

Stefan Schiman

Increased Optimism in Financial Markets Following US Elections

Business Cycle Report of December 2016

Increased Optimism in Financial Markets Following US Elections. Business Cycle Report of December 2016

Following the election of Donald Trump as the next US president, financial markets became more upbeat in their appraisal of the growth outlook for the USA. British value added and especially gross fixed capital formation grew at a robust pace after the Brexit decision. Economic sentiment improved in the euro area and in Austria prior to Italy's constitutional referendum. In Austria, the pace of economic growth in the third quarter somewhat exceeded the euro area average; summer tourism results were extremely good. But due to strong immigration, unemployment remains high (especially in the tourism sector), although it has barely risen this year owing to accelerated employment growth.

Contact:

Stefan Schiman: WIFO, 1030 Vienna, Arsenal, Objekt 20, stefan.schiman@wifo.ac.at

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", <http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf> • Cut-off date: 5 December 2016.

Data processing: Astrid Czaloun (astrid.czaloun@wifo.ac.at), Christine Kaufmann (christine.kaufmann@wifo.ac.at), Maria Riegler (maria.riegler@wifo.ac.at), Martha Steiner (martha.steiner@wifo.ac.at)

ISSN 1605-4709 • © Austrian Institute of Economic Research 2016

Impressum: Herausgeber: Christoph Badelt • Chefredakteur: Michael Böheim (michael.boeheim@wifo.ac.at) • Redaktionsteam: Tamara Fellinger, 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

The US economy remains resilient, following some temporary loss in momentum in the first half of 2016. Meanwhile, the unemployment rate has fallen to such a level (below 5 percent) that wage pressures are gradually rising. The election of Donald Trump as the next US president prompted a further improvement in business expectations: many investors changed from gold and Treasury bonds to US stocks, thereby triggering an increase in long-term interest rates and the dollar exchange rate.

The UK, in contrast to most forecasts, registered robust growth in the three months following the Brexit vote at the end of June 2016. Even gross fixed capital formation, which is strongly determined by assessments of future prospects, expanded. So far, the Brexit decision has not had any adverse impact on the real economy. There is also no indication yet of a devaluation-related upward pressure on prices.

In the euro area, where solid quarter-on-quarter growth of 0.3 percent was registered in the third quarter, assessments of the economic situation have improved again recently. Apparently businesses and private households did not let themselves be disconcerted by the constitutional referendum in Italy on 4 December. Referendums and elections, the foundations of Western democracy, have often been stylised too fast recently as uncertainty factors for the real economy.

In Austria, the pace of economic growth in the third quarter slightly exceeded the average growth rate in the euro area (trend-cyclical component +0.4 percent, +0.5 percent according to Eurostat guideline). Evidence from latest business surveys points to further expansion. Growth is being driven by robust domestic economic activity: private consumption is gradually adapting to higher disposable incomes

stemming from the tax relief at the beginning of 2016; investment increased further. Goods exports according to the National Accounts stagnated in the third quarter, however. By contrast, exports of tourism services expanded, which was made possible by the successful summer season – the number of arrivals reached a new peak. Since there is little scope for productivity increases here, the high demand does act as a price booster but also prompts the creation of a disproportionately high number of jobs. But since at the same time a large number of immigrants are looking for jobs in tourism, the unemployment rate is also very high.

Overall, unemployment barely increased further in 2016, however; the increase affected mostly Syrians having a right to asylum. Unemployment of Austrian citizens posted a first slight decline since the upswing in 2010-11, and employment rose markedly. Most of the employment gains, which have accelerated sharply in the course of this year, continued to be accounted for by foreign labour, mostly from Hungary and Romania. The improvement seen in the labour market has recently continued: in November, unemployment was lower than a year before, the unemployment rate was 9.0 percent.

