

Marcus Scheiblecker

# Economic Downturn in Emerging Market Economies Weighing on Austrian Exports

## Business Cycle Report of August 2015

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The Austrian economy grew by 0.3 percent in the second quarter of 2015, compared with the previous quarter, slightly more briskly than in the previous three months (first quarter +0.2 percent). Economic activity in emerging market economies is slackening further: China's economy continues to lose momentum, and Brazil and Russia are mired in crisis. The USA is experiencing ongoing robust growth with no major fluctuations. In Europe, the situation continues to improve, albeit only gradually. Developments of domestic demand in the EU going forward will determine the pace of growth of the Austrian economy.

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Economic activity appears to be slowing further in emerging market economies. The Chinese economy keeps losing steam; uncertainty about future developments triggered strong erratic price swings on China's stock exchanges. In Brazil, Latin America's largest country, the crisis persists, and Russia's economy, in addition to the collapse of commodity price suffers from the consequences of the sanctions imposed by the EU and USA because of the Ukraine crisis.

The USA, Austria's most important overseas market, is experiencing continued vigorous economic expansion. GDP growth remained dynamic at 0.6 percent quarter-on-quarter in the second quarter. Business surveys suggest that the favourable development will continue also in the near future. Demand from the USA is currently the most important pillar of Austrian exports.

The EU economy continues along a sluggish upward path, with stronger growth being registered in East Central Europe than in the other EU countries. In the euro area, economic developments have been quite mixed: the economy grows especially in those countries where domestic demand is robust. The extraordinary measures taken by the ECB in the form of extensive euro area government bond purchases so far have not had any effect on inflation, which for several months now has stood only slightly above the 0-percent mark; however, investment activity has been improving continuously on higher construction demand.

In Austria, economic growth remains barely above stagnation. While aggregate domestic and external demand failed to provide stimulus to the Austrian economy also in the second quarter, production nevertheless increased at a somewhat brisker pace than in the first quarter. Real GDP grew by 0.3 percent on a quarterly basis in

the second quarter, with the increased production flowing into inventories. Consumer spending rose only marginally, and investment slightly dampened growth. Business surveys still do not point to a marked acceleration in production growth in the coming months, a development that can normally be expected in a recovery phase. The persistently weak growth has not shown any cyclical upward or downward deviations since the second quarter of 2011. This goes especially for industrial production – a phenomenon seen also in Germany and the USA and inconsistent with the assessment given in business surveys of the situation in and the outlook for this sector. As, contrary to previous experiences, the current economic recovery in the euro area is being driven by consumer demand, in addition to construction investment, and the range of products exported by Austria is focussed rather on equipment, the Austrian economy continues to lag behind the European cycle.

At 1.0 percent, inflation in Austria in June still markedly exceeds the euro area average, but the far bigger problem is the high unemployment rate. The number of unemployed persons continues to rise on the back of weak economic growth and a rising labour supply. In July it totalled just under 320,000 (+33,500 compared with a year before), the highest rate ever reported in that month by AMS (Public Employment Service).

## 1. Momentum moderates further in emerging market economies

Following a gradual weakening of trend growth in China in recent years, economic activity has increasingly exhibited a downward tendency recently. Exports have been clearly losing momentum since the beginning of the year. Goods exports rose by a mere 1 percent in the first half of 2015. The creeping appreciation vis-à-vis the dollar until the beginning of 2014 appears to have affected the competitiveness of Chinese products in international markets for some time to come. The exchange rate has remained largely stable since then, but the dollar has been appreciating vis-à-vis many other currencies, and the renminbi with it. At the beginning of August 2015 China reacted by devaluing its currency by 2 percent against the dollar.

The strategy introduced by China's central government to support the economy by stimulating domestic demand has had only a limited effect so far. High levels of indebtedness of regions and municipalities as well as of many companies have increased financial market uncertainty, which the central bank has countered by repeated interest rate cuts since the beginning of 2015. Share prices plunged as uncertainty heightened. In mid-June, the share price index of China's biggest stock exchange in just a few weeks lost more than 30 percent of its value. The government felt compelled to suspend the trading of many shares and carry out supporting purchases, but share prices, while fluctuating extensively, remained at approximately that level.

