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Slowdown Continues

Business Cycle Report of November 2012

As expected, weak global demand, especially in advanced economies, dampens world trade and production. Confidence indicators continue their downward trend or remain at low levels. Austrian companies expect production to stagnate and employment to decline.

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The world economic situation continues to weaken. In analogy to the decline in demand in advanced economies, world trade growth has been particularly weak of late. The three big economic areas USA, EU and East Asia face different problems: US equipment investment shrank in the third quarter, not least against the backdrop of economic policy imponderables ("fiscal cliff") in the coming year. In Europe, economic activity is dampened by austerity programmes prescribed in several countries and the unstable situation in the banking sector. Japan's economy suffers from the after-effects of the natural disasters that hit in 2011 and diplomatic tensions with China. China, on the other hand, is also experiencing a further slowdown in economic activity.

At the same time, however, private consumption keeps growing steadily in the USA, and real estate property is again increasing in value. In the EU, industrial production has not declined further lately, yet prospects remain dim. Germany, Austria's most important trading partner, is registering a slowdown in economic activity.

For Austria, leading indicators have not changed substantially since WIFO's latest forecast, negative assessments continue to prevail. Manufacturing is particularly affected, whereas the situation in the construction sector is somewhat better. The tourism industry is more optimistic about the short-term outlook. Employment growth has decelerated appreciably of late; unemployment has risen further, with the seasonally adjusted unemployment rate picking up slightly to 7.2 percent. Inflation accelerated noticeably in September, while it hardly changed for Austria's major trading partners. The strengthening of the euro in recent months has dampened the effects of the persistently high level of commodity prices, especially those of energy and food, on the Austrian economy.

World trade posted its weakest performance in more than a year (three-month moving average -0.1 percent compared with the previous period) in August. In the big economic areas USA, EU and Japan, imports are shrinking owing to subdued domestic demand, export developments are following different patterns: while exports increased recently in the EU, they declined in the USA. Japan's exports slumped against a backdrop of chilled diplomatic relations with China.

In Latin America and the Middle East, import demand is still growing, albeit at a slower pace, while exports are already falling. In addition to persistently weak import demand, Asia is now also experiencing a decline in exports.

The slowdown in world trade is reflected in developments of industrial production: in Japan, it contracted sharply recently, while in the EU, the USA, in Latin America and

World trade stagnating

Weak global demand, especially in advanced economies, is dampening world trade and production.

The USA is experiencing a decline in equipment investment and exports. Japan's industry is under pressure from chilled diplomatic relations with China.

in the Middle East stagnation continued. In the Asian countries, the expansion of industrial production stabilised at low levels, after strong growth in the summer months.

Owing to the severity of the preceding economic crisis, the US economy is recovering at a slow pace. Apart from weak global demand, domestic factors such as private households' lengthy debt reduction and political gridlock, which contributes considerably to uncertainty about the economic, fiscal and financial policy outlook, also play a role here: in the third quarter, equipment investment declined, industrial inventories increased, and exports fell for the first time in more than three years. Growth was also dampened by natural factors such as extensive crop failures, which led to an extremely sharp decline in agricultural stock levels. The fact that at +0.5 percent GDP nevertheless grew more strongly in the third quarter than in the second quarter (+0.3 percent) was on the one hand due to continuing robust private consumption and stable construction investment, both of which benefited from the pick-up in house prices, and, on the other hand, to the upturn in government spending, especially military spending, which contributed around one third to GDP growth. Consumer confidence has also picked up further lately, in tandem with the increase in assets and the improved job market.

Business confidence (as measured by the ISM Purchasing Managers' Index) is stagnating. Firms' investment restraint is not least due to the unclear economic policy situation: in case of legislative inactivity, restrictive fiscal measures amounting to more than 4 percent of GDP would automatically enter into force ("fiscal cliff") at the beginning of 2013 – an extent that would exceed the total structural budget cuts by the peripheral EU countries in 2011 and 2012 (around 3 percent of GDP)¹.

Economic developments in Japan remain fragile, with diplomatic tensions with China and the after-effects of the natural disasters that hit in 2011 weighing on the economy. The readings of the Central Bank of Japan's already low Tankan leading indicators partly declined for the third quarter; the purchasing managers' index dropped to its lowest level in the past 18 months.

Growth in China has been weakening since the fourth quarter of 2011. Although GDP expanded by 2.2 percent in seasonally adjusted quarter-on-quarter terms in the third quarter of 2012, the year-on-year increase was only 7.4 percent, the lowest in more than three years. As exports rose more strongly than imports, China's trade surplus widened further.

