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# Growth Slowing Down Further

## Economic Outlook for 2005 and 2006

**Economic growth is set to decelerate to a rate of only 1.8 percent this year, with no stronger momentum in sight for 2006, even if the outlook is particularly uncertain at the present juncture. While the stimulus from exports is slackening, consumption and investment are failing to revive. Despite notable employment gains, the strong increase in labour supply is driving unemployment further up. The high price of oil is a major cyclical risk; in conjunction with domestic factors it is pushing headline inflation to a relatively high 2.5 percent this year. The decline of the euro against the dollar should benefit the European export industry.**

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Already in its forecast of last spring, WIFO has pointed to the heightened cyclical risks, which now appear more likely to materialise. Growth incentives from exports are fading in the euro area, while internal demand remains lacklustre due to the lack of confidence on the part of consumers and investors alike. The current projections are built upon the assumption of an interest rate cut by the ECB. Overall, however, policy in the euro area appears unable to effectively address the problem of deficient domestic demand and the slow pace of growth. Area-wide GDP is therefore expected to expand by only 1½ percent in volume this year, taking the period of slow growth into its fifth year, interrupted only by short-lived export-induced hiccups. The changing environment during the last three months, with rising oil prices and the euro depreciating against the dollar, should on balance have a slightly positive effect on the euro area and the Austrian economy in a medium-term perspective.

Austria exhibits a similar cyclical pattern as the euro area. Real GDP in the first quarter 2005 was 2 percent higher than one year ago, but edged up by a mere 0.2 percent from the previous quarter. Exports and industrial output, the drivers of last year's expansion, are losing momentum. The increase in merchandise exports is expected to narrow to 4.2 percent in volume this year, since aggregate demand in key trading partners like Italy and Germany is tending weaker. Although Austrian exports have in the last years lost some of their important market shares in the new EU member states, they should be able to make up for such losses in the medium term, given their high price competitiveness.

Manufacturing output remained flat in the first quarter 2005 on a seasonally adjusted basis, held back by the slackening of foreign demand. The regular WIFO business survey, while not suggesting a further weakening, does not point to an early recovery of industrial activity. On annual average 2005, production is expected to rise by 3 percent in real terms, which would enable the manufacturing sector to make a major contribution to GDP growth also this year. The slower pace of exports and industrial activity is prompting firms to be more cautious in their investment decisions. Besides, many projects have been carried forward into 2004 for tax reasons. Therefore, investment in machinery and equipment is expected to increase by only 1½ percent this year.

A relatively better performance is observed for the construction sector, which is benefiting from a further increase in funds for the improvement in the transportation infrastructure, notably road construction. Moreover, a recovery of new home construction and renovation activity is in sight. Construction output is projected to gain 2 percent in volume both in 2005 and 2006.

*Table 1: Main results*

| | | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| | | Percentage changes from previous year | | | | | |
| GDP | | | | | | | |
| Volume | | + 0.7 | + 1.2 | + 0.8 | + 2.2 | + 1.8 | + 1.9 |
| Value | | + 2.5 | + 2.5 | + 2.3 | + 4.1 | + 3.9 | + 3.8 |
| Manufacturing[1], volume | | + 2.2 | + 0.5 | + 0.2 | + 5.1 | + 3.0 | + 3.4 |
| Wholesale and retail trade, volume | | + 2.4 | + 2.2 | + 0.4 | + 1.2 | + 1.5 | + 1.8 |
| Private consumption expenditure, volume | | + 1.0 | − 0.1 | + 0.6 | + 1.5 | + 1.5 | + 1.8 |
| Gross fixed investment, volume | | − 2.1 | − 3.4 | + 6.2 | + 3.6 | + 1.8 | + 2.7 |
| Machinery and equipment[2] | | + 1.6 | − 6.5 | + 5.1 | + 7.0 | + 1.5 | + 3.5 |
| Construction | | − 5.0 | − 0.8 | + 7.0 | + 0.8 | + 2.0 | + 2.0 |
| Exports of goods[3] | | | | | | | |
| Volume | | + 6.3 | + 4.3 | + 2.5 | +13.1 | + 4.2 | + 5.5 |
| Value | | + 6.5 | + 4.2 | + 1.9 | +13.9 | + 5.6 | + 6.0 |
| Imports of goods[3] | | | | | | | |
| Volume | | + 5.5 | + 0.3 | + 6.8 | +10.4 | + 2.6 | + 5.0 |
| Value | | + 5.0 | − 2.0 | + 5.0 | +12.5 | + 4.7 | + 5.7 |
| Current balance | billion € | − 4.13 | + 0.75 | − 1.17 | + 0.75 | + 1.57 | + 1.42 |
| As a percentage of GDP | | − 1.9 | + 0.3 | − 0.5 | + 0.3 | + 0.6 | + 0.6 |
| Long-term interest rate[4] | in percent | 5.1 | 5.0 | 4.2 | 4.2 | 3.3 | 3.5 |
| Consumer prices | | + 2.7 | + 1.8 | + 1.3 | + 2.1 | + 2.5 | + 1.9 |
| Unemployment rate | | | | | | | |
| Eurostat definition[5] | in percent | 3.6 | 4.2 | 4.3 | 4.5 | 4.6 | 4.6 |
| National definition[6] | in percent | 6.1 | 6.9 | 7.0 | 7.1 | 7.2 | 7.3 |
| Economically active emplyees[7] | | + 0.4 | − 0.5 | + 0.2 | + 0.7 | + 0.9 | + 0.6 |
| General government financial balance according to Maastricht definition | | | | | | | |
| As a percentage of GDP | | + 0.3 | − 0.2 | − 1.1 | − 1.2 | − 1.9 | − 1.9 |

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.

