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International Downturn Weighing on Economic Activity in Austria

Business Cycle Report of September 2008

Following a slowdown of economic expansion in Austria in the second quarter (+0.4 percent quarter-on-quarter, seasonally adjusted, +2.0 percent year-on-year), firms' expectations regarding business conditions in the months ahead are deteriorating further. Weak demand from major trading partners is weighing on exports and industrial activity in Austria. Manufacturers assess their order book levels as below average. Stimulus is being provided by the construction sector.

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Austria's real GDP expanded at a seasonally and working day adjusted quarter-on-quarter rate of 0.4 percent in the second quarter (after +0.6 percent in the first quarter), according to WIFO's recent estimates. On a year-on-year basis, GDP growth was 2 percent. Against the background of the downturn in the most important sales markets, goods exports clearly lost momentum (+0.4 percent quarter-on-quarter) – in the first half of 2007, the growth rate had still been 2 percent. While the economic performance in Germany and Italy in the second quarter of 2008 remained below the level seen in the first quarter, GDP growth in Great Britain and Spain – countries that were affected by a deterioration in real estate values – was almost zero. Leading indicators point to a further slowdown in economic activity in Europe: the European Commission's Economic Sentiment Indicator, for instance, in August showed a further darkening of sentiment in the manufacturing and construction sectors in both the euro area and the EU as a whole.

The slowdown in Austrian exports weighed notably on value added in manufacturing, which expanded at a rate of just 0.2 percent in real terms quarter-on-quarter in the second quarter, down from +1.2 percent in the first quarter. Evidence presented in WIFO's most recent business survey suggests that industrial activity will decline further. While stocks of finished goods are being built up, the surplus of firms with insufficient domestic and foreign order book levels in August exceeded the average for the last five years. The assessment of the future economic situation has also worsened noticeably: one quarter of the surveyed companies anticipate unfavourable developments over the next six months, whereas less than one tenth expect conditions to improve.

Stimulus is being provided by the construction sector. Firms still describe their order book levels as good and intend to keep staff numbers stable. Construction value added, which expanded again by 0.4 percent quarter-on-quarter in the second quarter, proves a pillar of the economy also in the current cyclical downturn. Spending on infrastructure construction increased considerably, whereas residential investment expanded only moderately.

