››› Investment is making a comeback in the euro area

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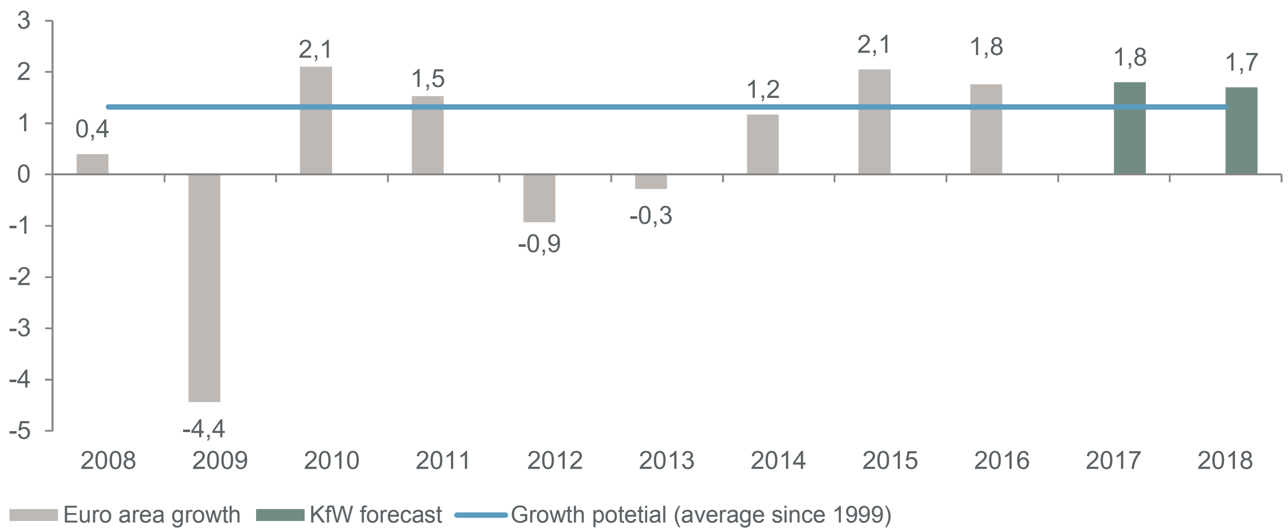
- KfW Research lifts euro area growth forecast: +1.8 % for 2017 (previous forecast +1.6 %); growth should continue at a similar pace in 2018: +1.7 %
- There are no signs the upswing might wane any time soon; business confidence is on the highest level of the past six years
- Revival of investment activity creates second pillar of growth
- After the elections in autumn, a time window will open to restart the stalling reform process in the euro area

Economic growth in the euro area

Real gross domestic product, per cent variation on previous year



Sources: Eurostat, KfW Research

A successful start to the year

The European economy is continuing to make good progress. In the final estimate, first-quarter GDP growth was even revised upward slightly to 0.6 %. That was in line with our expectations. Although the momentum remained only moderate in a historic comparison, the euro area nevertheless overtook the United States and the United Kingdom. Apart from the stability of the upswing, it is also broad-based across the region. Production picked up at decent to good rates in all economies. Italy in particular surprised by doubling its growth rate (+0.4 %), matching that of France (+0.4 %). Spain remained the uncontested growth champion (+0.8 %), with Germany close behind (+0.6 %).

Trend reversal in investment is increasingly likely

We have been sceptical whether investment may join private consumption to become the second pillar of European growth this year already. But the past three months have seen mounting signs that businesses are becoming more willing to invest. First, investment contributed 0.3 percentage points to euro area growth in the past quarter. Investment gained considerable momentum in Germany (+3.4 %), Spain (+2.0 %) and France (+1.2 %). Admittedly, Italy posted a drop (-0.8 %). In the face of above-average performance in the preceding half-year, this is most likely to be a correction. Second, the extraordinarily high business confidence in Europe has solidified. Measured by the purchasing managers' index, confidence levels had already surged upward in the first quarter. In April and May businesses reported further improvements to their business situation, which is reportedly better than it has been in the past six years. Third, industrial capacity appears to be increasingly stretched. The last time a higher level of utilisation was achieved was in 2008. And our KfW Research Business Cycle Clock also shows that the output gap, defined as the difference between actual economic output and production potential, is closing further. Fourth, the political risks in Europe have been vanishing since the elections in spring. Neither in France nor in the Netherlands were Eurosceptics able to make inroads. Taken together, these developments have brightened the investment climate. We therefore expect European business managers to gradually take more courage and take advantage of the good borrowing conditions to modernise and expand their capital stock.

