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Robust Economic Growth Continues Amid Slight Darkening of Sentiment

Business Cycle Report of November 2007

The Austrian economy expanded by 0.8 percent quarter-on-quarter and 3.4 percent year-on-year in the third quarter of 2007, according to WIFO's latest flash estimate. While exports continued to be the main driver of the upswing, investment in machinery and electrical equipment also posted substantial gains. Private consumption, by contrast, does not show any signs of a pick-up. The deterioration in sentiment indicators points to moderation in economic growth in the fourth quarter.

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The international financial crisis and the appreciation of the Euro did not yet dampen growth of the Austrian economy in the third quarter. According to first estimates, it was almost unchanged at +3.4 percent year-on-year or +0.8 percent quarter-on-quarter. Exports lost some momentum over the year, but continue to be an important driver of economic activity. Investment in machinery and electrical equipment is another mainstay of activity. Investment in transport equipment and construction, on the other hand, lacked dynamism in the third quarter. Against this background and in view of rising risks it is doubtful whether manufacturers will be able to fully realise their ambitious investment plans.

Private consumption remains the weak point of economic activity. Retail sales rose by 1.3 percent in volume in the first three quarters of 2007, a decline from the previous year. While sales of some important consumer durables (e.g., furniture) developed favourably, car sales were very sluggish: in the first three quarters, the number of newly registered cars declined by 4.3 percent from a year earlier, with one of the reasons most likely being the high fuel prices. The share of diesel-powered cars is decreasing noticeably as diesel fuel is now only just a little cheaper than petrol.

Consumer sentiment is little optimistic, but varies among income groups: while households in the upper two income quartiles are uniformly optimistic regarding the development of their financial situation over the next 12 months, households in the lower two quartiles anticipate a decline in income. This reflects the weak increase in real disposable wages and salaries in recent years as well as the fact that, at 38¹/₃ percent the first-bracket rate of tax has been extremely high since the last tax reform.

In 2008, higher wage settlements will provide a positive stimulus to private consumption. The pay round for the metal industry produced settlements exceeding last year's by around 1 percentage point. The actual wages are raised by 3.5 percent and workers will receive a profit-linked one-off payment (200 € or less). The rate of increase agreed for the trade sector is +3.1 percent, clearly lower (for three times as many employed persons) than that for the metal industry. The low salaries in trade (gross monthly pay lower than 1,450 €) are raised more strongly through an extra award of +45 €.

The degree to which wage settlements will allow private consumption growth will largely depend on inflation developments. Risks in this respect have increased. In

November, crude oil prices surpassed 95 \$ a barrel for the first time, and political turmoil (Iraq–Turkey) resulted in speculative purchases. Food prices are also driving inflation. In September, consumers paid 11 percent more for dairy products and eggs than a year before, and almost 5 percent more for bread and cereal products. Overall, food items contributed one fifth to total inflation (2.1 percent) in September.

Table 1: Flash estimates of quarterly national accounts

	Second quarter	2006 Third quarter	Fourth quarter	First quarter	2007 Second quarter	Third quarter
Adjusted for seasonal and working day effects, percentage changes from previous quarter, volume						
<i>GDP, expenditure approach</i>						
Final consumption expenditure						
Households ¹	+ 0.4	+ 0.3	+ 0.4	+ 0.4	+ 0.4	+ 0.5
General government	+ 0.5	+ 0.5	+ 0.4	+ 0.3	+ 0.4	+ 2.0
Gross capital formation	+ 0.8	+ 0.8	+ 0.8	+ 0.7	+ 0.5	+ 0.4
Exports	+ 0.9	+ 2.0	+ 2.2	+ 1.7	+ 0.9	+ 1.2
Imports	+ 1.4	+ 1.6	+ 1.6	+ 1.1	+ 0.4	+ 1.0
Gross domestic product	+ 0.8	+ 0.8	+ 0.8	+ 1.0	+ 0.7	+ 0.8
<i>GDP, output approach</i>						
Agriculture, forestry	- 0.2	+ 0.1	+ 0.1	- 0.4	- 1.0	- 0.6
Industry, including energy	+ 1.8	+ 1.7	+ 2.2	+ 1.7	+ 1.3	+ 1.3
Construction	+ 1.1	+ 1.3	+ 1.1	+ 0.7	+ 0.5	+ 0.5
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.4	+ 0.3	+ 0.5	+ 0.5	+ 0.5	+ 0.4
Financial intermediation; real es- tate, renting and business activities	+ 0.6	+ 0.6	+ 0.8	+ 1.1	+ 1.2	+ 1.0
Other service activities	+ 0.1	+ 0.2	+ 0.1	- 0.0	+ 0.3	+ 0.6
Taxes on products	+ 0.1	+ 0.3	+ 0.5	+ 0.6	+ 0.3	+ 0.1
Subsidies on products	+ 2.1	+ 1.1	+ 0.3	- 0.6	- 0.0	+ 0.5
Percentage changes from previous year						
Gross domestic product, volume	+ 2.8	+ 3.0	+ 3.4	+ 3.6	+ 3.3	+ 3.4

