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# What to watch: The ECB in a pickle, China v. Germany – from complementarity to substitution, and UK trade tricks to reduce Brexit inflation

**Ludovic Subran**
**Chief Economist**
ludovic.subran@allianz.com

**Ana Boata**
**Head of Economic Research**
ana.boata@allianz-trade.com

**Bjoern Griesbach**
**Senior Investment Strategist**
bjoern.griesbach@allianz.com

**Jasmin Gröschl**
**Senior Economist for Europe**
jasmin.groeschl@allianz.com

**Françoise Huang**
**Senior Economist for APAC**
francoise.huang@allianz-trade.com

**Yao Lu**
**Sector Advisor**
yao.lu@allianz-trade.com

## Executive summary

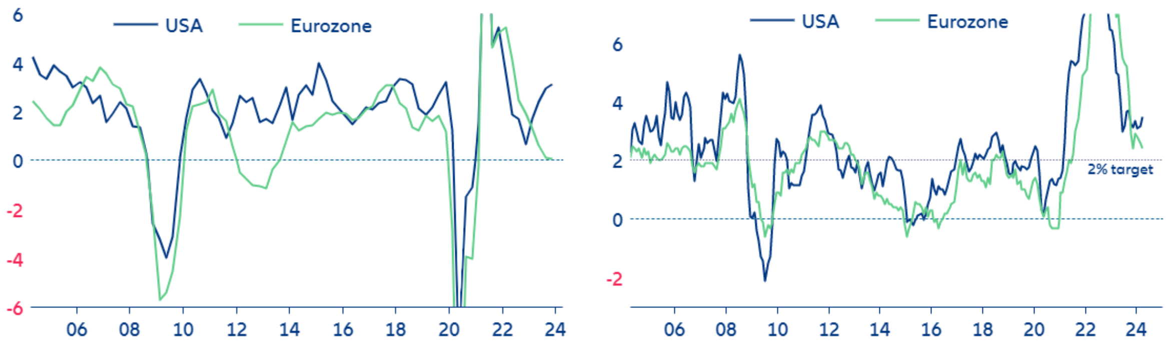
This week we look at three critical issues:

- **ECB: Moving closer to cuts but not there yet.** At the 11 April meeting, we expect the ECB to keep the deposit rate unchanged at 4.0% for the fifth consecutive time. In the meantime, quantitative tightening remains on autopilot, and the complete expiration of the TLTRO funding by year-end should not affect overall liquidity provisioning. Policymakers will reiterate that initial rate cuts could start from June onwards, contingent on continued disinflation. Given the recent strong US economic data, the Fed is in a different boat and a transatlantic monetary policy divergence cannot be ruled out. However, this should not derail the Eurozone economy. A cumulative 1pp rate delta over the next two years could lead to a 4% depreciation of the euro, which should only marginally increase inflation while benefiting the economy's struggling export industry.
- **China and Germany: The trade tide is turning.** Ahead of the German Chancellor's trip to China next week, we find that the historic trade relationship could be on the rocks. China's global export shares in key sectors like machinery, chemicals, and electrical equipment have surpassed Germany, while the latter's critical dependence on Chinese imports has increased significantly from 6% in 2004 to 22% in 2022. Despite a fivefold increase in German direct investments in China from 2010 to 2022, firms have experienced lower turnover of -EUR6.2bn and lower returns on investments of -EUR24.8bn in 2022. To address these challenges, companies are reinvesting profits in China but also facing domestic economic difficulties, resulting in job cuts in Germany.
- **UK: New border controls to be largely offset by aggressive tariff-suspension measures.** Over four years after Brexit, border controls on agricultural imports from the EU will finally be implemented on 30 April, costing GBP2bn to British importers and potentially pushing up inflation by +0.15pp. At the same time, and as of today, the UK decided on a massive two-year tariff suspension on almost half of its imports. This smart counter attack could cut total import costs by GBP7bn, and subsequently decrease inflation by -0.6pp. All in all, our inflation forecast for the UK is expected ex ante at 2.6% in 2024 and 2.2% in 2025, from 6.9% in 2023. Taking into account both measures, UK inflation could land at 2.4% in 2024, and 2.0% in 2025, all other things equal.

