

Sandra Steindl

First Quarter: Economy Still Robust

Business Cycle Report of May 2008

The Austrian economy expanded at a seasonally and working day adjusted rate of 0.8 percent quarter-on-quarter in the first quarter of 2008, following +0.6 percent in the fourth quarter of 2007. On a year-on-year basis, growth accelerated to 3.5 percent in real terms. Economic activity is picking up once more on the back of strong value added growth in industry and construction. Trade and tourism also posted good results. Given the deterioration of the international environment, the outlook for activity in the coming months remains subdued. In the USA the economy grew hardly at all in the first quarter, and in Europe, too, the outlook is darkening further.

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 13 May 2008. • E-mail address: Sandra.Steindl@wifo.ac.at

Real GDP increased by 0.8 percent quarter-on-quarter in the first quarter of 2008, according to WIFO's flash estimate; compared with the same period a year earlier, the increase was 3.5 percent. External demand remained the main driver of growth. Exports rose by 2 percent in real terms (seasonally and working day adjusted) from the previous quarter.

Investment demand growth has been slowing for a year now. Gross fixed capital formation, which had still accelerated at a seasonally and working day adjusted quarter-on-quarter rate of 1.1 percent in real terms at the beginning of 2007, rose by just +0.3 percent in the first quarter of 2008, reflecting weak business spending on machinery and equipment. By contrast, the construction capital formation even gained momentum at the beginning of 2008, growing more vigorously than in the three previous quarters.

Private household consumption remained weak also in the first quarter (+0.2 percent in real terms, seasonally and working day adjusted), with accelerating inflation exerting an additional drag on consumption growth.

In manufacturing, value added in the first quarter of 2008 benefited anew from re-strengthened external demand. At +1.7 percent in real terms compared with the previous quarter it grew more strongly than in the fourth quarter of 2007 (+1.6 percent quarter-on-quarter). In April, capacity utilisation improved again on the back of rising production. Leading indicators for the second quarter nevertheless point to decelerating activity in the manufacturing sector: in the WIFO business survey, companies gave a less optimistic assessment of order books than last year.

Prompted by the housing crisis in the USA, global economic activity is gradually losing momentum. Real GDP in the USA grew by 0.1 percent quarter-on-quarter in the first quarter and thus for the second consecutive time expanded hardly at all. Losses in housing wealth, together with rising fuel prices, dragged down personal consumption expenditure (+¼ percent in real terms quarter-on-quarter). Economic activity in Europe was still robust at the beginning of the year, albeit with geographical differences. While industrial order and production levels remained high in Germany, capacity utilisation in manufacturing declined in Spain, France and Italy. More forward-looking business cycle indicators have weakened in all of Europe since the beginning of the year. Both business and consumer surveys point to a slowdown in activity

in the second quarter. Consumer sentiment is dampened by surging food and fuel prices – in Spain and UK in addition by losses in housing wealth.

Price pressures increased globally in March. In Austria, too, the Harmonised Index of Consumer Prices (HICP), at +3.5 percent (following +3.1 percent in both January and February) indicated an accelerating upward drift in prices; the inflation rate was thus just slightly lower than the 3.6 percent recorded in the euro area.