In August, the OECD Composite Leading Indicator provided mixed signals for the big emerging market economies: while it remained unchanged for China, it declined once more for India. Brazil, by contrast, is registering a steady upward trend.

Following a marked decline in industrial production in the EU as a whole and in the euro area earlier in the year, tentative signs of a slight improvement emerged in August, also in crisis countries such as Greece, Portugal, Spain and Ireland, among others. For the second time in a row, the three-month moving average growth rate for the EU as a whole as well as for the euro area came in slightly higher compared with the previous period. In Greece, production for the first time since the outbreak of the financial market crisis again exceeded the year-earlier level. However, the increase recorded in Ireland was smaller than the robust growth experienced in the summer months. Following a stabilisation of production, Portugal now recorded an increase in the three-month moving average. Spain was able to maintain its level. In France and Poland, the three-month moving average of industrial production stabilised for the first time after months of decline; in the UK, the downward trend was also halted for the time being. The indicator for Italy remains negative, albeit less so than of late.

Government spending supports growth in USA

Slowdown persists in China

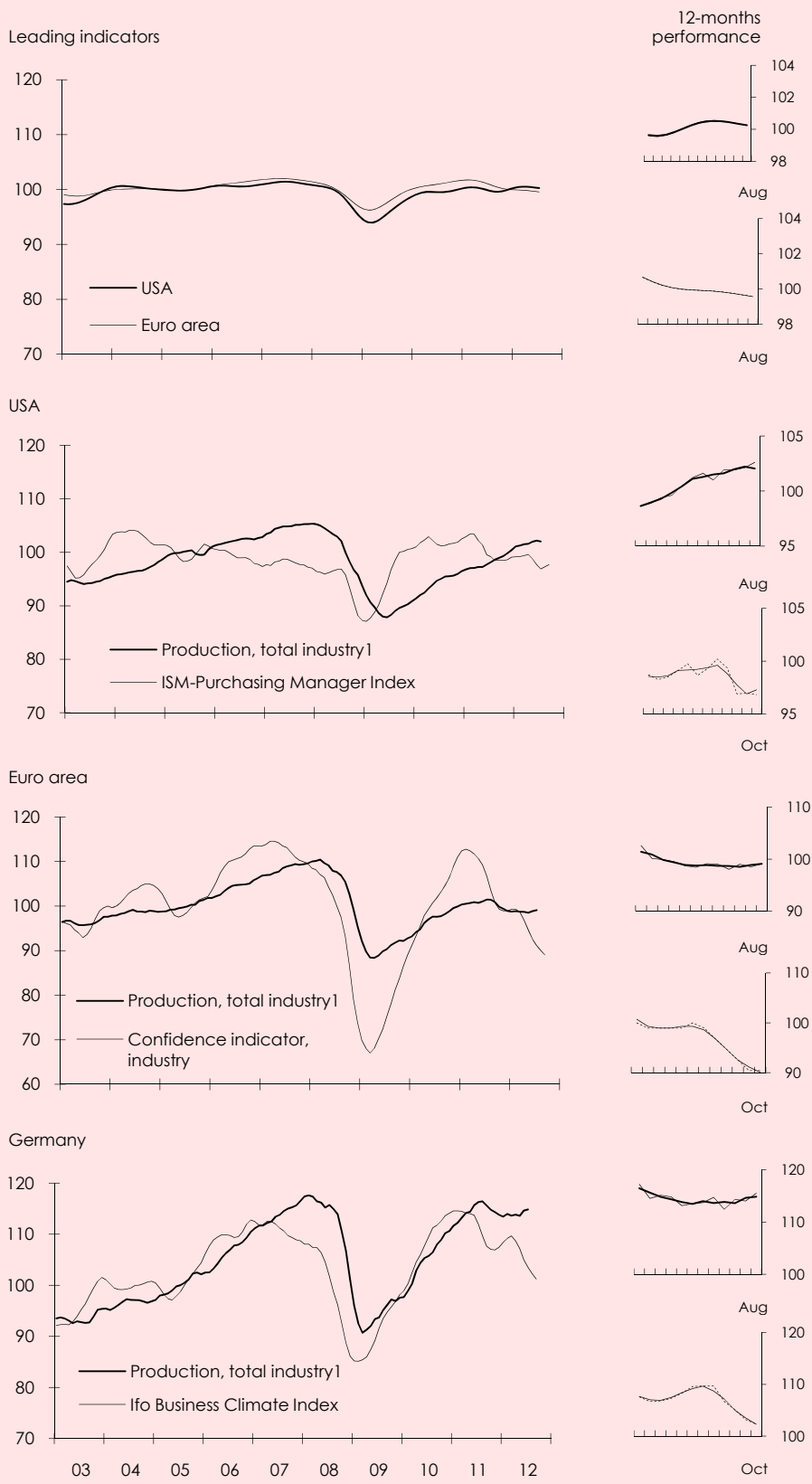
Slight rebound of EU industrial production

