››› Euro area is poised for more growth in 2018

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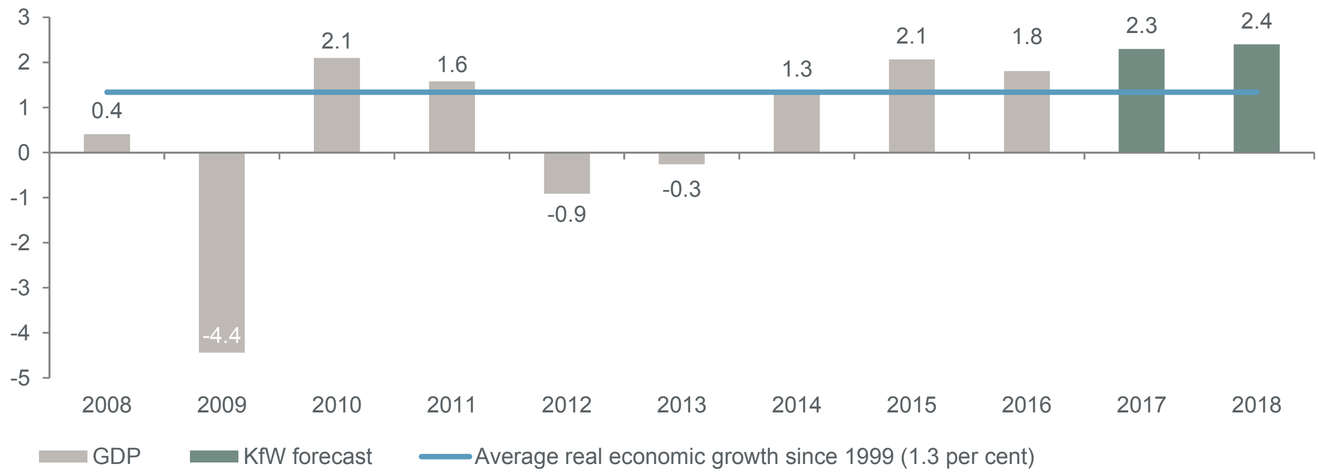
- KfW Research lifts growth forecast for the euro area to 2.3 % in 2017 (previous forecast +2.2 %), with growth momentum set to continue in 2018: +2.4 % (+2.0 %)
- Sentiment indicators continue to soar in the fourth quarter
- Domestic demand remains robust; export sector is providing additional impetus: brightening global economy so far counterbalances euro strength
- First tangible results from Brexit negotiations improve prospects for orderly departure

Euro area gross domestic product

Variation on previous year in per cent, adjusted for prices



Sources: Eurostat, KfW Research

Economic engine is purring nicely

The year 2017 is not quite over yet, but one thing is becoming clear already: the euro area has been the positive surprise among the world's important economies. The third quarter seamlessly ties into this year's positive development. As we had expected, economic output expanded by 0.6 % on the previous quarter, just marginally less than in early summer. Combined with the good first half, which was even corrected upward slightly, the economy of the monetary union is poised to mark its best year in a decade. This is true not only of the pace of growth in itself but also of the quality of the upturn. Growth now rests on a broad basis, both regionally and on the demand side. This has strengthened the currency area's resilience to unexpected shocks.

Germany and Spain remain reliable pillars of growth among the large euro countries. But the stronger momentum has now reached France and Italy, too. Both countries have been able to catch up more and more. Particularly for Italy, the faster pace of growth is good news, making it easier for the country to tackle numerous economic problems such as high government debt and large stocks of bad loans. From August to October, Italy's output expanded by 1.7 % on the previous year's quarter, a rate not seen since 2010, during the first recovery after the slump caused by the financial crisis.

Exports are providing additional thrust

The majority of the most important economies are expected to grow at a faster rate this year. At the same time, global trade is picking up again after years of weakness. Italy as well as the euro area appears to be benefiting well from this broad-based improvement in the global economic environment. Thus, the increased momentum of European growth since the end of 2016 has been entirely the result of external trade. This is all the more noteworthy as the euro has appreciated significantly since then. That has made the price of European goods and services less attractive. But the strength of the common currency has not yet had a noticeable dampening effect on export demand.

Nonetheless, the robust domestic upswing remains the most important pillar of the recovery in the monetary union, although the pace of domestic demand growth has been seen to drop slightly since the beginning of the year. Private consumption is being bolstered by improvements on the labour market and associated income growth. The unemployment rate is falling continuously. Employment growth has been even better as a result of strong increases in labour participation. In the summer, more people were in employment in the euro area for the first time than before the crisis, and a new record high was recorded in the third quarter. But despite the more welcoming labour market conditions, wage growth is still subdued, which dampens consumption momentum. On the other hand, the good economic situation is reviving urgently needed investment activity, which has been weak for a long time in many euro area countries. But upside potential remains, particularly in light of the high investment backlogs.