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

The job market continued to develop favourably in October. The number of persons employed rose by 1.8 percent from a year earlier, and the unemployment rate edged down slightly (-0.4 percentage point), in spite of a substantial cutback in training programmes. The number of vacancies, a leading indicator, has been rising less from month to month, however, and in October was only slightly higher than in the previous year. This could indicate a slowing of economic activity.

Evidence from the WIFO business cycle surveys shows that sentiment in trade and industry has passed its peak. Recent months saw a slight, but continuous deterioration in the assessment of the state of the economy. In manufacturing, the share of companies that had increased their output in the previous three months fell below the 30-percent mark for the first time in 18 months in October. Capacity utilisation declined by 1 percentage point to 85 percent since the summer, while the assessment of order books has followed a slight downward trend already since the beginning of the year. Although companies continue to give a positive assessment of the current situation, the indicator has been falling slightly from month to month. Production growth must therefore be expected to moderate in the fourth quarter.

Economic growth in the USA was unexpectedly vigorous in the third quarter¹: GDP grew at an annualised rate of 3.9 percent. Robust private consumption and the strength of exports due to the depreciation of the dollar played a decisive role here.

**US economic growth
still vigorous**

¹ A detailed analysis of the global economic outlook is provided by Ederer, St., Marterbauer, M., Scheibl-
ecker, M., Schulmeister, St., Steindl, S., Walterskirchen, E., "Strong Global Growth Decelerating. International
Economic Outlook 2008", WIFO-Monatsberichte, 2007, 80(11), [http://www.wifo.ac.at/www/jsp/index.jsp?
fid=23923&id=30421&typeid=8&display_mode=2](http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=30421&typeid=8&display_mode=2).

Government spending (military budget) provided additional stimulus, whereas residential investment continued its tailspin.

The reaction of financial markets to the good third-quarter results was only modestly positive as a clear slowdown is overwhelmingly expected for the fourth quarter. Apart from new housing construction, this development increasingly affects the banking sector, which has already begun to cut jobs.

Prices in the USA are accelerating in reaction to the increase in crude oil prices and the depreciation of the dollar, with the rate of inflation reaching 2.8 percent in September. Against the background of rising inflation, the US central bank is likely to act cautiously and cut interest rates further only in small steps.

Euro area economic activity has so far remained relatively resilient in the face of international turmoil. Sentiment indicators remain high despite the deterioration of the business climate observed in recent months in industry, construction and trade.

In the second quarter, the euro area economy expanded by 2.5 percent, compared to the same quarter the year before. The Euroframe indicator suggests that the rate of growth will moderate to 2.3 percent in the third quarter, and to 1.5 percent in the fourth quarter. The muted economic expectations reflect the impact of the US real estate crisis, the euro appreciation and the increase in crude oil prices.

According to the Eurostat estimate, inflation was 2.6 percent in October 2007. Given the relatively low crude oil prices in the autumn of 2006, inflation rates of more than 2 percent are likely in the next few months.

In Germany, evidence from recent business surveys suggests that the upturn will continue, albeit at a slower pace. Sentiment worsened somewhat for the fifth time in a row in October. There is no indication however that the German economy might be sliding into recession.

