Brexit postponed again but euro area growth remains weak for the time being

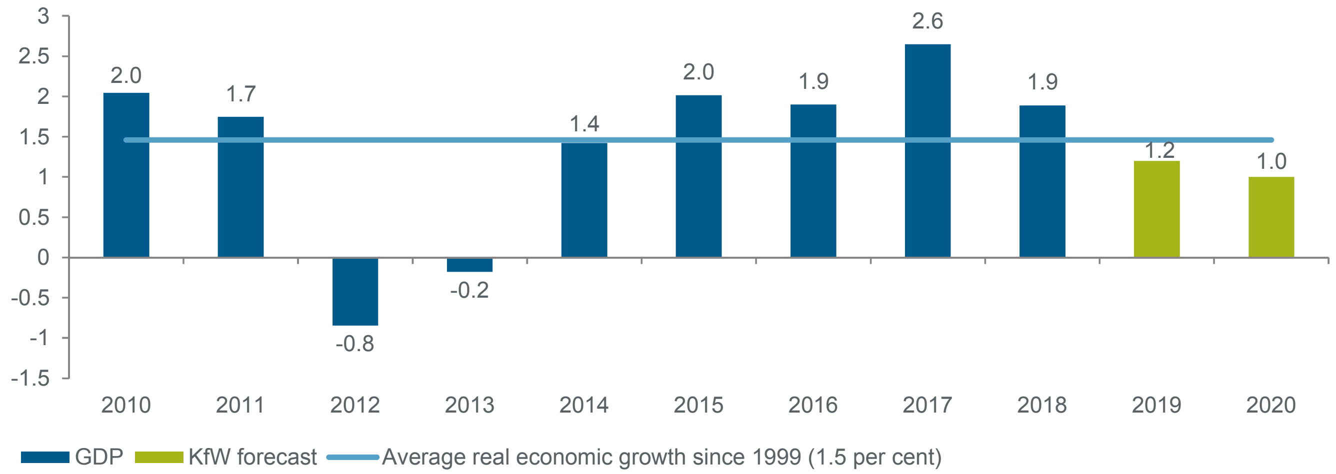
5 December 2019

Author: Dr Philipp Scheuermeyer, phone +49 69 7431-4017
Press contact: Christine Volk, phone +49 69 7431-3867, christine.volk@kfw.de

- Growth in the euro area was a low +0.2% in the third quarter but nevertheless slightly better than generally expected. While Spain and France grew at a healthy pace again, Germany and Italy are on the bottom of the list of the large euro states.
- The short-term economic indicators point to persistently weak cyclical dynamic in the final quarter but there are signs that the industrial recession has bottomed out.
- Some of the political headwind in particular has subsided of late. Most notably, a hard Brexit was avoided in October and the trade conflicts of the US have eased slightly. KfW Research therefore upgrades its forecast for the autumn and winter quarter and, hence, for annual growth in 2019 and 2020.
- We now expect 1.2% growth for the current year (previous forecast 1.0%). Economic output should grow by 1.0% in 2020 (previous forecast 0.7%).

Euro area gross domestic product

In percent on previous year, adjusted for price and calendar variations



Source: KfW Research, Eurostat

Slow but clearly positive growth in summer

From July to September, the euro area economy maintained the sluggish pace of the previous quarter, growing by 0.2%. Most economic observers had expected even weaker growth in light of declining sentiment indicators and, at times, an escalation of political risks. The French and Spanish economies in particular showed themselves to be robust, with quarterly growth of 0.3 and 0.4%. Germany and Italy, by contrast, each grew by only a marginal 0.1%. Because of the relatively heavy weight of its very cyclically oriented industry, Germany is particularly affected by the global industrial slowdown. The main reasons the euro area's largest economy still managed to escape a technical recession – two consecutive negative quarterly growth rates – were the solid growth of consumption demand and residential construction investment. Private consumption is currently also the main driver of growth in the euro area as a whole.

Downward trend of industrial sector continues for the time being

On the output side, the growth of the euro area in the summer was again generated in the services sector. Industrial output, on the other hand, contracted by a quarterly average of 0.9%. A major reason for the industrial recession was the exceptionally high political uncertainty. In particular, the trade conflicts started by the US have been creating uncertainty around the globe, putting the brakes on corporate investment activity. The threat of a no-deal Brexit had a similar effect, although this is now far less likely. The European automotive industry is facing US special tariffs, which so far have been threatened but not imposed, and the conversion to new drive technologies is a considerable structural challenge.