Table 1: Quarterly national accounts

			2007				2008	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage change from previous quarter					
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.2	+ 0.1	+ 0.6	+ 0.5	- 0.3	+ 0.8
Households ¹			+ 0.1	- 0.1	+ 0.3	+ 0.4	+ 0.2	+ 0.3
General government			+ 0.0	- 0.1	+ 1.6	+ 1.1	- 1.8	+ 2.5
Cross capital formation			+ 0.7	+ 0.5	+ 0.5	+ 0.5	+ 0.6	+ 0.8
Gross fixed capital formation			+ 1.0	+ 0.9	+ 0.9	+ 0.7	+ 0.6	+ 0.7
Machinery and equipment			+ 1.4	+ 1.3	+ 1.1	+ 0.9	+ 1.1	+ 0.7
Construction			+ 0.5	+ 0.3	+ 0.4	+ 0.5	+ 0.5	+ 0.4
Exports, goods and services			+ 2.3	+ 2.0	+ 1.6	+ 1.2	+ 0.8	+ 0.5
Goods			+ 2.4	+ 1.6	+ 1.2	+ 1.2	+ 1.0	+ 0.4
Services			+ 1.8	+ 1.9	+ 1.8	+ 1.6	+ 1.2	+ 1.0
Imports, goods and services			+ 1.9	+ 1.5	+ 1.7	+ 1.0	- 0.2	+ 1.4
Goods			+ 2.2	+ 1.7	+ 1.7	+ 0.8	- 0.2	+ 1.7
Services			+ 1.0	+ 1.2	+ 1.2	+ 0.9	+ 0.6	+ 0.5
Gross domestic product			+ 0.8	+ 0.6	+ 0.6	+ 0.7	+ 0.6	+ 0.4
Manufacturing			+ 1.2	+ 0.9	+ 0.9	+ 1.5	+ 1.2	+ 0.2
	2006	2007	2007				2008	
			First quarter	Second quarter	Third quarter	Fourth quarter	First quarter	Second quarter
			Percentage change from previous year					
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 2.4	+ 1.2	+ 1.5	+ 1.1	+ 0.8	+ 1.4	+ 1.1	+ 1.3
Households ¹	+ 2.4	+ 1.0	+ 1.5	+ 1.0	+ 0.4	+ 1.0	+ 1.0	+ 0.8
General government	+ 2.3	+ 1.8	+ 1.3	+ 1.2	+ 1.9	+ 2.6	+ 1.4	+ 2.8
Cross capital formation	+ 2.4	+ 3.6	+10.6	+ 2.3	+ 4.2	- 1.1	- 2.0	+ 6.6
Gross fixed capital formation	+ 2.6	+ 4.7	+ 8.1	+ 3.1	+ 4.9	+ 3.1	+ 1.5	+ 4.5
Machinery and equipment	- 0.8	+ 5.9	+ 6.0	+ 1.0	+ 8.8	+ 7.9	- 1.3	+ 7.6
Construction	+ 4.2	+ 2.8	+10.3	+ 3.7	+ 1.4	- 1.2	+ 3.1	+ 2.3
Exports, goods and services	+ 7.5	+ 8.8	+ 9.4	+ 9.0	+ 8.2	+ 8.5	+ 5.9	+ 3.5
Goods	+ 8.2	+ 9.1	+11.2	+10.9	+ 7.7	+ 6.9	+ 5.4	+ 3.6
Services	+ 5.3	+ 7.9	+ 5.2	+ 3.4	+ 9.6	+13.1	+ 7.2	+ 3.2
Imports, goods and services	+ 5.1	+ 7.5	+10.1	+ 5.3	+ 8.8	+ 6.0	+ 1.9	+ 5.7
Goods	+ 5.2	+ 8.4	+12.0	+ 5.9	+10.1	+ 5.8	+ 1.3	+ 6.5
Services	+ 4.8	+ 4.0	+ 1.1	+ 2.8	+ 4.9	+ 6.6	+ 5.2	+ 2.0
Gross domestic product	+ 3.4	+ 3.1	+ 3.8	+ 3.2	+ 2.7	+ 2.6	+ 2.8	+ 2.0
Manufacturing	+ 9.9	+ 5.5	+ 7.7	+ 5.4	+ 4.8	+ 4.5	+ 4.9	+ 4.6
<i>Gross domestic product, value</i>	+ 5.3	+ 5.3	+ 5.8	+ 5.1	+ 5.0	+ 5.1	+ 5.4	+ 5.0

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

Notwithstanding slackening manufacturing activity, firms invested in machinery and equipment in the second quarter; but here, too, a slight downward trend has recently become apparent (+0.7 percent quarter-on-quarter, down from an average of +1 percent in the previous four quarters).

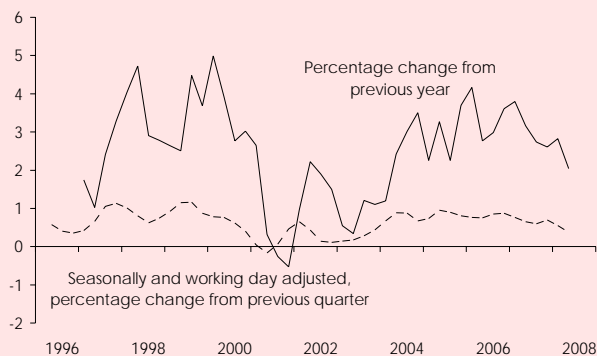
Sharp price increases continue to darken consumer confidence. Consumer demand advanced only slowly also in the second quarter (+0.3 percent in real terms quarter-on-quarter). The inflation rate according to the traditional Austrian calculation method remained high in July, at 3.8 percent (after 3.9 percent in June). As in recent months, the largest upward contribution to annual inflation came from the prices of fuel and other energy sources. Compared with the previous month, inflation in this category moderated slightly, however. The crude oil price, which had surged since the beginning of the year, eased, with the price of Brent crude averaging 113 \$ a barrel in August (133 \$ in July).

