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Economic Slack Persists in the Euro Area

Business Cycle Report of May 2013

Global economic developments have been quite uneven in the first months of 2013. While the US economy expanded again more strongly, and China experienced some loss in momentum, stagnation continued unchanged in the EU. The OECD's Composite Leading Indicator signals a revival of the world economy in the second quarter. The German and Austrian economies may also benefit with some lag from this development. However, the pace of activity in Austria is likely to still remain lacklustre in the first half of the year. Business surveys do not yet indicate that the economy is gathering steam. Employment figures are stagnating while unemployment is on the rise, and inflation is receding against the background of weak commodity price developments.

For definitions of terms used, see "Methodological Notes and Short Glossary", in this volume and <http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf> • All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Data processing: Christine Kaufmann, Martha Steiner • Cut-off date: 7 May 2013. • E-mail address: Marcus.Scheiblecker@wifo.ac.at

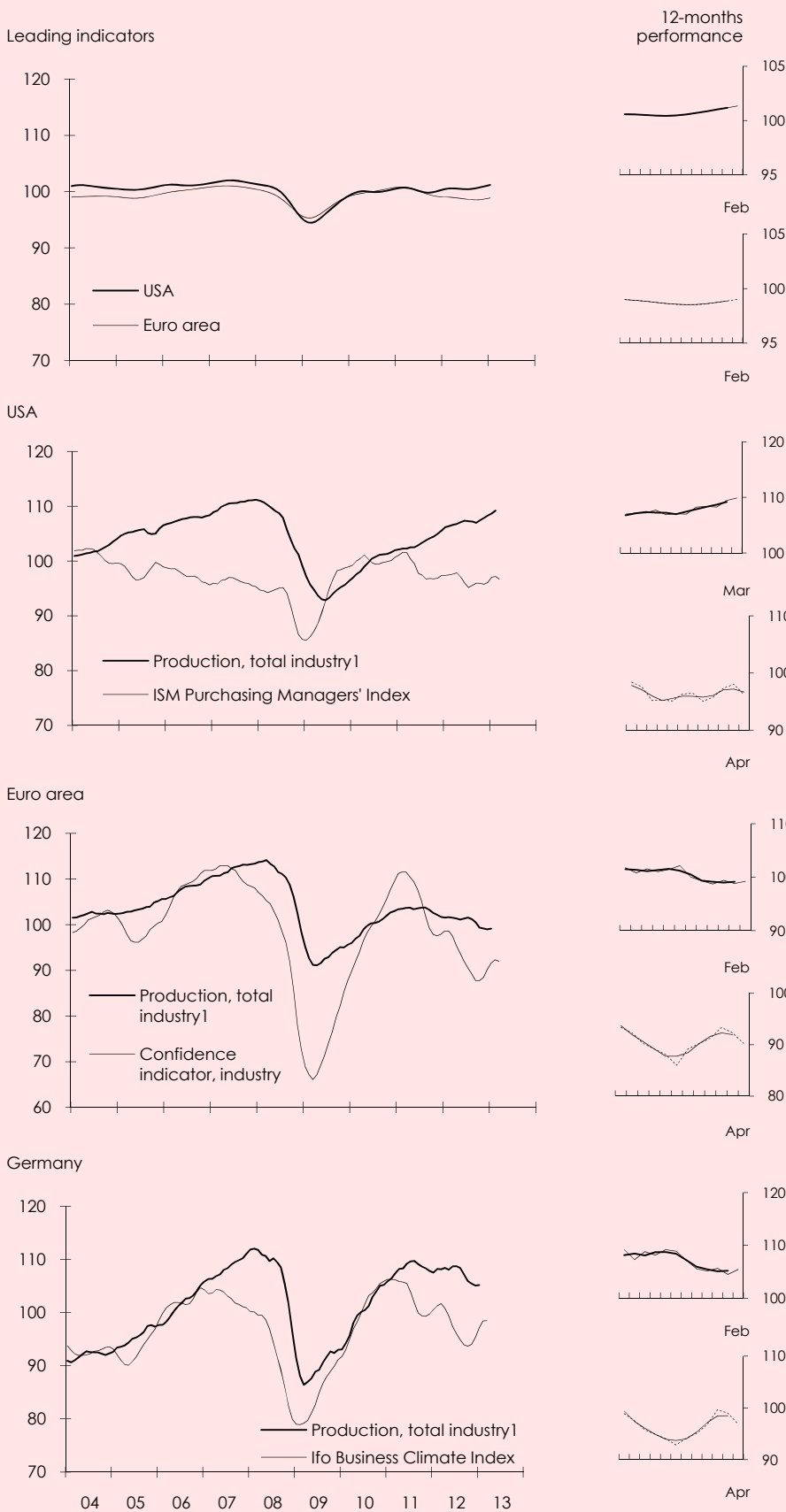
Signs are mounting that the pace of global economic growth is accelerating, which is likely to benefit the economies that are intensively involved in world trade from mid-year onwards. The OECD's Composite Leading Indicator, which depicts global economic developments, has been on the rise for six months. Activity is gaining traction notably in emerging market economies.