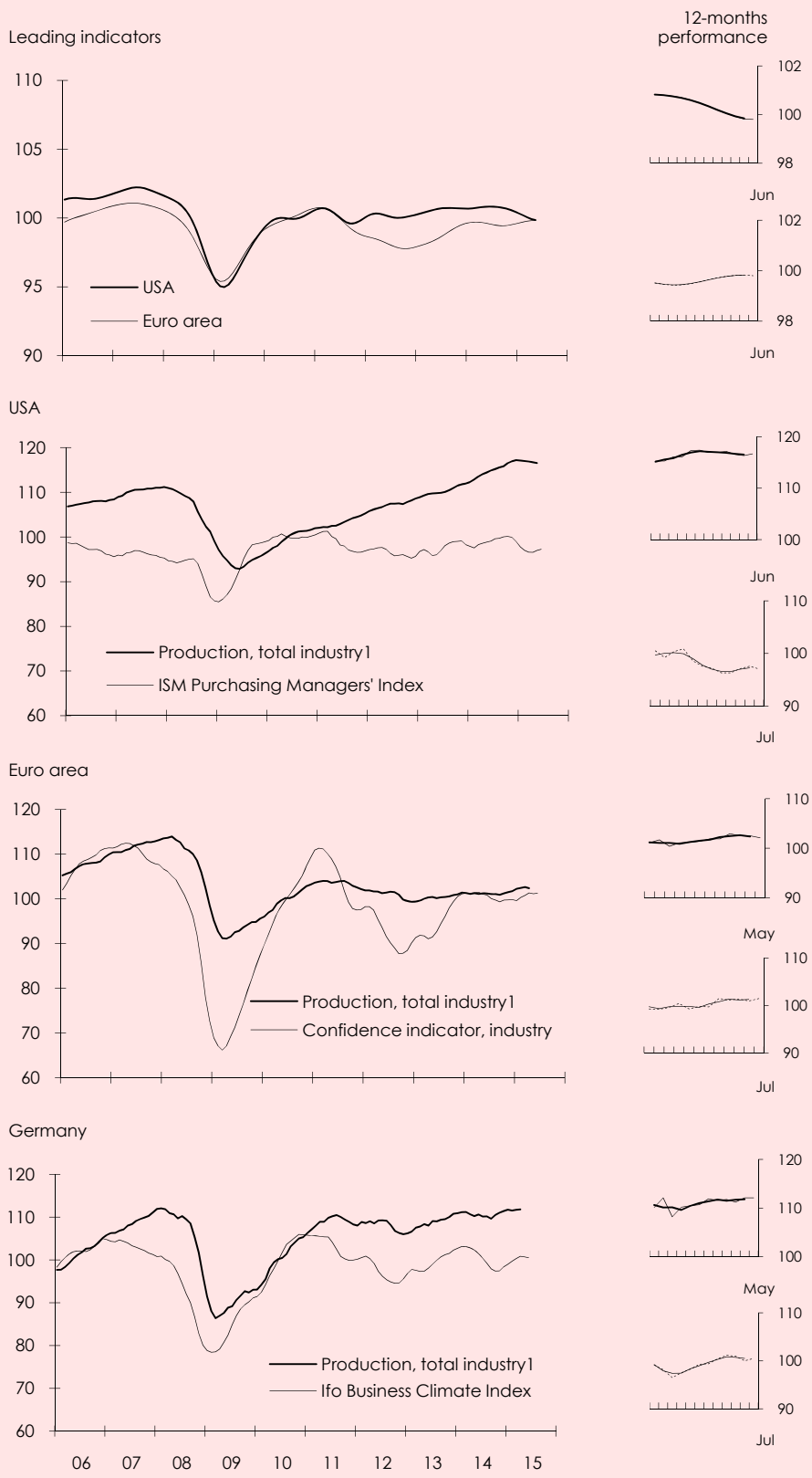
This situation renders investment financing more difficult and is likely to adversely affect domestic demand also by weakening consumer demand, given that broad sections of the population have invested their savings in shares. Both demand components are dampening the demand for imports and are therefore weighing on the global economy. China's merchandise imports plummeted by almost 17 percent in the first half of 2015.

