

»» KfW Research Business Cycle Clock Euro Area



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Where are we in the business cycle?

In the second quarter, euro area growth was 1.6% on the previous year. Is that much? It depends: It is little compared with the upswing preceding the financial crisis. But it is a lot compared with the mixed performance during the debt crisis. So where are we now? Do we have to weatherproof our economy for a new recession? Or should we open our wallets ahead of an impending upswing?

Our new KfW Research Business Cycle Clock is a useful guide for assessing the current position of the euro area in the cycle. It traces the course of the cycle and divides it into four basic phases: upturn, boom, downturn and recession.

Methodology

On the horizontal axis, the business cycle clock shows the output gap, that is, the deviation of real economic output from production potential. A negative output gap can be interpreted as underutilisation while a positive output gap

gap can be interpreted as overutilisation of capacities. The vertical axis represents the difference between GDP growth and growth of production potential on the previous year.

Data on potential GDP are published on an annual basis only. For our quarter-on-quarter calculations we therefore interpolate the values on the assumption of a steady quarterly growth rate.

Our business cycle clock assigns a quarter with a negative output gap and real growth below the increase in production potential to a recession phase. In an upturn phase the output gap remains negative, although actual growth exceeds potential growth. As a result, during an upturn the output gap normally closes gradually until a boom phase is reached and capacity utilisation is above-average.

The cycle in the euro area

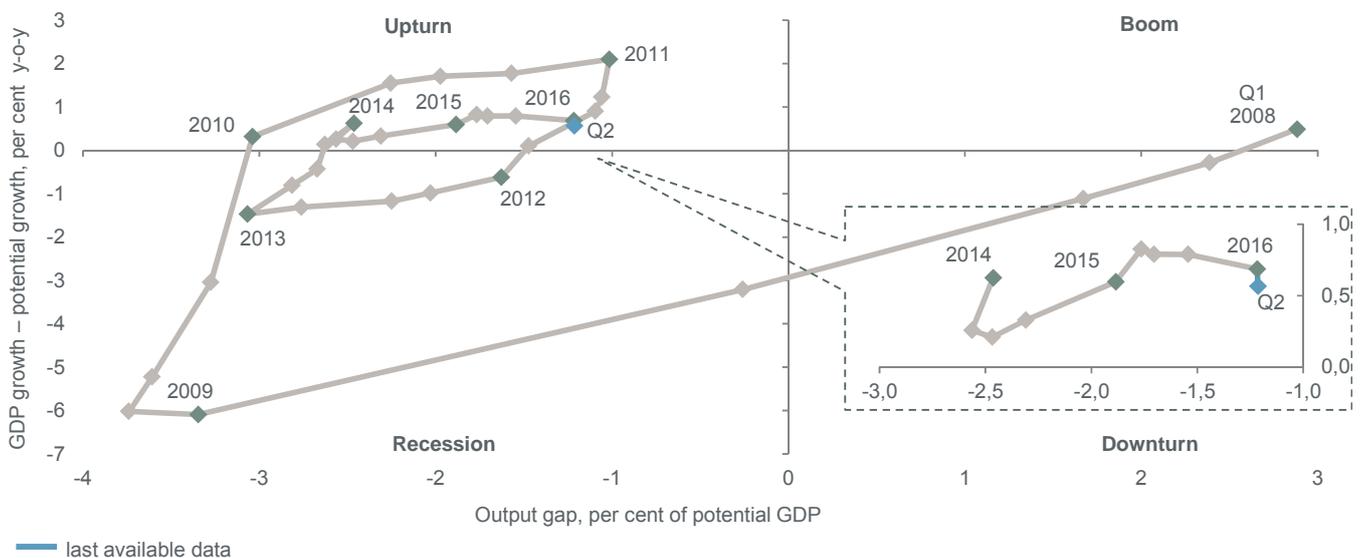
After the trough in the financial crisis the

euro area entered an upturn phase in 2010. However, the debt crisis put an end to it before the output gap could be closed completely and took the currency zone back into a recession. Since then the euro area completed a full cycle, as it were – although with a consistently negative output gap.

Analysing the euro area as an aggregate obviously masks major divergences between the member states. Whereas a boom phase began in Germany in 2011, for example, the output gap in Greece at the height of the crisis was nearly -14%, significantly wider than the euro area average.

Since late 2013 the euro area has been in a renewed but very moderate upturn. As the actual increase in economic output is only marginally above potential growth, the output gap is closing only slowly. ■

Figure: KfW Research Business Cycle Clock Euro Area



Note: From now on the KfW Research Business Cycle Clock will be included in every Business Cycle Compass Euro Area.

Sources: Ameco, Eurostat, KfW Research

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