Mild Downturn in Austria

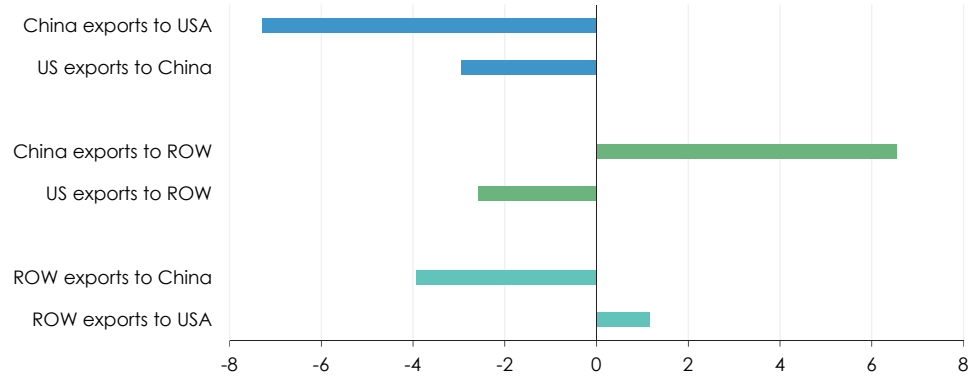
Business Cycle Report of February 2020

Stefan Schiman

- **To stabilise the supply of liquidity to the banks, the Fed buys treasury bills on a large scale.**
- **Bilateral trade between the USA and China dropped by almost a quarter due to the trade conflict. Unlike the USA, China found other customers for the most part.**
- **Strict EU emissions regulations, which have been in force since the beginning of 2020, will continue to weigh on the automotive industry.**
- **As expected, the Governing Council of the ECB left key interest rates unchanged at its first meeting in 2020.**
- **From the beginning of 2020, the minimum wage in Poland will gradually be almost doubled until 2024.**
- **In Germany and Austria, the industrial economy continued to cloud over in the fourth quarter of 2019.**
- **The construction industry in Austria benefitted from the mild weather in January.**
- **Tourism continues to expand uninterruptedly and is responsible for a strong increase in prices in the restaurant and hotel sector.**
- **The seasonally adjusted unemployment rate fell to 7.1 percent in January.**

Shifts in global trade of goods since the outbreak of the trade conflict between the USA and China

Change average September to November 2019 versus average April to June 2018 in billion $, seasonally adjusted



Bilateral trade between the USA and China collapsed by almost a quarter with the trade conflict. Unlike the USA, China found other customers for the most part.

"The new protectionism of the USA has largely missed its goal of reducing the foreign trade deficit. In the long term, it will lead to welfare losses for all concerned."

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The trade conflict between China and the USA and the crisis in the automotive industry are having a negative impact on industrial activity worldwide. New strict EU emission regulations will continue to create a difficult environment in the future. However, the service sector is proving to be a strong pillar of the economy. In Austria, tourism in particular continues to expand unabated.

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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) • **Cut-off date:** 5 February 2020

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Impressum: Herausgeber: Christoph Badelt • Chefredakteur: Andreas Reinstaller (andreas.reinstaller@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 • https://bulletin.wifo.ac.at • Verlags- und Herstellungsort: Wien

Contact: Stefan Schiman, MSc (stefan.schiman@wifo.ac.at)

The Fed, the central bank of the USA, is once again purchasing public debt securities on a large scale. In contrast to previous programs, only short-term treasury bills are being bought. The aim is not to dampen interest rates and stimulate the economy, but to ensure that banks are supplied with liquidity. Their demand for safe investments has increased sharply due to the financial market regulations of recent years.

