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Darkening Sentiment

Business Cycle Report of June 2008

Firms' assessment of the economic situation in the coming months has become less positive. The deterioration in sentiment indicators points to slowing growth in the coming quarters. In the first quarter, the Austrian economy still expanded at a very vigorous pace, though (+0.7 percent quarter-on-quarter, +3.3 percent year-on-year). Net exports were the main pillar of the economy; domestic demand showed no signs of picking up.

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WIFO's business surveys indicate a substantial darkening of sentiment. Notably the manufacturers of intermediates, capital goods and consumer goods have become significantly more pessimistic in their expectations for the business situation over the next six months. Production expectations and the assessment of the current business situation have already fallen below their longer-term averages. The appraisal of current order books, while also having deteriorated, still stands above its mean value. The results of the WIFO business survey thus signal a deceleration in the pace of production growth over the coming quarters.

In the first quarter, the international financial crisis and the appreciation of the euro did not yet have a dampening effect on the Austrian economy. Growth remained vigorous at +0.7 percent quarter-on-quarter (adjusted for seasonal and calendar effects), and at +3.3 percent on an annual basis, according to WIFO's revised quarterly calculation. This was a slight downward revision from the result of WIFO's flash estimate released one month ago (+3.5 percent year-on-year and +0.8 percent quarter-on-quarter, respectively). Goods exports lost some momentum, while the construction sector benefited from the mild winter, and tourism from the early timing of Easter. Business spending on machinery and vehicles continued to be very subdued. Judging by developments until now it is doubtful whether firms in manufacturing will fully implement their investment plans for this year.

Private consumption did not accelerate, in spite of strong employment gains. In the first quarter, retail sales rose at a faster pace than recently only because of the early timing of Easter. While sales of some consumer durables developed favourably, car sales remained relatively weak. In the first four months of 2008, the number of newly licensed cars rose by 0.8 percent from a year before.

Consumer sentiment is barely optimistic, as high price increases are eroding household purchasing power. In the first four months, both gross contractual wages and consumer prices were up 3.3 percent from a year earlier. However, due to the "cold progression", net wages declined by around ½ percent in real terms.

Rising energy and food prices are spurring inflation. In May, crude oil for the first time traded higher than 125 \$ per barrel; speculative purchases played an important role here. At the consumer level, energy and food prices were up 13 and 7 percent, respectively, from a year before; these two groups contributed three fifths to overall inflation. The price of diesel fuel was up 30 percent from a year earlier, while prices of bread and grain products were around 11 percent higher.