The Austrian economy expanded at a seasonally and working day adjusted rate of 0.8 percent in real terms in the third quarter, according to preliminary calculations, a slight acceleration from the previous quarter (+0.7 percent, revised). On a year-on-year basis, third quarter growth was 3.4 percent in real terms (+3.3 percent in the second quarter). Thus the economic upturn remained very resilient also after mid-year.

Total export growth rebounded in the third quarter (+1.2 percent), following some moderation in the previous quarters. As at the same time total imports grew at a slower pace, the most important contribution to economic growth came from net exports.

Signs of a substantial acceleration of private consumption are still lacking also at this stage of the economic upturn, despite employment gains and hence a more positive development of household income levels. In the third quarter, the rate of increase (seasonally and working day adjusted) was only 0.5 percent in real terms, only marginally higher than in the previous quarter (+0.4 percent). Government consumption, by contrast, rose by +2.0 percent in real terms (purchase of Eurofighters), much more strongly than in the second quarter of 2007 (+0.4 percent).

Growth in gross fixed capital formation was also modest, decelerating from still +1.3 percent in real terms in the first quarter to +0.7 percent in the third. Construction investment, which had been positively affected by the mild winter weather in the first quarter but since then had increasingly lost momentum, as well as stagnating vehicle investment played a decisive role here. Purchases of machinery and electrical appliances have been accelerating strongly since the beginning of the year; they rose at a rate of 1.6 percent in real terms in the third quarter, unchanged from the previous period.

Up to now the US economy has withstood the threat of recession brought on by the housing crisis, largely helped by the cut in interest rates.

Euro area: economic activity losing momentum

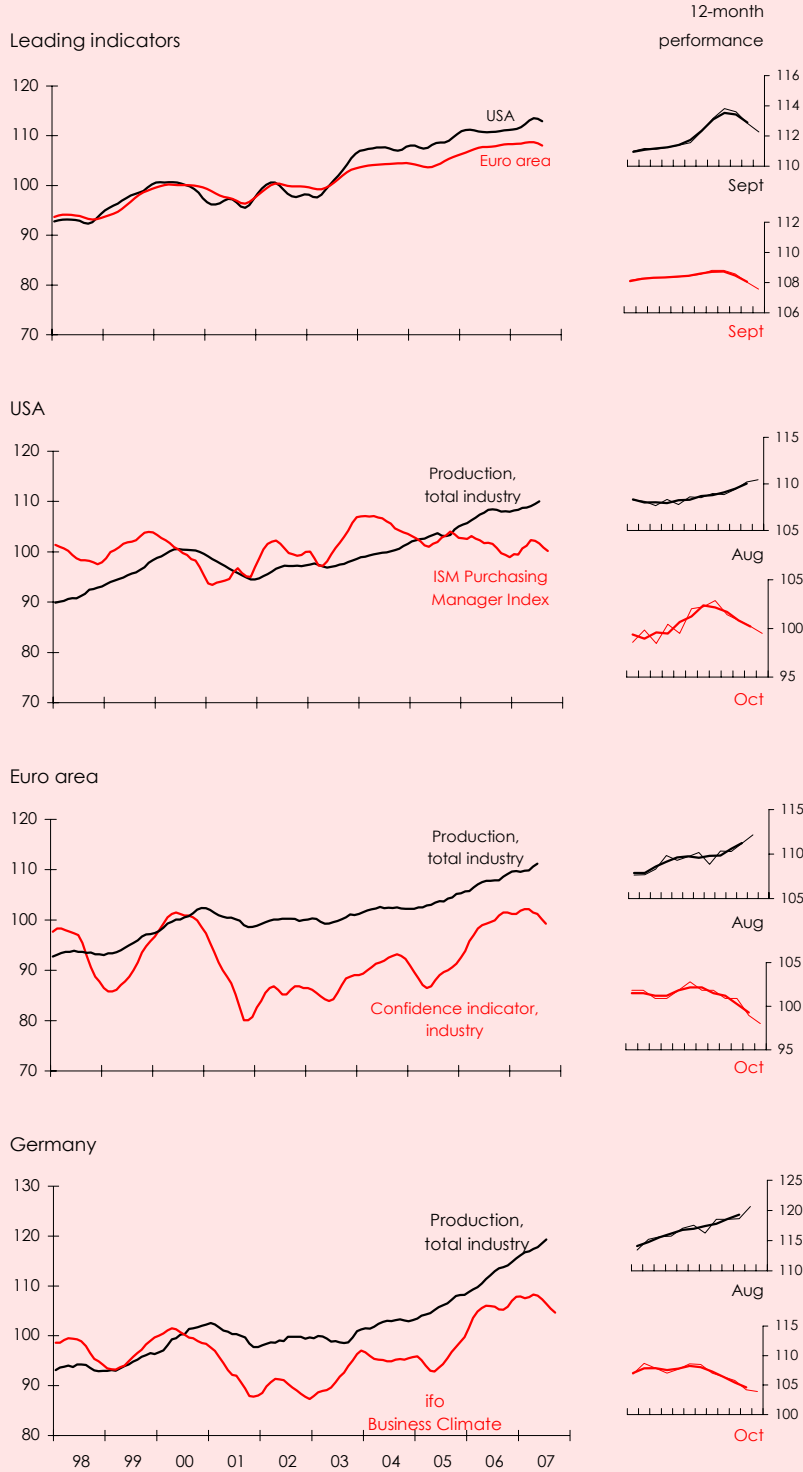
Business sentiment in the euro area has somewhat deteriorated in recent months. The impact of the international financial crisis, the appreciation of the euro, and rising crude oil prices are dampening economic expectations.