## ECB: Moving closer to cuts but not there yet

**The ECB will stay on hold today but hint at initial rate cuts in the summer if incoming data confirms the disinflation track.** The ECB is expected to maintain the status quo at today's meeting, holding the deposit rate at a historically high 4.0% for a fifth consecutive meeting (MLF: 4.75%, MRO: 4.5%). Last month, the consensus among the Governing Council leaned towards awaiting more data, but the accounts also mentioned that "the case for considering rate cuts was strengthening". This shift was underpinned by a significant reduction in the ECB staff's inflation estimates for this year to 2.3% from December's 2.7%. Since then, inflation trends have aligned with these revised predictions. However, robust domestic inflation – particularly from the service sector as highlighted in our recent report[1] – coupled with ongoing high wage growth suggests that inflation may not subside quickly from here on. Additionally, base effects are currently making headline inflation seem more favorable than it truly is. Over the last quarter, the annualized monthly core inflation rate has increased to 3.8%. On top, the recent rebound in oil prices by around 10% over the past couple of weeks does not bode well for energy inflation. So, the ECB will indeed need a few more positive data prints to confidently declare a win over inflation and begin the rate cutting cycle.

Figure 1: GDP growth and inflation, y/y in %

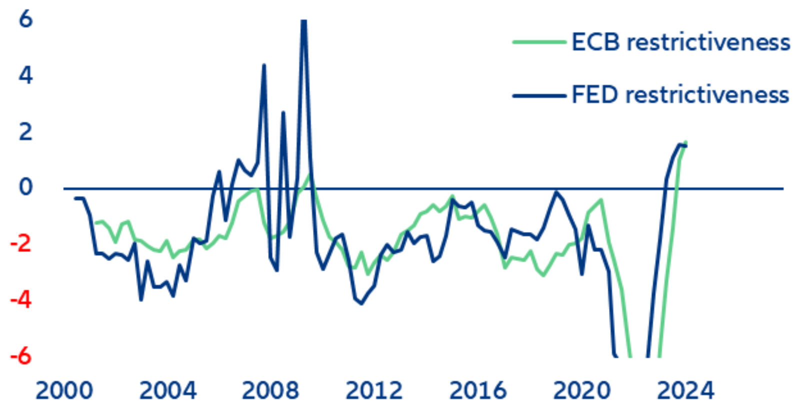



*Sources: LSEG Datastream, Allianz Research*

**Meanwhile, the Fed is already in a different boat, which could lead to a potential monetary divergence.** Despite some challenges, the overall disinflation path appears to be on track in the Eurozone. However, the region is grappling with subpar growth momentum, having experienced five quarters of stagnation and an increasingly negative output gap. In contrast, the US economy is thriving thanks to an excessive fiscal policy boost, and the disinflation process seems to have stalled (Figure 1). Despite this economic divergence, the ECB has now become more restrictive than the Fed in terms of monetary policy by certain measures: The real policy rate, calculated as the current policy rate minus inflation, has increased sharply in the Eurozone – primarily due to lower inflation. Currently, the real policy rate is 1.6%, which is 1.4pps above the estimated neutral real rate. In the US, the real policy rate is 2.0%, standing 1.3pps above the neutral rate (Figure 2). By this measure, the ECB is currently more restrictive than the Fed despite weaker fundamentals. Importantly, in both regions, monetary policy is at its most restrictive level in decades. But given the economic divergence, the Fed might have the leeway to delay action, while the ECB cannot afford to do so. This perspective is increasingly reflected in market expectations, which now expect the Fed to cut approximately 30bps less than the ECB in 2024 (Figure 3).

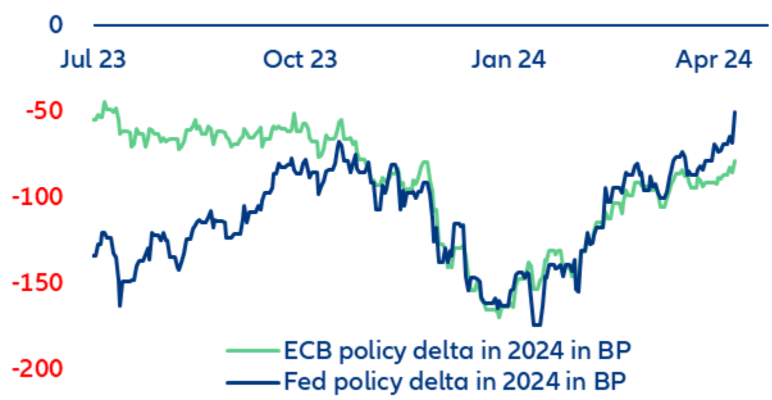
[1] *What to watch: 05 April 2024*.

