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## Setback in Economic Activity

### Business Cycle Report of February 2009

**In the fourth quarter of 2008, seasonally and working day adjusted GDP declined for the first time since mid-2001, mainly in response to the deep recession in the export-oriented manufacturing industry. Private households, on the other hand, increased their consumption, albeit very moderately. Tourism registered a strong start of the winter season. The economic downturn is also reflected in rapidly slowing inflation and sharply rising unemployment.**

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Austria's real gross domestic product declined at a seasonally and working day adjusted quarterly rate of 0.2 percent in the fourth quarter of 2008, according to recent calculations by WIFO. It thus exceeded the year-earlier level only by a mere 0.3 percent. For 2008 as a whole, real GDP growth was 1.8 percent. The dampened economic output in the fourth quarter primarily reflected the setback in activity in the export-oriented industry. The demand for exports remained 1 percent in real terms below the level seen in the third quarter, and 4.2 percent below the year-earlier level. Manufacturing value added declined by 1.6 percent in real terms compared with the third quarter, and by 1.4 percent compared with a year before.

The results of WIFO's January 2009 business cycle survey suggest that industrial production will decline further. Companies are more pessimistic than they have been in a long time in their assessment of order books, particularly export order books, and their business outlook. Capacity utilisation, notably by big companies and the motor vehicle industry, has fallen markedly. A major part of the survey respondents anticipate further steep production declines. The balance of positive and negative responses reached -22 percentage points, following still +5 percentage points in July 2008 and +17 percentage points in January 2008. However, production expectations were slightly more positive in January 2009 than in December 2008 – this could be a first sign of a slight slowdown in the decline.

The downturn of the global economy is intensifying. US economic output fell at a markedly faster pace in the fourth quarter of 2008 (-1 percent in real terms quarter-on-quarter, seasonally adjusted). The euro area has been in a recession since spring 2008. Production fell sharply at the end of 2008 (November -5 percent, seasonally adjusted, compared with August) and so did industrial new orders (-15 percent). Although the downturn in construction and retailing has been less severe, unemployment is nevertheless already rising strongly.

Economic activity in the East-Central European EU countries has also deteriorated, with industrial production suffering from appreciably slowing demand from the West. Construction output and retail sales, by contrast, have weakened only moderately so far in most countries. Emerging Asia has seen export demand and industrial production plummet. The worldwide production decline is also reflected in global trade, which contracted by 6 percent in real terms month-on-month in November 2008; leading indicators point to a continuation of the downward trend in the coming months.

In Austria, too, those sectors of the economy that are driven by domestic demand have been more stable than the export sector. Household spending was marginally higher in the fourth quarter of 2008 than during the previous quarter (+0.4 percent in real terms, seasonally and working day adjusted, +1 percent year-on-year). This may in part be attributable also to the slight increase in real disposable income: the inflation rate fell to 1.3 percent in December, from still 3.8 percent three months earlier, reflecting the sharp fall in commodity prices. While overall real retail sales in the fourth quarter stagnated at the year-earlier level, motor vehicle sales declined markedly (-11.6 percent). In December 2008, new passenger car registrations were down 16 percent from a year earlier.

Table 1: Flash estimates of quarterly national accounts

	2007		2008			
	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 <sup>1</sup>	+ 0.2	+ 0.4	+ 0.1	+ 0.2	+ 0.4	+ 0.4
General government	+ 0.1	+ 0.0	- 0.1	+ 0.2	+ 0.5	+ 0.2
Gross capital formation	+ 0.5	+ 0.5	+ 0.5	+ 0.5	+ 0.2	+ 0.1
Exports	+ 1.8	+ 1.3	+ 0.8	+ 0.3	- 0.8	- 1.0
Imports	+ 1.4	+ 1.0	+ 0.4	- 0.2	- 0.2	- 0.2
Gross domestic product	+ 0.7	+ 0.7	+ 0.5	+ 0.2	+ 0.0	- 0.2
<i>GDP, output approach</i>						
Agriculture, forestry	+ 1.4	+ 1.3	- 0.0	- 0.8	- 1.0	- 0.4
Industry, including energy	+ 1.4	+ 1.8	+ 1.1	- 0.1	- 0.4	- 0.8
Manufacturing	+ 1.0	+ 1.8	+ 1.5	- 0.0	- 0.7	- 1.6
Construction	+ 0.3	+ 0.3	+ 0.2	+ 0.2	+ 0.2	- 0.1
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.6	+ 0.5	+ 0.4	+ 0.2	+ 0.2	+ 0.2
Financial intermediation; real es- tate, renting and business activities	+ 0.9	+ 0.6	+ 0.3	+ 0.2	+ 0.2	- 0.1
Other service activities	+ 0.3	+ 0.4	+ 0.2	+ 0.3	+ 0.4	+ 0.4
Taxes on products	+ 0.3	+ 0.4	+ 0.4	+ 0.3	+ 0.2	+ 0.2
Subsidies on products	+ 1.0	+ 0.8	+ 0.6	+ 0.7	+ 0.8	+ 0.8
Percentage changes from previous year						
Gross domestic product, volume	+ 2.7	+ 2.6	+ 2.9	+ 2.4	+ 1.5	+ 0.3

