KfW Research
KfW Business Cycle Compass Eurozone

Economy is facing headwinds

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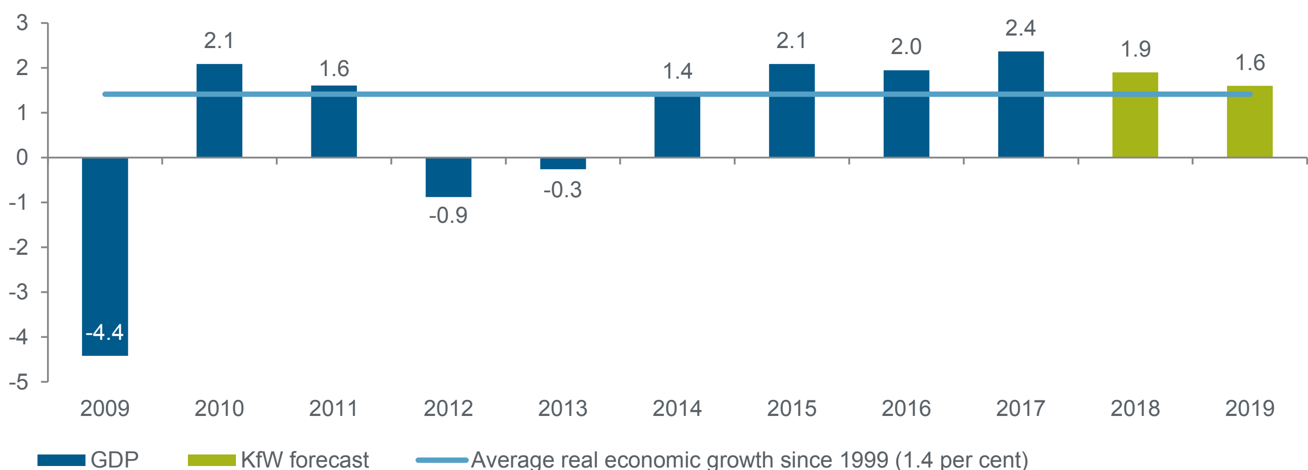
- Third-quarter growth in the euro area was a surprisingly paltry 0.2 % on the previous quarter; the problems of the automotive industry with the introduction of the new WLTP emissions testing protocol have significantly accelerated the tangible growth slowdown since the start of the year.
- KfW Research expects automobile production to normalise by spring 2019; despite several disappointing signals from the sentiment indicators, we see our growth scenario intact with expansion rates within the potential range.
- The downward revision of our business cycle forecasts is therefore only minor: GDP is set to grow by 1.9 % in real terms in 2018 and by 1.6 % in 2019 (previous forecasts 2.0 % and 1.7 %)
- While the headwind from foreign trade will likely continue for the time being, domestic demand basically remains on a solid footing. Key factors are the good labour market situation, the upward trend in real wages and a noticeable fiscal impetus next year.
- The list of downward risks remains long, including the risk of a disorderly Brexit and a global trade war, while Italy is keeping the financial markets and the EU on tenterhooks.

Euro area gross domestic product
Variation on previous year in per cent, adjusted for prices



Source: KfW Research

2018 has been a year of cyclical stumbling blocks

We have known for some time now that the euro area will no longer be able to build on the economic momentum of the previous year. The high expectations at the start of the year have thus dropped to a normal level. Still, growth in the summer was disappointing again. Real gross domestic product expanded by a mere 0.2 %. That makes the third quarter one of the weakest since the beginning of the recovery in 2013. As was the case in the preceding quarters, economic development was significantly burdened by temporary factors. After inclement weather, an influenza wave and strikes in the first half, now it was the automotive industry experiencing problems converting to the new WLTP approval and emissions testing protocol by the beginning of September, slowing economic activity all across Europe. As a result, nearly 6 % fewer vehicles rolled off the assembly lines in the euro area than in the three months before. Given the high importance of the automotive industry in Germany, the effects of production cuts here were particularly noticeable.

So as one of the four largest countries of the currency union, Germany failed to be the usual reliable pillar of growth and, with a contraction of 0.2 %, took an unfamiliar position at the tail end of the field. Italy also had to endure a decline in real gross domestic product by 0.1 %. This was partly a consequence of a pronounced drop in investment

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

momentum, which may indicate growing uncertainty over the impacts of the Italian government's economic policy direction. By contrast, growth picked up again in France (+0.4 %) and Spain delivered the familiar good result (+0.6 %).

Has the downturn begun or will the boom continue?

