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Industrial Production Booming, Consumer Demand Subdued

Business Cycle Report of December 2006

The boom in the export-oriented industry and in the construction industry is driving economic growth. While evidence from the monthly business cycle survey conducted by WIFO suggests a stabilisation of growth in the months to come, there is no indication of a deceleration. Consumption and trade, on the other hand, continue to be sluggish; their stimulation is a necessary prerequisite of a strong sustained boom. The noticeable decline in unemployment is the result of accelerating economic growth, the mild weather and the high number of persons enrolled in training programmes.

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The Austrian economy grew by 3.2 percent year-on-year or 0.9 percent quarter-on-quarter (seasonally and working-day adjusted) in real terms in the third quarter of 2006, according to the revised quarterly calculation by WIFO. Expansion is driven by the booming export-oriented industry. The manufacturing industry increased its output by 2.3 percent in volume quarter-on-quarter, or by almost 9 percent year-on-year. Production is growing at such a fast rate that despite the strong increase in output per man-hour both the number of persons employed and the number of hours worked are rising. With the earnings situation positive, capacity utilisation and sales expectations have improved considerably, prompting companies to realise investment projects and to push ahead purchases of machinery, electrical appliances and vehicles. In the third quarter, business spending on machinery and equipment outpaced the year-earlier level by 3.9 percent in volume.

The boom in industry is mainly fuelled by brisk external demand. Merchandise exports exceeded the year-earlier level by 8.3 percent in real terms in the third quarter. Companies still view their foreign orders in hand as very high and by far exceeding the long-term average. While according to the WIFO business cycle survey for November companies expect a consolidation of economic activity in the coming months, they do not anticipate a marked slowdown. They are only slightly more cautious in their production expectations and assessment of the future business situation than in their assessment of the current situation.

Current international framework conditions are favourable. In the euro area, third-quarter GDP growth exceeded the year-earlier level by 2.7 percent. Here too, industry is the main engine of economic activity. As capacity utilisation is rising, companies increasingly implement their investment projects. However, current data also indicate some risks surrounding the short-term business outlook, among them notably the still modest expansion of private household consumer demand, which will need to gather speed if the overall economy is to start booming. Other factors are the marked slowdown in the pace of US growth prompted by the decline in private residential investment and a deceleration in industrial production, and the deterioration of monetary framework conditions for euro-area economic activity owing to the noticeable increase in short-term interest rates and the rapid increase recently in the price of the euro on foreign exchange markets.

