››› Euro Area two months after the Brexit vote – solid growth, but more divergence

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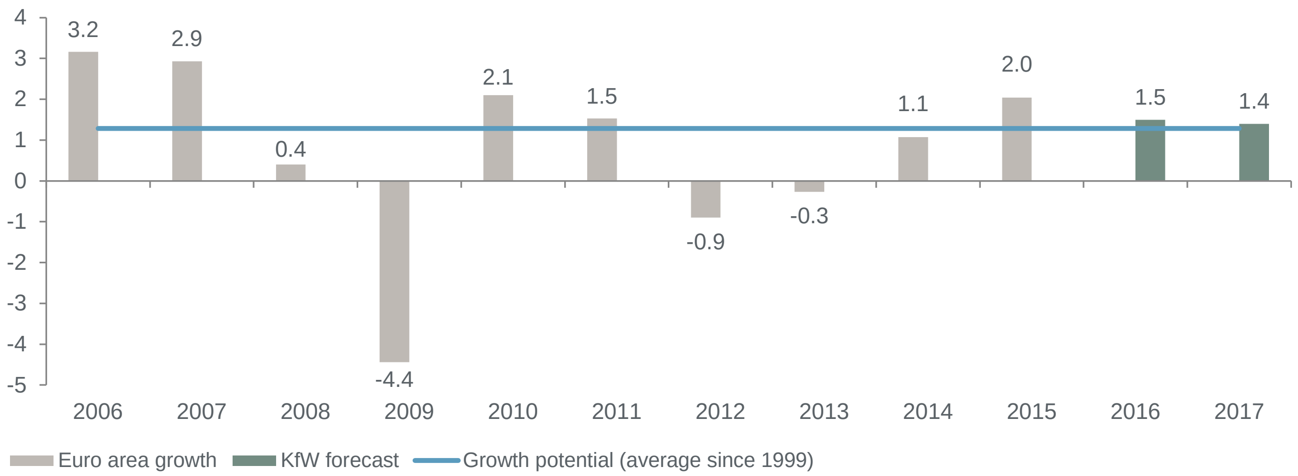
- KfW Research revises its growth forecast for the euro area upwards: +1.5 % in 2016, +1.4 % in 2017 (previous forecasts +1.3 % and +1.1 %)
- No radical sentiment change in the business community after the Brexit vote; however, political uncertainty hampers investment and delays self-sustaining upswing
- Divergences between euro states have widened again recently; Italy remains the euro area's problem child

Economic growth in the euro area

Real gross domestic product in per cent



Sources: Eurostat, KfW Research

Euro area growth: a slowdown, but no disappointment

After the positive surprise at the start of the year and 0.5 % growth in the first quarter, most analysts predicted a noticeable downturn in the second quarter. Against that background, the 0.3 % growth on the previous quarter cannot be seen as a disappointment. On the contrary: The first half-year of 2016 is still one of the stronger ones since the financial crisis.

However, the euro area is facing stronger headwinds again. The UK vote to exit the EU has created new realities and is weighing on the economic recovery. The hope that investment gradually replaces consumption as a growth driver and a strong, self-sustaining upswing takes hold will not be fulfilled for the time being. The recovery is still being sustained by consumption.

No general sentiment reversal yet

And yet, financial markets as well as businesses have by and large handled the Brexit vote well. Most share markets returned to positive territory after initial losses, the pound sterling lost value but did not crash through the floor, and interest rate spreads on sovereign bonds from periphery states rose only marginally. So far, only few hard economic figures on the period following the referendum are available. Measured by the usual indicators, though, business sentiment is subdued, but not pessimistic.

Nevertheless, it is still too early to give the all-clear with regard to the economic risk of the Brexit. We still expect the UK economy to cool down with negative consequences for exports from the euro area. Moreover, it will be some years before we know what the trade relations between the United Kingdom and the EU will look like in the future. Until there is clarity, businesses specialising in relevant export operations are likely to hold off on long-term investments. That will come at the expense of growth.

Recovery continues, but political uncertainties hamper vigorous upswing

Even beyond the Brexit, political uncertainty is hampering economic development. In addition to escalation in Turkey and continuing tension in Ukraine, uncertainties within Europe stand in the way of economic recovery. The search for a new government in Spain has been dragging on for almost nine months and a third round of voting can no longer be ruled out. Furthermore, 2017 is the year of general elections in large countries such as Germany and France. Election years often come along with higher public spending and tax cuts. However, the trend towards a strengthening of the fringes as well as the euro area's integration, which some are calling into question, are causing uncertainty and holding back investment.