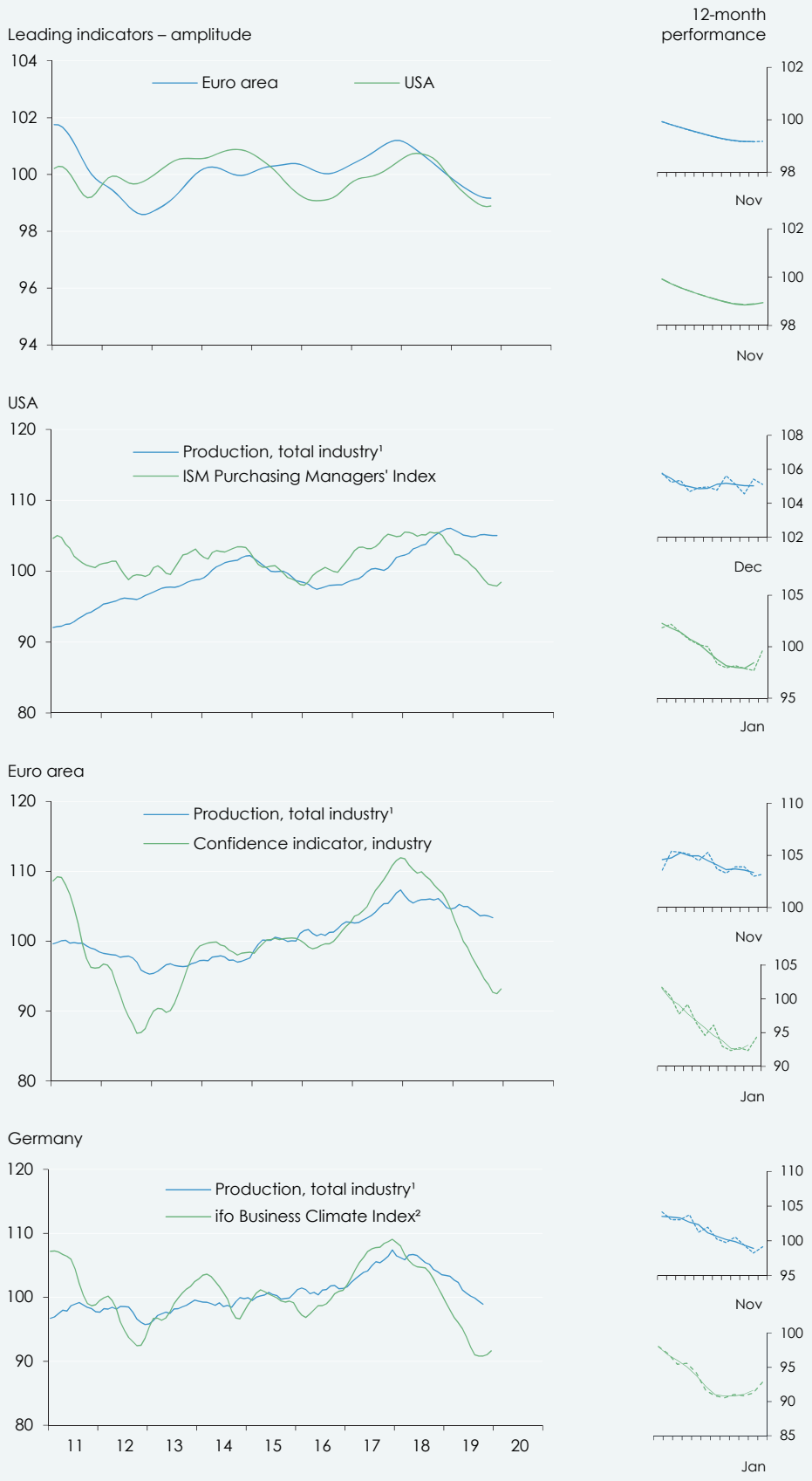
As a result of the trade conflict, China's exports to the USA have slumped by an average of 7.3 billion $ (–18 percent) per month over the last year and a half, while US exports to China have fallen by 3 billion $ per month (–26 percent). China was able to make up much of the shortfall in other markets, while the USA found no other customers. Since, in addition, part of the lost imports from China were replaced by imports from other countries, the US trade deficit has so far narrowed only slightly.

