

Markus Marterbauer

Cautious Recovery of Domestic Demand

Economic Outlook for 2006 and 2007

Austria's economy is expected to expand by 2.4 percent in real terms this year, slightly faster than the euro area average. Exports and manufacturing output continue to drive activity forward, and a revival of investment in machinery and equipment is deemed imminent. Higher wage settlements and low inflation will allow private household spending to recover. The labour market is shaped by a strong increase in part-time jobs and rising labour supply. The number of unemployed should decline this year, due to public expenditure on training measures being reinforced.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 29 March 2006. • E-mail address: Markus.Marterbauer@wifo.ac.at

In the export-oriented sector of the Austrian economy, business activity remains favourable, with merchandise exports expected to gain 6.5 percent in volume this year. Notably the domestic suppliers of motor vehicle components should profit from the carrying forward of purchases in Germany to be expected in the run-up to the VAT increase on 1 January 2007. Demand from the oil-exporting countries as well as from the EU accession candidates Bulgaria and Romania is rising briskly. Fuelled by strong exports, domestic manufacturing value added will increase by an inflation-adjusted 5 percent this year, taking the boom in the industrial sector into its third year.

In spite of the favourable climate as regards both demand and financing conditions, domestic corporate investment has remained flat up to the end of 2005. Results from the regular WIFO investment and business climate tests suggest for the motor vehicles and the steel industry as well as for machinery and plant installation that the repeatedly deferred investment projects are now about to be implemented. Overall, investment in machinery and equipment may increase by 4 percent in volume this year.

The construction sector also takes an optimistic view on its order situation. Output and investment should go up by 2.5 percent in 2006, supported notably by higher investment in road construction and a pick-up of industrial building. Demand for new homes is rising also as a result of swift population growth, calling for a substantial housing supply increase over the medium term.

Most recently, conditions for a tentative recovery of private consumption have also improved. Wage settlements of an average 2¾ percent have been higher than in the last few years. Despite the high energy prices, consumer price inflation eased markedly in early 2006. On annual average, headline inflation may moderate to 1.7 percent, allowing per-capita real incomes to rise by ¾ percent in net terms. Assuming no further increase in the saving ratio, the trend in disposable income would enable private consumption to go up by 1.9 percent in volume. Such an increase would significantly exceed the average for the last five years (+1 percent p.a.), but still fall short of the long-term trend rate of 2¼ percent.

A revival of consumer demand would impact favourably on both the labour market and public finances. Private consumption is substantially more labour-intensive than exports and also more rich in tax and social contribution revenues. The number of people in dependent active employment is projected to rise by 34,000 from last year. Following the trend of the last years, the bulk of the jobs newly created will be part-

time, mainly sought by women. However, even the number of full-time jobs may start heading up, after having declined significantly over the last five years. The construction sector is adding to its workforce, and in manufacturing the momentum of output growth is such that despite sizeable productivity gains job losses have virtually come to an end.

Table 1: Main results

		2002	2003	2004	2005	2006	2007
		Percentage changes from previous year					
GDP							
Volume		+ 1.0	+ 1.4	+ 2.4	+ 1.9	+ 2.4	+ 2.0
Value		+ 2.2	+ 2.8	+ 4.4	+ 4.0	+ 4.3	+ 4.0
Manufacturing ¹ , volume		+ 0.4	- 0.1	+ 4.6	+ 3.4	+ 5.0	+ 4.2
Wholesale and retail trade, volume		+ 2.0	+ 0.3	+ 1.9	+ 0.4	+ 1.9	+ 1.9
Private consumption expenditure, volume		+ 0.3	+ 1.6	+ 0.8	+ 1.4	+ 1.9	+ 2.0
Gross fixed investment, volume		- 5.0	+ 6.1	+ 0.6	+ 0.9	+ 3.2	+ 2.7
Machinery and equipment ²		- 8.2	+ 7.7	+ 0.8	+ 0.2	+ 4.0	+ 3.5
Construction		- 2.3	+ 4.8	+ 0.5	+ 1.5	+ 2.5	+ 2.0
Exports of goods ³							
Volume		+ 4.3	+ 2.6	+12.9	+ 3.2	+ 6.5	+ 5.7
Value		+ 4.2	+ 1.9	+13.9	+ 4.6	+ 7.4	+ 6.2
Imports of goods ³							
Volume		+ 0.3	+ 6.5	+11.4	+ 1.9	+ 5.5	+ 5.4
Value		- 2.0	+ 5.0	+12.5	+ 4.8	+ 6.8	+ 6.2
Current balance	billion €	+ 0.75	- 0.48	+ 0.58	+ 1.16	+ 1.63	+ 1.83
As a percentage of GDP		+ 0.3	- 0.2	+ 0.2	+ 0.5	+ 0.6	+ 0.7
Long-term interest rate ⁴	in percent	5.0	4.2	4.2	3.4	4.0	4.3
Consumer prices		+ 1.8	+ 1.3	+ 2.1	+ 2.3	+ 1.7	+ 1.9
Unemployment rate							
Eurostat definition ⁵	in percent	4.2	4.3	4.8	5.2	5.2	5.2
National definition ⁶	in percent	6.9	7.0	7.1	7.2	7.1	7.2
Persons in active dependent employment ⁷		- 0.5	+ 0.2	+ 0.7	+ 1.0	+ 1.1	+ 0.9
General government financial balance according to Maastricht definition							
As a percentage of GDP		- 0.4	- 1.2	- 1.0	- 1.7	- 1.9	- 1.5

Source: WIFO Economic Outlook. – ¹ Value added, including mining and quarrying. – ² Including other products. – ³ According to Statistics Austria. – ⁴ 10-year central government bonds (benchmark). – ⁵ According to Eurostat Labour Force Survey. – ⁶ According to Labour Market Service, as a percentage of total labour force excluding self employed. – ⁷ Excluding parental leave, military service, and unemployed persons in training.

