

Sandra Steindl

Economic Growth Driven by Strong Industrial Activity

Business Cycle Report of June 2007

Against the background of robust economic activity in Europe, Austria's economy grew at a seasonally and working day adjusted rate of 0.9 percent in real terms quarter-on-quarter in the first quarter of 2007. The previous year's level was exceeded by 3.5 percent. Driver of the expansion, apart from the once again strong manufacturing industry, was the construction sector, which benefited from the mild winter weather. Business sentiment among companies continues to be positive; order levels are hitting record highs. According to WIFO's monthly business survey the buoyant industrial activity is set to stabilise in the months to come, however.

All staff members of the Austrian Institute of Economic Research contribute to the Business Cycle Report. • Cut-off date: 6 June 2007. • E-mail address: Sandra.Steindl@wifo.ac.at

According to the revised figures, the Austrian economy expanded in the first quarter at a seasonally and working day adjusted rate of 0.9 percent in real terms from the previous period (following +0.7 percent in the fourth quarter). Compared to the previous year, the growth rate was 3.5 percent. Main drivers of the development were once again the manufacturing sector (+1.6 percent in real terms quarter-on-quarter) and the construction industry (+0.9 percent in real terms quarter-on-quarter).

Given the good sales situation, manufacturing companies increasingly invested in expansion: the demand for equipment rose by 0.7 percent in real terms from the previous quarter. Construction investment also increased significantly in the first quarter (+1.0 percent in real terms quarter-on-quarter), with both investment in residential and non-residential building construction rising noticeably as the sector benefited from the mild winter weather. Foreign trade results fell behind the high rates of last year: goods exports rose by 1.3 percent (seasonally adjusted) quarter-on-quarter, imports advanced by 0.7 percent.

The current international environment is favourable. While industrial activity in the USA has moderated in recent months, the European economy continues to record stable growth. Investment activity is turning into the main engine of growth, and the upturn is becoming more broad-based geographically. Euro area real GDP grew by 0.6 percent (seasonally adjusted) in the first quarter, compared with the previous quarter. In spite of consumption losses early in the year following the increase in the value added tax rate, economic growth in Germany regained momentum thanks to robust industrial activity and reached 0.5 percent. Sentiment indicators for the current quarter show a high degree of confidence among companies; incoming orders in industry continued to rise at a robust pace.

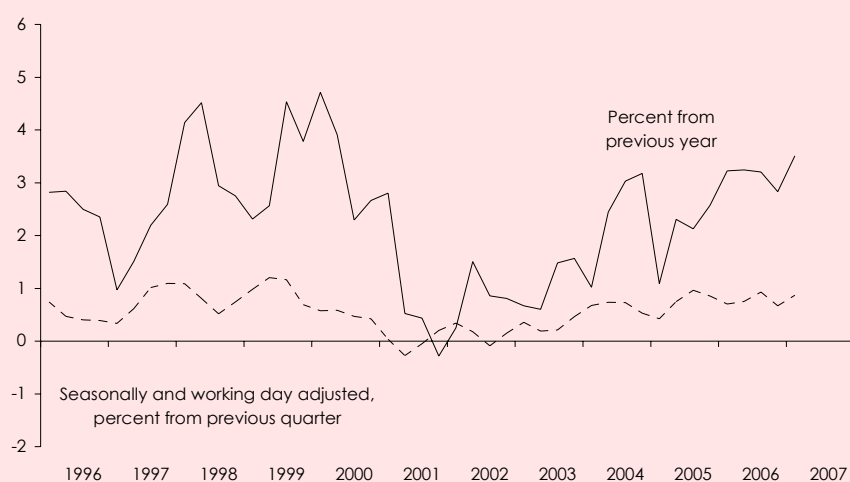
The results of the WIFO business survey for May point to an expansion in industrial production also in Austria, although it has probably already reached its peak. Manufacturers reported their highest order levels since 1990. With the labour market stabilising, consumer sentiment is also seen to brighten substantially. Personal consumption expenditures rose only modestly in the first quarter, though with the rate of change (+1.5 percent in real terms year-on-year) held down by the decline in fuel consumption owing to the mild weather. Business was particularly good for retailers. Value added in the trade sector rose by 0.5 percent in real terms quarter-on-quarter (+2.4 percent year-on-year), with the modest development of motor vehicle sales having a dampening effect, however.