Although the industrial economy in the EU has recently stabilised, new strict emission regulations will continue to put pressure on the production and sales of motor vehicles in the years to come. They require a significant increase in the market share of electric and hybrid vehicles, which is questionable in view of the weaknesses of this technology (short driving range, sparse charging infrastructure).

As expected, the Governing Council of the ECB left key interest rates unchanged at its first meeting in 2020. The deposit rate, relevant for monetary policy, has been quoted at –0.50 percent since September 2019. The German economy remains in a downturn, even though the mood in industry has not deteriorated further recently. In Austria, the clouding of the industrial economy slowed down in the fourth quarter. Due to the continued strong growth in value added in services, the overall economy grew solidly by 0.3 percent compared to the previous quarter. In contrast, the positive momentum in construction slowed in the course of the year, but the sector benefitted from milder weather in January. At the same time, the mild winter apparently did not harm tourism, with demand expanding unabated at the beginning of the winter season. This means that the above-average price increase in the restaurant and hotel sector is continuing. Accommodation services were 5.2 percent more expensive in December than in the previous year, catering services 3.3 percent more expensive, and overall consumer prices rose by 1.7 percent.

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. – [1] Excluding construction. – [2] Manufacturing.

The expansion of employment and the decline in unemployment continued in December and January. The increase in employment was about a quarter higher than the decrease in unemployment. In January, the seasonally adjusted unemployment rate fell to 7.1 percent.

1. The Fed is once again purchasing securities on a large scale

The Fed's purchases of short-term treasury bills are intended to meet the sharp rise in demand for safe investments in the wake of financial market regulation.

Since mid-October 2019, the Fed has been buying public debt securities again. Whereas in the course of quantitative easing in the wake of the economic crisis in 2008 it mainly bought long-dated government bonds in order to dampen interest rates and stimulate the economy, the Fed is now buying short-term Treasury bills ("T-bills"), in the amount of about 180 billion $ so far. The current purchases of securities have little effect on long-term interest rates and are not a measure to stimulate the economy. Rather, they serve to secure the supply of liquidity. In September 2019, the US money market experienced strong fluctuations. The overnight rate rose to as much as 10 percent on 17 September, with the result that the key interest rate could no longer be kept within the target corridor of 2.00 to 2.25 percent and rose to as high as 2.30 percent. This was due to an excess demand for central bank money.

As a result of the quantitative easing programmes, the central bank balance sheet had multiplied. As a transition to a "normalisation" of monetary policy, the Fed subsequently wanted to keep its balance sheet at least constant. In doing so, it probably underestimated the overall demand for bank reserves. The misjudgement is probably due to the increase in demand for central bank money as a result of the financial market regulations that were enacted after the financial market crisis to limit systemic risk. The Dodd-Frank and Basel III regulations require banks to hold more secure and liquid assets, and many banks need central bank reserves to meet these requirements. The turmoil was finally triggered in September 2019 by two further factors that increased the demand for central bank reserves: the issuance of a large amount of debt securities by the Department of the Treasury and the maturity of quarterly corporate income tax liabilities. The current purchases of securities are again increasing the central bank balance sheet in order to avoid a liquidity shortage in the future.

2. Trade conflict between the USA and China strongly dampens bilateral trade

Trade diversion effects partly compensate for the slump in bilateral trade. The US foreign trade deficit narrowed only slightly.

In the trade conflict between the USA and China, which has now been going on for around two years, China's tariffs on products from the USA rose from 8 to 21 percent on average, while those of the USA on Chinese goods increased from 3 to 21 percent. Bilateral trade between the USA and China has already shrunk considerably. The decline in US exports to China began earlier, shrinking by 3 billion $ or about a quarter since the second quarter of 2018). The effect on Chinese exports to the USA came later, falling by 7.3 billion $ or 18 percent over the same period.