The significant increase in world market prices for crude oil, in conjunction with a number of domestic factors like higher housing costs and the increase in the tobacco tax are driving headline inflation up to a projected 2.5 percent rate. While the rise in inflation has so far cancelled out the positive effects of the tax reform on real disposable income, these effects may start showing up in the second half of the year. Whether the gains in disposable income will lead to higher consumption or higher savings will depend on consumer confidence. On annual average, net real income per employee may edge up by 0.7 percent, having declined by almost 3 percent since 1995. For 2005, WIFO is expecting an increase in consumer spending by 1.5 percent in volume. At the same time, the savings ratio will move up slightly, from 8.9 percent to 9.3 percent of disposable income. On the assumption of moderating oil prices, the rate of inflation may fall to 1.9 percent in 2006. Since, however, the effects of the tax reform will fade, household spending is set to accelerate only marginally to +1¾ percent.

Labour market developments have for the last several years been determined by a strong increase in labour supply. By 2006, the latter will be higher by 150,000 persons than in 2000. This increase is explained by an inflow from the new EU countries and from Germany (with the "Hartz-IV" reforms taking effect), together with a large number of foreign residents being given access to the labour market by acquiring Austrian nationality, and the increase in the early retirement age. The number of people in active employment is rising strongly when compared with the subdued rate of economic growth. In 2006, this number will be higher by over 90,000 than in 2000. In the current year, not only the number of part-time jobs predominantly filled by women is rising, but also that of full-time jobs, many of which are taken by men. New jobs are being created in social services, data processing, personnel rental agencies and in the trade sector. The employment rate will be at 63 percent of the population of working age following the national definition and over 68 percent according to Eurostat. Nevertheless, the rise in employment will not be enough to fully accommodate the higher labour supply, thus leading to higher unemployment. Since 2000, the jobless figure has gone up by 50,000 and is expected to increase by a further 11,000 in 2005 and 2006 combined, to a total of 255,000. The unemployment rate will reach 7.3 percent of the dependent labour force on the traditional national definition, or 4.6 percent of the total labour force according to Eurostat.

Higher corporate profits will boost tax revenues somewhat beyond expectations this year. The general government deficit is projected to remain unchanged at 1.9 percent of GDP next year, reflecting the adverse impact of the cyclical weakness.

Conflicting signals from the cyclical indicators and major uncertainties relating to the data base are at the background of the current assessment. The risks to the forecast are skewed rather towards a weaker outcome than projected, with the outlook for 2006 being particularly vague. The baseline assumption is for GDP growth remaining steady at close to 2 percent. The 2005 tax reform and the "growth package" of early May will provide some stimulus and may contribute towards growth in Austria slightly exceeding the euro area average, both this year and next. In the event, the pace of activity would be clearly higher than for the two most important trading partners, i.e., Germany and Italy, but once again weaker than in the Scandinavian countries.

## Global activity slightly losing momentum

The world economy is still in a period of above-average growth, even if the pace is decelerating. The gain in global output is expected to moderate from 5 percent in 2004 to around 4 percent in 2005, the expansion of world trade from 9 percent to 7½ percent. The forward momentum keeps being sustained by China and the USA. The Chinese economy is growing at a steady rate close to 10 percent. Its share in world output has reached 13 percent, thereby contributing about one-quarter to global economic growth. China's integration into the global economy is adding to the growth of its exports amounting to some 25 percent per year. Lively domestic demand keeps imports rising at a similar pace, thereby providing important stimulus for other Asian economies. China's current account remains in strong surplus.

Domestic demand is the main driving force of the US economy. The strong upward drift of real estate prices is igniting private household spending as well as residential investment. No turnaround is yet in sight, but a burst of the speculative bubble on key real estate markets remains a cyclical risk. Business fixed investment in machinery and equipment has been growing strongly since early 2003. The sustained robustness of internal demand is confirmed by buoyant import growth. The WIFO projections nevertheless assume a slight deceleration of activity in 2005 and 2006, as suggested by a number of indicators. The ISM index of purchasing managers points to a slowdown in industrial output growth. The increase in the federal funds rate to 3 percent has so far had no repercussions on long-term interest rates, which are held down by the unabated lively internal and foreign demand for low-risk securities. Further increases in short-term interest rates may lead to an inverted rate structure, which in the past has repeatedly triggered a fall in investment. Nevertheless, real GDP growth is expected to exceed 3 percent both this year and next.

