

Marcus Scheiblecker

## Strong Economy in the USA, Economic Growth in Europe Still Muted

### Business Cycle Report of August 2018

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After a rather sluggish growth at the beginning of the year, economic activity in the USA gained considerably momentum in the second quarter. In the EU, following a weak start, economic growth stabilised in the second quarter, although it slowed again in the euro area. The economy in Austria continues to expand strongly. Despite growth slowing down in comparison to previous quarters, GDP continues to expand faster than in the average of euro area countries. Unemployment dropped again in July.

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**JEL-Codes:** E32, E66 • **Keywords:** Business Cycle Report

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. For definitions used see "Methodological Notes and Short Glossary", <https://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf> • Cut-off date: 9 August 2018.

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ISSN 1605-4709 • © Austrian Institute of Economic Research 2018  
Impressum: Herausgeber: Christoph Badelt • Chefredakteur: Michael Böheim ([michael.boeheim@wifo.ac.at](mailto:michael.boeheim@wifo.ac.at)) • Redaktionsteam: Tamara Fellingner, Ilse Schulz, Tatjana Weber • Medieninhaber (Verleger) und Redaktion: Österreichisches Institut für Wirtschaftsforschung • 1030 Wien, Arsenal, Objekt 20 • Tel. (+43 1) 798 26 01-0 • Fax (+43 1) 798 93 86 • <http://bulletin.wifo.ac.at> • Verlags- und Herstellungsort: Wien

Despite growing uncertainty regarding looming international trade disputes, the global economy enjoyed strong growth in the second quarter of 2018. Indicators for many major emerging economies point to sustained expansion. In the USA, the increase in the second quarter of +1 percent in real terms was double the rate of the first quarter (+0.5 percent), compared to the previous period.

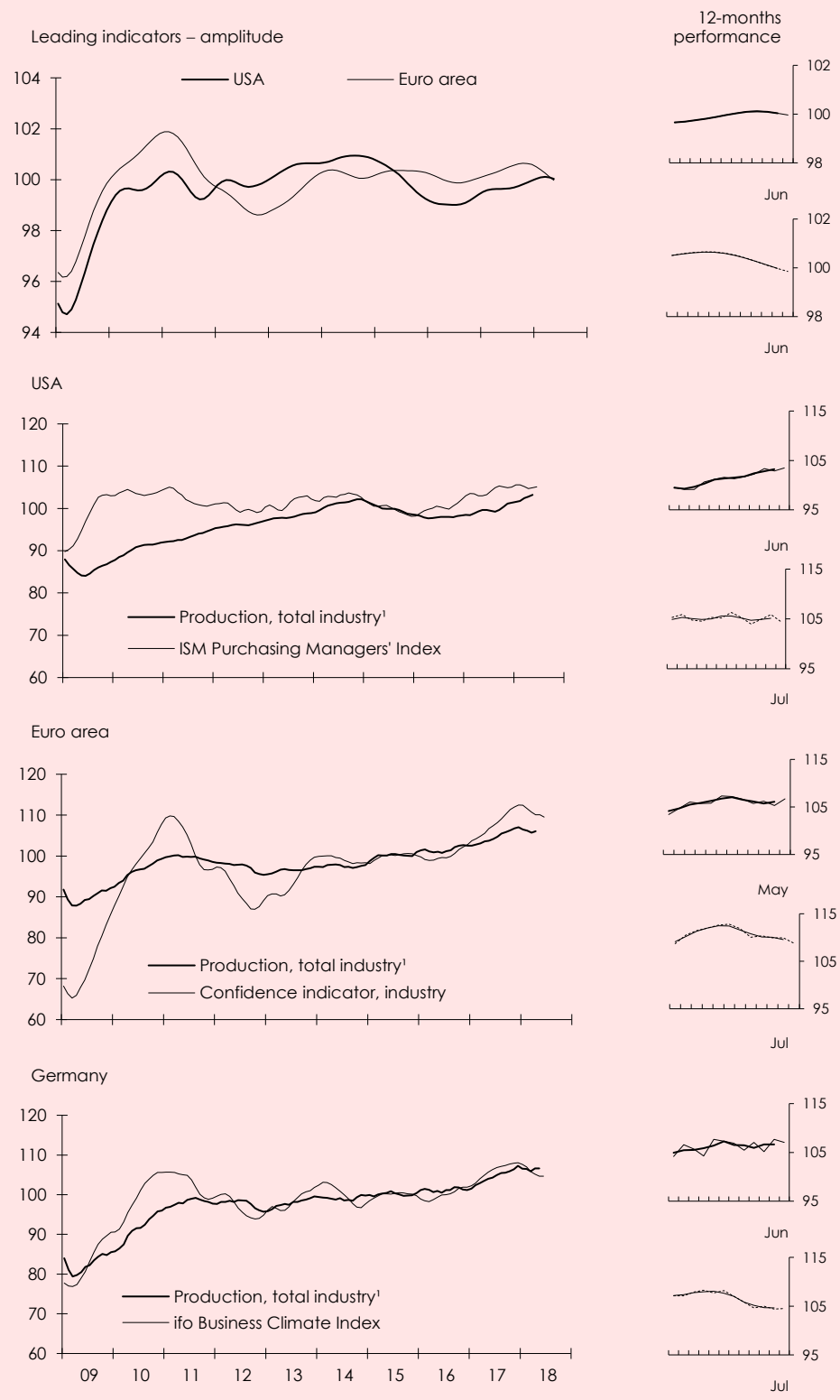
The strong economic growth of the previous year slowed somewhat in the euro area and in the EU. While the economy in the euro area in the fourth quarter of 2017 was still growing similar to the previous quarters at +0.7 percent, the growth rate dropped to 0.4 percent at the beginning of 2018. Investment demand lost much of its impetus and exports even declined. Only consumer demand revived and boosted the trend.