However, the increase in tariffs not only dampened bilateral trade but also triggered diversionary effects. China's export losses thus could almost completely be compensated; exports to other countries rose by 6.5 billion $ or around 4 percent in the same period despite stagnating world trade. Companies in the USA were less successful in this respect, with US exports to other countries falling by 2.6 billion $ or 2 percent. At the same time, the loss of supplies from China was partly replaced by imports from other countries, which increased by 1.2 billion $ or 0.7 percent over the same period.

Not least the trade diversion effects have so far limited the impact of the trade conflict on economic growth. According to Oxford Economics, US GDP is likely to have been dampened by a maximum of 0.2 percent, and China's GDP by 0.5 percent. However, the overall economic effect is also relatively small because economic policy measures have been taken in both countries to counteract the negative effects. In addition, there were no significant negative effects on the US financial markets.

Contrary to the USA's original goal, its foreign trade deficit has hardly narrowed so far, but has shifted from China to its other trading partners. Despite the sanctions, Chinese producers did not reduce their export prices significantly, not least because the devaluation of the Chinese currency gave them new scope to set prices. The fact that the trade conflict did not trigger an acute crisis, but rather that the consequences are slowly taking effect, could have habituation effects; the long-term welfare losses are nevertheless high. The longer the high tariffs remain in place, the more difficult it will be to dismantle them, since politically relevant minorities will benefit from them and new supply chains will be established.

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3. EU puts new strict emission regulations for motor vehicles into effect

On January 1, an EU law came into force that requires the average CO_2 emissions of new passenger cars to be reduced to 95 g per km by 2021. This corresponds to a 21 percent reduction compared to 2018. Car manufacturers have individual targets according to their range of vehicles. Failure to meet the targets will result in fines of 95 € per gram of CO_2 over the limit, multiplied by the number of cars sold in 2020 and 2021 whose engines exceed the limit.

This measure could increase the share of electric and hybrid vehicles from 8 percent of all new cars sold in 2019 to 18 percent in 2020 and 25 percent in 2021. This would be accompanied by a significant reduction in CO_2 emissions. But even then, car manufacturers would have to face penalties due to the increased emission limits. Moreover, if the charging infrastructure is not greatly expanded and the range of electric cars does not increase, demand for these vehicles may not grow sufficiently to meet the targets.

Sales of vehicles with internal combustion engines will be further curbed in the EU by new strict emission regulations.

3.1 ECB sees its moderately optimistic outlook confirmed

The Governing Council meeting on 23 January brought no change in monetary policy. The deposit rate, which is actually the lower limit of the key interest rate corridor, but which has acted as the key interest rate since the switch from interest rate tenders to fixed rate tenders in the financial market crisis of 2008, has been –0.50 percent since September 2019. The marginal lending rate and the main refinancing rate have been at –0.25 and 0 percent respectively since 2016.

With regard to economic growth, the Governing Council acknowledged that risks are "less pronounced as some of the uncertainty surrounding international trade is diminishing" and that data have improved somewhat "in line with our baseline scenario of sustained but moderate growth". Inflation expectations in the markets have "either stabilised" or even "slightly increased" since the last ECB meeting in December, after having been a major reason for the comprehensive easing package in September. In addition, the ECB says there are "further signs of a moderate increase" in underlying inflation, but these are "in line with existing expectations". This refers, for example, to the rise in the core inflation rate to 1.4 percent at the end of 2019.

At its first meeting in 2020, the Governing Council left the key ECB interest rates unchanged, as expected.

3.2 Minimum wage to be raised substantially in Poland

Inflation in Poland is likely to rise temporarily due to an increase in energy prices. The government froze electricity prices in January 2019. Following objections by the European Commission, however, this regulation had to be lifted at the turn of 2019-20. As a result, a stronger price increase can now be expected. The impact on purchasing power will be dampened by an increase in the minimum wage: the monthly minimum wage rose by a good 15 percent to 2,600 Złoty (approx. 610 €) at the beginning of January 2020 and will continue to rise steadily to 4,000 Złoty (approx. 940 €) in 2024. This is almost twice the current level, which is roughly the same as in the Czech Republic, Slovakia and Croatia and slightly higher than in Hungary and Romania. The current minimum wage in Poland is about one third, the target value is about 60 percent of the German minimum wage.