*Table 2: World economy*

| | | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| | | Percentage changes from previous year | | | | | |
| *Real GDP* | | | | | | | |
| Total OECD | | + 1.1 | + 1.6 | + 2.1 | + 3.4 | + 2.5 | + 2.3 |
| USA | | + 0.8 | + 1.9 | + 3.0 | + 4.4 | + 3.8 | + 3.1 |
| Japan | | + 0.2 | – 0.3 | + 1.4 | + 2.7 | + 1.5 | + 1.8 |
| EU 25 | | + 1.8 | + 1.1 | + 1.0 | + 2.3 | + 1.6 | + 1.8 |
| EU 15 | | + 1.8 | + 1.1 | + 0.9 | + 2.2 | + 1.5 | + 1.7 |
| Euro area | | + 1.7 | + 0.9 | + 0.7 | + 2.0 | + 1.5 | + 1.7 |
| Germany | | + 1.2 | + 0.2 | ± 0.0 | + 1.6 | + 1.2 | + 1.3 |
| New member states[1] | | + 2.4 | + 2.4 | + 3.7 | + 4.9 | + 4.5 | + 4.5 |
| China | | + 7.5 | + 8.3 | + 9.3 | + 9.5 | + 9.3 | + 9.0 |
| *World trade, volume* | | + 0.1 | + 3.5 | + 4.7 | + 9.1 | + 7.2 | + 7.5 |
| *Market growth*[2] | | + 2.3 | + 1.8 | + 5.1 | + 8.4 | + 4.5 | + 4.8 |
| *Primary commodity prices* | | | | | | | |
| HWWA index, total | | – 8 | – 5 | – 4 | +18 | +23 | – 2 |
| Excluding energy | | – 3 | – 6 | – 6 | +18 | + 8 | + 8 |
| *Crude oil prices* | | | | | | | |
| Average import price (cif) for OECD countries | $ per barrel | 23.6 | 24.1 | 28.4 | 37.8 | 50.0 | 47.0 |
| *Exchange rate* | | | | | | | |
| $ per euro | | 0.896 | 0.945 | 1.131 | 1.243 | 1.25 | 1.18 |

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.

*While in the USA the lively pace of economic growth is decelerating somewhat, the expansion in Asia remains strong, fuelled by booming activity in China. Overall, the global economic performance remains favourable.*

## Booming prices for raw materials

Strong global demand for raw materials has pushed up prices markedly, by an average 30 percent on a dollar basis from 2003 to 2004, according to the index of the Hamburg World Economics Institute (HWWA). The strong upward drift is continuing this year, with a year-on-year increase by 20 percent in May. Oil prices have almost tripled since the end of 2001, but also food and industrial commodity prices have moved up significantly. The terms of trade have thereby shifted markedly in favour of commodity producers, holding back economic growth in the industrialised countries that are net absorbers of raw materials.

