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Industrial Activity Remains Lively, Consumption Slowed By Strong Inflationary Pressures

Business Cycle Report of December 2007

The Austrian economy grew by 3.4 percent in real terms year-on-year in the third quarter. The boom in the export industry continued, and the results of the WIFO Business Cycle Survey point to only a slight deceleration in the coming quarters. By contrast, consumption growth was very modest. Rising inflationary pressures exert a dampening impact on the growth of real disposable income and household consumption expenditure.

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The Austrian economy continued to expand at a robust pace in the third quarter. Real GDP advanced at a year-on-year rate of 3.4 percent, according to WIFO's national accounts. Economic activity was once more driven mostly by robust expansion in the manufacturing sector (+7.9 percent year-on-year) fuelled by vigorous goods exports (+5.9 percent). Austrian exporters are benefiting from the strong expansion of the world economy continuing also in the third quarter. Real GDP growth was just under 3 percent in the EU and the USA, but significantly higher in the emerging markets. However, signs are mounting that developments are clearly decelerating, notably so in the USA where the crisis in the housing sector is increasingly spreading to consumer demand. Besides, the turmoil on international financial markets has not yet been overcome. The effective euro appreciation is affecting the competitiveness of the euro area economy.

In Austria, the construction industry was also a driver of economic activity in the first half of 2007. Notably civil engineering registered very brisk demand generating a strong increase not only in production and employment but also in prices (+3.9 percent). Now signs of a gradual slowdown of the rapid expansion are beginning to emerge. While real value added growth still reached 2.2 percent in the third quarter, employment gains slowed to +0.5 percent in October. Business spending on equipment and machinery also accelerated in the third quarter (+6.7 percent). Overall, however, the pickup in investment has been less pronounced than might be expected in view of the buoyant export activity.

Most important of all, the upswing has not yet spread to household consumption and those branches of industry that are dependent on it. In the third quarter, private consumption growth was just 1.9 percent in real terms compared with a year earlier, hence once again much lower than in the long-term trend. Real value added growth in the retail sector was 1.2 percent, whereas motor vehicle trade and wholesale trade registered a decline.

The expansion of household consumption expenditure is slowed down notably by the modest increase in nominal incomes. Lately, inflationary pressures have also had a dampening effect on real incomes and consumer demand, however. Consumer price inflation was 2.8 percent in October, mostly driven by strong price increases for dairy products as well as fuel, electricity and gas. Current developments of producer

prices for food and world market prices for crude oil do not suggest an easing of consumer price inflation in the coming months.

