

Stefan Schiman

# Euro-Area Confidence Rises Despite Deflation in Some Countries

## Business Cycle Report of May 2014

### Euro-Area Confidence Rises Despite Deflation in Some Countries. Business Cycle Report of May 2014

Economic output stagnated in the USA in the first quarter of 2014, while the upturn continued in the UK, and economic activity gathered steam in Spain. The increase in the value added tax rate in Japan was preceded by extensive household purchases in anticipation of that increase. China's currency depreciated noticeably, and investors increasingly withdrew capital from Russia and Ukraine. In March, five euro-area countries registered a decline in the consumer price index, while tax increases pushed up prices in Austria. Production expectations for the coming months eased somewhat, and the reform of NoVA (duty on new car purchases) prompted consumers to bring forward car purchases. Winter tourism has been weak so far. Given the prevailing economic situation, the seasonally adjusted unemployment rate continued to rise in April, reaching a peak of 8.3 percent.

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In the USA, investment and exports dropped sharply in the first quarter of 2014, but private consumption continued to grow at a robust pace, with overall real GDP consequently stagnating. The unemployment rate fell noticeably to 6.3 percent in April. Japan recorded a substantial trade deficit in the first quarter. The value added tax increase from 5 percent to 8 percent with effect from 1 April was preceded by extensive household purchases of durable consumer goods in anticipation of that increase.

China's currency this year has depreciated noticeably for the first time since the crawling peg to the dollar went into effect in 1994. It is uncertain whether or not this is an expression of deepening investor distrust amid beginning defaults, or a result of exchange market intervention by the central bank aimed to influence market sentiment in the run-up to the easing of the fixed rate regime. With the substantial interest rate increase by the Turkish central bank at the end of January and attention of financial market actors shifting to the trouble spot in Eastern Europe, capital flight from Asia's emerging market economies has declined for the time being. Recently, capital has been withdrawn notably from Russia and Ukraine.

In the EU, many sentiment indicators have reached their highest levels seen since the economic crisis; in Spain, economic activity gained traction in the first quarter, and in the UK the upturn proceeded. The mild winter stimulated construction activity. Given the current low-interest rate environment, Portugal can refinance itself on favourable terms in the capital markets after the expiry of the bailout programme.

Deflationary trends have become more frequent in the euro area, however; they are closely related to the in some cases sizeable under-utilisation of capacity. In March, prices in five euro countries were below year-earlier levels. Austria is not affected by this development. Apart from a higher degree of capacity utilisation, various tax increases have also contributed to price pressures there.

According to WIFO's Business Cycle Survey, the assessment of the current situation remained stable, but expectations for the coming months deteriorated, in particular in the cyclically sensitive manufacturing sector. Consumer confidence has remained subdued lately. The reform of NoVA (duty on new car purchases) prompted consumers to bring forward purchases of cars. The very mild weather and the late timing of Easter weighed on winter tourism. The seasonally adjusted unemployment rate rose to a new peak of 8.3 percent in April, owing to unutilised capacity and the quickly growing labour supply.

## 1. Marked decline in US unemployment rate

The upturn suffered a setback in the USA in the first quarter: gross investment and exports tumbled, real GDP stagnated compared with the previous quarter. The harsh winter was one of the factors behind the weak investment activity. The Leading Economic Index published by the Conference Board improved further in March, signalling that the economy may be strengthening again. Consumer confidence maintained its upward trend in the first quarter, in line with the continuing positive development of private consumption.

The unemployment rate fell from 6.7 percent in March to 6.3 percent in April. It thus reached the 6.5 percent target originally set and meanwhile dismissed by the central bank as the threshold up to which interest rate increases were ruled out much sooner than predicted several months ago. While employment increased considerably, the labour supply also fell further, thereby contributing to the decline in unemployment.

