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Growth Accelerating in the First Quarter of 2007

Business Cycle Report of May 2007

The Austrian economy grew by 0.8 percent quarter-on-quarter or 3.2 percent year-on-year in the first quarter of 2007, according to WIFO's latest flash estimate. Goods exports and investment are the main pillars of the upturn. The sentiment among manufacturers is currently as optimistic as last recorded in 2000. Private consumption, on the other hand, shows hardly any signs of a pickup. First quarter retail sales clearly exceeded last year's volume, yet the private consumption result was held down by weak car sales and lower fuel consumption due to the mild weather.

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In the first quarter of 2007, the Austrian economy grew by 0.8 percent in real terms from the previous period owing to strong economic activity and the mild weather at the beginning of the year. Compared to the first quarter of 2006, the real growth rate was 3.2 percent.

At the beginning of the year, Austria's export trade once more constituted the mainstay of economic activity. While according to the revised data economic expansion had lost some momentum in the fourth quarter of 2006 (+0.6 percent in real terms quarter-on-quarter), it accelerated again at the beginning of 2007 (first quarter 2007 +0.8 percent). On a year-on-year basis, real GDP advanced by 3.2 percent. The expansion of construction investment (in real terms +9.3 percent compared to a year earlier, +1.0 percent compared to the previous period) also contributed significantly to economic growth, the good result being in part attributable to the mild weather.

Business spending on machinery and equipment, on the other hand, at the beginning of the year grew at a somewhat slower pace than in the previous periods (first quarter just under +0.5 percent in real terms); this was the case for vehicles as well as machinery and equipment.

Although the economic revival has been underway already for a year now, the reaction of private household expenditure on consumer goods continues to be subdued, rising by just 0.3 percent in volume quarter-on-quarter in the first quarter. While the rate of change was held down by the reduction in heating expenditure due to the mild winter, the money thus saved was not spent for other consumption purposes. Business developed more favourably for the trade sector, however. New car purchases are not showing an upward tendency, though.

Foreign trade once more provided a strong stimulus. Following some moderation in growth in the third quarter, goods exports gathered speed again, growing at a seasonally adjusted rate of 2.5 percent in volume quarter-on-quarter in the first quarter. Services exports also continued to grow, with the mild winter dragging down the result for tourism exports.

The expansion of goods imports has been losing some momentum for several quarters now. At the beginning of the year the real growth rate stood at 1.1 percent. With exports expanding at a faster pace, net exports are providing a continuously growing contribution. Services imports edged up 0.6 percent in real terms from the previous period.

On the production side, the strongest expansion in value added was posted by the manufacturing sector (+1.3 percent in real terms compared to the previous period), the banking and insurance sector (+1.2 percent) and the real estate sector (+1.3 percent), while the construction industry increased production by 0.7 percent.

The results of the WIFO business cycle survey for April show that companies in manufacturing continue to be highly optimistic. 43 percent of the surveyed companies judge their current business situation to be good; this is the highest value ever recorded since this question was included in the survey 25 years ago. The excellent sentiment among manufacturers is increasingly spreading to the business services and retailing sectors.

Table 1: Flash estimates of quarterly national accounts

	2005 Fourth quarter	2005 First quarter	2006 Second quarter	2006 Third quarter	2006 Fourth quarter	2007 First quarter
Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume						
<i>GDP, expenditure approach</i>						
Final consumption expenditure						
Households ¹	+ 0.5	+ 0.4	+ 0.5	+ 0.5	+ 0.4	+ 0.3
General government	+ 0.4	+ 0.3	+ 0.1	+ 0.2	+ 0.2	+ 0.2
Gross capital formation	+ 0.5	+ 0.7	+ 1.1	+ 1.1	+ 1.0	+ 0.9
Exports	+ 1.7	+ 3.0	+ 1.7	+ 1.7	+ 1.8	+ 1.8
Imports	+ 1.3	+ 2.4	+ 1.6	+ 1.5	+ 1.3	+ 1.1
Gross domestic product	+ 0.9	+ 0.7	+ 0.8	+ 0.9	+ 0.6	+ 0.8
<i>GDP, output approach</i>						
Agriculture, forestry	+ 0.3	+ 0.4	+ 0.5	+ 0.5	+ 0.4	+ 0.5
Industry, including energy	+ 1.8	+ 1.9	+ 2.2	+ 2.2	+ 1.6	+ 1.2
Construction	+ 1.2	+ 1.4	+ 1.2	+ 1.0	+ 0.7	+ 0.7
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.6	+ 0.5	+ 0.5	+ 0.5	+ 0.3	+ 0.5
Financial intermediation; real estate, renting and business activities	+ 0.7	+ 0.6	+ 0.7	+ 0.8	+ 0.9	+ 1.0
Other service activities	+ 0.3	+ 0.1	+ 0.1	+ 0.1	+ 0.2	+ 0.2
Taxes on products	+ 0.5	+ 0.3	+ 0.3	+ 0.4	+ 0.4	+ 0.2
Subsidies on products	+ 1.1	+ 1.3	+ 1.0	+ 0.7	+ 0.4	+ 0.2
Percentage changes from previous year						
Gross domestic product, volume	+ 2.6	+ 3.2	+ 3.2	+ 3.2	+ 2.8	+ 3.2

