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Economy Improving at Modest Pace

Business Cycle Report of December 2013

GDP grew at a seasonally and working day adjusted rate of 0.2 percent in the third quarter, compared with the previous quarter. Hence the upturn set in at only a modest pace. In the EU countries, economic activity remains sluggish and uneven. Weak price dynamics prompted the European Central Bank to cut its benchmark interest rate.

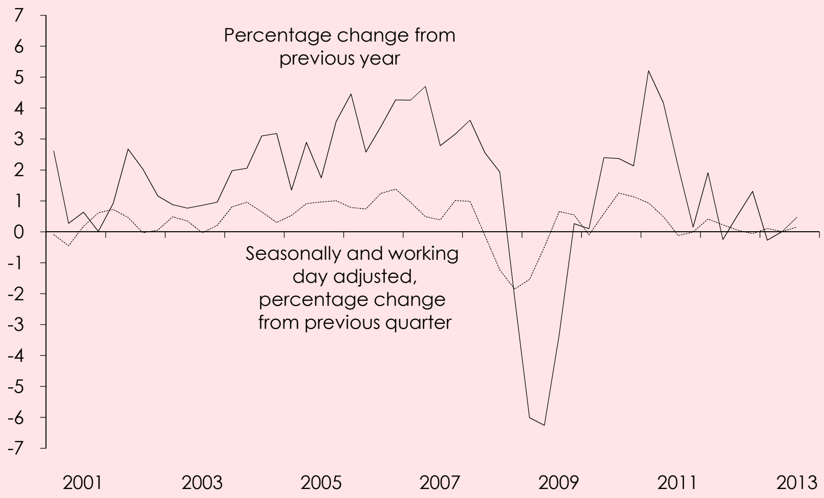
For definitions of terms used, see "Methodological Notes and Short Glossary", http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf • All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Data processing: Christine Kaufmann, Martha Steiner • Cut-off date: 5 December 2013. • E-mail address: Stefan.Schiman@wifo.ac.at

The slight fall in the euro exchange rate as a result of the European Central Bank's cut in the benchmark interest rate on 13 November 2013 has for the most part already been offset by the persistently loose monetary policy pursued by the USA and Japan. World trade has remained subdued recently. The emerging market economies, whose import demand had been dampened by capital outflows, provided again a stronger stimulus to foreign trade in September.

In the USA, the upturn accelerated in the third quarter, with notably private consumption and investment contributing to the expansion. The growth in demand from federal states and municipalities for the first time compensated for the restraint by the central government caused by the automatic budget cuts. Although the unemployment rate is trending down, the central bank so far has fully maintained its loose monetary policy. This is supposed to preserve investor confidence despite the uncertainty created by fiscal policy. In financial markets, a tightening of monetary policy in the form of higher yields on government bonds outstanding was already anticipated. In Japan, growth forces shifted: while in the first half of 2013 private consumption and exports had still expanded at a vigorous pace on the back of the strong depreciation of the yen and the associated wealth effects, growth in the third quarter was driven primarily by investment. Sentiment indicators are developing favourably, but deflation has not yet been overcome.

In the EU, economic activity remains sluggish and uneven. Germany and France saw momentum weaken noticeably in the third quarter of 2013; by contrast, the pace of GDP contraction slowed in Italy, and Spain pulled out of recession. In the Netherlands, private consumption continued to decrease markedly as high levels of household indebtedness coincided with declining wealth and a restrictive budget policy; investment, by contrast, expanded vigorously. In the UK, the upturn continued. Euro area inflation averaged 0.7 percent in October, its lowest level ever, apart from the crisis year 2009. Easing commodity prices and weak (in part negative) wage developments in several EU countries dampened price dynamics. As a consequence, the ECB cut its benchmark interest rate from 0.5 percent to 0.25 percent as from 13 November. The unemployment rate in the euro area remained high at 12.1 percent in October.

Figure 1: Growth of real GDP



Source: WIFO.

