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Economy Headed Towards Further Expansion

Business Cycle Report of November 2006

Economic expansion, while slowing in the USA since summer, has been gaining further momentum in Europe. The third quarter saw Austria's economy growing once again, by 0.9 percent in real terms (seasonally adjusted, quarter-on-quarter), with real GDP thus exceeding the year-earlier level by 3.3 percent. The impetus in foreign trade was passed on to domestic demand. Investment activity once again expanded strongly, benefiting from continued buoyant industrial growth.

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The global economic upswing is continuing despite a slackening of economic activity in the USA, largely due to the sizeable contribution still made by emerging market countries. After buoyant expansion in the second quarter, developments in the euro area are viewed with optimism, with the European Commission's sentiment indicators showing a persistent upward trend. In Germany, industrial production and the level of capacity utilisation in the manufacturing sector clearly exceed the long-term average. Expansion is now for the first time driven also by increased domestic demand.

Austria's real GDP advanced at a seasonally and working-day adjusted rate of 0.9 percent quarter-on-quarter in the third quarter (after also +0.9 percent in the second quarter), according to the latest WIFO flash estimate. Apart from exports, growth is increasingly driven by domestic demand. Particularly investment has been rising – notably investment in machinery and equipment, which has livened up since the beginning of the year.

Private household consumption, on the other hand, has remained fairly stable since early in the year, advancing at a quarter-on-quarter rate of 0.4 percent each quarter. On a year-on-year basis, the growth rate was 1.9 percent in real terms in the third quarter.

Foreign trade continues to provide strong stimulus to the economy. Export growth, at +1.7 percent quarter-on-quarter, was only marginally lower than in the second quarter (+2.0 percent). Imports keep exhibiting strong momentum, in reaction to favourable domestic economic trends (+1.7 percent, after +1.5 percent in the second quarter).

Industrial activity is very brisk, with the level of value added in manufacturing once more expanding vigorously (+2.6 percent in volume quarter-on-quarter, after +2.2 percent in the second quarter). In the latest WIFO business cycle survey companies once more gave a highly positive assessment of their order books; they consider production well secured for the next four to five months.

Consumer price inflation declined noticeably in September, with the rate of inflation dropping to 1.4 percent, mainly as a result of a slower increase in the price for mineral oil products compared with last year.

The third quarter saw yet another rise in employment (+59,300) and vacancies thanks to the good performance of the economy. The number of unemployed persons registered with the AMS ("Labour Market Service") dropped to 214,400 in Octo-

ber (–23,000 from the year-earlier level), accompanied by a rise in the number of persons in vocational training programmes (+10,000). The seasonally adjusted unemployment rate amounted to 6.7 percent according to the national method of calculation, or 4.7 percent according to Eurostat.

Table 1: Flash estimates of quarterly national accounts

| | 2005 | | | 2006 | | |
|---|----------------|---------------|----------------|---------------|----------------|---------------|
| | Second quarter | Third quarter | Fourth quarter | First quarter | Second quarter | Third quarter |
| Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume | | | | | | |
| <i>GDP, expenditure approach</i> | | | | | | |
| Final consumption expenditure | | | | | | |
| Households ¹ | + 0.6 | + 0.6 | + 0.5 | + 0.4 | + 0.4 | + 0.4 |
| General government | + 0.6 | + 0.4 | + 0.3 | + 0.3 | – 0.0 | + 0.1 |
| Gross capital formation | – 0.1 | + 0.3 | + 0.8 | + 1.2 | + 1.5 | + 1.7 |
| Exports | + 1.8 | + 2.0 | + 1.8 | + 1.8 | + 2.0 | + 1.7 |
| Imports | + 1.1 | + 1.5 | + 1.3 | + 1.4 | + 1.5 | + 1.7 |
| Gross domestic product | + 0.7 | + 0.9 | + 0.8 | + 0.7 | + 0.9 | + 0.9 |
| <i>GDP, output approach</i> | | | | | | |
| Agriculture, forestry | – 1.1 | + 0.7 | + 1.9 | + 1.9 | + 1.5 | + 0.5 |
| Industry, including energy | + 1.6 | + 1.8 | + 1.6 | + 1.3 | + 2.2 | + 2.6 |
| Construction | + 0.8 | + 0.7 | + 0.7 | + 0.7 | + 0.6 | + 0.6 |
| Wholesale and retail trade; repairs; hotels and restaurants; transport, communication | + 0.5 | + 0.7 | + 0.5 | + 0.2 | + 0.6 | + 0.7 |
| Financial intermediation; real estate, renting and business activities | + 1.0 | + 1.0 | + 0.7 | + 0.5 | + 0.7 | + 0.6 |
| Other service activities | + 0.6 | + 0.4 | + 0.3 | + 0.2 | + 0.1 | + 0.2 |
| Taxes on products | + 0.4 | + 0.7 | + 0.6 | + 0.5 | + 0.6 | + 0.7 |
| Subsidies on products | + 0.7 | + 0.9 | + 1.1 | + 1.3 | + 1.0 | + 0.7 |
| Percentage changes from previous year | | | | | | |
| Gross domestic product, volume | + 2.3 | + 2.1 | + 2.6 | + 2.9 | + 3.3 | + 3.3 |