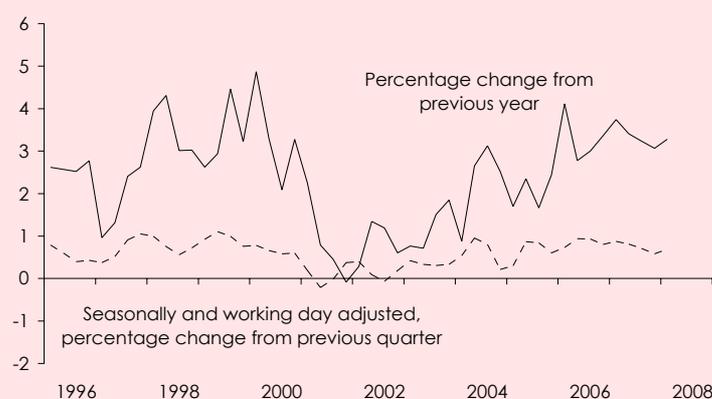
Table 1: Quarterly national accounts

			2006	2007				2008
			Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter
			Percentage changes from previous quarter					
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.3	+ 0.4	+ 0.5	+ 0.8	+ 0.5	- 0.2
Households ¹			+ 0.3	+ 0.3	+ 0.5	+ 0.4	+ 0.1	+ 0.2
General government			+ 0.4	+ 0.4	+ 0.4	+ 2.0	+ 1.2	- 1.7
Cross capital formation			+ 0.8	+ 0.8	+ 0.6	+ 0.6	+ 0.6	+ 0.6
Gross fixed capital formation			+ 1.2	+ 1.1	+ 0.9	+ 0.7	+ 0.5	+ 0.3
Machinery and equipment			+ 1.1	+ 1.9	+ 1.5	+ 0.8	+ 0.4	+ 0.4
Construction			+ 1.6	+ 0.8	+ 0.3	+ 0.3	+ 0.5	+ 0.6
Exports, goods and services			+ 2.5	+ 2.3	+ 1.8	+ 1.1	+ 1.2	+ 1.2
Goods			+ 3.1	+ 2.9	+ 1.3	+ 0.9	+ 0.9	+ 1.0
Services			+ 1.8	+ 2.1	+ 2.7	+ 3.1	+ 3.0	+ 2.6
Imports, goods and services			+ 1.9	+ 1.5	+ 1.0	+ 1.5	+ 0.9	- 0.3
Goods			+ 1.9	+ 1.8	+ 1.1	+ 1.3	+ 0.9	- 0.2
Services			+ 1.2	+ 1.0	+ 1.3	+ 1.7	+ 1.6	+ 1.3
Gross domestic product			+ 0.8	+ 0.9	+ 0.8	+ 0.7	+ 0.6	+ 0.7
Manufacturing			+ 2.6	+ 1.9	+ 0.9	+ 1.1	+ 1.5	+ 1.6
	2006	2007	2006	2007				2008
			Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter
	Percentage changes from previous year							
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 2.1	+ 1.7	+ 1.9	+ 1.0	+ 1.6	+ 2.3	+ 1.8	+ 1.5
Households ¹	+ 2.1	+ 1.4	+ 1.9	+ 0.9	+ 1.6	+ 1.9	+ 1.2	+ 1.4
General government	+ 2.1	+ 2.4	+ 2.0	+ 1.3	+ 1.4	+ 3.3	+ 3.7	+ 1.9
Cross capital formation	+ 3.7	+ 4.1	+ 1.4	+ 10.4	+ 0.3	+ 4.8	+ 2.3	+ 3.4
Gross fixed capital formation	+ 3.8	+ 5.2	+ 3.8	+ 9.9	+ 3.8	+ 4.8	+ 3.7	+ 0.7
Machinery and equipment	+ 1.5	+ 7.1	- 4.1	+ 8.5	+ 2.2	+ 9.8	+ 8.4	- 1.6
Construction	+ 5.1	+ 3.9	+ 7.8	+ 12.1	+ 4.5	+ 1.7	+ 0.8	+ 3.5
Exports, goods and services	+ 7.5	+ 9.1	+ 8.4	+ 10.0	+ 9.5	+ 8.5	+ 8.5	+ 6.4
Goods	+ 7.9	+ 9.0	+ 8.6	+ 11.4	+ 10.9	+ 7.6	+ 6.6	+ 3.3
Services	+ 6.4	+ 9.4	+ 8.1	+ 6.4	+ 5.5	+ 11.0	+ 14.5	+ 15.1
Imports, goods and services	+ 5.6	+ 6.6	+ 5.6	+ 9.5	+ 4.7	+ 8.1	+ 4.4	+ 2.0
Goods	+ 5.5	+ 7.2	+ 4.1	+ 11.0	+ 5.0	+ 8.9	+ 4.0	+ 1.3
Services	+ 6.1	+ 4.5	+ 10.9	+ 2.5	+ 3.4	+ 5.5	+ 6.2	+ 6.4
Gross domestic product	+ 3.3	+ 3.4	+ 3.4	+ 3.7	+ 3.4	+ 3.2	+ 3.1	+ 3.3
Manufacturing	+ 8.8	+ 7.4	+ 10.0	+ 9.5	+ 7.7	+ 6.5	+ 6.0	+ 6.1
Gross domestic product, value	+ 5.1	+ 5.7	+ 5.3	+ 6.2	+ 5.5	+ 5.7	+ 5.6	+ 6.3

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

Figure 1: Growth of real GDP

Percentage change from previous period



Source: WIFO.

