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Trade Tensions Darkening Economic Climate

Business Cycle Report of August 2014

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The US economy overcame the slowdown registered at the beginning of the year in the second quarter of 2014. The high unemployment rates in some EU countries have declined slightly recently. The UK experienced continuing expansion in the second quarter of 2014, and Spain saw the upswing gain traction. Trade tensions with Russia are weighing on the economic climate in Germany and Austria, with Austrian exports to Russia already dropping markedly in the first four months of this year. Private consumption remains sluggish in Austria; demand for consumer durables is weak. The labour market situation has not yet eased.

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Following the weather-related slump in investment in the first quarter of 2014, growth accelerated again in the USA in the second quarter of 2014, according to first estimates. The Fed will end its asset purchase programme in October 2014, given that economic conditions are stable and the labour market situation is relatively favourable. In China, the government is once again supporting economic activity with additional investment, and has eased lending regulations to achieve the growth target of 7.5 percent. The British economy continued on a growth path in the second quarter (+0.8 percent, compared with the previous quarter), supported by the strong services sector; industrial production remained weak, however. Spain saw the upswing gain traction in the second quarter (+0.6 percent, compared with the previous quarter); the unemployment rate fell slightly further. It also declined somewhat in other EU countries with high unemployment levels.

The economic climate darkened in Germany and Austria: The German Ifo Business Climate Index fell repeatedly as trade tensions increased. According to WIFO's Business Cycle Survey, the assessment of conditions deteriorated in particular among Austrian firms in manufacturing and in construction. Foreign trade did not pick up in the first four months of the year, not least owing to the marked decline in exports to Russia. Private consumption and spending on consumer durables also have not yet broken free from stagnation. Only the tourism industry saw the situation improve since the winter months, as some of the unconsumed winter holidays were taken instead in early spring. Inflation remained stable at 1.9 percent in June. The seasonally adjusted unemployment rate stood at 8.5 percent in July.

1. USA: economic activity more lively again in second quarter of 2014

US real GDP rose by 1.0 percent during the second quarter of 2014, compared with the previous quarter, according to a first estimate. Hence the economy returned to the growth path it had temporarily left in the first quarter of 2014 owing to the severe winter and the related weakness of investment. But economic activity in the six winter months is assumed not to have been as weak as expected; the rate of change was revised upwards both for the fourth quarter of 2013 and the first quarter of 2014 (from +0.7 percent and -0.7 percent, respectively, to +0.9 percent and -0.5 percent, respectively).

Since the beginning of 2014, the Fed has been gradually reducing its monthly asset purchases from \$ 85 billion to currently \$ 25 billion. According to a new timetable, they will be ended in October 2014. While this outlook is meant to increase the planning safety of market participants, financial markets are likely to remain volatile, given the uncertainty about the time of the first interest rate increase in 2015. In June, the inflation rate remained unchanged at 2.1 percent, while the core inflation rate fell to 1.9 percent. The rapid decline in the unemployment rate did not continue in July; the seasonally adjusted unemployment rate, after having fallen to 6.1 percent in June, stood at 6.2 percent.

The Fed is set to end its asset purchases in October 2014.

2. China's economy sluggish

China's real GDP expanded by 2 percent in quarter-on-quarter terms, and by 7.5 percent in year-on-year terms in the second quarter of 2014, according to the official statistics authority. This subdued growth compared with recent years was supported by new public investment in rail infrastructure and social housing construction. In addition, an easing of the rules on banks' loan-to-deposit ratio resulted in strong credit expansion. The Markit Purchasing Managers' Index rose from 50.7 in June to 51.7 in July.

The business cycle index published by the Japanese government had plunged as a result of the demand shortfall caused by the value added tax increase in April 2014. While sales of consumer durables continued to decline in June, the leading indicators relevant for private consumption such as consumer confidence and sales forecasts improved after having fallen for months prior to the tax increase. New machinery orders dropped significantly, however.

Consumer confidence improving again in Japan.

3. EU: high unemployment rates slowly falling

Recent months have seen unemployment rates decline in some EU countries faced with high and rising unemployment owing to the economic crisis: in Spain, the rate has been falling since September 2013, but at 24.5 percent nevertheless remained one of the highest rates recorded in the EU in June 2014. In Portugal, the downward trend has continued since May 2013; the rate stood at 14.1 percent in June. Though declining slightly in June 2014, the unemployment rate nevertheless remained high also in Croatia (16.3 percent), Slovakia (13.8 percent), Italy (12.3 percent), Ireland (11.8 percent), Bulgaria (11.6 percent), Lithuania (10.5 percent) and Slovenia (10.1 percent).