Sentiment indicators are breaking records

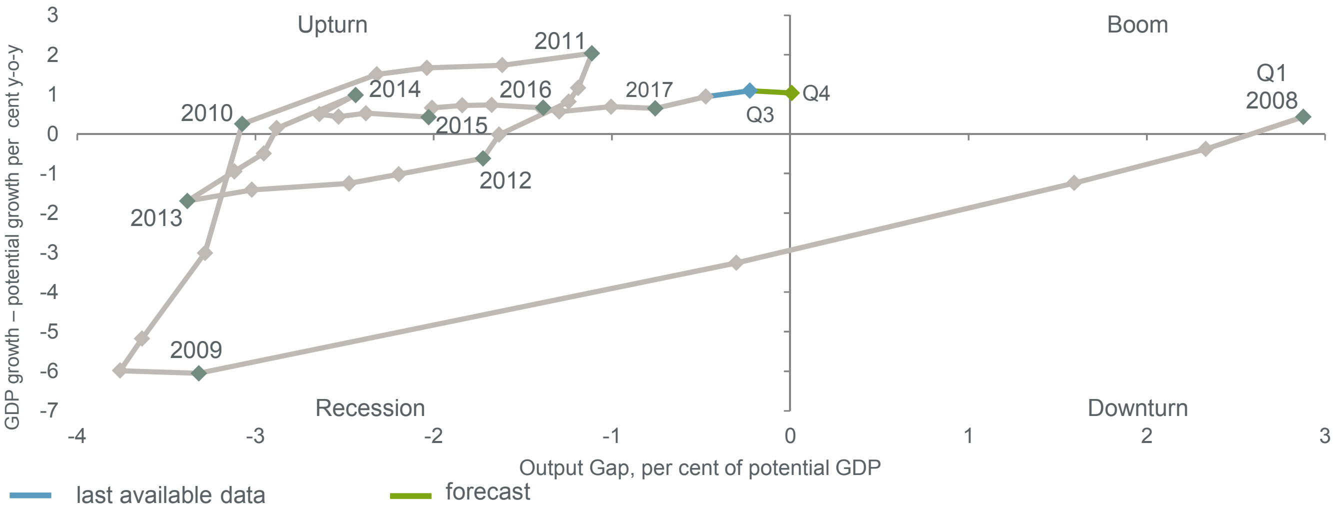
The KfW Research Business Cycle Clock shows that the euro area is experiencing a strong upswing. The output gap is (just barely) in negative territory, showing minor underutilisation of aggregate economic production potential. Thus, the conditions for a boom are not yet given. If, as we predict, the strong growth continues in the final quarter, the gap should close again at the end of the year for the first time since the financial crisis. The good state of the European economy suggests this is likely. Sentiment indicators are on remarkably high levels. The results of the most recent consumer and business survey of the European Commission are just one example. It revealed that business optimism has not been this high since the year 2000.

Forecast for 2018: Euro area will continue to grow fast – but risks remain

Given the high starting levels and consistently positive signals from the business cycle indicators, we expect the euro area to not only keep growing steadily in the final quarter but to take the momentum into the new year as well. That means real GDP growth of 2.3 % for 2017. We have raised our forecast for 2018 to 2.4 % and thereby positioned ourselves above the consensus estimates. This prediction assumes that external conditions will remain positive. Global economic growth should pick up slightly again next year and act as a tailwind for the export sector of the euro area. We expect fiscal policy to be slightly expansionary. Although the ECB has begun to end its ultra-loose monetary policy it is proceeding gradually and cautiously. Progress has also been made in the adjustment of banks' balance sheets – especially in Italy. Financing conditions should therefore remain favourable for the time being and, along with high capacity utilisation, encourage enterprises to step up the modernisation of their capital stock. The associated productivity gains and continuing labour force underutilisation will create necessary scope for enduring momentum above the potential rate, which is currently estimated at around 1.5 %.

The political risks to the business cycle have currently slipped into the background but not vanished. The Brexit negotiations are showing first signs of progress, but that is merely a snapshot. Moreover, an unfavourable election outcome in Italy and delays in the necessary further development of the euro area as a result of the difficulty of forming a new government in Germany might again weaken the confidence in the common currency. An unexpected slowdown in US growth, triggered by a hastened tightening of monetary policy or protectionist economic-policy measures, may also have the potential to significantly dampen economic momentum in Europe. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research