In Poland the minimum wage will almost double by 2024.

3.3 German economy remains in a downturn

Due to a deterioration in the main building industry and the service sector, the ifo Business Climate Index fell from 96.3 points in December to 95.9 in January. However, the index for the manufacturing sector continued to recover. Accordingly, the cloudiness of the German industry appears to be slowly subsiding. The easing of the effects of the trade conflict between China and the USA and the car crisis is having a positive effect. However, the "ifo-Konjunkturuhr" (ifo business cycle clock) still sees the industrial sector as being in recession, as negative reports predominate both in the assessment of the current situation and in expectations. The service sectors are in a downturn (predominantly positive assessment of the situation, predominantly negative expectations). This diagnosis also applies to the economy as a whole. Only the construction sector is still booming (both the assessment of the current situation and the expectations are predominantly positive). No sector is in an upswing.

The economic climate in German industry has recently improved somewhat.

4. Industrial activity in Austria clouds over further

According to WIFO's Flash Estimate, the Austrian economy grew by 0.3 percent (trend-cycle data) in the fourth quarter of 2019 compared to the previous quarter, and by 1.1 percent year-on-year. Overall, GDP in 2019 expanded by 1.6 percent compared to 2018, with growth slowing down in the course of the year. At the end of 2019 the momentum consolidated, which was dampened by the slowdown in industrial activity.

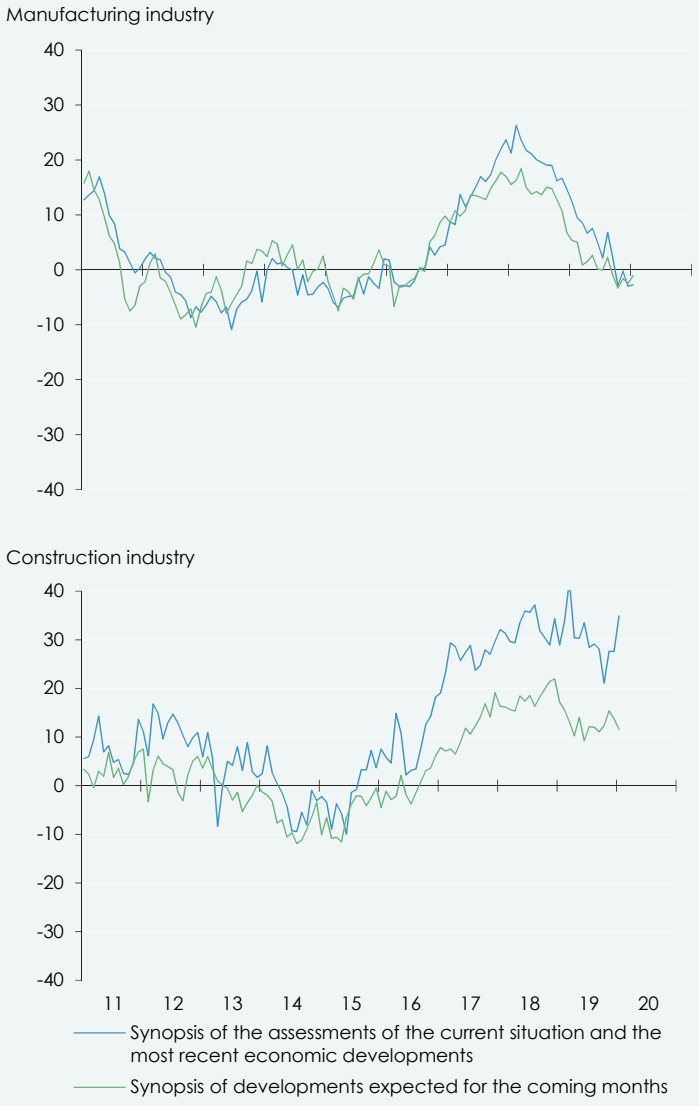
Manufacturing contracted for the third consecutive quarter, but the decline slowed down recently (third quarter of 2019 –0.5 percent quarter-on-quarter, fourth quarter –0.3 percent according to WIFO's Flash Estimate). By contrast, no slowdown was registered in the services sector, with market services continuing to expand at a quarter-on-quarter rate of 0.5 percent. Value added in the construction industry also continued to grow, albeit with a declining intensity in the course of the year.

