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## Business Confidence Higher

**Latest survey information for Austria and the euro area points to a marked increase in business confidence. Robust economic growth is evident also outside the euro area. In Austria inflation dropped to 1 percent in March, its lowest rate since 2003. In April, the labour market benefited significantly from the economic recovery.**

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Evidence from the business survey conducted in April by WIFO (with support from the European Commission) indicates a constant improvement in business sentiment, with the industrial confidence indicator derived from this survey reaching its highest level since 2001. Three quarters of the companies in Austria's manufacturing sector reported sufficiently or more-than-sufficiently filled order books. The assessment of the current and future business situation continues to follow an upward trend that has prevailed for a short while now. Surveys in the construction and business services sectors also paint a favourable picture.

By contrast, private households were found to be only slightly more optimistic than in the previous survey. While it is true that their assessment of the general economic development and their own financial situation was more favourable in the first quarter of 2006 than at the end of 2005, consumer confidence concerning labour market developments was found to be subdued.

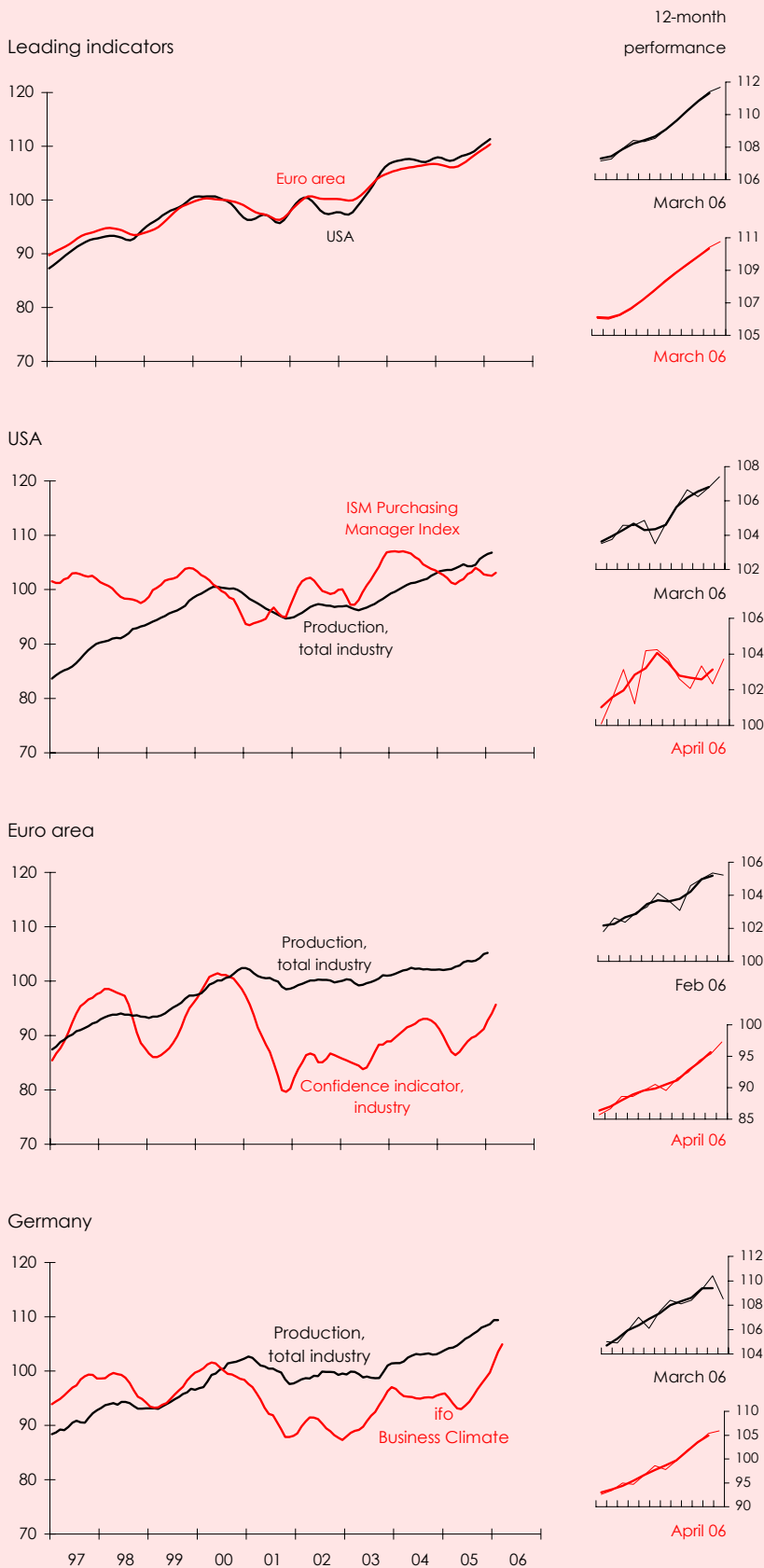
In the first quarter of 2006, the Austrian economy grew by 0.5 percent in real terms quarter on quarter, and hence at a marginally lower pace due to the weather than in the previous period. This time the main impulse stemmed from domestic demand.

