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Business Cycle Report of June 2017

Employment Boom Raises Consumer Confidence, Impetus Provided by World Trade Boosts Exports. Business Cycle Report of June 2017

In the first quarter of 2017, the Austrian economy registered its strongest growth in six years. Private consumption remained a solid pillar of economic activity, while exports benefitted from strong impetus provided by emerging market economies, especially via the tight supply chains with Germany, and by East Central Europe. Unemployment declined as a result of the upswing that set in with the tax reform implemented in 2016, with strong second-round effects creating additional demand; consumer sentiment again caught up with that in Germany. Nevertheless, the labour market is faced with structural problems. The massive increase in labour supply brought about by opening the labour market for citizens from Eastern countries, the ageing of the labour force, and the implementation of pension reform measures contributed to an entrenchment of unemployment.

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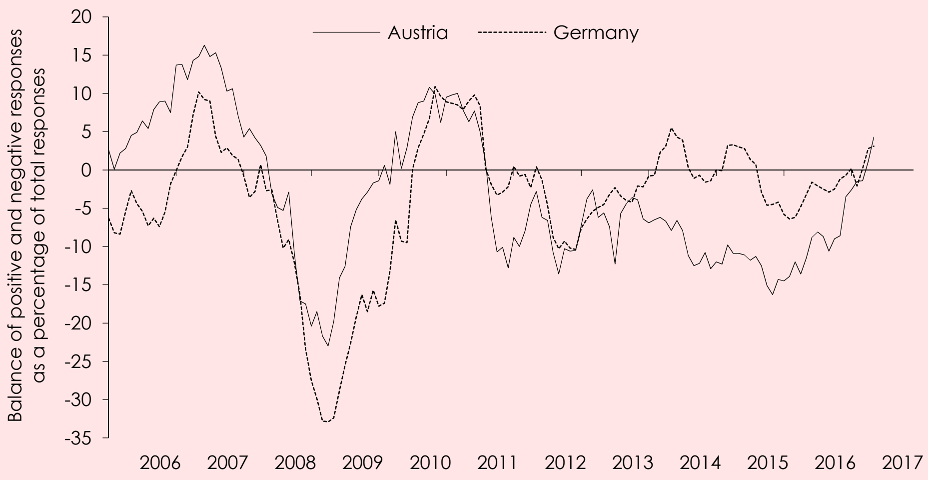
The consumption-driven economic upturn that set in in Austria at the end of 2015 has received additional stimulus from abroad this year. The export industry on the one hand has benefitted from accelerating industrial activity in emerging market economies, notably via the supply chains to Germany, and, on the other hand, from the pick-up in activity in East Central Europe thanks to new EU subsidies. Exports and manufacturing activity picked up at the fastest pace in six years in the first quarter of 2017. At the same time the positive impetus the tax relief provided last year to private consumption appears to trigger substantial second-round effects so that the dynamism in consumer spending is expected to stabilise sustainably: the improvement in households' income situation has stimulated the demand for employment-intensive services, among other things, which in turn has led to an increase in the demand for labour. Employment is growing more strongly this year than it did last year, and unemployment is declining noticeably. This has caused a sustained improvement in consumer sentiment (Figure 1) and is expected to increasingly strengthen also lower incomes, which have benefitted only less than proportionately from the tax reform. The broad-based improvement in the employment and income situation benefits not only private consumption, but increasingly also construction investment.

But the current employment boom masks structural problems in the labour market caused by the strong growth of the labour force in recent years: owing to demographic and displacement effects, the proportion of long-term unemployed, which had remained constant for many years, has doubled since 2013 (Figure 2). Therefore the unemployment rate is not dropping to the cyclically customary level, despite an increase in the number of job vacancies, and in May 2017 stood at 8.6 percent (seasonally adjusted). Notably low-skilled persons, older persons and persons with a health problem are affected by long-term unemployment. So far, unemployment has barely fallen among persons from former guest-worker countries (Turkey, Yugoslavia), and has declined by about one fifth of the increase since 2012 among Austrian citizens, while the number of employed foreigners from EU countries continues to rise.

