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# Austrian Economy Slowly Decelerating

## Business Cycle Report of March 2008

**In the fourth quarter of 2007, the Austrian economy expanded by 0.6 percent compared to the preceding period (seasonally and working day adjusted), still at a vigorous pace. However, there has been a steady decline in growth momentum already since the second quarter of 2007 and also in the first months of 2008, as business surveys show. Until January no signs were yet apparent that this trend was accelerating as a consequence of the slowing US economy, but in February the assessment of the production outlook deteriorated markedly. The exchange rate development is posing a rising threat to Europe's export industry.**

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GDP rose at a seasonally and working day adjusted rate of 0.6 percent quarter-on-quarter in the fourth quarter of 2007, according to the second calculation. While the growth momentum was still high, growth slowed by 0.1 percentage point each quarter since the first quarter of 2007 (+0.9 percent). The growth rate generally reaches its highest value a few quarters before the actual business-cycle peak. At the time of the turnaround in the economy, the growth rate falls back to its average level. At this stage the economy operates at its maximum capacity. If one considers the GDP development a suitable economic indicator, this peak in economic activity was reached in Austria around the turn of the year 2007-08.

Industrial production usually runs somewhat ahead of overall economic activity. Here, the highest growth rates were recorded already in the fourth quarter of 2006. The peak in industrial activity is likely to have occurred half a year later. This is confirmed also by the data companies provided on capacity utilisation, which according to the WIFO business cycle survey reached its peak in the second quarter of 2007.

The course of events in the USA is casting a shadow over international economic developments: after almost flat GDP growth in the USA in the fourth quarter of 2007 (+0.2 percent quarter-on-quarter), evidence from recent business surveys points to a decline in manufacturing activity. The Fed faces the dilemma of either shoring up the economy by means of yet another interest rate cut, or fighting accelerating inflation by interest rate increases. Extensive fiscal policy measures have already been taken in the USA to underpin private consumption.

Euro area economic growth shifted into a lower gear at the end of 2007 – for the most part independently of possible effects of the US financial crisis – and at +0.4 percent quarter-on-quarter in the fourth quarter of 2007 was only half as high as in the third quarter. This slowdown must not be over-interpreted – in the second quarter of 2007 the growth rate had been +0.3 percent and thus also clearly lower than in the preceding period (+0.8 percent). However, both industrial production developments and business surveys suggest that the growth momentum is weakening.

The situation in Austria's construction industry appears to be improving again at the beginning of 2008 after some weakness in the fourth quarter, according to WIFO's latest business cycle survey. Tourism expanded at a particularly vigorous pace, with

both the number of overnight stays and sales revenue in the first half of the 2007-08 winter season substantially higher than a year before.

