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# Domestic Upswing Strengthened by Investment Demand

## Business Cycle Report of September 2006

**The upswing of Austria's economy, after having lost some momentum at the beginning of the year, began to pick up speed again in the second quarter. Real GDP grew at a seasonally and working-day adjusted rate of 0.9 percent quarter-on-quarter in the second quarter (+0.6 percent in the first quarter). On a year-on-year basis, the growth rate was 3.2 percent (+3.1 percent in the first quarter). Expansion of the world economy is no longer limited to just a few regions, but has spread to all major economic regions.**

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In the second quarter of 2006, year-on-year economic growth in the euro area surpassed that in the USA. While expansion in the USA decelerated, economic activity in the euro area regained speed. Asia's economy keeps growing at a robust pace, and in Japan, the economic recovery that has begun recently is continuing.

The buoyant world economy is increasingly stimulating domestic demand in the euro area. This holds true also for the Austrian economy: while at the beginning of the year the main stimulus to growth had come primarily from abroad, the second quarter saw a marked rise in investment demand. Gross fixed investment growth, which last year had still been dragging on, accelerated steadily and at +2.2 percent in real terms quarter-on-quarter in the second quarter almost came up to that of goods exports (+2.8 percent). Nearly all major investment demand components picked up noticeably. Investment in machinery and electrical appliances rose by 1.5 percent from the first quarter, while investment in vehicles grew by 3.8 percent. The rate of growth of private household consumption remained unchanged for the time being, advancing by 0.4 percent in volume from the previous period in both the first and the second quarter. Government consumption, which in the first quarter had risen by 0.5 percent owing in part to Austria's EU Council presidency, advanced only modestly in the second quarter (+0.2 percent).

Foreign trade continues to provide considerable stimulus to the economy. The quarter-on-quarter rate of growth of goods exports accelerated further, to +2.8 percent in volume from +2.1 percent in volume in the first quarter. Goods imports also picked up as investment demand started to head up, albeit expanding at a slower pace than goods exports.

Manufacturing recorded the strongest increase in value added (+1.5 percent in real terms, quarter-on-quarter, in the second quarter, +1.9 percent in the first quarter). The finance and insurance sector and the real estate sector also posted gains (+0.6 percent), as did the construction industry (+0.6 percent). While no sector of the economy recorded a decline in value added, the public administration sector stagnated.

WIFO for the first time calculated the contributions to GDP growth of the individual demand components. According to these calculations, consumption contributed 0.3 percentage point to overall economic growth of 0.9 percent in the second quarter. Investment spending, at +0.4 percentage point, provided a clearly higher con-

tribution than in the first quarter. At +1.3 percentage points, exports were the driving force behind growth, whereas imports, at -1.1 percentage points, had a dampening effect.

