››› Upswing in the euro area is strengthening

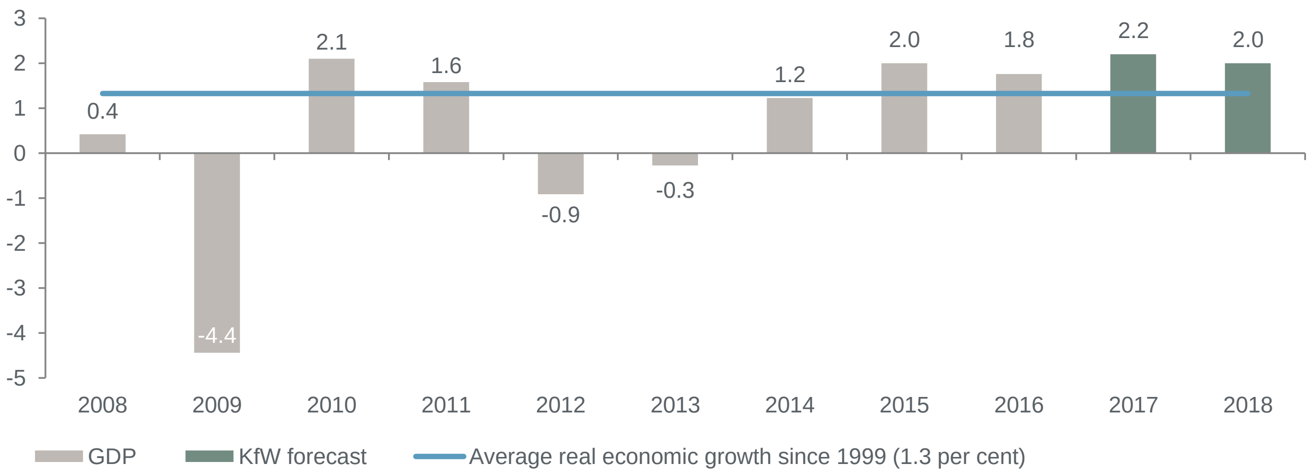
7 September 2017

Author: Dr Philipp Ehmer, phone +49 69 7431-6197, philipp.ehmer@kfw.de
Press contact: Christine Volk, phone: +49 69 7431-3867, christine.volk@kfw.de

- KfW Research revises its growth forecast for the euro area upward: +2.2 % in 2017 (previous forecast +1.8 %); growth in 2018 is set to remain strong at 2.0 % (+1.7 %)
- This would make 2017 the year with the fastest expansion within a decade
- Hard cyclical indicators have now caught up with outstanding business confidence; the euro area is entering an economic boom phase
- Political risks have recently weakened and have little impact on the business cycle; strength of the euro could be a headwind, but pace of growth may also accelerate

Gross domestic product of the euro area

Variation on previous year in per cent, adjusted for price effects



Sources: Eurostat, KfW Research

Strong business cycle in first half of 2017

The euro area economy exhibited strong first half-year performance, with second-quarter growth up 0.6 % on the preceding quarter. Growth in the first six months of this year reached a momentum not seen since 2010. At the time, the starting position was particularly favourable given the preceding recession and the associated potential for recovery. But the current upswing – measured by the quarterly growth rates – is now entering its fifth year. Given the sustained high growth rate, the current business cycle is most probably nearing its peak. And all euro countries are now benefiting from the economic development. After the debt crisis, such a uniform pace of growth should not be taken for granted, and it facilitates the single monetary policy and coordination of fiscal policy between the member states of the euro area.

In the second quarter, both domestic demand and external trade provided positive impetus. It is true that private consumption is no longer benefiting from the growth in real income generated by the oil price decline and low inflation of 2016. But euro area unemployment is still falling and the employment rate is on the rise, thus bolstering consumption. Investment grew faster than private consumption in the second quarter, though some countries still need to catch up. External trade was rather an obstacle to growth in 2016 but turned out to provide cautious stimulus in the first half of 2017.

Euro area entering an economic boom phase

The euro area economy is on a robust upswing. Since the start of the year, confidence indicators have climbed to levels even higher than in 2016 and occasionally point to an even faster pace of growth. The hard cyclical indicators also picked up in the second quarter: Industrial output increased by 1.3 % on the preceding quarter, incoming orders grew by 1.1 %, and capacity utilisation reached a level last seen in 2008. The contradiction between very positive sentiment indicators and only moderately positive hard cyclical indicators, which was particularly evident in the first three months of the year, has dissolved at least in part. The upswing in the euro area has thus consolidated.

