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Heightened Cyclical Risks

Economic Outlook for 2005 and 2006

The short-term business outlook in the euro area is surrounded by considerable uncertainty. Recent gains in exports and profits have so far not translated into higher investment and consumer spending. High oil prices constitute a further risk element. Owing to the positive incentives from the tax reform, the Austrian economy is performing better than the euro area as a whole. GDP is projected to expand at a steady 2¼ percent p.a. in 2005 and 2006. The rate of unemployment is nevertheless unlikely to decline, given the massive increase in labour supply.

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Economic growth in Austria is expected to edge up to around 2¼ percent in 2005 and keep the same pace in 2006. The expansion is driven mainly by private consumption and construction activity. Private households, benefiting from tax cuts and rising employment this year, should spend at least part of their net income gains on consumer goods. Construction will also grow notably faster than last year, as suggested by the high order volumes in civil engineering and some segments of the building sector. However, stimulus from foreign demand is set to slacken with global growth shifting into lower gear. Investment in machinery and equipment will also decelerate from last year when spending was upward biased by the imminent expiry of the investment tax premium ("Investitionszuwachsprämie"). Overall, economic growth in Austria is likely to outpace that in the euro area both this year and next.

The cyclical risks in the euro area have mounted significantly over the last months. The external stimulus has become weaker in recent months and has spurred domestic demand only to a limited extent so far. In spite of sharply rising profits, investment in the euro area is lacking momentum. Large companies are reducing their debt and employment levels, while private households, growing more sceptical about their situation notably in Germany, restrain their spending on residential building and current consumption. This is the key factor for the sluggishness of activity in the euro area.

The major retarding element for business activity in Europe is not the high euro exchange rate: exports are performing strongly, and weak internal demand is not related to the euro exchange rate. Neither can high oil prices be taken for the main obstacle, since the USA and the Asian economies are growing fast despite the high oil price. Nor is activity being held back by the monetary regime in the euro area, which has followed an expansionary stance since 2001, albeit not to the same degree as in the USA. Substantial differences exist with regard to fiscal policy and real estate prices. In the USA and the UK, the distinctly expansionary budgetary stance, together with swiftly rising real estate prices, have lent firm support to domestic demand. In the euro area, the course of budgetary policy has been broadly neutral, with rising deficits being tolerated in the face of persistently sluggish activity. Unlike in the Anglo-Saxon countries, real estate prices remained flat in most euro area member states, providing little stimulus for residential construction and consumption.

Among the risks to the present projections one should include the oil price rather than the euro exchange rate. The former is the main determinant of headline inflation, which in 2004 rose to an average 2.1 percent in Austria, some ½ percentage point being accounted for by higher oil prices. A further acceleration to a rate of 2.5 percent should be expected for 2005, driven by higher prices for energy, housing and cigarettes. Underlying this projection is the assumption of an average price of $ 44 per barrel of crude oil (Brent) in 2005. Next year, inflation should abate markedly to a rate of 1.8 percent, with energy prices assumed receding and administered prices broadly stable.

Table 1: Main results

		2001	2002	2003	2004	2005	2006
		Percentage changes from previous year					
GDP							
Volume		+ 0.7	+ 1.2	+ 0.8	+ 2.0	+ 2.2	+ 2.3
Value		+ 2.5	+ 2.5	+ 2.3	+ 3.9	+ 4.5	+ 3.9
Manufacturing[1], volume		+ 2.2	+ 0.5	+ 0.2	+ 4.8	+ 4.0	+ 3.7
Wholesale and retail trade, volume		+ 2.4	+ 2.2	+ 0.4	+ 1.2	+ 2.2	+ 2.4
Private consumption expenditure, volume		+ 1.0	– 0.1	+ 0.6	+ 1.5	+ 2.0	+ 2.2
Gross fixed investment, volume		– 2.1	– 3.4	+ 6.2	+ 3.8	+ 1.8	+ 2.7
Machinery and equipment[2]		+ 1.6	– 6.5	+ 5.1	+ 7.1	+ 1.5	+ 3.5
Construction		– 5.0	– 0.8	+ 7.0	+ 1.1	+ 2.0	+ 2.0
Exports of goods[3]							
Volume		+ 6.3	+ 4.3	+ 2.5	+12.2	+ 6.0	+ 7.0
Value		+ 6.5	+ 4.2	+ 1.9	+13.0	+ 6.5	+ 7.5
Imports of goods[3]							
Volume		+ 5.5	+ 0.3	+ 6.8	+ 8.4	+ 6.0	+ 7.1
Value		+ 5.0	– 2.0	+ 5.0	+10.4	+ 6.8	+ 7.8
Current balance	billion €	– 4.13	+ 0.75	– 1.11	– 1.25	– 1.59	– 1.09
As a percentage of GDP		– 1.9	+ 0.3	– 0.5	– 0.5	– 0.6	– 0.4
Long-term interest rate[4]	in percent	5.1	5.0	4.2	4.2	3.9	4.3
Consumer prices		+ 2.7	+ 1.8	+ 1.3	+ 2.1	+ 2.5	+ 1.8
Unemployment rate							
Eurostat definition[5]	in percent	3.6	4.2	4.3	4.5	4.5	4.5
National definition[6]	in percent	6.1	6.9	7.0	7.1	7.1	7.1
Economically active emplyees[7]		+ 0.4	– 0.5	+ 0.2	+ 0.7	+ 0.8	+ 0.9
General government financial balance according to Maastricht definition							
As a percentage of GDP		+ 0.3	– 0.2	– 1.1	– 1.3	– 2.0	– 1.8