Source: WIFO. – <sup>1</sup> Including private non-profit institutions serving households.

The winter tourist season had a very promising start. Thanks to the good weather and the lag with which – as experience shows – an economic downturn has an impact on tourism, both the number of overnight stays and real sales volumes rose at a year-on-year rate of 6.8 percent in November and December.

The industrial and commercial building industry, which is driven by investment, has already weakened noticeably. Production in the civil engineering sector, however, has been lively. Overall real value added in the construction sector in the fourth quarter of 2008 remained 0.6 percent below the year-earlier level. The construction firms surveyed in the WIFO business cycle survey have grown increasingly pessimistic regarding developments of new orders, production, prices and employment.

Owing to the slump in industrial production, the number of unemployed rose sharply in December and January – despite the rapid expansion of short-time working. Recent figures show an increase by 10,000 (seasonally adjusted) from November 2008, with the unemployment rate rising to 6.4 percent of the dependent labour force (+0.8 percentage point compared with the cyclical low in March 2008). The number of persons in dependent active employment fell slightly compared with the previous quarters.

The international financial crisis, which was triggered off in the USA in summer 2007, in recent months has also spread globally to the real economy. In the western industrial countries, manufacturing production (seasonally adjusted) has been falling already since summer 2008, with the decline accelerating appreciably towards the end of the year. Emerging markets cannot evade the consequences of the shortfall in overall economic demand in the industrial countries as their production is frequently geared towards export. Exports, industrial production and also GDP already declined in seasonally adjusted quarterly terms in many emerging markets of Asia in the fourth quarter of 2008. China reported real GDP growth of 6.8 percent year-on-year in the fourth quarter of 2008, but economic output seems not to have increased any more in seasonally adjusted quarter-on-quarter terms.

The worldwide production decline is also reflected in the evolution of world trade: In November 2008, the Centraal Planbureau recorded a contraction by 6 percent from a month earlier. Leading indicators point to a further marked decline in international trade activities in the coming months.

The worldwide weakening in demand has caused a substantial fall in commodity prices. According to the HWWI Index, prices more than halved between their peak in summer 2008 and the beginning of 2009, largely in response to the collapse of world market prices for crude oil; but food and industrial raw material prices are also clearly trending down.

In the USA, real GDP contracted by 1 percent quarter-on-quarter and 0.2 percent year-on-year, respectively, in the fourth quarter of 2008. The recession, which according to the National Bureau of Economic Research began in December 2007, has thus intensified considerably. The decline has been particularly steep for manufacturing output, which in November was already 8 percent lower than at the beginning of 2008. The sharp fall in new orders and the Purchasing Managers' Index, which has dropped well below its contraction-expansion threshold, point to a marked decline in industrial production also at the beginning of 2009.

Companies are slashing investment in reaction to the demand shortfall and more unfavourable financing conditions. In the fourth quarter of 2008, business spending on machinery and equipment was down 7.8 percent from the previous quarter and 10.9 percent from a year earlier. The real estate market has still not steadied yet, with neither house prices nor residential investment (fourth quarter -6.5 percent in real terms, compared with the previous quarter) showing signs of stabilising.

High losses in housing and stock wealth, and rapidly rising unemployment (in January 2009 the unemployment rate rose to 7.6 percent of the labour force) have dampened consumer demand (fourth quarter -0.9 percent in real terms quarter-on-quarter, -1.3 percent year-on-year).

US economic policy has intensified its expansionary stance. In December, the Fed cut its key interest rates to within a range of 0 percent to 0.25 percent, and Congress is tying an economic stimulus package worth about 6 percent of GDP.