Following a weak result in the fourth quarter of 2012 (+0.1 percent in real terms, compared with the previous period), growth accelerated again in the USA in the first quarter of 2013 (+0.6 percent). China saw expansion slow on a quarter-on-quarter basis from +2.0 percent in the fourth quarter of 2012 to +1.6 percent in the first quarter of 2013. The purchasing managers' indices likewise do not indicate that economic activity has gained momentum since the beginning of the year. According to the Economic Sentiment Indicator released by the EU, sentiment among businesses in the euro area remains negative. Having risen around the turn of the year, the indicator fell yet again in April. However, the extent of the decline was still within the fluctuation range of short-term setbacks during an upswing. While surveys in Germany and France painted a more pessimistic picture, improved results were reported by Italy, Portugal and even Greece. Industrial production in the euro area has been at low levels since October 2012 but has not declined further since. Following a sharp fall in the fourth quarter of 2012, aggregate output in Germany is likely to have risen again in the first quarter of 2013, albeit only relative to the low level recorded in the previous period. Hence Germany, too, is currently facing a difficult economic situation. Weak global economic activity continues to weigh on exports. Industrial production increased again in February after declining markedly in January. However, the Ifo Business Climate Index fell for the second consecutive time in April. This was due to a worsening in the assessment of the current situation as well as of business expectations.

WIFO's Business Cycle Survey also reflects the lacklustre performance of the Austrian economy since the beginning of the year. In April, WIFO's more comprehensive leading indicator fell for the first time since October 2012. While compared with other European countries aggregate output barely declined at the end of 2012, the economy is not expected to turn around in the months ahead.

Figure 1: 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.

The weakness of the economy continues to be clearly reflected in a persistent rise in unemployment figures in Austria; meanwhile, employment growth has given way to stagnation.

Price pressures are easing increasingly in Austria as a result of the decline in commodity prices; in March, inflation as measured by the national CPI fell to 2.3 percent.

According to first estimates, real GDP grew by 0.6 percent in the first quarter of 2013, compared with the previous quarter, overcoming the weakness observed at the end of 2012. Personal consumption expenditures (+0.8 percent in real terms) were once again the main driver of growth. The automatic fiscal curtailment, which is to produce government savings of 0.8 percent of GDP by autumn 2013, like the forthcoming budget repair measures so far has left no trace on households' propensity to consume. The latest Conference Board index even showed a substantial improvement in consumer confidence.

Investment demand was also a major contributor to growth. While investment in equipment rose by 0.8 percent in real terms, the demand for residential buildings increased by more than 3 percent. Only external trade remained subdued in the first quarter of 2013.

Labour market conditions are improving further. The unemployment rate fell from 7.7 percent in February and 7.6 percent in March to 7.5 percent in April, but is still at such a high level that the Federal Reserve Bank does not see the need for a more restrictive monetary policy. Given the low inflation rate (February 2.0 percent, March 1.5 percent) and the calm commodity price development, the central bank will leave the key interest rate at around 0 percent for the time being.