Figure 2: Monetary policy restrictiveness, in pp above neutral real rate




*Sources: LSEG Datastream, Fed, Allianz Research*
*Notes: The chart shows the difference of the real policy rate and the Holsten-Laubach-Williams neutral real rate estimate. The real policy rate is the current nominal policy rate less y/y headline inflation.*

Figure 3: Central bank pricing in 2024, policy rate delta in bps




*Sources: Bloomberg, Allianz Research*

**A potential 'higher for longer' scenario in the US means downside pressure on the EUR but the exchange rate pass-through on inflation appears manageable.** Our analysis indicates that a cumulative 1pp policy rate divergence over two years leads to approximately a 4% depreciation of the euro against the USD (Figure 4). If the 'higher for longer' scenario in the US materializes and the Fed delays rate cuts well into 2025, we could indeed see such an outcome, with the EURUSD dropping from 1.07 currently to around 1.03. However, we remain confident that a further depreciation of the euro would not pose significant concerns to the Eurozone for several reasons. First, the inflationary impact of exchange rate pass-through is relatively limited; ECB research suggests that a 4% depreciation of the euro would increase inflation by less than 0.2pp[2] – a minor concern given the broader disinflationary context. Second, a weaker euro could provide a vital boost to Europe's faltering export sector, aiding in the economic recovery. Lastly, the exchange rate is a function of a variety of macroeconomic factors over the medium to long term. Considering the structural overvaluation of the USD, the ultimate shift in the EURUSD exchange rate may be less pronounced.

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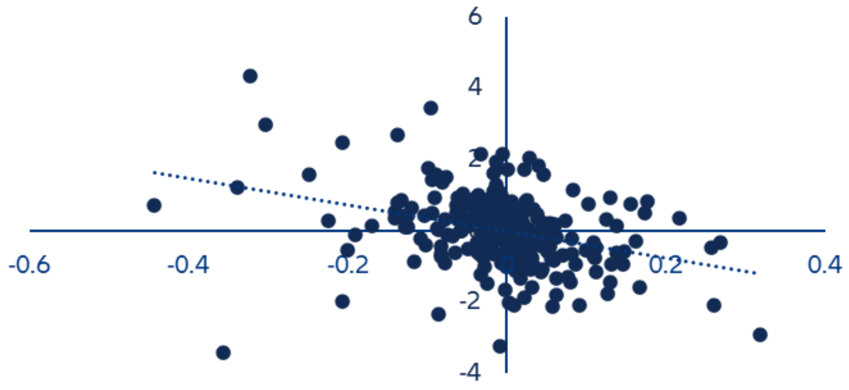
*[2] See "The transmission of exchange rate changes to euro area inflation" by Ortega et al, 2020. The authors estimate that a 1% depreciation of the euro leads to an increase of headline HICP inflation by 0.04pp. A literature review reveals that the range of impacts in other studies ranges between 0.01 and 0.09pp.*

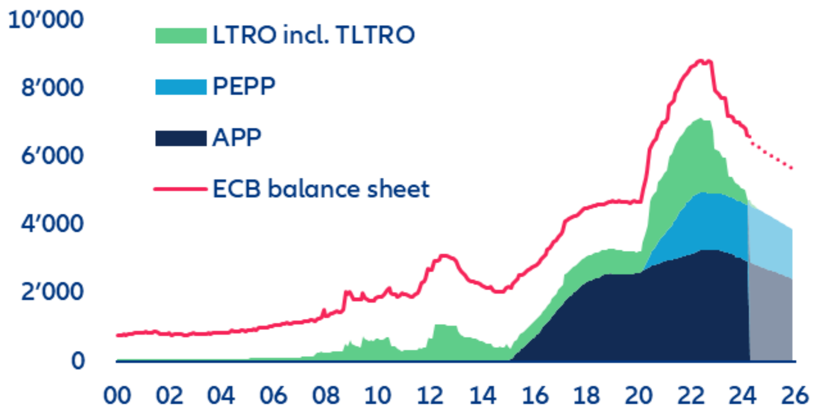
Figure 4: Weekly change in the interest rate differential between US and German 2y government bonds in pp (x-axis) and the corresponding EURUSD move in % since 2019 (y-axis).