Table 1: Flash estimates of quarterly national accounts

	2006	2007				2008
	Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter
	Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume					
<i>GDP, expenditure approach</i>						
<i>Final consumption expenditure</i>						
Households ¹	+ 0.3	+ 0.3	+ 0.5	+ 0.4	+ 0.1	+ 0.2
General government	+ 0.4	+ 0.4	+ 0.4	+ 2.0	+ 1.2	- 1.7
Gross capital formation	+ 0.8	+ 0.7	+ 0.6	+ 0.5	+ 0.5	+ 0.5
Exports	+ 2.5	+ 2.3	+ 1.9	+ 2.0	+ 1.9	+ 2.0
Imports	+ 1.9	+ 1.5	+ 1.1	+ 1.6	+ 1.3	+ 0.4
Gross domestic product	+ 0.9	+ 0.8	+ 0.8	+ 0.7	+ 0.6	+ 0.8
<i>GDP, output approach</i>						
Agriculture, forestry	+ 0.8	+ 0.5	+ 0.3	+ 0.3	+ 0.5	+ 0.6
Industry, including energy	+ 2.2	+ 1.5	+ 1.0	+ 1.3	+ 1.5	+ 1.8
Construction	+ 1.2	+ 0.7	+ 0.5	+ 0.5	+ 0.6	+ 0.7
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.3	+ 0.3	+ 0.3	+ 0.6	+ 0.8	+ 0.8
Financial intermediation; real estate, renting and business activities	+ 0.9	+ 1.3	+ 1.3	+ 0.8	+ 0.3	+ 0.2
Other service activities	+ 0.2	+ 0.2	+ 0.3	+ 0.5	+ 0.3	+ 0.1
Taxes on products	+ 0.5	+ 0.6	+ 0.3	+ 0.0	- 0.0	+ 0.0
Subsidies on products	+ 0.3	- 0.6	- 0.0	+ 0.5	+ 1.1	+ 1.7
	Percentage changes from previous year					
Gross domestic product, volume	+ 3.4	+ 3.7	+ 3.6	+ 3.2	+ 3.0	+ 3.5

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

The situation on the labour market, which generally reacts with some lag to cyclical movements, still remains favourable. Following the particularly strong increase in February and March (+3.2 percent and +3.0 percent, respectively), the number of persons in dependent active employment in Austria again exceeded the year-earlier level by 2.6 percent in April. The unemployment rate fell from 5.8 percent in March to 5.7 percent in April, according to the Austrian method of calculation. In seasonally adjusted terms, however, both employment growth and the decline in the unemployment rate are slowly coming to a halt.

In the USA, recently published quarterly balance sheets confirm the anticipated write-downs by major banks resulting from the financial and real estate crisis. According to first estimates, the overall economy, at +0.1 percent quarter-on-quarter in real terms, grew hardly at all, as already in the fourth quarter of 2007. The central bank once more followed an expansionary policy, cutting interest rates in the first four months of the year in four consecutive steps by a total of 225 basis points, from 4.25 percent to 2 percent. In addition to declining investment demand, expansion was dampened mainly by slower growth of private consumption expenditure: Private consumption, which accounts for around two thirds of overall GDP growth, expanded by only ¼ percent in real terms in the first quarter. This was the lowest growth rate seen in the last four years. The demand for durable consumer goods declined for the first time in two years.

Firms' investment demand also slackened at the beginning of the year. Residential investment, which had already been falling throughout 2007, in the first quarter of 2008 was 7½ percent (in real terms, seasonally adjusted) lower than the level re-

**US weakness
dampens global
growth**

corded in the previous three months. The outlook for future construction activity also remains subdued: March saw a decline both in the number of building permits, which is considered a leading indicator, and in the number of housing starts. The deterioration of real estate values has been accelerating since the beginning of 2008. In February, the Standard & Poor's/Case-Shiller Index, a composite index of the weighted price developments in 20 metropolitan areas, declined by around 13 percent from a year before. The supply of well-priced real estate is growing also as a result of the rising number of foreclosures.

Losses in housing wealth, coupled with soaring fuel prices and rising unemployment, continue to weigh on consumer sentiment. Consumer confidence, as measured by the Conference Board and by the Reuters and University of Michigan Index, deteriorated further in April. Labour market conditions have worsened increasingly in recent months; the unemployment rate climbed to 5.1 percent in March, its highest level in three years, before edging down again to 5.0 percent in April.

In Japan, too, leading indicators point to a softening of both consumer and business confidence. The appreciation of the yen vis-à-vis the dollar, coupled with the slowdown in the USA, dampens export prospects. According to preliminary figures, export growth already slowed in April.