Table 1: Quarterly national accounts

	2012 Second quarter	2012 Third quarter	2012 Fourth quarter	2013 First quarter	2013 Second quarter	2013 Third quarter
	Percentage changes from previous quarter					
Adjusted for seasonal and working day effects, volume						
Final consumption expenditure	– 0.1	– 0.3	– 0.2	+ 0.1	+ 0.2	+ 0.1
Households[1]	– 0.0	– 0.1	– 0.1	– 0.0	+ 0.1	+ 0.1
General government	– 0.2	– 0.3	– 0.1	+ 0.1	+ 0.2	+ 0.4
Cross capital formation	– 0.2	– 0.3	– 0.5	– 1.0	– 0.9	– 0.3
Gross fixed capital formation	– 0.1	– 0.3	– 0.5	– 0.4	+ 0.1	+ 0.2
Machinery and equipment	– 0.5	– 1.5	– 1.1	– 0.4	+ 0.0	+ 0.1
Construction	+ 0.7	+ 0.7	+ 0.3	– 0.2	+ 0.1	+ 0.3
Exports, goods and services	+ 0.7	+ 0.8	– 0.0	+ 0.4	+ 0.3	+ 0.4
Goods	+ 0.9	+ 0.7	– 0.8	+ 0.2	+ 0.2	+ 0.3
Services	+ 1.0	+ 1.0	+ 0.8	+ 0.8	+ 0.7	+ 0.7
Imports, goods and services	– 0.2	– 0.1	– 0.2	– 0.1	+ 0.1	+ 0.2
Goods	– 0.2	+ 0.1	– 0.5	– 0.1	+ 0.2	+ 0.3
Services	+ 0.9	+ 0.5	+ 1.0	+ 0.3	– 0.5	– 0.2
Gross domestic product	+ 0.2	+ 0.0	– 0.1	+ 0.1	+ 0.0	+ 0.2
Manufacturing	+ 0.3	– 0.8	– 0.6	+ 0.0	+ 0.3	+ 0.4

	2011	2012	2012 Second quarter	2012 Third quarter	2012 Fourth quarter	2013 First quarter	2013 Second quarter	2013 Third quarter
			Percentage changes from previous year					
Volume, chained prices								
Final consumption expenditure	+ 0.7	+ 0.4	+ 0.5	– 0.3	– 0.8	– 1.6	– 0.5	+ 0.3
Households[1]	+ 0.8	+ 0.5	+ 0.8	+ 0.1	– 1.1	– 1.2	– 0.9	+ 0.1
General government	+ 0.3	+ 0.2	– 0.5	– 1.5	+ 0.2	– 2.8	+ 0.6	+ 0.9
Cross capital formation	+ 12.2	– 1.2	– 4.0	– 3.8	+ 7.1	– 5.0	– 5.7	– 2.2
Gross fixed capital formation	+ 8.5	+ 1.6	+ 2.7	+ 0.7	– 0.1	– 3.8	– 1.0	+ 0.0
Machinery and equipment	+ 14.3	+ 2.1	+ 6.7	– 4.1	– 2.1	– 8.1	– 2.0	– 1.2
Construction	+ 2.5	+ 2.5	+ 1.7	+ 5.4	+ 1.4	+ 0.9	– 0.2	+ 0.7
Exports, goods and services	+ 6.6	+ 1.2	+ 0.7	+ 2.0	+ 0.4	+ 2.0	+ 3.3	+ 1.9
Goods	+ 8.1	+ 0.4	– 0.4	+ 1.0	– 0.4	+ 0.8	+ 3.4	+ 1.6
Services	+ 2.8	+ 3.3	+ 4.2	+ 4.7	+ 2.5	+ 4.6	+ 3.1	+ 2.6
Imports, goods and services	+ 7.6	– 0.3	+ 0.2	– 1.7	– 0.2	– 1.3	– 0.0	+ 0.8
Goods	+ 8.6	– 1.4	– 1.6	– 2.4	– 1.4	– 1.8	+ 0.0	+ 0.6
Services	+ 3.8	+ 4.5	+ 7.7	+ 1.2	+ 5.3	+ 1.0	– 0.3	+ 1.1
Gross domestic product	+ 2.8	+ 0.9	– 0.3	+ 0.5	+ 1.3	– 0.3	+ 0.0	+ 0.5
Manufacturing	+ 8.3	+ 1.2	+ 0.1	+ 0.9	+ 0.8	– 1.9	+ 0.8	+ 2.3
Gross domestic product, value	*+ 4.9*	*+ 2.6*	*+ 1.1*	*+ 2.4*	*+ 3.6*	*+ 2.0*	*+ 1.7*	*+ 1.9*

Source: WIFO. – [1] Including private non-profit institutions serving households.

