KfW Research
KfW Business Cycle Compass Eurozone

››› Investment shows signs of life

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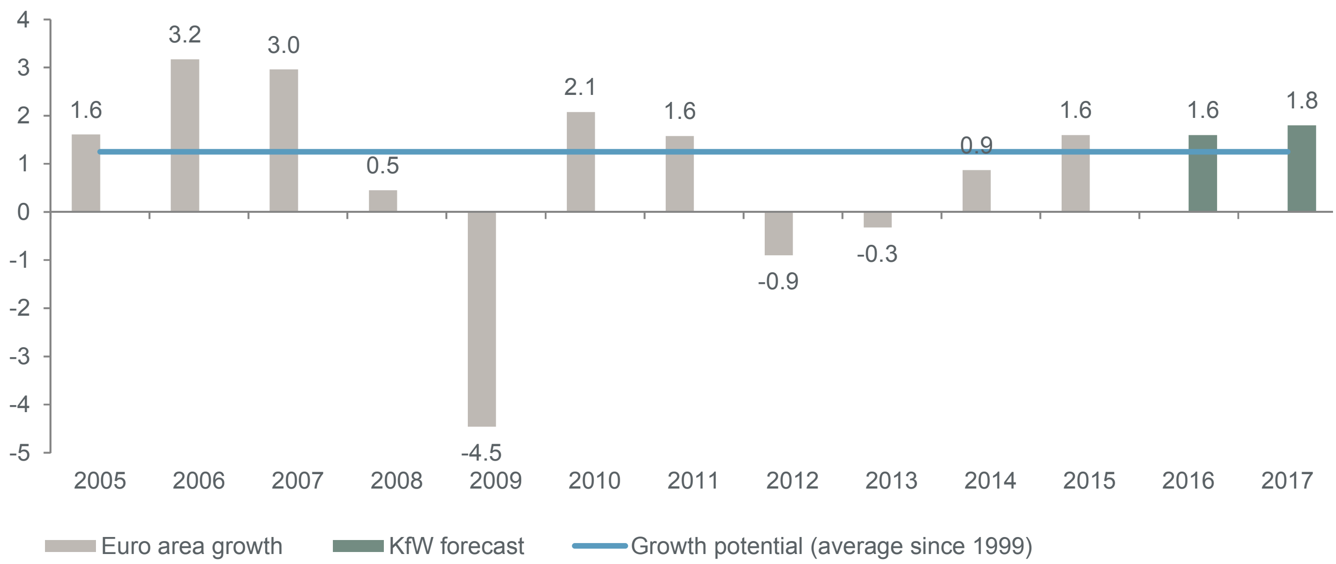
- KfW Research confirms its real gross domestic product growth forecast for the euro area of +1.6 % in 2016 and +1.8 % in 2017
- The euro area started the year with surprisingly strong quarter-on-quarter growth of 0.6 %, driven not only by private consumption but also by investment.
- High pace will not continue; growth will slow temporarily in the second quarter
- In the short term, a pro-Brexit vote is the main risk to the economy in the currency region; in order to reduce further downward risks, Europe must take one step further from crisis containment to crisis resolution

Economic growth in the euro area

Real gross domestic product in per cent



Source: Eurostat, KfW Research

Euro area is off to a good start

The strong first-quarter 2016 growth in the euro area was a positive surprise. The financial market turmoil at the start of the year nurtured expectations of weaker momentum. But this concern turned out to be unfounded. On the contrary, seasonally adjusted real gross domestic product grew by 0.6 % in the first quarter. That rate was not just double the growth of the previous quarter, but also more than in the UK (+0.4 %) and the USA (+0.2 %).

Domestic demand remains strong despite uncertainty

Domestic demand clearly remains the driver of the upswing. Concern over the performance of the emerging market economies and some European banks does not appear to have left a strong impression on consumers or investors, unlike the financial markets. As in the past year, private consumption is proving to be a reliable pillar. Sustained by the gradual improvement of the labour market, private consumption increased by a sound +0.6 %.

In order to place the euro area recovery on a stable foundation, however, the investment restraint that has persisted since the financial market crisis must come to an end. Gross fixed capital formation is still not significantly higher than in late 2010. In this regard, the currency union is lagging far behind the USA, where investment activity has increased by more than 20 % and returned to pre-crisis levels during the same period. So it is all the more important that slightly stronger investment growth of +0.8 % is now discernible in the second consecutive quarter.

The chances for European businesses to continue their urgent expansion and renewal of capital stock are fundamentally good since enterprises can reap the benefits of a favourable financing environment and continuing economic recovery. Capacity utilisation is approaching the peak level achieved after the financial crisis. And although the European Commission's economic surveys show that European manufacturers have been less content since the start of the year, they have received enough orders to secure production for the next 3.8 months – the longest time since the establishment of the currency union.

In the difficult economic environment, the 0.4 % export growth was unable to keep pace with imports, which increased by 0.7 %. External trade reduced growth by a total of 0.1 percentage points.

High initial growth pace cannot be maintained – growth forecast reaffirmed

Despite the encouragingly strong first quarter, we see no cause for euphoria and maintain our previous growth forecast of 1.6 % for 2016 and 1.8 % for 2017. The fundamental growth momentum is probably weaker than the good start to the year suggested. We expect the second quarter in particular to see slower growth before the pace picks up again in the second half of the year. For one thing, the mild weather conditions of the past winter led to higher than normal economic activity, particularly in the construction industry. For another, after a strong January industrial output in the euro area was down significantly across two consecutive months – a liability for the start to the new quarter. This is in line with the slight drop in confidence among European purchase managers, which also suggests a slower pace of growth. In addition, the UK referendum on the Brexit and the June elections in Spain are again causing major political uncertainty.

Convergence is increasing, but there are warning signs ahead

The latest crisis has illustrated that, in the existing institutional framework of the euro area without significant fiscal equalisation mechanisms, economic convergence among the member states is of crucial importance for the medium-term stability of the single currency area. Sufficiently synchronous economic cycles reduce the economic-policy target conflicts among the member states. It is therefore encouraging to see the progress that can be observed since 2010 confirmed again at the start of the year. The pace of growth in all four major euro countries either remained steady or accelerated, with Germany expanding by 0.7 %, France by 0.6 %, Spain by 0.8 % and Italy by 0.3 %. Their growth patterns were also similar, as investment activity increased in all four countries, although much more strongly in Germany and France than in Spain and Italy.

There are further warning signs that economic development may drift apart once again. A glance at the most recent ECB data on the dynamics of loans to non-financial corporations shows this. While credit exposures to larger enterprises are growing in France (+4.5 % on the previous year) and Germany (+3.5 %), the recovery on the credit markets in Spain (-1.5 %) and Italy (-1.9 %) is stagnating. If these trends solidify, the challenges for the single monetary policy will grow further.

Europe is engaging in crisis containment, not resolution

There are other downward risks to our economic forecast besides the threat of increasing economic divergence. The way Europe is handling economic and political crises is one particular risk. While crises are being successfully contained, they are usually not fundamentally overcome. This is true of issues as diverse as the Greek debt crisis, refugee migration and the high volume of non-performing loans in parts of the European banking system. None of these problems has been conclusively resolved. That turns them into latent risks that hamper economic activity by creating uncertainty, and may potentially compromise the economic recovery in a significant manner if they become acute. In the weeks ahead, however, the UK's vote on continuing membership of the European Union will be the main focus of attention. A British vote to leave the EU would weigh heavily on the recovery of the Euro area. ■