Despite financial market volatility, the euro area recovery remains on track

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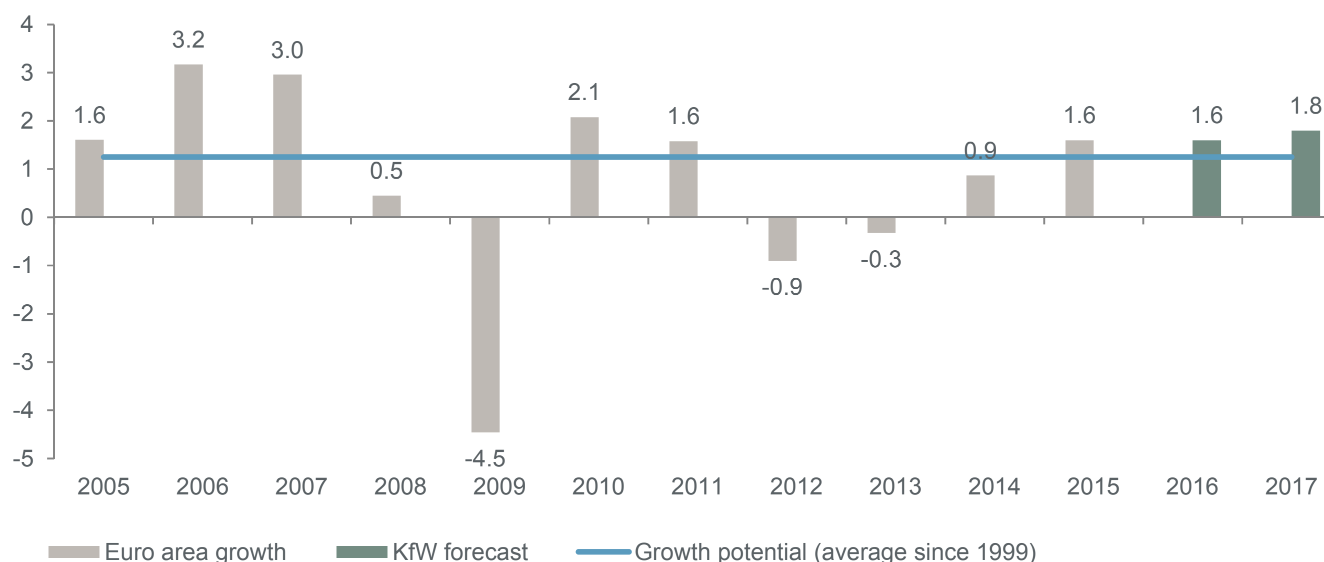
Author: Philipp Ehmer, +49 69 7431-6197, philipp.ehmer@kfw.de
Press contact: Christine Volk, +49 69 7431 3867, christine.volk@kfw.de

- KfW Research lowers forecast for 2016 to +1.6 % (previously: +1.8 %); for 2017 we expect euro area real GDP growth of 1.8 %
- Private consumption continues to drive growth while investment is held back by uncertainties
- Financial market turmoil is one of the main risks to the economy this year

Economic growth in the euro area

Real gross domestic product in per cent



Source: Eurostat, KfW Research

Private consumption is driving growth

In the fourth quarter of 2015, seasonally adjusted euro area GDP grew by 0.3 % on the previous quarter, continuing the growth momentum from the summer. Across the year 2015, GDP was up 1.6 %. That was the highest rate since 2011 and it was also distributed broadly across the member states last year, with Greece being the only country unable to achieve real growth. Convergence across the euro area has thus increased.

Last year private consumption was one of the main growth drivers. It was supported by increases in real incomes resulting from low energy prices and by a gradual decline in unemployment. Investment also contributed to growth but languished because of businesses' continued restraint. Public expenditure provided slight impetus in 2015 while foreign trade gave hardly any.

We expect the recovery to continue throughout the year. In view of the bumpy start to the year on the financial markets and the current economic downturn in some emerging economies, we have adjusted our previous forecast for 2016 downward slightly from +1.8 to +1.6 %. For 2017 we expect price-adjusted GDP in the euro area to grow by 1.8 %.