The Austrian economy improved modestly in the third quarter of 2013. Investments declined at a slower pace, growth of private consumption and exports remained sluggish. Austrian businesses are modestly optimistic, according to WIFO's Business Cycle Survey. The weakness in consumption also had an adverse impact on summer tourism: the number of overnight stays rose solely as a result of increased foreign demand (especially from the Anglo-American region and Eastern Europe). The effects of the easing of oil prices can also be felt in Austria: the inflation rate fell to 1.4 percent in October. The positive gap vis-à-vis the euro area, but also vis-à-vis Germany, is maintained due to the higher core inflation dynamics. The seasonally adjusted unemployment rate, at 7.9 percent, stagnated at a high level in November.

Loose monetary policy determines exchange rate developments

The yen and the dollar have recently continued their downward trend vis-à-vis the euro and the pound sterling.

The loose monetary policy pursued by the USA and Japan continues to determine exchange rate developments. The moderate decline in the euro-dollar exchange rate after the ECB cut the benchmark rate on 13 November has been largely offset again, with the exchange rate recently exceeding 1.35 dollars per euro. The upward trend of the euro exchange rate that began in mid-2012 when the monetary policy easing in the USA was intensified has not yet come to a halt. The pound sterling also continued to gain value; at just under $ 1.65 recently, the exchange rate was already higher than before the depreciation at the beginning of this year. By contrast, the Japanese yen, which had depreciated sharply already at the beginning of 2013, continued to loose value vis-à-vis the dollar recently.

World trade expanded at a more vigorous pace in September, but a longer-term comparison shows a persistently weak growth momentum. The emerging market economies again provided stronger stimulus to foreign trade; the negative effects of the capital outflows in early summer are likely to have weakened.

USA upturn accelerated

Domestic demand in the USA expanded at a brisk pace in the third quarter. The continuous decline in demand at the federal government level was offset at the state and local levels.

Economic activity in the USA accelerated further in the third quarter of 2013, with real GDP growing by 0.9 percent compared with the previous quarter. Domestic demand remains the basis of the upturn. Private consumption expanded at a robust pace. Investment grew markedly, with inventory accumulation playing a major role in this context. Public sector demand, which had declined since the autumn of 2012 as a result of the budget restrictions, had a stabilising effect in the third quarter. The economic stimulus provided by the central government remained negative, but growing public sector demand at the state and local levels offset this decline.