Figure 1: Consumer confidence

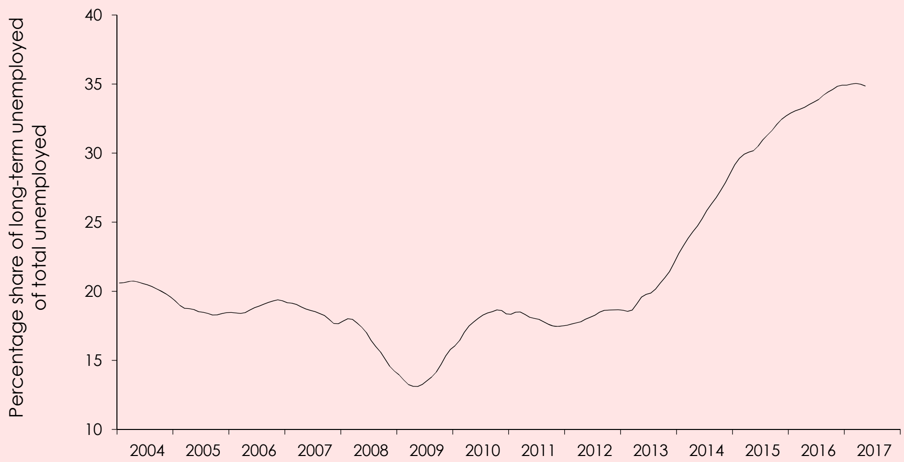
Seasonally adjusted



Sources: European Commission; WDS – WIFO Data System, Macrobond.

Figure 2: Long-term unemployment

Seasonally adjusted



Sources: Public Employment Service Austria (AMS), Main Association of Austrian Social Security Institutions.

In addition to Germany and Austria, the industrial region of northern Italy also saw exports pick up in the first quarter. Economic activity remained of medium strength in France, and dynamic in Spain, continuing to catch up. In the UK, devaluation-related price increases dampened consumption; in East Central Europe, new EU subsidies are fuelling an upturn. Tourism demand from Russia rebounded last winter, following the strong decline in the previous two years, as the stabilising crude oil price led to a recovery in Russians' purchasing power.

1. Lively demand from emerging market economies

Germany and Austria appear to benefit again from soaring demand from emerging market economies.

Following a period of slackness that had lasted for several years, spring 2016 saw the beginning of a marked uptick in import demand, which spread from East Asia and in the course of the year also reached the emerging market economies of South America and Eastern Europe (Russia). According to latest data, this upward trend has slightly weakened this year. The increased demand initially stimulated goods trade in these regions, for the exports from East Asia, Latin America and Eastern Europe also picked up. Among industrialised countries, notably Japan has been experiencing an increase in goods exports since mid-2016, while the latter have grown rather modestly so far in the euro area as a whole. But the German export industry is believed to have already received a positive impetus from the increased demand from emerging market economies, with the expansion of goods exports accelerating to +6.6 percent, year on year, in the first quarter of 2017. The Austrian export industry benefits from this development via close trade relations and supply chains with Germany; in the first quarter of 2017, goods exports grew by 8.4 percent compared with a year before and by 3.1 percent compared with the previous quarter (trend-cycle component). These were the sharpest increases in six years (first quarter of 2011 and third quarter of 2010, respectively).

1.1 Strong investment dynamics observed in the USA

The US economy expanded at an extremely weak pace, according to the flash estimate for the first quarter of 2017; the rate was raised only slightly in the second calculation (from +0.2 to +0.3 percent, compared with the previous quarter). The notoriously weak first-quarter growth in recent years is attributable to seasonal adjustment issues that are only gradually being rectified. Against this background, the apparent uncoupling of the investment momentum from the remaining economic momentum is remarkable. While consumer demand slackened noticeably in the first quarter, the government curbed its demand, and firms liquidated inventories, fixed investment rose by 2.3 percent, compared with the previous quarter. Exports also increased. The reasons behind the weak consumption include real income losses due to increases in energy prices at the beginning of the year and delayed tax refunds.

1.2 Strong foreign trade growth in Central Europe's industrial regions

Economic growth in the EU as a whole in the first quarter of 2017 was revised up from +0.4 to +0.5 percent; hence the momentum in economic activity at the beginning of the year equalled that in the euro area. The growth rates for the EU are broadly in line with the average for recent years, while the euro area for the second consecutive time registered slightly above-average growth.