The economic downturn in the euro area has deepened considerably towards the end of 2008. In November, the Industrial Production Index fell by 1.6 percent month-on-month and was thus already 5 percent lower than its reading in August 2008. The marked fall in new orders since autumn (August to November -15%, cumulated) points to further production declines in the coming months. The European Commission's Industrial Confidence Indicator for the euro area showed a balance of -34 percentage points in January. This represents a decline by 41 points since mid-2007, much sharper than during the 1992-93 and 2001-02 recessions. Compared with December 2008, it fell only little, however (-1 percentage point).

## Global trade shrinking appreciably

*The sharp decline in production has taken hold not only in industrial countries but has spread also to emerging economies. Weakened demand has prompted a marked fall in commodity prices.*

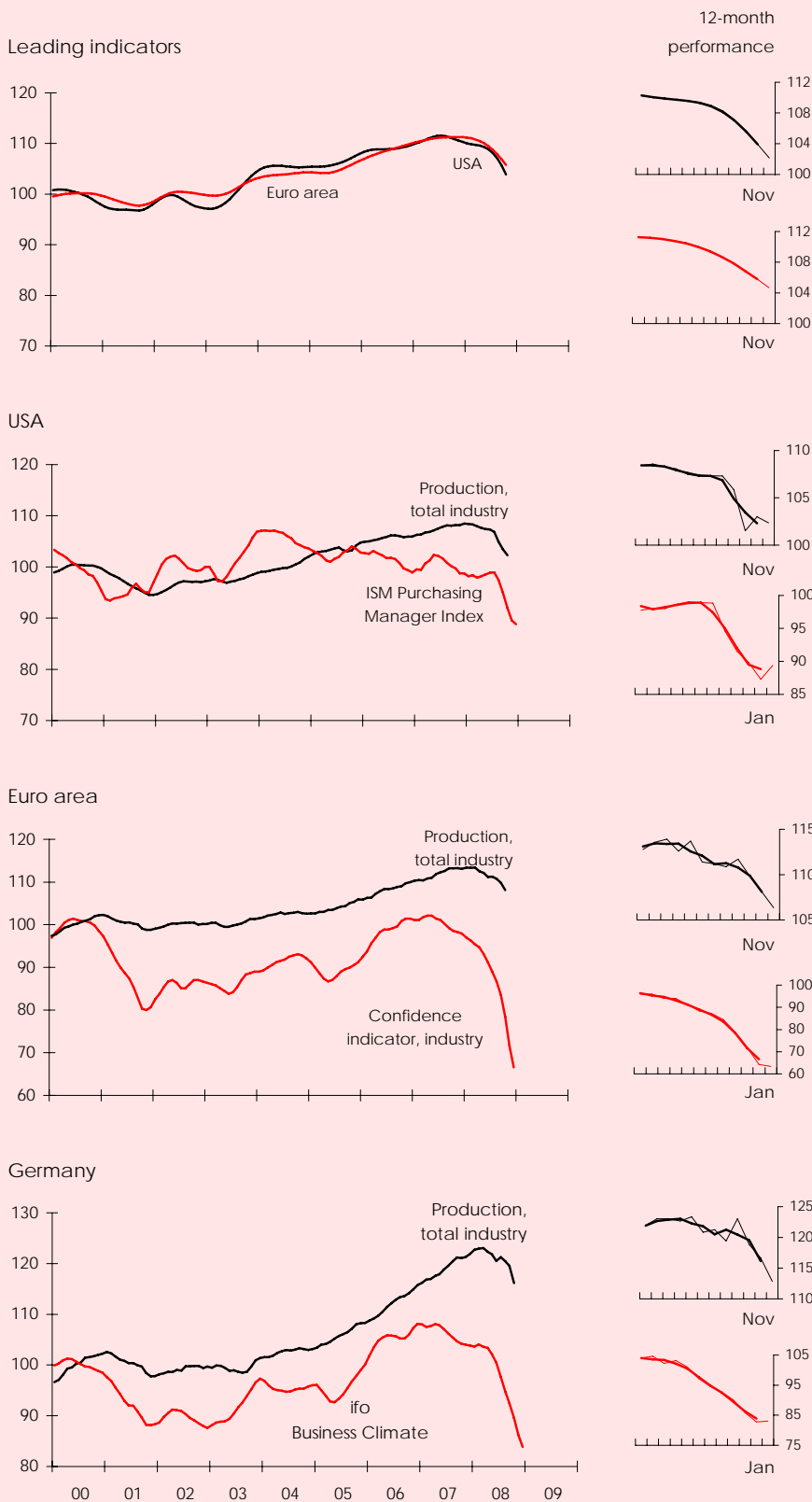
## US recession deepening

*In the USA, the steep economic downturn is spreading from residential construction to industry and trade.*

