

Markus Marterbauer, Sandra Steindl

## Cyclical Recovery Continuing

**Results of the WIFO business cycle survey show that the business climate in the manufacturing and construction industries has brightened markedly in the first quarter of 2006. But there are no indications that a revival of investment activity has already gotten off the ground. Improvement in consumer sentiment has been modest, with retail sales disappointing until the end of 2005. In contrast, the winter tourist season had a good start. Inflation is slowing down. While the number of employed persons has been on the rise, unemployment numbers reached a new peak in winter.**

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 13 February 2006. • E-mail addresses: [Markus.Marterbauer@wifo.ac.at](mailto:Markus.Marterbauer@wifo.ac.at), [Sandra.Steindl@wifo.ac.at](mailto:Sandra.Steindl@wifo.ac.at)

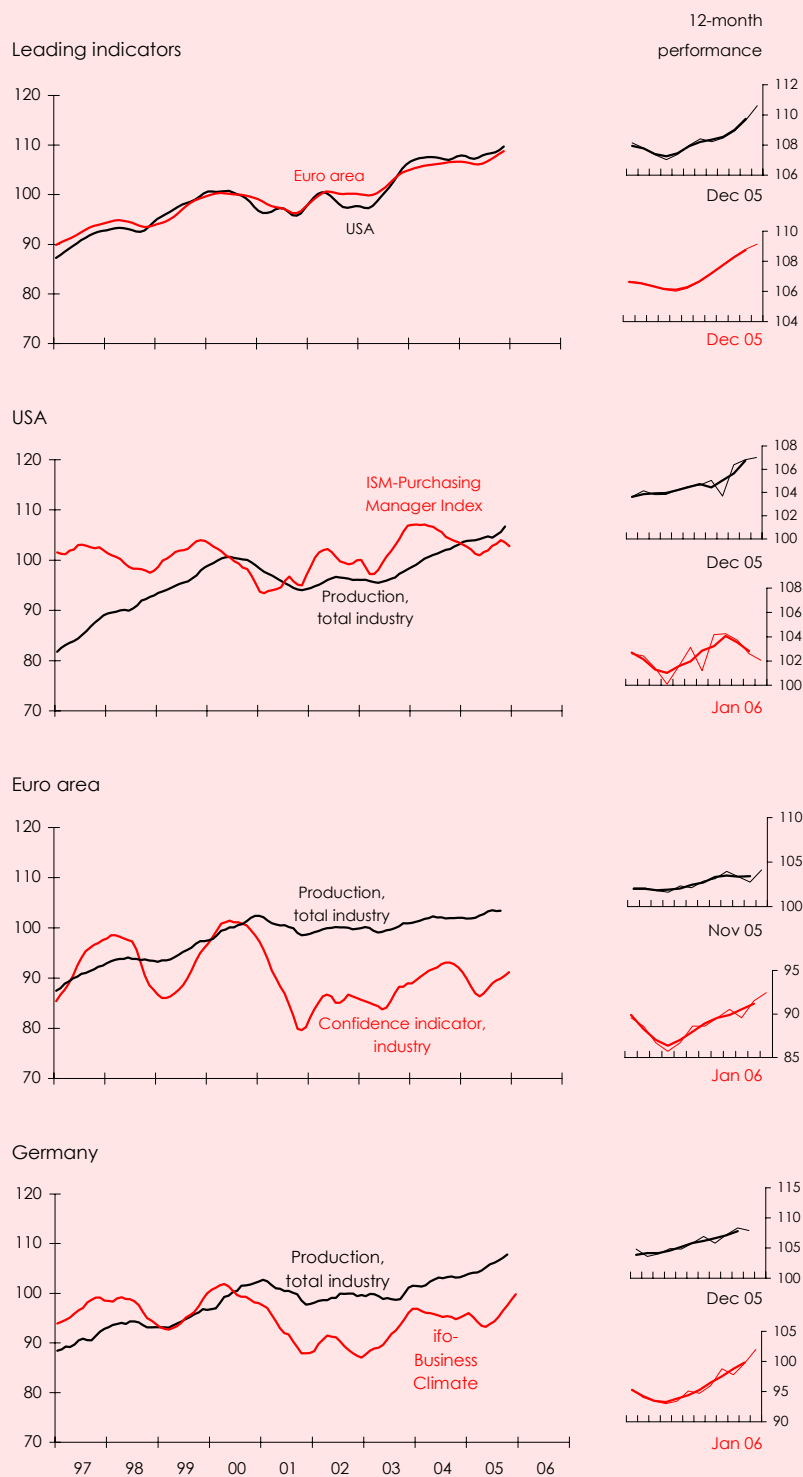
At the beginning of 2006, the tendency of Austria's economy towards recovery is continuing. This is suggested notably by the WIFO business cycle surveys for the manufacturing and construction industries. The majority of firms in these sectors expect an increase in output and assess their incoming orders and business situation favourably. The seasonally adjusted balance of positive and negative output expectations rose to +14.5 percentage points in the first quarter of 2006. Improvement in the business climate has been particularly marked in the chemical industry and in the technical processing sector (including machine and vehicle construction, metal working and electrical engineering). Manufacturing output and export figures are available only for the period until November 2005; according to them, merchandise exports from January to November 2005 outpaced last year's record level by 4.5 percent in value. The accumulated growth rate of the working-day adjusted production index for the manufacturing sector was 4.7 percent year-on-year.

