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Economic Developments Marked by Debt Crisis

Business Cycle Report of December 2011

European economic policy-makers continue to discuss which measures to take to restore financial markets' confidence in the credit-worthiness of countries with high sovereign debts. Meanwhile, borrowing costs have risen also for states with relatively low debt levels. The real economy continues to lose momentum, although there are still no signs of a sharp fall in economic output.

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The difficult decision on how to stabilise financial markets for European bonds has to be taken in a phase of declining and greatly varying momentum for economic activity. The rise in government bond yields in recent months even suggests that insecurity on financial markets about the ability of individual euro countries to service their debts has mounted. Against this background, politicians are increasingly trying to bring about an easing of the situation by announcing intensified austerity efforts. This, however, entails the danger of further dampening economic activity.

Meanwhile, borrowing costs have increased also for states with comparably unproblematic debt levels. Even interest rates for German bonds recently posted a slight increase following a marked decline. The real economy has been largely spared from the consequences up to now. Economic activity has been slowing since spring, as evidenced by business surveys, but so far the downward trend has not accelerated. In the third quarter, quarter-on-quarter economic growth in the euro area remained unchanged at 0.2 percent. In Germany, growth even accelerated slightly from +0.3 percent to +0.5 percent; while the export industry is constantly losing momentum, domestic demand is growing at quite a robust pace. Consumer confidence and retail sales suggest that consumer demand will remain stable also towards the end of the year.

As for the Austrian economy, the revision of the quarterly national accounts showed that real growth was 0.3 percent in the third quarter of 2011 compared with the previous quarter (after +0.5 percent in the second quarter). Hence economic activity has moderated once again. While the pace of expansion is likely to weaken further, Austria, too, is not facing an imminent fall in economic output. In November, firms' assessments of future economic developments did not deteriorate further, and labour market developments can also be judged to be faintly positive.

Both the OECD's leading indicator and the Ifo World Climate Index suggest that the global economy is losing momentum. This holds especially for the euro area, important emerging markets and developing countries. Growth is expected to accelerate only in Japan and the USA in the near future. In Japan, demand is driven notably by the ongoing reconstruction work following the environmental disaster in March 2011.

According to the revised GDP growth rates for the first half of 2011, momentum in the USA steadily strengthened since the beginning of this year (first quarter +0.1 percent, quarter-on-quarter, second quarter +0.3 percent, third quarter +0.5 percent), with net exports and consumer demand providing the main impetus recently. Overall investment demand, by contrast, dampened growth, notably owing to the de-

World economy expanding at slower pace

Leading economic indicators point to a weakening of global economic activity. In the USA, positive signs are increasing, despite imminent government budget cuts.

cline in inventory investment, while equipment investment grew at a brisk pace (+3.7 percent in real terms, compared with the previous period). Having stagnated in recent months, the Purchasing Managers' Index rose again in the November survey, suggesting that production developments will still remain favourable also in the fourth quarter.

