Business cycle is losing momentum

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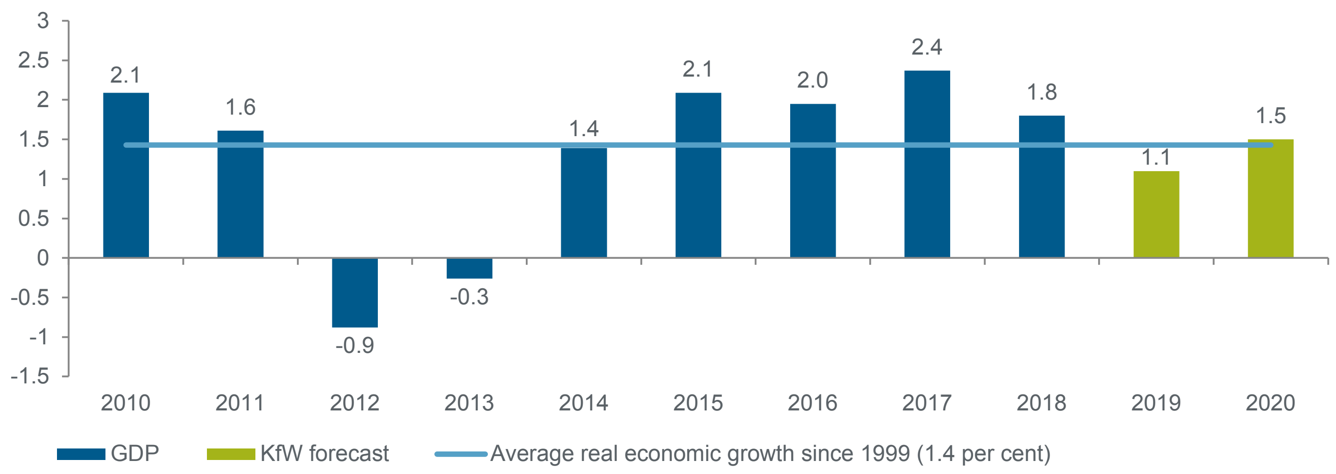
- KfW Research has significantly downgraded its growth forecast for the euro area. For 2019 we now predict a growth rate of just 1.1% (previous forecast 1.6%). Next year we expect a moderate revival to 1.5%.
- In 2018, real GDP in the monetary union grew 1.8%, faster than the potential rate. Measured against the high expectations at the beginning of the year, however, the outcome is nevertheless disappointing. Final-quarter growth also remained a paltry 0.2%. Hopes of a forceful rebound failed to materialise.
- Although negative factors are easing (WLTP, low water levels of inland waterways, yellow vest protests), there are few signs of improvement in the short term. The rapid downturn in business sentiment signals a weak start to the year. On the back of sound domestic demand, however, the chances of stronger growth momentum in the second half of the year are good.
- The slow pace of the business cycle makes the economy more susceptible to external shocks. Should pronounced downward risks such as a disorderly Brexit, an expansion of trade conflicts or a financial crisis in Italy materialise, a recession can no longer be ruled out. But there is scope for positive surprises. International trade, in particular, could master the turnaround faster than anticipated.

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



Source: KfW Research

Economic development in 2018 was merely satisfactory

The growth rate alone could suggest that the economic performance of the monetary union last year was quite positive. After all, the real growth of 1.8% in aggregate output remained above the potential growth rate of currently just under 1.6%, as estimated by the European Commission. It should also be noted that the euro area can now look back on a five-year recovery and its fundamentals are robust.

On balance, however, the prevailing sentiment is one of disappointment for two main reasons. First, the high expectations at the start of the year, which predicted a continuation of the unusually strong performance of 2017, were not fulfilled. Second, the business cycle lost more and more of its momentum as the year progressed. In the second half-year, quarterly growth rates slumped to a lame 0.2%. The economic weakness is striking compared with the 0.7% consistently achieved in 2017.

Manufacturers are at the epicentre of the slowdown

European industry, understood here as manufacturing, is currently going through a particularly hard time. Manufacturing output contracted by 1.8% during the course of the year; it was down 1.2% in the final quarter alone. Part of this decline was due to temporary pressures, such as the conversion to the new WLTP standard for certification and emissions testing in the automotive industry and low water levels in inland waterways. But the breadth of the contraction is an indication that there is more to it than country and sector-specific effects. In fact, industrial output declined in all four large euro countries in the final quarter as well. At the same time, a number of industrial branches reported declines in production, among them mechanical engineering.