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

Asia's economy is growing at a robust pace. Expansion continues unabated notably in China, where real GDP growth accelerated to more than 10 percent year-on-year in the third quarter. China's trade surplus remains high, and investment demand is rising markedly. India, too, is increasingly becoming an engine of world economic growth.

Japan appears to have overcome recession; the second quarter saw growth rates moderating, however (+0.2 percent in real terms quarter-on-quarter, after +0.8 percent in the first quarter), with notably external demand disappointing. For the third quarter, leading indicators point to a steady acceleration in economic activity. Although Japan's Central Bank has moved away from its zero interest policy of recent years, its key interest rates remain low with consumer price inflation modest. In August, the consumer price index exceeded the year-earlier level by 0.9 percent.

The petroleum exporting countries contribute to the expansion of the world economy by reinvesting their increased revenues.

Economic expansion in the USA has decelerated markedly in recent months, with the quarterly rate of change estimated at +0.4 percent in real terms in the third quarter (+0.6 percent in real terms in the second quarter).

The decline in construction activity is cutting into economic growth, but so far has hardly prompted an increase in real estate prices. Residential construction investment has been on a downward trend for the past year, with investment in machinery and equipment also losing momentum. The low GDP growth rates in the third quarter reflect not only a decline in investment activity, but also an increase in imports: After a weak second quarter, imports of goods and services rose by 1.9 percent from the previous period in the third quarter. Consumer spending, which ad-

World economy set for stable growth

Despite a slackening of economic activity in the USA, the world economy continues to expand vigorously thanks to high growth rates in Asia and persistently strong momentum in Europe.