The favourable labour market trends continued in May. The number of jobs rose by 2½ percent year-on-year, and the unemployment rate declined (-½ percentage point), despite a cutback in the vocational training programmes offered by the Pub-

lic Employment Service. The accelerated pace of employment growth observed since the turn of the year is most likely largely the result of the introduction of the obligation for companies to immediately notify the authorities of new employment contracts. This measure may have added 20,000 to 30,000 persons to the official number of people in employment. At the same time, it strongly raised the revenue from wage tax and social insurance contributions. Employment also developed very favourably even when adjusted for the administrative special effect. Job vacancies, a leading indicator, on the other hand have been rising at a slower pace month after month, exceeding the year-earlier level only marginally in May (+500). This signals – similarly to the sentiment indicators – a slowdown in economic activity. The seasonally adjusted unemployment rate also has not fallen further since February, but has already reached a relatively low level (5.1 percent in May, according to the national calculation method, or 4.2 percent in seasonally adjusted terms in April, according to Eurostat).

In the first quarter, growth in the USA was dampened by reduced spending on residential construction and durable consumer goods (cars). Residential investment continued to decline sharply, and falling real estate prices as well as rapidly rising consumer prices suppressed households' spending propensity. The dollar depreciation on the other hand bolstered export growth. Some recent data (e.g., employment gains in May) have strengthened expectations in the USA that the economic downturn might be less pronounced than feared.

The US economy grew somewhat more strongly than assumed at the start of the year. Real GDP advanced at a quarter-on-quarter pace of +0.23 percent in the first quarter, up from +0.14 percent in the fourth quarter of 2007. In quarterly annualised terms, the growth rate was +0.9 percent, up from +0.6 percent. The tax rebates should support private consumption in the second half of the year. Domestic demand, the engine of economic growth, is nevertheless expected to weaken in 2008, compared with the year before. Export growth on the back of the massive depreciation of the dollar will, however, prevent a decline in the gross domestic product.

Prices increased sharply in the USA, boosted by soaring commodity and crude oil prices and the collapse of the dollar: Inflation stood at just under 4 percent in April. Given the upward drift in prices, the Central Bank is likely to adopt a more cautious stance in its interest-rate policy. In the first four months it cut interest rates four times by a total of 225 basis points.

The Euro area economy has remained robust up to now, despite the international turmoil. The business climate in industry, construction and trade has been deteriorating since the turn of the year, however. According to the European Commission survey, confidence in the economic situation has dropped below its long-term average for the first time in two years. The pace of activity in the euro area is set to slacken in the coming months.

Growth accelerated at the start of the year, little affected by the financial market turbulence. This follows from a first estimate by Eurostat. Euro area real GDP grew by +0.8 percent quarter-on-quarter in the first quarter – benefiting also from the mild weather conditions in winter – or by +2.2 percent compared with the same period a year before.

The Euroframe Indicator, which weights leading variables (relative to the previous quarter), suggests growth will decelerate to 1.7 percent in the second quarter and to 1 percent in the third quarter. The dampened economic expectations reflect the impacts of the US housing crisis, the euro appreciation and soaring crude oil prices.

Retail sales volumes have followed a downward trend since the beginning of the year, and in April were down ½ percent from March. Strong inflationary pressures are weighing on household purchasing power and particularly the willingness to buy expensive food products. Food prices were up 6 percent from a year before in April.

