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Industry and Construction Experiencing Boom

Business Cycle Report of February 2007

Austria's economy expanded by 3.3 percent in real terms year-on-year in the fourth quarter, according to WIFO's flash estimate; this corresponds to a seasonally adjusted GDP growth by 0.8 percent from the previous quarter. Notably manufacturing and construction are registering very strong growth causing a sizeable increase in the number of full-time jobs and enabling a reduction in unemployment. In contrast, those sectors of the economy that are dependent on private household consumption show no signs of a robust revival. Wage growth has been modest and does not permit a strong expansion of consumption, despite low consumer price inflation.

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Austria's industry is experiencing a stable boom, with real value added in the manufacturing sector advancing by 7.5 percent year-on-year in the fourth quarter of 2006. In WIFO's business survey for the first quarter of 2007, firms continue to be optimistic, assessing their export orders once more somewhat more positively than in the previous quarter; prices obtained continue to rise, and production expectations for the next few months have scarcely weakened. Business has developed particularly well in the technical processing sector, which comprises the steel industry as well as the motor, metalworking and electrical industries. The chemical industry and firms supplying the construction sector also view their business situation with great optimism.

The first quarter saw capacity utilisation climb to 85.1 percent, a new record high. Capacity bottlenecks induce firms to realise planned investment projects, which is helped by an excellent profit performance. The trade cycle has turned from export-driven recovery into strong investment-driven growth.

This becomes apparent also in the construction sector, which in the fourth quarter of 2006 recorded a 5.5 percent increase in real value added compared with a year earlier. In WIFO's business survey for the first quarter of 2007, firms judge their order situation as being somewhat weaker than in autumn, but still strikingly better than in long-term comparison. Owing to the mild weather, construction firms are able to convert brisk demand into substantial output increases, and with order levels highly favourable need not fear a slump in spring.

The boom in industry and construction is reflected on the labour market: in January, the number of persons in active dependent employment rose by 72,000 (+2.3 percent) from a year earlier, the fastest pace of job growth since 1991. The majority of the jobs added in industry (+7,000) and in construction (+10,000) are full-time and consequently cause a decline in the number of unemployed persons, many of whom wish to work full-time. The prevailing conditions are particularly favourable now for the fight against long-time unemployment. The services sectors are also boosting employment, albeit primarily in part-time jobs, for instance in retailing. These jobs are predominantly filled with additional job seekers entering the labour market.

The employment gains in the tertiary sector do not suggest a pick-up in private household consumption, however. While it would be yet another important step in

the trade cycle if export and investment growth were to spread to consumer demand, there is currently no indication of such a development. In the fourth quarter of 2006, private consumption increased at a rate of 1.7 percent in volume year-on-year. Real retail sales grew by just 0.6 percent in December, according to first preliminary calculations, with very low sales figures recorded for motor vehicles.

Table 1: Flash estimates of quarterly national accounts

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

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

In spite of a recovery of consumer sentiment, there is only little indication of a pick-up in demand, with notably weak real wage increases preventing a revival of consumer spending. At the end of last year, the gross increase in per-capita wages amounted to around 1 percent, while the net increase was markedly lower.

Price developments are supporting incomes. Owing to an easing of crude oil prices and price declines in the communications sector, consumer price inflation stood at only 1.5 percent all in all in December. For the entire year 2006, the increase was 1.5 percent for the consumer price index and 1.7 percent for the harmonised consumer price index – in both cases below the rate defined by the European Central Bank as consistent with price stability.

Global economic growth is believed to have exceeded 5 percent in real terms in the year 2006. Expansion has been particularly brisk in Asia: China does not exhibit any signs of decelerating output growth, with GDP once more rising by around 10 percent. Commodity prices continue to ease, with crude oil prices on a euro basis down 20 percent in January 2007 from a year earlier. This can be attributed to both an expansion of production and weaker demand in Europe owing to the mild weather.

The US economy grew at a faster-than-expected pace in the fourth quarter of 2006. According to first preliminary calculations, real GDP advanced by 0.9 percent quarter-on-quarter, which is equivalent to an increase by 3.4 percent year-on-year. Household consumption, encouraged by a decline in fuel prices and relatively good labour market conditions, rose by 3.7 percent in volume from a year earlier. Strong export growth and brisk public-sector demand (also for military hardware) also acted as drivers of growth. Private residential investment in contrast is increasingly

Global economic conditions remain favourable

Growth in Asia remains robust. In the USA, private households' high propensity to spend is putting off a slowdown in economic activity.

turning into a factor that is putting a brake on economic activity. Prompted by the marked decline in real estate prices, residential investment has been falling dramatically and in the fourth quarter of 2006 was down a good 12 percent from a year earlier. However, so far the slump in real estate prices has not yet triggered the slowdown in private household consumption that was to be expected.

