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Low Crude Oil Price Encourages Domestic Demand in Some Countries

Business Cycle Report of June 2015

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The USA and several large emerging market economies saw economic momentum decelerate in the first quarter of 2015. In the EU, the recovery spread to France and Italy. Economic growth in Austria accelerated slightly. Sentiment indicators remained largely pessimistic. The sluggishness of industrial activity in Germany and the structural weakness of its import sector dragged down Austrian exports; the quick rise in rents and lacklustre income developments weighed on private consumption in Austria.

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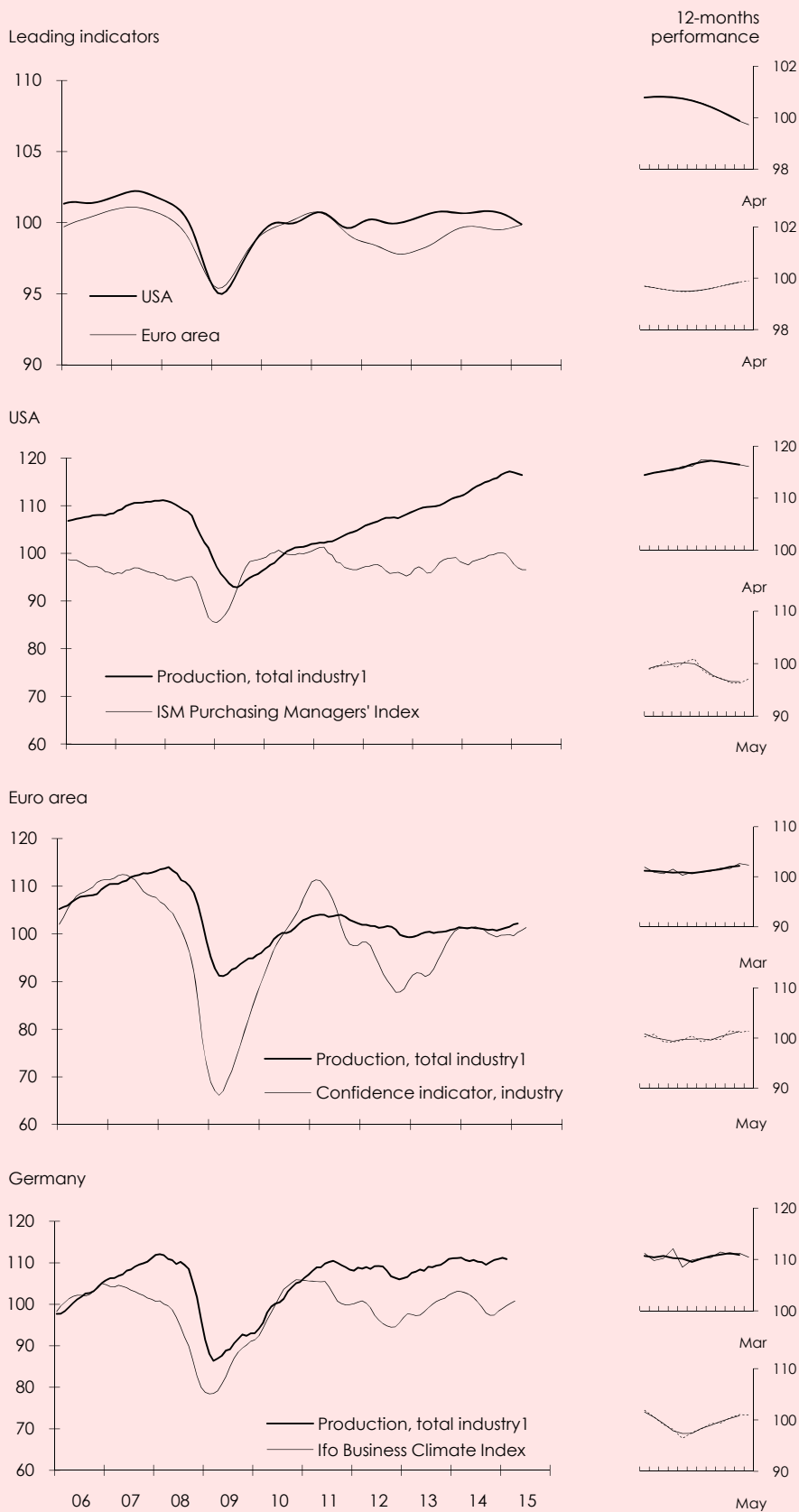
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Economic activity suffered a setback in several large emerging market economies at the beginning of 2015. China saw the expansion moderating, while in Brazil and Russia economic output even contracted in the first quarter. In the USA, economic activity slowed as a result of the marked appreciation of the dollar, i.a. By contrast, growth accelerated in India and Japan, with exports in the latter supported by the weak yen. In the EU, the recovery broadened; apart from Germany and Spain, real GDP also grew in France and Italy in the first quarter. Strengthening domestic demand in these countries is reflected in vigorous import growth. At the end of April, secondary market yields on government bonds of the euro countries, including Germany, surged by around 50 basis points, despite the fact that government bond purchases by the ECB have been exerting a dampening effect on yields.