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

Consumers anticipate a further easing on the labour market but only a minor improvement in their financial situation. As regards larger-scale purchases, they intend to be somewhat less frugal than in recent years. The retailing sector posted noticeable increases in the first quarter, which were however countered by weak car sales and reduced fuel consumption due to the mild weather.

Consumer price inflation rose slightly to 1.8 percent in March, attributable for the most part to price increases for energy, food and clothing.

The labour market was relatively quick in reacting to the economic upturn. In April, the number of persons in dependent employment exceeded the year-earlier level by 64,700. Firms also offered additional full-time jobs. This was reflected in a reduction in unemployment, which was further increased in the winter months owing to the mild weather. In April the decline in unemployment slowed down noticeably compared to a year earlier (–13,000 after –33,000 in the first quarter).

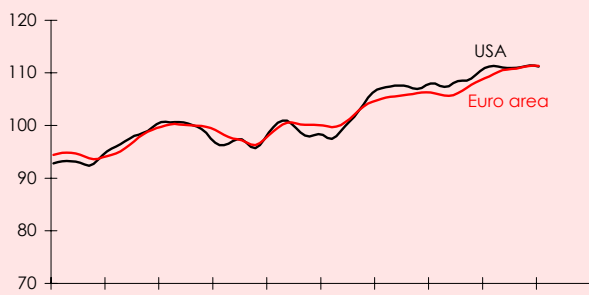
The international environment is favourable: global economic growth is set to remain strong, though easing somewhat due to the slowdown in the USA. The outlook for Europe and the emerging markets remains unclouded.

**US economy slowing
as expected**

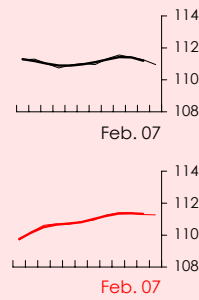
Figure 1: International business climate

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

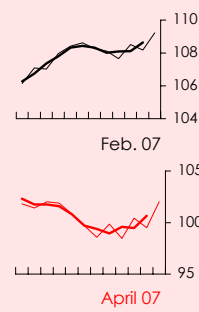
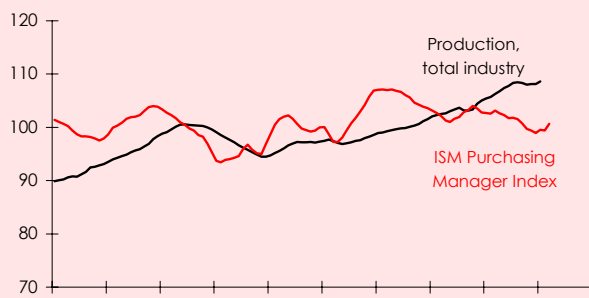
Leading indicators



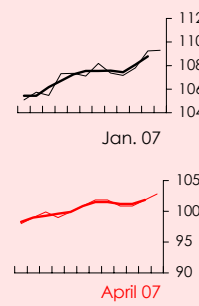
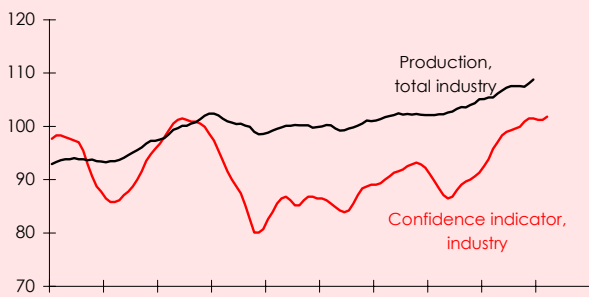
12-month performance



