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Robust Economic Activity Despite Increasing Risks to International Trade

Business Cycle Report of September 2018

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The Austrian economy continued to grow at a strong pace in the late summer of 2018, although the trend toward declining unemployment slowed. In the euro area, growth remains stable, albeit modest. The US economy has benefitted from expansive fiscal policy, posting particularly strong growth rates. Recent trade-policy signals have been stoking uncertainty. This, in combination with a sharp depreciation in emerging market currencies, has had a dampening effect on global trade, with potential knock-on effects for export-oriented industrialised economies.

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While the volume of global trade has grown considerably in recent years, the pace of growth slowed noticeably over the last few months. Trade disputes, uncertainty associated with Brexit, and the strong decline in exchange rates in many emerging markets witnessed since the start of 2018 have all exerted negative pressure on foreign trade activity.

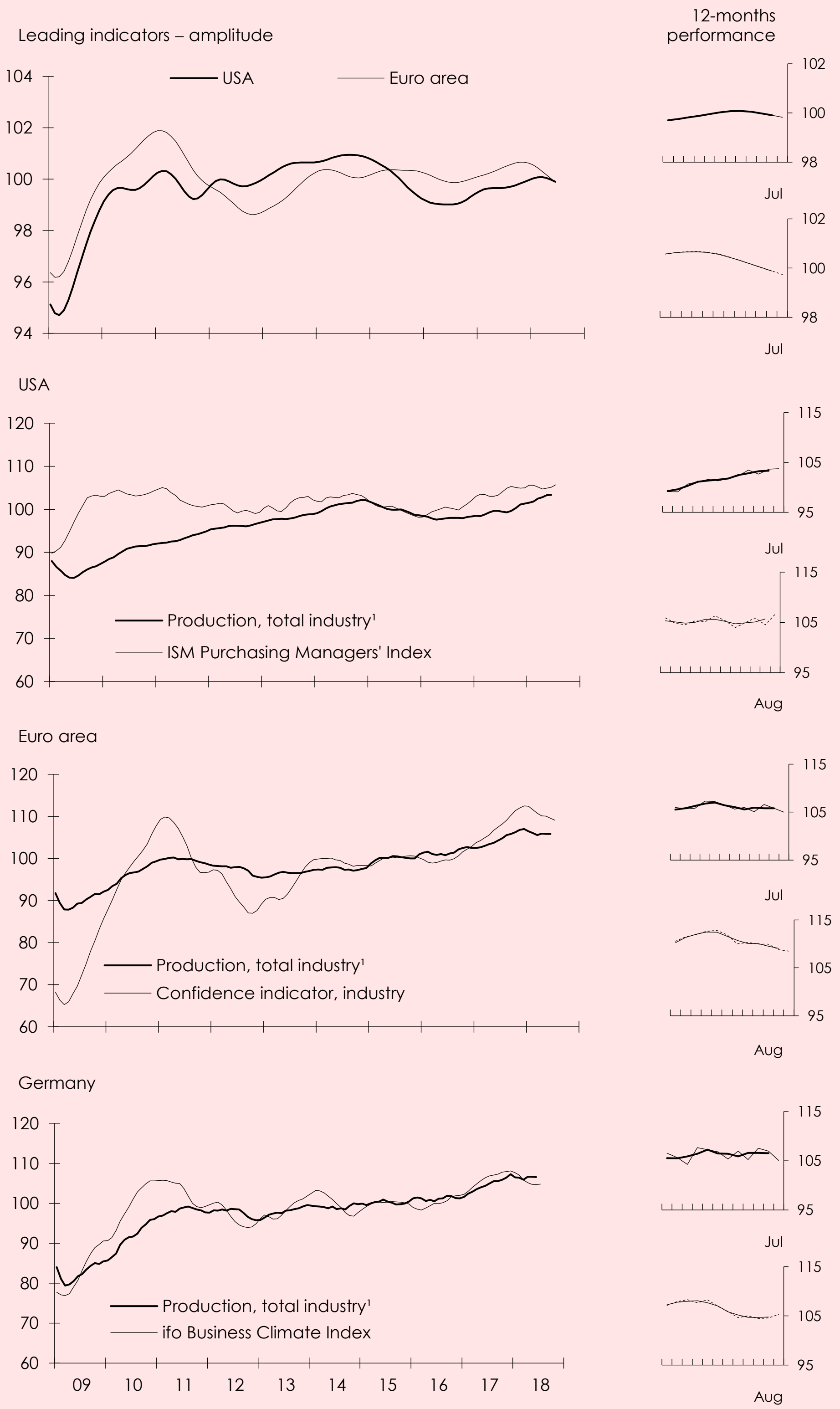
However, in the most important countries and economic regions, the domestic economy stabilised growth. GDP growth was particularly robust in the USA, thanks to expansive fiscal spending (second quarter over +1 percent compared with the previous period, corresponding to an annualised rate of +4.2 percent).

