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Strong Growth in 2007, Sizeable Cyclical Risks for 2008

Economic Outlook for 2007 and 2008

GDP in Austria is growing by 3.4 percent in volume this year, ¾ percentage point above the euro area average. Strong business activity is driven by exports and has meanwhile extended to construction and equipment investment. The swift expansion of demand and output is accelerating the growth of employment and of government revenues. Yet, the impact on private household consumption remains muted. The crisis on international financial markets, whose repercussions cannot be fully assessed as yet, will also exert a dampening effect. For 2008, GDP growth is expected to moderate to a rate of 2.4 percent in real terms, close to the long-term average.

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In 2007, the Austrian economy is benefiting from the strong momentum of exports and investment in western and eastern Europe and is expected to grow by 3.4 percent in volume, broadly the same rate as last year. Austrian exports are rising by more than 8 percent in real terms, manufacturing output by 7.3 percent. High corporate earnings, fully utilised productive capacities and undiminished business optimism translate into a sizeable increase in investment (+8 percent for machinery and equipment in real terms). The business cycle has thereby passed the crucial stage from being entirely export driven towards taking root in investment. Further support comes from construction activity, rising by 5 percent this year, on the back of a stable expansion in civil engineering, a steady recovery of residential building and a reinforcement of industrial construction activity.

Nevertheless, the recovery is unlikely to turn into a cyclical boom, for two reasons: first, the weakening international environment in the wake of slackening activity in the USA and the global financial crisis, and second, the persistent sluggishness of private consumption in Austria.

The worldwide turbulences on financial markets originated from the sub-prime segment of the US real estate market and have been spreading since. Several banks have been faced with solvency problems, and risk premia for corporate financing have increased substantially. While timely counter-action by central banks has contributed towards calming the situation, the extent and duration of the problems in the global financial system are still unclear. Immediately affected by the crisis is the US economy. The fall in real estate prices and the scope of mortgage financing have led to a slump in housing investment, which is down by one-fifth from its peak in 2005. The drop in asset values and weaker employment growth will also dampen private household spending over the next few quarters, leading to a marked slowdown of US economic growth to annual rates below 2 percent in 2007 and 2008 and significantly adding to the risk of recession.

At present it is too early to judge to what extent the currently robust global activity will suffer from the financial market crisis. Sustained by the strong expansion in Asia, the world economy is enjoying in 2007 the fifth consecutive year of strong growth (+5 percent in volume). Notably the Chinese economy (+11 percent in 2007) is a key driver for south-east Asia and the world at large. Healthy rates of growth are recorded also for the OPEC countries, for Latin America and even Africa.

Table 1: Main results

		2003	2004	2005	2006	2007	2008
		Percentage changes from previous year					
GDP							
Volume		+ 1.2	+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.4
Value		+ 2.4	+ 4.4	+ 3.9	+ 5.1	+ 5.8	+ 4.4
Manufacturing[1], volume		+ 0.2	+ 2.4	+ 3.1	+ 8.8	+ 7.3	+ 3.0
Wholesale and retail trade, volume		+ 0.4	+ 1.1	+ 0.2	+ 1.0	+ 1.8	+ 2.2
Private consumption expenditure, volume		+ 1.3	+ 1.8	+ 2.0	+ 2.1	+ 1.9	+ 2.1
Gross fixed investment, volume		+ 5.9	+ 0.1	+ 0.3	+ 3.8	+ 6.3	+ 3.7
Machinery and equipment[2]		+ 7.2	– 1.4	+ 0.7	+ 2.1	+ 8.0	+ 4.5
Construction		+ 4.9	+ 1.3	+ 0.1	+ 5.1	+ 5.0	+ 3.0
Exports of goods[3]							
Volume		+ 2.9	+12.5	+ 3.2	+ 6.8	+ 9.0	+ 6.5
Value		+ 1.9	+13,9	+ 5.4	+ 9.5	+10.6	+ 7.5
Imports of goods[3]							
Volume		+ 6.0	+11.7	+ 2.8	+ 3.8	+ 8.4	+ 6.2
Value		+ 5.0	+12.5	+ 5.9	+ 8.0	+ 9.5	+ 7.5
Current balance	billion €	–	+ 3.99	+ 5.16	+ 8.23	+ 9.47	+ 10.46
As a percentage of GDP		–	+ 1.7	+ 2.1	+ 3.2	+ 3.5	+ 3.7
Long-term interest rate[4]	in percent	4.2	4.2	3.4	3.8	4.3	4.5
Consumer prices		+ 1.3	+ 2.1	+ 2.3	+ 1.5	+ 1.9	+ 2.0
Unemployment rate							
Eurostat definition[5]	in percent	4.3	4.8	5.2	4.8	4.3	4.2
National definition[6]	in percent	7.0	7.1	7.3	6.8	6.3	6.2
Persons in active dependent employment[7]		+ 0.2	+ 0.7	+ 1.0	+ 1.7	+ 1.9	+ 0.9
General government financial balance according to Maastricht definition							
As a percentage of GDP		– 1.6	– 1.2	– 1.6	– 1.1	– 0.4	– 0.5

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 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.