1. Election of Trump as US president raises optimism in financial markets

Expectations that economic activity and companies' profitability in the USA will benefit from Donald Trump's forthcoming presidency predominate in global financial markets for the time being: after his election victory on 9 November 2016, noticeable portfolio shifting from less risky Treasury bonds into stocks from the USA could be observed: the S&P Index surged, while at the same time yields on government bonds rose in most advanced economies. The capital inflow into the USA becomes apparent through the appreciation of the dollar; since Trump's election victory its value has increased vis-à-vis both the euro and the yen. In addition, the marked decline in the price of gold can also be interpreted as a consequence of market participants' increased optimism.

2. Accelerated wage dynamics in USA

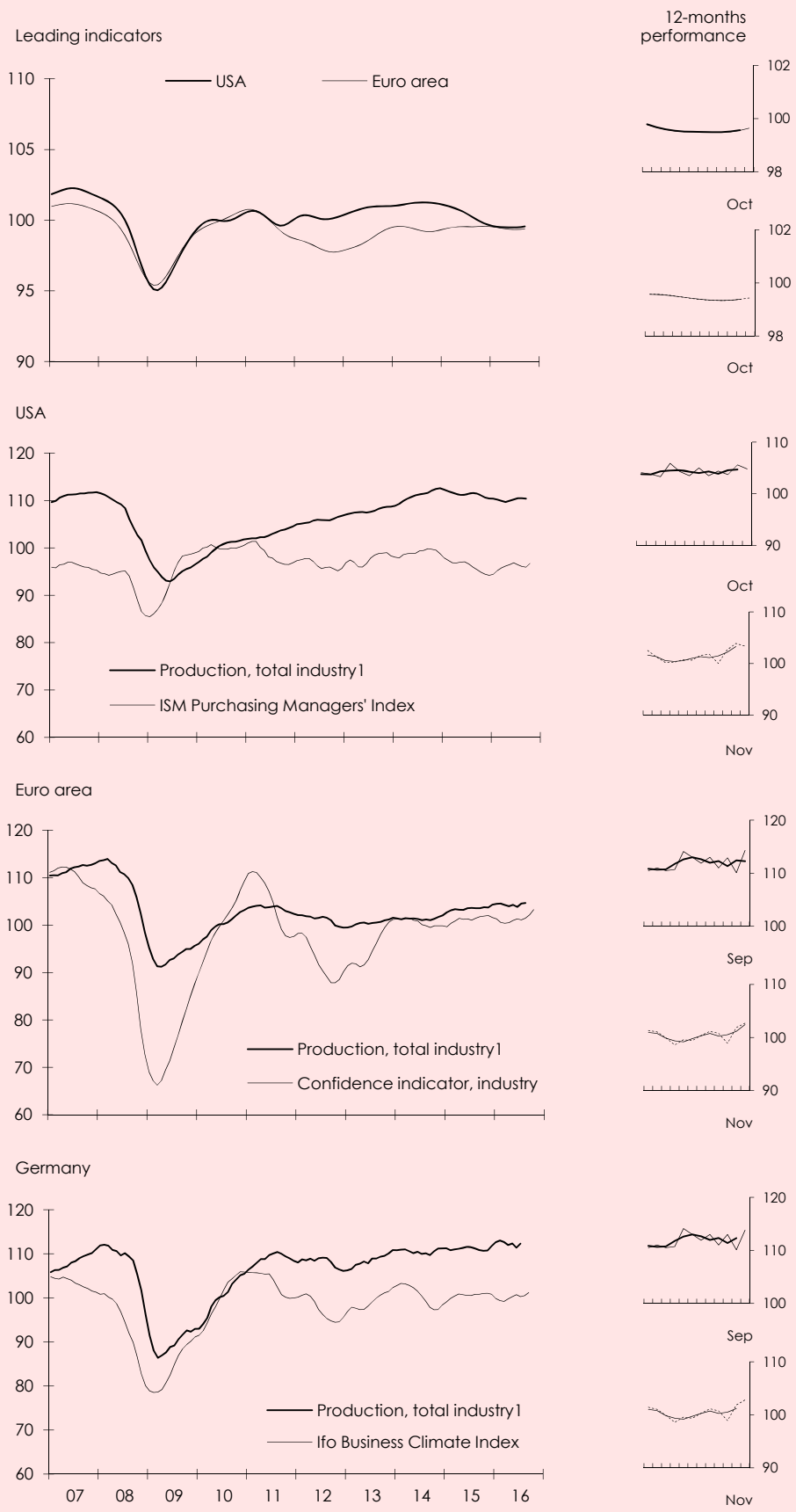
In the second estimate of the Quarterly National Accounts, quarter-on-quarter real GDP growth in the third quarter was revised up by 0.1 percentage point to 0.8 percent, since private consumption dynamics are now estimated to be higher. Hence, the third quarter stands out even more clearly from the first and the second, when GDP expanded by a mere 0.2 and 0.4 percent, respectively. The second calculation confirmed the relatively high contribution of exports to growth in the third quarter as well as less buoyant investment activity. This was the first positive contribution of exports to growth since a year before, when they had been restrained by the dollar's sharp appreciation. Economic activity is expected to remain robust in the fourth quarter. Although the already high level of confidence among consumers did not rise further, business confidence as measured by the Purchasing Managers' Index improved in October and November.