KfW Business Cycle Compass Eurozone

Our KfW Research Business Cycle Clock shows that the boom phase has not yet been reached. Nevertheless, the output gap, the discrepancy between actual economic output and economic output achieved with normal capacity utilisation, has recently closed at a rapid pace. Measured by that indicator, the euro area business cycle is on an uptrend not seen for nearly ten years. The lower political risks in Europe have contributed to this development. Election results in the Netherlands and France were clearly pro-European, anti-European forces have weakened in Germany as well, and the risk of a Brexit variant that would damage the euro area's economy has recently waned in our view. The output gap might close completely in the current quarter.

Forecast for 2017: strongest growth of the past ten years

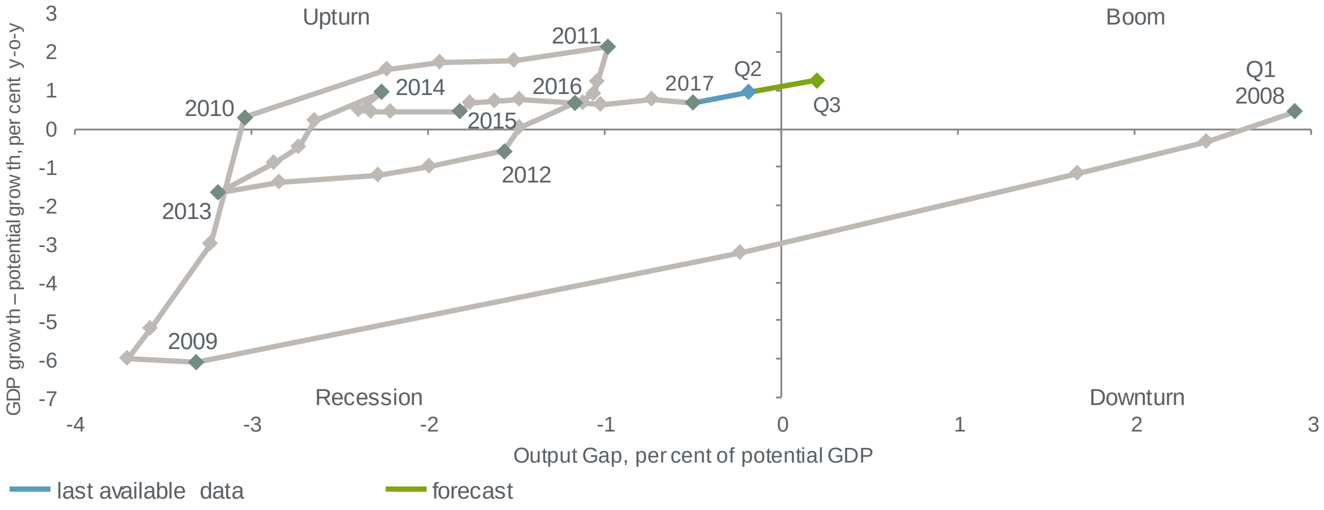
On the basis of the currently very positive cyclical indicators, we do not expect growth to slow for the rest of the year. Political uncertainties remain, however, for instance with regard to the coming election in Italy, US trade policy, and Brexit. But the recent past has shown that the effect of such uncertainties on the business cycle is often overestimated. The Brexit vote, for example, did not have any major negative cyclical effect in the immediate aftermath, that is, in the second half of 2016. In Italy the growth rate even picked up after the Renzi government resigned in December, and the long phase of the transition government in Spain in 2016 failed to dampen growth there as well. We expect real GDP growth of 2.2 % for the year as a whole, and that would make 2017 the most successful year of the euro area economy in the last decade. The pace of growth should slow only slightly in 2018. The real growth rate is set to remain at 2 %, not least as a result of the overhang expected for the end of this year.

Forecast risks are evenly distributed

One factor that might slow the pace of growth in the euro area is the significant appreciation of the euro. Since the start of the second quarter, the currency has already appreciated by 6 % on a trade-weighted basis (12 % against the US dollar). If the strength of the euro continues and rises even further, it could ultimately have a dampening effect. The same applies to the unpredictable trade policy of the US and to the possible aggravation of the political situation in Italy should parties that propagate an exit from the euro area form the next government. In combination with a fundamental turnaround on the bond market, this could lead to serious distortions in the financial markets.

Other factors, in turn, might drive growth even higher than we expect. Confidence indicators in the euro area are compatible with further economic revival, and the global business cycle is in good shape. Moreover, the banking problem in the euro heavyweight Italy has also defused somewhat recently, and reforms initiated swiftly in France might provide more impetus for new investment there. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research