German companies displayed a high degree of optimism in the ifo Business Survey conducted in April. The ifo Business Climate Index, which in February had already reached its highest level in more than ten years, rose further in the two following months. While expectations for the future remained high, companies once more assessed the current economic situation more optimistically than in the previous survey. This favourable assessment is probably a result not only of an upswing of the business cycle, but also of special effects: consumers are expected to effect advance purchases of durable goods ahead of the increase in value added tax at the beginning of 2007 and firms in the construction sector will profit this year from last year's increase in the number of building permissions (owing to the abolition of the state subsidy for the purchase or construction of private homes at the end of 2005).

Surprisingly the steep increase in commodity prices in the past – particularly for oil products – has not yet shown any significant second-round effects on inflation throughout the world. In the euro area too, inflation is still within a range that can be described as price stability. In Austria, inflation continued also in March of this year on the downward path started in October 2005. The general inflation rate, as measured by the national CPI, was 1 percent, the lowest rate since October 2003.

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, Munich), OECD.

The good performance of the global economy is also reflected in a marked increase in foreign demand for exports. Total exports in January and February 2006 exceeded the year-earlier level by a good 10 percent, according to Statistics Austria. In 2005, the current account posted a surplus of € 3 billion, which corresponded to 1.2 percent of the nominal GDP. The sizeable increase from the previous year was only to a lesser extent due to the good performance of merchandise exports – a much greater part of the surplus can be attributed to vigorous services exports (with services imports posting markedly weaker gains).

April saw a first significant improvement of labour market conditions. Employment growth accelerated, and the number of persons registered as unemployed dropped by around 13,400 (–5½ percent). A large part of this decline can be attributed to the expansion of training measures (+11,000). The two developments together rendered a marked decline in unemployment.

Forecasts for the US economy point to a slight slowdown in economic activity later in the year. Among the most important arguments for this assessment are the persistent foreign trade imbalance, the high budget deficit (which can only be overcome by means of a restrictive fiscal policy) and the central bank's repeated interest rate hikes. In the fourth quarter of 2005, economic growth in the USA indeed decelerated to 0.4 percent from the previous period, but accelerated again to 1.2 percent early this year. Besides, business survey evidence does not yet suggest growth will slow soon. The ISM Purchasing Managers' Index registered a slight decline in March but has been on an upward trend since mid-2005; the Conference Board Consumer Confidence Index, which had increased in March, improved further in April, climbing to its highest level since May 2002. Equally, manufacturing firms once more posted marked gains in new orders in February.

Forecasts for Asia's economies also paint an optimistic picture. Japan should be emerging from its protracted slump, with economic growth projected by WIFO to stabilise at a level above 2 percent. Meanwhile, the persistent deflationary phase may also have come to an end – the central bank intends to return the course of its monetary policy to normal. China's economy is expected to continue to expand at a robust pace. Skyrocketing oil prices apparently have not been able so far to slow down the momentum of this energy-intensive and commodity-based economy.

Measured by the results of business surveys, Germany's economy has brightened significantly. The main indicator, the ifo Business Climate Index, got over its low point in mid-2005 and has improved consistently in recent months, soaring to a 15-year high in April 2006. Although in the past this index illustrated output developments and cyclical turning points well (Figure 1), this result must not be interpreted as a sign that economic growth will equally climb to its highest level in 15 years (see box "Forecasting Power and Structure of Business Surveys"). Another important economic indicator for Germany, the "ZEW Financial Market Survey", conducted by ZEW in Mannheim among financial market experts, in the past also showed a close correlation to economic growth (Figure 1).