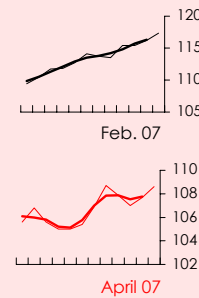
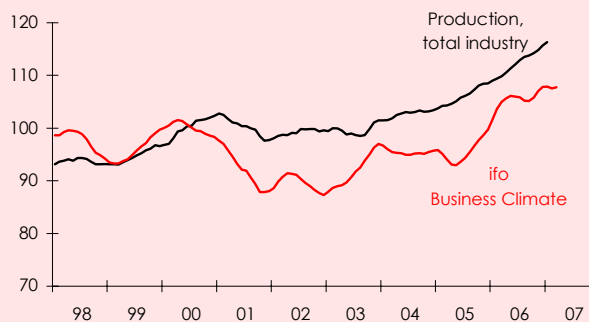
USA



Euro area



Germany



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

In the USA, the slowdown was concentrated mainly in the housing sector, with new building investment falling sharply. Private consumption has so far held up well against the downward tendencies thanks to solid employment and real wage gains. Experience shows, however, that house price and residential construction developments tend to have a lagged effect on private consumption¹.

Last year's interest rate increase was one of the causes of the end of the house price boom. In the USA in response to the cooling of the economy an interest rate cut for the second half of this year seems to be plausible.

Economic activity in Japan is trending only slightly upward. After expanding at a rate of 2.2 percent in 2006, Japan's economy is not likely to grow much faster this year. Recent signs indicate that private consumption may be picking up. Deflation has come to an end; prices are rising scarcely at all.

In the emerging markets, economic activity continues to expand at an extremely robust pace. This holds true for China as it does for India, Southeast Asia and Latin America. Some emerging market countries are benefiting from terms-of-trade profits resulting from high commodity prices – apart from crude oil, the prices for most metals have also soared.

Economic activity in the euro area is gathering speed in spite of a slowdown in the US economy, high crude oil prices and the depreciation of the dollar. Its internal dynamics, fuelled by investment activity and positive sentiment, proves to be more important than exogenous factors.

In its spring forecast, the European Commission raised its growth projection for the euro area by ½ percentage point to 2.6 percent. The accelerated growth has beneficial effects on the labour market and on public finances: in 2007, the unemployment rate in the euro area is set to fall by ½ percentage point to 7.3 percent, while the deficit is predicted to drop by the same extent to 1 percent of GDP.

These projections are underpinned by the positive sentiment among companies in the euro area. The Business Climate Indicator for the EU reached an all-time high in April, with notably order books judged very optimistically.

Measured by historical standards, the economic upturn in the euro area so far has not been exceptionally strong. Economic activity is dampened less than expected by the VAT increase in Germany, though.

Inflation has remained low in spite of high crude oil prices and the buoyant economy. Consumer price inflation in the euro area stood at 1.9 percent in March, according to preliminary estimates. It shows substantial variation across the individual countries: inflation is lowest in France, the Benelux countries and Scandinavia, and highest in the UK, Ireland, Spain and Greece.

In the light of the economic recovery and the slight pickup in inflation, the European Central Bank raised its benchmark interest rate by 0.25 percentage point, with a further increase being expected by many for June. The ECB thereby intends to avert rising inflation expectations and their spillover.

A risk to the economic outlook for the EU is related to the possibility that – similar to the USA – the house price boom may soon be coming to an end in the UK, Spain and other EU countries. This risk is augmented by the interest rate increase.

The German economy is strengthening further. The dip following the increase in the value added tax rate has been less pronounced than expected. Most institutes project a real GDP growth of 2½ percent and a reduction in the budget deficit to less than 1 percent of GDP this year. Unemployment is falling markedly on the back of accelerated growth and labour policy measures.

¹) Walterskirchen, E., "The Effect of House Prices on Growth", Austrian Economic Quarterly, 2006, 11(4), pp. 173-179, http://www.wifo.ac.at/www/jsp/index.jsp?typeid=8&display_mode=2&id=28038&language=2&fid=23923.

US economic growth decelerated continuously in the course of 2006. In the first quarter of 2007 it was only 0.3 percent compared to the previous quarter. The slowdown was mainly a result of falling house prices and residential investment. It will have little impact on Europe as long as the dampening effects remain limited to the housing market.