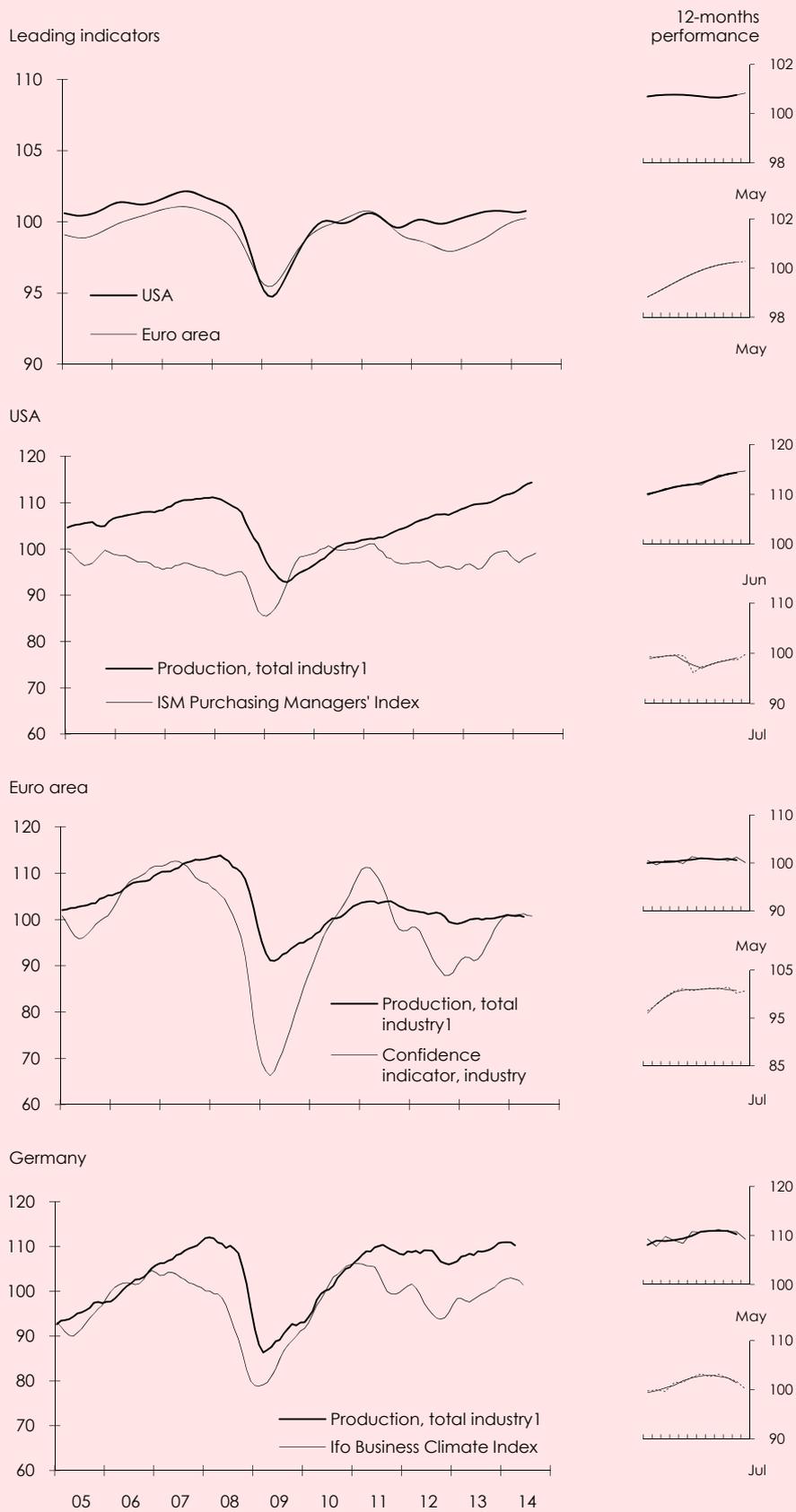
Following already extremely low rates of 0.5 percent in both May and June, euro area inflation is assumed to have fallen further to 0.4 percent in July, according to provisional estimates.

