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Economic Growth Slowing Down

Economic Outlook for 2008 and 2009

GDP growth in Austria is set to abate from 3.4 percent in 2007 to 2.2 percent in 2008. A first preview to 2009 suggests a rate of growth around 2 percent. Main reason for the deceleration is a weakening of the international environment, as witnessed by the cyclical downturn in the USA, the crisis on financial markets and the appreciation of the euro. In Austria too, investment growth is losing momentum, and the support to activity from private consumption will be constrained by the meager gains in real incomes. The latter are squeezed also by a marked rise in inflation, projected at an annual 2.6 percent for 2008. The slow-down of growth will keep the rate of unemployment at 6¼ percent of the labour force (4¼ percent on Eurostat definitions).

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Austria's export industry enjoyed a boom in 2006 and 2007, benefiting from favourable economic conditions worldwide, an acquired strong market position in the rapidly growing economies in eastern and southeastern Europe and its high degree of price competitiveness. Both merchandise exports and manufacturing output expanded by 7 percent to 8 percent in volume, a pace that even allowed a net increase in the industrial workforce. The business cycle reached its peak in the first half of 2007. Since then, leading indicators like the quarterly WIFO business survey have been signalling a slowdown, mainly because global economic conditions have weakened since last summer:

- Following a slump in real estate prices and residential investment, consumer demand and GDP growth have ebbed in the USA; with growth of real GDP projected at barely above 1½ percent p.a. for 2008 and 2009, a major engine of global growth is losing steam.
- The crisis of confidence and lending on international financial markets is going on: with credit and financing conditions tightening and business confidence weakening, private investment will be affected.
- The substantial appreciation of the euro is weighing on industrial price competitiveness, thereby holding back the major driver of business activity in the euro area; prevailing differentials of both growth and interest rates between the USA and Europe make a further dollar depreciation likely. Euro area GDP is projected to moderate to 1.9 percent and 1.7 percent in volume in 2008 and 2009, respectively.
- Nevertheless, these dampening effects hit the world economy in a period of robust expansion driven mainly by the emerging markets in Asia. Global growth is expected to edge down from slightly above 5 percent in volume in 2007 to around 4½ percent.

WIFO therefore assumes that growth of Austrian exports will decelerate somewhat over the forecast period. Exports of goods and services is expected to increase by 5½ percent in volume per year. As a consequence, also the boom in manufacturing will subside, with value added gaining some 3 percent p.a. Already in 2007, lively exports gave less stimulus than expected to investment in machinery and equip-

ment which edged up by only 5 percent in real terms, despite high corporate earnings. First results from the WIFO investment survey of autumn 2007 point to a slackening of investment growth in 2008. This holds also for the construction sector, where the boom of 2006-2007 triggered not only a sizeable increase in employment, but also a jump in prices. While steady growth over the projection period may be expected for civil engineering and residential building, construction of industrial and commercial buildings may lose some momentum. For the whole construction sector, value added may rise by some 2½ percent in volume.

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	+ 2.2	+ 2.0
Value		+ 4.4	+ 3.9	+ 5.1	+ 5.8	+ 4.6	+ 4.0
Manufacturing ¹ , volume							
		+ 2.4	+ 3.1	+ 8.8	+ 7.8	+ 3.3	+ 3.0
Wholesale and retail trade, volume							
		+ 1.1	+ 0.2	+ 1.0	+ 1.3	+ 1.8	+ 1.8
Private consumption expenditure, volume							
		+ 1.8	+ 2.0	+ 2.1	+ 1.6	+ 1.9	+ 1.9
Gross fixed investment, volume							
Machinery and equipment ²		+ 0.1	+ 0.3	+ 3.8	+ 5.0	+ 2.5	+ 1.9
Construction		- 1.4	+ 0.7	+ 2.1	+ 5.0	+ 2.5	+ 1.0
		+ 1.3	+ 0.1	+ 5.1	+ 5.0	+ 2.5	+ 2.5
Exports of goods ³							
Volume		+ 12.5	+ 3.2	+ 6.8	+ 8.0	+ 6.3	+ 6.0
Value		+ 13.9	+ 5.4	+ 9.5	+ 9.8	+ 7.3	+ 6.5
Imports of goods ³							
Volume		+ 11.7	+ 2.8	+ 3.8	+ 7.1	+ 6.2	+ 5.9
Value		+ 12.5	+ 5.9	+ 8.0	+ 8.4	+ 7.5	+ 6.6
Current balance							
	billion €	+ 3.99	+ 5.16	+ 7.11	+ 9.32	+ 9.37	+ 10.11
	As a percentage of GDP	+ 1.7	+ 2.1	+ 2.8	+ 3.4	+ 3.3	+ 3.4
Long-term interest rate ⁴							
	in percent	4.2	3.4	3.8	4.3	4.1	4.4
Consumer prices							
		+ 2.1	+ 2.3	+ 1.5	+ 2.1	+ 2.6	+ 2.1
Unemployment rate							
	Eurostat definition ⁵						
	in percent	4.8	5.2	4.8	4.3	4.2	4.3
	National definition ⁶						
	in percent	7.1	7.3	6.8	6.2	6.2	6.3
Persons in active dependent employment ⁷							
		+ 0.7	+ 1.0	+ 1.7	+ 2.0	+ 0.9	+ 0.7
General government financial balance according to Maastricht definition							
	As a percentage of GDP	- 1.2	- 1.6	- 1.4	- 0.6	- 0.7	- 0.6

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.

