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Stefan Schiman

World Trade Weak Again at Start of 2015

Business Cycle Report of May 2015

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The weakness of the Chinese economy, the marked appreciation of the dollar and the sharp fall in activity in Russia dampened world trade growth at the beginning of the year. The EU economy is currently benefiting from the recovery in some euro area periphery countries, the expansion of domestic demand in Germany, and the pick-up in industrial production in Eastern Europe. The improvement in the terms-of-trade on account of the fall in crude oil prices stimulated Austrian imports. While this depressed net exports, domestic demand increased to the same extent. The decline in investment eased somewhat. Real GDP barely expanded, and the unemployment rate increased further.

Contact:

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

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Data processing: Christine Kaufmann (Christine.Kaufmann@wifo.ac.at), Martha Steiner (Martha.Steiner@wifo.ac.at)

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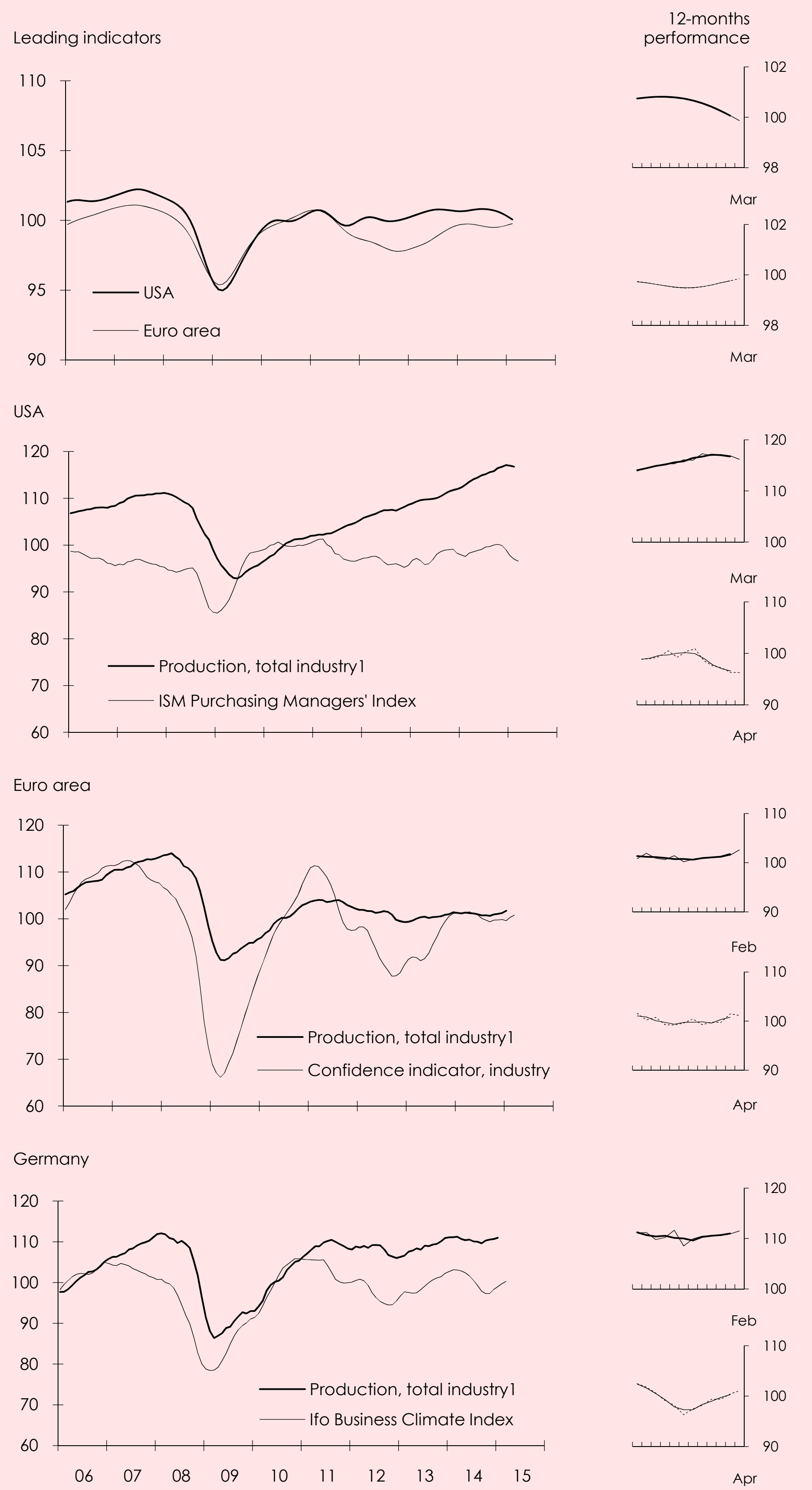
Several factors were decisive for the renewed softening of world trade at the beginning of 2015: Chinese economic growth in the first quarter of 2015 was as slow as last recorded during the economic crisis, the marked appreciation of the dollar hampered US exports, and economic conditions in Russia and Brazil deteriorated further. Only Eastern Europe has experienced a broad recovery in industrial production in recent months; this rules out the Russia-Ukraine crisis as the cause of the investment slump in the rest of Europe. Rather, the sluggishness of activity in the euro area is a result of insufficient domestic demand. This is apparent, inter alia, in the downward trend of the core inflation rate (March 2015: 0.6 percent), and is related to the restrictive fiscal policy. All in all, the sentiment indicators for the EU and the euro area suggest that the expansion will remain modest.

