Allianz Research | 12 July 2024

What to watch: China's Third Plenum, Germany's penny-pinching budget, what happens next in France and ECB preview

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In summary

This week we look at four critical issues:

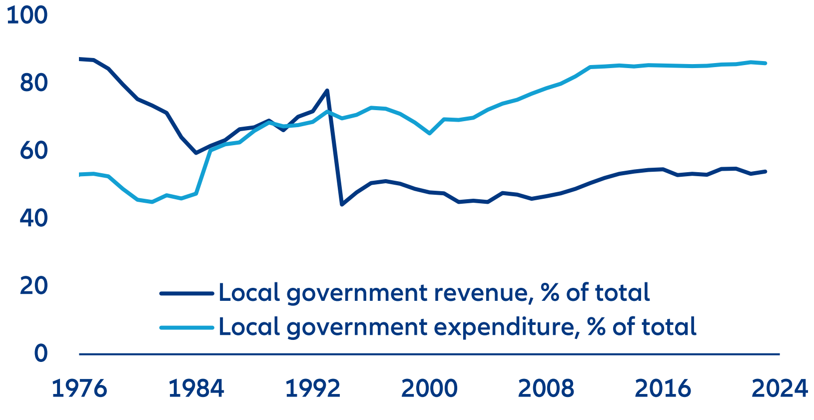
- **China's Third Plenum: don't hold your breath.** All eyes are on China's Third Plenum, taking place in Beijing next week, for clues on how policymakers plan to combat economic slowdown. The central government could take on more spending and debt responsibilities to alleviate the pressure on local governments. More wide-ranging tax reforms could also be considered. To address the struggling property market, we estimate that close to another 700 million square meters of housing inventories need to be absorbed, which would require RMB4trn of funding (3.2% of GDP). This could boost housing sales and household confidence, and help developers finish ongoing projects. But recent plena have fallen short of expectations and this edition may also only provide policy directions in line with the current approach.
- **Germany: penny-pinching on public investments.** Germany needs EUR600bn in additional public investments over the next decade to revive its economic growth. But its latest budget does not even come close despite manageable debt and low interest rates. Public investments fell by as much as -EUR21.7bn in 2023 and private companies are also underinvesting, especially in the manufacturing sector. A 1% decline in the business outlook leads to a reduction in investment activity by -1.8%, while increased economic policy uncertainty results in a significant -17.4% drop. In this context, increasing public investments, reducing economic policy uncertainty and boosting the business environment would go a long way to revive the appetite for private investments as well.
- **French elections: The cost of uncertainty.** With no party winning an absolute majority in the French elections, the battle is on to form the next government before the 2025 draft budget bill is due at the end of September. The most likely scenario remains a moderate/centrist or technocratic minority government, with risks of moderate fiscal slippages. A minority left-wing government is another possibility though it would be more unstable and struggle both politically and legally to deliver on core electorate pledges such as the unwinding of the pension reform or the 14% increase in the minimum wage. We estimate that increased political uncertainty will knock 0.1-0.2pp off France's GDP growth in Q3 and Q4.
- **ECB: More data please.** At the 18 July meeting, we expect the ECB to pause, keeping the deposit rate unchanged at 3.75%, after a controversial initial rate cut in June. We maintain our forecast of another 25bps cut in September as the next batch of inflation and wage data should confirm that disinflation is on track despite some recent upside surprises. Quantitative tightening is set to continue on autopilot, given that the worst-case political outcome in France has been avoided. With fragmentation risks fading, there is no reason to expect an activation of the ECB's Transmission Protection Instrument (TPI) anytime soon.

China's Third Plenum: don't hold your breath

With a slowing economy and geopolitical tensions on the rise, all eyes are on China's long-awaited Third Plenum, scheduled for 15-18 July in Beijing. The meeting of the Central Committee of the Communist Party of China takes place every five years and traditionally reveals the medium-term direction for economic policies and structural reforms. In the statements likely to be issued when the plenum concludes, observers will be looking for clues on how Chinese policymakers intend to revive the slowing economy in the context of rising geopolitical tensions. In particular, recent official statements and high-level meetings suggest that the topics of government finances, the property sector and the new high-quality growth model could be discussed at the plenum. The latter will probably focus on the supply side as usual, with the long-term technology and innovation push in industrial sectors[1]. Below, we look at what measures could be considered to break the negative feedback loop, in which the real estate downturn weighs on local government revenues, which in turn weighs on fiscal expenditure and economic activity, exacerbating the weakness in the housing market.