Labour supply keeps rising at a solid pace, due to the continued inflow of foreign labour and a decline in new claims for early retirement. Short-term relief for the strained labour market situation is not in sight. Nevertheless, due to higher public spending on active labour market policy, the average number of person enrolled in training activities will be higher by 11,000 than last year. Since these will not be counted as unemployed, the registered jobless figure will edge down by 3,000 from last year. For next year, no further extension of funds earmarked for qualification measures is foreseen, and the subsidies from the European Social Fund are likely to be cut. The official unemployment figure is expected to increase by 5,000 to a level of 255,000 in 2007.

The general government deficit has been widening markedly in recent years and is expected to reach some € 5 billion or 1.9 percent of GDP this year. Healthy corporate profits and the pick-up of wages and consumer spending will be reflected in higher tax and contribution revenues. However, also public expenditure may turn out higher than budgeted, given rising costs for purchases of material goods and personnel and since additional funds have been committed for labour market policy, research and education. No Federal budget bill has yet been submitted for 2007. On the basis of the

present growth forecast and assuming restraint being exerted on public expenditure the projection is for a general government deficit in the order of 1½ percent of GDP.

The projection rests on a number of relatively optimistic assumptions:

- oil prices remain high, but without rising further;
- the euro depreciates slightly against the dollar;
- short- and long-term interest rates will but slightly increase further;
- the real estate price bubble in the USA will not burst, such that consumer expenditure will decelerate only gently;
- restraint on private investment in Austria will come to an end;
- the private household propensity to save will not increase further.

The short-term risks to the forecast lie mainly with the assumptions on the international scenario. As regards Austria, it remains to be seen whether the expected revival of investment in machinery and equipment actually materialises. Private consumption may advance even somewhat more strongly if a decline in the propensity to save can be achieved. In 2007, growth may turn out a bit stronger than the 2 percent assumed in the present WIFO projections, if in the EU, supported by an increase of public investment in infrastructure, innovation and education that would be required in order to achieve the Lisbon goals, a powerful cyclical upswing would be set in motion.

The world economy has since 2004 followed a path of vigorous expansion. Growth of real output should attain 4½ percent or more this year, that of world trade a rate almost twice as high. The most dynamic area is Asia which benefits notably from the sustained boom of the Chinese economy. China's GDP, according to official figures, is growing at 9 percent per year in volume. With exports and imports rising about twice as fast, China's integration into the global economy is progressing rapidly. Growth in China is stimulating production also in Japan and other economies in Asia. However, in this area also internal demand is rebounding markedly. Signs are mounting in Japan that the period of stagnation that lasted for one-and-a-half decade has finally been overcome.

The economies in Latin America have also resumed an upward trend. They benefit from lively demand for industrial raw materials, but also from rising confidence in political developments in the region.

Oil prices on world markets resumed a strong upward drift in the second half of 2005, largely as a consequence of the damages to refinery installations in the Caribbean caused by hurricanes. In August and September, spot market quotations for Brent rose for the first time above the threshold of \$ 60 per barrel. Since that time, the situation on oil markets has hardly eased: refinery capacities constitute a supply bottleneck, demand from China and India keeps rising fast, and the international political situation is unstable. The uncertainties surrounding Iran's nuclear policy, the critical conditions in Iraq and Palestine, and the conflicts about oil production facilities in Nigeria all add to the high price volatility.

The WIFO forecast assumes oil prices to remain high, at an average import price for the industrialised countries of nearly \$ 60 per barrel in 2006 and 2007. The risks are clearly biased towards prices increasing further rather than easing. The price jump implies a deterioration in the terms-of-trade for the oil-importing advanced economies, weighing on income and output. A positive counter-weight arises from the fact that the income gains for the oil producing countries are channelled into higher demand for investment and durable consumer goods. A major beneficiary of the "re-cycling" of the high oil revenues is Germany, with its export strength concentrated in the categories of goods concerned.

Since the beginning of 2005, the euro has weakened by about 9 percent against the dollar. Most analysts attribute this to the widening short-term interest rate differ-

Global economic activity keeping strong momentum

On the back of rapid expansion in Asia and America, world trade and world GDP are growing strongly.

Persistently high commodity prices

High oil prices are dampening activity in the industrialised economies and constitute a major risk to the short-term outlook.

ential between the USA and Europe, a factor that may lead to a further small depreciation of the euro in 2006 and 2007. However, the exchange rate outlook is particularly uncertain, as the high US current account deficit is widely regarded as a key risk factor for dollar depreciation. Underlying the WIFO projections is an exchange rate of \$ 1.16 per euro for 2006.

