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Boom Continuing Amid Rising Risks

Business Cycle Report of August 2007

According to WIFO's latest flash estimates, the Austrian economy grew by 1 percent quarter-on-quarter or 3.8 percent year-on-year in the second quarter. Hence, the growth momentum was even stronger than in the first quarter. Goods exports and investment remain the key driving factors of the economic upswing. In contrast, private consumption shows hardly any signs of a pickup. Financial market turbulences point to heightened risks for the second half of the year.

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Evidence from WIFO's July business survey shows that companies in the manufacturing sector continue to be highly optimistic. 41 percent of the surveyed companies judge their current business situation to be good, whereas only 10 percent are not content with it. In the last few months this assessment has not improved further, though.

While consumers expect the economic situation to improve, they assess their current financial situation to be more unfavourable than at any time in the last fifteen years. Hence, they intend to be thriftier with regard to large-scale purchases. This discontent can be explained by the fact that private net income of employees continue to stagnate despite the economic upturn. Inflation rose owing to higher prices for energy and food, hitting the 2 percent mark in May and June. Given a contractual wage increase of just 2.4 percent and high marginal tax rates, the purchasing power of a private household will rise only if an additional family member takes employment.

The economic revival was reflected in significant job gains (July +60,700 over the previous year), with only around one third of the new jobs being filled with unemployed persons, however. Hence, given the employment boom, the decline in unemployment (July -11,300) is relatively small. In part this is also due to the cutback on training measures – with the amount of funds spent for labour market policy measures remaining unchanged.

The upturn accelerated once more in spring, according to WIFO's latest flash estimate. In the second quarter Austria's real GDP rose by 1 percent (seasonally and working day adjusted) from the previous period, a dynamic rate last seen in 1999. On a year-on-year basis, real GDP growth advanced to +3.8 percent from +3.5 percent in the first quarter.

The main impetus for this marked expansion came once more from exports (+1.5 percent in real terms quarter-on-quarter), with both goods and services exports rising vigorously (+1.4 percent and +1.6 percent, respectively). Thanks to the buoyant economy imports also continued to rise (+1 percent in real terms). Goods imports grew more strongly (+1.2 percent) than services imports (+0.7 percent).

Gross fixed investment expanded at a seasonally and working day adjusted quarterly rate of +0.8 percent in real terms in the second quarter, more slowly than in the first quarter (+1.5 percent). The mild weather at the beginning of the year played a decisive role here, benefiting notably building investment in the first quarter. The lat-

ter expanded at a considerably slower pace in the second quarter (+0.6 percent in real terms) than in the previous period (+1.4 percent). Business spending on machinery and equipment again rose strongly in the second quarter (+1.5 percent in real terms), however, growth was relatively weak for an economic upturn. A marked acceleration is anticipated for the coming quarters, as is suggested also by the results of the WIFO investment survey.

Table 1: Flash estimates of quarterly national accounts

	2006				2007	
	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 ¹	+ 0.5	+ 0.4	+ 0.4	+ 0.3	+ 0.3	+ 0.6
General government	+ 0.6	+ 0.5	+ 0.5	+ 0.3	+ 0.1	+ 0.2
Gross capital formation	+ 0.2	+ 0.5	+ 1.1	+ 1.2	+ 1.2	+ 0.9
Exports	+ 1.6	+ 1.7	+ 1.9	+ 2.1	+ 1.7	+ 1.5
Imports	+ 1.1	+ 1.3	+ 1.6	+ 1.7	+ 1.3	+ 1.0
Gross domestic product	+ 0.7	+ 0.8	+ 0.9	+ 0.8	+ 0.9	+ 1.0
<i>GDP, output approach</i>						
Agriculture, forestry	- 0.3	- 0.2	+ 0.0	+ 0.0	- 0.5	- 0.8
Industry, including energy	+ 1.9	+ 1.6	+ 1.6	+ 2.4	+ 2.5	+ 2.5
Construction	+ 1.0	+ 1.7	+ 2.3	+ 1.8	+ 0.7	+ 0.2
Wholesale and retail trade; repairs; hotels and restaurants; transport, communication	+ 0.6	+ 0.5	+ 0.4	+ 0.5	+ 0.4	+ 0.3
Financial intermediation; real estate, renting and business activities	+ 0.5	+ 0.6	+ 0.6	+ 0.8	+ 1.0	+ 1.0
Other service activities	+ 0.6	+ 0.1	+ 0.3	+ 0.0	- 0.3	+ 0.1
Taxes on products	+ 0.0	+ 0.1	+ 0.3	+ 0.6	+ 0.8	+ 0.6
Subsidies on products	+ 3.1	+ 2.1	+ 1.1	+ 0.3	- 0.6	- 0.0
Percentage changes from previous year						
Gross domestic product, volume	+ 4.1	+ 2.8	+ 3.0	+ 3.4	+ 3.5	+ 3.8