Growth forecast revised upward, but without euphoria

That is why we have raised our growth forecasts for the Eurozone. We now expect a growth rate of 1.8 % this year and 1.7 % next year (previous forecasts were 1.6 % for both years). The high confidence levels alone would definitely justify even more optimism. So far, however, the available hard data indicate no fundamental increase in the rate of growth. Industrial output in Europe stagnated in the first quarter, for example. The decline in unemployment is continuing but not accelerating. Since real wage growth has been dampened by the energy price-induced rise in inflation in 2017, private consumption – which is still the most important pillar of Europe's upswing – cannot be expected to make higher growth contributions at this time.

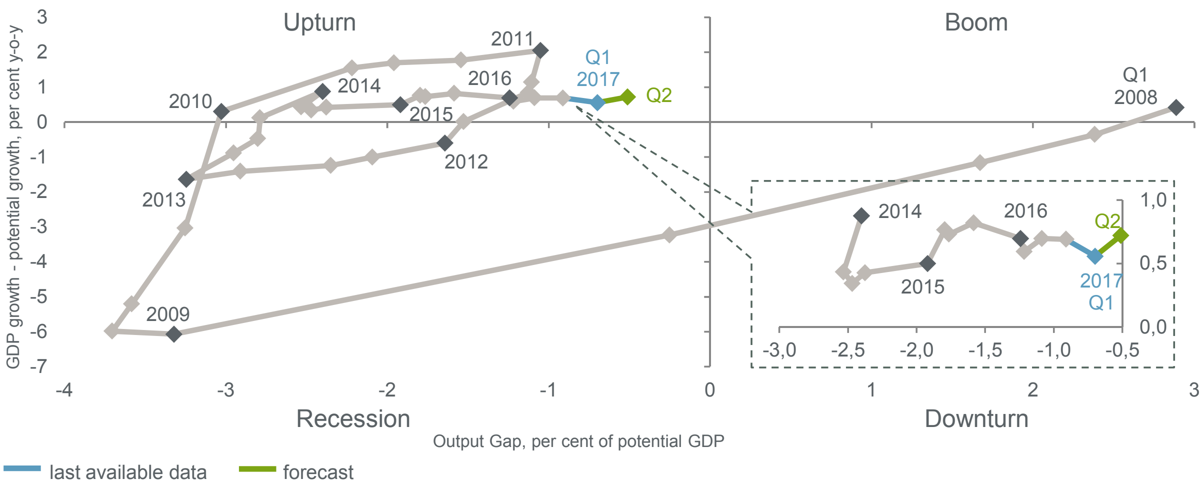
With protectionism and Euroscepticism lurking, downward risks remain high

The upswing in Europe is entering its fourth year and growth rates are decidedly stable. Nevertheless, political developments may arise that could derail what appears to be a robust upswing. The United States' withdrawal from the climate change agreement shows that isolationist ideas remain on the table there. Negative surprises in US trade policy therefore cannot be ruled out in the medium term. After the UK elections the focus in Europe is likely to shift increasingly to Brexit. Although an agreement is in the interest of all, especially the UK, tough talks must be expected that may create uncertainty time and again, even if the cyclical risk to the euro area remains limited for the foreseeable future. Finally, the situation in Italy remains worrying. The banking system is creaking under the strain of high volumes of non-performing loans that can be disposed of only slowly. New elections are also scheduled, with the risk of Eurosceptical parties reaching a majority. As the reform of the electoral law is taking shape, early elections in autumn 2017 are now likely.

Synchronised electoral cycle opens up opportunities

Apart from downward risks, however, we definitely see good chances that the European economy will grow more strongly than we now forecast. There is an inherent risk to an early election in Italy, but it would also have the appeal that France, Germany and Italy would start a new legislative period almost in synchrony. Together with the economic recovery and new awareness of the importance of the EU in a world where uncertainty factors abound, that will open a time window to restart the institutional reform of the euro area. If tangible progress that strengthens the foundation of the currency union in a sustainable way then becomes apparent, the investment momentum should pick up even more amid the already positive sentiment. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research