Table 1: Quarterly national accounts

			2005				2006	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage changes from previous quarter					
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.5	+ 0.6	+ 0.6	+ 0.5	+ 0.5	+ 0.4
Households <sup>1</sup>			+ 0.5	+ 0.7	+ 0.7	+ 0.5	+ 0.4	+ 0.4
General government			+ 0.4	+ 0.6	+ 0.4	+ 0.3	+ 0.5	+ 0.2
Cross capital formation			- 0.2	- 0.0	+ 0.3	+ 0.6	+ 1.3	+ 2.1
Gross fixed capital formation			- 0.0	- 0.0	+ 0.4	+ 0.9	+ 1.3	+ 2.2
Machinery and equipment			- 0.7	+ 0.0	+ 1.3	+ 1.6	+ 2.1	+ 3.0
Construction			+ 0.0	+ 0.4	+ 0.5	+ 0.6	+ 0.7	+ 0.9
Exports, goods and services			+ 1.2	+ 1.8	+ 2.0	+ 1.8	- 2.0	+ 2.2
Goods			+ 0.3	+ 2.1	+ 2.4	+ 1.7	+ 2.1	+ 2.8
Services			+ 1.7	+ 1.9	+ 1.8	+ 1.6	- 16.8	+ 1.3
Imports, goods and services			+ 0.8	+ 1.1	+ 1.5	+ 1.3	- 2.9	+ 1.7
Goods			+ 0.7	+ 1.1	+ 1.6	+ 1.1	+ 1.3	+ 1.5
Services			+ 0.5	+ 0.8	+ 1.1	+ 1.2	- 16.9	+ 1.8
Gross domestic product			+ 0.4	+ 0.7	+ 0.9	+ 0.8	+ 0.6	+ 0.9
Manufacturing			+ 0.5	+ 2.1	+ 2.1	+ 2.3	+ 1.9	+ 1.5
	2004	2005	2005		2005		2006	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage changes from previous year					
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 1.8	+ 1.8	+ 1.6	+ 1.1	+ 1.9	+ 2.3	+ 1.8	+ 1.7
Households <sup>1</sup>	+ 1.9	+ 1.7	+ 1.5	+ 0.8	+ 2.0	+ 2.5	+ 1.8	+ 2.0
General government	+ 1.4	+ 1.9	+ 2.0	+ 2.1	+ 1.8	+ 1.8	+ 1.8	+ 0.8
Cross capital formation	+ 0.5	- 0.4	- 7.7	+ 6.4	+ 1.1	- 2.7	+ 4.5	+ 6.3
Gross fixed capital formation	+ 0.6	+ 0.3	- 1.8	+ 3.1	+ 0.2	- 0.6	+ 5.7	+ 5.2
Machinery and equipment	- 1.6	+ 0.2	+ 0.2	+ 2.8	+ 0.7	- 2.6	+ 7.7	+ 8.2
Construction	+ 1.6	+ 0.4	- 4.0	+ 3.5	- 0.1	+ 0.8	+ 4.4	+ 3.5
Exports, goods and services	+ 10.0	+ 6.4	+ 6.3	+ 6.3	+ 6.4	+ 6.6	+ 5.2	+ 2.8
Goods	+ 12.7	+ 5.8	+ 5.2	+ 6.9	+ 5.3	+ 5.7	+ 12.5	+ 7.7
Services	+ 2.7	+ 8.1	+ 9.0	+ 4.5	+ 9.2	+ 9.6	- 12.7	- 12.9
Imports, goods and services	+ 8.7	+ 5.2	+ 5.6	+ 8.1	+ 5.5	+ 1.9	+ 3.4	+ 1.8
Goods	+ 10.9	+ 5.9	+ 6.7	+ 9.4	+ 6.4	+ 1.7	+ 8.2	+ 5.2
Services	+ 1.4	+ 2.6	+ 1.7	+ 3.2	+ 2.5	+ 2.9	- 15.8	- 11.4
Gross domestic product	+ 2.4	+ 2.0	+ 1.1	+ 2.3	+ 2.1	+ 2.6	+ 3.1	+ 3.2
Manufacturing	+ 2.3	+ 2.6	- 3.7	+ 2.8	+ 3.9	+ 7.0	+ 6.1	+ 6.9
Gross domestic product, value	+ 4.2	+ 3.9	+ 3.5	+ 4.1	+ 3.9	+ 4.2	+ 4.0	+ 4.7

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

Inflation remains low despite increased capacity utilisation and higher fuel prices. The consumer price index rose by 1.5 percent in July, according to the national method of calculation. Hence Austria is again one of the countries in the euro area where price stability is highest.

The labour market usually reacts with some lag to changes in the course of the business cycle. First signs of improvement have become apparent in recent months. In August, employment again posted sizeable gains (+1.9 percent year-on-year, or +0.2 percent month-on-month, seasonally adjusted). Unemployment declined (-18,500 year-on-year, or -2,200 month-on-month, seasonally adjusted); the expansion of training activities continued to contribute to this decline.

The US economy grew at a quarter-on-quarter rate of 0.6 percent in the second quarter, at a markedly slower pace than on average in the previous periods. In the first quarter, the rate had still been as high as +1.4 percent, however compared with the unfavourable result for the fourth quarter of 2005 (+0.4 percent).

**Economic activity moderating in the USA**

Table 2: Contributions to GDP growth

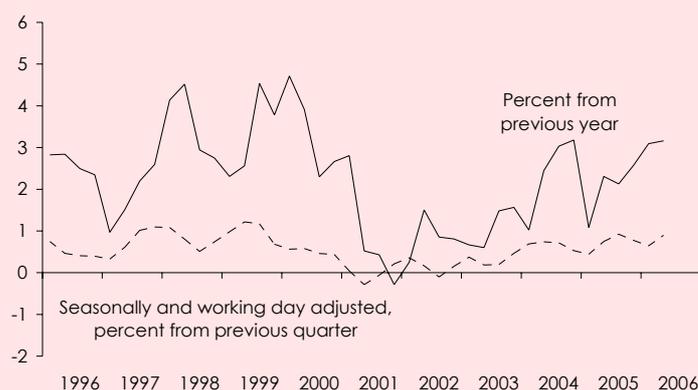
Adjusted for seasonal and working day effects, volume