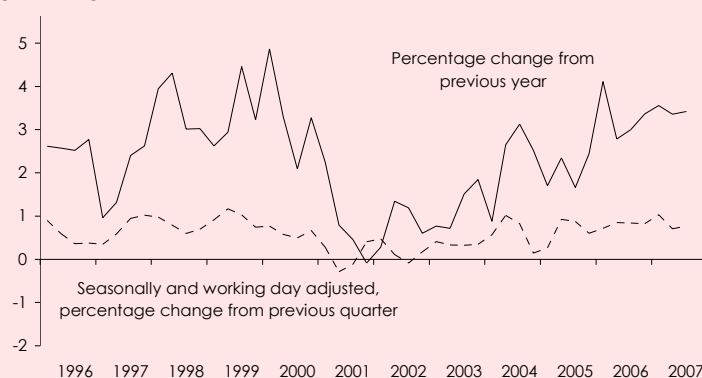
Table 1: Quarterly national accounts

			Second quarter	2006 Third quarter	Fourth quarter	First quarter	2007 Second quarter	Third quarter
Percentage changes from previous quarter								
<i>Adjusted for seasonal and working day effects, volume</i>								
Final consumption expenditure			+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 0.4	+ 0.8
Households ¹			+ 0.4	+ 0.3	+ 0.4	+ 0.4	+ 0.4	+ 0.5
General government			+ 0.5	+ 0.5	+ 0.4	+ 0.3	+ 0.4	+ 2.0
Cross capital formation			+ 0.8	+ 0.8	+ 0.8	+ 0.7	+ 0.5	+ 0.4
Gross fixed capital formation			+ 1.2	+ 1.3	+ 1.4	+ 1.3	+ 0.8	+ 0.7
Machinery and equipment			+ 0.2	+ 0.2	+ 1.0	+ 0.9	+ 0.9	+ 0.7
Construction			+ 1.8	+ 2.1	+ 1.6	+ 1.0	+ 0.6	+ 0.3
Exports, goods and services			+ 0.9	+ 2.0	+ 2.2	+ 1.7	+ 0.9	+ 1.2
Goods			+ 0.5	+ 2.2	+ 2.4	+ 2.0	+ 0.7	+ 0.9
Services			+ 1.5	+ 1.6	+ 1.6	+ 1.6	+ 1.7	+ 1.6
Imports, goods and services			+ 1.4	+ 1.6	+ 1.6	+ 1.1	+ 0.4	+ 1.0
Goods			+ 1.5	+ 1.5	+ 1.5	+ 1.3	+ 0.7	+ 1.1
Services			+ 1.7	+ 1.6	+ 0.9	+ 0.2	+ 0.2	+ 0.5
Gross domestic product			+ 0.8	+ 0.8	+ 0.8	+ 1.0	+ 0.7	+ 0.8
Manufacturing			+ 2.0	+ 2.0	+ 2.7	+ 2.2	+ 1.3	+ 1.3
	2005	2006	Second quarter	2006 Third quarter	Fourth quarter	First quarter	2007 Second quarter	Third quarter
Percentage changes from previous year								
<i>Volume, chained prices</i>								
Final consumption expenditure	+ 2.0	+ 2.1	+ 2.4	+ 1.9	+ 1.9	+ 1.0	+ 1.6	+ 2.2
Households ¹	+ 2.0	+ 2.1	+ 2.5	+ 1.7	+ 1.9	+ 0.8	+ 1.6	+ 1.9
General government	+ 1.9	+ 2.1	+ 2.1	+ 2.4	+ 2.0	+ 1.3	+ 1.4	+ 3.1
Cross capital formation	- 1.3	+ 3.7	+ 1.9	+ 4.6	+ 1.4	+ 11.9	- 1.1	+ 6.3
Gross fixed capital formation	+ 0.3	+ 3.8	+ 1.0	+ 4.4	+ 3.8	+ 9.6	+ 3.4	+ 4.3
Machinery and equipment	+ 1.0	+ 1.5	+ 2.5	+ 1.6	- 4.1	+ 8.1	+ 1.6	+ 6.7
Construction	+ 0.1	+ 5.1	+ 0.1	+ 6.0	+ 7.8	+ 12.0	+ 4.4	+ 2.8
Exports, goods and services	+ 6.2	+ 7.5	+ 6.0	+ 5.8	+ 8.4	+ 7.9	+ 8.3	+ 6.8
Goods	+ 6.3	+ 7.9	+ 4.8	+ 6.6	+ 8.6	+ 9.6	+ 8.0	+ 5.9
Services	+ 6.2	+ 6.4	+ 9.6	+ 3.7	+ 8.1	+ 3.3	+ 8.9	+ 8.9
Imports, goods and services	+ 5.0	+ 5.6	+ 4.1	+ 4.6	+ 5.6	+ 8.1	+ 4.4	+ 5.5
Goods	+ 5.7	+ 5.5	+ 3.9	+ 4.8	+ 4.1	+ 9.3	+ 5.0	+ 6.5
Services	+ 2.6	+ 6.1	+ 4.7	+ 3.9	+ 10.9	+ 2.5	+ 1.7	+ 1.9
Gross domestic product	+ 2.0	+ 3.3	+ 2.8	+ 3.0	+ 3.4	+ 3.6	+ 3.4	+ 3.4
Manufacturing	+ 3.2	+ 8.8	+ 6.1	+ 7.8	+ 10.0	+ 9.5	+ 8.0	+ 7.9
Gross domestic product, value	+ 3.9	+ 5.1	+ 4.9	+ 4.9	+ 5.3	+ 6.0	+ 5.7	+ 6.2

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

Figure 1: Growth of real GDP

Percentage change from previous period



Source: WIFO.

In the USA, economic growth still maintained much of its momentum in the third quarter. Real GDP expanded by 1.2 percent quarter-on-quarter or by 2.8 percent year-on-year, respectively, according to the revised data. This was largely attributable to exports, which – benefiting from continuing buoyant world trade and the effective depreciation of the dollar – rose by 10.2 percent in real terms from a year earlier, as well as to non-residential investment and private consumption (+3 percent).

