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## Economic Upswing Gaining Strength

**The Austrian economy grew by 3 percent in volume year-on-year in the second quarter of 2006, according to WIFO's latest flash estimate. Goods exports continued to gain momentum, and investment activity also strengthened. There is no indication of a pick-up in private consumption and housing construction, however. Sentiment among companies in the manufacturing sector is currently as optimistic as it was last in 2000. However, the pace of economic expansion is expected to slow at the beginning of 2007 at the latest, given that the international framework conditions will deteriorate and carry-forward effects due to the VAT hike in German will come to an end.**

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The second quarter of 2006 saw the economic upswing in Austria gather momentum. According to WIFO's latest flash estimate, real GDP grew by 1 percent quarter-on-quarter, thus at a markedly faster pace than in the first quarter (+0.6 percent). On a year-on-year basis, the growth rate stood again at 3 percent in the second quarter.

Austrian exports are benefiting from the strong expansion of the world economy. They are the main drivers of the economic upswing and stimulate investment. Total exports grew briskly in the second quarter (+1½ percent quarter-on-quarter), rising by a good 9 percent in volume from the year-earlier level, largely in response to the revival of the European economy and the favourable development of price competitiveness. Exports to the oil-producing countries increased at a particularly fast pace (recycling of petrodollars).

Fuelled by booming exports, the industrial sector expanded at an even faster pace. In the second quarter, the level of value added in manufacturing exceeded that in the previous period by a good 2 percent. Survey evidence suggests that the upward tendency is likely to persist also in the third quarter – despite political uncertainties in the Middle East: companies expect a noticeable production increase and assess their order levels and business situation more favourably than in the preceding months.

Building firms view their business situation with particular optimism. This holds true notably for the civil engineering, which recorded high gains in new orders. However, the improved order situation has so far translated only to a limited extent into production growth. In the second quarter, expansion in the construction industry continued to be modest, at +½ percent in volume quarter-on-quarter, mainly slowed down by a slackening of the residential construction.

The upward tendency in the production sector is slowly spreading to investment in machinery and equipment, which in the second quarter rose by about 1½ percent in real terms quarter-on-quarter, exceeding the year-earlier level by 5½ percent. Evidence from the WIFO investment survey had already heralded a marked expansion of investment activity in 2006.

The trade sector recorded disappointing results also in the second quarter. While motor vehicle dealers registered a decline in sales compared with last year, business was weak also for wholesalers.

Overall, the trade, transport, and hotel and restaurant sectors grew by only 0.2 per cent quarter-on-quarter, while according to the national accounts the accommodation and restaurant business, benefiting from Austria's EU Presidency and the "Mozart Year 2006", registered a relatively strong increase in value added. Private consumption and residential construction continue to be the weak points of Austria's economic development. The second quarter again saw no increase in consumer spending, with private household expenditure rising by about ½ percent quarter-on-quarter, the same rate as in the last five quarters. On a year-on-year basis, domestic consumer spending grew by 1¼ percent according to WIFO's latest flash estimate, hence hardly any faster than last year.

Table 1: Flash estimates of quarterly national accounts

	2005				2006	
	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second 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>	+0.4	+0.4	+0.5	+0.5	+0.4	+0.5
General government	+0.3	+0.4	+0.4	+0.4	+0.4	+0.3
Gross capital formation	-1.5	+0.5	+1.5	+0.6	+0.1	+0.5
Exports	+1.4	+2.0	+2.0	+1.2	+1.3	+1.6
Imports	+0.9	+1.4	+1.6	+0.9	+1.0	+1.0
Gross domestic product	+0.2	+0.5	+0.7	+0.7	+0.6	+1.0
<i>GDP, output approach</i>						
Agriculture, forestry	-0.5	-0.7	-0.8	-0.3	+0.0	+0.2
Industry, including energy <sup>2</sup>	+0.4	+0.9	+1.2	+1.3	+1.8	+2.1
Construction	+0.6	+0.7	+0.7	+0.6	+0.5	+0.6
Wholesale and retail trade, repairs, hotels and restaurants, transport, communication	-0.1	+0.4	+0.7	+0.6	+0.0	+0.2
Financial intermediation, real estate, renting and business activities	+0.3	+0.5	+1.0	+0.9	+0.6	+0.9
Other service activities	+0.3	+0.2	+0.2	+0.2	+0.2	+0.2
Taxes on products	+0.2	+0.4	+0.6	+0.5	+0.3	+0.8
Subsidies on products	+0.9	+0.9	+1.0	+1.0	+1.1	+0.8
	Percentage changes from previous year					
Gross domestic product, volume	+1.6	+1.8	+1.5	+2.3	+3.0	+3.0

