

Sandra Steindl

Austrian Economy Buoyant at Year-End 2007 – Current Surveys Indicate Slowdown

Business Cycle Report of February 2008

The Austrian economy grew at a seasonally and working day adjusted rate of 0.7 percent in real terms quarter-on-quarter in the fourth quarter of 2007. The growth rate for the year 2007 as a whole was 3.4 percent in real terms. Export-oriented production, without exception a mainstay of economic activity, still expanded at a vigorous pace also at year-end. The developments of order volumes in the first quarter of 2008 suggest a slowdown in industrial activity, however. Exchange rate fluctuations in international financial markets increase the uncertainties surrounding the outlook for the economy, and, coupled with accelerated consumer price inflation dampen consumer confidence.

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 13 February 2008. • E-mail address: Sandra.Steindl@wifo.ac.at

Growth in Austria lost only some momentum in the fourth quarter. Real GDP increased by 0.7 percent quarter-on-quarter (following +0.8 percent in the third quarter), according to WIFO's latest flash estimates. The manufacturing sector proved to be still robust at year-end (fourth quarter 2007, +1.2 percent in real terms quarter-on-quarter), albeit at a rate of growth clearly lower than that at the beginning of the year. Construction, in the first half of the year also a driver of activity in Austria, expanded only just moderately in the fourth quarter (+0.5 percent, compared with the previous quarter).

Against the background of decelerating growth in external demand, foreign trade also lost some momentum at year-end. In the fourth quarter, exports rose by 7.0 percent in real terms year-on-year, according to the national accounts. Overall growth in 2007 reached 8.1 percent in real terms, while imports increased by 7.0 percent in real terms. The international environment has deteriorated further in recent weeks: the US economy hardly grew at all in the fourth quarter (+0.2 percent in real terms, quarter-on-quarter), with notably the decline in residential investment exerting a dampening effect. The expansion of personal consumption expenditures, in recent years the engine of economic activity in the USA, until now has been slowed only little by the loss in value of real estate and financial assets brought about by the mortgage crisis. This development, coupled with the US dollar's further depreciation against the euro, is nevertheless impacting on European companies' export confidence. Sentiment indicators show deterioration in industrial and consumer confidence indicators in the euro area.

In Austria, too, the results of the WIFO business cycle survey reflect a slowdown in industrial activity. The share of companies with sufficient or more-than-sufficient order book levels has been declining for several months now, but, at around 75 percent in January still exceeded the long-term average.

Reflecting the boom in the export-oriented industry, investment demand also expanded in 2007, albeit at a slower pace than in previous periods of upswing. Business spending on machinery and equipment, while exceeding the year-earlier level by 6.5 percent in real terms, also lost some momentum in the fourth quarter. Industrial activity failed to feed through into private consumption also in 2007 (+1.5 per-

cent in real terms year-on-year), which rather grew at a slower pace yet again in the fourth quarter (+0.3 percent quarter-on-quarter). The uncertainty surrounding future developments, and price increases for essential commodities are weighing on consumer confidence. In December, inflation according to the national method of calculation stood at 3.6 percent, with notably food and energy prices higher than a year earlier. Collectively agreed wages rose by 2.5 percent in December, hence clearly slower than consumer prices.

Table 1: Flash estimates of quarterly national accounts

	2006		2007			
	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 ¹	+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 0.3
General government	+ 0.4	+ 0.4	+ 0.3	+ 0.5	+ 2.1	+ 1.2
Gross capital formation	+ 0.9	+ 1.0	+ 1.2	+ 1.3	+ 0.8	+ 0.6
Exports	+ 2.0	+ 2.3	+ 2.1	+ 1.7	+ 1.6	+ 1.5
Imports	+ 1.7	+ 1.9	+ 1.6	+ 1.2	+ 1.8	+ 1.3
Gross domestic product	+ 0.8	+ 0.8	+ 1.0	+ 0.8	+ 0.8	+ 0.7
<i>GDP, output approach</i>						
Agriculture, forestry	+ 0.3	+ 0.9	+ 1.0	+ 1.4	+ 1.7	+ 1.6
Industry, including energy	+ 1.7	+ 2.2	+ 1.7	+ 1.0	+ 1.1	+ 1.2
Construction	+ 1.3	+ 1.1	+ 0.8	+ 0.5	+ 0.5	+ 0.5
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.3	+ 0.4	+ 0.5	+ 0.5	+ 0.7	+ 0.8
Financial intermediation; real estate, renting and business activities	+ 0.7	+ 0.9	+ 1.3	+ 1.5	+ 1.0	+ 0.6
Other service activities	+ 0.2	+ 0.2	- 0.0	+ 0.2	+ 0.4	+ 0.2
Taxes on products	+ 0.3	+ 0.6	+ 0.7	+ 0.5	+ 0.3	+ 0.3
Subsidies on products	+ 1.1	+ 0.3	- 0.6	- 0.0	+ 0.5	+ 1.1
Percentage changes from previous year						
Gross domestic product, volume	+ 3.0	+ 3.4	+ 3.6	+ 3.5	+ 3.5	+ 3.2