Table 2: World economy

	2002	2003	2004	2005	2006	2007	
	Percentage changes from previous year						
<i>Real GDP</i>							
World total	+ 2.8	+ 3.8	+ 5.1	+ 4.4	+ 4.6	+ 4.4	
Total OECD	+ 1.5	+ 2.0	+ 3.3	+ 2.6	+ 2.9	+ 2.8	
USA	+ 1.6	+ 2.7	+ 4.2	+ 3.5	+ 3.3	+ 3.0	
Japan	+ 0.1	+ 1.8	+ 2.3	+ 2.7	+ 2.3	+ 2.5	
EU 25	+ 1.2	+ 1.2	+ 2.4	+ 1.5	+ 2.2	+ 2.0	
EU 15	+ 1.1	+ 1.0	+ 2.3	+ 1.4	+ 2.1	+ 1.9	
Euro area	+ 0.9	+ 0.7	+ 2.1	+ 1.3	+ 2.1	+ 1.9	
Germany	+ 0.1	- 0.2	+ 1.6	+ 0.9	+ 1.9	+ 1.2	
New member states ¹	+ 2.6	+ 3.8	+ 5.1	+ 4.6	+ 4.0	+ 4.0	
China	+ 8.3	+ 9.3	+ 9.5	+ 9.3	+ 9.0	+ 9.0	
<i>World trade, volume</i>	+ 3.4	+ 4.9	+ 8.1	+ 7.3	+ 8.5	+ 8.0	
<i>Market growth²</i>	+ 2.0	+ 5.6	+ 9.1	+ 5.5	+ 6.3	+ 5.5	
<i>Primary commodity prices</i>							
HWVA index, total	- 5	- 4	+ 18	+ 29	+ 21	+ 4	
Excluding energy	- 6	- 6	+ 18	+ 6	+ 15	+ 8	
<i>Crude oil prices</i>							
Average import price (cif) for OECD countries	\$ per barrel	24.1	28.4	36.3	50.3	59.0	58.0
<i>Exchange rate</i>							
\$ per euro	0.945	1.131	1.243	1.245	1.16	1.12	

Source: WIFO Economic Outlook. – ¹ Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia. – ² Real import growth of trading partners weighted by Austrian export shares.

Economic activity in the USA disappointed towards the end of 2005. GDP in the fourth quarter edged up by 0.4 percent from the previous period, exceeding the year-earlier level by 3.2 percent. A major dampening factor was weaker private consumption, partly caused by the immediate impact of the autumn hurricanes and by the expiry of price concessions granted by car manufacturers. Beyond these, more lasting influences are at work: the rise in real estate prices has recently lost momentum in a number of regions, thereby weakening the incentive for higher household consumption. As a consequence of the swift increase in interest rates by the Federal Reserve (totalling 3.75 percentage points since summer 2003), mortgage rates are also drifting upwards, critically affecting private households which have raised their debt to high levels.

More favourable is the trend in the industrial sector. Output has strengthened further towards the end of last year, and incoming orders remain lively. On the back of rising capacity utilisation and encouraging sales prospects, corporate investment is growing markedly, albeit at a somewhat slower pace of late. GDP growth is expected to moderate gradually from 3.5 percent in 2005 to around 3 percent in 2007. However, the risks would appear to rather lean towards the negative side. A possible slump in real estate markets remains the major risk for business activity in the USA. Moreover, the high current account deficit, which may widen to over 7 percent of GDP by 2007, may undermine economic growth, not only in the USA but for the world economy at large.

The euro area economy expanded by 1.3 percent in volume in 2005. Towards the end of the year, the economy gave mixed signals. On the one hand, a revival of investment activity appeared to emerge, supported by healthy profits, an improving

Risks for cyclical activity in the USA

Under the impact of repeated interest rate hikes and real estate prices leveling off, economic growth is gradually decelerating in the USA.

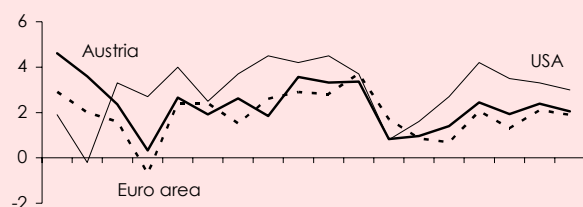
Recovery of investment in the euro area

sales outlook and a tentative rebound of capacity utilisation. In a number of euro area member states investment is firmly pointing upwards, a tendency that should become stronger during 2006, as suggested also by a significant brightening of the industrial business climate. On the other hand, the upward trend in industrial production of last autumn was interrupted in December and January.