The economic slowdown is beginning to take hold of the labour market. While August also saw high employment gains compared with a year before (+80,000, +2.4 percent), the seasonally adjusted quarter-on-quarter rate of change has been declining since the spring. The reduction in unemployment has also lost momentum in the course of the year. In August, 184,000 persons were registered as unemployed, a decline by 7,000 (3.8 percent) from a year before, which compares with a decline by still 29,000 (-10.7 percent) in the first quarter. Seasonally adjusted, the number of unemployed is already on the rise month-on-month. The number of registered job

vacancies, a leading indicator for job market developments, has been falling since July (August -2,700 year-on-year).

Figure 1: Growth of real GDP

Percentage change from previous period



Source: WIFO.

Second quarter GDP growth in the USA was revised to 0.8 percent quarter-on-quarter. The acceleration in the middle of the year was a result of both the positive contribution from net exports and the stimulation of consumer demand (+0.4 percent compared with the previous quarter) by means of tax rebates paid out by the government between the end of April and mid-July. While exports benefited from the weak dollar, imports declined, reflecting softening demand for consumer durables and slowing business equipment investment.

The stimulating effect the payment of tax cheques has had on private consumption expenditure is likely to fade in the third quarter, but private household confidence nevertheless rose in August. Both the Conference Board Consumer Confidence Index and the Reuters/University of Michigan Index improved but are still extremely low following the steady decline since mid-2007. Private consumption expenditure is not likely to accelerate in the third quarter, despite this improvement in sentiment. The weakening labour market and high energy and food prices are impacting on real household disposable income. The unemployment rate rose to 6.1 percent of the labour force in August (July 5.7 percent), and inflation picked up to 5.6 percent in July from 5.0 percent in June.

There are no signs yet of real estate markets easing, with prices in July falling again at two-digit rates year-on-year according to the S&P/Case-Shiller Home Price Index, and the number of building permits and housing starts declining yet again. Production remains subdued not only in construction but also in the industrial sector. Although industrial production rose again month-on-month in June and July, capacity utilisation fell to 79.8 percent in the second quarter, its lowest level since the beginning of 2005.

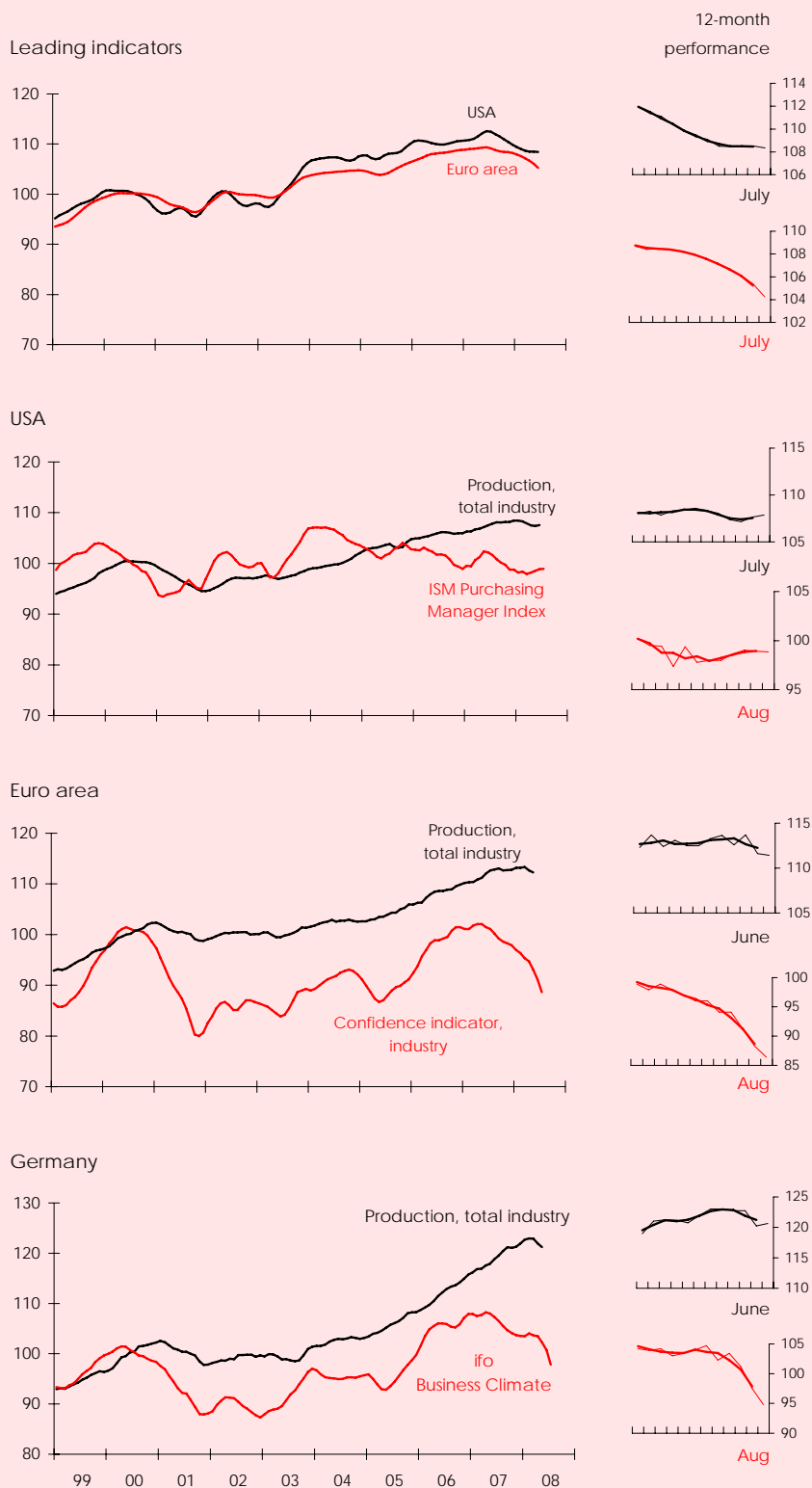
In Japan, the government announced an economic package to stimulate the economy. Real GDP decreased by 0.6 percent quarter-on-quarter in the second quarter. Both external demand and investment and domestic consumption contracted. The Consumer Price Index rose also in Japan as a result of soaring energy prices at the global level. In June, inflation hit the 2-percent mark for the first time since the beginning of 1998.