Manufacturing firms are benefiting from the economic rebound in the euro area. Aided by the euro's depreciation against the dollar over the year 2005, the majority of the European Monetary Union countries have been able to expand their export activity considerably, with industrial confidence registering a marked rise. The increased demand for capital goods and consumer durables is benefiting notably German companies. But so far, the revived demand for exports in the euro area has not triggered a stable growth in capital investment. It is true that the investment activity of companies has grown, but it continues to be susceptible to setbacks. In this context, great significance must be attached to the development of raw material prices and of the exchange rate: while the Euro exchange rate has remained unchanged at about \$ 1.20, crude oil prices on the world markets again trended clearly upwards in January, amounting to around \$ 65 per barrel recently. With world politics surrounded by great uncertainties (possible sanctions against Iran by the international community of states, "caricature dispute"), there is a risk of surging oil prices, which would hit the EU economy in a not particularly strong starting position.

Investment activity in Austria also remained muted until the end of 2005, despite gains in manufacturing output, improvement in the business climate and a favourable earnings situation. This is reflected by weak machinery and vehicle imports and feeble wholesale sales. But the results of the WIFO Investment Survey suggest that investment activity may be expected to pick up in 2006.

Figure 1: International business climate

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



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

Apart from the manufacturing sector, sentiment is favourable also in the construction industry. Building construction and civil engineering companies are reporting favourable order levels, expect to be able to achieve higher prices and plan to employ additional staff. The construction boom is sustained by a growing demand for housing and favourable order levels in road and railroad construction.

Business continues to be subdued for those sectors of the economy that are dependent upon private consumer demand. In November, retail sales exceeded the year-earlier level by 1.5 percent in volume, with the overall growth rate for 2005 being estimated at about 1.25 percent. The demand for motor vehicles remained very slack. From January to November, car dealers and petrol stations registered a 1.5 percent decline in sales in real terms year-on-year, with the total number of newly licensed cars in 2005 down 1.1 percent from the high level of the previous year. January saw a slight improvement in consumer sentiment, probably also owing to the agreement on higher pay rises and the containment of consumer price inflation. In view of the persistently unfavourable labour market conditions, consumers have been cautious in their purchases, notably of cars.

A favourable beginning was registered for the winter tourist season, with sales in November and December outpacing the year-earlier level by 5.8 percent and the number of overnight stays rising by 4 percent. Early snowfalls were the main contributors to the positive result. Most regions continue to report a very good booking situation, and the winter season is promising vigorous gains.

The rise in consumer prices abated towards the end of the year 2005. In December, headline inflation was 1.6 percent. The upward drift in transport and housing cost ebbed from the high level a year earlier. With a growth averaging 2.3 percent in 2005, the consumer price index rose at a pace equalling that of the contractual wage index.

No turnaround is yet in sight on the labour market. Both the number of unemployed persons and that of persons in active employment have been rising steeply. In January, 327,000 persons were registered as unemployed (+11,000 year-on-year); the number of persons in vocational training programmes, which is not included in the official unemployment figure, amounted to 54,000 (+5,500). At the same time the number of persons in active dependent employment rose by 30,000 from last year. Additional jobs are being created notably in the heterogeneous area of commercial services. Only small job cuts are recorded for the manufacturing sector.

