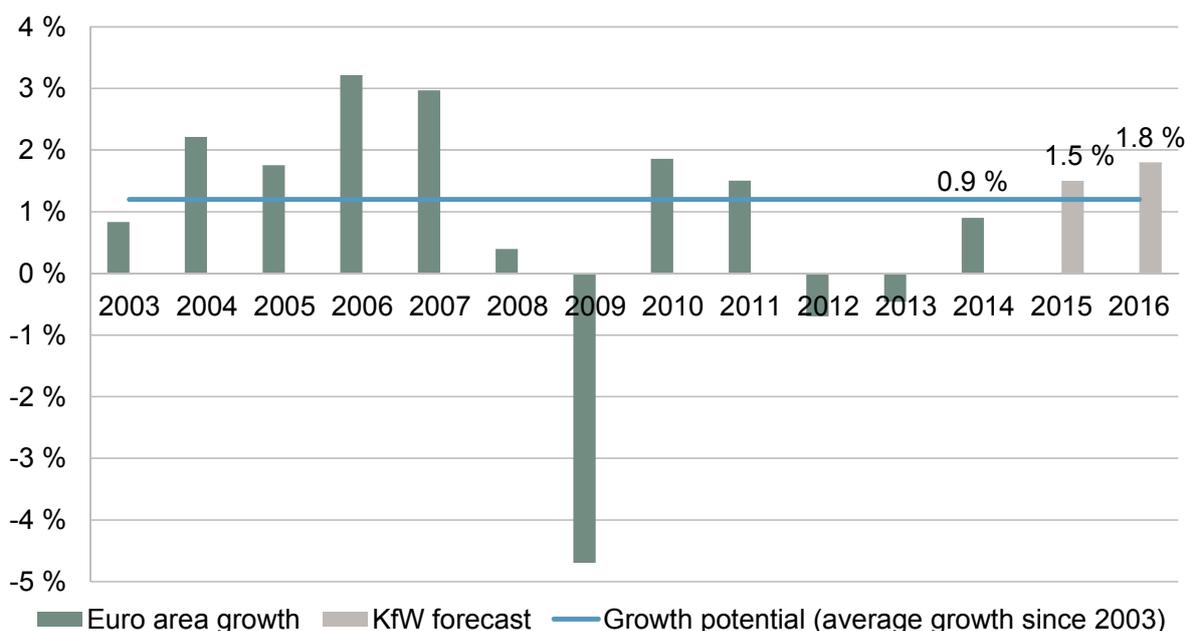


KfW Business Cycle Compass Eurozone

The 'two' is within reach

- *Euro area remains on previous growth path after the third quarter (forecast for 2015: 1.5%).*
- *KfW Research continues to expect the pace of growth to pick up slightly, reaching 1.8% in 2016.*
- *Monetary and fiscal policy are providing impetus; improvements to the labour markets and the banking system create opportunities for the start of a self-sustaining recovery.*
- *Further progress in reducing unemployment is urgently needed; more flexibility in Europe's economies remains important*

Growth of real gross domestic product of the euro area



Source: AMECO, KfW Research

KfW's economic forecast: more growth, little by little

Last summer production in the European Monetary Union (EMU) increased by 0.3% on the previous quarter (adjusted for price and seasonal effects), which was in line with our expectations. We also assume that the minor decline in economic momentum since the start of the year will not continue. The persistently good sentiment captured in surveys among both consumers and enterprises supports our view. For 2015 we therefore continue to forecast price-adjusted gross domestic product (GDP) to expand by 1.5%. For the year ahead we see the

pace of growth to accelerate for the fourth time in a row to 1.8%. The increasing convergence of economic cycles between the important economies of the euro area (Germany, France, Italy, Spain) is also encouraging.

Monetary policy impetus reaches real economy

Despite this progress, the long phase of weakness has not been overcome yet. Euro area output remains below potential owing to lack of demand. That is the backdrop for the ECB's expansive policy which, following the decision in favour of a comprehensive bond purchase programme a year ago, has now adopted further easing measures. The monetary policy impetus is reaching the real economy along two major pathways. First, the EMU is gaining price competitiveness through the induced depreciation of the euro. This primarily benefits countries with quite rigid labour markets and price-sensitive export goods, such as Italy and France. It has enabled exports from the EMU to remain relatively strong in an environment of weak global trade. Second, banks have revived their lending to European enterprises. New lending to non-financial corporations has returned to strong growth rates of some 10%. While on the demand side low interest rates make borrowing attractive, on the supply side the implementation of higher capital requirements by the regulator should now be largely completed. The EMU will still benefit from these favourable monetary conditions next year.

Fiscal policy is no longer restrictive

Following the severe consolidation, fiscal policy in 2015 was neutral. Next year it should have a supporting effect for the first time since 2010. Based on the autumn forecast of the EU Commission, a fiscal impetus of 0.3% of GDP is to be expected (change of the cyclically adjusted primary balance). To a limited extent, additional expenditure will be required to manage the refugee influx and the fight against terrorism. From a stabilisation policy perspective, the fiscal expansion will be at least adequate for the euro area but the existing institutional framework of the EMU continues to leave public budgets little scope for action.

Improvement on the labour markets bolsters consumption

Consumption remains the most important driver of growth. Next year real incomes will not benefit from falling energy prices as they did this year but the positive effect on demand should persist to some extent after the turn of the year. More important for a lasting improvement of the consumption climate will be a continuous reduction in the unemployment rate, particularly in Spain, Ireland and Italy. People's willingness to spend should rise as job security improves. It will be of paramount importance to quickly move the reduction in unemployment, given its (unacceptably) high current level, into the focus of economic policy so as to strengthen social cohesion and political stability in the EMU's member states. Relying on growth alone will not be sufficient; it should be supported by pushing ahead with the flexibilisation of European labour markets. That would also improve EMU's shock resistance.

Political risks predominate

The risks to our forecast are primarily of a political nature. The threat of terrorism and geopolitical conflicts outside Europe's borders are a cause for concern. The long list of European controversies is no less relevant either. The debates over the further institutional development of the euro area, reforms in the programme countries and potential departures from the EU now include the challenge of managing refugee migration as a matter of urgency.

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