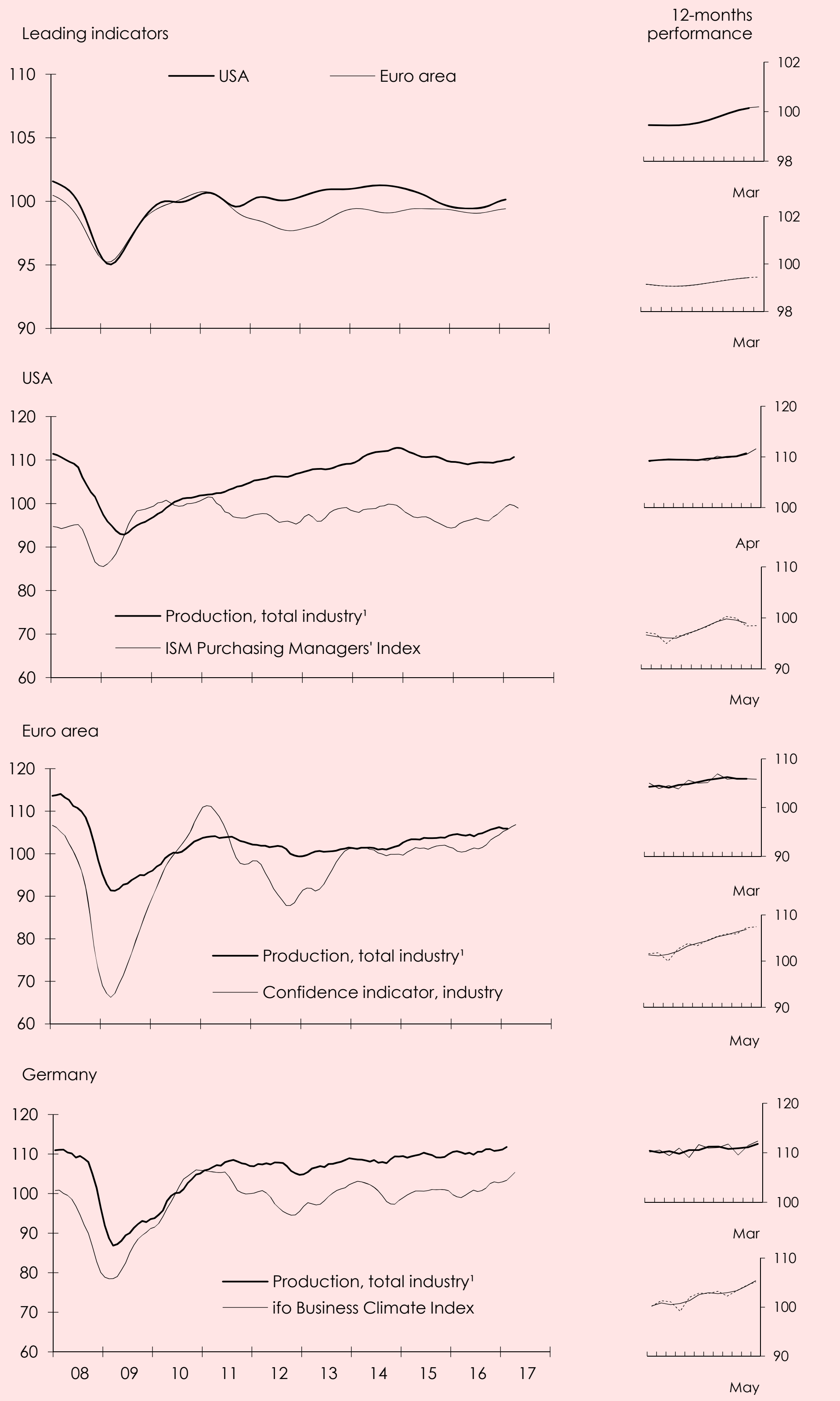
Economic growth accelerated in Eastern European EU countries and moderated in the UK in the first quarter.