Exports remain important pillar of economic activity in Austria

Even though the job market has brightened and the economic upturn has made good headway, there is still no indication of a pickup in private consumption. Investment demand was also rather subdued over the summer. Foreign trade continues to provide the main stimulus. In the third quarter, the economy expanded at a seasonally and working day adjusted rate of 0.8 percent quarter-on-quarter. Hence, no signs of a slowdown are yet apparent.

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.

As regards the sectoral composition of value added growth, the strongest third quarter growth was posted by the manufacturing industry and the real estate sector (which also comprises business services). Only agriculture and trade registered a decline in real value added compared with the previous quarter.

Manufacturers' assessment of the economic situation has been deteriorating slowly but continuously for several months now. This will be reflected with a lag in production data; for this reason, economic activity is likely to see some moderation in the fourth quarter.

In manufacturing, the share of companies that increased their output in the previous three months fell below the 30-percent mark for the first time in 18 months in October. Average capacity utilisation declined by 1 percentage point to 85 percent since the summer, while the assessment of order books has followed a slight downward trend already since the beginning of the year. Companies continue to view the current situation as good, albeit somewhat less so from month to month. The majority of survey participants are still optimistic regarding the outlook for their own company's business situation, but are less upbeat with respect to the overall economy.

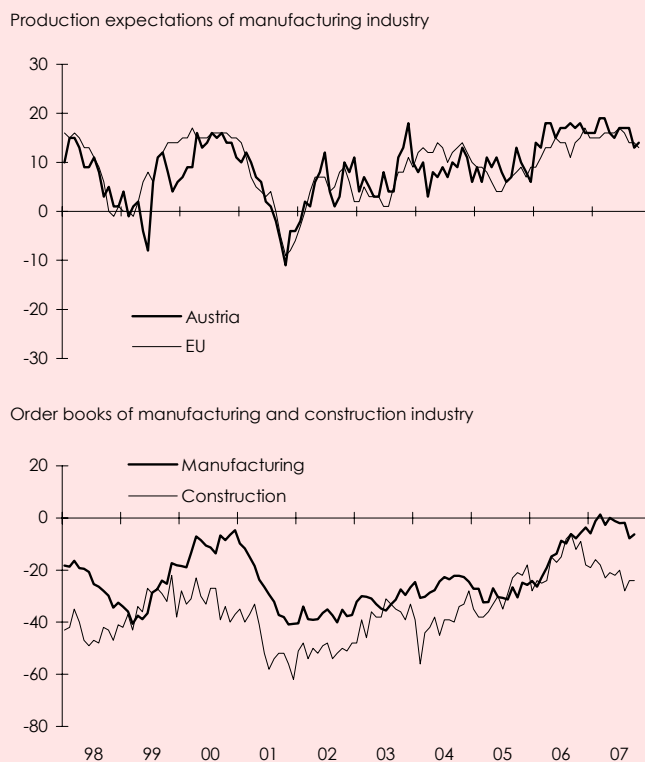
The slowdown in economic activity is reflected in the production of primary products: capacity utilisation declined by 2 percentage points since the spring, with only one quarter of companies increasing their production. Expectation indicators fell to their long-term averages. There is little indication however of an economic slowdown in the capital goods industry and in the industry supplying motor vehicle components.