The favourable development observed in the labour market has recently continued. Employment expanded as expected in November (+178,000 jobs), the unemployment rate fell to 4.6 percent, thereby prompting rising wage pressures. Hourly wages increased at a year-on-year rate of 2.8 percent in October, and 2.5 percent in November. The core inflation rate (+2.1 percent in October) did not rise further, indicating good, but no over-utilisation of resources. For this reason it is assumed that, after a long pause, the central bank may continue its policy of modest interest rate hikes in December. Headline inflation rose slightly to 1.6 percent in October – on the back of temporarily rising crude oil prices.

US exports rebounded in the third quarter, while private investment softened; consumption was stronger than previously calculated.

Figure 1: International business climate

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



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply ManagementTM), Ifo (Institute for Economic Research, Munich), OECD. - ¹ Excluding construction.

3. Stagnation of domestic demand in Japan

In Japan, GDP grew by 0.5 percent, compared with the previous quarter, and by 0.9 percent, compared with a year before, in the third quarter. The expansion was mainly driven by external trade: exports were 2 percent higher than in the previous quarter, while imports declined. Construction investment increased sharply in the third quarter while consumer spending and investment in machinery and equipment stagnated. Domestic demand, which had driven the economic momentum in the first half of the year, stagnated in the third quarter.

Economic growth in China was reported to have been 6.7 percent in the third quarter, the same rate as in the first and the second quarter of 2016, and therefore was exactly in line with the government's target growth of 6.5 to 7 percent. Value added in the services sectors, at +7.6 percent once again posted above-average growth. Economic activity is driven by domestic demand, the export momentum is weak. The Manufacturing Purchasing Managers' Indices signal a modest acceleration in economic activity in the fourth quarter.

During the first half of 2016, the Russian economy recovered somewhat from the downturn experienced last year. Since the crude oil price has been stagnating since then, the rebound lost momentum in the third quarter. In the fourth quarter, the gradual stabilisation of economic activity is likely to continue; the Manufacturing Purchasing Managers' Index improved markedly in October.

In China, the services sector is the driver of economic momentum.

Russian economy recovering from 2015 downturn.

4. UK: robust growth after "Brexit shock"

Economic growth in the UK – unlike most forecasts predicted – for the time being has not been impaired by the outcome of the referendum on 23 June 2016 in favour of leaving the EU. Real GDP grew by 0.5 percent quarter on quarter, and by 2.3 percent year on year, in the third quarter, hence more sharply than in the euro area. Private consumption expanded vigorously, but so did gross fixed capital formation, which had been predicted to plunge as a consequence of the outcome of the referendum. It is possible, however, that part of this investment had been fixed already prior to the referendum.

