››› Germany and the euro area after Brexit: expected upturn will not now occur

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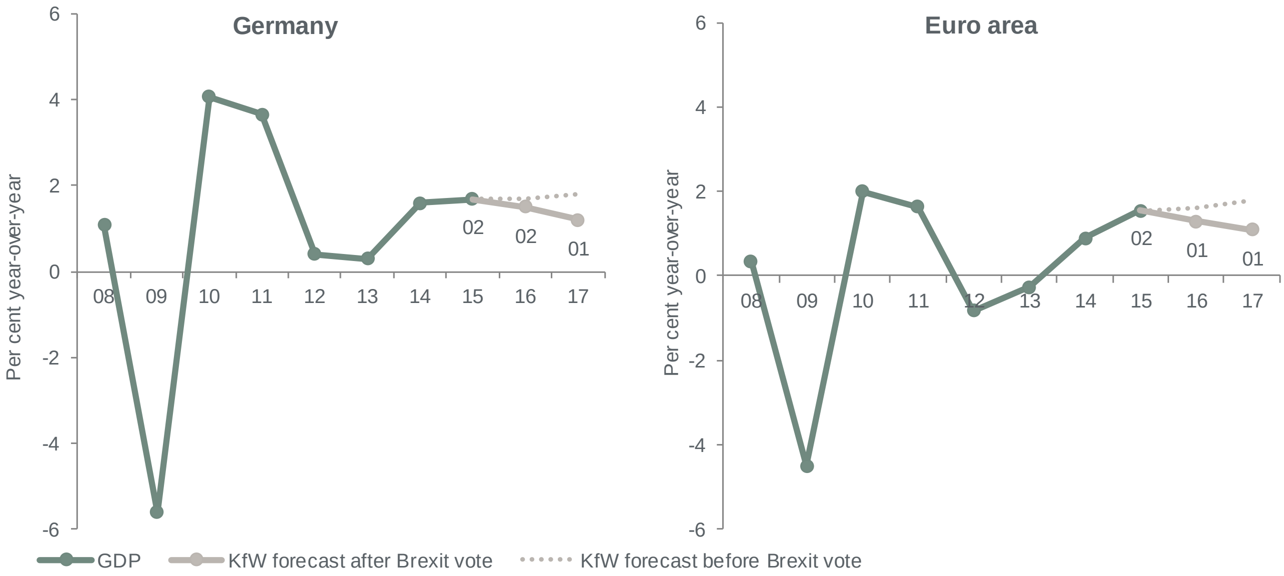
- Due to the Brexit vote, KfW Research has slightly reduced its German economic growth forecast for 2016 to 1.5 % (previously 1.7 %) and that for 2017 more significantly to 1.2 % (previously 1.8 %); a smaller statistical overhang affects 2017; the euro area is expected to grow by only 1.3 % in 2016 and 1.1 % in 2017 (previous forecasts: 1.6 % and 1.8 %)
- Germany: Uncertainty and weaker export growth dampen business investment; employment, consumption and residential construction continue to grow appreciably
- Euro area: The weakest links are the most affected; Brexit puts pressure on still fragile domestic demand; a weak banking sector – particularly in Italy – hampers new lending
- United Kingdom: Economy will slow considerably in the second half despite monetary policy stimulus; political uncertainties severely inhibit investment; an uncertain outlook for the UK property market depresses consumption and the financial sector
- Uncertainty is exceptionally high, above all due to the unclear plans of the British government and the difficulty of assessing longer-term financial market developments; the longer the timetable and goals of Brexit remain unclear, the worse it is for the UK economy; in the European Union, in contrast, planning certainty remains intact

Gross domestic product, price-adjusted



Sources: KfW Research, Destatis, Eurostat

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

Brexit vote leads to a revised forecast

In our latest economic forecasts for Germany and the euro area, we predicted a slight acceleration of real growth in 2016 and 2017. Our forecasts were explicitly based on the assumption that the United Kingdom would vote to remain in the EU on 23 June. However, a majority of English and Welsh voters opted in favour of Brexit, outvoting the two less populous parts of the country, Northern Ireland and Scotland. This result means we have had to update our forecasts.