In Brazil, Latin America's largest economy, the economic crisis has persisted since mid-2013. The first quarter of 2015 saw yet another contraction in economic output. Weak global demand for commodities continues to weigh on developments. The unemployment rate rose from around 5 percent at the beginning of 2015 to almost 7 percent in June, and the real lost around 20 percent of its value vis-à-vis the dollar. The rate of inflation subsequently rose from 7 percent to around 9 percent over the same period.

*In China, the world's second largest economy, problems in financial and capital markets threaten to be a major strain on the domestic economy, after external trade has also lost most of its driving force. Russia and Brazil remain mired in crisis.*

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 Russian economy shrank for the third consecutive time in the first quarter of 2015, with the downward momentum accelerating further. Price declines in international commodity markets, in tandem with the negative effects of the sanctions imposed in the course of the Ukraine conflict, are a major strain on the economy. The value of Austrian merchandise exports to Russia fell by 8 percent already in 2014, with Russia's share in Austria's international merchandise exports consequently declining to 2.5 percent. A further drop by almost 40 percent has been observed since the beginning of 2015. Inflation surged in Russia as a result of the high loss in the rouble's value vis-à-vis the dollar and the euro in the second half of 2014. Only a slight decline has been observed since it peaked at almost 17 percent in March 2015.

*The decline in the volume of world trade observed in recent months may continue.*

## 2. US economy still going strong

USA real GDP rose at the relatively brisk rate of +0.6 percent in the second quarter of 2015, according to the first estimate; the rate for the first quarter was revised from -0.2 percent to +0.2 percent. In the second quarter, growth was mainly driven by private consumption, while investment demand stagnated, following the sharp increase in the previous quarter. External trade and government consumption also contributed to growth.

*The USA may soon supersede Italy as the second most important market for Austrian exports.*

Industrial production has continued to grow very evenly without any cyclical fluctuations since 2010 (see box). The first half of 2015 saw some moderation in momentum, but the Purchasing Managers' Index suggests a further increase in the coming months.

For the first time in four months consumer prices rose again on a year-on-year basis in June 2015, with inflation picking up to 0.1 percent. In view of this development, the Fed further postponed its announced and already long-awaited key interest rate increase. The Federal Funds Rate has stood unchanged at just over 0 percent since the end of 2008. The unemployment rate continues to decline and in June reached 5.3 percent, its lowest level since 2008.

With a share of 6.1 percent and an increase in exports of more than 10 percent, the USA continued to be the third most important sales market for Austrian goods also in the past year. Italy's share is only slightly higher at 6.4 percent. Should exports to Italy continue to stagnate, the USA may soon become the second most important sales market for Austrian goods.

## 3. European economic recovery remains on track

The European economy has been on a recovery path since last year. While growth did not accelerate in the EU in the first quarter (fourth quarter of 2014 and first quarter of 2015 +0.4 percent each), the rebound in domestic demand mitigated the dampening effect of foreign trade. Since the fourth quarter of 2014 the economy in the EU as a whole and the economy in the euro area have once more been growing in unison, with the stronger growth momentum in the countries of East Central Europe that are not members of the monetary union making up for the UK's below-average growth in the first quarter of 2015 (+0.3 percent). Particularly strong economic growth was registered in the Czech Republic (+3.1 percent), Romania (+1.6 percent), Poland (+1.0 percent), Bulgaria (+0.9 percent), Hungary, Slovakia and Slovenia (+0.8 percent). Growth remained subdued only in the Baltic countries, owing to their geographical vicinity to Russia.