	Final consumption expenditure	Gross capital formation	Exports	Imports	Gross domestic product
	Percentage points		Percentage changes from previous year		
2004, First quarter	+ 0.4	+ 0.0	+ 1.5	- 1.1	+ 0.7
Second quarter	+ 0.3	+ 0.1	+ 1.7	- 1.3	+ 0.8
Third quarter	+ 0.4	+ 0.3	+ 1.3	- 1.3	+ 0.7
Fourth quarter	+ 0.3	+ 0.2	+ 0.8	- 0.7	+ 0.5
2005, First quarter	+ 0.2	- 0.0	+ 0.6	- 0.3	+ 0.4
Second quarter	+ 0.4	- 0.0	+ 0.9	- 0.5	+ 0.7
Third quarter	+ 0.5	+ 0.1	+ 1.1	- 0.7	+ 0.9
Fourth quarter	+ 0.3	+ 0.1	+ 1.0	- 0.7	+ 0.8
2006, First quarter	+ 0.4	+ 0.3	- 1.1	+ 1.1	+ 0.6
Second quarter	+ 0.3	+ 0.4	+ 1.3	- 1.1	+ 0.9

Source: WIFO.

Figure 1: Growth of real GDP

Percentage changes from previous period



Source: WIFO.

Residential construction investment has been falling since mid-2005, as was to be expected after the housing boom of recent years, with the decline accelerating to -2.6 percent (seasonally adjusted) in real terms in the second quarter. Building permit statistics suggest a continuation of this trend: in July, the number of applications was 6.5 percent below the June rate and more than 20 percent below the rate a year before.

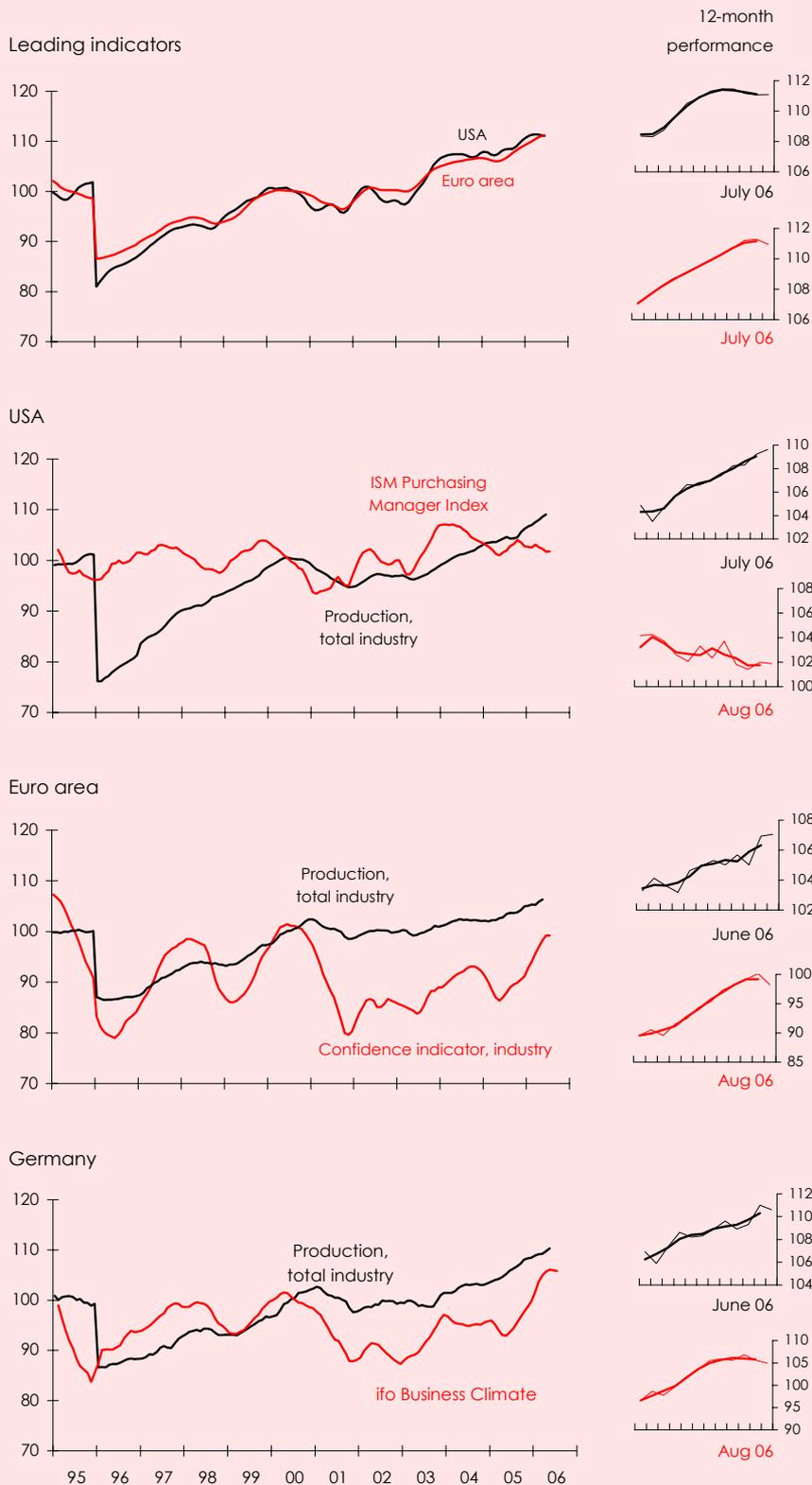
Apart from residential construction investment, private households have become increasingly more restrained also in their consumption expenditure (+0.6 percent in real terms in the second quarter of 2006) – in recent years the driving force of dynamic expansion, with spending on consumer durables static. The results of consumer confidence surveys – the University of Michigan Consumer Sentiment Index and the Conference Board Consumer Confidence Index – rather suggest a further decline.

