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Economy Supported by Higher Retail Sales

Recent months have seen a further improvement in business and consumer sentiment. Low headline inflation contributes to a strengthening of purchasing power, and companies intend to expand their investment activity. Employment, notably in part-time jobs, is growing strongly owing to the economic rebound, whereas the rate of unemployment growth is decelerating.

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The deceleration of inflation in January raised private households' real purchasing power and gave fresh stimulus to private consumption. In the fourth quarter, real retail sales (without cars) were up 2 percent year-on-year. Preliminary reports suggest that business in retail trade was brisk in January, the overall result being depressed by weaker car sales, however. Private consumption should grow at a faster pace this year. According to the WIFO investment survey, investment activity may also be expected to pick up: firms in the manufacturing sector intend to increase their investment expenditure by 7.7 percent from last year. Despite modest year-on-year export growth in the fourth quarter, companies assessed their foreign orders quite favourably at the beginning of the year.

The positive assessment of foreign orders is connected with the revival of economic activity in the euro area. Notably Germany has seen a marked improvement in sentiment. This brightening continues to be primarily sustained by an increase in exports, but investment activity has also begun to rebound. Crude oil prices and the euro exchange rate have stabilised and hence reduced uncertainty.

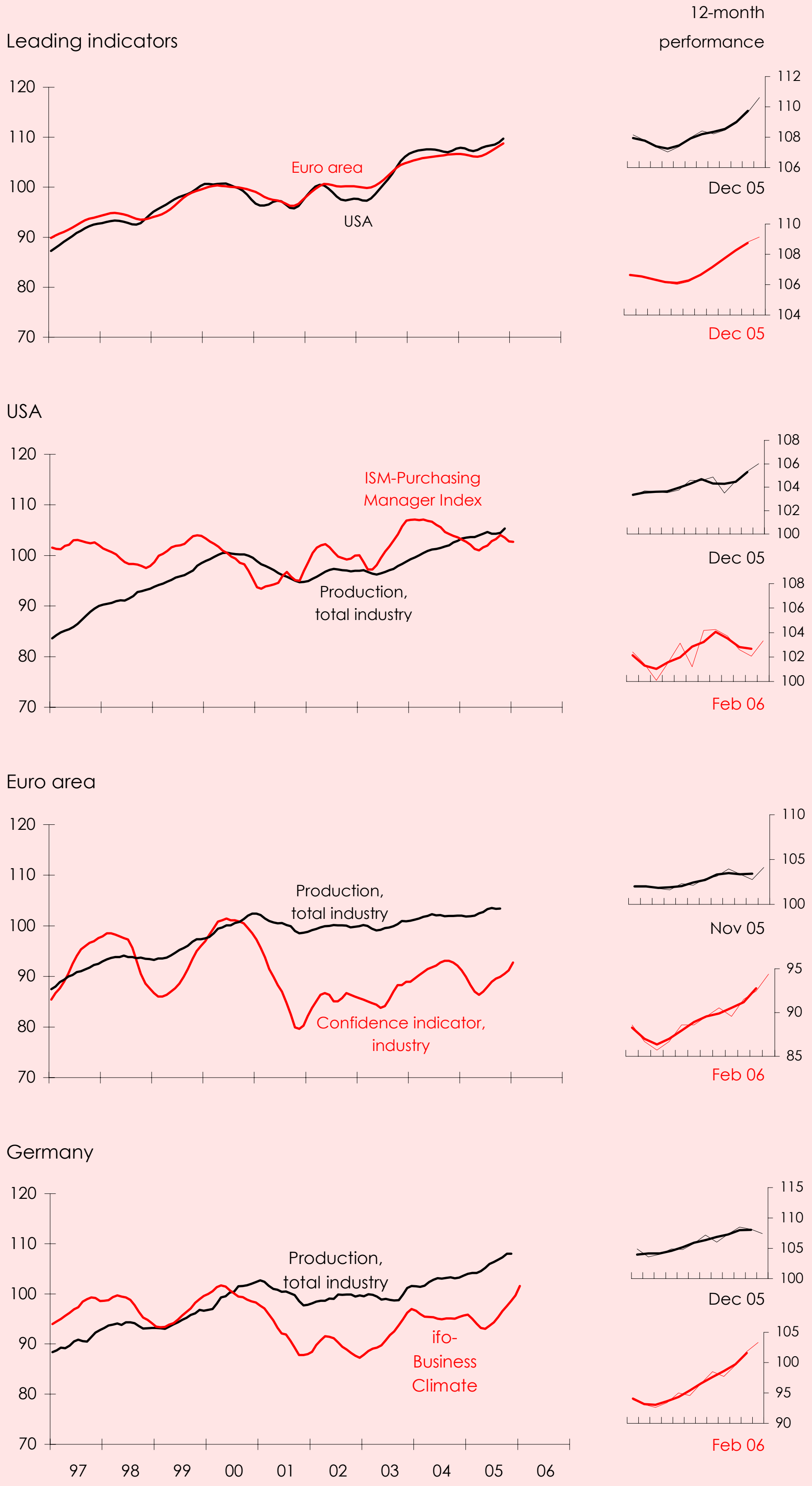
In Austria, industry surveys have shown an upward tendency for several months now. Firms in the manufacturing sector anticipate a production increase and are more optimistic in their assessment of order levels than in the preceding months. While till now construction companies described their business situation as particularly good, sentiment in the sector has darkened in recent months due to long and heavy snowfalls this winter.