After an unpleasant slowdown in the first quarter of the year, growth in the euro area stabilised at +0.4 percent in the second quarter. Leading indicators suggest a similar pace of growth in the third quarter. Fuelled by higher energy prices, in both June and July inflation slightly exceeded the 2 percent rate targeted by the ECB. The German economy seems to be regaining momentum due to domestic economic forces after the disappointing developments of exports and industrial production in the first half-year. The ifo Business Climate Index posted a strong increase in August, after a marked decline witnessed since the beginning of the year. The construction industry and service sector both have a considerably more optimistic view of the current business situation and near future. And while survey participants in the manufacturing sector once again had a somewhat more pessimistic view of the current situation, their outlook for the future grew more optimistic.

Leading indicators testify to the ongoing positive economic environment in Austria. While the pace of growth has slackened since the beginning of the year, the slowdown was slight and has not accelerated. Economic indicators for the service sector and construction industry remain very strong. In Austria's manufacturing industry, confidence remains rather high.

Figure 1: International business climate

Seasonally adjusted, 2015 = 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 domestic tourism industry has had a successful summer season thus far (May to July). There was a marked increase in the number of overnight stays by foreign guests; duration-of-stay figures also increased for the first time in many years.

Despite the ongoing strong pace of growth, the downward trend in unemployment has slowed, according to current data. The economy also appears to be adding jobs at a slower pace. Nevertheless, the number of vacancies reported to the Public Employment Service Austria (AMS) continued to expand rapidly.

1. Global trade suffers from exchange rate turbulence and trade policy risks

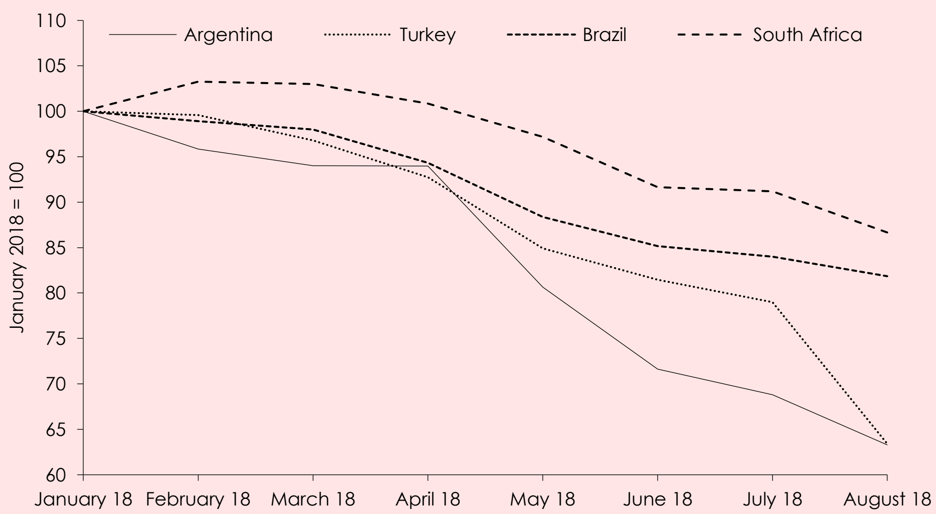
The Turkish lira and Argentinian peso have suffered massive declines since the beginning of the year; in Brazil and South Africa, as well, significant currency depreciation has occurred.

