

Flash Economics

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Why are non-residents concerned about the situation in the euro zone?

Since the second quarter of 2018, non-residents have become massive sellers of euro-zone equities, which shows their concern about the euro zone's situation.

What are they concerned about? Probably all of the following:

- The decline in potential growth in the euro zone;
- The possibility of another crisis in Italy;
- The prospect of an industrial crisis in Germany;
- A depreciation of the euro as interest rates remain low;
- Europe's political weakness with respect to the United States.

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Non-residents are showing their wariness of the euro zone

Since the second quarter of 2018, non-residents have been sellers of euro-zone equities (Charts 1A and B), which shows investors' wariness of the euro zone's situation.

Chart 1A
Euro zone: Purchases of equities by non-residents (USD bn)

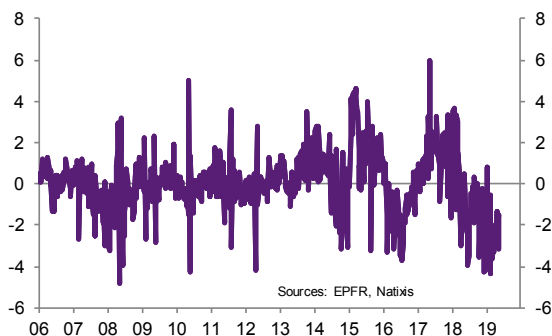
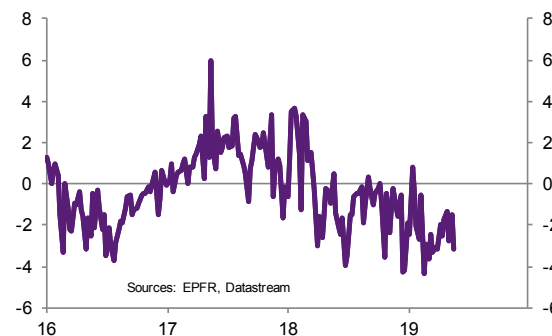


Chart 1B
Euro zone: Purchases of equities by non-residents (USD bn)



What could account for non-residents' wariness of the euro zone?

The likely causes of non-residents' wariness of the euro zone

We see **five likely causes** of non-residents' wariness of the euro zone.

- 1- The decline in potential growth in the euro zone (Chart 2A) due to the low productivity gains (Chart 2B): given the return to full employment (Chart 2C), the potential growth rate is the highest growth rate it is possible to reach.

Chart 2A
Euro zone: Real GDP and potential growth (Y/Y as %)

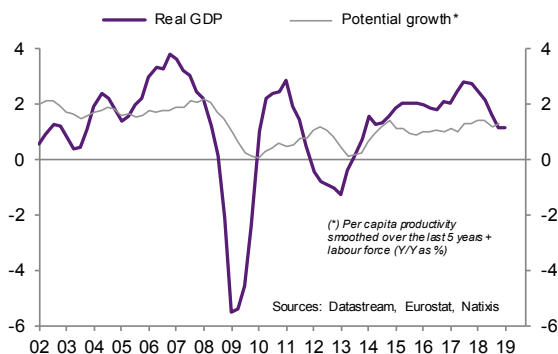


Chart 2B
Euro zone: Per capita productivity (Y/Y as %)

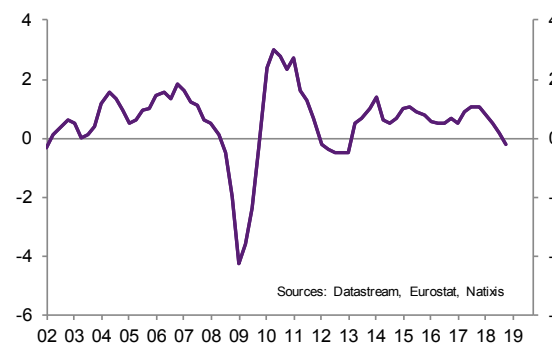
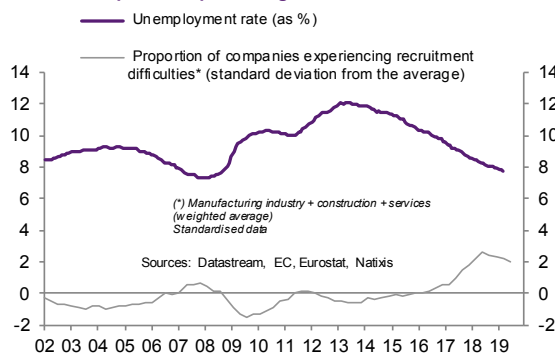


Chart 2C
Euro zone: Unemployment rate and proportion of companies experiencing recruitment difficulties*



2- The possibility of another crisis in Italy, given the chronic weakness of growth (Chart 3A) caused by under-investment (Chart 3B), which could eventually lead to either a sharp increase in the fiscal deficit or another political crisis.

