Markus Marterbauer

Oil Price Hike Driving Up Inflation, Dampening Economic Growth

Economic Outlook for 2008 and 2009

In 2008, the Austrian economy is set to grow by 2.3 percent in volume. While lively activity in manufacturing, construction and tourism boosted GDP in the first quarter more strongly than expected earlier this year, a cyclical slowdown is under way. A major factor is the unabated increase in oil prices on world markets, which drives up inflation to a projected average rate of 3.5 percent this year. The implicit squeeze in household real disposable income restrains the growth of private consumption. The business cycle downturn spreading from the USA to the other industrialised countries will weigh on growth of Austrian exports, industrial output and investment. In 2009, therefore, GDP growth is expected to moderate to 1.4 percent. Whereas employment is posting strong gains in 2008, the downward trend in unemployment may turn around next year.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 25 June 2008. • E-mail address: Markus.Marterbauer@wifo.ac.at

The world market price for oil of type Brent rose from about 90 $ per barrel at the beginning of the year to 135 $ of late. Reasons have been the shift of speculation away from financial and real estate markets towards commodities, the continued rise in oil demand and the absence of a supply increase since 2005. This, together with high world market prices for food has triggered a significant acceleration of consumer price inflation. In Austria, headline inflation is likely to rise to an average 3.5 percent this year, the highest rate since 1993. In 2009, inflation is expected to abate to 2.7 percent, assuming a slower upward drift of energy and food prices.

The high rate of inflation leads to a decline in employees' real per-capita earnings by 0.7 percent and to a gain in household real disposable income by a modest 0.7 percent in 2008. Even assuming a reduction in private saving as a share of disposable income, as it is typical for periods of massive energy price hikes, the sluggish income growth will weigh on consumer demand. Private household spending will edge up by only 1.1 percent in volume in 2008, less than half the pace observed in a longer-term perspective. In 2009, no rebound should be expected either. The service sector and small-scale manufacturers are suffering most from the reluctance of consumers to spend more. In wholesale and retail trade, value added may increase by only 1¼ percent p.a. in real terms.

Whereas private consumption levelled off in the first quarter, value added in manufacturing continued to expand strongly, by 6 percent in volume year-on-year, according to the WIFO quarterly national accounts. The industrial boom of the last two years, with a cumulated increase in value added by 16 percent, thereby continued virtually unabated. Nevertheless, in the regular WIFO business cycle survey the leading indicators signal a marked slowdown for the manufacturing sector on the back of slackening activity in key trading partner countries.

Several factors weigh on aggregate demand in the euro area, leading to a cyclical downturn:

- The US economy has been in stagnation for the last nine months; domestic demand is receding, with imports barely rising.
- The effective appreciation of the euro is dampening exports and investment in Europe.
- Credit conditions for firms and households are deteriorating.
- In Ireland and Spain, the construction and real estate crisis is going on.
- The swift rise in commodity prices is adding to inflation, thereby squeezing real disposable income and consumption by private households.

Support to business activity derives from the markedly expansionary stance of fiscal and monetary policy in the USA, the cyclically-induced widening of government deficits in the euro area and the lively domestic demand in the emerging markets. GDP in the euro area may still expand by 1¾ percent in volume this year, whereas for 2009 a slowdown to a growth rate of 1 percent should be expected. The new EU countries still enjoy buoyant domestic demand, although a deceleration is in sight as inflationary pressure and high private household indebtedness weigh on private consumption. At an estimated 4.5 percent in 2009, GDP growth nevertheless remains distinctly stronger than in the EU 15.

Table 1: Main results

		2004	2005	2006	2007	2008	2009
		Percentage changes from previous year					
GDP							
Volume		+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.3	+ 1.4
Value		+ 4.4	+ 3.9	+ 5.1	+ 5.7	+ 5.1	+ 3.8
Manufacturing[1], volume		+ 2.4	+ 3.1	+ 8.8	+ 7.2	+ 3.8	+ 2.2
Wholesale and retail trade, volume		+ 1.1	+ 0.2	+ 1.0	+ 0.7	+ 1.3	+ 1.2
Private consumption expenditure, volume		+ 1.8	+ 2.0	+ 2.1	+ 1.4	+ 1.1	+ 1.2
Gross fixed investment, volume		+ 0.1	+ 0.3	+ 3.8	+ 5.3	+ 2.4	+ 1.0
Machinery and equipment[2]		– 1.4	+ 0.7	+ 2.1	+ 7.1	+ 3.0	± 0.0
Construction		+ 1.3	+ 0.1	+ 5.1	+ 3.9	+ 2.0	+ 1.7
Exports of goods[3]							
Volume		+ 12.5	+ 3.2	+ 6.8	+ 8.6	+ 5.0	+ 4.8
Value		+ 13.9	+ 5.4	+ 9.5	+ 10.5	+ 6.7	+ 5.8
Imports of goods[3]							
Volume		+ 11.7	+ 2.8	+ 3.8	+ 8.5	+ 4.3	+ 4.3
Value		+ 12.5	+ 5.9	+ 8.0	+ 9.6	+ 7.3	+ 5.7
Current balance	billion €	+ 4.84	+ 4.92	+ 6.29	+ 8.76	+ 8.03	+ 7.71
As a percentage of GDP		+ 2.1	+ 2.0	+ 2.4	+ 3.2	+ 2.8	+ 2.6
Long-term interest rate[4]	in percent	4.2	3.4	3.8	4.3	4.4	4.4
Consumer prices		+ 2.1	+ 2.3	+ 1.5	+ 2.2	+ 3.5	+ 2.7
Unemployment rate							
Eurostat definition[5]	in percent	4.8	5.2	4.7	4.4	4.2	4.4
National definition[6]	in percent	7.1	7.3	6.8	6.2	5.8	6.1
Persons in active dependent employment[7]		+ 0.7	+ 1.0	+ 1.7	+ 2.1	+ 2.1	+ 0.5
General government financial balance according to Maastricht definition							
As a percentage of GDP		– 3.7	– 1.5	– 1.5	– 0.5	– 0.6	– 0.7

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 Public Employment Service Austria, as a percentage of total labour force excluding self employed. – [7] Excluding parental leave, military service, and unemployed persons in training.