Table 1: Quarterly national accounts

			2005				2006		
			Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter	
			Percentage changes from previous quarter						
<i>Adjusted for seasonal and working day effects, volume</i>									
Final consumption expenditure			+ 0.6	+ 0.6	+ 0.4	+ 0.3	+ 0.4	+ 0.4	
Households ¹			+ 0.6	+ 0.6	+ 0.5	+ 0.3	+ 0.4	+ 0.4	
General government			+ 0.6	+ 0.4	+ 0.3	+ 0.3	- 0.0	+ 0.1	
Cross capital formation			- 0.1	+ 0.3	+ 0.7	+ 1.1	+ 1.3	+ 1.6	
Gross fixed capital formation			+ 0.4	+ 0.6	+ 0.8	+ 1.1	+ 1.4	+ 1.5	
Machinery and equipment			+ 0.1	+ 1.0	+ 1.0	+ 0.6	+ 0.6	+ 1.4	
Construction			+ 0.3	+ 0.5	+ 0.8	+ 1.1	+ 1.3	+ 1.3	
Exports, goods and services			+ 1.8	+ 2.0	+ 1.8	+ 1.8	+ 1.8	+ 1.4	
Goods			+ 2.1	+ 2.4	+ 2.1	+ 2.6	+ 2.3	+ 1.6	
Services			+ 1.8	+ 1.8	+ 1.7	+ 1.2	+ 1.5	+ 1.3	
Imports, goods and services			+ 1.1	+ 1.5	+ 1.3	+ 1.6	+ 1.6	+ 0.8	
Goods			+ 1.0	+ 1.7	+ 1.4	+ 1.5	+ 1.5	+ 0.8	
Services			+ 0.7	+ 1.0	+ 1.0	+ 1.6	+ 0.7	+ 0.8	
Gross domestic product			+ 0.7	+ 0.9	+ 0.8	+ 0.7	+ 0.9	+ 0.9	
Manufacturing			+ 2.7	+ 2.6	+ 2.0	+ 1.9	+ 2.0	+ 2.3	
	2004	2005	2005						2006
			Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter	Third quarter	
			Percentage changes from previous year						
<i>Volume, chained prices</i>									
Final consumption expenditure	+ 1.8	+ 1.8	+ 1.1	+ 1.9	+ 2.3	+ 1.4	+ 1.9	+ 1.6	
Households ¹	+ 1.9	+ 1.7	+ 0.8	+ 2.0	+ 2.5	+ 1.3	+ 2.3	+ 1.9	
General government	+ 1.4	+ 1.9	+ 2.1	+ 1.8	+ 1.8	+ 1.8	+ 0.8	+ 0.5	
Cross capital formation	+ 0.5	- 0.4	+ 6.4	+ 1.1	- 2.7	+ 6.2	+ 3.8	+ 3.6	
Gross fixed capital formation	+ 0.6	+ 0.3	+ 3.1	+ 0.2	- 0.6	+ 5.6	+ 2.6	+ 4.5	
Machinery and equipment	- 1.6	+ 0.2	+ 2.8	+ 0.7	- 2.6	+ 7.7	+ 2.0	+ 3.9	
Construction	+ 1.6	+ 0.4	+ 3.5	- 0.1	+ 0.8	+ 4.4	+ 3.1	+ 5.1	
Exports, goods and services	+ 10.0	+ 6.4	+ 6.3	+ 6.4	+ 6.6	+ 10.5	+ 7.6	+ 6.7	
Goods	+ 12.7	+ 5.8	+ 6.9	+ 5.3	+ 5.7	+ 14.1	+ 7.1	+ 8.3	
Services	+ 2.7	+ 8.1	+ 4.5	+ 9.2	+ 9.6	+ 1.7	+ 9.0	+ 2.6	
Imports, goods and services	+ 8.7	+ 5.2	+ 8.1	+ 5.5	+ 1.9	+ 9.7	+ 5.2	+ 4.8	
Goods	+ 10.9	+ 5.9	+ 9.4	+ 6.4	+ 1.7	+ 10.1	+ 4.9	+ 4.7	
Services	+ 1.4	+ 2.6	+ 3.2	+ 2.5	+ 2.9	+ 7.9	+ 6.5	+ 5.4	
Gross domestic product	+ 2.4	+ 2.0	+ 2.3	+ 2.1	+ 2.6	+ 2.9	+ 3.3	+ 3.2	
Manufacturing	+ 2.3	+ 2.6	+ 2.8	+ 3.9	+ 7.0	+ 6.1	+ 6.1	+ 8.7	
Gross domestic product, value	+ 4.2	+ 3.9	+ 4.1	+ 3.9	+ 4.2	+ 3.8	+ 4.9	+ 4.4	

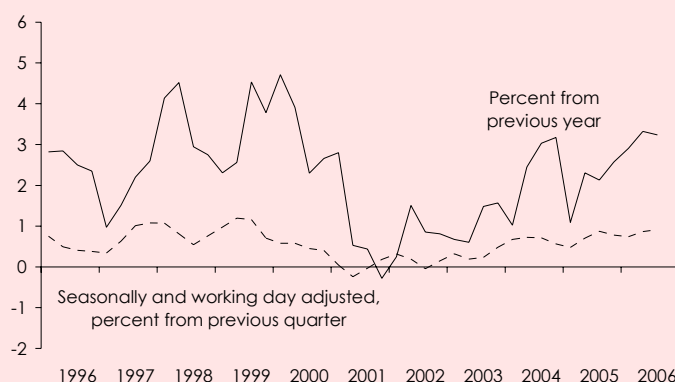
Source: WIFO. – ¹ Including private non-profit institutions serving households.

Sluggish domestic demand remains the main problem for economic expansion also in Austria. While it is true that firms in the construction sector are optimistic in view of growing investment activity and good infrastructure and residential construction order levels – with value added rising by 5½ percent in real terms year-on-year in the third quarter, consumer spending by private households continues to advance at a rate below the long-term average (+1.9 percent in real terms in the third quarter compared with last year). Consumer demand has thus been very sluggish for six years now. In trade, value added once more increased only little (+0.8 percent year-on-year, and +0.3 percent quarter-on-quarter), with notably wholesale trade and motor vehicle sales exerting a dampening effect. While consumer sentiment has admittedly brightened in recent months, developments of real disposable income do not allow much leeway for additional expenditure, and the propensity to save has shown a constant upward tendency.