Monthly data on industrial production and capacity utilisation, however, do not yet indicate an imminent weakening, nor do incoming orders suggest a slowdown in production in the coming months.

*Leading indicators for the USA paint an uneven picture for the future course of the economy. While private households are showing considerably more restraint in their consumer spending and residential construction investment, company data do not suggest an imminent downturn.*

Figure 2: International Business Climate

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



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply Management™), ifo (Institut für Wirtschaftsforschung), OECD.

The Japanese economy continues to strengthen. The deflationary phase appears to have been overcome, with consumer prices rising again for some months now. This prompted Japan's Central Bank in July to move away from its zero interest policy of the last six years and to raise its key interest rate by 0.25 percentage point. However,

**Growth momentum sustained in Asia**

the consumer price index in July was only 0.8 percent above the year-earlier level, despite sizeable increases in crude oil prices.

China's economy still does not show any tendency towards slowing; the positive development has even gathered some additional speed thus far this year, with growth rates exceeding 10 percent. Exports and investment demand continue to be the driving force behind the expansion. The most recent appreciation against the dollar and the gradual increase in exchange rate flexibility are not likely to impair the expansionary export economy within the foreseeable future.

*While the economies of China and India continue to grow at a robust pace, Japan's economy appears to have overcome the deflationary phase and is rapidly recovering.*

The economies of the EU countries are currently growing at a pace unseen in many years. In the second quarter of 2006, real GDP expanded by 0.9 percent quarter-on-quarter in both the euro area and the EU, which were thus performing better than the USA (+0.7 percent). Growth has been broadly based also regionally: with the exception of Italy and Greece, all of the 16 EU countries for which GDP flash estimates are available for the second quarter, recorded growth rates of at least +0.8 percent.

Austria's most important trading partners among the new EU member countries are registering very lively growth, owing to the catching-up process and favourable economic conditions in the euro area. Hungary and the Czech Republic are experiencing rapid expansion of their export industry as well as high domestic demand. GDP continues to grow at a vigorous pace in Poland, the largest economy in East Central Europe.

The export industry continues to be a main pillar of economic activity in the euro area. However, during the second quarter, the importance of net exports decreased compared with the previous period, while domestic economic activity turned increasingly into a mainstay of the upswing: private household consumption, at a quarter-on-quarter growth rate of 0.3 percent in real terms, indeed advanced at a slower pace than at the beginning of the year (+0.7 percent), but gross fixed investment jumped by +2.1 percent after +0.9 percent in the first quarter. The stimulus provided by foreign trade may be expected to be passed on lastingly to domestic demand now. This would be an important precondition for a sustained economic upswing.