Hence the only economic development so far that can in part be linked to the Brexit referendum is the pound's substantial depreciation. While it began already a year ago, it accelerated for a short period of time on account of the referendum. As the pound had appreciated steadily since March 2013, the effective exchange rate is only little lower than the level around which it had fluctuated in the years following the financial crisis. However, exchange rate developments vis-à-vis individual currencies were mixed. For instance, the depreciation vis-à-vis the dollar was higher than the previous appreciation, with the result that currently the exchange rate of the pound is the lowest seen since the dollar boom in 1985.

HICP inflation in the UK rose from 0.6 percent in July and August 2016 to 1.0 in September and 0.9 percent in October 2016. It is not likely, however, that this rise is already a consequence of the depreciation, since inflation in the euro area accelerated at a similar pace over this period (from 0.2 percent in July and August to 0.5 percent in October).

Gross fixed capital formation in the UK was increased and not curbed in the three months following the referendum on leaving the EU.

5. Italian referendum did not darken euro area economic climate

According to Eurostat's flash estimate, GDP in the euro area rose by 0.3 percent in the third quarter of 2016, compared with the previous quarter. The basis of growth has widened, Italy (+0.3 percent) and France (+0.2 percent) contributed positively. Above-average growth was registered in Spain and the Netherlands (+0.7 percent each). HICP inflation in the euro area was 0.5 percent in October, while the core inflation rate was 0.7 percent. The unemployment rate was 9.8 percent in November.

Economic activity is expected to remain robust also in the fourth quarter: consumer confidence, which had still been unchanged in October, improved noticeably in

Politically surprising turns, as are customary in a democratic system, are often too quickly stylised as uncertainty factors for the real economy.

November. Business confidence, having already reached an all-year high in September, strengthened further in October, but in November fell again to the level recorded in September. The Markit Composite Purchasing Managers' Index climbed to an all-year high in November. Managers were surveyed only after the presidential election in the USA, hence a negative "Trump shock" failed to materialise. Other political unpredictabilities that are customary in a democratic system, such as the constitutional referendum in Italy on 4 December, are often also too quickly stylised as uncertainty factors for the real economy that restrain production. However, a somewhat higher level of sensitivity can be observed in financial markets: The yields on Italian government bonds have risen somewhat more briskly in recent weeks than, for instance, those on Spanish bonds, but they are still lower than the yields on US Treasury bonds.

6. Germany: sentiment brightening after weak third quarter

Economic activity in Germany lost momentum in the third quarter. GDP rose by a mere 0.2 percent, seasonally adjusted, compared with the previous quarter, after growth of 0.4 percent in the second quarter and 0.7 percent in the first quarter. Output growth stabilised at +1.5 percent compared with a year before, owing not least to the good result achieved in the first half of the year. Against the background of high job security, rising real wages and sizeable pension increases, private consumption maintained its ground as a pillar of economic growth; in addition, government spending continued to expand vigorously. Investments did not provide any stimulus, and exports shrank slightly. Economic activity is expected to pick up again in the fourth quarter: the Ifo Business Climate Index rose to an all-year high in October and remained at that level in November.

7. Solid economic activity in Austria

Compared with the flash estimate made at the end of October 2016, the second calculation of the Quarterly National Accounts for the third quarter shows a slow-down of momentum in the manufacturing sector, which was not fully compensated for by the upward revision in the services sector, notably to accommodation and food services. Therefore the annual GDP growth rate was revised down by 0.1 percentage point to +1.2 percent; the seasonally and working-day adjusted change vis-à-vis the previous quarter does not change in the first number after the decimal point (trend-cycle component +0.4 percent, according to WIFO, +0.5 percent, according to Eurostat guideline).