Table 1: Quarterly national accounts

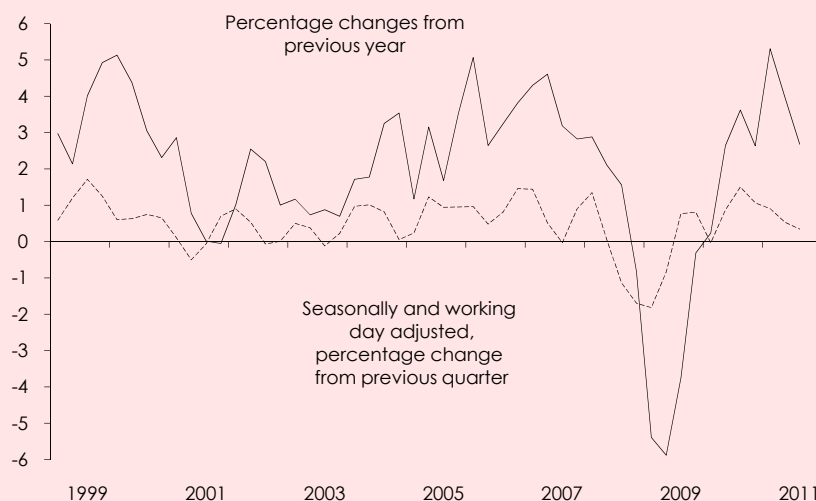
			2010				2011	
			Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter
Percentage changes from previous quarter								
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.3	+ 0.4	+ 0.3	+ 0.2	+ 0.3	+ 0.3
Households ¹			+ 0.4	+ 0.5	+ 0.2	- 0.1	+ 0.2	+ 0.4
General government			- 0.1	+ 0.1	+ 0.4	+ 0.7	+ 0.6	+ 0.3
Cross capital formation			+ 1.8	+ 2.6	+ 1.8	+ 0.7	+ 0.4	+ 0.6
Gross fixed capital formation			+ 0.7	+ 1.3	+ 1.1	+ 0.8	+ 1.2	+ 0.8
Machinery and equipment			+ 2.2	+ 3.0	+ 2.9	+ 2.0	+ 2.0	+ 2.0
Construction			- 0.5	- 0.2	- 0.1	+ 0.1	+ 0.3	- 0.3
Exports, goods and services			+ 4.0	+ 2.6	+ 1.4	+ 2.3	+ 1.1	+ 0.5
Goods			+ 7.3	+ 4.1	+ 0.4	+ 2.3	+ 1.4	+ 0.9
Services			+ 1.2	+ 0.9	+ 0.8	+ 1.3	+ 1.3	+ 0.9
Imports, goods and services			+ 3.8	+ 3.0	+ 1.5	+ 2.0	+ 1.3	+ 0.5
Goods			+ 4.2	+ 3.5	+ 1.6	+ 1.8	+ 1.2	+ 1.0
Services			+ 2.0	+ 2.2	+ 1.9	+ 1.5	+ 0.9	+ 0.4
Gross domestic product			+ 0.9	+ 1.5	+ 1.1	+ 0.9	+ 0.5	+ 0.3
Manufacturing			+ 4.1	+ 4.0	+ 3.0	+ 3.4	+ 1.2	+ 0.7
	2009	2010	Percentage changes from previous year					
			Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter
<i>Volume, chained prices</i>								
Final consumption expenditure	- 0.1	+ 1.5	- 0.1	+ 1.4	+ 1.7	+ 0.2	+ 2.4	+ 0.4
Households ¹	- 0.3	+ 2.2	- 0.3	+ 2.6	+ 2.5	- 0.3	+ 1.9	+ 0.2
General government	+ 0.2	- 0.2	+ 0.8	- 1.9	- 0.5	+ 1.3	+ 3.5	+ 1.0
Cross capital formation	- 11.9	+ 3.6	+ 6.1	+ 9.9	+ 6.2	+ 28.2	+ 7.5	+ 5.3
Gross fixed capital formation	- 8.3	+ 0.1	- 0.1	+ 0.1	+ 4.2	+ 4.0	+ 5.1	+ 4.7
Machinery and equipment	- 9.7	+ 4.3	+ 3.4	+ 2.8	+ 15.2	+ 12.8	+ 9.5	+ 13.7
Construction	- 7.6	- 2.9	- 1.8	- 2.1	- 3.0	- 1.2	+ 2.6	- 0.7
Exports, goods and services	- 14.3	+ 8.3	+ 12.3	+ 11.1	+ 8.8	+ 13.3	+ 6.3	+ 5.1
Goods	- 16.6	+ 10.9	+ 15.3	+ 13.3	+ 12.2	+ 17.6	+ 6.4	+ 5.8
Services	- 8.3	+ 2.2	+ 4.5	+ 5.8	+ 0.3	+ 4.8	+ 5.9	+ 3.4
Imports, goods and services	- 13.8	+ 8.0	+ 9.9	+ 10.9	+ 8.8	+ 14.4	+ 6.6	+ 4.1
Goods	- 14.7	+ 9.1	+ 12.1	+ 11.8	+ 9.7	+ 15.0	+ 6.7	+ 4.3
Services	- 10.2	+ 3.7	+ 1.6	+ 7.4	+ 5.5	+ 11.2	+ 6.2	+ 3.9
Gross domestic product	- 3.8	+ 2.3	+ 2.6	+ 3.6	+ 2.6	+ 5.3	+ 4.0	+ 2.7
Manufacturing	- 15.3	+ 7.4	+ 11.2	+ 10.4	+ 9.6	+ 19.5	+ 10.3	+ 8.4
Gross domestic product, value	- 2.8	+ 4.1	+ 4.2	+ 5.7	+ 4.5	+ 7.7	+ 6.0	+ 4.7

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

The situation on the US labour market is also easing further, albeit hesitantly. Since the most recent crisis, unemployment has been declining at an uncharacteristically slow pace. In November 2011, the seasonally adjusted unemployment rate fell yet again (to 8.6 percent), but was thus only 1.5 percentage points below its long-term peak reached in October 2009 (10.1 percent). Consumer surveys also give grounds for cautious optimism: both the Consumer Sentiment Index and the Consumer Confidence Index rose markedly in November. This is remarkable considering that the expiry in February 2012 of the social security tax reduction and of the extended unemployment benefits will dampen household income.

