14 Dec 2021

Research Briefing | Eurozone

Easing supply bottlenecks to bolster industrial rebound

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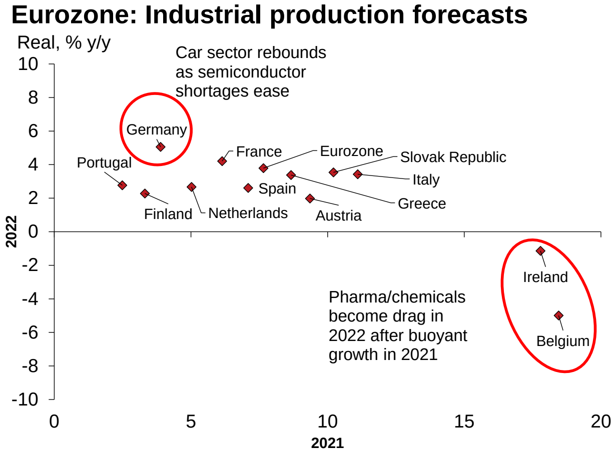
- **The easing of the severe supply-chain bottlenecks that brought the eurozone's industrial recovery to a standstill in early 2021 will be gradual, with setbacks along the way very possible. But we see signs that the worst is over and we expect eurozone industrial production to grow a strong 4% in 2022. This year's laggards – Germany and the auto sector – are likely to outperform.**
- **The clearest indication of easing is in the supply of intermediate goods, where clogging due to the massive restocking cycle and hoarding of inputs is fading. Progress in vaccinating the global factory workforce suggests that the drag from Covid-related supply disruptions should begin to fade.**
- **Resolving the semiconductor shortage, where an upshift in demand has coincided with severe supply constraints, may take longer. A budding rebound in car production and guidance from automakers suggest that we are past the trough. But chip supply may be more limited than expected, which would weigh heavily on carmakers and their suppliers.**
- **We think the current slowdown in factory orders reflects a fading impetus from the inventory cycle and delayed orders in the face of lengthy delivery times. But we forecast strong growth in global goods demand next year. And with a mountain of backlogs accumulated in recent months and disbursements from the EU recovery fund ramping up, the outlook for production looks strong.**
- **Renewed virus-related disruptions remain a downside risk. Firms may also hesitate to raise output and capex due to low visibility on underlying demand trends, risking extended or temporarily amplified supply-demand imbalances. But we also see some upside should bottlenecks fade faster than expected and robust demand growth prompt cash-rich corporates to invest.**

Figure 1: German industry lagged its peers in 2021, but easing supply bottlenecks should bolster the outlook for 2022

Eurozone: Industrial production forecasts



Source: Oxford Economics/Haver Analytics

Germany's industrial sector was a clear laggard among its European peers in 2021, as a shortage of semiconductors weighed heavily on the car sector and its suppliers. But supply bottlenecks should ease, bolstering the region's industrial sector in 2022 and leading to German industry outperforming.

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Easing supply bottlenecks to bolster industrial rebound

Supply bottlenecks have likely peaked

Supply bottlenecks severely undermined the rebound in eurozone industry this year. The ifo institute put the drag on German GDP growth in 2021 conservatively at over 1ppt of GDP. Admittedly, German industry was hit especially hard by the bottlenecks, given its dependence on the automotive sector where nearly all firms suffered from shortages in early Q4. Nonetheless, the impact of scarcities was rife, not least on carmaker suppliers, bringing the industrial recovery to a standstill in early-2021 (**Figures 2** and **3**).

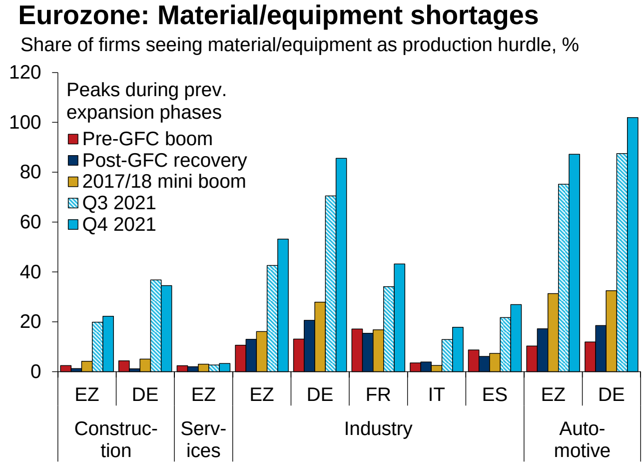
However, we see growing signs that supply bottlenecks are easing. True, we only expect gradual improvement and see risks skewed to the downside; nonetheless, the signals support our baseline view that industrial production will pick up in the coming quarters, bolstering the wider recovery. We think it is useful to distinguish three distinct but mutually reinforcing factors that caused the bottlenecks:

Overwhelming demand: The demand-supply imbalances that often mark the early stages of an economic upcycle offer the clearest signs of easing. The rebound in underlying demand since the trough of last year was amplified by a massive restocking cycle and increased hoarding of inputs as shortages began to broaden. This triggered the strongest and most synchronous surge in factory orders on record for eurozone industry, overwhelming supply. But demand is now slowing as restocking has progressed, and firms have ramped up output. This has led to a marked improvement in intermediate goods makers' assessment of their finished goods inventories, which will ease generalized bottlenecks in upstream sectors (**Figures 4** and **5**).

Disrupted global supply chains: Covid- and weather-related production cuts wreaked havoc on supply chains this year. But our global research indicates a broad if somewhat tentative turnaround is underway (see here for related global, US, and Asia research). For instance, Asian manufacturing hubs have ramped up output as infection waves slowed and vaccination campaigns picked up speed. This rise in production has lifted the global manufacturing output PMI to a four-months high in November after soft readings over the summer. Over time, this should improve the availability of key, internationally sourced inputs.

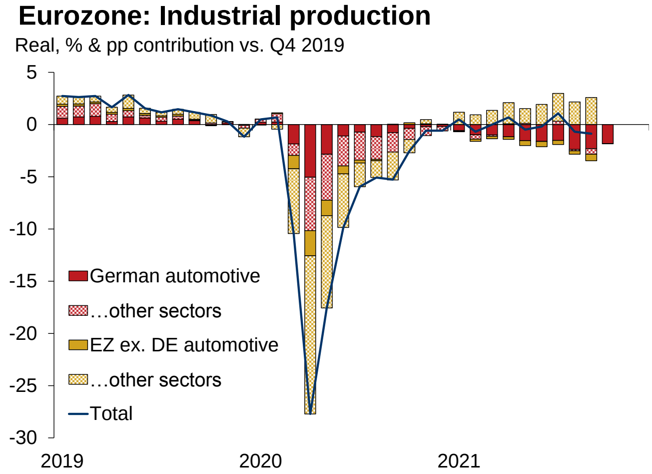
Transportation bottlenecks: Global transport networks fell out of synch due to the simultaneous resurgence in demand amid stop-and-go supply patterns. European transport networks have generally been less clogged than those in

Figure 2: A record number of firms suffered from material or equipment shortages in Q4



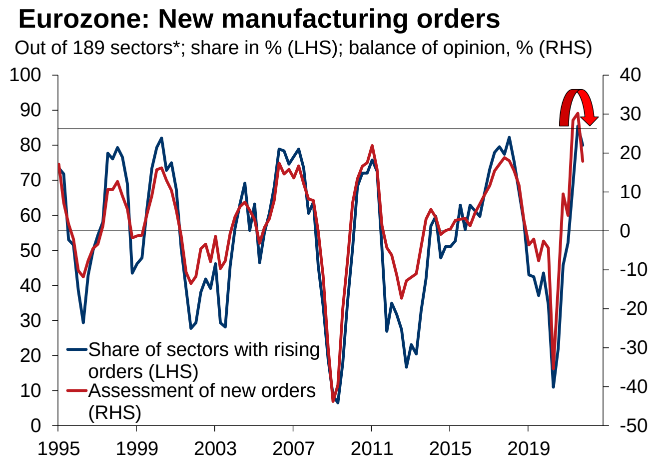
Source: Oxford Economics/Haver Analytics

Figure 3: Eurozone industry's recovery stalled in 2021 as German car production plunged



Source: Oxford Economics/Haver Analytics

Figure 4: Strongest and broadest rebound in factory orders on record is now easing



Source: Oxford Economics/Haver Analytics (*data from ESI survey for 22 manufacturing sectors in largest 9 eurozone countries, where available) the US. For instance, less than a fifth of Swiss industrial firms mention regional or global logistics as an issue, which should be relatively representative of the rest of Europe (**Figure 11**). Recently, moderating container transport costs also suggest an easing. Still, it will likely take some time until the strain from restocking fully fades.