In recent months, however, the two economic indicators have been drifting apart: While the ifo index continued to rise until April, the ZEW indicator since February has not shown any further cyclical improvement. One reason for this divergence may lie in the fact that due to the wording of its questions the ifo index considers, apart from the performance of the economy, also special effects that are reflected in economic growth. It therefore appears plausible that companies will answer "Yes" when asked whether or not they expect their economic situation to improve in the coming months if they anticipate advance purchases ahead of the VAT increase at the beginning of 2007. Similarly, the abolition of the state subsidy for the purchase or construction of private homes as of the end of 2005 may influence survey results for the construction sector to a degree going beyond what might normally be expected on account of the prevailing economic situation. ifo infers economic growth from manufacturers' assessments of their business situation, whereas the ZEW Financial

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**Strong growth  
overseas continuing**

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**German economy  
growing due to  
favourable cyclical  
conditions and  
special effects**

Market Survey polls financial market experts on their assessment of economic activity.

### *Forecasting Power and Structure of Business Surveys*

The value of an index that is based on qualitative assessments in business surveys will not necessarily provide information about the strength of economic activity, but rather about its breadth, as the index is derived from the unweighted balance of optimistic and pessimistic responses. Hence, it investigates how many companies are optimistic and not how optimistic they are. Besides, the companies supply information in relation to the past; apart from an assessment of economic activity, the results can therefore also contain some trend growth estimation for a given sector.

Naturally, knowledge of the composition and structure of the index is required for a meaningful interpretation.

#### *ifo Business Climate Index*

The ifo Business Climate Index has been produced for more than 30 years and is based on around 7,000 monthly survey responses of German companies in manufacturing, construction, wholesale and retail trade. The firms are asked to assess their current business situation ("good", "satisfactory", "poor") and their expectations for the following six months ("more favourable", "unchanged", "more unfavourable"). The responses are weighted according to the importance of the industry and aggregated. The indices are calculated as the balance of the percentages of the answers "good" and "poor" for the business situation, and as the balance of the percentages of the answers "more favourable" and "more unfavourable" for the expectations. The Business Climate Index is a mean value of the balances of the business situation and of expectations. The balances can fluctuate between extreme values of -100 (all responding firms assess their situation as poor or expect business to get worse) and +100 (all responding firms assess their situation as good or expect an improvement in their business).

#### *ZEW Financial Market Survey*

The ZEW Financial Market Survey is a monthly survey conducted for the first time in 1991; it displays the expectations of Germany's financial sector on developments in six important international financial markets. A total of about 350 analysts participate in the survey, including around 270 experts from banks, 50 from insurance and investment companies and 30 from large industrial enterprises. They are asked about their medium-term expectations concerning economic activity, the inflation rate, short-term and long-term interest rates, the stock market, exchange rates and the oil price. In addition, they are requested to assess the profit situation in 13 German industries. Here again, only qualitative assessments are included in the survey.

#### *WIFO Business Cycle Survey*

WIFO began to conduct its monthly business survey in 1964. While the set of questions and structure of the survey resemble those of the ifo Business Survey, the number of companies polled in Austria every month is higher relative to the country's economic size (1,000 companies). Participants are asked to assess the most recent past, the present situation and the development in the next few months ("better", "unchanged", "worse"). Here, too, the assessments are weighted according to the importance of the industry, aggregated and balanced.