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

Private consumption continues to lack dynamism. In the second quarter it inched up by 0.6 percent from the previous period, but the first quarter result was distorted downward by the low energy consumption due to the mild winter. While some consumer goods categories did grow at rates typical of the business cycle, no upward tendency became yet apparent for vehicle sales. Public consumption, at +0.2 percent over previous quarter, expanded at a slower pace than private consumption.

As can be expected given the buoyant foreign trade sector, it was notably the manufacturing industry that benefited from the upturn. For the second time in a row, it reached the highest growth in value added (+2.6 percent seasonally and working day adjusted) since the introduction of the quarterly calculations (1988). The real estate industry, which comprises the highly cyclical sector of business services, also expanded at a robust pace (+1.5 percent). Growth in the construction industry (+0.2 percent) was weaker than in the first quarter, which had been blessed by mild winter weather (+0.7 percent). Construction activity appears to be gradually losing steam.

The first half of 2007 saw the economy boom on almost all major markets. Growth does not appear to be slowing in China, Japan's economy has fallen into step again, and Europe is recording a vigorous upswing. The most recent moderation in the USA came as no surprise: The strong growth had for the most part been based on an expansion of indebtedness reflected in a near nil household saving rate and a current account deficit of 6 percent of GDP. The housing boom, fanned by house price increases, had been a key driving force behind robust consumption in the USA. A correction was foreseeable, with the increase in interest rates providing the cause.

**US housing crisis
spreading to banking
sector**

However, the problems facing the housing markets in the USA have not been surmounted yet and are set to dampen consumer spending for years to come.

The economic slowdown in the USA up to now has had an adverse impact mainly on the construction of new homes. Now it is increasingly affecting also the banking sector. Some mortgage banks are no longer able to obtain credits. European banks are also affected through the securitisation of debts. This has led to major declines in stock markets at the beginning of August. Plunging stock prices encouraged recession fears, which received a further boost from weak labour market developments in the USA.

Last year's increase in interest rates was among the reasons for the end of the house price boom, which led to a massive decline in housing investment. The Fed left the federal funds rate unchanged at 5.25 percent at the beginning of August. An interest rate cut in the USA, which could have a calming effect, is quite unlikely in the coming months, given that inflation in the USA has accelerated and the Fed judges the threat of inflation to be high.

The downward risks for the US economy have doubtlessly risen. Furthermore, the conditions for granting credits may very well be tightened following the problems with sub-prime loans. While private consumption has so far withstood the downward tendencies, thanks to vigorous job and real wage gains, experience shows that a lagged impact of house price and housing construction developments on private consumption has to be expected¹.

The crisis on the US mortgage market sent stock prices plummeting also on the European stock markets at the beginning of August. After wrong speculation on the US housing market, a German small and medium-sized companies' bank had to be saved in a rescue operation by German banks and the Ministry of Finance. However, growth momentum and earnings performance appear to be strong enough to withstand the turmoil triggered by the mortgage markets.