According to the flash estimate by Eurostat, economic growth in the euro area dropped again slightly to 0.3 percent in the second quarter. A rise in real GDP of 0.4 percent was again recorded for the EU as a whole.

In Austria the upswing continued in the second quarter, barely losing speed. First calculations of the Austrian Institute of Economic Research (WIFO) revealed an increase in GDP in real terms of 0.7 percent compared to the previous period. Exports decreased again; however, investment demand continued to grow strongly. Private household consumption again enjoyed strong growth. As a result of the marked rise in employment in recent years, earned income has grown significantly and the growing confidence of private households in view of the positive development in the labour market is encouraging consumption.

Figure 1: International business climate

Seasonally adjusted, 2015 = 100, 3-month moving average



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

This sustained economic activity has resulted in a further drop of the unemployment rate. At 7.6 percent in July 2017, it was already significantly lower than in the previous year and now has dropped to 6.9 percent. While the average unemployment rate in the EU is almost as low again as during the boom period before the financial and economic crisis, the rate in Austria is still above this level.

June's inflation rate of 2 percent was the same as the average of recent months; to date price pressure has not yet increased. It was mainly the increase in fuel prices which affected the rate of price increases.

## 1. No end in sight to the upswing in the USA

In the second quarter of 2018, the economic upswing in the USA accelerated to +1 percent after slowing somewhat at the beginning of the year to +0.5 percent in real terms compared to the previous period. In particular, private consumption rose strongly (+1 percent in real terms). Gross fixed capital formation grew more slowly than in the two previous quarters (+1.2 percent).

This means that the second longest upswing of the last 50 years continues. The unemployment rate dropped to 3.8 percent in May, its lowest value since 1969. Only during the boom period of 2000, it was that low, at 3.8 percent. In July 2018, it rose again slightly to 3.9 percent.

The number of new applicants for unemployment benefit was as low in July 2018 as it was in 1969. So far, it has been possible to satisfy the increasing demand for labour by extending working hours and increased participation in the labour market which goes hand-in-hand with an upswing in economic activity. The trend in real wages still does not appear to react to tension in the labour market. In July the official employment cost index exceeded the previous year's figure by 2.7 percent; however, the inflation rate was almost as high at 2.9 percent.

