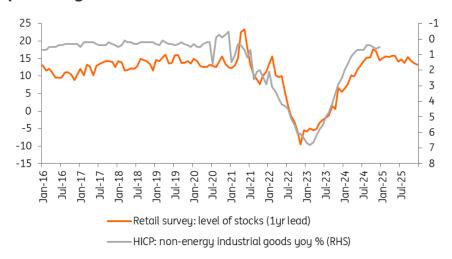
Source: LSEG Datastream

Continued struggles in the first quarter

The December survey of the European Commission showed weakened orders in the manufacturing sector, and the flash PMI indicated this trend continued in January. At the same time, the assessment of stock levels increased to a level last seen during the financial crisis. The combination of high inventories and falling demand is likely to weigh on growth, as companies will first try to reduce their inventories before producing more.

As the graph suggests, this could imply a significantly negative growth contribution from inventories in the first quarter. Admittedly, some of this negative impact will be offset by net exports, as inventories typically have a high import component (the PMI survey mentioned companies buying fewer inputs), but that will not erase the negative GDP impact entirely. The bottom line is that we continue to believe that the winter months will see eurozone GDP (at best) stagnating on the back of the ongoing crisis in manufacturing.

Downward pressure of retail inventories on goods inflation is petering out



Source: LSEG Datastream

Non-energy goods inflation bottoming out

While the inventory cycle will weigh on growth in the short run, an optimist might suggest that high inventories can also reduce goods inflation. Companies might be more willing to accept price concessions to get rid of excess inventories. This is certainly true, but when discussing consumer price inflation, it makes more sense to look specifically at inventories in the retail sector. Indeed, surveys on stock levels there have been a good leading indicator of goods price inflation.

While inventories are still perceived to be high, it doesn't appear that there will be much more downward impact on goods inflation.

Author

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone peter.vandenhoute@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central

Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.