Uncertainty inhibits investment

We expect Britain's decision to have a slowing effect on the German and European economies too. However, the largest negative impact is likely to be on the UK itself. First, companies' demand for goods will probably decline in response to Brexit. Firms based in the EU's second largest economy will hold back from investing for the time being. It is not only the UK's future economic development that is unclear in the wake of Brexit: in addition, political uncertainty plays a greater role than in other European countries. Not only do the parties have to regroup and find a new head of government – there is also a possibility that Scotland may split from the United Kingdom. In this environment, businesses are typically refraining from investing.

UK less attractive for inward direct investment

This also applies to foreign inward direct investment, half of which comes from within the EU. However, the UK is considered by many companies around the world as a gateway to Europe. For that reason, foreign direct investments which are not affected by rule changes regarding capital movements between the UK and the EU are also expected to decline. In the long term this reduces Britain's growth potential and increases the risks arising from the twin deficits in the government budget and current account.

British households more cautious now

Second, British households will rein in their consumer spending to some extent. Slower employment growth will lead to more moderate income growth. A looming rise in inflation due to the devaluation of sterling will reduce purchasing power faster than the export sector can benefit from increased competitiveness. Greater fear of job losses will also increase saving due to the precautionary motive. Finally, greater uncertainty in property markets reduces the expected asset values of UK home-owners, especially in London.

Export outlook less favourable

Third, 44 % of British exports go to the EU. Until the negotiations with the EU have been completed (and possibly thereafter), trade barriers such as tariffs are not expected. However, demand from the EU for British exports is expected to decline, because Brexit will also strain the economic recovery in the rest of Europe. The pound's depreciation – by 11 % against the euro and 15 % against the US dollar – will help exports in principle. But since the UK economy has little export-oriented industry, reluctance to invest and consume is likely to have a greater impact on growth.

Challenges for London's financial centre

Fourth, Brexit casts doubt on the City's status as Europe's most important financial centre. It seems certain that the European Banking Authority (EBA) will be relocated to the continent. More important, however, is the threatened loss of the "single passport" which gives banks domiciled in the UK access to the EU financial market. The financial sector is extremely important to the British economy, accounting for 8 % of total gross value added – higher than average and twice as much as in Germany.

The UK will be economically hardest hit

Overall, we believe the economic pressures after Brexit will be greater in the UK, as the epicentre of the shock wave, than in the rest of Europe. However, since the UK was in good shape before the referendum and given the mild reaction of the financial markets so far, we do not expect a recession.

German investment and exports weaker

In Germany, exports and business investment in particular are likely to be negatively affected by the Brexit decision. The UK is a key market for the German automotive industry, and also the chemical and pharmaceutical industries. German exports to the UK totalled EUR 89.3 billion in 2015, accounting for 7.5 % of all German goods exports and just under 3 % of German GDP. The recovery of export growth which we expected before the Brexit referendum will suffer a significant setback under the new conditions – not only because exports to the UK itself will be weaker, but also because the vote will have knock-on effects on the economies of other trading partners. As a result, those countries' demand for German exports is likely to be weaker than previously thought.

Given the gloomy sales outlook coupled with a likely prolonged period of uncertainty about Germany's future relationship with its third most important export market, companies will probably hold back from investing for the time being. In the first quarter, strong growth in business investment had kindled hopes that the investment backlog was gradually starting to clear.

Domestic demand is stabilising

By contrast, the German labour market and domestic demand – particularly consumption and residential construction – are expected to go on steadily rising, thereby alleviating external headwinds. However, due to weaker business investment and hence a less vigorous increase in employment, growth in domestic demand may not now be as strong as would have been possible under different circumstances, especially in 2017.