Surprisingly strong US growth, decline in Japan

The positive contribution from net exports and the expansionary fiscal policy supported growth in the USA in the second quarter. In Japan, GDP is shrinking amid rising inflation.

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.

After the fall in economic output in the second quarter (-0.2 percent quarter-on-quarter in the euro area, -0.1 percent in the EU), Europe's economy is set to cool further. A negative contribution to growth in the second quarter came from exports as

Europe's economy cooling

well as manufacturing value added. The decline in new orders received in May and June points to a protracted slowdown in industrial production. In August, the European Commission's Economic Sentiment Indicator fell again substantially in both the euro area and the EU as a whole. On EU average, the index reached its lowest level since December 1993; the underlying indicators declined in the manufacturing and construction sectors, but also in the services sector. Influenced by the negative developments in real estate markets, confidence indicators deteriorated particularly in Great Britain and Spain. The outlook for EU exports is dampened by slack global demand and the weak dollar, even though the euro exchange rate fell from its all-time high of 1.58 \$ in July 2008 to \$ 1.50 on average in August. In the first week of September it fell further, to 1.42 \$ (rate of 08 September 2008).

Consumer confidence did not deteriorate further in the euro area and on EU average in August, despite persistently high food and energy prices. Eurostat's flash estimate shows a slight decline in euro area HICP inflation, to 3.8 percent in August from 4.0 percent in July. In July, inflation was highest in Slovenia (6.9 percent). Above-trend inflation rates (exceeding 5 percent) were observed also in Belgium, Luxembourg, Malta, Spain and Cyprus; the lowest rate was registered for the Netherlands (3.0 percent).

The economic slowdown put an end to the decline in unemployment in most European countries. The seasonally adjusted unemployment rate has remained unchanged at 7.3 percent since April in the euro area, and has also remained stable at 6.8 percent on EU-27 average. Unemployment has been rising again in Spain and Ireland since the beginning of the year.

Germany's economy, having briskly expanded at the beginning of the year (first quarter +1.3 percent in real terms quarter-on-quarter), contracted by 0.5 percent in the second quarter. The result reflected notably the slowdown in the domestic demand: both consumer demand and construction investment inhibited growth; the decline in construction investment must also be seen as a counter-reaction to the strong weather-related growth in the first quarter.

