Euro area recovery continues

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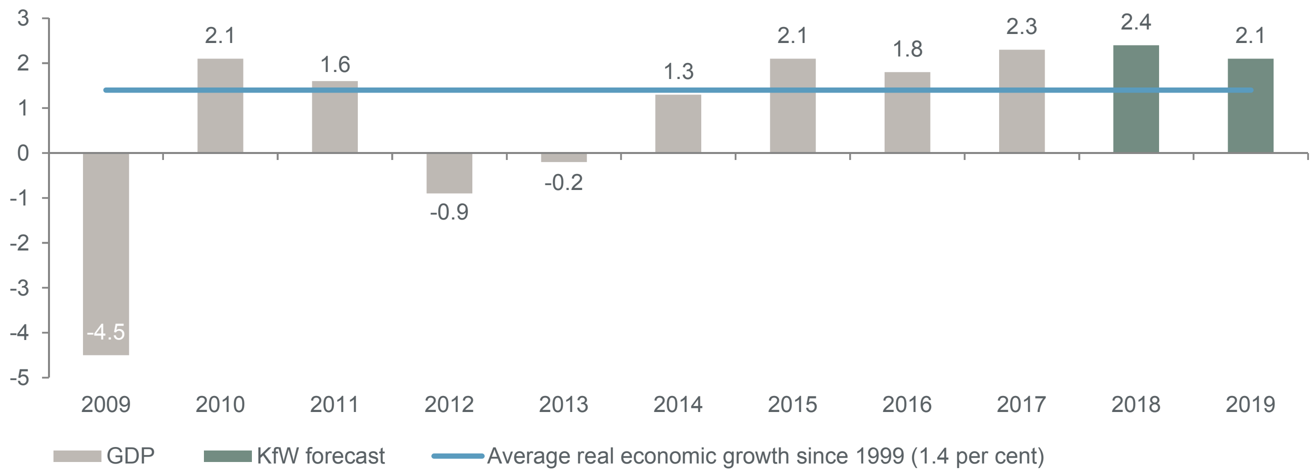
- KfW Research confirms its +2.4 % growth forecast for the euro area for 2018; momentum is anticipated to slow moderately in 2019 (initial forecast: +2.1 %)
- Growth has been continuing for five years and is now above potential, credit conditions are tightening, raising the likelihood of slower growth from 2019
- Current situation remains good as hard cyclical indicators point to strong growth but sentiment indexes have recently been slightly weaker
- Political risks in euro area have diminished, focus is now on financial markets

Euro area gross domestic product

Variation on previous year in per cent, adjusted for prices



Sources: Eurostat, KfW Research

2017 was the most successful year in the past decade

In the past year the euro area economy grew at the fastest pace since 2007. In the last quarter it grew again by 0.6 % on the previous quarter and the year-on-year growth rate for 2017 as a whole climbed to 2.3 %. The euro area's economic output is now nearly 6 % higher than before the financial crisis.

Consumption remains the main driver of the upswing. The reduction in unemployment continued steadily in 2017 and even gathered pace. In January 2018 unemployment was 8.6 %, one percentage point lower than the year before. In addition, labour market participation has grown further and the employment rate has exceeded the pre-financial crisis peak since last year. This will bolster private consumption even as inflation rates rise. As the recovery has become more firmly established, investment has also gained in importance as a second pillar of growth for two reasons. First, faith in the stability of the recovery has grown over time because political risks in the euro area have diminished, for example, and economic sentiment indicators have reached multi-year highs. Second, the increasing duration of the recovery is stretching output capacities to their limits, requiring companies to invest in order to keep up with demand. The external trade balance has been less important for the recovery of the past years than domestic demand. Nevertheless, foreign trade also provided positive impetus in 2017 despite the appreciation of the euro which began after the presidential elections in France. These statements on growth components also apply to the fourth quarter of 2017: It was primarily foreign trade and investment that contributed to the successful annual result.

A vigorous start to the new year

Most of the key economic indicators signal that the high momentum will continue in the first quarter of this year. Industrial output grew continuously during the past year, with the December level approaching the pre-crisis high of 2008. Companies' order books looked even better, filling at an increasingly faster pace in 2017 to reach an all-time high. Foreign orders from outside the euro area in particular increased significantly in the second half of the year. This shows that international business so far has not been impaired by the appreciation of the euro.

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Figures for the first sentiment indicators for 2018 are now available. While the Purchasing Managers' Index improved again in January as a result of positive developments in the euro periphery, it dropped slightly in February, if at a very high level. It is still too early to assess whether this was a one-off setback or whether it signals a trend reversal. Nevertheless, the index for the cyclically very sensitive manufacturing sector dropped (noticeably) for the second consecutive quarter. In January capacity utilisation was 84.4 %, close to the all-time high of a good 85 %. This highlights the need for additional investment.