As the individual country reports show, notably the industrial regions of Central Europe benefitted in the first quarter from the impetus provided by global trade: in Germany (+0.6 percent, quarter on quarter), Italy (+0.4 percent) and Austria (+0.6 percent), the acceleration of growth was export-driven. Imports also expanded sharply there, owing to strong international supply linkages. Economic activity remained of medium strength in France (+0.4 percent), and dynamic in Spain (+0.8 percent), continuing to catch up, with exports growing at a brisker pace. Outside the euro area, the growth momentum shifted slightly: in the UK, it declined, as devaluation-related price increases dampened private consumption. Eastern European EU countries, by contrast, experienced robust economic growth, following a slowdown of the expansion in 2016 due to the absence of investment subsidies from the EU.

Sentiment indicators have recently reached very high levels in the euro area. In May, the Markit Economics Purchasing Managers' Index rose to its highest level in six years, and the ifo Business Climate Index also reached a record high. The surveys by the European Commission also signal a high degree of business confidence. The inflation rate stood at 1.4 percent in May 2017, according to the flash estimate, while core inflation came in at only +1.0 percent. The unemployment rate receded slightly to 9.3 percent in April.

Figure 3: International business climate

Seasonally adjusted, 2010 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institute for Economic Research, Munich), OECD. – [1] Excluding construction.

2. Austria: highest economic growth in six years

In Austria, the high GDP growth rate for the first quarter 2017 was revised up further in the second calculation relative to the flash estimate made at the end of April: the quarterly growth rate (trend-cycle component) from 0.6 to 0.7 percent, the annual growth rate from 2.0 to 2.3 percent (+2.0 percent, calendar adjusted). The seasonally and calendar adjusted quarterly growth rate according to Eurostat guidelines, which also contains the irregular component, was revised up from 0.5 to 0.6 percent.

The acceleration of growth in Austria at the beginning of 2017 originated with the export-driven manufacturing sector.

The upward revision concerned primarily foreign trade, manufacturing and construction. Construction activity on the one hand benefitted from the mild weather in January and March, on the other hand the improved income and employment situation of private households has increasingly spurred residential construction. Particularly buoyant growth was recorded for goods exports in the first quarter of 2017. They may, on the one hand, have been stimulated by accelerating industrial activity in emerging market economies in the preceding six months, especially via supply chains to Germany. On the other hand, new regional subsidies from the EU have been fuelling a pick-up in economic activity in East Central Europe, most likely causing again growing demand for capital goods. This also explains the vigorous expansion of manufacturing activity in Austria (highest growth in six years). Private consumption remains the driver of the solid underlying momentum of activity in Austria. The impetus provided by the 2016 tax relief is likely to increasingly translate into a sustainable stabilisation of the consumption momentum; this is illustrated by the ongoing improvement in consumer sentiment.

2.1 For first time since 2011 consumer sentiment mostly positive

Following the economic upswing in 2010-11, which was halted by the euro area crisis, consumer sentiment deteriorated progressively (Figure 1), reaching a trough in November 2015. Since then it has been improving gradually, recently at an accelerating pace. In April 2017, optimistic assessments outweighed pessimistic appraisals for the first time since August 2011. In May 2017, sentiment improved yet again markedly, catching up with that in Germany, which since the end of 2013 without exception had been better than in Austria, owing to better labour market and income developments in Germany. This development can be attributed to different factors, as the components of the Consumer Confidence Indicator show:

Following the adjustment of the income tax rate by the 2015-16 tax reform, households' real disposable income rose vigorously (2016 +2.3 percent). As a result, consumer restraint eased, and private households bought considerably more consumer durables (+3.1 percent). Apart from increased consumption, income gains were also used for savings and for debt repayment. Therefore, the "households' financial situation" and "households' saving possibilities" components of the Consumer Confidence Indicator have recovered strongly since entry into force of the tax reform.