Production in the EU has not declined further recently; the situation has stabilised for the time being notably in the crisis countries on the euro area periphery. Unemployment remains extremely high in many countries.

¹ IMF, World Economic Outlook, Washington D.C., October 2012, p. 63ff, p. 69.

Figure 1: International business climate

Seasonally adjusted, 2005 = 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 sentiment regarding the economy (Economic Sentiment Indicator) continues to decline, however; in October it fell to its lowest level recorded in the last three years in the euro area. At 11.6 percent and 10.6 percent, respectively, both the euro area and the EU as a whole recorded the highest seasonally adjusted unemployment rate ever. The situation remains particularly critical in Spain (25.8 percent), Greece (July 25.1 percent), Portugal (15.7 percent) and Ireland (15.1 percent). The austerity programmes of these countries are connected with high social and economic costs especially in the labour market.

The spreads between interest rates on long-term government bonds issued by euro area countries and by Germany have been decreasing since the summer. The interest rates for 10-year German, Dutch, Finnish and Austrian bonds recently were close to, or below 2 percent, respectively, while for France and Belgium they were below 3 percent, for Ireland and Italy just under 5 percent, for Spain and Slovenia under 6 percent; interest rates were higher for 10-year Portuguese, Cypriot and Greek bonds.

While the ECB's conditional readiness to defend some countries against speculative attacks on financial markets has been accompanied by an easing of refinancing conditions, the capital flight problem does not appear to have been averted yet. Between June 2011 and June 2012, capital flight from Spain reached 27 percent of that country's GDP, while in the case of Italy it amounted to 15 percent of GDP². According to the ECB, bank deposits held by non-euro area investors decreased further on euro area average between January and September 2012. Developments differed considerably across countries: Germany (since January € +24 billion or +3 percent) and Finland (€ +23 billion or +14 percent) recorded above-average inflows, while the situation in Ireland, where deposits from third countries are of great importance, stabilised. But above-average capital outflows to third countries were registered not only by Spanish banks (€ -49 billion or -20 percent), but also by banks in the Netherlands (€ -71 billion or -13 percent), Luxembourg (€ -26 billion or -8 percent) and Austria (€ -16 billion or -17 percent). For the most part these outflows started when rating agencies downgraded banks in these countries in the summer (in the case of Austrian banks because of their high involvement in the East and their low equity ratios). Greece saw the capital flight to third countries decelerate.

In the Netherlands, Luxembourg and Austria, capital outflows are offset by an increase in deposits from the euro area³. German banks are recording the strongest inflows, however (€ +105 billion or +9 percent since the beginning of the year). But Italian and Spanish banks have also registered slight gains again since early in the year.

Commodity prices expressed in euros fell for a second straight time on a month-on-month basis in October. On the one hand this was the result of a strengthening of the euro in recent months, but the price increase in dollar terms was also halted for the time being. A longer-term comparison shows persistently high world market prices notably of crude oil and food. Overall, HICP inflation in the euro area remains stable at 2.5 percent and thus above the ECB's medium-term target of inflation rates of "below, but close to, 2 percent".

Germany's economy is deteriorating. Following the decline in confidence indicators, real economic indicators are now also pointing down, according to IMK. The DIW economic barometer also suggests yet a further weakening in the fourth quarter. Ifo's Business Climate Index fell for the sixth consecutive time in October. In the first

Euro area: mixed signals from financial markets

The strengthening of the euro interrupted the upward drift in commodity prices. Overall, energy and food prices remain high, however.

Export outlook darkening

² IMF, Global Financial Stability Report, Washington D.C., October 2012, p. 26ff.

³ Demand deposits held by private households, non-financial corporations and the public sector excluding the central state: the Netherlands € +24 billion or +9 percent since January 2012, Luxembourg € +17 billion or +13 percent, Austria € +10 billion or +9 percent.

half of the year, notably net exports contributed positively to growth in Germany, whereas domestic demand (in particular investment) stagnated.