The US economy grew by 3.5 percent in real terms in 2005, according to first preliminary data. Particularly fourth-quarter GDP fell markedly short of expectations, with real growth amounting to only 0.3 percentage point quarter-on-quarter and 3.1 percent year-on-year. Notably consumer demand, until recently a mainstay of economic activity, showed a decelerating trend. The decline was higher than average for sales of durable goods, possibly in reaction to the expiry of generous discounts in the car industry. The US manufacturers General Motors and Ford have not yet overcome their severe crisis and are cutting jobs in large numbers, while Japanese car makers have been able to considerably increase their sales in the USA.

Investment activity also lost momentum. In the fourth quarter, real non-residential investment edged up a mere 0.7 percent from the previous quarter. The reported extensive increase in inventories may point to a possible revision of the national accounts for the fourth quarter – individual demand aggregates may be expected to be revised upwards in a second calculation. Should this not be the case, the increase in inventories would be an indication for a weakening of demand and economic activity. Additional data need to be waited for in order to be able to render a conclusive interpretation.

Signals are increasing that a slowdown of economic activity in the USA is imminent. Monetary policy has left its expansionary course already in recent months, and the Fed's short-term interest rate was raised to 4.5 percent at the end of January. Further rate hikes under the new Federal Reserve Chairman Bernanke cannot be ruled out. Short-term interest levels already now come close to those of long-term interest rates. In the past, a flat or even inverse structure of interest rates was often a sign of an imminent slowdown of the economy. However, a flattening of the structure of interest rates is not only the result of a rise in short-term interest rates, but also of low long-term interest rates. The latter are a consequence of the strong influx of capital

## US economy losing momentum

*Growth of the US economy appeared weaker at the end of 2005, with the extent of the slowdown still being undetermined.*

into the USA, and stabilise the real estate market – which is overheated in several market segments.

Flash estimates of fourth-quarter GDP are not yet available for the euro area. The forecast of the European Commission for the quarter suggests a real GDP growth of around 0.6 percent quarter-on-quarter, which would be as high as in the third quarter and equal a 2.0 percent year-on-year increase. Exports are the main drivers of the rebound in the euro area. A major factor here has been the easing of foreign exchange rates, with the euro to US dollar exchange rate at \$ 1.20 in January falling 8 percent below the year-earlier rate.

The future course of the economy will largely depend on the extent to which the good profit situation and the brightening of sales expectations will translate into a stimulus for investment. The results of the business cycle survey of the European Commission point to an improvement in industrial confidence since mid-2005. The balance of positive and negative responses in the EU reached –6 percentage points, thus somewhat exceeding the long-term average. The improvement in the business climate has been particularly pronounced in the German manufacturing sector, which is benefiting from its high competitiveness and the worldwide pickup in the demand for capital goods and consumer durables. In the new EU countries, industrial confidence has developed favourably notably in Hungary, whereas business sentiment has deteriorated in Slovakia. Great Britain also had to register a marked slowdown in manufacturing activity.

Despite improved framework conditions and sentiment, investment activity has not set out yet on a stable upward trend. Notably the rate of capacity utilisation in the euro area continues to be relatively low, and at 81.7 percent in the first quarter of 2006 is still below the long-term average. Economic growth continues to be susceptible to setbacks that may follow from a darkening of sentiment. In this context, the future development of raw material prices and the euro exchange rate is of considerable importance.

Subdued private household consumption, mainly in response to the small advance in real disposable income and unfavourable consumer sentiment, has led to a slowdown of economic growth in the EU in the last five years. No measurable improvements are yet in sight in this respect. German real per-capita income continues its marked decline. Consumer confidence is slowly recovering. Having brightened in Germany, Hungary and Poland, it continues to be muted in Great Britain and Italy, however. The slightly more optimistic consumer sentiment so far has not translated into retail sales growth. According to the business cycle survey of the European Commission, the number of German households planning to buy a new car in the next 12 months has risen markedly from previous years. This is an indication of first advance purchases ahead of the VAT increase on 1 January 2007.