Semiconductor shortages: The particularly pernicious scarcity in chips was the key reason for the deep plunge in car production throughout this year. The shortage was due to both buoyant demand and disrupted supply, but we think that the recent rise in German car production marks a turning point (**Figures 6** and **13**). That said, the number of German automotive firms affected by material shortages remained extremely high in November. What's more, strong demand in other sectors is likely to keep semiconductor supply tight for a while, as it takes time to ramp up production capacities. So, we assume only a gradual improvement in carmakers' chip supplies over the course of H1 2022. The tight supply will hold back carmakers' demand for other intermediate goods.

Strong outlook for production growth in 2022

An easing in supply bottlenecks is the first pillar of our forecast of strong industrial production growth next year. This should allow previously constrained firms to begin working off the mountain of backlogs that they accumulated (**Figure 7**). In many sectors, this is more about sustaining high output given limited spare capacity, but there should be a material lift to activity in the automotive industry where bottlenecks pushed firms' capacity utilisation well below average (**Figure 12**).

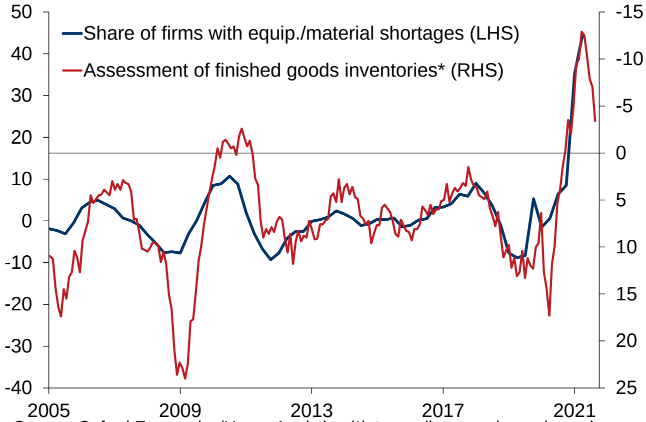
The second pillar is that we also expect strong gains in foreign demand next year of about 5% y/y after this year's 11% jump, as we see the global economy continuing to grow at an above-average pace (**Figure 8**).

The third pillar is a pickup in investment. For one, corporate investment should pick up strongly, given sustained elevated capacity-utilisation levels, easing uncertainty, and this year's lacklustre rebound, with the latter likely in part due to the bottlenecks. Indeed, firms' capex plans for 2022 are at record highs, with firms having some catching up to do after two weak years (**Figure 9**). In addition, we expect government investment to grow at the fastest pace on record as countries begin deploying the funds from the EU recovery fund (**Figure 14**).

Figure 5: Material shortages could ease fast as restocking has made a lot of progress

Eurozone: Manufacturing (ESI survey)

y/y change, pp, 2Q lag (LHS); Balance of opinion, % (RHS, inverted)

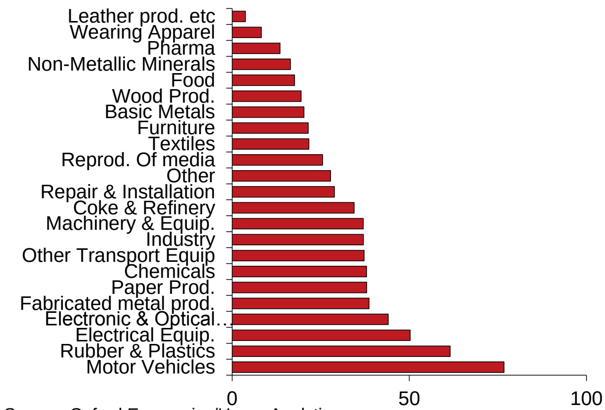


Source: Oxford Economics/Haver Analytics (*intermediate goods producers)

Figure 6: Automotive sector looks most affected by bottlenecks that aren't purely demand driven

Eurozone: Severity of supply shortages

pp chg. in share of firms reporting material/equip. shortages that is not explained by order book dynamics, based on ESI survey data, Q4'21