Chart 3A
Italy: Real GDP and potential growth (Y/Y as %)

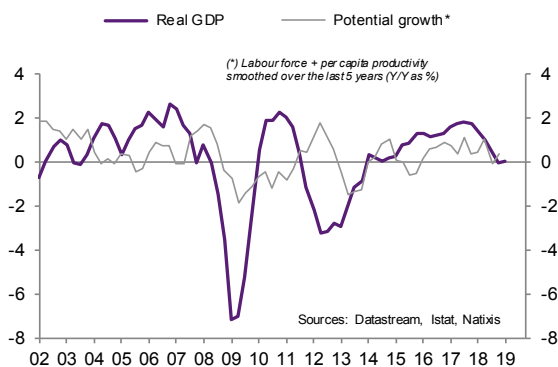
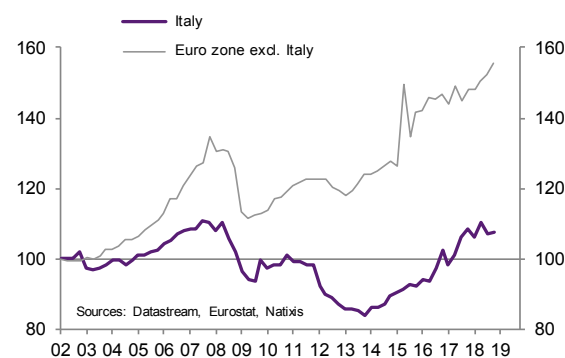


Chart 3B
Real productive investment (2002:1 = 100)



3- The prospect of an industrial crisis in Germany (Chart 4A) given Germany's specialisation in declining industries (conventional cars, chemicals, industrial capital goods, Charts 4B and C).

Chart 4A
Germany: Manufacturing production (IPI)

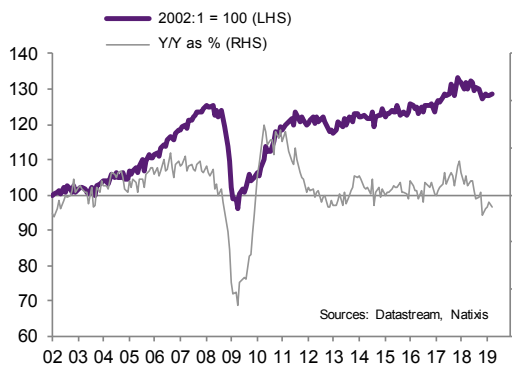


Chart 4B
Germany: Car production (Y/Y as %)

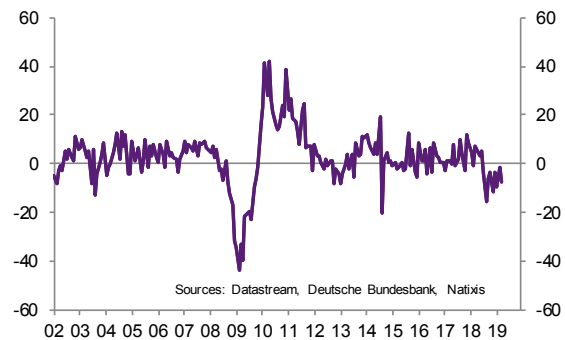
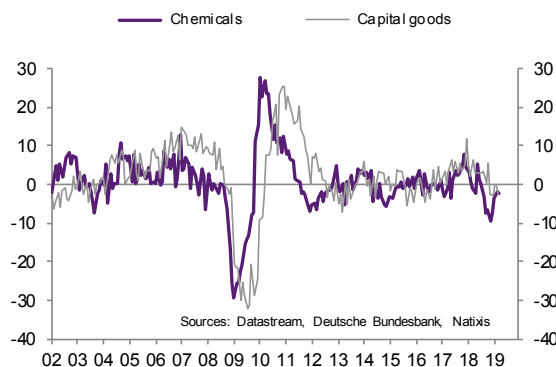
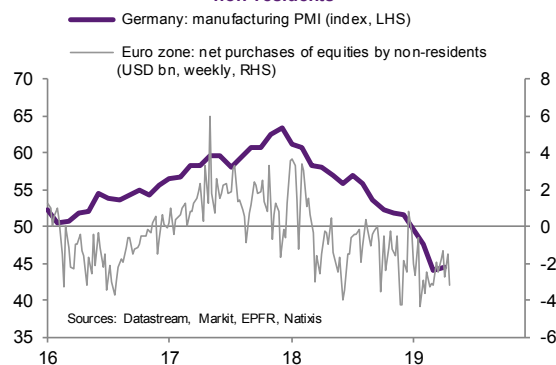


Chart 4C
Germany: Production (IPI, Y/Y as %)



The parallelism between the outlook for industrial production in Germany and non-residents' purchases of euro-zone equities is impressive (Chart 4D).