The global slowdown appears to have hardly had any impact on China's economy until now. In the first quarter of 2008, real GDP growth once more stayed in the two-digit territory. Measures to curb overheating and inflation have so far been ineffective. In March the consumer price index rose by 8 percent, food prices rose by around 20 percent from a year earlier.

Global food price increases constitute not only an economic, but also a humanitarian problem, in particular in developing countries, leading to unrest and export restrictions. Prices of agricultural raw materials are pushed up by a shortage of supplies due to crop failures and the increased demand from emerging economies, but also by speculation. The real estate market downturn and persistent financial market uncertainty are likely to have set free finance capital that was increasingly reinvested in commodity markets.

Economic activity in the EU is slowly cooling, although the picture varies geographically. Industrial capacity utilisation in the EU reached its peak in the second quarter of 2007 and declined steadily thereafter. It stood at 83.4 percent in April. While capacity utilisation has again improved in Germany since the beginning of the year, owing to the ongoing expansion of industrial production, the indicator has fallen notably in Spain, France and Italy.

Judging from leading indicators, economic activity is set to decelerate further in all of Europe in the second quarter. Evidence from the European Commission's most recent survey shows that confidence in the economic situation for the first time in two years dropped below its long-term average in both the euro area and the entire EU. April saw industrial confidence indicators deteriorate notably in UK, France and Italy, whereas sentiment softened moderately in Germany. In Spain and UK, where developments in housing markets caused negative wealth effects, consumer confidence also dropped markedly in April. After the construction and housing boom of recent years that was driven by low interest rates, the anticipated correction in the Spanish housing market is now unfolding. While apartment sales dropped by 27 percent year-on-year in January, the number of mortgage loan approvals also declined to a similar extent at the beginning of the year. In UK, real estate banks also tightened their credit conditions considerably. Foreclosures and renewed housing depreciation followed. Wealth losses caused by this development, coupled with increased uncertainty, are depressing consumer and investment demand. After strong growth in 2007, the economy has been cooling since the beginning of 2008 (first quarter +0.4 percent in real terms, seasonally adjusted).

Lower investment spending and weak consumption are depressing growth in the USA. Inflationary pressures on food and energy prices have increased globally.

Economy slowly cooling also in Europe

While industrial production continued to expand in Germany at the beginning of the year, signs of slowing economic activity are mounting notably in UK and France.

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.

In the EU as a whole, inflation has been accelerating at a rising pace since the beginning of the year. It averaged 3.6 percent in the euro area in March, an increase from 3.3 percent in February. The lowest rates were observed in the Netherlands (1.9 percent) and Portugal (3.1 percent), the highest in Slovenia (6.6 percent) and Spain (4.6 percent). Eurostat's flash estimate for April sees inflation easing moderately in the euro area (3.3 percent). Hence, it still remains above 2 percent, the threshold set by the ECB as consistent with price stability, which renders expansive action to

stabilise the cooling economy difficult. The key interest rate in the euro area has stood unchanged at 4 percent since June 2007. Under the impact of the interest rate differential and the more unfavourable course of economic activity in the USA as well as the persistently high US current account deficit, the euro appreciated further vis-à-vis the dollar. In mid-April, the exchange rate for the first time since the introduction of the euro almost hit the 1.60 \$ mark.

The euro area seasonally adjusted unemployment rate stood at 7.1 percent, unchanged with respect to the previous months of the year, and the average rate for the EU 27, seasonally adjusted, also did not decline further in March.

After weaker economic performance at the end of 2007, the German economy appears to have again grown vigorously in the first quarter of 2008. Notably industry and construction expanded. As a year before, the mild winter had a positive effect on building production, with building construction order levels rising markedly in January and February. Foreign trade, after moderating somewhat in late 2007, also gathered speed again at the beginning of the year. So far no adverse impact of the euro appreciation has become apparent. Even so, companies are pessimistic on this matter. The Ifo Business Climate Index, after rising since January, fell in April. Companies gave a clearly more pessimistic assessment of both the current situation and the developments in the next six months. Activity in the construction sector is also likely to moderate in the second quarter, compared with the good performance at the start of the year due to the mild weather.

