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Cyclical Recovery of Investment

Economic Outlook for 2006 and 2007

Austria's economy is expected to grow by 2.4 percent in volume in 2006. Exports and gross fixed capital formation will sustain the cyclical recovery, while private household demand will hardly pick up from its current weakness. Inflation should decelerate, leading to moderate real income gains. The increase in budgetary funds for active labour market policy will prevent unemployment from rising further, but will, together with higher spending on other items, widen the government deficit.

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The domestic export industries have seen a marked revival of activity since last summer. Austria is benefiting mainly from established supply relations with industrial manufacturers in Germany and other European countries which take advantage of continued strong global growth, rising demand from oil-exporting countries and the depreciation of the euro vis-à-vis the dollar. The momentum of merchandise exports should further increase to a rate of 6½ percent in volume in 2006, on account of additional demand stimulus from Germany. The rise in the standard VAT rate from 16 to 19 percent as from 1 January 2007 will lead to sizeable front-loading of purchases of durable consumer goods, notably of motor cars. The boom of German car manufacturers will strongly boost orders of the high-performing Austrian suppliers. Thus, the domestic manufacturing sector may enjoy an increase in its value added by 4.3 percent in volume in 2006.

For the further cyclical course it will be decisive whether the profits of exporting firms will be channelled into higher investment. First positive signs in that direction can be observed: the WIFO investment survey of autumn 2005 suggests that sentiment has turned around in the automobile and the steel industry as well as in machinery and industrial plant construction, with firms no longer deferring investment projects but planning their implementation. Corporate spending on machinery and equipment may go up by 3 percent in 2006 from last year. Likewise, the construction industry is optimistic in judging its order situation, such that construction investment is expected to expand by 2.5 percent in 2006.

The current recovery may translate into a sustained cyclical upswing provided that the upward trend spills over to private household income and consumer demand. In that respect, no indications have appeared so far, even if pre-Christmas retail sales have been reported lively¹. Private consumption has been growing by only 1 percent per year in volume since 2000, half the rate corresponding to the long-term average. The main reasons have been the small gains in real earnings and the rise in the saving ratio, which attained 9.4 percent of household disposable income in 2005. In 2006 and 2007, consumer demand is projected to gain nearly 2 percent, respectively, deemed insufficient as to act as a strong driver of overall growth. The moderate increase in consumption will be supported by higher wage settlements and decelerating inflation. Headline inflation is expected at 1.9 percent both in 2006

¹ Wüger, M., "Konsumnachfrage in Österreich weiterhin verhalten – Zuwächse im Weihnachtsgeschäft", WIFO-Monatsberichte, 2005, 78(12), pp. 821-833, http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo.search.get_abstract_type?p_language=2&pubid=25846.

and 2007, on the assumption of oil prices on world markets stabilising. Spill-over effects of higher energy prices onto prices of other goods and services have so far been largely absent.

Table 1: Main results

		2002	2003	2004	2005	2006	2007	
		Percentage changes from previous year						
GDP								
Volume		+ 1.0	+ 1.4	+ 2.4	+ 1.9	+ 2.4	+ 2.0	
Value		+ 2.2	+ 2.8	+ 4.4	+ 3.7	+ 4.3	+ 3.9	
Manufacturing ¹ , volume								
		+ 0.4	- 0.1	+ 4.6	+ 3.3	+ 4.3	+ 3.7	
Wholesale and retail trade, volume								
		+ 2.0	+ 0.3	+ 1.9	+ 0.9	+ 1.8	+ 1.9	
Private consumption expenditure, volume								
		+ 0.3	+ 1.6	+ 0.8	+ 1.4	+ 1.8	+ 2.0	
Gross fixed investment, volume								
Machinery and equipment ²		- 5.0	+ 6.1	+ 0.6	+ 0.8	+ 2.7	+ 2.4	
Construction		- 8.2	+ 7.7	+ 0.8	± 0.0	+ 3.0	+ 3.0	
		- 2.3	+ 4.8	+ 0.5	+ 1.5	+ 2.5	+ 2.0	
Exports of goods ³								
Volume		+ 4.3	+ 2.6	+ 12.9	+ 3.5	+ 6.5	+ 5.7	
Value		+ 4.2	+ 1.9	+ 13.9	+ 4.8	+ 7.4	+ 6.2	
Imports of goods ³								
Volume		+ 0.3	+ 6.5	+ 11.4	+ 1.8	+ 5.3	+ 5.2	
Value		- 2.0	+ 5.0	+ 12.5	+ 4.8	+ 6.6	+ 6.0	
Current balance		billion €	+ 0.75	- 0.48	+ 0.58	- 0.17	+ 0.70	+ 0.67
As a percentage of GDP			+ 0.3	- 0.2	+ 0.2	- 0.1	+ 0.3	+ 0.3
Long-term interest rate ⁴		in percent	5.0	4.2	4.2	3.4	3.7	4.0
Consumer prices			+ 1.8	+ 1.3	+ 2.1	+ 2.3	+ 1.9	+ 1.9
Unemployment rate								
Eurostat definition ⁵	in percent	4.2	4.3	4.8	5.2	5.2	5.2	
National definition ⁶	in percent	6.9	7.0	7.1	7.2	7.2	7.2	
Persons in active dependent employment ⁷			- 0.5	+ 0.2	+ 0.7	+ 1.0	+ 1.1	+ 0.9
General government financial balance according to Maastricht definition								
As a percentage of GDP			- 0.4	- 1.2	- 1.0	- 1.7	- 1.9	- 1.5