The Austrian economy grew by 0.1 percent, quarter on quarter, in the first quarter of 2015, following stagnation in the second half of 2014. Private consumption remained weak in an environment of relatively high inflation, rising unemployment and a considerably high tax burden. The decline in fixed investment moderated somewhat. Exports barely grew, owing to weak external demand. Expectations of export orders deteriorated despite the depreciation of the euro, according to a quarterly survey conducted within the framework of WIFO's Business Cycle Survey. The absence of a quantity reaction may be due to the fact that export companies have not yet lowered their sales prices but are waiting to see whether the exchange rate shock is a lasting phenomenon or just a temporary effect of the expansionary monetary policy. The monthly surveys of the WIFO Business Cycle Survey continue to show largely negative responses in all sectors.

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 tourism industry posted an increase in overnight stays in the 2014-15 winter season (November 2014 to April 2015); price-adjusted sales and the quality of the services demanded declined, however; notably city tourism developed favourably. Inflation dynamics in April were again largely determined by extremely high rent increases (+5.0 percent, as measured by the CPI) and the slightly above-average increase in administered prices in tandem with a continuing decline in fuel prices compared with a year before. The seasonally adjusted unemployment rate rose further to 9.3 percent in May.

1. Economic setback in the USA and large emerging market economies

According to the second national accounts estimate, economic growth in the USA slowed more sharply in the first quarter of 2015 than envisaged in the first estimate; real GDP contracted by 0.2 percent compared with the previous quarter. The setback was largely due to the sharp decline in exports (-2.0 percent) accompanied by a slackening in domestic demand. Although external trade is of secondary importance to the USA, given the size of its economy and its geographical location, the substantial and simultaneous appreciation of the dollar vis-à-vis the euro and the yen and a strike by dock workers considerably dampened the growth momentum¹. But economic influences were not the only factors weighing on developments in the first quarter. Construction investments were postponed because of the harsh winter in some parts of the USA. A strike by dock workers on the West Coast of the USA adversely affected exports. This barely had an impact on GDP, though, since stocks of unshipped goods increased at the same time.

Economic activity disappointed also in most of the large emerging market economies at the beginning of 2015: compared with a year before, real GDP rose by a mere 7.0 percent in China, while it shrank by 1.6 percent in Brazil and by 1.9 percent in Russia. A positive development was registered in India, where the annual rate of growth in real GDP rose to 7.5 percent in the first quarter.

2. Growth accelerated in Japan

In Japan, economic growth accelerated in the first quarter of 2015, with real GDP advancing by 0.6 percent compared with the previous quarter. The largest contribution to growth (+0.5 percentage point) came from the increase in stocks, however. Stock surpluses that had arisen as a result of a consumption and investment shortfall owing to the value added tax hike in April 2014 were reduced in the second half of 2014. Following a sharp curtailment in 2014, residential construction and equipment investment picked up slightly in the first quarter of 2015. Private consumption growth remained subdued (+0.4 percent, compared with the previous quarter); in the three months following the tax increase in 2014 it had plummeted by more than 5 percent from the previous quarter. Exports again benefited from the weak yen; but owing to the pick-up in domestic demand, imports also grew vigorously, with net exports consequently making a negative contribution to growth in the first quarter.

Investment in Japan did recover in the first quarter of 2015, but the major share of the additional production could not be sold during the same period, thus causing an increase in stocks.