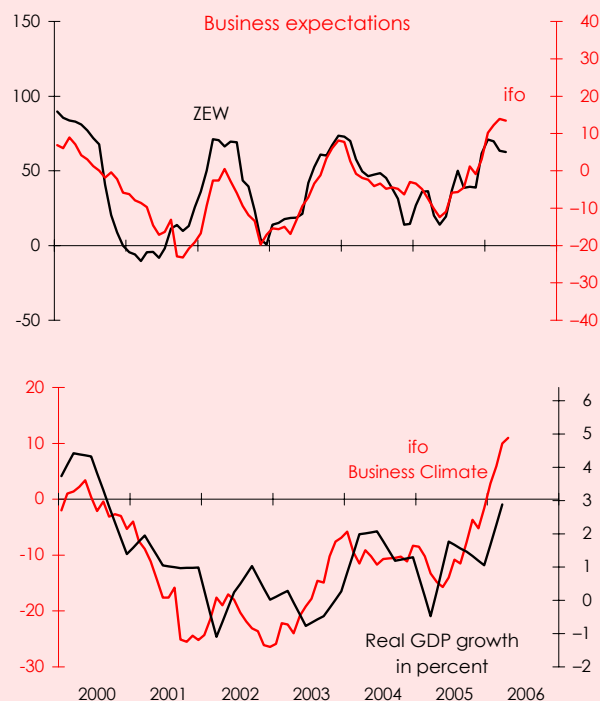
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<http://www.zew.de/de/publikationen/Konzeption.php3>, <http://www.itkt.at/index.php?id=13>.

German firms have been reporting vigorous output growth, but retail sales figures do not yet indicate a marked pickup in consumption. In March, the index of nominal retail sales (seasonally and working-day adjusted; excluding motor vehicle trade) fell by 3 percent month-on-month, after -0.9 percent in February. As regards the motor vehicle retail trade, no data are yet published for the beginning of the year that might enable a check of a possible carry-forward effect. According to Germany's

Federal Bureau of Motor Vehicles and Drivers (Kraftfahrt-Bundesamt), the total number of cars in Germany was 46 million at the beginning of 2006, their average age being 8.1 years. More than half of these cars were first registered before 1999. Against this background, the demand for cars might rise considerably this year if the VAT increase by 3 percentage points acts as sufficient incentive for private households to effect advance purchases.

Figure 2: Business cycle surveys for Germany

Differences between the percentage shares of firms giving positive and negative replies



Source: Federal Statistical Office Germany, Centre for European Economic Research, ifo (Institute for Economic Research, Munich).

Consistent with survey results in the euro area and in Germany, Austria too has seen a constant brightening of business sentiment in recent months. In April, the industrial confidence indicator climbed to its highest level since 2001, albeit still remaining below the value of 2000. Companies once more assessed both their current business situation and the prospects for the next few months more optimistically.

In April, manufacturers assessed their order situation much more favourably than in recent years, reporting strong gains notably in foreign orders (in particular in the motor industry). One factor that may play a role here, apart from improved global economic conditions, is the carry-forward effect ahead of the increase in the value added tax in Germany, which should also benefit Austrian motor industry suppliers. Firms in the manufacturing sector expect sales prices to rise and employment to grow further over the coming months.

The industrial production index registered a year-on-year increase by 6.3 percent (working-day adjusted) in February, while the seasonally adjusted month-on-month increase from January stood at 0.2 percent. The expansion was particularly vigorous in the energy sector due to the cold winter, but manufacturers of capital goods and consumer durables also recorded gains of a good 6.0 percent each.

Manufacturers of intermediate and capital goods also gave a much more positive judgement on their economic situation than in the previous survey. In contrast,

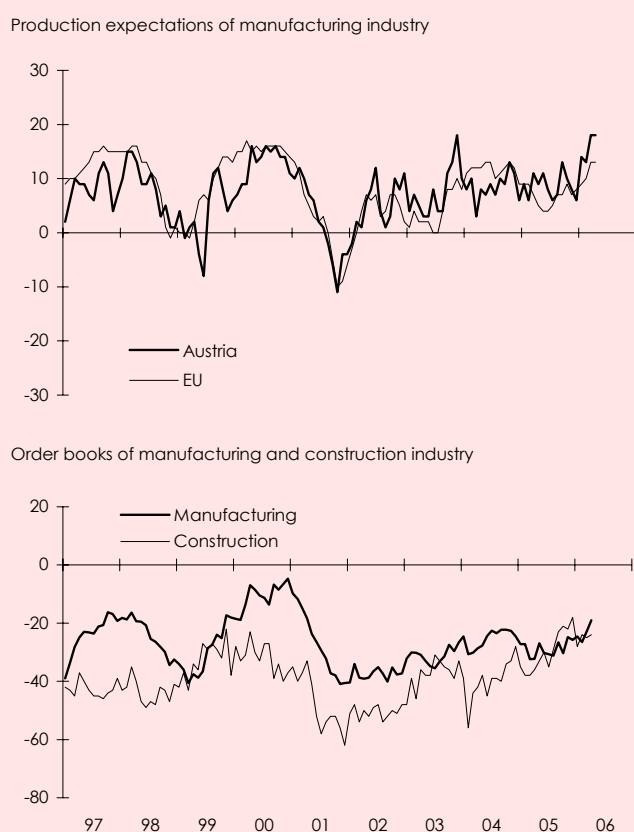
**Further improvement  
in Austrian business  
sentiment**

manufacturers of consumer goods, food, beverages and tobacco do not anticipate a significant improvement in their output levels.