Cyclical upturn in the euro area

The euro-area economy is growing at a faster-than-expected pace, forecasts are continuously revised upwards. Unemployment and budget deficits are falling noticeably as expansion accelerates.

Activity scarcely dampened by German VAT hike

The high inflation-free growth in Germany suggests that previous estimates of potential output growth (+1 percent to +1½ percent) were too low. Inflation rose only marginally to a rate of less than 2 percent in the first few months of 2007, despite the sizeable VAT increase.

With its manufacturing industry specialising to a greater extent than that of other European countries in machinery and vehicles, Germany benefits especially from the international investment boom.

The ifo Business Climate Index is considered an important early indicator for economic developments in Germany; in April, it climbed further in spite of the appreciation of the Euro, almost reaching its all-time high of December 2006. German companies in the services sector also assess their business situation more favourably than in the previous survey. More than one third of services companies intend to invest increasingly in information and communication technologies this year, according to a ZEW survey.

The economic upturn in Austria continued unabated in the first quarter, despite the German VAT hike. Growth gathered momentum relative to the fourth quarter: according to WIFO's latest flash estimate, real GDP advanced by 0.8 percent quarter-on-quarter. On a year-on-year basis, the growth rate was a good 3 percent in the first quarter – similar to 2006.

The robust growth in the euro area is having a positive effect on Austrian exports. They sustain the upturn, together with investment spending, while consumer demand is recovering only gradually. The expansion of the European economy and the favourable development of price competitiveness contributed significantly to the high dynamism of exports.

Investment activity accelerated noticeably as capacity utilisation improved markedly amid a boom in exports, thereby triggering a "self-supporting" upturn. Evidence from the WIFO investment survey shows that manufacturing companies intend to increase their investment by 21 percent in nominal terms in 2007 (excluding mining, +15 percent).

Vigorous employment gains have led to an increase in private household disposable income, which benefited the retail sector in the first quarter, although weak car sales and low fuel consumption weighed on the result for private consumption.

Business sentiment among manufacturers continues to be highly optimistic, according to the WIFO business survey for April. 43 percent of the surveyed companies judge their current business situation to be good; this is the highest value ever recorded since this question was included in the business survey 25 years ago.

Companies are extremely optimistic about their production output and business situation in the months ahead. Order book levels did not improve further in the latest survey; the assessment of export orders has remained at a high level for already half a year now.

Companies in the construction sector are confident regarding the outlook for the months ahead, despite some deceleration in order book growth. Activity in the business services sector is also accelerating. This is reflected notably in strong employment gains.

Goods exports in January and February exceeded year-earlier levels by around one tenth in nominal terms. This was largely due to the expansion of exports to the EU (+7 percent). Exports to OPEC countries, CIS countries, the USA and non-OPEC developing countries grew at a far above-trend pace. The new EU member states also proved to be very receptive to Austrian export goods.

Austrian economy growing at undiminished pace

Optimism abounding in industry

The sentiment among manufacturers has been excellent for several months now. It is also stimulating business services and retailing.

Exports continue to spur economic activity

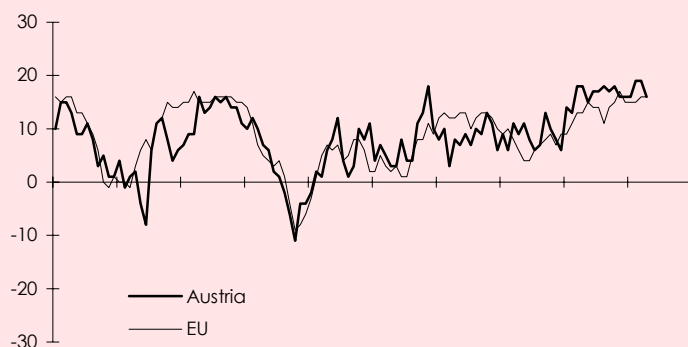
Imports rose at a clearly slower pace (+6.1 percent) than exports (+10.5 percent) in January and February – notwithstanding rising domestic demand and buoyant investment activity. Hence the trade balance improved further, according to the Foreign Trade Statistics. Austria recorded a small trade surplus also vis-à-vis the EU.

Exports continued to exhibit undiminished momentum, expanding at two-digit nominal growth rates at the beginning of the year.

