

»» Economy is navigating through calmer waters amid looming political shockwaves

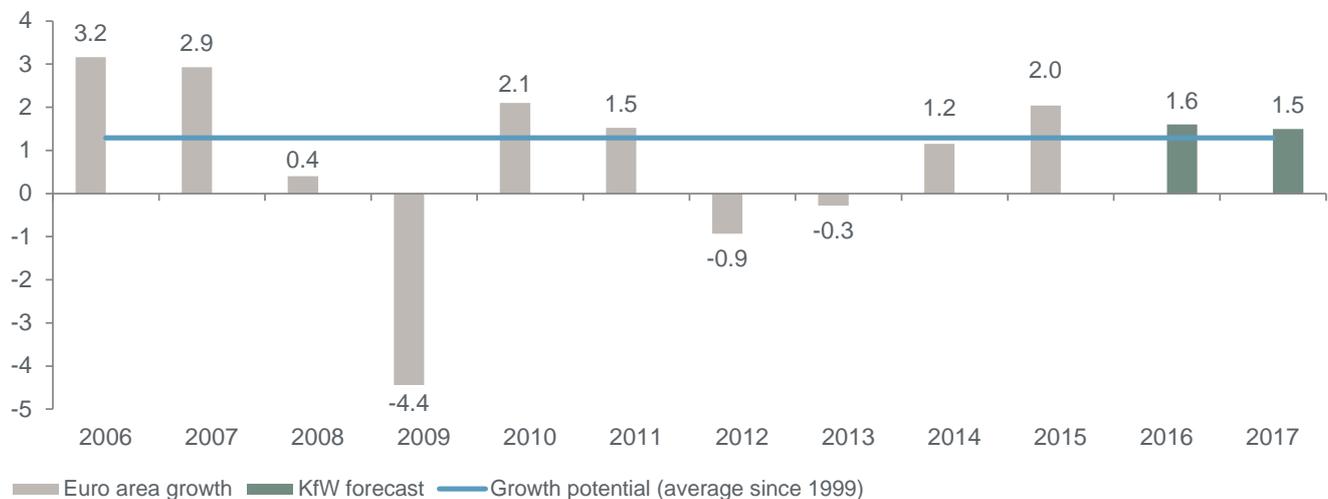
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- Euro area growth continued in the third quarter with remarkable consistency – despite disturbances from financial markets and politics.
- KfW Research revises its growth forecast for the euro area slightly upwards: +1.6% in 2016, +1.5% in 2017 (previous forecasts: +1.5% and +1.4%)
- The employment rate in the monetary union is approaching the previous record of 2008. The improving job market remains the foundation for recovery and bolsters private consumption.
- Following the Brexit vote and Trump’s election victory, the rejection of the constitutional reform in Italy signified another success of nationalist-populist forces. Further important decisions are the upcoming elections in France and Germany. Despite higher business confidence levels, enterprises will therefore remain cautious.

Economic growth in the euro area

Real gross domestic product, per cent variation on previous year



Sources: Eurostat, KfW Research

Euro area shows resilience

So far this year, the economic foundation of the single currency area has turned out to be more stable than was feared. Concern over the banks and the global economy at the start of the year caused share prices to drop. The Brexit vote in June ushered in a period of increased political uncertainty which has been mounting after Donald Trump’s victory in the US presidential election and the failure of the constitutional referendum in Italy. Political positions that question economic integration and proven mechanisms of international cooperation are currently gaining approval and influence in Western democracies. In this environment, the consistency of euro area growth is an asset in itself. In the

third quarter, production expanded at the same rate as in the previous quarter (+0.3%).

Growth is set to accelerate in the final quarter

Because of the better-than-expected third-quarter, we have lifted our growth forecast for 2016 moderately to 1.6%. The pace should even accelerate somewhat towards the end of the year (forecast of KfW research: +0.5% on the previous quarter). After the slump in sentiment that followed the Brexit vote in June, European enterprises are now significantly more confident. The European sentiment indicator thus climbed to an annual high in November, as did the Composite PMI.

KfW Research

KfW Business Cycle Compass Eurozone

According to our KfW Research Business Cycle Clock, the euro area will thus remain in a cautious recovery. The output gap, that is, the difference between actual and potential GDP, however, continues to close only at snail's pace. That shows that the euro area is moving in the right direction – the only thing that leaves something to be desired is the pace. Per capita incomes are still below the pre-crisis high of almost ten years ago.