Government finances: reallocating spending responsibilities between central and local governments and widening the tax base. Local government finances have regularly been a topic of concern in the past decade, with the current concerns revolving around mounting (official and off-balance-sheet) debt and declining fiscal revenues in the context of the real estate slump. Total local government debt has risen from c.60% of GDP in 2019 to more than 70% of GDP in 2023 (with more than two-thirds being off-balance-sheet debt), following the Covid-19 years and the ongoing property sector downturn that started in 2021. Indeed, since 2021, the share of land sales revenue in total local government revenue declined from 30% to 20% in 2023. In this context, top leaders at a key economic meeting in December 2023 said they were considering a "new round of fiscal and tax reforms", sparking hopes that further policy support in that direction could be unveiled with the Third Plenum. In particular, the fiscal responsibilities between the central government and local governments could be restructured: the latest data show that local governments represented 54% of total budgetary revenues in 2023, while accounting for 86% of budgetary expenditure (Figure 1). The central government could thus take on more spending and debt responsibilities to alleviate the pressure on local governments. More wide-ranging tax reforms could also be considered to sustainably improve the revenue structure of local governments, which are currently highly dependent on the property sector.

Figure 1: Local government revenue and expenditure, % of total budgetary revenues and expenditures (respectively)



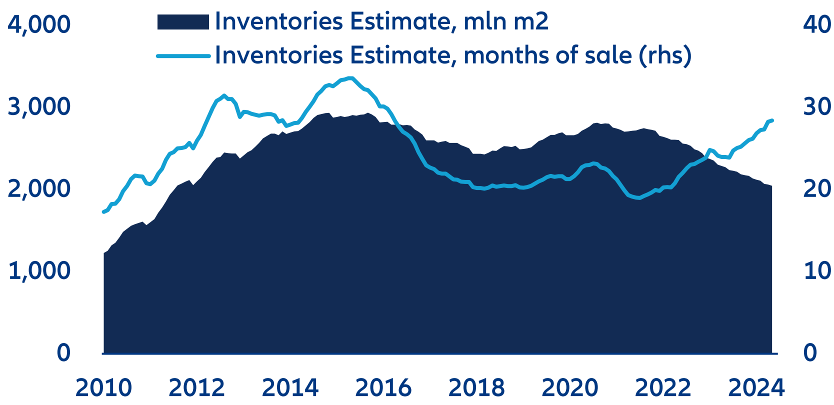
Sources: LSEG Datastream, Allianz Research

The property sector: absorbing housing inventories could cost around RMB4trn (3.2% of GDP). Though initially policy-driven to rein in financial risks related to developers, the crisis is now weighing on the domestic economy, through the sector's links with government finances and its impact on business and consumer confidence. Policymakers have thus put in place several measures to support housing demand and ease financial conditions for healthy real estate developers and white-listed construction projects, including cutting policy rates, removing the

[1] *See our past research on the topic: China: keeping the dragon awake and What to Watch 21 June.*

floor to mortgage rates, easing purchase conditions and restrictions, earmarking bank loans to the real estate sector etc. In particular, the latest support package from mid-May included RMB300bn of cheap loans from the central bank for local governments to purchase existing housing inventory. While this is likely a step in the right direction to support housing demand, stabilize prices and ultimately restore confidence, the scale remains insufficient. We estimate that there are currently up to around 2bn square meters of housing inventories, corresponding to 28 months of sales (Figure 2). Returning to the pre-crisis inventory level of 19 months of sales (in June 2021), based on the current pace of sales, would imply that 677mn square meters of housing inventories will need to be absorbed. Considering the average market housing price and the fact that the government is likely to make the purchases with a discount, absorbing 677mn square meters of housing inventories would require around RMB4trn of funding (3.2% of GDP). A plan of that amount, even spread out over a few years, would provide a boost to housing sales and household confidence and help real estate developers finish ongoing projects.

