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## Cyclical Recovery Losing Momentum

**In the last couple of months, business surveys in the euro area point to a slowdown of the recovery in the manufacturing sector. The boom in exports has not, or only hesitantly been transmitted to domestic demand. In Austria, exports and manufacturing output were still relatively lively early this year, while retail sales in the first two months of 2005 disappointed, given the positive income effects from the tax reform. The marked upward drift of inflation is squeezing private purchasing power.**

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The slowdown of the recovery, which could already be observed in the fourth quarter, continued early this year. For the last couple of months, manufacturers have become more sceptical in their judgement of foreign orders and business expectations. Despite rising profits, reflected by healthy corporate tax revenues, investment remains subdued. Private households remain cautious in their spending behaviour, despite the gains in disposable income from the tax reform. The strong rise in energy prices, the high euro exchange rate and, more recently in the last weeks also the weakening stock market values are undermining corporate and household confidence.

Unlike in the USA, the UK and many Asian countries, economic policy in the euro area and Japan has not been successful in generating a cyclical upturn. The extended cyclical weakness in the euro area has entered its fifth year in 2005, and there are no signs that it may be overcome in the course of the year. The short revival of activity in the euro area (and in Japan) in 2004 was entirely sustained by exports, without giving major incentives to domestic demand.

In Austria, the pace of activity is broadly in line with the euro area average and thus somewhat stronger than in the major trading partner countries Germany and Italy. Although nominal exports still exceeded the year-earlier level by 11½ percent in the first two months of the year (February +8 percent), growth is decelerating as a consequence of less buoyant global trade and the impact of the high euro exchange rate.

Industrial production mirrors the variations in export strength. In February, the index of manufacturing output was 4 percent higher than one year ago, but the gain has narrowed here as well, and with a further deceleration to be expected for the months to come. In the regular WIFO business survey of March and April, manufacturers judged their order and business situation once again more sceptical than in the months before.

In the construction sector, the level of orders has improved further, and an increase in output may be expected. Sales volumes, however, disappointed in the first two months of 2005. In spite of the net income gains on account of the tax reform, volume retail sales were no higher than one year ago. The marked acceleration of inflation dampened private purchasing power and the uncertain labour market outlook made households more cautious in their spending behaviour. The significant increase in sales in March carries an upward bias due to a calendar effect (early date of the Easter holiday) and is likely to be corrected in April. More substantial gains may be expected for the second semester, as tax cuts usually take their full effect on consumption only with a lag.

As expected, investment was sluggish after the fiscal investment premium ("Investitionszuwachsprämie") had expired. At the moment, the trend can only be assessed on the basis of imports of machinery and motor vehicles, which broadly stagnated at the year-earlier level in the first two months of the year.

Higher energy and housing costs has given momentum to inflation. In March, the rate of headline inflation stood at 2.9 percent. Energy prices went up by 9 percent, adding ½ percentage point to the overall rate. Higher housing costs (+7 percent) pushed the inflation rate up by 1 percentage point. Hefty price increases were recorded also for tobacco (due to an increase in the tobacco tax), health services and insurance premia. As a result, inflation has exceeded the euro area average. Higher inflation has been reflected in a decline in per-capita gross real income, but net real income increased owing to the tax reform.

Because of the subdued activity and the rise in labour supply, unemployment remains somewhat above the year-earlier level. As the number of people in vocational training, people taking retirement and recipients of pre-retirement benefits has increased, registered unemployment is rising only slightly. The number of jobs went up by a healthy 30,000 year-on-year in April, the bulk of which are female jobs in services. In manufacturing, job conditions have weakened in the last months, confirming (together with the more pessimistic survey responses for the euro area and for Austria) the slower momentum of the recovery.