Sentiment indicators past their peak

While the industrial confidence indicator has been following a slight downward trend over recent months, the basic sentiment remains positive.

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.

Source: European Commission, WIFO business cycle survey.

The assessment of the current business situation by companies in the construction industry continues to be positive, yet no longer reaches last year's high level. 84 percent of construction companies describe their current business situation as good or satisfactory, as compared to an average of just 68 percent in the last ten years. Expectations for the coming months remain optimistic, with the majority of companies anticipating an increase in building prices.

The business services sector shows no sign of a slowdown. In October – as already throughout the year – 80 percent of companies reported their order books to be sufficient or more than sufficient.

Annual average nominal goods export growth was 10.3 percent in the year to August. Exports to the EU 27 rose at the same pace as exports to third countries. Far-above-average growth was registered for exports to CIS countries, Southeast Europe, CEEC 5 and emerging market countries (non-OPEC).

Export growth moderated in July and August, according to preliminary calculations. It would be premature, however, to infer a slowdown in economic activity from these provisional data as they frequently undergo substantial correction.

Imports grew at a slower pace than exports (around +8 percent year-on-year from January till August), despite a pickup in domestic demand and solid investment activity. The balance of trade in goods posted a surplus of € 0.7 billion.

Business spending on machinery and equipment, together with exports, has been the main pillar of economic activity this year. The manufacturers polled in WIFO's investment survey intend to increase their business fixed investment by one fourth, or, including mineral oil processing and mining, even by one third. Investment plans were revised upwards by 10 percent relative to autumn 2006, in reaction to the good performance of the economy.

Manufacturers of primary and intermediate products and the capital goods industry have been the main drivers of this development. All in all, given the industry's need for expansion, construction investment has been growing more strongly than investment in machinery and equipment.

While overall economic investment picked up in the first three quarters of 2007, it was far from reaching two-digit growth rates. It is therefore uncertain whether all planned projects will be realised this year, despite the currently modest outlook for economic activity.

The retail sector increased its sales by 1.9 percent in value in September. In real terms, sales equalled those in September 2006. However, there was one sales day less in 2007; adjusted for calendar effects, the real increase was 1.5 percent. This is a preliminary evaluation by Statistics Austria; it is based on about half the retail trade volume.

Real sales growth in the first three quarters was 1.3 percent, hardly higher than a year earlier. Hence, the export and investment boom has not yet spread to private consumption. While the sale of non-durable and a few durable consumer goods (e.g., furniture) developed quite favourably, passenger car sales remained very weak. In the first three quarters, the number of new car registrations fell by 4.3 percent relative to the previous year (–9.3 percent in September), with the high fuel prices probably being one of the reasons. The share of diesel-powered passenger cars is falling noticeably as diesel fuel is now only just a little cheaper than petrol.

Tourism sales reached a volume of € 8.8 billion from May to September 2007, according to preliminary calculations. This corresponds to an increase of 5.4 percent compared to the same period a year earlier. The number of nights spent over the same period increased by 3.3 percent, with the demand from resident guests rising at a higher-than-average pace of +3.7 percent (foreign guests +3.1 percent).

Positive balance of trade in goods

In the first eight months of 2007 exports expanded at a faster pace than imports. The balance of trade in goods posted a clear surplus.

Investment plans revised upwards

Investments are growing noticeably in 2007. According to WIFO's investment Survey, manufacturers plan to increase their investment by one third in 2007 from the year-earlier level.

Private consumption still lacks momentum

Private consumption continues to be a weak point of economic activity. Retail sales growth remains subdued, and the number of newly registered passenger cars is declining noticeably.

Successful summer tourist season

These strong gains in summer tourism can be largely attributed to the good economic situation, Austria's high competitiveness in the field of short holiday breaks as well as the benign weather in the main season.