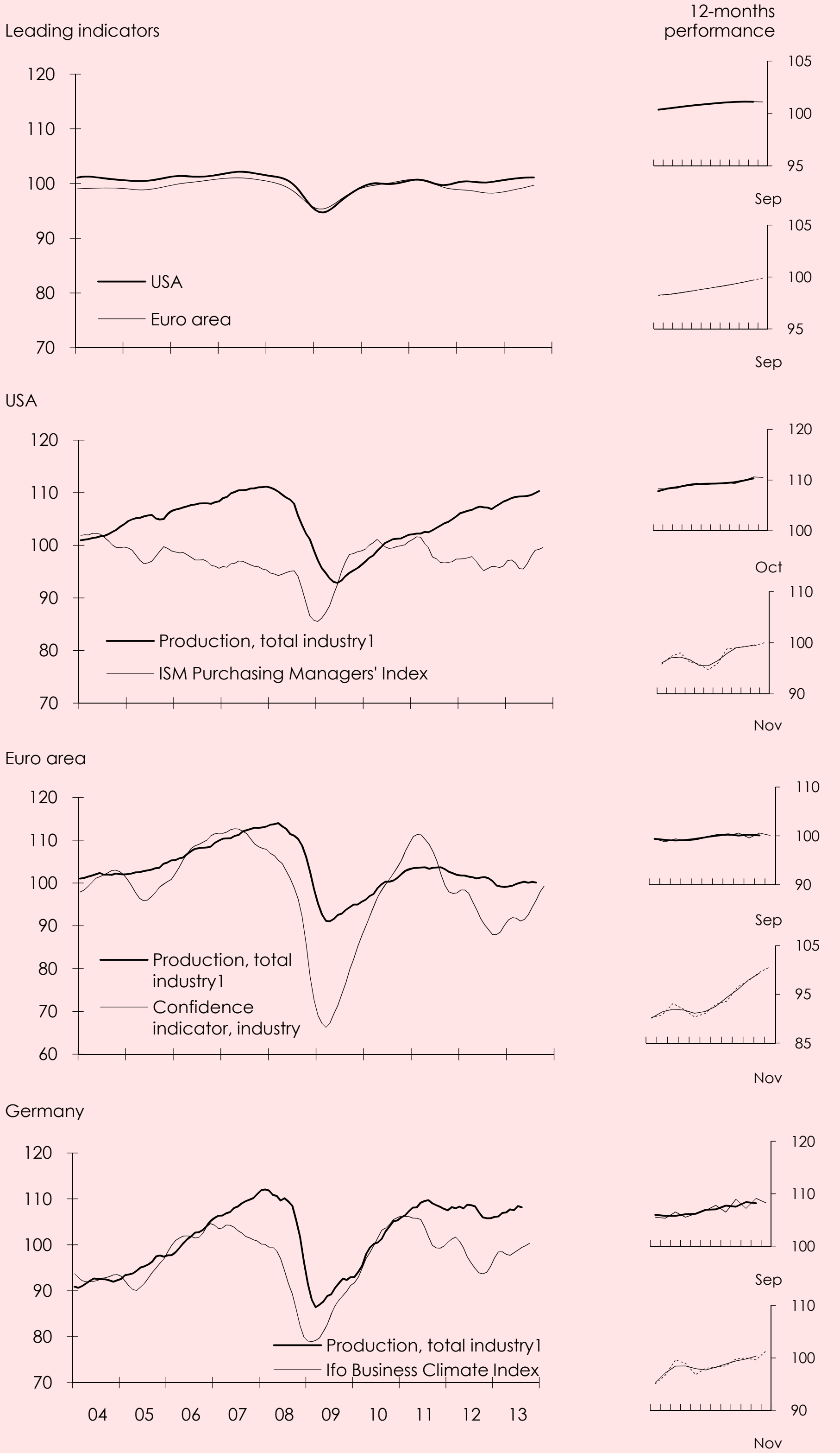
The recovery of the real estate market remains on track: building permits and house prices have kept rising recently. The Conference Board Consumer Confidence Index did decline again in November, but the longer-term upward trend has not yet been interrupted.

The Fed so far has not scaled back its bond purchases, despite the decline in the unemployment rate. But financial markets already anticipated a tightening, long-term government bond yields increased.

The central bank's third bond-buying programme has been under way since September 2012; under this programme, the Fed buys $ 85 billion in treasury and mortgage bonds per month. In May, hints by central bank chairman Ben Bernanke that the Fed was going to tighten its monetary policy triggered strong shifts in global capital flows. But the bond-buying programme has been fully continued since then, although the seasonally adjusted unemployment rate – a central indicator of monetary policy within the "Forward Guidance" framework – has declined further: it fell from 7.6 percent in June to 7.3 percent in October. The downward trend of the unemployment rate – unlike in the EU – has persisted since mid-2011, but this is not attributable exclusively to an improved employment situation: there has been little momentum in the labour supply, the labour force participation rate was 1 percentage point lower in October compared with a year before (62.8 percent). For this reason, and to counteract the uncertainty caused by fiscal policy, quantitative easing is being maintained. Meanwhile, the target of raising the benchmark interest rate as soon as the unemployment rate falls below 6.5 percent has been qualified. Nevertheless, financial markets already anticipated the expected tightening of monetary policy: the yields of US Treasury bonds with a maturity of 10 years have risen to levels between 2.5 and 3 percent since June 2013, after hovering in the low range of 1.5 to 2 percent following the extension of "Operation Twist" in June 2012 and the subsequent third round of quantitative easing. Price developments are not an obstacle to the persistent easing of monetary policy: inflation declined to 1.0 percent in October.