### 1.1 Sharp increases in real estate prices reduce demand overhang

Housing starts continue their upward trend; however, the number of housing starts still remains comparatively low and has likely not kept up with the rise in demand. The price increase according to the S&P/Case-Shiller index has thus accelerated noticeably in the last two years (February 2014 +12.9 percent compared with a year before), already reaching again the levels recorded in 2002 and 2003. New-home prices continued to rise markedly in March (+12.6 percent). This somewhat dampened the demand overhang, so that the number of single-family homes sold from January to March fell by 1.8 percent compared with the same period a year earlier, and by 13.3 percent in March alone. Existing-home sales also weakened.

*Following a marked increase in real estate prices, the supply of housing in the USA continues to rise amid declining demand.*

## 2. High trade deficit and extensive front-loading of purchases in Japan

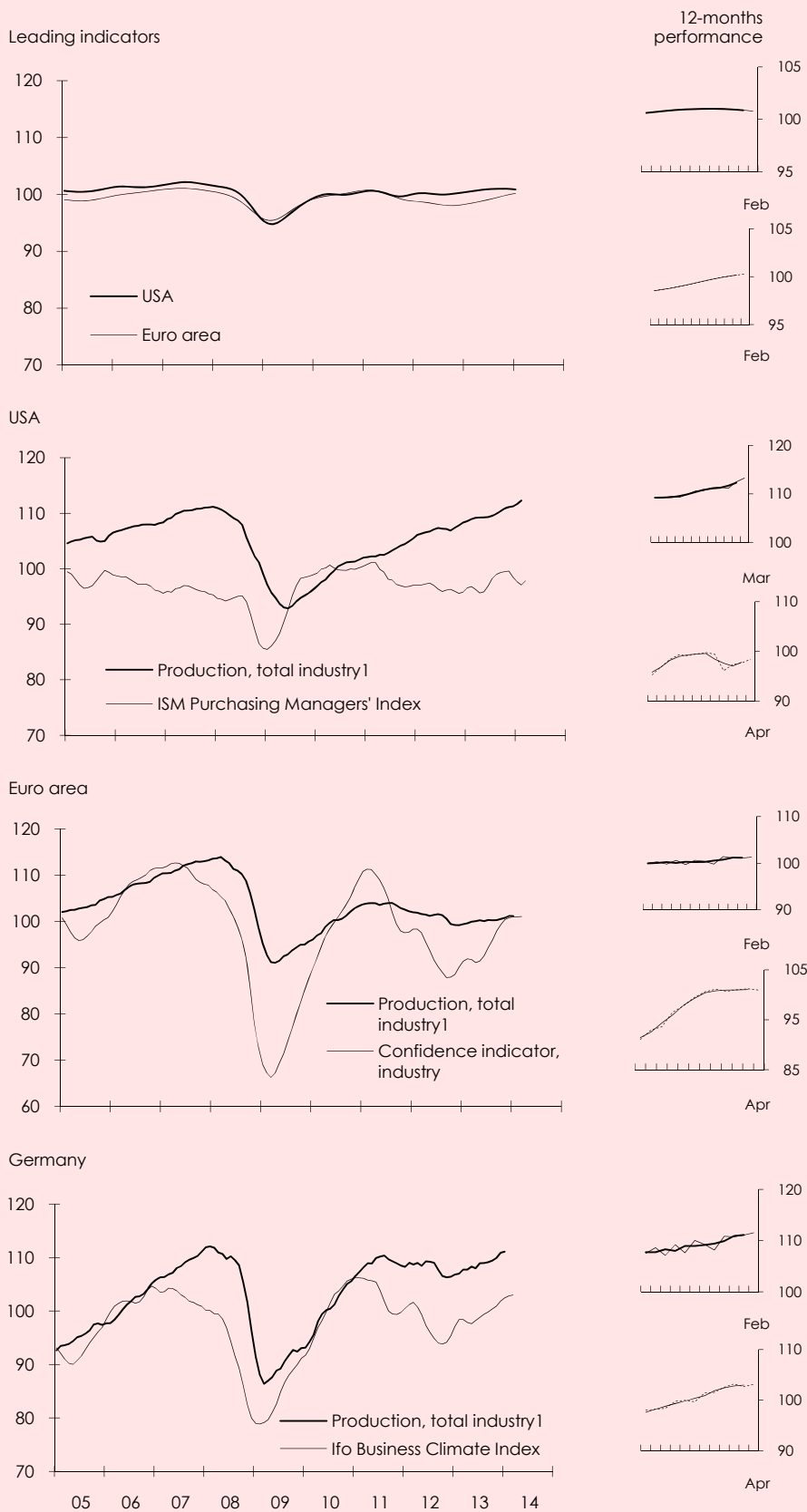
Japan's trade deficit has widened increasingly over recent months, and in the first quarter of 2014 alone was as high as the surpluses of the years 2009 and 2010 taken together (around 5 trillion yen, April 2013 to March 2014 –14 trillion yen). This development occurred largely on account of the substantial increase in energy imports that became necessary owing to the temporary shutdown of numerous nuclear power plants.