China's economy expanded at a pace of 2.3 percent in the third quarter of 2011, almost as vigorously as in the previous quarter. However, the official purchasing managers' index for the Chinese economy for the first time since February 2009 fell below 50, implying a sustained deterioration. The Central Bank recently eased its monetary policy stance again, after seeking for some time to dampen inflation by credit tightening.

Figure 1: Growth of real GDP



Source: WIFO.

For Japan, 2011 was a turbulent year: in the first quarter, economic output fell by 1.7 percent compared with the previous quarter; the earthquake disaster in March made production conditions considerably more difficult. The decline continued also into the second quarter. The reconstruction work started thereafter triggered a marked expansion in the third quarter (+1.4 percent). According to the Tankan survey, industrial sentiment brightened further in October 2011, suggesting that economic developments will remain favourable towards the end of the year.

Economic policy in the euro area so far has not delivered a credible plan for the solution of the sovereign debt problems. The discussion on how to boost demand for government bonds of the southern countries of the monetary union is under way. So far, the announcement of rigorous austerity packages in the respective countries has failed to sufficiently convince the markets. Concept proposals for artificially boosting demand (EFSF, purchase by ECB) to reduce financing costs have likewise produced no results up to now. So far, the countries have also not succeeded in agreeing on the alternative of raising reasonable finance by issuing jointly guaranteed euro bonds. In the meantime, scepticism in the financial markets has increased further. Secondary market yields on Greek government bonds already exceeded 30 percent; borrowing new money on the markets therefore remains impossible. The yield is already 12 percent also for Portugal.

Meanwhile, also big euro area countries are feeling the impact of the financial markets' loss in confidence. In Italy (government debt higher than 120 percent of GDP), the monthly average yield rose by 2.2 percentage points in one year. Recently Italy had to borrow money on the free market at an interest rate of 7.9 percent. Financing conditions have also begun to deteriorate for France and Austria, with the yields for both countries having risen from 2.7 percent in September to 3.4 percent in November; Austria's public debt, at around 75 percent of GDP is lower than that of France (85 percent).

