

Gerhard Rünstler

# Tensions Mounting in World Economy

## Business Cycle Report of August 2011

**Following the strong rebound observed since the autumn of 2010, the pace of global economic activity is now moderating markedly. While Asia continues to provide a strong impetus to growth, the US economy grew only modestly in the second quarter, and the latest data for the euro area also signal a slowdown in the pace of expansion in the coming months. Weakening economic activity and the developments surrounding sovereign debt in the USA and the euro area have considerably increased financial market tensions of late and have caused massive stock market losses. Austria's economy still did well overall in the second quarter: GDP expanded by 1.0 percent compared with the previous quarter.**

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The momentum in global economic activity has moderated recently. Asia's and Latin America's emerging economies continue to provide a strong impetus to growth, but in the USA, the economy once more expanded at a moderate pace in the second quarter (+0.3 percent, first quarter +0.1 percent). At the same time the labour market recovery has remained tepid, with the unemployment rate in July standing almost unchanged at 9.1 percent, only 0.4 percentage point below the year-earlier level. Managers' expectations concerning future economic conditions were also subdued in the USA in the second half, owing to the persistent problems in the labour market and the precarious state of the country's finances. In its July forecast, the Conference Board expects persistently moderate growth for the second half of 2011.

For the euro area, figures for economic growth in the second quarter are not yet available. Industrial production continued to increase in April and May, but latest business cycle surveys point to a decline in the pace of the upswing also here. Industrial confidence, for instance, after steadily improving since the second quarter of 2009 has been declining again since April 2011, according to EU business surveys. However, it is still clearly above its long-run average. Firms in Germany continue to assess their current business situation favourably, according to the Ifo Business Climate Index, but here, too, business expectations are deteriorating markedly.

In July, the weaker economic outlook, the controversial discussion on the government debt ceiling in the USA and the debt crisis in the euro area triggered financial market tensions. Following a rescue package totalling € 78 billion for Portugal in May, further loans of € 109 billion and debt restructuring became necessary in the euro area for Greece. In the first week of August, the Dow Jones Index fell by around 11 percent from its peak recorded at the beginning of May, the DAX by around 17 percent. Secondary market yields for Italian and Spanish government bonds at times rose above 6 percent. Recently the rating agency Standard & Poor's lowered the rating of US government bonds from "AAA" to "AA+".

Austria's economy still did well overall in the second quarter: GDP expanded at a seasonally and working day adjusted rate of +1.0 percent compared with the previous quarter (first quarter +0.8 percent). Industrial production moderated in the course of the second quarter, according to the data available so far (April +1.5 percent, May -0.5 percent, first quarter average +1.1 percent). In WIFO's Business Cycle

Survey, manufacturers still assessed their current order books favourably. However, the leading indicators (production expectations, business situation in six months' time) have been declining for several months now and in July were close to their long-time averages. Civil engineering activity remains weak, with the production index in April falling 13.9 percent below its year-earlier level. Real tourism sales rose by 1.7 percent in early summer (May and June) compared with a year before.