*Economic conditions are improving further in the EU as a whole as well as in the countries of the euro area. Growth is concentrated in those countries where domestic demand is robust. East Central Europe continues to register stronger growth than the other EU countries.*

Barely any data are yet available on economic growth in the euro area in the second quarter of 2015 – in addition to Austria this is the case only for Spain, where the upswing accelerated further in the second quarter of 2015 (first quarter +0.9 percent, second quarter +1.0 percent). Similar to the German economy, the Spanish economy is currently being driven by domestic demand, whereas the stimulus provided by foreign trade plays a minor role.

Although industrial production in the euro area developed unfavourably from March to May 2015, the Economic Climate Indicator published in July pointed to

ongoing modest expansion. It is, however, too weak to be able to bring down the still very high unemployment rate (unchanged at 11.1 percent since April).

### *Growth without cyclical movements*

The 2008-09 recession in almost all economies caused a structural rupture in the production potential that so far has not been made up for by an economic backswing. Even in countries where growth rates returned to levels similar to those before the crisis, as for instance in the USA, the shift in levels caused by the economic crisis persisted. In Germany or Austria, for instance, an economic backswing occurred after the crisis between 2009 and 2011, which, however, was not able to completely close the output gap that had arisen. In both countries industrial production subsequently embarked on a new, lower growth path. Possible causes of this problem and their elimination are the topics of intensive discussion among scientists and political advisors<sup>1</sup>. In comparison with the problems associated with a lower growth path, the absence of cyclical movements that was also observed faded into the background of the discussion.

Literature dealt with the phenomenon of absent business cycles already before the 2008-09 recession<sup>2</sup>. It was partly attributed to improved fine-tuning of the economy by a better economic policy<sup>3</sup>. Other authors argue that improved information technologies have constrained inventory changes, one of the drivers of cyclical fluctuations, by rendering them easier to plan in the production process (just-in-time production)<sup>4</sup>.

The onset of the financial and economic crisis then abruptly ended the discussion on the loss of cyclical movements of production. The downturn, triggered by a financial market bubble, was even sharper than the one prompted by the Great Depression of the 1920s. Some countries experienced a backswing, as is usual for a business cycle, albeit often only a partial one. Since then, an absence of cyclical fluctuations over a period of several years has again been observed in some economies, however. This applies especially to that component of national output that should be influenced most strongly by cyclical fluctuations: industrial production.

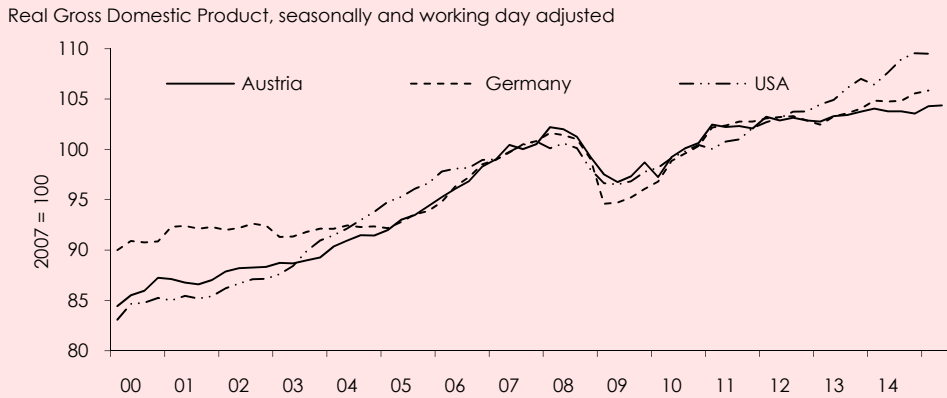
As Figure 2 shows for GDP in the USA, Germany and Austria, it started to move along a steady growth path after the bursting of the "dot-com bubble", which was interrupted only by the financial and economic crisis. The USA subsequently experienced a very subdued and incomplete (no closing of production gap) economic backswing. Since 2011 the path has again been running steadily upwards, but again lacking cyclical fluctuations. In Germany and Austria, a stronger backswing can be seen to have occurred after the crisis, but since then developments have been similar to those in the USA, free from fluctuations, albeit with lower trend growth.

