››› Economic performance is good, but risks have grown

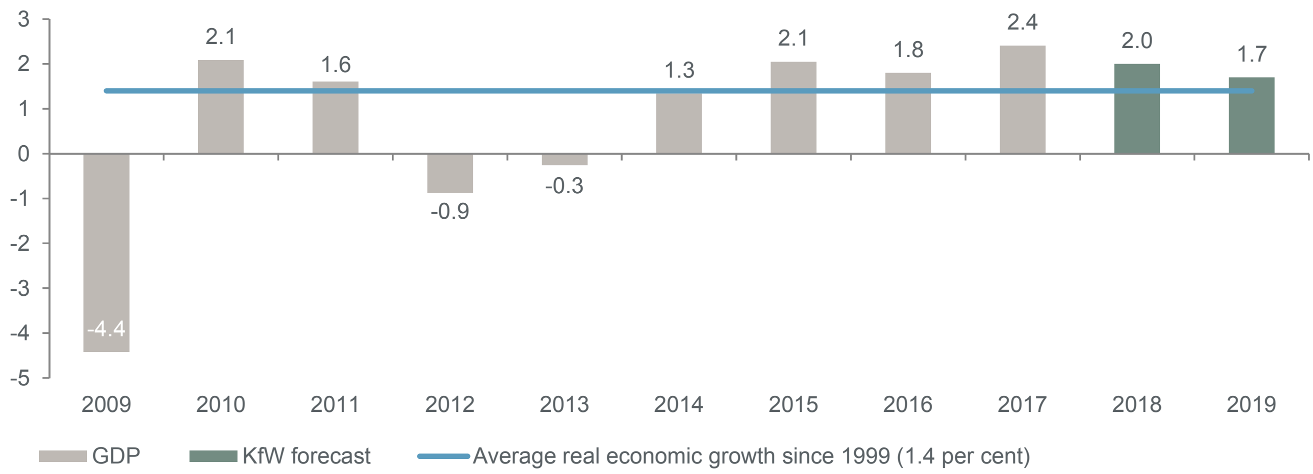
7 September 2018

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

- KfW Research lowers its growth forecast for the euro area. We expect real GDP growth of 2.0 % in 2018 and 1.7 % in 2019 (previous forecasts were 2.2 and 1.9 %)
- In the first half of 2018, growth decreased by nearly half from 2017
- Slowdown is not a harbinger of a recession; economic indicators still show strong business cycle
- Nonetheless, the forecast is subject to numerous downward risks – from a global trade war to the crisis of the Turkish lira to the return of high government bond spreads in the euro area

Euro area gross domestic product

Variation on previous year in per cent, adjusted for prices



Sources: Eurostat, KfW Research

Correction to the high growth rate of 2017

In the first half of this year, the euro area economy grew at a significantly slower pace than in 2017. Quarterly growth rates averaged just under 0.4 % on the preceding quarter and were merely half as high as in the previous year. While various special effects had slowed the growth rate in the first quarter, such as low temperatures that impaired construction activity, it is now becoming increasingly clear that the slowdown is not just temporary. Rather, we believe the slower rate of growth is an indicator that the business cycle is set for a prolonged phase of more moderate growth.

The situation has become inverted, especially in industrial production and exports. Both were the strongest drivers of growth in 2017: Adjusted for prices, exports grew by 5.5 % and industrial production by more than 3 %, the highest rate since 2011. However, both have now received a damper. Industrial production decreased slightly in the first half of 2018 and international trade also weighed on growth. In the second quarter alone, foreign trade reduced GDP growth by -0.2 PP.

Economic growth in the euro area currently relies on domestic demand. Unemployment has now dropped to just 8.2 %, below the average level of the years 2004–2008, in other words, during the upturn before the financial crisis. At the same time, wage growth is slowly gaining momentum and consumer confidence remains near the all-time high. In this environment, private consumption remains an important pillar for the business cycle. However, the development of investment in the past quarter was particularly positive. A plus of 1.2 % on the previous three months brought real investment in the euro area a little closer to the pre-crisis high in 2007.

The half-year ended on a bad note from a cyclical point of view, however. In June, industrial production and incoming orders, in particular, decreased significantly. In the second quarter, 1.5 % fewer new orders were received overall than at the end of last year. International orders dropped at almost twice that rate. Industrial production fell by 0.4 % during the same period.