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

The number of persons in active employment will continue to rise strongly, by a projected 34,000 in 2006. Half of the increase is accounted for by foreign labour. In addition, service jobs for women, many of them part-time, will post further substantial gains. Nevertheless, job opportunities will also become brighter in sectors where full-time jobs for men prevail, such as in construction where overall employment is set to rise for the first time since 1997. Only few jobs will be lost in manufacturing in 2006, but the strong increase in output will be accommodated by substantial gains in hourly productivity (+4½ percent per year). For 2006, government funds for active labour market policy are envisaged to increase by one-third. As a consequence, the number of people in labour market training will go up by around 10,000 on annual average. Raising the qualification levels of the unemployed, notably among women re-entering the labour force and of young school-leavers, is important and efforts to that effect should continue beyond 2006. Since participants in training organised by the labour market service are not counted as unemployed, the jobless rate is not expected to increase further. It will remain at the high level of 7.2 percent of the dependent labour force (according to the conventional national definition) or 5.2 percent of the total labour force (Eurostat definition).

The general government deficit is likely to be kept below the threshold of 2 percent of GDP in 2006. Although spending on personnel, retirement benefits, labour market,

research and education will increase, revenues from profit taxes will exceed the budgetary plans and a reform of public administration will help save costs. A draft for the 2007 Federal budget has not yet been presented. From the perspective of the cyclical scenario and assuming a restrictive stance for public expenditure, the general government deficit should be expected in the order of 1½ percent of GDP.

Short-term risks for the WIFO projections derive from the volatility of oil prices and the exchange rate of the euro to the dollar. The front-loading of private spending in Germany ahead of the VAT increase and one-off events in Austria (such as the take-over of the Council presidency in the EU in the first semester) will provide stimulus to GDP growth in 2006. The subsequent year may see a reverse echo-effect, exacerbated by the need to cut the high government deficit. The outlook for GDP growth in 2007, tentatively projected at around 2 percent, is necessarily vague at the present stage. The cyclical momentum may prove stronger than assumed, if investment were to accelerate to a boom, public spending to provide further incentives to qualification and research, if private household disposable income would post substantial gains and consumer demand picks up from its protracted sluggishness.

Business activity has significantly gained momentum since last summer. The export-oriented industries report a substantial improvement of order levels, benefiting notably from rising demand for investment goods and consumer durables from oil-exporting countries, a marked decline in relative unit labour costs and the lower euro exchange rate against the dollar. In the third quarter 2005, German GDP edged up by 0.6 percent in volume from the previous period, exceeding the year-earlier level by 1.3 percent. For the further course of the business cycle it is now crucial whether the high export earnings will continue to be channelled primarily into debt redemption, buy-back of own shares and investment abroad, or whether they will translate into the long-deferred revival of domestic investment.

In the last years, the German economy has been suffering mainly from a pronounced weakness of consumer spending under the impact of employees' real income losses and a rising propensity to save. Moreover, construction investment has seen a sustained decline since the mid-nineties. Both components of aggregate demand have shown no signs of recovery so far.

WIFO nevertheless expects a strong demand push for 2006, triggered by the raise of the standard VAT rate from 16 percent to 19 percent as from 1 January 2007. One-third of the increase in the tax burden is to be compensated by a cut in non-wage labour cost. In 2006, pre-emptive buying of durable consumer goods, especially of motor cars, is likely to occur on a large scale (the VAT raise amounts to an average price increase of around € 700 at the purchase of a new car). The German automobile industry will therefore enjoy substantial output gains in 2006. Moreover, ahead of the phasing-out of the subsidy for new-home buyers, purchases of apartments and residential investment will be temporarily stimulated. Altogether, these carry-forward effects will boost GDP by some ½ percent in 2006, which would make for an overall growth rate close to 2 percent, the strongest expansion the German economy has seen since 2000.

This should, however, not be taken as evidence for the crisis in private consumption having finally been overcome, since the demand carried forward will be missing in 2007. Experience shows that an increase in indirect taxes triggers early price increases and massive advance purchases, which become fully offset in the subsequent year. For 2007, the German government is targeting a comprehensive programme of budgetary retrenchment, beyond the VAT increase. The extent of the implicit dampening effect on growth will depend on the specific consolidation measures, but also on how far the cyclical recovery will have progressed by then. In any case, the danger of a renewed setback on the way towards stronger growth of the German economy remains high. GDP may expand by some 1¼ percent in real terms in 2007.