Figure 2: 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.

Japan: growth forces are shifting

In Japan, private consumption and exports, which had fuelled growth in the first half of the year, lost considerable momentum in the third quarter. Investment supported the upturn.

In Japan, the expansion moderated in the third quarter of 2013, but with GDP growing by 0.5 percent quarter-on-quarter remained robust. Growth forces shifted, the effects of the depreciation and of the simultaneous increase in wealth weakened: Exports declined compared with the previous quarter, and private consumption stagnated. Growth in the third quarter was driven predominantly by construction investment. But public-sector investment also increased vigorously, helped by the expansionary fiscal policy.

The sentiment indicators (Tankan indices) rose further in the third quarter. Notably big businesses preponderantly expect their economic situation to improve. This is probably not least a result of the expectation that consumers will bring forward some purchases in anticipation of the VAT increase planned for April 2014. Expectations of price increases have not yet firmed, wages and the GDP deflator declined again in the third quarter.

The economic momentum in China barely changed in November, according to the Purchasing Managers' Index compiled by the HSBC Bank and the data provider Markit. GDP growth accelerated to 2.2 percent, quarter-on-quarter, in the third quarter.

Economic activity in EU still weak and uneven

Germany and France saw economic activity weaken in the third quarter. The pace of GDP contraction in Italy slowed, and Spain pulled out of recession. The UK experienced ongoing expansion.

In Germany and France, the two largest economies in the euro area, activity lost momentum in the third quarter: after still growing by 0.5 percent in the second quarter, economic output contracted moderately in France. Exports declined noticeably. In Germany, GDP advanced by 0.3 percent, following extraordinarily high growth of 0.7 percent in the second quarter. Private consumption, which had picked up in the first half of the year, stagnated again. Investment growth remained persistently high. Italy's economy contracted further (–0.1 percent), but the pace of the decline has been slowing for a year. With modest GDP growth of 0.1 percent in the third quarter, Spain is assumed to have pulled out of a two-year recession. Following a year of recession, the Netherlands registered a moderate increase in economic output compared with the previous quarter (+0.1 percent), owing to a further sharp increase in investment in the third quarter. Private consumption continued to decline markedly (–0.5 percent) on the back of the high level of household indebtedness, declining wealth and the restrictive budget policy. The UK economy gained momentum: activity expanded by 0.8 percent in the third quarter, after +0.7 percent in the second quarter. Rising wealth supported private consumption, but growth in public-sector demand also contributed to the upturn. With real estate prices picking up, the central bank stopped the purchase of mortgage-backed securities and put the focus of the bond-buying programme entirely on small and medium-sized businesses.

Business confidence has improved; firms in the UK are particularly optimistic. The unemployment rate in the EU remains high.

The upward trend of the German Ifo Business Climate Index observed over the past year intensified in November. But unlike in previous periods of economic upturn, trend interruptions occurred, indicating considerable downward risks. The European Commission's Sentiment Indicator improved further in November. The indicator for Germany has been exceeding its long-term average already since July, while the indicators for France, Italy, Spain and the Netherlands are still lower than their average levels. The indicator for the UK surged in summer and has stayed at this very high level since.

In October, the unemployment rates were 10.9 percent in the EU as a whole, and 12.1 percent in the euro area. They have thus remained at extremely high levels since the beginning of the year.