This phenomenon is even more apparent in the case of industrial production (Figure 2), which in the past was subject to even greater cyclical fluctuations than GDP. But such fluctuations are lacking before as well as after the crisis. This absence of cyclical fluctuations in industrial production is, however, in contrast with business surveys for this sector also depicted here, which clearly reflect cycles of several years.

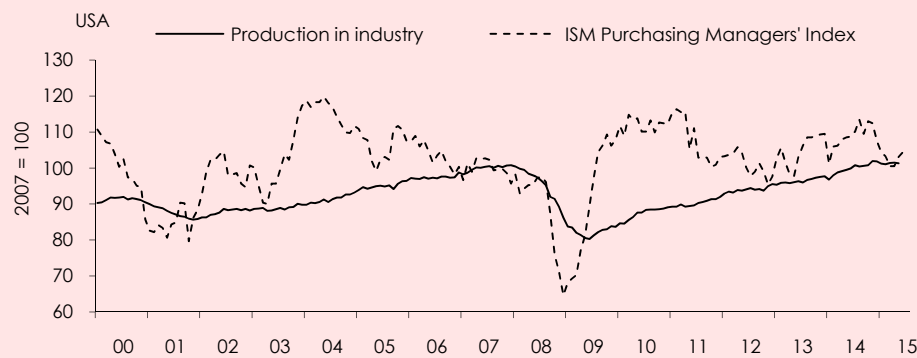
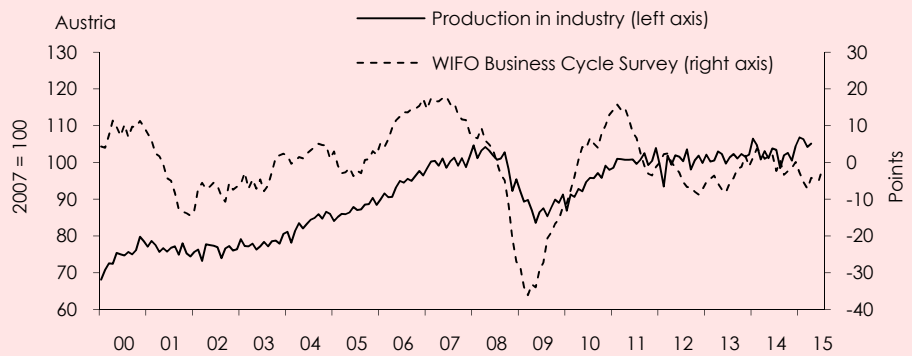
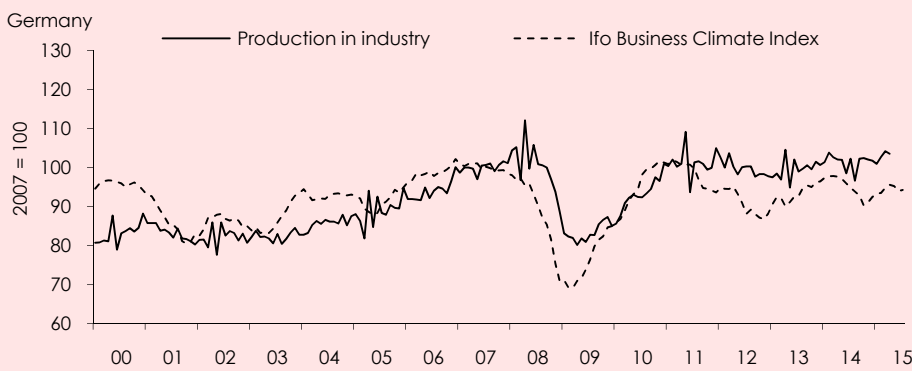
<sup>1</sup> E.g., IMF, "Lower Potential Growth: A new reality", World Economic Outlook, 2015. – <sup>2</sup> Stock, J., Watson, M., "Has the business cycle changed and why?", NBER Macroeconomics Annual, 2002, <http://www.nber.org/chapters/c11075.pdf>. – <sup>3</sup> Bernanke, B., The Great Moderation, Federal Reserve, Washington, D.C., 2004, <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2004/20040220/default.htm> (accessed on 15 April 2011). – <sup>4</sup> The New York Times, "Origins of 'The Great Moderation'", 23 January 2008, <http://www.nytimes.com/2008/01/23/business/23leonside.html?ref=business&r=1&>.