The cyclical slowdown in the EU dampens the growth of Austrian export markets from 11 percent in 2006 to only 5.8 percent in 2008. At the same time, the substantial appreciation of the euro implies a temporary weakening of price competitiveness.

Austrian goods exports should therefore grow by a more moderate 5 percent in volume this year and next, compared with 8.2 percent in 2007.

Manufacturing production has been booming in the last two years, but the weaker momentum of exports is now taking its toll. In 2008, real output is set to expand by 3.8 percent, followed by a slimmer gain of 2.2 percent in 2009. The lower capacity utilisation associated with the cyclical downturn may induce firms to a more cautious investment behaviour, despite continued satisfactory corporate earnings. This is confirmed by latest results from the regular WIFO investment survey showing that industrial investment plans for 2008 have been revised down from last autumn. Corporate spending on machinery and equipment is projected to go up by an inflation-adjusted 3 percent this year.

Higher prices for commodity inputs have so far had only a minor effect on construction output which in the first quarter has benefited from clement weather conditions. After the boom of 2006-07 with a cumulated value added increase of 8 percent in real terms, a slowdown should nevertheless be expected towards an estimated +2 percent in 2008 and somewhat lower in 2009.

From January to May, total employment grew massively, by 90,000 from the same period of last year. While this mirrors the benign cyclical conditions during the second half of 2007, it is probably also due to a significant degree to the new obligation in force since early 2008, whereby newly-hired employees have to be registered with the social security administration before taking up work. The more cyclically-determined seasonally-adjusted employment trend month-on-month has become flatter since the beginning of the year. Other factors as well point to a slackening on the labour market: thus, the number of unfilled vacancies is stagnating, and the number of unemployed, when adjusted for seasonal variations, has not declined further since February. On annual average 2008, the number of people in dependent active employment is expected to exceed the level of last year by 68,000, while registered unemployment should recede by 13,000 to a total 209,000. The cyclical slowdown under way will weaken the situation on the labour market with the usual time lag. In 2009, unemployment is likely to pick up by some 15,000 persons, yielding an unemployment rate of 6.1 percent of the dependent labour force (national definition) or 4.4 percent of the total labour force according to Eurostat definitions.

Government revenue remains on a firm upward trend. Buoyant receipts from wage tax and social contributions reflect the strong growth of employment and higher nominal wages. Indirect taxes, however, are rising more moderately despite strong inflation, on account of the persistent sluggishness in private consumption. Overall, government revenues are nevertheless exceeding budgetary plans. Despite the cut in unemployment insurance contributions and the frontloading of the increase in retirement benefits, the general government deficit may narrow to 0.6 percent of GDP in 2008. In 2009, the deficit may edge up somewhat on the back of weaker cyclical conditions.

The present projections assume a significant slowdown in economic growth during 2008, while a recession should be avoided. However, with a view to the high volatility of commodity prices, exchange rates and on financial markets and their repercussions on the real economy, extent and duration of the cyclical downturn remain highly uncertain. A turnaround of the cycle is expected as from early 2009. Should the positive impulses on business activity be delayed, GDP growth in 2009 could turn out significantly lower than anticipated in the present context.

Global economy still expanding strongly

The world economy has enjoyed a boom for the last five years. The pace of growth has lost momentum only in few regions, notably in the USA where business activity has levelled off to stagnation. The fall in domestic demand in the USA is weighing on export growth in Asia and Latin America. However, internal demand in the emerging markets and trade links between them have strengthened considerably. Thus, in China, propelled by private consumption and public infrastructure investment, real GDP jumped by 10.6 percent year-on-year in the first quarter, down by only 1 percentage point from the average rate recorded for 2007. Many economies in Asia, like Japan, are benefiting from China's strong demand for imports.

The strong momentum of global economic growth has hardly slackened so far, owing mainly to lively domestic demand in the emerging markets. However, the rise in commodity prices to record highs and the persistent financial market crisis are undermining the short-term growth outlook.

However, the emerging market economies suffer not only from weaker US demand, but also from the massive increase in inflation. Food and energy items account for a substantially higher share in the consumer basket than in the industrial countries and possibilities for their substitution are poor. The jump in prices for these goods therefore reduces drastically the scope for purchases of other goods.

The crisis on international financial markets has been hanging over the world economy for almost one year. The implicit dampening influence will fade only once the situation on US mortgage markets stabilises, for which there is still no evidence. Central banks have been successful worldwide in their attempt to prevent bankruptcies of financial institutions from spreading, by massively injecting liquidity into the banking system. However, persistently high risk premia on inter-bank markets and other signs indicate that the danger of a systemic banking crisis is still looming.