Figure 2: Housing inventories, in mn square meters and in months of sales



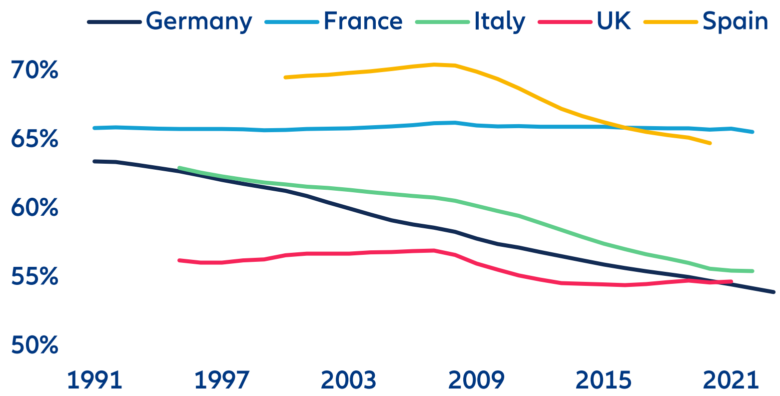
Sources: LSEG Datastream, Allianz Research

Don't hold your breath: The Third Plenum may fall short of expectations by only providing policy directions in line with the current (maybe needed) moderate and gradual approach. Next to watch will be the July Politburo meeting. Historically, third plena have sometimes delivered key policy shifts and reforms, starting with the one in December 1978 that kicked off the "reform and opening". More recent plena were not as impactful. The November 2013 plenum committed to further economic reforms and market-driven resource allocation but implementation later fell short of expectations. The last Third Plenum, in February 2018, did not even focus on economic policy – breaking with tradition. The upcoming Third Plenum is happening around eight months later than expected. Most likely, the statements of this Third Plenum will only provide policy directions in line with the current moderate and gradual approach to managing the economic slowdown. This approach may fall short of expectations of a strong stimulus, but may be necessary in the balancing act between supporting the economy without exacerbating structural risks (e.g. government finances). Concrete implementation plans could be announced in the months that follow the plenum. Next to watch will be the July Politburo meeting towards the end of the month, which will tackle policy measures for the rest of 2024.

Germany: penny-pinching on public investments

Too little, too late? Germany needs EUR600bn in additional public investments over the next decade to revive its economic growth. But its latest budget doesn't even come close. The governing coalition plans a supplementary budget of around EUR11bn for 2024 due to lower potential growth, with total expenditure expected to reach EUR489bn this year, including EUR53bn for investments. In 2025, the budget volume is set at EUR481bn, with EUR57bn earmarked for investments and an additional EUR40bn available through the Climate and Transformation fund and the EEG levy. Despite government debt projected at 64% of GDP in 2024 and 61.8% in 2025 – on average about -25pps lower than that of other Eurozone economies – financing is not a concern for Germany. Interest payments are projected to stay just below 1% of GDP over the next two years, which is -2.3pps lower than the average for peers in the Eurozone, the UK and US. But investments have not significantly contributed to GDP since 2018 and are forecasted to remain subdued until late 2025. The challenge lies in stimulating growth as the projected EUR600bn needed for investments over the next decade[2] has not been budgeted for. The coalition provides EUR23bn in tax breaks for investing companies distributed over 2025 and 2026, subsidies for e-mobility, a reduction in electricity taxes and support for electricity price components. But this will not be enough to revitalize Germany's aging capital stock, which has declined by -10pps over the past two decades (Figure 3), and to drive sustainable growth.

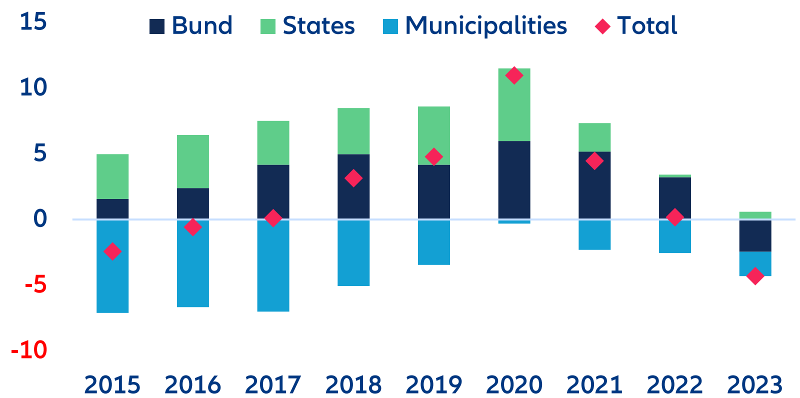
Figure 3: Share of net/gross fixed capital stock in %