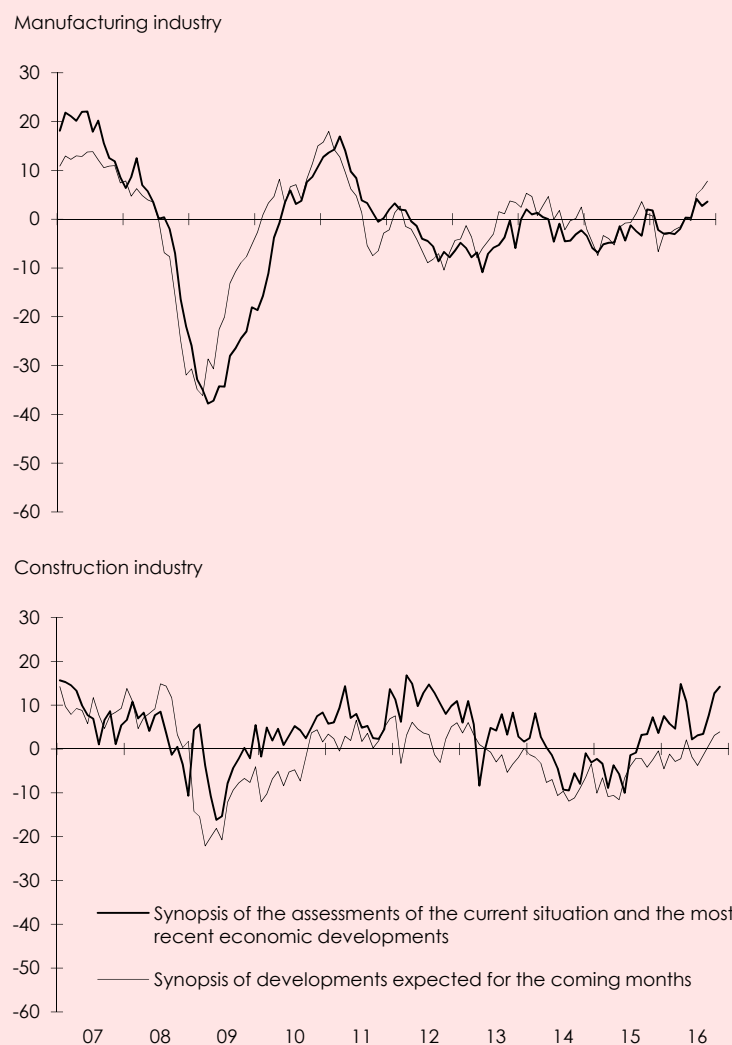
Investment and export growth weakened somewhat in the third quarter compared with the previous quarter. With domestic demand driving economic activity, imports grew slightly more briskly than exports, and the contribution of net trade remained negative. On the output side, value added in the hotel and restaurant sector benefited from the successful summer tourism season.

Companies' growing willingness to invest is reflected in vehicle statistics: in 2016, motor vehicle registrations until October rose by 6.3 percent compared with the same period a year before. The number of newly registered passenger cars, which account for three quarters of all new registrations, rose by 6.1 percent. The brisk demand for vehicles is not limited to vehicles for commercial use, and therefore not only concerns equipment investment, but also private consumption. Developments of household real income have been very positive, owing to the income tax reform that entered into force at the beginning of 2016, and the low inflation rate. As calculated already in WIFO's Flash Estimate, growth in private consumption accelerated in the third quarter, as it is gradually adjusting to the higher disposable income owing to the tax relief. However, measured by these strong growth stimuli, private consumption is still rather subdued, owing to the fact that job worries amid high unemployment dampen consumers' willingness to spend. Consumer confidence did improve in the course of the year, but hovered around the same low level as during the stagnation phase that started in 2012.

Growing willingness to consume and invest boosts the demand for motor vehicles.

Figure 2: 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.

Value added growth in Austria is expected to accelerate further in the fourth quarter of 2016. While production data are not yet available (the latest figures are from September), business surveys without exception point to further expansion. For instance the Composite Current Situation Index has been rising briskly since September, according to WIFO Business Cycle Survey. The Expectations Index has picked up even more sharply. Developments in the individual sectors signal a broad-based economic recovery. In November, confidence improved especially in the services sector, while in construction assessments of the current situation had spiked already in October and improved further in November. Manufacturers' expectations have been optimistic since September; industrial production increased markedly in August and September. An on-going economic upswing is also suggested by the rapid improvement of expectations of primary product manufacturers in November, provided it persists in the coming months. Capital goods manufacturers have also become much more optimistic in their assessment of the current situation and future prospects.