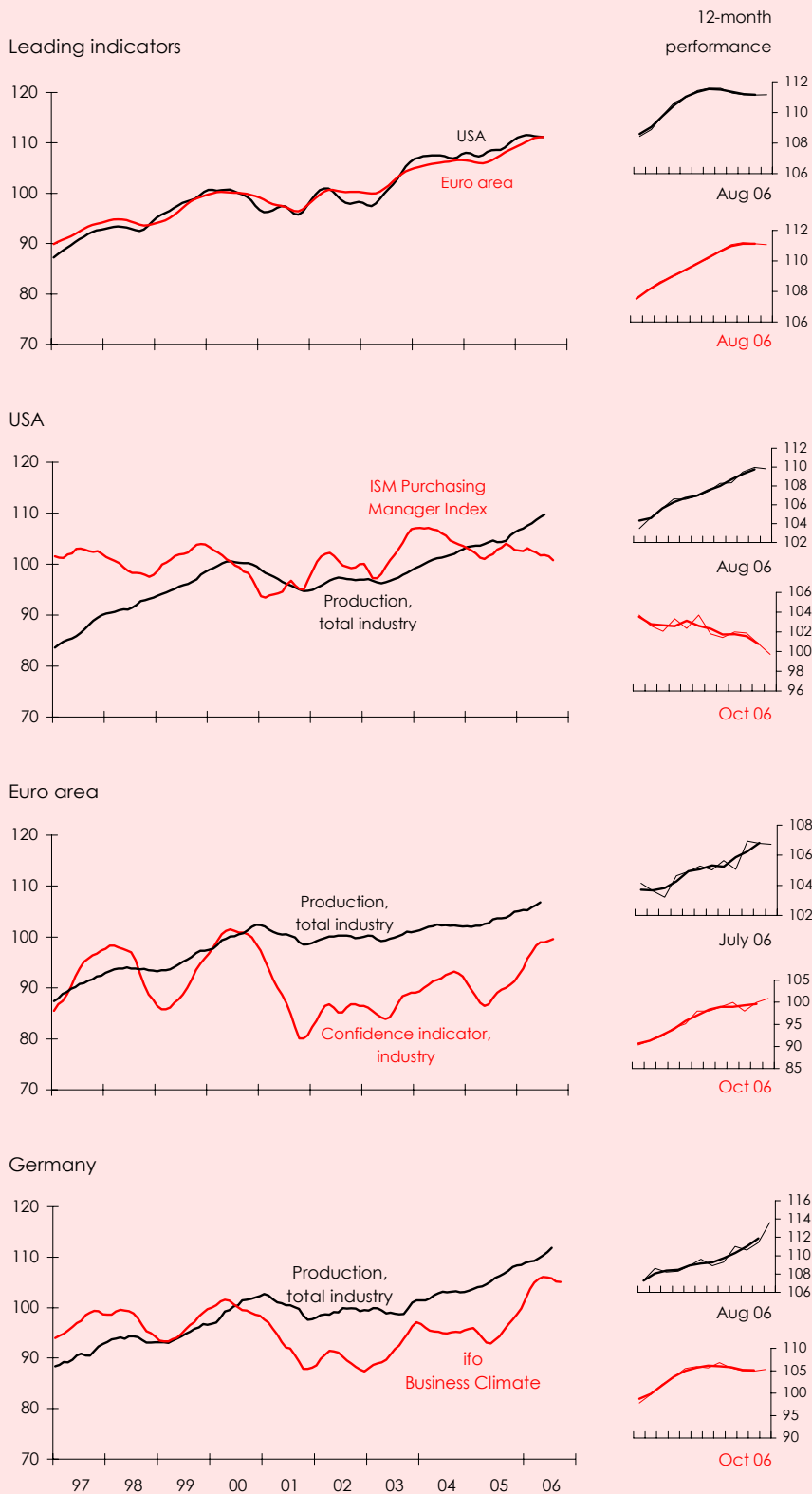
Slowdown in USA

With the cooling of the housing market, economic growth in the USA clearly lost momentum in the third quarter.

vanced by 0.8 percent in volume in the third quarter (+0.6 percent in the second quarter), continues to be the engine of growth, fuelling around 70 percent of GDP.

Figure 1: International Business Climate

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



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institut für Wirtschaftsforschung), OECD.

The US industrial sector is currently suffering a bout of weakness, with both capacity utilisation and industrial production decreasing in September. Mining, manufacturing and water and energy supply recorded a 0.6 percent decline in output from the previous month, while the rate of capacity utilisation for total industry dropped from 82.5 percent in August to 81.9 percent in September.

The assessment by consumers of current economic trends is mixed: while the Conference Board Consumer Confidence Index weakened in October in reaction to the deteriorated outlook for the labour market, the University of Michigan's Index surprisingly rose by 8.2 points.

The economic upswing, which set in fully in the euro area in spring 2006, is broadly based regionally. After high growth rates in the second quarter (+0.9 percent seasonally adjusted relative to the previous period), the economy continued to perform favourably also in the third quarter. Stimulus is provided mainly by domestic demand, notably by businesses' high propensity to invest. Expansion in the manufacturing sector is gathering pace; among the large EU countries, Germany, Spain, France and Italy registered an increase in capacity utilisation. Overall, the rate of manufacturing capacity utilisation in the euro area rose to 83.9 percent in the fourth quarter, thus exceeding its long-term average.

October saw a further improvement in the European Commission's Industrial Confidence Indicator. The results of consumer confidence surveys, which had been on an upward trend since mid-2005, remained unchanged in October, however.

The good performance of the economy has already had an impact on the labour market: In the third quarter, the unemployment rate was 7.8 percent (seasonally adjusted) of the labour force (down from 8.5 percent in the third quarter of 2005).

After economic recovery set in fully also in Germany in spring, sentiment indicators now give mixed signals on the short-term business outlook: While economic expectations of financial market experts surveyed for the ZEW Index have been declining for nine months now, the ifo Business Climate Index rose for the first time in three months in October. September saw industrial production at a high level, with capacity utilisation in the manufacturing sector at 86.4 percent clearly exceeding the long-term average. Investment in expansion projects is likely to follow. Impetus is generated also by the construction industry: the excess supply following German reunification has dwindled, and the demand for new investment is rising again.