In the EU, first signs of the impact of the international financial crisis have already become visible:

- Several European banks are directly hit by the crisis in US mortgage financing.
- The dollar has come under significant downward pressure vis-à-vis the euro.
- A correction is under way also on some over-heated European real estate markets, particularly in Spain and Ireland, but also in the UK.
- Due to the weakness of consumer demand, the cyclical upturn in the euro area is lacking a broad base, making it more vulnerable to international shocks.

WIFO expects a slowdown of economic growth in the EU, to an extent currently difficult to predict. The present assumption is for GDP growth of 2.1 percent in volume in 2008 (after +2.9 percent in 2007). For the euro area, growth in 2008 (+1.9 percent) may fall back below the long-term average.

In contrast to past cyclical episodes, it is unlikely this time that lively export and investment activity will give rise to a boom in private consumption. Private household demand is falling markedly short of its momentum observed between 1998 and 2000. It is expected to edge up by only 1.9 percent in volume this year, below its long-term average already for the seventh year in a row (in 2000, the last year of a cyclical high, the increase amounted to 3.9 percent). Among the reasons for the spending restraint, sluggish private income growth stands out. While gross national income is growing rapidly, per-capita income of workers and employees is gaining only 2.6 percent in 2007. After taxes and adjusted for inflation, net real incomes are unchanged from last year. If private disposable income is nevertheless growing by 2 percent in real terms, this is entirely due to higher employment and a strong rise in property incomes. No substantial gain can be expected for 2008 either. Assuming an increase in gross nominal income per capita by 3 percent, slightly accelerating inflation (+2 percent) and somewhat higher deductions will leave a marginal 0.3 percent advance in real disposable per-capita income. Therefore, the scope for an increase in private consumption remains limited in 2008 (+2.1 percent in volume).

The strong economic growth will lead to a sizeable increase in the number of people employed, by 60,000 on annual average in 2007. Owing to the boom in manufacturing industry and construction, the gains are not confined to part-time jobs, but also extend to full-time jobs. Against this background, the decline in unemployment by 15,000 (or 20,000 when participants in job training activities are included) is disappointingly small. Particularly the long-term unemployed hardly benefit from the cyclical boom, and also for young job-seekers the situation has improved little so far. The number of jobs held by foreign workers, however, is rising swiftly, whether from western, southern or eastern Europe. In 2008, the fall in unemployment will decelerate further as growth slows down, to an average jobless rate of 4.2 percent of the labour force. If unemployment does not sufficiently diminish even in times of buoyant activity, the prospects for further substantial inroads in the years to come do not appear favourable. A genuine improvement in the labour market situation over the medium term will only be achieved by means of a coherent strategy for growth and job creation on the basis of a broad array of policy measures.

The current favourable business cycle situation is confirmed by strong increases in government revenues from corporate tax, wage tax and social security contributions. As a result, the general government deficit will narrow further, possibly to a ratio of 0.4 percent of GDP. In 2008, progress towards a balanced budget is unlikely to continue, because of the less benign cyclical outlook as well as of policy decisions on a number of additional expenditures.

The lack of a rebound in consumer demand and the repercussions of the crisis on international financial markets will dampen the cyclical upswing earlier than hoped for. GDP growth in Austria is projected to decelerate markedly in 2008, even if it should stay above the euro area average. A further reduction of unemployment as well as of the government deficit is unlikely to occur.

The cyclical slowdown may turn out more severe than assumed in this central projection, notably in case of a further weakening of the external economic conditions. The major potential risks derive from a continued appreciation of the euro, a slump in real estate prices in a number of EU countries, and from the US economy slipping into a recession.

Strong global expansion to lose some momentum

The world economy is currently in its fifth year of strong expansion. WIFO expects global output to gain some 5 percent in volume and world trade around 7 percent on annual average 2007. Next year, growth is likely to slow down only mildly. The persistently strong expansion in China is a key driver of global growth. According to official sources, China's real GDP rose by a swift 11.5 percent year-on-year in the first half of 2007, fuelled by booming exports and investment. The momentum of growth continues to exceed expectations of international observers as well as government plans. The measures taken to dampen business activity have so far had little effect. The acceleration in the rise of costs of living, swiftly widening income disparities and deteriorating environmental conditions are all clear signs of cyclical overheating.