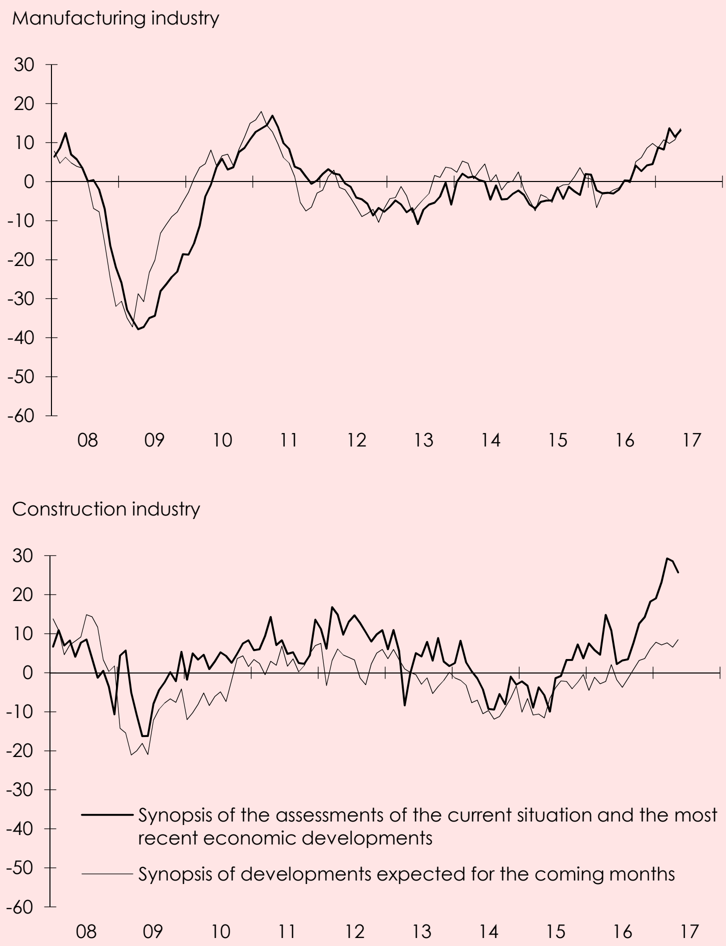
The positive impetus provided by the tax relief has sustainably stabilised consumer demand via second-round effects.

Apart from assessing their own financial situation more favourably, consumers are also considerably more optimistic regarding the overall economic environment. The net balance of optimism about this question has improved by around 20 points since mid-2016. Hence the tax relief is believed to have had substantial positive second-round effects: the subsequent firming of private demand prompted an acceleration in economic growth, notably through an increase in value added of employment-intensive services. This, on the other hand, led to an increase in the demand for labour and thus in income from wages, with the result that the initial impetus provided by the tax relief contributed to a self-supporting strengthening of the consumption momentum.

This becomes apparent not least in the improved assessment regarding the "unemployment expectations in the next months". This sub-component has considerably determined consumer confidence in recent years. Until the end of 2015, consumers became increasingly more pessimistic in their assessment of the unemployment risk; since then this pessimism has diminished, and there has been a broad-based improvement in the spending mood. In addition to the positive consumer sentiment, Austrian firms also gave yet another highly optimistic assessment of economic activity in May, an indication that the upturn is set to continue.

Figure 4: Results from the WIFO Business Cycle Survey

Indices of the assessment of the current economic situation and of business expectations, seasonally adjusted