Sources: LSGE Datastream, Allianz Research

Since 2004, public investments in Germany have been on a downward trend. This underinvestment has particularly affected public infrastructure such as railways, highways and waterways, with a peak loss of -EUR21.7bn in 2023, leading to deterioration over time. In the budgets for 2023 and 2024, only a small fraction – 2.2% and 2.0% respectively – was allocated to road investments. Rail and public transport fared slightly better with 2.4% in 2023 and 3.8% in 2024, thanks to special funds for Deutsche Bahn. Projections indicate that German public investments are set to be just below 3% of GDP in 2025, the second-lowest among European economies. The fixed investment stock has shown no growth since 2019, not only because of insufficient budget allocations but also a routine underspending of funds, especially at the municipal level where staff shortages have played a role (Figure 4). With net fixed capital formation declining over the past four years, reversing this trend will require more than the government's current plans, and adhering strictly to the debt-break policy is unlikely to help.

Figure 4: Net investments, in EURbn



Sources: LSGE Datastream, Allianz Research

At the same time, uncertainty and the economic downturn are slowing down private investments. The capex-to-depreciation ratio of the 98 largest listed German companies has been decreasing since 2018, indicating declining

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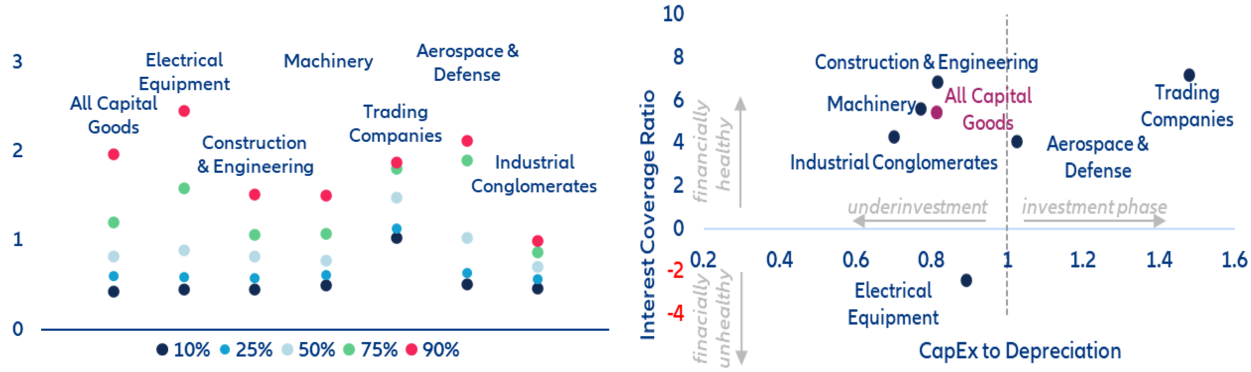
[2] *Dullien, Sebastian, Gerards Iglesias, Simon, Hüther, Michael and Rietzler, Katja (2024). Herausforderungen für die Schuldenbremse. Investitionsbedarfe in der Infrastruktur und für die Transformation, IW-Policy Paper Nr. 2.*

investment activity in assets. This is especially visible in manufacturing, which has been struggling since 2019. While trading companies have increased their investments in assets over the past year, firms in aerospace & defense and electrical equipment, as well as industrial conglomerates, have decreased investment activities. Only companies in machinery, construction and engineering have shown relatively stable investment levels. In 2023, there was a wide disparity in investment patterns among manufacturing companies. The top 10% of companies had a CapEx to depreciation rate of 2, while the median manufacturing company was not even replacing assets that wore out (0.8<1); the bottom 10% was massively underinvesting with a ratio of just 0.4 (Figure 5, left). Despite being financially healthy based on the interest coverage ratio (ICR), German manufacturing companies are investing too little on average (Figure 5, right). The challenging business climate and persistent economic uncertainty have created a negative cycle that is affecting investment decisions. A slight deterioration in the business outlook leads to a decrease of -1.8% in asset investment activity among listed German companies, while a 1% increase in economic policy uncertainty results in a significant -17.4% drop. In this context, increasing public investments, reducing economic policy uncertainty and boosting the business environment would go a long way to revive the appetite for private investments as well.

