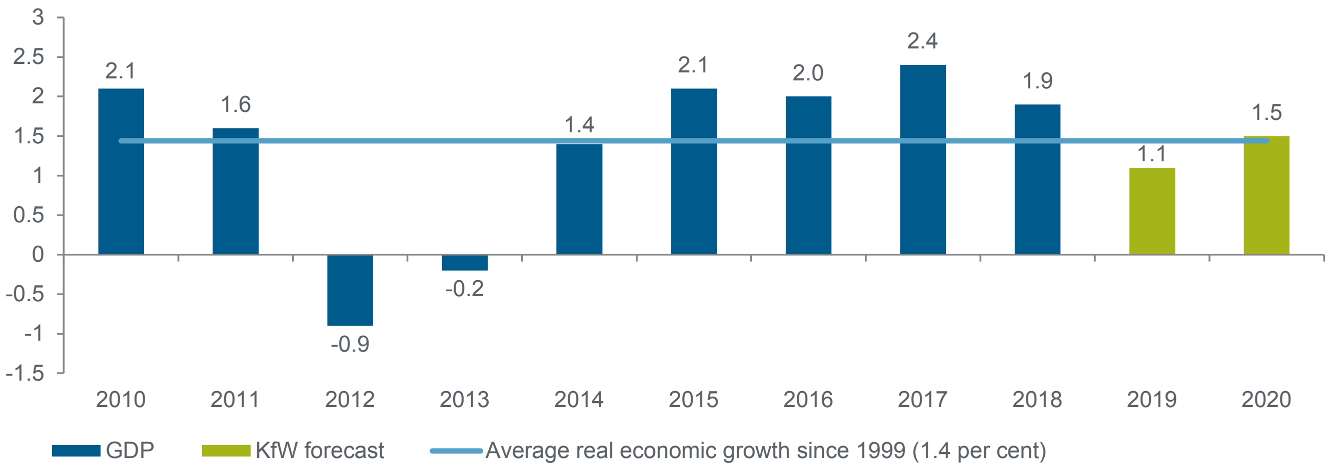
Good start to the year is not a turnaround

6 June 2019

Author: Stephanie Schoenwald, phone +49 69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Wolfram Schweickhardt, phone: +49 69 7431 1778, wolfram.schweickhardt@kfw.de

- The first quarter exceeded beginning-of-the-year expectations. Driven primarily by strong private consumption, real GDP in the euro area expanded by 0.4%, twice the rate of the preceding quarter.
- Nevertheless, KfW Research has not changed its forecasts for the monetary union. The growth acceleration will likely turn out to be unsustainable. We still project economic output to grow by 1.1% in 2019 and see a good chance that growth may pick up to 1.5% next year.
- The contrast between weak export-driven manufacturing and the robust domestic economy remains. The most recent escalation of the ongoing trade conflicts will likely reinforce the scepticism prevailing among industrial firms for the time being. But the positive labour market environment, favourable financing conditions and fiscal impetus ensure stable domestic demand growth rates.
- Geopolitical risks have grown once again. The likelihood of a hard Brexit and a renewed conflict over Italy's budget policy has risen. Moreover, trade conflicts may spread and intensify, causing the crisis in the industrial sector to spill over into the rest of the economy. We would then be forced to significantly downgrade our forecast for 2020.

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



Source: KfW Research

Euro area exhibits a welcome growth spurt ...
Economic activity picked up after the weak second half of 2018. The doubling of the growth rate to 0.4% on the previous quarter is good news for now and should have allayed concerns over an imminent recession – which we believe were exaggerated to start with. What is positive is that the recovery was spread across the most important member states. While Spain's expansion was vigorous (+0.7%) and France's steady (+0.3%), Germany also made another visible contribution to growth in the monetary union (+0.4%). Italy, too, succeeded in expanding its economic output after two negative quarters (+0.1%).

Momentum was in particular provided by domestic consumers (+0.5%) and investors (+1.1%). A significant boost probably came from catching-up effects in the automobile market, so it will likely be short-lived. Private and commercial vehicle registrations in the euro area picked up noticeably after disruptions from the introduction of the WLTP standard last year. Another positive was the favourable weather during the winter months, which benefited the already booming construction industry in Germany.

... but the outlook is meagre
The jubilation over the good start to the year, however,

should soon give way to gloom. We expect the growth rate for the current quarter to level off again at 0.2%. For one thing, the temporary drivers mentioned above have vanished and for another, the industrial sector shows no fundamental trend reversal. Rather, the weakness triggered by the cyclical slowdown and special adverse factors threatens to become entrenched because of the ongoing trade conflicts. At any rate, the early indicators published so far are not encouraging. The Purchase Manager's Index for manufacturing fell again in May and is well within the contraction zone. The details of the European Commission's monthly economic sentiment indicator (ESI) reveal the causes for the persistent gloom in the business sector: New orders in Europe's industrial sector have continued to drop as a result of low international demand.