At the cut-off date of this report, no flash estimate was yet available for fourth-quarter euro area GDP. The quarterly forecasts of the European Commission suggest a growth rate of +0.5 percent in real terms quarter-on-quarter, which would be unchanged from the rate in the third quarter and would mean an expansion by 2.7 percent compared with the previous year. Economic activity continues to be driven by exports, but investment is increasingly gaining momentum.

Industry is experiencing a boom. Supported by strong external demand, firms assess the current economic situation very positively and are optimistic regarding the outlook for production in the months ahead, even though growth rates are set to flatten somewhat. The industrial confidence indicator published by the European Commission in January reached a balance of responses of +5 percent, only slightly lower than the long-term peak (+6 percent) recorded at the end of 2006. Industrial activity, while moderating in France and Italy, is accelerating at a particularly brisk pace in countries that have traditionally been very export-oriented, such as Germany, the Netherlands and Austria.

Manufacturing capacity utilisation in the euro area rose to 84.4 percent in January 2007, thus clearly exceeding the year-earlier reading of 81.9 percent. In Spain, Finland and Austria, capacity utilisation in January approached or even surpassed the all-time high recorded by the European Commission. High levels of capacity utilisation, strong corporate profits and stable sales prospects constitute framework conditions that are very conducive to a revival in investment. The manufacturers surveyed by the European Commission plan to increase their investment volumes by 5 percent in 2007.

Industrial confidence is about as high as it was during the boom in 2000, whereas consumer confidence, while slowly improving, remains distinctly below those levels. Further progress will depend on the extent to which export and investment growth will spread to private household consumption. The reason why so far this feed-through has been insufficient lies mainly in the modest real incomes. With nominal per-capita wages in the euro area rising by just around 2½ percent year-on-year in the autumn of 2006, the rate of increase was thus scarcely higher than the inflation rate and clearly lower than GDP growth per employee.

Many analysts consider the current development in Germany a key determinant of the further course of the euro area economy. The increase in the general rate of value-added tax from 16 percent to 19 percent took effect at the beginning of 2007. Indications provided by first data and survey results as to the effects of this measure vary greatly. The Federal Statistical Office in a preliminary calculation of the inflation rate for January anticipates the harmonised consumer price index to rise by 1.8 percent in year-on-year terms. This is an increase by just 0.4 percentage point from December and clearly lower than the theoretically calculated VAT effect of up to +1½ percentage points. Two special factors appear to have dampened the impact of the tax increase on prices, however: First, prices for fuel and heating oil dropped considerably at the beginning of 2007, and second, retailers appear to launch special sales on a large scale.

Euro area industrial activity accelerating at brisk pace

Europe's industry benefits from a buoyant world economy and proves to be highly competitive.