Financial market turmoil is only a moderate burden on the real economy

The currently very high volatility on the financial markets will probably affect the euro area real economy only moderately. Several banks were recently forced into the defensive for various reasons. Investors' concerns include a possible collapse of Chinese economic growth, excessive burdens from non-performing loans and the impact of the new Bank Re-

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.

covery and Resolution Directive (BRRD) on banks' default risks.

In our opinion, the banking sector in the euro area is well capitalised though and the abundant ECB liquidity provides a buffer against distortions on the financial markets. Established market indicators support this view. It is true that premiums for loan loss insurance for debtors in the banking sector have significantly increased since the start of the year. However, corresponding indexes for European banks such as the iTraxx Senior Financials are still considerably below the 2012 level and far below the levels of the year 2008. We therefore do not believe there is cause for expecting an acute credit crunch and, hence, there is no reason for making a sharper correction to our forecast.

Gloom is more whinging than an economic trend reversal

Coinciding with the financial market turmoil, sentiment in the real economy has darkened. Both the Economic Sentiment Indicator surveyed by the EU Commission and the Purchasing Manager's Index provided by Markit dropped significantly in the first two months of the year, with the Purchasing Manager's Index falling to a 13-month low. However, both indicators are still in a range that shows economic growth.

Hard economic indicators are no major cause for concern either. Although industrial production dropped at the end of 2015, the level of incoming orders in the manufacturing sector remained stable. Capacity utilisation even increased to 82 % in early 2016, climbing back to the highest post-financial crisis level achieved in 2011.

The recovery is on track and domestic demand is driving growth

Private consumption will remain the key growth driver in the euro area this year. Reasons for this include consumers' pent-up demand following recently weak economic development. This applies to Italy, in particular, where a three-year recession just ended in 2015. We also expect further moderate increases in employment and impetus from the oil price that will raise real incomes, at least during the first half of the year.

Investment activity continues to be hampered by major uncertainties. Some of these are of economic origin, such as the extent of major emerging economies' weak performance and the turmoil on the financial markets. Other disruptions come from European policy issues, such as a possible Brexit and a lack of political stability in some euro member states. However, the favourable financing environment and ongoing economic recovery partly offset these uncertainties. As a result, investment could replace private consumption as the primary growth driver in 2017.

Public expenditure will likely provide some impetus to growth, not least as a result of additional government spending on the integration of refugees. The downturn in China and other resources-exporting emerging economies is limiting the growth of exports. At the same time, the euro area's recovery is leading to rising imports, so foreign trade on balance is not expected to provide any impetus.

Downward risks predominate

A better-than-expected development could come from a higher pace of employment growth or a decline in the restraint of corporate investors. However, we believe a significantly higher risk exists that the situation will develop less positively than we anticipate.

In addition to political imponderables and the cooling of some emerging economies, we consider the recent developments on the financial markets to be a particular downside risk to our forecast. The events shortly before and after the turn of the year in parts of the Italian and German banking market illustrated how critically investors are questioning the resilience of financial institutions. The enduring low interest rate environment has been putting persistent downward pressure on their profitability. As customers are able to replace increasingly larger portions of loans they took out on old terms with more favourable new financing offers, banks are losing more and more revenue potential the longer interest rates remain at the current low level.

The combination of slowing Chinese growth, the Federal Reserve's more persistent than expected wait-and-see attitude and the expansive monetary policy course in other currency areas could prompt the ECB to implement an even more expansive monetary policy this year. Particularly in light of weaker inflation data recently reported for the euro area and a euro exchange rate that has appreciated by 5 % against the main partner currencies since December 2015, the ECB can be expected to place its main focus on stabilising inflation while accepting some banks' reduced profitability. Therefore, the situation of the financial institutions with regard to interest income is unlikely to improve for the time being. As mentioned above, we do not expect this to turn into an acute threat to the economy – although that could change in future should other parameters deteriorate. ■