Short-term fluctuations on the raw material and foreign exchange markets, often driven by speculation, have had a considerable impact on the euro area economies over the last few years. January again saw a marked rise in world market prices for crude oil, most recently reaching a good \$ 65 per barrel. Possible sanctions on Iran by the international community of states might lead to a supply shortage. The "caricature dispute" is another example of the latent instability of the international political situation.

The spill-over of the increase in oil prices onto the prices of other goods and services so far has been quite moderate in the euro area. Over the short term, a surge in crude oil prices may first and foremost cause a feeling of insecurity among investors and consumers. This would weaken overall economic demand and would constitute a risk to the economy at a time when confidence is already frail. It can be derived from past experience that a rise in oil prices by 10 percent will slow down economic growth in the euro area and in Austria by around 0.1 percentage point. Should the ECB be induced by the oil price hike to increase interest rates further,

## Economic rebound in the EU

*The revival of the economy in the European Union is limited to export and investment, with no sign yet of an improvement in consumer demand.*

## Upward drift of oil prices continuing

*Oil prices have been tending upwards again since the end of 2005, largely in reaction to the instability of the international political situation.*

corporate and household credit demand might decline and economic growth be impaired over the medium term.

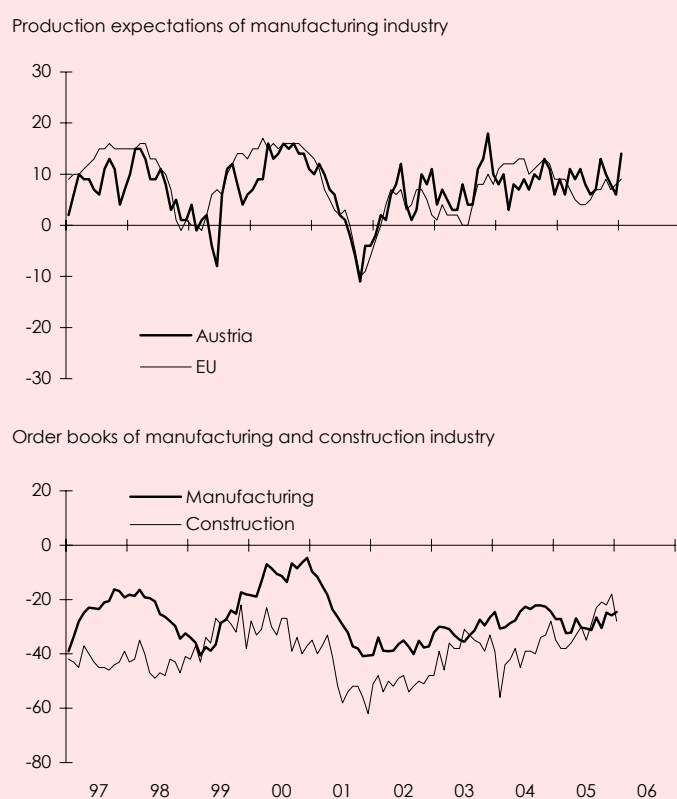
The WIFO business cycle survey of January 2006 paints an optimistic picture for the manufacturing sector. The seasonally adjusted balance of companies anticipating a production increase and those expecting a decline was +14 percentage points. This reflects a steady continuation of the recovery since the first quarter of 2005. The excess of optimistic companies was at its highest level since the third quarter of 2000. Improvement in sentiment was particularly pronounced in the chemical industry and in the technical processing sector (machine and vehicle construction, iron and electrical goods industry). The favourable production expectations are underpinned by a more optimistic assessment of order levels and sales prices.

## Improvement in business expectations

*Austrian companies in manufacturing and construction are quite optimistic regarding their order situation and production expectations, according to the WIFO business cycle survey at the beginning of the year; current production is registering modest gains.*

Figure 2: WIFO business cyclesurvey

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



Source: European Commission, WIFO business cycle survey.