The upswing in Spain is likely to have gained momentum: according to first estimates, real GDP advanced by 0.6 percent in the second quarter of 2014, compared with the previous quarter. Since the first modest increase in the third quarter of 2013 (+0.1 percent), growth rates have thus been rising continuously (fourth quarter of 2013 +0.2 percent, first quarter of 2014 +0.4 percent).

The upswing gained traction in Spain and continued in the UK.

Figure 1: International business climate

Seasonally adjusted, 2010 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply ManagementTM), Ifo (Institute for Economic Research, Munich), OECD. - ¹ Excluding construction.

After real GDP increased at a quarterly rate of 0.7 percent and 0.8 percent respectively already in the previous four quarters, the upswing in the UK continued unabated in the second quarter of 2014 (+0.8 percent). Given the tepid recovery following the financial market crisis in 2008, it was only then that real GDP exceeded the level recorded in the first quarter of 2008. In Germany, the pre-crisis peak was exceeded already in the first quarter of 2011, while in Austria and in the USA this was the case in the second quarter of 2011, and in Japan as late as the first quarter of 2014; on euro area average, this level has not been reached at all yet. Developments in the UK are marked by persistently weak industrial production, which plummeted in 2009. Hence the upswing is to a more-than-proportional degree driven by the services sector. Construction activity shrank somewhat, following growth in the previous quarter.

4. Germany: optimism weakening

German domestic economic activity is on an expansion path, but the outlook for foreign trade is darkening, as latest economic indicators show: GfK's Consumer Confidence Index maintained its upward trend in July amid falling unemployment and increasing purchasing power. By contrast, Ifo's Business Climate Index, an important leading indicator for the German as well as the Austrian economy, fell for the third time in succession in July. The decline reflects increasing uncertainty notably among industrial companies, which is likely to have risen considerably already prior to the trade sanctions against Russia that have now been adopted: three quarters of the interviews forming the basis of the current survey figures were held before the USA (and later the EU) decided on more severe sanctions. Sentiment has darkened especially in manufacturing, while the services sector is not affected, and construction and the trade sector to a lesser extent. Seasonally adjusted manufacturing new orders fell significantly in June (–3.2 percent compared with May, according to a first estimate), following a decline of 1.6 percent already in the previous month.

The Ifo Business Climate Index has fallen significantly recently.

5. Tensions with Russia weighing on Austria's foreign trade

External merchandise trade was persistently weak in the first four months of 2014, with the value of goods exports rising by a mere 1.8 percent compared with a year before. Hence, external trade dynamics have barely been higher so far than in the previous two years when economic activity was weak (merchandise exports +1.5 percent and +1.8 percent, respectively). Unlike last year, however, merchandise imports have risen slightly this year (January to April +1.3 percent, compared with a year before); this may be an indication of a consolidation of domestic demand.

External trade has lost momentum, not least owing to the sharp decline in exports to Russia. While in the first quarter of 2014 exports to Russia had been 4.4 percent lower than their level a year before, in the period from January to April 2014 they already remained 11.7 percent below that level. As regards the most important product groups, the sharpest declines were recorded in exports of iron and steel (SITC 67), machinery specialized for particular industries (SITC 72) and general industrial machinery and equipment n.e.s., and machine parts n.e.s. (SITC 74). With a share of 2.8 percent (as at 2013), Russia is the tenth-largest target market of Austrian merchandise exports. Exports to the UK (+13.2 percent), the Czech Republic (+6.1 percent), Hungary (+6.1 percent) and Poland (+4.4 percent), countries with strong economies, increased in the first four months of 2014. Exports to France posted yet another vigorous increase, owing to special effects in the pharmaceutical sector. Following a sharp slowdown since 2011, growth of exports to China accelerated again (January to April +13.5 percent).

Austrian exports of iron, steel and machinery to Russia declined significantly in the first four months of 2014.