Unlike during the cyclical high from 1998 to 2000, the upswing in 2006 and 2007 has never been transmitted to private household demand which of late has even slowed to a mere 1.6 percent increase. No substantial pick-up in consumer spending should be expected for 2008 either, despite higher wage settlements. The income gains will be offset by a significant acceleration of inflation, with the headline rate rising above 3 percent in the months to come and the annual average for 2008 expected at 2.6 percent. The upward drift is mainly driven by hikes in food and energy prices. The implicit dampening impact on private consumption is particularly noticeable insofar as these items weigh heavily in the consumption basket of the low-income brackets with a high spending propensity. Household demand, adjusted for inflation, is therefore projected to grow by only 1.9 percent p.a. over the forecast period.

The slackening of GDP growth will slow the momentum of job creation. The number of persons in dependent active employment is set to move up by 30,000 in 2008 and

a further 22,000 in 2009. These gains will not suffice to make further inroads into unemployment, given the steady increase in the population of working age, rising labour force participation rates and the continued inflow of labour from abroad. WIFO's projection for the total number of unemployed is for an average 220,000 or slightly higher, broadly unchanged up to the forecast horizon. The corresponding jobless rate is 6¼ percent of the dependent labour force (national definition) or 4¼ percent of the total labour force (Eurostat definition).

The slowdown of job creation as well as of profit growth will be reflected, with the usual lag, by a slower growth momentum of government revenues. At the same time, additional spending decided by the Federal government on research, education and social welfare will take effect. WIFO expects that the general government balance in the Maastricht definition will stabilize at a deficit around 0.6 percent of GDP. This outlook is necessarily vague, particularly for 2009 in the absence of budget drafts for all government levels for that year.

With the stimulus from the export boom only partially transmitted to business investment, private demand lacking momentum and the international financial market crisis still unresolved, the cyclical upswing of domestic activity will ebb earlier than hoped-for. Growth of GDP, while once again exceeding the euro area average, will fall slightly below its long-term trend. Under such auspices, a further fall in unemployment has become unlikely, as has the narrowing of the government deficit. Should the external conditions deteriorate even further, the cyclical slowdown may prove sharper than assumed in the present projections.

Global economic growth is set to lose momentum over the projection period, from a real rate slightly above 5 percent in 2007 to an expected 4½ percent each in 2008 and 2009. Main reasons are the marked slowdown in the USA whose strong imports fuelled output worldwide during the last years, and the persistent liquidity and credit crisis on international financial markets.

Strong global activity to slacken somewhat

After five years of swift expansion, global economic activity is losing some momentum. Main reasons are the crisis on financial markets and the slowdown of growth in the USA. Demand and output growth in the emerging market economies remains strong for the time being.