Signs of an economic slowdown are evident, despite the good results for the quarter. The housing crisis has deepened further: in the third quarter, home prices dropped 4.5 percent year-on-year, according to the Case-Shiller Home Price Index, and real residential investment fell 16 percent in real terms below the year-earlier level. The unfavourable situation in the housing market is weighing on consumer sentiment, which according to the Conference Board has deteriorated considerably since July 2007. Expectations have worsened even more strongly than the assessment of the current situation, lately also in reaction to marked price increases for mineral oil products.

Weak incoming orders and the deterioration in business confidence point to a slowdown in output growth also in the industrial sector. The services sector (with the exception of retail trade and transportation) and commercial building construction by contrast continue to grow at a vigorous pace.

The turbulence in the international financial system emanated from the US mortgage markets. They entered a state of crisis in July 2007, which has deepened markedly since then. The worldwide liquidity and confidence crisis in financial markets following in its wake has not yet been resolved. The short-term interest rate in the euro area interbank market recently stood at 4.8 percent, exceeding the European Central Bank's reference interest rate by $\frac{3}{4}$ percentage point. Banks are likely to exercise great restraint in granting new credits.

The repercussions on foreign exchange markets have been even more striking. The euro has appreciated by around 13 percent against the dollar since the beginning of 2007. Important economic factors influencing the exchange rate such as the difference between USA and euro area growth and interest rates suggest a further depreciation of the dollar in the coming months.

The European Commission's Economic Sentiment Indicator has been showing a continuous deterioration for the euro area since early summer. Industry, while still booming, is registering a decline in incoming orders. The significant appreciation of the euro may also play a part here as it drags down companies' profit margins and impairs their competitiveness on the global market. Consumer sentiment is underpinned notably by the considerably improved situation on the labour market. Real disposable income growth has remained very muted, though. Besides, the upward drift in prices the public are particularly aware of (for instance fuels and food) has accelerated noticeably in recent months. Headline inflation stood at 2.6 percent in October and is estimated by Eurostat to reach 3 percent in November. Evidence from the surveys conducted by the European Commission shows that as a result consumer confidence has declined at a rapid pace from a record high in May.

German manufacturers continue to produce considerably more than last year, and sentiment among the companies polled by Ifo has deteriorated only marginally since the summer. The export-oriented industry remains the driver of economic activity. The retail sector, on the other hand, from January to October registered a drop in sales by 1.6 percent in volume compared with the same period a year before, reflecting the increase in the value added tax rate at the beginning of the year and the modest pay rises. The German economy therefore remains susceptible to deceleration due to the deterioration in global economic conditions.

USA: good third quarter, but clear signs of slowdown

Export and investment are growing at a robust pace in the USA. The housing slump is increasingly having repercussions on consumer demand.