Table 2: World economy

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
Real GDP						
World total	+ 4.9	+ 4.4	+ 5.0	+ 4.9	+ 4.0	+ 3.5
Total OECD	+ 3.1	+ 2.4	+ 3.0	+ 2.7	+ 1.6	+ 1.4
USA	+ 3.6	+ 3.1	+ 2.9	+ 2.2	+ 1.4	+ 1.4
Japan	+ 2.7	+ 1.9	+ 2.4	+ 2.1	+ 1.6	+ 1.0
EU 27	+ 2.5	+ 1.9	+ 3.1	+ 2.8	+ 2.0	+ 1.4
EU 15	+ 2.1	+ 1.6	+ 2.8	+ 2.6	+ 1.7	+ 1.1
Germany	+ 1.1	+ 0.8	+ 2.9	+ 2.5	+ 2.0	+ 1.1
New EU countries[1]	+ 5.7	+ 4.8	+ 6.6	+ 6.2	+ 5.0	+ 4.5
China	+10.1	+10.4	+11.1	+11.4	+ 9.5	+ 8.5
World trade, volume	+10.6	+ 7.9	+ 8.8	+ 7.1	+ 6.3	+ 6.1
Market growth[2]	+ 9.4	+ 7.5	+11.0	+ 7.6	+ 5.8	+ 4.8
Primary commodity prices						
HWWA index, total	+18.5	+28.5	+19.7	+ 3.7	+42	+ 6
Excluding energy	+18.1	+ 5.6	+22.0	+ 9.5	+24	+ 7
Crude oil prices						
Brent, $ per barrel	38.2	54.4	65.1	72.5	120.0	130.0
Exchange rate						
$ per euro	1.243	1.245	1.256	1.371	1.56	1.60

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

With a view to slackening overall demand in the industrialised countries, the ongoing financial market crisis and the high commodity prices, WIFO expects a marked deceleration in global growth. After annual rates of nearly 5 percent in volume over the last five years, the projection for this year and next is in the range of 3½ percent to 4 percent.

Jump in oil prices

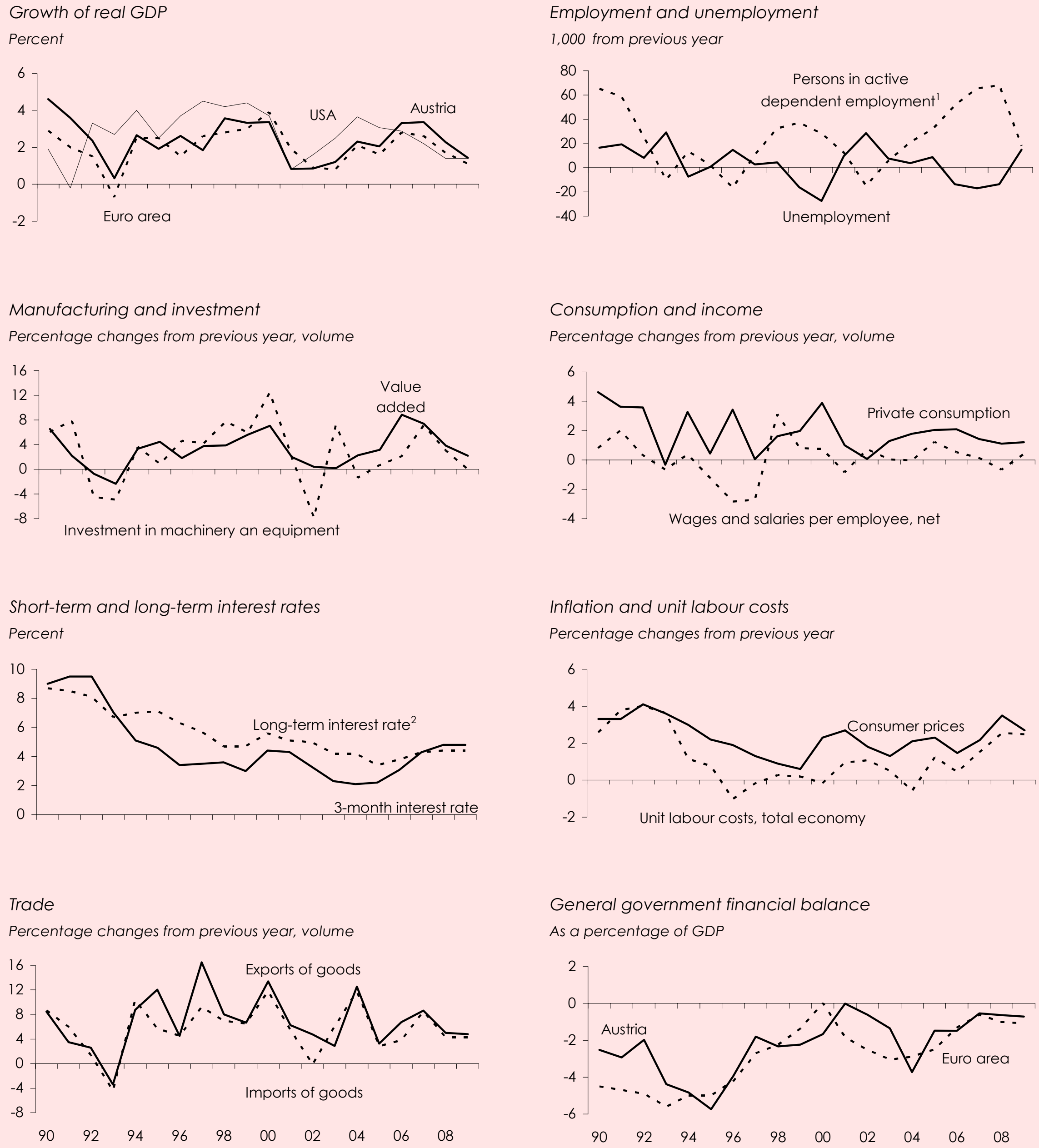
World market prices for crude oil have increased massively over the last four years. Since the beginning of 2008, the upward drift has gained further momentum. One barrel of type Brent, as demanded in Europe, was recently traded at over $ 130, as compared with $ 90 in December 2007. There are several reasons for the steep price increase:

- Speculation has shifted from financial and real estate towards commodity markets.
- Demand for oil continues to increase overall, notably in the emerging markets, whereas it already declines somewhat in Europe.
- Oil supply has been broadly flat since early 2005.