The negative impact of the softening of world trade on Austrian exports in the first quarter of 2015 was partly offset by the depreciation of the euro, and so exports maintained the modest momentum observed at the end of 2014. Meanwhile, the improvement in the terms of trade owing to the decline in crude oil prices in 2014 was followed by the lagged stimulation of imports at the beginning of 2015. Unlike in the previous quarter, overall net exports therefore did not contribute significantly to growth. But since investments no longer shrank as briskly as previously, real GDP merely stagnated in the first quarter (+0.1 percent compared with the previous quarter). Accelerated rent increases and the more than proportional rise in the tax burden in 2014 as a result of what is called "cold progression" kept private consumption growth flat. Services, however, remained a mainstay of economic activity; sales picked up particularly in the mobile phone sector. Given the persistent slack in the economy, the seasonally adjusted unemployment rate rose to 9.2 percent in April 2015.

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.

1. World trade growth moderating

World trade lost momentum at the beginning of 2015 as the import demand of emerging market economies – particularly in Asia – continued to decline. In the first quarter of 2015, China's real GDP expanded by a mere 1.3 percent quarter on quarter and by 7.0 percent year on year, as slowly as last recorded during the economic crisis in 2009. Russia and Brazil saw economic conditions deteriorate further. Export growth in advanced economies decelerated in line with the slackening of demand from emerging markets. In addition, US exports are suffering from the impact of the marked appreciation of the dollar. Imports may possibly show a lagged response.

The slowdown in China, the economic slump in Russia and Brazil, and the appreciation of the dollar act as a drag on the expansion of world trade.

2. Dollar appreciation dampens expansion in USA

At the beginning of 2015, the upswing in the USA was dampened by the marked appreciation of the dollar. With exports declining, economic output stagnated in the first quarter of 2015 compared with the previous quarter, following growth by 0.5 percent in the fourth quarter of 2014. In addition, the expansion of private consumption and investment weakened. Production nevertheless exceeded the year-earlier level by 3 percent, owing to extremely weak growth in the first quarter of 2014 (harsh winter). For the year 2014 as a whole, real GDP growth was 2.4 percent. The Conference Board Consumer Confidence Index fell in April, following a significant increase in January; the underlying upward trend was maintained, however. The University of Michigan Consumer Sentiment Index rose in April.

3. EU: sentiment indicators modestly confident

Registering at 103.7 points for the euro area, and 106.4 points for the EU as a whole in April, the Economic Sentiment Indicator published by the European Commission indicated a continuation of the modest expansion (average 1990-2014: 100 points). This is consistent with the results for April of the Markit Purchasing Managers' Index for the euro area (53.9 points; a mark of 50 points meaning stagnation). At a country level, notably France and Germany registered below-average readings; by contrast, the Ifo Business Climate Index for Germany rose again significantly in April.

Confidence Indicators for Germany are contradictory.

3.1 Industrial production recovers only in Eastern Europe

Goods production is lacking major impetus especially in the large EU countries: in February 2015, it exceeded year-earlier levels by a mere 0.5 percent in Germany, 1.2 percent in France, 0.3 percent in the UK, and 1.0 percent in Spain. In Italy it declined by 0.2 percent. Ireland, by contrast, registered a vigorous expansion (+30.3 percent). Industrial production has recovered in many eastern European countries in recent months (between +4.6 percent and +5.9 percent in the Czech Republic, Estonia, Poland, Lithuania, Slovenia and Hungary). Hence the Russia-Ukraine crisis apparently has not had any major dampening effects on goods production in the EU. Rather, the weakness of production in Western Europe is the result of businesses' low sales expectations owing to weak domestic demand.