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

Employment, as a lagging indicator, follows the buoyant activity of 2007. In January, the number of persons in active dependent employment rose by 2.9 percent (+90,400), an acceleration from a year earlier. Unemployment also declined more strongly than recently (-26,500 persons, -9 percent), notably in tourism and construction.

US growth weakened substantially in the fourth quarter. Real GDP increased at a quarter-on-quarter rate of 0.2 percent (seasonally adjusted) in the fourth quarter, according to advance estimates. For the year 2007 as a whole real GDP rose by 2.2 percent. The expansion was slowed down notably by the decrease in residential fixed investment prompted by the real estate crisis (-16.9 percent). It accelerated further in the course of the year, with real residential fixed investment in the fourth quarter down 6½ percent from the previous quarter. The number of housing permits, which is considered a leading indicator of future developments, also dropped significantly in December.

Private consumption was dragged down moderately by the uncertainties and financial losses triggered by the real estate and financial crisis. It expanded by +0.5 percent in real terms quarter-on-quarter in the fourth quarter, a decline from the average rate recorded in the previous four years (+0.8 percent) when private consumption had always been the main driver of growth. The number of home sales has dropped more strongly up to now (-5 percent in December, compared to November). Compared to December 2006, when existing home purchases were still largely driven by cheap loans, the decline was around 40 percent.

Signs of slowing global economy

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 recent fall in the Conference Board Consumer Confidence Index shows a darkening of sentiment among private households also with respect to future developments. Notably their expectations regarding employment conditions and personal income developments have deteriorated. Employment growth decelerated markedly at the beginning of the year, with notably the weakened construction sector and manufacturing cutting jobs in January.

Economic policy has reacted to both the turbulence in international financial markets and the dampened growth prospects. The central bank cut interest rates twice within a short period of time, by a total of 125 basis points. The key interest rate thus stood at 3 percent at the end of January. The package planned by the government to stimulate economic activity, with tax rebates for private households and investment incentives for companies, could also provide support to private consumption and investment.

In emerging Asia, economic activity has remained robust despite international uncertainties, with no slowdown yet apparent in China and India. Triggered by an export and investment boom, China's GDP grew at an annual rate of more than 10 percent for the fifth consecutive year in 2007. The rapid expansion has recently prompted a marked acceleration of inflation, with the consumer price index increasing by 6.5 percent in December 2007. Measures taken to ease economic strains have so far had hardly any effect.

Japan's economy has been lacking momentum, a consequence of subdued consumer and investment demand. Confidence indicators at the beginning of the year signal hardly any acceleration.

Sub-prime mortgage debt increased further in the course of the US real estate crisis, with numerous large banks worldwide consequently reporting losses in recent months. This caused uncertainties in financial markets, which, along with signs of a cooling economy in the USA, triggered strong turbulences on international stock exchanges in mid-January. Apart from the correction taking place in real estate markets, stock market losses are now also causing wealth losses and can thereby influence consumer demand. The extent of the impact on the real economy is difficult to judge as yet.

The exchange rate of the euro remained high due to the quick interest rate cuts by the US central bank; the average rate in January was \$ 1.47.

Economic activity in the euro area has been losing momentum since mid-2007. Capacity utilisation in the manufacturing sector passed its peak in the second quarter of 2007, and reached 84.4 percent in the first quarter of 2008. Evidence from the European Commission's monthly business survey shows a decline in industrial confidence indicators. Firms still rate order book levels as satisfactory, however with a falling tendency. On the one hand, stagnating US demand for imports, exacerbated by the high euro exchange rate, is weighing on foreign trade, and on the other hand rising uncertainty is slowing expansion investment. Consumer confidence, which is considered a leading indicator, has also been on a steady decline since mid-2007. Price increases for basic goods are dampening private consumption. According to Eurostat's flash estimates, euro area inflation was 3.2 percent in January, up from 3.1 percent in December. The labour market, on the other hand, continues to provide positive stimulus. The seasonally adjusted unemployment rate in the euro area was 7.2 percent in December, down from 7.8 percent a year earlier.

