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Abrupt Interruption of Economic Recovery in First Half of 2014

Business Cycle Report of September 2014

Abrupt Interruption of Economic Recovery in First Half of 2014. Business Cycle Report of September 2014

World trade growth did not accelerate further as expected in the first half of 2014, but slackened again. The reason for this development lies in the weak import demand of many emerging market economies, a consequence of the capital flight following the announced trend reversal of US monetary policy. Export-oriented economies in Europe such as Austria were more strongly affected than the USA, where the upswing continued thanks to robust domestic demand. Moreover, Austrian firms have again curtailed their gross investment this year. The seasonally adjusted unemployment rate stagnated once again at 8.5 percent in August.

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For definitions used see "methodological references and glossary of terms", http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf • All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 8 September 2014.

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Following vigorous GDP growth in the second quarter, the US economy is likely to continue its recovery from the slowdown experienced early in the year. In Japan, by contrast, demand dropped sharply following the increase in VAT implemented on 1 April 2014. As this development was, however, preceded by considerable effects from frontloaded consumption, GDP barely increased in the first half of 2014.

So far, the expected export-driven recovery has failed to materialise in the euro area, a consequence of slackening demand notably from emerging market economies. It was striking how simultaneously the weakness in imports set in both in South America, Southeast Asia and Eastern Europe; it no doubt stems from the extensive capital outflows triggered by the announcement of plans to wind down the loose monetary policy in the USA, which resulted in an increase in interest and inflation rates as well as in new capital flow management measures. In Russia, the slowdown was furthermore exacerbated by the economic sanctions. In Germany, economic activity in the second quarter of 2014 was not as weak as suggested by the GDP contraction. The latter was merely a consequence of a lack of construction investment that had been planned for early summer but had been brought forward owing to the mild winter. Economic output stagnated in France, however, and contracted again in Italy.

The Austrian economy was also not able to elude the weakening of global export demand. In addition, the curtailment of gross investment depressed economic activity in the first half of the year. The economic slack is likely to persist in the third quarter of 2014: WIFO's Leading Indicator fell further in August, the results of WIFO's Business Cycle Survey remained weak. Moreover, private consumption, apart from exports the major contributor to GDP growth, is not providing any considerable positive stimulus. Inflation eased somewhat in July (1.8 percent); the seasonally adjusted unemployment rate once again did not rise in August (8.5 percent).

1. USA: economy gains further strength

The US economy in mid-2014 continued its recovery from the downturn experienced in the first quarter of 2014. In August, the Markit Purchasing Managers' Index reached its highest level since April 2010, and the PMI published by the Institute for Supply Management (ISM) rose again markedly. Both the Conference Board Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index improved sharply in August. Real GDP grew at a quarterly rate of 1.0 percent in the second quarter, following a contraction of 0.5 percent in the first quarter.

2. Japan: demand shortfall following strong effects from frontloaded consumption prior to VAT hike

The effects from frontloaded consumption prior to the increase in VAT implemented on 1 April 2014 and a subsequent collapse of demand dominate the course of economic activity in Japan.

The increase in the value added tax rate from 5 percent to 8 percent on 1 April 2014 dominated the course of economic activity in Japan throughout the first half of the year. Extensive purchases and investments were frontloaded in the first quarter of 2014, and exports also rose sharply. The upsurge in demand resulted in a quarterly increase in real GDP of 1.5 percent. With the entry into force of the tax increase, notably private consumption collapsed. The pattern of a marked rise and decline was broad-based across all demand components with the exception of public demand, which followed a slightly anti-cyclical path. The decline in private consumption and construction investment in the second quarter was greater than their growth in the first quarter, while that in fixed investment, exports and imports was smaller. Overall, GDP fell by 1.7 percent in the second quarter compared with the previous quarter, following an increase of 1.5 percent in the first quarter.

3. Capital outflow triggers substantial decline in emerging market economies' import demand

The decline in emerging market economies' import demand triggered by capital outflows is likely to affect the export-oriented EU countries more severely than the USA.

Imports of emerging market economies have slackened considerably throughout the year so far. The decline is broad-based across Southeast Asia as well as South America and Eastern Europe. The announcement that the US Central Bank plans to wind down its loose monetary policy triggered extensive capital outflows from emerging market economies, including large economies such as India, Brazil and Russia. Several countries experienced a pick-up in inflation and interest rates, and some countries introduced new capital flow management measures. In Russia, this negative stimulus was amplified by the escalation of the conflict with Ukraine and the economic sanctions imposed by the USA and the EU. Export-oriented EU countries are likely to be affected more severely by the weak import demand of emerging market economies than the USA, where the upswing is based on robust domestic activity.