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

Gross real income advanced in the second quarter, thanks to the modest increase in prices. Consumer prices gained 1.6 percent, collectively agreed wages rose 2.8 percent from a year earlier. In June, headline inflation abated to 1.5 percent, with higher energy prices accounting for approximately half of the inflation, while the other prices overall were very stable. Summer saw another hike in petrol and diesel prices due to the rise in crude oil prices, which at the beginning of August reached a record high of \$ 78 per barrel.

The economic rebound and higher labour market flexibility led to a significant increase in the number of persons in active employment (+54,600 in July). The situation was most favourable in the sectors with a high or rising proportion of persons employed part-time: business services, trade, tourism, and health services. The stabilisation of the job situation in manufacturing suggests that the number of full-time jobs is also likely to rise this year. According to the Microcensus, the proportion of persons in part-time jobs in the first quarter of 2006 reached 22.5 percent of the total labour force (+1½ percent compared with a year earlier), the number of persons in full-time jobs did not follow a clear trend.

The number of unemployed persons stood at 197,000 in July, a decline by 14,000 from last year. This decline can be attributed for the most part to the expansion of vocational training (+9,000) and other labour policy measures (hiring subsidies, etc.). The good performance of the economy also contributed to the reduction in the

number of unemployed persons, which confirms the rule that the unemployment rate will fall as soon as economic growth reaches at least 2½ percent.

The world economy was on a clear upward path in the first half of 2006. Framework conditions for further expansion have, however, deteriorated in recent months. Crude oil prices climbed to new record highs, and central banks raised interest rates; even long-term interest rates, which thus far had remained exceptionally low, rose noticeably, which will put a brake notably on the expansion of consumer credits and mortgage lending. House price inflation in the USA and a series of other countries slowed down considerably in reaction to the interest rate hikes. Consequently, private consumption is to a lesser degree stimulated by wealth effects, and residential building construction in these countries is no longer driven by expectations of strongly rising home prices.

Production growth in the USA decelerated markedly in the second quarter. Real GDP rose by 0.6 percent quarter-on-quarter, clearly slower than on average in recent quarters. The demand for durable consumer goods and notably residential investment declined. Building permit and consumer confidence developments indicate a slowdown in the pace of expansion, accompanied by deteriorating labour market conditions. Inflation climbed to 4.2 percent in May and June. Meanwhile, the central bank raised interest rates to a level that can be regarded as restrictive. Less optimistic economic expectations and the interest rate increase triggered a fall in stock prices in the USA that also spread to European stock markets.

Japan's economy continues to expand, albeit at a somewhat slower pace than in the first quarter. GDP growth is projected to reach almost 3 percent this year. The labour market is also already benefiting from the good performance of the economy. Judged by the price indices, the deflationary phase appears to have come to an end. The Bank of Japan thus moved away from the "zero interest rate policy" and cautiously raised the key interest rate.

Economic activity in the emerging market countries continues to be extraordinarily robust. This holds true for China as it does for India, South East Asia and Latin America. Some emerging market countries are benefiting from terms-of-trade profits resulting from high commodity prices – apart from crude oil, the prices for most metals have also risen considerably.

The fast growth of the world economy – notably the rise of China and India – has boosted the demand for crude oil and raw materials. The temporary shut-down of the largest US oil field at the beginning of August drove the crude oil price to a new all-time high (exceeding \$ 78 a barrel).