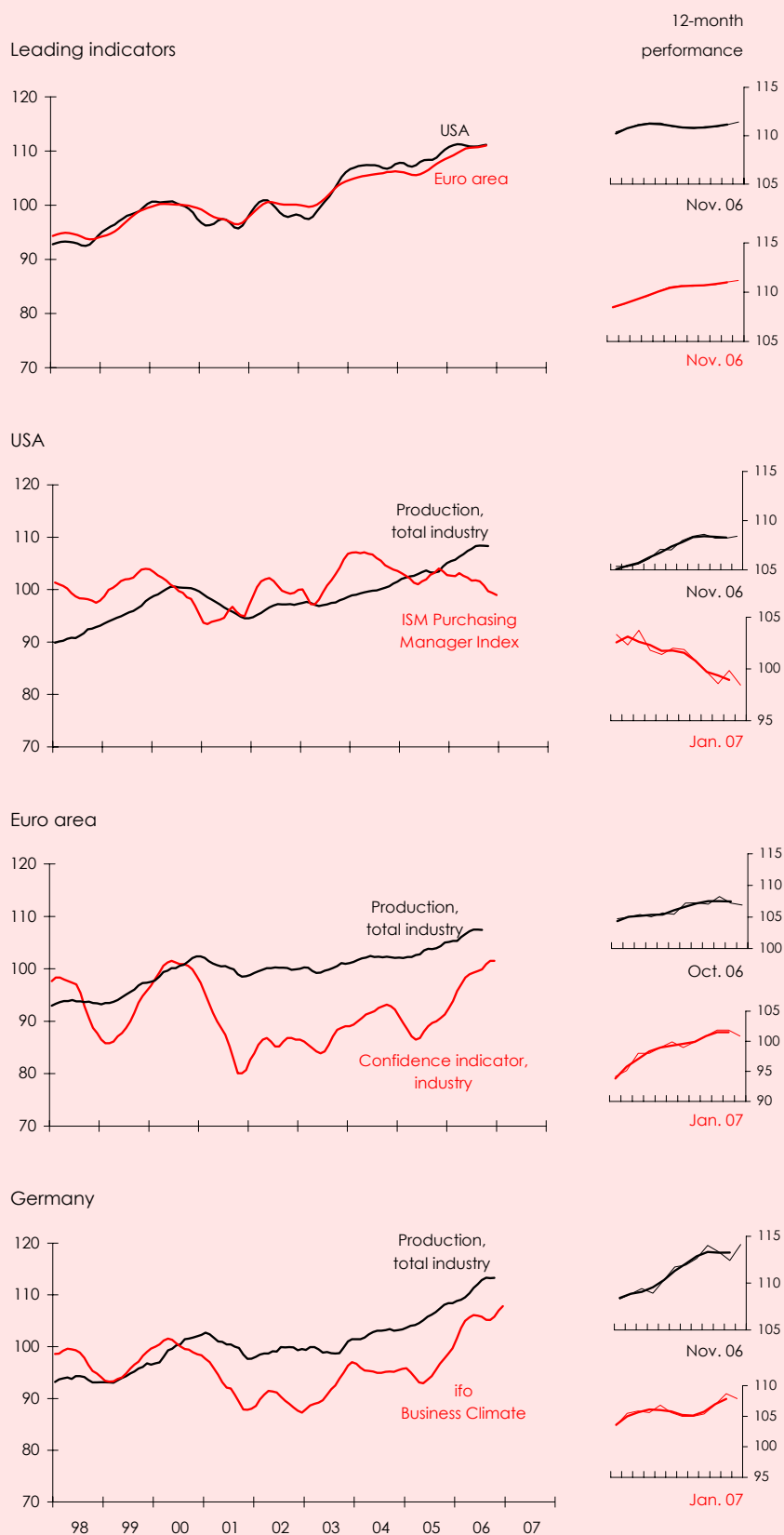
Consumer demand lagging behind

Weak wage settlements hold down euro area consumer demand.

Divergent VAT effects in Germany

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.

Retailers resort to price rebates and special sales as a countermeasure to impending demand shortfalls following extensive advance purchases in autumn 2006. Notably durable consumer goods, among them mostly cars, were bought in advance. In 2006, the number of newly registered cars exceeded the year-earlier level by 4 percent, but declined sharply in January (-11 percent year-on-year). The results of the consumer surveys conducted by the European Commission paint a similar picture: While in the fourth quarter of 2006 the balance of affirmative responses to the question about current larger-scale purchases was +30 percent, the January survey showed a fall to -3 percent.

Sizeable carry-forward effects contributed to a substantial increase in value added in manufacturing and trade in the fourth quarter of 2006. According to preliminary data released by DIW, real GDP, at +0.8 percent quarter-on-quarter expanded at a rate higher than anticipated by German institutes for economic research. Current indicators for the beginning of 2007 suggest some deceleration in trade activity. The healthy pace of industrial activity, on the other hand, is set to continue. Manufacturers are benefiting from the strong demand for capital goods and their persistently high price competitiveness.

Austrian manufacturers are experiencing a boom not seen for many years. Their business situation is even more favourable than it was in 2000, with real value added surpassing the year-earlier level by 7.5 percent in the fourth quarter of 2006. The strong increase in employment, number of hours worked and productivity per man-hour are evidence for the extremely good economic situation.

Judging by the results of the WIFO business survey for the first quarter of 2007, the brisk activity in manufacturing is set to continue. Sentiment is particularly optimistic among firms in the technical processing industry (comprising the steel industry as well as the motor, metalworking and electrical industries). The positive balance of companies with optimistic production expectations has been exceeding 20 percentage points for four quarters now. Companies view their business situation as very favourable and are able to obtain rising sales prices. Stocks have dwindled considerably, and firms are increasingly complaining about material and capacity bottlenecks. The chemical industry and suppliers of the construction sector also judge their business situation very positively, whereas assessment turned less optimistic at the beginning of the year in the primary sector (petroleum, iron and paper industries) and in industries manufacturing traditional consumer goods (food, leather and textile industries).