Figure 1: Indicators of economic performance

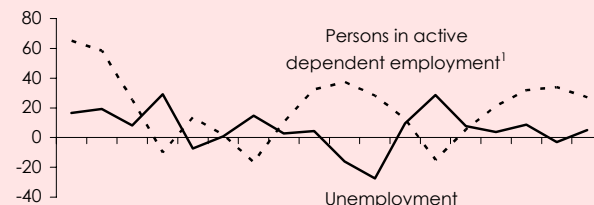
Growth of real GDP

Percent



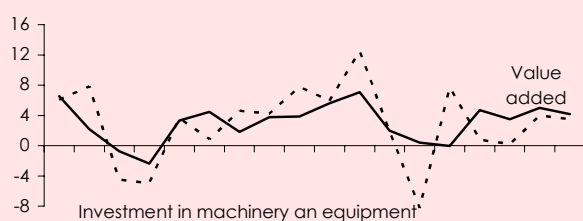
Employment and unemployment

1,000 from previous year



Manufacturing and investment

Percentage changes from previous year, volume



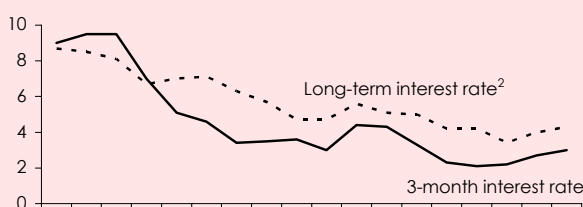
Consumption and income

Percentage changes from previous year, volume



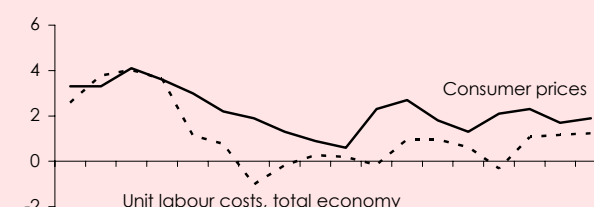
Short-term and long-term interest rates

Percent



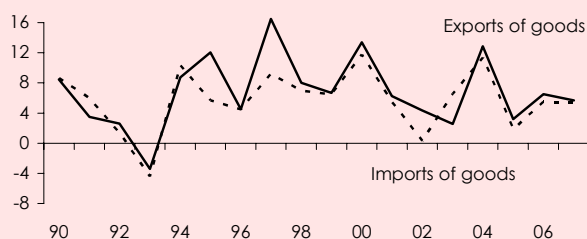
Inflation and unit labour costs

Percentage changes from previous year



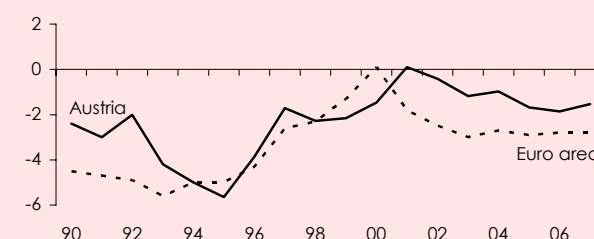
Trade

Percentage changes from previous year, volume



General government financial balance

As a percentage of GDP



Source: WIFO Economic Outlook. – ¹ Excluding parental leave, military service, and unemployed persons in training. – ² 10-year central government bonds (benchmark).

The sluggishness of consumer demand remains the key problem of the euro area business cycle. With a rate of 1.3 percent in volume in 2005, growth of private household spending remained below its long-term trend for the fifth year in a row.

The main reason should be seen in the but modest advance of disposable income. In addition, consumer confidence is in many countries undermined by a weak labour market situation and the prospects of further restraint in social security and welfare spending. The cyclical recovery driven by exports and investment should nevertheless exert a positive impact on private incomes and consumption. Household demand is therefore expected to gradually pick up momentum in 2006 and 2007.

For the euro area, WIFO expects GDP growth to attain 2.1 percent in real terms in 2006, before abating slightly in 2007. This profile mirrors the temporary cyclical setback in Germany (with its GDP accounting for almost 30 percent of total euro area GDP) under the impact of a restrictive fiscal policy stance.

Consumer price inflation is projected to remain stable slightly above an annual rate of 2 percent, broadly unchanged from the last few years. In the current year, it is mainly the high energy prices that prevent inflation from falling. No substantial spillovers to prices of other consumer goods categories have been observed so far, with the "core" rate of inflation (excluding energy and unprocessed food items) hovering around 1½ percent. The increase in the standard VAT rate in Germany is expected to temporarily boost the euro area inflation rate by some 1/3 percentage point.

During the last few months, the European Central Bank has raised its short-term refinancing rate by ½ percentage point, justifying the move largely with the danger of second-round effects of the jump in energy prices. The rate increase came at a very early stage of the cyclical recovery. Given its expectations for growth and inflation, WIFO, in its present forecast, anticipates an additional increase in the key policy interest rate by ¼ percentage point in 2006.

The acceleration of economic growth will lead only to a limited decline in unemployment and government deficits. More substantial relief on both accounts can only be expected, once the recovery spills over to private consumption – the latter having a stronger impact on employment and tax revenues than increases in export or investment demand. The rate of unemployment is likely to edge down in the euro area from 8.6 percent in 2005 to just above 8 percent by 2007. The aggregated general government deficit may narrow from 3 percent of GDP in 2005 to nearly 2½ percent in 2007, largely owing to the comprehensive consolidation programme to be implemented in Germany.

Growth performance in Germany was once again disappointing in the fourth quarter of 2005, when GDP adjusted for seasonal and calendar effects remained flat from the previous three-months period. Private household spending, when adjusted for inflation, has been stagnating since 2001, mainly due to real income losses suffered by employees and a marked increase in the saving ratio. Consumer demand has not picked up in the fourth quarter either, even if the sentiment among private households is improving.

Due to sizeable advance purchases of durable consumer goods, notably motor cars, ahead of the increase in the standard VAT rate from 16 percent to 19 percent as from 1 January 2007, WIFO, however, expects a revival of private consumption in the course of 2006. These pre-emptive purchases will raise Germany's GDP by around ½ percent in 2006. The boost to consumption will, however, be short-lived, with a corresponding setback to be expected for 2007.

The VAT increase will push up the headline rate of inflation by at least 1 percentage point. Adverse effects are to be expected for real incomes, in particular old-age pensions for which no nominal increase is foreseen for the next few years.

For the German export industry, the situation remains favourable. Goods exports benefit in particular from higher demand from the oil-producing countries for investment goods and consumer durables, as well as from the significant fall in relative unit labour costs and the decline of the euro exchange rate against the dollar. The impulse from buoyant exports still awaits being translated into higher investment.

Due to the front-loading of demand, growth of real GDP is likely to attain nearly 2 percent in 2006, before abating to a rate of 1¼ percent in 2007. The deceleration

Lively exports are increasingly providing stimulus for investment in the euro area. Nevertheless, private household spending remains subdued.

Business sentiment in Germany improving

Due to buoyant exports and the front-loading of domestic demand ahead of the VAT increase, the German economy will enjoy solid growth in 2006. In 2007, the restrictive stance of fiscal policy is likely to lead to a setback.

in the latter year is explained not only by the negative echo-effect of the advance purchases, but also by the impact of the comprehensive programme of fiscal consolidation and the compliance with the requirements of the Stability and Growth Pact.

The export-oriented sector has since 2004 been the major force of the cyclical recovery in Austria. Goods exports are rising strongly (also in 2005, when foreign trade data are adjusted for distortions related to the export and import of goods only for repair purposes ("Veredelungsverkehr", notably for aircrafts). The recovery in key trading partner countries and the high degree of price competitiveness of domestic firms suggest that export strength will continue in 2006.