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.

Employment has already reacted significantly to the cyclical recovery. In 2004, the number of economically active employees increased by 21,000. For 2005 and 2006, gains of more than 25,000 per year are expected, the bulk of them in full-time jobs, and particularly for commercial services, trade and health services. In spite of the healthy increase, the rate of unemployment is unlikely to decline, remaining at 7.1 percent (or 4.5 percent on Eurostat definitions). The main reason is a massive increase in labour supply: the domestic labour force is growing for demographic reasons, a high number of people acquiring Austrian nationality and as a consequence of the pension reform; additional foreign labour is coming mainly from Germany, the effects of the social reforms ("Hartz IV") further reinforcing the inflow. At the same time, the number of Austrians working in Germany is steadily declining.

The second stage of the tax reform will raise the general government deficit to around 2 percent of GDP in 2005. High receipts from VAT and corporate tax at the beginning of the year and rising inflation are bringing within reach the government target of keeping the deficit below 2 percent of GDP. In 2006, net government borrowing should decline somewhat, as foreseen in the stability programme. While the expiry of the investment premium will have a positive impact on the government balance, the tax reform carries shortfalls in income and corporate tax revenues.

Slackening global economic growth

The world economy is currently in a pronounced cyclical upswing. Total output increased by almost 5 percent in 2004. The highest growth rates were recorded in China, the USA, Latin America and the emerging economies in East Asia. The strong momentum of economic activity has been reflected in the expansion of world trade by 9 percent. Differences in the pace of growth between world regions have been determined primarily by the strength of internal demand. In Japan and the euro area, where domestic demand was virtually stagnant, GDP growth was lagging behind the OECD average.

Table 2: World economy

		2001	2002	2003	2004	2005	2006
		Percentage changes from previous year					
Real GDP							
Total OECD		+ 1.1	+ 1.6	+ 2.2	+ 3.6	+ 2.7	+ 2.6
USA		+ 0.8	+ 1.9	+ 3.0	+ 4.4	+ 3.8	+ 3.1
Japan		+ 0.2	– 0.3	+ 2.4	+ 2.6	+ 1.5	+ 1.8
EU 25		+ 1.7	+ 1.1	+ 0.9	+ 2.4	+ 2.0	+ 2.3
EU 15		+ 1.7	+ 1.0	+ 0.8	+ 2.2	+ 1.9	+ 2.2
Euro area		+ 1.6	+ 0.8	+ 0.5	+ 2.0	+ 1.7	+ 2.2
Germany		+ 0.8	+ 0.1	– 0.1	+ 1.6	+ 1.2	+ 1.6
New member states[1]		+ 2.4	+ 2.4	+ 3.8	+ 5.0	+ 4.6	+ 4.1
China		+ 7.3	+ 8.0	+ 9.1	+ 9.5	+ 8.8	+ 8.3
World trade, volume		+ 0.3	+ 3.3	+ 4.1	+ 9.0	+ 7.2	+ 7.1
Market growth[2]		+ 2.4	+ 1.8	+ 4.4	+ 8.7	+ 6.5	+ 6.5
Primary commodity prices							
HWWA index, total		– 8	– 5	– 4	+18	+ 6	– 2
Excluding energy		– 3	– 6	– 6	+18	+ 1	+ 6
Crude oil prices							
Average import price (cif) for OECD countries	$ per barrel	23.6	24.1	28.4	37.8	44.0	39.0
Exchange rate							
$ per euro		0.896	0.945	1.131	1.243	1.34	1.28

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.

