

Marcus Scheiblecker

Economy in Phase of Sluggish and Weakening Activity

Business Cycle Report of November 2014

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First GDP estimates point to a stagnation of the Austrian economy in the third quarter of 2014. Leading economic indicators suggest that the situation will deteriorate slightly further in the coming months. So far there is no evidence of a subsequent pick-up in momentum, but there is also no indication of a sharper downturn going forward. The Austrian economy is in a phase characterised by sluggish and weakening activity.

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The Austrian economy currently lacks impetus for growth both at home and from abroad. Consumer demand suffers from private households' unfavourable income situation, while businesses are delaying investment decisions owing to the bad economic outlook.

The biggest problem, however, lies in the weakness of goods exports to euro area countries as well as to emerging market economies, which had provided an important impetus to the global economy over the past years.

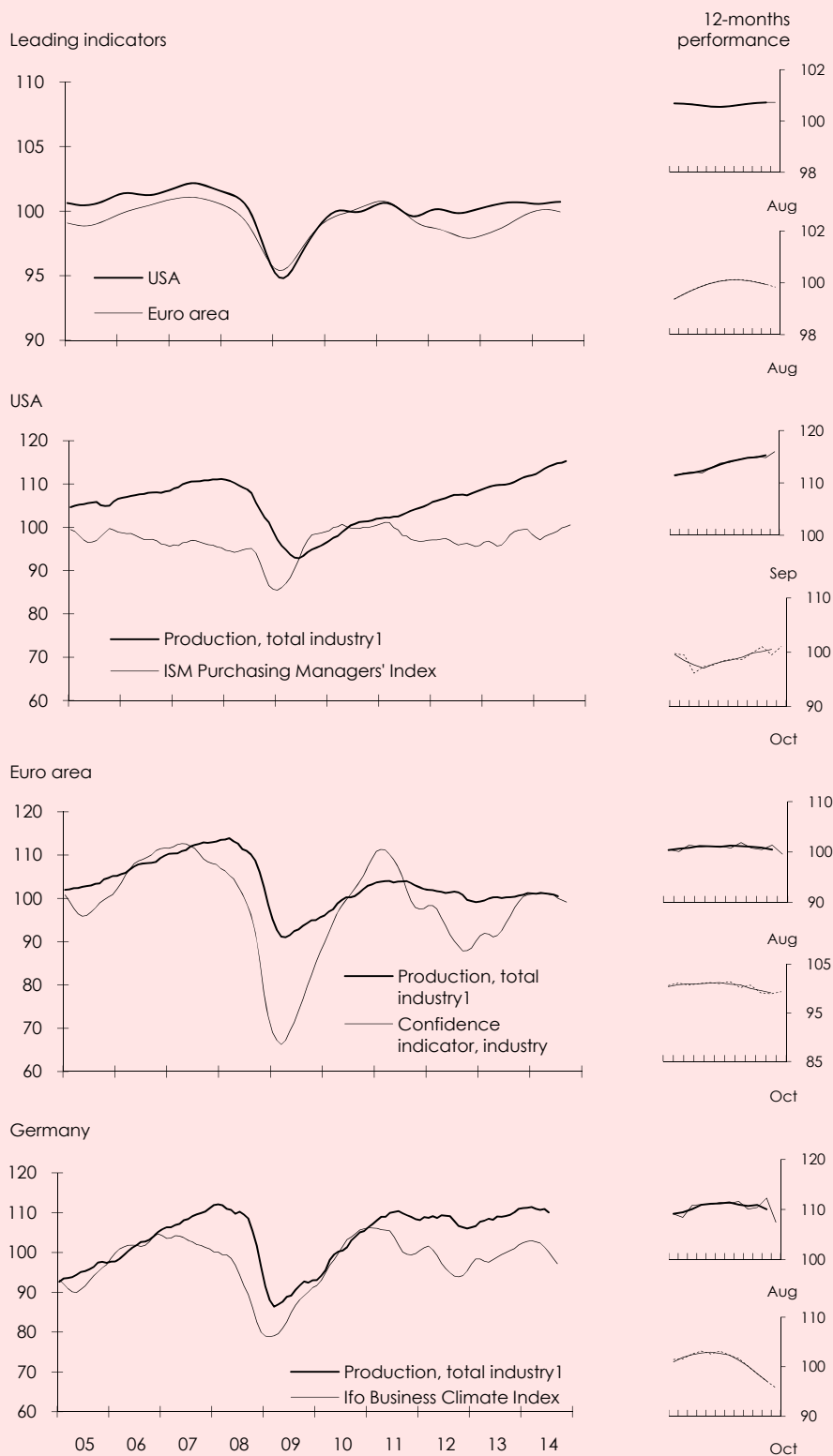
Only the USA is currently experiencing vigorous economic growth. Real GDP quarter-on-quarter growth of 1.1 percent in the second quarter was followed by yet another sharp increase of 0.9 percent in the third quarter. While the US Central Bank has ended its asset purchase programme aimed to expand the money supply on the back of the progressing recovery of the labour market, fiscal policy, on the other hand, is not yet becoming more restrictive. The newly incurred national debt is expected to reach around 6 percent of GDP in 2014; the government debt is thus growing steadily (2013: 105 percent of GDP).

