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High Euro Exchange Rate Weighing on Export-Led Recovery

The revival of exports continued in the third quarter, leading to a healthy increase in manufacturing output. The latest strong rise in the euro exchange rate is not only weighing on exports, but also detracts from the euro area's attractiveness as a target for investment.

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The brightening of domestic business conditions continued over the last summer. In the third quarter, the value of exports rose by 12 percent above the year-earlier level. Particularly strong was demand from the USA and south-eastern Europe, but also from Germany. Austrian companies benefited from supplies to the booming German export industry. However, the marked rise in the euro exchange rate, which affects the German economy more than others, suggests an imminent slackening of export growth.

The swift expansion of global economic activity is gradually losing momentum. While growth of GDP in the USA was still strong in the third quarter, at 1 percent from the previous period, leading indicators point to a deceleration in the year-end quarter. In Japan and Europe the pace slowed already in the third quarter, due partly to the high oil prices.

The lively orders from abroad have led to a strong increase in Austrian manufacturing output this year. The production index exceeded the year-earlier level by 8 percent in the third quarter. The motor car industry was booming, and also investment goods manufacturers posted massive gains. Only the consumer goods sector suffered a setback, which is in line with sluggish private consumption in the euro area. In the construction sector, the order situation improved in summer, suggesting that output losses during the first semester are now being made up for.

In the summer months, private households raised their spending markedly from last year, as could be expected given the rather poor results in the base period. For the whole year 2004, gains in private consumption will nevertheless remain modest. Consumer sentiment, unlike business confidence, has not improved this year. Retail sales in the third quarter rose by nearly 3 percent in volume from the (low) level of last year, with growth extending also to motor car purchases. On account of this revival, sales tax revenues were relatively strong. Towards the end of the year, investment is expected to be robust, in view of the imminent phasing-out of the investment premium and a cut in the corporate tax rate.

The most recent information on the current business trend is provided by the regular WIFO survey among companies of November. There, firms saw their order and business situation positive overall, although not better than in the previous months. Many firms expect an increase in sales prices, probably as a consequence of higher energy and raw materials costs.

In autumn, the oil price pushed up the rate of inflation, leading to a slight fall in employees' real per-capita income. In early December, the situation on oil markets calmed and the price of Brent eased to around 40 $ per barrel. In Austria, the rate of inflation reached 2.6 percent in October, of which 0.6 percentage point were due to the more expensive energy products.

The pace of the cyclical recovery has so far not been strong enough as to make major inroads into unemployment. The jobless figure maintained a relatively high level in November, edging down by only 1,400 year-on-year. A rise in the recorded unemployment rate was prevented only by a higher number of people out of work being enrolled in training measures or applying for retirement benefits. The number of people in active employment increased by a sizeable 30,000 or 1 percent as a result of the labour market becoming more flexible. Unfortunately, no information is available on the split between full-time and part-time jobs. The significant increase in job vacancies by 11 percent bodes well for a further recovery of employment in the months to come.

Strong rise in the Euro exchange rate

In early December, the euro exchange rate rose to 1.34 $, exceeding the year-earlier level by around 10 percent. The main reasons for the dollar decline are to be seen in the high current account deficit of the USA, in the greater strength of US domestic demand compared with that of the euro area, and in portfolio shifts from dollar to euro assets. The latter is mainly the case for central banks holding high dollar reserves.

The effects of the high euro exchange rate for the euro area economy are unfavourable on balance. The ECB President therefore called the euro appreciation "unwelcome". Exports into the dollar area are being dragged down, affecting Germany in particular and, indirectly, Austria. Apart from exports, what also suffers is the attractiveness of the euro area for investors. Yet, at the present juncture a rebound in investment would be crucial to secure a self-sustained cyclical upturn in the euro area. In present circumstances, however, the euro area becomes less attractive as a location for internationally operating companies, since the costs of establishing a new plant or enlarging an existing one are rising relative to other locations, and because the strong exchange rate variations add to investment risks. If the exchange rate shift is regarded as permanent, multinational companies will rather be induced to invest in the dollar area (including China), given also the significantly higher growth prospects compared with the euro area.

Imports are becoming cheaper as a consequence of the euro appreciation. Without the latter, prices of oil and other commodities would have gone up even faster. Also holiday travel to the dollar area (USA, Caribbean, China) is now clearly more affordable. In the short run, therefore, consumers and tourists may reap the benefits from a stronger euro, as long as setbacks in exports and employment exert no drag on their purchasing power.