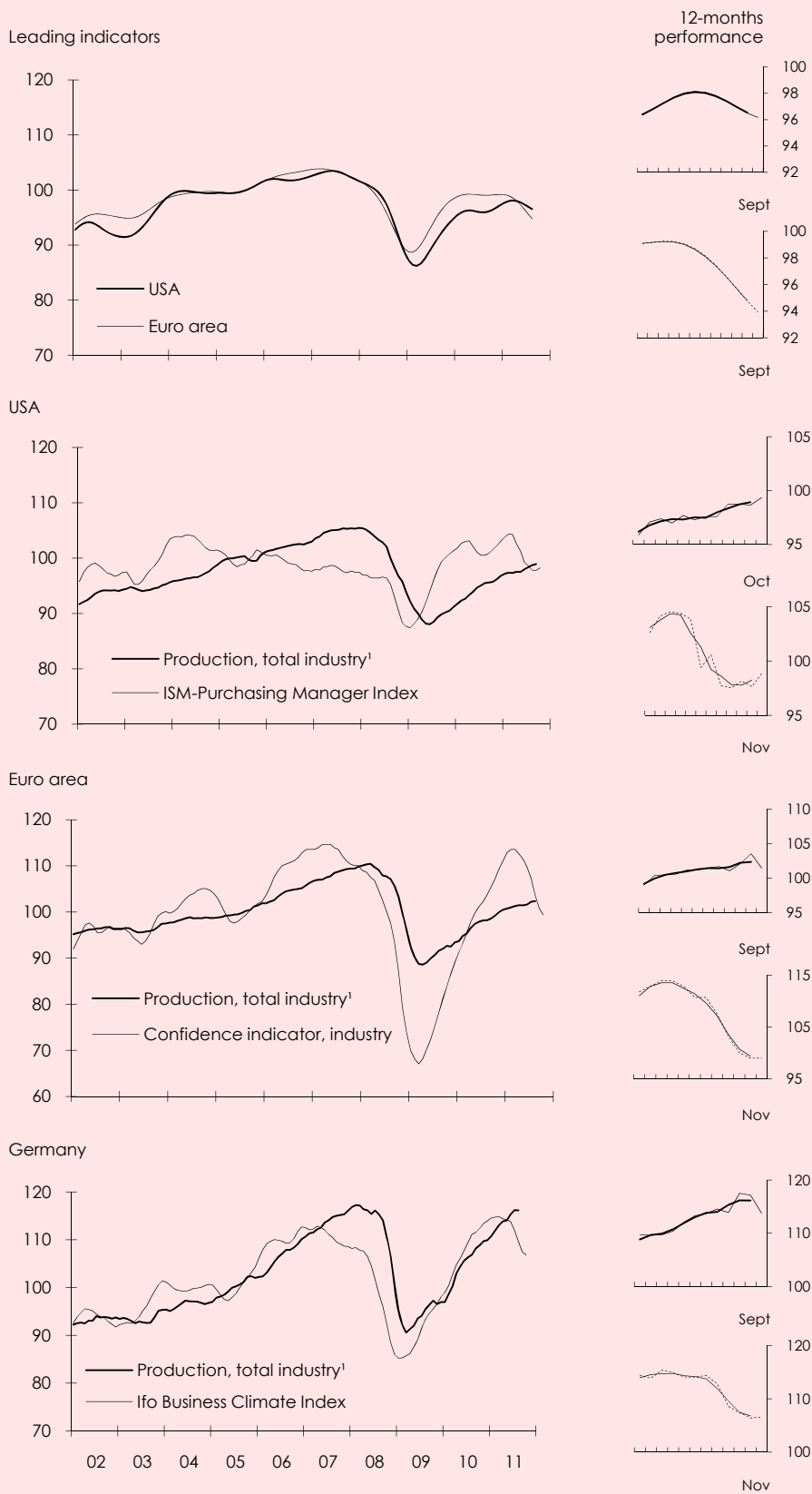
Until now, only Germany has benefited from the uncertainties. Fears of suffering losses on other countries' euro government bonds resulted in an increase in the demand for German bonds accompanied by a decline in their yields. In November, buyers for the first time showed greater restraint also with respect to German bonds; as a consequence, their yields also rose modestly. International rating agencies are already threatening to downgrade the rating of euro countries that until now enjoyed triple-A rating.

Increased saving efforts in the euro area

The confidence crisis in the financial sector is spreading to an ever-growing number of countries in the euro area: confidence both in public finance and in the banking system continues to dwindle.

Figure 2: 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.

Up to now, the euro area real economy has developed favourably in the face of the turmoil in financial and capital markets. The pace of economic growth slowed

down markedly in the second quarter (+0.2 percent, first quarter +0.8 percent), but did not decelerate further in the third quarter. However, this largely reflects the good result achieved by Germany: in the third quarter, the German economy expanded by 0.5 percent, while GDP growth in all of the other euro area countries remained broadly flat.

The seasonally adjusted unemployment rate in the euro area followed a downward trend until April 2011; since then it has been going up again, rising gradually from 9.9 percent in May to 10.3 percent in October. In addition, the industrial confidence indicator has deteriorated considerably since spring 2011, and so has also the consumer confidence index since the summer.

As regards the economic outlook for the near future, leading indicators are giving mixed signals. While the industrial confidence indicator darkened less in October and even remained constant in November, new orders posted a noticeable decline recently. This development occurred also in Germany, where new orders fell for three months. November saw a marked increase, which did not make up for previous losses, however. These indicators suggest that the euro area economy is likely to stagnate towards the end of this year. The decline in new orders may subsequently lead to a drop in production.

A problem still unsolved is the situation in the European banking system. The value of stocks of leading euro area banks has dropped dramatically since the beginning of 2011. Many banks are once again confronted with insufficient equity capital. The European Banking Authority's latest estimate of the additional capital banks need to raise was € 115 billion. The possibility that public funds will have to be used again to support some banks cannot be ruled out.