The sharp increase in prices continues to dampen the propensity to consume. Real retail sales fell in July, leaving them 1.5 percent lower than in June (seasonally and working day adjusted). Leading indicators suggest that economic activity will remain subdued also in the third quarter. According to the Ifo Business Climate Index, the assessment of both the current business situation and the outlook for the next six months deteriorated markedly in August. Industrial and export activity may, however, stabilise now that the strain caused by the high euro exchange rate and price increases for crude oil is easing.

The German labour market has so far shown hardly any weakening tendency. In August, the unemployment rate fell by 0.1 percentage point to 7.6 percent.

Austria's real GDP expanded at a seasonally and working day adjusted quarter-on-quarter rate of 0.4 percent in the second quarter. In year-on-year terms, GDP rose by 2.0 percent. The slowdown in growth is particularly apparent in manufacturing, where value added expanded hardly at all compared with the previous quarter (+0.2 percent in real terms). Evidence from the WIFO business survey suggests that the pace of expansion will decelerate further in the third quarter. While stocks of finished goods are being built up, the balance of firms with insufficient domestic and foreign order book levels in August exceeded the average for the last five years.

Firms' expectations regarding the business situation in the next six months have deteriorated even more sharply. While only around one tenth of the firms anticipate an improvement, one fourth assume conditions will deteriorate over the next six months. Manufacturers have not been so pessimistic since the 2001 downturn.

Confidence indicators show that sentiment in the industrial sector has darkened further in Europe.

Germany's economy contracting

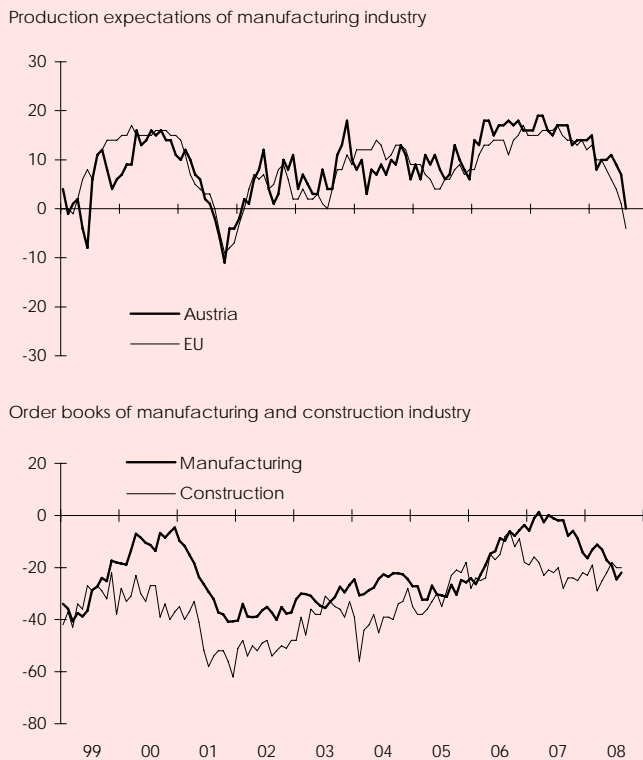
After the decline in GDP in the second quarter, sentiment in Germany is deteriorating further.

Austria: slowdown in industrial and export activity

Industrial and export activity is slowing also in Austria amid weakening global demand.

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.

The loss in momentum in the industrial sector is reflected in foreign trade. Given the fall in demand in the most important export countries, goods exports (according to the national accounts) rose by only 0.4 percent quarter-on-quarter in the second quarter of 2008 (+3.6 percent in real terms, year-on-year) – after +1½ percent in real terms in the second quarter of 2007. According to the Foreign Trade Statistics, cumulated exports to Germany and Italy between January and June exceeded the year-earlier level by only 3.3 percent in nominal terms. In the boom year 2007, exports to Germany had been 9.4 percent higher, those to Italy 10.8 percent.