The impact of high crude oil prices on the world economy and inflation has thus far been surprisingly small, with the rise from \$ 28 per barrel in 2003 to around \$ 70 in 2006 hardly impairing global economic growth. The effects have apparently been smaller than in the model results for the past according to which a rise in the crude oil price by \$ 10 per barrel dampened global economic growth by almost ½ percentage point while accelerating inflation by ½ percentage point. The impact on global economic growth is lessened above all by the fact that, given a continuous rise in crude oil prices, the recycling of petrodollars will function well over several years: the oil-producing countries spend the major part of their oil revenues on imports. Austrian exports to OPEC countries and the former USSR, for instance, in the first five months of 2006 exceeded the year-earlier level by about one third.

Moreover, the pass-through of higher energy prices onto the prices of industrial goods and wages has thus far been less marked than in the past. Prices of industrial goods have remained almost unchanged, despite a substantial surge in petrol, diesel, electricity and gas prices. On the one hand prices are being held down by high productivity gains in manufacturing, on the other hand costs are being lowered by cheap imports of intermediates from Asia and Eastern Europe. The spillover of surging energy costs into wages has been limited, wage settlements have remained moderate.

## US economy slowing

*The world economy continued to develop very favourably in the first half of the year. Recent months have, however, seen deterioration in the framework conditions for further expansion.*

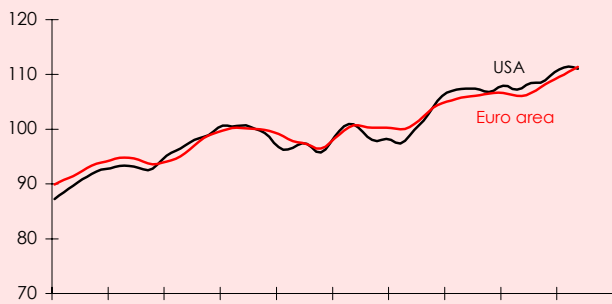
## Impact of higher oil prices lower than in the past

*The world economy has so far been little affected by the high and still rising crude oil prices as the pass-through of higher energy costs onto the prices of industrial goods and wages has been limited and the recycling of petrodollars is working.*

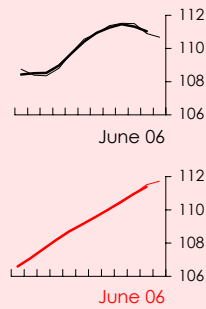
Figure 1: International business climate

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

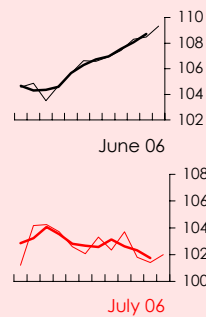
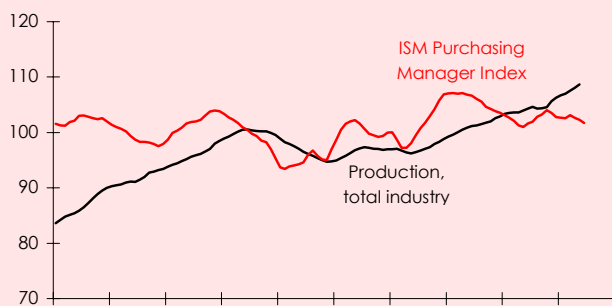
Leading indicators



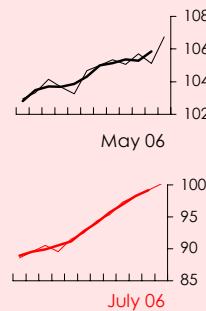
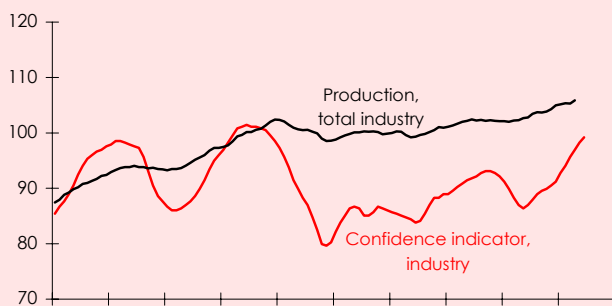
12-month performance