Economic activity is cooling also in Great Britain. After buoyant growth in the first three quarters of 2007, real GDP growth decelerated to a seasonally adjusted quarter-on-quarter rate of just 0.6 percent in the fourth quarter.

The German economy grew by 2.5 percent in real terms year-on-year in 2007. Foreign trade and investment in machinery and equipment provided the main stimulus. Supported by a favourable order situation with above-trend order book levels, companies expanded their production capacities. Developments in trade and industry remain favourable, even though the high growth rates seen in summer were most likely no longer reached in the fourth quarter. Uncertainty among companies is mounting. Evidence from the IFO business survey shows that in January companies in trade and industry assessed their current business situation somewhat less positively than a month before. The slowdown of economic activity in the USA, coupled with

The US economy expanded only insignificantly in the fourth quarter. Recent developments in financial and real estate markets indicate that further moderation in growth lies ahead.

Violent turbulence once more hitting financial markets

The sub-prime crisis and the economic downturn in the USA sent stocks tumbling.

Economic slowdown in Europe

Signs of a slowdown in economic activity are mounting also in Europe.

Germany: uncertainty mounting

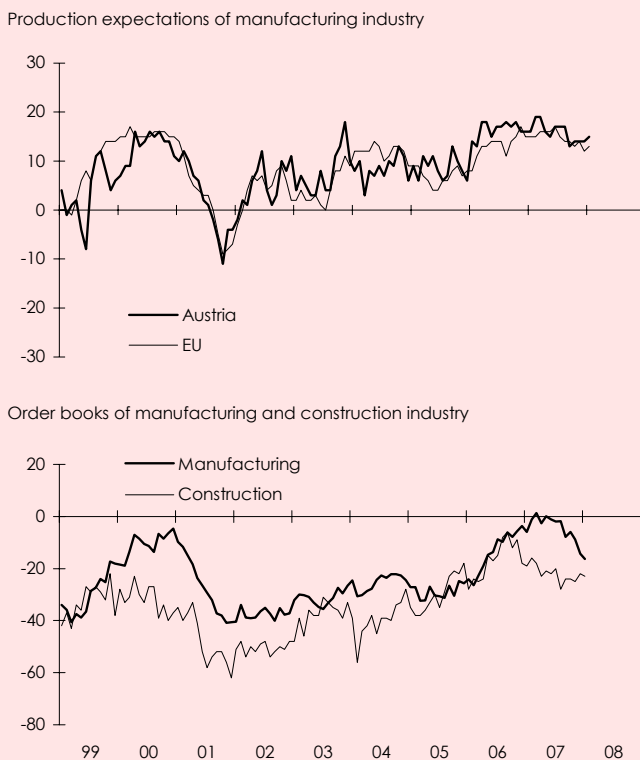
the strong euro, is weakening the export sector. External sales of the manufacturing sector expressed in real terms declined already at the end of 2007 from a year earlier.

Following the VAT increase at the beginning of 2007, household consumption expenditure remained restrained throughout the entire year. It also lagged behind in the fourth quarter on account of the increase in living cost, despite improved labour market conditions. This is suggested by the weak retail sales recorded in December. In January, seasonal unemployment rose less than usual, with the downward trend observed in 2007 thus continuing. Thanks to the decline in unemployment payments as well as higher tax revenues, the government budget achieved a breakeven for the first time since 1989.

The Austrian economy grew at a seasonally and working day adjusted quarter-on-quarter rate of 0.7 percent in real terms in the fourth quarter of 2007. For the year 2007 as a whole real GDP growth was +3.4 percent from the previous year. Real value added growth in manufacturing, at +1.2 percent quarter-on-quarter was still robust in the fourth quarter, but around 1 percentage point lower than in 2006. Evidence from WIFO's business survey suggests that a further slowdown in manufacturing growth may lie ahead. The proportion of companies with sufficient or more-than-sufficient order book levels has been falling since mid-2007, but at around 75 percent is still exceptionally high.

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.

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Construction expanded by 0.5 percent in real terms quarter-on-quarter in the fourth quarter. Activity in this sector also lost momentum towards the end of the year. However, an exceptionally high number of construction firms anticipate business and employment conditions to develop more favourably and building prices to rise

The assessment of the economic situation has recently deteriorated in Germany, despite robust industrial growth.

Vigorous growth in Austria at year-end 2007

After dynamic expansion in the first three quarters of 2007, growth in Austria moderated only slightly in the fourth quarter.

again in the first quarter of 2008. In 2007, building costs were determined to a much greater extent by material costs – given the high level of commodity prices – than by wage developments.