The good performance of industry and the construction sector has been decisive for full-time employment to expand again and for unemployment to decline. However, it is still mainly part-time jobs that are being created, for instance in trade, despite weak business. In November, the increase in the number of persons enrolled in training programmes accounted for just a good fifth of the decline in the number of persons registered as unemployed by 26,000. The mild weather, coupled with the good performance of the economy, contributed positively to this development.

Figure 1: Growth of real GDP

Percentage changes from previous period



Source: WIFO.

In the USA, economic growth is slowing down noticeably. In the third quarter, real GDP advanced by 3 percent from the year-earlier level, but by just a mere 0.5 percent from the previous quarter, with the contraction of residential investment exerting the strongest dampening impact. The strong appreciation of house prices of recent years has given way to a steady decline, causing – with some lag – a contraction not only of construction investment, but due to the wealth effects connected with it also of household consumption. Private household consumer expenditure, while being supported by the fall in energy prices, exceeded the year-earlier level by just under 3 percent in the third quarter.

The weakening demand in the construction sector is also impairing industrial production. Purchasing managers have become clearly more cautious in their assessment of economic activity: In November, the ISM index even indicated a decline in industrial production. Corporate investment activity remains lively for the time being, however, and the stock market does not yet show any signs of weakness.

The EU economy continued to grow at a vigorous pace in recent months. Expansion is still driven by brisk industrial activity, which is benefiting from the favourable development of global demand, but increasingly also from a pick-up in investment in the euro area. The third quarter saw real GDP advance by 2.7 percent year-on-year, and by 0.5 percent compared with the (very high) level of the previous quarter, according to preliminary calculations.

The industrial sector continues to expand at a rapid pace; it is currently in the midst of a boom period. This becomes apparent also when looking at the European Commission's Confidence Indicator: Companies are now even more optimistic than during the last boom period in 2000. Brisk demand has led to a substantial expansion of the level of capacity utilisation, which climbed to 84 percent in the fourth quarter, thus clearly exceeding the long-term average. High levels of capacity utilisation and favourable sales expectations are now prompting a pick-up in investment activity.

The boom in industry is largely driven by production developments in Germany. Due to their strong orientation towards capital goods and their high price competitiveness, German industrial enterprises profit in particular from the buoyant global demand. Both the European Commission's Confidence Indicator and the ifo Business Climate Index confirm the marked optimism among German manufacturers.

By contrast, those sectors that are dependent on household consumer demand are recovering at a much slower pace than industry in the euro area. The Consumer Confidence Indicator, though also having surpassed its long-term average, still remains clearly below the levels reached in 2000. While employment growth is accelerating and unemployment gradually declining, wage rises have been very modest – with per-capita incomes only slightly higher in real terms than last year. Wage in-

Marked deceleration of US economic growth

In the USA, economic growth is decelerating markedly due to the decline in private residential investment and industrial output.