Apart from foreign trade, domestic demand is increasingly becoming a driver of the recovery underway in Germany. During the first half of the year, private consumption expenditure rose by 1.1 percent in volume year-on-year. Until the end of the year, advance purchases of durable consumer goods ahead of the increase in value added tax should provide further impetus. German institutes of economic research estimate this effect at about € 4 billion.

The good performance of the economy has also improved the outlook for the labour market, with the seasonally adjusted unemployment rate in the third quarter dropping to 8.5 percent of the labour force, a decline from 9.2 percent in the third quarter of 2005.

After sizeable increases last year, the crude oil price has been falling since August 2006, most recently to around \$ 60 per barrel. There are currently hardly any signs of temporary bottlenecks, which apart from a pickup in demand were the main cause of the price hike. The third quarter saw the HWWA Index of World Market Prices of Commodities rising by around 18 percent on a dollar basis compared to the year-earlier period. Price developments for energy commodities have been smoother than early in the year.

Expansion in the euro area continuing

The economic situation in the euro area continues to be favourable. This is suggested by business surveys and the increase in industrial capacity utilisation.

Industrial production picking up in Germany

The upturn in the German economy continues, albeit without accelerating further.

Oil prices easing

Euro area inflation dropped markedly from 2.3 percent in August to 1.7 percent in September, with price increases abating in all countries except Italy and Portugal.

Declining crude prices slow inflation in the euro area.

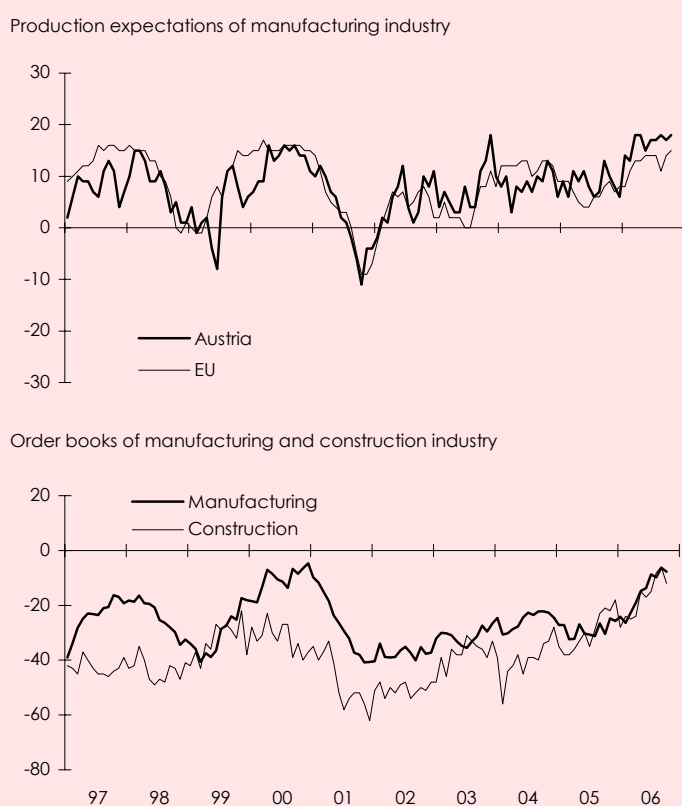
Austria's economy continues to be buoyant. After dynamic growth in the second quarter (+0.9 percent quarter-on-quarter), real GDP once more advanced at a seasonally and working-day adjusted rate of 0.9 percent in the third quarter. On a year-on-year basis, the growth rate was 3.3 percent. On the production side, the strongest expansion quarter-on-quarter was once more posted by the manufacturing sector, which at +2.6 percent clearly exceeded the rate recorded in the second quarter (+2.2 percent). At +0.7 percent, the trade, hotel and restaurant, and transport sectors also posted a strong expansion in value added, while the increase remained constant in the construction industry (+0.6 percent quarter-on-quarter).

WIFO flash estimate for the third quarter of 2006

The Austrian economy grew by 0.9 percent in volume quarter-on-quarter in the third quarter, with the manufacturing industry once more expanding at a vigorous pace.

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.

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The pickup in domestic activity has set in motion more broad-based growth across the individual demand components. External trade still continues to make a major contribution to growth, thanks to the good performance of the European economy: In the third quarter, exports exceeded the year-earlier level by 6.2 percent in volume. On a seasonally adjusted quarter-on-quarter basis, export growth moderated somewhat, however. The revival of investment demand is reflected in a stronger growth of imports relative to the previous quarter; imports also outpaced the year-earlier level by 6.2 percent in real terms.