Economic activity in China was rather subdued in the first quarter of 2013. GDP growth slowed from a seasonally adjusted quarter-on-quarter rate of 2.0 percent in the fourth quarter of 2012 to 1.6 percent in the first quarter of 2013. The two purchasing managers' indices also show that activity has been lacklustre since the start of this year. For the emerging market economies as a whole, the OECD Composite Leading Indicator signals vigorous growth for the second quarter of 2013. Notably Latin America is expected to see economic conditions improve markedly.

More EU countries are now affected by the difficult economic situation than was the case a year ago. While the domestic economic crisis in the problem countries has not yet subsided, lack of demand from abroad now also weighs on developments in countries with strong exports such as Germany and Austria.

In the aftermath of the bursting of the real estate bubbles, some EU countries are not only experiencing a shrinking of the over-dimensioned construction sector, but the persistent decline in property prices also reduces the collateral basis of banks. For this reason, the banking sector is also set to implement structural adjustment measures, in addition to further write-downs. This concerns not only the euro area but also numerous new EU countries and countries of the Balkan region.

As a counter-reaction to the extremely poor performance of the German economy in the fourth quarter of 2012 (real GDP -0.6 percent), a better result is anticipated for the first quarter of 2013. This trend will also be reflected in the euro area and EU averages. No improvement is to be expected for the majority of EU countries, however.

The most recent surveys conducted among businesses in the euro area suggest that stagnation will extend into the second quarter. The European Commission's European Sentiment Indicator released in April showed a further drop in business confidence. Having increased somewhat around the turn of the year, not least because of the easing of the situation in financial markets, confidence was dampened by the problems affecting banks in Cyprus and by the resurgence of the euro crisis.

As the economic weakness has by now also spread to euro countries with strong exports, and inflationary pressures have eased further on the back of the decline in commodity prices, the ECB lowered the key interest rate by 25 basis points to 0.50 percent. Unlike the USA and Japan, where the respective key interest rate has

US economy gathers strength

US economic policy remains expansionary, despite the automatic fiscal curtailment. After growth dipped at the end of 2012, economic activity regained momentum in the first quarter of 2013.

No signs yet of a turnaround in EU

Latest business surveys do not yet suggest that the difficult economic situation in the EU is improving.

stood at 0 percent for many years now, the euro area still has leeway for monetary easing.

Figure 2: World commodity prices

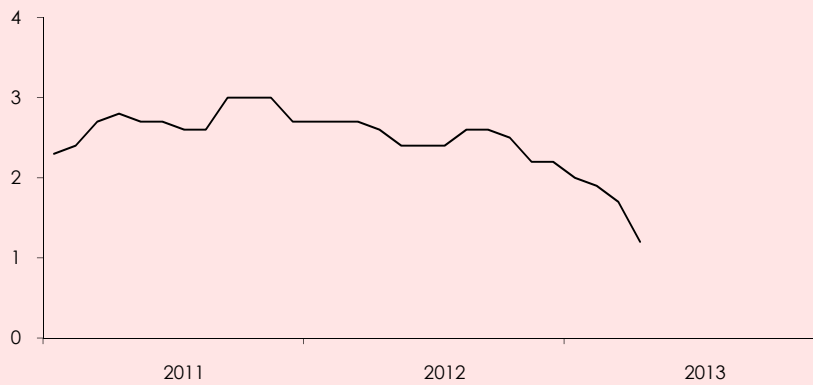
In euros, year-to-year percentage changes



Source: HWWI.