Since the beginning of 2008, oil prices have increased by almost one-half. This is driving up inflation and dampening private consumption in the industrialised countries to a noticeable extent.

In view of the latest price jumps, the further trend in world market prices is difficult to anticipate. Supply capacity shortages, in particular in non-OPEC countries, the very low level of stocks in the USA and expectations fed by investment banks point to a further price increase until at least this summer. In the medium term, oil demand should subside somewhat, due to the high prices and the cyclical slowdown in the industrialised countries. Prices on annual average 2008 and 2009 will nevertheless exceed the level of the previous years by a substantial margin. Underlying the present WIFO projections is an average price for Brent of $ 120 per barrel in 2008 and of $ 130 in 2009. In that case, prices would be higher by 66 percent and 79 percent than in 2007.

Figure 1: Indicators of economic performance



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

The massive oil price hike is weighing on business activity in the oil-importing countries. In the last few years already, this has given rise to a significant drain in purchasing power and a squeeze in private real disposable income. Together with higher food prices, the energy price jump has prevented a transmission of the cyclical upswing to consumer demand, and thereby its translation into a genuine boom. On the other hand, the high prices boosted income and demand in the oil-exporting countries. This benefits indirectly notably those industrialised countries whose economies specialise in exports of investment goods, in particular Germany.

Overall, the further increase in oil prices reinforces the cyclical downturn in the euro area. The impact on headline inflation is estimated at ½ percentage point p.a. or more over the entire projection period, while about 0.2 percentage point are shaved off annual GDP growth.

US economy stagnating

The US economy has hardly been growing during the last nine months, although policy intervention has been able so far to avert a recession. Real GDP in the first quarter 2008 edged up by 0.2 percent from the previous period, yielding an increase by 2.5 percent year-on-year. Exports increased markedly on the back of continued robust global demand and the hefty depreciation of the dollar, while import growth was more subdued because of weak domestic demand and the rise in import prices. In seasonally-adjusted terms, the entire GDP growth of the first quarter was accounted for by net exports.

The US economy has been stagnating since autumn 2007. A powerful cyclical recovery is not in sight, despite a pronounced expansionary policy stance. A major dampening force is the exacerbating crisis on real estate markets.

The retarding cyclical factors gained further ground in the first quarter. Residential investment fell by 21 percent from the year-earlier level, with no stabilisation yet being visible in the data on housing starts for single and multi-family homes, building permits or house prices. The Case-Shiller index shows house prices for the first quarter at 13 percent below the level of last year. Private consumption growth is decelerating further, edging up by a meagre ¼ percent in the first quarter from the previous three-months period. Retail sales for April and May suggest that the flat upward trend continued in the second quarter, despite a steeper fall in consumer confidence due to the deteriorating situation on the labour market. Employment remained on a downward trend, and unemployment rose to a rate of 5.5 percent in May, exceeding the year-earlier level by nearly 1 percentage point. Although private disposable income is being sustained by tax rebates since May, the positive effect is largely offset by the rise in energy prices. Headline inflation has been close to 4 percent for the last seven months.

WIFO considers a substantial revival of US business activity during the remainder of the year as unlikely. GDP for the 2008 as a whole is projected to gain about 1.4 percent in real terms. Even assuming a gradual recovery as from the second semester, average GDP growth in 2009 will hardly be stronger than in the current year. Although fiscal and monetary policy are both exerting a markedly expansionary effect, a decisive rebound of demand and output is held back by the end of the credit boom and the associated increase in the private saving ratio.

Robust activity in the euro area under strain from many sides

In early 2008, economic activity in the euro area was still robust. Real GDP in the first quarter went up by a seasonally-adjusted 0.8 percent from the previous quarter and by 2.2 percent year-on-year. The amount of the increase is probably exaggerated due to mild weather and one-off factors in a number of countries. The momentum of demand and output differs markedly between countries as well as between economic sectors. For Germany, the Federal Statistical Office reports real GDP growth of 1.5 percent seasonally adjusted for the first quarter vis-à-vis the previous period. Not only construction was buoyant, but also production in manufacturing. By contrast, the Italian economy expanded by only 0.4 percent, thereby offsetting the setback by the same amount in the fourth quarter 2007 and extending the stagnation in which the Italian economy has been caught since early 2007. Activity in Spain remained virtually flat in the first quarter, mainly due to the slump in the construction sector.

GDP in the euro area grew strongly into early 2008. However, a combination of adverse influences may have triggered a cyclical downturn in spring.

The overall buoyancy in the euro area in the first quarter 2008 was mainly driven by exports and construction activity, the latter benefiting from clement weather conditions. However, private households barely increased their spending.

At present, several factors combine to weigh on aggregate demand in the euro area:

- In the USA, domestic demand is receding, thereby withdrawing the main stimulus of global economic activity.
- The exchange rates of the euro vis-à-vis the dollar and the yen have risen to a high level, which dampens exports and investment.
- The strong upward drift of commodity prices squeezes household real disposable income and, as a consequence, private consumption.
- The international financial market turmoil has now been lasting for one year and deteriorates credit conditions for companies and households. Several countries in the euro area suffer from a crisis in the real estate and construction sector.

Nevertheless, a number of factors effectively sustain aggregate demand:

- The emerging market economies continue to enjoy solid growth, despite the strong acceleration of inflation.
- The distinctly expansionary monetary and fiscal policy in the USA is apparently able to avert a recession.
- The automatic fiscal stabilisers are leading to a higher government deficit in the euro area, thereby sustaining aggregate demand.