## Euro area industrial activity shrinks markedly

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 economic downturn in the euro area has so far been concentrated in the industrial sector. Construction activity has weakened at a slower pace – in November, the production index was down 5 percent compared with its reading in the fourth quarter of 2007. Real retail sales have slowed only little until now: The year-on-year change of –1 percent in December was primarily attributable to the sharp rise in consumer prices in 2008. However, pressure is mounting on consumer demand due to falling employment and rising unemployment.

The seasonally adjusted unemployment rate climbed to 8 percent of the labour force in December 2008, an increase by  $\frac{3}{4}$  percentage point from its low in the first quarter of 2008. A particularly sharp rise in unemployment was registered in countries whose long-run real estate boom collapsed: Spain's unemployment rate recently climbed to 14.4 percent of the labour force (first quarter 2008 9.3 percent), that of Ireland to 8.2 percent (5 percent).

The economies of the East-Central European EU countries have so far been primarily affected by weakening demand from Western Europe. This is reflected in a decline in industrial production. In the largest economies Poland, Hungary, Czech Republic and Slovakia, the production index recently fell at a rate within a range of 10 percent to 15 percent from its peak in spring 2008. The decline accelerated markedly in November and December. The downturn has been much more severe in the Baltic countries.

Developments in the sectors depending on domestic demand have remained relatively positive, but it will become increasingly difficult to service the quickly risen (foreign currency) debts. Construction output has hardly fallen so far – except for Hungary, where a restrictive budgetary policy has dampened investment. Retail sector activity has slowed only little to date in the big countries; only the Baltic countries have seen retail sales fall markedly.

The business cycle in Austria is primarily determined by exports – 60 percent of manufactured goods and services are exported. The economic downturn began in the export sector in mid-2007, remaining subdued at first. As from the second quarter of 2008, external demand for goods fell at an ever-increasing pace. In the fourth quarter it was down 1.1 percent in real terms compared with the third quarter (–6.7 percent compared with a year before), according to the National Accounts. According to the Foreign Trade Statistics, the year-on-year difference in November was –14 percent in nominal terms, compared with still +3 percent in the first eleven months of the year. While exports to the USA have been shrinking markedly already over a longer period of time, those to the EU27 for the first time contracted that strongly in November (–16 percent).

The decline in external demand primarily affects Austria's industrial sector. In the fourth quarter of 2008, seasonally and working day adjusted real value added in the manufacturing sector remained 1.6 percent below the level recorded in the previous quarter and already 1.4 percent below the year-earlier level. The companies affected in particular are those in the technical processing sector (mechanical engineering and steel engineering industries, motor vehicle industry, metal industry) and manufacturers of intermediate products.

The results of the WIFO business cycle survey point to further marked production declines in the coming months. The proportion of companies expecting production to decline exceeded that of optimistic reports by 22 percentage points in January 2009. Order book levels have been falling significantly. Capacity utilisation shrank to a mere 77.4 percent in January, compared with still 82.3 percent six months earlier. The decline was particularly sharp among companies with a staff of more than 500 (–8.3 percentage points) and in the motor vehicle industry (–13.5 percentage points).

There are first signs in WIFO's January 2009 business survey of a slowdown in the production decline, however, which might be confirmed in the coming months: Com-

*Industrial production and new orders have been falling sharply in the euro area since August 2008; the downturn in the construction and retail trade sectors has been less intense.*

## Beginning downturn in East-Central Europe

*Industrial production in East-Central Europe is declining markedly in reaction to falling export demand; domestic demand still remains stable.*