The euro area economy, by contrast, is losing steam again. The industrial sector is especially affected – the production index fell by 1.8 percent in August compared with July; the 0.9 percent increase in July had not offset the decline witnessed in the previous two months. Weak consumer demand continues to dampen consumer price inflation. Following a rate of 0.3 percent in September, inflation is expected to rise to 0.4 percent in October, according to preliminary estimates. Moreover, the financial crisis apparently has not yet been completely overcome: in the ECB's latest stress test, 25 of the 130 assessed system-relevant banks in the euro area did not pass the test, and so far 13 of the former have not been able to raise the capital needed

to fill their equity gap. The prevailing uncertainties are also apparent in financial markets, where for instance in October the yields of Greek government bonds surged from 6.7 percent to more than 9 percent in just a few days.

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 lack of foreign demand alongside sluggish consumption growth and the decline in investment in the third quarter caused stagnation of the Austrian economy. It had gradually lost some of its strength already in the previous two quarters. The industrial production index fell by 0.7 percent in July compared with a month before, and by 2.4 percent in August. Compared with a year before, the decline was 2.3 percent in August. WIFO's leading indicator pointed to an ongoing downward trend also in September and October, and this trend is expected to persist at least until the end of 2014.

The Austrian banks passed the ECB's stress test; only one institution requires an extra equity injection.

In line with the European trend, inflation eased also in Austria (September 1.6 percent, August 1.7 percent). The drivers of inflation were once again rents and a few food prices.

Employment continued to increase somewhat also in October, despite the weak economic momentum, with unemployment rising at the same time, however. In October, 310,300 persons were registered as unemployed with AMS (Public Employment Service). Hence the seasonally adjusted unemployment rate remained unchanged at 8.6 percent.

1. Emerging market economies still lack upward momentum

The loss of momentum observed since last year in emerging market economies continued in the third quarter of 2014. China's economy, at +1.9 percent on a quarter-on-quarter basis did grow approximately as briskly as in the second quarter (+2.0 percent), but business surveys continue to show a lack of decisive impetus in the short term. Therefore, growth for the year 2014 as a whole is expected to remain below 7.5 percent. This would be the lowest annual rate recorded since the beginning of the boom in China in 1990 and would confirm the gradual flattening of the trend growth in recent years.

In India, the growth rate for both 2012 and 2013 stood below 5 percent, which was the lowest rate recorded in more than ten years. Growth is expected to remain modest also in 2014. In South America, signs of a crisis are emerging in Brazil and Argentina. In Brazil, GDP fell on a quarter-on-quarter basis in the first and the second quarter of 2014, with the special holidays declared on the occasion of the Soccer World Cup extremely depressing output in the second quarter, however. The Argentine economy was able to formally overcome the technical recession (GDP contraction in the fourth quarter of 2013 and the first quarter of 2014) in the second quarter when growth entered positive territory compared with the previous period, but the accelerated depreciation of the Argentine peso vis-à-vis the dollar (around -20 percent in January 2014) is likely to continue to weigh on domestic demand for some time to come.