The Russia-Ukraine crisis does not hamper goods production in the EU. Ireland's industry is booming.

They may improve though, given the positive sales developments in recent months. In February, real retail sales rose by 3.4 percent compared with a year before in the EU, and by 2.8 percent in the euro area. However, the momentum weakened in March (EU +2.5 percent, euro area +1.6 percent). The upward trend is apparent not only in eastern European countries, although it is strongest there, but also in Germany, Europe's largest economy. Private consumption picked up in Germany already in the fourth quarter of 2014; the robust growth of retail sales in January and February suggests that it remained strong also in the first quarter of 2015. Purchasing power increased in Germany as a result of the expansion of various pension benefits (pensions for mothers, retirement for some at age 63), the entry into force of new minimum wage legislation, and rising real wages. Retail sales growth in France also accelerated in February, and slowed only slightly in March. In Spain, the consumption-driven upswing strengthened, with real GDP posting quarter-on-quarter growth

In Spain, the upswing accelerated in the first quarter of 2015. Private consumption is driving activity also in Germany.

of 0.9 percent in the first quarter of 2015, exceeding the year-earlier level by 2.6 percent. In the UK, overall economic growth slowed to +0.3 percent in the first quarter compared with the previous quarter (+2.4 percent compared with a year before).

3.2 Restrictive fiscal policy dampens economic activity

Government deficits shrank further in the EU in 2014 (2013 EU average –3.2 percent of GDP, euro area –2.9 percent, 2014 –2.9 percent and –2.4 percent, respectively). Thus fiscal policy maintains a persistently restrictive stance, especially since public revenue remained high in 2014 (EU 45.2 percent of GDP, euro area 46.6 percent), with the result that it is made more difficult for private households to reduce their – owing to the financial and euro crisis – elevated debt levels while at the same time increasing consumption. As this drags down economic growth (2014 EU +1.4 percent, euro area +0.9 percent), the government debt ratio rose further despite the deficit reduction, by 1.3 percentage points on EU average (to 86.8 percent of GDP) and by 1 percentage point in the euro area (to 91.9 percent of GDP). Denmark, Germany, Estonia and Luxembourg registered a government surplus in 2014. The highest deficit was recorded by Cyprus (–8.8 percent of GDP), followed by Spain (–5.8 percent), Croatia and the UK (–5.7 percent each). The lowest government debt ratio in 2014 was registered by Estonia (10.6 percent of GDP), the highest by Greece (177.1 percent), Italy (132.1 percent) and Portugal (130.2 percent).

3.3 Core inflation rate hitting record low

Headline inflation is driven by crude oil price developments.

The sharp fall in prices eased somewhat in the EU as a whole and the euro area in March, with both areas registering an inflation rate of –0.1 percent (February –0.3 percent in both areas). Like the acceleration of the price decline in December 2014 and January 2015, its deceleration reflects energy price developments: after the crude oil price had fallen from around € 70 at the beginning of November 2014 to € 40 in mid-January 2015, it climbed to € 55 by mid-April. The increase since January 2015 accelerated as a result of the euro's depreciation against the dollar: the exchange rate, which stood at $ 1.25 per € in mid-December 2014, has dropped to as low as $ 1.06 since then.

Aside from these fluctuations in headline inflation, the core inflation rate continues along its downward trajectory. At 0.6 percent in March 2015, it reached a record low in the euro area already for the second time this year. Even the lowest inflation rate recorded in the wake of the economic crisis had been somewhat higher (February 2010 +0.7 percent) and quickly overcome. Hence the easing of deflation on the back of energy price developments since February 2015 cannot obscure the fact that domestic price pressures are extremely weak owing to persistently low demand.

4. Austria: weakness in global trade weighs on exports, imports boosted by falling crude oil prices

Services underpin economic activity, manufacturing and construction production are shrinking.