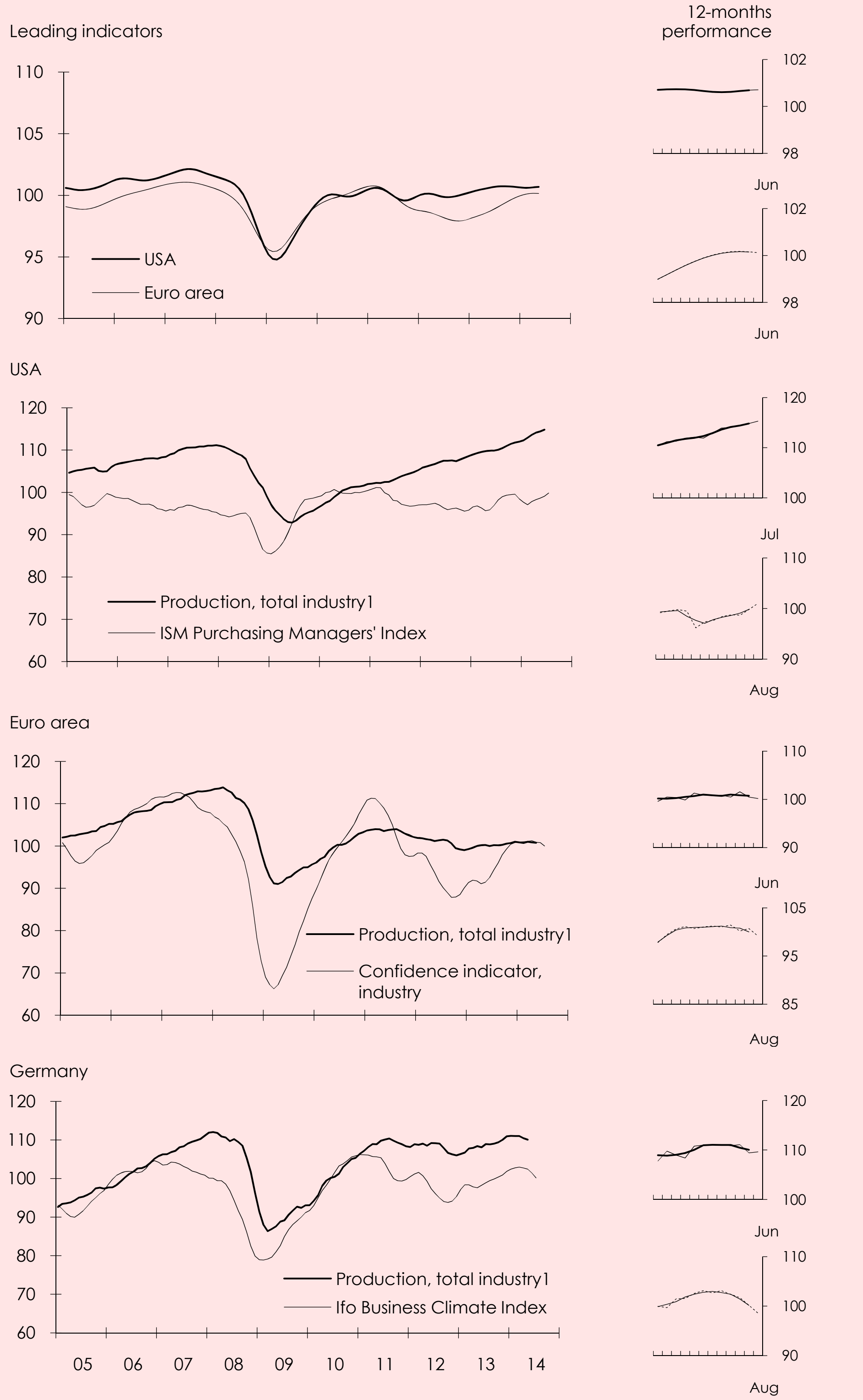
A special effect arose in Brazil: the introduction of additional holidays in the host cities of the soccer world cup resulted in production losses and a larger contraction in GDP in the second quarter (–0.6 percent compared with the previous quarter, first quarter –0.2 percent).