Table 2: World economy

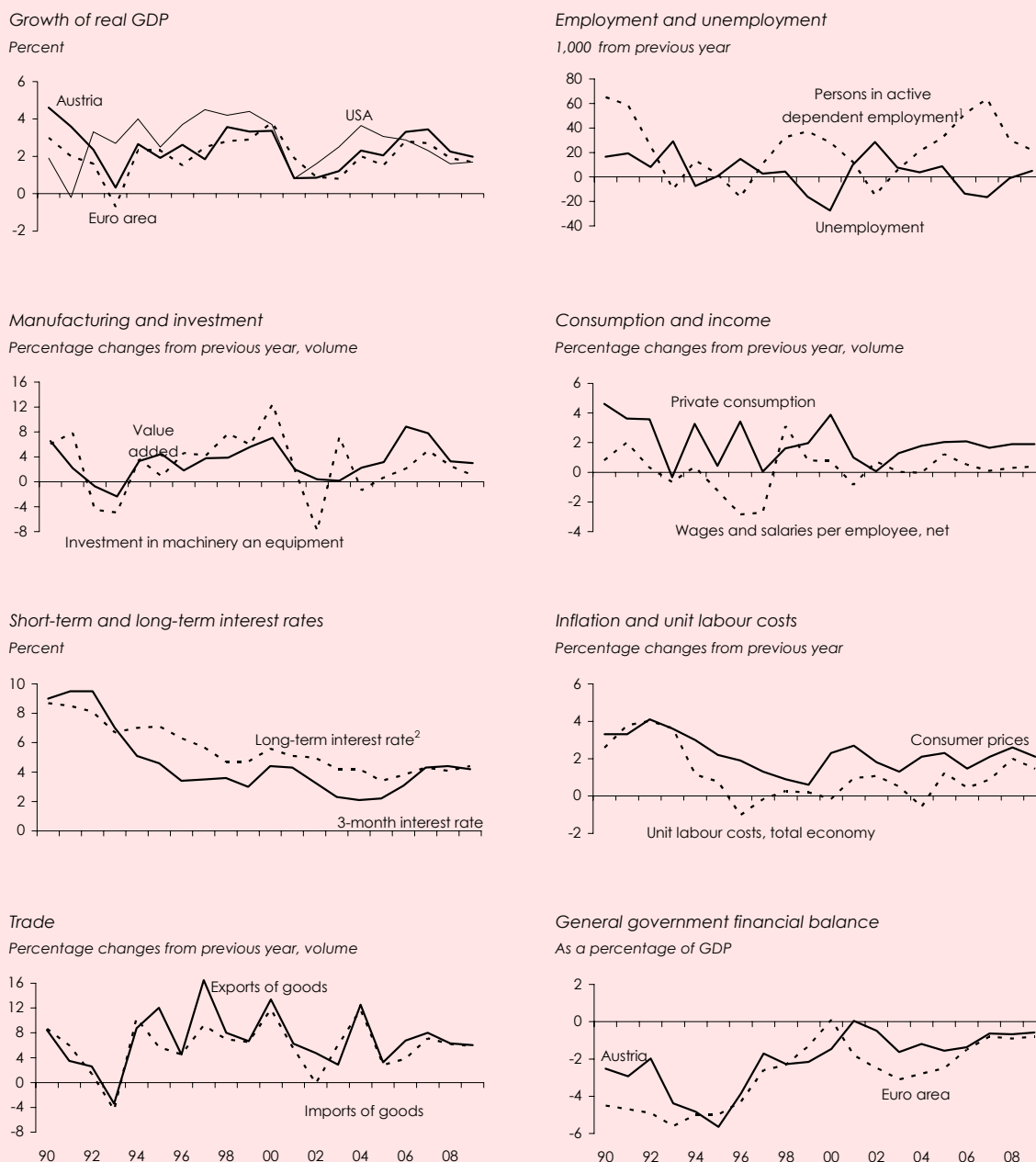
	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
<i>Real GDP</i>						
World total	+ 5.3	+ 4.8	+ 5.5	+ 5.1	+ 4.6	+ 4.5
Total OECD	+ 3.2	+ 2.6	+ 3.0	+ 2.7	+ 2.2	+ 2.3
USA	+ 3.6	+ 3.1	+ 2.9	+ 2.3	+ 1.6	+ 1.7
Japan	+ 2.7	+ 1.9	+ 2.4	+ 1.8	+ 1.5	+ 1.6
EU 27	+ 2.5	+ 1.8	+ 3.0	+ 3.1	+ 2.3	+ 2.1
EU 15	+ 2.3	+ 1.6	+ 2.8	+ 2.7	+ 1.9	+ 1.7
Euro area	+ 2.0	+ 1.5	+ 2.8	+ 2.7	+ 1.9	+ 1.7
Germany	+ 1.1	+ 0.8	+ 2.9	+ 2.6	+ 1.8	+ 1.8
New member countries ¹	+ 5.5	+ 4.7	+ 6.2	+ 6.0	+ 5.5	+ 5.0
China	+10.1	+10.2	+11.1	+11.5	+10.5	+10.0
<i>World trade, volume</i>	+10.3	+ 7.2	+ 8.9	+ 6.5	+ 6.8	+ 6.2
<i>Market growth²</i>	+ 9.1	+ 7.4	+10.3	+ 7.8	+ 6.3	+ 6.0
<i>Primary commodity prices</i>						
HWVA index, total	+18.5	+28.6	+19.4	+ 2	+ 5	+ 3
Excluding energy	+18.1	+ 5.6	+22.0	+ 3	+ 0	+ 5
<i>Crude oil prices</i>						
Average import price (fob)						
Brent, \$ per barrel	38.0	55.0	65.1	72.0	85.0	88.0
<i>Exchange rate</i>						
\$ per euro	1.243	1.245	1.256	1.37	1.52	1.55

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

In the emerging market economies, no signs of cyclical weakening have as yet been observed. In China, economic policy is rather struggling with imbalances related to the sustained boom of investment and exports. The overheating of activity is

witnessed by an accelerating rise in living costs (inflation has recently been recorded above an annual rate of 6 percent), swiftly widening income differentials, and deteriorating environmental conditions. Real GDP increased by an estimated 11½ percent in 2007. For this year and next, only a slight moderation is expected, possibly triggered by slackening import demand from the USA and a marked further tightening of monetary policy.

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).

Many other economies in Asia benefit from China's lively import demand, as do the commodity suppliers in Latin America and Africa. Although Japan's exports are also stimulated by the expansion in China, domestic sluggishness of consumption and investment is proving once again as stubborn. Most recently, the economy has even slipped back into deflation.

Lively demand, notably from the emerging Asian markets, is the main driver behind an almost steady increase in world oil prices since 2003. In 2007, the price of Brent,

the reference brand for Europe, averaged \$ 72 per barrel. Mainly the weakness of the dollar, but also geopolitical tensions added further momentum to the upward drift in the fourth quarter. Given the unabated strong demand and the fact of limited global reserves being increasingly reflected in prices, WIFO assumes prices of internationally traded oil to maintain a high level. Underlying the projections is an assumed \$ 85 and \$ 88 per barrel for 2008 and 2009, respectively.