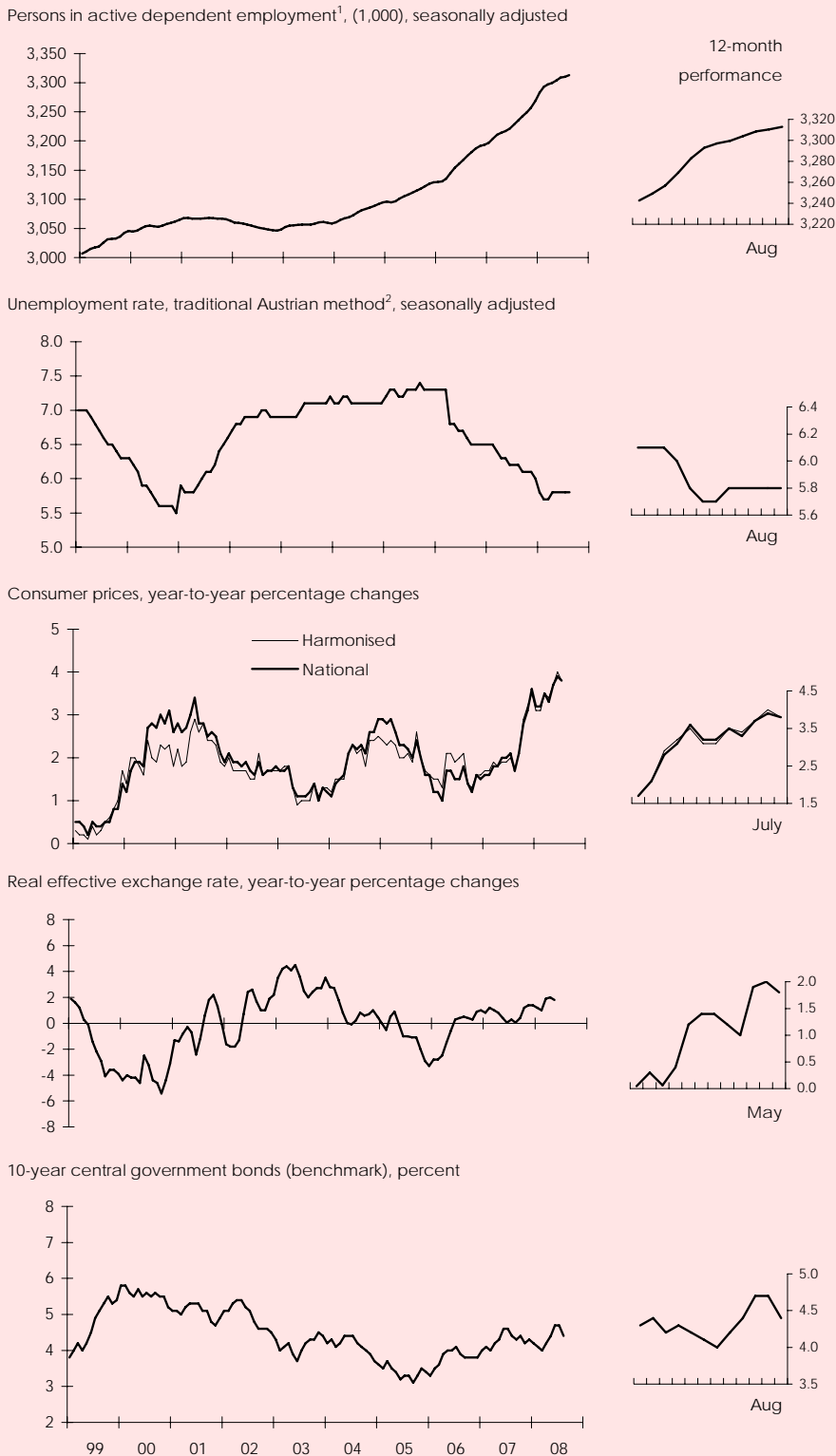
The construction sector has been a solid pillar of the economy also in the current cyclical downturn, with construction value added again expanding by 0.4 percent in real terms quarter-on-quarter in the second quarter (+1.1 percent year-on-year). Construction investment rose by 2.3 percent compared with a year earlier. Investment in non-residential construction expanded at an annual rate of 3.6 percent in real terms, reflecting increased public sector demand for civil engineering work. Residential construction investment, by contrast, rose only modestly (+0.3 percent).

In the WIFO business survey, the entire construction sector continues to give a highly positive assessment of current order book levels, and firms anticipate a persistent rise in prices and stable employment levels.