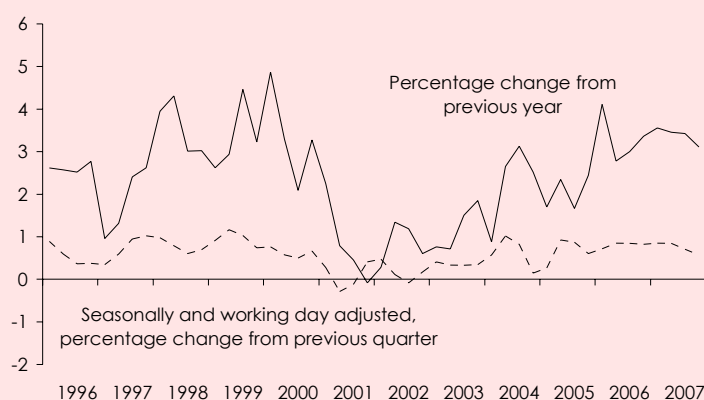
Table 1: Quarterly national accounts

	2006		2007					
	Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter		
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure	+ 0.4	+ 0.3	+ 0.4	+ 0.5	+ 0.8	+ 0.5		
Households <sup>1</sup>	+ 0.4	+ 0.3	+ 0.3	+ 0.5	+ 0.5	+ 0.3		
General government	+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 2.0	+ 1.2		
Cross capital formation	+ 0.9	+ 1.0	+ 1.2	+ 1.2	+ 0.8	+ 0.7		
Gross fixed capital formation	+ 1.2	+ 1.2	+ 1.0	+ 0.8	+ 0.6	+ 0.4		
Machinery and equipment	+ 0.2	+ 1.1	+ 1.9	+ 1.2	+ 0.1	+ 0.3		
Construction	+ 2.0	+ 1.6	+ 0.8	+ 0.2	+ 0.2	+ 0.3		
Exports, goods and services	+ 2.0	+ 2.3	+ 2.1	+ 1.2	+ 1.2	+ 1.2		
Goods	+ 2.2	+ 2.8	+ 2.2	+ 1.2	+ 1.2	+ 1.3		
Services	+ 1.6	+ 1.7	+ 1.7	+ 1.8	+ 1.8	+ 1.6		
Imports, goods and services	+ 1.7	+ 1.9	+ 1.5	+ 1.1	+ 1.6	+ 1.2		
Goods	+ 1.6	+ 1.9	+ 1.8	+ 1.1	+ 1.6	+ 1.1		
Services	+ 1.4	+ 0.8	+ 0.6	+ 1.0	+ 1.7	+ 1.8		
Gross domestic product	+ 0.8	+ 0.8	+ 0.9	+ 0.8	+ 0.7	+ 0.6		
Manufacturing	+ 2.1	+ 2.6	+ 2.1	+ 0.9	+ 0.7	+ 0.8		
	2006	2007	2006		2007			
			Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter	Fourth quarter
<i>Percentage changes from previous year</i>								
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 2.1	+ 1.7	+ 1.9	+ 1.9	+ 1.0	+ 1.6	+ 2.3	+ 1.8
Households <sup>1</sup>	+ 2.1	+ 1.4	+ 1.7	+ 1.9	+ 0.9	+ 1.6	+ 1.9	+ 1.2
General government	+ 2.1	+ 2.5	+ 2.4	+ 2.0	+ 1.3	+ 1.4	+ 3.4	+ 3.8
Cross capital formation	+ 3.7	+ 6.5	+ 4.6	+ 1.4	+ 11.6	- 1.2	+ 8.2	+ 9.0
Gross fixed capital formation	+ 3.8	+ 4.8	+ 4.4	+ 3.8	+ 10.1	+ 3.9	+ 5.0	+ 1.6
Machinery and equipment	+ 1.5	+ 6.3	+ 1.6	- 4.1	+ 9.0	+ 2.6	+ 10.6	+ 3.3
Construction	+ 5.1	+ 3.7	+ 6.0	+ 7.8	+ 12.1	+ 4.5	+ 1.7	+ 0.2
Exports, goods and services	+ 7.5	+ 8.1	+ 5.8	+ 8.4	+ 8.5	+ 9.0	+ 8.1	+ 6.8
Goods	+ 7.9	+ 8.3	+ 6.6	+ 8.6	+ 10.5	+ 8.8	+ 7.9	+ 6.2
Services	+ 6.4	+ 7.5	+ 3.7	+ 8.1	+ 3.4	+ 9.4	+ 8.6	+ 8.8
Imports, goods and services	+ 5.6	+ 6.6	+ 4.6	+ 5.6	+ 9.1	+ 5.0	+ 7.6	+ 4.8
Goods	+ 5.5	+ 7.4	+ 4.8	+ 4.1	+ 10.5	+ 5.8	+ 9.2	+ 4.3
Services	+ 6.1	+ 3.4	+ 3.9	+ 10.9	+ 2.5	+ 1.6	+ 2.0	+ 6.9
Gross domestic product	+ 3.3	+ 3.4	+ 3.0	+ 3.4	+ 3.6	+ 3.5	+ 3.4	+ 3.1
Manufacturing	+ 8.8	+ 7.2	+ 7.8	+ 10.0	+ 9.5	+ 7.7	+ 6.5	+ 5.4
Gross domestic product, value	+ 5.1	+ 5.8	+ 4.9	+ 5.3	+ 6.0	+ 5.4	+ 5.9	+ 5.8

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

Figure 1: Growth of real GDP

Percentage change from previous period



Source: WIFO.