The strong expansion in China has a strong pulling effect on the rest of the world. Merchandise imports are set to rise by about 17 percent in volume this year, benefiting in particular the neighbouring economies in the Far East. Even in Japan, real GDP growth has picked up to around 2 percent p.a. in the last years under the impact of lively external demand, although private consumption remains lacklustre and the risk of deflation remains.

Asia is the growth hub of the world economy, but activity has accelerated also in Latin America, Africa and Europe. The downturn in the USA and the crisis on financial markets will put a brake on the pace of expansion.

Table 2: World economy

		2003	2004	2005	2006	2007	2008
		Percentage changes from previous year					
Real GDP							
World total		+ 4.0	+ 5.3	+ 4.9	+ 5.4	+ 5.1	+ 4.8
Total OECD		+ 1.9	+ 3.2	+ 2.5	+ 3.0	+ 2.6	+ 2.3
USA		+ 2.5	+ 3.9	+ 3.2	+ 2.9	+ 1.9	+ 1.8
Japan		+ 1.4	+ 2.7	+ 1.9	+ 2.2	+ 1.8	+ 2.0
EU 27		+ 1.3	+ 2.5	+ 1.8	+ 3.0	+ 2.9	+ 2.1
EU 15		+ 1.1	+ 2.3	+ 1.6	+ 2.8	+ 2.7	+ 1.9
Euro area		+ 0.8	+ 2.0	+ 1.5	+ 2.8	+ 2.7	+ 1.9
New member countries[1]		+ 4.1	+ 5.5	+ 4.7	+ 6.2	+ 5.5	+ 5.2
China		+10.0	+10.1	+10.2	+10.7	+11.0	+10.0
World trade, volume		+ 5.3	+10.3	+ 7.2	+ 8.9	+ 7.05	+ 7.0
Market growth[2]		+ 5.4	+ 9.1	+ 7.4	+10.3	+ 8.5	+ 6.3
Primary commodity prices							
HWWA index, total		– 4	+18	+29	+19	+ 1	+ 3
Excluding energy		– 6	+18	+ 6	+22	+ 9	+ 0
Crude oil prices							
Average import price (cif) for OECD countries	$ per barrel	28.4	36.3	50.6	61.1	64.0	69.0
Exchange rate							
$ per euro		1.131	1.243	1.245	1.256	1.35	1.40

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.

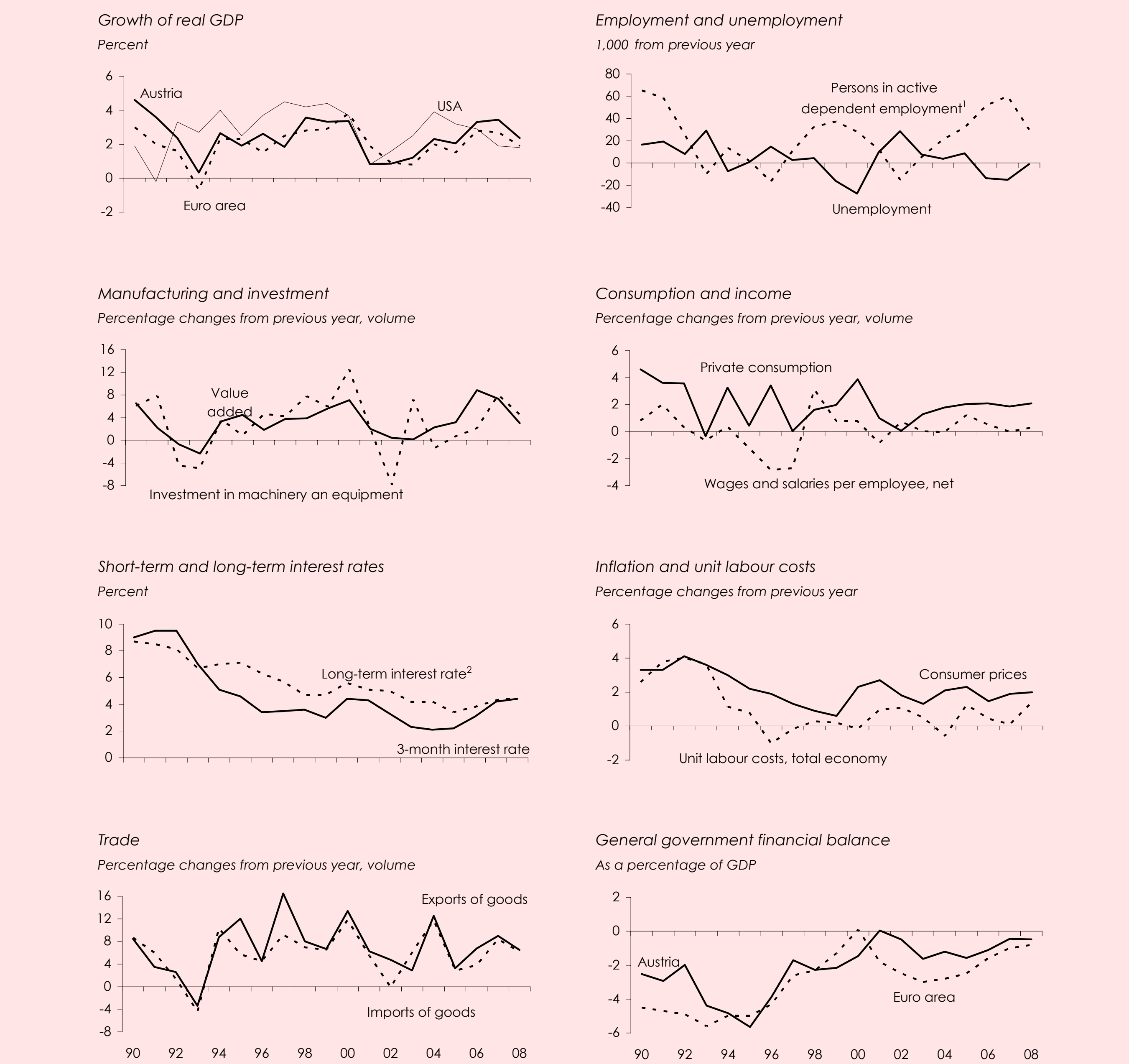
Global economic growth is supported not only by the rapid expansion in Asia, but also by strong gains in the OPEC countries benefiting from high oil prices, in Latin America and even in Africa. The recent turbulences on international financial markets and the cyclical slowdown in the USA are hitting the world economy in a period of relatively stable and solid growth.