The boom in industry continues to be driven by strong external demand. The demand structure benefits Austrian manufacturers, who also gain from their high price competitiveness (see box "Revised and New Competitiveness Indicators for Austria"). The optimistic assessment in the WIFO business survey of foreign orders on hand is confirmed by the export data published by Statistics Austria, although the latter are available only with considerable lag. Between January and November 2006 goods exports exceeded the year-earlier level by 12 percent in value. Brisk growth in demand was registered notably from CIS and OPEC countries, which make use of their high profits from oil production. Exports to the 12 new EU member countries and to non-EU countries expanded somewhat more strongly than those to the EU 15.

According to the WIFO business survey, manufacturing capacity utilisation, at 85.1 percent reached a new record high in the first quarter of 2007. In the sectors that manufacture capital goods, the average utilisation rate stood at almost 90 percent. This is also reflected in production statistics, even though these data become available with considerable lag. In October and November, the capital goods industry posted a 13 percent growth in output from the previous year. However, approximately one quarter of the machinery, vehicles and electrical appliances invested in Austria were manufactured abroad, with capital goods imports from January to November 2006 outpacing the year-earlier level by 7 percent, according to Statistics Austria. Sales results reported by the wholesale trade do not fit into the picture of a brisk demand for capital goods, they advanced by just around

The increase in the rate of value-added tax appears to have accelerated inflation in Germany to a lesser-than-expected degree. The trade sector worries about a possible major slump at the beginning of the year.

Austria: Industry experiencing solid boom

Firms in technical processing, suppliers to the construction sector and chemical companies expressed particular optimism in the WIFO business survey.

High capacity utilisation generates pickup in investment

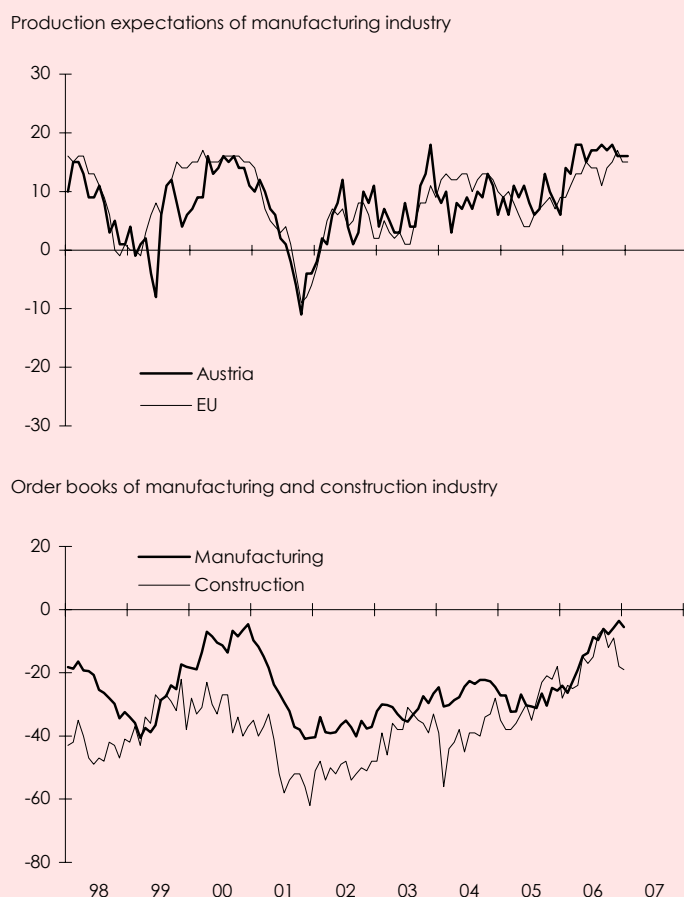
2½% in real terms in October and November 2006 compared with the same period a year earlier.

However, there are many signs indicating that the pickup in investment is gathering speed. In the fourth quarter, real gross investment advanced by 4.5 percent year-on-year or 0.9 percent quarter-on-quarter, respectively. In the course of the year 2006, the trade cycle turned from export-driven upswing to growth driven by strong investment. In this way it has become more solid.

Owing to brisk demand, industry is reaching production capacity limits and reacts with substantial expansion of investment volumes.