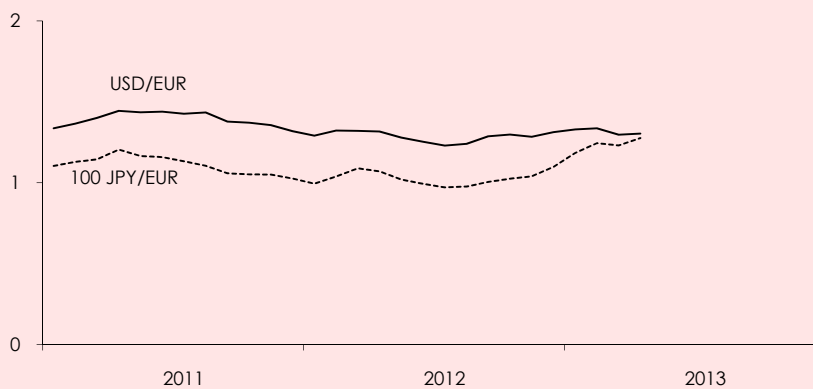
Figure 3: Inflation rate in the Euro area

Percent



Source: Eurostat.

Figure 4: Exchange rates



Source: EZB.

Given the low levels of interest rates, international investment capital is flowing into securities markets, while there is currently less demand for commodities and real estate. In spite of the poor performance of the German economy, the DAX rose markedly above its peak level of 2007, the boom year before the recession. Yields on government bonds of euro area countries have fallen constantly since the beginning of 2013. The benchmark yields for German and Austrian government bonds have hit a new bottom at currently 1.2 percent and 1.6 percent, respectively, the result for both countries being a slightly negative long-term real interest rate.

Labour market conditions in the euro area continue to deteriorate, however: employment is declining (fourth quarter of 2012 -0.3 percent, quarter-on-quarter), and unemployment is increasing. The seasonally adjusted unemployment rate, having stood at 11.9 percent at the beginning of 2013, rose to 12.3 percent until April. The situation in Spain (26 percent) and Greece (27 percent) must be called alarming. Owing to the high levels of youth unemployment, the risk of a de-qualifying of human capital is particularly high in these countries. This may reduce their production potential for the future.

Driven by strong demand from third countries, the German economy continued to do quite well until the third quarter of 2012. However, production activity slumped towards year-end (fourth quarter of 2012 -0.6 percent in real terms). But the unfavourable developments of industrial production and external trade are likely to have been partly caused by special effects. Hence a counter-movement is to be expected in the first quarter of 2013, the German economy should have grown somewhat.

However, the global economic weakness is a major strain on the German economy. Until February, there were no signs yet of an upward trend in exports, with incoming orders from abroad moving downward rather than upward. Business surveys also reflect the slack in the German economy. The Ifo Business Climate Index dropped again in April, after a marked increase around the turn of the year. The component for the current business situation, while still suggesting growth, fell for the second time in a row. Especially expectations for the future deteriorated considerably. The problematic nature of and the ongoing discussion about saving Cyprus's banking system may have acted as a drag on this indicator. The acceleration in the pace of global economic activity signalled by the OECD Composite Leading Indicator for the second quarter of 2013 has not yet begun to be reflected in the German economy.

Domestic demand, by contrast, is expected to fare slightly better. The seasonally adjusted growth of household consumption stabilised the economy in the fourth quarter. Consumer confidence has been on a steady upward trend already since the end of 2012. In January 2013, the index of real retail sales reached its highest level recorded since mid-2008, but fell somewhat in February and March.

As in Germany, business surveys conducted in Austria currently portray a picture of economic activity that shows little momentum. The indicator for the assessment of the current economic situation dropped in April, and so did that for expectations for the future. Notably firms in the construction sector assessed the current situation clearly more negatively. In 2012, this sector of the economy had proven resilient against the general slowdown. The marked deterioration in the assessment of the current situation may have also been related to the heavy snowfalls in winter, which extremely impeded building production in April.

But pessimism has also increased in other sectors of the economy. The resurgence of the discussion about the stability of the euro area on account of the Cyprus crisis may have played a role with respect to expectations for the future. However, in their assessment of the current situation manufacturers were only marginally more sceptical than in the March survey.

WIFO's Leading Indicator, which in addition to business surveys also considers other economic data, deteriorated for the first time since October 2012 in April 2013. Having only just barely missed the stagnation line in March 2013 at -0.03, it fell back to

Lacking stimulus from external trade weighs on German economy

Results of the Ifo Business Cycle Survey point to an extended period of weak growth in Germany.

