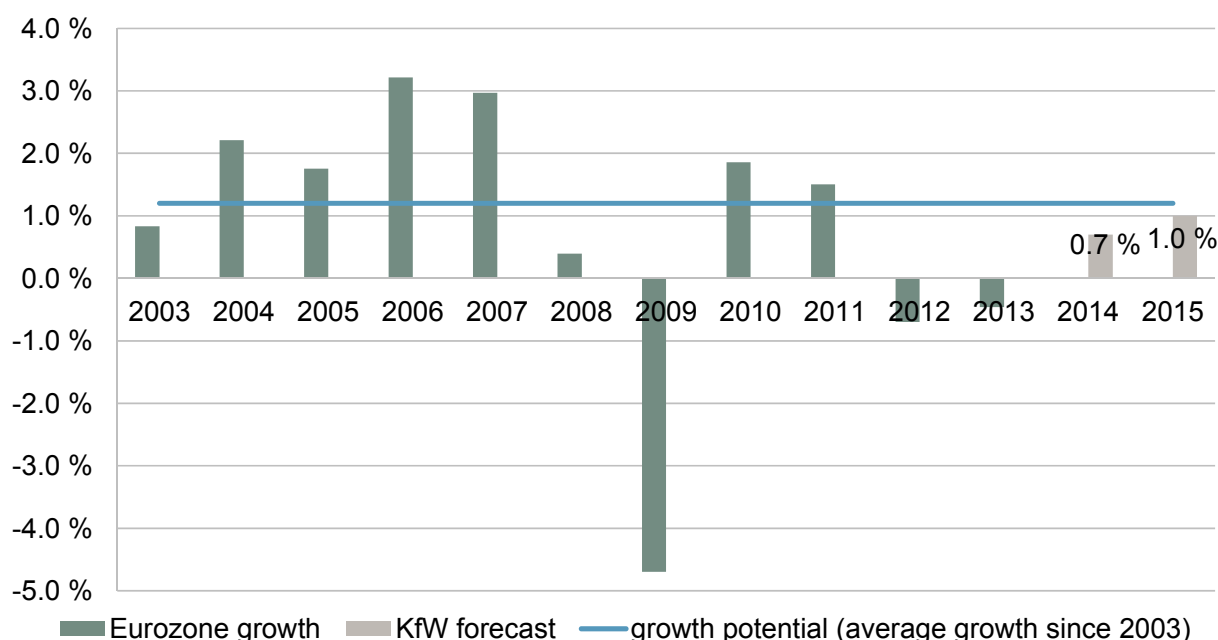


KfW Business Cycle Compass Eurozone: October 2014

Eurozone economy: few signs of life

- *KfW is forecasting weak growth of 0.7% for 2014 (price-adjusted).*
- *The eurozone stagnated in the second quarter of 2014, with only private consumption and exports making any positive contribution. The second half of the year will be tough, too.*
- *KfW anticipates 1.0% growth for 2015, although the downside risks will prevail.*

Growth of real gross domestic product in the eurozone



Sources: AMECO, KfW Research

Stagnation in the second quarter: lack of investment suppresses growth

The economy of the eurozone was trading water in spring. Gross domestic product (GDP)¹ growth was 0.0% in the second quarter of 2014, compared with the previous quarter, after +0.2% at the start of the year. Private consumption and exports made a slightly positive contribution to growth, while it was suppressed by gross fixed capital formation and changes in inventories. Public expenditure remained growth neutral. The production side shows that gross value added declined in both manufacturing (-0.4%) and construction (-1.8%).

¹ Unless otherwise specified, information on GDP and its components refers to figures adjusted for price, seasonal and calendar effects.

Looking ahead: KfW forecast for 2014 and 2015

Private households and the export sector will prevent a relapse into recession in the second half of the year. While retail sales declined at the start of the third quarter, new car registrations continue to exhibit robust dynamics. The weaker euro will also provide positive impetus for export growth. This requires monetary policy to remain expansionary. There is a danger that a bond purchase programme is already factored in. The disappointment on the foreign exchange markets about an overly-tentative approach by the ECB could therefore lead to a severe setback.

If the sentiment picks up again, we expect a slightly positive contribution to growth from corporate investment towards year-end. Capacity utilisation is slowly reaching its long-term average too, so that we could soon see the first tentative investments in expansion. Fewer projects are failing due to financing problems than in recent years – many banks are increasingly better equipped. However, the balance sheet adjustments in the European banking sector are not yet completed. The European economy would benefit if the need for additional equity were quickly clarified.

At present, key additional impulses for the current economy as well as for the eurozone's long-term potential can only come from the public sector. In order to raise the long-term growth trend, many countries will ultimately have to create reliable and forward-looking frameworks for investments in innovation, modernisation, education, as well as in research and development. There is a danger that some of the necessary measures could burden rather than promote growth in the short term. The structural reforms should therefore protect disposable income, especially in the lower to middle-income groups. Where there is room for manoeuvre, higher public expenditure can replace the lack of demand. Political consensus in Germany stipulates that a balanced budget takes priority, even against the background of demographic development.

A combination of intelligent structural reforms, more public investment and a weak euro would prompt us to revise our forecast upwards. However, this has only been discussed to date; specific measures are not yet known and therefore not yet included in the forecast either. Nonetheless, we assume that France's European partners will at least share the budgetary policy direction.

France and Italy burden the eurozone, Spain's contribution is positive.

France, Italy and Spain, together with Germany, account for more than three-quarters of the eurozone's GDP. Developments in these countries therefore have a significant influence on growth in the currency union. Economic output in France and Italy is predicted to merely stagnate up to year-end, given the current mix of monetary, wage and fiscal policy. The focus in Paris should be on measures for improving price competitiveness, and in Rome for increasing productivity. Spain is making a positive contribution to eurozone growth. It remains to be seen to what extent this is down to pent-up demand after the severe recession. The long-term growth potential of the reform states in the periphery is likely to remain below the growth rates achieved at present.

Considerable downside risks remain: anxious glances towards the East

The downside risks prevail at present for our forecast; sources of growth are lacking. The realignment of business with Russia in many companies may lead to additional negative surprises. Expectations of the ECB are growing against the background of the discussion in Europe about the direction of economic policy and difficult economic policy coordination. Hence, the debate about the ECB's correct monetary policy for Europe and the member state's appropriate fiscal policy for Europe is likely to continue, as long as there are few signs of life from the eurozone.

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