US economy scarcely growing

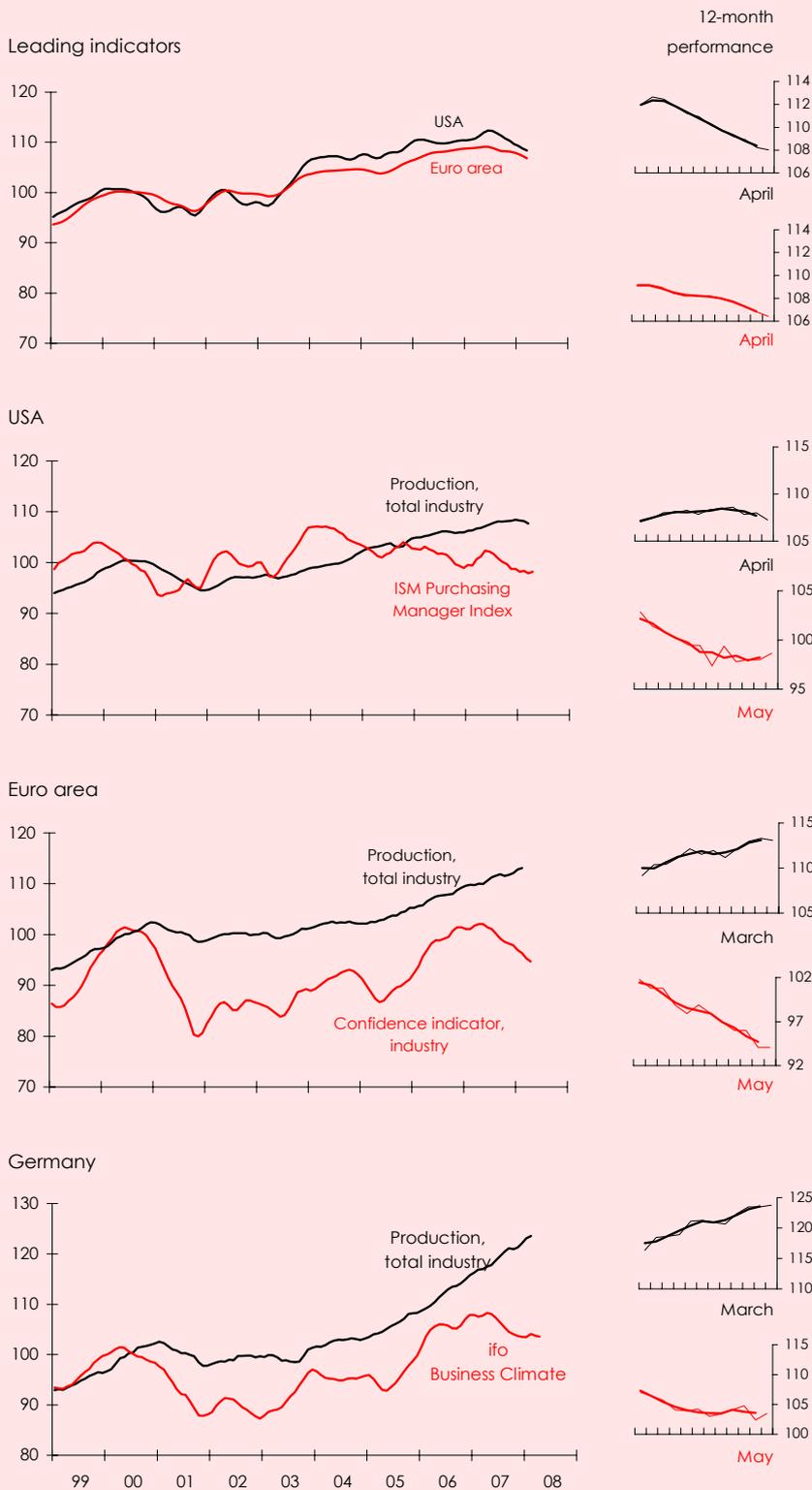
The US economy is on the brink of recession. The interest rate cuts and the tax rebates could help to avoid stagnation this year, however.

Euro area economy robust in first quarter

Business sentiment in the euro area has followed a downward trend in recent months. The impact of the international financial crisis, the euro appreciation, and soaring crude oil prices are dampening economic expectations. Economic developments nevertheless withstood the downward pressure in the first quarter.

Figure 2: International business climate

Seasonally adjusted, 2000 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institute for Economic Research, Munich), OECD.

Euro area inflation was 3.3 percent in April and is estimated at 3.6 percent in May by Eurostat. In the OECD's view, a "drastic" fall in crude oil prices is nowhere in sight, but food prices might weaken in the second half of the year in the event of normal harvests. They will nonetheless remain permanently higher than in previous years, mainly

as a result of rising demand from China and India and speculation on further price rises.

The German economy has so far successfully escaped the global downward trend. After moderating somewhat towards year-end, real GDP expanded at a vigorous pace in the first quarter (+2.6 percent, compared with the same quarter a year earlier, adjusted for calendar effects). The global shocks will affect the German economy with a lag, however. Negative impulses stem not only from US financial markets, crude oil prices and the appreciation of the euro, but also from the economic slowdown observed in Great Britain, Spain and Italy. Private consumption in Germany does not yet show any upward tendencies that could offset the negative impact from the external side, despite improved labour market conditions.

The Austrian economy expanded at a seasonally and working day adjusted quarterly rate of 0.7 percent in real terms in the first quarter of 2008, up from +0.6 percent in the fourth quarter of 2007. This represents a slight downward revision from the results of the WIFO flash estimate released at the beginning of May. Revisions were made with respect to the value added data for some services sub-sectors and for the construction and the industrial sectors. But also the revised estimate shows slightly accelerated growth in manufacturing activity compared with the previous quarter (+1.6 percent, up from +1.5 percent in the fourth quarter of 2007).