The manufacturing sector which is predominantly oriented towards foreign markets is enjoying the third consecutive year of favourable business conditions, with net output expected to expand by 5 percent in volume. In particular the suppliers of motor car components should be able to post sizeable gains. Despite lively foreign demand and healthy output gains, investment in machinery and equipment has remained lacklustre so far. However, the favourable business environment should now persuade investors to no longer hold back with the implementation of the many projects planned. WIFO expects a substantial increase in corporate spending on machinery, business vehicles and electronic equipment, as suggested by the results from its regular investment and business surveys. However, such rebound has so far not been confirmed by the official statistics.

Higher wage settlements, a slowdown in consumer price inflation and the rise in the saving ratio having come to a halt allow private consumption to gain nearly 2 percent in volume this year, the strongest increase since 2000. By spreading to private consumption, the cyclical recovery may make a decisive step forward. This would be a crucial condition for an improvement in the labour market as well as in public finances. A pick-up in private consumption presupposes that private household confidence stabilises and that private saving as a share of disposable income does not resume its upward trend.

In 2007, a number of dampening effects will be felt, most notably a slowdown of growth in Germany as a result of budgetary restriction. For the whole year 2007, WIFO expects GDP growth for Austria at around 2 percent.

The world economy is currently taking a very favourable development. Nevertheless, important short-term risks to the forecast derive from the international environment. Oil prices have more than doubled since 2001, a further increase may hold back growth of investment and consumption. While the exchange rate of the euro vis-à-vis the dollar has declined since the beginning of 2005, a renewed euro appreciation would weigh on exports and investment. A marked slackening of consumer demand in the USA, possibly triggered by a slump in real estate prices, could derail an important engine for the global economy.

On the other hand, the economy may prove more robust in 2007 than assumed in the present projections. This would notably be the case if economic policy would move EU-wide to a pro-active support for investment in infrastructure, education, training and innovation, along the lines of the Lisbon process.

According to official data from Statistics Austria, growth of merchandise exports of 4.6 percent in nominal terms in 2005 trailed importantly the strong 13.9 percent advance of the previous year. In real terms, the increase was 3.2 percent. The foreign trade statistics would imply market share losses both in East-central and in western Europe. However, two special factors need to be borne in mind: first, the statistically recorded losses of market shares should be taken as a correction of the extraordinary gains in 2004; second, since 1 January 2005 the intra-EU foreign trade statistics no longer register goods exported or imported for the purpose of being repaired – a special form of trade ("Veredelungsverkehr") that played a significant role in 2004 mainly in the category "aircrafts". Adjusted for this special factor, the figures for

Gradual recovery of domestic demand in Austria

Strong activity in the export-oriented sector may translate into higher investment in 2006 and, to a lesser extent, into increased private household spending. In such a scenario, the Austrian economy will grow by 2.4 percent in real terms this year.

Export sector in inherently strong position

nominal export growth change to 11.8 percent and 8 percent for 2004 and 2005, respectively. Thus, the deceleration was much less sharp than suggested by the unadjusted foreign trade data.

Exports were lively towards the end of 2005. According to preliminary national accounts data, merchandise exports in the 4th quarter rose by almost 2 percent in volume, on a seasonally adjusted basis, from the previous period. Austria is taking advantage of buoyant demand in major trading partner countries: German exports keep strong forward momentum, and the economies of the oil-exporting countries and in Southeast Europe are expanding fast. Austria's exports to Russia and to the OPEC members jumped by about 20 percent in 2005, exports to Bulgaria and Romania by some 15 percent. Total merchandise exports are projected to increase by 6½ percent in volume in 2006; for 2007, WIFO expects a slight deceleration, mainly on account of the slowdown of activity in Germany.

Strong exports are providing stimulus for manufacturing output, with value added rising by almost 2 percent seasonally adjusted in the fourth quarter 2005 from the previous period. In the WIFO business survey of last March, firms expressed a good deal of confidence concerning output expectations and current order levels. WIFO therefore expects real value added in manufacturing to increase by 5 percent in volume in 2006, taking buoyancy in the industrial sector into its third year in a row. Output of domestic suppliers to the German motor car industry should prove particularly dynamic this year.

In early 2006, manufacturing output rose to an extent that for the first time since 2001 employment virtually stopped declining. The job total in manufacturing now amounts to some 570,000. While wages and salaries are set to go up by 3 percent in 2006 and thereby more than in the last few years, the increase nevertheless remains well below the gain in hourly productivity of about 5 percent. Manufacturing labour costs therefore remain on a downward trend even in nominal terms. Compared with their level ten years ago, unit labour costs are down by about one-sixth.

Conditions for a revival of private investment appear favourable. Lively export demand makes for solid gains in industrial output and rising capacity utilisation. Profits are high and financing conditions easy. Nevertheless, no signs of a pick-up in investment have been observed until the end of 2005. According to preliminary national accounts data, corporate spending on machinery and equipment edged up by only 0.7 percent seasonally adjusted in the fourth quarter from the level three months earlier. The slow momentum is confirmed by the sluggishness of machinery and vehicles imports, which are traditionally a good indicator for investment activity. Imports in this category (abstracting from the distortions caused mainly by aircraft repair transactions) were no higher in value in the fourth quarter than one year earlier. Whereas demand went up for communication equipment and office machinery, metal-processing machines and motor vehicles suffered a marked decline.

WIFO expects for the first quarter a pick-up in investment in machinery and equipment, which is corroborated by survey results. According to the WIFO Autumn 2005 investment survey, manufacturers intend to step up their capital expenditure by 7 percent in volume this year. The WIFO business surveys of January and February indicate a further brightening of sales prospects, which should induce firms to liquidate the backlog of deferred investment projects. WIFO expects investment in machinery and equipment to increase by 4 percent in volume in 2006 and by a similar rate in 2007.