Growth in Germany to accelerate temporarily

The German economy will benefit in 2006 from a recovery of exports. In addition, the envisaged increase in the VAT rate will lead to widespread pre-emptive buying. GDP growth is projected to accelerate to almost 2 percent, but a setback should be expected for 2007.

Driven by a pick-up in exports, business activity in the euro area has recovered somewhat in the second half of 2005, with GDP edging up by 1½ percent from last year. Exports should remain lively also in 2006. The comfortable profit situation and improving sales prospects may trigger a rebound in investment, although capacity utilisation remains rather low. Consumer sentiment has so far not headed up significantly. Confidence is being undermined by the jump in energy prices, high unemployment and uncertainty created by reforms to the social welfare system that are not always carefully targeted and well communicated. Moreover, wage policy is pointedly restrictive in many countries which, while being conducive to higher exports, dampens private consumption.

In 2006, the euro area economy will receive additional stimulus from the temporary revival of domestic demand in Germany, such that GDP growth is expected to exceed 2 percent. The setback in 2007 should turn out less pronounced than in Germany, since fiscal policy in other EMU countries is likely to be less restrictive.

Activity picking up gradually in the euro area

While exports have strengthened markedly in the euro area since mid-2005, consumer sentiment remains subdued. The slight decline in unemployment is partly due to statistical effects.

Table 2: World economy

	2002	2003	2004	2005	2006	2007	
	Percentage changes from previous year						
<i>Real GDP</i>							
Total OECD	+ 1.5	+ 2.0	+ 3.3	+ 2.6	+ 2.9	+ 2.7	
USA	+ 1.6	+ 2.7	+ 4.2	+ 3.6	+ 3.3	+ 3.0	
Japan	- 0.3	+ 1.4	+ 2.7	+ 2.2	+ 2.3	+ 2.5	
EU 25	+ 1.2	+ 1.2	+ 2.4	+ 1.7	+ 2.2	+ 2.0	
EU 15	+ 1.1	+ 1.1	+ 2.3	+ 1.6	+ 2.1	+ 1.9	
Euro area	+ 0.9	+ 0.7	+ 2.1	+ 1.5	+ 2.1	+ 1.9	
Germany	+ 0.1	- 0.2	+ 1.6	+ 1.1	+ 1.9	+ 1.2	
New member states ¹	+ 2.6	+ 3.8	+ 5.1	+ 4.3	+ 4.0	+ 4.0	
China	+ 8.3	+ 9.3	+ 9.5	+ 9.3	+ 9.0	+ 9.0	
<i>World trade, volume</i>	+ 3.4	+ 4.8	+ 7.9	+ 7.3	+ 8.5	+ 8.0	
<i>Market growth²</i>	+ 1.8	+ 5.1	+ 8.4	+ 5.0	+ 6.3	+ 5.5	
<i>Primary commodity prices</i>							
HWWA index, total	- 5	- 4	+ 18	+ 39	+ 10	+ 11	
Excluding energy	- 6	- 6	+ 18	+ 10	+ 15	+ 8	
<i>Crude oil prices</i>							
Average import price (cif) for OECD countries	\$ per barrel	24.1	28.4	36.3	57.0	57.0	62.0
<i>Exchange rate</i>							
\$ per euro		0.945	1.131	1.243	1.250	1.16	1.12

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

Within the euro area, cyclical developments continue to be rather uneven. The Italian economy, Austria's second-largest trading partner, is currently ridden by major problems. Its competitiveness is insufficient, but the traditional way out through currency devaluation has been definitely closed by EMU participation. In 2005, real GDP edged up by a slim ¼ percent, and expectations for 2006 are for a growth rate of 1 percent at best. Apart from the huge economic and social challenges facing economic policy, the government deficit must be reduced, which is projected at over 4 percent of GDP for 2006. Also the Portuguese economy is lagging in competitiveness and is at the same time feeling the toll of measures currently taken to consolidate public finances. In a second group of Member States, to which next to Austria also Belgium, the Netherlands and France belong, GDP growth in 2006 is likely to exceed 2 percent. Markedly stronger growth may be expected for Finland, Ireland, Spain and Greece.

Unemployment in the euro area receded slightly in 2005, to a rate of 8.6 percent of the labour force according to Eurostat. However, the labour market situation is substantially different across countries: in Spain, Ireland and Finland the decline in unemployment reflects the favourable business conditions. However, the improvement in Italy contrasts with the cyclical sluggishness. Like in other countries, policy tries, ahead of the parliamentary elections, to reduce the statistically recorded unem-

ployment by bringing more people into training measures and widening the definition of employment. In Germany, France, Greece and Belgium, the unemployment rate has stabilised at a high level. A number of smaller EMU countries, such as Portugal, the Netherlands and Austria, register an increase in jobless figures. For 2006, the European Commission expects a further slight fall in the euro area unemployment rate, to 8.4 percent of the labour force.