Strong global growth in 2017 was also reflected in a robust expansion in the volume of world trade. In recent months, however, this expansion has increasingly lost steam. There are a variety of reasons for the current slowdown in global trade. For one, numerous questions surround US trade policy: the free trade agreement with Canada and Mexico (NAFTA) is under renegotiation, and there are also considerable uncertainties regarding the future of US trade with Europe, China, and Turkey.

This uncertainty is compounded by the continued absence of a deal on the terms of Britain's relationship to the EU after its official departure in March of 2019. A "hard" or "no-deal" Brexit would have widespread negative impacts and would considerably disrupt trade between the UK and the EU.

Figure 2: Exchange rate developments in selected emerging market countries since the beginning of 2018

Dollar per national currency



Source: WDS – WIFO Data System, Macrobond.

An additional factor weighing heavily on global trade is a strong decline in the value of many emerging market currencies: since the beginning of the year, the Turkish lira has lost nearly a third of its value vis-à-vis the dollar. The Argentinian peso has also come under considerable pressure, depreciating by a similar amount. As a consequence, the Argentinian central bank has increased the key interest rate to 60 percent. This measure not only makes imports more expensive for domestic consumers. It also raises new uncertainties concerning global trade, as the dislocation in Argentina could potentially spill-over to other emerging markets. This, in turn, could have negative impacts on EU and Austrian exports to emerging market countries.

In past quarters, foreign trade has already made little contribution to growth in numerous countries; in some cases, it has even acted as a brake on growth. However, domestic economic developments have exerted a countervailing and stabilising effect.

Table 1: GDP growth and net export contribution in the USA, the euro area and Germany since 2017

Volume, seasonally and working-day adjusted

		2017				2018	
		First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
USA							
GDP	percentage change	+ 0.4	+ 0.7	+ 0.7	+ 0.6	+ 0.5	+ 1.0
Net export	contribution in percentage points	− 0.0	+ 0.0	− 0.0	− 0.2	− 0.0	+ 0.3
Euro area							
GDP	percentage change	+ 0.7	+ 0.7	+ 0.7	+ 0.7	+ 0.4	+ 0.4
Net export	contribution in percentage points	+ 0.6	+ 0.1	+ 0.3	+ 0.4	− 0.2	− 0.2
Germany							
GDP	percentage change	+ 1.1	+ 0.5	+ 0.6	+ 0.5	+ 0.4	+ 0.5
Net export	contribution in percentage points	+ 0.7	− 0.2	+ 0.3	+ 0.3	− 0.1	− 0.4

Source:: BEA, Eurostat, WIFO calculations.

2. Robust growth in the USA thanks to expansive fiscal policy

Growth remains dynamic in the USA. Following a strong uptick in output in the second quarter of 2018, companies and consumers remain optimistic.

Second quarter growth accelerated in the USA, showing a real quarter-over-quarter expansion of 1 percent and an annualised increase of 4.2 percent. There are also no indications of a slowdown on the horizon. US growth has been buoyed by strong economic fundamentals as well as expansive fiscal spending.

The inflation rate has gradually climbed from 2.1 percent at the beginning of the year to 2.9 percent in June and July. Furthermore, the USA is nearly running at full employment, but very low real wage increases still do not point to an economic overheating. In the second half of the year, the stimulative effects of fiscal policy should wane, encouraging a return to a more modest growth path. Monetary policymakers have sought to act as a moderating force, and remain committed to gradual interest rate hikes. In June, the Fed instituted a 25 basis point increase, bringing the benchmark rate to between 1,75 and 2 percent.

The sentiment among the business community remains optimistic. While the ISM Purchasing Managers' Index suffered a decline in July after two successive months of increases, the index jumped higher in August. This clearly suggests that the US economy will continue to expand. Surveys of consumer confidence provide a mixed picture, however. In 2017, the Consumer Confidence Index of the Conference Board surpassed the levels witnessed during the peak of the boom in 2006-07, and in August 2018, after a strong increase, the index even reached the high water mark last attained in 2000. Only at that time households assessed their economic situation even better. By contrast, the University of Michigan's Consumer Sentiment Index showed no significant change until July and even declined marginally in August. Nevertheless, consumer spending, which is the most important demand component in the USA, should continue to undergird growth in the months ahead.