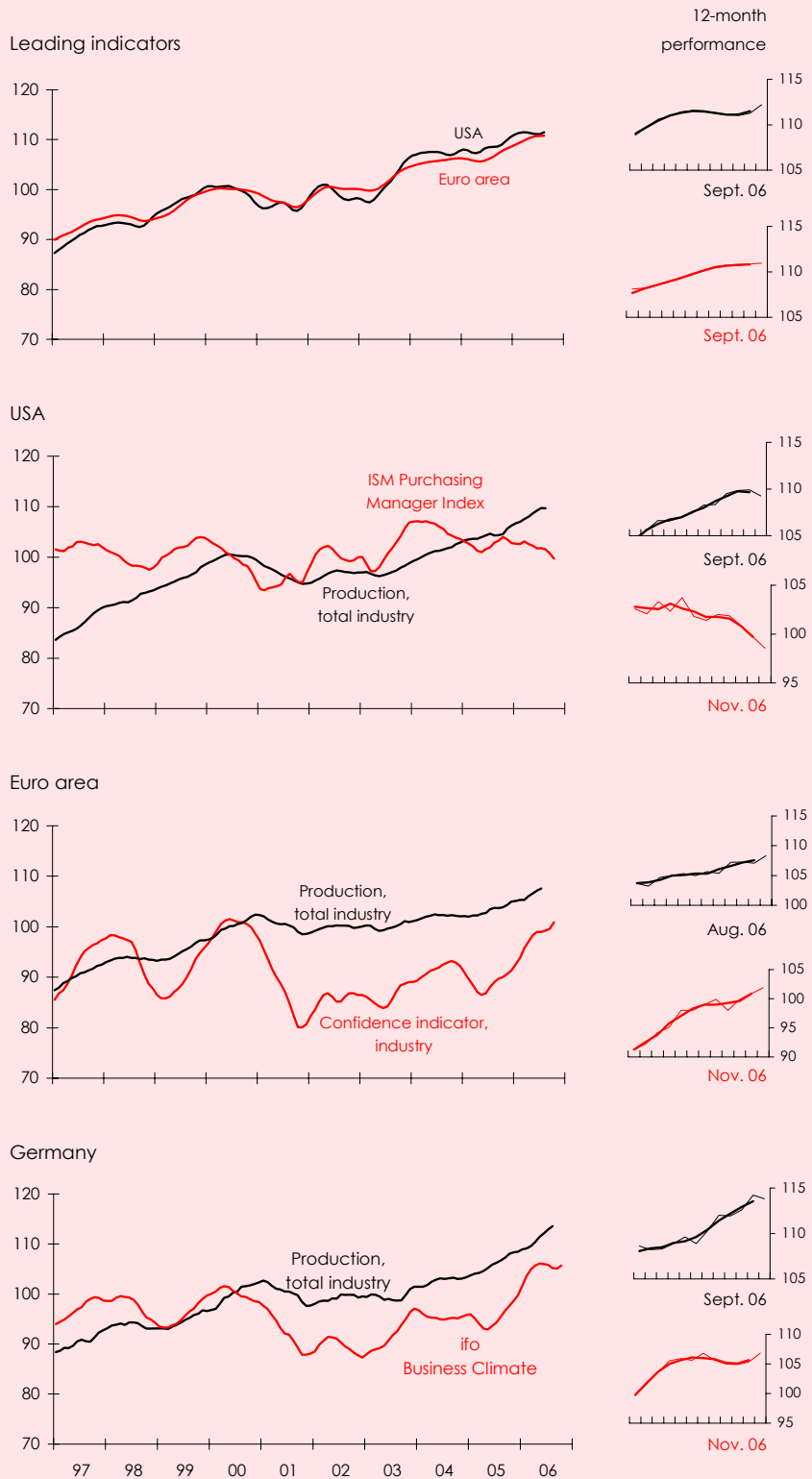
EU industry buoyant

Accelerated growth of industrial output and investment is stimulating the euro area economy, with Germany being a driver of activity here. However, developments remain susceptible to prevailing risks as long as consumer demand does not assume a leading role.

creases and consumer sentiment have been particularly subdued in Germany. Private consumption currently benefits from carry-forward effects of the forthcoming VAT increase, but is likely to slump in the first quarter of 2007.

Figure 2: International Business Climate

Seasonally adjusted, 2000 = 100, 3-month moving average



Source: European Commission, Deutsche Bundesbank, ISM (Institute for Supply ManagementTM), ifo (Institut für Wirtschaftsforschung), OECD.

The monetary framework conditions for economic activity have deteriorated of late in the euro area, with the euro noticeably strengthening against the dollar especially in the second half of November and the European Central Bank driving short-term interest rates clearly upwards since October 2005. While the two developments will hardly be able at present to slow the pace of industrial activity, which is currently very robust and fuelled by optimism, their dampening impact will nevertheless come to bear over the medium term.

The condition of Austria's manufacturing industry is extremely favourable, with output in the third quarter of 2006 exceeding the year-earlier level by almost 9 percent in volume. The number of employed persons is rising as are the number of hours worked and output per man-hour – reliable evidence of a period of boom. The results of the WIFO business cycle survey suggest that the expansionary forces will persist in the fourth quarter. They are driven notably by lively external demand, with foreign orders in hand by far exceeding the long-term average.