4. Economy sluggish in most euro countries

After slipping out of recession a year ago, the euro area economy failed to gain traction also in the second quarter of 2014; real GDP stagnated compared with the previous quarter (first quarter +0.2 percent). However, this situation is dominated by the special effects of construction in Germany. Slack demand is weighing not only on economic growth, but also on price developments. August saw a further fall in inflation (0.3 percent, according to provisional estimates). On 4 September, the ECB once again cut the benchmark interest rate, by 0.1 percentage point to 0.05 percent. At the same time it announced an extensive program for the purchase of asset-backed securities.

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 strong GDP growth registered in Germany in the first quarter of 2014 (+0.7 percent, compared with the previous quarter) was a temporary effect due mainly to – for the time of the year – relatively buoyant construction activity (+4.1 percent): owing to the mild winter, part of the construction investment planned for early summer was brought forward. This did not provide any additional stimulus, though; on the contrary, there was a lack of construction activity in the second quarter of 2014 (–4.2 percent), causing GDP to contract by 0.2 percent compared with the previous quarter. Not counting this effect, real GDP would have increased by around 0.3 percent in the first quarter, and by 0.4 percent in the second. Thus the modest economic momentum observed in the previous year continued, and the Ukraine crisis did not yet have any substantial impact on economic developments. The Ifo Business Climate Index shows, however, that economic activity also has not improved since the second quarter: consistent with the economic performance, the indicator for the assessment of the current business situation has been declining markedly since May 2014; expectations concerning the business outlook deteriorated already at the beginning of the year.

Economic developments in Germany were dominated by front-loaded construction investment, not by the Ukraine crisis.

In France, real GDP stagnated for the second time running in the second quarter, compared with the previous quarter. Private consumption was weak in the first half of the year, and the downward momentum of gross investment strengthened. Only the positive stimulus from government demand supported economic activity and prevented a recession in the first half of the year. In Italy, the recession continued, however (second quarter –0.2 percent, first quarter –0.1 percent); in the second-largest target market of Austrian exports, real GDP has been shrinking since the second half of 2011, with a short interruption in the fourth quarter of 2013. In Spain, by contrast, the upswing appears to have picked up speed: real GDP expanded at a quarterly rate of 0.6 percent in the second quarter of 2014. Since the first small increase in the third quarter of 2013 (+0.1 percent), growth rates have thus been rising continuously (fourth quarter of 2013 +0.2 percent, first quarter of 2014 +0.4 percent).

In France, the expansion of government consumption prevented a recession in the first half of 2014.

Economic activity weakened in Austria's three most important eastern European trading partners in the second quarter of 2014. In the Czech Republic, real GDP stagnated compared with the previous quarter, after having risen vigorously during the winter half-year. The robust quarterly growth rates recorded in Hungary and Poland declined slightly from 1.1 percent in both cases at the beginning of the year to 0.8 percent and 0.6 percent, respectively.

Economic activity weakened in key target markets in Eastern Europe in the second quarter of 2014.

5. Austria: economic activity fails to gain momentum

Economic activity in Austria, having slightly accelerated in the second half of 2013 owing to increased export demand, flattened again in the first half of 2014. GDP grew at a seasonally and working day adjusted quarterly rate of 0.2 percent in the second quarter. Both external and domestic factors were decisive for the abrupt moderation in activity: Austrian exports to Russia have been falling markedly (from January to June 2014 –12.0 percent, year-on-year), but this only partly explains the weakness of external trade. A decisive factor for the development of Austrian exports has been the slowdown in global trade described above owing to the decline in emerging market economies' import demand. Not only because of Austria's direct trade relations with these countries, rather because of the effects on third countries has the Austrian economy not been able to elude this influence. Exports to Germany, Austria's most important market, have also not picked up noticeably so far. Hence foreign trade has not grown as expected this year, but has weakened again.

Decline in export dynamism weighed on economic activity in Austria.

The downward trend of equipment investment flattened in the second quarter of 2014 (–0.2 percent compared with the previous quarter, after –1.0 percent and –0.6 percent in the third and in the fourth quarter of 2013). The increase of 1.3 percent in the first quarter of 2014 must be considered an outlier: it was due to the strong expansion of vehicle investment owing to purchases being brought forward prior to the increase of NoVa (duty on new car purchases) on 1 March 2014.

Amid stagnating domestic demand, stocks are being reduced again.