Economic activity in Russia was weak already in 2013. In 2014, in addition to the economic slack, there is also the drag from economic sanctions in connection with the Ukraine crisis. Since the beginning of 2014, the Russian rouble has lost almost 20 percent of its external value vis-à-vis both the euro and the dollar. Although exports to Russia make up only 3 percent of Austrian exports, this market belongs to the 10 biggest buyers of Austrian goods.

Economic growth in China continues its slowing trend. Economic sanctions exacerbated the recession in Russia.

2. US economy posting vigorous growth

A weather-related disappointing result in the first quarter of 2014 (real GDP -0.5 percent compared with the previous quarter) was again followed by a sharp increase of 1.1 percent in the second quarter. GDP posted yet another sizeable expansion in the third quarter (+0.9 percent), according to preliminary calculations. Private consumption and fixed investment demand rose again vigorously. This higher domestic demand is likely to have been covered increasingly by domestic production, given

that imports shrank over the same period. This dampened the impetus provided by the USA for global economic activity in the third quarter.

Apparently a sustained firming of momentum became possible as a result of the economic policy measures taken during the crisis of 2008. Since then, unemployment has been declining slowly but steadily, in part also because of the drop in the labour force participation rate. The central bank saw itself confirmed in its expansionary monetary policy. As the unemployment rate dropped again below 6.5 percent and the inflation rate has exceeded 1.5 percent for several months now, the Fed recently wrapped up its bond-buying programme. The key interest rate continues to be around 0 percent, however.

In spite of the massive government debt, which with a share of GDP above 100 percent is markedly higher than that in the euro area (below 90 percent), US fiscal policy has not taken any considerably restrictive measures so far in 2014, since unlike the EU, it rather pursues economic policy objectives. While the national budget deficit is continuously shrinking due to the pick-up in activity, with a share of GDP of around 6 percent in 2014 it definitely exceeds that share in the euro area considerably (below 3 percent).

Business as well as consumer surveys suggest that the positive economic momentum will persist until the end of 2014.

In the USA, growth picked up sharply in the second and the third quarter of 2014. Monetary policy is gradually adopting a less expansionary stance on the back of modest inflation and favourable labour market developments, while fiscal policy has not taken any clearly restrictive steps so far this year.

3. Impetus to growth comes to standstill in euro area

The European economy has not yet reached a sustainable growth path. After the recession ensuing the financial crisis had been overcome in the euro area in 2013, the recovery witnessed around the turn of the year came again to a standstill, with available data (so far still based on the ESA 1995) pointing to stagnation in the second quarter of 2014. Household consumption posted only very weak growth, and fixed investment contracted. Nevertheless, extra-EU trade, which is less important for the euro area as a whole, encouraged modest economic growth. Exports grew somewhat more briskly at +0.5 percent in real terms on a quarter-on-quarter basis than imports (+0.3 percent).

The economic weakness becomes apparent especially in a downward trend of industrial production since April 2014. In August, the production index fell by 1.8 percent compared with July, and by 1.9 percent compared with a year before. The sharpest decline was recorded for the production of capital goods and intermediates. Business surveys in many euro countries point to a further slight dampening of economic activity, although the EU purchasing managers' index increased somewhat in October.

Inflation is decelerating further, reflecting lacking aggregate demand and the gradual decline in crude oil prices. According to Eurostat's flash estimate, euro area inflation was 0.4 percent in October 2014, slightly higher than in September (0.3 percent). Hence it has been 0.5 percent at the most for six months already and has therefore been persistently running below the target regarded by the ECB as consistent with price stability (2 percent). Having lowered the key interest rate to practically 0 percent already on 4 September, the ECB decided as a further measure to buy private-sector covered bonds.