Of all expenditure aggregates of GDP, exports, whose development is slightly ahead of that of overall economic activity, once again made the largest contribution to growth in the fourth quarter. They expanded vigorously also at the end of the upturn, losing only little momentum in the fourth quarter, despite a deteriorating international environment. Total exports increased by 8.1 percent, whereas imports rose by 7.0 percent in real terms in 2007, according to the National Accounts.

The major portion of exports still goes to the EU 27 (around 72 percent, according to the Foreign Trade Statistics). Around 5 percent of Austria's exports go to the USA; hence Austria's foreign trade sector is likely to be affected only indirectly by a downturn in the US economy. The share of Austrian exports to South-East Europe and to CIS countries rose in 2007.

Prompted by the lively demand for exports, industry invested in expansion in 2007, with business spending on machinery and equipment exceeding the year-earlier level by 6.5 percent in real terms. When growth shifted into slower gear, investment growth also moderated at the end of the year.

2007 saw household consumption expenditure rise by +1.5 percent in real terms, just a modest increase from a year earlier. Due to its strong weight, it nevertheless contributed +0.8 percentage point to GDP growth of 3.4 percent. Private consumption tends to fluctuate only little, and since the first quarter of 2003 has hardly exhibited any dynamism. After an average quarter-on-quarter increase of 0.4 percent in real terms in the first three quarters of 2007, the rate dipped slightly to +0.3 percent in the fourth quarter.

The sentiment among private households has darkened since then. Price increases for consumer goods are weighing on expectations regarding their personal financial situation. Besides, in the fourth quarter of 2007, the rate of increase of collectively agreed wages (+2.5 percent) was much lower than that of consumer prices (+3.2 percent). This development has been accompanied by a decline in consumer confidence regarding future economic conditions and a further fall in unemployment.

Against this background, retail sales growth moderated in the second half of the year, compared to the same period a year earlier. At year-end, price increases led to a fall in real retail sales (fourth quarter –2.2 percent in real terms year-on-year, according to research data by KMU, the Austrian Institute for SME Research).

In the first two months of the current winter season (November and December 2007), tourism sales reached € 3.10 billion, according to preliminary estimates, an increase by 13.0 percent compared to the same period a year before. The number of overnight stays rose by 9.3 percent year-on-year over the same period, with above-trend growth of +9.6 percent recorded for the demand by foreign travellers (nights spent by domestic travellers +8.8 percent).

The sales increase was mainly attributable to the favourable economic situation in 2007, Austria's high competitiveness in the field of short holidays, and the good weather at the beginning of the season.

Demand trends were quite diverse in the most important markets of origin: While in November and December 2007 a clear year-on-year increase was recorded in the number of nights spent in Austria by guests from the important markets of origin Netherlands (+12.7 percent) and Germany (+8.4 percent) as well as from France (+9.1 percent) and Belgium (+8.2 percent), a lower-than-average increase was posted for overnight stays by travellers from Switzerland (+5.8 percent) and Italy (+5.4 percent). A decline was recorded in the countries of origin Great Britain

Exports still driving growth

Foreign trade remained dynamic also at year-end 2007.

Private consumption lacking momentum

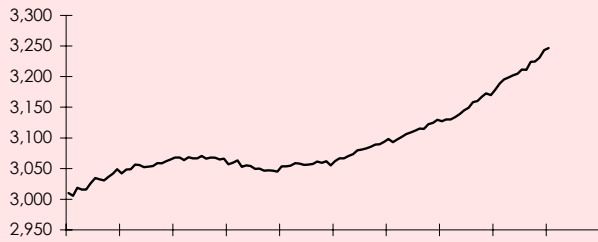
The global financial crisis and rising food and energy prices are weighing on consumer sentiment.

Surge in tourism sales reported for winter season

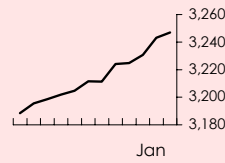
(-4.2 percent) and USA (-2.0 percent), with the drop in demand by guests from the USA most likely attributable – at least in part – to the weak dollar vis-à-vis the euro.