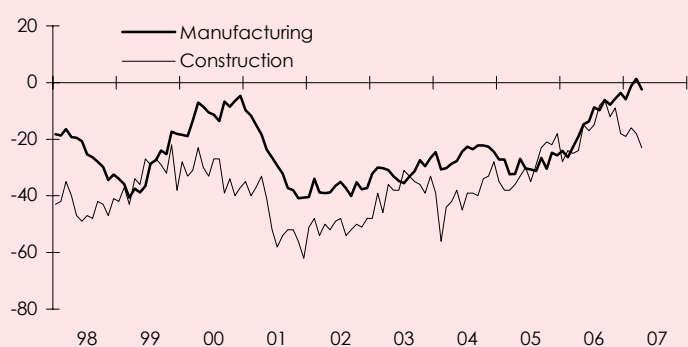
Figure 2: WIFO business cycle survey

Differences between the percentage shares of correspondents giving positive and negative replies, seasonally adjusted

Production expectations of manufacturing industry



Order books of manufacturing and construction industry



Source: European Commission, WIFO business cycle survey.

Private consumption is made up of retail sales and car purchases, services and fuel consumption. The retail sector recorded clear gains in the first quarter (real sales advanced by 2.3 percent), with notably the demand for durable consumer goods rising. These gains were countered by weak car sales (new car registrations dropped 3½ percent in the first quarter) and lower fuel consumption due to the mild weather, though.

Later in the year the drag on household spending due to fuel consumption will disappear. Besides, many private households will get refunds from their energy providers for their reduced energy consumption, which should translate into an increase in their purchasing power. Consequently, private consumption is set to develop more favourably than in the first quarter.

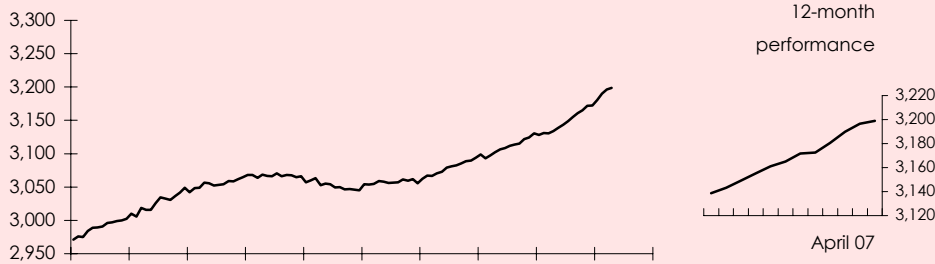
According to preliminary calculations, the tourist industry recorded a slight year-on-year increase in sales from November 2006 till March 2007 (+0.5 percent). The number of nights spent, however, remained 1.1 percent below the high year-earlier level. This was largely attributable to the persistent lack of snow, which, while the number of guest arrivals increased (+1.2 percent), resulted in a shorter duration of stays.

Pickup in retail trade – private consumption partly weak

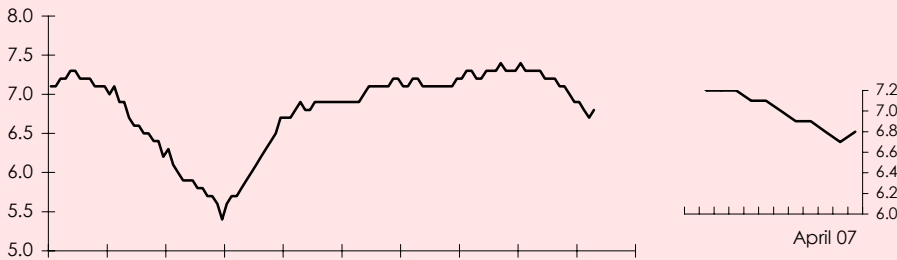
Tourism dampened only little by lack of snow

Figure 3: Key Economic Indicators

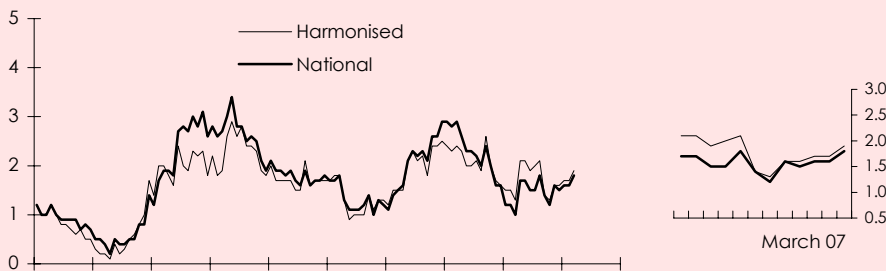
Persons in active dependent employment¹, (1,000), seasonally adjusted