Source: Oxford Economics/Haver Analytics

Figure 7: Order backlogs are extremely high by historic standards, especially for carmakers

Eurozone: Assessment of order backlog (ESI)

Balance of opinion, %

Source: Oxford Economics/Haver Analytics

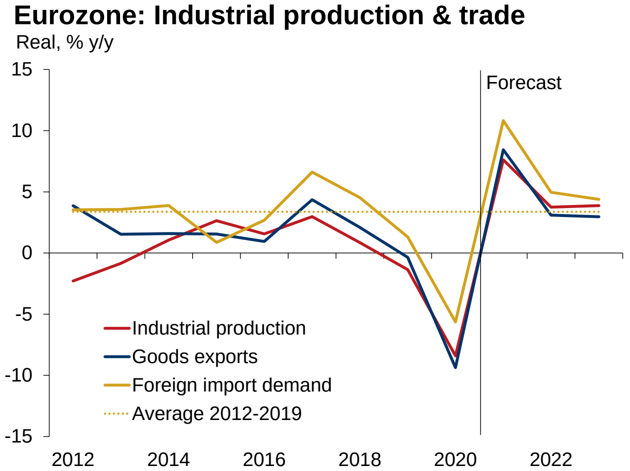
Overall, this backdrop bolsters the outlook foremost for countries and sectors that suffered the most under supply bottlenecks this year and that are closely tied into global supply chains. In particular, Germany and the automotive sector should outperform the eurozone average after having been the laggards in 2021. Whereas we project eurozone industrial production growth slowing to 3.7% in 2022 from 7.6% this year, we expect a pickup in Germany to 5.1% growth in industrial production after this year's disappointing 3.9% rise (**Figures 1** and **10**). But we also forecast strong industrial production growth in most other countries, with the exception of Ireland and Belgium. There, the chemical and pharma sector saw outsized gains in 2021 that we expect to be partially reversed.

We see some upside risks, but the balance is still to the downside

Renewed virus-related disruptions remain a key downside risk. We have recently cut our near-term GDP growth outlook due to the renewed restrictions in some eurozone countries and toned down the Q1 2022 forecast due to the potential impact of an Omicron wave. However, should a future Omicron wave trigger renewed lockdowns, this could easily cause a return of severe supply-chain disruptions. In such a scenario, GDP could be 2% and industrial production 2.5% lower than in our baseline in 2022 (**Figure 15**).

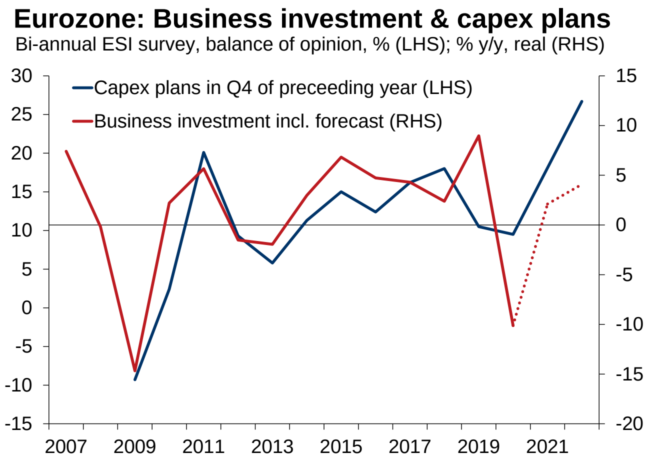
We also see a chance that firms may hesitate to ramp up output and capex due to low visibility of underlying demand trends. Indeed, there is an unusual disconnect in recent surveys between improving production expectations among capital goods producers and an easing among producers of intermediate goods amid a renewed rise in uncertainty (**Figure 16**). This mismatch risks extending or temporarily amplifying supply-demand imbalances. German factory orders also slowed significantly recently, although we think that is due to easing restocking needs and some delays in orders amid long delivery times rather than due to the industrial cycle ending. Another risk is that governments' ambitious investment agenda could be delayed as worsening labour shortages constrain capacity in the near term. However, we also see some potential upside risks. Should bottlenecks fade faster than expected, then the production recovery could be more front-loaded. And given the investment needs from the digital and green transitions, we could see a more sustained capex cycle, one that is jumpstarted by fiscal policy.

