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Europe Gets Caught in the U.S.-China Crossfire

Heavily reliant on exports, eurozone economies have been hurt by dwindling global trade flows

By Paul Hannon and Nick Kostov

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Europe's export engine is losing steam. That worries Mario Draghi.

Mr. Draghi, president of the European Central Bank, is expected to announce on Thursday that fresh monetary stimulus is on its way, seeking to offset a downturn in world trade that has quieted the eurozone's factories. ECB officials as recently as December believed such measures would no longer be needed.

The central bankers' change of heart reflects a weakness in the eurozone's economy: It depends heavily on trade for growth, meaning events far from its borders hold a disproportionate sway on its prospects.

Today, Europe is emerging as a big loser from trade tensions between the U.S. and China, which are compounding a wider slowdown in global trade. Even though European companies might seem out of the line of fire, they are suffering from a lull in their own exports to China as that country's manufacturing base curbs investments. And their customers elsewhere are flashing caution lights on spending.

In a June news conference, Mr. Draghi blamed "ongoing weakness in international trade in an environment of prolonged global uncertainties" for signs of slowing growth in the eurozone.

"In the past, when Europe slowed down things would pick up in the U.S. [while] China and Asia every year were growing a lot," says Bruno Grandjean, chief executive of French machine-component maker Redex SA, which is heavily dependent on exports and expects sales this year to fall roughly 3%. "Today, the three big continents are interconnected and all three are in the same situation."

Mr. Grandjean describes Redex's experience as "a soft landing," and the eurozone doesn't appear to be heading for recession, at least not soon. But slowing growth is the price it must pay for its dependence on overseas demand for its goods—and for its inability to develop a more dynamic economy at home.

Years of low investment and stagnant productivity, combined with policies that have fostered low-paid, insecure jobs rather than cutting-edge industries, have left Europe with an inherently slow-moving economy. Its companies have responded by looking to Asia and the U.S. for growth, which has left Europe exposed.

"The looming downturn is mainly caused by turbulence in global trade," German Chancellor Angela Merkel told reporters Friday. "I hope the trade talks between the U.S. and China will make progress, because it's obvious that the German exports are connected to these events."

Over recent months, German industrial leaders including luxury auto maker Daimler AG and chemicals giant BASF SE have slashed their profit forecasts, blaming weakening global demand and trade conflicts. Markus Schön, managing director of DVAM Asset Management, said he couldn't recall a time when German companies issued so many surprise profit warnings.

Still, many European companies are doubling down on exports given weakness closer to home.

Mario Draghi, president of the European Central Bank, is expected to announce a stimulus plan to offset the drag on trade.
PHOTO: ANDREAS ARNOLD/BLOOMBERG NEWS

"We have seen an increasingly erratic demand in Europe in the last quarters, therefore we are looking to expand our business in other areas with higher growth potential, such as China and Southeast Asia," said Andrea Tomat, chief executive of Lotto Sport Italia SpA, a sportswear and shoes producer near Venice.

World trade growth slowed sharply toward the end of last year, having surged in 2017 to a six-year high. It isn't expected to recover in 2019. The World Trade Organization sees flows of goods across national borders slowing further.

It's no coincidence that the eurozone's best year of growth in a decade—which prompted some economists to prematurely hail a "euroboom"—accompanied the 2017 trade burst. In that year alone, exports to China from German mechanical engineering companies, which supply machinery, equipment and other products, rose 23%.

Germany was an early mover into China as its economy opened four decades ago. Volkswagen AG in 1985 started building cars in Shanghai. German manufacturers salivated over China's vast market for everything from chemicals to luxury cars, and in particular for industrial equipment to fill the country's factories. German exports to China exploded from less than $10 billion in 2000 to over $100 billion last year.

The flip side of that surge is the chill that spreads across the eurozone economy when trade flows languish.

"Europe's reliance on trade is extraordinary," says Ashoka Mody, a Princeton University economics professor and former International Monetary Fund official. "It's an almost ironclad law: When world trade growth slows, Europe's growth in the next year slows."

Nowhere is reliance on trade heavier than Germany, Europe's largest economy and its largest exporter by an even greater margin.

Early last year its economy, which Mrs. Merkel had adroitly steered through the financial crisis and Europe's protracted struggles with high debts and weak banks, looked like one of the world's strongest. It boasted one of the globe's lowest unemployment rates and a growing government budget surplus.

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But by year-end, the German economy had only narrowly avoided slipping into recession. In the three months through June, the economy probably did shrink due to waning exports and a weakening construction sector, the country's central bank said Monday.

Germany, more than other large developed economies, buys from and sells to the rest of the world. Economists at Bruegel, a Brussels-based research institute, estimate that the country exports $21,000 of goods and services for each of its citizens. The comparable figure for France, the eurozone's second-largest economy, is $12,388. For the U.S., it's $6,800.

With just one-quarter of the U.S. population, Germany accounts for roughly the same share of total world exports. The Organization for Economic Cooperation and Development estimates that more than one-fourth of German jobs rely on exports, compared with less than a 10th of U.S. jobs.

A prototype of the Mercedes-Benz GLB concept vehicle, manufactured by Daimler AG, on display at the Auto Shanghai 2019 show. PHOTO: QILAI SHEN/BLOOMBERG NEWS

“If I had a wish,” said Karl Haeusgen, supervisory board chairman of German hydraulic component developer Hawe Hydraulik SE, “I’d wish for trade conflicts to be solved because it would be a great psychological stimulus.”