3. Growth in euro area remains sluggish

Euro area growth continues to trail behind that of the USA. Fiscal policy has delivered no growth stimulus in the EU, and the budgetary deficit, unlike in the USA, has been constantly shrinking.

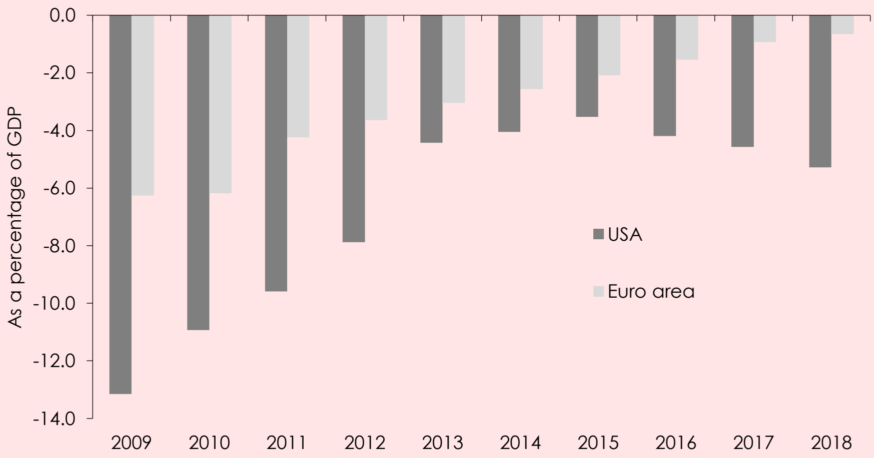
On the whole, the pace of growth in the euro area and EU noticeably lost steam at the beginning of 2018. While real GDP expanded 0.7 percent in the third and fourth quarter of 2017, in the first and second quarter of 2018, real quarterly growth declined to 0.4 percent. Weak export performance was a primary drag on growth. However, the economy was bolstered by private consumer spending, which is encouraged by a good labour market situation.

The EU and US economies are currently in very different places: the USA is experiencing one of its longest boom phases. Unemployment remains low, at 3.9 percent; inflation is running at nearly 3 percent; and monetary policy is tightening in view of the impending cyclical tension. Only fiscal policy is behaving in an unusual manner: expansive government spending has boosted economic performance in recent years through the continuous expansion of government deficits and debt.

In the euro area, by contrast, economic performance has been more modest: the tepid recovery that set in after the recession of 2013 did not gain real traction until

2016. And while unemployment rates have declined considerably in many euro area countries, they remain stubbornly high in others. In July, the inflation rate was relatively low at 2.1 percent, as this figure includes higher energy prices; core inflation (excluding energy and unprocessed food) is 1.3 percent. The euro area has yet to sustainably achieve the monetary policy goal of 2 percent inflation. Accordingly, the ECB has left the key interest rate unchanged at 0 percent. The economic upswing has induced government revenues to rise faster than expenditures; as a result, the balance is constantly improving and the public debt level has been shrinking as a percentage of GDP.

Figure 3: General government net lending or net borrowing in the USA and the euro area



Source: Eurostat; IMF; WDS – WIFO Data System, Macrobond. 2018: forecast.

Surveys of business sentiment for the euro area point to moderate expansion in the third quarter as well. The Purchasing Managers' Index was essentially unchanged in August (+0.1 point), although stronger increases were witnessed in France and Germany.

German performance increasingly reliant on domestic trends.

The slowdown in global trade has had clear impacts on the German economy. While net external contribution in the fourth quarter of 2017 was positive (+0.3 percentage points), it has been trending negative since the beginning of 2018 (first quarter –0.1 percentage points, second quarter –0.4 percentage points).

Flagging export demand was partially offset by domestic demand, however. Private household consumption rose by 0.5 percent in the first quarter and by 0.3 percent in the second quarter in real terms since the beginning of 2018. Higher gross capital formation has additionally buttressed growth. Current trends should continue into the third quarter of 2018. The ifo Business Climate Index rose for the first time since the end of 2017, registering a considerable jump. While manufacturers and retailers still have a somewhat more pessimistic view of the current business situation, service sector and construction industry firms both grew considerably more optimistic. Furthermore, compared to the last ifo survey in July, expectations in all four sectors have become more optimistic.