*Sources: LSEG Datastream, Allianz Research*
*Notes: The regression line reads y=-3.74x-0.03 with an R2 of 0.12. The coefficient -3.74 is statistically significant. Interpretation: if the 2y interest rate differential increases by one percentage point, the EUR depreciates by 3.74% on average. 2y government bond yields can be used as an approximation of the expected cumulative monetary policy path over the next two years.*

**Going forward, we maintain our forecast of two ECB rate cuts this summer, followed by three additional cuts in 2025.** By the next ECB meeting in June, two more monthly inflation reports and an additional set of quarterly wage data will be available. Should these indicators align with policymakers' expectations, any meeting from June onward could potentially see an initial rate cut. While we currently favor July for the first move – which would be closer in line with our baseline prediction of an initial Fed adjustment – June remains a possibility. Anticipating a rebound in economic growth in the latter half of the year, we expect the ECB to pause after September and delay further cuts until the inflation target is sustainably met, which we expect in Q1 2025. In the meantime, quantitative tightening remains on autopilot and will continue at around EUR25bn per month until June and then increase to around EUR32bn until year-end, when the ECB will also partially stop reinvesting maturing bonds in the PEPP program (Figure 5). Despite the complete expiration of the TLTRO funding by year-end, liquidity should not be an issue on the macro level going forward as it was also highlighted in the latest ECB bank lending survey. First, there are still plenty of excess reserves around and second, according to the ECB's new operational framework, the spread between the deposit rate and the refinancing rate will narrow from 50bps to 15bps from 18 September onwards, allowing easier access to credit for banks from the lender of last resort – if needed. Third, in case of larger liquidity issues, there is no reason to believe that the ECB would not reintroduce longer term operations again.

Figure 5: ECB balance sheet, in EURbn.

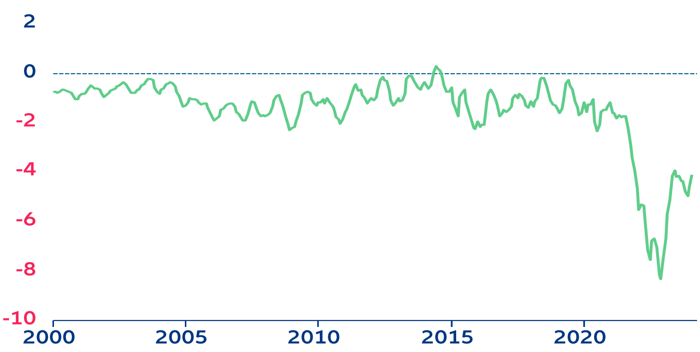



*Sources: LSEG Datastream, Allianz Research*
*Notes: Shaded area shows Allianz Research forecast*

## China and Germany: The trade tide is turning

**Ahead of the German Chancellor's trip to China next week, we find that trade relationship could be on the rocks, even as Germany's critical dependency on China has risen starkly.** While the two countries have historically enjoyed a strong complementary partnership, intensifying industrial competition is threatening German manufacturing in sectors where it once held dominance. Trade structures between Germany and China are changing, with exports as a share of GDP to China decreasing by nearly a third since its peak in Q4 2020. The German trade balance with China has been tilted for a long time but the German trade deficit has intensified over the last two years (Figure 6). Moreover, we find that Germany's critical dependency[3] on China has increased from 6% of imports in 2004 to 22% in 2022. This covers 212 product types, of which 74 are in the computers & telecom, electronics and household equipment sectors, while 44 products are in textiles and 33 in chemicals. The sectoral breakdown has shifted towards higher value-added industries over the years.