Cyclical activity in the USA continues to be driven by buoyant consumer demand. Private household expenditure on consumer goods is fuelled by substantial wage increases, with real earnings per employee climbing at an annual pace around 2 percent. In addition, consumption is benefiting from positive wealth effects deriving from rising house prices. The boom on key segments of the real estate market is also stimulating investment in residential construction which in the third quarter 2005 was up by 7 percent in volume from last year. House price inflation and the increase in residential investment have both hardly abated over the last few quarters.

Corporate fixed investment is also posting substantial gains, on the back of rising capacity utilisation and encouraging sales prospects. Overall growth of real GDP may nevertheless moderate from 3.6 percent in 2005 to around 3 percent in 2007, as the marked increase in short-term interest rates by the Federal Reserve will dampen consumption and construction investment.

The major cyclical risk in the USA is a possible slump on real estate markets. A further risk is the high current account deficit, which may rise above 7 percent of GDP by 2007: a possible sharp depreciation of the dollar would entail an upward drift in long-term interest rates. However, the bulk of the burden resulting from devaluation would have to be borne by the trade partners of the USA.

Against the backdrop of generally weak internal demand, the cyclical profile in the euro area over the last few years was importantly influenced by the trend in raw materials prices and the euro exchange rate. Thus, revisions to the short-term forecasts were often dictated by the erratic movements on these markets. Since last September, world market prices for crude oil have come down from a peak of \$ 70 per barrel to below \$ 60. Predictions for the further course of oil prices are subject to considerable uncertainty, since the high instability of the global political situation is reflected by a substantial speculative premium on prices. Demand for oil and other energy commodities is unabated, partly because of the high energy-intensity of the economic boom in China. For the purpose of the present forecast, WIFO assumes an average import price of crude oil for the industrialised countries of \$ 57 per barrel for 2006 and of \$ 62 for 2007.

Since the beginning of 2005, the euro has fallen against the dollar from \$ 1.35 to below \$ 1.20 per euro. Most analysts see the main reason for this decline in the widening of the short-term interest rate differential between the USA and Europe. The latter will remain marked both in 2006 and 2007, suggesting a further gradual depreciation of the euro. On the other hand, the high current account deficit of the USA should weaken the dollar in the medium term, although timing and extent of such a correction are difficult to predict. The WIFO assumption is for an average exchange rate of \$ 1.16 per euro in 2006.

In 2005, the Austrian economy grew by 1.9 percent in volume. In the second half of the year, activity picked up notably in the export-oriented parts of manufacturing industry. The results of the latest WIFO investment survey suggest that the high export earnings will increasingly be channelled into investment, which would bring the two-year-long stagnation of investment in machinery and equipment to an end. With the transmission of stimulus from exports to investment, the recovery should have advanced by an important step.

US current account deficit moving to record high

Business activity in the USA remains lively. Marked increases in interest rates will lead to slightly slower growth in 2006 and 2007. A major risk derives from the possibility of a slump in real estate prices.

High uncertainty surrounding commodity prices and exchange rates

The volatility of crude oil prices and of the euro exchange rate is very high, with substantial repercussions for cyclical activity.

Cyclical recovery in Austria sustained by exports

Lively activity in the export industries will be supplemented in 2006 by temporary expansionary effects. Austria will benefit from the front-loading of demand in Germany ahead of the VAT increase. Particularly the suppliers to the German motor car industry should enjoy hefty increases in new orders. The take-over of the EU Council presidency by Austria in the first semester 2006 should raise demand for hotel and restaurant services. The favourable business conditions plus the one-off effects will accelerate GDP growth to a rate of 2.4 percent in 2006, with the expansion being driven by exports and investment.

Internal demand, while tentatively picking up, remains subdued in a longer-term comparison. Currently there are no signs for the cyclical recovery being transmitted to private incomes and consumption. For the fifth year in a row, growth of private household demand in 2005 remained below its long-term trend, which is rather unusual. For several years now, consumption has been restrained by the sluggish growth of real net earnings and an increase in savings as a share of household disposable income. In particular the unfavourable development of employees' earnings and the low spending propensity act as a drag on retail sales and other services branches. In 2006, private consumption growth of a projected 1.8 percent in volume should approach its long-term trend.

The short-term cyclical risks stem as before from the instability on commodity and foreign exchange markets. A new jump in oil prices or an appreciation of the euro would weigh on economic growth. On the other hand, exports may prove more dynamic than anticipated. A full translation of the high profits into investment would create a key impulse for a self-sustained upswing, if it were transmitted onto private incomes and consumer demand.

A first outlook on 2007 remains necessarily vague at the present stage. WIFO hypothesises the cyclical recovery to continue, with domestic demand possibly gaining strength. With the one-off effects of 2006 fading and fiscal policy likely to turn more restrictive in order to cut the high budget deficit, growth may lose some momentum. In all, the WIFO projection is for GDP growth around 2 percent in 2007.