Table 1: Quarterly national accounts

			2005	2006				2007
			Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter
			Percentage changes from previous quarter					
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.5	+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 0.3
Households ¹			+ 0.5	+ 0.4	+ 0.5	+ 0.5	+ 0.4	+ 0.3
General government			+ 0.4	+ 0.3	+ 0.1	+ 0.2	+ 0.3	+ 0.3
Cross capital formation			+ 0.3	+ 0.5	+ 1.1	+ 1.3	+ 1.1	+ 1.0
Gross fixed capital formation			+ 0.7	+ 1.1	+ 1.3	+ 1.3	+ 1.1	+ 1.0
Machinery and equipment			+ 0.7	+ 0.5	+ 0.7	+ 0.9	+ 0.5	+ 0.7
Construction			+ 0.8	+ 1.4	+ 1.6	+ 1.7	+ 1.4	+ 1.0
Exports, goods and services			+ 1.6	+ 2.8	+ 1.4	+ 1.3	+ 1.2	+ 1.1
Goods			+ 2.2	+ 2.8	+ 2.4	+ 1.8	+ 1.5	+ 1.3
Services			+ 1.5	+ 1.6	+ 1.0	+ 0.7	+ 0.6	+ 0.7
Imports, goods and services			+ 1.2	+ 2.3	+ 1.4	+ 1.2	+ 1.0	+ 0.6
Goods			+ 1.5	+ 1.7	+ 1.8	+ 1.2	+ 0.9	+ 0.7
Services			+ 0.8	+ 3.9	+ 0.8	+ 1.1	+ 0.7	+ 0.5
Gross domestic product			+ 0.9	+ 0.7	+ 0.8	+ 0.9	+ 0.7	+ 0.9
Manufacturing			+ 1.7	+ 1.9	+ 2.3	+ 2.5	+ 1.9	+ 1.6
	2005	2006	2005	2006				2007
			Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter	First quarter
			Percentage changes from previous year					
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 1.8	+ 1.8	+ 2.3	+ 1.7	+ 2.1	+ 1.6	+ 1.8	+ 1.3
Households ¹	+ 1.7	+ 2.0	+ 2.5	+ 1.7	+ 2.4	+ 1.8	+ 2.1	+ 1.5
General government	+ 1.9	+ 1.2	+ 1.8	+ 1.8	+ 1.1	+ 0.9	+ 0.9	+ 0.8
Cross capital formation	- 0.4	+ 3.3	- 2.7	+ 4.0	+ 2.7	+ 4.5	+ 2.4	+ 16.3
Gross fixed capital formation	+ 0.3	+ 4.3	- 0.6	+ 5.2	+ 2.2	+ 4.4	+ 5.4	+ 6.8
Machinery and equipment	+ 0.2	+ 3.2	- 2.6	+ 4.3	+ 2.8	+ 3.0	+ 2.8	+ 4.1
Construction	+ 0.4	+ 5.2	+ 0.8	+ 7.0	+ 1.8	+ 5.5	+ 7.1	+ 10.3
Exports, goods and services	+ 6.4	+ 8.8	+ 6.6	+ 11.5	+ 8.0	+ 7.7	+ 8.2	+ 4.9
Goods	+ 5.8	+ 10.2	+ 5.7	+ 14.7	+ 7.3	+ 9.2	+ 10.0	+ 6.2
Services	+ 8.1	+ 4.8	+ 9.6	+ 3.5	+ 10.3	+ 3.7	+ 2.4	+ 1.6
Imports, goods and services	+ 5.2	+ 6.8	+ 1.9	+ 9.8	+ 5.3	+ 5.9	+ 6.4	+ 4.4
Goods	+ 5.9	+ 6.6	+ 1.7	+ 10.3	+ 5.2	+ 6.2	+ 5.2	+ 4.9
Services	+ 2.6	+ 7.3	+ 2.9	+ 7.8	+ 5.8	+ 5.2	+ 10.5	+ 1.8
Gross domestic product	+ 2.0	+ 3.1	+ 2.6	+ 3.2	+ 3.2	+ 3.2	+ 2.8	+ 3.5
Manufacturing	+ 2.6	+ 7.9	+ 7.0	+ 6.7	+ 6.6	+ 9.0	+ 9.0	+ 8.9
Gross domestic product, value	+ 3.9	+ 4.7	+ 4.2	+ 4.3	+ 5.1	+ 4.8	+ 4.7	+ 5.5

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

Figure 1: Growth of real GDP



Source: WIFO.