Figure 5: Distribution of CapEx to depreciation rate for German industrials (left) and median interest coverage ratio to CapEx to depreciation (right) in 2023



Sources: LSGE Datastream, Allianz Research. Notes: Sample of 98 listed German industrial companies; a CapEx to depreciation rate >1 means that industries are in a capital-investment phase or no longer investing in assets if <1. A ratio of 1 means that assets are replaced as they wear out. A lower ICR ratio indicates lower financial health as less operating profits are available to meet interest payments

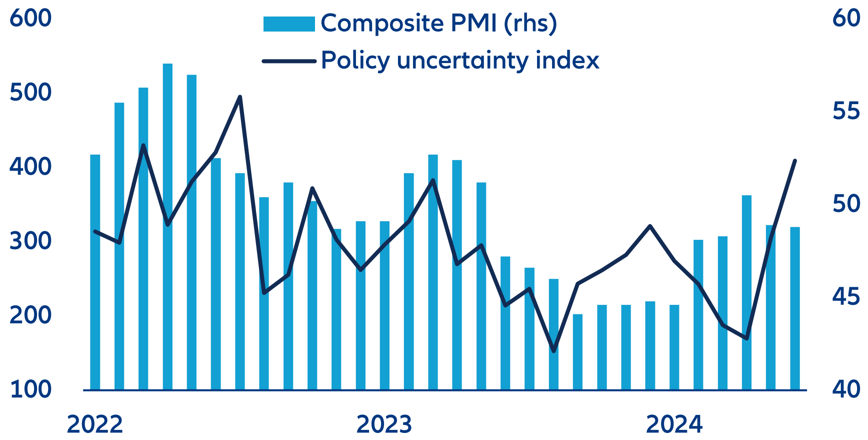
French elections: The cost of uncertainty

With no party winning an absolute majority in the French elections, the battle is on to form the next government before the 2025 draft budget bill is due at the end of September. The most likely scenario remains a moderate/centrist or technocratic minority government. Although it has been the tradition in the Vth Republic (since 1958) to appoint the leader of the biggest group in the National Assembly as Prime Minister (in this case it would be the left-wing Nouveau Front Populaire alliance), we think President Macron is more likely to appoint a centrist or moderate figure who would get the implicit or explicit backing of more MPs. This would make the government inherently more stable than a left-wing one, given the reduced risk of no-confidence motions. The looming deadline is end-September/early-October, when the government must pass its 2025 budget draft bill. Moreover, credit rating agencies will deliver their updated decisions on 11 October (Fitch), 25 October (Moody's) and 29 November (S&P). If the government does not have a budget to show by then, they could put France on the negative watchlist. Risks of a no-confidence motion would increase if the government is forced to push through the budget bill using Article 49.3 to bypass a vote, while missing the hard deadline of 31 December could lead to a government shutdown in 2025 – an outcome never before seen in recent French political history. In case of political gridlock over the budget, the most likely scenario is that the government will enact the previous year's expenditures with decrees (without the President's sign-off) and would eventually get the Parliament's approval to collect taxes.

A minority left-wing government is another possibility, though it would be more unstable. Pushing through electoral pledges such as the unwinding of the pension reform or the 14% increase in the minimum wage would face strong opposition from RN, LR and Ensemble MPs, which would threaten to take down the government. Beyond political opposition, some of the pledges would also be legally difficult to implement: even if the government tried to bypass the Assembly and use decrees to increase the minimum wage or lower the retirement age, the judiciary would likely strike these measures down on the grounds that they do not have funding. This would require the government to find new funds to close the shortfall in the budget bill[3], i.e. through Parliament. We doubt that the RN would agree on raising new taxes and the Parliament would likely reject a budget bill[4] that includes this. President Macron could also refuse to sign off decrees and laws. Third, the Senate would likely stall the process of passing bills. The NFP government would then be compelled to soften its stance to remain in power or be forced to resign.

Increased policy uncertainty will knock 0.1-0.2pp off growth per quarter in the short term. The longer the uncertainty lasts, the higher the negative effects on business investment and consumer spending. An increase in the Economic Policy Index (EPI) tends to have a significant negative effect on GDP growth in the following quarter. Figure 6 shows that the EPI increased substantially in May and in June in the wake of the dissolution of the National Assembly. It has likely increased further in July amid the surprise election outcome. Assuming that it rose by half of what it did in June, and that it remains at this level through September amid continuing uncertainty over policymaking, we estimate that French GDP growth would be cut by around -0.1pp in Q3 2024 and up to -0.2pp in Q4 2024.