Private consumption remained sluggish. Following the decline in personal consumption expenditure in 2007, first quarter retail sales hardly suggest an upward tendency. Latest survey results show that consumer confidence remains subdued.

The labour market continued to benefit from the good performance of the economy at the beginning of the year. However, unemployment fell at a slower pace in April, given lower unemployment in the mild winter. The unemployment rate fell to 8.1 percent in April (April 2007 9.5 percent), according to the traditional Austrian method of calculation; in seasonally adjusted terms it was unchanged at 7.9 percent.

The Austrian economy expanded at a seasonally and working day adjusted rate of 0.8 percent in real terms quarter-on-quarter in the first quarter of 2008. Following a period of cooling-down in late 2007, industrial activity rebounded – real value added in manufacturing expanded by +1.7 percent quarter-on-quarter, after +1.6 percent in the fourth quarter of 2007. Leading indicators nevertheless suggest some moderation in the second quarter. Business conditions in the manufacturing sector have been deteriorating steadily since industrial activity reached its peak, which is assumed to have occurred around mid-2007. Evidence from the WIFO business survey shows that the proportion of companies reporting order books to be 'sufficient' or 'more than sufficient', after declining for a year, has not fallen further since the beginning of this year.

Owing to weaker demand from their trading partners, Austrian companies' assessment of foreign order levels has, however, been unfavourable since the beginning of the year, and deteriorated further in April. Although the main focus of Austrian exports lies on the EU 27 (in 2007 30 percent of exports went to Germany, 9 percent to Italy, according to Austria's Foreign Trade Statistics), the sizeable appreciation of the euro vis-à-vis the dollar indirectly – through supplies to the German export industry – dampens Austrian export prospects. In addition to goods exports, services exports, for instance business services exports, are increasingly gaining in importance. After moderating somewhat at year-end, growth in goods exports accelerated once again (+9.1 percent on average in nominal terms year-on-year in January and February, according to the Foreign Trade Statistics). Imports rose by 6.9 percent in nominal terms.

German economy buoyant

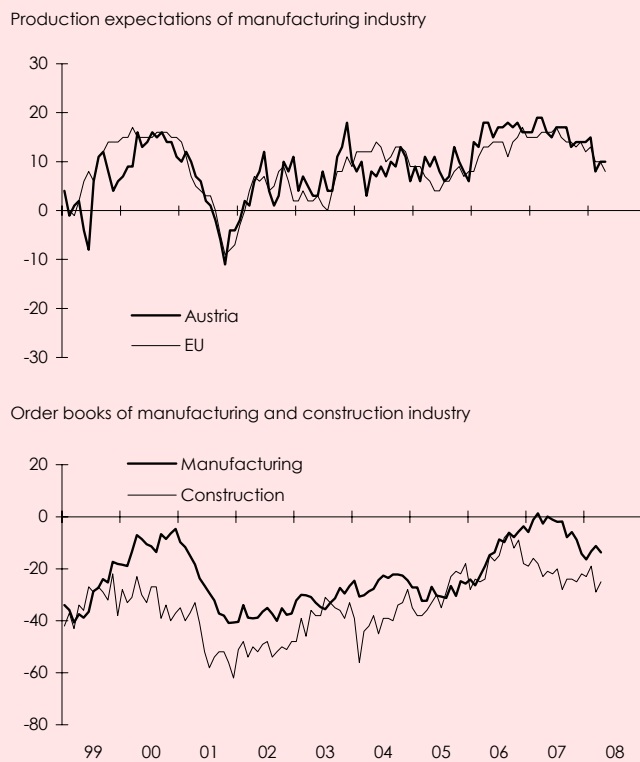
Although moderating in late 2007, economic activity in Germany was again buoyant at the beginning of 2008.