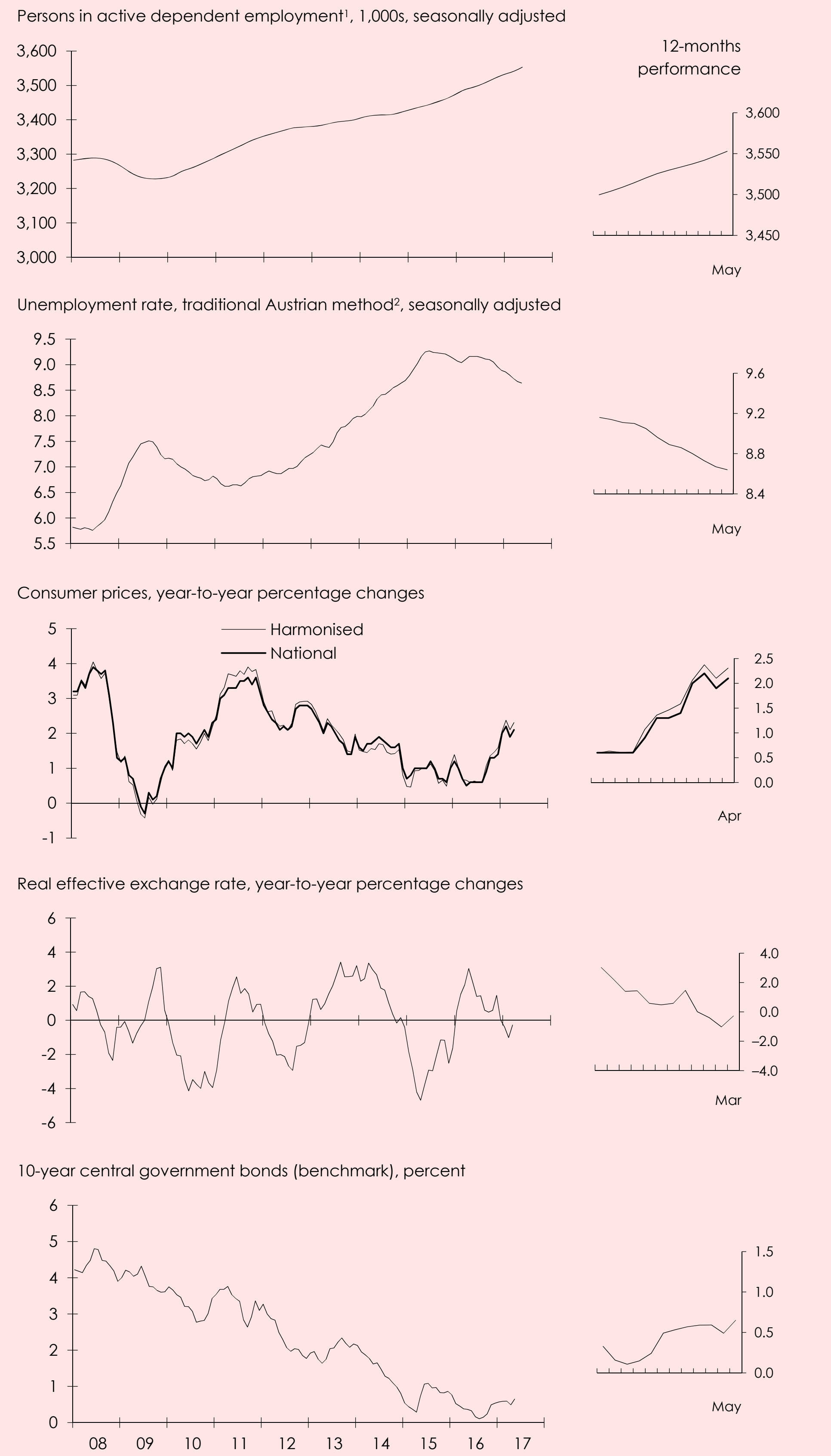
Source: WIFO Business Cycle Survey. Data refer to index points (percentage points) between +100 and –100. Values above 0 imply positive expectations, values below 0 indicate negative expectations.

2.2 Positive trend reversal of winter tourism demand from Russia

The development of the crude oil price has a greater impact on tourism demand from Russia than the EU sanctions imposed because of the Ukraine crisis.

Tourism demand from Russia appears to be largely dependent on the crude oil price, as the development of the number of nights spent in Austria in the last three years shows. After the former's sharp fall from mid-2014 onwards, demand declined by 34 percent, year on year, in the 2014-15 winter season, and by another 27 percent the following winter. In 2014, the EU imposed sanctions on Russia because of the Ukraine crisis, which caused a deterioration in the diplomatic relations between Russia and the EU and therefore may also have had a negative effect on tourism. In the last winter season, the negative trend was reversed, however: from November 2016 until April 2017, the number of guests from Russia increased by 10 percent compared with the same period a year before – the recovery of the crude oil price that began in mid-2016 may thus have had a greater impact on tourism demand from Russia than the sanctions that are still in force. At around 727,000, travellers from Russia accounted for a good 1 percent of all overnight stays this season (contribution to the increase in the total number of overnight stays +0.1 percentage point), thus ranking eleventh among foreign guests.