In a concerted action with the US Federal Reserve Bank, Canada's Central Bank, Japan's Central Bank, the Bank of England and the Swiss National Bank, the ECB at the beginning of December provided substantial liquidity in US dollars to global financial markets. Notably banks in the euro area had previously reported problems in the supply with dollar liquidity. Having raised the key interest rate twice by 25 basis points in April and July 2011, the ECB felt compelled to lower it by $\frac{1}{4}$ percentage point each at the beginning of November and December. In September and October, the ECB provided the credit sector with additional liquidity of € 260 billion (just under +13 percent compared with the end of August).

After experiencing a marked loss in momentum already in the second quarter of 2011 (+0.5 percent, after +0.9 percent in the first quarter of 2011), the Austrian economy saw the pace of activity decelerate further in the third quarter (+0.3 percent), with the impetus from abroad coming to a virtual standstill. While total exports still rose by 0.5 percent in real terms relative to the previous quarter, the pace of import growth, at +0.5 percent remained broadly unchanged. Real merchandise exports increased at a rate of 0.9 percent, roughly equal to that for merchandise imports (+1.0 percent). In the WIFO Business Cycle Survey of November 2011, firms reported yet another deterioration in new orders from abroad. Hence the demand for Austrian export goods is set to decline in the near future.

Aggregate demand developments in the third quarter were largely determined by domestic components: household consumption grew at a quarter-on-quarter rate of +0.4 percent in real terms in the third quarter, more strongly than in the second quarter (+0.2 percent). Government consumption increased by +0.3 percent in real terms. Real retail sales (excluding motor vehicles) have been deteriorating already since autumn 2010, with a slight rise in August 2011 interrupting temporarily the downward movement. Consumer confidence surveys have been reflecting a marked worsening of sentiment only since summer 2011, however. Consumer confidence is generally strongly influenced by media reporting. Hence the discussions about the euro area debt crisis likely play a major role in the worsening of sentiment. November saw yet another fall in the index.

Weakening economic activity and the uncertainty caused by the discussions surrounding the debt crisis in the euro area are expected to dampen investment de-

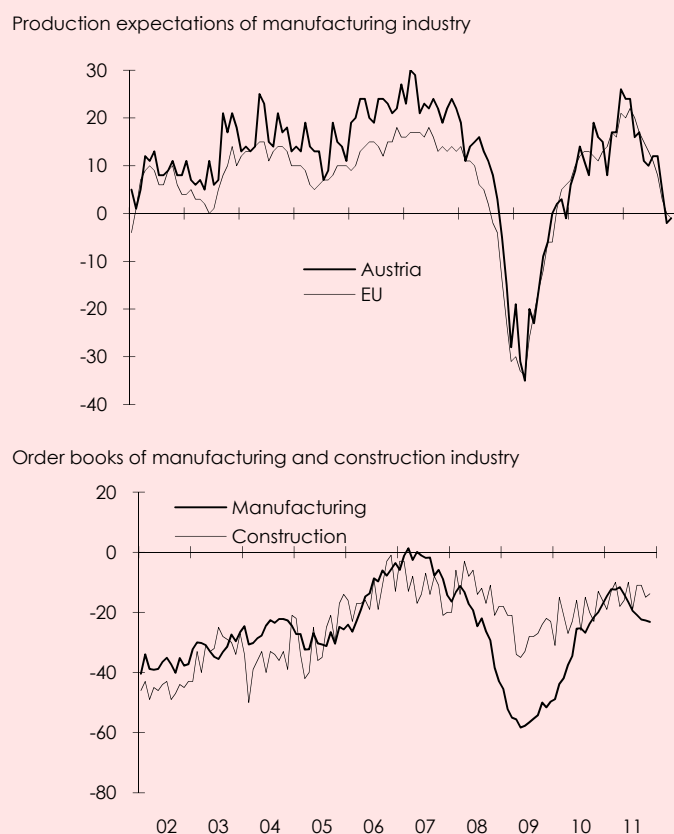
Weakening export demand dampens economic activity in Austria

Economic activity in Austria continued to slow down in the third quarter. Growth in overall output decelerated to +0.3 percent in real terms in the third quarter, following an increase by 0.5 percent in the second quarter.

mand. However, growth in equipment spending has not slowed down further since the beginning of 2011. In the second and third quarters, equipment demand rose by +2.0 percent in real terms, almost as briskly as at the beginning of the year. Businesses appear to plan their investment cautiously, but the backlog that arose during the 2008-09 crisis requires an increase in replacement investment. This is also confirmed by capacity utilisation data firms provided in WIFO's Business Cycle Survey of September 2011.