Inflation continues to be high in Austria. In January, the inflation rate stood at 3.3 percent. While it was thus somewhat lower than in December, an ongoing upward impetus to prices emanates from price developments in crude oil and agricultural commodities markets.

An extremely favourable situation can be observed on the labour market. The latter usually reacts with a lag to cyclical developments. While employment continues to grow at a robust pace, unemployment is falling once again. In February, the seasonally adjusted unemployment rate according to the Austrian method of calculation dropped to 5.9 percent. The seasonally adjusted unemployment rate according to Eurostat fell to 4.2 percent in January (no data are yet available for February). Hence, Austria had the fifth lowest unemployment rate of all 27 EU countries.

In the USA, there are signs that economic growth will moderate further. In the fourth quarter, GDP expanded a scant +0.2 percent (seasonally adjusted) quarter-on-quarter, following an increase by +1.2 percent in the third quarter. Notably the protracted decline in residential investment over eight straight quarters (fourth quarter 2007 –7.0 percent quarter-on-quarter, seasonally adjusted) has had a dampening effect. Private consumption growth, while also easing from +0.7 percent in the third to +0.5 percent in the fourth quarter, was still relatively high against the background of the financial market crisis and the ensuing worsening of financing conditions.

The sharp decline in stock prices early in 2008 has so far not been reflected in a higher propensity to save. The personal saving rate has been falling for years, hitting 0 percent in the fourth quarter (down from 0.4 percent in the third quarter). In the past, private households in the USA adjusted their consumption behaviour to quite a large extent to changes in their wealth. The loss in wealth caused by tumbling real estate and stock prices is therefore likely to impair consumption growth in the coming quarters.

As in the past, economic policy has reacted very quickly to the economic slowdown and has taken several measures to stabilise the economy. They include a deal reached between the government and banks on freezing private household mortgage repayments. They would have constituted a much greater burden on borrowers in the coming months than in 2007, when the financial crisis merely became evident. Besides, fiscal policy provides for about \$ 120 billion worth – representing roughly 1 percent of GDP – of tax rebates to private households to shore up the economy. Monetary policy has also reacted with a substantial cut in the key interest rate. The central bank, for instance, within eight days cut its benchmark rate by 1.25 percentage points at the beginning of 2008, in spite of clear signs of accelerating inflation. Further interest rate cuts in the near future were not ruled out.

These extensive stimulating measures, while not being able to stall the economic downturn, should at least mitigate it. Their effect will however largely depend on the extent to which they act as an incentive for private households to increase their consumption in the usual way. At present there is a risk for the development of consumption expenditures that households will increase their saving to rebuild wealth that has been destroyed notably by the mortgage crisis.

The economic slowdown is also reflected in job market developments: Unemployment has once more followed an upward trend since the beginning of 2007. The unemployment rate rose from 4.4 percent in March 2007 to 5.0 percent in December, and has maintained that level since then.