The diminishing momentum for economic activity in the euro area is not yet reflected in an increase in unemployment. In September, the harmonised seasonally adjusted unemployment rate was 11.5 percent, unchanged from the three previous months and down from the 12 percent still recorded in September 2013. The youth unemployment rate was 23.3 percent in September, also somewhat lower than a year before (24 percent). However, the steady decline witnessed until August 2014 came to a standstill in September. Should the current economic weakness persist, the rate is likely to quickly rise again. The economic measures with a total value of € 300 billion announced by the new European Commission should therefore be implemented as soon as possible, however not without due consideration of the appropriateness of the individual projects over the long term.

The forces driving economic growth in the euro area strengthened at the beginning of 2014, but this trend did not persist. Domestic demand declined again, interrupting the tentative tendencies towards improvement.

Given the weakness of the real economy in the euro area, a potential resurgence of the problems in financial markets poses a heightened risk. The euro area economy still suffers from the effects of the 2008-09 financial crisis, which apparently has not yet been completely overcome. The most recent stress test the ECB conducted among 130 system-relevant banks in the euro area found 25 institutions to have an equity shortfall; of these, 13 have not been able so far to raise additional capital.

4. Austria's economy suffers from weak foreign demand

According to preliminary calculations, Austria's economy continued to lose momentum in the third quarter, with real GDP stagnating compared with the previous quarter. A gradual loss in economic momentum became apparent already in the first and the second quarter of 2014. Private consumption followed a persistently unfavourable trend (only +0.2 percent compared with the previous quarter). The tense labour market situation, the relatively high rate of inflation at 1.6 percent, and the substantial tax burden are dampening the purchasing power.

Businesses are once again reducing their investment activity on the back of the darkening economic outlook. Vehicle investment had still expanded sharply at the beginning of 2014 prior to the increase of NoVA (duty on new car purchases), but declined again in the third quarter, partly as a counter-reaction, partly on account of the difficult economic situation. Construction investment had also grown vigorously at the beginning of the year before declining again in the third quarter.

The absence of economic stimulus from abroad in recent years continues to have an effect on domestic demand. The lack of foreign demand dampens notably investment demand. With its longer duration, businesses increasingly no longer consider the phase of weakness to be a short-lived and quickly passing business cycle fluctuation. They might therefore react with sharper employment cuts than current economic growth would suggest. Matters are similar for investment demand and its financing possibilities.

The lack of impetus from foreign trade exerts a particular drag on a small open economy like Austria, given that it reacts more strongly to changes in the global economic cycle, posting above-average growth in times of favourable economic conditions, but below-average growth in phases of an economic slowdown. Austria's foreign trade is confronted with problems in almost all regions except North America. The euro area faces the risk of slipping back into a technical recession, and the economies of emerging market countries, having provided an important impetus in recent years (e.g., Brazil, Russia, India and China), are also growing at a slower pace.

The value of Austrian goods exports to euro countries increased by 1.4 percent in July 2014 compared with a year before, after -3.2 percent in June. It fell again sharply in August (-7.2 percent). Around half of Austrian exports go to this region. Developments were particularly unfavourable since the beginning of the year with respect to exports to Russia (-12.4 percent) and South America (-7.6 percent). Exports to Asia, by contrast, increased by 3.0 percent until August. Cumulated exports to North America rose by 6.9 percent, owing to lively economic activity there.

Until August 2014, of all the regions mentioned above, only exports to North America (above all to the USA) and to Asia contributed to an increase in Austrian exports. All the other regions made a negative contribution (Table 1).

This development is not so much a result of a lack of competitiveness of Austrian exports, but it also occurs in Germany, which is currently regarded as a highly competitive site of major industries and exports. In both countries, goods exports have posted similarly weak trend growth since the beginning of 2011 (Figure 2).

Industrial production, a sector that is particularly exposed to business cycle fluctuations (in open economies notably to economic influences from abroad), has been stagnant since 2011 both in Germany and Austria, with cyclical fluctuations apparently absent altogether (Figure 3).

The weakness of domestic demand is largely a result of the global economic slack. The duration of phases of economic weakness impairs the demand for labour and investment more strongly than their depth.

Austrian cumulated goods exports posting only 1 percent growth since beginning of 2014.