Scope of the financial market crisis still uncertain

The crisis on US real estate markets has spread quickly as from mid-July 2007 to other parts of the financial system. In August a liquidity crisis broke not only in the USA, but also in Europe and Asia, prompting the central banks to massive interventions. Particularly in the USA, however, the problem is not confined to a shortage of liquidity, as in many economic sectors the number of insolvencies has risen significantly. In the first instance affected are private households which can no longer honour their home loan obligations, subsequently mortgage institutions and construction firms, and finally hedge funds and private equity funds. Credit markets have come under severe pressure worldwide, and risk premia for corporate loans have risen considerably. The marked increase in uncertainty and less favourable financing conditions may have induced many firms to postpone planned investment projects.

Stock markets reacted with sometimes heavy daily volatility. Overall, stock market corrections have so far been rather limited, although confidence has been undermined more permanently. Any substantial repercussions on the real economy in the USA or major solvency problems with banks and investment funds could trigger further falls in share prices.

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 crisis in the subprime segment of the US real estate market has spread quickly to other parts of international financial markets, with liquidity and solvency problems emerging. The extent and duration of the crisis are difficult to assess at present.

The impact of the crisis has been comparatively stronger on foreign exchange markets. The marked slowdown of business activity in the USA, the persistently high current account deficit and the quick interest rate moves by the Federal Reserve have led to a sizeable depreciation of the dollar against the euro. In the months to come, the dollar may lose further ground and weigh heavily on demand and output growth in the euro area. For the purpose of the present projections, WIFO has assumed an exchange rate of $ 1.40 per € on annual average 2008. A further euro appreciation by 10 percent is expected to dampen GDP growth in the euro area by roughly ¼ percentage point.

Danger of recession looming in the USA

Growth in the USA had decelerated noticeably already before the onset of the financial market crisis. Real GDP in the first half of 2007 rose by only 1.7 percent year-on-year. Residential investment was the major element holding back growth, being down 20 percent in volume in the second quarter from its peak of end-2005. In August, building permits and housing starts were more than one-third below their respective highs. The deep recession in residential construction has major repercussions on supplier industries (like timber or brick). Real estate prices have been on a downward trend only since last spring. From 2000 they have moved up by more than 70 percent, offering a large potential for a downward correction.

As expected by WIFO, US GDP growth has slowed markedly, so far mainly due to a sharp downturn in residential investment. Should the crisis spread to demand by private households, the US economy risks slipping into a recession.