Business surveys signal an acceleration of economic growth in the fourth quarter of 2016.

7.1 2016 goods exports weak so far

Nominal goods export growth has been weak overall so far in 2016 (January to August +0.6 percent, compared with a year before). It has been supported by the demand from Germany (+2.2 percent), Austria's by far largest trading partner. The demand from France, Czech Republic, the UK, China, Spain and the Netherlands has grown at a similarly robust pace (+1.8 percent to +2.5 percent). By contrast, exports to the USA, which has established itself as Austria's second-most important target market in recent years owing to the lively demand for Austrian goods, have declined by 4.5 percent so far this year. The euro depreciation last year improved the price competitiveness of Austrian exports; in 2015, exports to the USA rose by almost 17 percent in nominal terms; both increases in real exports and higher prices in euro terms are likely to have contributed to these gains. This year, the mirror-image effect appears to predominate: the strong dollar has weighed on exports from the USA (January to August 2016 -3.2 percent, 2015 +19 percent) and equipment investment in the USA, thereby dampening the demand for imported primary products and capital goods. But special effects (highly volatile development of foreign trade in pharmaceutical products) may also play a role here.

Exports to Italy and Switzerland (third and fourth-largest target market, respectively) stagnated and/or fell slightly. The decline in exports to Poland (-6.6 percent), Slovenia (-1.1 percent) and Hungary (-0.1 percent) can be explained by the expiry of the last EU development program and the related temporary investment slump in these countries. Foreign trade with Russia is still determined by the sanctions (goods exports -11.8 percent). Among the relevant target markets, Austrian goods exports expanded only to Slovakia (+6.4 percent) and Romania (+5.3 percent).

7.2 Increase in current account surplus in the first half of 2016

In spite of the weakness of foreign trade, Austria's current account surplus in the first half of 2016, at 3.3 percent of GDP was the highest surplus recorded since 2010; it was largely attributable to tourism services bringing in a surplus of 3.4 percent of GDP. Besides, the deficit in the income balance shrank compared with the first half of 2015. The capital account balance, by contrast, turned slightly negative. Nevertheless, it is not yet possible to make a final assessment of foreign trade developments based on these data, given that they are normally subjected to extensive revisions. For instance, the current account surplus for 2014 and for 2015 was revised from 1.9 percent and 2.5 percent of GDP to 2.4 percent and 1.8 percent of GDP, respectively. Hence the current account surplus has not risen steadily since 2012, but shrank temporarily in 2015.

7.3 Fuel prices did not dampen inflation in October

The factors boosting prices in recent months and years also determined the inflation rate in October (+1.3 percent): on the one hand, the upward drift in prices was mainly due to price increases for catering and accommodation services (+3.1 percent and +3.7 percent, respectively), and on the other hand, to apartment rent increases (+3.7 percent). But the acceleration of inflation compared with the previous month (September 2016 +0.9 percent) was due to the base effect of fuel prices: in September, they had still been markedly lower than a year before, while in October they were 0.7 percent higher, given that in October the crude oil price rose, on average, to 49.7 \$ per barrel. It did decline again in November, but picked up to just under 55 \$ following the agreement by the OPEC cartel on 30 November 2016 to cut production.