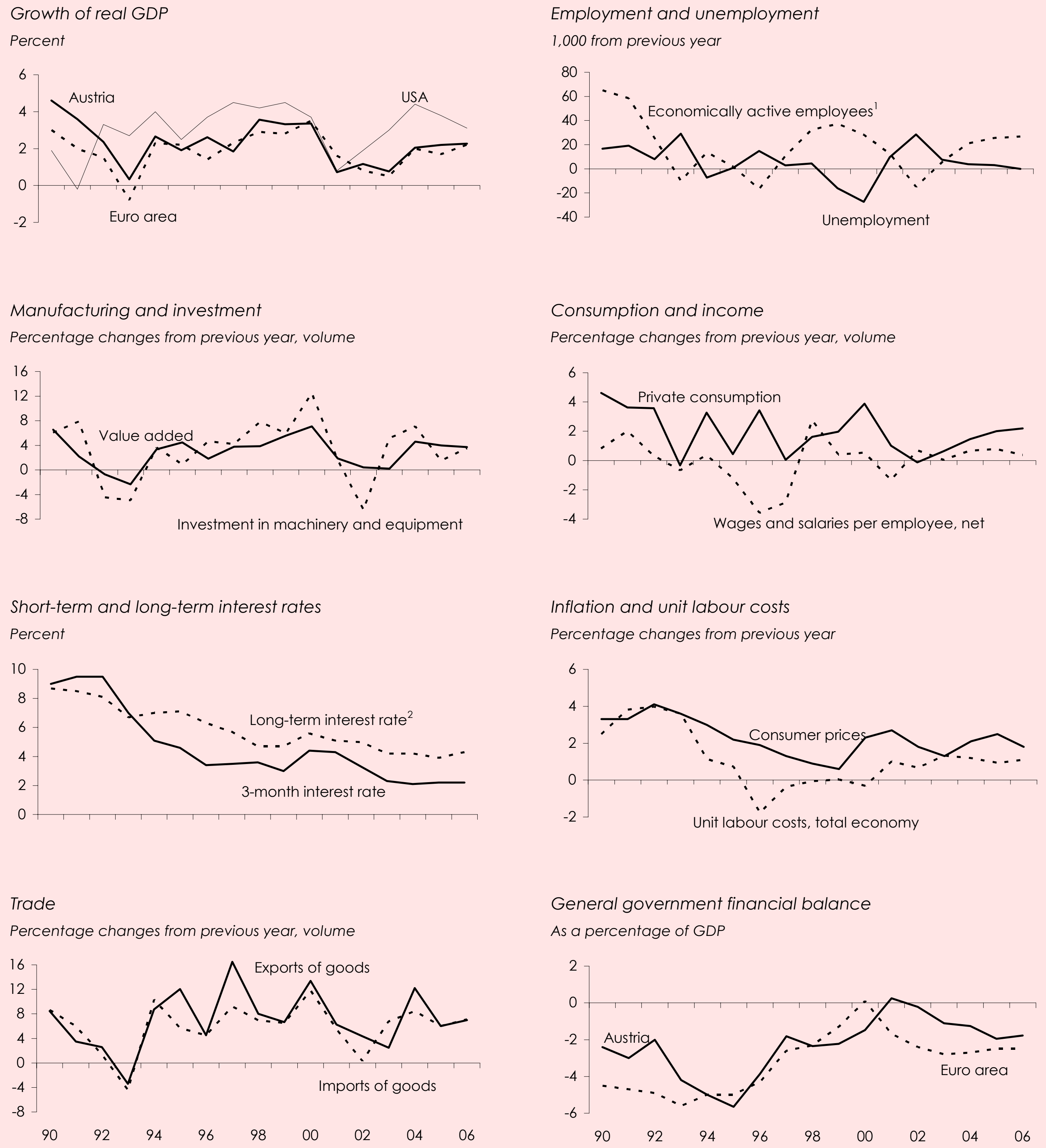
The world-wide upturn is set to slacken somewhat in 2005 and 2006. Growth in the OECD area is expected to abate from 3½ percent in 2004 to 2¾ percent in 2005 and 2006, respectively. In parallel, the expansion of world trade will decelerate.

The US economy grew by 4½ percent in 2004. Investment was stepped up strongly, residential building boomed, and private consumption also posted substantial gains. Ignited by strongly expansionary monetary and fiscal policy, the pick-up translated into a self-sustained upswing that has been unabated by the stepwise increase in interest rates.

In 2005 and 2006, growth in the USA will slow down. Under the impression of high deficits in the current account as well as in public finances, fiscal and monetary policy will turn more restrictive. Notwithstanding the marked depreciation of the dollar, the expansion is accompanied by rising current account gaps, with domestic demand largely outpacing that in Europe and Japan and with the under-valuation of the renminbi making for a large trade deficit vis-à-vis China. The strong import flow in the USA, mirrored by the current account imbalances, is providing strong demand stimulus for the other areas of the world.

In a number of countries, such as the USA and China, economic activity is approaching capacity limits, giving rise to inflationary tendencies. The rate of inflation in the USA may remain only slightly below 3 percent, which will induce the central bank to further raise interest rates gradually.

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).

Economic data for Japan have recently been revised downwards, yielding a growth rate of GDP of 2.6 percent for 2004. The rise in exports has been checked by the decline in the dollar, while domestic demand remained anaemic. Nevertheless, the "ailing" Japanese economy performed better than the euro area over the last two years. The rising yen exchange rate and the fragility of domestic demand suggest, however, that GDP growth will moderate to only around 1½ percent each in 2005 and 2006.