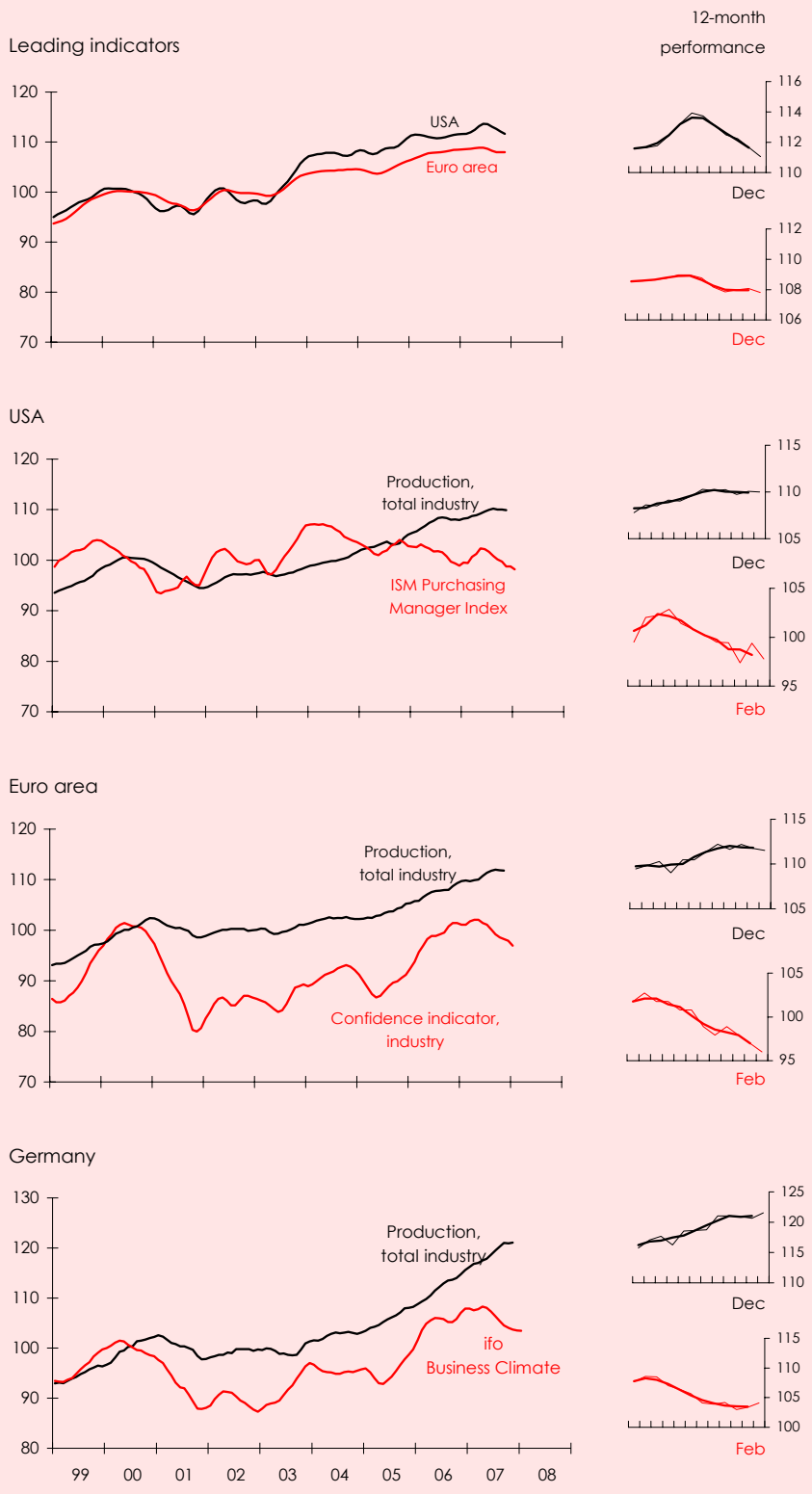
Industrial capacity utilisation has also been declining in the USA since mid-2007 (June 2007 82.2 percent, January 2008 81.5 percent), a consequence of slackening industrial production: it rose at a slower pace in recent months and stagnated in December. In the February survey of the Institute of Supply Management, businesses assessed new orders yet less favourably; employment in this sector is falling. The respective indicator, which has a highly informative value, declined to 48.3 points, the lowest reading since 2003. A reading below 50 normally indicates a contraction.

### USA: Effectiveness of economic policy doubtful

*The degree to which tax rebates and interest rate cuts in the USA will be able to support consumption will largely depend on the extent private households will use the additional funds to increase their savings.*

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.

The possibility of a recession in the USA and the unfavourable euro/dollar exchange rate for European exporters are also reflected in the European Commission's business surveys. The Economic Climate Index for the euro area declined once more – from a high level – in February, largely a result of a more pessimistic assessment of the near-term outlook. The assessment of the current situation was only slightly less positive than in the previous month, however.

Industry confidence indicators for the euro area and for the EU have also followed a downward trend since mid-2007, dampened notably by the more sceptical assessment of the near-term outlook.