Austrian economy lacks momentum

Much the same as the euro area average and the German economy, the Austrian economy is not making headway. In April, WIFO's leading indicator deteriorated for the first time since October 2012.

–0.07 in April, given that the deterioration in the survey results was not offset by the improvement in the majority of the other components.

The decline in the production index for the producing sector is yet further evidence for the economic weakness in the first quarter (–0.7 percent in January, –1.1 percent in February, in seasonally adjusted month-on-month terms). The production of durable consumer goods was particularly affected in February (–5.4 percent). Production in the construction sector shrank by 2.6 percent in February.

The subdued performance of the Austrian industry is mainly a result of a lack of foreign demand. On the one hand, economic activity is weak in the euro area, Austria's key sales market, while on the other hand the economy has been lacking strength globally in recent months. Should the world economy gain traction from the second quarter of 2013, as signalled by the OECD Composite Leading Indicator, Austria's economy may also benefit from this development from mid-year onwards. To date this is not reflected in Austrian export data, and business surveys do not yet show signs that activity is gathering strength.

Consumer confidence in Austria declined slightly in April for the first time since the autumn of 2012. According to the most recent survey for Austria, the European Commission's Consumer Confidence Indicator fell by 3½ points from March. This loss in confidence is in contrast with the development of the indicator for Germany or the weighted average for the euro area, which shows a further improvement in consumer sentiment. In April, Austrian private households gave a more pessimistic assessment notably of the outlook for the general economic situation and their personal saving possibilities in the coming 12 months. The increase in the number of passenger car registrations recorded in January (+9.6 percent, compared with a year before) which can be attributed to private households gave way to two-digit declines in February and March. Overall, new passenger car registrations plummeted in the first quarter of 2013 (around –17 percent, compared with a year before). The propensity to purchase durable consumer goods appears to be very subdued; this becomes also apparent in the latest readings of the Consumer Confidence Indicator.

Car dealers recorded a sharp drop in sales in February, owing to the collapse in the demand for new passenger cars. Wholesalers also registered a decline in both nominal and real terms. In retailing, by contrast, seasonally and working day adjusted sales came in better in February. In March, retail sales remained below the year-earlier level, according to preliminary calculations by Statistics Austria. The Business Cycle Survey for retailing also suggests that the sector's business environment is set to remain weak. In the April survey, firms gave a clearly more negative assessment of the current business situation than at the end of 2012; negative appraisals also predominated with respect to business expectations for the coming months.

From November 2012 until March 2013, tourism sales rose by 5.6 percent year-on-year, reaching a total of € 11,390 million, according to preliminary calculations. Adjusted for price changes, revenues grew by 2.9 percent, while real expenditure per night spent fell by 2.3 percent. The good overall result was largely due to above-average growth in March owing to the early timing of Easter (nights spent +15.7 percent; in 2012, Easter was in April). Despite this favourable development, guests' propensity to spend decreased, which is also shown by the decline in real expenditure per night spent.

In the first five months of the current winter season (November to March), the number of overnight stays rose by 5.3 percent overall. The demand from abroad grew at the above-average rate of +6.7 percent, while the number of nights domestic travellers spent in Austria increased only marginally compared with a year before (+0.7 percent).

The development of external trade reflects the global economic weakness. Especially the euro area is faced with insufficient demand.