Economic growth in the euro area has remained robust, in spite of the slowdown in the US economy, high crude oil prices and the depreciation of the dollar. The internal dynamics of the economic activity, sustained by investment and positive sentiment, has proved to be more important than exogenous factors. In the second quarter, euro area real GDP grew by 0.7 percent quarter-on-quarter (+3.1 percent year-on-year), according to the revised estimates. For the second quarter, leading indicators point to ongoing positive developments, which are likely to have lost some steam, however. The Euroframe leading indicator indicates lively growth for 2007, with surveys in industry and construction confirming the robust nature of the upturn.

Growth in the euro area continues to be driven by exports and investment. Consumer spending still lacks momentum, with retail sales in June exceeding the year-earlier level by just close to 1 percent, and the personal savings ratio following a slightly upward trend over recent quarters.

The unemployment rate in the euro area dropped markedly in reaction to the economic upturn, and in June remained stable at 6.9 percent (seasonally adjusted). The lowest unemployment rate was recorded by the Netherlands.

Inflation remains low in the euro area, despite high crude oil prices and the buoyant economy. It stood at 1.9 percent in June and for July is estimated at 1.8 percent by Eurostat. Against the background of the economic rebound and the rising inflation risks following from it, the European Central Bank raised its key interest rate by 0.25 percentage points every quarter. Many anticipate another interest rate increase for September. Statements by the ECB's president that the central bank would exercise "great vigilance" in observing inflation developments also point in that direction.

¹ Marterbauer, M., Walterskirchen, E., "Einfluss der Haus- und Wohnungspreise auf das Wirtschaftswachstum" (Effect of House Prices on Economic Growth), WIFO-Monatsberichte, 2005, 78(11), pp. 761-774, http://www.wifo.ac.at/www/isp/index.jsp?fid=23923&id=25815&typeid=8&display_mode=2.

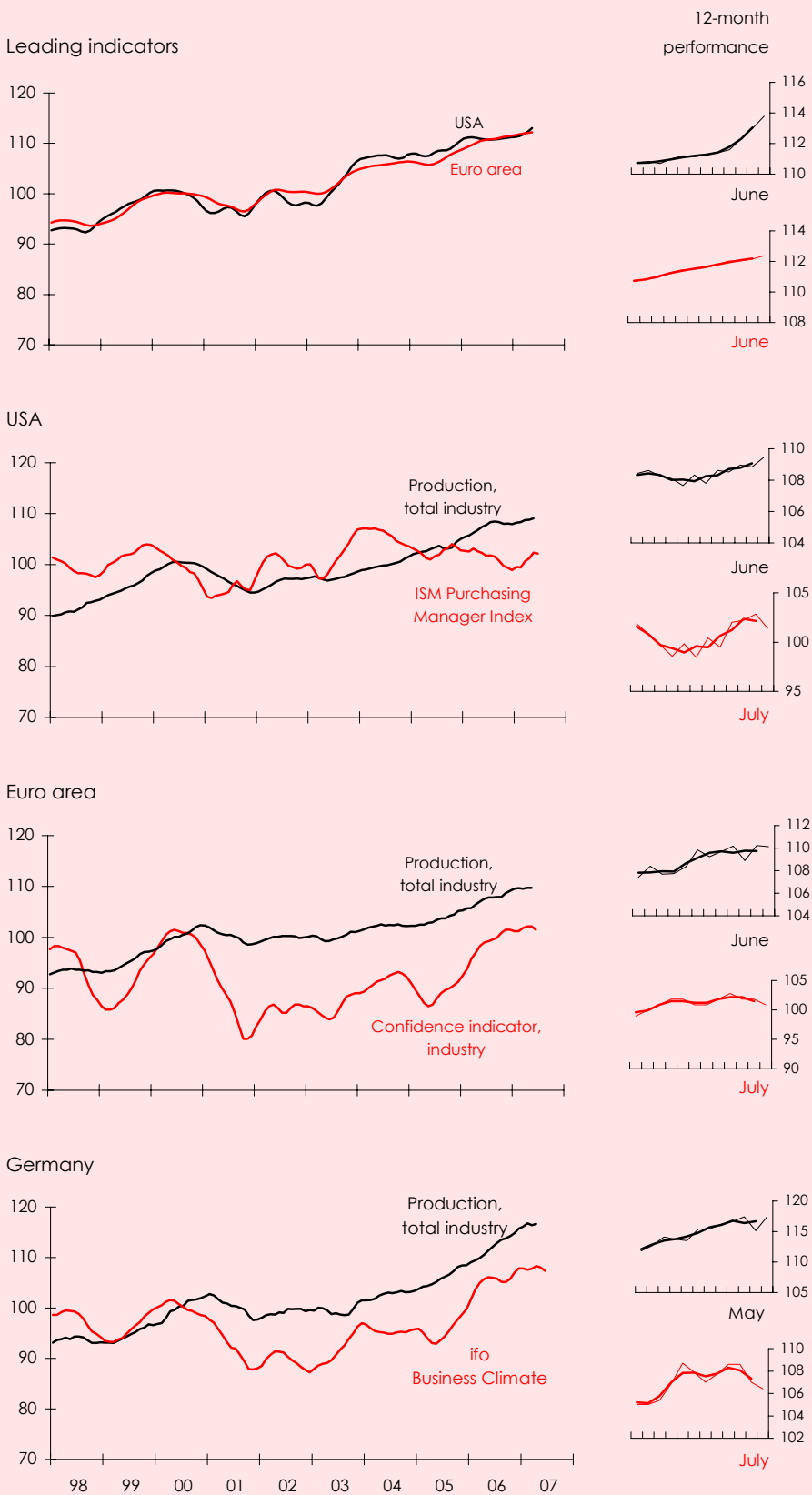
Growth of the US economy decelerated markedly, to a seasonally adjusted annual rate of just 1¼ percent in the first half of 2007. The housing crisis affects not only the construction industry but also the banking sector.