Figure 8: Foreign demand growth to continue to exceed pre-pandemic pace in 2022 and 2023



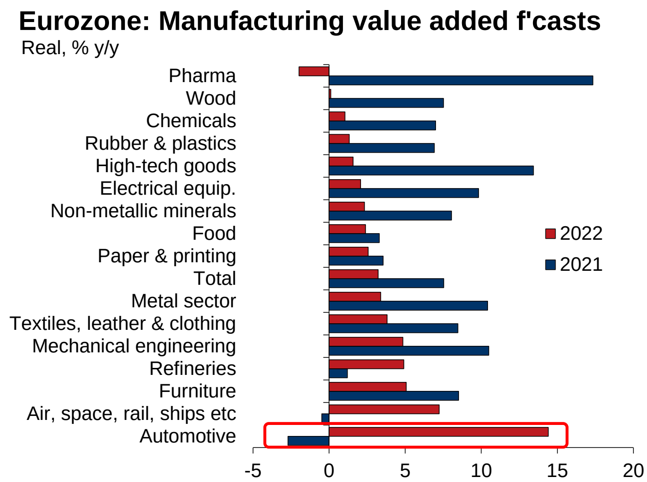
Source: Oxford Economics/Haver Analytics

Figure 9: Record number of firms plan ramp-up in investment next year after disappointing 2021



Source: Oxford Economics/EU Commission

Figure 10: Production rebound in auto sector clearly stands out within manufacturing



Source: Oxford Economics/Haver Analytics

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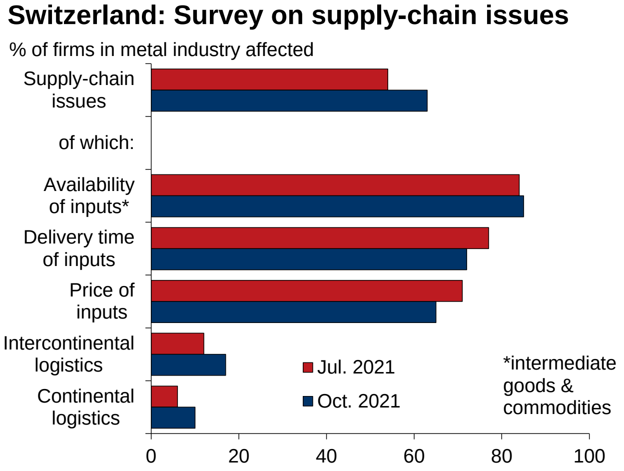
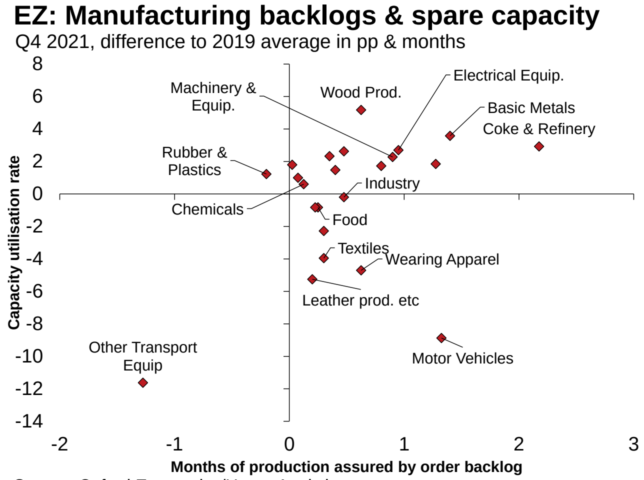
Figure 11: In Europe bottlenecks appear to have been mostly about inputs, not logistics



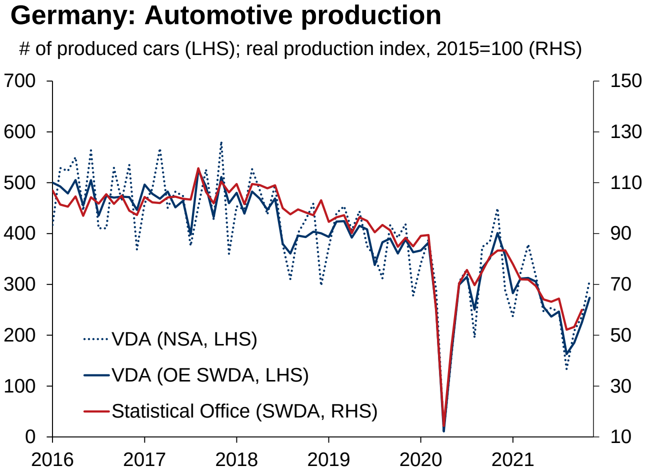
Source: Oxford Economics/BAK Swissmechanic Wirtschaftsbarometer