Crude oil prices rose to a new high of $ 55 per barrel of late. The hike is largely a consequence of the fast-growing world economy. In the further course of the year, oil prices should come down from what are deemed "exaggerated" levels to more normal ones.

Short-term outlook for the euro area uncertain

In the euro area, the cyclical recovery remained subdued. Sustained by external demand, real GDP rose by 2 percent in 2004. Domestic demand contributed substantially to growth only in a few countries, while it virtually stagnated in Germany and Italy.

So far, the recovery in the euro area has been too weak as to make notable inroads into unemployment. The jobless rate remains stuck at close to 9 percent, despite wage restraint and the deregulation of labour markets. With the greater flexibility in work arrangements, the employment rate is increasing (more part-time and mini-jobs).

The slow pace of the recovery in Europe is primarily a consequence of the hesitant spending behaviour of firms and private households alike, which is related to heightened uncertainty in the business outlook. The high euro exchange rate and the oil price hike are not the key obstacles: euro area exports are pulling ahead vigorously, and despite the high oil prices economic activity in the USA and Asia is booming.

Monetary policy in the euro area has been expansionary since 2003, albeit not to the same degree as in the USA. Although euro area real interest rates are low, they stimulate residential construction and consumption much less than in the Anglo-Saxon countries.

Great differences exist in the conduct of fiscal policy. In the USA and the UK, the distinctly expansionary budgetary stance, together with strongly rising real estate values, have played a decisive role for the rise in domestic demand. Most euro area countries, for their part, have followed a cyclically neutral budgetary course. This is not only a reflection of the Maastricht criteria, but also of the dominating policy paradigm whereby structural budget deficits should be reduced even in periods of recession. The new Stability and Growth Pact constitutes an economically meaningful adjustment to reality, taking account of the fact that the cyclical component will continue to drive up budget deficits as long as the economy has not passed the cyclical trough. At the same time the new rules rightly foresee that in periods of cyclical upturn structural budget deficits should be reduced by ½ percent of GDP per year.

In 2005, activity in the euro area is set to lose some momentum from last year, with output growth projected at 1½ percent to 1¾ percent. While stimulus from foreign demand is slackening, consumption and residential construction are unlikely to generate a self-sustained upswing. The substantially better corporate profit situation should, however, give incentives for investment. For 2006, assuming a decline in both oil prices and the euro exchange rate, GDP growth in the euro area may be expected at above 2 percent.

The risks and uncertainties of the current projections relate to the oil prices rather than to the external value of the euro. The latter has stabilised between $ 1.30 and $ 1.35 in the last months, whereas oil prices have moved up to $ 55 per barrel. Should oil prices, contrary to expectations, remain at that level, it would shave ¼ to ½ percentage point off euro area GDP growth.

No change in euro area interest rates expected

In view of the buoyant economic activity, the US central bank continued its policy of cautiously raising interest rates in early 2005. The Fed reiterated its intention to exert further measured monetary restraint in order to pre-empt inflationary pressure. In the further course of the year, it will increase interest rates in small steps only, in order not to risk a collapse of real estate prices.

The European Central Bank is pursuing a "steady hand" policy. Since June 2003 it has left the key interest rates unchanged. Also this year, the ECB is likely to tread carefully, not following the rising trend in the USA in a parallel move, given the sizeable output gap in the euro area and the low core inflation. The danger of rising inflation is rather low in the face of the moderate pace of the recovery and the high exchange rate of the euro.

Long-term interest rates follow a steady course, despite the rise in policy-controlled rates in the USA, suggesting that inflationary expectations are subdued. Bond yields will remain below 4 percent on annual average in 2005, before regaining the 2003 level of 4.3 percent.

Persistent weakness of investment and consumption in Germany

Business activity in Germany picked up in the wake of the global economic upturn. Growth of real GDP, at 1.6 percent in 2004, exceeded the average for the last ten years, albeit being boosted by the higher number of working days. As the recovery was sustained almost entirely by exports, it lost momentum in the second half of the year when foreign demand slackened. The rise in oil prices undermined further the already fragile spending mood of households.

Notwithstanding the dampening impact of the euro appreciation, German firms were able to raise their exports by 10 percent, being particularly successful in Asia and the OPEC countries. Deliveries within the euro area also increased strongly, where Germany benefited from an improved competitive position due to its below-average wage and price increases. The current account, in the definition of the balance of payments statistics, posted a surplus equivalent to 3.4 percent of GDP in 2004. Economic policy in Germany remains primarily geared towards further boosting the surplus through gains in competitiveness, e.g., with plans for lowering the corporate tax burden.

Private households restrained their demand slightly in 2004. The tax cuts introduced at the beginning of the year were offset by rising charges in the context of the health care reform and higher energy costs. Consumers' spending propensity was held back by a series of negative factors, such as "Hartz IV" or the increase in weekly working hours.