Monetary policy continues to rely on the non-standard measures of purchasing government bonds to stimulate the economy and raise inflation to its target. The favourable interest environment is meant not only to facilitate investment and stimulate consumption through low interest rates on loans and savings, but it is also to relieve public budgets through lower interest expenditure. The budding domestic demand may increasingly benefit from it in the future.

Figure 2: Economic growth, industrial production and business climate



Industrial production and business climate<sup>1</sup>



Source: Eurostat, Ifo, ISM, OECD, WIFO. – <sup>1</sup> Manufacturing (NACE 2008, Section C).

Inflation in the euro area has been standing below 0.5 percent already for a year. The deflationary phase appears to have been overcome for the time being, but the

rate has been stuck at around ¼ percent since May. Commodity markets can currently be expected to have an effect of lowering rather than driving up prices. The price of oil, which had slightly recovered from its trough in early 2015, fell again to around \$ 50 per barrel in July. The dollar-euro exchange rate is likely to have stabilised at a new level of around \$ 1.1 per euro since the beginning of March, and has barely changed since then.

#### 4. Demand in Austria remains sluggish

Economic activity in Austria has been gaining increasing traction since mid-2014, albeit without showing a cyclically driven acceleration in the pace of expansion. According to first calculations, real GDP increased by 0.3 percent, quarter on quarter, in the second quarter of 2015, slightly more briskly than in the first quarter (+0.2 percent). However, growth of all demand components remained subdued.

*The development of the Austrian economy still lags behind the euro area average. Contrary to previous experiences, first economic stimuli this time are not provided by foreign trade and equipment investment, but by private consumption and construction demand. This is the reason why currently the Austrian economy is not leading the way but lagging behind.*

Figure 3: 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.

In the euro area, growth is currently being driven by increasing demand for consumer goods and buildings. First incentives to economic activity usually stem either from foreign trade or equipment investment. Given that Austrian exporters scarcely produce consumer goods having high income elasticity, Austria does not benefit from an increase in external demand. Only when the rebound in demand stimulates investment can economic conditions be expected to improve also in Austria.



Private consumption in Austria barely gained momentum in the second quarter and posted only very modest growth. So far savings from lower fuel prices have not flown into consumption. Apparently private households were not yet convinced that these price reductions would be sustainable. The tax reform, the volume of which transpired already in the second quarter, also did not induce households to bring forward some purchases in anticipation of the income relief. Inflation, by contrast, remained quite high at 1 percent in June, weighing on real disposable incomes. Yet, retail sales have been growing somewhat faster in real terms since the beginning of the year than in previous years (June +3.7 percent, compared with a year before). However, according to Statistics Austria, the highest increases were registered in the non-cyclically sensitive categories such as pharmacies, cosmetics and food, while sales declines were recorded both for furniture, DIY and electrical appliances, and clothing and shoes.

Consumer confidence has again darkened substantially in recent months and has almost dropped to the record lows registered in recent years. The decline in new passenger car registrations (first six months of 2015 –3 percent, compared with a year before) also reflects consumers' reluctance to spend.