German economic performance remains good, despite the slowdown in exports and associated drag on industrial production. Germany's harmonised unemployment rate of 3.4 percent is exceptionally low and one of the lowest in Europe. The German government has been generating ever-higher surpluses for four years running; in 2018, the debt-to-GDP ratio is expected to drop below 60 percent for the first time. Furthermore, inflation has been trending at around 2 percent for several quarters, thus fulfilling the ECB's inflation target.

While continued strong German performance will boost aggregate euro area and EU growth figures, increased domestic activity in Germany will have few positive knock-on effects for other EU countries.

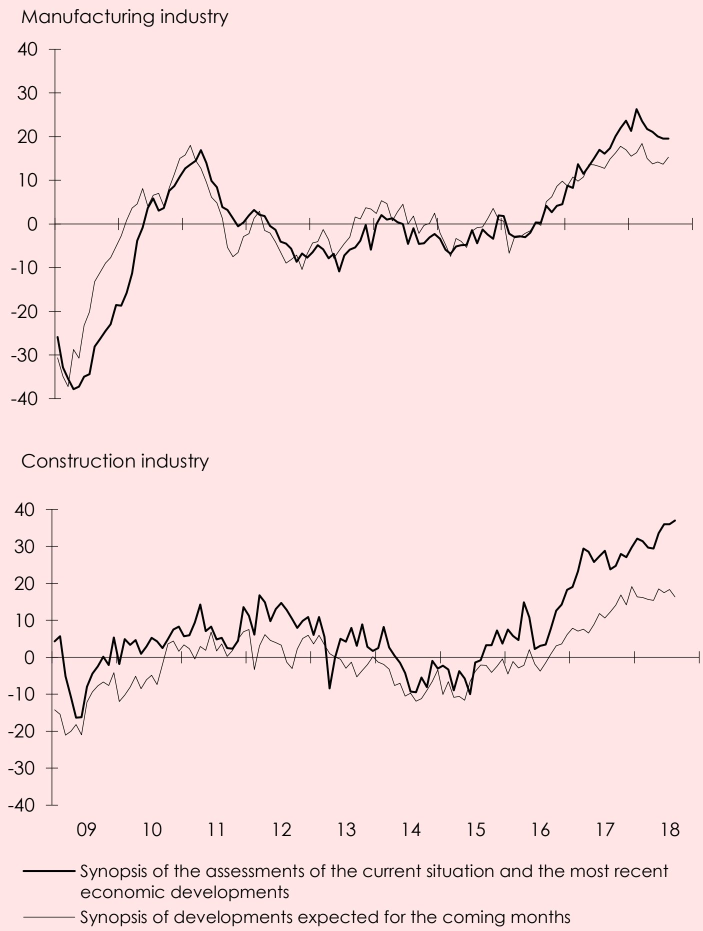
4. Only slight decline in pace of Austrian growth

Austrian economy proves more robust than expected. No sign to end of upswing in sight, according to the WIFO-Konjunkturtest (business cycle survey).

While the upswing in economic activity has lost steam in Germany and the rest of the euro area since the beginning of 2018, the slowdown in Austria has been marginal. After posting an increase of +0.9 percent compared to the previous period in the third and fourth quarter of 2017, growth slowed to 0.8 percent (first quarter of 2018) and 0.7 percent (second quarter of 2018). In contrast to developments in many other countries, Austrian industrial production and exports have hardly lost ground: in June 2018, industrial production was up to 5 percent on the year (when adjusted for working days). Growth has been additionally bolstered by domestic demand. Real consumer spending grew 0.5 percent in the first and second quarter, exceeding the growth rate of previous quarters. The steadily improving labour market situation has led to higher wages and higher consumer confidence, thereby also improving the willingness of consumers to spend.

Figure 4: Results from the WIFO-Konjunkturtest

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



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

Investment demand has also remained strong. Gross capital formation expanded by 1.3 percent in the first quarter and 1.2 percent in the second quarter, equalling the growth rates witnessed in the second half of 2017 compared with the previous period. While the demand for machinery and equipment flattened, construction investment continued to increase.