Share prices are likely to be overrated when measured by the S&P 500 stock price index; however, no further upwards trend was recorded in recent months. Compared to the highest value to date at the beginning of 2018, the index actually dropped. Real estate prices, measured by the Case-Shiller Index, exceeded their highest level so far, dating back to 2006, at the end of 2017. However, since then the general increase in prices put this rise into perspective. According to this index, in April and May real estate prices increased by 6.7 percent and 6.5 percent, respectively, as compared to the previous year. Furthermore, the debt ratio of private households and corporations in relation to GDP is still below the rate from before the financial market and economic crisis hit. Recently, the saving ratio of private households was revised upwards. Accordingly, in the second quarter it was slightly lower at 6.8 percent than in the first quarter (7.2 percent).

Likewise, the ISM Purchasing Managers' Index (PMI) does not contain any indications that the economy will soon bottom out. In the July survey the companies polled remained confident regarding trends for the months to come. The trade dispute of the USA with China and the EU does not yet appear to have had any effect on business activity nor investment behaviour.

Nor does it seem likely that consumption of private households – the most important demand component in the economy of the USA – will lose its impetus in the short term. The consumer surveys carried out by the Conference Board, Reuters and the University of Michigan also reflect a large measure of confidence and an optimistic view of the future for the coming months.

The US Federal Reserve continues to successively tighten its monetary policy, but fiscal policy counteracts with expansive measures. This means the upswing could certainly continue for the next few quarters.

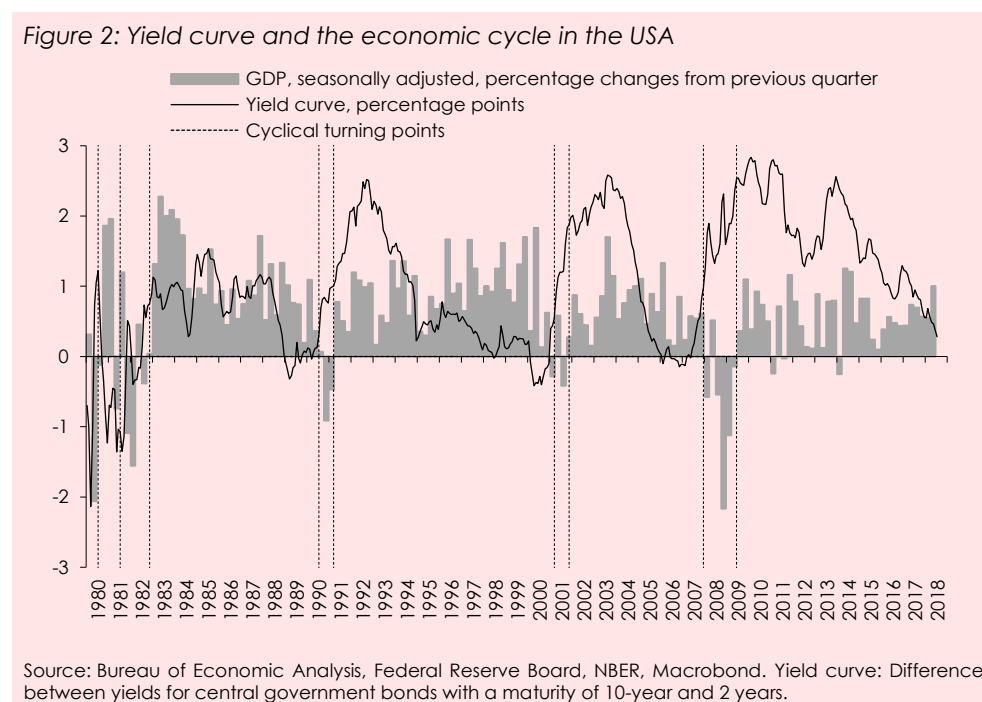
One indicator which proved reliable in the past in predicting turning points in the economic cycle is the yield curve. It compares the yields of debt securities with different maturity dates. Since the probability of unforeseen events occurring over a longer lockup period is higher, for example changes in debtor risk, such debt securities usually offer higher returns than those with a shorter lockup period. A sudden tightening of the monetary policy will cause a direct rise in short-term interest rates. Long-term interest rates display a similar response; however, long-term inflation expectations – which are cushioned by the more restrictive monetary policy – play a role here. Demand for long-term debt securities can subsequently increase relative to demand

*Wage trends in the USA continue to ignore the strain on the labour market.*

for short-term debt securities. This lessens the resulting difference in yield or it can even become negative.