WIFO therefore expects business activity in the euro area to decelerate markedly over the next few quarters, although extent and duration of the slowdown are difficult to project at present, as well as the point of time by which a positive turnaround may be expected. The present forecast assumes that the trough of the cycle will be reached at the turn of the year 2008-09. With such a profile underlying, real GDP growth may abate to an average 1.7 percent in 2008 and further to 1.1 percent in 2009. There is nevertheless a substantial risk for the slowdown lasting longer and GDP growth in 2009 turning out even lower.

Strong inflation and no further fall in unemployment in the euro area

Inflation is set to remain high in the coming months, and the declining trend in unemployment is about to reverse. Economic policy within the EU is thereby facing difficult challenges.

The sluggishness of consumer demand in the euro area is closely related to the marked upward drift in consumer prices to an annual rate of 3.7 percent in May. However, inflation rates differed significantly across the euro area, ranging from 2.1 percent in the Netherlands to 6.2 percent in Slovenia. If strong differentials were to persist within a monetary union, they would give rise to shifts in relative price competitiveness and to the build-up of imbalances in the real economy.

The seasonally-adjusted rate of unemployment in the euro area currently stands at 7.1 percent of the labour force, unchanged since February 2008, but 1½ percentage points lower than before the onset of the last cyclical upswing in 2005. In autumn 2008, with the usual time lag of about six months, the weaker activity will be reflected on the labour market. The downward trend in unemployment is likely to turn around.

Economic policy in Europe is thereby facing a series of difficult challenges calling for a balanced application of the different instruments at its disposal. The European Central Bank is confronted with a dilemma in setting interest rates: while inflation calls for monetary restriction, the weakening business activity would advise in favour of an easier stance. WIFO expects interest rates to go up, both in the short and the long-term domain. As far as fiscal policy is concerned, the relatively small government deficits (0.6 percent of GDP on aggregate for the euro area in 2007) offer leeway for automatic stabilisers to operate fully. Should the cyclical downturn prove more severe than assumed in the present forecast, additional discretionary budgetary measures would be warranted. These should, however, be co-ordinated within the EU, given the close economic linkages between member states.

Lively domestic demand in East-Central Europe, but growing cyclical risks

Private consumption and investment is driving output growth in the new EU countries. However, high indebtedness of private households and the sharp acceleration of inflation constitute substantial cyclical risks.

In the new EU countries, the strong expansion of economic activity in 2007 (+6 percent in volume) was mainly driven by internal demand. A significant increase in private incomes, but even more a generous extension of credit to households fuelled private consumption. In addition, investment was buoyant. While the strength of internal demand renders the new member countries somewhat less vulnerable to the global demand slowdown, they are nevertheless subject to significant cyclical risks. Most directly, these consist in the sharp acceleration of inflation. Most recently, the year-on-year increase in consumer prices was "only" about 4 percent in Poland and Slovakia, but nearly 7 percent in the Czech Republic and Hungary, and in Romania 8½ percent. In Bulgaria and the three Baltic countries, headline inflation significantly exceeded 10 percent. Reasons are partly cyclical overheating with mounting upward pressure on unit labour costs, but to a large part also the jump in prices for food and energy which have a much higher weight in the consumer basket than in western Europe.

Apart from inflation, which eats into real purchasing power and may jeopardise competitiveness, the high indebtedness of private households constitutes an important cyclical risk. In addition, high current account deficits in some countries expose them to turbulences on international capital markets. WIFO expects GDP growth in the new EU countries to slacken significantly, to a projected 4½ percent in 2009, still markedly exceeding the euro area average.

Austria: signs of slowdown after strong start into 2008

After a positive start into 2008, the short-term outlook for Austria is becoming dimmer. Extent and duration of the cyclical downturn are currently difficult to assess.

The Austrian economy grew surprisingly strongly in the first quarter 2008, as real GDP gained a seasonally adjusted 0.7 percent from the previous period and 3.3 percent year-on-year. Productive capacity utilisation was satisfactory overall, notably in manufacturing, construction and tourism. Profits were probably healthy, and job creation was strong. Nevertheless, cyclical framework conditions have weakened once again since the last WIFO projections of March 2008, mainly on account of the massive increase in oil prices, the ensuing rise in inflation and the negative repercussions on real disposable incomes. Together with the other retarding forces affecting the European economy, the Austrian business cycle is heading for a downturn, setting in somewhat later though than expected earlier this year. A large number of leading indicators confirm the downward trend: in the regular WIFO business survey, manufacturers judge order flows and output, and even more the business outlook for the next six months, more pessimistic than in spring, consumer confidence has weakened and the increase in job vacancies has levelled off.

How long and steep the downturn will be, and by when the forces of recovery will again take the lead, is still unclear. In the present projections, WIFO dates the start of a recovery for early 2009, although confirming evidence is currently lacking. The WIFO estimate for potential output growth is in the range between 2.3 percent and 2.7 percent per year, depending on the methodology applied. The present projections see GDP growth for 2008 at the lower end and for 2009 dropping significantly below this corridor.

Weaker foreign market growth holding back exports

Merchandise exports will expand by a more moderate 5 percent in volume this year, as demand for imports by major foreign trade partners slackens and the strength of the euro reduces price competitiveness.

In 2006 and 2007, merchandise exports rose by a cumulated 15 percent in real terms. Austria's export-oriented industries benefited from the cyclical upswing in trading partner countries and demonstrated strong price competitiveness on the basis of sizeable advances in labour productivity.

With global economic activity slowing down, prospects for Austrian exporters are turning gloomier. However, direct trade relations with the USA, Ireland and Spain, where domestic demand has slumped already, are relatively loose. Of direct impact is only the stagnation in Italy where 9 percent of Austrian exports go to. In the new EU countries, accounting for 17 percent of Austrian exports, demand remained lively until the first quarter 2008. The most important trading partner remains Germany with 30 percent of Austrian exports. The latter performed well during the last few years, mainly because Austrian companies deliver primarily to the German export industries and are less affected by the lacklustre domestic demand, sluggish retail sales or receding construction activity. Due to its high export dependency, Germany should be particularly strongly affected by the international slowdown; on the other hand, German investment goods manufacturers take a major share of the higher demand originating from the oil-exporting countries.