The pace of growth of Austrian exports did not accelerate in the first quarter of 2015 (+0.7 percent compared with the previous quarter). The weakening of global trade, notably of the demand from Asia, might even have caused a slowdown in export momentum; this was forestalled by the marked depreciation of the euro, however. Provided that world trade does not soften any further, the full quantity effect of the exchange rate change will come to bear not before the latter half of the year. However, a lagged quantity effect impacted import developments in the first quarter of 2015: the sharp decline in crude oil prices since mid-2014 improved Austria's terms of trade, i.e., made imports cheaper. After having stagnated in the second half of 2014, imports picked up by 0.8 percent quarter on quarter in the first quarter of 2015. These overlapping effects in foreign trade will reverse in favour of net exports in the latter half of the year when the quantity effect of the depreciation will come to bear while that of the decline in crude oil prices will wane. In line with the meagre foreign trade growth, investment contracted further in the first quarter of 2015 (gross fixed capital formation –0.6 percent, compared with the previous quarter), and private consumption remained lacklustre (+0.1 percent). Both manufacturing and construction companies cut back on investment. Services once more proved a mainstay of economic activity in the first quarter of 2015. However, only the information and communication sector recorded a noticeable acceleration in value added growth (+0.9 percent): sales picked up as competition intensified again with the arrival of a new mobile phone provider on the market – in 2013 it had declined as a result of mergers of providers, which had led to substantial price increases. Overall, real GDP expanded by 0.1 percent in the first quarter of 2015, compared with the previous quarter.

WIFO's Leading Indicator has recently stabilised. In April, a positive effect came from the pick-up in Austrian manufacturers' production expectations, the Ifo Business Climate Index, and the ATX and Euro Stoxx 50-stock indices. By contrast, the Austrian business climate index, consumer confidence and production expectations in the euro area and Germany performed poorly.

4.1 Investment decline increasingly erodes capital stock

The outlook for the coming months stabilised somewhat in April, according to WIFO's Business Cycle Survey.

The slight recovery of industrial production observed since December 2014 continued in February 2015, but did not accelerate. WIFO's Business Cycle Survey in April showed a slight improvement in Austrian companies' appraisals of the economy: the assessments of the current situation and the outlook for the coming months improved compared with the previous two months, but the majority of companies remain sceptical about the current and expected economic activity. There are some tentative signs that the production of capital goods may be stabilising, following a marked deterioration in the outlook in the winter months owing to the softening of world trade. The upward revision of investment expectations is presumably a result of the stabilisation of crude oil prices and the euro exchange rate at relatively low levels. Nevertheless, the majority of assessments remained negative in April, reflecting businesses' still pessimistic sales expectations owing to the shortfall of effective demand in the euro area. The capacity utilisation rate in manufacturing is 82 percent and therefore in line with the long-run average, however. Hence the weakness of investment that has persisted for years is increasingly eroding the capital stock and depressing the demand for replacement investment.

4.2 Tourism demand from Italy rising again

One month before the end of the 2014-15 winter season, the number of overnight stays, at 58.8 million exceeded the year-earlier level by 2.2 percent. Nights spent by international guests, who account for more than three quarters of the entire tourism demand, rose more briskly (+2.4 percent) than domestic demand (+1.3 percent). In particular developments in February, the main month of the season, contributed to the positive result. But the strongest growth was posted by city tourism (Vienna +6.8 percent).

The vigorous rise in the number of nights spent by Italian guests (+10.0 percent) points to increasing stabilisation in the Italian economy. In line with the favourable economic situation in the USA, Poland and the UK, the demand for overnight stays of guests from these countries also grew (+8.9 percent, +8.4 percent and +6.7 percent, respectively). These four source countries accounted for 9.5 percent of nights spent by foreigners during the winter season. The demand of German guests, who book approximately half of all overnight stays of international guests, rose by 3 percent. The demand of Russian guests collapsed (–31.7 percent) on account of the Russia-Ukraine crisis, the sharp fall in economic activity in Russia and the substantial depreciation of the rouble.