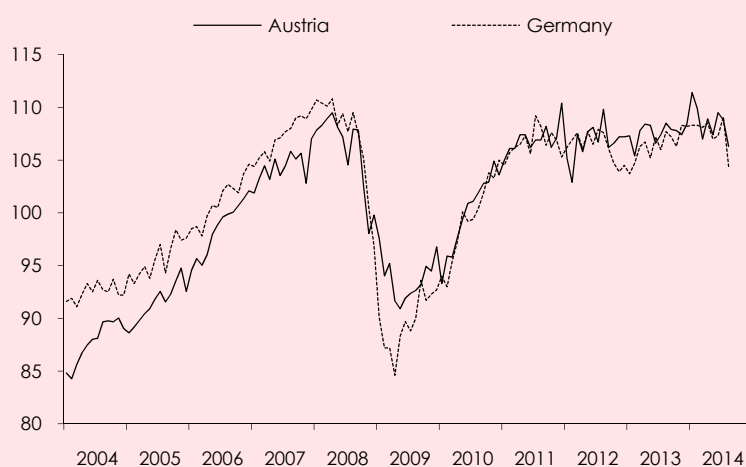
Table 1: Contribution of exports to growth, regional breakdown

		January to August 2014, cumulated Contribution to annual rate of change of nominal goods exports in percentage points
Euro area 18		- 0.10
North America		+ 0.48
South America		- 0.11
Asia		+ 0.28
Russia		- 0.35
Total exports	in percent	+ 1.0

Source: Statistics Austria.

Figure 2: Goods exports from Germany and Austria since 2004

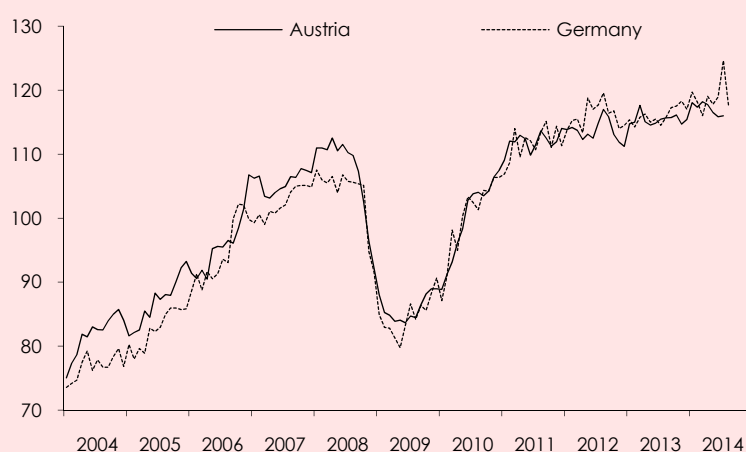
Seasonally adjusted



Source: Eurostat.

Figure 3: Index of industrial production in Germany and Austria since 2004

2010 = 100, seasonally adjusted



Source: Eurostat.

This difficult situation will persist at least until the end of 2014, as evidenced by leading indicators. WIFO's Leading Indicator, for instance, after continuously moving downwards in previous months, points to a further, albeit somewhat slower, decline also in October; there are still no signs that this trend is about to end. According to

the most recent analysis, the decline is largely attributable to the international components, while domestic components point in different directions.

Firms' assessment of their future business situation has not yet improved either, according to WIFO's most recent Business Cycle Survey. The derived seasonally adjusted index of business expectations did rise slightly on a month-on-month basis in October 2014, but this change lies within the normal fluctuation margin and therefore cannot be interpreted as a trend change.

Figure 4: 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.

4.1 Inflation easing modestly, consumption remains weak

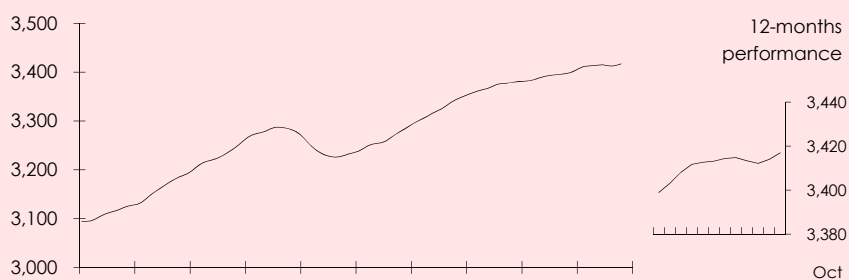
According to Statistics Austria, inflation climbed to 1.9 percent in June, the highest level recorded so far in 2014, and since then has been falling modestly from month to month. In September it stood at 1.6 percent. Inflation has been easing also in the euro area as a whole in recent months. However, the harmonised CPI for Austria, at 1.4 percent in September remained clearly above the euro area average of 0.3 percent.