Indicators continue to show an upward business cycle

However, the current momentum must be put into perspective with the extremely positive development in 2017. Even if the volume of incoming orders continues to decrease, the order books remain well filled in broad areas of the monetary union. Capacity utilisation declined slightly of late but is still at 84 %, higher than in nine out of ten cases in the past 20 years. The purchase manager index as one of the most important sentiment barometers now appears to have stabilised on a level of roughly 54, which points to continuing robust growth.

Besides, a moderate slowdown is not unusual after the high momentum of 2017 and in an upswing that has continued for five years now. Our KfW Research Business Cycle Clock shows that the euro area economy has been in a boom phase for the past three quarters. The output gap is positive, that is, the economy is growing above its production potential with above-average capacity utilisation. Lately, however, the curve ceased to move further into the boom quadrant.

Growth has slowed but remains on a high level

We see hardly any signs that the growth slowdown since the start of the year could be a harbinger of an imminent end of the cycle. The labour market, wage levels and consumer confidence show that the conditions for consumption are very good. With the economy running at full capacity, the need for investment is high and borrowing conditions remain good, despite the ECB's gradual exit from its very expansionary monetary policy. The environment is therefore good for investment as well, even if it is being dampened by certain political uncertainties, for example with respect to future trade and economic relations with the UK. International trade is the only area that is likely to face rough sailing for the time being.

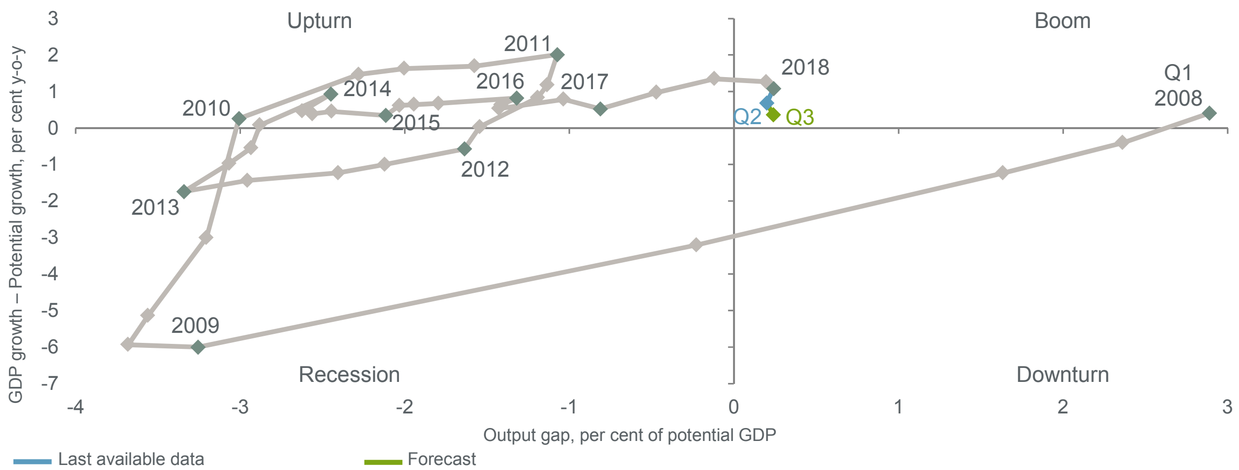
For one thing, the euro appreciated significantly between April 2017 and April 2018. The trend has reversed since then but currency appreciations sometimes take a while to affect growth. For another, further burdens on trade with the US through tariffs are off the table for now but it is unclear whether that situation will last. In addition, the disputes between the US and other trade partners as well as Iran and Russia and the crisis in Turkey threaten to put the brakes on exports from the euro area.

We generally consider the euro area economy to be so stable that the burdens from external trade will cause no more than a moderate downturn. For the current year we expect GDP growth of 2.0 %, in 2019 it is likely to slow to 1.7 %. That means a downward revision to our previous forecasts by 0.2 percentage points each. Part of the decrease for 2018 is due to the weaker-than-expected first half. Despite the slowdown on 2017, these growth rates are still above the long-term average.

A range of downward risks

Our forecast is subject to various downward risks. These include a possible trade war between the US and China in particular, which would slow down growth not just through reduced trade volumes but mainly through heightened economic uncertainty and investment restraint. Tighter borrowing conditions for emerging market economies, triggered by more stringent US monetary policy, could lead to capital outflows and weakening economic activity in those countries. A hard Brexit without a new trade deal can still not be ruled out and will probably remain a possibility into the next year. Finally, within the euro area itself the danger exists that, depending on the Italian government's fiscal policy course, government bond spreads in the euro area will increase again and have a dampening effect on economic growth. ■

KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research