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High Euro Exchange Rate Weighing on Cyclical Recovery

Economic Outlook for 2005 and 2006

Driven by buoyant exports, the Austrian economy grew by around 2 percent in 2004. For 2005 and 2006, growth is projected at an annual 2¼ percent, boosted in 2005 by the second step of tax cuts, and by some pick-up in the pace of activity in the euro area in 2006. Major uncertainty surrounds the exchange rate of the euro, where a further upward drift may weaken the cyclical recovery in the euro area.

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The world economy expanded more strongly in 2004 than in any year over the last 1½ decades. The strong momentum of foreign demand boosted Austrian exports by 10 percent in volume in 2004, leading also to sizeable gains in manufacturing output. Growth of GDP rose to close to 2 percent in Austria, matching the pace of the euro area. Set against the upswing in the USA and in Asia, the performance of the euro area was nevertheless disappointing. As from the middle of last year, the moderate recovery was held back by the sharp rise in the euro exchange rate, high oil prices and spending restraint on the part of private households.

While the rebound of activity set in relatively late in Austria, it continued into the second semester. In the third quarter, real GDP rose by a healthy 0.8 percent quarter-on-quarter and 2.7 percent from the year-earlier period. Growth of exports was unabated, and investment was stimulated by the imminent expiry of the fiscal investment premium ("Investitionszuwachsprämie"). Private consumption also recovered, with pre-Christmas sales taking an encouraging start. In the regular WIFO business survey, firms remained broadly satisfied with their current order and business situation, although there was no further improvement in the overall assessment from the months before.

For 2005, the projection for GDP growth is now taken down to 2.2 percent, on account of the strong euro and the repercussions of the massive rise in oil prices. The pace of exports will be slowed by the rise in the exchange rate and the slackening of world trade growth. As some investment has been partly carried forward into 2004, the corresponding negative "echo" effects should be expected for 2005. According to the latest WIFO investment survey, manufacturers intend to restrain spending on new machinery and equipment in 2005. Rising inflation as a consequence of high oil prices will squeeze purchasing power somewhat, although the tax reform will lower companies' tax burden and make for an average gain of 1¼ percent in employees' real net earnings. GDP growth in 2005 is set to exceed the euro area average by a clear margin.

Assuming some moderation in the euro exchange rate as well as in oil prices in 2006, growth in the euro area is projected to accelerate to 2¼ percent in 2006. Under these assumptions – which are subject to considerable uncertainty given the high volatility of exchange rates and oil prices – GDP in Austria may be expected to expand by 2.3 percent.

The outlook for inflation is dominated by the high oil prices. Price increases averaged 2 percent in Austria in 2004, ½ percentage point of which was due to the rise in energy costs. For 2005, inflation should be expected to accelerate to 2.3 percent, as electricity, gas and rents become more expensive and the tobacco tax has been raised. In 2006, the rate of inflation should subside to 1.7 percent, if prices of some energy items abate and administrative prices hold steady.

Main results

		2001	2002	2003	2004	2005	2006
		Percentage changes from previous year					
GDP							
Volume		+ 0.7	+ 1.2	+ 0.8	+ 1.9	+ 2.2	+ 2.3
Value		+ 2.5	+ 2.5	+ 2.3	+ 3.5	+ 4.5	+ 3.9
Manufacturing[1], volume		+ 2.2	+ 0.5	+ 0.2	+ 5.2	+ 4.0	+ 3.7
Whole sale and retail trade, volume		+ 2.4	+ 2.2	+ 0.4	+ 1.5	+ 2.4	+ 2.4
Private consumption expenditure, volume		+ 1.0	– 0.1	+ 0.6	+ 1.6	+ 2.1	+ 2.2
Gross fixed investment, volume		– 2.1	– 3.4	+ 6.2	+ 3.2	+ 1.6	+ 2.7
Machinery and equipment[2]		+ 1.6	– 6.5	+ 5.1	+ 6.0	+ 1.5	+ 3.5
Construction		– 5.0	– 0.8	+ 7.0	+ 1.0	+ 1.7	+ 2.0
Exports of goods[3]							
Volume		+ 6.3	+ 4.3	+ 2.5	+10.0	+ 6.0	+ 7.0
Value		+ 6.5	+ 4.2	+ 1.9	+11.0	+ 6.5	+ 7.5
Imports of goods[3]							
Volume		+ 5.5	+ 0.3	+ 6.8	+ 7.2	+ 6.0	+ 7.1
Value		+ 5.0	– 2.0	+ 5.0	+ 8.8	+ 6.3	+ 7.8
Current balance	billion €	– 4.13	+ 0.75	– 1.11	– 2.38	– 2.39	– 2.72
As a percentage of GDP	%	– 1.9	+ 0.3	– 0.5	– 1.0	– 1.0	– 1.1
Long-term interest rate[4]	%	5.1	5.0	4.2	4.2	3.9	4.3
Consumer prices		+ 2.7	+ 1.8	+ 1.3	+ 2.0	+ 2.3	+ 1.7
Unemployment rate							
Percent of total labour force[5]	%	3.6	4.2	4.3	4.5	4.4	4.2
Percent of dependent labour force[6]	%	6.1	6.9	7.0	7.1	6.9	6.7
Dependent employment[7]		+ 0.4	– 0.5	+ 0.2	+ 0.7	+ 0.8	+ 0.9
General government financial balance according to Maastricht definition							
As a percentage of GDP	%	+ 0.3	– 0.2	– 1.1	– 1.3	– 2.0	– 1.8

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

The pace of GDP growth so far has allowed a substantial number of new jobs being created, but not to make major inroads into unemployment, as labour supply has increased markedly. Employment is responding to the improved business conditions, with the number of employees in active employment having gone up by 20,000 in 2004. Further gains by more than 25,000 per year are expected over the projection period, extending increasingly to the creation of new full-time jobs. Unemployment edged up by almost 4,000 to a total 244,000 in 2004, but should revert to the 2003 level in 2005. The rate of unemployment may decline to 6.7 percent by 2006 (4.2 percent of the labour force according to Eurostat definitions).

At a ratio of 1.3 percent of GDP, the general government deficit in the Maastricht definition was markedly higher in 2004 than anticipated. Foregone revenues from income and corporate tax on account of the investment premium, but also shortfalls in VAT revenues, are the main reasons for the slippage. The second step of the tax reform will raise the deficit further to around 2 percent of GDP in 2005, abstracting from possible one-off measures to keep it below that mark. Revenues from wage tax will turn out rather lower than projected last October, given the downward revision of wage prospects. In 2006, the deficit should edge down to 1¾ percent of GDP, as assumed in the stability programme. While the expected cyclical recovery and the phasing-out of the investment premium should improve the budget balance, the tax reform will further erode income and corporate tax receipts.