ECB cuts interest rate amid weak price dynamics

The economic slowdown in emerging market economies noticeably curbed commodity price inflation. This easing has been increasingly working its way through to consumer prices in advanced economies: inflation in the euro area fell to 0.7 percent in October 2013, the lowest level since the crisis year 2009[1]. This decline was largely driven by the year-on-year fall in energy prices of 1.7 percent. The upward

[1] The flash estimate puts inflation at 0.9 percent in November.

drift in prices of food, alcoholic beverages and tobacco also diminished (+1.9 percent; until August 2013 above +3 percent). Owing to wage pressures in the peripheral countries of the euro area, core inflation also eased further: excluding energy and unprocessed food, inflation stood at only 1.0 percent in October. Some of those euro countries where wages are under great pressure owing to economic policy targets and the absence of the possibility of depreciation are in deflation: in October, consumer prices fell by 1.9 percent in Greece, and by 0.5 percent and 0.1 percent, respectively, in Cyprus and Ireland. They stagnated in Spain and Portugal. Inflation in the EU as a whole averaged 0.9 percent, in particular owing to stronger inflationary pressures in the UK (October +2.2 percent).

Euro area inflation fell to 0.7 percent in October, the lowest level since the crisis year 2009. Weak wage dynamics as well as easing energy prices were the main drivers behind this decline.

The easing of inflation prompted the European Central Bank to lower its main refinancing operations rate from 0.5 percent to 0.25 percent with effect from 13 November 2013. At the same time it reduced the interest rate on the marginal lending facility to 0.75 percent from 1 percent. The interest rate on the deposit facility was left unchanged at 0 percent. This action on interest rates did not come unexpectedly: the yields on long-term government bonds of Portugal, Spain, Italy and Ireland had registered declines of around 0.5 to 1.5 percentage points already since mid-September. Before the ECB cut the benchmark interest rate also by 0.25 percentage point in the spring, similarly sized declines in yields had been recorded. This decline was largely offset again over the summer, when expectations of a tightening of monetary policy in the USA prompted capital outflows from higher-interest bonds. The yield differentials, which mirror the differences in risk, remained largely unchanged: Portuguese government bonds recently traded at around 6 percent, those of Spain and Italy at around 4 percent, and Irish bonds at around 3.5 percent. Greek bond yields still stand above 8 percent.

In mid-November the ECB lowered the benchmark interest rate from 0.5 percent to 0.25 percent. The yields on government bonds of peripheral countries fell between 0.5 to 1.5 percentage points.

Austria: economy gradually improving

Following stagnation in the first half of 2013, the Austrian economy expanded at a quarter-on-quarter rate of 0.2 percent in real terms in the third quarter, while domestic demand remained flat. Private consumption overcame the stagnation observed since the beginning of 2012, rising again by 0.1 percent in real terms. Overall investment, by contrast, was once again negative, although increasingly less so. Gross fixed capital formation posted a slight increase (+0.2 percent). Stimulus to growth came also from foreign trade: following quarter-on-quarter growth of 0.3 percent in the second quarter, exports expanded by 0.4 percent in the third quarter. The persistent weakness of domestic demand weighed on imports also in the third quarter, they rose by a mere 0.2 percent. The relatively subdued demand for exports as well as investment restraint impaired the production of goods, although not as badly as in the first quarter. Value added grew by 0.4 percent in real terms compared with the previous quarter. Construction value added also increased (+0.4 percent), following a decline in the first half of the year.

Private consumption increased moderately in the third quarter, and investment declined at a slower pace. Exports gained some momentum.

WIFO Business Cycle Survey: outlook modestly optimistic

Austrian businesses are increasingly optimistic regarding the current economic situation and future developments. According to the WIFO Business Cycle Survey, the assessment of the present situation improved slightly for the third time running in November, and the business expectations index rose for the fourth consecutive time in November, reaching the highest level since July 2011, when the economic slowdown set in. This development is being driven by a marked improvement in expectations in the cyclically sensitive manufacturing sector. The autumn analysis and evaluation of the WKO (Austrian Economic Chamber) economic barometer also shows an improvement, with business expectations for the first time since 2010 being more optimistic than the assessment of the present situation.