Figure 6: France' composite PMI index and policy uncertainty index



Sources: LSGE Datastream, Allianz Research

ECB: More data please

We expect the ECB to pause at its next meeting, before cutting again in September, as more data is needed to confirm the path towards price stability. After a controversial initial cut in June, the ECB is set to take a breather at its next meeting on 18 July, holding the deposit rate at 3.75% (MLF: 4.50%, MRO: 4.25%). In the last meeting, the ECB got a bit ahead of itself by pre-committing too early to a cut despite upside surprises in inflation and wage data that came out shortly before the meeting. Also, upward revisions for inflation from quarterly staff projections (2024: 2.5%, +0.2pp and 2025: 2.2%, +0.2pp) made it difficult for President Lagarde to justify the cut at the last press conference. The ECB is now unlikely to make the same mistake twice. At the annual ECB Forum in Sintra, Lagarde reiterated her mantra that more data is needed to support another cut, and she will most certainly reinforce that message at the next meeting.

The latest inflation print was reassuring but not convincing. Inflation in the Eurozone inched down from 2.6% y/y to 2.5% in June but core inflation stayed put at 3.0%. Prices in the services sector are still rising strongly (4.1% y/y or 6.0% m/m annualized and seasonally adjusted). They now account for the largest contribution to headline inflation, followed by food and goods. The drag from energy thanks to negative base effects has faded completely (Figure 7). Wage growth reaccelerated to 4.2% y/y in June, according to the monthly Indeed wage tracker, which provides a more frequent and up-to-date picture than the official quarterly series. But households are not spending their

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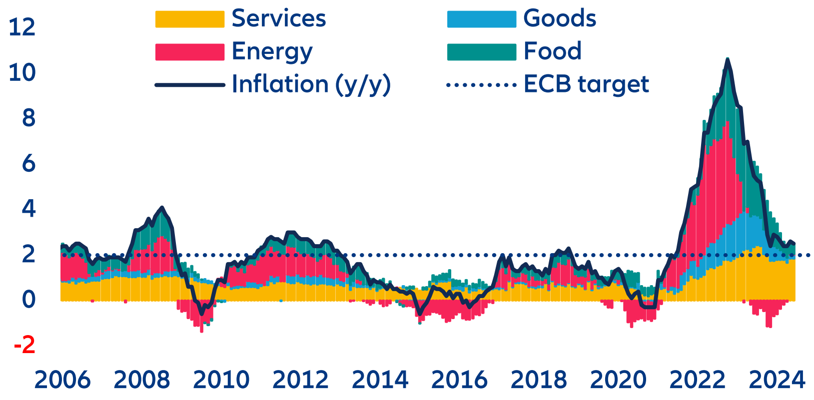
[3] More precisely, in the Social Security bill associated with the budget bill.

[4] Another hurdle to lower the retirement age by decree is that the NFP government would need to ask the Constitutional Council to rule that the retirement age passed in the 2023 reform should not have been written in the law.

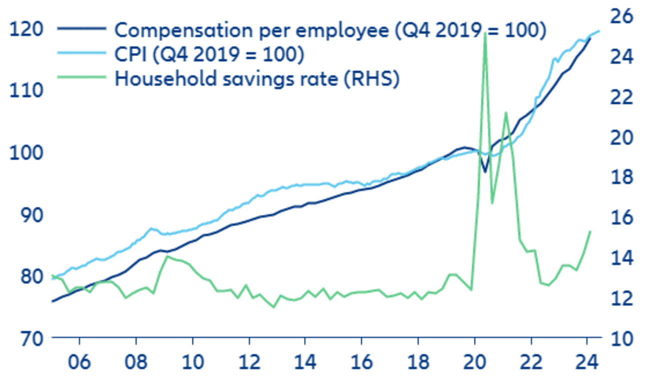
additional euros but choose to save them instead (Figure 8). This is most likely caused by a combination of increasing precautionary savings amid geopolitical uncertainty and eroded purchasing power due to the significant decreases in real income after years of high inflation. While lower consumption demand despite rising wages is good news for inflation, it is bad news for economic growth.