Euro area economy performing strongly

In the euro area, the upswing is based on strong investment and export growth. A spillover of the US housing and credit crisis onto the euro area economy is not very probable.

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.

One uncertainty surrounding the economic outlook for the EU relates to the possibility that – similar to the USA – the house price boom may soon be coming to an end in Great Britain, Spain and other EU countries. This risk is augmented by the interest rate increase.

The upturn of the German economy continued in spring, with growth most likely moderating from early in the year, though.

While the seasonally adjusted rate of growth of industrial activity did not accelerate further in April and May, the gap in production output compared with the year-earlier level rose to +5¼ percent. The demand for capital goods increased relative to the first quarter, with order book levels in April and May exceeding those in the first quarter by around 2 percent (seasonally adjusted). Large-scale orders from abroad played an important role here. Notably the manufacturers of capital goods benefited from demand developments. Germany gains especially from the international investment boom, given the specialisation of Germany's industry in machinery and vehicles.

Private consumption, which in the first quarter had been affected by the VAT increase, recovered in the second quarter. Retail sales volumes expanded, with the number of new cars purchased also rising.

Germany's labour market is on a clear upward trend. In June, the number of persons employed exceeded the year-earlier level by 458,000 (+1.2 percent). Unemployment declined much more strongly (–712,000) than jobs increased. This implies that a substantial proportion of unemployed persons did not find a job that is subject to social insurance contributions, but due to Hartz IV measures are no longer regarded as unemployed.

The outlook for the labour market remains favourable: According to Ifo's Employment Barometer, the readiness of companies to employ more staff improved further in July. The lack of skilled personnel is becoming increasingly apparent.

The good sentiment among German companies persists, notwithstanding a slight decline in July in Ifo's Business Climate Index. The upturn is not in jeopardy and is set to continue also in the second half of the year despite the dollar depreciation and higher crude oil prices, provided the turmoil on the financial markets calms down.

The Austrian economy grew by +3.3 percent in 2006, moderately exceeding the rate computed in first calculations. The main reason lies in higher value added figures for the banking and insurance sector.

The second quarter saw yet another slight strengthening of the upturn. According to WIFO's latest flash estimate, real GDP advanced by 1 percent (seasonally and working day adjusted) quarter-on-quarter and by 3.8 percent year-on-year.