Figure 3: Key economic indicators

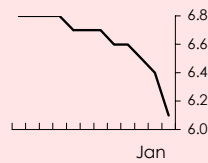
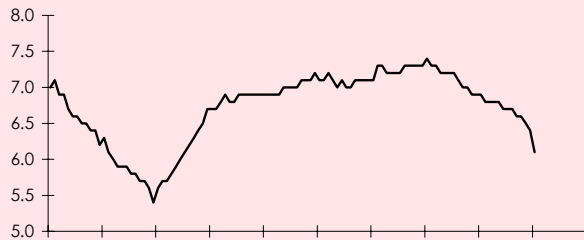
Persons in active dependent employment¹, (1,000), seasonally adjusted



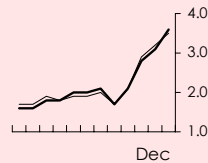
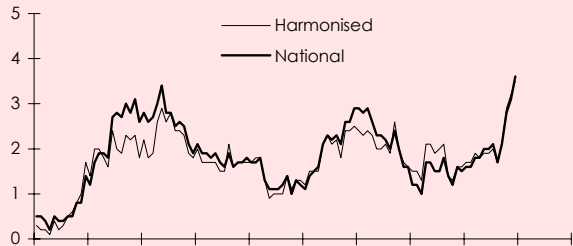
12-month performance



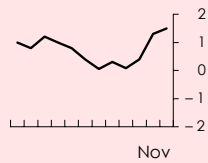
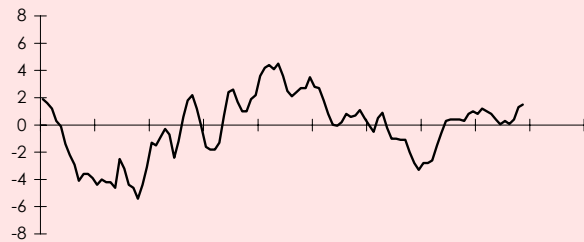
Unemployment rate, traditional Austrian method², seasonally adjusted



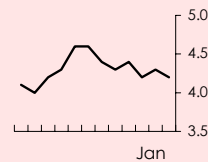
Consumer prices, year-to-year percentage changes



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.

Headline inflation in Austria averaged 2.2 percent in 2007. A significant increase was recorded in the course of the year, with consumer price inflation reaching 3.6 percent in December (+0.5 percentage point from November). As in the months before, the increase was attributable mainly to higher fuel and food prices. Particularly high price increases were registered for dairy products and eggs as well as for bread and grain products. Overall, the expenditure category "food and non-alcoholic beverages" contributed more than one fourth to the increase in the consumer price index.

The scarcity of supply caused by crop failures, and a rapidly growing demand spurred rising world market prices for agricultural commodities in the course of 2007. Like energy, transport and labour costs, they are considered an important influencing variable for the development of food prices. The HWWI Index of World Market Prices of Commodities, which includes food, drink and tobacco as well as energy and industrial raw materials, in the fourth quarter of 2007 rose by almost 25 percent based on euro prices relative to a year earlier.

The expenditure categories housing, water and energy as well as transport accounted for around two-fifths of the annual inflation. Notably the price of fuel rose sharply (+23 percent year-on-year in December). Fuel price developments eased somewhat in January 2008 as the crude oil price fell against the background of cyclical risks. In January it was around \$ 90 per barrel, an increase by more than 70 percent from a year earlier.

The Harmonised Index of Consumer Prices (HICP) rose by 3.5 percent in December, outpacing the euro area average of +3.1 percent.

Employment developments have been following the dynamic trend of economic activity registered in 2007 with the usual lag. In January 2008, the number of persons in active dependent employment rose by 2.9 percent (+90,400) year-on-year, outpacing the favourable trend of the year before (annual average for 2007 +2.1 percent, +65,500). The number of persons working limited hours and earning no more than € 349 per month also rose markedly in January.

The mild winter and the lively demand for tourism services curbed unemployment notably in construction and tourism. Although seasonal unemployment had been low in January 2007, when weather conditions had also been favourable and had allowed lively construction activity, unemployment in the construction sector fell once more this year, compared to a year earlier. A total of 268,800 job seekers were registered in Austria in January, a year-on-year decrease by 9 percent (-26,500). The decline lost some vigour towards the end of 2007 before accelerating again in recent months. In January, the seasonally adjusted unemployment rate was 6.1 percent, according to the traditional method of calculation, or 4.3 percent, according to the calculation by Eurostat.

Following stagnation towards the end of last year, the number of job vacancies registered with AMS (Public Employment Service) also rose in January (+3,600 to 34,000). Nevertheless, this development also reflects a slowdown in economic growth compared to the first half of 2007, when the year-earlier level had still been exceeded by just under 8,000.

Food prices rising further

Inflation rose to 3.6 percent in December, driven mainly by higher energy and food prices.

January sees stronger-than-expected fall in unemployment

Following the course of the business cycle, employment increased at a robust pace at the beginning of the year. The seasonally adjusted unemployment rate in January dropped more sharply than at year-end, also on account of the warm weather.