Chart 4D
Manufacturing PMI and purchases of equities by non-residents



4- A depreciation of the euro (Chart 5A) given the persistently low level of interest rates in the euro zone (Chart 5B) and the short-term capital outflows (Chart 5C).

Chart 5A
Euro/dollar exchange rate (EUR 1 = USD...)

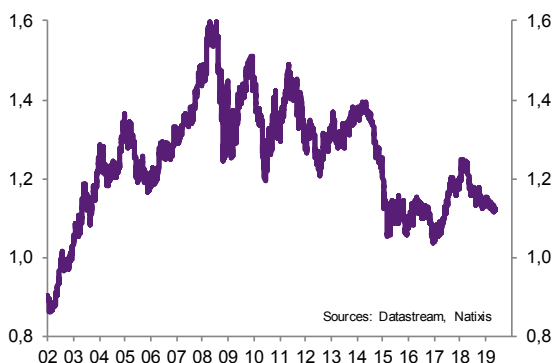
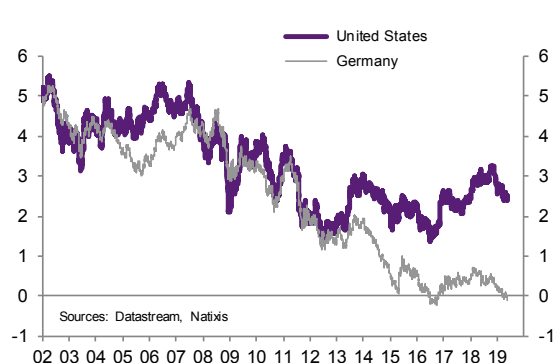
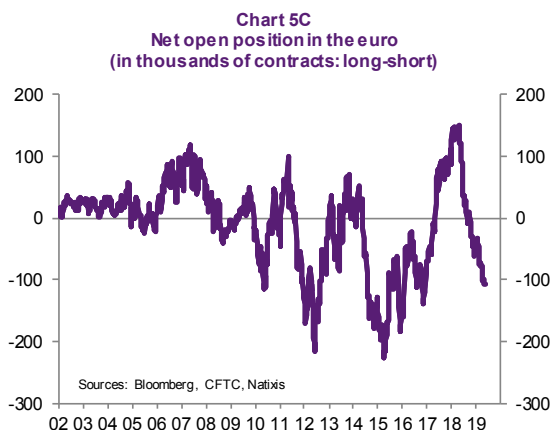


Chart 5B
Interest rate on 10-year government bonds (as %)

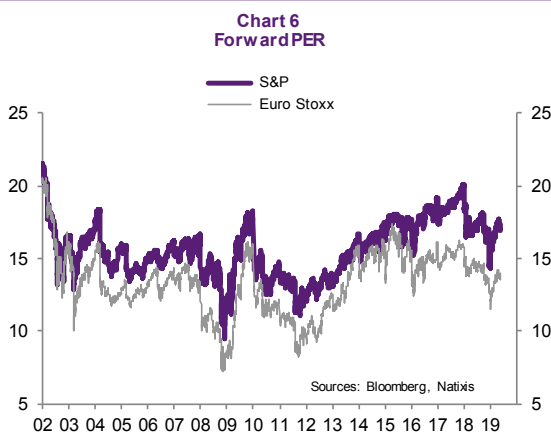




5- Europe’s political weakness with respect to the United States, given the United States’ ability to impose its laws and sanctions on the world, something Europe does not have; and also Europe’s political division (break-up of the Franco-German couple, tensions with Italy, Hungary and Poland, etc.)

Conclusion: Non-residents’ concerns are understandable

The valuation of euro-zone equities is abnormally low (Chart 6) and this has to be related to non-residents’ sales of euro-zone equities.



But we can understand why they are concerned about:

- The low level of potential growth in the euro zone;
- The possibility of another crisis in Italy;
- The prospect of an industrial crisis in Germany;
- The risk of a depreciation of the euro;
- Europe’s weakness and its political divisions.

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