Given the good first half-year overall, as well as the only slightly subdued sentiment in spite of the Brexit vote, we have revised our forecast for 2016 slightly upwards from 1.3 % to 1.5 %. The euro area should roughly maintain its expansion rate in 2017. We expect growth of 1.4 % (previous forecast 1.1 %). According to our KfW Research Business Cycle Clock, the euro area thus remains in a phase of cautious upturn. But it is still too weak to close the output gap, the difference between actual and potential GDP.

Widening divergence – Italy remains the problem child

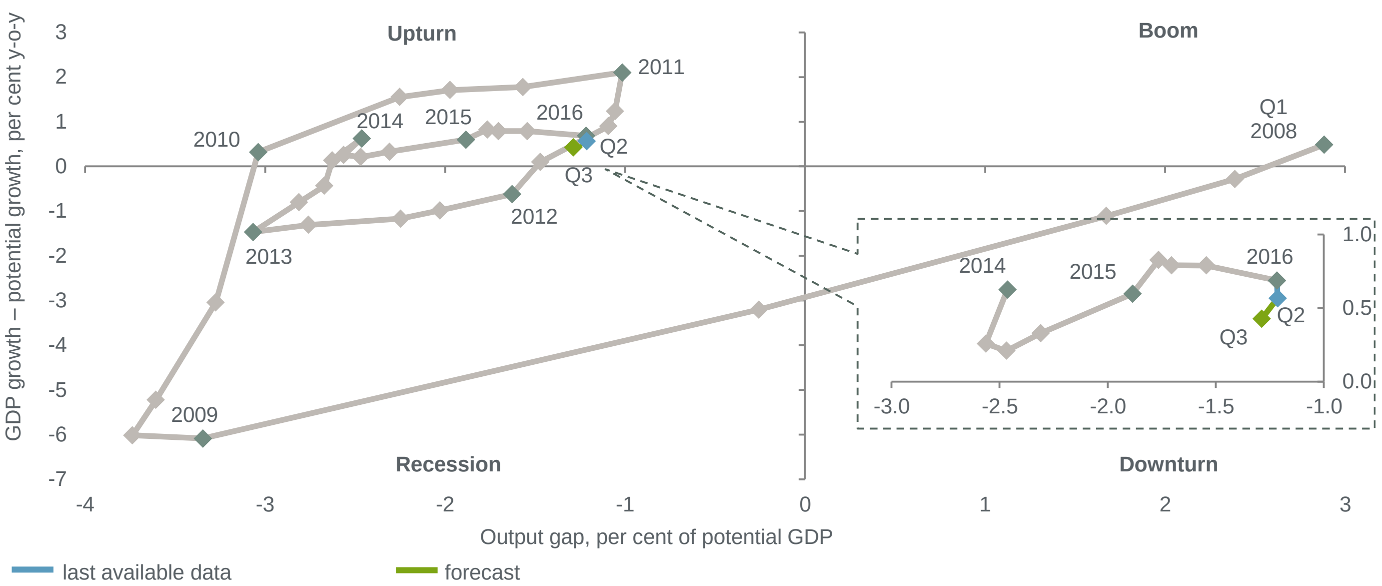
However, the robust growth across the monetary union masks widening divergences between the states. While the quarterly growth rates had converged since the second half of 2015, divergences between states are now growing again. Of the large economies Germany and, especially, Spain have shown strong growth momentum, while France and Italy stagnated.

In France the disappointing trend can be attributed in part to one-off effects. In particular, the fierce strikes of May and June prompted by labour market reforms are likely to have weighed on growth in the second quarter. In addition, expenditures made in the first quarter for the UEFA European Championship 2016, such as ticket purchases, may have reduced consumption in the second quarter.

The stagnation in Italy, on the other hand, rather reflects the current state of its economy. The country is still grappling with the legacy of more than three years of recession. The recovery on the labour market has now weakened, investment remains almost 30 % below the pre-crisis level of 2008, and the economy has made hardly any advances in productivity in 20 years. Another legacy of the crisis is a high stock of impaired loans and an ailing banking sector.

Various measures aimed at supporting the banking sector with the participation of the private sector so far have only been able to solve the most pressing problems. The deeper causes, however, still remain. The business model of Italian banks is geared towards lending to small and medium-sized enterprises. This business will not thrive again until Italy returns to growth. But the impetus that could set in motion a positive chain reaction is still lacking. This is all the more true as the political situation is tense because of a referendum on constitutional reform that will likely take place in November. A negative vote on the planned reform could create political instability and further damage the economic environment. The most recent earthquake, in turn, hit a region that – in purely economic terms – has no significant transport hubs so no major production losses are to be expected. Overall, we currently do not expect a recession in Italy. Nevertheless, growth will likely remain below 1 % – not enough to start the necessary trend reversal. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research