Table 1: Flash estimates of quarterly national accounts

	2010				2011	
	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume						
<i>GDP, expenditure approach</i>						
Final consumption expenditure						
Households <sup>1</sup>	+ 0.3	+ 0.3	+ 0.2	+ 0.2	+ 0.2	+ 0.2
General government	- 1.2	+ 0.2	- 0.0	+ 0.1	+ 0.4	+ 0.3
Gross capital formation	- 0.7	+ 2.3	+ 4.6	+ 4.9	+ 2.5	+ 1.4
Gross fixed capital formation	- 1.2	+ 0.3	+ 1.6	+ 1.3	+ 0.9	+ 0.6
Exports	+ 2.7	+ 4.1	+ 3.1	+ 1.4	+ 2.2	+ 1.8
Imports	+ 2.5	+ 3.8	+ 3.1	+ 1.6	+ 2.1	+ 0.8
Gross domestic product	+ 0.2	+ 0.9	+ 1.2	+ 1.0	+ 0.8	+ 1.0
<i>GDP, output approach</i>						
Agriculture, forestry	+ 0.1	- 0.6	- 0.8	- 0.1	- 0.1	- 0.5
Industry, including energy	+ 0.1	+ 2.7	+ 3.5	+ 2.9	+ 3.5	+ 3.7
Manufacturing	+ 0.3	+ 3.8	+ 3.8	+ 2.1	+ 2.2	+ 3.0
Construction	- 1.6	- 1.3	- 0.7	- 0.2	+ 0.3	+ 0.4
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.4	+ 0.6	+ 0.7	+ 0.5	+ 0.3	+ 0.2
Financial intermediation; real estate, renting and business activities	+ 0.9	+ 0.9	+ 0.9	+ 0.9	+ 0.6	+ 0.4
Other service activities	+ 0.5	+ 0.5	+ 0.4	+ 0.2	+ 0.2	+ 0.3
Taxes on products	+ 0.1	+ 0.0	- 0.0	- 0.2	- 0.3	- 0.2
Subsidies on products	+ 1.4	+ 1.1	+ 0.9	+ 0.7	+ 0.3	+ 0.3
Percentage change from previous year						
Gross domestic product, volume	+ 0.2	+ 2.4	+ 2.6	+ 3.2	+ 4.2	+ 3.7

Source: WIFO. – <sup>1</sup> Including private non-profit institutions serving households.

In June and July 2011, active employment rose at a seasonally adjusted month-on-month rate of 0.2 percent each. The seasonally adjusted unemployment rate according to the Austrian method of calculation has remained unchanged at 6.7 percent since January. Vacancies have been declining slightly in recent months, however, while unemployment figures have been rising again.

The upward pressure on prices in commodity markets is easing as economic activity slows. But the rise in commodity prices has fuelled annual inflation in the industrialised countries. In the euro area, the inflation rate as measured by the HICP reached 2.7 percent in June 2011. Inflation excluding energy and unprocessed food is moderate, however (June 1.8 percent). In Austria, inflation as measured by the harmonised CPI stood at 3.7 percent in June (3.3 percent, according to the national CPI). HICP core inflation (excluding energy and unprocessed food) was 3.0 percent, exceeding the euro area average by 1.2 percentage points.

The upturn in world trade slowed somewhat in the second quarter: following quarter-on-quarter growth of +2.5 percent in the first quarter (according to Centraal Planbureau), the volume of world trade expanded at a three-month average growth rate of only 1 percent<sup>1</sup> in April and May. The emerging economies continue to provide a strong impetus to growth. In April and May their imports rose at a three-month aver-

## Slowdown in global economic activity

<sup>1</sup> The three-month average growth rate is comparable to the quarter-on-quarter growth rate.

age rate of around 2 percent. Latin America also saw vigorous economic growth in the first quarter of 2011 (+4 percent). Imports of the industrialised countries, by contrast, stagnated.

As economic activity slowed, the situation in the commodity markets eased somewhat: the price of crude oil (Brent) fell from \$ 116 to \$ 109 per barrel in the first week of August, and the HWWA Commodity Price Index excluding energy receded again slightly from the peak recorded in March. Expressed in US dollars, it exceeded its year-earlier level by 26.3 percent in July (April 2011 +28.3 percent).

In the USA, economic growth remained subdued at +0.3 percent in the second quarter (first quarter +0.1 percent). Developments in the critical sectors have been muted: employment remained almost unchanged in July compared with the previous month, and increased by a mere 0.2 percent compared with a year before. Vacancies are particularly scarce in the services sector. In July the unemployment rate, at 9.1 percent, was 0.5 percentage point lower than a year before, but 0.1 percentage point higher than at the beginning of 2011. House prices, after recovering somewhat in the second half of 2010, have been stagnating again since the beginning of 2011, according to the Case-Shiller Index.

Given the persistent difficulties in these areas, expectations concerning future economic conditions were also less optimistic in the USA in July. The Conference Board, in its July forecast anticipated persistently subdued growth in the second half of 2011. The Manufacturing Purchasing Managers' Index (PMI) fell again in July, to a level only marginally above its long-term average. The Conference Board Measure of CEO Confidence also retreated sharply. Consumer confidence, by contrast, remained unchanged.