The inflation rate (CPI) stood at 1.8 percent in April. At 1.7 percent according to the HICP it was lower than the euro area average. Notably services for housing maintenance became more expensive.

The buoyant economy continues to have a positive impact on the labour market. May saw active employment in Austria rise by 2.0 percent, while the number of unemployed fell by 197,800 (-6.6 percent compared to a year earlier). The seasonally adjusted unemployment rate was 6.8 percent according to the national definition, or 4.4 percent according to Eurostat.

The US economy grew at a quarter-on-quarter pace of only 0.2 percent (seasonally adjusted) in real terms in the first quarter. Responsible for the slowdown, apart from sluggish investment, was notably the negative contribution from net exports. Personal consumption expenditures again proved to be an important mainstay of economic activity (accounting for around two thirds of GDP). Their real increase by 1.1 percent from the previous quarter was reflected in a once again negative saving ratio.

After a weak first quarter, industrial production was increased in April, and capacity utilisation rose to 81.6 percent. This could point to a pickup in investment. To date labour market developments have remained robust, despite the slack economy, and have sustained the positive sentiment among consumers. In April, the seasonally adjusted unemployment rate stood at 4.5 percent.

The outlook for the economy will be determined largely by the impact the slowdown in industry and the construction sector will have on consumer spending and companies' readiness to take on new staff. According to the Conference Board Consumer Confidence Index and the Reuters/University of Michigan's Consumer Sentiment Index – which are advance indicators of private households' buying behaviour – consumer confidence has stabilised in recent months after declining at the beginning of the year.

With their economies continuing to expand at a rapid pace, China and India contribute significantly to world economic growth. The growing global interdependence and the current account surplus of these countries keep the level of long-term interest rates low internationally.

Japan's economy appears to have overcome the crisis, despite currently sluggish investment growth and the prevailing weakness in industrial production. Sustained by private consumption and net exports, real GDP advanced at a quarter-on-quarter pace of 0.6 percent in the first quarter. The central bank has held its key interest rate steady at 0.5 percent since February 2007.

While growth in the USA, where investment and industrial activity are rather sluggish at present, is largely driven by private consumption, the impetus in Europe stems mainly from vigorous business investment and excellent order book levels in industry. In the first quarter, the euro area economy grew at a robust pace of +0.6 percent (seasonally adjusted) quarter-on-quarter. The upswing is broad-based geographically. Only Italy saw sluggish growth in private consumption and industrial production.

In the euro area, the assessment of the outlook for the current quarter is altogether positive. The European Commission's business climate indicator points to ongoing strong expansion in industrial production in the months ahead. The consumer confidence index rose noticeably in May, reflecting a high measure of household confidence both in the euro area and in the EU as a whole.