Available data for the current account balance in the first nine months of 2005 suggest that, on an accrual base, the surplus for the whole year amounted to € 1 billion or slightly above. As late as in 2003, there had been a deficit of € ½ billion. The marked improvement of the external balance within two years should, however, be interpreted with caution. Rather than reflecting actual developments of exports and

Austrian firms benefit from strong export growth and from lively demand for motor cars in Germany. Sizeable advances in hourly productivity in industry make for further improvements in price competitiveness.

Third consecutive year of strong growth in industry

Manufacturing value added is expected to grow by 5 percent in real terms in 2006. Employment is no longer falling, notwithstanding strong advances in productivity.

Favourable conditions for higher investment in machinery and equipment

Results from the regular WIFO business and investment surveys point to a recovery of business fixed investment. Rising capacity utilisation, good sales prospects and favourable financing conditions all make for a positive investment climate.

Severe problems of statistical recording of external transactions

imports, it may be shaped by problems in the statistical base. Particularly eye-catching is the apparent drop in Austrian tourism spending abroad in 2004 (imports of tourism services –12 percent), which is derived from survey data considered implausible by WIFO. This figure by itself improves the current account balance by around € 1 ½ billion. In addition, the preliminary data show for the first nine months of 2005 an increase in "other services" export revenues by 12 percent. While some gains in this item should be expected, an increase of the reported size, with an impact of € +¾ billion on the current account, would be truly surprising. Whether these figures stand up to future data revisions remains to be seen.

Table 3: Productivity

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 1.0	+ 1.4	+ 2.4	+ 1.9	+ 2.4	+ 2.0
Employment ¹	– 0.1	+ 0.1	– 0.0	+ 0.6	+ 0.8	+ 0.8
Productivity (GDP per employment)	+ 1.1	+ 1.3	+ 2.5	+ 1.3	+ 1.6	+ 1.2
<i>Manufacturing</i>						
Production ²	+ 0.4	– 0.0	+ 4.7	+ 3.3	+ 5.0	+ 4.2
Employees ³	– 2.5	– 1.7	– 0.6	– 0.9	– 0.2	– 0.5
Productivity per hour	+ 3.5	+ 1.3	+ 4.5	+ 5.0	+ 5.0	+ 4.9
Working hours per day per employee ⁴	– 0.5	+ 0.3	+ 0.8	– 0.5	+ 0.2	– 0.2

Source: WIFO Economic Outlook. – ¹ Dependent and self-employed according to National Accounts definition. – ² Value added, volume. – ³ According to Federation of Austrian Social Security Institutions. – ⁴ According to "Konjunkturerhebung" of Statistics Austria.

In a medium-term perspective, the improvement in the current account has been even more marked, against the backdrop of a deficit of more than € 5 billion in 2000. Although the massive turnaround partly mirrors the high price competitiveness of Austria's outward-oriented sector, it has been primarily due to sluggish import growth and is therefore an expression of the weakness of domestic demand. A major factor has been the adverse trend in machinery and equipment investment (with an import ratio of roughly two-thirds) and in private consumption (whose import content is about one-fourth).

Owing to good snow conditions, the tourism industry enjoyed an excellent winter 2005-06 season. Results should also be positive for the whole year 2006. Demand from foreign customers is projected to go up by roughly 6 percent in nominal and 3¾ percent in real terms from last year. Temporary effects in Austria's favour are the term of the EU presidency and the Mozart anniversary.

Demand from the new dynamic markets enjoying strong income gains is rising rapidly. Overnight stays by visitors from the 10 new EU member states amounted to some 4 million in 2005. Even if this accounts for only 5 percent of total foreign overnight stays, the year-on-year increase was 10 percent.

Since spending by Austrian tourists abroad is rising less than tourism exports, the net surplus of the tourism services balance is growing substantially.

According to preliminary national accounts data, value added of the construction sector increased by 1.6 percent at constant prices in 2005. Although results for the first quarter were weak as expected given the severe winter conditions, construction is set to perform strongly in the further course of the year. This is confirmed by the results from the WIFO business and investment surveys which signal high order levels and suggest an upturn in investment. Adjusted for weather conditions, employment in the construction sector is rising and unemployment edging down. Due to higher funds being allocated to infrastructure projects, demand for civil engineering works is particularly buoyant. ASFINAG, the motorway construction agency, will invest a total € 1.25 billion this year into the high-level road network.

The sharp improvement in the current account balance is explained by strong export growth and weak domestic demand, although considerable problems of statistical recording also play a role.

Positive trend in tourism

Good snow conditions in the winter season and the effects of Austria's Council presidency in the EU are boosting the earnings of the Austrian tourism industry. The surplus in the cross-border tourism services balance is growing markedly over the forecast period.

Lively construction activity

New home construction disappointed in 2005, but latest signs are for an improvement. Rising demand for dwellings is leading to an increase in building permits for subsidised housing. Even so, construction output is falling short of what is needed in a medium-term perspective, given the projected population increase. Financing supplied by banks and building societies was subdued in the 1st quarter. Renovation activity is less lively than expected. The projected increase in machinery and equipment investment should also trigger the long-awaited recovery in industrial building activity. Overall, WIFO expects for 2006 and expansion of construction output by an inflation-adjusted 2½ percent.

Output in civil engineering continues to post solid gains. Residential and commercial building activity shows signs of recovery.

In January and February, the consumer price index rose by a moderate 1.2 percent year-on-year, reflecting some slowdown in the rise of energy costs, but also statistical effects. The strong price increases for housing services in the first semester 2005, distorted by measurement problems, is now leading to recorded price declines which temporarily take 0.5 percentage point off the consumer price index increase. On annual average 2006, WIFO expects headline inflation at a rate of 1.7 percent, HCPI core inflation (excluding energy and unprocessed food items) should also match 1.7 percent.