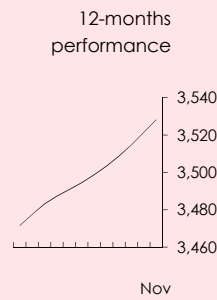
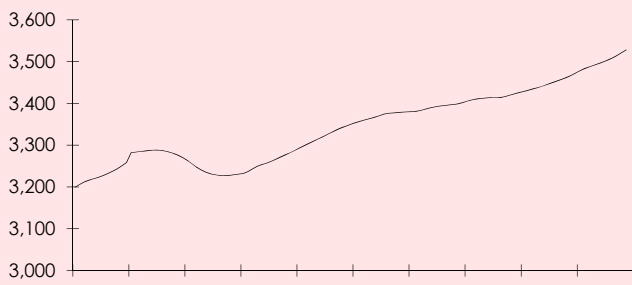
Prices of goods in the "food and non-alcoholic beverages" expenditure category rose at a below-average annual rate in October (+1.1 percent). But the impression that food prices are rising relatively sharply in Austria is correct: the micro basket of goods and services, which comprises goods purchased on a daily basis, hence notably food, but no fuels, rose by 1.9 percent. Much higher inflation rates than for food were registered for rents and for tourism-related services (restaurants and hotels, package holidays, recreational and cultural services), which already in the past had been responsible for most of the inflation differential vis-à-vis Germany and the euro area average.

Goods exports in 2016 have suffered from the weak demand from the USA, a temporary investment slump in Eastern Europe and the sanctions with Russia.

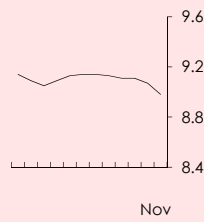
Rents and the prices of catering services rose much more sharply than did food prices.

Figure 3: Key economic indicators

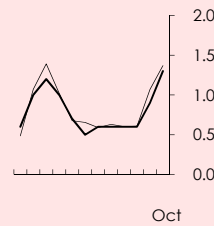
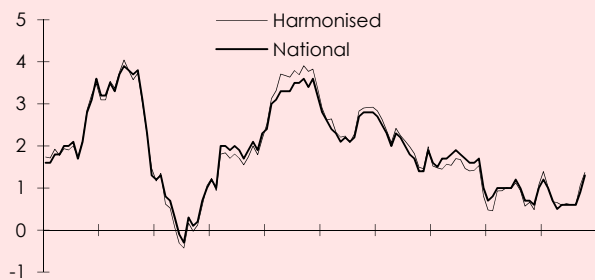
Persons in active dependent employment¹, (1,000), seasonally adjusted



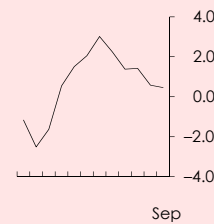
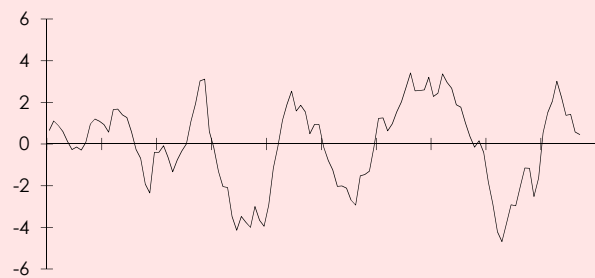
Unemployment rate, traditional Austrian method², seasonally adjusted



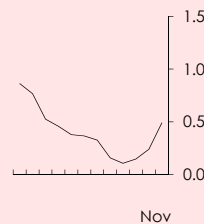
Consumer prices, year-to-year percentage changes



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 persons with 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.

7.4 Rising employment growth and inflation due to successful summer tourism season

The reason for the sharp price increases for tourism-related services lies in the coincidence of lively demand and little scope for productivity increases in this segment. In the 2016 summer season (May to October), guest arrivals as a measure for the attractiveness of the destination, reached just under 23 million, an all-time high. Particularly sharp increases were registered for arrivals of guests from the North (Germany, the Netherlands, Belgium, Denmark, Sweden, Czech Republic). The demand from the USA and Russia, by contrast, declined noticeably, a situation similar to that for goods exports. Favourite destinations were both in the mountains and at swimming lakes and in regions with a wellness infrastructure. City destinations registered lower growth; in summer 2016, especially the tourism sector in Vienna was not able to reach the high growth rates registered in previous years. According to first available data, city trips appear to become less attractive all over Europe, in particular owing to the more strongly perceived terrorist threat. Although Vienna is considered to be relatively safe, tourism here suffers from the decline in the demand for trips to other European cities such as Paris or London, given that especially long-distance travellers often visit multiple destinations.