Austrian firms invested in machinery and equipment despite the slowdown in the pace of economic expansion; but here, too, a slight downward trend has recently become apparent. Investment in machinery and equipment is showing a high degree of volatility in the economic cycle; it expanded at a year-on-year rate of 7.6 percent in real terms in the second quarter (+0.7 percent quarter-on-quarter).

**Pickup in infrastructure
and equipment
investment**

Figure 4: Key economic indicators



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, having developed favourably in the first quarter, weakened in the summer months due to the rise in energy costs. Customer frequency fell by 2.1 percent

Weaker retail sales performance

year-on-year in the second quarter, after –1.1 percent in the first quarter, according to the Austrian Institute for SME Research.

Consumer surveys have been showing a darkening of sentiment already since the beginning of the year, which intensified further as inflation accelerated in recent months. In the second quarter, contractual wage increases (+3.4 percent) stayed below the rate of inflation (3.6 percent).

Against this background, private consumption growth remained weak in the second quarter (+0.8 percent in real terms, compared with a year before); the demand for consumer durables, which is highly responsive to cyclical trends, is falling.

Austria's tourism sector has been successful in the summer season up to now and in the 2007-08 winter season and may have regained market shares. In the first half of the 2008 summer season (May to July), the tourism industry recorded a sales increase by 3.8 percent in real terms from the relatively high level seen in the same period a year before (+3.2 percent in real terms), according to preliminary estimates.

From May to July 2008, the number of overnight stays rose by 3.8 percent. The good overall result is attributable to strong demand in May (+16.4 percent) and positive developments in July (+2.8 percent); June saw a decline by –3.3 percent, which was in part due to calendar effects.

While a strong increase was recorded notably in the number of overnight stays by guests from Russia (+122.1 percent) and eastern neighbouring countries (Poland +36.3 percent, Czech Republic +20.4 percent, Hungary +8.0 percent), overnight stays by guests from Denmark also rose markedly (+5.2 percent). The increase was slightly below-trend for overnight stays by guests from Italy (+4.9 percent), Germany (+4.3 percent) and the Netherlands (+3.9 percent), whereas a decline in demand was recorded in the case of Belgium (–4.2 percent), Great Britain (–4.5 percent) and the USA (–17.4 percent) – in the USA probably largely due to the weak dollar.

Inflation, which at 3.9 percent had hit its highest level in 15 years in June, moderated slightly to 3.8 percent in July. The largest contribution (around one third) to headline inflation in July again came from year-on-year price increases for fuel and heating oil. Fuel prices were up 25 percent on average from a year before, but eased slightly on a month-on-month basis.

0.8 percentage point of headline inflation in July was attributable to the rise in food prices; they were up by 7.4 percent on average from a year earlier. Agricultural prices have begun to ease gradually. Crude oil prices have been falling since mid-July 2008: in August, the price of Brent crude averaged \$ 113 a barrel (\$ 133 in July). The HWWI Index of World Market Prices of Commodities, which comprises food, beverages and tobacco as well as energy and industrial raw materials, stabilised in July and in August fell already markedly in both euro and dollar terms.

The number of persons in dependent active employment has increased by almost 3 percent year-on-year since the beginning of 2008. In August, the growth rate was still 2.4 percent (+80,100). After seasonal adjustment, a clear weakening of the upward trend becomes apparent: while at the beginning of the year employment had still expanded by +0.4 percent month-on-month, this rate has slowed to only +0.1 percent in recent months.

At the same time unemployment has been falling at a slower pace. In August, a total of 184,000 job seekers were registered, a decline by 7,300 (–3.8 percent) from a year before, which compares with a decline by still 29,000 (–10.7 percent) in the first quarter. On a seasonally adjusted basis, the number of unemployed persons is already rising month-on-month.

The cost burden caused by the rise in energy prices dampens retail sales and consumer sentiment.

Brisk tourism demand

Inflation high also in July

The inflation rate stood at 3.8 percent in July. The rise in energy and food prices, while still accounting for more than half of headline inflation, eased slightly.

Decline in unemployment decelerating

Both employment expansion and the decline in unemployment have been losing momentum since the beginning of the year.

The unemployment rate according to the Austrian method of calculation rose to 5.0 percent in August (after 4.8 percent in July). Developments of job vacancy figures (-2,700 year-on-year) also suggest that the labour market is beginning to weaken in reaction to the prevailing economic situation.