Export boom and buoyant industrial activity are the twin engines powering growing investment dynamics apparent for almost all components of investment demand. Investment in equipment (in particular machinery and vehicles) is expanding at a

Domestic demand stimulated by investment

While investment activity is showing an upward trend, consumer demand remains subdued.

particularly fast pace. Construction investment is also rising, with residential construction developing more favourably than non-residential construction.

Private consumption is lagging behind the other demand components in terms of growth. While the year-earlier level was exceeded by 1.9 percent in volume, growth has hardly accelerated since the beginning of the year, advancing each quarter at a seasonally adjusted rate of +0.4 percent quarter-on-quarter. Public consumption expenditure has also been subdued.

Evidence from the WIFO business cycle survey commissioned by the European Commission signals a continuation of the stable upward tendency. Manufacturers once more give a very positive assessment of their order books and anticipate an increase in output. The positive trend in the production of motorcars and motorcar components, with a very good order situation and a capacity utilisation rate of 88 percent, among other things reflects the stimulus advance purchases are providing to the German motor industry. Since the beginning of the year, the average rate of capacity utilisation in the Austrian manufacturing sector has risen by 2.5 percentage points to 84.4 percent. Sentiment continues to be positive also in the construction industry and in the business services sector.

Austrian consumers increasingly anticipate an economic upturn in the next 12 months. They display greater optimism now regarding both their own financial situation and labour market conditions.

A positive sentiment in industry is signalled also by the BA-CA Purchase Managers' Index, with those surveyed reporting a further acceleration of output growth in October.

Austria's export trade has been developing very successfully, with exports from January to August rising by 12 percent compared to the same period a year earlier, according to Statistics Austria. Around 70 percent of exports went to the EU 25, more than 30 percent to Germany. Due to the revival of the German economy and the increased demand from Italy, the value of goods delivered to these countries rose by 10 percent and 12½ percent respectively (cumulated from January to July). For the most important component, "machinery and vehicles", which makes up 40 percent of total exports, the cumulative growth rate for the first seven months of 2006 exceeded 10 percent.

The pickup in domestic investment demand in recent months was reflected by an increase in goods exports, which from January to August rose by +11.5 percent in value year-on-year.

According to preliminary calculations, tourism sales from May to September 2006 climbed to € 8.61 billion, an increase by 1.8 percent compared to the same period a year earlier. After stagnation in July and a strong decline in August, the number of overnight stays increased markedly in September, thus improving the result for the 2006 summer season noticeably, with total sales posting a modest increase of around 2 percent. Due to the sizeable growth in sales during the 2005-06 winter season, a rate of at least +4 percent may be expected on average for the 2005-06 tourism year.

The number of overnight stays from May to September 2006 fell by altogether 1.6 percent year-on-year; the demand from foreign guests declined by 2.7 percent, whereas that from resident visitors rose by 1 percent. Overnight stays by guests from the US posted strong gains, those by visitors from France, Great Britain and Switzerland rose at a somewhat slower pace. The markets of origin Germany, the Netherlands and Belgium registered a decline.

Leading indicators point to persistent upturn in Austria

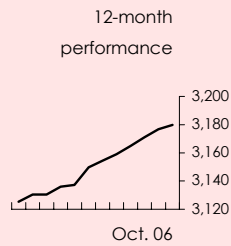
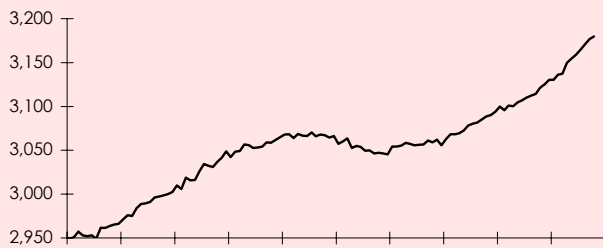
Foreign trade continues to grow

Export sector benefits from the good performance of Europe's economy.