Apart from arrivals, the number of overnight stays – a more important economic key figure – also increased sharply overall compared with a year before (+5.1 percent to around 73 million, of which around 51 million were by foreign guests), reaching its highest level since 1993. The downward trend of the average length of stay observed for several years flattened this year, with the average length of stay in Austria almost equal to that in the previous summer (3.2 nights, 1993: 5.0 nights). As the increase in tourism demand has barely any effect on productivity, it goes hand in hand with a considerable positive effect on employment: of the 44,800 additional jobs (+1.8 percent) that were created in the private (i.e., not public-sector related) sector of the economy in the twelve months until October 2016, 5,600 (+3.1 percent) or 12.5 percent were in the "accommodation and food services" sector, while it accounts for only 6.3 percent of value added by the private sector. Nevertheless, the unemployment rate in the tourism industry did not fall below 13 percent in the summer, and at the end of the summer season in October surged to just under 23 percent, approximately the same level as in April 2016. Hence the strong employment growth was not sufficient to absorb the influx of labour, since a large number of immigrants are looking for a job in tourism.

7.5 First decline in unemployment among Austrian citizens since 2011

Employment growth continued to accelerate again markedly in 2016. After +20,400 in 2014 and +31,500 in 2015, the number of persons employed in 2016 up to and including October increased by around 50,900 compared with the same period a year before. Of this number, 15,300 of the persons newly employed were Austrian citizens; the employment of Austrian citizens had decreased in 2013 and 2014, and had risen only slightly in 2015. The most important countries of origin of the 35,600 newly employed foreigners were Hungary (almost 6,900) and Romania (almost 4,800). The employment of persons from EU countries rose again somewhat more sharply than a year before (+27,800), but at a slower pace than during the years from 2012 to 2014, when the opening of the labour market for persons from Eastern countries had triggered a noticeable increase (+37,800 p.a.). Given that, following the sharp declines in 2013 and 2014, the number of employed persons from third countries rose at an accelerated pace, overall employment of foreigners increased more briskly in 2016 than in the three previous years.

With the acceleration of employment growth, unemployment growth slowed from +35,000 in 2015 to +4,600 in the current year (up to and including October). Having risen markedly from 2012 until 2015, owing to, among other things, displacement effects, unemployment of Austrian citizens declined for the first time since the economic upswing in 2010-11, albeit at a modest pace. The number of unemployed persons from other EU countries also rose at a considerably slower pace. As this development just about offset the decline in the unemployment of Austrian citizens (around 1,000 persons in both cases), the dynamics in the current year have been

In contrast to the positive overall trend, city tourism suffers from a more strongly perceived terrorist threat.

As a large number of immigrants are looking for a job in tourism, the unemployment rate in this sector is very high, despite strong employment dynamics.

Employment dynamics have strengthened further this year; employment of Austrian citizens is on the rise again.

Unemployment growth slowed markedly in 2016 and was largely limited to persons having a right to asylum.

determined notably by the unemployment of persons having a right to asylum or to subsidiary protection: until October, at least 3,000 additional persons from Syria were registered as unemployed.

Labour market conditions have recently improved further: the unemployment rate even fell slightly in November 2016 and stood at 9.0 percent in both seasonally adjusted and unadjusted terms. In sum, no seasonal effects were therefore apparent. The number of persons unemployed fell to 355,700 in November (–3,600, compared with a year before, Austrian citizens unemployed –6,000). The number of job vacancies rose by 8,900 to 39,900. By contrast, owing to new immigrants, the number of persons enrolled in vocational training increased by around 2,700 to 73,500 (unemployed foreigners in training +4,800, unemployed Austrian citizens –2,100).