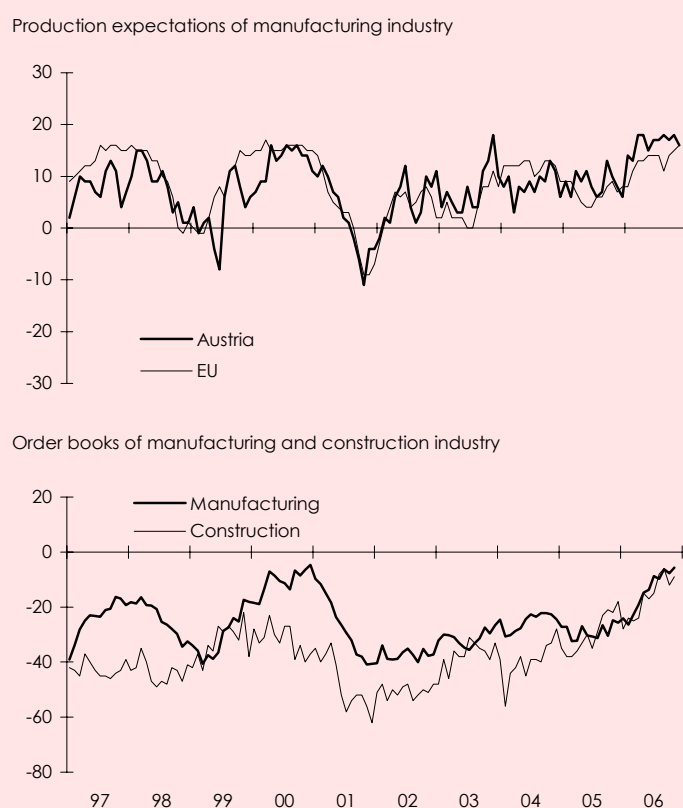
Export data by Statistics Austria, which are, however, available only with considerable lag, confirm the optimistic assessment of external demand in the WIFO business cycle survey. Merchandise exports exceeded the year-earlier level by around 10 percent in the third quarter. Brisk demand is recorded from petroleum producing countries (spending their high profits from their commodities production), South East Europe (where Austrian exporters hold a good market position), and Germany (thanks to lively demand for motor vehicle components and processed goods).

Austria: Boom in export-oriented industry

The considerable expansion of industrial production is driven by brisk external demand. Evidence from the WIFO business cycle survey suggests a continuation of the boom.

Figure 3: WIFO business cycle survey

Differences between the percentages of correspondents giving positive and negative replies, seasonally adjusted



Source: European Commission, WIFO business cycle survey.

The WIFO business cycle survey for now suggests a consolidation, but no weakening of the boom in manufacturing. Production expectations have stabilised at the high levels observed during the summer months, companies assess their business situation in six months only a little more cautiously than their current situation, and order books are growing at only a slightly slower pace.

High levels of capacity utilisation, optimistic sales expectations and the good earnings situation are prompting companies to expand their investment activity. Business spending on machinery and equipment in the third quarter advanced by 3.9 percent in real terms year-on-year and by 1.4 percent quarter-on-quarter. Lively investment activity is also confirmed by the data on capital goods production (+11 percent year-on-year in the third quarter).

Translating favourable export developments into investment activity is an important step in the business cycle, which failed to materialise in recent years mainly as a consequence of weak capacity utilisation. Now the cyclical framework conditions appear to have improved to such an extent that companies use their high profits also for an expansion of capacities. In the third quarter, total gross investment in fixed assets contributed 0.4 percentage point to GDP growth of 0.9 percent from the previous quarter.

2006 has been an extremely good year also for the construction sector. Value added increased by 5½ percent in real terms from the year-earlier level in the third quarter. Employment is growing, and the number of unemployed persons fell by more than 10 percent in autumn compared with a year earlier. While lively demand has led to a strong expansion of production notably in residential construction, firms in infrastructure construction are constantly operating at full capacity.

Evidence from the WIFO business cycle survey of November confirms the good performance of the construction sector, with companies assessing their order books very favourably and anticipating price increases and further employment gains.

The boom in export and industrial activity so far has not spread to consumption and trade. Household expenditure advanced by 1.9 percent in volume from a year earlier and by only 0.4 percent from the previous quarter in the third quarter. In trade, value added increased by 0.8 percent and 0.3 percent respectively, with retail trade recording more favourable results than the wholesale trade and the motor vehicle sector.

While the sluggish expansion of consumption is also related to a stronger propensity to save by private households, it is above all a consequence of weak income growth. In the autumn months, the standard wage index was only 2.7 percent higher than a year earlier. Due to the ongoing strong expansion of part-time jobs the increase in actual wages is likely to be even lower. Per-capita real wages increased very modestly until the summer, and only the halt to rapidly surging energy prices has permitted slight improvements since September. Consumer price inflation in September and October decelerated to +1.4 percent and +1.1 percent respectively, owing in part to stable prices for petrol and diesel fuel as well as constant health care costs.

Robust investment activity

While until recently economic activity was fuelled by strong export growth, accelerating investment has now also assumed an important role in the upswing.