4.1 Construction industry benefits from mild weather in January 2020

The results of the January 2020 WIFO-Konjunkturtest (business cycle survey) show an improvement in the economic assessment by the majority of Austrian companies. However, there are still major differences between the sectors: while the economic assessments in the service industries and in the construction sector were confident, producers in the manufacturing sector remained sceptical despite slight gains. In the construction industry, the mild temperatures had a particularly favourable effect: the weather was cited by only 1 percent of respondents as the primary obstacle to production (December 2019: 9 percent).

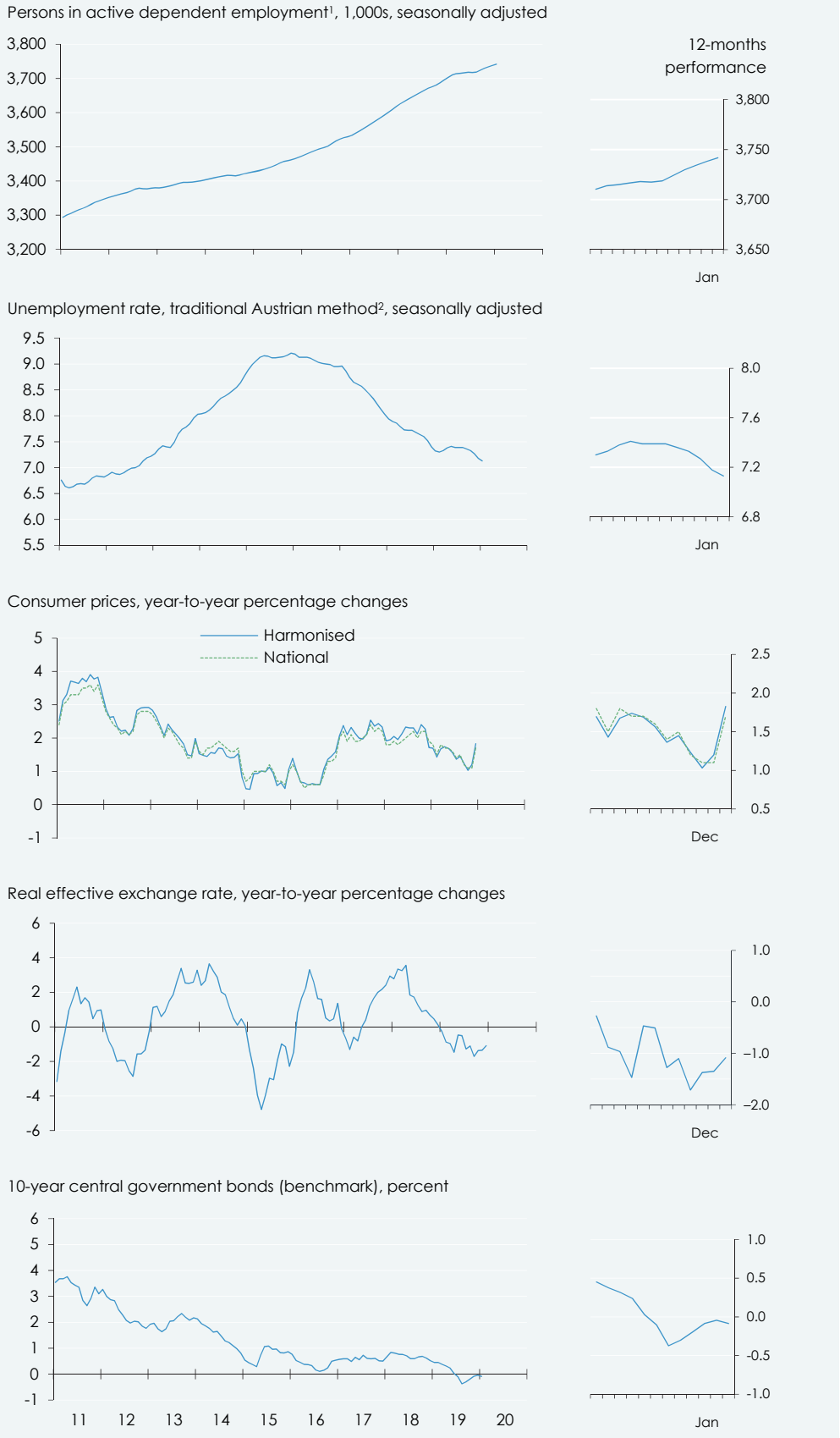
Figure 2: **Results from the WIFO-Konjunkturtest (business cycle survey)**