The development of the working-day adjusted production index (excluding energy supply) confirms the results of the WIFO business cycle survey. The production index (accumulated) on its latest reading was 4.7 percent higher than a year earlier (here figures are available only up to November 2005). Austrian manufacturers benefit from gains in market shares in South East Europe, rising demand from oil producing countries, and their close supplier ties with the German export industry. The second half of 2005 saw a slowdown in production growth in Austria's motor car industry, however. But Austrian suppliers of motor vehicle components are set to gain extraordinarily this year from advance purchases ahead of the VAT increase in Germany. Capacity utilisation in the manufacturing sector, at 81.9 percent in the first quarter of 2006 was slightly above the average of the last five years, albeit clearly lower than during the 1999-2000 boom. Business and commercial services firms,

unlike companies in manufacturing, are currently experiencing a lack of orders, although here too expectations for the coming months improved in January.

Firms in the construction industry also view their business situation with optimism in the WIFO business cycle survey. They assess the order situation both in building construction and civil engineering as extremely good, with the indicator rising to the highest level for January in five years. While the building construction sector is benefiting from the rising demand for housing, the civil engineering industry is gaining from the increase in orders from the public sector in the sub-branches of tunnel, road and temporary way construction. The companies expect to be able to achieve higher prices. The favourable trend in the construction sector is also reflected in an improved employment situation: since mid-2005, no construction jobs have been lost on balance. In the fourth quarter, the number of persons in active employment exceeded the year-earlier level by 2,000 (+1.0 percent). The companies polled in the WIFO business cycle survey display an increased readiness to increase staff numbers further.

Gains in merchandise exports and manufacturing output, together with a marked improvement in the business climate, ought to stimulate investment. A good profit situation together with favourable financing terms provides supportive framework conditions. But until the end of 2005 a rebound in investment was not in sight, as became apparent by weak machinery and vehicle imports (80 percent of investment goods are imported): imports in these commodity groups from January to November were down a good 5 percent in value (accumulated) from a year earlier, and even around 10 percent lower year-on-year in October and November. The stagnation in wholesale trade is yet another indication of the absence of lively investment activity. The results of the WIFO Investment Survey suggest a marked improvement in investment intentions for 2006<sup>1</sup>.

Following the extremely robust growth in 2004, merchandise exports rose at 4.5 percent in nominal terms in the first 11 months of 2005. First results of Austria's foreign trade statistics for November (+2.1 percent) point to a slowdown, which is, however, not confirmed by the development of the business climate in the export industry. Strong export gains were posted in 2005 for pharmaceutical and chemical products (+11.1 percent). Switzerland now ranks second after Germany as the most important export destination for Austria's chemical industry. Machine and vehicle exports decelerated in the autumn of 2005, which was in contrast to the pickup in the demand for investment goods observed in the euro area.

Austrian exporters once more achieved high gains in South East Asia (+10.7 percent) and in the Baltic states (+33.8 percent), where they are also winning market shares. Strong demand was experienced also from oil exporting countries (CIS +21.5 percent, OPEC +17.7 percent). Higher earnings from oil sales increasingly translate into demand for capital goods and consumer durables. Admittedly, the importance of these markets all in all is relatively insignificant. The 10 new EU countries together have a share of 12.6 percent in total Austrian merchandise exports, with exports to these countries growing by 3.1 percent in the period from January to November 2005. Exports to the EU 15, which increased by 3.6 percent from January to November (to Germany +3.4 percent), make up 58.8 percent.

Austrian merchandise imports, with a growth of 4.8 percent from January to November, slightly outpaced exports. The rates for October and November point to a slowdown here too, maybe in part due to the temporary easing of the crude oil price. However, machinery and vehicle imports also declined.

<sup>1</sup> See Czerny, M., Falk, M., Schwarz, G., "2006 kräftige Belebung der Investitionen nach Rückgang im Vorjahr. Ergebnisse des WIFO-Investitionstests vom Herbst 2005" ("Planned Manufacturing Investment is Forecast to Increase by 9.2 percent in 2006. Results of the WIFO Investment Survey of Autumn 2005"), WIFO-Monatsberichte, 2006, 79(2), [http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo\\_search.get\\_abstract\\_type?p\\_language=2&pubid=26157&pub\\_language=-1&p\\_type=0](http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=2&pubid=26157&pub_language=-1&p_type=0).