The value added tax rate was raised from 5 percent to 8 percent with effect from 1 April 2014. This is why, at +2.9 percent the highest inflation rate since 1991 was recorded in the Tokyo area in April. In March, households on a large scale brought forward purchases prior to the implementation of this VAT increase: compared with February, nominal retail sales grew by 6.3 percent (for comparison: USA +1.1 percent), while compared with March of last year they rose by 11.0 percent (USA +3.8 percent). An increased demand was reported particularly for durable consumer goods such as cars, entertainment electronics and clothing.

*The value added tax rate in Japan was raised from 5 percent to 8 percent with effect from 1 April 2014, which subsequently triggered price increases.*

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. – <sup>1</sup> Excluding construction.

### 3. Depreciation in China

China's GDP grew by 7.4 percent in the first quarter, compared with a year before, and by 1.4 percent on a quarter-on-quarter basis. Hence the momentum remained relatively subdued (fourth quarter of 2013 +7.7 percent and +1.7 percent, respectively). In February and March the yuan depreciated noticeably for the first time since the crawling peg to the dollar went into effect in 1994 (apart from a short episode in 2012). The exchange rate fell in two stages (by around 1 percent each time) before and after 17 March 2014, the date the central bank raised the admissible fluctuation margin vis-à-vis the dollar from 1 percent to 2 percent. The yuan had appreciated by more than 30 percent against the dollar since mid-2005. Whether the most recent turnaround is an expression of deepening investor distrust amid beginning defaults in China's business sector, or has been actively brought about by exchange market intervention by the central bank aimed to influence market sentiment in the course of the increase in the admissible fluctuation margin and a possible further currency liberalisation is uncertain.

*It is uncertain whether the most recent depreciation in China is an expression of deepening investor distrust or a result of exchange market intervention by the central bank.*

### 4. Capital flight shifting to Russia and Ukraine

Speculative capital flight, which had intensified again in some emerging market economies at the beginning of 2014, was stopped for the time being by further interest rate increases at the end of January, among other things: the interest rate action by the Turkish central bank, which more than doubled the key interest rate by raising it from 4.5 percent to 10 percent with effect from 29 January 2014, is assumed to have had the strongest effect. India simultaneously raised its rate from 7.75 percent to 8.0 percent, while in South Africa the rate was increased from 5.0 percent to 5.5 percent one day later. In addition, the attention of financial market actors and capital flight recently shifted to the trouble spot Ukraine. Hence the Ukrainian central bank saw the necessity of an interest rate shock similar to the one in Turkey: on 14 April, the key interest rate was raised for the first time since the outbreak of the financial market crisis; the increase was substantial (from 6.5 percent to 9.5 percent). But Russia, too, is faced with difficulties refinancing in the capital market: an interest rate increase from 5.5 percent to 7.0 percent at the beginning of March was followed by a further increase to 7.5 percent on 25 April, not least because a routine auction of government bonds had failed for the third time in succession.

*While at the beginning of 2014 speculative capital flight had still affected Turkey, Indonesia, India and South Africa, it recently shifted to the trouble spot in Eastern Europe.*

### 5. EU: sentiment indicators reach temporary peaks

The Markit Composite Purchasing Managers' Index for the euro area climbed to 54 points in April, its highest level in almost three years. The increase was primarily driven by improved business sentiment in the services sector. The European Commission's consumer confidence index also rose to the highest level seen so far since the outbreak of the financial market crisis. In the services sector, the sentiment indicator for the EU continued to rise at a faster pace in April than its counterpart for the euro area; this was due to continued confidence in the UK.