The sharper rise in September was largely attributable to an increase in apartment rents. Above-average price increases were also registered in the "food and non-alcoholic beverages" and "restaurants and hotels" expenditure categories. Inflation was dampened especially by the "clothing and shoes" expenditure category.

Like in the euro area as a whole, inflation has recently begun to soften in Austria.

Figure 5: Key economic indicators

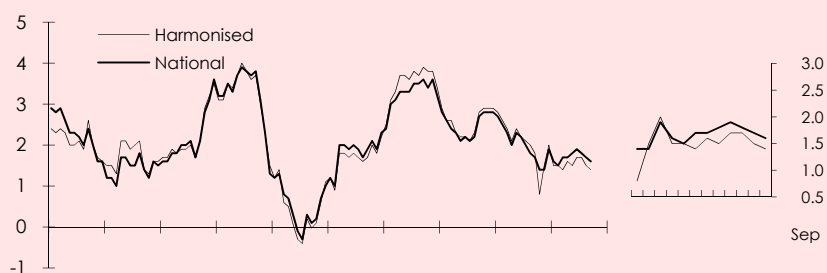
Persons in active dependent employment¹, (1,000), seasonally adjusted



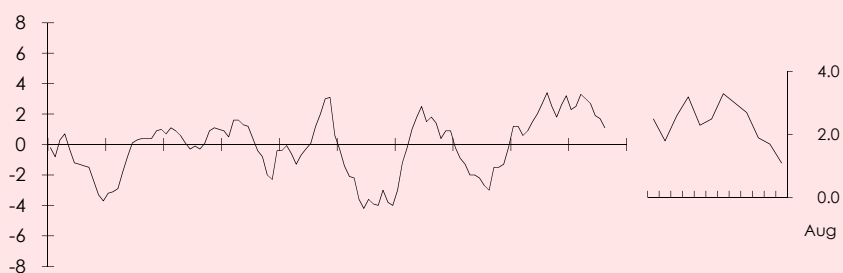
Unemployment rate, traditional Austrian method², seasonally adjusted



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. – 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.

Austrian consumers remain pessimistic about the future. The tense labour market situation, the modest income growth, and the worsened cyclical conditions continue to weigh on consumer confidence. Retailers' expectations for the months ahead are also gloomy, according to WIFO's Business Cycle Survey of October. These indicators point to a difficult environment for the coming Christmas business.

4.2 Labour market mirrors economic slack

According to data from the Association of Austrian Social Insurance Agencies, the number of people in dependent active employment in October 2014 probably rose by 19,000 (+0.6 percent) compared with a year before, and by 0.1 percent (seasonally adjusted) compared with September. Employment thus continued to rise moderately, notwithstanding the difficult economic situation.

Unemployment increased at the same time. In October 2014, there were 30,000 more people registered as unemployed with AMS (Public Employment Office) than a year before (+11 percent). The seasonally adjusted data for September and October show an acceleration of the increase: following a quarter-on-quarter increase by only 0.3 percent each in June and July, the number of unemployed people rose again by 0.6 percent and 0.5 percent, respectively, in September and October.

The unemployment rate was 8.1 percent in October, up 0.7 percentage point from October 2013. While the seasonally adjusted unemployment rate according to the Austrian method of calculation remained unchanged at 8.6 percent also in September and October, the rate calculated by Eurostat rose to 5.1 percent in September, an increase by 0.2 percentage point from the previous month.

Employment continues to grow moderately, notwithstanding the stagnation of the Austrian economy. However, the number of unemployed people is also rising.