Figures for economic growth in the second quarter are not yet available for the euro area. Industrial production continued to increase in April and May, albeit at somewhat slower rates than in the first quarter (April +0.2 percent, May +0.1 percent, compared with the previous month). In May it exceeded the year-earlier level by +4.0 percent. New orders received also continued to grow. But evidence from the most recent business cycle surveys points to a slowdown in the pace of the upturn here too. After improving steadily since the second quarter of 2009, industrial confidence, the most important indicator of EU Business Cycle Surveys, has been receding again since April 2011, mainly owing to the decline in the leading indicators new orders and production expectations. The Ifo Business Climate Index for Germany has been similarly high since the beginning of 2011 as in previous boom episodes, but expectations concerning the business situation in the coming months have been weakening increasingly since March.

Inflation is largely dominated by commodity price developments: in June, CPI inflation in the USA was 3.6 percent, while HICP inflation in the euro area stood at 2.7 percent; the core inflation rate (excluding energy and unprocessed food), by contrast, was 1.6 percent and 1.8 percent, respectively. The euro area HICP flash estimate for July shows a slight decline to 2.5 percent.

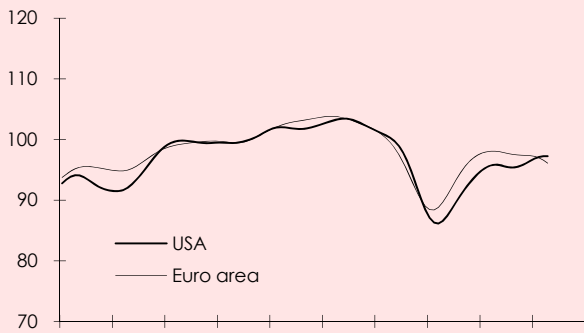
Economic policy in the last two months was dominated by the state of government finance in the USA and the euro area. In the USA, it became necessary to raise the legal limit on the national debt at the beginning of August. The debate on the structure of the consolidation measures was highly controversial, and only late was the default of the USA averted through a compromise. Apart from raising the debt ceiling of \$ 14.3 trillion (98 percent of GDP in 2010) by \$ 2.4 trillion, the deal also provides for cutting expenses by \$ 2.5 trillion (about 17 percent of GDP in 2010) over the next ten years. Concrete measures of how this is to be achieved were not specified, however. The rating agency Standard & Poor's then lowered the rating of US government bonds from "AAA" to "AA+". In the euro area – following a rescue package totalling € 78 billion for Portugal in May – further loans worth € 109 billion were also approved and debt restructuring was negotiated for Greece in July.

*Following buoyant growth until the beginning of 2011, global economic activity is now moderating. This, together with the developments surrounding sovereign debt in the USA and the euro area, has recently exacerbated financial market tensions.*

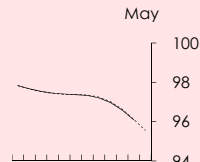
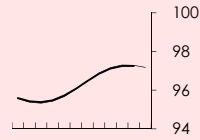
Figure 1: International business climate

Seasonally adjusted, 2005 = 100, 3-month moving average

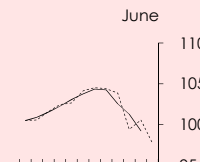
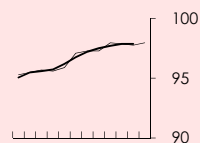
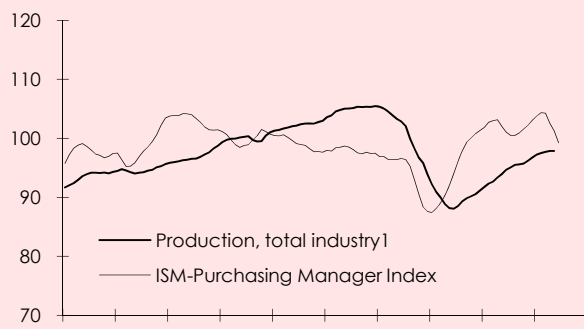
Leading indicators