The business climate index published by Germany's Ifo institute has been on an upward trend exceeding the long-term average for about one year and continued to rise in April. By contrast, France, the second-largest economy in the euro area, saw the business climate deteriorate somewhat in April.

#### 5.1 Economic activity gaining traction in Spain

The mild winter had a noticeable positive effect on building production in the euro area: in December, January and February it exceeded year-earlier levels, and also increased on a month-on-month basis.

In Spain, economic activity gained traction in the first quarter, with real GDP rising by 0.4 percent compared with the previous quarter. On a year-on-year basis, economic output increased for the first time since the second quarter of 2011; moreover, the expansion turned out to be strong at +0.6 percent.

As economic activity in the euro area is gradually improving, government bond markets are settling down. Portugal paid an interest rate of only 3.575 percent for a ten-year bond issued for the first time in three years. The country is expected to regain its full refinancing capacity once the bailout programme expires in May.

In the UK, the overall economic recovery proceeded in the first quarter, with real GDP rising by 0.8 percent compared with the previous quarter. This is the first major upturn experienced since the financial market crisis, given that the impact of the recovery in 2010 was extremely modest. Hence, real output in the first quarter of 2014 was still 0.6 percent down from the level recorded in the first quarter of 2008.

## 5.2 Higher number of euro countries experiencing deflation

Euro area inflation fell to 0.5 percent in March 2014 (USA 1.5 percent), a rate still clearly below the ECB's target of close to 2 percent<sup>1</sup>. Consumer prices declined in Greece (-1.5 percent), Cyprus (-0.9 percent), Portugal (-0.4 percent), Spain (-0.2 percent) and Slovakia (-0.2 percent). The deflationary development is a consequence of the widespread weakness of demand: capacity utilisation in these countries ranged between 46.8 percent (Slovakia) and 74.8 percent (Portugal), clearly below the euro area average of 79.5 percent (Austria 85.1 percent, Germany 83.9 percent).

## 5.3 Euro area current account surplus on the rise

The current account balance in the euro area increased further on a 12-month moving average basis, and between March 2013 and February 2014 amounted to 2.5 percent of GDP. This upward trend is due to an increase in the external trade balances of the peripheral countries amid further increases in the already high surpluses of Germany and the Netherlands. Imbalances in the external trade positions of the euro countries are thus not eliminated within the monetary union; rather, the net debt of these countries vis-à-vis the rest of the world decreases.

*The construction sector in the euro area benefited from the mild winter. Portugal refinanced itself again in the capital market with its current low-interest rate environment. In the UK, the upturn proceeded.*

*Until January 2014, prices fell only in Greece and Cyprus, while in March this was the case also in Slovakia, Portugal and Spain.*

*The euro area's growing current account surplus reduces its net debt vis-à-vis the rest of the world. Within the euro area, current account balances barely converge.*

## 6. Assessment of current economic conditions by Austrian businesses remains stable

According to WIFO's Business Cycle Survey, Austrian businesses, notably in the services sectors, assessed current economic conditions somewhat more positively in April than a month earlier. The assessment by firms in the manufacturing sector remained almost unchanged, while sentiment deteriorated in construction. The industrial production index, having surged in January, did fall in February, albeit to a level still exceeding the levels recorded in the two previous years. Economic expectations, by contrast, turned out to be less favourable than in recent months; uncertainty may have grown because of the Ukraine crisis. While the deterioration affected all of the sectors, it was particularly marked in the cyclically sensitive manufacturing sector and in construction. Expectations by firms in the services sector are more optimistic.