3. EU: economic recovery is spreading

Following a quarterly growth rate of 0.3 percent in the fourth quarter of 2014, real GDP rose by 0.4 percent in the euro area in the first quarter of 2015; in the EU as a whole, total economic output advanced again by 0.4 percent. While growth in the fourth quarter of 2014 had been strongly determined by special effects in Germany, developments in the first quarter of 2015 were more broad-based: in France, the

¹ However, GDP is assumed to have been adjusted only insufficiently for seasonal effects, so that the actual economic momentum in the USA may have been better at the beginning of the year than suggested by official statistical data (<http://blog.bea.gov/2015/05/20/accounting-for-seasonality-in-gdp/>).

economy grew by 0.6 percent compared with the previous quarter, in Italy by 0.3 percent. Spain saw growth accelerating to 0.9 percent. By contrast, the expansion weakened in Germany, the Netherlands and the UK. The sharp fall in crude oil prices noticeable also in euro terms in the second half of 2014 contributed to spurring an economic recovery in several countries at the beginning of 2015, as is apparent in the partly vigorous increase in imports owing to lower prices of primary products (France and the UK +2.3 percent, compared with the previous quarter, Germany +1.5 percent, Italy +1.4 percent). Except in France, the additional imports were intended for investments: in Germany, gross fixed capital formation growth accelerated from 0.8 percent in the fourth quarter of 2014 to 1.5 percent in the first quarter of 2015, in the UK from -0.6 percent to 1.5 percent, in Italy from 0.2 percent to 1.5 percent. France, on the other hand, experienced a sharp increase in households' energy consumption and car purchases. In Spain, the pick-up in the growth momentum in the first quarter was driven by government consumption, which expanded briskly for the first time following the decline since mid-2014.

In Germany, both private and government consumption kept expanding vigorously in the first quarter of 2015, and the momentum of equipment and construction investment strengthened somewhat. Nevertheless, the quarterly rate of growth of real GDP declined from 0.7 percent in the fourth quarter of 2014 to 0.3 percent. However, in the fourth quarter of 2014 more goods had been produced than had been consumed, and the acceleration in demand observed in the first quarter of 2015 largely fed on this previous expansion of stocks. Production and hence GDP therefore expanded less briskly than demand, and industrial production remained weak. Exports lost some momentum owing to the subdued world trade growth, resulting in a negative contribution from net exports. In the goods trade, Germany's structural import weakness deepened, however: the upward trend of the foreign trade balance continued in the first three months of 2015.

3.1 Surge in long-term interest rates in euro area

In anticipation of expansionary monetary policy measures, the yields on long-term government bonds of all euro countries began to decline at the beginning of 2014. Monetary policy was then eased considerably with key interest rate cuts in June and September 2014, the decision in July 2014 to purchase covered bonds, and in January 2015 to purchase government bonds. The yield on 10-year German federal bonds fell from 1.9 percent at the beginning of January 2014 to 0.04 percent in April 2015. This trend, which extended across countries, was interrupted at the end of April 2015 when the yields on bonds of the euro countries rose by approximately 0.5 percentage point; those on German bonds rose to more than 0.5 percent. Occasionally doubts were raised whether or not the ECB will fully carry out its government bond purchases as announced. But unlike the USA, where the yield on long-term government bonds had risen by 1 percentage point from May to September 2013 after hints by the then chairman of the Federal Reserve Ben Bernanke of a possible tightening of monetary policy, the ECB is sticking to its purchase programme.

Therefore it is unlikely that the interest rate increase observed across countries since the end of April 2015 is a risk mark-up on account of negative expectations by financial market participants, but rather a correction of the previous excessive downward trend. Expectations of a pick-up in economic activity on the back of a strengthening of domestic demand in many euro countries in the first quarter in tandem with higher inflation expectations may also have contributed to the upward correction.

The sharp fall in crude oil prices resulted in lower prices for many primary products. This caused an increase in investment demand in some countries and supported private consumption in France.

In Germany, consumption remains the main driver of the expansion. The structural deficit in the merchandise import sector deepened.

The rise in government bond yields partly corrects the downward trend observed since the beginning of 2014.

4. Austria: investment decline moderating

The results of the quarterly account largely confirm the flash estimate published at the end of April 2015: real GDP grew at a quarterly rate of 0.1 percent in the first quarter of 2015. Private consumption growth was similarly subdued. The decline in gross fixed capital formation moderated somewhat in the first quarter of 2015. Export growth barely accelerated owing to the slackness in external demand.