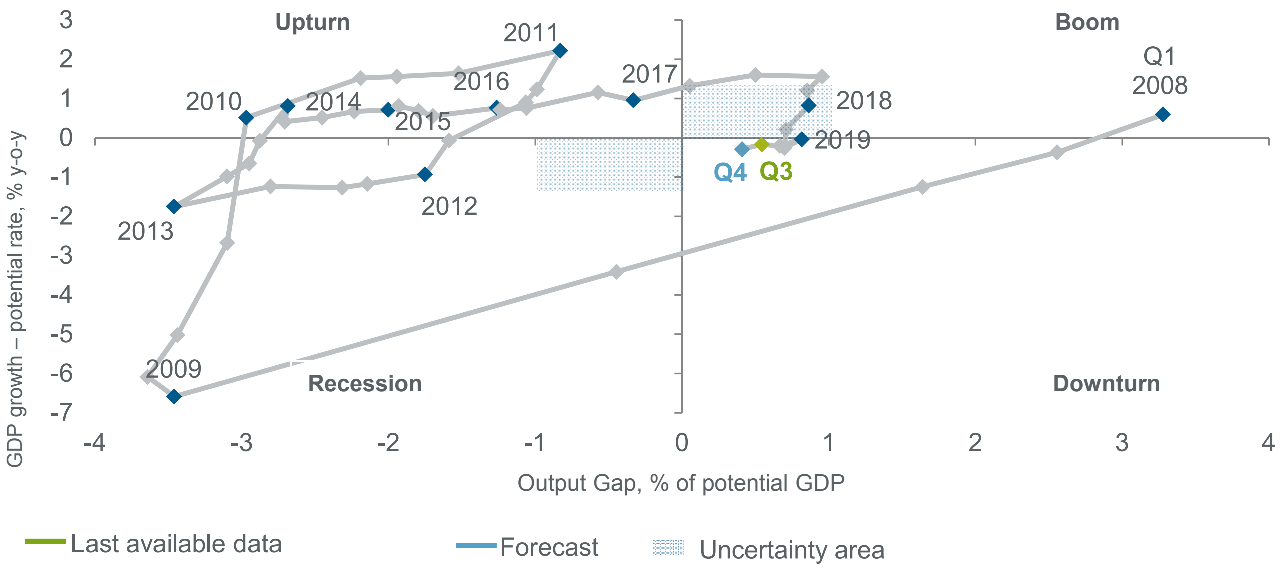
Political risks have decreased slightly

After escalating in the summer, however, the political risks have decreased slightly of late. What is of particular significance for the global economy is the partial agreement in the trade conflict between the US and China that was announced in October. There is still high uncertainty about the content and prospects of the agreement being implemented. But given the elections scheduled for November 2020, the Trump administration is probably eager for political achievements, an economic tailwind and rising share prices. We therefore see scope for limited de-escalation in the coming year, even if a far-reaching solution to the trade conflict is unlikely in light of the geostrategic conflicts of interest. Moreover, it is very positive for the European economy that a hard Brexit has now become unlikely. After a significant policy change, the EU and the UK government were able to negotiate an amendment to the backstop clause in the withdrawal agreement. The House of Commons has failed to ratify it so far but after the new elections on 12 December there is a possibility of swift ratification if the Conservatives emerge victorious. The leading opposition parties are aiming for an even softer solution in combination with a second referendum. Either way, the trade relations between the EU and the United Kingdom should remain unperturbed at least until the end of 2020, thanks to the transitional period enshrined in the withdrawal agreement.

Upgraded forecast does not mean euphoria

We have a more positive outlook on growth in the final quarter and at the start of the coming year than in the previous forecast, especially because a hard Brexit on 31 October was avoided. On the other hand, indicators such as the European Commission's Economic Sentiment Indicator or the Purchase Manager's Index of IHS-Markit still point to a weak economic performance. We therefore expect the weak growth since summer to continue in the winter half year. The quarterly rates should then gradually begin to return to trend growth from spring at the earliest. We have lifted our overall growth forecast for the current year to 1.2% (previous forecast 1.0%). We predict an annual rate of 1.0% for 2020 (previous forecast 0.7%). Assuming a cautious de-escalation of the trade conflicts, the industrial sector should be able to grow again moderately in the course of the coming year. In the services sector, the robust dynamic of 2019 will presumably decrease slightly but should nevertheless be sufficient to sustain further employment growth. On the demand side, private consumption therefore remains the mainstay of growth. The ECB's monetary policy, which has been even more expansionary since September, also provides positive impetus, especially for construction investment. Corporate investment activity, on the other hand, will likely be impaired by continuing heightened political uncertainty. According to the current budget plans, fiscal policy will deliver only a minor positive contribution in the coming year. But there would still be some scope left if downward risks such as a renewed escalation in the US-China trade dispute, the imposition of US tariffs on car imports or the residual risk of a disorderly Brexit should materialise and weigh on the labour market.

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research