Construction sector showing optimism

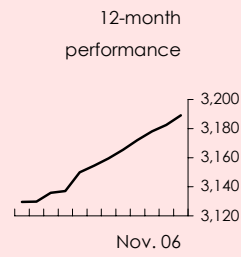
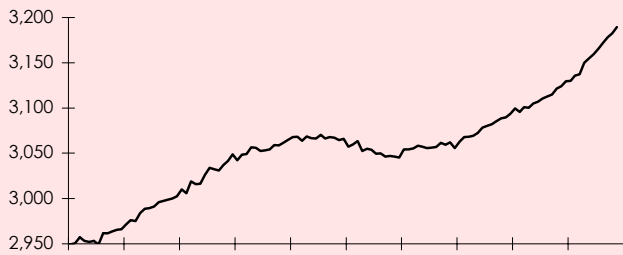
Companies in the construction sector are benefiting from brisk demand for housing and the ongoing favourable order situation in infrastructure construction.

Upturn not yet spreading to consumption

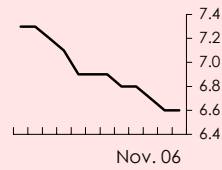
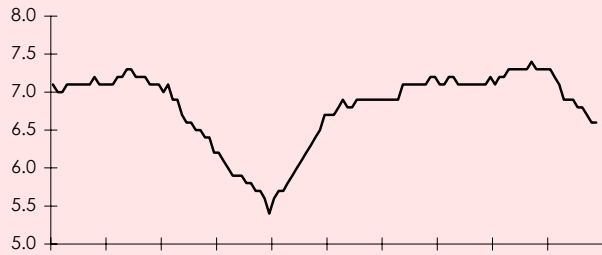
The sluggish growth of consumer demand, which is closely related to the modest rise in disposable income, is slowing down economic activity.

Figure 4: Key Economic Indicators

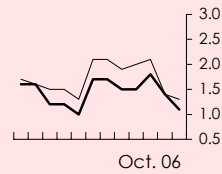
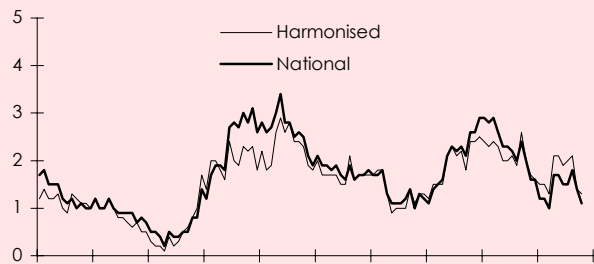
Persons in active dependent employment¹, (1,000), seasonally adjusted



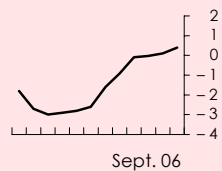
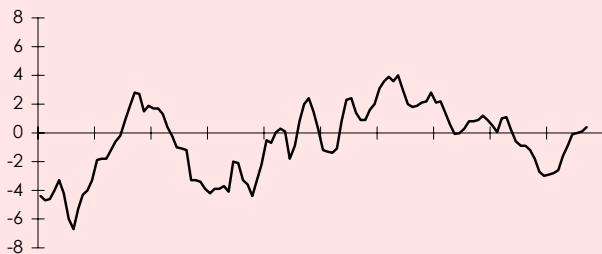
Unemployment rate, traditional Austrian method², seasonally adjusted



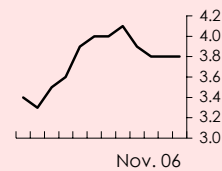
Consumer prices, year-to-year percentage changes



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



10-year central government bonds (benchmark), percent



Source: Austrian Labour Market Service, 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 Labour Market Service.

The good performance of the economy is also having an impact on the labour market. It is reflected especially in employment gains in manufacturing and construction, with the vast majority of the new jobs in these sectors being full-time. While the number of persons employed in industry advanced by 4,000 year-on-year in October, the construction sector saw an increase by almost 7,000. In November, the number of persons in dependent employment was raised by a total of 66,000 (+2.1 percent) relative to the previous year, with the bulk of the jobs filled still predominantly part-time. The number of persons employed in the trade sector, for instance, in October exceeded the year-earlier level by 9,000, despite weak business.

Rising employment numbers in industry and construction contribute to a particular extent to a decline in unemployment as the majority of jobless persons look for full-time jobs. In November, 232,000 persons were registered as unemployed, a drop by 26,000 from a year earlier. The number of persons enrolled in training programmes – they are not included in the official unemployment figure – most recently exceeded the year-earlier level by 7,000.

Substantial improvement of labour market

The strong growth in the number of persons employed and the decline in unemployment are increasingly a consequence of the economic upturn.