Slowdown in the USA, continued robust growth in Asia

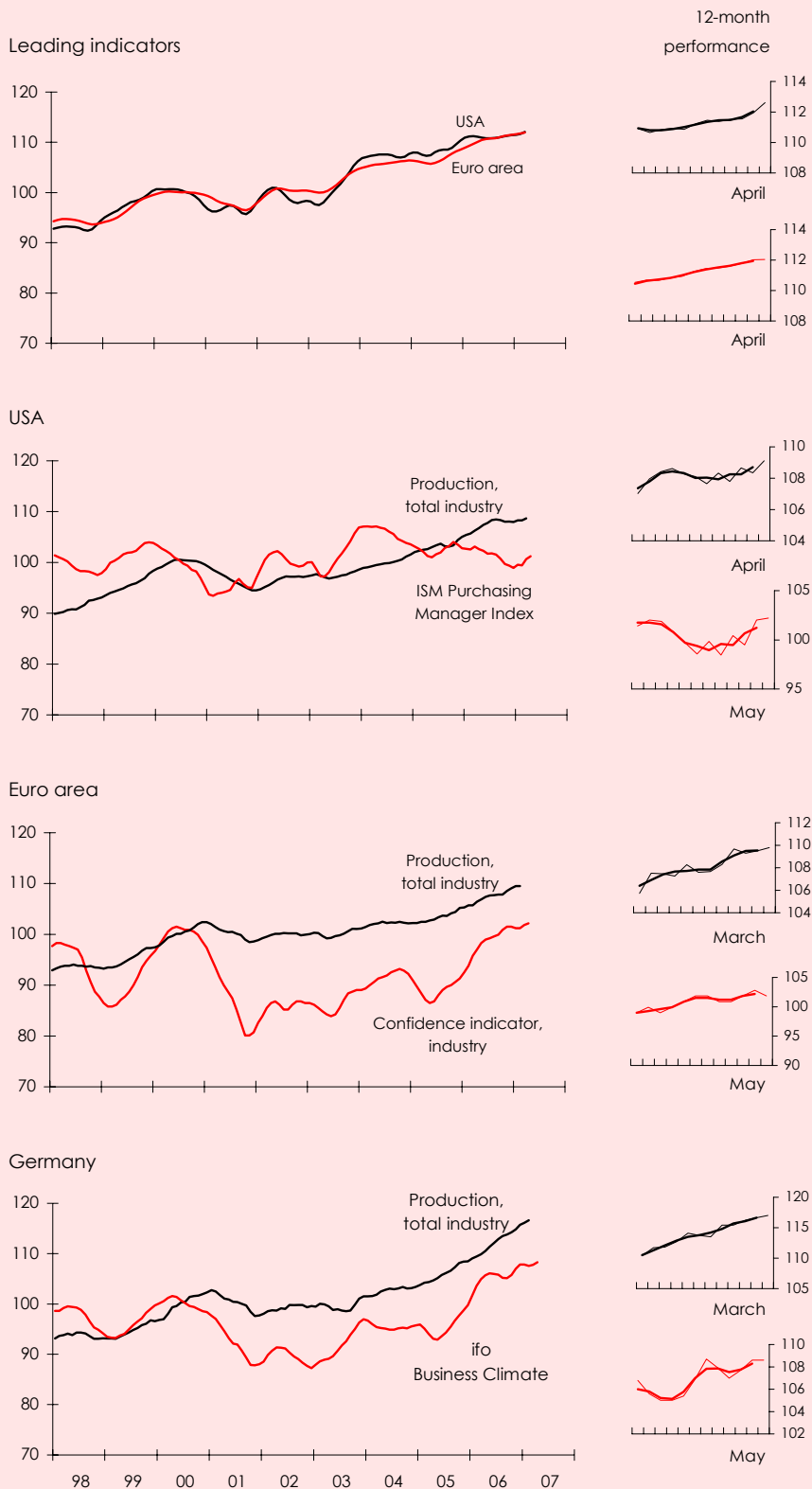
The US economy clearly lost momentum in the first quarter.

Upswing in EU continues

Following strong growth in the first quarter, leading indicators in the EU point to continued robust expansion.

Figure 2: 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.

At a quarter-on-quarter rate of +0.5 percent, the German economy expanded at a surprisingly vigorous pace in the first quarter despite the VAT increase. Growth was driven by investment following the increase in capacity utilisation as well as by the persistent export boom. The German chemical industry is doing particularly well, thanks to lively domestic and foreign demand. Sentiment indicators published by ZEW and Ifo, point to a continuation of the upward trend also in May. The climate for consumption is also brightening: consumer readiness to purchase larger items, which had been dampened by the VAT increase at the beginning of the year, rose again in the second quarter, mainly in reaction to a more favourable assessment of labour market conditions.