## Significant dent in euro area recovery

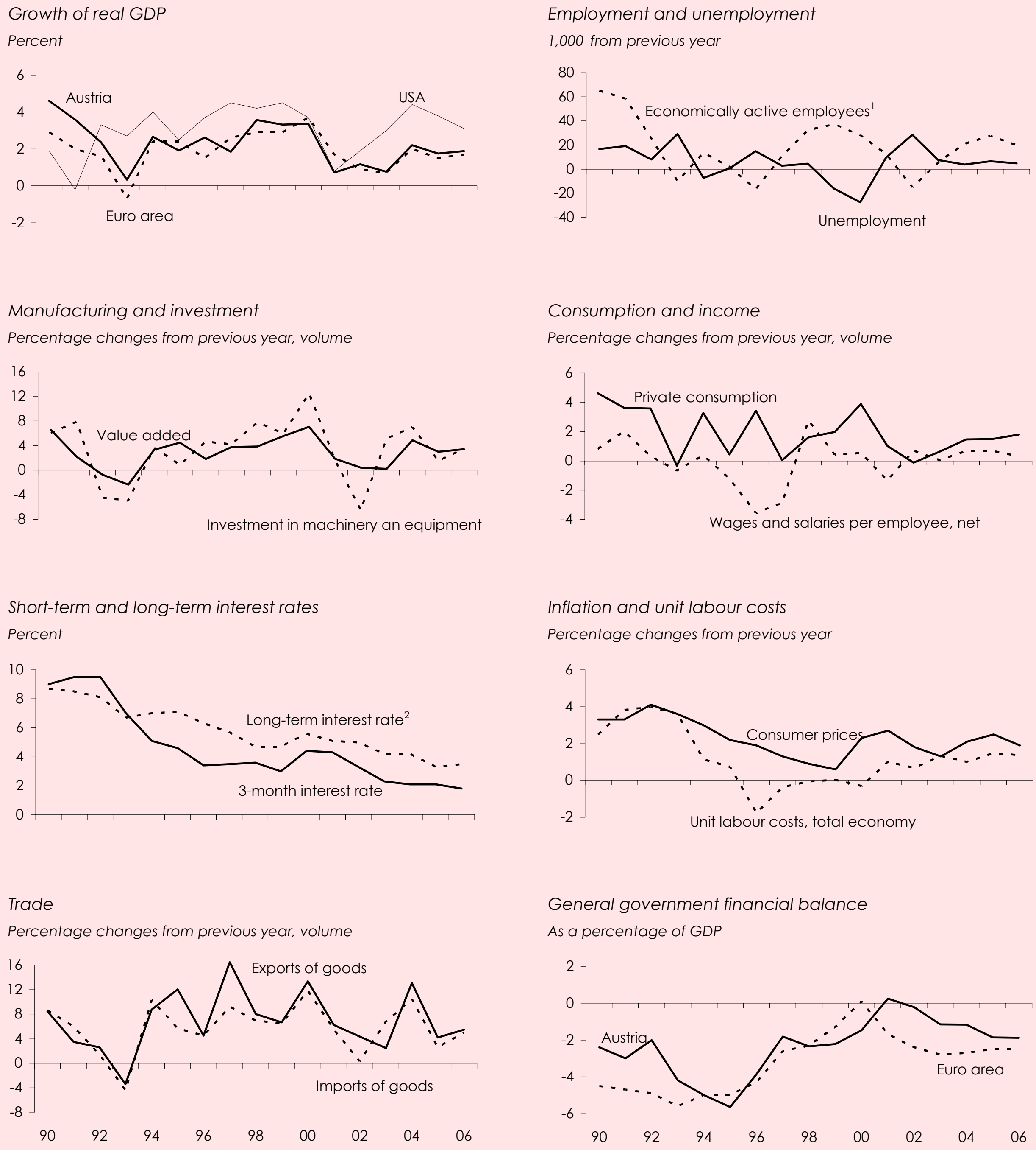
*The sluggishness of economic growth in the euro area has entered its fifth year. Owing to the weak sentiment of consumers and investors, the lively export activity of 2004 has not given stimulus to domestic demand. Economic growth in 2005 is set to moderate to around 1½ percent.*

In summer 2004, business activity started to slacken in the euro area, losing further momentum in the last few months. According to preliminary calculations by Eurostat, GDP in the first quarter 2005 declined from the previous period in Italy, Finland and the Netherlands, and virtually stagnated in Belgium, France, Denmark and Austria. For Germany, an increase by 1 percent was recorded, which may, however, been over-stated by the method of calendar adjustment applied. For the euro area as a whole, real GDP surged by a seasonally-adjusted 0.5 percent from the previous quarter, and by 1.3 percent year-on-year. The leading indicators suggest a further slowdown for the second quarter.

The positive incentives from foreign trade, which had sustained overall growth in 2004, have faded markedly. Industrial production remained flat in seasonally-adjusted terms in the first four months of this year, and industrial confidence has slumped across the board since the end of 2004, falling below its long-term average in May, according to the survey conducted by the European Commission for the euro area. Capacity utilisation has declined from 82 percent in the fourth quarter 2004 to 81 percent in the second quarter 2005, suggesting that investment will remain lacklustre. Consumers also show little optimism, with the confidence indicator flat since the end of 2004, depressed by the adverse labour market situation, the squeeze in real disposable income and the negative impact of labour market and social reforms.

The euro area economy is suffering from widespread uncertainty among investors and consumers. This uncertainty is enhanced by many reforms to the social security systems, if carried out without being embedded in a consistent overall reform design and accompanied by an appropriate macro-economic framework. Confidence in the problem-solving capacity of economic policy at the EU or the national level is low. GDP growth for the whole year 2005 is unlikely to exceed 1½ percent. The period of sluggish activity, interrupted only by short-lived revivals of exports that fail to ignite domestic demand, is thereby extending into its fifth year. Leading indicators do not point to a recovery in the next few quarters. Although the depreciation of the euro vis-à-vis the dollar should provide some relief for the export-oriented industries, the accompanying rise in import prices will weigh on disposable incomes.

*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 WIFO projections are based on the assumption that the ECB will cut interest rates by ½ percentage point during the projection period, motivated by slow economic growth and continued high price stability. Beyond such a move, no policy action to stimulate demand in the EU is in sight. Hence, growth is unlikely to gather momentum in 2006.

**Solid domestic demand in EU member states outside the euro area**

In the three member states of the EU 15 that are not part of the euro area, business activity was relatively more lively in the last years, mainly due to robust domestic demand. Confidence of consumers and investors in the economic outlook and in policy proved notably more resilient, and rising real estate prices stimulated both private consumption and investment in construction. However, house prices started falling in the UK which may hold back economic growth in the next few years.