In the first half of 2005, growth of merchandise exports of 3 percent in volume remained well below the high rates recorded in the previous year. The foreign trade statistics suggest market share losses both in East-central and in western Europe. This should, however, be seen as but a technical correction of the extraordinarily strong market share gains documented for 2004. Since the summer of 2005, exports seem to rebound, as for the third quarter the preliminary national accounts show a seasonally adjusted increase in exports of goods of almost 3 percent from the previous quarter.

Austria is taking advantage, first, of the business cycle recovery in major trading partner countries. The German export industries, entertaining close supply linkages with Austrian firms, are booming. Also demand from oil-exporting countries and from south-eastern Europe is growing strongly. Second, Austrian exporting firms benefit from their high price competitiveness. Unit labour costs are falling markedly relative to those of the trading partners, mainly brought about by strong gains in hourly productivity in manufacturing industry of 4 percent to 5 percent per year.

Volume exports of goods are projected to expand notably more strongly in 2006 than in 2005, by 6½ percent as compared with 3.5 percent. The stronger momentum will provide incentives for manufacturing output, which in the third quarter 2005 edged up by nearly 1½ percent from the previous period. For the whole year 2006, manufacturing value added is expected to increase by 4¼ percent at constant prices. The suppliers to the German automobile industry should enjoy particularly favourable demand conditions.

Demand and output in Austria are expected to grow by an inflation-adjusted 2.4 percent in 2006. The expansion should be sustained by exports, supported by a recovery of investment, whereas the weakness of consumer demand prevailing since 2001 is set to persist.

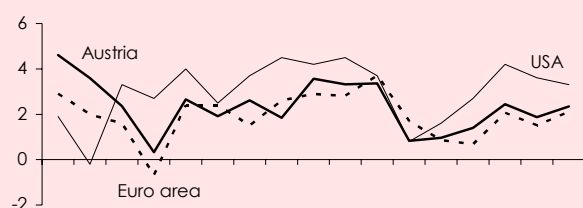
Strong export performance

Austrian companies benefit from buoyant exports and lively demand for motor cars in Germany. The strong increase in hourly productivity in manufacturing makes for further gains in price competitiveness.

Figure 1: Indicators of economic performance

Growth of real GDP

Percent



Employment and unemployment

1,000 from previous year



Manufacturing and investment

Percentage changes from previous year, volume



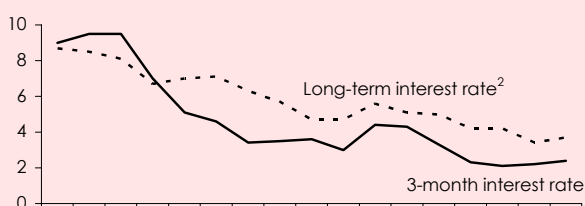
Consumption and income

Percentage changes from previous year, volume



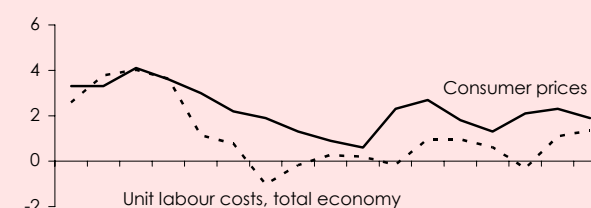
Short-term and long-term interest rates

Percent



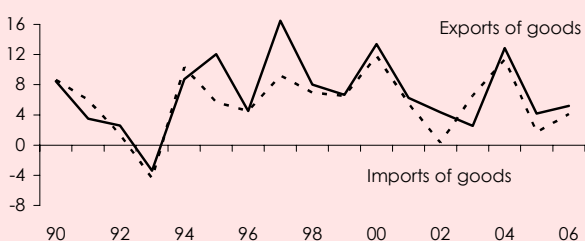
Inflation and unit labour costs

Percentage changes from previous year



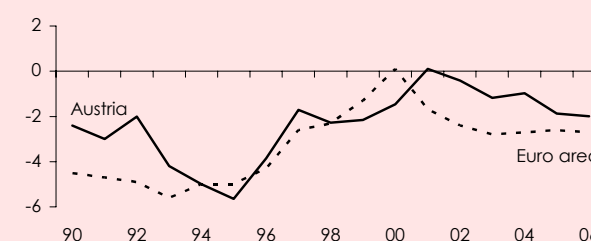
Trade

Percentage changes from previous year, volume



General government financial balance

As a percentage of GDP



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

Because of the strong productivity gains, even such a sizeable output growth can be accommodated with a smaller workforce. In 2005, the whole manufacturing sector employed 580,000 persons, some 10 percent less than ten years ago. Wage increases in 2006 will lag behind productivity growth. Labour costs in manufacturing will remain on a downward trend. In 2005, unit labour costs were more than 20 percent below their level of 1995.