Survey results for the construction industry suggest the prevailing positive mood is likely to persist. A very large proportion of the surveyed companies reported their order books to be "sufficient" or "more than sufficient", thereby considerably decreasing the excess of negative responses regarding the current business situation. Firms in the services sector also painted a positive picture of their economic situation, their assessments were found to have improved slightly as they continued their steady upward trend.

Figure 3: WIFO business cycle survey

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



Source: European Commission, WIFO business cycle survey.

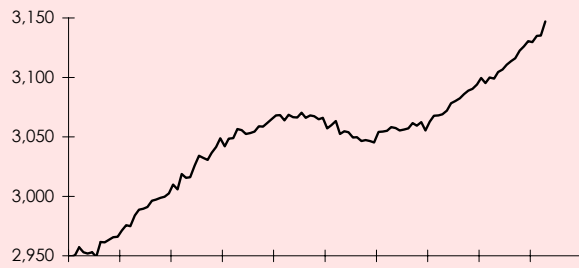
Consumer confidence rose only little in the first quarter. Although expectations among consumers concerning the general economic situation and their own financial situation are more optimistic now, scepticism remains with regard to the employment situation.

Production growth accelerated over the year 2005, with economic growth in the fourth quarter to 0.7 percent from the previous period. The beginning of this year saw a slight flattening in dynamics, causing growth to decelerate to 0.5 percent, according to first estimates. The extremely cold weather may have depressed the result. Nevertheless, in the first quarter of 2006, GDP rose at a vigorous pace compared with the same period a year earlier (+2.8 percent in real terms) due to the higher number of working days (+3¼ percent and +2 days, respectively).

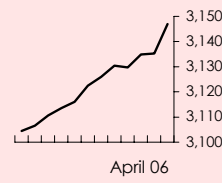
**Weather slows first-quarter growth**

Figure 4: Key economic indicators

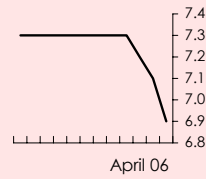
Persons in active dependent employment<sup>1</sup>, (1,000<sup>3</sup>), seasonally adjusted



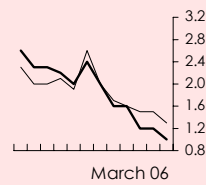
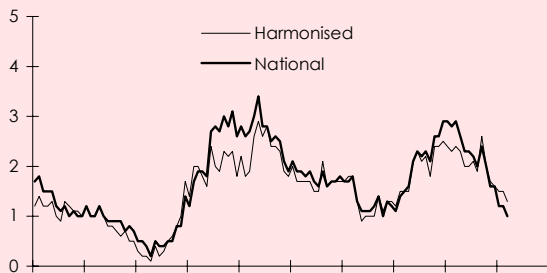
12-month performance



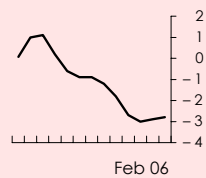
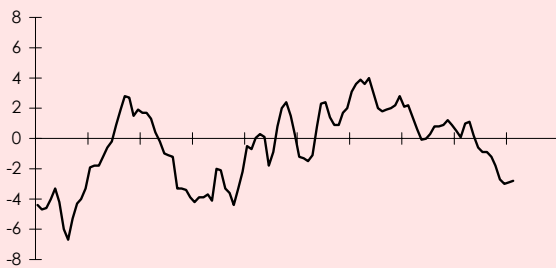
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



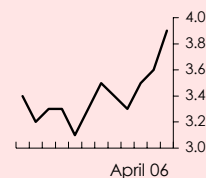
Consumer prices, year-to-year percentage changes



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 parental leave, military service, and unemployed persons in training. – <sup>2</sup> As a percentage of total labour force excluding self employed, according to Labour Market Service.