Figure 5: Key economic indicators



Source: Public Employment Service Austria, Main Association of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – [1] Excluding persons in valid employment contract receiving child care benefit or being in military service. – [2] As a percentage of total labour force excluding self employed, according to Public Employment Service.

When comparing this winter season with last year's, one needs to keep in mind that February 2016 had one leap day. The unadjusted figures for total arrivals and nights spent published by Statistics Austria (+2.5 percent and +0.1 percent, respectively, compared with a year before), after adjustment for the leap day rise to +3.2 percent and +1.1 percent, respectively. However, they are lower than the adjusted increases of the prior winter season (+4.2 percent and +3.0 percent, respectively). Tourism in the 2016-17 winter season was supported by domestic demand: the number of arrivals of foreign guests did rise more markedly than that of resident guests, but the length of stay declined more strongly for international guests than it did for resident guests. The favourable development of the winter tourism demand of resident guests is also related to the tax relief.

2.3 Fuel, tourism and housing driving inflation

Higher oil prices drive inflation to over 2 percent.

Inflation has accelerated above 2 percent since the beginning of the year, reaching 2.1 percent in April. This rise was mainly attributable to the base effect of crude oil price developments: the price of crude oil was lowest in January 2016 at less than 30 € per barrel, then followed an upward trend in the course of that year. It surged further after the OPEC countries agreed to cut production at the end of November 2016. Since March 2017 it has been falling again somewhat, since the supply of shale oil in the USA increased again owing to higher prices. However, in April 2017, the price of crude oil at 49 € per barrel still exceeded the year-earlier level by one third. Hence the cost of operation of personal transport equipment was up by 5.7 percent (contribution to inflation +0.42 percentage point), that of transport services by 7.0 percent (contribution to inflation +0.14 percentage point), compared with a year before.

In April, prices also soared again in those two segments that already for several years had been responsible for higher-than-average inflationary pressures in Austria: tourism-related services (catering services +2.9 percent, contribution to inflation +0.28 percentage point, package holidays +6.8 percent[1], contribution to inflation +0.12 percentage point, recreational and cultural services +2.7 percent, contribution to inflation +0.11 percentage point) and housing. Actual rentals paid by tenants were up by 3.8 percent from a year before (contribution to inflation +0.19 percentage point). Hence, the "transport", "restaurants and hotels", "recreation and culture" and "housing, water, energy" categories together contributed +1.5 percentage points to overall inflation of 2.1 percent.

2.4 Employment boom masks structural problems in labour market

Employment growth and the decline in unemployment have accelerated in recent months.

Since the beginning of 2017, employment has posted the fastest growth since 2011, and unemployment the sharpest decline since 2010. In the first four months of 2017, the number of persons in active dependent employment rose by 61,800, year on year (in 2016 as a whole +53,700). In parallel with the sharp expansion of employment, the number of persons unemployed fell by 10,700, year on year, until May (in 2016 as a whole +3,000). The decline in unemployment of Austrian citizens observed since 2016 has accelerated markedly this year: from January to April 2017, the number of persons having Austrian citizenship that were registered as unemployed was down by 11,000 compared with the same period in 2016. Hence about one fifth of the cumulative rise in unemployment since 2012 was offset (Figure 6, diagram on the right).