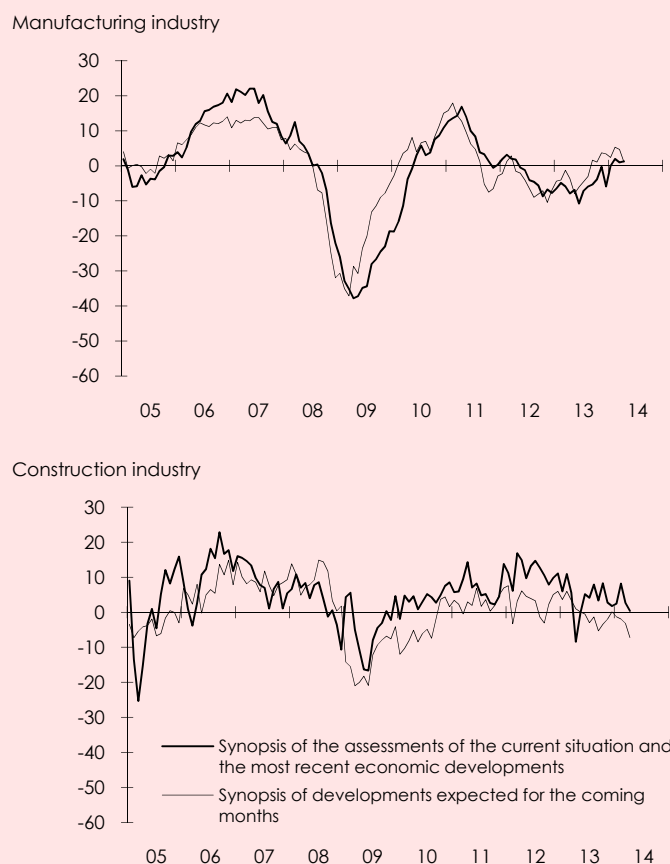
The leading indicator also fell noticeably in April compared with a month before. The decline was driven by the deterioration in sentiment among Austrian manufacturers as well as by the drop in job vacancies and by worsening production expectations in Germany.

*Economic expectations for the coming months have deteriorated lately in Austria, notably in the cyclically sensitive manufacturing sector.*

<sup>1</sup> In April 2014 it was 0.7 percent, according to advance estimates.

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.

### 6.1 NoVA reform prompts frontloading of car purchases

Consumer confidence in Austria, as measured against the European Commission's Consumer Confidence Indicator, remained subdued in April. Private households brought forward car purchases in anticipation of the change in NoVA (duty on new car purchases) with effect from 1 March 2014. The number of new car registrations for people in paid employment rose significantly in February compared with a year before (+22.8 percent, around +1,800 new registrations), but declined again in March (-7.9 percent). The relatively good sales development of the trade sector as a whole was largely determined by the sharp sales increase recorded by car dealers. Future business prospects for retailers remain muted.

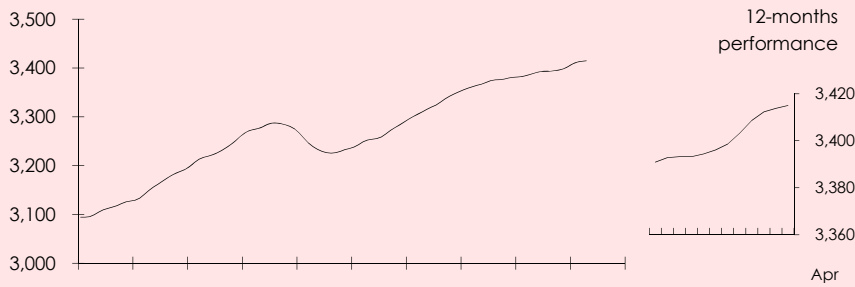
*In contrast to the euro area average, consumer climate in Austria did not improve.*