Quarter-on-quarter growth was strongest in the manufacturing sector (including energy and water supply), albeit at +0.7 percent somewhat weaker than in the previous period (+1.0 percent). Trade, hotel and restaurant business and transport industry grew at a rate of 0.6 percent each, the same pace as in the fourth quarter of 2005, while expansion in the business and financial services sector (also +0.6 percent) decelerated from the previous quarter. Lower-than-average growth in value added was recorded for the construction sector (+0.4 percent) and for agriculture and forestry (-0.1 percent). The main stimulus to growth this time stemmed from domestic demand.

Private household demand rose at a year-on-year rate of 0.5 percent in volume, the same pace as in the preceding quarters, while growth of government consumption expenditure edged up to +0.6 percent from +0.5 percent in the fourth quarter of 2005, also in response to the special effects of the Austrian Presidency of the EU Council. Gross investment growth, at +0.4 percent in real terms, continued to lack momentum. While developments were most unfavourable for investment expenditure in construction, business spending on machinery and equipment also remained very subdued.

Foreign trade gained further momentum: total exports, sustained by exports of goods and non-tourism-related services, rose by 1.4 percent in volume quarter-on-quarter. The increase in orders (notably from abroad) reported in business surveys led to accelerated growth in imports of intermediates. Total imports grew at a considerably faster pace, climbing to a quarter-on-quarter rate of +1.6 percent in real terms in the first quarter.

The positive trend observed in the Austrian foreign trade sector since 2000 is continuing. In 2005, the current account posted a surplus of € 3 billion or 1.2 percent of Austria's GDP, according to preliminary figures released by Oesterreichische Nationalbank. One factor here was the positive balance of trade in services, which was considerably higher than last year, but also the surplus achieved in the international trade in goods has risen. While travel continues to be the most important component of the balance of trade in services, revenues from transport, communications and transit trade are gaining in importance. In 2005, income from foreign investment clearly exceeded even tourism income and also contributed to an improved current account. This was largely due to slackening tourism imports, a fact that is difficult to comprehend.

According to the data available so far for the winter season (November 2005 to March 2006), the number of overnight stays fell by 3.2 percent from the year-earlier level. One reason for this decline lies in the fact that this year Easter was in April, last year in March. Hence, a turnaround can be expected for April, with tourism sales for the 2005-06 winter season likely to increase moderately on average.

The decline in the number of overnight stays of foreign visitors (November 2005 to March 2006 -4.3 percent) was for the most part due to the staying away of German guests (-10.6 percent), whereas both resident tourist travel and the demand from other important countries of origin developed favourably.

Inflation – as measured by the national CPI according to Statistics Austria – stood at +1.0 percent in March (after +1.2 percent both in January and February 2006), the lowest rate since October 2003. The Harmonised Consumer Price Index (HCPI) at +1.3 percent also shows a deceleration of inflation from recent months. The small price increase is boosting household purchasing power.

Both indices differ in part as to coverage: unlike the CPI, the HCPI also covers expenditure by travellers in Austria, whereas price changes for owner-occupied flats are included only in the CPI. Price increases were highest in the main group of "housing, water and energy", accounting for around two thirds of the overall rate of infla-

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**Foreign trade still key engine of economic growth**

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**Higher tourism sales in 2005-06 winter season**

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**Inflation abating despite new surge in commodity prices**



tion. Prices declined in the categories recreation and culture and in communication.

The cyclical recovery since last year has been the basis for modest but constant employment growth that accelerated in April. While the number of persons in dependent employment had risen at a monthly rate of around 1.0 percent in recent months, April saw an increase by 49,000 (+1.6 percent) from the year-earlier level.

Until recently, the increase in labour supply at the back of the cyclical recovery has exceeded the increase in labour demand, keeping unemployment high despite employment gains. April was the first month to show a decline even when allowing for the expansion in training activities: the number of persons registered as unemployed went down by 13,300 (-5.4 percent). The unemployment rate stood at 6.7 percent (according to the national method of calculation), edging down 0.5 percentage point from the year-earlier level. While this development was primarily attributable to an increase in the number of persons enrolled in training programmes (+11,000), the rate of unemployment was nevertheless found to be down even when allowing for this effect.

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### **Improvement of the labour market in April**