Turbulence in international financial markets continues

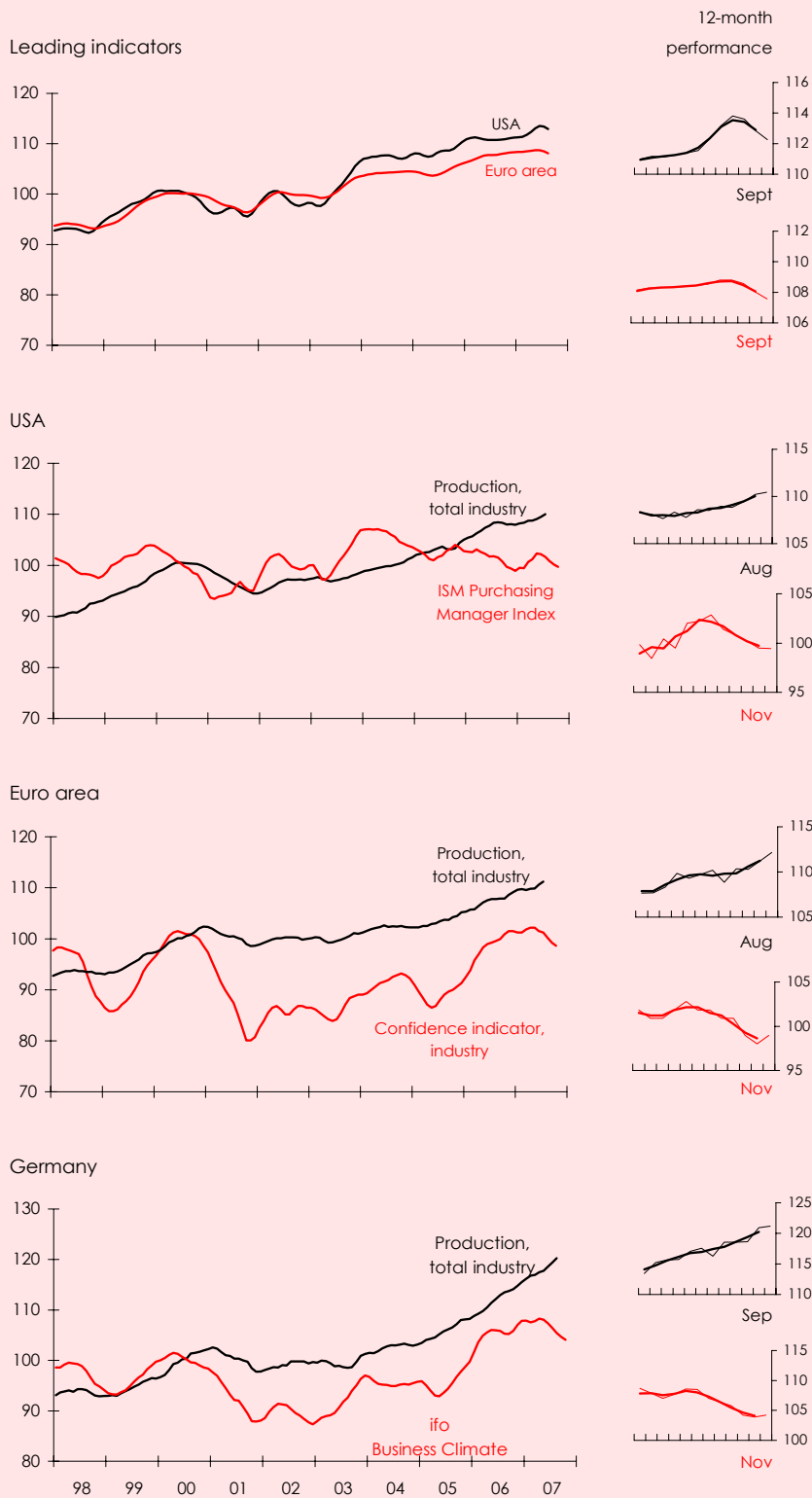
The liquidity and confidence crisis in international financial markets continues, with the depreciation of the dollar vis-à-vis the euro being a particularly grave matter.

Euro area economy moderating slightly

Euro area real GDP expanded by 0.7 percent quarter-on-quarter, or by 2.7 percent year-on-year, respectively, in the third quarter of 2007. The boom in industry is in contrast to sluggish consumer demand.

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.

Austria's export industry continued to be in very good shape in the third quarter, despite a worsening international environment. Goods exports exceeded the year-earlier level by 5.9 percent in real terms. In manufacturing, real value added expanded by 7.9 percent. The favourable trend of business is also reflected in excep-

Boom in Austria's export industry

tionally high employment gains. The manufacturing sector employed 595,000 persons in October, an increase by 15,000 from a year before.