Figure 3: WIFO Business Cycle Survey

Differences between the percentage shares of correspondents giving positive and negative replies, seasonally adjusted



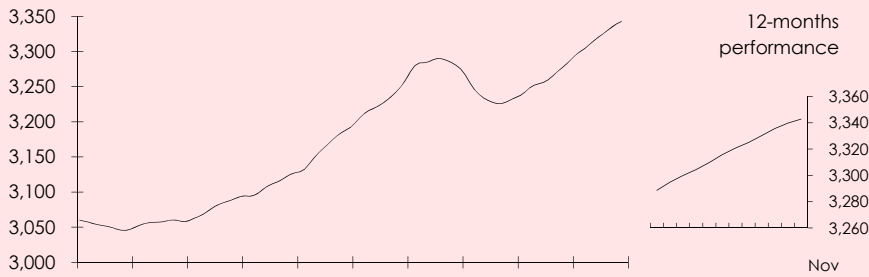
Source: European Commission, WIFO Business Cycle Survey.

Having risen for the first time in a long while in the first half of 2011 (first quarter +0.1 percent in real terms, second quarter +0.3 percent), the demand for construction investment again suffered a setback in the third quarter (-0.3 percent). Residential and non-residential construction were equally affected. In WIFO's November Business Cycle Survey, construction firms described construction volume and order book levels as too low. Hence, construction activity is still not likely to pick up in the near future.

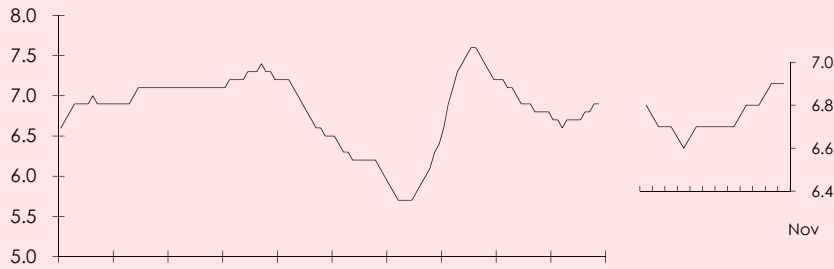
The weakening of the impetus provided by demand from abroad affected above all the production of goods. In the third quarter of 2011, it expanded at a quarter-on-quarter rate of 0.7 percent in real terms (after +1.2 percent in the second quarter and +3.4 percent in the first quarter). Manufacturers' expectations for the coming three months have also been worsening since the beginning of 2011, according to evidence presented in the WIFO Business Cycle Survey. Firms reported a decline in both domestic and export order books. Production expectations followed a similar pattern as in Germany and for the first time did not deteriorate further in November 2011. Although economic activity should continue to moderate, survey evidence does not yet suggest that developments could be as critical as during the 2008-09 recession.

Figure 4: Key economic indicators

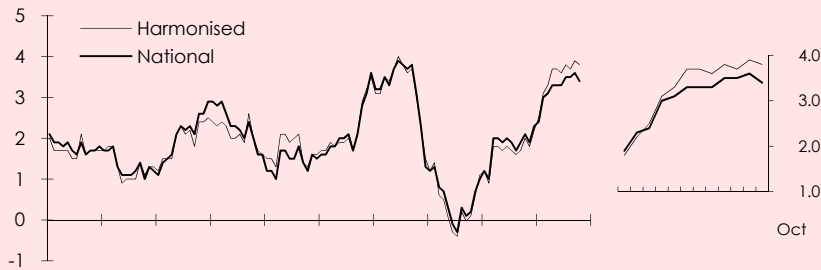
Persons in active dependent employment¹, (1,000), seasonally adjusted



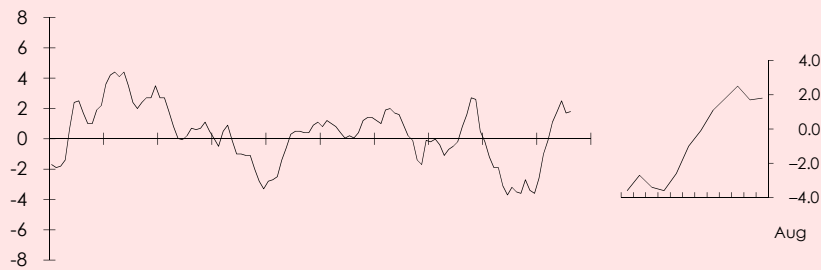
Unemployment rate, traditional Austrian method², seasonally adjusted