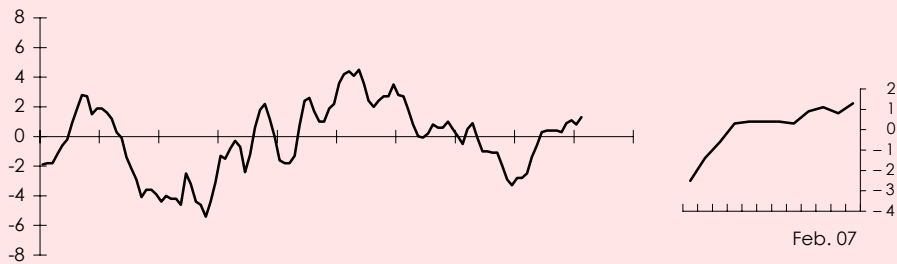
Unemployment rate, traditional Austrian method², seasonally adjusted



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 Office.

Notably the sizeable decline in the number of overnight stays by foreign guests in March (-7.1 percent) had an effect on the overall development. Looking at the countries of origin, the picture for the first five months of the 2006-07 winter season is quite diverse: while the demand by guests from Germany, Italy and France in part declined strongly, the number of nights spent by travellers from the UK increased markedly. The number of overnight stays by visitors from the Netherlands and the USA rose slightly, whereas that by guests from Belgium remained flat.

Tourism sales developed favourably notably in Burgenland, Lower and Upper Austria, Carinthia and Vienna, whereas Styria and Salzburg posted weaker, albeit still above-trend results. Only the tourist regions in Tyrol and Vorarlberg with their extremely strong dependence on winter tourism recorded sales losses.

The inflation rate stood at 1.8 percent in March, according to calculations by Statistics Austria. It thus continued its slight upward trend of recent months. Energy, clothing, food and restaurants were noticeably more expensive than a year earlier. A downward effect once more came from telephone charges, and the prices of industrial goods rose only insignificantly.

The harmonised index of consumer prices, at +1.9 percent in March, rose only slightly faster than the Austrian index. Hence, inflation was as high as in the euro area.

Collectively agreed wages advanced 2.4 percent year-on-year in the first quarter. The rate of increase moderated somewhat in recent quarters, mainly since wage settlements in 2006 were marked by the deceleration in inflation. This year's pay round will be influenced by the favourable economic situation amid persistently low inflation. Sharing the high profit gains with employees will be under discussion in some sectors.

Employment growth continued in April, but no longer reached the peak levels of recent months due to the weather. The number of persons employed grew by 64,700 from last year. More than half of the additional jobs were filled by men, which suggests a vigorous increase also in full-time jobs. While many jobs continued to be created in sectors with a high proportion of part-time jobs such as health services, business services, trade and tourism, the manufacturing sector, which typically employs full-time staff, put an end to its job cuts already last year, and in the first quarter employed around 15,000 more people than in the previous year. Construction companies posted even higher employment gains owing to a favourable order situation and the good weather (+18,000).

The supply of foreign workers increased at an accelerated pace from 2006. In the first quarter, the number of foreign workers employed in Austria exceeded the year-earlier level by around 25,000. The domestic labour supply also increased considerably, thanks to the buoyant economy.

In April, 219,400 persons were registered as unemployed with the Public Employment Service, a drop by 13,100 from a year earlier. The decline in April was much lower than in the first quarter (-33,500), with two thirds attributable to the seasonal sectors (notably the construction industry). The fall in unemployment was somewhat slowed down in the first four months of 2007 by the reduction of training measures (April -3,400); this year a bigger portion of the funds available for labour market policy measures is paid out to companies taking on apprentices.

This year saw winter tourism impaired by the unusual weather and snow conditions. Considering the unfavourable framework, tourism sales developed much better than expected.

Modest consumer price inflation despite buoyant economy

The inflation rate edged up to 1.8 percent in March. The rise was mostly attributable to price increases for energy, food and clothing.

High employment gains

Employment reacted extremely fast and intensively to the economic upturn. Companies offered not only additional part-time but also full-time jobs. This led to a drop in unemployment over the winter months, which was accelerated further due to the mild weather. In April, the decline in unemployment decelerated markedly.