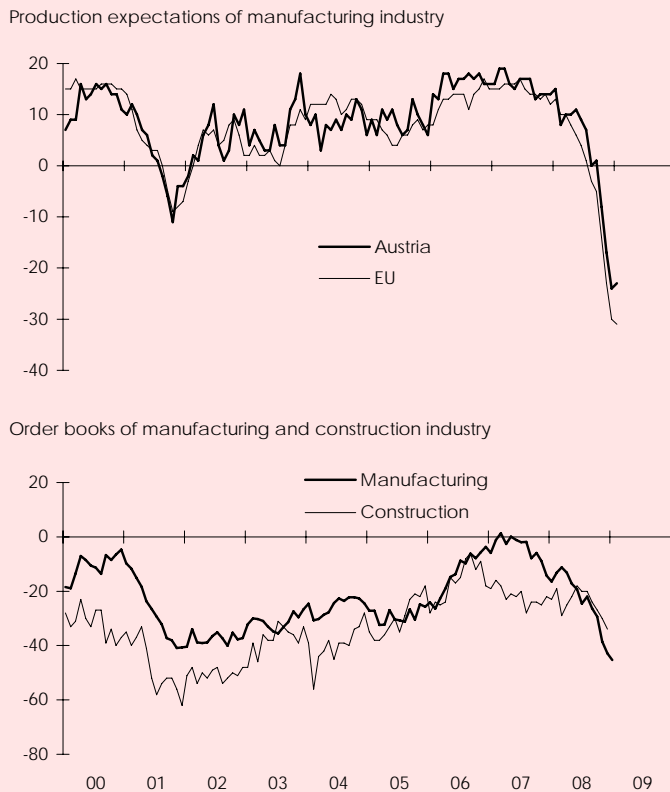
## Austrian export industry facing production downturn

*The downturn in industrial activity in Austria has been much more rapid than during the recessions in recent decades. The results of the WIFO business cycle survey give no reason to hope production will recover any time soon.*

panies' production expectations, and their assessment of foreign orders and the business situation in six months' time were slightly less pessimistic than in December.

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 value added declined in seasonally and working day adjusted terms at the end of the year (fourth quarter 2008  $-0.1$  percent in real terms, quarter-on-quarter). Latest available data show a vigorous increase in the nominal production value in the civil engineering sector over the first ten months of 2008, a result of the acceleration of public sector rail and road construction projects. Industrial and commercial construction activity weakened already in the course of 2008. With industrial investment slackening, it is notably this branch of the construction industry that is directly affected by the economic downturn.

In the WIFO business cycle survey, firms in the construction industry report a fall in new orders and production since the fourth quarter of 2008. The residential construction sector is particularly pessimistic. This probably reflects the problems in freely financed residential construction. While building prices rose vigorously in recent years, companies now expect them to fall sharply. Construction firms revised down their employment expectations almost equally clearly in January 2009.

Household consumption exerts a stabilising effect on the economy, given its lagged and weaker reaction to the downturn in export and investment activity. In the fourth quarter of 2008, household spending rose at a seasonally and working day adjusted quarterly rate of  $0.4$  percent in real terms, similar to previous quarters. The year-on-year increase, though, at only  $1$  percent in real terms, was only half as high as its long-run average, as already throughout 2008.

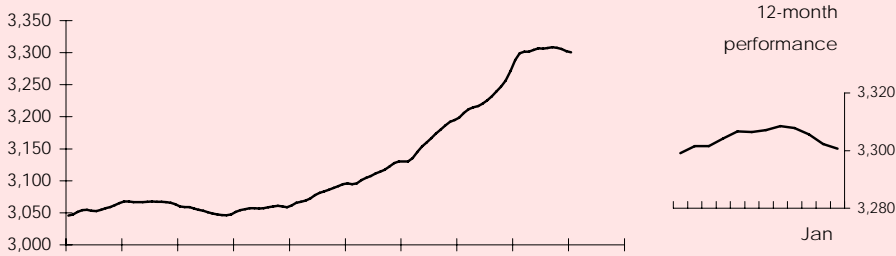
## Construction output in decline

*While demand remains lively in civil engineering, business has turned highly unfavourable particularly in the industrial and commercial building sector. The overall construction outlook is deteriorating appreciably.*