The manufacturing sector, which has links spanning across borders, is visibly suffering under the deterioration of the international environment and the resulting downturn in global trade. As the volume of exports from the euro area fell in the course of the year, European enterprises were also hit by losses of market share. Gradual losses in price competitiveness were likely a factor. The higher importance of goods producers contributed to weaker growth in Italy (-0.2%) and Germany (0.0%), while France (0.3%) and Spain (0.7%) performed better.

No recession yet but the danger has increased

Half a year of weak growth was enough to allow the monetary union to slip into the recession quadrant of our KfW Research Business Cycle Clock Given the notorious lack of precision in the measurement of production potential and its growth rate at the current margin, however, movements in the proximity of the origin of the coordinates system, marked by the uncertainty area, should not be given too much importance. Still, it is impossible to dismiss the concern that the cyclical weakness may turn into a full-blown recession. Although the one-off factors are fading, the deterioration in business confidence is clearly at odds with a fast return to stronger growth. Both the Purchase Manager's Index for the aggregate economy (PMI) and the Economic Sentiment Indicator surveyed by the EU Commission continued their decline into January.

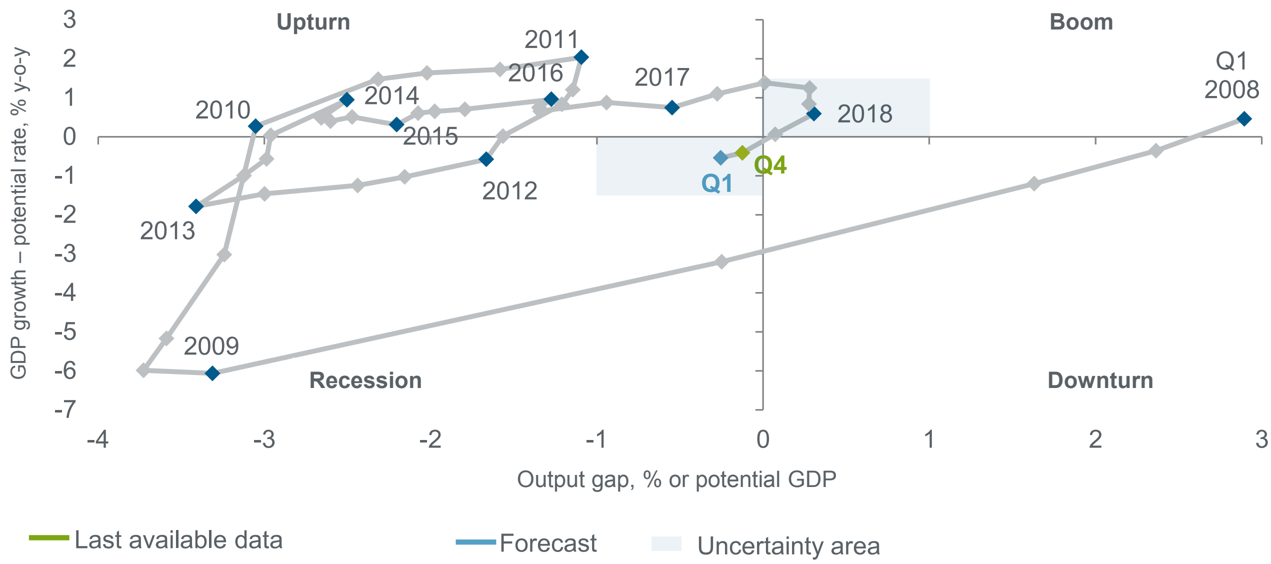
Growth will be below average in all of 2019 but may strengthen in the second half

Against this background we have significantly downgraded our growth forecast for 2019 to 1.1%. The year 2020 should then see slightly more lively growth of 1.5%. We expect the euro area to avoid slipping into recession and regain momentum again from the second half of this year. Because of the global economic cooling which is being exacerbated by trade tensions, international trade can be expected to experience further headwinds. The robust state of domestic demand suggests that it is strong enough to offset the weakness of the external sector and the high uncertainty in order to at least continue growing. The mix of a low rate of unemployment, an upward trend in real wages, high capacity utilisation rates and noticeable fiscal impetus is providing strong support for the economy.

Downward risks still prevail but things may turn out better than anticipated

Our forecast supposes that none of the major downward risks materialises. A recession looks virtually inevitable if the UK crashes out of the EU without a deal, if trade conflicts escalate, or if Italy sinks into severe financial turmoil. On the other hand, positive surprises are also possible. A fast recovery of the automotive industry and stockpiling before the Brexit date can provide an unexpected boost in the short term. The same applies to foreign trade in the medium term if the recent euro weakness has an effect, if trade conflicts are resolved and if China's economy recovers swiftly. The renewed rise in stock prices shows that market participants are currently giving this scenario a chance. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research