Figure 6: German trade deficit with China, three-month moving average in USDbn




*Sources: LSEG Datastream, Allianz Research*

**China is moving up global value chains, with global export market shares surpassing Germany in key sectors.** China's strategy of importing knowledge through cooperation and investing in highly innovative manufacturing businesses abroad has proven successful. It has steadily moved up the value chain and captured market share in advanced industrial sectors while simultaneously squeezing out European products from its domestic market. The impact is evident in shifting trade patterns. China's global export market share has continued to increase from less than 4% in 2000 to 14% in 2022. Meanwhile, German global export market shares have stagnated around 10% for a long time and settled at 8% in 2022. More importantly, China's global export share has surpassed that of Germany in three out of four main export sectors (Table 1): 1) machinery & equipment, 2) chemicals and 3) computers & telecom, electronics and household equipment. Highly specialized German machinery companies, manufacturers of combustion engine vehicles and producers of specialized chemicals are facing intense competition from Chinese rivals that are backed by price competitiveness and policy support from Beijing. Germany retains a lead in auto manufacturers and suppliers and transport equipment, but this has narrowed slightly in recent years. Indeed, while German exports of passenger cars to China rose by +38% over the last decade, they have declined sharply by -10% in the last two years. It is also interesting to differentiate between exports related to global value chains ("GVC-related exports" in Table 1), and those that go directly to the final market ("Traditional exports" in Table 1). China seems to be gaining ground much faster in traditional exports, probably reflecting two trends. On the one hand, at the earlier stages of industrialization, exports of goods that require less value-added and less sophisticated supply chains take off faster. On the other hand, more recently, China has been able to integrate long sequences of value chains domestically, thus providing goods that require less participation of other countries. This latter point is further supported by evidence in trade of intermediate products between Germany and China, which has slowed drastically in 2022 and 2023[4].

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[3] *See our reports Can the US and EU really "friendshore" away from China? and China: keeping the dragon awake.*

[4] *German exports of intermediate products to China had risen by +45% over the last decade but declined by -7% in the last two years. Similarly, German imports of intermediate products from China have more than doubled over the past decade but dropped by -34% between 2022 and 2023.*

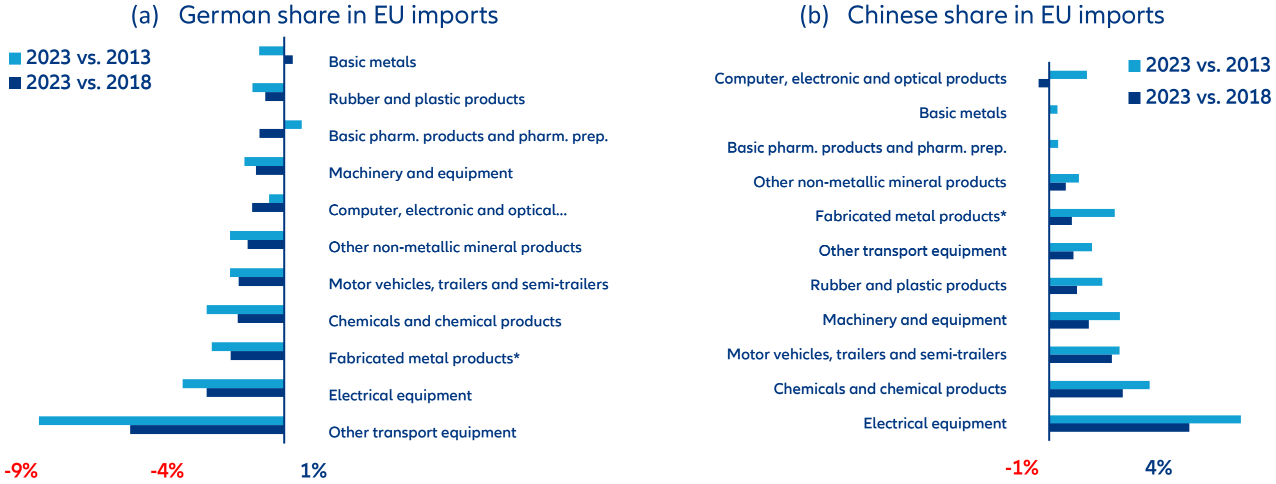
Table 1: Global exports market share (%) in 2022, China vs. Germany, total and in key sectors