The construction sector, benefiting from the mild weather conditions in winter, expanded at a quarter-on-quarter rate of 0.6 percent in the first quarter (+2.5 percent in annual terms). Notably civil engineering activity accelerated, thanks to rising infrastructure orders for road and railway superstructure construction.

While activity in the trade sector, at +0.3 percent, scarcely picked up further compared with the previous quarter, growth accelerated markedly in the real estate and business services sectors (to +1.4 percent quarter-on-quarter).

Gross fixed capital formation has been losing momentum for a year. Quarter-on-quarter growth rates, which had still exceeded 1 percent in real terms a year ago, fell to just 0.3 percent in the first quarter of 2008. Construction investment expanded by +0.6 percent quarter-on-quarter, a marked acceleration from the previous three quarters, whereas business spending on machinery and equipment moderated. Notably vehicle investment declined in the last two quarters, compared with the same two quarters a year earlier.

Foreign demand remained a pillar of growth also in the first quarter. The revised estimate hardly points to a further acceleration in export growth, however. In the first quarter, exports rose by 1.2 percent in real terms quarter-on-quarter. The year-on-year increase was 6.4 percent in real terms, while imports rose by a mere 2 percent. The demand for imports declined compared with the previous quarter.

Private consumption growth, at +0.2 percent in real terms quarter-on-quarter in the first quarter, remained weak and did not show any signs of accelerating. Compared with a year earlier, this represents a real growth rate of 1.4 percent.

Manufacturers' assessment of current order books and of foreign orders, while having deteriorated, still exceeds its longer-term average. Production expectations for the next three months and in particular business expectations for the next six months have darkened to such an extent, however, that they already stand below their medium-run trend value. This will be reflected with a lag in production figures; economic activity is therefore set to lose momentum in the second and third quarters.

Firms in the construction sector currently assess their order situation as only average, whereas business services companies continue to judge theirs as good.

Austria: First quarter GDP growth 3.3 percent

The Austrian economy expanded at a quarter-on-quarter rate of 0.7 percent in the first quarter, displaying no slowing tendency up to now. The improvement in the labour market has not yet translated into private consumption growth as high inflation is eroding purchasing power. Investment demand was also subdued in the first quarter. Net exports continue to provide the main stimulus.

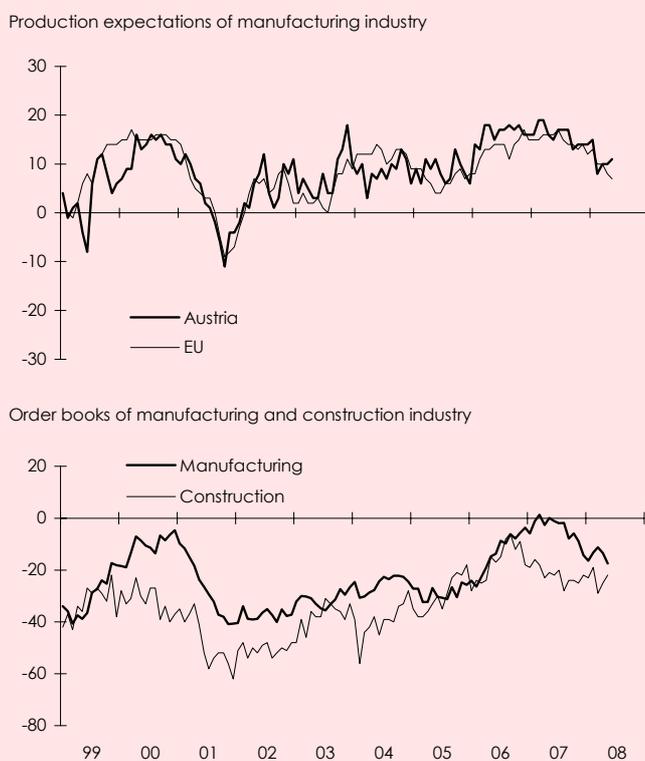
Business sentiment cooling

The assessment of current order books is deteriorating slightly, whereas a sharp deterioration is being registered in the appraisal of the production and business outlook for the coming months.