The new EU member states exhibit a clear growth advantage vis-à-vis the EU 15, as the catching-up process has gathered momentum. GDP for the 10 recently acceding countries is expected to grow by an average 4½ percent in volume both in 2005 and 2006. In most of the central and eastern European countries, activity is being driven by domestic demand, although the inflow of foreign direct investment remains strong. The latter may also be supported by positive confidence effects elicited by the accession to the EU, which has also provided a positive stimulus for investment in infrastructure and for the agricultural sector. The Czech Republic, Hungary and Poland suffer from high and further rising external account deficits, which may force economic policy to adopt a more restrictive stance in the years to come, leading to a slower expansion of activity.

**Heightened cyclical risks**

Business activity in Austria, after a friendly six-month period over the summer, slackened markedly in the fourth quarter 2004 and further into early 2005. In the first quarter, real GDP edged up by a mere 0.2 percent seasonally adjusted from the previous quarter, exceeding the year-earlier level by 2 percent. The slowdown is caused mainly by a slackening of exports and industrial activity observed across the whole euro area. Unlike in the surveys conducted by the European Commission for the euro area, the WIFO business survey for Austria does not foreshadow a further weakening of the business climate in the export-oriented manufacturing sector for the next few quarters. The current projections therefore assume an improvement in industrial business conditions for the second half of this year. The depreciation of the euro against the dollar may help in this regard, by benefiting the European export industries with the usual time lag.

*Following the poor performance in the first quarter 2005, business activity in Austria is faced with considerable cyclical risks. The major forward-looking indicators yield an unclear pattern. The growth forecast of 1¾ percent for 2005 is based on the assumption of a tentative rebound in the second half of the year.*

Domestic demand also disappointed early this year. Private consumption stagnated in the first quarter when adjusted for seasonal variations, held back by low wage settlements and rising inflation. The positive effects of the tax reform on disposable income are likely to feed through only after some time. The measures adopted on 1 May by the government summit devoted to "growth and employment" will provide additional stimulus to growth. Under these conditions, Austria's GDP may grow somewhat faster than the euro area average.

The uncertainties surrounding the present projections are rather skewed to the negative side than towards a more favourable outcome. Particular risks derive from the jump in oil prices on world markets with no downward correction in sight, and from the limited scope for policy action to counter the weakness of domestic demand in the euro area. For Austria, the assumption of a strengthening of export and consumer demand may prove too optimistic. The outlook for 2006 is therefore particularly uncertain.

**Deceleration of foreign trade**

Growth of merchandise exports has decelerated markedly, from +14 percent in nominal terms last year to only 3.6 percent in the first four months of 2005. This reflects the slackening demand from both the EU 15 and the new EU member states. In Italy, Austria's second most important trading partner (with a share of 8½ percent of total Austrian goods exports in 2004), the recession has led to a fall in demand also for Austrian goods. In the new EU member states, Austrian exports have been losing market shares over the last few years, albeit from a rather high level of some 9 percent. However, Austria succeeded in strengthening its position on the rising markets in south-eastern Europe.

*As a consequence of weak business conditions in key trading partner countries, export growth decelerated markedly in the first quarter, according to preliminary data. The high competitiveness of Austrian exports should, however, enable companies to gain market shares.*

Price competitiveness of domestic export firms is generally high. Relative unit labour costs have declined substantially, despite the appreciation of the euro over the last years. A further improvement of the unit labour cost position is expected up to the forecast horizon, due to modest wage settlements and the swift growth of labour productivity.

WIFO assumes that real commodity exports will expand by 4 percent or slightly more in 2005, despite the adverse trend at the beginning of the year. Growth of merchandise imports, projected at 2½ percent, should clearly lag behind, mainly because of cautious investment in machinery and equipment (with an import content of almost two-thirds) and of only modest gains in private consumption.

## Strong growth of industrial output levelling off

Manufacturing output is the most cyclically-sensitive component of overall production of goods and services. The production index, adjusted for seasonal and calendar effects, has been declining since late autumn 2004. According to preliminary national accounts data, real value added has remained flat in seasonally-adjusted terms in the first quarter, reflecting the slackening of foreign demand. Whereas last year the Austrian industry benefited from its high concentration on the production of motor cars and related components, it is now suffering from the weakening of exports in that sector: in the first quarter, exports of passenger cars fell 9 percent year-on-year, and also the production index for the automotive industry was below the year-earlier level in the first quarter, after having jumped by 30 percent in 2004.

*Results from the regular WIFO business survey show no clear trend of industrial output. Growth of manufacturing value added may decelerate markedly from last year.*

The results from the regular WIFO business survey show no clear trend for manufacturing output. Judgements of the order situation turned distinctly more pessimistic between November 2004 and spring 2005, but have stabilised since. WIFO therefore expects no further weakening of industrial activity for the second and third quarter, although signs of a speedy recovery are lacking as well. In such an environment of high uncertainty, manufacturing value added is projected to increase by 3 percent in volume this year.

The expected gains in production will not prevent further losses of industrial jobs, given that output per hour worked is estimated to rise by 4 percent or slightly more per year. This strong increase in productivity, accompanied by low wage settlements implies a marked fall in unit labour costs.