Figure 2 shows the yield curve for the USA as the yield spread between government bonds with a maturity of ten and two years related to the turning points in the economic cycle dated by BEA. This shows that recession periods with shrinking economic activity followed negative values in the yield curve around one year later.

The interest spread has been flattening out since 2016, most recently touching 0.3 percentage points; however, it is not yet negative. This means, based on this indicator, that a recession is not likely to occur in the short term.



## 2. Economic growth in the EU stabilises in the second quarter, albeit somewhat muted in the euro area

After a clear economic recovery in the previous year, the euro area has shown signs of cooling since the beginning of 2018. Major economies have seen economic growth slowdown. In Germany, the economy grew in the first quarter of 2018 by only 0.3 percent, although each quarter of the previous year had seen a rise in real GDP of at least 0.6 percent. In France, growth slowed at the beginning of the year from 0.7 percent to 0.2 percent, and also in the rise of 0.3 percent was slight. Flash estimates indicate that this weak trend will continue in the second quarter in both countries. After the economy of the euro area had expanded during the three previous quarters by 0.7 percent in each quarter, growth slackened in the first quarter of 2018 to 0.4 percent.

This fall was occasioned by export demand and investments. After a strong hike in the fourth quarter of 2017 of 2.4 percent in real terms compared to the previous quarter, exports in the euro area tumbled by 0.9 percent in the first quarter of 2018. The end of 2017 still saw dynamic growth in investment demand (+1.4 percent); however, this slumped in the first quarter of 2018 to 0.3 percent. In contrast, consumption of private households saw a clear rise (+0.5 percent; fourth quarter of 2017 +0.2 percent), stabilising the economy.

Since May, economic indicators assume the situation stabilising or even a slight recovery. From April to June, the Economic Sentiment Indicator of the EU remained essentially unchanged for the euro area, easing back slightly in July. Indicators for industry and the construction sector still remain at a high level. After weak performance at the beginning of the year, industrial production saw a strong hike in May.

Consumers' confidence continues to be characterised by high optimism. If the excellent values around the end of 2017/beginning of 2018 is ignored, this indicator is currently at its highest point for the last 13 years, exceeding even the very good results of 2007. This should give consumption a strong impulse for several months to come.

The flash estimate from Eurostat for the second quarter shows an unchanged modest rise in GDP of 0.4 percent in real terms for the EU as a whole. According to provisional calculations, this actually shows a slight slowing of the economy in the euro area (+0.3 percent after +0.4 percent).

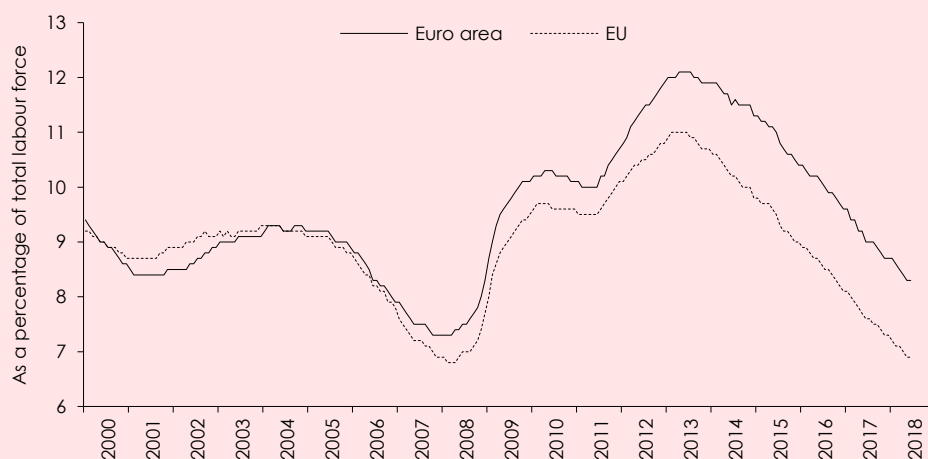
The dynamic development in consumption is not only due to the strong expansion of employment in the euro area and the whole EU, but also to the drop in the unemployment rate. Although the decrease was rather modest due to the marked rise in labour market participation in both economic areas, the unemployment rate in the EU has shown a downwards trend since the beginning of 2013. In May and June 2018, it was only 6.9 percent (Figure 3). This is the lowest rate since August 2008 and is close to its lowest level of 6.7 percent during the boom phase of 2008.