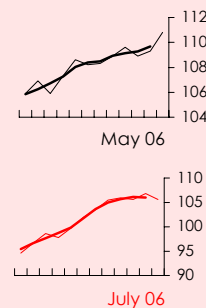
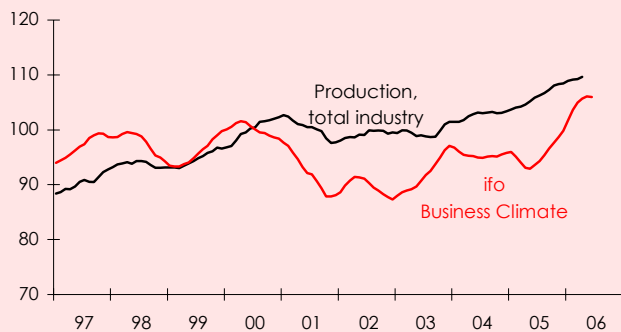
USA



Euro area



Germany



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institute for Economic Research, Munich), OECD.

The euro area economy (excluding Germany) expanded vigorously in the first quarter, at +2.3 percent year-on-year. Germany's economy lagged behind, pushing the overall euro area average down to +2.0 percent.

The second quarter saw a further pickup in economic activity, notably in Germany. Export activity once more gathered steam, signs of an investment upturn increased. Real GDP growth, which was 0.6 percent quarter-on-quarter in the first three months of the year, most likely increased somewhat in the second quarter.

At the beginning of August, the European Central Bank raised its key interest rate for the fourth consecutive time by 25 basis points to currently 3 percent. This is to ward off rising inflation expectations and notably a passing through of price increases onto wages. Headline inflation in the euro area stood at 2.4 percent in June, with core inflation (excluding energy and food) around 1 percentage point lower. The divergence of inflation rates among euro area countries is relatively wide: inflation is lowest in Finland (1.5 percent) and the Netherlands, and highest in Spain (4 percent).

Germany's economy is gathering steam. In the first quarter, expansion was still hampered by the unusually cold winter, mostly so in the construction industry. GDP advanced by only 0.4 percent quarter-on-quarter.

Growth is expected to have been much higher in the second quarter, with the construction industry having recovered from the harsh winter, and exports providing new stimulus. Industrial production increased markedly and posted strong gains in new orders. The football World Cup is likely to have contributed to a revival of the tourist trade. According to the Ifo index, companies assessed their business situation even more favourably than at the beginning of the year, with sentiment darkening slightly only in the summer.

Production growth will remain high in the second half of 2006, fuelled not least by carry-forward effects ahead of the VAT hike in Germany at the beginning of 2007, which stimulate private consumption and residential investment. They are likely to speed up economic growth in Germany by about ¼ percentage point in 2006.

For the first time since 2000, domestic demand is making a substantial contribution to production growth this year. At the same time economic expansion is sustained by high external demand. The moderate appreciation of the euro will hardly impair the competitive position of the German economy.

Unlike Germany, where slack economic growth over the medium term was largely due to weak investment and consumer demand, the Italian economy is suffering from unfavourable export and investment developments. Its competitive position has worsened dramatically since Italy acceded to the Monetary Union.

According to the latest WIFO flash estimate, Austria's real GDP in the second quarter advanced at a seasonally and working-day adjusted rate of 1.0 percent quarter-on-quarter. The considerable acceleration from the first quarter (+0.6 percent) was due to external as well as domestic stimulus. On a year-on-year basis, the growth rate was 3.0 percent.

The manufacturing sector saw a marked increase in value added, exceeding the level of the previous period by 2.1 percent in volume (seasonally and working-day adjusted) in the second quarter, after +1.8 percent in the first quarter. The construction sector, unlike industry, which performed well, did not gather momentum (+0.6 percent in volume quarter-on-quarter), despite the fact that building firms gave a very optimistic assessment of their order situation. The economic recovery provided considerable impetus to the financial services, and notably the business services sectors (+0.9 percent).