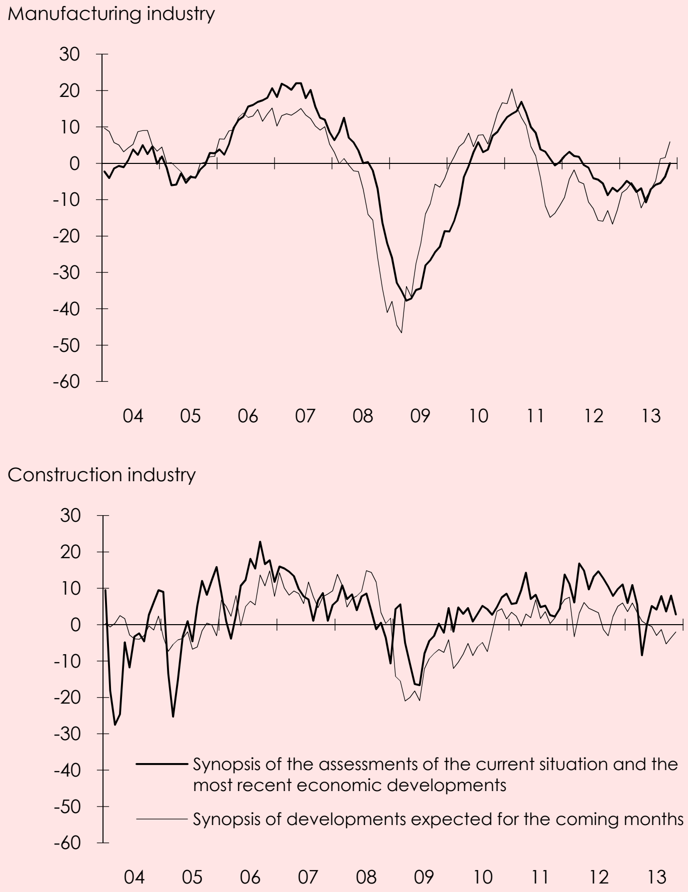
Summer tourism benefits from foreign demand

Tourism sales increased 1.3 percent, year-on-year, in the 2013 summer season, according to provisional calculations; in price adjusted terms, by contrast, sales declined. From May to October the number of overnight stays rose by 1.1 percent, compared with the same period a year before. While the number of nights spent by resident guests declined moderately (–0.3 percent), international demand posted an above-average increase (+1.8 percent). Sharp increases were registered in the number of nights spent by guests from Russia (+9.6 percent), the UK (+8.7 percent), the USA (+6.6 percent), Poland (+5.7 percent), the Czech Republic (+4.0 percent) and Hungary (+3.9 percent). A markedly lower number of overnight stays compared with a year before was recorded for guests from Denmark (–2.3 percent), Italy (–2.1 percent) and the Netherlands (–1.8 percent). The number of nights spent by German guests increased by 1.4 percent.

In the 2013 summer season, more guests came above all from the Anglo-American region and from Eastern Europe. The demand from countries with weak economies such as Italy, the Netherlands and Denmark declined.

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.

Easing crude oil prices dampen inflation

Parallel to developments in the euro area, inflation has been falling continuously in Austria (October CPI +1.4 percent, HICP +1.5 percent). While food prices continued to increase markedly (HICP +3.3 percent), energy prices (especially fuels and heating oil) registered an above-average decline (HICP –3.6 percent). The positive inflation differential vis-à-vis the other euro countries is primarily a result of the fact that the core inflation rate in Austria (October +1.9 percent, according to the HICP) exceeded the euro area average (+1.0 percent) since wages rose at a faster pace in Austria than, for instance, in the peripheral countries. Inflation in Germany (HICP +1.2 percent in October) also still remains lower than in Austria: price pressures following from the energy turnaround are being offset by a core inflation rate (October +1.4 percent, according to the HICP) that is lower than the one recorded in Austria.