Robust euro area growth is having a favourable effect on Austrian exports, which, together with investment, are driving the upturn. Firms in the manufacturing sector intend to increase their investment by 21 percent in nominal terms in 2007, according to the WIFO investment survey.

Evidence from WIFO's July business survey shows that companies in the manufacturing sector continue to be on the upbeat. The assessment of order books and production expectations remain at record levels. 41 percent of the surveyed companies judge their current business situation to be good, whereas only 10 percent are not content with it.

Manufacturers of capital goods, intermediates and motor vehicle parts judge their order situation to be particularly favourable. In contrast, the assessment of order books by manufacturers of non-durable consumer goods and the food and luxury food industry is clearly more unfavourable than that of other branches of industry.

The index of production for the manufacturing sector rose at a working day adjusted year-on-year rate of 7 percent in April and May – a slight decline from the first quar-

Germany: export and manufacturing boom

The German economy benefits to a particular extent from the high demand for capital goods in the EU, due to its extremely good competitive position in this line.

Austrian economy buoyant

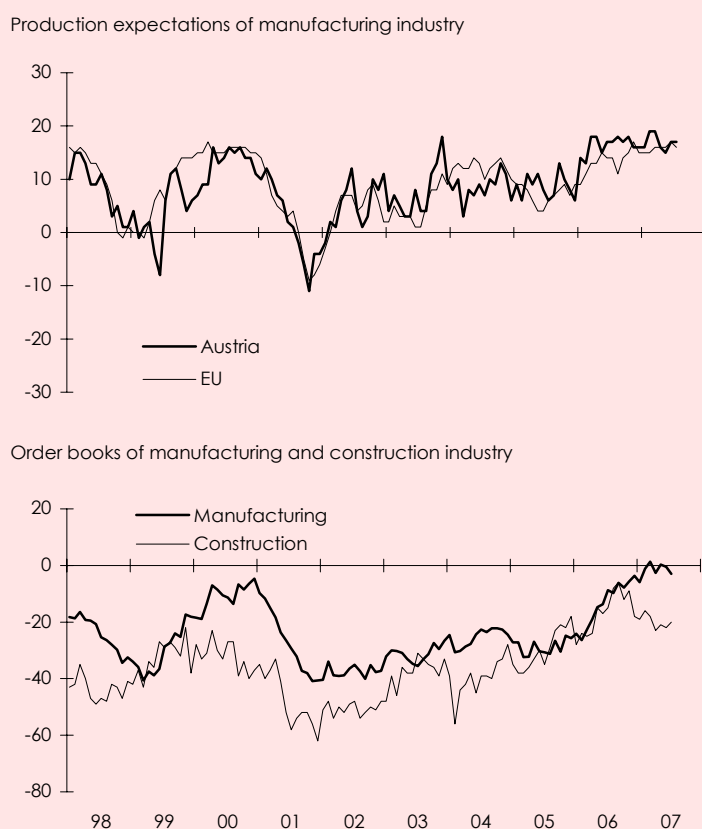
The sentiment among Austrian companies has been excellent for several months now, but has not improved further.

ter (+9 percent). Particularly strong production growth was recorded for capital goods and intermediates.

The construction industry continues to register above-trend growth. In the first quarter, building construction and civil engineering posted two-digit growth rates – also owing to the mild weather. Once these weather effects ended, growth flattened somewhat in the second quarter. While in recent years construction activity has mainly been driven by the civil engineering sector, owing to additional investment in road and rail infrastructure, residential and housing estate construction has of late assumed the leading role.

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.

The outlook for the construction industry for the months to come is optimistic: New orders have risen further, and sentiment remains upbeat. Growth is picking up also in the business services sector, which is reflected not only in business survey data, but also in strong employment gains.