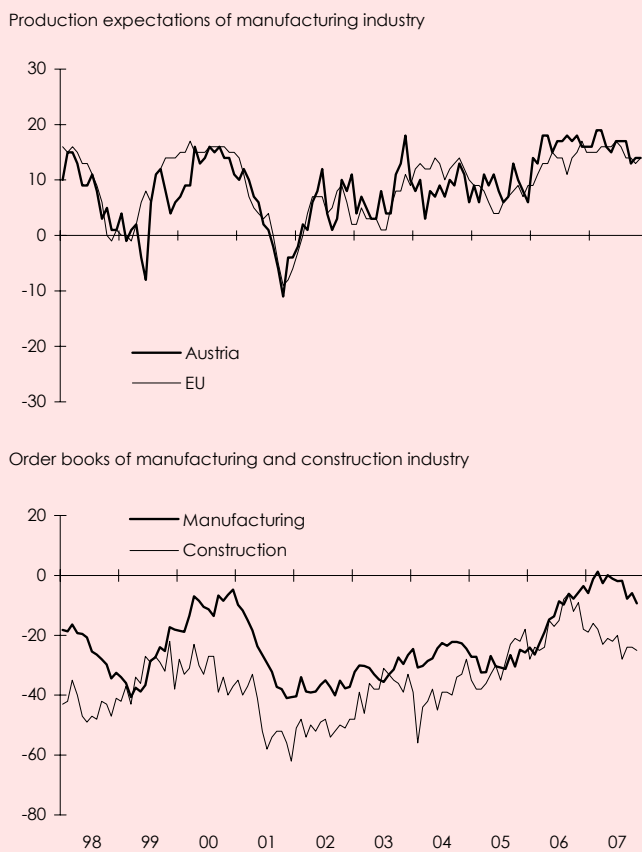
Export activity is likely to moderate slightly in the fourth quarter. This is suggested notably by the somewhat less favourable assessment of foreign order levels given by manufacturers in WIFO's November Business Cycle Survey. In the last few months, especially the manufacturers of primary products and capital goods reported a less favourable order situation. By contrast, the assessment given by the motor vehicle industry and manufacturers of food and non-durable consumer goods has even improved somewhat recently.

Overall, the companies polled in the WIFO Business Cycle Survey report only a slight moderation in the good performance of the industrial sector. Their production expectations as well as their expectations regarding the business situation in six months remain well above their long-term averages.

The manufacturing sector continues to expand at such a fast pace that additional labour is needed. According to the WIFO Business Cycle Survey, companies anticipate only a slight moderation in economic activity.

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.

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The strong expansion in the building sector has been contributing significantly to economic growth this year. The third quarter saw a slight deceleration in value added growth (+2.2 percent in real terms year-on-year, first half of the year +7.1 percent). The continuous expansion of production is reflected in employment gains (third quarter just under +4,000, or +1.5 percent year-on-year, respectively). The high rate of capacity utilisation permits a strong increase in building prices: according to the price index computed by Statistics Austria, building prices in the third quarter exceeded those a year earlier by 3.8 percent.

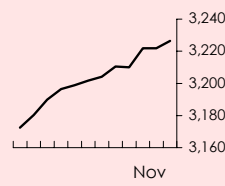
Vigorous building activity with strong price increases

Figure 4: Key economic indicators

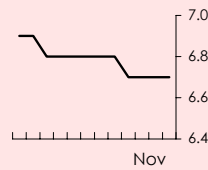
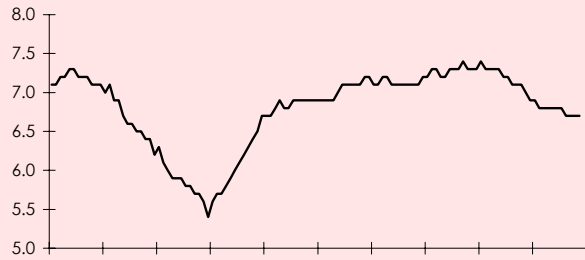
Persons in active dependent employment¹, (1,000), seasonally adjusted



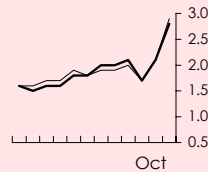
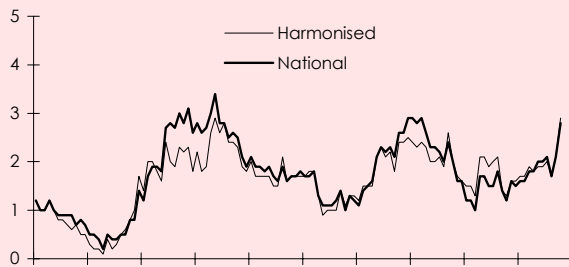
12-month performance



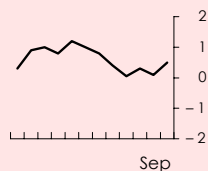
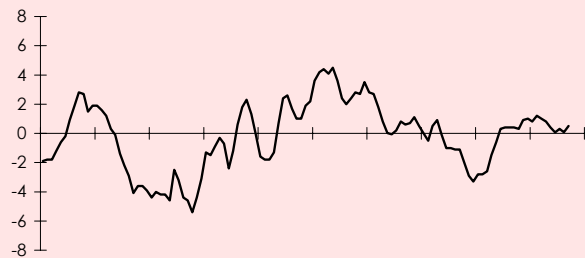
Unemployment rate, traditional Austrian method², seasonally adjusted



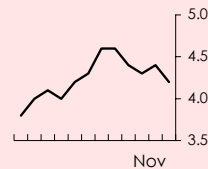
Consumer prices, year-to-year percentage changes



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.