Buoyant activity in the metal and electrical industries for the first time in years brought about higher wage settlements; the pass-through of the cost increase to the economy as a whole is expected to be limited, though. Sustained by the economic rebound and also benefiting from the mild weather, employment growth accelerated in almost all sectors of the economy in the first quarter of 2007. While in April the number of unemployed persons for the first time since 2002 dropped below the 4 million mark thanks to well-filled order books, labour market conditions improved even further in May.

The Bundesbank (German Federal Bank) estimates the impact of the VAT increase on inflation in Germany at around +1 percentage point to date¹. According to Eurostat's flash estimates for May, euro area inflation remained unchanged at 1.9 percent. To curb inflationary pressures during the upswing, the key interest rate was raised gradually from 2 percent at the end of 2005 to 3.75 percent. Given the robust economic expansion in the euro area, strong monetary expansion, and higher wage settlements in Germany, the ECB might take another interest rate step in June.

Oil prices continue to be highly volatile. Following their decline at the beginning of the year due to weather conditions and lower consumption, they rose again in the second quarter. In May, the price of Brent Crude stood at 67.9 \$ per barrel. As the revenues of the oil exporting countries normally flow back into the international economic system with a time lag, exports are set to once more gain vigorous momentum.

The strong acceleration of commodity prices eased at the beginning of the year. In May, the HWWI Index of World Market Prices of Commodities exceeded the year-earlier level (in dollar terms) by around 1 percent.

Following an increase by +0.7 percent in the fourth quarter of 2006, Austrian real GDP growth in the first quarter of 2007 accelerated to 0.9 percent (seasonally adjusted) compared to the previous period, according to the second calculation. Industrial activity is dynamic, with high order volumes providing a strong stimulus. The working day adjusted production index rose by 8.5 percent year-on-year in the first quarter. Value added growth in manufacturing was 8.9 percent in real terms. Construction also posted high gains (+9.7 percent year-on-year in real terms), with civil engineering recording a particularly high increase in order book levels. Factors benefiting the boom in the construction sector were the buoyant economy combined with the mild weather.

The dynamic industrial activity continues to strengthen investment. Construction investment grew by 10.3 percent in real terms, compared to the first quarter of 2006. Given the favourable sales situation, companies invest increasingly in expansion. The demand for equipment exceeded the year-earlier level by 4.1 percent in real terms.

The results of the monthly WIFO Business Cycle Survey commissioned by the European Commission signal a continuation of the upward trend; growth in industry appears to have already reached its peak, though: companies judge the production

German industry booming

The German economy continues on its growth path.

Oil prices rising again

After a short decline at the beginning of the year, crude oil prices are rising again.

Investment strengthened by Austria's booming industry

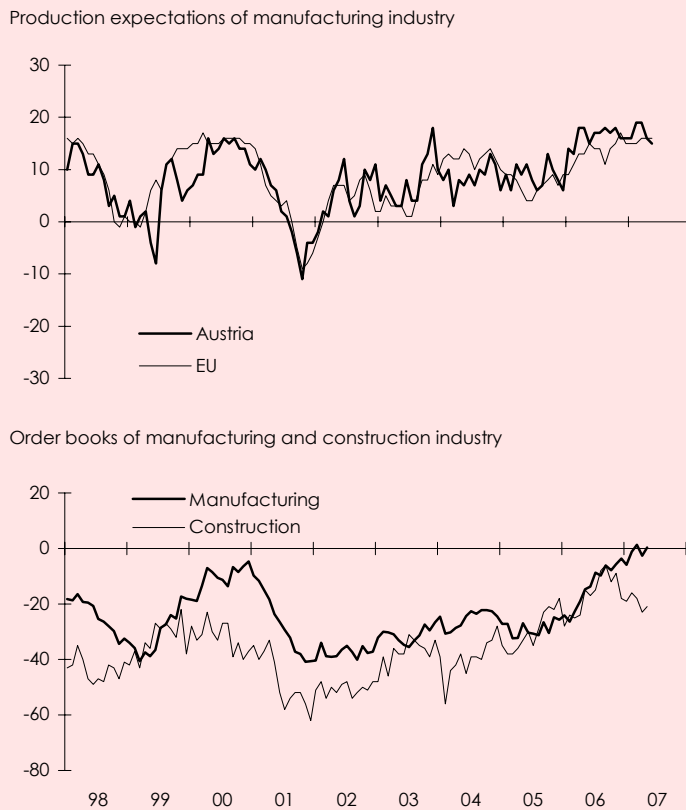
The Austrian economy grew by 0.9 percent in real terms quarter-on-quarter in the first quarter. Manufacturing and construction expanded vigorously.