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.

The robust growth of investment is also reflected in the construction sector, where real value added in the fourth quarter of 2006 surpassed the year-earlier result by 5.5 percent. While in the WIFO business survey for the first quarter of 2007 firms in the construction industry are slightly more cautious than they were in autumn in their appraisal of order books, their assessment of the business climate is still at a record level. The mild weather allows building firms to reduce their high workload by continuing to work also during the winter months.

The labour market profits from this development: In December, the number of persons employed in construction exceeded the year-earlier level by 10,000; in January the number of unemployed persons fell by only 1,700 from the previous year, however. Provided the labour supply does not grow too fast, lively activity in this sector offers the opportunity to substantially reduce the still high unemployment rate in construction.

Construction industry benefiting from brisk demand and mild weather

The mild winter allows the construction industry to quickly translate filled order books into construction activity.

Given the good order situation, it is not likely that the high levels of construction activity in winter will be followed by a lack of orders in spring. The outlook for the construction industry remains favourable.

Revised and New Competitiveness Indicators for Austria

The nominal effective and real effective exchange rate indices for Austria offered by the WIFO database were revised by WIFO on behalf of OeNB (Austria's central bank). The harmonised methodology used so far and binding on the members of the European Economic and Monetary Union was retained, with concept and composition of the indicators remaining unchanged.

To account for the increasingly more complex structure of trade, the number of competitor and target countries was enlarged (from 53 to 62) and the basis for the calculation of the weighting schemes changed from 1995 to 1997 averages to 1999 to 2001 averages. The first quarter of 1999 has been left unchanged as the base period. The revised indices are "chained" indices: For the period up to 1999, their course is determined by the old sample of competitor and target countries and the old calculation period, whereas for the period since the beginning of 1999 the index calculation is based on the new sample of competitor and target countries and the new calculation period.

A characteristic of the Austrian competitiveness indicator is that it also includes travel and tourism. This subindex was constructed on a new database and the matrix used to calculate the weights was changed from overnight stays to tourism revenues and expenditures.

While until now the indicator of price competitiveness was calculated using the CPI as deflator, harmonised consumer price indices are used as deflators in the calculation of the new indicator – so far as they are available. New indicators of cost competitiveness based on unit labour costs as deflator have been added.

All indicators show that the competitiveness of the Austrian economy has improved further since 1999. The real effective exchange rate index for the economy as a whole fell by 3 percent between the first quarter of 1999 and the fourth quarter of 2006, while relative unit labour costs for industrial goods exports declined by 17 percent.

See in detail: Köhler-Töglhofer, W., Magerl, Ch., Mooslechner, P., "Revised and New Competitiveness Indicators for Austria Reflects Improvement Trend since EMU Accession", OeNB, Monetary Policy and the Economy, 2006, (Q4/06), http://www.oenb.at/de/img/gewi_2006_q4_analyse5_tcm14-50633.pdf.

The lively export and investment activity needs yet to feed into private household consumer demand. While according to the European Commission's indicator consumer confidence improved considerably during 2006, this is not yet reflected in a measurable rise in demand. The fourth quarter saw real consumer demand of private households rise by only 0.4 percent quarter-on-quarter and 1.7 percent year-on-year.

Available data for the demand for motor vehicles show very weak results. Retail trade also posted only modest sales gains (December 2006: +0.6 percent in real terms year-on-year). More favourable results were reported at the beginning of the winter season regarding the demand of Austrian guests in Austrian tourism enterprises. The number of overnight stays rose by 4.6 percent in November and December, with overall sales of domestic tourism enterprises outpacing the year-earlier result by 5.5 percent.

Subdued growth in consumption is primarily a result of the low increase in incomes. At the end of 2006, the index of agreed minimum wages and salaries was only 2.6 percent higher than a year earlier. Hence the gross increase in employees' real per-capita wages was only around 1 percent, the net increase was even lower.

Consumer prices rose at a rate of 1.5 percent year-on-year in December, equivalent to the inflation rate for 2006 as a whole. Inflation as measured by the harmonised consumer price index was slightly higher. The increase in energy prices over the year still contributed substantially to the upward drift in prices of the economy as a whole, but in recent months inflation was slowed down owing to a moderation in crude oil prices. Electricity and gas prices in contrast still show an upward tendency.

The decline in communication prices once more accelerated towards the end of the year due to brisk competition in the mobile phone sector. The prices for food and various services continue to grow faster than those for industrial and commer-

No acceleration in consumption growth

Consumer demand remains subdued; this is not surprising considering the modest increase in real incomes.