The turbulences on international financial markets, triggered by the crisis on US mortgage markets, have been spreading quickly to other areas since last summer. The liquidity squeezes periodically emerging in this context have been countered by massive interventions by central banks, which have helped to avoid a deeper financial market slump. Nevertheless, the confidence crisis on interbank markets has revived of late, with restraint on credits becoming tighter. Deteriorating financing conditions and persistent uncertainty will probably induce many companies to defer planned investments.

With investor confidence undermined in a lasting way, volatility on stock markets has increased in recent months. Real estate values have drifted down primarily in those industrialised countries where gains have been the highest during the last ten years. Apart from the USA, this was the case notably in Ireland, Spain and the UK. Repercussions of a correction on asset markets for the real economy would be particularly severe if it would affect stock and real estate markets at the same time. A consequence of the turnaround of real estate and share values in North America and Europe is that the high net savings in Asia and a number of EU countries are looking for new investment opportunities. Latin America, but also eastern and southern European countries may therefore see their external capital inflows further increase.

The impact has been particularly visible on foreign exchange markets. In the course of 2007, the euro has moved up from \$ 1.29 to \$ 1.49. The European currency has also appreciated markedly vis-à-vis the Japanese yen and the Chinese yuan. While the stronger exchange rate is dampening the adverse impact of higher commodity prices, it undermines at the same time the competitiveness of exports, thereby weakening the major support of business activity in the euro area. In view of the slowdown of growth and the swift cuts in interest rates in the USA, WIFO expects the appreciation of the euro to continue. The assumption underlying the projections is for an average exchange rate of \$ 1.52 per euro for 2008.

Driven by exports and domestic private consumption, US GDP still advanced swiftly in the second and third quarter 2007, by 0.9 percent and 1.2 percent respectively (in volume, from the previous period). For the whole year, growth should have attained 2.3 percent. Increasingly, however, retarding factors are making themselves felt: residential investment slumped by an inflation-adjusted 16 percent year-on-year in the third quarter and was down by 25 percent from its peak in late 2005. The decline in house prices – by 4.5 percent year-on-year in the third quarter according to the Case-Shiller index – suggests that the fall in housing construction will take on further momentum, lasting until the end of 2008 as assumed in the WIFO projections. In addition, the amount of outstanding mortgage loans affected by higher interest rates will rise significantly in the coming months, possibly entailing increasing default on repayments. The United States Department of Treasury is currently taking measures to rein in the negative repercussions for the homebuyers concerned as well as for the economy at large. Even if these prove effective, the private saving ratio is still likely to go up and household consumption to advance at a slower pace. WIFO therefore expects GDP growth to moderate to an inflation-adjusted 1.6 percent in 2008, with the trough of the cycle to be hit around the middle of the year. The economy is not assumed to slide into a recession in the sense of a fall in GDP over two consecutive quarters, although such an outturn can by no means be excluded. Further interest rate cuts and a more expansionary fiscal stance should lead to a gradual revival of business activity.

Crisis on international financial markets persisting

The situation on international financial markets has not calmed so far. The euro exchange rate is under considerable upward pressure.

Marked slowdown of US growth

GDP growth in the USA is expected to abate from 3 percent in 2006 to only 1½ percent in 2008.

GDP in the euro area is likely to have grown by 2.7 percent in volume in 2007, mainly supported by exports, manufacturing output and investment in machinery and equipment. Since last summer however, the business surveys by the European Commission show a decline in industrial confidence and manufacturing orders have slackened markedly. Part of the explanation may be the significant appreciation of the euro which squeezes profit margins and weighs on competitiveness.

The episode of favourable business conditions has led to a substantial decline in unemployment. In October, the seasonally-adjusted rate of unemployment stood at 7.2 percent, down by $\frac{1}{4}$ percentage point from last year. Despite this improvement, private consumption has not accelerated since disposable income registered only modest gains: in the third quarter 2007, employees' per-capita earnings rose by only 2 percent from the year-earlier period in nominal terms. Towards the end of the year, real incomes and consumer demand were also dampened by a significant increase in inflation (November +3.1 percent). The European Central Bank is facing a difficult task: on the one hand, higher inflation would call for a restrictive monetary stance; on the other, the persistent instability on financial markets, the upward pressure on the euro and the cyclical weakening would advise in favour of loosening the monetary reins. WIFO assumes that the ECB will keep the key refinancing rate constant at 4 percent over the projection period.

The subdued increase in per-capita incomes and the relatively strong inflation will leave little room for a significant pick-up in private consumption growth in 2008. At the same time, exports and manufacturing output are set to lose momentum with the slackening of demand in the USA and the appreciation of the euro. Likewise, the indicators for the construction sector point to a cyclical slowdown, particularly in Ireland and Spain. WIFO assumes that real GDP growth for the euro area will decelerate to 1.9 percent in 2008, with the cycle reaching its lower turning point at the end of the year.

The German economy is expected to have grown by 2.6 percent in real terms in 2007, almost the same rate as the year before. The key factor for the recovery from a four-year-long stagnation was the high level of external competitiveness achieved, both as regards price and quality, which enabled companies to fully benefit from the global economic boom. Domestic demand, however, remained subdued even in the period of cyclical high; indeed, private consumption edged down by 0.2 in volume in 2007 on the back of sluggish wage growth and the increase in VAT. For this reason, business activity remains highly vulnerable to a deterioration in the external environment. In 2008, real GDP is projected to rise by 1.8 percent, as weaker exports and investment growth will not be fully compensated by a tentative recovery of consumer demand.