The building sector, where output and employment developments have been very positive, has lately shown symptoms of overheating. Now a slowdown appears to be in the offing.

The companies polled in the WIFO Business Cycle Survey expect activity in the building sector to slowly slacken. Notably office and commercial building construction are registering a decline in new orders, albeit from a very high level. In the civil engineering sector, orders from public infrastructure companies provide for a high rate of capacity utilisation.

There are still no signs that the buoyant export and investment activity is spreading to private consumption. Real retail sales were just 0.3 percent above the year-earlier level in the third quarter, and even stagnated in September (albeit with one sales day less than a year before). Overall, real household consumption in the third quarter exceeded the year-earlier level by 1.9 percent.

Sales developments of durable consumer goods have been quite mixed. While the demand for furniture has been rising vigorously due to the higher number of apartments completed, passenger car sales have been falling noticeably: from January to October, the number of newly registered passenger cars dropped by 3.9 percent compared to the corresponding period the previous year. A particularly strong decline was recorded for registrations of diesel-powered passenger cars (-8.5 percent), in part a consequence of the expiry at mid-year of the tax incentive for the installation of particle filters, another factor being the considerably higher net increase in recent months in the price of diesel fuel compared with other fuels.

The main reason for the lacklustre private consumer demand lies in unfavourable income developments. In October, collectively agreed wages exceeded the year-earlier level by 2.4 percent in nominal terms. In real terms, this corresponds to a substantial reduction by 0.4 percent in per-capita income already before the deduction of fees. Even strong employment growth has caused just a modest rise in disposable household income and hence consumer demand.

Inflation rose to 2.8 percent in October, the highest rate since March 2005. Food, housing and fuels were the main contributors to the rapid surge in prices. The consumer price increase was particularly high for milk and dairy products: in October, the year-on-year price increase was 14 percent for full-cream milk, 19.5 percent for cheese, 26 percent for butter and 20 percent for yoghurt. No correction of the strong increase in prices is yet apparent at the producer price level. Food prices contributed 0.7 percentage point overall, hence around one fourth, to the CPI increase.

Housing costs rose notably on the back of the strong increase in electricity and gas prices (+9 percent and +7 percent, respectively). Fuel prices increased 10 percent year-on-year in October, adding +0.4 percentage point to the inflation rate. In international crude oil markets, prices surged to record highs of almost \$ 100 per barrel in November; while oil prices have somewhat eased since then, Brent crude, at around \$ 90 per barrel still costs about one third more than a year earlier, foreboding persistently high fuel prices for the consumer in the coming months.

Employment expanded vigorously also in November, with the number of persons in dependent active employment exceeding the year-earlier figure by 54,700 (+1.7 percent). Employment gains in manufacturing and construction suggest that substantial portions of the additional jobs are full-time. Jobs continue to rise at a particularly vigorous pace in financial and business services, health services and in retailing.

No pickup in private consumption

Growth in household consumption and retail sales remains subdued.

Marked consumer price inflation

Consumer prices for milk and dairy products as well as for fuels, electricity and gas have risen noticeably, with inflation approaching the 3-percent mark.

Rapid employment growth but weak rise in job vacancies

Around one third of the additional jobs are filled with previously unemployed persons. In November, 223,600 persons were registered as unemployed with the AMS (Public Employment Service), a decline by 8,100 from a year before. In addition, the number of persons enrolled in vocational training programmes dropped by 8,000. Two thirds of the employment expansion fall to the share of new entrants to the labour market, among them notably women and foreign workers.

Notwithstanding the persistently benign employment trend, the labour market too is showing signs that the economy is losing momentum: the number of job vacancies registered with the AMS stood at 33,300 in November, a year-on-year increase by 900. In the first half of 2007 it had still exceeded the year-earlier level by almost 8,000.

The number of employed persons has been rising at an extraordinary pace also in autumn, while the number of unemployed persons has been falling moderately. The slower rise in job vacancies suggests that the job market is losing momentum.