5.1 Sentiment darkening in industry and construction

While uncertainties triggered by the Ukraine crisis were not reflected in WIFO's Business Cycle Survey to the same extent as in the German Ifo index, first signs of a darkening of sentiment emerged in July: the assessment of export orders, which since the beginning of the year had been optimistic (share of industrial firms judging their orders to be "sufficient" or "more than sufficient") and had risen to 62 percent until June 2014, deteriorated to 59 percent in July. The pre-crisis peak was 78 percent (June 2007), whereas the lowest level recorded during the recession was 30 percent (July 2009). Other indicators for the manufacturing sector, such as the assessment of the present situation and production expectations, also fell in July. The assessment of the present situation deteriorated further among manufacturers of intermediate products, and even significantly so among manufacturers of consumer goods and in construction. Business sentiment worsened noticeably in the construction sector; the only time it had been worse than in July 2014 had been at the height of the economic crisis in 2009. Similar to the German Ifo survey, sentiment in services was found to be better than in the other sectors, with indicators merely stagnating, though. The more optimistic sentiment registered after the weak winter in the hotel and restaurant sector strengthened.

Improved confidence in tourism lifts sentiment in the services sector.

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.

The deterioration in sentiment observed in the Austrian economy also becomes apparent in the development of WIFO's Leading Indicator: in July, it fell for the fourth time running. The decline was broad-based across almost all sub-components. Notably the indicators for confidence in the manufacturing sector and consumer confidence deteriorated significantly compared with the previous month. Hence, a growing amount of evidence now suggests that the economy is losing steam.

WIFO's Leading Indicator declined significantly in July.

5.2 Private consumption remains tepid

Consumer sentiment in Austria, as measured against the European Commission's Consumer Confidence Indicator, remains tepid. Consumer confidence has barely changed since December 2013, with pessimistic assessments still outnumbering optimistic ones. Consumers' willingness to purchase cyclically sensitive consumer durables (such as new passenger cars or furniture) also did not follow any noticeable upward trend in the first half of 2014. New passenger car registrations (apart from the tax-related increase in February due to households' bringing forward purchases prior to the increase of NoVa duty on new car purchases) remained considerably below their level a year before. Retail sales (excluding cars), supported by stable developments in the food sector, are likely to have picked up slightly in the first half of the year (+1.2 percent in nominal terms, +0.3 percent in real terms, compared with a year before).

5.3 Early summer tourism buoyant after weak winter

In May and June 2014, noticeably more guests than last year spent their holidays in Austria (+6.1 percent). The number of nights spent rose briskly (+4.7 percent), albeit at a slower pace than the number of guests, given the declining length of stays. Both domestic (+5.4 percent) and foreign travellers (+4.3 percent) spent more nights in Austria. The demand from German guests, the largest group among foreign travellers, rose significantly in the first two months of the 2014 summer season, following a marked decline in the winter due to the mild weather. The largest increase in the number of nights spent in Austria was recorded for Czech, Italian, Hungarian and Belgian guests, while Swedish and Russian guests cut down their stays. The strong increase overall is in part a consequence of cancellations of holidays in the winter, given that tourists frequently plan their holiday budget ahead and "make up for" an unconsumed winter holiday in the summer.

Winter holidays that were not consumed owing to the warm weather were partly made up for in early spring.

5.4 Inflation rate higher than in other euro countries

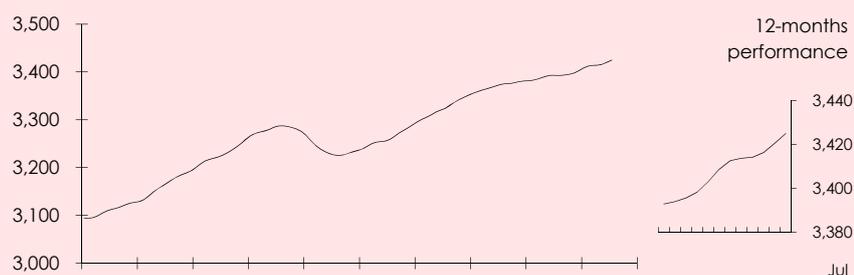
Inflation as measured by the consumer price index stood at 1.9 percent in June 2014, which was a slight increase from the previous month (May 1.8 percent). The increase in excise duties in March 2014 contributed around ¼ percentage point to the current inflation rate, while administered prices accounted for 0.1 percentage point. The largest upward impacts to inflation came from restaurant and tourism services (restaurants and cafeterias, hotels, package tours), alcoholic beverages and tobacco, as well as apartment rents and telephone charges. Energy prices were 1.6 percent below their level a year earlier in June.