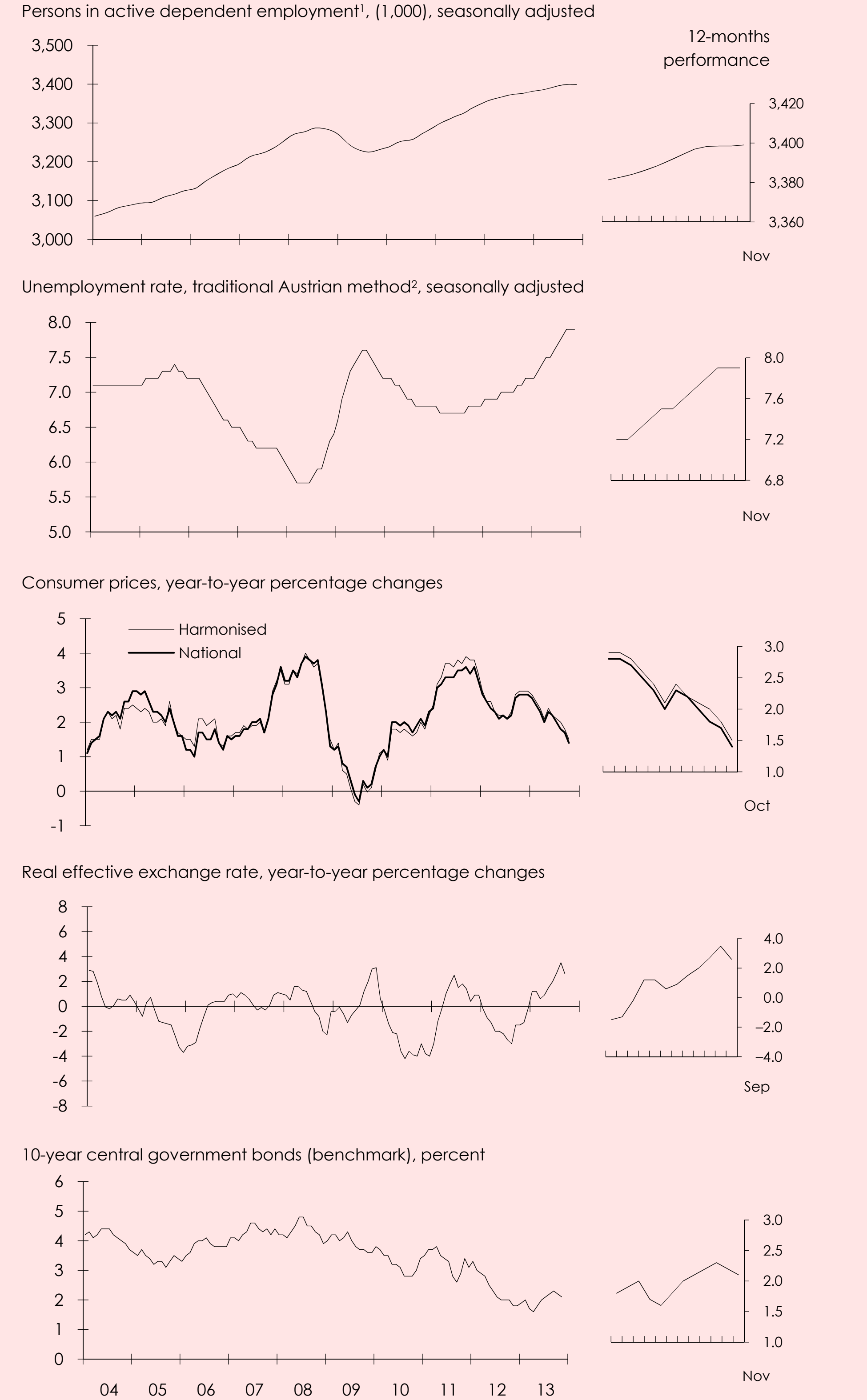
The positive inflation gap vis-à-vis the euro area and Germany is maintained, owing to the higher core inflation rate in Austria.

Unemployment rate stagnating at high level

The seasonally adjusted number of persons employed stagnated in November. Hence it was not possible to reduce the unemployment rate, which, as in the previous month, stagnated at a high level in seasonally adjusted terms (7.9 percent). Employment was only moderately higher than in November of last year (+0.5 percent). For this reason the new entrants to the labour market could not be absorbed. Compared with a year before, the unemployment rate rose by 0.7 percentage point, with the number of jobless persons exceeding the year-earlier level by 31,500.

Year-on-year growth in employment was insufficient to prevent a rise in unemployment. The number of persons employed has stagnated lately.

Figure 4: 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.