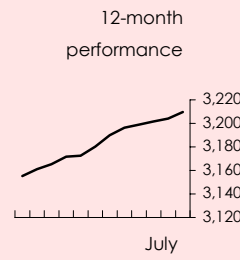
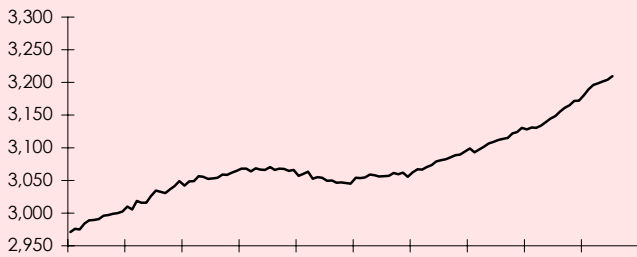
Between January and May, the year-on-year increase in goods exports averaged 10 percent in nominal terms, with the expansion of exports to the EU (+10 percent) – notably to Germany – contributing significantly to this favourable result. Above-trend growth was registered for exports to Southeast Europe, OPEC countries, CIS countries and non-OPEC developing countries. The new EU countries also proved to be very receptive to goods exported by Austria.

Imports increased at a clearly slower pace than exports, notwithstanding rising domestic demand and buoyant investment activity. Between January and May, they exceeded the year-earlier level by around 8 percent on average. The trade balance showed a surplus of almost € ½ billion.

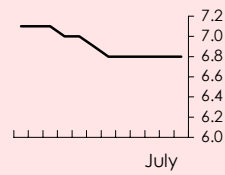
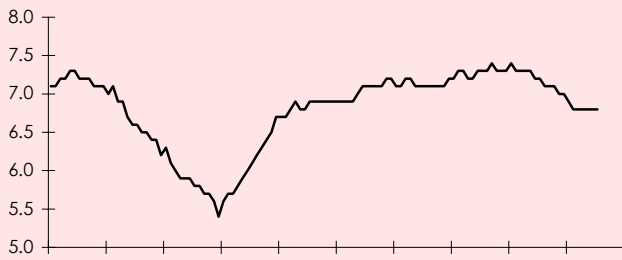
Manufacturing spurred by exports

Figure 3: Key Economic Indicators

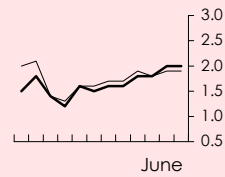
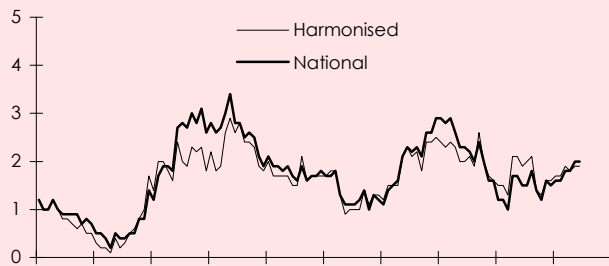
Persons in active dependent employment¹, (1,000), seasonally adjusted



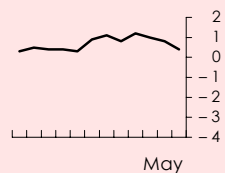
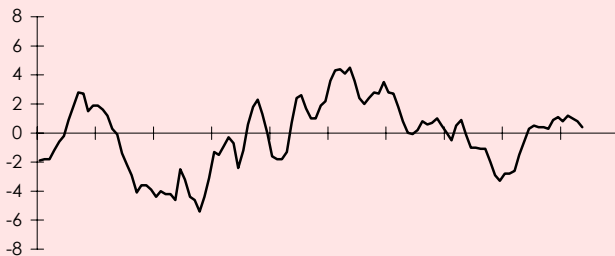
Unemployment rate, traditional Austrian method², seasonally adjusted



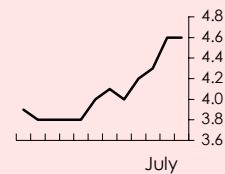
Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



Exports continued to grow at an undiminished pace in the first half of 2007. Financial market turbulences pose risks for the second half, however.

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.

Retail sales grew at a relatively slow pace from January to May (+1½ percent in real terms year-on-year). Furthermore, sales of new cars declined again; new car registrations were down from a year earlier, with the high fuel prices believed to be among the reasons for the weak car sales. Moreover, the increase in the number of leasing and demonstration cars acquired is a sign for a shift in car registrations from dependently employed persons (consumption) to self-employed persons (investment).