In the light of the adverse international environment, the euro area's resilience relies on the domestic economy. Based on current data we remain optimistic about the development of domestic demand. The foundation is the robust labour market. Employment growth rates are stable and unemployment in the currency union dropped to 7.6% in April, the lowest level since the summer of 2008. In addition, moderate real wage growth has bolstered private consumption. This is consistent with consumer confidence, which is moving sideways on a respectable level. The sentiment in the more domestically oriented services sector also confirms our assessment. The relevant Purchase Manager Index has clearly disconnected from the sentiment downturn in manufacturing, signalling an expansionary course for service industries.

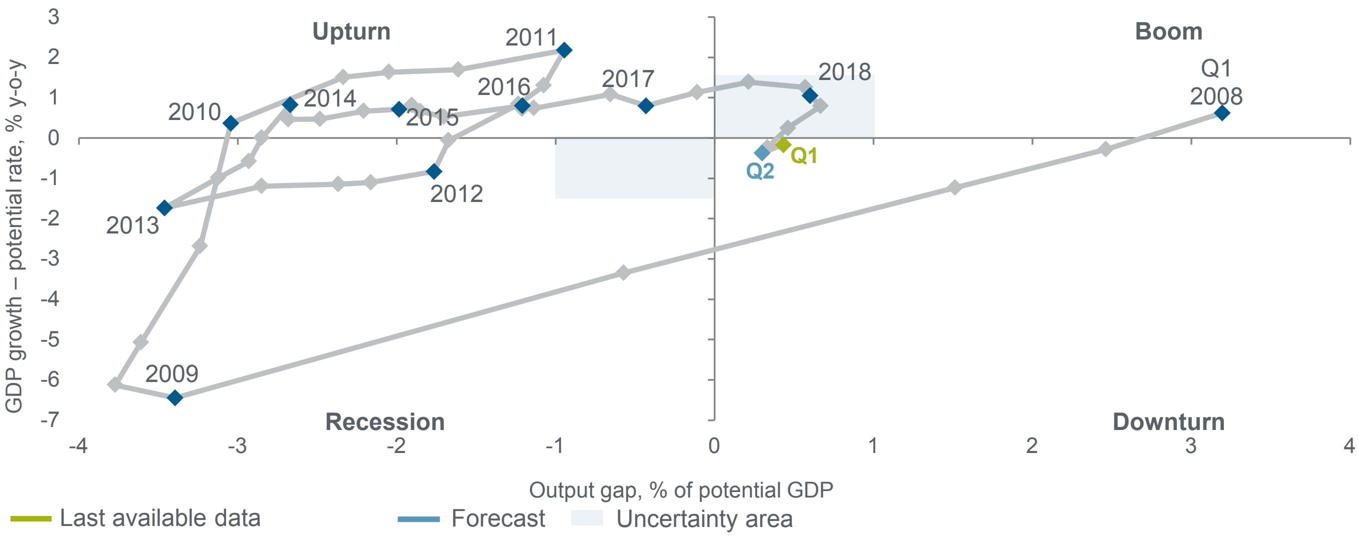
Monetary policy will remain loose for some time, and fiscal policy provides support

The KfW Research Business Cycle Clock illustrates the fragile economic situation. Compared with the previous year, growth no longer matches the increase in production potential. But that would at least be necessary in order for pressure on capacity to drive inflation back towards the target mark of just under 2%. As this is currently unforeseeable, the ECB will likely keep benchmark interest rates low for some time to come. The new series of targeted longer-term refinancing operations (TLTRO III) aims to secure the transmission of monetary policy and, thus, ensure favourable funding conditions in all member states. This will bolster investment which, not least thanks to low borrowing costs, has been exceptionally stable for a phase of cyclical weakness combined with high uncertainty. Fiscal policy also provides some help to the economy this year.

Our forecast remains unchanged, but downward risks have grown

The unexpectedly strong first quarter balances out our more sceptical assessment of short-term growth momentum. We therefore maintain our forecast of real GDP growth of 1.1% this year and 1.5% next year, provided the external headwinds ease and the industrial sector recovers by the end of the year. Given the ongoing escalation of the US-China trade conflict and threats of new punitive tariffs against Mexico, this assumption is fraught with great uncertainty. Compounding this is the heightened threat of a hard Brexit in the wake of the resignation of the UK Prime Minister and emerging renewed disputes over Italy's fiscal policy direction. However, we see the persistence of the geopolitical disruptions as the greatest downward risk. The longer they prevent the trend reversal in the industrial sector, the higher the likelihood of damage to the labour market and, with it, the aggregate economy. In that case we would have to significantly reduce our forecast, particularly for 2020. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research