Figure 7: Eurozone headline inflation and contributions by subcomponent, in %



Sources: LSEG Datastream, Allianz Research

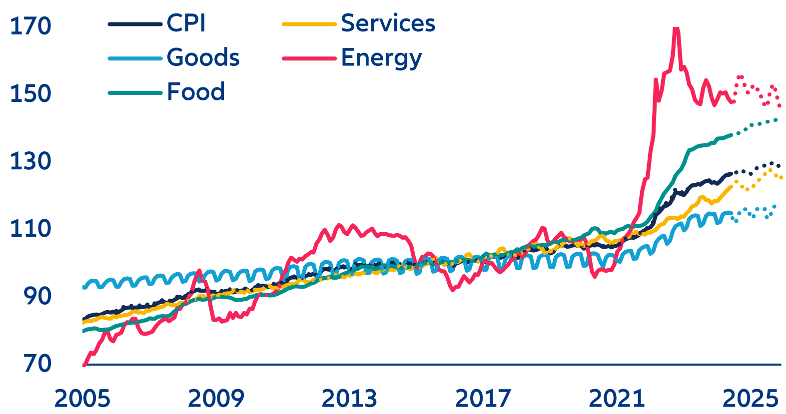
Figure 8: Eurozone nominal wages and CPI (index) and household savings rate (%)



Sources: LSEG Datastream, Allianz Research

The lingering deviation among inflation components suggests there could still be some surprises on the last mile. The four main subcomponents of CPI (goods, services, food and energy) are cointegrated, which implies they should not deviate too much from each other in the long run. Figure 9 shows our forecast for each of these four components, as well as the resulting headline CPI, which from 2025 onwards is set to grow by 2%, in line with consensus forecasts. However, this would mean that the price levels of the four components will remain significantly dispersed compared to the last decades. This raises the question of whether it is possible that energy prices are some 30% higher than those of services, when in the past the maximum deviation was around +-10%. Anecdotally speaking, can restaurants (services) afford to raise their prices by only 10%, for example, if electricity bills (energy) and ingredients (food) have risen by much more? Similar lagged catch-up effects can be observed in the insurance business (see Allianz Global Insurance Report 2024). While history is often not a reliable predictor of the future, if past patterns hold, the effort to bring these components closer together could result in unexpected inflation outcomes. If service prices rise sharply to close the gap with energy and food, headline inflation could exceed expectations. Conversely, if geopolitical tensions ease or a recession occurs, energy costs might drop more than anticipated, reducing the dispersion but leading to lower-than-expected headline inflation. The bottom line is that inflation forecasting still carries a high degree of uncertainty even though we are seemingly on the last mile.

Figure 9: Eurozone CPI and subcomponents, index (2015=100)



Sources: LSEG Datastream, Allianz Research
Notes: Dotted lines show Allianz Research forecasts.

Nevertheless, we continue to expect one more cut in September, maintaining our long-held view of two rate cuts in 2024 followed by four more cuts in 2025. In September, the ECB will have one more round of quarterly wage data and two more inflation prints at hand. We expect these to confirm the outlook of ongoing disinflation, thereby supporting another rate cut from still highly restrictive policy rate levels. Headline inflation will likely touch or even undershoot the inflation target of 2% in the coming months, thanks to favorable base effects giving additional support to a cut. After September, we expect the ECB to remain on hold as base effects will become unfavorable again, raising public opinion pressure. Also, the risk of an increasing transatlantic policy divergence will force the ECB to postpone the easing cycle until the Fed follows suit (Figure 10). [5] Four more rate cuts in 2025 will lead to a terminal rate of 2.5% which assumes a real neutral rate of around 0.5%. At the same time, quantitative tightening will remain on autopilot. As the worst-case scenario of political outcomes in France has been avoided, and Eurozone fragmentation risks are dissipating again, there is no reason to expect the ECB to revert to quantitative easing via its TIP tool for the foreseeable future.[6]

[5] *See 2024_04_11_what_to_watch.pdf (allianz.com) for what a policy divergence would mean for the euro and Eurozone inflation.*

[6] *See our recent analysis of potential market outcomes after the French election 2024_06_28_what_to_watch.pdf (allianz.com)*

These assessments are, as always, subject to the disclaimer provided below.