Headline inflation dropped from 1.6 percent in December to 1.2 percent in January. Inflationary pressures were restrained by a decline in computer, mobile phone and camera prices. The rate of price increases was further depressed by a change in the statistical calculation: as from January 2006, average prices are no longer computed as an arithmetic mean, but as a geometric mean. This is believed to have reduced the measured rate of inflation by around 0.1 to 0.2 percentage point.

The economic rebound and notably higher labour market flexibility led to significant employment gains. In February, the number of persons in active employment rose by almost 39,000 year-on-year. High growth rates were posted by the sectors with a high proportion of persons employed part-time: business services, retail trade, tourism, and health services. About half of the employment gains were attributable to the extremely heterogeneous class of business services: it ranges from technical services, management and tax consultants' offices to cleaning services and personnel leasing agencies. Owing to a lack of social security statistical data it is difficult to estimate at present whether or not there have also been gains in full-time employment. While clearly fewer jobs were cut in manufacturing in the course of the economic recovery, transport and public sector employment continues to decline.

Figure 1: 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), OECD.

The number of unemployed rose only slightly year-on-year in February (+1,700). The fact that more people are enrolled in vocational training programmes (+7,800) played some part here. However, the number of unemployed persons with an assurance of reemployment also rose by around 8,000. Given the economic rebound and the strong expansion of labour market policy measures (training programmes, integration aids), unemployment figures may be expected to stabilise further in the next few months. In particular the shift of economic growth from export to more employment-intensive domestic demand should benefit full-time employment, the development of which is crucial for the integration of the unemployed into the labour market.

Economic growth high in Asia, muted in the USA

The global economy expanded vigorously in 2005 (by almost 4.5 percent), despite the surge in crude oil prices. China, where growth continued at a robust pace and spread also to other Asian countries, was a major driver of economic activity.

The world economic climate improved further at the start of the year according to survey evidence released by the Ifo Institute. Prospects are more favourable now notably in Western Europe and Asia, whereas North America has seen a slight decline in the indicator. Japan's economy has been growing only modestly compared to the upswing in Asia. But domestic demand in Japan has clearly gained momentum, with the deflationary phase appearing to have been overcome.

In the USA, real GDP in the fourth quarter increased at a seasonally adjusted rate of just 0.4 percent quarter-on-quarter. The slowdown can be attributed to the adverse effects of the hurricanes, coupled with a reaching of capacity limits, and rising interest rates. But notably the easing of real estate prices, which in recent years had shown a continued upward tendency and had thus spurred consumption, had a major impact.

US headline inflation, boosted by soaring energy prices, stood at 4 percent in January. The unemployment rate dropped to 4.7 percent in January. February saw a marked deterioration in consumer sentiment, however, as relatively favourable labour market conditions did not offset the adverse impact home prices had on consumer confidence.

The Federal Reserve has raised its key interest rate by 150 basis points since mid-2005. In contrast to what happened in previous phases with interest rate increases, long-term interest rates have declined slightly over the same period. The yield curve has flattened considerably, meaning a substantial narrowing of spreads between short- and long-term interest rates. Such a development in the yield curve has typically been a forerunner of a slowdown or even recession in the USA[1] – with a lag of two to four quarters.