In the euro area the rate for May and June dropped to 8.3 percent. The decrease since 2013 (12.1 percent) is considerable; however, the gap to its lowest level at the beginning of 2008 (7.3 percent) is greater. Furthermore, the rate varies appreciably between individual euro area countries. While the drop of the unemployment rate in Germany had a mitigating effect on the average for the euro area, the rates in Greece (around 20 percent), Spain (15 percent) and Italy (11 percent) are still far from levels before the crisis.

*The unemployment rate in the EU dropped to almost the same level before the financial and economic crisis hit. However, there are major differences between member countries.*

Figure 3: Harmonised unemployment rate in the euro area and the EU

Seasonally adjusted, ILO definition



Source: Eurostat, Macrobond.

### 3. Austria's economy shows strong growth again in the second quarter of 2018

The Austrian economy grew in real terms by 0.8 percent in the first quarter of 2018, almost as strongly as in the two previous quarters (+0.9 percent)<sup>1</sup>. In contrast to the USA and the euro area average, growth in Austria did not slow at the beginning of 2018. Exports rose, although they showed an average downward trend across the euro area, and particularly in Germany. Also, the demand for gross fixed capital formation slowed down in Austria.

Indicators such as business surveys and industrial production indices point to a progressive cooling down in economic activity since the beginning of 2018. The WIFO

*The WIFO Flash Estimates for the second quarter of 2018 revealed an increase in GDP in real terms of 0.7 percent. This means the Austrian economy continued to show strong growth as in the previous quarter (first quarter +0.8 percent).*

<sup>1</sup> According to the seasonally adjusted figures by Eurostat Standard, growth was even higher at +0.9 percent than in the fourth quarter of 2017 (+0.8 percent). However, the second quarter saw growth slowing to +0.5 percent.

Flash Estimate for the quarterly national accounts reports a growth rate of 0.7 percent for the second quarter.

Figure 4: Results from the WIFO-Konjunkturtest

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



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

This expansion was broad-based, receiving impulses from within the domestic economy as well as from abroad. Business investment activity expanded again in the second quarter. Demand for gross fixed capital formation (machinery and equipment, construction and other investment) rose by 1.2 percent (first quarter +1.3 percent). Private consumption (including non-profit institutions serving households) continued to perform strongly in the second quarter (+0.5 percent).

Although consumer activity rose slightly compared to the second half of 2017, export growth slacked somewhat. Industrial activity remained robust; value added in manufacturing rose by around 1.3 percent (first quarter of 2017 +1.7 percent). As with exports, the strong upswing in the second half of 2017 did not continue during the first half of 2018.

### 3.1 Increasing complaints by Austrian manufacturers of a labour shortage

The manufacturing industry continues to enjoy an upswing, although performance appears to be slackening off slightly. The industrial production index saw strong growth until February; however, growth plummeted in March and April, with significant recovery not occurring until May. Business surveys in this field appear to show a less dynamic

trend than in the recent past. In WIFO-Konjunkturtest (business cycle survey) the companies polled had a less optimistic view of the current situation in both June and July and of trends for the coming months. The survey carried out by the Austrian Economic Chambers (WKO) on economic activity and the Bank Austria Purchasing Managers' Index indicate strong growth for the coming months, although the rate will slow slightly.

The slowing of economic activity will relieve capacity bottlenecks in manufacturing. The WIFO-Konjunkturtest of April saw companies reporting a drop-in capacity utilisation for the first time since 2016. But capacity utilisation remains unusually high and saw a slight rise again in July.