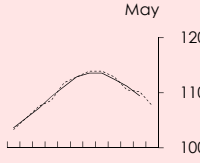
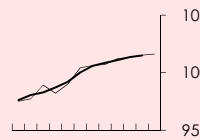
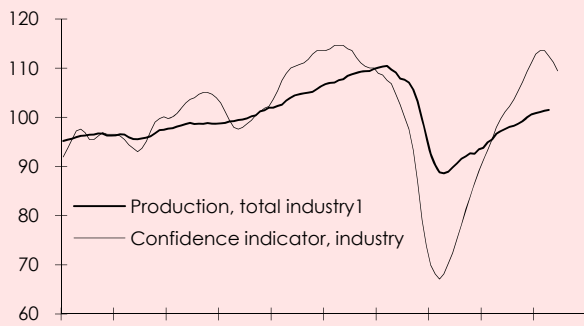
12-months performance



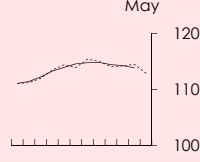
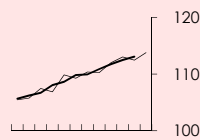
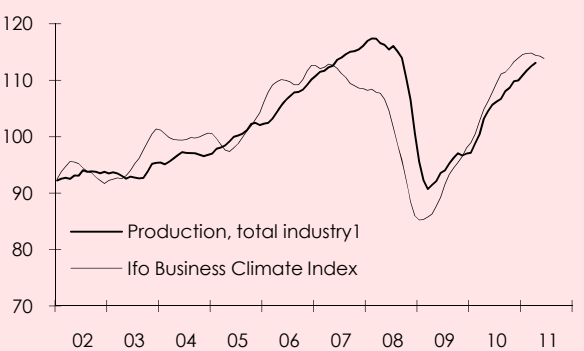
USA



Euro area



Germany



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management<sup>TM</sup>), Ifo (Institute for Economic Research, Munich), OECD. - <sup>1</sup> Excluding construction.

These developments, coupled with the deceleration in economic activity, sparked financial market tensions. Stock prices tumbled: in the first week of August, the Dow Jones Index was around 11 percent below the peak at the beginning of May, the Dax around 17 percent. At the same time the secondary market yield for Italian and Spanish government bonds at times rose above 6 percent, exceeding those for German bonds by 3 percentage points.

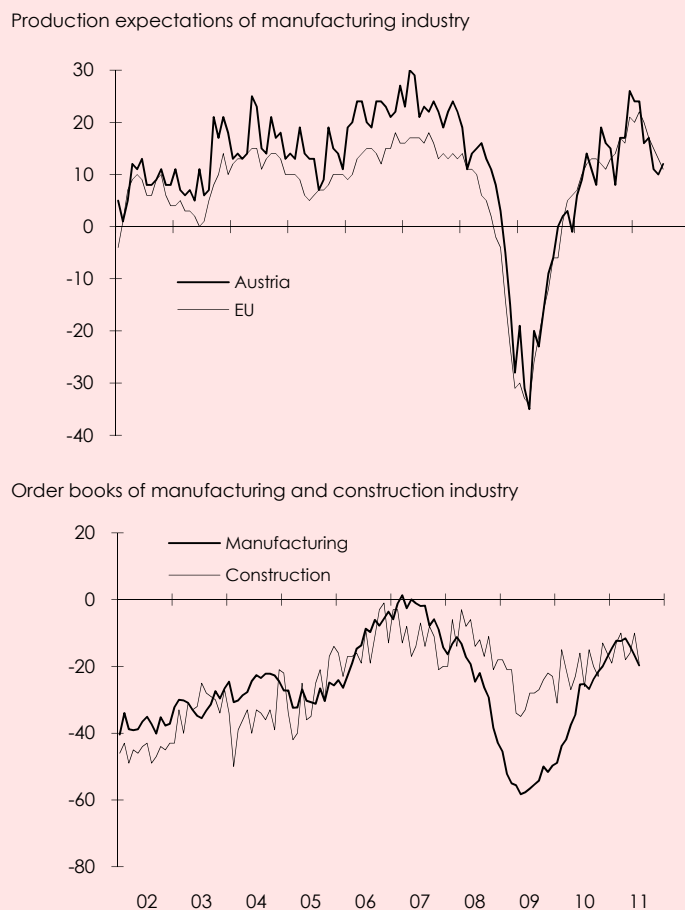
Austria's economy still did well overall in the second quarter: GDP expanded at a seasonally and working day adjusted quarter-on-quarter rate of +1.0 percent, slightly more strongly than in the first quarter (+0.8 percent, revised). The increase compared with the first quarter was due to a higher contribution from net trade: while total real export growth in the second quarter, at +1.8 percent on a quarter-on-quarter basis was slightly slower than recently (first quarter +2.2 percent), import growth lost even more momentum (second quarter +0.8 percent, after +2.1 percent). Private consumption growth remained unchanged at +0.2 percent, while gross fixed capital formation rose at a somewhat slower pace (+0.6 percent, compared with +0.9 percent in the first quarter).