According to our KfW Research Business Cycle Clock, the euro area economy has now entered a boom phase, the late phase of the current cycle. That does not mean we expect the upturn to end soon. Before the financial crisis, the euro area was in the boom quadrants of our illustration for 16 quarters with only minor interruptions. Based on the outstanding economic data, we expect a further widening of the output gap in the current quarter, that is, a positive deviation between actual performance and production potential.

Growth will continue unabated in 2018 but pace may slow in 2019

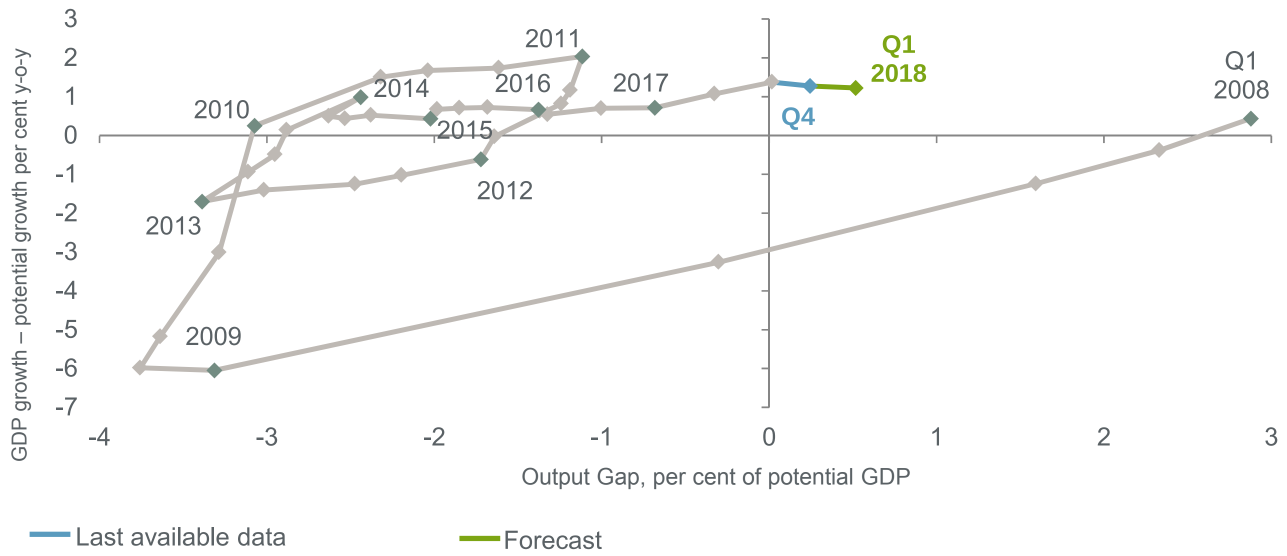
Current cyclical data provide no indication of an imminent cooling. Sentiment indicators are no longer rising and expectation components have receded moderately but that is a normal development given the record levels these indicators have reached. Some economies are still feeling the long-term consequences of the crisis. Many still have high unemployment rates and need to catch up on investment that was put off during the crisis. We expect continued robust real economic growth of 2.4 % this year.

Several factors point to slower momentum in 2019. The current upswing has been underway for 19 quarters already. It will be nearly six years early next year – provided no negative surprises occur in 2018. The duration of this recovery phase alone makes it plausible to assume that growth has now reached the peak of the current cycle. This is all the more so as the economy is now growing faster than its potential rate and the stimulus from expansionary monetary policy will decrease. That will make the financing environment less attractive. Here, too, the decline will start from a high level. But the interest rate reversal has already been initiated and the turmoil in the stock markets in early February is an expression of market participants' heightened risk aversion. In addition, although global economic growth remains robust, momentum is not increasing outside the euro area either.

Risk: primarily – but not only – the financial markets

The risk of slower economic growth will materialise especially if interest rates rise faster than previously expected and create greater volatility in the financial markets. A sudden tightening of borrowing conditions might hamper investment activity and shake this increasingly important pillar of the recovery. Some of the political risks have now shifted away from the monetary union to other regions. The scenario of a hard Brexit, for example, still cannot be ruled out, nor can a US trade policy that is harmful to growth and sets in motion a protectionist spiral. Finally, should the euro continue to appreciate strongly it will be increasingly difficult for the euro area economy to maintain constant growth despite the resulting negative consequences for exports. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research