Gross fixed capital formation continued to decline in the second quarter, primarily owing to weak construction investment. Equipment investment, on the other hand, which had dropped substantially in previous quarters, for the first time increased again slightly. According to evidence presented in WIFO's Business Cycle Survey, companies' expectations of future business conditions remain bleak and continue to weigh on their willingness to invest. The indicator, while rising slightly for the second consecutive time in July, still remained at a below-average level.

Foreign trade is also not providing any stimulus to the Austrian economy at present. Real exports even declined slightly on a quarter-on-quarter basis in the second quarter (–0.1 percent), while imports stagnated. Notably merchandise trade dampened the result, whereas services exports increased.

From January to May merchandise exports fell by 0.2 percent in value terms. While exports to third countries increased by 1 percent, those to the EU declined by 0.7 percent. The pattern of the development of exports to third countries was consistent with the economic situation in the respective region: while merchandise exports to North America increased by 17 percent in the first five months of 2015, those to Asia (ASEAN group) declined by 3.5 percent, and those to South America (Mercosur countries) fell by 2.3 percent. Merchandise trade with Russia, Austria's eleventh most important sales market, plunged by almost 40 percent over the same period.

Total exports to the EU declined, notably as a consequence of the drop in exports to the EU 15 countries, by almost 3 percent (January to May 2015). By contrast, merchandise sales on the important sales markets in East-Central Europe (MOEL 5) increased by almost 5 percent compared with a year before.

#### 4.1 Good start of summer tourism season

Austrian tourism revenue rose by 1.2 percent in the first two months of the 2015 summer season compared with the same period a year before, reaching a volume of € 3,150 million. Sales declined on a price-adjusted basis, the quality indicator "real expenditure per night spent" dropped by 1.9 percent.

The number of nights spent in May and June 2015 totalled 17.14 million, which was an increase of 2.1 percent from a year before. The demand from international guests (65.0 percent of total nights spent) grew sharply overall (+3.7 percent), while the number of nights spent by domestic travellers declined by 0.7 percent. Strong stimulus to the growth in demand came again from city tourism (Vienna +6.2 percent, Austria excluding Vienna +1.4 percent).

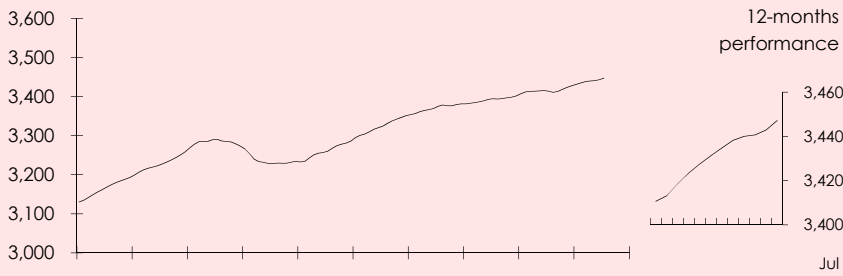
The sharpest year-on-year increases were registered for nights spent by guests from the USA (+10.2 percent), Sweden (+10.1 percent) and Italy (+7.9 percent). Rather marked declines were recorded in the source countries France (–5.2 percent), Belgium (–10.2 percent) and especially Russia (–30.2 percent; EU sanctions, devaluation of the rouble).

*Lower oil prices, the weakness of the euro, and low interest rate levels so far have not stimulated the Austrian economy.*