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.

Figure 3: **Key economic indicators**



Source: Public Employment Service Austria, Federation of Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – [1] Excluding persons in 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.

The demand for tourism in Austria continues to grow unabated. This is accompanied by strong price increases in the hotel and restaurant sector.

4.2 Tourism flourishing at the beginning of the winter season

In November and December 2019, the number of guest arrivals rose by 3 percent year-on-year, the number of overnight stays by 4.5 percent and sales by 5.5 percent in nominal terms, although weather conditions were rather unfavourable for winter sports tourism. The average temperature was well above the long-term average, and a sufficient natural snow cover was not formed everywhere. However, thanks to the investments made in recent years in the snow-making infrastructure, winter sports activities could be practised in many places without significant restrictions. In the Alpine provinces, especially in Salzburg and Tyrol, the number of overnight stays rose considerably (+6.8 percent and +5.7 percent respectively). At the same time, the demand for activities apart from winter sports increased. Burgenland (+7.3 percent) with its thermal spa locations especially benefitted, with Styria (+2.7 percent) also benefitting to a lesser extent. City tourism in Vienna rose by 3.5 percent, after the number of overnight stays had already increased by nearly 17 percent in the previous year.

4.3 Tourism and housing again price drivers

Consumer prices rose by 1.7 percent in December. Prices rose strongly again in the two sectors that have been responsible for above-average inflation in Austria for several years: in the hotel and restaurant sector (accommodation services +5.2 percent, catering services +3.3 percent) due to the strong increase in demand and in the housing category (maintenance and repair of dwellings +3.1 percent, rentals for housing +2.6 percent). Together, the categories "housing, water, energy" and "restaurants and hotel services" contributed more than half (0.9 percentage points) to the headline inflation rate in December.

4.4 Unemployment rate fell to 7.1 percent in January

The mild winter weather so far has had a favourable effect on unemployment. Seasonally adjusted, it already fell by 3,800 persons or 1.3 percent in December, and in January it fell again by a good 1,800 or 0.6 percent. In January, the seasonally adjusted unemployment rate was 7.1 percent, unadjusted it was 8.7 percent. About 62,500 persons were unemployed due to seasonal factors. Parallel to the decline in unemployment, employment continued to expand. According to preliminary estimates, the number of persons in active dependent employment was about 3,700 or 0.1 percent higher in January than in the previous month; in December the increase amounted to 4,100. The expansion in employment was about a quarter higher than the reduction in unemployment. Contrary to December, the number of job advertisements also expanded again in January, which meant that there were around 3.7 unemployed per vacancy in seasonally adjusted terms.