According to the WIFO-Konjunkturtest (business cycle survey) that was conducted in August, Austrian manufacturers have an unchanged positive assessment of the current business situation (+19.5 points on balance). The majority of firms reported production increases; however, their share was lower than in spring, however. Manufacturing orders remain strong: 87 percent of surveyed firms described order backlogs as at least sufficient (long-term average 67 percent). There was no month-over-month change in the volume of foreign orders reported by survey participants. Expectations concerning the coming three months improved somewhat in August (+1.6 points).

The optimistic sentiment amongst Austrian manufacturers was broadly visible across individual manufacturing subsectors, both with a view to the current situation (intermediate goods subsectors +19.9 points; consumer goods manufacturers +10.9 points; capital goods subsectors +26.9 points) and business expectations (intermediate goods subsectors +12.8 points; capital goods subsectors +18.4 points; consumer goods subsectors +16.0 points).

In August, nearly 90 percent of construction companies indicated their order books were "sufficiently full" or better.

Construction companies' assessment of the current business situation was essentially unchanged in August. The index rose marginally by 1 point, thus reaching 37 points. The index thus remained over 35 points, testifying to the extremely optimistic sentiment amongst Austrian construction companies. The component indicators also underwent little change in August. A somewhat larger share of companies reported an increase in construction activity over the past three months (August +25 points on balance; July +23 points). 89 percent of companies described their order books as "sufficiently full" or better (July 90 percent). Only 5 percent of the surveyed companies viewed a lack of orders as the greatest production restraint. The percentage of companies indicating they were not impacted by any production restraints fell from 45 percent to 39 percent. Lack of skilled workers was viewed as the greatest problem (41 percentage points).

Despite the current positive environment, construction companies are much more cautious about the coming months. The index value for future expectations has not increased since the beginning of the year, and in August, it fell by 2 points. With a view to employment and prices survey participants reported somewhat more pessimistic expectations. In August, the value for employment expectations stood at 11 points on balance (the same value that was reported in June 2018), and building price expectations fell from 23 to 22 points. The majority of companies thus expect prices to increase or trend sideways.

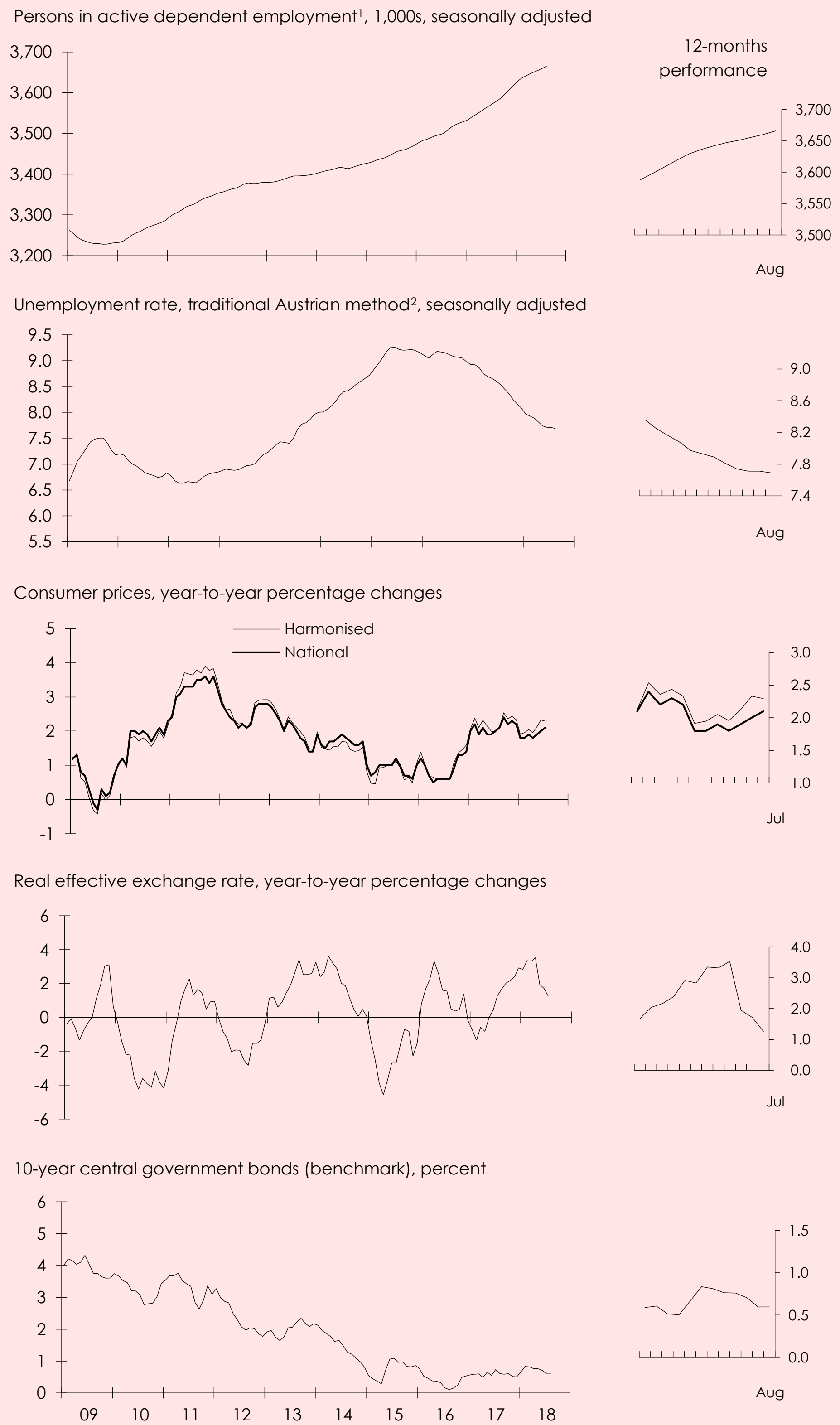
4.1 Successful summer season for tourism industry so far