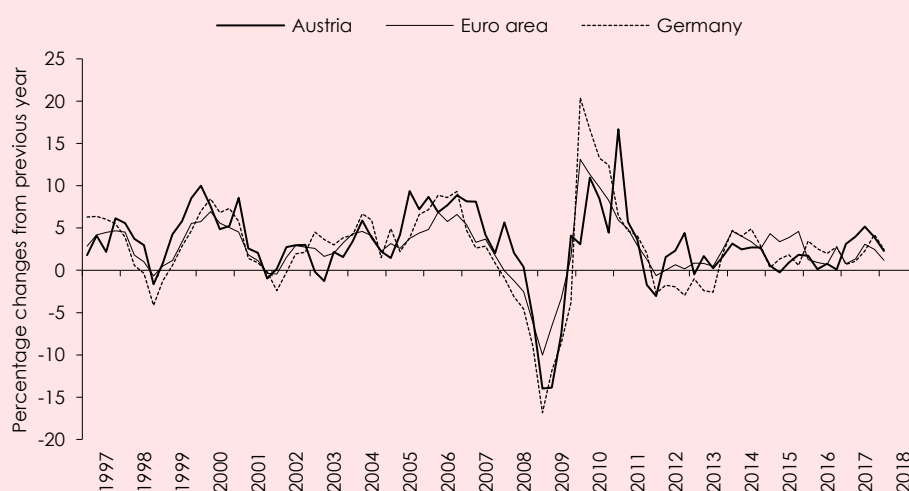
The available capacities are increasingly seen by companies as limiting production. The percentage of companies which do not see any obstacles to production has tended to drop since mid-2016. However, the reason given is not a lack of demand (this partial index reached its lowest level since 1996 in July 2018) but a labour shortage (highest level since 1996) and "material". Difficulty finding financing and "other reasons" were not given as limitations. On average, companies reported secured production for a period of 4.4 months.

So far, the economic upswing has been quite labour intensive in the euro area average, Germany and Austria and thus has been accompanied by a rapid rise in employment. This applies not only to the number of jobs, but also to the number of hours worked. Productivity per hour rose significantly in manufacturing, above all in periods of strong economic growth during the peaks of 2000, 2006 and 2010 (Figure 5). In contrast, no appreciable rise was reported in 2017.

*Productivity is rising at a much lower rate than in previous boom periods.*

Figure 5: Productivity per hour in manufacturing

Unadjusted



Source: Eurostat; WDS – WIFO Data System, Macrobond. Gross value per hour worked by employees.

### 3.2 Rise in fuel prices is driving domestic inflation

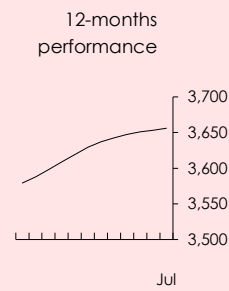
Inflation in Austria continued to rise in June 2018. After a rise of 1.9 percent in consumer prices in May compared to the previous year, the index rose in June by 2.0 percent. As was the case in May, according to Statistics Austria the hike in fuel prices was the determining factor. The positions which showed strikingly higher price rises during past years in Austria than in the average for the euro area remain the determining factor for the difference in the inflation rate.

According to the CPI rentals for housing rose in June 2018 by 3.6 percent compared to the previous year; this added 0.18 percentage points to the inflation rate. Prices for tourism services also saw above-average rises. For example, prices for restaurant and hotel services rose by 3.1 percent (restaurant services +2.9 percent; accommodation services +4.6 percent).

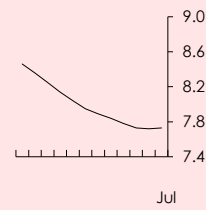
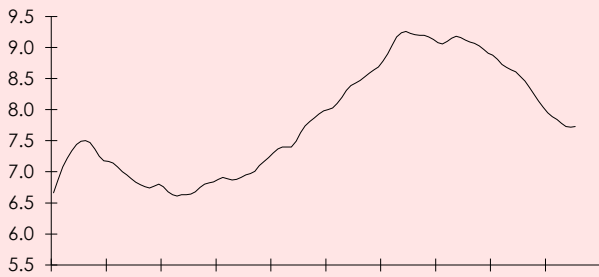
*To date it was primarily the price hikes in rentals for housing and tourism services which caused a rise in the consumer price index. But the rise in fuel prices is starting to take effect.*