¹ Deutsche Bundesbank, "Konjunkturlage in Deutschland" ("Economic Conditions in Germany"), Monthly Report, May 2007, pp. 44-59.

and sales outlook for the months to come positively, albeit without anticipating a further improvement. After a strong first quarter, developments in the construction industry also appear to be cooling somewhat. Companies expect sales levels to be sufficient, however, and believe employment will continue to post extraordinary gains.

Figure 3: 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.

External demand, the most important pillar of economic activity last year, lost some momentum in the first quarter of 2007. Goods exports rose by 6.2 percent in real terms year-on-year (following +10.0 percent in the fourth quarter of 2006). Services exports exceeded the year-earlier level by 1.6 percent in real terms, with the lack of snow in winter weighing on the result for the tourist trade. Goods imports advanced by 4.9 percent from a year earlier. More than 70 percent of Austrian goods exports go to the EU 27, around 30 percent to Germany. This percentage dropped slightly at the beginning of the year owing to the increase in the value added tax rate in Germany. Overall, the cumulative nominal growth of exports to the EU 27 was around 4 percent in the first quarter, according to the foreign trade statistics. Goods exports to third countries, at +10 percent, rose at a clearly higher rate.

With real value added growth of 2.4 percent compared to the first quarter of 2006, business was particularly lively for the trade sector. Clothing sales benefited from the positive consumer sentiment, combined with the unusually warm weather in March – the summer collection was in demand much earlier than usual. In May, consumers exhibited confidence notably regarding the general economic situation and the

External trade losing momentum

Export growth decelerated somewhat, despite the favourable environment in Europe.

Retail sales on the rise

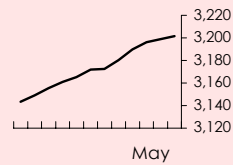
stabilisation of labour market conditions. While the current financial situation is described as less favourable, the outlook for the coming 12 months is very positive.

Figure 4: Key economic indicators

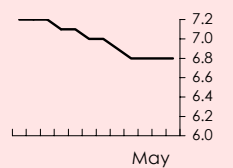
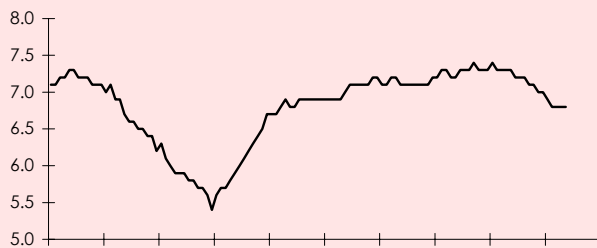
Persons in active dependent employment¹, (1,000), seasonally adjusted



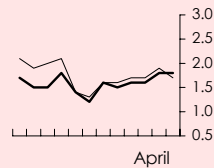
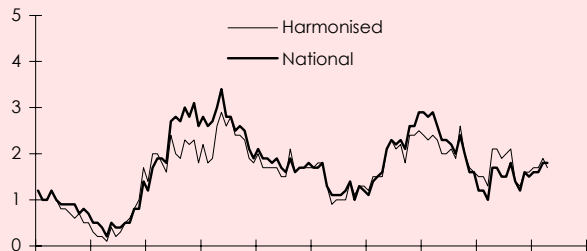
12-month performance



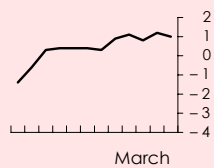
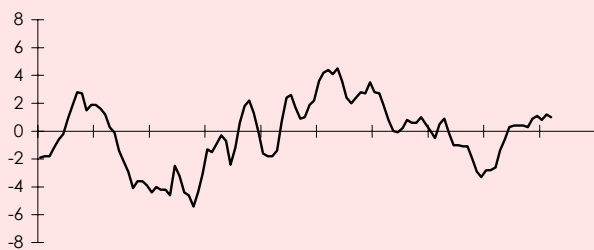
Unemployment rate, traditional Austrian method², seasonally adjusted



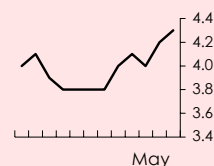
Consumer prices, year-to-year percentage changes



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.