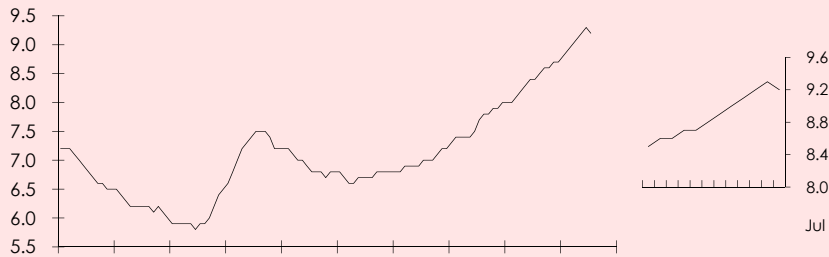


Figure 4: Key economic indicators

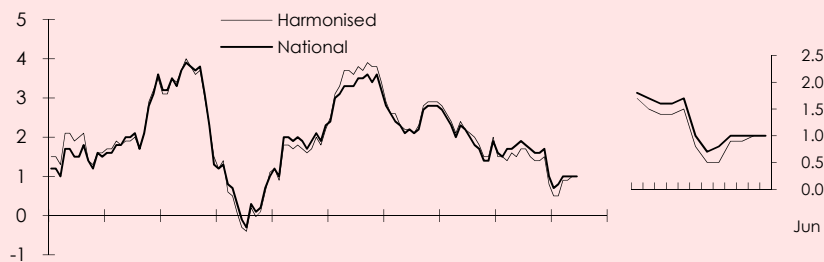
Persons in active dependent employment<sup>1</sup>, (1,000), seasonally adjusted



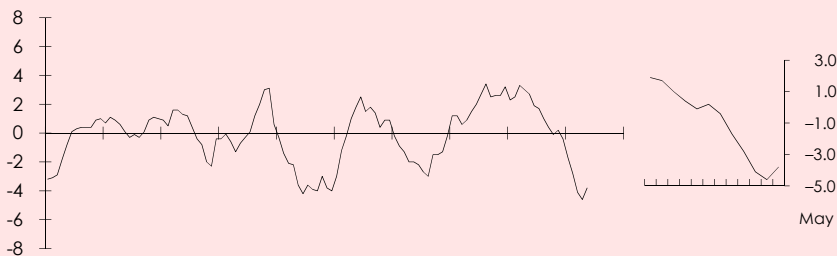
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



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. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> As a percentage of total labour force excluding self employed, according to Public Employment Service.

## 4.2 Inflation stable at 1 percent

Consumer prices in Austria rose by 1 percent year on year for the fourth consecutive time in June, according to Statistics Austria. On euro area average, inflation accelerated from -0.1 percent to 0.2 percent in the last four months; hence the gap between Austria and the euro area narrowed somewhat. As in the preceding months, inflationary pressures in Austria were highest in the categories "Restaurants and Hotels" and "Housing, Water and Energy" (apartment rents +4.9 percent, maintenance costs for rented flats +3.3 percent). Price developments of fossil energy sources still contribute to reductions in inflation – fuel prices were down by almost 9 percent compared with a year earlier.

The calculation of the consumer price index according to the harmonised method for all of Europe also resulted in an inflation rate of 1 percent. Hence Austria had the second-highest rate in the euro area after Malta (+1.1 percent)

*The inflation rate remained unchanged at 1 percent in Austria in June, still markedly higher than the euro area average.*

## 4.3 Labour market situation worsens further

Employment continues to rise in spite of weak economic growth. In July, the Association of Austrian Social Insurance Agencies registered more than 3.5 million persons in dependent active employment, an increase of almost 1 percent compared with a year earlier. However, a month-on-month comparison of seasonally adjusted data shows that the increase almost came to a halt already in May.

The labour force keeps growing owing to fewer people applying for early retirement, an increase in the labour force participation of women, and the brisk influx of labour from abroad. The currently weak economic growth does not create a sufficient number of additional jobs, with unemployment consequently rising markedly. In July, almost 320,000 persons were registered as unemployed with AMS (Public Employment Service), an increase of 33,500 or almost 12 percent from a year before. However, 8,300 persons had been enrolled in vocational training courses the same month in 2014.

The unemployment rate according to the national method of calculation reached 8.1 percent in July (July 2014: 7.4 percent). No month-on-month change in the unemployment rate is apparent on a seasonally adjusted basis. The harmonised unemployment rate according to Eurostat was 6 percent, according to preliminary estimates, 0.1 percent lower than a month before.

*The unemployment rate continues to grow briskly in Austria. The weak economic growth cannot absorb the rising labour force.*