*Table 3: Productivity*

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| | Percentage changes from previous year | | | | | |
| *Total economy* | | | | | | |
| Real GDP | + 0.7 | + 1.2 | + 0.8 | + 2.2 | + 1.8 | + 1.9 |
| Employment[1] | + 0.6 | − 0.1 | + 0.1 | + 0.9 | + 0.9 | + 0.8 |
| Full-time equivalent | + 0.4 | + 0.1 | + 0.0 | + 0.8 | + 0.8 | + 0.7 |
| Productivity (GDP per employment) | + 0.1 | + 1.3 | + 0.7 | + 1.2 | + 0.8 | + 1.1 |
| Full-time equivalent | + 0.3 | + 1.1 | + 0.7 | + 1.4 | + 1.0 | + 1.2 |
| *Manufacturing* | | | | | | |
| Production[2] | + 1.9 | + 0.4 | + 0.2 | + 4.9 | + 3.0 | + 3.4 |
| Employees[3] | + 0.2 | − 2.5 | − 1.7 | − 0.6 | − 0.9 | − 0.8 |
| Productivity per hour | + 2.1 | + 3.4 | + 1.6 | + 4.6 | + 4.4 | + 4.2 |
| Working hours per day per employee[4] | − 0.4 | − 0.5 | + 0.3 | + 0.8 | − 0.4 | ± 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.

## Cyclical pattern of machinery and equipment investment unclear

According to preliminary national accounts data, investment in machinery and equipment (including "other" equipment) exceeded the year-earlier level by only 2½ percent in volume in the first quarter 2005, after an increase of 7 percent in 2004. Weaker investment is also mirrored by the import statistics, which shows a decline of machinery and vehicles imports for the first quarter.

Two reasons explain the slowdown: first, the expiry of the fiscal investment premium ("Investitionszuwachsprämie") at the end of 2004 provoked a massive frontloading of capital spending, particularly on vehicles, with a subsequent negative echo-effect in early 2005; second, greater scepticism about the business outlook induced many firms to hold back with planned investment projects. The regular WIFO investment survey (which catches rather the cyclical determinants of investment) currently delivers no clear picture, which makes a forecast more difficult. The present projections assume an increase in machinery and equipment investment by an inflation-adjusted 1½ percent from last year.

*After a strong advance last year, investment in machinery and equipment will post more modest gains of some 1½ percent this year.*

## Benign outlook for construction activity

Construction investment is currently acting as a cyclical stabiliser, growing by a projected 2 percent in volume this year and next. Civil engineering companies exhibited continued optimism in the WIFO business survey. The last years have seen a substantial increase in resources being spent on transport infrastructure, notably road construction.

After several years of decline, auspices are for a positive turnaround in new home construction. Building societies report an increasing demand for new loans, home-building co-operatives enjoy a rising number of newly-registering clients, and the upward drift in rents may indicate that housing supply is becoming shorter. Building firms have turned more optimistic in the WIFO business survey, and orders for renovation are reported rising. The only exception is industrial construction which is held back by the uncertain business outlook and cautious investment behaviour.

*The favourable order situation in civil engineering and a recovery of residential building and renovation bode well for construction activity.*

## Lively inflation

The strong momentum of inflation early this year was caused by four different components: housing costs, energy prices, the increase in the tobacco tax and higher costs of health services. Prices of manufactures, on the other hand, followed a downward trend. Headline inflation will reach 2.5 percent this year, the highest rate since 2001. The outlook for next year is surrounded by considerable risk, due to the high uncertainty concerning commodity prices. WIFO expects crude oil prices to ease somewhat. Domestic factors should also have some moderating impact on inflation, with overall unit labour costs hardly rising and no increase in indirect taxes and public charges in prospect. The inflation rate may thus subside to slightly below 2 percent.

*Table 4: 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 | + 2.3 | + 2.5 | + 2.6 |
| Gross real earnings per employee[1] | – 0.6 | + 0.9 | + 0.5 | + 0.2 | – 0.2 | + 0.6 |
| Net real earnings per employee[1] | – 1.3 | + 0.7 | + 0.0 | + 0.7 | + 0.7 | + 0.3 |
| Total economy | | | | | | |
| Unit labour costs | + 1.0 | + 0.7 | + 1.3 | + 1.0 | + 1.5 | + 1.4 |
| Manufacturing | | | | | | |
| Unit labour costs | + 1.1 | – 0.6 | – 0.5 | – 3.2 | – 2.1 | – 1.6 |
| Relative unit labour costs[2] | | | | | | |
| Vis-à-vis trading partners | – 0.9 | – 0.6 | + 1.7 | – 0.7 | – 1.6 | – 2.1 |
| Vis-à-vis Germany | – 0.6 | – 0.4 | – 0.1 | – 0.1 | – 0.6 | – 1.1 |
| Effective exchange rate, manufactures | | | | | | |
| Nominal | + 0.9 | + 1.3 | + 3.7 | + 1.2 | – 0.2 | – 0.2 |
| Real | + 0.5 | + 0.8 | + 2.9 | + 1.0 | + 0.4 | ± 0.0 |

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

*High energy prices, but also domestic factors are making for a strong upward drift in consumer prices. Headline inflation will surge to 2.5 percent this year, before abating to slightly below 2 percent in 2006.*

Low settlements for wages and salaries, coupled with lively inflation, will lead to a decline in gross real per-capita income this year. However, the tax reform will make for modest gains in net income compared with last year. However, average net incomes have fallen by almost 3 percent in real terms since 1995 under the impact of modest wage settlements, the spreading of part-time employment and a rising tax burden on labour incomes.

