Euro area growth is losing momentum

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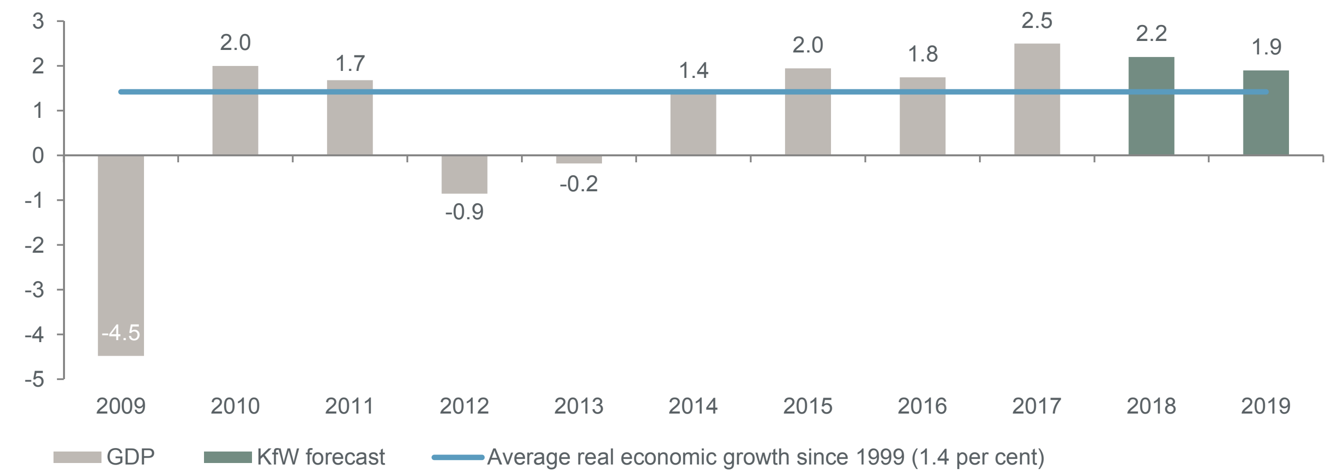
Author: Stephanie Schoenwald, phone +49 69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 69 7431-3867, christine.volk@kfw.de

- First-quarter growth in euro area is weaker than expected: KfW Research lowers growth forecasts to +2.2 % for 2018 (previously 2.4 %) and to +1.9 % for 2019 (previously 2.1 %).
- Slowdown partly due to one-off factors but growth momentum should pick up again in spring on the back of solid fundamentals.
- Sentiment indicators have dropped considerably from record levels at the end of 2017 but still signal growth above the potential rate.
- Global economic tailwind is weakening but consumption and investment are driving growth.
- Political risks are rising again, with the escalating transatlantic trade conflict and possible confrontation between Italy and the EU topping the list.

Euro area gross domestic product

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



Sources: Eurostat, KfW Research

Euro area economy was off to a slow start to the year

After the strong upturn last year, first-quarter growth was considerably more subdued than suggested by the record high business confidence levels at the start of the year. Euro area output grew by a mere 0.4 % on the previous quarter. That means the rate of overall economic expansion was roughly halved. The decline was mainly due to weak exports, which contracted significantly in Germany and Italy. This is in stark contrast with the preceding quarters, in which trade grew to become a major driver of the business cycle. Private consumption, in turn, proved to be a solid mainstay of growth. That was a positive surprise given the declining levels of retail turnover. Gross fixed capital formation also contributed again to growth, if at a slower momentum. Of the four large member states, France experienced the sharpest drop, followed by Germany. Spain convinced with unwavering strong momentum. Italy was on a steady upward trend before the political turmoil began but solely on the back of a significant build-up in inventories.

Special factors have probably overstated the slowdown, which is a silver lining. The combination of a severe influenza outbreak, strikes and inclement weather dampened economic activity in the winter months. This applies in particular to the internationally well-integrated manufacturing sector, especially since the economic weakness extended well beyond the euro area in the first quarter. So there is reason to be optimistic that exports and cyclical momentum will revive again in the spring.

Record sentiment is history

The euphoria in the business community has subsided. Sentiment indicators across the euro area have declined since the start of the year. For the moment, however, we still do not see the need to correct our growth expectations downward for the rest of the year. For one thing, we have expected underlying cyclical momentum to slow gradually in the next quarters. For another, the sentiment indicators remain on above-average levels and signal growth above the potential rate. Admittedly, a further noticeable deterioration in confidence would be hard to reconcile with our growth scenario. Even so, the EU Economic Sentiment Indicator has developed quite steadily since March while the Purchase Manager's Index fell again in May. However, the survey result was adversely affected by the high number of holidays in May.