Our KfW Research Business Cycle Clock shows that the European economy is still in a boom phase but already moving dangerously close to the downturn quadrant towards the end of the year. We remain optimistic and do not yet see a convincing reason to substantially revise our previous economic scenario. We continue to see trend growth – which is being hidden by one-off effects – within the range of the potential rate. It must be noted that the widely monitored Purchasing Manager Index for the aggregate economy (PMI composite) continued its nosedive in November and dropped to the lowest level in nearly four years. All the same, at 52.4 points it is still clearly in the expansion range. A more positive picture has also been presented by the EU Commission's economic sentiment indicator (ESI) and national indicators such as the ifo business climate index, which still achieve above-average levels.

Domestic demand must – and can – sustain the growth

While foreign trade provided a strong boost in the euro area in 2017, this year it has become the main burden, especially for manufacturing. Foreign trade delivered a negative contribution to growth (-0.2 PP) in the third quarter as well. This is not likely to improve any time soon. Global demand is suffering from the tense trade-policy environment and economic sanctions. In addition, tightening lending conditions from rising US interest rates are slowing the business cycle in emerging economies.

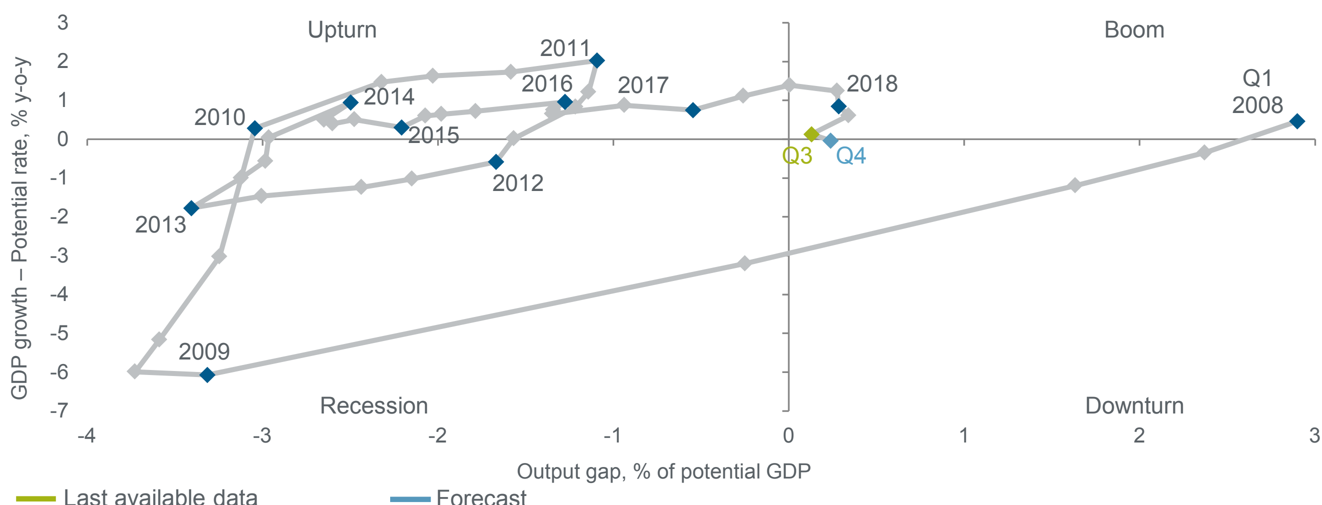
It is true that the current weakness of the euro against the dollar should make European providers somewhat more competitive in international markets. But it is best not to expect too much of this. In real terms, the euro is tending to appreciate further in relation to a broad basket of currencies of major trading partners.

The stability of domestic demand is therefore a key prerequisite for our growth forecast to materialise, which we have moderately revised downward to 1.9 % for 2018 on the basis of the weak third quarter and to 1.6 % for 2019. The fundamental conditions for a solid expansion of private consumption remain intact. Unemployment is on a 10-year low, and real wages are growing at a decent rate and should receive a boost from falling energy prices in the short term. High capacity utilisation shows a continuing need for investment. And despite the slow reduction in monetary policy support, financing conditions for enterprises should remain favourable. Furthermore, fiscal policy in 2019 will support the business cycle with an impulse of just under 0.5 % of GDP.

Risk environment remains difficult

Production cuts and transport restrictions resulting from low water levels in the Rhine river and intense protests in France against reform policies might provide a negative surprise in the current quarter. In addition, the three most important downward risks for the European economy remain unchanged and may even lead to a veritable crisis. First, under Trump it is conceivable that trade conflicts escalate at any time despite the recent agreement reached between the US and China at the G20 summit. Second, a disorderly Brexit cannot be ruled out until the British Parliament has given its approval to the withdrawal agreement, which is anything but certain. Third, Italy is threatening to slip into a downward spiral fuelled by rising risk premiums, shaky banks and declining growth as a result of the new government's plan to loosen fiscal policy. All of this makes it all the more important to use the Euro Summit of 14 December to achieve tangible results in the efforts to make the euro area more crisis-resilient. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research