### 6.2 Dry weather and late timing of Easter weighing on winter tourism

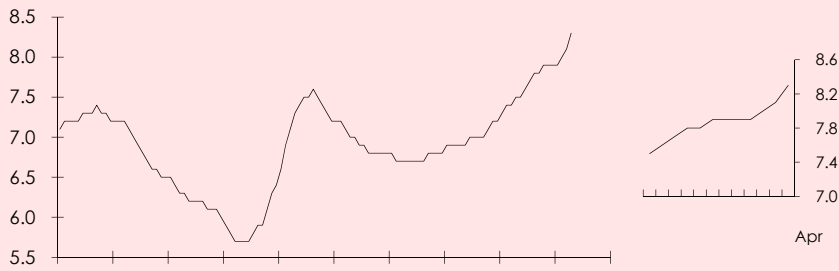
In the 2013-14 winter season so far (November to March), real tourism sales remained 6.6 percent below the year-earlier level; the price-adjusted expenditure per night spent declined by 2.7 percent. The number of nights spent fell more sharply than the number of arrivals (guests), with the average duration per stay consequently declining again. These weak tourism results so far are largely attributable to the relatively dry winter north of the Alps and to the late timing of Easter (Holy Week in April, 2013 in March). A particularly marked decline was registered in the number of nights spent by German guests (-8.1 percent); French and British travellers also cut down on their winter holidays in Austria. By contrast, the number of nights spent by guests from Poland and the USA increased.

Figure 3: Key economic indicators

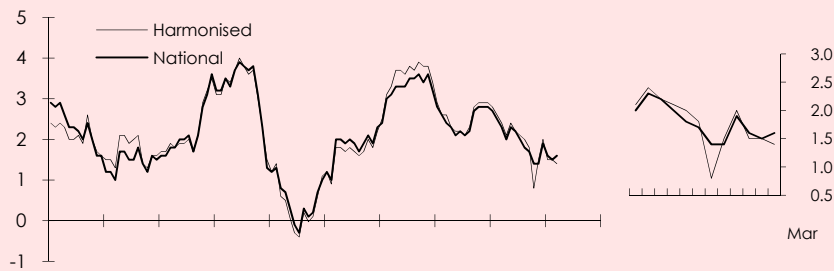
Persons in active dependent employment<sup>1</sup>, (1,000), seasonally adjusted



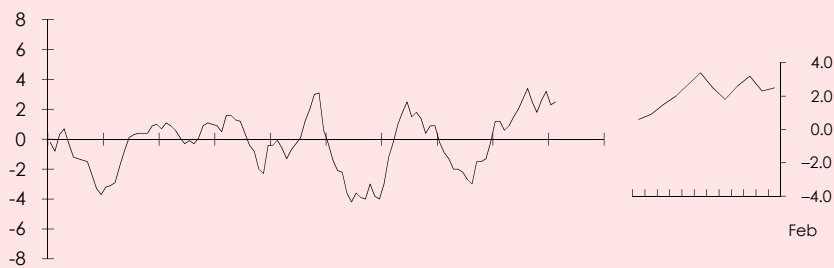
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



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. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> As a percentage of total labour force excluding self employed, according to Public Employment Service.

### 6.3 Rising tax burden triggers price increases

Inflation stood at 1.6 percent (HICP 1.4 percent) in March; Austria does not share the problem of many euro countries of too low an inflation rate – relative to the ECB's target. The risk of an unforeseen economic setback triggering a deflation spiral is small. In March, around 0.25 percentage point of the inflation rate was attributable to tax effects, with consumer prices therefore rising at a comparatively fast pace from February at +0.9 percent. The price increases were driven above all by increases in the tobacco tax and the engine-based insurance tax, and to a lesser extent by tax increases for alcoholic beverages and sparkling wine, and by the reform of NoVA. Above-average increases in services prices (restaurant trade, news transmission) – in addition to the tax increases – remain the main factor dominating the inflation differential vis-à-vis Germany and the euro area.

*The increase in excise duties raised inflation by around 0.25 percentage point in March 2014.*

### 6.4 Unemployment rate reached new peak

Adjusted for seasonal effects, the number of persons employed stagnated again in April. The seasonally adjusted unemployment rate rose further and reached a new peak at 8.3 percent. The number of unemployed persons grew by 34,400 compared with a year before. The rise in unemployment is a result of continuing cyclically related under-utilisation of capacity – the number of job vacancies fell again – and of substantial labour supply growth.

*Labour market conditions deteriorated further in April owing to weak economic activity: unemployment rose, while the number of job vacancies declined.*