4.3 Accelerated rent rises and increased tax burden dampen private consumption

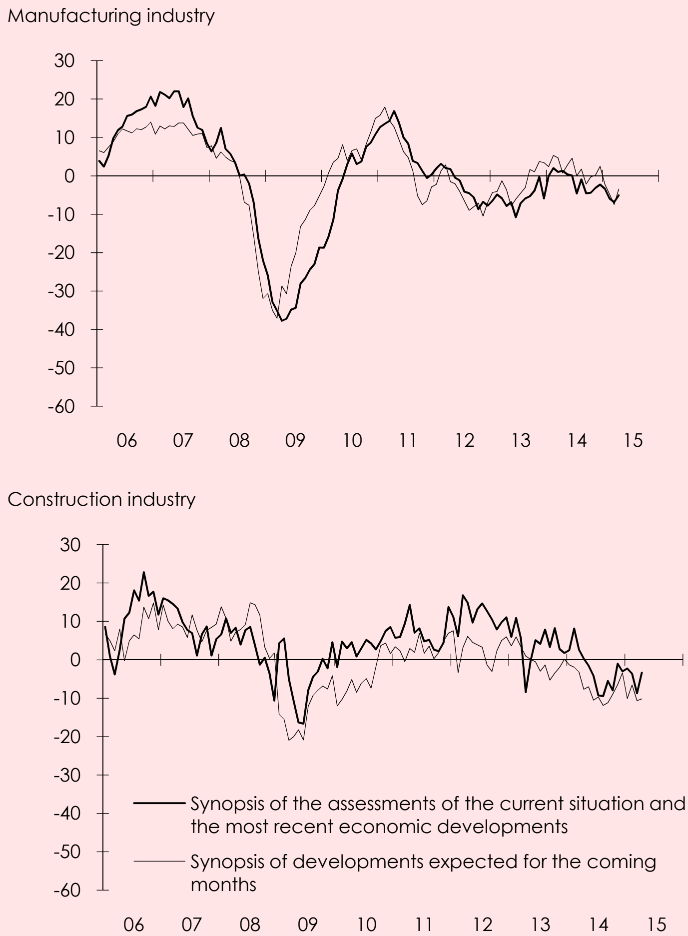
Rents were 5 percent above year-earlier levels in March 2015; fuel prices were down by 11 percent.

In March 2015, inflation as measured by the Consumer Price Index was 1.0 percent. Inflation as measured by the Harmonised Index of Consumer Prices (HICP), which allows a comparison with other countries, was +0.9 percent, the highest rate in the EU (EU average –0.1 percent, Germany +0.1 percent). The largest upward contribution to CPI inflation came from the "Housing, Water and Energy" component (+0.3 percentage point). Especially rents posted yet another vigorous increase (contributing

+0.2 percentage point). Rent increases have constantly been higher than on EU average or in Germany already since 2008. Since the end of 2013 the increase has accelerated once more, reaching +5.0 percent in March 2015 (EU +1.5 percent, Germany +1.3 percent). Other drivers of inflation were administered prices, recreation and cultural services as well as restaurants and hotels; the price increase in the latter group, however, was in line with that in Germany (+2.6 percent, Austria +2.7 percent, EU +1.5 percent). Although in March the decline in fuel prices compared with a year before was smaller than that in January and February 2015, the "transport" component, with its contribution of –0.4 percentage point to inflation, considerably dampened CPI inflation.