*In the European Union, the growth momentum is shifting to domestic demand, thanks to the stimulus provided by foreign trade. The first half of the year saw accelerated growth in investment and private consumption. The situation on the labour market is also beginning to ease.*

A survey conducted by the ECB among banks in the euro area confirms this upward trend: net demand for loans by enterprises increased to 20 percent in July, compared with 18 percent in April. Notably small and medium-sized enterprises took up credits, whereas larger-sized companies increasingly issued bonds (+4.1 percent). In both cases the companies polled declared to use the means primarily for investment in fixed assets.

Whether or not the stimulus to economic activity is exerting a lasting influence also on private household consumption is difficult to judge. Consumer spending in the euro area indeed rose by 0.7 percent in the first and 0.3 percent in the second quarter, yet this result could be a consequence of advance purchases in anticipation of the VAT increase in Germany at the beginning of 2007. The vigorous increase of 1.1 percent in private household consumer expenditure in Germany in the first quarter was followed by a decline of 0.4 percent in the second quarter, however.

Real retail sales (excluding cars) in the euro area posted gains of 2.5 percent in July compared with a year before, with acceleration in the growth trend not yet apparent, however. A potential carry-forward effect of the VAT increase in Germany will have an impact notably on car sales; hence the retail sales trend excluding cars is likely to be less representative of the overall consumption trend.

Consumer confidence and bank surveys show growing optimism regarding future developments. The Indicator of Consumer Confidence, after rising constantly in the euro area since mid-2005, advanced further in July; in August it remained unchanged, however. According to a survey conducted by the ECB, net demand for consumer credit continued to increase in the second quarter (to 28 percent, up from 18 percent in the first quarter).

## Buoyant growth in the EU

The good performance of the economy is already having repercussions on the labour market. On euro area average, the seasonally adjusted unemployment rate stood at 7.8 percent in July 2006 compared with still 8.5 percent in July 2005. Employment gained further momentum in the second quarter.

The German economy, which had been stagnating in recent years, began to accelerate noticeably at the beginning of 2006. Real GDP, after quarter-on-quarter growth of 0.3 percent in the fourth quarter of 2005, advanced 0.7 percent in the first and 0.9 percent in the second quarter of 2006. Early in the year growth was still mainly driven by exports, with private consumption also developing favourably. In the second quarter, however, growth was fuelled by the sharp increase in gross fixed investment, whereas the contribution of net exports and private consumption lost momentum. Real gross fixed investment rose by 3.5 percent from the previous period in the second quarter; this was by far the highest growth rate seen in recent years. Investment in equipment posted sizeable gains (+2.5 percent in volume), and so did construction investment (+4.6 percent), which had been falling for years.

At the beginning of 2007, the value added tax will be raised by 3 percentage points to 19 percent. This is likely to prompt many households to bring forward notably big-ticket purchases this year. Private consumption expenditure is therefore set to rise more strongly this year than would be expected normally in this phase of the business cycle. Whether or not this upturn will also benefit private consumer demand even in 2007, thus enabling a persistent improvement in the growth performance, is difficult to judge against this background.

Sentiment continued to be good in August, according to the Ifo business survey for that month. The assessment by companies of their current business situation has been at its highest level in twelve years for half a year now, yet expectations regarding future developments have turned less optimistic recently. Expectations of an "echo reaction" to the carry-forward effects appear just as plausible as does the assumption of deterioration after the excellent developments in recent months. The ZEW indicator shows even more clearly that expectations have darkened, but as it predominantly portrays the assessment of financial market developments, it tends to over- or undershoot<sup>1</sup> and hence is less suited for an analysis of economic trends.

The latest business cycle survey carried out by WIFO on behalf of the European Commission confirms the good state of the Austrian economy. In August, the industrial confidence indicator, which is derived from this survey, reached the high level of the year 2000. Also, companies assessed their current order situation – notably of foreign orders – much more favourably than on average in recent years. While this holds true notably for cyclically sensitive sectors (manufacture of intermediates, motor vehicles and capital goods), manufacturers of consumer durables also registered an improvement in their order situation. In contrast, the situation changed only little for manufacturers of food, beverages and tobacco and of non-durable consumer goods.