Austria: Industry providing fresh stimulus

With industrial activity rebounding, Austria's economy still fared well also in the first quarter of 2008.

Figure 2: WIFO business cycle survey

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



Source: European Commission, WIFO business cycle survey.

Construction activity also accelerated once more in the first quarter, with real value added expanding at a seasonally and working day adjusted rate of +0.7 percent quarter-on-quarter (+3 percent in annual terms), thanks to the mild winter.

However, in the most recent WIFO business survey, companies assessed current order books as merely average. Against this background they now plan to take on fewer staff than is usual for this time of year.

Following sluggish business in the second half of 2007, retail sales rose again more strongly in the first quarter of 2008. Additional stimulus was provided by the early timing of Easter. Car sales, which had declined in real terms the year before, also picked up.

Household spending for a consumption rose at a seasonally and working day adjusted quarterly rate of just 0.2 percent in real terms in the first quarter of 2008. Surveys of consumer confidence have indicated a darkening of sentiment since the beginning of the year due to the acceleration of inflation. Private households anticipate a worsening of their personal financial situation. In the current economic upswing, household spending is therefore not likely to exercise its usual role as a pillar of economic activity in the more mature phase of the upswing.

In the period from November 2007 to March 2008 the Austrian tourist sector recorded a marked sales increase of 15.3 percent, according to provisional estimates. Although sales in the same period a year earlier were relatively low, owing to the lack of snow and the late timing of Easter in 2007, and inflation accelerated, this figure represents a strong sales increase relative to the results seen in the previous three

Construction sector benefiting from mild winter

Good results in retail trade

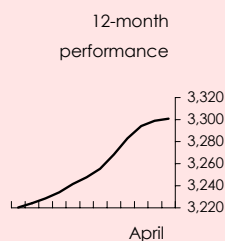
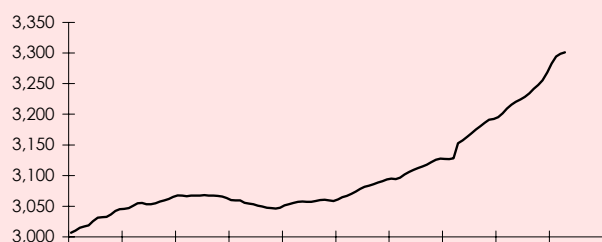
The retail sector posted good first-quarter results, due to the early timing of Easter this year.

Vigorous growth in tourism sales recorded for winter season

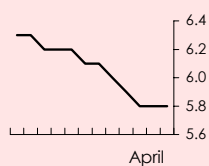
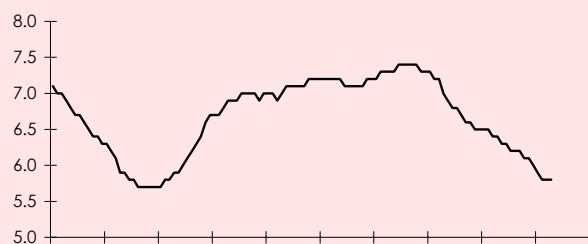
decades. Thus, Austria's tourism is on a growth path that will enable it to offset part of the loss in market shares suffered in recent years.