Private consumption stagnated also in the first half of 2014 (+0.1 percent in both the first and the second quarter, compared with the previous quarter) and therefore considerably dampened economic activity. Firms do not expect sales to increase in the short run, and are gradually reducing their stocks. The stock reduction got under way already in mid-2011, was interrupted in the second half of 2013, and continued in 2014.

Economic activity is likely to remain subdued or even weaken further in the third quarter of 2014.

Along with the stock reduction, the results of the WIFO Business Cycle Survey and the WIFO Leading Indicator of August also suggest that economic activity will remain subdued or even weaken further in the third quarter. Companies' assessments of the current situation and their expectations concerning the future general economic situation had deteriorated noticeably especially in manufacturing in July, and barely changed overall in August, thus remaining markedly below their long-run averages. While sentiment did improve in manufacturing in August, it deteriorated in the services sector. Notably in the hotel and restaurant industry did expectations for late summer worsen considerably. In addition, the downward trend observed in construction continued in the summer. WIFO's Leading Indicator fell further in August.

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.

5.1 Private consumption remains lacklustre

Consumer confidence deteriorated further in the summer. Pessimistic assessments of households' future financial situation and of the general economic outlook for the next twelve months once again outweighed optimistic appraisals. In addition, consumers expect a worsening of labour market conditions. In August, the European

Commission's (seasonally adjusted) Consumer Confidence Indicator stood at –11.2 points. The modest increase in households' disposable income, along with weak consumer confidence, is dampening consumers' willingness to spend. The volume of retail sales rose slightly in July, but in seasonally adjusted terms declined by 0.6 percent compared with a year before. In the business cycle survey of August, retailers once again assessed their present business situation as well as the outlook for the coming months negatively.

5.2 Buoyant early summer tourism followed by weak activity in July

From May to July 2014, arrivals of guests from the CEEC and the USA increased, while those of guests from Germany, the Netherlands and Russia decreased.

Tourism revenue from May to July 2014 stagnated compared with the same period a year before, according to first estimates. The unfavourable result of overnight stays in the first half of the summer season with an increase of only 0.2 percent mainly reflects the sharp drop in July 2014 (–4.9 percent) owing to the bad weather, which almost offset the vigorous increase recorded in the low season months of May and June (combined +4.5 percent). The influence of the weather also determined the regional distribution: Carinthia and the western federal provinces posted losses, while the other regions recorded an increase in revenue. The increase in the number of nights spent by resident guests bolstered activity in the hotel and restaurant industry; the demand from international guests softened somewhat, which was mainly due to the decline in the number of nights spent by travellers from Germany (–3.9 percent) and the Netherlands (–6.2 percent) as well as Russia (–7.5 percent). Tourism demand from the Czech Republic, Hungary and Poland, where economic activity is comparatively robust, grew noticeably (+9.1 percent, +12.2 percent and +10.6 percent, respectively). Overnight stays of travellers from the USA, where growth picked up briskly in the second quarter of 2014, rose sharply (+11.9 percent). Tourism demand from Italian guests (+7.5 percent) expanded, although GDP shrank again in Italy, albeit at a reduced pace.

5.3 Inflation rate receded slightly in July

The inflation rate as measured by the consumer price index was 1.8 percent in July 2014, slightly lower than in the previous month (1.9 percent). The increase of excise duties in March 2014 contributed around ¼ percentage point to the inflation rate, while that of administered prices accounted for 0.1 percentage point. The strongest drivers of inflation in July were housing, water, energy and services (primarily restaurants and cafeterias, hotel accommodation and package tours, housing, health as well as basic charges and prices of mobile phones). Energy prices were 1.4 percent lower than a year earlier in July, while those of mineral oil products were down by 3.0 percent.