In the view of the European Central Bank[2], the present situation differs from similar developments in the past in so far as the almost inverted yield curve primarily reflects especially low long-term interest rates, whereas in the past an inverted yield curve was the result of a marked increase in short-term interest rates at the end of an overheated business cycle. A more significant downturn in the US economy can of course not be ruled out at the present juncture.

European central bank hikes key interest rate again

The European Central Bank (ECB) raised its key interest rate, i.e., the rate at which the financial sector is provided with central bank money, again at the beginning of March (+25 basis points to 2.5 percent), with the key lending rate now being once more higher than the rate of inflation. The ECB wants to ward off rising inflation expectations and in particular a passing through of price increases to wage increases, and in this way underpins the priority of price stability over other objectives of economic policy. Criticism voiced by some – e.g., the Ifo Institute – on the recent interest rate increase addresses concerns that the economic recovery in the euro area

[1] Estrella, A., Rodrigues, A. P., Schich, S., "How Stable is the Predictive Power of the Yield Curve?", Review of Economics and Statistics, 2003, 85(3), pp. 629-644.

[2] European Central Bank, Monthly Bulletin, February 2006, p. 25.

needs yet to be strengthened, and that there is no indication of a serious wage-price spiral. The ECB did not comment on whether more rate increases are in the offing in the course of this year, although this is generally expected.

The European Central Bank voiced an exceptionally strong warning against excessive real estate speculation. The marked increase in home prices in some countries of the euro area (Spain, Ireland, amongst others) is likely to have contributed to the decision to raise interest rates.

Headline inflation in the euro area was 2.4 percent in January, while core inflation (excluding energy and food prices) stood at just 1.2 percent. The divergence of inflation rates among euro area countries was relatively wide: it was lowest in Austria (1.5 percent), followed by the Netherlands and Germany. A relatively high upward drift in prices was registered in Spain (4.2 percent).

Expectations in the euro area improved

In the fourth quarter, economic growth in the euro area decelerated to a seasonally adjusted rate of 0.3 percent, following a quarter-on-quarter increase by 0.7 percent in real terms in the third quarter. Compared to the same period a year earlier, the increase was 1.7 percent. Hence, the growth rate recorded in the euro area for the whole of 2005 was only 1.3 percent (USA +3.5 percent).

Fourth-quarter GDP growth in the euro area was relatively weak, coming in at just 0.3 percent quarter-on-quarter. Recent months have seen a marked improvement in business expectations, however, mainly in response to the stabilisation of the euro exchange rate and the oil price, as well as the turnaround in sentiment in Germany.

Both consumer and industrial confidence surveys by the European Commission and the Euroframe Indicator have depicted an upward tendency in recent months. Notably Germany has seen a marked improvement in expectations. For this reason, the European Commission slightly raised its forecast for euro area growth in 2006 to 1.9 percent. This assessment is supported by the rebound in private investment – fuelled by optimistic expectations, vigorous corporate profits and continuing favourable financing conditions.

The economic recovery in the euro area thus far has been too weak for unemployment to be reduced significantly. In January, the seasonally adjusted unemployment rate in the euro area stood at 8.3 percent, unchanged compared to the previous month.

Pick-up in German retail sales

A recovery of the German economy is in the offing. In 2005, GDP rose at a rate of just under 1 percent, somewhat slower than the euro area average of 1.3 percent. The only incentive came from strong external demand and the depreciation of the euro. After vigorous growth in the third quarter (up 0.6 from the previous quarter), Germany's economy stagnated in the fourth quarter.

The beginning of the year saw a marked brightening in business and consumer sentiment, with the Ifo business climate index pointing clearly upwards, in February in particular. While positive signals have been sent notably by the German car industry, the improvement in expectations is also reflected in rising stock prices (DAX).

Until now, private consumption was the weak point of economic growth. At the beginning of the year, however, Germany's retail trade reported a good performance, with sales in January exceeding the year-earlier level by 1.7 percent in volume – albeit with one additional working day. The clothing trade, which had already been posting high sales gains, was able to benefit further from the severe winter.