| | China | Germany | Has China surpassed Germany? |
|---|---|---|---|
| **Total** | **14%** | **8%** | **Yes, in 2012** |
| GVC-related exports | 10% | 9% | Yes, in 2021 |
| Traditional exports | 18% | 8% | Yes, in 2009 |
| **Computers & Telecom, Electronics, Household Equipment** | **33%** | **7%** | **Yes, in the early 2000s** |
| GVC-related exports | 26% | 7% | Yes, in the early 2000s |
| Traditional exports | 40% | 7% | Yes, in the early 2000s |
| **Machinery & equipment** | **24%** | **17%** | **Yes, in 2019** |
| GVC-related exports | 17% | 20% | No, but Germany's lead has declined from 11pp in 2017 to 3pp in 2022 |
| Traditional exports | 29% | 15% | Yes, in 2018 |
| **Chemicals** | **11%** | **10%** | **Yes, in 2022** |
| GVC-related exports | 8% | 11% | No, but Germany's lead has declined from 9pp in 2017 to 3pp in 2022 |
| Traditional exports | 14% | 8% | Yes, in 2017 (with a blip in 2020) |
| **Autos manufacturers and suppliers, transport equipment** | **6%** | **17%** | **No, but Germany's lead has declined from 15pp in 2018 to 11pp in 2022** |
| GVC-related exports | 4% | 18% | No, but Germany's lead has declined from 15pp in 2018 to 13pp in 2022 |
| Traditional exports | 9% | 17% | No, but Germany's lead has declined from 14pp in 2018 to 8pp in 2022 |

*Sources: World Bank (WITS), Allianz Research. Note: "GVC-related exports" stands for global value chain related exports. This corresponds to goods that cross more than one border i.e. that participate in different stages of supply chains. Traditional exports cross only one border from the source country directly to the final market.*

**The window of opportunity is narrowing for German manufacturing as the economic relationship between Germany and China shifts from complementarity to substitution – even within the EU.** German machinery exports to BRIS (excluding China) and ASEAN countries have decreased by -23% and -14%, respectively, compared to 2019, while Chinese machinery exports to these regions have seen significant growth of +89% and +31%. In Europe, which accounts for two-thirds of German exports, China has also gained market share at Germany's expense. While Germany has historically been a major source of imports in the EU market, particularly in advanced manufacturing sectors like motor vehicles and machinery, its market share has been declining. In the last five and 10 years, 10 out of 11 advanced manufacturing sectors have experienced a decrease in market share, with basic metals (+0.3pp between 2018 to 2023) and pharmaceutical products (+0.6pp between 2013 to 2023) being the only exceptions (Figure 7a). Transport equipment, excluding motor vehicles, has faced the most significant downturn, with declines of -5.3pps and -8.4pps. In contrast, China has been making significant gains in the EU market across all sectors (Figure 7b). Only computer, electronic and optical products have recorded a slight downtick (-0.4%). The momentum is especially strong in electrical equipment, which has risen by 5.1pps from 2018 to 2023 and 7.0pps from 2013 to 2023. This trend highlights the growing competitiveness of China and the challenges it poses to Germany's traditional strengths in the market.

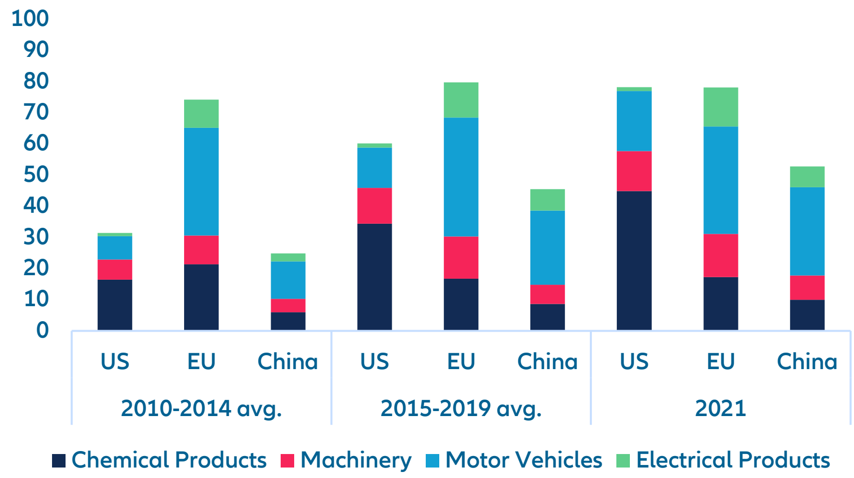
Figure 7: Change in shares of Germany and China in EU imports by economic activity




*Sources: Eurostat, Allianz Research. Note: Fabricated metal products do not include machinery and equipment.*

**Shrinking revenues and market share put pressure on profits of German firms operating in China.** While some German companies have soured on the Chinese market, it remains an attractive destination for investments by large corporations. Between 2010 and 2022, German direct investments to China have increased fivefold, particularly in motor vehicles, and quadrupled in chemicals (Figure 8). But German investments have underperformed globally compared to their competitors. As a result, German firms have experienced a lower turnover in China of -EUR6.2bn and less returns on their direct investments of -EUR24.8bn in 2022 compared to a counterfactual scenario without knowledge and technology transfers.[5] To stay competitive, companies are reinvesting their profits made in China back into the country, reducing funds to be sent to Germany. Further economic challenges at home linked to high energy prices and rising bureaucracy are adding pressure on internationally active firms. This has resulted in job cuts domestically, prompting calls for EU-driven protectionist and de-risking measures. But German companies would likely benefit more from policies that reduce their regulatory and tax burdens at home and remove obstacles to innovation. These would go a long way to help companies regain competitiveness at the global stage.