Private consumption growth was subdued in the first quarter (+1.5 percent year-on-year). Less energy was needed for heating purposes due to the mild weather. As energy providers refund higher advance payments only with a lag to private households, this led to a "forced savings effect" in the first quarter.

While wholesalers also reported the course of business to be good, car dealers posted a decline in sales in the first quarter.

Tourism developed quite favourably, considering the lack of snow in the 2006-07 winter season: according to preliminary calculations, sales volumes slightly exceeded the previous all-time record set last year (+0.7 percent) and for the first time reached more than € 10 billion. The number of overnight stays, totalling 59.4 million, maintained its high level.

The overall result of the past winter season was determined notably by the decline in the demand by foreign guests (-1.3 percent in total); the number of overnight stays by resident travellers stagnated. High losses (-6.1 percent) were recorded in Germany – the most important market of origin; the number of overnight stays by Italian and French guests also declined. A substantial increase could be observed on the British market, however, whereas the demand from the Netherlands, Belgium, the USA and Switzerland rose at a slower pace.

Sales developments in the 2006-07 winter season followed a clear East-West gradient: while the tourism sector in Burgenland, Lower and Upper Austria and Vienna posted strong gains, sales declined compared to last year for the tourist industry in Vorarlberg, Tyrol, Salzburg and Styria, i.e., in regions that are more dependent on winter sports. Only Carinthia was able to register a vigorous sales increase thanks to relatively favourable snow conditions.

The national inflation rate (CPI) rose to 1.8 percent in April from 1.7 percent in the first quarter of 2007, with the expenditure group "Housing, Water and Energy" continuing to account for about half of the increase. The cost of housing maintenance increased noticeably. While food and non-alcoholic beverages in April registered a marked price increase from previous months, prices in the "Communications" group declined once again.

The harmonised inflation rate (HICP) stood at 1.7 percent in April and was thus lower than the average for the first quarter and persistently lower than the euro area average (1.9 percent). The national index and the HICP differ in part as to what they cover, one example being the price development of owner-occupied flats, which is taken into account only in the CPI.

Due to the good performance of the manufacturing sector, producer prices for industrial goods, at +3.4 percent rose clearly faster than on average in 2006 (+1.8 percent).

The buoyant economy continues to have a positive effect on the labour market. In May, the increase in the number of persons in dependent active employment reached 62,800 (+2.0 percent) and was broad-based across larger parts of the economy. Strengthened construction investment and the excellent order situation in industry translated into employment gains in construction and manufacturing. The heterogeneous sector of business services, which also encompasses manpower leasing, also took on additional staff.

The number of vacancies registered with "AMS" (Public Employment Service) continues on an upward trend, and with 41,900 in May exceeded the year-earlier level by 7,400.

The number of persons registered as unemployed fell to 197,800 in May, a drop by 6.6 percent compared to the same month a year earlier. The pace of the decline in unemployment moderated in May as the spring revival that is normal for this time of

Retailers posted strong increases in sales volumes. Consumption expenditures were dampened by the decline in fuel consumption.

Sales up in winter tourism despite lack of snow

Persistently moderate inflation

Headline inflation was 1.8 percent in April, slightly higher than in the first quarter. This can be largely attributed to price increases for housing, energy and food.

Further employment gains

While employment continues to react to the economic upswing, the decline in unemployment decelerated in May.

the year had already set in sooner due to the mild winter. The reduction in training measures (-5,500 year-on-year in May) is another factor that has slowed down the decline in unemployment since the beginning of the year.

The seasonally adjusted unemployment rate according to the national method of calculation was 6.8 percent in May, a decline by 0.5 percent from a month earlier. According to Eurostat, the seasonally adjusted unemployment rate was 4.4 percent.