Sentiment in Austria's economy improving further

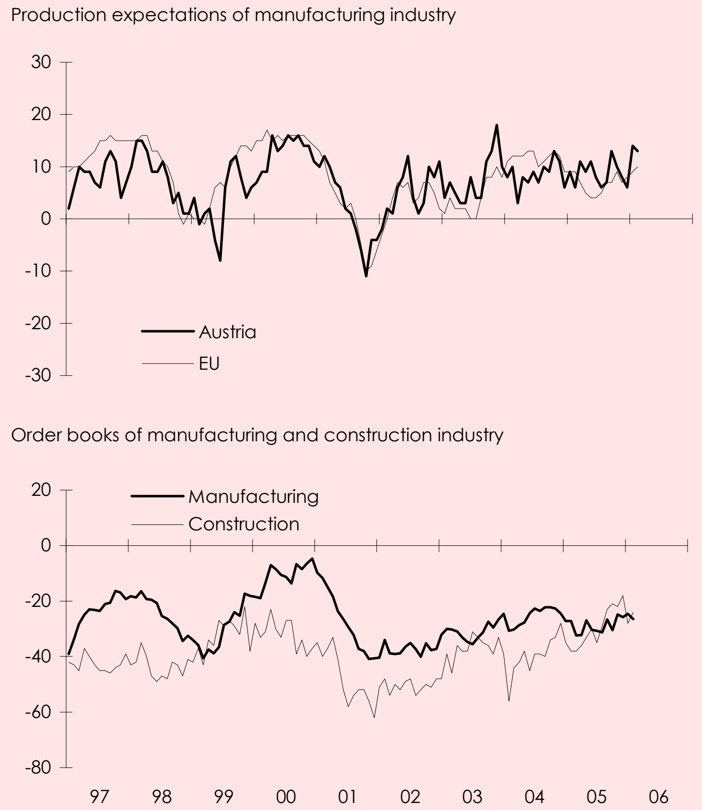
Austria's economy grew by 0.5 percent (seasonally adjusted) from the previous period in the third quarter, and by 0.7 percent in the fourth quarter, according to a flash estimate by WIFO. Over the year 2005, Austria's economy grew at a rate of almost 2 percent, clearly outpacing the euro area average of 1.3 percent. The effects of the tax reform and of measures introduced to stimulate economic activity played a major part in this lead in 2005. Over the medium term (2000-2005), Austria's economy developed in line with both the euro area and EU average for the same reason.

The results of business surveys conducted by WIFO show a generally positive sentiment in the manufacturing sector in recent months. The economic recovery became more firmly rooted. While the assessment of current order levels did not improve further in February, it was clearly better than the long-term average.

The construction sector saw a slight deterioration in the previously highly favourable assessment in January and February, most likely due to the cold weather and heavy snowfalls this winter.

Figure 2: WIFO business cycle survey

Differences between the percentages of correspondents giving positive and negative replies; seasonally adjusted



Source: European Commission, WIFO business cycle survey.

Change in statistical procedure lowering 2005 export growth

Exports grew at an annual rate of 4.6 percent in 2005. This figure is lowered substantially by the fact that from 2005 onward intra-EU statistics no longer include aircraft repairs as exports and imports. Merchandise exports to the former USSR and to OPEC countries flourished ("recycling of petrodollars"). Among the new EU countries, Poland proved particularly receptive to goods exported by Austria, while exports to the other EU countries remained relatively weak.

Imports rose at an annual rate of 4.8 percent in 2005, at the same pace as exports. The trade balance showed a deficit of € 1.5 billion, stemming mainly from higher prices for oil and oil products.

Good snow conditions benefiting winter tourist season

According to preliminary calculations, tourism sales in the first half of the 2005-06 winter season (November to January) outpaced the year-earlier level by 3.6 percent in nominal terms.

Measured by the number of overnight stays, the demand was relatively weak (+1 percent), with the number of nights spent by non-residents stagnating. The picture was quite diverse on the markets of origin of importance to Austria: While overnight stays by resident visitors and visitors from Great Britain and Italy were much more frequent, guests from the USA, Germany and the Netherlands stayed away. The decline in the number of nights spent by German visitors can be partly explained by shifts in school holidays from January to February.

Owing to the favourable snow conditions, the tourism sector was able to post marked sales gains in most federal provinces. Only Tyrol recorded stagnating revenues in the first half of the winter season due to its high proportion of German guests, while in Vorarlberg the increase remained below the Austrian average.