Table 3: Productivity

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 1.0	+ 1.4	+ 2.4	+ 1.9	+ 2.4	+ 2.0
Employment ¹	- 0.1	+ 0.1	- 0.0	+ 0.6	+ 0.9	+ 0.8
Productivity (GDP per employment)	+ 1.1	+ 1.3	+ 2.5	+ 1.3	+ 1.4	+ 1.2
<i>Manufacturing</i>						
Production ²	+ 0.4	- 0.0	+ 4.7	+ 3.3	+ 4.3	+ 3.7
Employees ³	- 2.5	- 1.7	- 0.6	- 0.9	- 0.5	- 0.8
Productivity per hour	+ 3.5	+ 1.3	+ 4.4	+ 4.6	+ 4.6	+ 4.9
Working hours per day per employee ⁴	- 0.5	+ 0.3	+ 0.8	- 0.3	+ 0.2	- 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 "Konjunktererhebung" of Statistics Austria.

The good profit situation and benign sales prospects encourage companies to embark on major investment projects, as confirmed by early results from the latest WIFO investment survey. Motor car and steel manufacturers as well as the machinery and plant installation sector plan to strongly step up their spending on fixed capital. Total investment in machinery and equipment, which stagnated in 2005, should go up by at least 3 percent in 2006. Such a rebound is a crucial step in the process of a cyclical recovery, which should allow income and employment to increase in the economy as a whole.

Investment in construction is also picking up. From a slow start early in the year, construction activity has gained strong momentum since mid-2005. In the WIFO business and investment surveys, firms now show distinctly greater optimism. Conditions are most favourable in civil engineering, which benefits from higher funds being allocated to infrastructure projects. Activity is also heading up in residential building and renovation. Rising demand for new homes is mirrored by a higher number of building permits for subsidised homebuilding. Higher investment in business equipment would also trigger the long-awaited recovery of industrial and commercial building activity. For 2006, WIFO expects construction output to expand by an inflation-adjusted 2.5 percent.

For the first time in three years, gross fixed capital formation should outpace GDP growth in 2006, taking the investment ratio for the whole economy to 21 percent of GDP, which is still below the mark of 22 percent attained in the cyclical high of 1999-2000.

The deficit in the trade balance has narrowed from € 5 billion in 2000 to around € ½ billion in 2006. This mirrors, on the one hand, the strong performance of goods exports gaining an annual 6 percent in volume between 2000 and 2006. On the other hand, it is also a reflection of the sluggishness of both consumption and investment entailing an only subdued import growth.

The rebound in exports will strengthen the trade balance also in 2006. At the same time, the imminent recovery of investment will lead to a pick-up in imports, given that 80 percent of equipment investment are covered by imported goods. The merchandise trade account will be close to balance.

In foreign tourism, one-off effects will be operating. Austria's holding of the EU Council Presidency in the first semester 2006 will temporarily boost tourism exports, from which hotels, restaurants and communication services will benefit. Spending by Austrian residents abroad is set to barely increase. The surplus in the tourism services balance will thereby increase further, possibly reaching € 4 billion in 2006 (according to the balance of payments statistics, excluding cross-border passenger transports). The current account will be close to balance over the projection period.

Rebound of investment

Results from the regular WIFO business survey suggest a spill-over of stimulus from lively exports to investment. Construction firms report an excellent order situation.

Tourism contributing towards an improvement in the current account

Strong growth of merchandise exports and high earnings from tourism, partly resulting from the EU presidency episode, will shape the trend in the current external account.

In 2005, contractual wages rose by an average 2.3 percent, at the same pace as consumer prices. Somewhat more favourable is the outlook for 2006. Settlements in the wage round of last autumn were $\frac{1}{4}$ to $\frac{1}{2}$ percentage point higher than one year earlier. Gross earnings per capita should on average rise by 2.8 percent year-on-year.

In real terms, gross wages per head may increase by almost 1 percent in 2006, as inflation gradually abates. In November 2005, headline inflation fell to a year-low 1.6 percent, with the base effect no longer being biased by high fuel prices. For 2006, WIFO expects the annual average rate of inflation at 1.9 percent and core inflation (excluding energy and unprocessed food items) at 1.6 percent. Measured inflation will also be dampened by a statistical effect, since the transition to a new calculation method will shave 0.1 to 0.2 percentage point off the official rate.

Slight improvement in real wages

Inflation is set to decelerate, partly because the jump in energy costs does not trigger second-round price increases for other goods and services. This leaves scope for small gains in real wages.