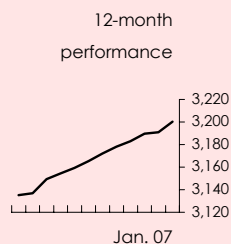
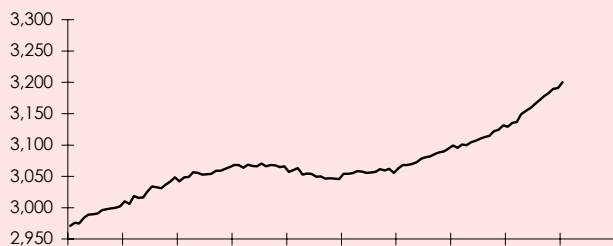
Stable prices

The price rise in Austria lies below the inflation target set by the European Central Bank.

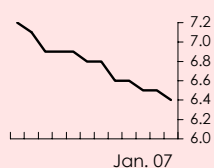
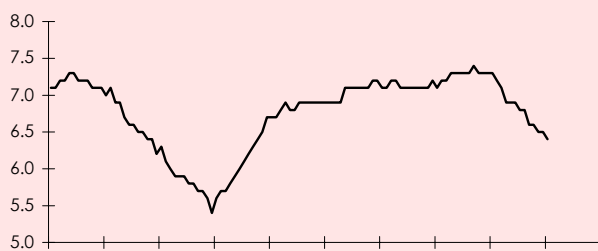
cial goods. Particularly vigorous price increases have recently been recorded in the category "Education".

Figure 3: Key economic indicators

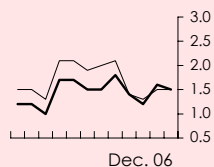
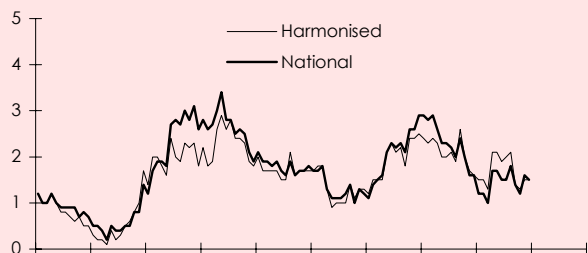
Persons in active dependent employment¹, (1,000), seasonally adjusted



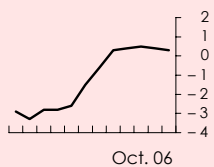
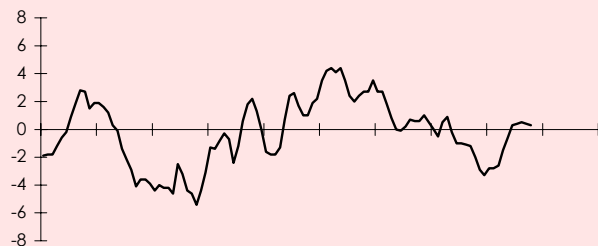
Unemployment rate, traditional Austrian method², seasonally adjusted



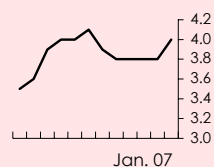
Consumer prices, year-to-year percentage changes



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 boom experienced in industry and construction is clearly evident on the labour market. The manufacturing sector recorded a year-on-year employment gain by 7,000 in December, while the construction industry, at +10,000 posted an even higher increase – also as a consequence of the mild weather. The bulk of the newly created jobs were full-time jobs for men. The services sector is also recording a strong increase in employment, principally, however, in part-time jobs. The number of persons employed in retailing, for instance, rose by 4,000 from last year, in spite of weak business.

In January the number of persons in active dependent employment rose by altogether 72,000 (+2.3 percent) from a year earlier. This sizeable increase also generates a marked decline in unemployment. As unemployed persons look primarily for full-time jobs, the favourable development in industry and construction now creates the best precondition also for a reduction in long-term unemployment. The improvement in the labour market is also reflected in an increase in the number of vacancies by almost 7,000 to 30,000. Most recently the ratio of vacancies registered with the AMS ("Labour Market Service") to the number of unemployed was 1 to 10. While it is true that January saw the number of persons registered as unemployed decline by 31,000 from a year earlier, the unemployment figure, at 295,000 still continues to be very high.

Marked decline in unemployment

January saw the highest job growth since 1991, contributing to a marked decline in unemployment.