### Private consumption may rebound in the second half of 2005

With household disposable income being boosted by the cuts in direct taxes in 2005, consumer demand was expected to support business activity. So far, however, this has hardly been the case. Real consumer spending in the first quarter edged up by only 0.3 percent seasonally adjusted from the previous quarter, exceeding the year-earlier level by a meagre 0.7 percent. Strong inflation weighed on consumer demand. Inflation is expected to decelerate in the course of the year, and the gains in disposable income from the tax reform should translate into higher consumption with a time lag. However, this will depend a great deal on the redistributive impact of the tax reform and on consumer confidence. WIFO expects private consumption to grow by an inflation-adjusted 1½ percent on annual average, implying a slight increase in the household saving ratio from 8.9 percent to 9.3 percent of disposable income. Consumption growth may barely accelerate in 2006, as the positive effect of lower inflation will be largely offset by the diminishing stimulus from the tax reform. Even with no further increase in the saving ratio, consumption is unlikely to expand by more than 1¾ percent.

*Strong inflation weighed on consumer demand early this year. In the second semester, the positive income effects of the tax reform should provide some relief.*

Value added of the trade sector disappointed in the first quarter, falling markedly from the previous period and edging up by only ½ percent year-on-year in real terms. The poor results in wholesale trade are a reflection of slackening exports and investment. Sales of motor vehicles again fell short of their level one year ago. Retail sales fared somewhat better, with value added exceeding the year-earlier level by 1.8 percent at constant prices; however, adjusted for the calendar effect of the earlier Easter holidays, net output has probably remained flat. According to preliminary information, overall turnover may have picked up in the second quarter. The outlook for the whole year is still rather vague. The WIFO projection is for an increase in value added by 1½ percent at constant prices.

*Table 5: 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 | + 1.5 | + 1.8 |
| Durables | − 0.1 | − 2.4 | + 3.6 | + 4.4 | + 2.2 | + 2.5 |
| Non-durables and services | + 1.2 | + 0.1 | + 0.3 | + 1.1 | + 1.4 | + 1.7 |
| Household disposable income | + 0.1 | + 0.2 | + 1.5 | + 1.5 | + 2.0 | + 1.7 |
| | As a percentage of disposable income | | | | | |
| Household saving ratio | 7.6 | 7.8 | 8.9 | 8.9 | 9.3 | 9.3 |
| | Percentage changes from previous year | | | | | |
| Direct lending to domestic non-banks[1] | + 3.5 | + 1.2 | + 1.6 | + 5.0 | + 1.7 | + 2.7 |
| | Percentage changes from previous year | | | | | |
| Inflation rate | | | | | | |
| National | 2.7 | 1.8 | 1.3 | 2.1 | 2.5 | 1.9 |
| Harmonised | 2.3 | 1.7 | 1.3 | 2.0 | 2.4 | 1.8 |
| Core inflation[2] | 2.3 | 2.0 | 1.3 | 1.6 | 2.0 | 1.7 |

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

Output in other private service branches was livelier than in the trade sector, e.g., in banking and insurance or in rental services. Hotels and restaurants saw their output increase by 7 percent in volume in the first quarter, owing to the early date of Easter which many foreign customers used for an additional skiing holiday.

Demand for labour continued to strengthen, such that the number of people in dependent active employment over the period from January to May was higher by 31,000 than one year ago. New jobs are being created mainly in business-related services, which benefit from the outsourcing of services from industry and the public sector, as well as in social services, trade and transportation. Job losses are being recorded for the manufacturing sector, which can only partly be explained by reclassification in the social security statistics.

## Unemployment rising despite sizeable employment gains

Despite overall business activity being lacklustre, the number of people in dependent active employment is set to increase by 0.9 percent in the current year. Many of the new jobs are part-time predominantly taken by women, although also the number of full-time jobs and male employment are both growing. Employment of Austrian nationals is heading up again, after having declined markedly in 2002 and 2003. Foreign employment is expected to rise to the same extent as domestic in 2005 and 2006.

*Labour supply is expected to increase by 150,000 persons over the period from 2000 to 2006. This is the reason why unemployment is rising in parallel with strong gains in employment.*

The employment rate, i.e., people in active employment as percent of the population of working age (15 to 64 year olds) is rising steadily, to a projected 63.2 percent in 2006. The EU Labour Force Survey uses a much wider definition for employment, such as including recipients of child-care benefits or working family members in agriculture. Following this definition, the employment rate stands at 68.4 percent, coming close to the Lisbon target of 70 percent.