Slowdown in inflation enabling gains in real earnings

Price increases for oil products slowed in the last few months, but electricity and gas prices have been raised markedly. Energy prices for final consumers may go up by about 5 percent this year, yielding a direct impact on the overall inflation rate close to ½ percentage point. Secondary effects of the jump in energy prices in recent years on other goods and services have been rather limited. Prices of manufactures have even declined on a seasonally-adjusted basis in the last months and should hardly increase on annual average. This reflects the fall in manufacturing unit labour costs (by 2 percent p.a. over the projection period) as well as an increasingly competitive business climate. Prices for communication services remain on a downward trend.

Inflation decelerated markedly in recent months, with second-round effects from higher energy prices remaining subdued. Headline inflation is projected at an average 1.7 percent in 2006, which would allow a slight increase in real earnings.

Table 4: Earnings and international competitiveness

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year					
Gross earnings per employee ¹	+ 2.2	+ 1.9	+ 2.0	+ 2.4	+ 2.8	+ 2.5
Gross real earnings per employee ¹	+ 1.2	+ 0.4	+ 0.0	+ 0.4	+ 1.1	+ 0.6
Net real earnings per employee ¹	+ 1.0	+ 0.1	+ 0.3	+ 1.0	+ 0.8	+ 0.3
Total economy						
Unit labour costs	+ 1.0	+ 0.6	- 0.3	+ 1.1	+ 1.2	+ 1.2
Manufacturing						
Unit labour costs	- 0.3	- 0.1	- 3.5	- 1.5	- 2.1	- 1.9
Relative unit labour costs ²						
Vis-à-vis trading partners	- 0.6	+ 2.9	- 0.8	- 0.3	- 1.1	- 1.3
Vis-à-vis Germany	- 1.5	+ 1.5	+ 0.3	+ 2.0	+ 0.4	- 0.4
Effective exchange rate, manufactures						
Nominal	+ 1.2	+ 3.7	+ 1.2	- 0.5	- 0.5	- 0.3
Real	+ 0.8	+ 3.0	+ 1.0	- 0.5	- 1.0	- 0.8

Source: WIFO Economic Outlook. – ¹ Employees according to National Accounts definition. – ² In a common currency; minus sign indicates improvement of competitiveness.

Unit labour costs for the economy as a whole are projected to edge up by 1.2 percent in nominal terms in 2006. Adjusted for inflation, labour costs are falling, implying a further decline in the share of wages in national income. Due to the slowdown in inflation and somewhat higher wage settlements in last autumn's wage round, real earnings per employee will edge up, by 1.1 percent in gross and 0.8 percent in net terms year-on-year, respectively.

Private household demand picked up somewhat in the second half of 2005. On annual average, consumption growth of 1.4 percent in volume remained below its long-term trend for the fifth year in a row. For 2006, WIFO projects a slight accelera-

Recovery in private household demand

tion to a rate of 1.9 percent. This is brought about mainly by the slowdown in inflation, which strengthens real disposable incomes. However, in spring households will be faced with an additional, if temporary burden, when receiving the final bills for their energy consumption in 2005. The projections are based upon the assumption that the household saving ratio as a share of disposable income, after an increase by 2 percentage points since 2001, will not rise further. Tax cuts in the past have normally led to a short-term increase in the saving ratio, which was corrected in the subsequent year. If this pattern should recur in the present instance, consumption may increase a bit more than implied by the projections.

Higher wage settlements and decelerating inflation contribute towards a revival of private consumption.

Table 5: Private consumption, income and prices

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 0.3	+ 1.6	+ 0.8	+ 1.4	+ 1.9	+ 2.0
Durables	+ 0.3	+ 3.2	+ 0.6	+ 1.7	+ 2.4	+ 2.2
Non-durables and services	+ 0.3	+ 1.5	+ 0.8	+ 1.4	+ 1.8	+ 2.0
Household disposable income	+ 0.7	+ 2.3	+ 1.2	+ 2.1	+ 1.9	+ 1.9
	As a percentage of disposable income					
Household saving ratio	7.7	8.6	9.0	9.5	9.6	9.5
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+ 1.2	+ 1.6	+ 5.0	+ 4.7	+ 5.4	+ 5.0
	Percentage changes from previous year					
Inflation rate						
National	1.8	1.3	2.1	2.3	1.7	1.9
Harmonised	1.7	1.3	2.0	2.1	1.9	1.9
Core inflation ²	2.0	1.3	1.6	1.5	1.7	1.7

Source: WIFO Economic Outlook. – ¹ End of period. – ² Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

Preliminary results signal a positive trend in retail sales early this year, supported also by higher spending by foreign tourists. Sales by car dealers, garages and petrol stations rise at a slower pace. Wholesale trade turnover was disappointing in 2005, but should rebound this year under the impact of lively foreign trade and a recovery of investment. For the trade sector as a whole, WIFO expects value added to expand by 1.9 percent in volume.

The number of people in dependent active employment has been growing strongly since 2004. In 2006, it will exceed the year-earlier level by 34,000 or 1.1 percent. Many indications suggest that it is primarily part-time jobs that are on the rise; thus, jobs in the service sector and female jobs are particularly dynamic. Yet, in 2006 the number of full-time jobs may also edge up – for the first time since 2000¹, since the construction sector is adding to its workforce and job losses in manufacturing industry are coming to an end.

Labour supply continues to grow swiftly. In 2006, the population of working age (from 15 to 59 years) will increase by 40,000 from last year, exceeding the level of 2003 by 120,000. In a medium-term perspective, population growth and rising participation rates will prevent an overall labour shortage from emerging.