The results achieved in the period from May to September 2007 differ widely across the individual markets of origin of importance for Austria: while the demand from the Netherlands, Switzerland and Belgium rose vigorously, the German market recorded a modest increase (+1.7 percent). The number of nights spent by British guests slightly exceeded the year-earlier level, whereas somewhat fewer visitors from Italy spent nights in Austria compared with last year. The marked decline in the demand from the USA may be largely attributable to the weak dollar.

According to the data so far available for the summer season (May to September), the tourist industry in Vorarlberg and Burgenland was particularly successful. Tourism revenues in Styria, Carinthia and Lower Austria were more or less in line with the Austrian average. Tyrol, Vienna and Salzburg recorded marginally lower-than-trend sales – with the comparison for Vienna starting out from an extremely high level. Upper Austria recorded the weakest result of all.

Prices on international crude oil markets accelerated strongly in autumn, mainly in reaction to political turmoil (Turkey-Iraq crisis) and speculative purchases following in its wake. In November, one barrel of crude (Brent) traded at \$ 95 for the first time.

Headline inflation was 2.1 percent in September, according to calculations by Statistics Austria, hence higher than thus far this year. Inflation rates are likely to remain relatively elevated also in the coming months, given that inflation was particularly low in the respective year-earlier months. Besides, the extremely high prices of crude oil are quickly spilling over into fuel prices. This is already heralded by the wholesale price index for October, which surged by 6.4 percent from a year earlier. Wholesale prices rose 73 percent for cereals, seeds and animal food, 21 percent for fruit, vegetables and potatoes, 12 percent for petrol and diesel fuel, and 11 percent for milk and eggs.

Food prices, in addition to energy prices, are the main drivers of consumer price inflation. In September the price of dairy products and eggs was 11 percent higher than a year before, and the price of bread and cereals rose by almost 5 percent. Overall, food contributed one fifth to headline inflation, whereas the expenditure category "housing, water and energy" accounted for one third of the annual inflation.

The Harmonised Index of Consumer Prices rose by +2.1 percent in September, at the same rate as the Austrian index. Consumer price inflation was in line with the euro area average.

Collectively agreed wages in September exceeded those a year earlier by 2.4 percent – similar rates were registered in the previous months of this year. In 2008, wages based on collective agreements are likely to increase by a good 3 percent, given that the autumn pay round produced noticeably higher settlements owing to the good performance of the economy and the pickup in inflation.

At the end of October the collective bargaining partners agreed to an increase of the actual wages of the 164,000 persons employed in the metal industry and in mining by 3.5 percent (minimum wages +3.6 percent). Of this increase, 0.3 percent can be distributed individually in the firm by works agreement. If no agreement is reached, all actual wages will be raised by 3.5 percent. In addition, a one-off payment of € 200 was agreed on, depending however on the company's EBIT: companies with an EBIT of less than 6 percent will pay a one-off bonus of just € 150, while companies with a loss will pay no bonus at all.

Notwithstanding a slight decline in demand in September, summer tourism developed clearly more favourably than last year. The global economic revival and the benign weather in the main season provided new impetus to summer holiday tourism.

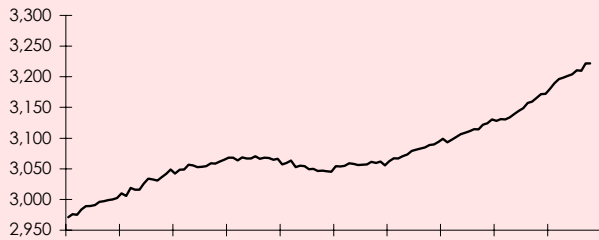
Food and energy prices accelerating

In September, headline inflation rose to 2.1 percent, mainly driven by higher prices of energy, housing and food. Inflation will remain relatively high also in the coming months.