Germany only growing at potential rate

All in all, under the new conditions, we forecast growth of 1.5 % for the German economy in 2016 (our forecast before the Brexit referendum: 1.7 %) and 1.2 % in 2017 (previous forecast: 1.8 %). The weak second half now expected for 2016 will reduce annual average growth in 2017 due to the low starting level (statistical overhang effect). This year's growth figure, on the other hand, will not be affected as much, thanks to a generally very good first half. Furthermore, the large variation in the number of working days from 2015 to 2017 overstates the decline in real growth: Adjusted for the calendar effect, according to our new forecast Germany will grow by 1.4 % in each of the years from 2015 to 2017.

Therefore, the basic trend of the German economy this year and next year – like last year – is expected to be at around the potential rate. That is another reason why business investment is likely to be sluggish for the foreseeable future, because such a rate of growth reduces the need for expansion investment. This represents a lost opportunity to accelerate growth, given the earlier likelihood of a steady improvement in the external economic environment and a healthy domestic economy, finally leading to higher investment.

Setback for the euro zone

The euro zone's recovery will also slow as a result of the UK's decision to leave the European Union. However, we do not expect an economic slump on the scale of the 2008/2009 financial crisis or the 2012 euro crisis. Instead, we anticipate a temporary slowdown and have lowered our forecast for 2016 to 1.3 % (previous forecast: 1.6 %) and for 2017 to 1.1 % (previous forecast: 1.8 %).

Uncertainty mainly affects the weakest links

The direct impact on the euro zone via foreign trade is likely to be moderate. Exports to the UK amount to around 2.5 % of GDP, therefore the British market is less significant for the euro zone than it is for Germany alone. Nevertheless, Brexit is likely to have a larger impact on the rest of the euro zone. The increased uncertainty mainly weighs on those economies which are still struggling with the aftermath of the financial crisis. Despite improvements in growth – including a strong first quarter throughout Europe – domestic demand remains fragile in many parts of the euro area, which will thus be more strongly affected than Germany.

Consumption has been a key factor in the recovery, but unemployment remains extraordinarily high, making households cautious in their spending habits. Despite low interest rates, investment remains very weak and barely above the level of 2010. In the southern EU countries, downward momentum is exacerbated by higher risk aversion and corresponding stock market losses. For example, the Italian equity index FTSE MIB is 13 % and the Spanish IBEX 35 11 % lower than on 23 June.

Weak point: the European banking sector

The European financial system was firmly shored up following the financial crisis. In addition to the safety net created by the European Stability Mechanism (ESM), the ECB's monetary policy also provides stability. As a result, government bond spreads have remained within tight ranges and banks have access to abundant central bank liquidity. Nevertheless, Brexit comes at just the wrong time for the European banking sector: low interest rates and tougher regulation eat away at profitability in any case.

Further pressures now threaten due to depreciation as a consequence of asset price falls, particularly for assets priced in sterling, and banks could face costly relocations. The volume of loans at risk of default could turn out greater than previously thought due to the economic slowdown. Consequently, the Brexit vote has reinforced the downward trend in bank stocks already apparent since the beginning of the year. The difficult situation in the banking sector is likely to have a negative impact on the still delicate recovery in the credit market, thus further weakening aggregate demand.

Italy: a test for the banking union

Italy is especially hard hit. The sectoral index has plummeted by 31 % since 23 June, and by 54 % since the beginning of the year. Large parts of the Italian banking sector are suffering from non-performing loans now totalling EUR 360 billion. Solutions attempted so far, such as the creation of the Atlante rescue fund, have proved insufficient. Failed attempts at recapitalisation suggest that private investors are not currently prepared to make the necessary funds available.

The results of the current EBA stress tests are due to be published at the end of this month. Analysts anticipate a capital requirement in the double-digit billions for the examined Italian banks, at least in the stress scenario. Soon after the Brexit decision, the new European banking union is facing its first test. Government funds may only be used to support banks in the case of a bail-in of shareholders and bond creditors amounting to at least 8 % of total liabilities. The European Commission, EU member states and the Italian government must do everything in their power to arrive at a common solution within the terms of the new banking directive. We believe the rules are sufficiently flexible to allow this.■