Merchandise exports rose by 5 percent in nominal terms in the first quarter. Deliveries to the EU 27 increased almost as quickly as those to third countries. Exports to CIS and OPEC countries, to Southeast Europe, CEEC and the emerging market countries (non-OPEC) registered strong above-trend growth. Exceptionally high nominal increases were recorded for agricultural products and fuels.

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.

Export and import prices rose on the back of the commodities boom; recent information about this is not yet available, however. Merchandise imports grew at a weaker pace than exports in the first quarter due to sluggish domestic demand, exceeding the year-earlier level by 4 percent in nominal terms. The merchandise trade balance registered a surplus both vis-à-vis the EU and third countries (+ € 450 million).

The retail sector posted a real sales increase of 1.4 percent in the first quarter, largely owing to the fact that the Easter holiday fell in March this year. While sales of some consumer durables (e.g., furniture) developed favourably, sales of non-durable consumer goods remained slack owing to the sharp increase in food prices.

Slightly more passenger cars were registered on average in the first four months of 2008 than in the same period a year earlier. The proportion of diesel-driven vehicles has been falling markedly due to their generally higher price than that of petrol-driven cars and to the fact that the price of diesel is already higher than that of petrol.

Private consumption advanced by just under 1½ percent year-on-year in the first quarter – similar to the trend observed in recent years. Consumer sentiment reflects little optimism. Consumers anticipate a worsening of their personal financial situation over the coming twelve months owing to the price increase and the economic slowdown. Although the autumn pay round resulted in considerably higher wage increases than a year before, strong upward price pressures prevent real wages

Merchandise trade surplus

Austrian exports did not lose momentum in the first two months of 2008 despite the appreciation of the euro and weak economic activity in the USA. They declined in March, however, largely on account of fewer working days. Exports grew faster than imports, resulting in a positive balance of merchandise trade.

No acceleration in consumption growth

Private consumption will not offset the anticipated slowdown in export momentum. Retail sales growth remains subdued, with a slight increase recorded in new passenger car registrations.

from rising. Growth in private household purchasing power results exclusively from employment gains.

According to preliminary calculations, Austria's tourist industry increased its sales by 10 percent or more in the 2007-08 winter season, compared with the year-earlier level, which had been suppressed by the lack of snow. Thus, tourism is on a growth path that will enable it to regain market shares.

The number of overnight stays rose by 6.6 percent in the winter season, with the demand by foreign guests rising at a faster pace (+7.4 percent) than that by resident travellers (+4.0 percent). Notably the high demand observed in December 2007 and in February 2008 contributed to the good overall result. The reversed trend in March and April 2008 clearly reflects the calendar effect of the Easter holiday compared with a year earlier.

The number of overnight stays by guests from Austria's neighbouring eastern countries and from Russia rose very briskly, whereas a lower-than-average increase was recorded in the demand from Germany (+6.4 percent), the most important country of origin, as well as from Belgium, the Netherlands, France and Denmark. The number of overnight stays by guests from Great Britain on the other hand rose modestly. Almost the same number of Italian travellers as in the year-earlier season visited Austria this season, whereas noticeably fewer guests came from Switzerland and the USA (-9.9 percent), probably largely due to the persistent appreciation of the euro.

All federal provinces posted strong sales increases, with Vienna, Styria, Vorarlberg, Lower Austria and Tyrol experiencing two-digit growth rates. Salzburg's sales increase was slightly lower than the Austrian average, whereas the growth gap was bigger for Burgenland, Carinthia and Upper Austria.

Price increases in international commodity and crude oil markets were largely driven by growing global demand and subsequent speculative purchases. In May, one barrel of Brent crude for the first time traded higher than 125 \$ in Rotterdam. The prices of industrial raw materials and food products also soared: iron ore cost 70 percent more than a year before, with steel prices rising accordingly. This development is reflected in Austria's wholesale price index: In May it was up 11.7 percent from a year earlier, suggesting persistently high consumer price inflation over the coming months.