Figure 8: German direct and indirect investments in China, in EURbn




*Sources: Deutsche Bundesbank, Allianz Research*

[5] *Elasticities stem from Hunnekes, F., Konradt, M., Schularick, M., Trebesch, C., and J. Wingenbach, 2023. [Exportweltmeister-Germany's Foreign Investment Returns in International Comparison](), JIE, forthcoming.*

## UK: New border controls to be largely offset by aggressive tariff-suspension measures

**Over four years after Brexit, border controls on agricultural imports from the EU will finally be implemented on 30 April, costing GBP2bn to British importers and potentially pushing up inflation by +0.15pp.** After being delayed five times, equivalent border controls on agricultural imports from the EU will come into force at the end of this month. Physical checks, health certificates and identification before entering the UK will apply to GBP21bn of agricultural imports from the EU (Figure 9) i.e. 3% of all UK imports and close to 8% of imports coming from the EU. According to the European Commission, this would represent a 10% tariff-equivalent increase[6] or GBP2bn for companies, without much cushioning from the GBPEUR (expected to remain broadly stable around 1.18). Considering: (i) a 30% import intensity; (ii) that their weight in the UK CPI basket is around 6%; (iii) that the imports of these goods from the EU account for around 75% of the total UK imports and (iv) that companies will pass through the costs entirely, we expect a +0.15pp inflation increase over 12 months, with dairy, meat and fish products most affected.

Figure 9 - Products that will be subject to border controls for imports coming from the EU

| | UK imports from the EU (GBPbn) |
|---|---|
| Preparations of cereals, flour, starch or milk; pastrycooks' products | 5.0 |
| Meat and edible meat offal | 4.4 |
| Dairy produce; birds' eggs; natural honey; edible products of animal origin | 3.5 |
| Preparations of meat, of fish, of crustaceans, molluscs or other aquatic invertebrates | 2.7 |
| Residues and waste from the food industries; prepared animal fodder | 1.9 |
| Animal, vegetable or microbial fats and oils and their cleavage products; prepared edible fats | 1.4 |
| Live trees and other plants; bulbs, roots and the like; cut flowers and ornamental foliage | 1.2 |
| Live animals | 0.6 |
| Fish and crustaceans, molluscs and other aquatic invertebrates | 0.2 |
| Products of animal origin, not elsewhere specified or included | 0.1 |
| Total | 21.0 |

*Sources: ITC, Allianz Research*

**At the same time, and as of today, the UK decided on a massive two-year tariff suspension on almost half of its imports. This smart counter attack could cut total import costs by GBP7bn, and subsequently decrease inflation by -0.6pp.** Following 245 applications for duty suspension from the private sector, the UK government decided to implement temporary tariff suspensions on specific goods that are not under FTAs and operate under the WTO's Most Favored Nation status. This represents more than 45% of total UK imports worth GBP300bn, which will go from a 3.2% trade-weighted average tariff to zero overnight. The tariff suspension spans mineral fuels, metals, cars (6.2% average tariff previously), natural pearls and precious stones (1.3% average tariff), as well as several agrifood products (12.2%). By using the tariff difference, the import intensity and imported share of each product and their respective weight in UK inflation, we calculate that the measure will provide a welcome GBP7bn cost relief to UK importers and potentially lead to a reduction in consumer inflation by -0.6pp over 12 months, assuming corporates pass through the entire boon to their customers (good luck with that!).

**All in all, our inflation forecast for the UK is expected ex ante at 2.6% in 2024 and 2.2% in 2025, from 6.9% in 2023. Taking into account both measures, UK inflation could land at 2.4% in 2024, and 2.0% in 20025, all other things equal.**

[6] *The economic impact of the Services Directive: A first assessment following implementation.*

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