Retail sales posting vigorous turn-of-the-year growth

Private consumption growth, which was to be expected to follow in the wake of the tax reform, is an important precondition for a strengthening of economic activity. The signs are favourable: in December, real retail sales (without cars) were up 3.3 percent from the previous year. Declining car sales depressed the result, however: In the second half of 2005, the total number of newly licensed cars was down by around 3 percent from its year-earlier level, probably owing to the high prices for petrol and diesel oil.

Consumers appeared more confident in February as they anticipated an improvement in their financial situation and assessed labour market conditions less sceptically.

The wholesale trade statistics show a decline in real sales in the second half of 2005 (–0.8 percent). This can be partly explained by the relatively weak expansion of foreign trade.

Marked decline in January inflation

The inflation rate fell from 1.6 percent in December to 1.2 percent in January, its lowest level since December 2003, according to calculations by Statistics Austria. The downward movement was mainly due to lower prices in the expenditure categories recreation and culture. Moreover, the January 2005 increase in the tobacco tax no longer has an impact on the rate of inflation, bringing it down by an additional 0.2 percentage point. Without the highly fluctuating prices for seasonal goods, the rate of increase was just 1.0 percent in January. Consumer prices fell by 0.1 percent month-on-month in January.

The inflation rate was 1.2 percent in January, thus markedly lower than in the previous month. A major factor was the decline in the prices of cameras, computers, mobile phones and package tours.

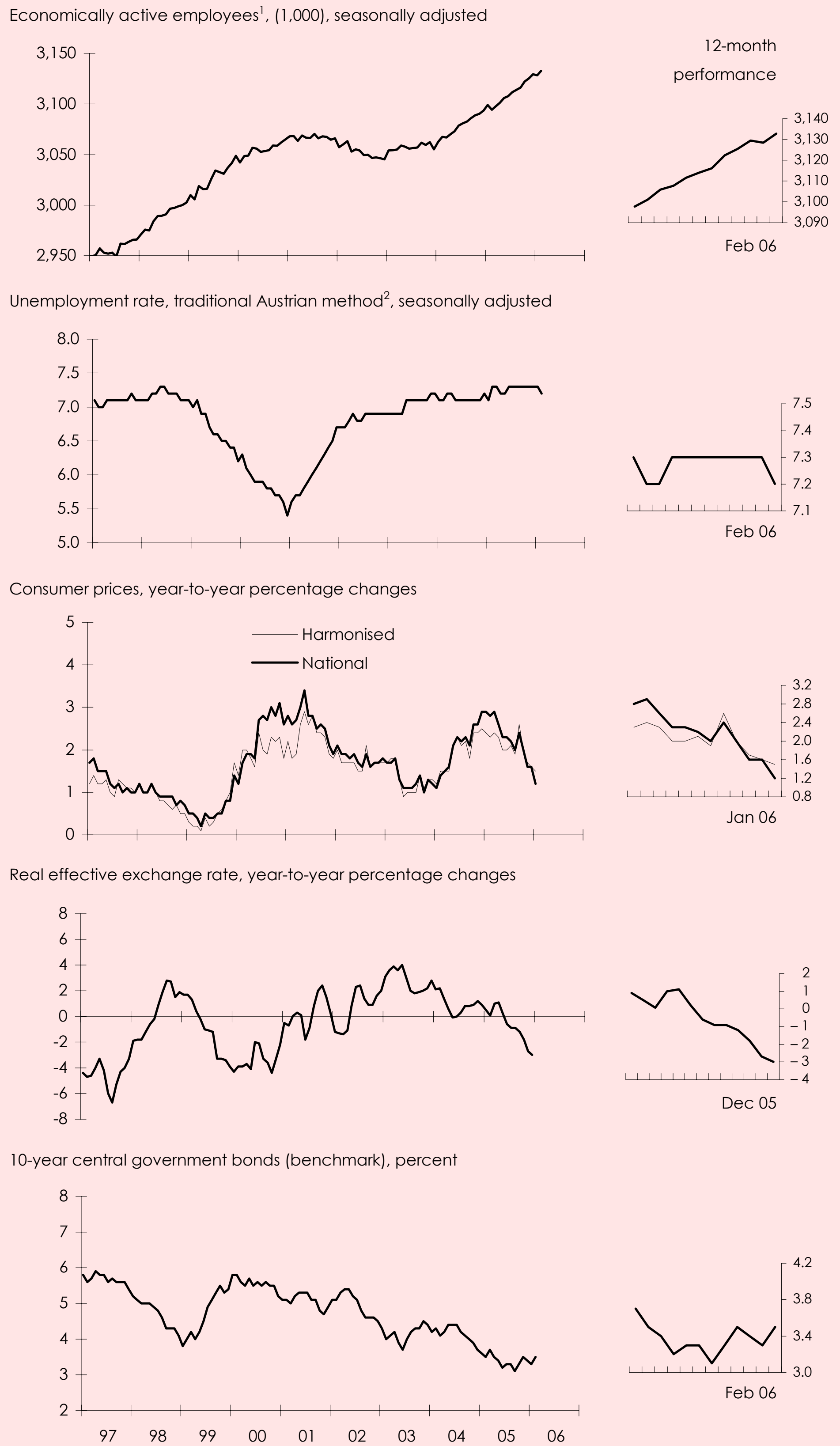
Statistics Austria has revised the basket of goods and weighting of the Consumer Price Index: As from January 2006, the Consumer Price Index is published on the basis of 2005 = 100. Average prices are no longer calculated by means of the arithmetic mean formula, but on the basis of the geometric mean formula. This is likely to have subtracted 0.1 to 0.2 percentage point from the inflation rate.