In the new EU member states, lively GDP growth of around 6 percent in volume was driven predominantly by strong advances in consumer demand and construction investment. Households' readiness to incur debt increased markedly. Only in Hungary, growth of internal demand and GDP was held back by the restrictive stance of budgetary policy.

Strong domestic demand led to a sizeable increase in the number of jobs and a significant decrease in unemployment; in some countries, like in the Baltics or Bulgaria, activity is overheating, as witnessed by high current account deficits and rising inflation. Fiscal and monetary policy will likely move to a more restrictive stance in 2008 and 2009, while export growth is dampened by decelerating demand in western Europe. Nevertheless, the re-direction of global financial flows may lead to a further increase in capital transfers towards the east-central European economies. Real GDP is expected to expand by slightly above 5 percent p.a. over the projection period.

Euro area business cycle beyond the peak

At the same time as the euro appreciates markedly, inflation in the euro area is gaining momentum. This confronts monetary policy with difficult challenges and slows the pace of cyclical activity.

Short cyclical upswing in Germany

Due to the weakness of consumer demand, the German economy appears particularly vulnerable to the deterioration in the international growth environment.

Strong internal demand in the new EU member states

In eastern and south-eastern Europe, private consumption and demand for construction are booming. This is increasingly reflected in sizeable macro-economic imbalances.

In 2007, Austria's GDP increased by 3.4 percent in volume. Growth was primarily supported by lively exports which, however, gave only moderate stimulus to investment in machinery and equipment. Demand for construction proved surprisingly strong, notably early in the year, whereas private consumption failed to gather momentum.

The peak of the cycle was passed in the first semester 2007. The slowdown of growth was first induced by the fact that firms, while encouraged by the export boom to elaborate comprehensive investment strategies, eventually hesitated to implement these plans to the same extent as in the past. Reasons may have been the noticeable worsening of financing conditions as from the middle of the year as well as the sharp appreciation of the euro vis-à-vis the dollar. In addition, and unlike during the boom in 2000, private household demand did not take over a leading role in prolonging the cycle. This was mainly the result of only lean gains in private incomes, which in net terms and on a per-capita basis hardly edged up despite the overall favourable business conditions. In addition, the household saving ratio edged up to an unforeseen extent.

Leading indicators suggest that the export boom will slightly lose momentum in 2008. Growth of investment in machinery and equipment as well as in construction is also set to decelerate. Despite higher wage settlements, private consumption is unlikely to pick up significantly, in view of the rise in inflation driven by higher cost of food and energy. On these assumptions, WIFO expects the business cycle to reach its trough in late 2008.

There is a risk, however, for the cyclical downturn to set in earlier and take a steeper profile than outlined in the present scenario. Should the crisis on international financial markets deepen further, the US economy slide into a recession and the euro appreciate more strongly against the dollar than anticipated, the downturn in Europe could turn out more severe. In the event, the Austrian economy would find it difficult to withstand such retarding forces, given its strong export dependency and the lasting weakness of domestic demand.

2007 saw the prolongation of the export boom, with merchandise sales abroad rising by 8 percent in volume year-on-year, exceeding the level of 2000 by 60 percent. Austrian exporters benefited from lively demand in key trading partner countries and from strong price competitiveness. Apart from the EU countries where about 75 percent of Austrian exports are sold, south-eastern Europe and the oil-exporting countries were strongly expanding markets. However, market shares were lost in the USA, as a consequence of the adverse trend in the dollar/euro exchange rate. The appreciation probably hits Austrian companies primarily via indirect effects, i.e., declining competitiveness of companies in Germany and elsewhere with which Austrian firms maintain close supply relations. For 2008, WIFO expects merchandise exports to gain a further 6.3 percent in real terms.

Austria: buoyant activity to lose momentum

Lively activity in Austria's export industries is gradually abating, accompanied by a slowdown in investment. With consumer demand lacking strength, overall economic activity is shifting into lower gear.

Export and industrial buoyancy set to cool down

Table 3: Productivity

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 2.3	+ 2.0	+ 3.3	+3.4	+ 2.2	+ 2.0
Employment ¹	+ 0.2	+ 0.8	+ 1.2	+1.5	+ 0.6	+ 0.5
Productivity (GDP per employment)	+ 2.2	+ 1.2	+ 2.1	+1.9	+ 1.6	+ 1.5
<i>Manufacturing</i>						
Production ²	+ 2.3	+ 3.2	+ 8.8	+7.8	+ 3.3	+ 3.0
Employees ³	- 0.6	- 0.8	+ 0.2	+2.4	- 0.6	- 0.9
Productivity per hour	+ 2.1	+ 4.6	+ 8.4	+5.5	+ 4.4	+ 4.2
Working hours per day per employee ⁴	+ 0.8	- 0.6	+ 0.2	-0.2	- 0.5	- 0.3

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.