Sales volumes were disappointing. Motor vehicle sales even declined. Business was bad also for wholesalers in the second quarter. Overall, the trade, hotel and restaurant, and transport sectors advanced by a mere 0.2 percent in volume quarter-on-

## Economic upswing in the euro area

*Economic growth in the euro area appears to have accelerated in the second quarter. This is suggested by industrial production, new orders received and business surveys.*

## Germany's economy also brightening

*Economic growth in Germany appears to have picked up markedly in the second and third quarters. It is very doubtful if this relatively strong growth momentum will continue into next year, given the substantial VAT increase at the beginning of 2007.*

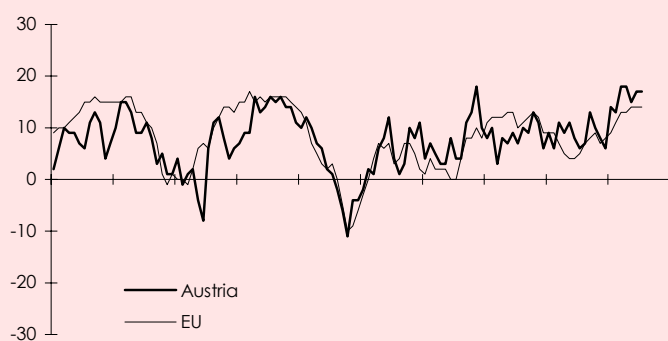
## WIFO flash estimate for the second quarter 2006

*Economic expansion gathered speed also in Austria in the second quarter. Real GDP grew by 1 percent from the previous period, hence at a clearly faster rate than in the first quarter. In the first six months it rose by 3 percent compared to the same period a year earlier.*

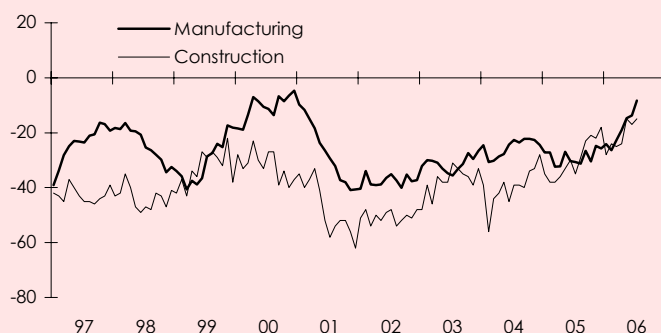
quarter. The increase in value added was highest in the accommodation and restaurant business, with higher demand stimulated by Austria's presidency of the EU Council.

Figure 2: WIFO business cycle survey

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



Order books of manufacturing and construction industry



Source: European Commission, WIFO business cycle survey.

The latest WIFO flash estimate shows clearly that the upward tendency in the production sector is gradually spreading to investment. In the second quarter, total investment rose by 0.5 percent in real terms relative to the previous period, after +0.1 percent in the first quarter. The good performance of the economy and the persistent optimism regarding future developments induced companies to increase their investment in equipment considerably, with notably the demand for machinery and electrical appliances gaining momentum. In contrast, construction investment growth was subdued, with non-residential construction in the first quarter doing better than residential construction.

With global economic expansion continuing, total export growth gathered further pace also in the second quarter, advancing at a seasonally and working-day adjusted rate of 1.6 percent in volume quarter-on-quarter, or 9.1 percent year-on-year, with the main impetus stemming from goods exports. Tourist travel also posted significant gains, which were higher on a year-on-year basis – due to Easter falling in the second quarter this year – than evident in the quarter-on-quarter changes (which are adjusted for this calendar effect). Total imports also increased, fuelled by buoyant external demand and a pickup in investment demand. They rose at a seasonally adjusted rate of 1.0 percent in volume from the previous quarter, or +6.5 percent year-on-year.

The second quarter did not yet see any acceleration in consumer spending. Consumption expenditure of private households grew by 0.5 percent in volume (seasonally and working-day adjusted), no faster than in the previous five quarters. Domestic consumer spending advanced 1.8 percent in volume year-on-year. Government



consumption expenditure once again posted only modest gains (+0.3 percent quarter-on-quarter).

Evidence from the WIFO business cycle surveys of recent months indicates a further brightening of sentiment in the manufacturing sector, suggesting that the economy will remain buoyant also in the third quarter.