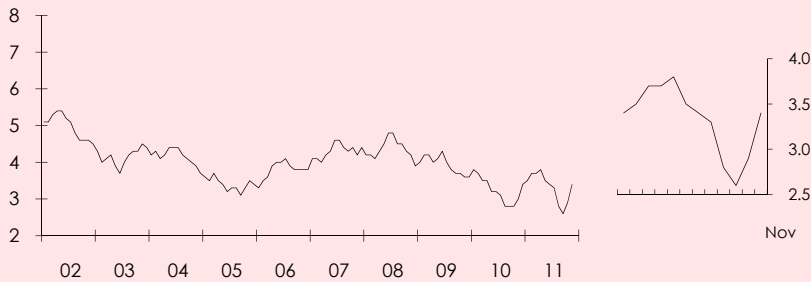
Consumer prices, year-to-year percentage changes



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.

*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.

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.itkt.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 or persons carrying out alternative service with a valid employment contract. By deducting their number one arrives at the number of "persons in dependent active employment".

Austrian tourism sales in the 2011 summer season rose by 3.8 percent year-on-year, according to preliminary calculations. This growth largely reflects a marked upward drift in prices in the tourism sector, however; the number of nights spent increased less strongly (+2.4 percent). In addition, real expenditure per night spent declined.

From May to October 2011, the demand for overnight stays by travellers from abroad exceeded the year-earlier level by 3.2 percent, while that by resident guests

Slight pick-up in overnight stays

increased by a mere 0.8 percent. The number of guests from Austria's eastern neighbouring countries rose at a particularly brisk pace. Overnight stays by guests from Russia exceeded the year-earlier level by 30.5 percent. Higher-than-average rates of increase were also recorded for the demand from Poland (+26.4 percent), Hungary (+18.2 percent) and the Czech Republic (+12.8 percent).

The increase in summer tourism benefited notably the federal provinces of Lower Austria, Vorarlberg, Upper Austria and Vienna, they posted higher-than-average gains; Tyrol and Burgenland, by contrast, registered lower gains.

The Austrian inflation rate, which at 3.6 percent in September 2011 had reached the highest level since September 2008 (+3.8 percent), fell again to 3.4 percent in October. Once again, the main drivers of inflation were price increases for mineral oil products: compared with a year before, the rates of increase are still considerably high, but crude oil prices have been falling noticeably since spring 2011. Food prices also increased appreciably compared with a year before (+4 percent).

The European Union's Harmonised Index of Consumer prices rose by 3.8 percent in Austria in October. Hence inflation was considerably higher than the euro area average (+3.0 percent). While price increases for food and mineral oil products were similar to those recorded in the other euro area countries, above average increases were registered in the "Recreation and culture" and "Hotels, cafeterias and restaurants" categories. The discontinuation of price reductions granted in the tourism sector during the economic crisis is much more strongly reflected in the HICP than in the CPI due to their higher weight in the HICP.

In November 2011, the seasonally adjusted number of persons registered as unemployed with the Public Employment Service (AMS) rose by 0.6 percent from the previous month, to around 255,000. Hence about 10,000 more people were without a job than in spring. The upward trend, while continuing, is not getting stronger. Unemployment is also rising markedly on a year-on-year basis: while in November 2010 244,000 persons had been without a job, this number was up by around 9,000 in November 2011. However, the Public Employment Service (AMS) considerably reduced its training activities over this period; the number of persons enrolled in training fell by 7,000.

The unemployment rate according to the national method of calculation rose to 6.9 percent in November 2011 and thus corresponded to the seasonally adjusted rate; it had been 6.8 percent in November 2010 and 6.9 percent in October 2011. The unemployment rate according to the Eurostat definition was 4.1 percent in Austria in October, once again the lowest rate in the EU.

Employment is still growing: the number of persons in active dependent employment rose by 1.8 percent year-on-year in November (+59,000). Based on the seasonally adjusted series, the month-on-month rate of increase was 0.1 percent. Hence the upward momentum has moderated somewhat in recent months, with the steady economic slowdown appearing to affect the demand for labour now.

Inflation falling again

The inflation rate declined in Austria to 3.4 percent in October. Falling crude oil prices and the moderation in economic activity are easing price pressures.

Ongoing employment expansion despite rising unemployment

Since the beginning of 2011, the supply of labour has been growing more strongly than demand. As a consequence, unemployment has increased in recent months in spite of rising employment.