The Harmonised Index of Consumer Prices, which is based on a different weighting system, with a year-on-year rise by 1.5 percent in January rose much faster than the CPI, but at a much slower pace compared to the euro area average (+2.3 percent). Austria recorded the lowest rate for January 2006 in the EU area.

The autumn 2005 pay round was much influenced by substantial price increases in the preceding months, resulting in a higher increase in collectively agreed wages than in previous pay rounds. The standard wage index, rising by 2.7 percent year-on-year at the beginning of the year, outpaced the increase in the first quarter of 2005 by 0.5 percentage point.

A 3.1 percent pay rise was agreed for the metalworking industry. Many large companies were able to post significant profit gains due to booming exports, whereas small metalworking companies doing business on the domestic market find it much more difficult to cope with the high wage increase. In trade, where sales and profit growth remained subdued, the collective bargaining partners agreed on a 2.7 percent increase in real wages. The salaries of civil servants were also raised by 2.7 percent, following an earlier agreement on a 2.5 percent increase in pensions under the statutory pension insurance scheme for workers and salaried employees (ASVG).

Figure 3: Key economic indicators



Source: Austrian Labour Market Service, Federation of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – [1] Excluding persons in parental leave and military service, and unemployed persons in training. – [2] As a percentage of total labour force excluding self employed, according to Labour Market Service.

February saw employment growth accelerating further, with the number of economically active persons rising by 38,600 (+1.3 percent) year-on-year. Approximately 70 percent of the new jobs were filled by women; this fact, together with the development of the demand for labour by sectors, suggests a strong expansion of part-time employment. Additional jobs were offered primarily in sectors with a higher-than-average proportion of part-time employees: in business services, trade and tourism. Half of the employment gains were made in the highly heterogeneous area of business services: technical offices, business and management consultancy, cleaning services, personnel leasing, etc. The tourist sector added extra jobs for Austria's presidency of the EU Council. The manufacturing and construction sectors, with their exceptionally high proportion of persons employed full-time, saw moderate job cuts in January. Transport and the public sector also registered a decline in the number of dependent employees. However, employment dynamics in the construction sector is underestimated as some foreign workers act as fake self-employed entrepreneurs.

Unemployment rising only moderately

The economic rebound and notably higher labour market flexibility led to significant employment gains. The number of unemployed persons rose only little in February.

The foreign (dependent) workforce grew at a somewhat slower pace at the beginning of the year. In January it stood at 365,900, exceeding the year-earlier level by 10,500. The fast expansion of the total labour supply is mainly a result of higher employment figures for the domestic workforce (mainly women).

Unemployment growth decelerated markedly in response to the cyclical recovery and the expansion of labour market policy measures. In February, 311,700 persons were registered as unemployed with the AMS ("Austrian Labour Market Service"), an increase by 1,700 from last year. 58,900 persons were enrolled in vocational training programmes, exceeding the year-earlier level by 7,800. At the same time the number of unemployed persons with an assurance of reemployment rose by around 8,000.

The increase in the number of job vacancies confirms the rise in demand: in February, 26,100 vacancies were registered with the AMS, an increase by 2,600 (+11 percent) from last year. Contrary to the trend in employment, the rise in the number of job vacancies has not accelerated in recent months.