Political disruptions create pressure and pose major downward risks

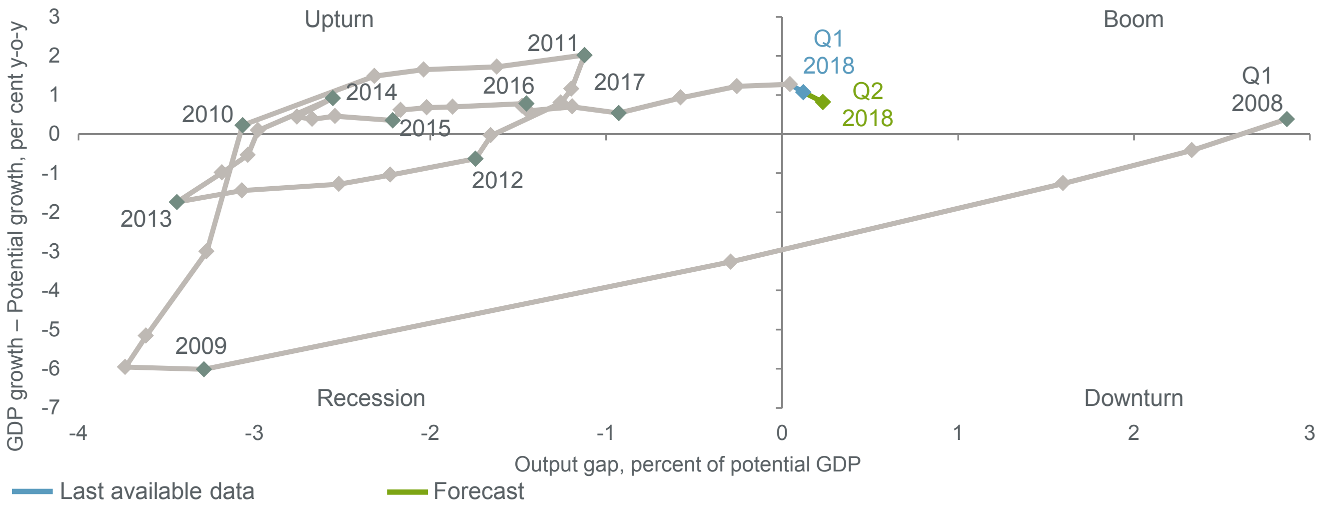
The waning optimism is likely due in part to heightened risks of a cyclical downturn. Apart from sharp corrections to asset prices, political moves in particular could spell trouble. The turmoil surrounding the formation of government in Italy has illustrated this impressively. For now, we expect increased risk premiums and heightened uncertainty to leave traces only in the Italian economy. However, continued eurosceptical rhetoric and open confrontation with the EU involving the presentation of the budget in autumn have the potential to erode cohesion within the euro area and trigger lasting distortions in the financial markets. Apprehension over transatlantic trade relations is also growing. With the end of the exception granted to the EU for US tariffs on steel and aluminium imports and more specific considerations regarding import tariffs on European cars, a damaging escalation of the conflict over trade policy is drawing nearer.

Euro area business cycle has passed its peak, growth remains solid

Irrespective of these developments, euro area fundamentals remain intact. Unemployment is receding continuously and has recently fallen to a new post-crisis low (8.5 %). Employment is growing accordingly. This is the right environment for private consumption to remain a pillar of growth, although higher inflation rates have recently dampened real wages growth. Investment should continue to grow as well. According to our KfW Research Business Cycle Clock, economic activity in the euro area is now above its production potential, which means it has reached full capacity utilisation. On the back of favourable borrowing conditions and solid sales expectations, enterprises should move forward with investing in the renewal and expansion of capital stock.

Given the generally good shape of the European economy, continuing high levels of business confidence and the role of the one-off factors, in essence we stick to our previous growth scenario. But owing to the weak first quarter it is inevitable that we revise our forecast downward despite the continuing positive overall picture. We therefore lower our growth forecast for 2018 to 2.2 %. Further adverse factors will impact on the growth rate next year. Increasing capacity constraints will slow down growth more and more on the supply side, while external trade will provide weaker impetus on the demand side. The protectionist measures and policy of stiffer sanctions adopted so far by the US administration have a minimal direct quantitative impact. But together with Brexit they generate uncertainty among exporters over the future conditions and opportunities in international business. The euro will also remain on a higher level across the forecast horizon than in 2017. Moreover, financing conditions will gradually tighten in the course of monetary policy normalisation. We therefore expect an overall economic growth rate of just 1.9 % for next year. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research