Euro area economy defies political risks

7 March 2017

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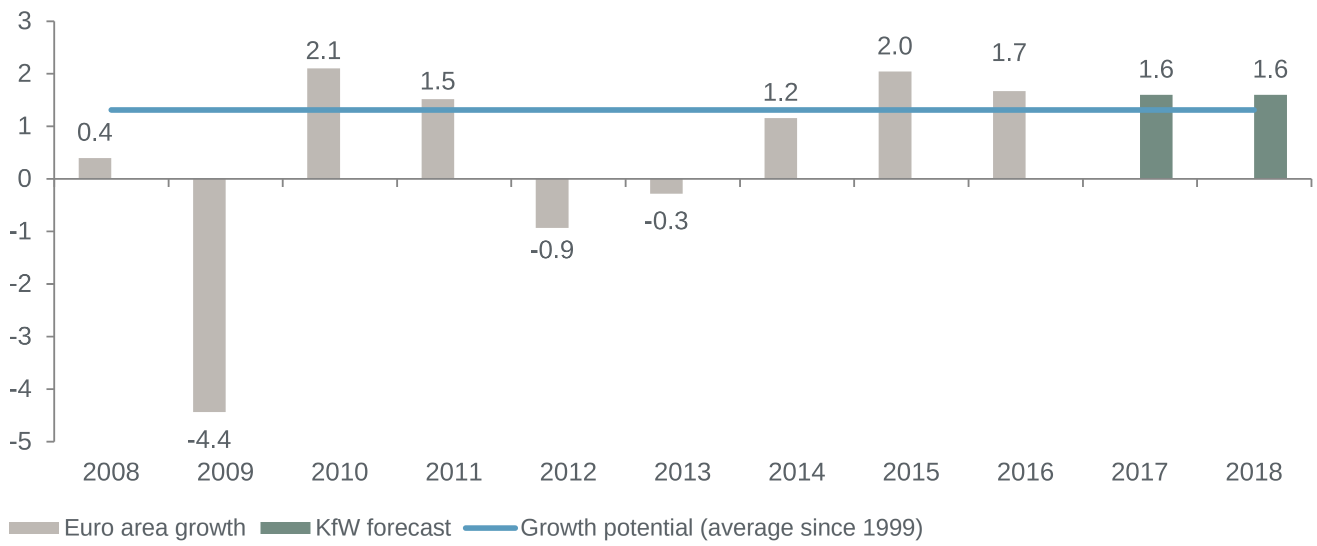
- KfW Research raises euro area growth forecast slightly: +1.6 % for 2017 (previous forecast +1.5 %); growth should continue at the same pace in 2018: +1.6 % (initial forecast)
- Increased political risks are not yet putting any major pressure on the business cycle; but activity cannot really take off in this environment
- Very high business confidence levels indicate strong start to the year 2017; output gap might almost close this year
- Growth could turn out weaker; eurosceptic forces are expanding their influence, making political consensus harder and slowing the reform process

Economic growth in the euro area

Real gross domestic product, growth year over year in per cent



Sources: Eurostat, KfW Research

Private consumption grew more strongly in 2016 than investment

With GDP growth of 0.4 % in the final quarter, the euro area closed the year 2016 with similar success as the year before. Full-year growth was 1.7 %, with private consumption again being the main driver. Investment, on the other hand, particularly business investment in equipment and machinery, remained on a low level. This is likely due in part to last year's events, the most prominent of which was the Brexit. The popular vote of the UK to leave the EU, heightened Euro-scepticism in many regions and banking problems towards the end of the year failed to nurture a good investment climate in 2016.

Moderate response to political events

Nonetheless, growth last year was actually 0.1 percentage points higher than we expected in early 2016. This was due to the measured response to unexpected events, both in financial markets and in the real economy. As was the case following the Brexit, market stakeholders also responded prudently to the resignation of the Italian government, for instance. Even if investments increased at a moderate pace only, the sharp drop feared by some failed to come about.

However, there is no doubt that political developments in the euro area and beyond are putting the brakes on the business cycle. While growth is continuing on a good level, business activity in the euro area cannot really take off amid all the uncertainty. This way, pent-up consumption and investment spending which was put on hold in several countries, some of which have been in recession for a number of years, cannot come back.

Into 2017: full steam ahead

Several economic indicators improved towards the end of 2016 and the euro area economy started the year 2017 with momentum. Industrial production is on a post-financial crisis high, and so is the value of orders received. Capacity utilisation is higher than the long-term average and business confidence, measured by the purchasing managers' index, for example, has improved significantly. Companies rated their business situation very positively particularly in the first two months of the year. Their confidence levels are currently on a six-year high.