Production expectations for the months to come have already been high for several months now. Manufacturers of motor vehicles and motor vehicle components are particularly optimistic regarding their prospects for sizeable output growth. Austrian motor industry suppliers could benefit also in the next few months from the carry-forward effect ahead of the increase in the value added tax in Germany.

Companies were less optimistic than in the previous survey regarding their assessment of the six-month business outlook, however. The decline became apparent already in the July survey and continued in August. Yet the indicator is still at a very high level. Notably manufacturers of intermediate and capital goods are less optimistic now.

<sup>1</sup> On the forecasting power and structure of these indicators, see Scheiblecker, M., "Business Confidence Higher. Business Cycle Report of May 2006", Austrian Economic Quarterly, 2006, 15(2), [http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo\\_search.get\\_abstract\\_type?p\\_language=1&pubid=26596](http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=1&pubid=26596).

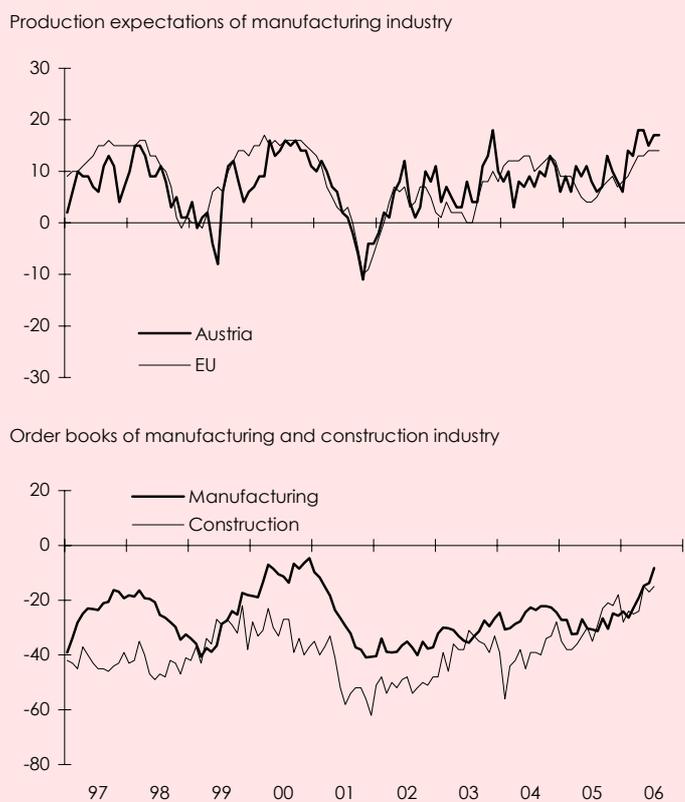
## German economy buoyant this year

*The German economy is currently growing at a robust pace, with all demand components having picked up. Yet prospects for the future are difficult to judge.*

## Excellent performance of Austria's economy continuing

Figure 3: WIFO business cycle survey

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



Source: European Commission, WIFO business cycle survey.

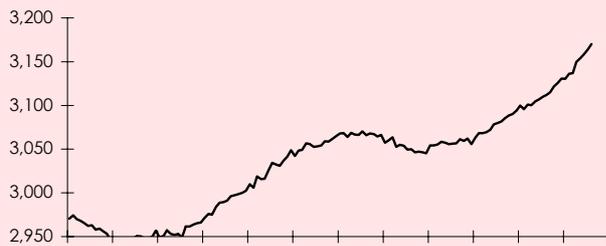
In July, as in the preceding month, the consumer price index according to the national method of calculation exceeded the year-earlier level by 1.5 percent. Considering the soaring cost of fuel (+8.2 percent) and household energy (+7.2 percent), the rate of inflation was thus very low. Skyrocketing crude oil prices in recent years thus far have had only minor second-round effects and still have not yet started an inflation spiral. A downward pressure in July came from price declines in the categories "communication" (-3.8 percent), "clothing and footwear" (-2.4 percent), and "recreation and culture" (-1.9 percent).

The EU-Harmonised Index of Consumer Prices for Austria increased by 2 percent in July. The inflation rate measured according to this harmonised method was higher as it also covers expenditure by travellers in Austria, with expenditure for restaurants and hotels – which rose more strongly recently – consequently having greater weight than in the CPI. But Austria's rate of inflation was still one of the lowest in the euro area even when calculated according to this method. In July, it was lower only in Finland (+1.4 percent) and in the Netherlands (+1.8 percent).