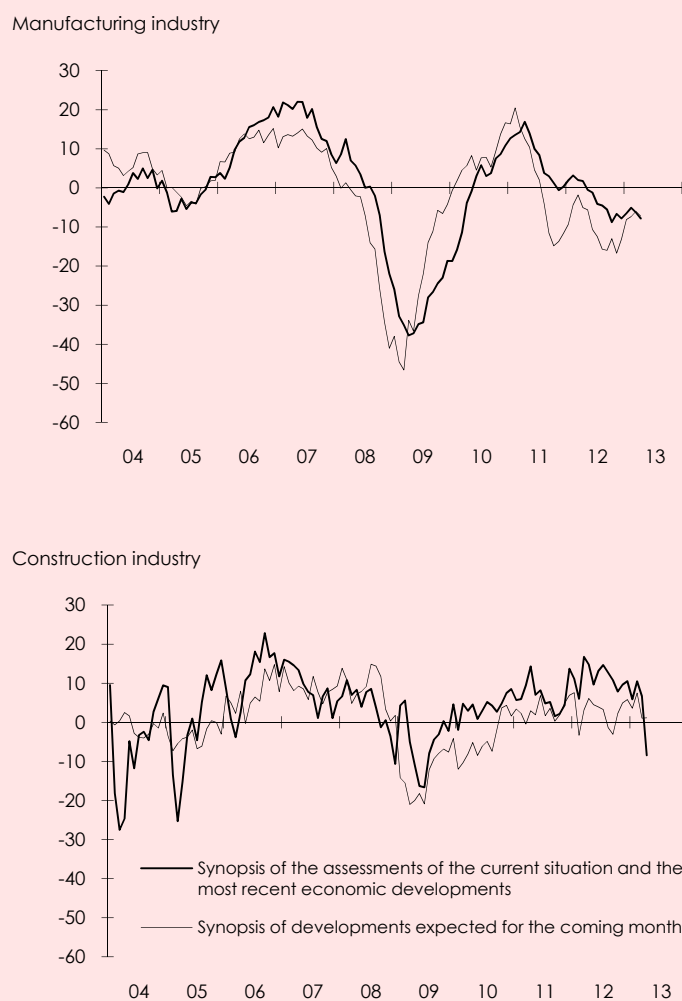
Private consumption in Austria remains very lacklustre

Personal consumption expenditure currently also contributes little to support the economy.

Winter tourism season successful so far

Figure 5: Results from the WIFO Business Cycle Survey

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



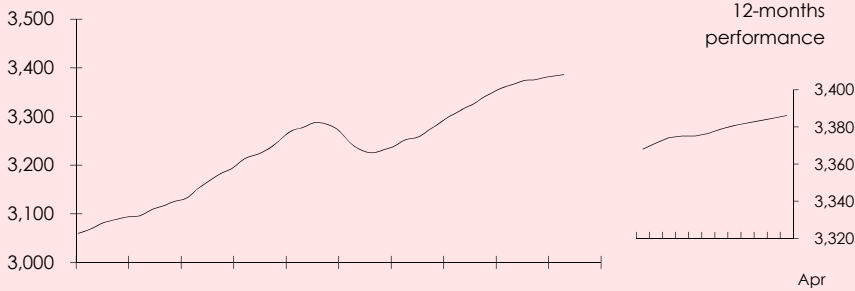
Source: WIFO Business Cycle Survey. Data refer to index points (percentage points) between +100 and -100. Values above 0 imply positive expectations, values below 0 indicate negative expectations.

Among the key foreign source markets, above-average increases were registered from November 2012 to March 2013 in the number of nights spent by guests from Russia (+11.5 percent), Germany (+11.0 percent) and UK (+6.9 percent). Overnight stays by guests from Switzerland (+6.0 percent), Sweden (+5.6 percent), the USA (+4.5 percent) and Denmark (+4.3 percent) also rose noticeably, while those by guests from Belgium (+3.5 percent) and France (+2.0 percent) increased at a more modest pace. A somewhat lower demand than last year was recorded for guests from the Czech Republic (-0.8 percent), the Netherlands (-1.5 percent) and Hungary (-1.7 percent), while the number of nights spent in Austria by guests from Poland (-3.9 percent), Romania (-5.5 percent) and Italy (-6.3 percent) was markedly lower than a year before.

In the 2012-13 winter season up to now, tourism revenues accelerated at an above-average pace in Vorarlberg, Tyrol and Salzburg. A somewhat weaker sales increase was recorded for Vienna, Carinthia and Styria, while growth was modest in Burgenland and Upper Austria. Only Lower Austria registered stagnation.