Volume import growth of Austrian trading partners is likely to moderate from 7.6 percent in 2007 to 5.8 percent in 2008. In addition, the strong effective euro appreciation by 2¼ percent in 2008 will lead to losses of market shares, particularly in the USA and other countries with weaker currencies. As a result, Austrian exports of goods will increase by a more moderate 5 percent when adjusted for inflation, with some further deceleration to be expected for 2009.

Industrial boom subsiding

Leading indicators point to a cooling of the boom in manufacturing. Incoming orders are slackening and output expectations are scaled down. Industrial output is expected to increase by 3.8 percent this year.

Manufacturing firms increased their value added by a cumulated 16 percent in 2006 and 2007. Capacity utilisation remained high until early 2008. According to the national accounts, value added rose by a seasonally-adjusted 1.6 percent in the first quarter 2008 from the previous period and by 6 percent year-on-year.

However, companies sampled in the regular WIFO business survey have since the middle of 2007 reported a gradual decline in both the stock and the inflow of orders. Lately, output growth has stabilised at close to the long-term average, while a marked increase in inventories was reported. Since the beginning of 2008, business expectations for a six-month horizon were markedly revised downwards. This goes in particular for the suppliers of investment and consumer goods, whereas manufacturers of motor cars and vehicle components report broadly stable order inflows and output expectations.

Table 3: Productivity

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
Total economy						
Real GDP	+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.3	+ 1.4
Employment[1]	+ 0.2	+ 0.8	+ 1.2	+ 2.2	+ 1.3	+ 0.4
Productivity (GDP per employment)	+ 2.2	+ 1.2	+ 2.1	+ 1.1	+ 0.9	+ 1.0
Manufacturing						
Production[2]	+ 2.3	+ 3.2	+ 8.8	+ 7.4	+ 3.8	+ 2.2
Employees[3]	– 0.6	– 0.8	+ 0.2	+ 2.6	+ 0.7	– 1.2
Productivity per hour	+ 2.1	+ 4.6	+ 8.4	+ 5.0	+ 3.4	+ 3.4
Working hours per day per employee[4]	+ 0.8	– 0.6	+ 0.2	– 0.3	– 0.3	± 0.0

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.

WIFO expects a noticeable deceleration of manufacturing output growth for the remainder of the year. On annual average 2008, value added may expand by an inflation-adjusted 3.8 percent, followed by a more moderate gain of 2.2 percent in 2009.

During the boom of the last few years, also the industrial sector added substantially to its workforce, and even shortages of qualified labour emerged in some occupations. With the slower business momentum, labour demand is set to ease. In 2008 as a whole, industrial employment may edge up slightly from the previous year, whereas in 2009 a decrease by some 7,000 jobs or 1 percent is likely, broadly in line with the long-term trend.

With capacity utilisation about to decline and reduced sales prospects, firms may be induced to revise down their investment plans. Early results from the WIFO Spring 2008 investment survey suggest that manufacturers envisage an increase in their investment by only half the size reported last autumn.

Successful tourism industry

After a highly satisfactory winter season, the positive trend in tourism looks likely to extend into the summer months. Spending by foreign customers in Austria is expected to reach a record € 16.9 billion, corresponding to a year-on-year increase by 8 percent in current and 4.3 percent in real values). Contrary to widespread expectations, the hosting of the European soccer championship will play only a marginal role in this regard, since it has essentially led to substitution between different categories of visitors in the high-frequency month of June. The strong increase for the year as a whole is rather the result of the upgrading of supply and service quality, as firms have successfully specialised on offering wellness, urban and short-term holidays, for which demand is growing fast. For the hotel and restaurant sector, WIFO expects real value added to expand by 3.6 percent in 2008. Growth should stay firm also in 2009, with a projected increase in value added by 2.5 percent and of tourism exports by 3.4 percent.

Lively demand for tourism services, both from domestic and foreign customers, boosts earnings to record highs, notably for top-quality suppliers.

Small increase in imports

Growth of merchandise imports will slow markedly over the projection period. This is explained by the deceleration of export growth (with an import content of about one-third) as well as the slackening of investment in machinery and equipment and of purchases of durable consumer goods. The trade balance should be close to equilibrium in 2008 and 2009.

Official data show a clear downward trend for expenditure by Austrian travellers abroad. However, the main reason might be problems of statistical recording: for several years already, tourism imports are apparently under-reported, by an estimated amount of several billion euro. The official figure for the current account surplus of € 8¾ billion in 2007 should thereby be taken with caution.

Problems of statistical recording of expenditure by Austrian travellers abroad undermine the quality and interpretation of current account data.

Significant real income losses due to high inflation

Since November 2007, headline inflation in Austria has been consistently above the mark of 3 percent, reaching with 3.7 percent in May its highest rate in several years. More than half of the consumer price index increase is accounted for by the rise in energy and food prices. For the next few months, no moderation of the upward drift is in sight. Oil prices are likely to move further up during summer, such that energy overall will become 13 percent more expensive in 2008 than last year. For processed food, Austrian consumers will have to pay 7 percent more this year, even if the hike of food prices on world markets were to abate in the next few months. Higher raw material costs are also exerting upward pressure on manufactures prices. Service price inflation has so far been moderate, but is expected to pick up gradually once higher wages feed into prices. Headline inflation is likely to move up towards 4 percent in the next few months, yielding an estimated rate of 3½ percent for 2008 as a whole. Assuming a stabilisation on commodity markets, inflation may subside to an average 2.7 percent in 2009.