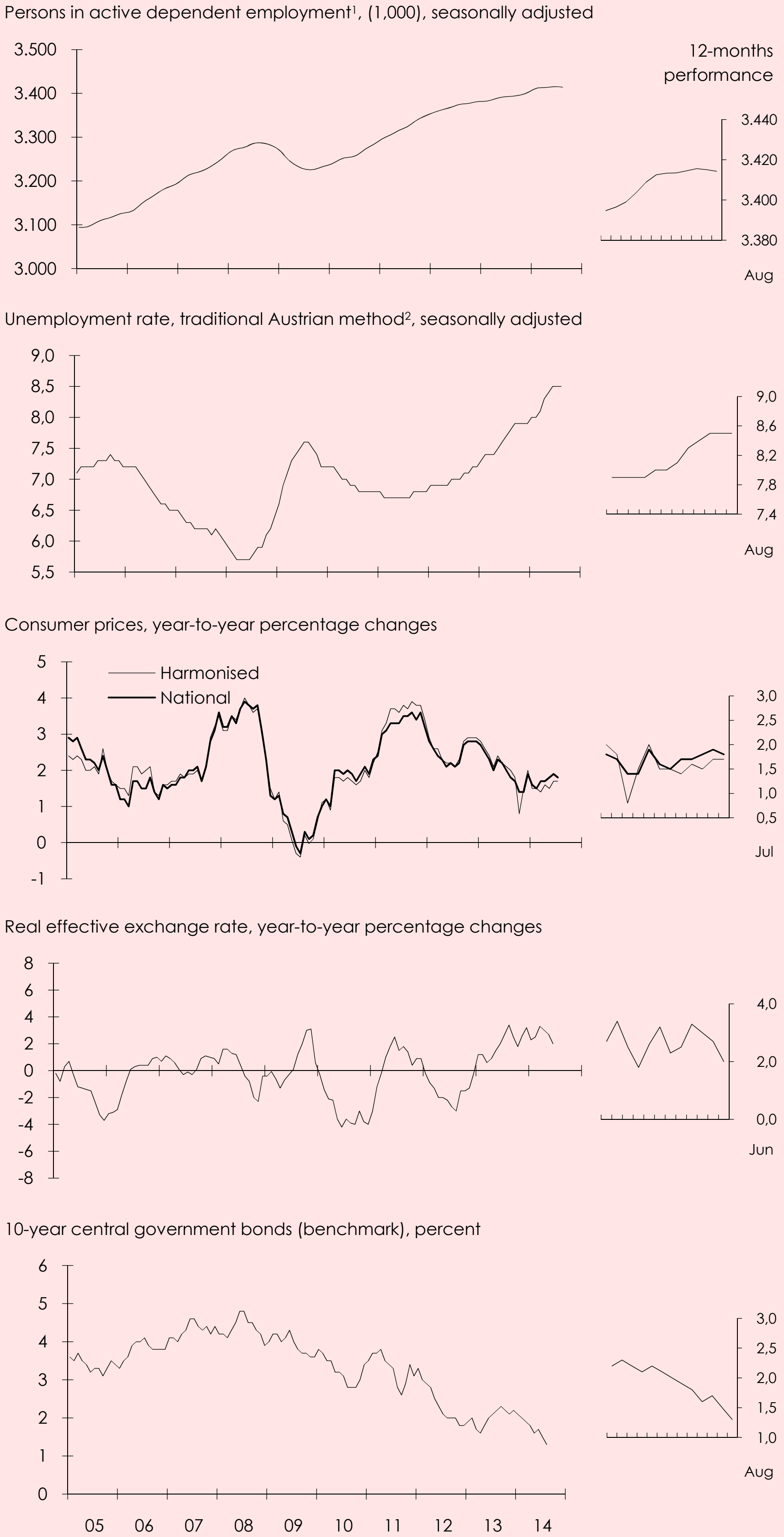
Higher services and food price inflation determines the inflation differential vis-à-vis the euro area average.

The inflation rate as measured by the Harmonised Index of Consumer Prices was somewhat lower (1.7 percent) than CPI inflation in July, owing to a different weighting of components, but as in previous months was the highest rate recorded in the euro area. The inflation differential of 1.3 percentage points vis-à-vis the euro area average and of 0.9 percentage point vis-à-vis Germany is mainly due to higher services price inflation in Austria (contribution to the inflation differential vis-à-vis the euro area average: restaurants and cafeterias +0.2 percentage point, telephone equipment and services +0.2 percentage point, hotel accommodation +0.1 percentage point, medical services +0.1 percentage point). Higher price increases than in the euro area were also recorded for food (including alcohol and tobacco, +0.4 percentage point) and industrial goods (excluding energy, +0.2 percentage point).

5.4 Unemployment rate stagnates in August

The seasonally adjusted unemployment rate was 8.5 percent in August, according to first estimates, unchanged from the previous month. It had recently risen noticeably from February to June (+½ percentage point). The seasonally adjusted unemployment rate according to Eurostat stood at 4.9 percent in July. The number of job vacancies, which in July had dropped by 5.2 percent compared with a year before, barely declined further in August (–0.4 percent). The seasonally adjusted number of persons in active dependent employment remained stagnant.

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.