Figure 6: Key economic indicators

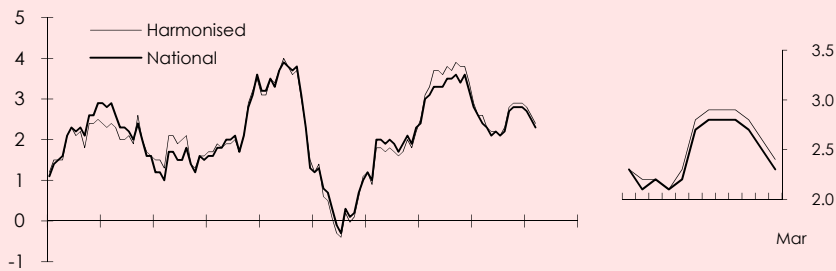
Persons in active dependent employment¹, (1,000), seasonally adjusted



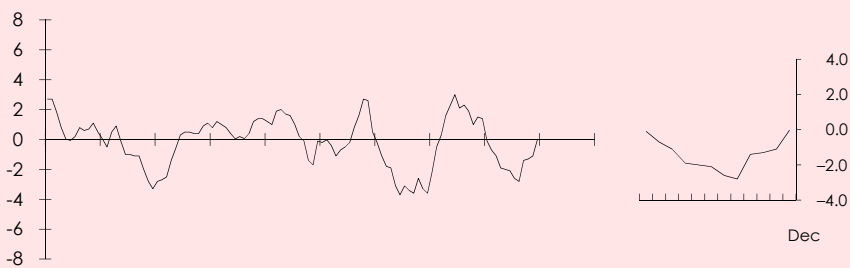
Unemployment rate, traditional Austrian method², seasonally adjusted



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. – ¹ Excluding parental leave, military service, and unemployed persons in training. – ² As a percentage of total labour force excluding self employed, according to Public Employment Service.

Inflation receded from 2.5 percent to 2.3 percent in March, according to calculations by Statistics Austria. One of the main sources of inflationary pressures in general in previous years were the prices of products made from fossil fuels. In March, the prices of mineral oil products in Austria were almost 5 percent lower than a year before, reflecting the currently slack global demand for crude oil. According to Statistics Austria, this dampened inflation by 0.26 percentage point. Given the globally below-average level of capacity utilisation and the lacklustre consumption growth, inflation nevertheless appears high at 2.3 percent. Housing costs, especially rents (March +3.8 percent), have become main driver of inflation in recent months.

Food prices also increased sharply (+3 percent), especially the prices of the basic foods meat (+5.5 percent), bread and cereals (+3.2 percent), and vegetables (+3.5 percent).

In March, inflation in Austria exceeded the euro area average by 0.7 percentage point. The trend of above-average inflationary pressures observed in Austria since October 2012 continued. They were largely driven by sharper price increases for services (e.g., hotel and restaurant services +0.25 percentage points compared with the euro area, telecommunication +0.21 percentage point, medical services +0.15 percentage point).

The weakening of economic activity observed since the spring of 2012 until recently had only little effect on the Austrian labour market. While unemployment began to rise on a year-on-year basis at the time of the economic turnaround around mid-2011, employment continued to grow vigorously.

Meanwhile, employment growth has come to a halt. In March and April, seasonally adjusted figures no longer showed an increase. The bad economic situation becomes particularly apparent in the rising number of unemployed persons: since the start of this year, the seasonally adjusted number of persons registered as unemployed has risen by more than 11,000, to a total of 279,500, a new peak.

The unemployment rate also increased markedly. The seasonally adjusted rate reached 7.4 percent in April, according to the Austrian method of calculation; it remained only just below the peak it reached during the recession in summer 2009 (7.6 percent). The unadjusted rate stood at 7.3 percent in April, an increase of 0.5 percentage point compared with a year before (6.8 percent).

Inflation rate declining further

Housing-related expenditure replaced fuels as the main cause of inflation.

Weak economic activity increasingly affecting labour market

Employment growth is coming to a halt; unemployment is rising sharply.