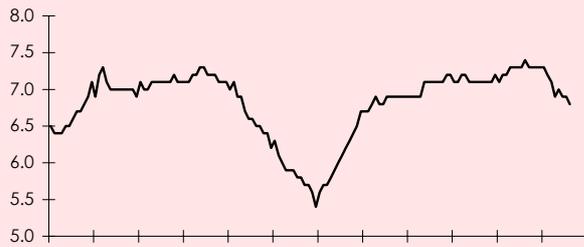
**Inflation low despite  
higher energy costs  
and economic  
upswing**

Figure 4: Key Economic Indicators

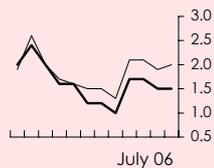
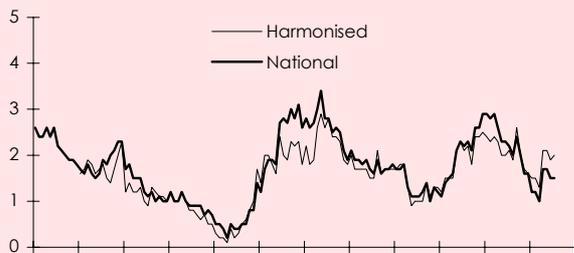
Persons in active dependent employment<sup>1</sup>, (1,000), seasonally adjusted



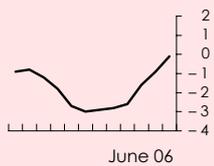
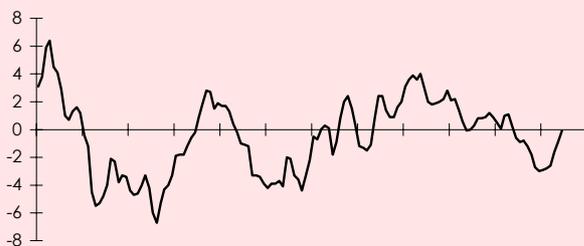
Unemployment rate, traditional Austrian method<sup>2</sup>, seasonally adjusted



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.

The number of overnight stays recorded in July 2006 was just under 13.8 million, according to Statistics Austria, hence at +0.2 percent barely exceeding the year-earlier result, despite the hot summer. The number of overnight stays from May to July 2006 (cumulated) also stagnated (-0.2 percent). While overnight stays by domestic visitors posted small gains (+1.5 percent), those by foreign guests decreased (-1.0 percent). Looking at the markets of origin, the picture was quite diverse: while the number of overnight stays by guests from the USA, Italy, France and Great Britain surpassed the year-earlier result, declines were recorded notably on Austria's main tourist markets Germany, the Netherlands and Switzerland.

In contrast, the number of arrivals from May to July exceeded the year-earlier level by 1.8 percent. At the same time the number of overnight stays in the highest hotel category rose by 4.5 percent. As a consequence of these two factors, tourism sales from May to July rose by 3.3 percent despite stagnation in the total number of overnight stays. Particularly high gains were recorded by Vienna and Lower Austria, whereas tourism sales were flat in Vorarlberg.

Accelerating economic growth has led to a marked increase in the demand for labour, with the number of persons in active dependent employment in August exceeding the year-earlier level by 1.9 percent (close to +60,000 employed persons); this time, the number of full-time jobs also increased. In August, employment advanced at a seasonally adjusted rate of 0.2 percent month-on-month, a similar pace as in July.

The number of job vacancies registered with the AMS (Labour Market Service) remains high, despite the marked gains in employment. In August, it exceeded the year-earlier level of 37,000 by close to 8,300. Compared with July 2006, the number of vacant positions also rose slightly, by +240 (seasonally adjusted).

18,500 fewer persons were registered as unemployed with the AMS in August. While vocational training activities were expanded considerably (+8,800), at least half of this decline can be attributed to the pick-up in economic activity. A constant decrease in unemployment becomes apparent also on a month-on-month basis (-2,200 or -0.9 percent, seasonally adjusted, from July).

The unemployment rate according to the national method of calculation fell from 6.9 percent in July to 6.8 percent in August due to seasonal factors, a decline by 0.4 and 0.6 percent, respectively, from a year before. According to the Eurostat definition, the seasonally adjusted rate dropped by 0.4 percentage point to 4.9 percent in August.

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### **Tourism not stimulated by July heat**

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### **Lower unemployment due to good performance of the economy and expansion of training programmes**