### Austria's industry and services sector less optimistic

*Economic activity in Austria is also likely to weaken, according to the WIFO Business Cycle Survey.*

Figure 2: WIFO Business Cycle Survey

Differences between the percentage shares of correspondents giving positive and negative replies, seasonally adjusted



Source: European Commission, WIFO Business Cycle Survey.

Industrial production trended downwards over the course of the second quarter. In May it fell by 0.5 percent relative to the previous month (April +1.5 percent). The coincident indicators of the WIFO Business Cycle Survey also signal a slowdown compared with the extremely buoyant development in the first quarter. While still 39 percent of firms were able to increase their production in the first quarter, only 28 per-

cent were able to do so in the second quarter. At the same time the percentage of firms recording production declines rose from 7 percent to 12 percent. Nevertheless, manufacturers continue to assess order books as well above average. As regards foreign trade, the momentum observed throughout the year points to a slowdown in the pace of growth: in April and May, goods exports were up by 12.2 percent and 20.2 percent respectively compared with a year before (first quarter +23.5 percent).

Austria is also likely to see manufacturing activity lose momentum in the coming months. The leading indicators of the WIFO Business Cycle Survey have been declining for several months and are currently close to their long-time averages. The number of firms in need of additional staff has also fallen markedly in recent months and in July only marginally exceeded the number of firms planning to lay off staff.

Developments in the construction sector have been mixed. In April, the production index for building construction exceeded the year-earlier level by 11.8 percent, and the assessment of the current business situation was in line with the long-time average. In civil engineering, by contrast, the production index was still 13.9 percent below the year-earlier level, and companies gave a pessimistic assessment of their business situation. The recovery of the business services sector is continuing, albeit at a moderate pace, with the assessment of order books again exceeding the long-term average in July. But the assessments given in the WIFO Business Cycle Survey suggest that the upturn in this sector will also slow in the coming months.

Tourism firms recorded a substantial year-on-year sales increase of +5.0 percent on average in May and June 2011, to €2.92 billion, according to provisional calculations. The increase primarily stemmed from higher prices, however: in real terms, sales increased by 1.7 percent.

The number of nights spent between May and June 2011 exceeded the year-earlier level by 3.7 percent. Overnight stays by travellers from abroad rose by 5.1 percent, while those by domestic travellers increased by a mere 1.4 percent.

As regards the foreign source countries of importance for Austria, developments over this period were particularly satisfactory with respect to overnight stays by guests from Russia (+31.4 percent), Poland (+26.3 percent) and the Czech Republic (+17.6 percent). The number of nights spent by guests from most of the other EU-27 countries in part also grew vigorously compared with the same period a year before (Germany +5.0 percent, Italy +6.1 percent, Hungary +3.7 percent, inter alia). By contrast, a marked decline was recorded in the demand by travellers from Denmark (-7.4 percent) and the UK (-14.5 percent).