Industrial production in the euro area (adjusted for seasonal effects) contracted in November (–0.4 percent) and December (–0.2 percent). New orders in the euro-area manufacturing sector also fell at year-end: gains of yet more than 2 percent in October and November were followed by a month-on-month decline by 3.6 percent in December.

The significant appreciation of the euro against the dollar in recent years is now leaving its mark on export demand and, consequently, industrial production. Euro area merchandise exports fell by 2.5 percent (seasonally adjusted) from November to December 2007, while imports rose by 0.7 percent over the same period, with the trade deficit consequently rising to € 4.2 billion; in December 2006, there had still been a surplus of € 2.4 billion.

As in the USA, monetary policy is facing the difficult decision between shoring up the economy by cutting interest rates, or curbing accelerating inflation by raising key interest rates. While in the past the US central bank's number one priority was economic growth, the ECB's main focus was rather on price stability. The USA also uses fiscal policy to spur growth; concerted action is not conceivable in the EU and is therefore unlikely.

Economic framework conditions are generally more favourable in the euro area than in the USA. Real estate prices, for instance, have risen strongly only in a few countries, there is no indication of a price bubble. Besides, private households in Europe tend to adjust their consumption behaviour much less to changes in their wealth than do households in the USA; consequently, consumer demand would be less affected by a price collapse for assets constituting their wealth.

The biggest difference between the euro area and the USA lies in the development of the personal saving rate: While it declined substantially in the USA in recent years (to 0.0 percent in the fourth quarter of 2007), it remained mostly stable at high levels in the euro area. In the event of a slowing economy private households can therefore sustain consumption dynamics by saving less; the leeway here is considerable. In the USA, a further decline in the saving rate is not likely – particularly in view of recent wealth losses.

However, the relatively high inflation rates observed currently diminish real disposable income also in the euro area, thereby reducing the stabilising effect of private consumption. Stimulus from exports should also slacken owing to the strong euro. While the euro-area economy is therefore likely to be adversely affected by the US slowdown, the phase of weakness will probably be less intense and shorter than in the USA.

Economic growth moderated in Germany – as in the entire euro area – in the fourth quarter of 2007. GDP expanded at a seasonally adjusted rate of 0.3 percent quarter-on-quarter, following +0.7 percent in the third quarter. This is largely consistent with the results of business surveys. January and February did not see a further deterioration in the assessment of the current business situation. Business has been substantially better since the beginning of the year in both the retail and the wholesale sectors. While the assessment of the situation in the manufacturing sector remained largely unchanged from the fourth quarter of 2007, the index declined markedly for

## Sentiment deteriorating in the EU

*Economic activity in the EU has been moderating for some time now – largely independently of the US financial crisis. This is also shown by the results of business surveys in the EU. While companies assess current economic developments only somewhat less positively, they have grown more sceptical about future developments. The constantly rising euro exchange rate threatens to drastically slow expansion in the export industry. Economic framework conditions, however, are far more favourable in Europe than in the USA.*

## German economy intact amid rising pessimism

the construction industry. The German manufacturing sector therefore appears to have continued on its expansionary course at the beginning of 2008.

In 2007, foreign trade remained a key engine of growth. Goods exports rose by 8.5 percent in nominal terms, with exports to EU countries, at +11.1 percent, rising at a faster pace than those to third countries (+4.1 percent). In the fourth quarter, exports exceeded the year-earlier level by only 3.2 percent. While deliveries to EU countries rose by 8 percent, those to third countries remained 4.4 percent below the year-earlier level. Notably exports to the USA declined sharply. They fell by around 13 percent, reflecting the weak dollar and close-to-flat economic growth in the USA.

2007 saw a further constant decline in the seasonally adjusted unemployment rate (according to Eurostat's method of calculation) – it dropped by 0.1 percentage point each month since July, and even 0.2 percentage point in both December 2007 and January 2008. The unemployment rate stood at only 7.6 percent in January 2008, down from yet 8.8 percent in January 2007. However, it still exceeds the euro area and the EU averages (7.1 and 6.8 percent, respectively).