The acceleration of consumer price inflation is primarily the result of price hikes for crude oil and food on world markets. Signs are mounting for prices of manufactures and services following the upward trend.

Table 4: Earnings and international competitiveness

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
Gross earnings per employee[1]	+ 1.8	+ 2.3	+ 2.7	+ 2.7	+ 3.3	+ 3.5
Gross real earnings per employee[1]	– 0.0	+ 0.6	+ 1.1	+ 0.6	– 0.2	+ 0.8
Net real earnings per employee[1]	– 0.0	+ 1.2	+ 0.5	+ 0.1	– 0.7	+ 0.4
Total economy						
Unit labour costs	– 0.6	+ 1.2	+ 0.4	+ 1.5	+ 2.6	+ 2.5
Manufacturing						
Unit labour costs	– 0.7	– 0.0	– 4.2	– 2.0	+ 0.4	+ 0.3
Relative unit labour costs[2]						
Vis-à-vis trading partners	+ 2.0	+ 0.8	– 2.4	– 0.5	+ 0.7	± 0.0
Vis-à-vis Germany	+ 2.4	+ 2.6	– 1.5	+ 0.8	– 0.6	+ 0.3
Effective exchange rate, manufactures						
Nominal	+ 1.5	– 0.6	+ 0.2	+ 1.2	+ 2.2	+ 0.4
Real	+ 1.1	– 0.9	– 0.5	+ 0.8	+ 2.1	+ 0.7

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

Despite higher wage settlements in the autumn 2007 wage round (with average per-capita gross wages rising by 3¼ percent), net real earnings will edge down by 0.7 percent this year, due to the unexpectedly high inflation. For the lower income brackets, real incomes will decline even more, as energy and food claim an over-proportional share of total consumption expenditure. Occasionally it has been considered to compensate the negative social repercussions of the higher inflation by cutting either VAT or mineral oil tax rates. However, such measures appear doubtful since a pass-through of the tax cuts to consumer prices cannot be expected in an environment of generally accelerating price increases. The social costs of high inflation should rather be addressed by targeted policy measures such as the cut in the unemployment insurance contribution rate for the low-income tier.

Sluggishness of consumption accentuating

The weakness of private consumption is one of the dominant problems of economic development since 2001. It is now becoming more severe, mainly due to the only small gains in disposable income.

Due to the strong rise in inflation, and despite lively employment growth, disposable income of private households is edging up by only 0.7 percent in real terms this year, i.e., one-third of the rate recorded last year. Even if households were ready to somewhat reduce their saving, as has been the case in the past in times of jumps in energy prices, the leeway for higher spending remains very narrow. In the present forecast, WIFO has revised down its estimate for private consumption growth in 2008 to an inflation-adjusted 1.1 percent. This corresponds to only half the long-term average increase. It will imply noticeable earnings losses for many small-scale manufacturers, traders and service providers. Some part of the revealed weakness of consumption is explained by the under-reporting of expenditure by Austrians travelling abroad.

Table 5: Private consumption, income and prices

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.8	+ 2.0	+ 2.1	+ 1.4	+ 1.1	+ 1.2
Durables	+ 4.0	+ 2.5	+ 1.9	+ 2.5	+ 1.3	+ 1.5
Non-durables and services	+ 1.5	+ 2.0	+ 2.1	+ 1.3	+ 1.1	+ 1.2
Household disposable income	+ 1.9	+ 2.6	+ 2.7	+ 2.4	+ 0.7	+ 0.9
	As a percentage of disposable income					
Household saving ratio	8.9	9.3	9.7	10.5	10.3	10.1
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+ 5.0	+ 4.7	+ 4.5	+ 3.6	+ 3.9	+ 2.8
	Percentage changes from previous year					
Inflation rate						
National	2.1	2.3	1.5	2.2	3.5	2.7
Harmonised	2.0	2.1	1.7	2.2	3.5	2.8
Core inflation[2]	1.6	1.5	1.3	1.9	2.5	2.4

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

Income growth is unlikely to pick up in 2009. While per-capita earnings may post somewhat stronger gains when adjusted for inflation, the cyclical slowdown will hold back employment growth. The framework conditions for consumer demand will therefore not turn more favourable in 2009. Private consumption is projected to go up by 1.2 percent in volume from this year.

Satisfactory utilisation of construction capacities

Construction activity remained robust until the first quarter 2008. Mild weather conditions allowed orders for new structures to be executed ahead of time, such that the sector's value added rose by 2.5 percent in volume from last year, according to national accounts data. The benign situation is mirrored also by the sustained swift increase in construction prices and sizeable employment gains; the latter were boosted also by new regulations whereby newly-hired workers have to be registered with the social security administration before taking up work. Nevertheless, the peak of the construction cycle has clearly been passed, as witnessed also by the more cautious judgments on orders and production in the regular WIFO business survey.

The construction boom during 2006 and 2007 has run its course. Utilisation of firms' productive capacities remains nevertheless high.

After two years of booming activity, with cumulated real output growth of 8 percent in 2006-07, WIFO now expects a slower forward momentum. Greater caution of firms in embarking on new investment projects should be reflected in weaker industrial and commercial building activity. Developments should be more steady in civil engineering which benefits from orders for new infrastructure. Overall, real construction output is projected to rise by 2 percent respectively in 2008 and 2009.

Employment rising strongly in 2008 – unemployment picking up in 2009

The number of people in dependent active employment rose extraordinarily strongly during the first five months of 2008, by 90,000 year-on-year. Primarily, strong cyclical activity in the second half of 2007 boosted labour demand with the usual time lag. However, even after adjustment for seasonal influences, employment jumped from the level of last December. The main reason was probably the new regulation requiring social security registration of newly-hired workers before they actually take up work. A sectoral breakdown of employment growth, which could facilitate an interpretation of latest labour market developments, is currently unavailable due to a changeover in the statistical classification.