Tourism sales rose in all federal provinces. Carinthia, Burgenland and Lower Austria posted above-average gains. In Salzburg and Vienna the growth rate was in line with the Austrian average, whereas in Vorarlberg, Upper Austria, Tyrol and Styria it was slightly lower.

The first estimates for July 2011 show that the recovery of employment is continuing: the number of persons in dependent active employment exceeded the year-earlier level by 2.3 percent. On a seasonally adjusted month-on-month basis, employment advanced by 0.2 percent each in June and July.

However, job openings have increased at a slower pace recently: while the number of vacancies still exceeded the year-earlier level by 1.7 percent in July, it has already been falling slightly on a seasonally adjusted basis since February. In July, the number of persons registered as unemployed was down by 0.9 percent compared with a year before. But here too, the seasonally adjusted figures are signalling a trend reversal, they have been rising again since April. The seasonally adjusted unemployment rate according to the Austrian method of calculation has stood unchanged at 6.7 percent since the beginning of 2011.

## Sales increase in tourism

*Tourism sales increased in May and June compared with a year before.*

## Labour market trends remain mixed

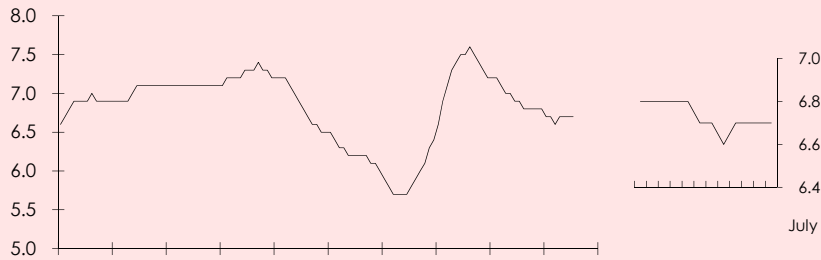
*The number of persons in dependent active employment has been on the rise in recent months. At the same time the number of unemployed persons has also increased marginally. Stagnant job openings suggest that the labour market is losing momentum, however.*

Figure 3: Key economic indicators

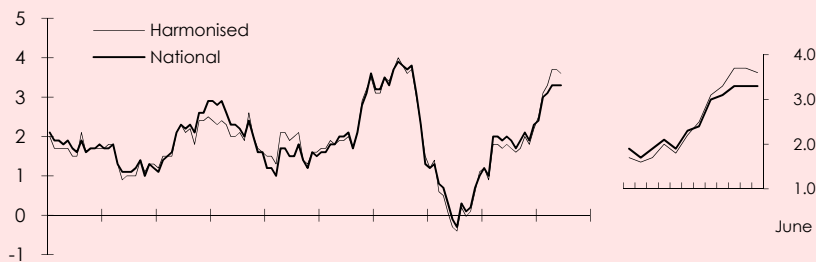
Persons in active dependent employment<sup>1</sup>, (1,000), seasonally adjusted



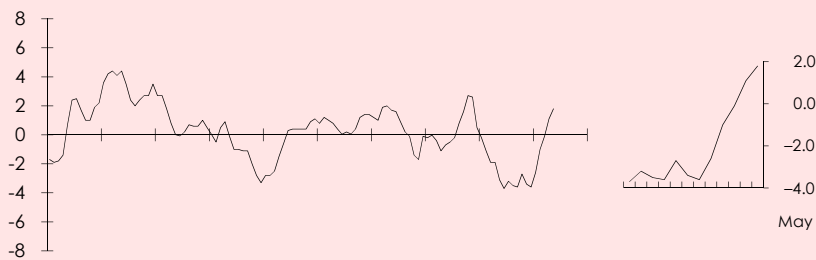
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



Consumer prices, year-to-year percentage changes



Real effective exchange rate, year-to-year percentage changes



10-year central government bonds (benchmark), percent



Source: Public Employment Service Austria, Federation of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> As a percentage of total labour force excluding self employed, according to Public Employment Service.



*Methodological Notes and Short Glossary**Period comparisons*

Time-series comparisons with the previous period, e.g., the previous quarter, are adjusted for seasonal effects. They also include effects that result from a different number of working days in the period (e.g., Easter). In the text, reference is made to "seasonally and working day adjusted changes".