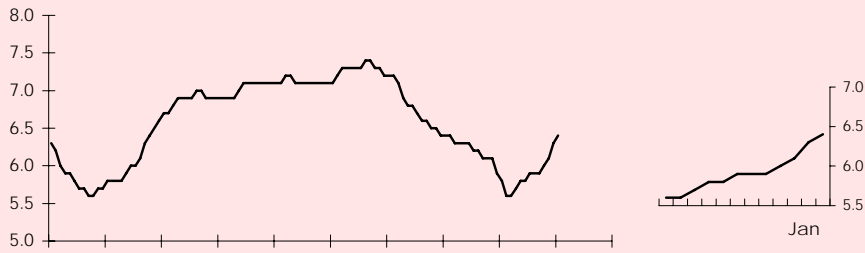
## Consumer demand stable

Figure 3: Key economic indicators

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



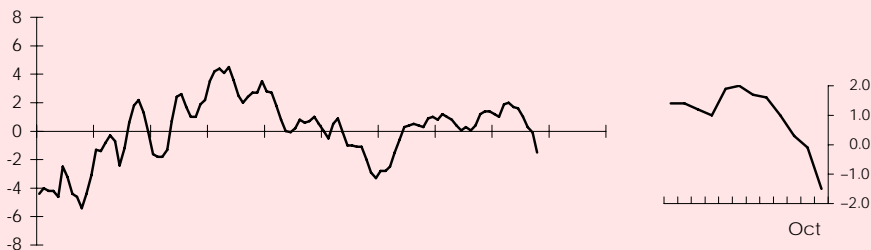
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



Source: Public Employment Service Austria, 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 Public Employment Service.



Consumer demand has so far been little affected by the economic downturn. This is apparent also in the evolution of business in the retail sector. In the fourth quarter, real retail sales were unchanged from a year earlier. December saw a year-on-year increase by 1.7 percent in real terms, although a slight decline by 0.3 percent was recorded for Christmas sales after adjustment for the higher number of selling days.

The motor vehicle trade (including repair workshops and petrol stations) fared appreciably worse, with real sales down by 11.6 percent year-on-year in the fourth quarter. New passenger car registrations fell accordingly in the fourth quarter, to around 8 percent below the year-earlier level (December –16 percent).

The wholesale sector, too, reacted more quickly than the retail sector to the economic downturn. Declining export and investment activity led to a marked drop in sales towards the end of the year (November –3.2 percent in real terms, year-on-year).

Austria's tourism industry recorded brisk growth at the beginning of the winter season. In November and December, both the number of overnight stays and real sales were up 6.8 percent from a year before. This was in part attributable to favourable weather conditions, but also to the fact that – as experience shows – an economic downturn affects the demand for tourism services only with a lag.

Consumer prices rose by just a mere 1.3 percent year-on-year in December 2008. In September the inflation rate had stood at 3.8 percent. On a month-on-month basis, consumer prices fell by 0.2 percent in December 2008. For all of 2008, the inflation rate came in at 3.2 percent.

The strong dampening effect on inflation largely stems from the sharp fall in world market prices for crude oil. Most recently Brent traded at around \$ 40 per barrel – about one third of its price in August 2008. In December 2008, fuel and heating oil prices paid by the consumer in Austria were about one fifth lower than a year before. Their decline dampened overall inflation by close to 1 percentage point. In addition, food price increases moderated considerably – again primarily a result of easing world market prices.

With inflationary pressures diminishing appreciably, strong growth in real wages has become possible. Collectively agreed wages recently were up 3.3 percent in nominal terms from the year-earlier level.

In January 2009, 301,500 persons were registered as unemployed, an increase by 33,000 from a year earlier. On a year-on-year basis, unemployment thus rose for the third consecutive time, with loaned employees particularly affected. A sharp rise in unemployment has already been registered in the industrial sector, despite the rapid expansion of short-time working. The 54,000 persons who were enrolled in vocational training programmes in January are not counted as unemployed.

Particularly in phases around the cyclical turning point (and in the case of statistical-administrative effects such as the introduction of the obligation to immediately report new employment contracts) labour market developments are better described by means of seasonally adjusted data than by year-on-year comparison. The seasonally adjusted number of persons in dependent active employment grew just modestly as from spring 2008, while that of unemployed persons rose steadily. Since October 2008 the number of persons in dependent active employment has been declining on a month-on-month basis (around –2,000 per month), and unemployment has been rising sharply (December +6,000 compared with the previous month, January +4,000 to 232,000). The seasonally adjusted unemployment rate was 6.4 percent of the labour force in January, an increase by 0.8 percentage point from its business cycle low in March 2008.

*While retail sales stagnate compared with a year earlier, the motor vehicle and wholesale sectors saw prices fall sharply already in the fourth quarter.*

## Marked increase in winter tourism

## Inflation quickly easing

*The inflation rate fell from 3.8 percent to 1.3 percent over a three-month period, largely in reaction to the cyclical slump in commodity prices.*

## Sharp rise in unemployment

*The downturn in industrial activity caused unemployment to rise rapidly in December and January.*