Imports may rise at the same rate as exports in 2008, namely by 6.2 percent at constant prices. This may come as a surprise when considering the expected slackening

of investment goods imports. Nevertheless, the import content of Austrian exports is increasing steadily; in addition, import figures will be boosted by the purchase of military aircraft. Despite the high oil prices, the trade balance is projected to remain in small surplus, like in 2007.

Lively exports benefit mainly the manufacturing sector. Its value added gained an estimated 8 percent in volume, almost as much as in the record year 2006. Production was stepped up to an extent that even with a strong advance in hourly productivity (+5.5 percent) the number of jobs went up by 2.4 percent. This is exceptional, as over the last decades industrial jobs were cut by an average 1 percent per year. Also in the regular WIFO business survey, manufacturers report a satisfactory level of capacity utilisation and are optimistic about the prospects for the next few months. The peak of the industrial cycle has nevertheless been passed by now, as indicated notably by the weaker flow of orders, both domestic and from abroad. WIFO therefore expects for 2008 a slowdown in manufacturing output, to a growth rate of real value added of 3 ¼ percent.

High capacity utilisation and massive profit increases prompted firms to set up optimistic investment plans, which they were, however, more cautious to implement than normally in a cyclical boom period. Growth of investment in machinery and equipment, calculated on the basis of a commodity flow approach, was 5.4 percent in volume year-on-year in the first nine months of 2007, according to the preliminary national accounts established by WIFO. Early results from the WIFO investment survey of autumn 2007 confirm that many investment projects planned last spring have eventually been postponed. This could be related to the appreciation of the euro, but also to the less favourable financing conditions. For 2008, the WIFO investment survey suggests a slight deceleration of capital formation, in line with the clouding business outlook. WIFO expects spending on machinery and equipment to edge up by 2½ percent, adjusted for inflation.

Construction investment and output gained 5 percent in volume in 2007, much as in the previous year. In the city of Vienna, large-scale projects are currently being launched in the areas of infrastructure, administrative and residential building. Capacity utilisation is high in civil engineering, due to the upgrading of road and rail-road infrastructure promoted and financed via the agencies of ASFINAG and SCHIG. Builders of industrial and office space structures have recently reported a somewhat weaker order situation in the WIFO business survey.

The strong expansion of construction output has been accompanied by lively job creation (+7,500 year-on-year for the period from January to November). At the same time, prices have increased markedly, of late by around 4 percent from one year ago. The upward pressure may ease when construction activity moderates in 2008. The WIFO projection is for an increase in value added by an inflation-adjusted 2½ percent.

Tourism earnings reached a new high of € 10.15 billion in the summer season of 2007, up by 5.5 percent in nominal terms from the year-earlier period. Overnight stays increased by 3.3 percent. For the whole year 2007, tourism export earnings gained an estimated 2 percent in volume. Despite the euro appreciation, growth may pick up to 2.9 percent p.a. in 2008 and 2009. Domestic companies have successfully embarked on a quality-upgrading strategy, resulting in higher earnings per customer and day.

Current statistics under-estimate tourism imports as they suggest a fall of spending by Austrians travelling abroad. The WIFO estimate is rather for an increase by 1.6 percent in real terms for 2007. With the strong euro, destinations abroad are now becoming even more attractive.

In 2006 and 2007, the export-oriented industries enjoyed the strongest boom in many years. As from now, the pace of growth will moderate under the impact of a weaker global environment.

Investment growth slackening

Manufacturing firms sampled by the semi-annual WIFO investment survey plan a moderate expansion of spending on fixed capital.

Well-performing tourism industry

After a satisfactory summer season, tourism companies remain optimistic. The transformation of supply towards higher quality is well under way.

In November, headline inflation accelerated to 3.1 percent, on the back of price hikes for food, fuel and housing costs. Consumers had to pay more for bread and cereals, milk and dairy products, fuel and heating as well as for electricity and gas.

Price pressure is unlikely to ease in the months to come. Supply shortages and swiftly rising demand are driving world market prices for cereals and milk up. As a consequence, meat prices should go up as well. WIFO expects food prices to increase by around 5 percent overall in 2008¹. Strong demand and upward-bound expectations will also keep oil prices on a rising trend. Hikes in prices for electricity and gas may follow. Overall, energy prices in 2008 may climb above the year-earlier level by some 5½ percent. With a share of around one-fifth, food and energy prices are also driving overall inflation. Costs of manufactures and services are picking up somewhat from the modest pace of the last years. Headline inflation in the first few months of 2008 may exceed 3 percent. On annual average, WIFO projects the rate of inflation at 2.6 percent.

Over the medium term, inflation will largely depend on developments on world markets for food and crude oil. Currently, there are no signs for a wage-price spiral being set in motion. Unit labour costs for the whole economy are set to edge up by 2 percent in 2008, an order of magnitude compatible with price stability. The current WIFO projection for 2009 is for headline inflation to moderate to 2.1 percent.

Demand by private households was lower than expected again in 2007. In the first nine months it exceeded the year-earlier level by only 1.4 percent after adjusting for inflation. For the year as a whole, consumption growth is estimated at 1.6 percent, thereby undershooting the long-term average for the seventh year in a row. With household spending accounting for 55 percent of GDP, its weakness is weighing heavily on overall economic growth.