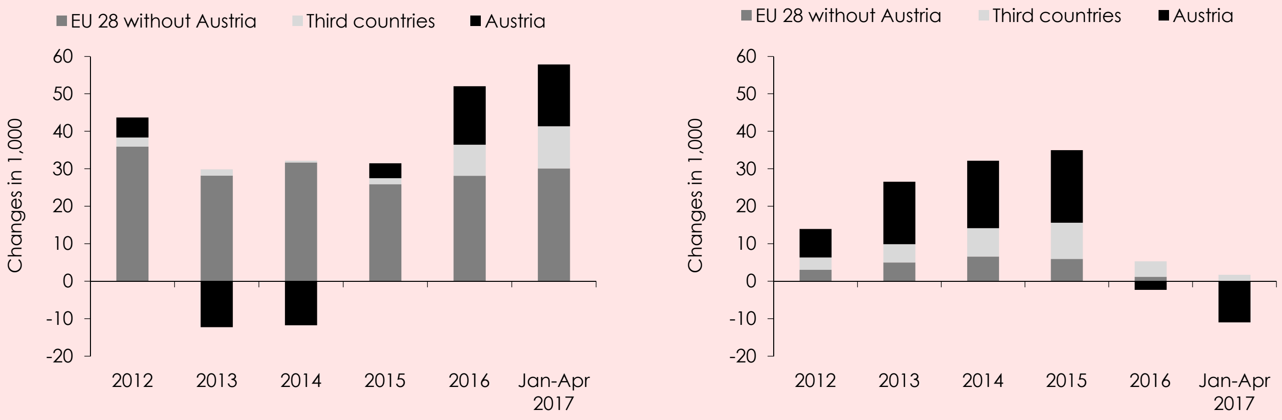
Unemployment firmed owing to the big influx of labour, employment prospects of low-skilled persons deteriorated.

For the first time since 2011, unemployment did decline slightly also among persons from the former guest-worker countries Turkey and Yugoslavia; but since then, only 2 to 3 percent of the cumulative increase has been offset. Gaining a foothold on the labour market remains difficult for this group of persons, given that the influx of (often younger and better-qualified) Hungarian, Romanian, Polish and Slovakian job seekers continues unabated (Figure 6, diagram on the left). The favourable evolution of

[1] This may largely be an "Easter holiday effect": timing of Easter this year in April as opposed to March in 2016.

the labour market currently observed masks structural problems that resulted from the opening of the labour market to people from the East, demographic ageing, and at the same time making access to retirement in Austria more difficult. As it was not possible for the resulting large influx of labour to be completely absorbed by an expansion of employment, the unemployment rate increased for the first time since 2013, despite the fact that the number of jobs offered did not decline (Figure 7). The proportion of long-term unemployed, which since records began in 2004 had fluctuated around a multi-year average of 18 percent[2], until 2015 surged to 30 percent (Figure 2). The proportion of long-term unemployed has risen further in the last two years (to around 35 percent); only in recent months has the increase flattened.

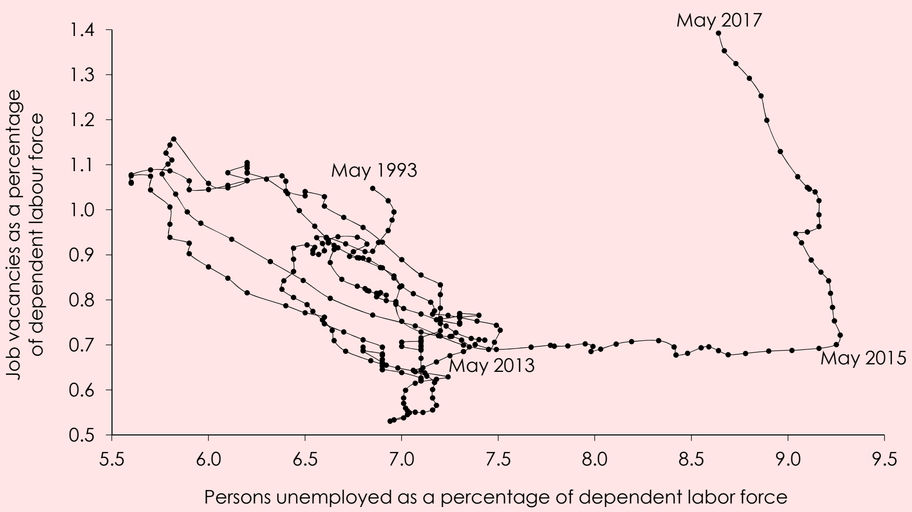
Figure 6: Employment and unemployment by provenance



Sources: Public Employment Service Austria (AMS), Main Association of Austrian Social Security Institutions.

Figure 7: Beveridge curve

Seasonally adjusted



Sources: Public Employment Service Austria (AMS), Main Association of Austrian Social Security Institutions.

[2] In 2009, the proportion of long-term unemployed declined since during the financial and economic crisis cyclical unemployment rose more sharply than did long-term unemployment.