The phrase "changed compared with a year before . . .", on the other hand, describes a change compared with the same period a year before and refers to unadjusted time series.

The analysis of the seasonally and working day adjusted development provides more precise information about the actual course of economic activity and shows turning points sooner. However, the data are subject to additional revisions as seasonal adjustment is based on statistical methods.

*Real and nominal values*

In principle, the values shown must be understood as real values, i.e., adjusted for price effects. Whenever values are shown as nominal values (e.g., foreign trade statistics), this is specifically mentioned.

*Production Sector*

This term comprises the NACE-2008 sections B, C and D (Mining and Quarrying, Manufacturing, Energy Supply) and is here used in an international comparison.

*Inflation, CPI und HICP*

The inflation rate measures changes in consumer prices compared with a year before. The Consumer Price Index (CPI) is a measure of national inflation. The Harmonised Index of Consumer Prices (HICP) is the basis for comparable measurement of inflation in the EU and for the evaluation of price stability in the euro area (see <http://www.statistik.at/>).

Core inflation as a monetary policy indicator is not clearly defined. WIFO follows the common practice of using the inflation rate excluding the product categories unprocessed food and energy for core inflation. Thus just under 87 percent of the goods and services contained in the consumer price index (CPI 2010) are included in the calculation of core inflation.

*WIFO Business Cycle Survey and WIFO Investment Survey*

The WIFO business cycle survey is a monthly survey in which around 1,100 Austrian firms are asked to assess their current and future economic situation. The WIFO investment survey is conducted twice a year, asking companies about their investment activity (<http://www.itkt.at/>). The indicators are balances between the positive and negative responses expressed as a percentage of the total number of firms sampled.

*Unemployment rate*

Austrian national definition: The number of persons registered as job seekers with the Public Employment Service expressed as a percentage of the dependent labour force. Labour force is the sum of the unemployed and the persons in dependent employment (measured in standard employment relationships). Database: registrations with the Public Employment Service (AMS) and Association of Austrian social insurance agencies.

Definition according to ILO and EUROSTAT: Any person who is not gainfully employed and is actively seeking work is considered unemployed. Gainfully employed persons comprise all persons who during the reference week worked for at least one hour in a self-employed capacity or in paid employment. Persons receiving child-care benefit and apprentices are classified as gainfully employed, whereas persons in military service or persons carrying out alternative service are not. The unemployment rate is the number of unemployed persons expressed as a percentage of the total labour force (unemployed persons plus gainfully employed persons). Database: data from household surveys ("Mikrozensus").

*Terms used in connection with the national definition of the unemployment rate*

Persons in training: Persons who at a set date are enrolled in AMS (Public Employment Service) training programmes. When calculating the unemployment rate, their number is not taken into account either in the denominator or in the numerator.

Persons in dependent active employment: "Persons in dependent employment" include persons receiving child-care benefit, as well as persons in military service or persons carrying out alternative service with a valid employment contract. By deducting their number one arrives at the number of "persons in dependent active employment".

Consumer price inflation was 3.3 percent in Austria in June 2011. The upward drift in prices was largely driven by price increases in the expenditure categories "Transport" (+5.5 percent) and "Food" (+4.4 percent, including non-alcoholic beverages).

**Inflation rate clearly exceeding euro area average**



The harmonised inflation rate (HICP) was 3.7 percent, 1.0 percentage point higher than the euro area average (2.7 percent).

While core inflation (excluding energy and food) in the euro area picked up from 0.8 percent in April 2010 to 1.8 percent, it rose from 1.0 percent to 3.0 percent in Austria. This deviation largely reflects the markedly higher price increase for services (+3.7 percent, euro area +2.0 percent). Hence the contribution to headline inflation by this product group alone exceeded that in the euro area by 0.9 percentage point.

*Austria's core inflation rate (excluding energy and unprocessed food) currently stands markedly above the 2-percent mark and exceeds the euro area average by more than 1 percentage point. HICP inflation was unchanged at 3.7 percent in June.*