The massive job increase since the beginning of the year reflects lively business activity, but also administrative changes. 2009 will see a cyclical turnaround on the labour market.

Table 6: Labour market

		2004	2005	2006	2007	2008	2009
		Changes from previous year, in 1,000					
Demand for labour							
Persons in active employment[1]		+ 25.1	+ 37.2	+ 55.9	+ 66.9	+ 72.0	+ 20.0
Employees[2]		+ 21.1	+ 31.9	+ 51.5	+ 65.5	+ 68.0	+ 18.0
Percentage changes from previous year		*+ 0.7*	*+ 1.0*	*+ 1.7*	*+ 2.1*	*+ 2.1*	*+ 0.5*
Nationals		+ 9.2	+ 20.0	+ 35.0	+ 43.6	+ 45.0	+ 11.0
Foreign workers		+ 11.9	+ 11.9	+ 16.5	+ 21.9	+ 23.0	+ 7.0
Self-employed[3]		+ 4.0	+ 5.3	+ 4.4	+ 1.4	+ 4.0	+ 2.0
Labour supply							
Population of working age	15 to 64 years	+ 34.4	+ 15.6	+ 18.5	+ 17.4	+ 18.0	+ 20.2
	15 to 59 years	+ 35.6	+ 48.5	+ 52.8	+ 18.8	+ 8.5	+ 13.7
Labour force[4]		+ 28.9	+ 45.9	+ 42.4	+ 50.0	+ 58.5	+ 35.0
Surplus of labour							
Registered unemployed[5]		+ 3.8	+ 8.8	– 13.5	– 16.9	– 13.5	+ 15.0
In 1,000		243.9	252.7	239.2	222.2	208.7	223.7
		Percent					
Unemployment rate							
Eurostat definition[6]		4.8	5.2	4.7	4.4	4.2	4.4
As a percentage of total labour force[5]		6.4	6.5	6.1	5.6	5.2	5.5
National definition[5, 7]		7.1	7.3	6.8	6.2	5.8	6.1
Employment rate							
Persons in active employment[1, 8]		62.3	62.8	63.6	64.5	65.6	65.7
Total employment[6, 8, 9]		67.8	68.6	70.2	71.4	72.2	72.2

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 Public Employment Service Austria. – [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.

The increase in seasonally-adjusted employment has lost momentum in the last few months, which signals a slowdown in economic activity, as does the trend in job vacancies: in May, 42,000 unfilled jobs were reported to the labour exchange, no more than one year ago, while at the beginning of the year the positive gap was still 3,500.

On annual average 2008, the number of registered unemployed may decline by 13,000 from last year. In the first quarter, the year-on-year fall was by 29,000, by May it had narrowed to 13,000. Like for the employment data, the lower unemployment figures reflect on the one hand lively activity, and the new registration requirements on the other. After adjustment for seasonal factors, the decline in unemployment has bottomed out since February. In 2009, a rebound by 15,000 to a total 223,000 is likely. The rate of unemployment is projected at 6.1 percent of the dependent labour force (national definitions) or 4.4 percent of the total labour force (Eurostat definition).

Strong increase in tax revenues levelling off

In the early part of the year, the government budget still benefited from strong job creation and the higher wage settlements. Revenues from wage tax for the first four months exceeded the year-earlier level by € 450 million or 7.5 percent. Contributions to the family benefit fund, which are based upon total payroll, went up by 5.8 percent, while social security contributions, which are subject to a monthly income ceiling of € 3,930, increased by 2.8 percent. However, receipts from indirect taxes were sluggish despite the marked upward drift in consumer prices.

High wage tax revenues should this year offset the budgetary cost of the measures to counter the effects of inflation. In 2009, the general government deficit is likely to widen.

As from 1 July 2008, employees' contributions to unemployment insurance will be reduced to zero up to a gross monthly income of € 1,100. For incomes above, they will rise gradually and reach the normal rate of 3 percent as from an income of € 1,350. This will exonerate significantly low-income earners and imply a budgetary revenue shortfall of € 150 million in 2008. At the same time, the government decided on further expenditure increases, such as the carrying-forward of the retirement benefit adjustment for 2009 to November 2008. The budgetary cost should be more than offset by the higher-than-expected increase in wage-related taxes. WIFO therefore expects the general government deficit for 2008 at 0.6 percent of GDP.

Table 7: Key policy indicators

	2004	2005	2006	2007	2008	2009
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	– 3.7	– 1.5	– 1.5	– 0.5	– 0.6	– 0.7
According to National Accounts	– 3.9	– 1.6	– 1.6	– 0.7	– 0.7	– 0.8
General government primary balance	– 0.9	+ 1.4	+ 1.2	+ 2.2	+ 2.1	+ 2.0
	Percent					
Monetary policy						
3-month interest rate	2.1	2.2	3.1	4.3	4.8	4.8
Long-term interest rate[1]	4.2	3.4	3.8	4.3	4.4	4.4
	Percentage changes from previous year					
Effective exchange rate						
Nominal	+ 1.5	– 0.7	+ 0.2	+ 1.1	+ 2.3	+ 0.5
Real	+ 1.0	– 1.0	– 0.6	+ 0.8	+ 2.2	+ 0.7

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

For 2009, government expenditure cannot be projected at present, no federal budget draft having yet been submitted. Government revenues will be dampened by the marked slowdown in demand and output growth. WIFO therefore expects the general government balance to weaken slightly vis-à-vis 2008, to a deficit of 0.7 percent of GDP.