Funds for active labour market policy are being reinforced markedly this year, allowing the number of persons enrolled in job training to increase by around 11,000 to a total of over 60,000. This category of jobseekers is not included in the official unemployment statistics. Some of these persons have joined the labour force from the "hidden reserve". Due to this statistical effect, the number of unemployed will stop rising further this year, for the first time since 2000, possibly edging down by 3,000 to a rounded total of 250,000. The unemployment rate is expected at 7.1 percent of the

Reinforcement of job training, decline in unemployment

The labour market is shaped by strong gains in both employment and labour supply. Due to an increase in the number of jobseekers enrolled in training activities, unemployment is set to edge down this year, but may rebound in 2007.

¹ Walterskirchen, E., "Aktive Beschäftigung in Österreich", WIFO study commissioned by the Federal Chamber of Labour, Vienna, 2006.

dependent labour force (following the conventional national definition) or 5.2 per cent of the total labour force on EU Labour Force Survey definitions. In 2007, allocations for active labour market policy are likely to be cut substantially, both as far as domestic budgetary spending and resources from the European Social Fund are concerned, with the consequence of a decline in the number of people receiving job training. Together with the projected slowdown of GDP growth, this is set to raise the jobless figure by some 5,000.

Table 6: Labour market

		2002	2003	2004	2005	2006	2007
		Changes from previous year, in 1,000					
<i>Demand for labour</i>							
Persons in active employment ¹		- 11.6	+ 8.5	+ 25.1	+ 36.6	+ 39.5	+ 32.5
Employees ²		- 15.0	+ 5.5	+ 21.1	+ 31.9	+ 34.0	+ 27.0
Percentage changes from previous year		- 0.5	+ 0.2	+ 0.7	+ 1.0	+ 1.1	+ 0.9
Nationals		- 20.1	- 10.4	+ 9.2	+ 20.0	+ 17.0	+ 13.0
Foreign workers		+ 5.1	+ 15.9	+ 11.9	+ 11.9	+ 17.0	+ 14.0
Self-employed ³		+ 3.4	+ 3.0	+ 4.0	+ 5.0	+ 5.5	+ 5.5
<i>Labour supply</i>							
Population of working age							
15 to 64 years		+ 42.9	+ 37.7	+ 34.4	+ 12.7	+ 9.0	+ 20.2
15 to 59 years		+ 13.4	+ 21.2	+ 35.6	+ 45.7	+ 40.5	+ 24.9
Labour force ⁴		+ 17.0	+ 16.1	+ 28.9	+ 45.6	+ 36.5	+ 37.5
<i>Surplus of labour</i>							
Registered unemployed ⁵		+ 28.5	+ 7.7	+ 3.8	+ 8.8	- 3.0	+ 5.0
In 1,000		232.4	240.1	243.9	252.7	249.7	254.7
		Percent					
Unemployment rate							
Eurostat definition ⁶		4.2	4.3	4.8	5.2	5.2	5.2
As a percentage of total labour force ⁵		6.2	6.3	6.4	6.5	6.4	6.4
National definition ^{5,7}		6.9	7.0	7.1	7.2	7.1	7.2
Employment rate							
Persons in active employment ^{1,8}		62.5	62.2	62.3	62.8	63.4	63.7
Total employment ^{6,8,9}		-	-	67.8	68.0	68.2	68.3

Source: WIFO Economic Outlook. – ¹ Excluding parental leave, military service, and unemployed persons in training. – ² According to Federation of Austrian Social Security Institutions. – ³ According to WIFO. – ⁴ Economically active employment plus unemployment. – ⁵ According to Labour Market Service. – ⁶ According to Eurostat Labour Force Survey. – ⁷ As a percentage of total labour force, without self-employed. – ⁸ As a percentage of population of working age (15 to 64 years). – ⁹ Changed survey method.

Government revenues in 2005 were higher by about € 900 million in gross terms than foreseen in the federal budget. The good profit situation of domestic companies is reflected by high yields of corporate tax and capital gains tax on dividends. While VAT revenues also exceeded expectations, wage tax revenues fell somewhat short of the budgeted figure. The general government deficit in the Maastricht definition declined to a ratio of 1.7 percent of GDP.

High corporate earnings, rising employees' incomes and a recovery of consumer demand will boost government revenues in the current year. At the same time, higher material inputs and personnel costs as well as additional funds allocated to labour market policy and research will raise overall expenditure. WIFO projects the general government deficit at 1.9 percent of GDP. For 2007, no federal budget draft has yet been submitted. On the basis of current assumptions on the short-term economic outlook, government revenues are expected to go up by slightly more than 3 percent. For government expenditure, a restrictive stance has been assumed. The general government deficit may thereby narrow to 1½ percent of GDP.

High budget deficit

Despite the impact of the tax reform, government revenues are rising faster than foreseen in the budget, but expenditure are also higher.

Table 7: Key policy indicators

	2002	2003	2004	2005	2006	2007
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	-0.4	-1.2	-1.0	-1.7	-1.9	-1.5
According to National Accounts	-0.6	-1.3	-1.1	-1.8	-2.0	-1.6
General government primary balance	+2.7	+1.7	+1.9	+1.1	+0.9	+1.2
	Percent					
<i>Monetary policy</i>						
3-month interest rate	3.3	2.3	2.1	2.2	2.7	3.0
Long-term interest rate ¹	5.0	4.2	4.2	3.4	4.0	4.3
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+1.3	+3.8	+1.2	-0.6	-0.6	-0.3
Real	+0.6	+2.9	+0.9	-0.7	-1.2	-0.9

Source: WIFO Economic Outlook. – ¹ 10-year central government bonds (benchmark).