Figure 2: Results from the WIFO Business Cycle Survey

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

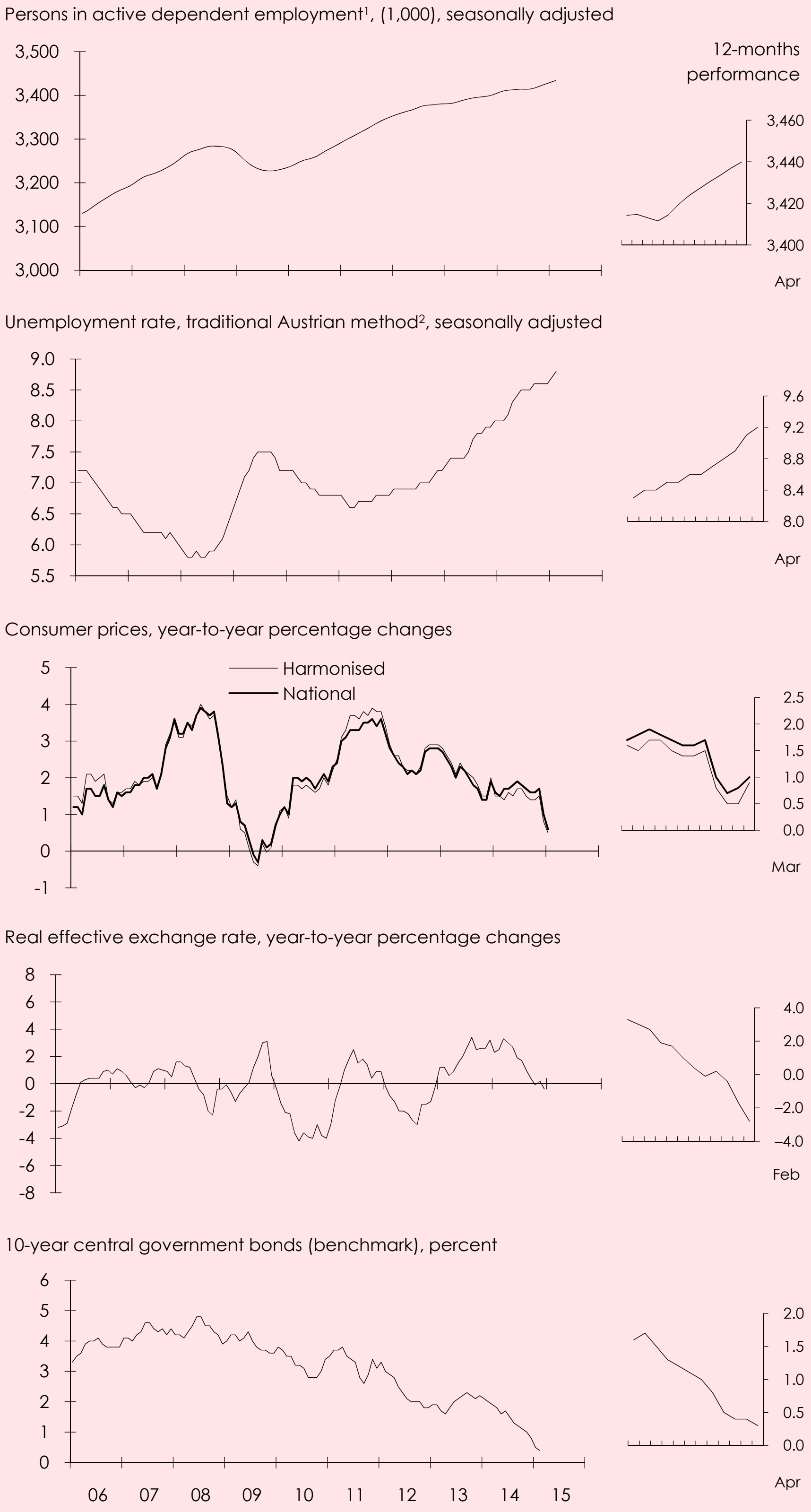


Source: WIFO Business Cycle Survey. Data refer to index points (percentage points) between +100 and –100. Values above 0 imply positive expectations, values below 0 indicate negative expectations.

Public revenue rose briskly in 2014; expenditure evolved in accordance with the economic situation.

The government deficit rose from –1.3 percent of GDP in 2013 to –2.4 percent in 2014. Excluding the capital transfer to HETA, the asset resolution company of Hypo Group Alpe Adria AG, it would have fallen to –1 percent of GDP. Consistent with developments in the rest of the euro area, the fiscal policy stance in Austria thus remains restrictive. Notably the sharp increase in revenue from taxes and social contributions (+3.1 percent), which made up 88 percent of total government revenue, restricts private households' leeway for consumption amid simultaneous deleveraging efforts, and therefore acts as a drag on economic activity. Government expenditure evolved in accordance with this unfavourable economic situation: while personnel expenses and material expenses grew less briskly (+1.6 percent each) than nominal GDP (+2.0 percent), social expenditure rose more sharply, owing to its role as an automatic stabiliser (+3.5 percent). The government debt ratio was 84.5 percent of GDP in 2014.

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.

4.4 Unemployment growing unabatedly

The seasonally adjusted unemployment rate rose from 9.0 percent in March 2015 to 9.2 percent in April, according to provisional estimates. The corresponding rate according to Eurostat rose to 5.6 percent[1] in March (+0.2 percentage point compared with the previous month). Around 352,000 people were registered as unemployed in April, an increase by around 44,500 from a year before (+14.5 percent). By contrast, the number of persons enrolled in vocational training courses fell by around 14,900 to 67,900 (–18 percent). The seasonally adjusted number of job vacancies fell further on a month-on-month basis in April, while that of persons in dependent active employment barely increased.

[1] Owing to the use of a new weighting procedure, the unemployment rate for 2014 according to Eurostat comes in 0.6 percentage point higher than until now.