According to WIFO's preliminary estimates, the first half of the summer season was extremely successful for the domestic tourism industry. Year-over-year growth in tourism revenues from May to July 2018 was 4.8 percent. This translates into a price-adjusted increase of 2.7 percent.

In contrast to the long-term trend, the number of guest arrivals (+3.5 percent) grew slower than the number of overnight stays (+3.8 percent). The extrapolated duration-of-stay figures increased for the first time since 2008 (+0.3 percent vis-à-vis May to July 2017), after falling continuously since 1993. Tourists visiting Austria in May to July 2018 stayed an average of 3.04 nights; in 1992 the average was 4.86 nights. In the first half of the 2018 summer season, the total volume of overnight stays was 37.5 million; foreign guests accounted for 69.7 percent of this figure.

Year-over-year growth in overnight stays by foreign guests during these three months was 4.7 percent; the comparable figure for domestic tourists was just 1.7 percent. Broken down by country of origin, growth was particularly pronounced among tourists originating from Poland (+12.5 percent) and the Czech Republic (+11.6 percent). However, tourism from Germany (+6.7 percent), the most important source market, Hungary (+5.9 percent) and the USA (+5.1 percent) showed strong gains as well. There was a 4.4 percent year-over-year rise in the number of overnight stays by tourists originating from Romania. Growth in tourism from the Netherlands and the UK (1.8 percent and 1.6 percent, respectively) was much more restrained. The volume of overnight stays by tourists from Belgium trended sideways. By contrast, there were declines in the number of overnight stays by tourists from Switzerland, France, Sweden, Russia and Italy during the first half of the 2018 summer season (between –2.0 and –3.9 percent). The decline among Danish tourists was particularly pronounced (–7.4 percent).

Figure 5: Key economic indicators



Source: Public Employment Service Austria, Main Association of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – [1] Excluding persons in valid employment contract receiving child care benefit or being in military service. – [2] As a percentage of total labour force excluding self-employed, according to Public Employment Service.

Considering the strong jump witnessed in July (+2.9 percent to 18.21 million overnight stays) and the importance of this month for the summer tourism market (nearly a quarter of tourists visit during July), a considerable year-over-year increase in visitation is expected. The most important month of the summer season is August, however (accounting on average for 27 percent of overnight stays).

4.2 Inflation rate increases slightly

In June 2018, the year-over-year change in the Austrian consumer price index stood at 2.0 percent. In July, it edged up slightly, hitting 2.1 percent. Increasing fuel prices are still the major driver of higher inflation. According to Statistics Austria, fuel prices in July 2018 were 14.8 percent higher than one year prior, and contributed +0.43 percentage points to the inflation rate.