Investment in machinery and equipment increased by 1 percent in 2004, having fallen for the last three years in a row. In view of the considerably improved profit situation, the increase has been very modest. Companies preferred to reduce their debt levels, some of them invested abroad. Preliminary calculations show that the corporate sector in Germany has turned from a net debtor to a net creditor.

The hesitant investment behaviour is accompanied by an aversion to hire new personnel. The recovery has until now hardly reached the German labour market. Although the number of employees has edged up in 2004 for the first time after three years, the increase has been confined to "mini-jobs", while the total of regular jobs liable to social security contributions fell by 440,000.

The cyclical recovery in Germany is expected to continue without, however, gaining momentum. The projections for GDP growth in 2005 differ widely, ranging from ½ percent to 1½ percent. Investment will play a key role for the growth profile, with the low utilisation of productive capacities after the extended stagnation period and the widespread uncertainty being the major impediments. Private consumption was stimulated in early 2005 by a further step of tax cuts, but its lasting effect is doubtful because of the low confidence of consumers.

The public sector deficit is projected to exceed once again, and by a clear margin, the Maastricht ceiling of 3 percent of GDP. The widening deficit has been a direct consequence of sluggish economic activity in the last years, making for a slightly expansionary fiscal stance.

Moderate cyclical recovery in Austria

Economic activity in Austria picked up noticeably until late summer 2004, but weakened in the year-end quarter. Real GDP, adjusted for seasonal and calendar effects, rose by 0.8 percent each (quarter-on-quarter) in the second and third quarter, but by only 0.3 percent in the fourth quarter. For the whole year 2004, growth attained 2 percent, matching the average for the euro area, but exceeding the 1.6 percent rate for Germany although the recovery in Austria had set in three months later than in Germany.

Table 3: Productivity

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year					
Total economy						
Real GDP	+ 0.7	+ 1.2	+ 0.8	+ 2.0	+ 2.2	+ 2.3
Employment[1]	+ 0.6	− 0.1	+ 0.1	+ 1.0	+ 0.8	+ 0.9
Full-time equivalent	+ 0.4	+ 0.1	+ 0.0	+ 0.8	+ 0.7	+ 0.8
Productivity (GDP per employment)	+ 0.1	+ 1.3	+ 0.7	+ 1.1	+ 1.4	+ 1.4
Full-time equivalent	+ 0.3	+ 1.1	+ 0.7	+ 1.2	+ 1.5	+ 1.4
Manufacturing						
Production[2]	+ 1.9	+ 0.4	+ 0.2	+ 4.6	+ 4.0	+ 3.7
Employees[3]	+ 0.2	− 2.5	− 1.7	− 0.6	− 0.8	− 0.4
Productivity per hour	+ 2.1	+ 3.4	+ 1.6	+ 4.7	+ 4.6	+ 4.1
Working hours per day per employee[4]	− 0.4	− 0.5	+ 0.3	+ 0.5	+ 0.2	± 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.

The slower pace towards the end of last year had been anticipated by WIFO already in its projections of last December. The WIFO business survey for the manufacturing sector shows satisfactory order levels for the first quarter 2005, despite a slight decline from the previous quarter. The current projections assume a steady further improvement, however with a flatter profile than in previous episodes of cyclical upturn. GDP growth is projected at 2.2 percent for 2005 and 2.3 percent for 2006, unchanged from last December. Nevertheless, the cyclical risks have increased markedly in the last few months. The external demand boom which by now has passed its peak has provided only limited incentives to domestic demand, as the high export earnings in the euro area have not translated into stronger investment. Large companies have turned cautious, reducing their debt as well as employment levels. The usual boost to disposable income induced by jobs newly created in the upswing has so far not materialised. Apart from these imponderables, the persistence of oil prices at current peak levels may ignite inflation and undermine private purchasing power. Still, WIFO, along with the international forecasters, assumes a decline in oil prices.

The risk of a further appreciation of the euro against the dollar appears to have mitigated from the forecast revision of last December. The exchange rate has moved little since, and the abating volatility points towards broad stabilisation; moreover, the growing interest rate differential between the USA and the euro area is taking some of the downward pressure off the dollar that derives from the high US current account deficit.

Export boom cooling in 2005

The economic recovery in 2004 was primarily driven by buoyant exports. Merchandise exports expanded by 12 percent in volume, the highest rate since the 13.4 percent recorded in 2000. Market absorption was particularly high in the USA, Asia and Southeast Europe, whereas exports to the new EU member states fared close to the overall average. The USA advanced to third position among Austria's largest export markets, behind Germany and Italy, and ahead of Switzerland and the UK deliveries to Germany also posted strong gains. In spite of the significant appreciation of the euro, Austrian exporters managed to strengthen their position on world markets, as goods exports grew faster by around 3 percentage points than Austria's trade-weighted foreign markets. Only a minor part of these gains in market shares may be explained by the slight fall in relative unit labour costs in the manufacturing sector (–½ percent in 2004 vis-à-vis the average of the trading partners).