Headline inflation stood at 3.3 percent in April, according to calculations by Statistics Austria, slightly down from the 3.5 percent observed in March. Food and transport services were both up 7 percent from a year before. Price increases for energy (fuels and heating oil) and foodstuffs accounted for three fifths of overall inflation. In the expenditure categories transport and energy, particularly high price increases were registered for diesel fuel (+30 percent year-on-year) and heating oil (+27 percent). Among foodstuffs, prices rose notably for pasta (+40 percent) and cheese (+20 percent).

The harmonised index of consumer prices rose by +3.4 percent in April, marginally faster than the domestic consumer price index. Inflation in Austria hardly differed from the euro area average (3.3 percent).

Employment growth continued undiminished in spring. The number of persons in dependent active employment rose by 87,000 (+2.6 percent) in May from a year before. Almost 60 percent of the additional jobs were filled by women. The strong acceleration in employment growth from December to January suggests that the introduction of the obligation to immediately report new employment contracts has had effect. This measure may have added 20,000 to 30,000 persons to the official employment number. The number of foreign workers rose faster this year than last year, exceeding the year-earlier level by 26,800 in April.

Successful winter tourist season

Winter tourism was considerably stronger than last year. The main stimulus was provided by the global economic revival and good snow conditions.

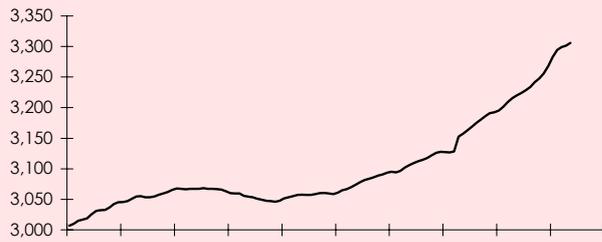
Food and energy prices driving inflation

The inflation rate reached 3.3 percent in April, largely fuelled by higher energy and food prices. These two product categories accounted for three fifths of the upward drift in prices.

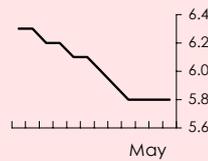
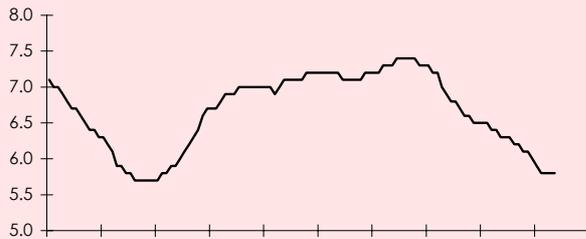
Employment growth undiminished

Figure 4: Key economic indicators

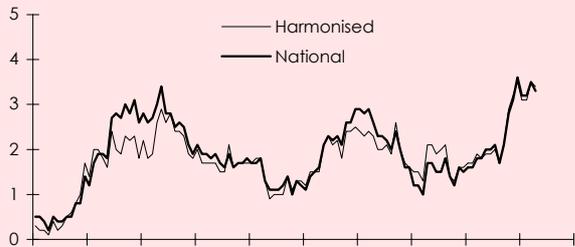
Persons in active dependent employment¹, (1,000), seasonally adjusted



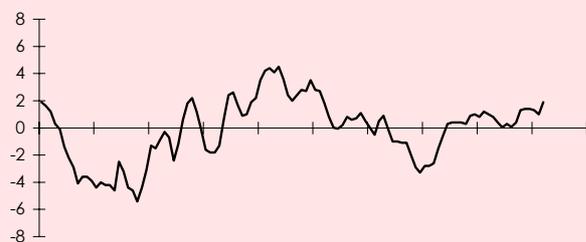
Unemployment rate, traditional Austrian method², seasonally adjusted



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.

In May, 184,800 persons were registered as unemployed with the Public Employment Service, a drop by 13,000 (–6.6 percent) from a year before. Including persons enrolled in vocational training programmes, the number of people looking for jobs was still clearly lower than a year earlier. The introduction of the obligation to immediately report new employment contracts might also have contributed to the decline in unemployment.

Employment and unemployment lag behind economic activity. The number of job vacancies, by contrast, is considered a leading indicator. It has been rising at a slower pace month after month since the start of this year, exceeding the year-earlier level by just 500 in May (following +5,300 in 2007). This indicates a slowdown in economic activity in spring.

The positive developments in the labour market continued in May. Employment rose by 2½ percent or more from a year earlier, unemployment fell by ½ percentage point.