Figure 3: Key economic indicators

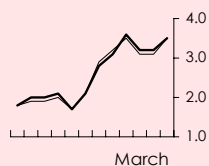
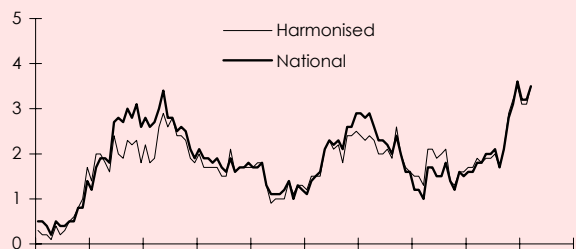
Persons in active dependent employment¹, (1,000), seasonally adjusted



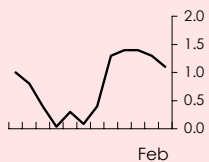
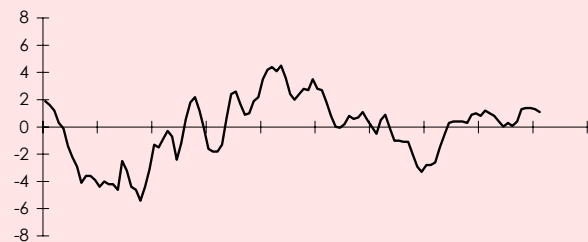
Unemployment rate, traditional Austrian method², seasonally adjusted



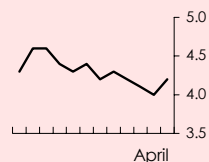
Consumer prices, year-to-year percentage changes



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 Service.

The number of overnight stays rose by 12.4 percent in the first quarter. The demand by foreign guests increased almost three times the pace (+14.3 percent) of that by resident travellers (+4.9 percent). In addition to the good results achieved in December 2007 (+9.5 percent) and in February 2008 (+8.7 percent), the favourable overall development can for the most part be attributed to the strong increase in demand in March 2008 (+25.2 percent), which was largely due also to the early timing of Easter.

Following an increase in the consumer price index by 3.2 percent in January and February, headline inflation rose to 3.5 percent in March and was thus again almost as high as in December 2007 (3.6 percent). Besides ongoing sharp food price increases, soaring fuel prices (+26 percent year-on-year) strongly contributed to overall inflation in March (+0.9 percentage point). The expenditure groups "transport" and "food and non-alcoholic beverages" together accounted for 2.1 percentage points of headline inflation.

In March, food prices were up 8.4 percent on average from a year before, with particularly high price increases registered for cheese (+21 percent), butter (+18 percent) as well as bread and grain products (+11 percent). The situation in agricultural markets remained tense. The HWWI Index of World Market Prices of Commodities, which encompasses food and alcohol and tobacco as well as energy and industrial raw materials, in the first quarter of 2008 rose by 36 percent based on euro prices from a year before. Oil prices hit a new record high, with one barrel of Brent crude for the first time trading at 120 \$.

The harmonised inflation rate (HCPI), at 3.5 percent, also indicated an acceleration of inflation (following 3.1 percent in January and February). It was thus slightly lower than the euro area average (3.6 percent).

Employment developments – as a lagging indicator – in the first four months of the year reflected strong economic activity last year and renewed value added growth in industry, construction and tourism. Following the particularly strong increase in February and March (+3.2 percent and +3.0 percent, respectively), the number of persons in dependent active employment in Austria exceeded the year-earlier level by 2.6 percent in April (+82,700). This substantial increase is likely to also have statistical administrative causes: Since the beginning of this year, the social insurance authority must be notified of conclusion of an employment contract already prior to the beginning date of employment. Due to the change in the statistical classification of economic activities as of the beginning of 2008 no data classified by industry is yet available.

The economic upswing has been accompanied by a steady decline in unemployment in the last two years. In April, 205,000 persons were registered as unemployed with the Public Employment Service, a decline by 14,300 from a year earlier. The unemployment rate stood at 5.7 percent in April, according to the Austrian method of calculation. In seasonally adjusted terms, however, both employment growth and unemployment decline are slowly coming to a halt.

The number of job vacancies, which is considered a leading indicator, fell in April for the first time in five years (–600 year-on-year).

Inflation picking up after short period of easing

Inflation rose to 3.5 percent in March, largely driven by increases in fuel and food prices.

Employment growth continues

Stronger economic expansion at the start of the year resulted in further employment growth.