Results of WIFO's Business Cycle Survey of May continue to show below-average assessments of economic conditions by Austrian businesses. Assessments of the current situation were slightly more pessimistic than in April, while expectations for the coming months improved somewhat. But overall, the majority of companies remain sceptical about the current and expected economic situation. The (seasonally adjusted) current situation index for the economy as a whole was -1.5 points in May, 1.1 points below its level a month earlier. This deterioration mainly reflected developments in the service industries, where the index fell by 2.5 points and at 0.5 point barely remained in positive territory. Firms in the construction industry continued to give a very pessimistic assessment of economic conditions; following a decline by 1.2 points, the index came in at -4.9 points. After the negative trend observed in recent months, the index for the manufacturing sector did rise by 1.0 point, but nevertheless remained clearly negative at -4.0 points.

The assessments of economic conditions by Austrian companies in the WIFO Business Cycle Survey have not improved yet.

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.

The WIFO Leading Indicator remained unchanged from the previous month in May and did not continue the upward movement observed in the preceding months. Overall, developments of the components of the indicator have been highly heterogeneous, with both domestic and foreign components contributing to a stagnation of the overall index.

4.1 Expectations of export orders deteriorating despite euro depreciation

In April, the quarterly survey conducted within the framework of the WIFO Business Cycle Survey showed that the competitiveness position of the companies surveyed had improved outside the EU as a result of the depreciation of the euro. By contrast, firms' expectations of export orders for the coming three months deteriorated. Firms are possibly not yet adjusting their prices on foreign markets to the changed exchange rate, but use the depreciation to strengthen their equity position. Reasons for the pricing-to-market behaviour could be the relatively sharp exchange rate fluctuations owing to strong monetary policy stimulus and the fact that the euro depreciation is not believed to be long-lasting. The euro-dollar exchange rate, for instance, recently rose again from slightly above \$ 1.05 per € in mid-April to just under \$ 1.15 per € in mid-May. Given the slackening external demand, firms' decision not to adjust prices may also have the objective not to exacerbate the dampening effect of the decline in exports on sales through price reductions. Either firms consider the euro weakness a temporary phenomenon, or doubts about a lasting economic recovery in the euro area predominate over the positive effects to be expected from the euro depreciation.

Firms are hesitant to adjust their export prices, given the uncertain exchange rate situation.

4.2 City tourism on the rise in 2014-15 winter season

Compared with the winter of 2013-14, the number of nights spent in the 2014-15 winter season (November 2014 to April 2015) rose by 2.1 percent to 65.8 million. Price-adjusted sales fell slightly, however (-0.5 percent); real expenditure per night spent, a quality indicator, declined by 2.5 percent. The demand from international guests, which constituted more than three quarters of the total demand, grew considerably more briskly (+2.5 percent) than that from domestic travellers (+0.6 percent). A vigorous increase in the number of nights spent was registered in February 2015, the main month of the winter season (+10.7 percent), while the gains were more modest in the less important months of December 2014 (+1.5 percent) and April 2015 (+1.9 percent), and a marked decline in the number of nights spent was recorded in March 2015 (-5.2 percent). City tourism provided an above-average impetus to growth during the winter season (nights spent in Vienna +5.8 percent). The tourism-intensive and winter sports-oriented federal provinces of Tyrol and Salzburg, which together accounted for 61 percent of the total number of nights spent in Austria, recorded a year-on-year increase of 2.1 percent and 1.8 percent, respectively, in the number of nights spent.

4.3 High rent increases continue in April

Inflation as measured by the Consumer Price Index was 1.0 percent in April 2015. Inflation as measured by the Harmonised Index of Consumer Prices (HICP), which allows a comparison with other countries, was 0.9 percent, the second-highest rate recorded in the EU (EU average 0.0 percent, Germany +0.3 percent). A large upward contribution to inflation came from the "Housing, Water and Energy" component (+0.22 percentage point). Especially rents rose again briskly (contributing +0.21 percentage point). Rent increases have constantly been higher than on EU average or in Germany already since the end of 2008. Since the end of 2013 they have been accelerating yet again, reaching 4.9 percent in April 2015 (EU +1.5 percent, Germany +1.3 percent). Other drivers of inflation, such as restaurant and hotel services (+2.9 percent), and, to a lesser degree, administered prices (+2.1 percent) in April grew at rates similar to those recorded in Germany (+2.9 percent and +1.6 percent, respectively). Although the prices of mineral oil products fell less briskly on a year-on-year basis in April than in the first quarter of 2015, the "transport" component, with its contribution of -0.43 percentage point to inflation, continued to dampen inflation considerably.