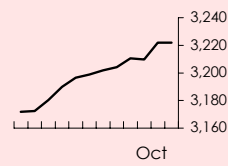
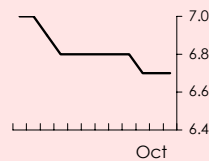
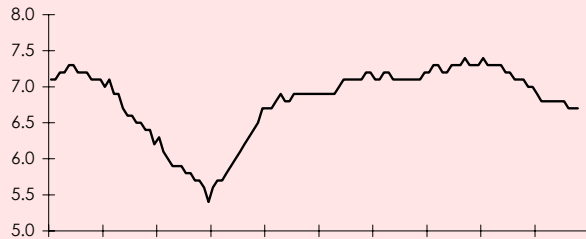
Wage settlements noticeably higher

The pay round for the metal industry produced settlements clearly exceeding those of last year, largely in reaction to the favourable economic situation and the pickup in inflation.

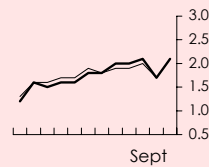
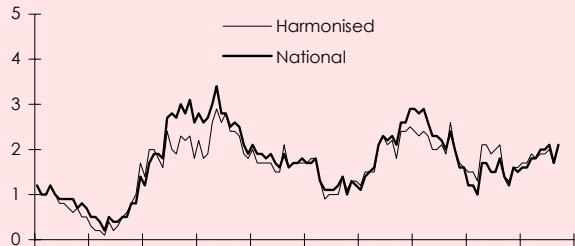
Figure 3: Key economic indicators

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

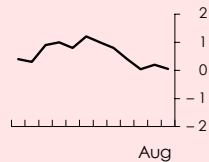
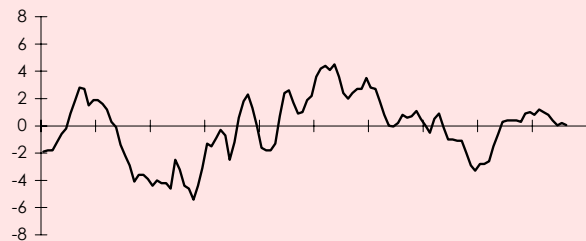
12-month performance

Unemployment rate, traditional Austrian method², seasonally adjusted

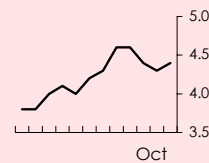
Consumer prices, year-to-year percentage changes



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 wages and salaries for the 512,000 persons employed in trade were raised by 3.1 percent, noticeably less than those in the metal industry. This settlement concerns three times as many people as the one for the metal industry. It provides for a pay rise in trade of at least € 45 per month, i.e., persons earning less than € 1,450 per

month will receive a higher than proportional increase. In a few smaller sectors the settlements are also of the order of about 3 percent. The pay rise agreed last year was 2.6 percent for metalworkers and 2.35 percent for persons employed in trade. Hence, this year's pay round yielded pay rises exceeding those in 2006 by $\frac{3}{4}$ to 1 percentage point. Unlike in the last two years, real net incomes of employed persons are therefore set to rise slightly in 2008 (by around $\frac{1}{4}$ percent to $\frac{1}{2}$ percent).

Employment growth continued unabated in autumn. The number of economically active persons rose by 56,200 (+1.8 percent) year-on-year in October. About 40 percent of the additional jobs were filled by men; this suggests a strong increase in full-time employment. The majority of new jobs were created in the business services, manufacturing, health services, trade and tourism sectors. While the number of people employed in manufacturing in September was up by 15,000 from a year earlier, construction added only few new jobs.

The number of foreign workers has been rising faster in 2007 than the year before, outpacing the year-earlier level by 21,000 in September. The domestic labour supply – prompted by lively economic activity – also grew vigorously.

About one third of the employment gains were accounted for by jobs filled by unemployed persons (also including participation in vocational training programmes); one third of the additionally employed persons came from the foreign, the other third from the domestic labour force (notably women). In October, 204,800 persons were registered as unemployed with the Public Employment Service, a decline by 9,800 from a year earlier. Including unemployed persons enrolled in training programmes, the number of jobseekers was down by 18,600 from the year-earlier level.

Employment and unemployment developments are lagging behind economic activity. Job vacancies, on the other hand, are considered to be leading indicators. They have been rising more slowly from month to month since the summer and in October exceeded the year-earlier level by only just 1,300 (after almost +8,000 in the first six months).

Employment growth undiminished

Labour market conditions continued to improve in October, with employment rising by 1.8 percent year-on-year, and the unemployment rate falling by 0.4 percent.