The company recently slashed its growth forecast to 0-3% for this year, compared with an initial expectation of between 6-8%, due to Europe’s weakening economy, Mr. Haeusgen said.

German industry leads Europe’s exports to Asia and the U.S., while surrounding European countries feed Germany’s supply chains. So when German manufacturers stumble, so do the companies across Europe that sell to them.

“Germany has slowed down,” said Mirco Cainelli, chief executive officer at Capi Group, a component manufacturer in northern Italy. “In Italy, we feel the consequences of this slowdown, given that our manufacturing sector is strictly linked to Germany.”

One of the foundations of Germany’s export edge is that its manufacturers moved early and decisively to engage lower-cost workers in countries to its east, such as Poland and Slovakia. A chill in Germany quickly spreads.

“Germany is exporting to China, and a U.S.-China trade conflict will hit Germany and so will hit neighboring countries that are part of German supply chains,” said Sergei Guriev, chief economist at the European Bank for Reconstruction and Development.

Growth in the 19-country eurozone is expected to barely exceed 1% annualized in the second quarter. Economists predict only modest improvement in coming quarters.

Without improved growth in Europe, the global economy will remain overly dependent on the U.S. and China to be the spenders of last resort. But the U.S. is becoming less willing, and China less consistently able, to provide the demand for consumer and investment goods that pulls other regions along.

The $13.6 trillion eurozone economy has had a good run, helping to end the long European debt crisis. Growth in 2015-2018 averaged over 2% a year, which is robust among mature economies with declining working-age populations. The eurozone even grew faster than the U.S. for two years running. Unemployment fell to 7.5%, from a crisis-era peak of 11%. ECB stimulus measures reduced financial tensions while banks digested bad loans and governments relaxed austerity policies.

“We may look back on 2015-18 as a rather happy phase that’s difficult to repeat, barring a global boom,” says Adam Slater, senior economist at consulting firm Oxford Economics.

Even in the good years, the experience for average Europeans has been mixed. Employment rates have increased in many countries, but the new jobs are often poorly paid and temporary. Economic pressure on households has provided fuel for antiestablishment politics, such as Italy’s 5 Star Movement or France’s “yellow-vest” street protests.

The eurozone, which used to have roughly balanced business with the rest of the world, now runs a current-account surplus—a broad measure of trade flows—of $400 billion a year.

Europe’s trade surplus in goods with the U.S. has risen sharply over the past decade. In 2008, Europe’s sales to U.S. customers were €65.1 billion ($72.6 billion) larger than its purchases from U.S. suppliers. By 2018 that gap had increased to €139.1 billion, and figures for the first five months of this year suggest it is still widening.

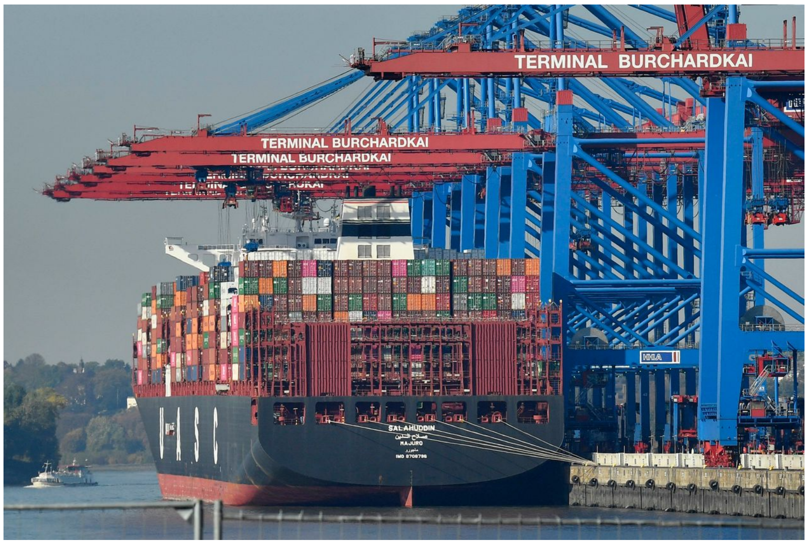
Germany is largely responsible for that surplus, exporting more than twice as much to the U.S. as its closest European rival, the U.K. Products that Europe sells to the U.S. are those that Germany excels at manufacturing: machinery, vehicles, and optical and medical equipment.

But that surplus has become a political target for President Trump, who has already slapped tariffs on steel and aluminum imports from Europe and is mulling whether to impose similar duties on automobiles, which are much more important for the European economy.

“If there is a serious trade war, it will inevitably have an effect on the economy and lead to strong recessionary tendencies” in Europe, said Bruegel Director Guntram Wolff. “You can resist a little, but not much.”

Services, which account for 66% of the eurozone economy and depend less on trade, continue to grow, supporting employment and keeping Europe out of recession. But Mr. Draghi last month warned that the services sector isn't immune to contagion.

"Weakening trade growth affects the manufacturing sector more than other sectors," Mr. Draghi said in June. "The key issue is: How long can the rest of the economy be insulated from a manufacturing sector that keeps on being weak?"



Loading a container ship at the harbor in Hamburg, Germany. PHOTO: MARTIN MEISSNER/ASSOCIATED PRESS

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