Restaurant and tourism services, alcoholic beverages and tobacco as well as housing and telephone costs became noticeably more expensive.

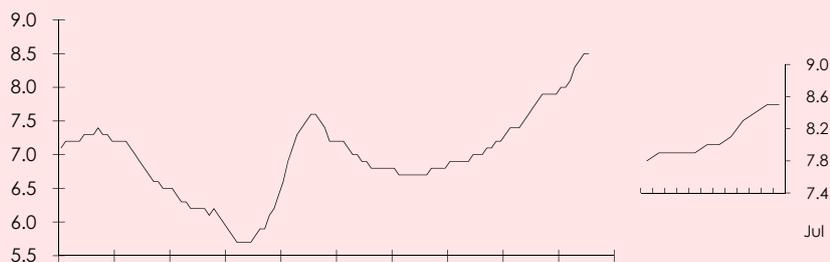
The inflation rate as measured by the Harmonised Index of Consumer Prices was somewhat lower in June (1.7 percent), owing to a different weighting of components, but, as already in previous months, nevertheless was the highest rate recorded in the euro area. The inflation differential (+1.2 percentage points compared with the euro area average, +0.7 percentage point vis-à-vis Germany) for the most part stems from stronger inflationary pressures in the Austrian services sector. Food (including alcohol and tobacco) accounted for 0.4 percentage point of the inflation differential compared with the euro area average, while industrial goods (excluding energy) contributed 0.2 percentage point. Price increases in restaurants and cafeterias accounted for 0.2 percentage point of the inflation differential vis-à-vis the euro area as a whole, while telephone charges contributed 0.2 percentage point, and hotels and medical services 0.1 percentage point each. Inflation dynamics currently prevailing in Austria are basically consistent with the level desired by monetary policy, but no doubt lie at the upper limit of the tolerance range, given the low dynamics of the real economy.

Figure 3: Key economic indicators

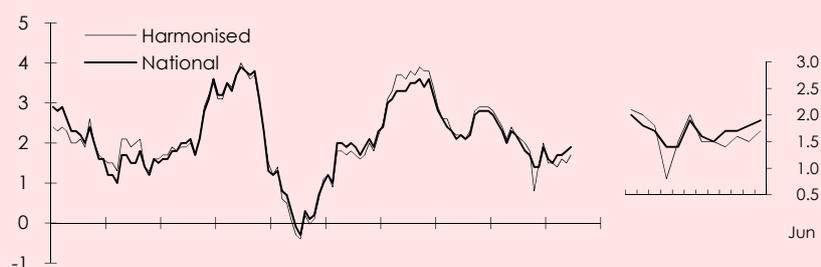
Persons in active dependent employment¹, (1,000), seasonally adjusted



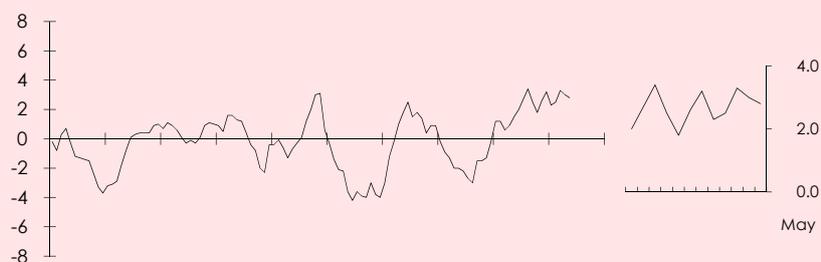
Unemployment rate, traditional Austrian method², seasonally adjusted



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.

5.5 Labour market not easing

The labour market situation remains tense: in July 2014, the seasonally adjusted unemployment rate was 8.5 percent, according to first estimates, which was an increase of 0.5 percentage point from February 2014. The strong upward trend observed in the first half of the year appears to have weakened in July; the number of jobless people rose at a somewhat slower pace also on a year-on-year basis in July 2014 (+11.6 percent) than in June and May (+16.2 percent and +15.5 percent, respectively). However, the number of job vacancies was down by 5.2 percent in July compared with a year before; therefore, the labour market situation is not likely to improve in the short run. Meanwhile, employment rose further in July.

The seasonally adjusted unemployment rate stood at 8.5 percent in July.