*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 | +32.0 | +24.5 |
| Employees[2] | | +12.4 | −15.0 | + 5.5 | +21.1 | +27.5 | +20.0 |
| *Percentage changes from previous year* | | *+ 0.4* | *− 0.5* | *+ 0.2* | *+ 0.7* | *+ 0.9* | *+ 0.6* |
| Nationals | | + 3.0 | −20.1 | − 10.4 | + 9.2 | +15.5 | + 9.0 |
| Foreign workers | | + 9.5 | + 5.1 | + 15.9 | +11.9 | +12.0 | +11.0 |
| Self-employed[3] | | + 1.5 | + 3.4 | + 3.0 | + 4.0 | + 4.5 | + 4.5 |
| *Labour supply* | | | | | | | |
| Population of working age | 15 to 64 years | +36.3 | +42.9 | + 37.7 | +34.4 | + 1.2 | + 8.6 |
| | 15 to 59 years | − 5.2 | +13.4 | + 21.2 | +35.6 | +31.3 | +38.9 |
| Labour force[4] | | +23.5 | +17.0 | + 16.1 | +28.9 | +38.5 | +29.5 |
| *Surplus of labour* | | | | | | | |
| Registered unemployed[5] | | + 9.6 | +28.5 | + 7.7 | + 3.8 | + 6.5 | + 5.0 |
| In 1,000 | | 203.9 | 232.4 | 240.1 | 243.9 | 250.4 | 255.4 |
| | | Percent | | | | | |
| Unemployment rate | | | | | | | |
| Eurostat definition[6] | | 3.6 | 4.2 | 4.3 | 4.5 | 4.6 | 4.6 |
| As a percentage of total labour force[5] | | 5.5 | 6.2 | 6.3 | 6.4 | 6.5 | 6.5 |
| National definition[5, 7] | | 6.1 | 6.9 | 7.0 | 7.1 | 7.2 | 7.3 |
| Employment rate | | | | | | | |
| Economically active employment[1, 8] | | 63.2 | 62.5 | 62.2 | 62.3 | 62.8 | 63.2 |
| 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 strong inflow of foreign labour is a major determinant of Austrian labour market developments. It is fuelled by a generous regulation for seasonal workers, bilateral agreements with the new EU member states for cross-border commuters, and the poor business situation in Italy and Germany. Moreover, access to the Austrian labour market has been liberalised for family members of foreign workers living in Austria. Finally, recent adjustments to the pension system are boosting labour supply by raising the effective retirement age.

Labour supply in 2004 was higher by 85,000 persons than in 2000 and will rise by a further 68,000 until 2006. GDP growth is by far not strong enough to absorb an access of such magnitude. The number of people in active employment was 36,000 higher in 2004 than in 2000, and will go up by another 56,000 by 2006. At the same time, unemployment is growing fast, by 50,000 from 2000 to 2004, followed by a cumulative 11,000 in 2005-06. The unemployment rate for 2006 is projected at 7.3 percent of the dependent labour force according to the conventional national definition, or at 4.6 percent of the total labour force on the basis of the EU Labour Force Survey.

## General government deficit close to 2 percent of GDP

The federal government budget for 2005 is shaped by the cuts in corporate and personal income tax which together weaken the government balance by around ¾ percent of GDP. For the months from January to May, tax revenues exceeded the budgetary target, notably for profit taxes reflecting comfortable corporate earnings. This suggests that the general government deficit in the Maastricht definition may be kept below 2 percent of GDP. Government expenditure has also been somewhat above plans so far. Rising unemployment and higher numbers enrolled in job training are putting strain on finances of the labour market service. Besides, interest expenditure has also been somewhat higher than expected.

*The cyclical weakness is weighing on government finances via a shortfall in tax revenues and rising outlays related to unemployment.*

*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 | −1.2 | −1.9 | −1.9 |
| According to National Accounts | +0.1 | −0.4 | −1.3 | −1.3 | −2.0 | −2.0 |
| General government primary balance | +3.7 | +3.0 | +1.8 | +1.7 | +1.0 | +0.9 |
| | Percent | | | | | |
| *Monetary policy* | | | | | | |
| 3-month interest rate | 4.3 | 3.3 | 2.3 | 2.1 | 2.1 | 1.8 |
| Long-term interest rate[1] | 5.1 | 5.0 | 4.2 | 4.2 | 3.3 | 3.5 |
| | Percentage changes from previous year | | | | | |
| *Effective exchange rate* | | | | | | |
| Nominal | +1.0 | +1.4 | +3.8 | +1.2 | −0.2 | −0.2 |
| Real | +0.3 | +0.6 | +2.8 | +0.9 | +0.3 | −0.1 |

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

In 2006, the government deficit will hardly narrow. Sluggish economic growth is dampening revenues from taxes and social contributions. A large part of the corporate tax cut will have its first impact on the 2006 budget. Federal expenditure for 2006 has been budgeted in a very restrictive way; whether such ambitious targets will actually be met remains to be seen.