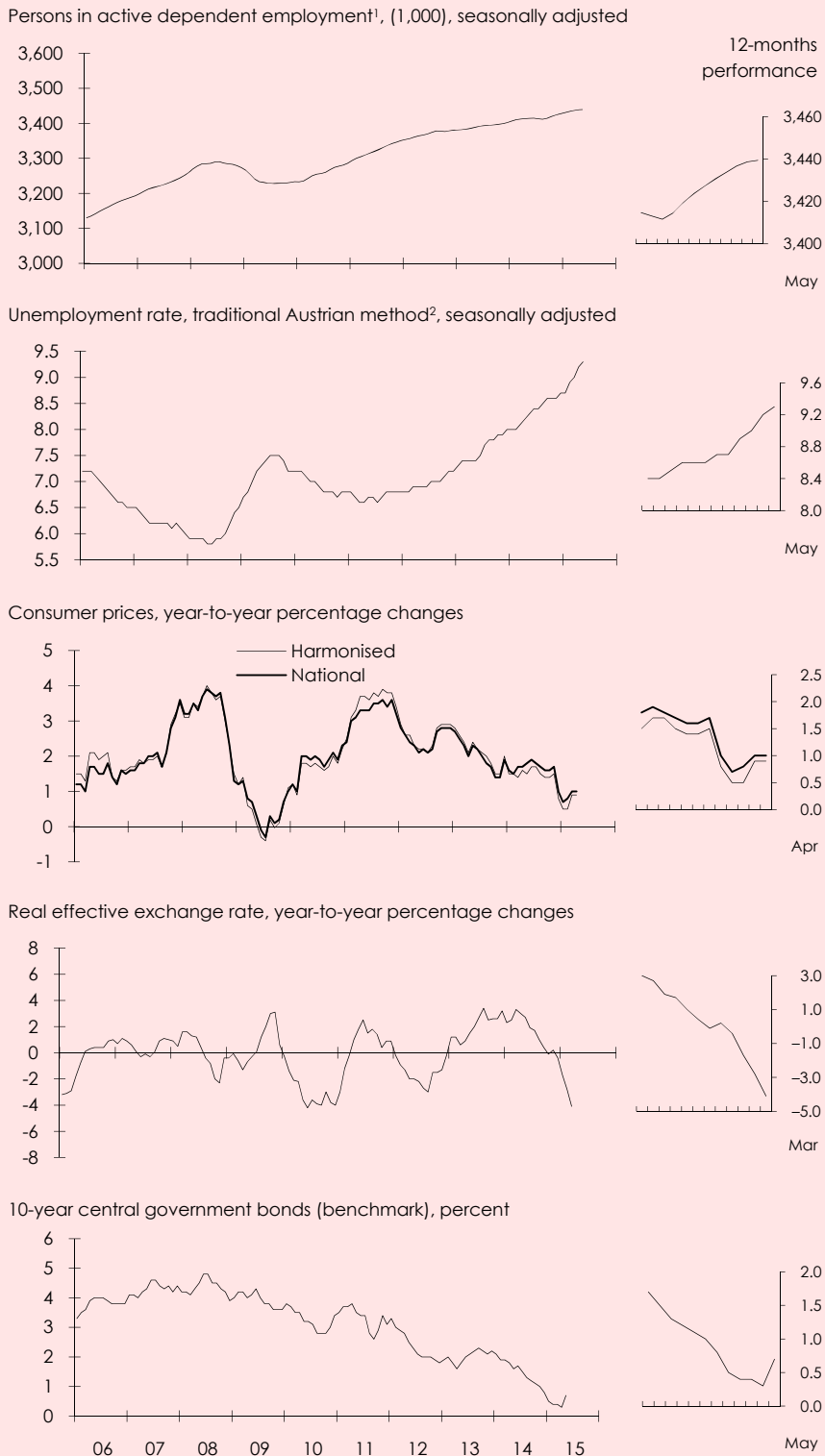
Rents rose by 4.9 percent year-on-year in April 2015, according to the HICP, administered prices by 2.1 percent.

4.4 Unemployment rate keeps rising

The seasonally adjusted unemployment rate rose from 9.2 percent in April 2015 to 9.3 percent in May, according to provisional estimates. The corresponding rate according to Eurostat rose to 5.7 percent in April (+0.1 percentage point compared with the previous month). Around 330,300 people were registered as unemployed in

May, an increase by around 39,400 compared with a year before (+13.6 percent), while the number of persons enrolled in vocational training courses fell by around 14,100 to 65,200 (-17.7 percent). The seasonally adjusted number of persons in dependent active employment increased slightly, the number of job vacancies declined once again in May compared with the previous month.

Figure 3: Key economic indicators



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.