Table 4: Earnings and international competitiveness

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year					
Gross earnings per employee ¹	+ 2.2	+ 1.9	+ 2.0	+ 2.4	+ 2.8	+ 2.5
Gross real earnings per employee ¹	+ 1.2	+ 0.4	+ 0.0	+ 0.1	+ 0.9	+ 0.6
Net real earnings per employee ¹	+ 1.0	+ 0.1	+ 0.3	+ 1.0	+ 0.6	+ 0.3
Total economy						
Unit labour costs	+ 1.0	+ 0.6	- 0.3	+ 1.1	+ 1.3	+ 1.2
Manufacturing						
Unit labour costs	- 0.3	- 0.1	- 3.5	- 1.3	- 1.7	- 1.7
Relative unit labour costs ²						
Vis-à-vis trading partners	- 0.6	+ 2.9	- 0.8	- 1.1	- 1.0	- 1.5
Vis-à-vis Germany	- 1.5	+ 1.5	+ 0.3	+ 0.1	+ 0.2	- 1.2
Effective exchange rate, manufactures						
Nominal	+ 1.3	+ 3.7	+ 1.2	- 0.5	- 0.5	- 0.2
Real	+ 0.8	+ 2.9	+ 1.0	- 0.5	- 0.9	- 0.2

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

The hike in fuel prices has calmed in recent months, although prices for electricity and gas were raised. No significant second-round effects of higher energy prices on prices of other goods and services have been observed so far. Prices of manufactures have barely edged up, and wage settlements have been in keeping with the goal of overall price stability. Nominal unit labour costs for the economy as a whole are projected to rise by $1\frac{1}{4}$ percent in 2006. In real terms, labour costs are falling, implying a further decline in the wage share (as a proportion of national income).

Private household demand in the third quarter of 2005 rose by a mere 0.4 percent at constant prices from the preceding three months. On annual average, consumption grew by 1.4 percent from the previous year. Over the period from 2000 to 2005, private consumption gained 1 percent p.a., just half the long-term trend rate. Unless household spending picks up significantly, the cyclical recovery will not translate into a self-sustained upswing.

In the course of 2005, purchases of durable consumer goods headed up, possibly reflecting lagged effects of the tax reform. Demand for passenger cars remained nevertheless subdued. New car registrations from January to October fell $\frac{1}{4}$ percent short of the year-earlier level, turnover of car dealers and of petrol stations by $\frac{3}{4}$ percent in volume up to September. Wholesale turnover also disappointed. Retail sales in the first nine months went up by 1.3 percent in real terms year-on-year.

In 2006, higher real incomes, steady growth of employment and late effects of the tax reform may give rise to a cautious revival of consumer demand (+1.8 percent at constant prices). Purchases of durable consumer goods are likely to grow notably faster than such of non-durables and services.

Private consumption to continue growing at a modest rate

Private consumption has been anaemic for the last five years. It is determined by the sluggish growth of employees' real earnings and a rising saving ratio.

Table 5: Private consumption, income and prices

	2002	2003	2004	2005	2006	2007
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 0.3	+ 1.6	+ 0.8	+ 1.4	+ 1.8	+ 2.0
Durables	+ 0.3	+ 3.2	+ 0.6	+ 2.0	+ 2.4	+ 2.2
Non-durables and services	+ 0.3	+ 1.5	+ 0.8	+ 1.3	+ 1.7	+ 2.0
Household disposable income	+ 0.7	+ 2.3	+ 1.2	+ 1.9	+ 1.9	+ 1.8
	As a percentage of disposable income					
Household saving ratio	7.7	8.6	9.0	9.4	9.5	9.4
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+ 1.2	+ 1.6	+ 5.0	+ 4.4	+ 2.8	+ 3.3
	Percentage changes from previous year					
Inflation rate						
National	1.8	1.3	2.1	2.3	1.9	1.9
Harmonised	1.7	1.3	2.0	2.2	1.9	1.9
Core inflation ²	2.0	1.3	1.6	1.5	1.6	1.6

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

For 2006, WIFO expects the number of persons in dependent active employment to increase by 34,000 or 1.1 percent. As demand is particularly strong for females in the service sector, the bulk of the net gain may be part-time jobs. Nevertheless, the number of male employees, who predominantly work full-time, is also heading up. The construction industry is for the first time since 1997 adding to its workforce, and the cut in manufacturing jobs is expected no higher than 0.5 percent. Labour supply continues to grow at a strong pace: inflow of labour from abroad remains lively, and the increase in the effective retirement age initiated by the pension reform will boost labour supply by around 8,000 persons in 2006.

For the first time since 2001, the number of unemployed is likely to rise no further in 2006, keeping a level of nearly 255,000. The unemployment rate is projected to remain constant at 7.2 percent of the dependent labour force (according to the conventional national calculation method) or 5.2 percent of the total workforce (following the EU Labour Force Survey). The stabilisation is brought about mainly by a reinforcement of active labour market policy measures, budgetary allocations for which will go up by one-third. Thereby, the number of people participating in training activities will increase by about 10,000 to a total of around 60,000. This group will not be included in the official jobless figure. Policy efforts for upgrading job qualifications will concentrate on the major problem groups on the labour market, notably young entrants and women returning to the labour market.