Fundamentals for 2017 indicate a continuation of the cautious recovery, ...

KfW Research estimates that real GDP in the euro area will grow at a nearly unchanged moderate pace of 1.5% in 2017. The recovery will continue to be sustained primarily by private consumption which benefits from the ongoing improvement of the labour market. A glance at the slow decline in the unemployment rate resulting from growing labour participation of older and female workers alone masks the more vigorous employment increase. In fact, the employment rate is almost back to its old record high of 66% in Q1 2008. That will probably provide further a boost to consumer spending and private household incomes even though rising energy prices are dampening the increase in real terms. Growing consumer spending also means higher imports, so external trade can contribute only little to growth even though it is supported by a slightly weaker euro. Monetary and fiscal policy is likely to provide only limited impetus. A further easing by the ECB can hardly be expected and national budgets will provide expansive impetus within a narrow range only, as they did this year, although the demand deficit in the euro area would justify a bolder expenditure policy overall.

... but political uncertainty is a burden and poses downward risks

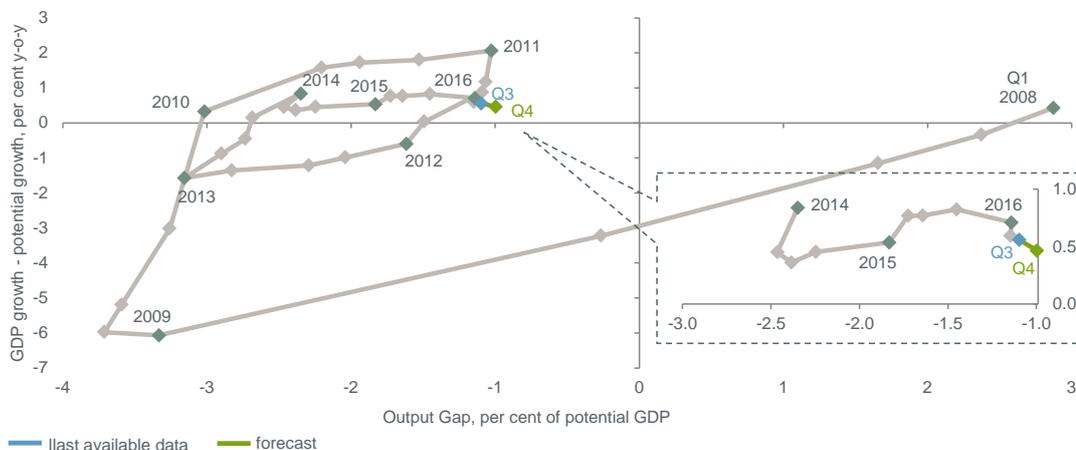
We expect that the urgently needed acceleration of investment activity will fail to come about next year as well – even though the economic environment would definitely permit a different scenario.

Capacity utilisation in the euro area is at a level not seen since 2008, sentiment in the business community is good and borrowing costs and constraints are low. But political shifts are creating an environment in which longer-term planning is subject to exceptional uncertainties. In the same way as businesses' planning processes are fraught with considerable, politically generated downward risks, so too is our economic forecast. The high uncertainty results from, among other things, the difficult developments in Turkey, the Middle East and Russia, but also from the imminent election campaigns in Germany and France.

Italy, Trump and Brexit – the consequences in our basic scenario

Irrespective of the downward risks, KfW Research expects the most recent voting rounds to have only limited economic impacts in 2017. The defeat of Prime Minister Renzi in Italy's constitutional referendum has put the brakes on the reform process and is making it more difficult to tackle the problems in the Italian banking sector. As a consequence, the already weak growth will slow yet again next year, but from today's perspective a recession can still be averted. The US economic policy changes announced by Donald Trump should also have limited effects in Europe that will primarily be transported through the financial markets in 2017. While rising interest rates are likely to have a slightly dampening effect, the falling euro exchange rate will help exporters. Expansive measures in the form of tax cuts and infrastructure spending are likely to boost US growth only moderately as the US economy is already operating near full capacity. Besides, implementing the measures will take time. We expect no significant protectionist interventions in the short term, and we still expect the Brexit process to cause the UK economy to cool off across the year and weigh on the economy in the euro area as well. The longer-term consequences will depend on the complex negotiations on the realignment of relations between the EU and the United Kingdom. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research