The seasonally adjusted data reveal that the strong export gains in the first half of 2004 levelled off subsequently. This will be reflected in smaller year-on-year increases in the first semester 2005.

Merchandise exports gained 12 percent in volume in 2004. Firms took advantage of the opportunities offered notably by markets in the USA, Asia and Southeast Europe. Because of the expected deceleration of world trade growth, exports in 2005 and 2006 will progress at a somewhat slower pace.

The slowdown in the international business cycle and the strength of the euro against the dollar will moderate export growth to a projected rate of 6 percent this year. In 2006, with the expected recovery of the dollar and unchanged market growth, exports may rise by 7 percent. The relative unit labour cost position in a common currency should improve further in 2005 and 2006, thereby consolidating the gains in market shares achieved in 2004.

Exports of tourism services remained flat in real terms in 2004. Major reasons were the cyclical sluggishness in Germany and Italy, to a lesser extent also the unfavourable exchange rate for visitors from the dollar area. The weaker dollar also encouraged travels to dollar area destinations. In 2005, tourism exports are expected to edge up by 0.5 percent in volume, followed by a more substantial pickup in 2006.

With export growth losing momentum in 2005, imports should also decelerate. The stimulus to private consumption from the tax reform and the oil price increase will weaken somewhat the current account balance in 2005, an effect that should be reversed in 2006.

Weak investment demand after the front-loading of projects

On account of the fiscal stimulus and of pent-up demand, investment in machinery and equipment rose substantially in 2003 and 2004, notably faster than on average in the EU. Spending remained lively up to the expiry of the investment premium at the end of 2004. Registrations of new trucks were particularly strong. The front-loading of demand will weigh on investment in the current year, which is confirmed by the latest WIFO investment survey for the manufacturing sector. Overall spending on machinery and equipment may rise by a modest 1.5 percent in volume. By 2006, the negative echo effect should fade, allowing equipment investment to expand by 3.5 percent. With the cyclical recovery making headway, capacity utilisation should return to satisfactory levels, as a key condition for stronger investment. Higher net corporate earnings from exports and the cuts in income and corporate tax are further positive elements.

Construction remained on an upward trend. After the hefty increase by 7 percent in 2003 prompted by the imminent expiry of the accelerated depreciation rule, a further 1 percent gain was recorded in 2004. Demand is mainly supported by civil engineering, which should rise further this year, according to the regular WIFO business survey. The increase in the financing capacity of Asfinag for road construction may play an important role in this regard. Building activity is also heading up. Total construction investment is expected to grow by a steady 2 percent p.a. over the projection period.

Tax cuts encouraging private consumption

In 2004, private household demand rose by 1.5 percent, twice as fast as in the year before. A further acceleration is expected for 2005. Nevertheless, consumption growth remains below the rates seen in previous cyclical upturns, despite the incentives provided by the tax reform. While the lower tax burden implies a significant gain in private households' disposable income, other factors work in opposite direction. Thus, rising inflation will squeeze disposable income in real terms. At the same time, the saving ratio is heading up further, although the higher energy costs as a sort of "forced" consumption should rather work towards a lower saving ratio. Usually, net income gains from tax cuts are only partly spent on consumption in the short run, the other part goes to higher saving. Since the onset of the cyclical slowdown in late 2000, the saving ratio is rising steadily[1], thereby reducing the role of consumption as a cyclical stabiliser. Like in Germany, one contributing factor has been the redistribution from net wages, salaries and social transfers (with a low saving ratio) towards the earnings of self-employed.

[1] The preliminary national accounts established by Statistics Austria show an exceptionally strong increase in the saving ratio for the year 2003, which may still be corrected downwards.

The pass-through of the oil-price-induced higher inflation to wages has been very limited so far. Effective earnings per capita in 2004 came out 2.2 percent above the year-earlier level. Average working hours went up on account of the strengthening of activity and a higher number of working days. In the autumn wage round, contractual wages and salaries were raised by 2 percent to 2.5 percent for most branches. Against an expected rate of inflation of 2.5 percent this implies a slight decline in gross real earnings in 2005.

The second stage of the tax reform will lower the wage and income tax burden by € 1.3 billion in 2005, providing a boost for private consumption. The positive effect is, however, dampened by higher inflation and a rise in the saving ratio.