The main reason for the lacklustre development is the modest advance of disposable income (by 2.3 percent in real terms in 2007). With net real income per employed person stagnating (+0.1 percent), household incomes rose only because of the higher number of people employed, and income from property and entrepreneurship is growing significantly. The assessment of consumer demand is complicated by the fact that the preliminary foreign exchange statistics shows a decline in expenditure by Austrian travellers abroad that is considered unrealistic.

Wage settlements of autumn 2007 were some ¾ percentage point higher than those of the previous year. A large part of the increase will, however, be neutralised by higher inflation. Net of taxes and adjusted for inflation, per-capita incomes may once again edge up only marginally in 2008, by an average 0.3 percent. Moreover, the consumption-dampening effect of higher inflation may be rather high since costs of food and housing are concerned most, which claim a particularly high share of total household spending in the lower income brackets with a high propensity to consume. In the bottom income quartile (i.e., the 25 percent income earners with the lowest income), food accounts for 17.6 percent of total spending, and housing and energy costs for 34.3 percent, whereas in the top quartile the corresponding ratios are 9 percent and 18 percent.

WIFO therefore projects no significant pick-up in consumer spending (in real terms +1.9 percent each in 2008 and 2009). Durable goods, notably furniture, may benefit from comparatively stronger demand than non-durables and services. Likewise, merchandise trade should advance only moderately. Here, the analysis is complicated by the statistics showing a jump in wholesale trade prices deemed unrealistic. The projected path for consumption implies a gentle decline of the saving ratio to slightly below 10 percent of disposable income by 2009. The profile is less steep than usual for a period of cyclical slowdown, which may be explained by people step-

Mounting inflationary pressure

High world market prices for food and crude oil are pushing domestic inflation upwards. Still, there are no signs for a wage-price spiral being set in motion.

Sluggish income growth and inflation holding back consumption

The higher wage settlements of 2007 are eroded by the marked acceleration of inflation. Growth of consumer demand remains subdued.

¹ For details, see Baumgartner, J., Sinabell, F., "Erzeugerpreise von Agrarprodukten und Nahrungsmittelpreise in Österreich. Entwicklungen am Beispiel von Getreide und Milch", WIFO-Monatsberichte, 2007, 80(12), pp. 965-977, http://www.wifo.ac.at/www/isp/index.jsp?typeid=8&display_mode=2&fid=23923&id=30843.

ping up personal saving for retirement on the one hand, and by the increasing inequality in the distribution of income.

Table 4: 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	+ 1.6	+ 1.9	+ 1.9
Durables	+ 4.0	+ 2.5	+ 1.9	+ 1.9	+ 3.0	+ 2.4
Non-durables and services	+ 1.5	+ 2.0	+ 2.1	+ 1.6	+ 1.8	+ 1.8
Household disposable income	+ 1.9	+ 2.6	+ 2.7	+ 2.3	+ 1.5	+ 1.6
	As a percentage of disposable income					
Household saving ratio	8.9	9.3	9.7	10.3	10.1	9.9
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+ 5.0	+ 4.7	+ 4.5	+ 3.2	+ 3.7	+ 4.3
	Percentage changes from previous year					
Inflation rate						
National	2.1	2.3	1.5	2.1	2.6	2.1
Harmonised	2.0	2.1	1.7	2.1	2.6	2.1
Core inflation ²	1.6	1.5	1.3	1.9	2.3	2.0

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

Table 5: 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	+ 2.8	+ 3.5	+ 3.0
Gross real earnings per employee ¹	– 0.0	+ 0.6	+ 1.1	+ 0.7	+ 0.9	+ 0.9
Net real earnings per employee ¹	– 0.0	+ 1.2	+ 0.5	+ 0.1	+ 0.3	+ 0.4
Total economy						
Unit labour costs	– 0.6	+ 1.2	+ 0.4	+ 0.9	+ 2.0	+ 1.5
Manufacturing						
Unit labour costs	– 0.7	± 0.0	– 4.2	– 2.3	– 0.2	– 0.7
Relative unit labour costs ²						
Vis-à-vis trading partners	+ 2.0	+ 0.8	– 2.4	– 1.0	– 0.5	– 1.0
Vis-à-vis Germany	+ 2.3	+ 2.6	– 1.5	+ 0.5	– 0.5	– 0.3
Effective exchange rate, manufactures						
Nominal	+ 1.5	– 0.6	+ 0.2	+ 1.2	+ 1.4	+ 0.2
Real	+ 1.1	– 0.9	– 0.5	+ 0.8	+ 1.6	– 1.8

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

The close relation between GDP growth and employment was once again confirmed by developments in 2007. As GDP expanded by 3.4 percent in real terms, the number of people in dependent active employment went up by 63,600 or 2 percent. The exceptionally strong boom in industry and construction boosted employment even in these sectors which regularly offer full-time jobs.