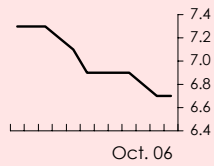
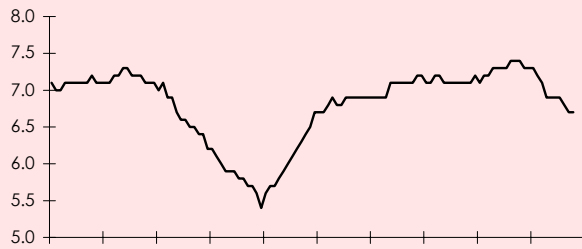
Late summer sales gains in tourism

Figure 3: Key economic indicators

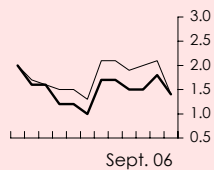
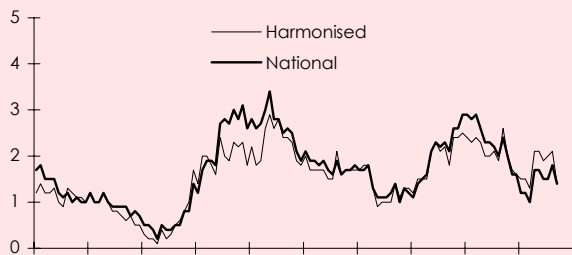
Persons in active dependent employment¹, (1,000), seasonally adjusted



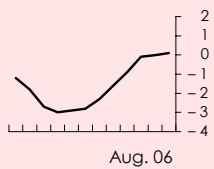
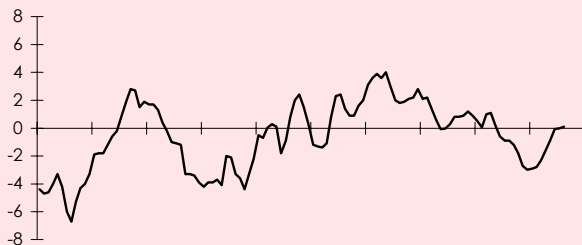
Unemployment rate, traditional Austrian method², seasonally adjusted



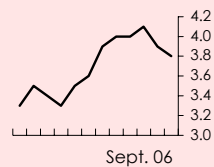
Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



Source: Austrian Labour Market Service, 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 Labour Market Service.

The inflation rate as measured by the national method of calculation (CPI) by Statistics Austria stood at 1.4 percent in September (1.8 percent in August, and 1.5 percent both in July and in June). Notably the price developments for mineral oil products had a downward impact: The strong price increase for fuel in September 2005, coupled with the current decline was reflected in the expenditure category "Transport". On a year-on-year basis, prices declined around 2 percent for fuel, and around 1 percent for heating oil. Further price declines were observed for "Recreation and Culture" and in the expenditure category "Clothing and Footwear". As in previous months, the main category "Housing, Water and Energy" again recorded high price increases (+4.6 percent on average), accounting for more than half of overall inflation.

The Harmonised Index of Consumer Prices (HICP) also indicates a deceleration of the upward drift of prices. The rate of inflation as measured by this index was 1.3 percent in September and thus markedly lower than the euro area average (1.7 percent).

In the first three quarters of 2006, the collectively agreed wages for employed persons rose by 2.7 percent on average year-on-year. In the autumn pay round, a pay rise of 2.6 percent allowing flexible implementation by the individual companies was agreed for the metal industry. Real income in this sector has been rising from last year due to lower headline inflation and the consideration of extra pay not included in last year's wage settlement. Consequently, at least last year's pay rise of 3.1 percent is achieved by means of a model that makes allowances for the companies' situation.

The good performance of the economy is giving positive impetus to the labour market, with both employment and the number of registered vacancies posting gains in October. The number of persons in dependent employment rose by 59,300 (+1.9 percent) year-on-year. While part of the increase can again be attributed to the expansion of part-time employment, sectors with predominantly full-time jobs such as the construction industry also posted employment gains. The fast rise in overall employment was accompanied by a much lower reduction in unemployment: it is precisely during a time of economic upswing that persons from the "hidden reserve" will increasingly enter the labour market.

In October, 214,400 persons were registered as unemployed with the AMS ("Labour Market Service"), a decline by around 23,000 from a year earlier. Particularly manufacturing, construction and other services, i.e. economic sectors that are sensitive to cyclical trends, registered a drop in unemployment. Around 63,000 persons were enrolled in vocational training programmes, an increase of 10,000 compared to October 2005. These persons are not included in the unemployment statistics. In October, the seasonally adjusted unemployment rate stood at 6.7 percent according to AMS or 4.7 percent according to Eurostat.

Inflation slowing markedly

In September, headline inflation stood at 1.4 percent and was thus markedly lower than in previous months, largely a consequence of the strong decline in fuel prices.

Labour market brightening further

The number of persons registered as unemployed dropped in October, accompanied by an increase in the number of job seekers enrolled in vocational training programmes.