Against this background, we expect a very successful first quarter in which growth could be 0.6 % compared to the previous quarter. Growth should then slow in the further course of the year. Political risks in particular continue to hamper economic activity. The tone is set for fiery Brexit negotiations, causing uncertainty in the business community, the direction of US trade policy is unclear and crucial European elections are on the calendar. In several countries, an exit from the euro or the EU will be demanded in these elections by parties that do not have to worry about seats in parliament but can at least hope for participation in government. The potentially far-reaching consequences of the elections are causing businesses to exercise restraint at this stage. We therefore expect no lasting upswing in investment spending for the time being. In 2017 growth should be on a similar level overall as last year, at 1.6 %. Should major political upheavals and nationalist reversals fail to emerge, we expect growth to continue on the level of 1.6 % for 2018 as well.

Output gap is closing further

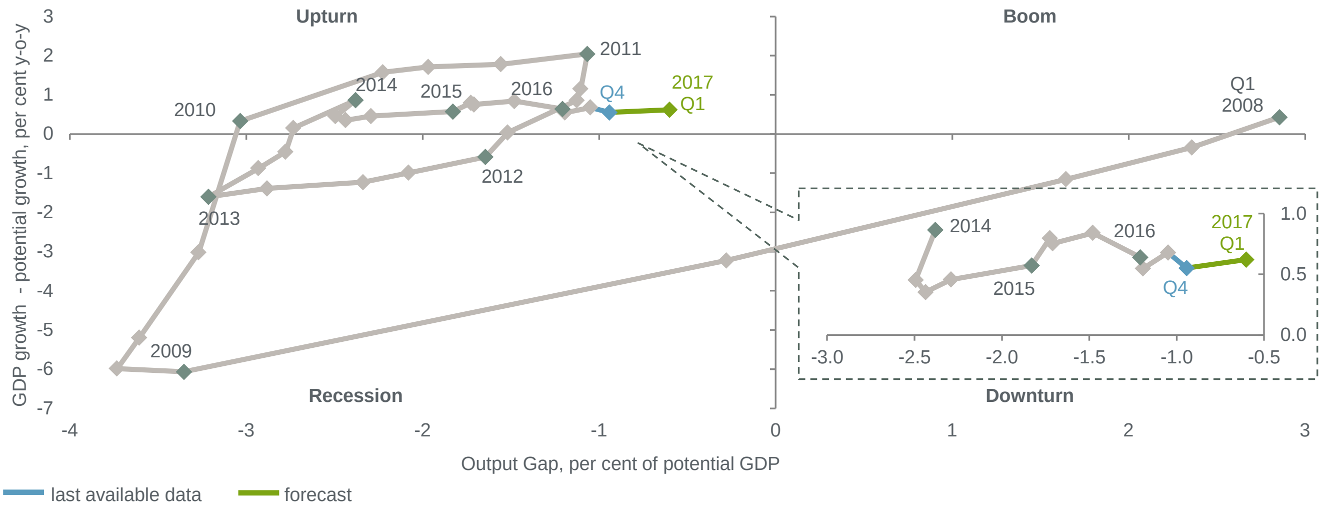
The euro area is now in its fourth consecutive year of recovery. The upswing before the financial crisis essentially lasted for five years. However, the economy is currently growing at a slower pace. Real GDP grew by 12.5 % overall between 2003 and 2008, but only by a good 6 % since 2013. Our KfW Research Business Cycle Clock shows: the economy boomed at the beginning of 2008. The output gap, that is, actual economic output in relation to potential GDP at normal capacity utilisation, was clearly positive (see figure). The picture was different at the end of 2016, when the output gap remained negative. Thus, the growth levels so far achieved should be understood primarily as a recovery from the severe financial and euro crisis. Unemployment remains at nearly 10 %. Finally, however, based on the strong start to the year 2017, the output gap might almost close – for the first time in nine years.

Forecast assumptions are mostly optimistic

In none of this year's elections – in the Netherlands, France and Germany – does our baseline scenario envision anti-European parties forming government. Surveys in France see the Front National ahead in the first round of elections but still give the party hardly a chance in the run-off. In Italy elections will take place by spring 2018 at the latest. Here, eurocriticism is spread out across broad sections of the party landscape. Even if the risk of an exit from the EU fails to materialise, future national policies are likely to become more critical of the Union – not only in Italy. This will make both the cooperation between the states and the reform course of national governments more difficult. After all, the eurosceptic forces often take positions that are opposed to those of established parties in other policy areas as well, such as labour market or fiscal policy. The recent widening in euro area sovereign bond yield spreads illustrates the concerns in this regard in the capital market.

If the eurosceptic parties achieve a result that is significantly lower than expected on the basis of current surveys, thereby removing policy obstacles to growth, positive surprises are also possible. An increase in investment spending in particular could create the conditions for a self-sustaining upswing. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research