Table 4: Private consumption, income and prices

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.0	– 0.1	+ 0.6	+ 1.5	+ 2.0	+ 2.2
Durables	– 0.1	– 2.4	+ 3.6	+ 4.4	+ 3.8	+ 3.5
Non-durables and services	+ 1.2	+ 0.1	+ 0.3	+ 1.1	+ 1.8	+ 2.0
Household disposable income	+ 0.1	+ 0.2	+ 1.5	+ 1.6	+ 2.3	+ 2.1
	As a percentage of disposable income					
Household saving ratio	7.6	7.8	8.9	9.2	9.6	9.6
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+ 3.5	+ 1.2	+ 1.6	+ 5.0	+ 5.2	+ 4.8
Inflation rate						
National	2.7	1.8	1.3	2.1	2.5	1.8
Harmonised	2.3	1.7	1.3	2.0	2.4	1.7
Core inflation[2]	2.3	2.0	1.3	1.6	2.1	1.7

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

The cuts in direct taxes, together with the expected increase in employment, will make for a non-negligible 2.3 percent gain in households' net disposable income in 2005. Employees' per-capita income should edge up by almost 1 percent net in real terms, employment by 0.8 percent. Private consumption will gain 2 percent or slightly more, both in 2005 and 2006, with demand for durable goods set to grow above the average rate.

Table 5: Earnings and international competitiveness

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year					
Gross earnings per employee[1]	+ 1.3	+ 2.1	+ 2.0	+ 2.2	+ 2.3	+ 2.5
Full-time equivalent	+ 1.6	+ 1.9	+ 2.1	+ 2.4	+ 2.5	+ 2.7
Gross real earnings per employee[1]	– 0.6	+ 0.9	+ 0.5	+ 0.2	– 0.2	+ 0.7
Net real earnings per employee[1]	– 1.3	+ 0.7	+ 0.0	+ 0.7	+ 0.8	+ 0.4
Total economy						
Unit labour costs	+ 1.0	+ 0.7	+ 1.3	+ 1.2	+ 0.9	+ 1.1
Manufacturing						
Unit labour costs	+ 1.1	– 0.6	– 0.5	– 3.1	– 2.1	– 1.4
Relative unit labour costs[2]						
Vis-à-vis trading partners	– 0.9	– 0.6	+ 1.4	– 0.6	– 0.8	– 2.5
Vis-à-vis Germany	– 0.6	– 0.4	– 0.1	– 0.1	– 0.9	– 2.2
Effective exchange rate, manufactures						
Nominal	+ 0.9	+ 1.3	+ 3.7	+ 1.2	+ 1.0	– 0.6
Real	+ 0.5	+ 0.8	+ 2.9	+ 1.0	+ 1.5	– 0.6

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

Rising inflation despite moderate internal demand growth

Higher housing and energy costs as well as price increases for cigarettes have accelerated the rise in consumer prices in recent months. The headline rate of inflation remained only just below 3 percent. With the most recent jump in oil prices, inflation is set to increase further in March. Upward pressure is also particularly strong for rents and other housing costs. Unlike during the last years, food prices are also heading up swiftly.

Rising energy prices, higher rents and the increase in the tobacco tax will rekindle inflation in 2005. In 2006, the overall price pressure is projected to abate.

The rate of inflation on annual average 2005 is projected at 2.5 percent, up from 2.1 percent last year. The acceleration is mainly due to the sustained increase in oil prices and the higher tobacco tax. In March 2005, the benchmark price for Brent rose to a new high of $ 55 per barrel. In line with international projections, WIFO assumes a decrease in oil prices in the further course of the year. If prices were to remain at the level of $ 55 per barrel until the end of the year, the annual rate of inflation would be 2.8 percent rather than 2.5 percent, according to results from simulations with the WIFO input-output model. Core inflation, i.e., excluding energy and unprocessed food, expected at 2.1 percent, remains well below the overall rate this year. This suggests that the acceleration of inflation is regarded as temporary and will feed only to a small extent through to wages and manufactures prices.

In 2006, the inflation rate should abate to 1.8 percent. This presupposes a decline in oil prices and a levelling-off of housing costs. Underlying the projections is the assumption of oil prices falling from an average $ 44 per barrel in 2005 to $ 39 in 2006.

Unemployment not to decline despite growing number of jobs

Demand for labour has reacted relatively early to the recovery of economic activity, such that the number of people in dependent active employment increased by 21,000 on annual average 2004. The positive trend continued into early 2005. A large part of the new jobs has been created in commercial, health and nursing care services. The strong increase in male jobs suggests that most of the jobs newly created are full time.