Figure 6: Key economic indicators

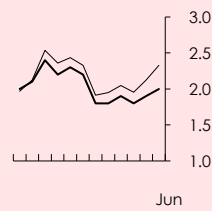
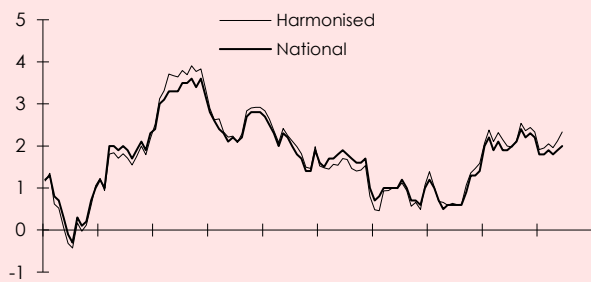
Persons in active dependent employment<sup>1</sup>, 1,000s, seasonally adjusted



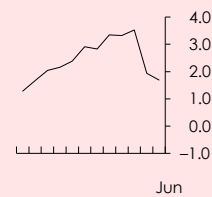
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



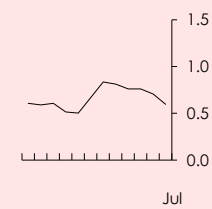
Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



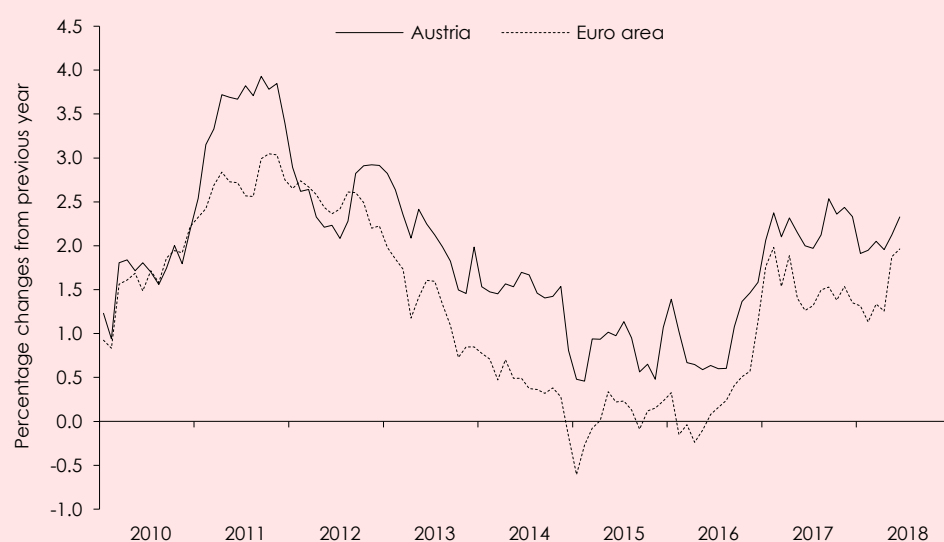
Source: Public Employment Service Austria, Main Association of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – <sup>1</sup> Excluding persons in valid employment contract receiving child care benefit or being in military service. – <sup>2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



The increment in inflation compared to the euro area shrank recently from its previously higher rate (Figure 6).

In May and June 2018, the rise in the harmonised index of consumer prices (HICP) for Austria was 0.2 and 0.3 percentage points above the average for the euro area, respectively, whereas the gap in the previous two months had been 0.7 percentage points. The difference to Germany almost disappeared. In May the rise in the HICP for Austria was actually below that for Germany; however, in June it was 0.2 percentage points higher.

Figure 7: Consumer price index, harmonised



Source: Eurostat; WDS – WIFO Data System, Macrobond.

### 3.3 Unemployment continues to fall appreciably

The sustained upswing in economic growth continues to bring about strong expansion of employment and a drop-in unemployment. According to the Public Employment Service Austria, the number of unemployed persons (including those in training) dropped by 29,800 compared to the previous year (-8 percent), while the number of those in active dependent employment rose by 85,000 (+2.3 percent). This prolonged upswing had a positive effect on the long-term unemployed since many companies had to recourse to this pool of labour. The number of unemployed officially registered as long-term unoccupied declined in July by 13,200 compared to the previous year, after having dropped by 14,400 in the previous month.

In WIFO's economic survey of July, the companies surveyed from manufacturing, the construction sector and services complained of labour shortages being the greatest obstacle to production. The recent increase in jobs was considerable; this occurred primarily in manufacturing and the construction sector.

*The unemployment rate dropped in July to 6.9 percent, 0.7 percentage points below the previous year's level.*