Italy's GDP is contracting; private demand is weak, not least owing to the restrictive fiscal policy. While confidence indicators signal a slight improvement of the situation, a return to the growth path is not yet in sight.

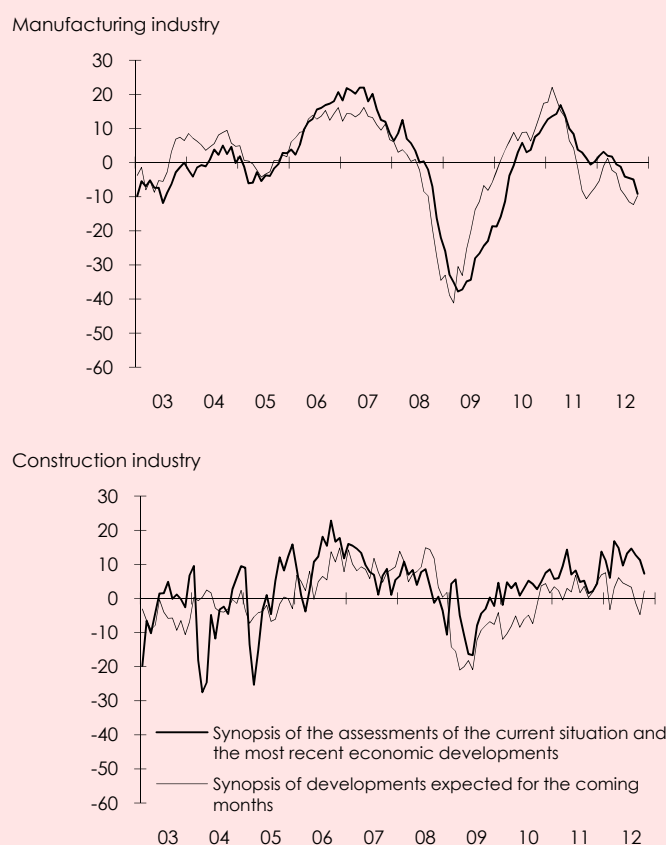
In Switzerland, the economic recovery has been subdued overall, but domestic demand and imports are growing at a steady pace. The continuous rise of the KOF Economic Barometer of ETH Zurich levelled off in October.

This development is reflected in Austria's foreign trade: from January to July, the trade in goods with member states of the European Union already declined compared with the same period a year before (exports € -0.3 billion, imports € -0.7 billion); however, thus far this has been offset by a sharper increase in the trade with non-EU countries (exports € +1.8 billion, imports € +2.1 billion).

The majority of Austria's key export markets are experiencing a deterioration of economic activity. Domestic companies expect production to stagnate and employment to decline. The labour market has cooled recently. Inflation rose noticeably in September.