While at the beginning of 2007 real GDP in Austria still expanded by +0.9 percent quarter-on-quarter, growth gradually decelerated thereafter, to +0.6 percent in the fourth quarter. As growth rates reach their highest level around two quarters before the business cycle peak, the latter is likely to have occurred around the end of 2007. At this point overall economic capacity utilisation is at its peak, and growth returns to its long-run average.

Expansion in the fourth quarter was again driven by exports. Goods exports rose at a seasonally adjusted rate of 1.3 percent at the end of 2007, a similar rate as in the previous quarter. Consumer spending remained subdued (fourth quarter +0.3 percent). Growth in gross fixed capital formation also decelerated again, from +0.6 percent in real terms in the third quarter to +0.4 percent in the fourth.

Industrial production growth reached its peak already in 2006. Here too, the cyclical peak should have occurred around half a year later. Industrial capacity utilisation was at its highest level, at 86 percent, in the second quarter of 2007, and has been subsiding since then, also owing to expansion investment (fourth quarter 2007 84½ percent, January 2008 83½ percent). Overall industrial production in 2007 expanded at the still vigorous pace of +6.6 percent.

Although the assessment by manufacturers of the production outlook had stabilised at a low level around year-end, following the decline in the previous year, in February the indicator turned out clearly worse than previously: It dropped almost to the initial level before the upswing in 2005.

Companies have lately been also considerably more pessimistic in the assessment of their business situation further ahead. The indicator improved or remained unchanged only for manufacturers of capital goods and motor vehicles.

The ongoing improvement in the labour market at the beginning of the year not only appears to represent a lagged reaction to the upswing, but may also suggest a still vigorous expansion in the services sector.

At the beginning of 2007, value added growth in the construction sector exceeded 10 percent, thanks to the buoyant economy and the mild weather. During the year, growth decelerated steadily. It stagnated (–0.3 percent) in the fourth quarter of 2007, compared with the year-earlier level, which had, however, been particularly high (up almost +8 percent in real terms from the fourth quarter of 2005). While the demand for housing construction declined in 2007 (in seasonally adjusted terms), construction activity in other sectors expanded moderately.

*Recent survey evidence suggests that the German economy continues to expand at a robust pace. While the current business situation was assessed less positively than in August 2007, this indicator rose again markedly in February. The situation in the German labour market continues to improve under these favourable framework conditions.*

### **Austrian economy losing further momentum**

*The Austrian economy developed very successfully in 2007 (+3.4 percent). But economic activity gradually lost momentum during the year. Evidence from recent business surveys suggests a slight acceleration of this trend in manufacturing.*

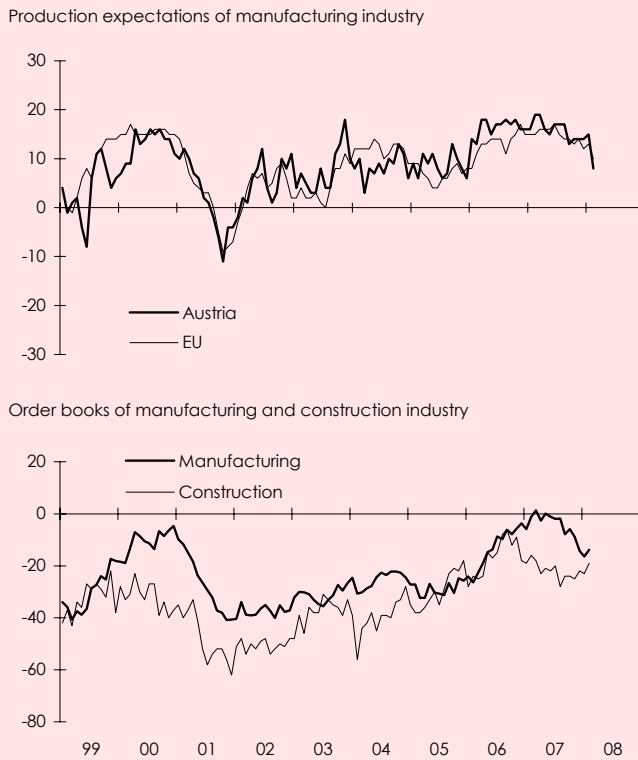
### **Slight pick-up in construction industry**

In the business cycle surveys conducted by WIFO in January and February 2008 firms in the construction sector gave a more positive assessment of order books. The assessment of the order situation improved in both building construction and civil engineering, with companies in these sectors planning to hire more staff.

