

## »» Heading for a lull – euro area faces prolonged phase of weakness

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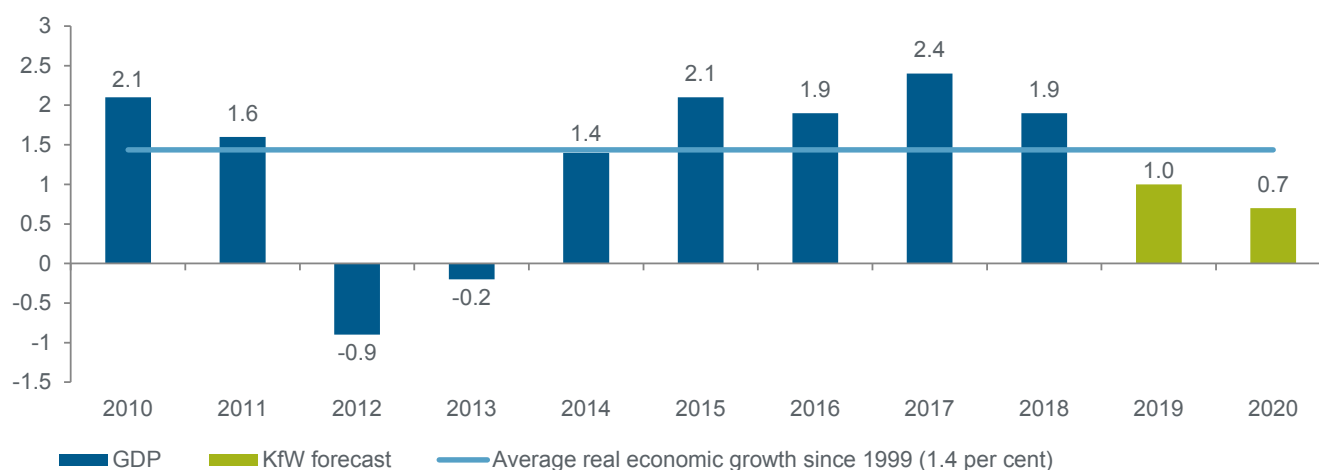
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- The growth spurt at the start of the year was short-lived. Real GDP in the monetary union grew by only a meagre 0.2% in the second quarter. The growth rate thus halved on the previous three months. While we had anticipated a loss of momentum of this magnitude, the hopes for an imminent brightening of the economic outlook have also been shattered.
- KfW Research has therefore lowered its growth forecast for the euro area. Nevertheless, the good start to the year should still see economic output grow by 1.0% in 2019 (previous forecast: 1.1%). Our growth downgrade for 2020 is more substantial: Next year we expect a further slowdown to 0.7% (previous forecast: 1.5%).
- We see little chance of tangible growth increases until mid-2020. The leading indicators show no signs of a trend reversal. Furthermore, the disruptions from trade policy disputes are not easing and the fierce debates over Brexit are going into the next round with an unpredictable outcome.
- The already struggling industrial sector is thus facing further pressure. Although consumption momentum has also weakened lately, the euro area should nevertheless be able to just barely avoid a recession thanks to the resilience of the domestic economy and supporting monetary and fiscal policy impetus. But it cannot be ruled out completely.

### Euro area gross domestic product

Variation on previous year in per cent, adjusted for prices



Source: KfW Research

### The euro area business cycle is losing steam again

The joy over the strong first quarter soon gave way to disenchantment. After the intermediate sprint favoured by temporary factors was over, the second quarter saw only a paltry 0.2% increase in economic output. The pace of growth thus halved on the previous three months. The decisive factor for the cyclical downturn was the sustained weakness in manufacturing which, because of internationally linked global value chains, is suffering under the weight of the trade conflicts and the associated uncertainty. Germany as one of the large member states has been hit particularly hard by this

development as it relies heavily on manufacturing, seeing economic output shrink by -0.1%. While Italy did not escape stagnation, France (+0.3%) and Spain (+0.5%) were able to better weather the adverse conditions.

### Growth looks to remain anaemic

We had previously expected the business cycle to gradually improve in the second half of this year. Contrary to our assumptions, however, the intensity of the political disturbances increased further in the meantime. The most recent expansion of tariffs marks a new escalation in the US-China

Note: This paper contains the opinion of the author and does not necessarily represent the position of KfW.

# KfW Research

## KfW Business Cycle Compass Eurozone

trade conflict and there is no end in sight to the dispute. In addition, the uncompromising strategy of the Johnson government in the meantime made a no-deal Brexit on 31 October appear all but inevitable. Although the intervention of the UK parliament means the cards have been reshuffled, the conflict continues with great intensity – and an unpredictable duration and outcome. The associated burdens are considerable, especially for the already struggling industrial sector. We have therefore revised our forecast and now expect only a more or less stagnating economic performance beyond the end of this year.

Our increased scepticism is corroborated by the currently available leading indicators, which signal a sustained industrial recession. The pessimism in the business sector has deepened once again in the third quarter. In July the Purchase Manager's Index for manufacturing fell to a new (record) low in the current cycle, as did the EU Commission's economic sentiment indicator (ESI). The marginal counter-movement in August signals a cautious bottoming out at best.

### No recession thanks to stabilising factors, ...

The KfW Research Business Cycle Clock shows that the euro area has entered a downward trend. Growth remains below the estimated potential growth rate and capacity utilisation is also declining. While it cannot be ruled out that the economy may slip into recession given the severe politically induced uncertainties, we do not currently expect this to occur.

Granted, there are sporadic signals that suggest the industrial crisis may be spilling over to the rest of the European economy. They include the weakening dynamic of private consumption to 0.2% after 0.4% in the first quarter. But overall, the domestic economy remains in good shape.

The purchasing managers' indexes for the service sectors remain steady in the expansion range. Besides, unemployment has been on the lowest level in 11 years since June. Along with further decent wage increases, that should at least keep consumers in the mood to buy. Economic policy is also providing the business cycle with a boost. The moderately expansionary fiscal policy and the automatic stabilisers that kick in during a phase of economic weakness are set to be supplemented by a new package of monetary policy measures from autumn. The associated favourable financing conditions should make a major contribution to helping businesses endure a temporary sales slump and balance investment activities.

### ... but a significant downgrade for 2020

Overall, the economic outlook has clearly dimmed. KfW Research has therefore corrected its growth forecast slightly to 1.0% for the current year and sharply to 0.7% for the coming year. We therefore do not expect the lull to end before mid-2020. The US election should then dampen the appetite for further trade conflicts. The risk situation is looking more balanced. A surprising end to the trade conflict between the US and China could provide an unexpected economic boost, as could a swift and constructive solution to Brexit. On the other side of the equation, considerable downward risks remain. The threat of punitive tariffs on European automobile imports is still on the table and the distortions in the case of a no-deal Brexit could turn out to be more significant than expected should the preparations for it prove to have been inadequate. ■

### KfW Research Business Cycle Clock Euro Area



Sources: Ameco, Eurostat, KfW Research