Figure 2: Results from the WIFO Business Cycle Survey

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



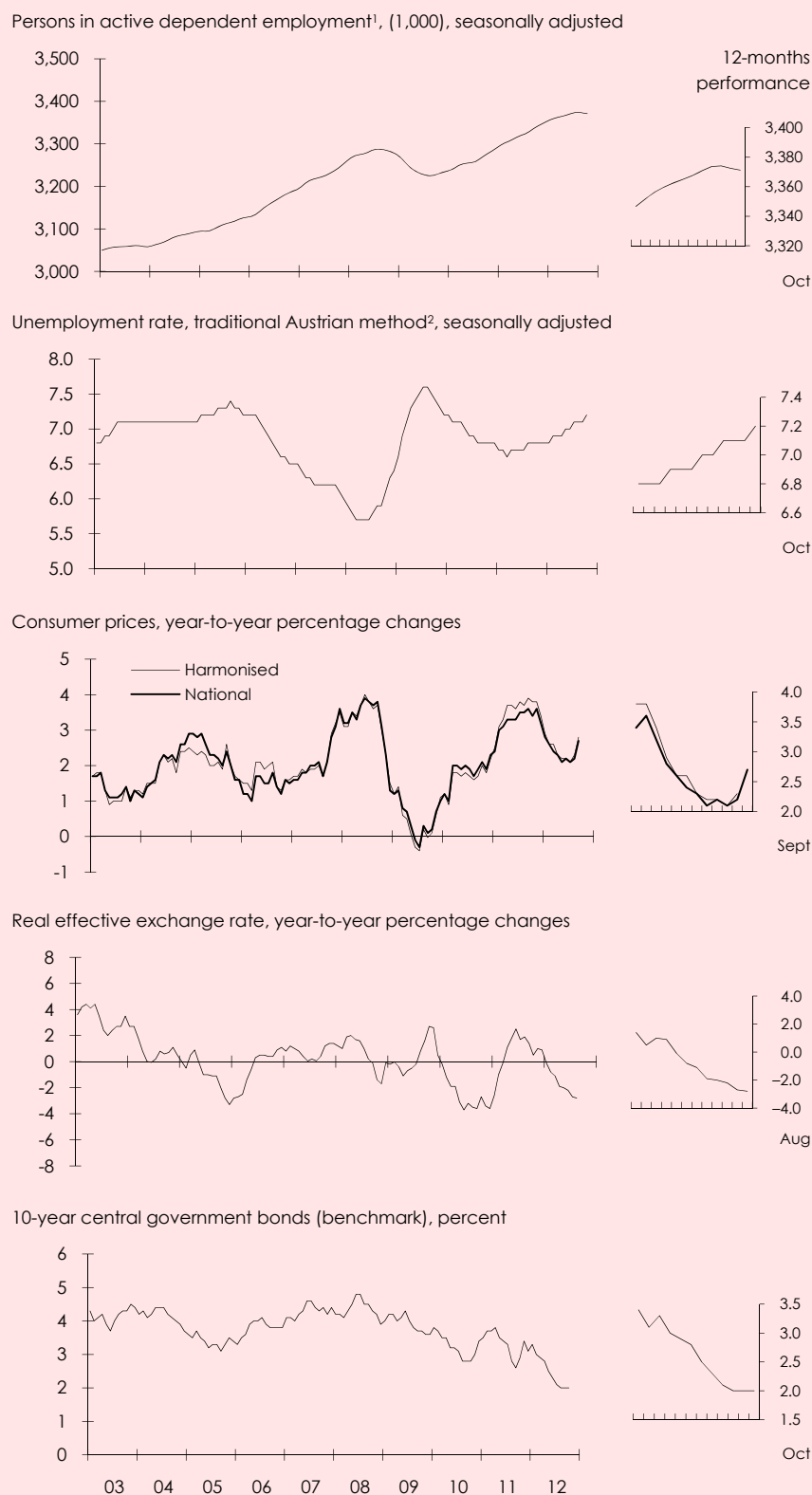
Source: WIFO Business Cycle Survey. Data refer to index points (percentage points) between +100 and -100. Values above 0 imply positive expectations, values below 0 indicate negative expectations.

On the basis of three-month moving averages, industrial production until August showed positive, albeit declining, rates of change. The outlook based on leading indicators has darkened further, however. The slowdown in manufacturing activity persists, according to WIFO's October Business Cycle Survey, with companies expecting a slight increase in selling prices in the coming months amid stagnating production and declining employment. The production of consumer goods is most severely affected, while capital goods manufacturers give a less pessimistic assessment of the situation. Construction firms are more optimistic, although they, too, expect a decline in employment in the coming months that will go beyond seasonal

WIFO Business Cycle Survey: further slowdown of economic activity

effects. The situation in the services sector stabilised in October, but assessments remain predominantly negative. An improvement in the outlook has been registered for the hotel and restaurant sector, however.

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.

Methodological Notes and Short Glossary

Period comparisons

Time-series comparisons with the previous period, e.g., the previous quarter, are adjusted for seasonal effects. They also include effects that result from a different number of working days in the period (e.g., Easter). In the text, reference is made to "seasonally and working day adjusted changes".

The phrase "changed compared with a year before . . .", on the other hand, describes a change compared with the same period a year before and refers to unadjusted time series.

The analysis of the seasonally and working day adjusted development provides more precise information about the actual course of economic activity and shows turning points sooner. However, the data are subject to additional revisions as seasonal adjustment is based on statistical methods.

Average rates of change

The time given refers to the initial and the final value of the period of computation: hence the average rate 2005-2010 comprises as the first rate of change that from 2005 to 2006, and as the last that from 2009 to 2010.

Real and nominal values

In principle, the values shown must be understood as real values, i.e., adjusted for price effects. Whenever values are shown as nominal values (e.g., foreign trade statistics), this is specifically mentioned.

Production sector

This term comprises the NACE-2008 sections B, C and D (Mining and Quarrying, Manufacturing, Energy Supply) and is here used in an international comparison.