## Revival in investment not yet in sight

*In spite of positive framework conditions, corporate investment activity remains subdued.*

## Exports posting moderate growth

*From January to November, merchandise exports outpaced last year's high level by 4.5 percent while merchandise imports rose by 4.8 percent.*

In the first eleven months of 2005, Austria had a current account deficit of € 1.3 billion, according to first estimates on cash basis by the Austrian National Bank, a modest improvement from last year, thanks to the positive development of services exports.

Real retail sales rose by 1.3 percent in October and by 1.5 percent in November year-on-year. The average growth rate for 2005 is estimated at 1.3 percent (+2 percent in nominal terms). The groups of computer and office machines, shoes and leather goods, and watches and jewellery posted the biggest gains. Car sales remained sluggish: in the fourth quarter, the number of newly licensed cars was down 5.5 percent from its year-earlier level, while the registration of used cars posted a slight decline.

Consumer sentiment has recently brightened somewhat, with the consumer confidence index in January rising by 5 percentage points from the previous month. The beginning of 2006 saw a slight improvement in the assessment by households of their financial situation over the next 12 months; this may also reflect the temporary easing of the situation on the oil markets. Labour market conditions are an essential determinant of consumer confidence; a turnaround is not expected here, a fact that is also keeping a lid on plans for major purchases. The saving ratio shows an upward tendency. According to calculations by the Austrian National Bank, Austrians are now increasingly venturing also into additional forms of financial investment such as fixed interest security investment funds, life insurance policies, and foreign currency deposits.

In November and December of 2005, tourism sales rose by 5.8 percent to € 2.6 billion year-on-year, according to preliminary calculations. Sales growth in the first third of the season was thus within the target band of +5 to +6 percent anticipated for the whole 6 months of winter 2005-06. The robust increase has been sustained mainly by good snow conditions and the numerous events on the occasion of the Austrian presidency of the EU Council and the "Mozart Year 2006". Most regions are reporting a very good booking situation also for the remaining winter season.

The number of overnight stays in the first two months of the 2005-06 winter season exceeded the year-earlier result by a good 4 percent, with a major contribution coming from domestic demand (+5.7 percent). The picture was quite diverse on the markets of origin that are of importance to Austria (+3.5 percent altogether): while overnight stays by guests from the Netherlands, Belgium, Italy and Great Britain posted vigorous gains, the demand from guests from the USA and Switzerland experienced a heavy slump, and that from German and French visitors stagnated. Gains were particularly high for the tourist industry in Burgenland, Carinthia, Vienna, Styria and Lower Austria.

With only 1.6 percent according to calculations by Statistics Austria, headline inflation in December was at its lowest level in 2005. The prices for fuel and lubricants rose by 8 percent on average from last year's high level. Prices increased markedly also in the main group of health care products (+6 percent) and for cigarettes (+10 percent; this reflected the increase in the tobacco tax in January 2005). Since January 2006, the prices for several brands of cigarettes have been lowered considerably, leading to the current discussion of a statutory regulation of minimum prices. Inflation was curbed further by the development in the communications sector (-8.1 percent year-on-year).

Headline inflation averaged 2.3 percent in 2005, according to the consumer price index as calculated by the national method, or 2.1 percent according to the harmonised CPI. The general increase in prices was thus about as high as in the euro area (2.2 percent) and also in line with the average increase in contractual wages (+2.3 percent).

## Modest increase in consumer demand

*The end of 2005 again showed no sign of recovery in retail trade, motor vehicle sales dropped markedly. Great concern notably over unfavourable labour market conditions has prevented consumer sentiment from brightening substantially.*

## Good start of winter tourist season

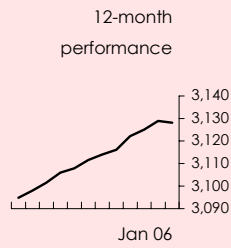
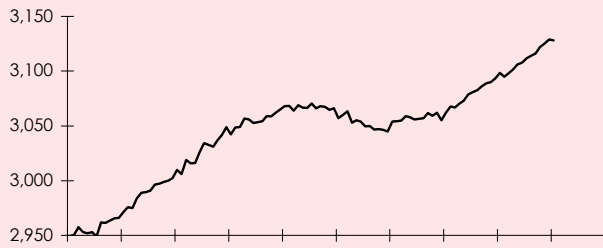
*Aided by the early onset of winter, the winter tourist season had a vigorous start, with sales in November and December outpacing those a year earlier by just under 6 percent.*