Evidence from the July survey suggests that the economic upswing is becoming more broadly based. Manufacturing has posted its best performance since the year 2000. More than one third of the companies have increased their output in recent months, with the average rate of capacity utilisation advancing 2 percentage points to 84 percent since the beginning of the year. Two thirds of the companies judge their order books as "sufficient", 14 percent as "more than sufficient".

The construction industry continues to view its economic situation as highly favourable, and the situation prevailing in the business services sector has improved markedly in recent months. The number of Austrian consumers anticipating an economic upturn in the next twelve months has also increased.

In the first five months of 2006, goods exports rose by 14 percent compared to the same period a year earlier. Export growth to the European Union (+11 percent) contributed substantially to this expansion. Exports to OPEC and CIS countries, the USA and non-OPEC developing countries grew at an extraordinarily rapid pace (about +30 percent in each case). Among the new EU countries, Hungary and the Czech Republic this year have not been very receptive to Austrian export commodities.

In the first five months of 2006, imports rose by 12 percent, at almost the same rate as exports, mainly reflecting higher crude oil prices and a pickup in investment activity. The value of raw material and fuel imports increased by just under 30 percent year-on-year.

Tourism sales advanced 3.1 percent on average in May and June, to € 3.1 billion, according to preliminary calculations. Hence the good results in June contributed substantially to tourism beginning to make up leeway. Substantial sales gains can be expected for the summer season.

The total number of overnight stays declined slightly in the first two months of the summer season (−0.9 percent), while that for resident visitors rose by 1.8 percent. The number of overnight stays by foreign guests fell by 2.4 percent from last year, mainly on account of the strong decline in the demand from the Netherlands, Germany and Switzerland. The number of visitors from the USA, France, Italy and UK increased from last year.

Vienna, which benefited from Austria's EU presidency and the "Mozart Year", posted particularly high gains in tourism sales, but so did Lower Austria and Burgenland. The other federal states (Salzburg, Tyrol, Styria, Vorarlberg) recorded only slightly higher or equal sales compared with last year.

Inflation was 1.5 percent in June, according to calculations by Statistics Austria. The upward trend in prices abated somewhat after rising in the preceding months. Soaring energy prices accounted for about one half of the inflation rate, whereas consumer prices excluding energy increased by only 0.8 percent. The development of telephone charges had a dampening effect on inflation, aided by only moderate price increases for industrial products and food and beverages. Rents, however, rose rapidly.

### Further improvement in business sentiment

*The favourable sentiment prevailing in the manufacturing sector has brightened further in recent months. The economic rebound has become more broadly based, spreading increasingly also to the business services sector.*

### Exports driving economic activity

*Austrian exports continued to accelerate in spring, expanding at double-digit rates from the year-earlier result.*

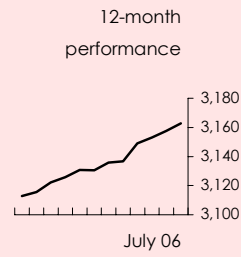
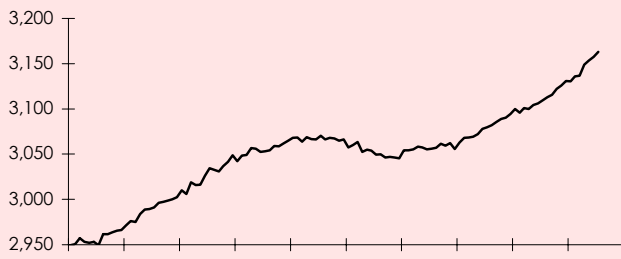
### City tourism gaining from EU Council presidency

*In the first two months of the summer season, tourism sales exceeded the year-earlier level by 3 percent. EU Council presidency and the "Mozart Year" had a positive effect on city tourism.*

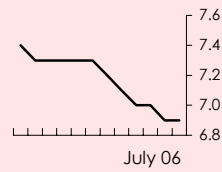
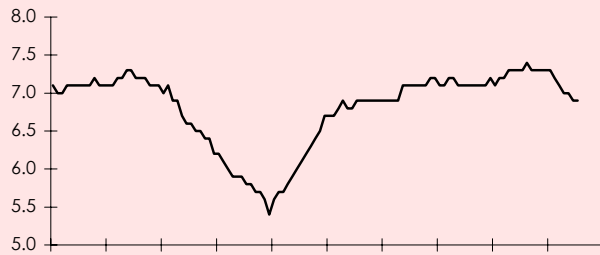
### Inflation moderate despite high oil prices