With business activity slowing down, employment growth is set to abate to close to 1 percent each in 2008 and 2009, with job losses resuming in the manufacturing sector. Overall demand for labour will no longer be strong enough for unemployment to decline further. On annual average, some 220,000 people will be out of work, equivalent to 4¼ percent of the labour force (unemployment rate according to Eurostat) or 6¼ percent of the dependent labour force (national definition). Half of the additional labour demand over the projection period will be covered by foreign workers, facilitated also by easier access to the Austrian labour market granted to qualified workers from abroad. In 2009, the transition period for labour market access of people from the new EU member states will end; whether it will be extended

No further decline in unemployment

From the high momentum in 2006 and 2007, employment growth will moderate with activity slowing down. Job creation will no longer be strong enough for unemployment to decline.

for two more years is still undecided. Domestic labour supply is also rising, as the population of working age (15 to 64 years) goes up by some 20,000 per year and female labour force participation continues its distinct upward trend.

Table 6: Labour market

		2004	2005	2006	2007	2008	2009
		Changes from previous year, in 1,000					
<i>Demand for labour</i>							
Persons in active employment ¹		+ 25.1	+ 37.2	+ 55.9	+ 67.8	+ 34.0	+ 26.0
Employees ²		+ 21.1	+ 31.9	+ 51.5	+ 63.6	+ 30.0	+ 22.0
Percentage changes from previous year		+ 0.7	+ 1.0	+ 1.7	+ 2.0	+ 0.9	+ 0.7
Nationals		+ 9.2	+ 20.0	+ 35.0	+ 41.6	+ 13.0	+ 9.2
Foreign workers		+ 11.9	+ 11.9	+ 16.5	+ 22.0	+ 17.0	+ 12.8
Self-employed ³		+ 4.0	+ 5.3	+ 4.4	+ 4.2	+ 4.0	+ 4.0
<i>Labour supply</i>							
Population of working age							
15 to 64 years		+ 34.4	+ 15.6	+ 18.5	+ 15.5	+ 19.8	+ 20.2
15 to 59 years		+ 35.6	+ 48.5	+ 52.8	+ 17.0	+ 10.2	+ 13.7
Labour force ⁴		+ 28.9	+ 45.9	+ 42.4	+ 51.3	+ 33.0	+ 31.0
<i>Surplus of labour</i>							
Registered unemployed ⁵		+ 3.8	+ 8.8	- 13.5	- 16.5	- 1.0	+ 5.0
In 1,000		243.9	252.7	239.2	222.7	221.7	226.7
		Percent					
<i>Unemployment rate</i>							
Eurostat definition ⁶		4.8	5.2	4.8	4.3	4.2	4.3
As a percentage of total labour force ⁵		6.4	6.5	6.1	5.6	5.5	5.6
National definition ^{5,7}		7.1	7.3	6.8	6.2	6.2	6.3
<i>Employment rate</i>							
Persons in active employment ^{1,8}		62.3	62.8	63.6	64.6	65.0	65.2
Total employment ^{6,8,9}		67.8	68.6	70.2	71.1	71.5	71.6

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.

On the back of lively economic activity, government revenues in 2007 turned out higher than anticipated at the time the budget was drafted. High company earnings boosted revenues from corporate tax and capital tax on dividends, while solid employment growth raised revenues from wage tax and from social security contributions. At the same time, public authorities incurred new expenditure, mainly at the regional level. WIFO expects the 2007 budget balance in the Maastricht definition to turn out at -0.6 percent of GDP (2006 the deficit was -1.4 percent of GDP).

For 2008, no further improvement of the budget balance should be expected. To be sure, revenues from profit taxes will continue to grow swiftly, the higher wage settlements will boost receipts from wage tax and social contributions, and the discretionary increases of the mineral oil tax and of health insurance contributions will take their full effect. However, at the same time new expenditures have been committed, such as in the context of the new federal revenue sharing agreement or with the increase in child care benefits.

The outlook for the general government budget in 2009 remains vague at the present stage. Growth of revenues will largely be determined by the cyclical profile. The trend in expenditure will only become clear once the territorial authorities (federal government, Länder and communities) have submitted their draft budgets. What has been agreed is a reinforcement of spending on "future-oriented" investment in the areas of education, research and development as well as on the social safety net. Budgetary savings planned in public administration at all government levels have not yet been specified in detail. Spending on military aircraft, for its part, should turn out substantially lower than in 2008. WIFO's early assumption is for a general government deficit (Maastricht definition) of 0.6 percent of GDP in 2009.

Budget deficit remaining lower than 1 percent of GDP

Lively activity is currently boosting revenues from taxes and social contributions. Additional government spending will take effect as from 2008.

Table 7: Key policy indicators

	2004	2005	2006	2007	2008	2009
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 1.2	- 1.6	- 1.4	- 0.6	- 0.7	- 0.6
According to National Accounts	- 1.3	- 1.7	- 1.5	- 0.7	- 0.8	- 0.7
General government primary balance	+ 1.6	+ 1.3	+ 1.4	+ 2.1	+ 2.0	+ 2.1
	Percent					
<i>Monetary policy</i>						
3-month interest rate	2.1	2.2	3.1	4.3	4.4	4.2
Long-term interest rate ¹	4.2	3.4	3.8	4.3	4.1	4.4
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+ 1.5	- 0.7	+ 0.2	+ 1.1	+ 1.5	+ 0.2
Real	+ 1.0	- 1.0	- 0.6	+ 0.7	+ 1.7	- 1.8

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