Table 6: Labour market

		2001	2002	2003	2004	2005	2006
		Changes from previous year, in 1,000					
Demand for labour							
Economically active employment[1]		+13.9	–11.6	+ 8.5	+25.1	+29.0	+30.9
Employees[2]		+12.4	–15.0	+ 5.5	+21.1	+25.5	+26.9
percentage changes from previous year		+ 0.4	– 0.5	+ 0.2	+ 0.7	+ 0.8	+ 0.9
Nationals		+ 3.0	–20.1	–10.4	+ 9.2	+15.5	+16.7
Foreign workers		+ 9.5	+ 5.1	+15.9	+11.9	+10.0	+10.2
Self-employed[3]		+ 1.5	+ 3.4	+ 3.0	+ 4.0	+ 3.5	+ 4.0
Labour supply							
Population of working age	15 to 64 years	+27.5	+27.0	+30.1	+14.9	+ 1.2	+ 8.6
	15 to 59 years	–13.8	– 1.2	+13.3	+17.4	+31.3	+38.9
Labour force[4]		+23.5	+17.0	+16.1	+28.9	+32.0	+30.9
Surplus of labour							
Registered unemployed[5]		+ 9.6	+28.5	+ 7.7	+ 3.8	+ 3.0	± 0.0
	in 1,000	203.9	232.4	240.1	243.9	246.9	246.9
		Percent					
Unemployment rate							
Eurostat definition[6]		3.6	4.2	4.3	4.5	4.5	4.5
as a percentage of total labour force[5]		5.5	6.2	6.3	6.4	6.4	6.4
National definition[5, 7]		6.1	6.9	7.0	7.1	7.1	7.1
Employment rate							
Economically active employment[1, 8]		63.3	62.8	62.6	62.9	63.4	63.8
Total employment[6, 8, 9]		–	–	–	67.5	68.0	68.4

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.

The expected gradual strengthening of activity will lead to an increase in employment by 26,000 people or 0.8 percent, keeping broadly the same pace in 2006. The employment rate (on Eurostat definitions) will reach about 68½ percent in 2006, which however includes people receiving child care benefits. It can reasonably be assumed that the Lisbon target, i.e., an employment rate of 70 percent by 2010, will be met.

The cyclical recovery is leading to a marked increase in employment, extending also to full-time jobs. The rate of unemployment remains nevertheless flat, as labour supply is rising significantly.

In spite of the sizeable employment gains, unemployment will not come down. On a seasonally adjusted basis, the jobless figure stagnated early this year; in February, because of severe weather conditions, it rose by 7,600 from one year ago, although more people were enrolled in training courses this year. The unemployment rate is projected to remain stuck at 7.1 percent (4.5 percent on Eurostat definitions) in 2005 and 2006. The reason lies in a massive increase in labour supply. The domestic labour force is growing for demographic reasons and as a consequence of the pension reform. Additional foreign labour is coming mainly from Germany, while the number of Austrians working in Germany is steadily declining, due to the difficult job situation.

General government deficit widening to around 2 percent of GDP in 2005

The tax reform is giving rise to a marked increase in the government deficit in 2005. A limited reduction may be expected for 2006, when business activity should strengthen further, the effect of the investment premium wears off and growth in public expenditure is to be subjected to tighter control.

The flow of tax revenues was relatively favourable in early 2005, with notably yields from sales and corporate tax posting strong gains. Higher inflation in the wake of the oil price hike will facilitate the achievement of this year's budgetary targets.

The second leg of the tax reform took effect at the beginning of 2005. It provides for tax cuts to the amount of € 2.6 billion. The lowering of the corporate tax rate from 34 percent to 25 percent will ease the tax burden for companies by almost € 1 billion which, for the larger part, will show up only in the budget for 2006. Wage and income taxpayers will be exonerated to the tune of € 1.3 billion with the second stage of the tax reform. The tax cuts are expected to boost GDP growth by ¼ percentage point each in 2005 and 2006, raising it thereby markedly above the euro area average. The direct negative impact of the tax reform on the general government balance amounts to ¾ percent of GDP in 2005 and ½ percent in 2006.

Whether the public sector deficit will remain below 2 percent of GDP this year will crucially depend on the amount of one-off revenues (e.g., from special dividends), the remaining expenditure on the investment premium that is difficult to foresee, and the further trend of sales tax revenues.

In 2006, the deficit may decline to 1¾ percent of GDP, as foreseen in the updated stability programme. While the tax reform will lead to shortfalls in income and corporate tax revenues, the expected further cyclical recovery and the expiry of the investment premium will have a positive impact on the budget balance. The business outlook for 2006 is obviously subject to considerable risk. One uncertainty relates to the actual amount of revenues foregone on account of the new taxation rules for corporate holdings.

Table 7: Key policy indicators

	2001	2002	2003	2004	2005	2006
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	+0.3	−0.2	−1.1	−1.3	−2.0	−1.8
According to National Accounts	+0.1	−0.4	−1.3	−1.4	−2.1	−1.9
General government primary balance	+3.7	+3.0	+1.9	+1.6	+0.9	+1.0
	Percent					
Monetary policy						
3-month interest rate	4.3	3.3	2.3	2.1	2.2	2.2
Long-term interest rate[1]	5.1	5.0	4.2	4.2	3.9	4.3
	Percentage changes from previous year					
Effective exchange rate						
Nominal	+1.0	+1.4	+3.8	+1.2	+1.0	−0.6
Real	+0.3	+0.6	+2.8	+0.9	+1.4	−0.7

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