Consumer prices edged up slightly in July, hitting 2.1 percent. According to the EU-wide harmonised consumer price index inflation remained unchanged at 2.3 percent.

Additional drivers of higher inflation were increasing rental prices (+3.6 percent; contribution to inflation rate: +0.18 percentage points) and higher prices in the category of "restaurants and hotels" (+3 percent; contribution to inflation rate: +0.35 percentage points).

The year-over-year change in the EU-wide harmonised consumer price index remained stable in June and July at 2.3 percent. This index registers a higher rate than the national consumer price index in part because of the greater weighting given by the former to the category of "restaurants and hotels". The Austrian harmonised inflation rate essentially corresponded to the EU average (+2.2 percent). The countries with the highest inflation rates were Hungary (+3.4 percent), Bulgaria (+3.6 percent) and Romania (+4.3 percent), while the lowest rates were registered in Ireland (+1.0 percent), Denmark (+0.9 percent) and Greece (+0.8 percent).

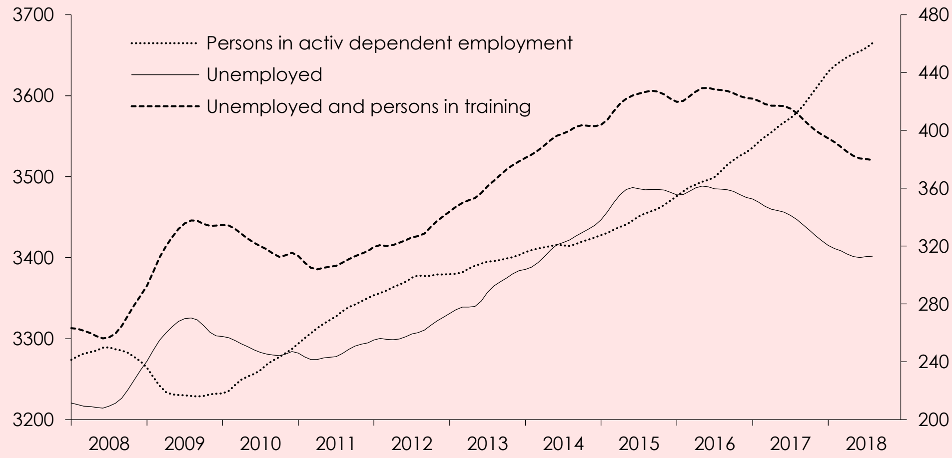
4.3 Labour market shows signs of weakening

Despite the slight slowdown, the economic upswing continues to generate demand for labour at a healthy pace. In August the number of persons in active dependent employment once again showed an increase of 2.4 percent compared to the previous year. The pace of job creation thus remains high, although not as dynamically as at the turn of the year 2017-18, when growth reached up to 3%. Compared to the beginning of 2018, a slight decline in the pace of job growth is also evident with a view to seasonally adjusted, month-over-month job creation figures (see Figure 6).

New job growth has slowed in Austria, despite strong economic fundamentals. The trend toward lower unemployment rates has also begun to lose steam.

Figure 6: Labour market developments in Austria

1,000 persons, seasonally adjusted



Source: Public Employment Service Austria, Main Association of Austrian Social Security Institutions, WDS – WIFO Data System, Macrobond.

Unemployment figures also continued to fall compared to the previous year. In August 2018, 23,300 fewer persons were registered as unemployed with the Public Employment Service Austria (AMS) when compared to one year prior. The trend toward lower unemployment has begun to slow, however, both in a year-over-year comparison (June –29,300 persons, July –24,600 persons) and in a month-over-month comparison. A reduction in training activities is one cause of this slowing trend. July and August

2018 were the first months in which no further decline in seasonally adjusted unemployment took place (July +63, August +190 individuals), but the number of persons participating in training activities continues to trend downward (July –1,200, August –950 persons). When including persons participating in training activities, unemployment figures continue to decline, even when the data are seasonally adjusted; however, the trend toward lower unemployment has clearly slowed (see Figure 6). The number of vacancies reported to the Public Employment Service Austria (AMS) continues to increase (July +14,100, August +17,500).