Figure 3: Key economic indicators

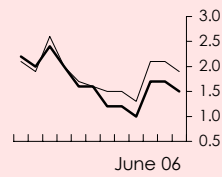
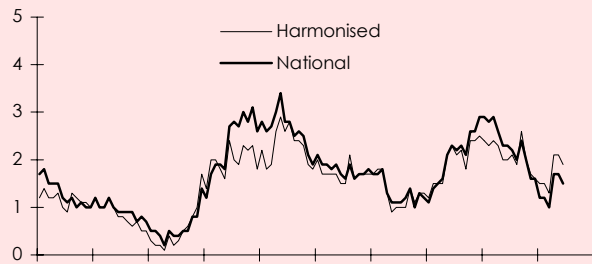
Persons in active dependent employment<sup>1</sup>, (1,000), seasonally adjusted



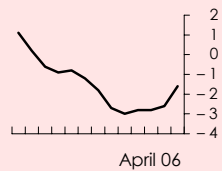
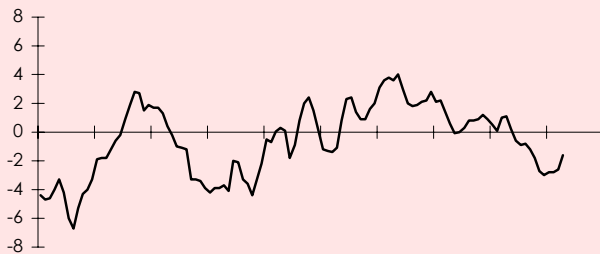
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



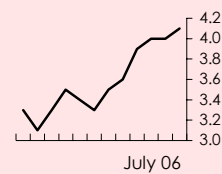
Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



Source: Austrian Labour Market Service, Federation of Austrian Social Security Institutions, Oesterreichische Nationalbank, Statistics Austria, WIFO calculations. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> As a percentage of total labour force excluding self employed, according to Labour Market Service.



In June, the Harmonised Consumer Price Index rose by 1.8 percent, faster than the Austrian CPI. Inflation was thus markedly lower than in the euro area (+2.4 percent).

Gross real incomes picked up noticeably, with the index of agreed minimum wages and salaries in recent months exceeding the year-earlier level by 2.8 percent. This year's pay round is much influenced by a more favourable economic situation, but also by lower price increases than last year: while inflation was about 2¼ percent in summer 2005, it stood at only 1.5 percent in June 2006.

Employment expansion accelerated further in July, with the number of persons in active employment growing by 54,600 year-on-year. The development in the individual sectors suggests that full-time employment may also be on the rise now. While many additional jobs continued to be offered in the sectors with a high proportion of persons employed part-time, i.e., in health services, business services, trade and tourism, the manufacturing industry on the other hand, which typically employs full-time staff, put an end to its job cuts, and in June recorded employment numbers that for the first time in years slightly exceeded those a year earlier. Firms in the construction industry significantly raised employment numbers, thanks to the favourable order situation in the sector.

While the foreign workforce grew at a relatively steady rate in recent months, by about +16,000 year-on-year, the domestic labour supply increased rapidly, prompted by the good economic situation and labour policy measures. In July, 197,000 unemployed persons were registered with AMS (Labour Market Service), a drop by around 14,000 from last year. This decline can be primarily attributed to the expansion of vocational training (+9,000) and other labour policy measures (hiring subsidies, etc.). The good performance of the economy also contributed to a stabilisation of unemployment.

*Inflation receded to 1.5 percent in June, with higher energy prices accounting for half of the inflation rate.*

### **Strong employment growth**

*The economic rebound and higher labour market flexibility have led to high employment growth. The number of unemployed persons is declining, primarily a consequence of additional labour market policy measures, but also of the good performance of the economy.*