*Value added growth in construction in the fourth quarter of 2007 was unchanged from the previous year. Results of business surveys have again become more optimistic at the beginning of 2008; growth should accelerate.*

**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.

In the first three months of the current winter season the tourism sector recorded a sales increase of more than 10 percent, according to advance estimates. The number of overnight stays rose by 7 percent, compared with the same period a year earlier. The expansion was somewhat higher for nights spent by guests from Austria (+7.8 percent) than for those by foreign guests (+6.7 percent). This development was supported by sufficient snow cover in the winter sports regions, which is of importance notably in a comparison with the beginning of the season a year earlier, when snow conditions were bad.

The increase in the number of overnight stays was highest for travellers from France (+10 percent), Switzerland (+6½ percent), Germany (+5 percent) and the Netherlands (+3½ percent). A decline from last year was registered in the number of nights spent in Austria by guests from the USA (-5 percent) and Great Britain (-4 percent). The high external value of the euro may have played a role here.

After rising continuously already in recent months, inflation advanced by another 0.5 percentage point, to 3.6 percent, in December. Apart from higher energy prices, this was mainly attributable to the sharp rise in the cost of food.

## Successful winter tourist season

*Both tourism sales and overnight stays have posted substantial gains in the 2007-08 winter season so far. This can be partly attributed to the favourable weather conditions.*

## Inflation easing somewhat

In January, inflation receded to 3.3 percent. Large upward contributions once more came from food and fuel, while the only downward contribution came from the expenditure category "communication".

*Inflation remains high. International factors will contribute substantially to price increases also in the near future.*

Figure 4: Key economic indicators



Source: Public Employment Service Austria, 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 Public Employment Service.



The main upward pressure on accelerating inflation has so far come from abroad. Substantial price increases were registered globally for petroleum, grain and dairy products. February saw another marked surge in wheat prices, which will be reflected not until the coming months in the Austrian rate of inflation. As world market prices are quoted in dollars, the strong euro up to now has had a dampening effect on inflation in Austria.

The pick-up in inflation in the entire euro area and in the EU is further evidence for the international origin of the latest inflationary pressures. The HICP inflation rate in Austria stood at 3.1 percent in January and was thus lower than the euro area average of 3.2 percent. The first estimate of the euro area inflation rate for February is unchanged at 3.2 percent.

The labour market generally reacts with some lag to cyclical fluctuations. This may be one of the reasons for the still positive development of labour market figures. They could also indicate that the services sector, which is not sufficiently depicted in business cycle surveys, continues to grow at a vigorous pace. The recent pick-up in construction activity and the good situation in tourism may also have played a role here. The number of persons in active dependent employment rose again in February, by +12,600 or +0.4 percent (seasonally adjusted) from January 2008. The year-on-year increase was almost +100,000 or +3.2 percent, the highest since the mid-1970s.

Employment growth went hand in hand with a decline by 32,800 or almost 12 percent in the number of unemployed persons from a year before. Compared with the previous month, the decline was 5,700 persons or 2.6 percent (seasonally adjusted).

What is remarkable is that the number of vacancies is still rising. The seasonally adjusted month-on-month increase was 1 percent in January and 1.7 percent in February, possibly also reflecting still buoyant activity in the services sector.

Due to the modification of the statistical classification of economic activities in effect as of the beginning of 2008 a sectoral breakdown of data is however not yet available.

The unemployment rate according to the traditional Austrian method of calculation stood at 7.5 percent in January, down 0.8 percentage point from a year earlier. In February it was 6.8 percent, down by as much as 1 percentage point from a year before. In February, the seasonally adjusted unemployment rate according to the Austrian method of calculation fell from 6.1 percent to 5.9 percent.

### Further improvement in labour market conditions

*While the economy is increasingly slowing, job market developments remain favourable. Rising employment continues to go alongside declining unemployment.*