Figure 12: Only the auto sector has significant spare capacity to quickly tackle backlogs



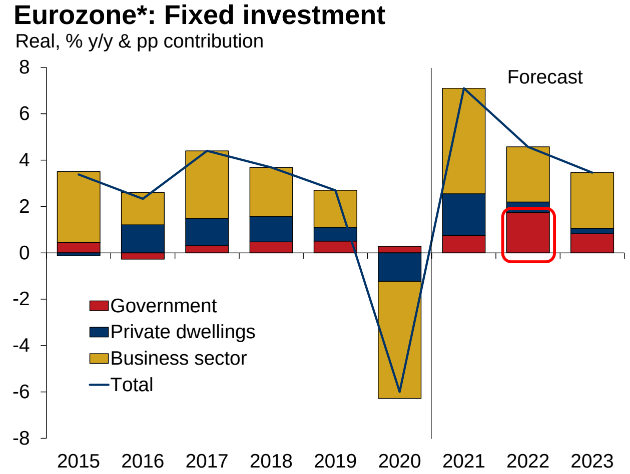
Source: Oxford Economics/Haver Analytics

Figure 13: Rebound in car production signals tentative easing in semiconductor shortages



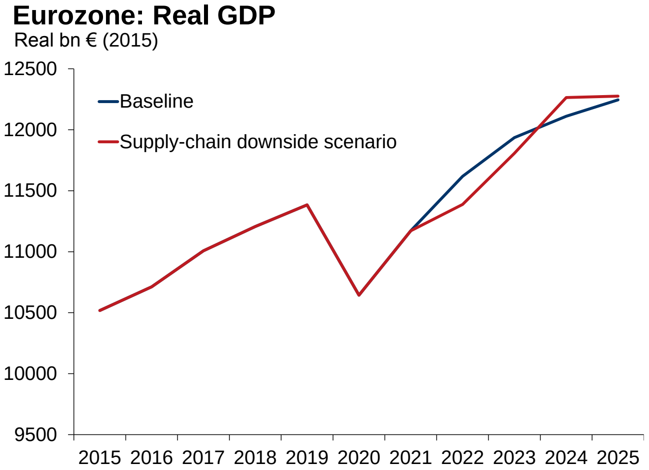
Source : Oxford Economics/Haver Analytics

Figure 14: Imlementation of EU recovery fund projects is expected to boost investment



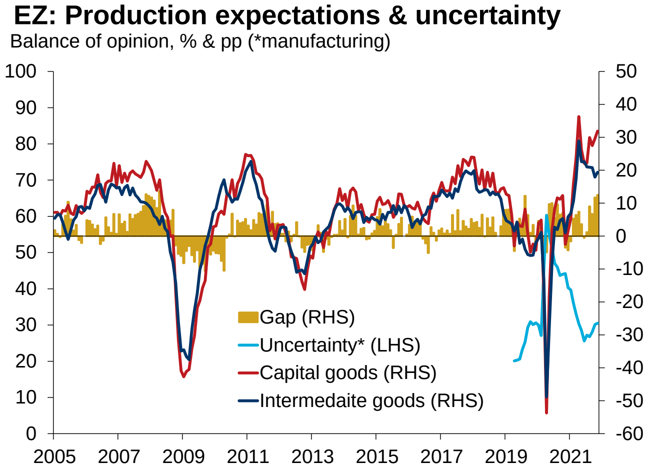
Source: Oxford Economics/Haver Analytics (*excl. Ireland)

Figure 15: New supply-chain disruptions could knock 2ppt off of 2022 GDP growth



Source: Oxford Economics/Haver Analytics

Figure 16: Are intermediate goods producers underestimating clients' demand strength?



Source: Oxford Economics/Haver Analytics

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