Inflation, CPI und HICP

The inflation rate measures changes in consumer prices compared with a year before. The Consumer Price Index (CPI) is a measure of national inflation. The Harmonised Index of Consumer Prices (HICP) is the basis for comparable measurement of inflation in the EU and for the evaluation of price stability in the euro area (see <http://www.statistik.at/>).

Core inflation as a monetary policy indicator is not clearly defined. WIFO follows the common practice of using the inflation rate excluding the product categories unprocessed food and energy for core inflation. Thus just under 87 percent of the goods and services contained in the consumer price index (CPI 2010) are included in the calculation of core inflation.

WIFO Business Cycle Survey and WIFO Investment Survey

The WIFO Business Cycle Survey is a monthly survey in which around 1,100 Austrian firms are asked to assess their current and future economic situation. The WIFO Investment Survey is conducted twice a year, asking companies about their investment activity (<http://www.konjunkturtest.at/>). The indicators are balances between the positive and negative responses expressed as a percentage of the total number of firms sampled.

Unemployment rate

Austrian national definition: The number of persons registered as job seekers with the Public Employment Service expressed as a percentage of the dependent labour force. Labour force is the sum of the unemployed and the persons in dependent employment (measured in standard employment relationships). Database: registrations with the Public Employment Service (AMS) and Association of Austrian social insurance agencies.

Definition according to ILO and Eurostat: Any person who is not gainfully employed and is actively seeking work is considered unemployed. Gainfully employed persons comprise all persons who during the reference week worked for at least one hour in a self-employed capacity or in paid employment. Persons receiving child-care benefit and apprentices are classified as gainfully employed, whereas persons in military service or persons carrying out alternative service are not. The unemployment rate is the number of unemployed persons expressed as a percentage of the total labour force (unemployed persons plus gainfully employed persons). Database: data from household surveys ("Mikrozensus").

Terms used in connection with the national definition of the unemployment rate

Persons in training: Persons who at a set date are enrolled in AMS (Public Employment Service) training programmes. When calculating the unemployment rate, their number is not taken into account either in the denominator or in the numerator.

Persons in dependent active employment: "Persons in dependent employment" include persons receiving child-care benefit, as well as persons in military service with a valid employment contract. By deducting their number one arrives at the number of "persons in dependent active employment".

The increase in the number of people in dependent active employment slowed down noticeably in October to just 1 percent compared with a year before (since August 2010 +1.7 percent per month on average); in seasonally adjusted terms, employment remained unchanged from a month before. At the same time the number of unemployed persons increased further: in October, the number of people registered as unemployed rose by 14,906 compared with a year before. The seasonally adjusted unemployment rate picked up slightly to 7.2 percent. But the number of people enrolled in vocational training programmes also continued to rise. Overall, in October, 22,426 more people were without a job than a year before.

Employment growth is slowing

Having dropped to 2.1 percent earlier this year, inflation surged to 2.7 percent in September and was thus about as high as at the beginning of the year. While price dynamics in the energy, housing, transport and food categories remain persistently high compared with a year earlier (especially in the case of mineral oil products), there are barely any signs of a further acceleration in month-on-month terms. The increase is therefore not attributable to aggravated inflation in these groups, but rather the result of a spreading to other product groups such as industrial goods (in particular clothing and shoes). International factors are assumed to have barely played a decisive role in the relatively strong price increase, especially given that key trading partners recorded hardly any change in the inflation rates in these commodity groups. Price increases of daily purchases (+3.1 percent) and of weekly purchases (+4.3 percent) continue to exceed CPI inflation.

Inflation rising markedly

From May to September 2012, tourism sales posted a year-on-year increase of 2.5 percent, according to provisional calculations, but stagnated in real terms. At the same time the number of nights spent increased, hence travellers made use of cheaper offers. In the summer season as a whole (April to October), real expenditure per night spent is likely to have been one-tenth below the level recorded in 2000.

Gains in tourism owing to foreign demand

The increase in the number of nights spent (April to September +2.7 percent, compared with the same period a year before) was largely attributable to the demand from abroad (+3.6 percent); by contrast, the nights spent by domestic travellers exceeded the year-earlier level by a mere 0.6 percent. While the number of guests from the three most important source countries Germany, the Netherlands and Switzerland continued to rise, the number of guests from Italy and Belgium declined. This development is largely in line with the economic situation in the respective countries. In addition, the influx of visitors from Russia (+18.9 percent) and the USA (+7.4 percent) was particularly strong, while at the same time the demand from Romania collapsed by one-tenth.