In spring, many private households received refunds for their reduced energy consumption during the mild winter, which increased their purchasing power. This has not yet been reflected in household consumption. However, the evaluation of consumption developments is rendered more difficult by statistical uncertainties regarding tourism expenditure by domestic travellers abroad.

The consumer confidence indicator established by the EU through household surveys is climbing from one peak to another in Austria. This reflects the general economic situation rather than the propensity to consume. Private households intend to continue to exercise thrift with regard to big-ticket purchases as they judge their own current financial situation to be more unfavourable than at any time since the introduction of the surveys in the nineties.

In the first two months of the summer season, tourism sales reached € 3.22 billion, according to preliminary calculations; this is an increase by 5.6 percent from the same period a year earlier. The number of overnight stays rose by 3.5 percent. Particularly lively demand was registered from domestic guests.

Looking at the markets of origin, the picture is quite diverse: While vigorous increases were registered on the main markets Germany (+4.7 percent), the Netherlands and Switzerland, marked declines were reported from Italy, the USA and France.

All federal provinces recorded sales increases in May and June. They were highest in Vorarlberg, Carinthia and Tyrol; Vienna marginally surpassed last year's record high.

Prices on the international commodity markets rose more strongly again in June. The price of Brent crude climbed to more than \$ 70 per barrel, an increase by almost \$ 4 from May.

Headline inflation stood at 2.0 percent in June, according to calculations by Statistics Austria. It was thus unchanged from May but higher than at the beginning of the year. Electricity, gas and food were noticeably more expensive than a year before, and clothing and restaurants also posted a higher-than-average price increase. Telephone charges continued to have a dampening effect and the prices of manufactured goods rose only marginally.

The Harmonised Index of Consumer Prices rose by +1.9 percent in June, somewhat more slowly than the Austrian index. Hence, inflation was in line with that in the euro area.

In the first half of the year, negotiated wages grew by 2.4 percent from a year earlier. This year's autumn pay round will be influenced by the favourable economic situation and the modest pickup in inflation. Sharing the high profit gains with dependently employed persons may be up for discussion in some sectors.

While employment growth continued in spring, it no longer reached the record levels of the winter months owing to the mild weather. In July, the number of persons in active dependent employment increased by 60,700 compared with a year earlier. More than half of all additional jobs were filled with men, suggesting a substantial increase in full-time employment. The majority of additional jobs were offered in the business services, health services, and trade and tourism sectors. Unlike in recent years industry and construction also added a significant number of new jobs.

Private consumption remains subdued

Private consumption remains a weak point of economic activity. Stagnating real net incomes allow relatively little leeway for higher expenditure without changes in the savings propensity or in consumer credits, respectively. The increase in purchasing power is for the most part attributable to employment gains.

Good beginning of summer tourist season

In the first few months of the summer season, tourism developed more favourably than last year. Early summer weather at the beginning of the early season provided stimulus to tourism in summer resorts.

Inflation accelerating marginally

Inflation hit the 2 percent mark in May and June, mainly due to price increases for electricity, gas and food.

Modest decline in unemployment despite strong employment gains

The foreign workforce is growing faster this year than last year, outpacing the year-earlier number by 20,000 in June. The domestic labour supply also grew at a vigorous pace – boosted by the buoyant economy.

The strong increase in employment was fed only by around one third from unemployment (including participation in training programmes); one third of the additionally employed persons were foreigners, another third came from the domestic workforce (mostly women). In June, 185,400 persons were registered as unemployed with the Public Employment Service, a decline by 11,300 from a year earlier. The decline was markedly lower in spring and summer than during the winter months. Measured against the increase in employment, the decline in unemployment was modest, in part slowed down by the reduction in training measures (July –6,300). A larger proportion of labour market policy funds are being spent on apprentices training measures.

Employment is posting significant gains, but only relatively few new jobs are filled with unemployed persons. The decline in unemployment has been modest when measured against the number of new jobs created.