Youth unemployment is a particularly severe social problem. The unemployment register shows for 2005 an average number of 41,000 job-seekers between 15 and 24 years of age. To this figure should be added some 6,000 young people looking for an apprenticeship and 19,000 participants in training courses, both groups not being included in the official unemployment figure. The number of young job-seekers has increased by 28,000 since the year 2000. The fight against youth unemployment through measures to encourage the offering of apprenticeships in 2005 and via additional programmes in 2006 to raise job-seekers' qualifications is of crucial importance; such initiatives should therefore be continued in the years to come. In addition, further measures would be required, targeted to the formal education system and the socio-economic companies.

Reinforced spending on active labour market policy

The rise in the unemployment rate will level off in 2006, owing to a substantially higher number of people enrolled in training activities. Employment will remain on a firm upward trend.

Table 6: Labour market

	2002	2003	2004	2005	2006	2007
	Changes from previous year, in 1,000					
<i>Demand for labour</i>						
Persons in active employment ¹	- 11.6	+ 8.5	+ 25.1	+ 36.6	+ 39.5	+ 32.5
Employees ²	- 15.0	+ 5.5	+ 21.1	+ 31.6	+ 34.0	+ 27.0
<i>Percentage changes from previous year</i>	- 0.5	+ 0.2	+ 0.7	+ 1.0	+ 1.1	+ 0.9
Nationals	- 20.1	- 10.4	+ 9.2	+ 19.6	+ 17.0	+ 13.0
Foreign workers	+ 5.1	+ 15.9	+ 11.9	+ 12.0	+ 17.0	+ 14.0
Self-employed ³	+ 3.4	+ 3.0	+ 4.0	+ 5.0	+ 5.5	+ 5.5
<i>Labour supply</i>						
Population of working age						
15 to 64 years	+ 42.9	+ 37.7	+ 34.4	+ 12.7	+ 9.0	+ 20.2
15 to 59 years	+ 13.4	+ 21.2	+ 35.6	+ 45.7	+ 40.5	+ 24.9
Labour force ⁴	+ 17.0	+ 16.1	+ 28.9	+ 45.45	+ 41.5	+ 32.5
<i>Surplus of labour</i>						
Registered unemployed ⁵	+ 28.5	+ 7.7	+ 3.8	+ 8.8	+ 2.0	± 0.0
In 1,000	232.4	240.1	243.9	252.7	254.7	254.7
	Percent					
<i>Unemployment rate</i>						
Eurostat definition ⁶	4.2	4.3	4.8	5.2	5.2	5.2
As a percentage of total labour force ⁵	6.2	6.3	6.4	6.5	6.5	6.4
National definition ^{5,7}	6.9	7.0	7.1	7.2	7.2	7.2
<i>Employment rate</i>						
Persons in active employment ^{1, 8}	62.5	62.2	62.3	62.8	63.4	63.7
Total employment ^{6, 8, 9}	-	-	67.8	68.0	68.2	68.4

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.

Tax revenues in 2005 significantly exceeded the federal budgetary plans. In particular the corporate tax and the capital gains tax on dividends yielded higher returns than anticipated, reflecting the excellent profit situation of domestic companies. The general government financial balance in the Maastricht definition should therefore turn out somewhat better than expected, limiting the deficit at 1.7 percent of GDP.

General government deficit to be kept below 2 percent of GDP

While federal government revenues are rising more strongly than foreseen in the budget, sizeable additional expenditures are being incurred at the same time. Over the entire projection period, the general government deficit is unlikely to rise above 2 percent of GDP.

Table 7: Key policy indicators

	2002	2003	2004	2005	2006	2007
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 0.4	- 1.2	- 1.0	- 1.7	- 1.9	- 1.5
According to National Accounts	- 0.6	- 1.3	- 1.1	- 1.8	- 2.0	- 1.6
General government primary balance	+ 2.7	+ 1.7	+ 1.9	+ 1.1	+ 0.8	+ 1.2
	Percent					
<i>Monetary policy</i>						
3-month interest rate	3.3	2.3	2.1	2.2	2.4	2.6
Long-term interest rate ¹	5.0	4.2	4.2	3.4	3.7	4.0
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+ 1.4	+ 3.8	+ 1.2	- 0.5	- 0.6	- 0.2
Real	+ 0.6	+ 2.8	+ 0.9	- 0.7	- 1.0	- 0.3

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

In 2006, the deficit could be somewhat higher. First, the "cost" of the tax reform in the area of profit taxes may take effect with a lag; second, new expenditure commitments will materialise, such as the adjustment of retirement benefits, wage increases for the public sector and additional funds for active labour market policy, research and education. Against these expenditure overruns should be set the savings gen-

erated by the administrative reform. The WIFO projection is for a general government deficit corresponding to 1.9 percent of GDP.

The outlook for 2007 remains vague since no federal budget proposal has as yet been submitted. On the basis of the present short-term projections, government revenues may increase by some 3/4 percent. For government expenditure, the assumptions made are for a restrictive stance; it has in particular been assumed that the "administrative reform II" will be implemented at all levels of government. The general government balance may yield a deficit in the order of 1½ percent of GDP.