## Upward drift of prices decelerating

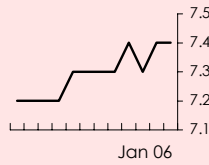
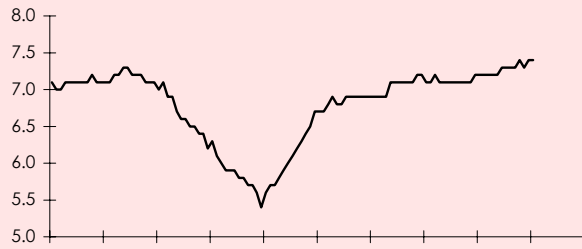
*The end of 2005 saw a deceleration in the upward drift of prices, attributable mainly to base effects.*

Figure 3: Key Economic Indicators

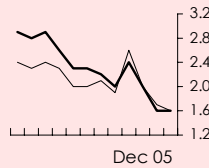
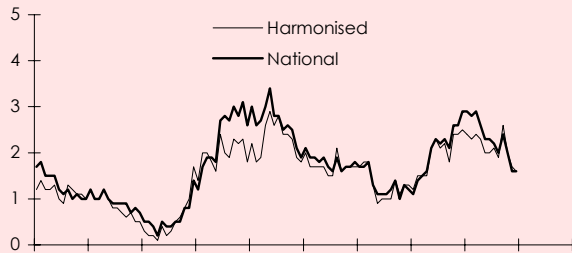
Economically active employees<sup>1</sup>, (1,000), seasonally adjusted



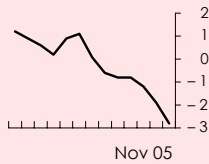
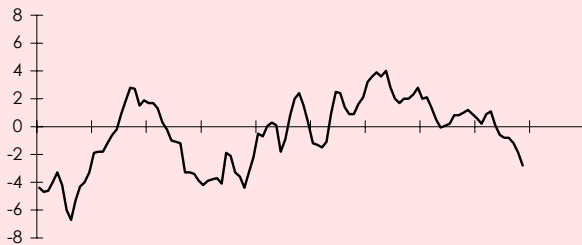
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



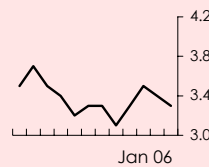
Consumer prices, year-to-year percentage changes



Real effective exchange rate, year-to-year percentage changes



10-year central government bonds (benchmark), percent



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



In January, 327,000 persons were registered as unemployed with the AMS (Austrian Labour Market Service), an increase by almost 11,000 from a year earlier. 54,000 persons were enrolled in vocational training programmes (+5,500) and were therefore not included in the official unemployment figure. The high unemployment rate this winter is also a consequence of the extremely cold weather accompanied by high precipitation, with employment numbers declining notably in the construction and forestry sectors in January. Nonetheless, the overall number of persons in dependent employment continues to rise and in January outpaced last year's level by 30,000 (+1 percent). The increase was thus slightly slower than in December (+1.2 percent). Many additional jobs have been created in the heterogeneous branch of business and commercial services, and employment has been rising also in retail trade and in the tourist industry. The construction industry has also posted employment gains since mid-2005, while the downward trend in manufacturing has weakened.

The number of unemployed persons has been rising persistently since the beginning of 2001. At the same time, the number of economically active employees has also been growing constantly since mid-2003. It may be assumed, however, that only the number of part-time jobs has risen in the last few years, whereas full-time jobs have been lost. Recent months have seen employment growth in a rising number of sectors. This suggests that the number of persons in full-time employment will not continue to decline further. Nevertheless, employment growth continues to be confined predominantly to part-time jobs.

In spite of all that, conditions in the Austrian labour market remain very unfavourable. In January, the seasonally adjusted unemployment rate stood at 7.4 percent of the dependent labour force according to the traditional Austrian method of calculation, or at 5.1 percent of the labour force according to Eurostat.

## **Both employment and unemployment growing further**

*While employment figures are at a record high, the number of unemployed persons has also reached a new peak. There are indications that for the first time in many years the number of full-time jobs has hardly declined in recent months.*