The share of residential construction in GDP is just below 5 percent. Thus, problems within the sector become relevant for the overall economy only if worsening conditions for mortgage financing and falling real estate prices have a knock-on effect on private household spending which accounts for 70 percent of GDP. Consumer demand in the second quarter edged up by a mere 0.4 percent (adjusted for inflation and for seasonal variations) from the previous period and by 2.9 percent from the year-earlier level. Consumer confidence has weakened noticeably of late, although there are no signs as yet of a slump in actual demand. Sentiment is also undermined by the downward trend on the labour market. Employment growth slackened markedly already in June and July and levelled off in August. Apart from job cuts in the construction industry, lay-offs are mounting also in the financial sector.

Investment in machinery and equipment, a crucial factor for the momentum of activity, reached a peak in early 2006, but has slackened since, to a year-on-year increase by 4 percent in volume in the second quarter 2007. Industrial output is also progressing at only a moderate pace.

Already at the occasion of the last revisions to the projections WIFO foresaw a marked slowdown of the US business cycle. Annual GDP growth will fall below 2 percent this year and is unlikely to accelerate in 2008. This projection implies that residential investment will continue to fall over the next few quarters, an assumption confirmed by the decline in real estate values. At the same time, the projection rules out a steep fall in either stock market or real estate values. In such an environment it is reasonable to assume a sustained, but moderate increase in private consumption of close to 2 percent. While the US economy is not expected to slip into recession in the sense of a quarter-on-quarter fall in GDP over two subsequent periods, such an event cannot be entirely excluded. As witnessed by the slow pace of construction and consumer demand, the economy has probably shifted into lower gear also in a medium-term perspective. Nevertheless, the timely cut in interest rates by the Federal Reserve and the depreciation of the dollar should have an expansionary impact.

Moderate growth in the euro area

Growth in the euro area in the second quarter fell markedly short of expectations. Real GDP edged up by only 0.3 percent quarter-on-quarter on a seasonally adjusted basis (+2.5 percent from one year ago). This figure reflects neither the impact of the growth slowdown in the USA nor the turmoil on international financial markets, but was rather the outcome of weak internal demand. In the construction sector, the unusually mild winter allowed works to resume as from the first quarter, a factor that dampened seasonally-adjusted growth in the subsequent period. But consumer demand also turned out lower than anticipated, despite a noticeable rebound in consumer confidence. Private household spending in the second quarter 2007 gained 0.5 percent in volume from the previous period and 1.5 percent year-on-year. Consumer confidence has picked up steadily from its trough at the beginning of 2003, up to a peak in May 2007. The balance of positive over negative responses nevertheless remained clearly below the level recorded during the boom in 2000. Since May, consumer sentiment has tentatively weakened, largely due to rising scepticism about the medium-term outlook.

Internal demand in the euro area is sluggish, which makes the overall performance vulnerable to external shocks.

Industrial activity, for its part, remains robust. While it may have passed its peak last summer, both output and business confidence still exceeds the respective long-term benchmarks by a comfortable margin. Output in July was 4 percent higher than one year ago. Firms are still optimistic in judging the current business situation, although output expectations for the next few months have moderated somewhat in July and August.

Due to the strong export performance, the situation as well as business sentiment is clearly better in the German manufacturing industry than in France or Italy. Industrial output in Germany in mid-2007 was 20 percent above the level of 2000, a result topped by only a few smaller countries (Austria +30 percent). In the other larger countries, developments in manufacturing were rather unfavourable: in France, production was up by only 5 percent and in Italy no higher than in 2000.

The euro area economy is expected to expand by an inflation-adjusted 2.7 percent in 2007, broadly the same rate as last year. While the pace is distinctly faster than during the period from 2001 to 2005, one should not consider the present episode as a cyclical boom, notably because the upturn is lacking a broad base, which makes it vulnerable to external shocks. Already in 2008, activity is projected to decelerate under the impact of slower growth in the USA and the appreciation of the euro. The profile of the slowdown is difficult to anticipate; the WIFO projection is for euro area GDP growth of 1.9 percent.

Cyclical improvement of labour markets and public finances in the euro area

Since GDP growth has been moving above the threshold of 2 percent p.a., labour markets in the euro area have started improving, supported also by a number of reforms. The unemployment rate has been on a downward trend since the middle of 2005. On annual average 2007, it may drop below 7 percent, a decline by almost 1 percentage point from last year. The fall is particularly strong in Germany, where the withdrawal of discouraged jobseekers from the labour force plays a major role. Despite the relatively strong increase in overall employment and the fall in unemployment, upward pressure on wages is largely absent, with per-capita earnings in the euro area in the first half of 2007 up by only 2¼ percent in nominal terms from last year. While the stagnation in real wages is holding inflation down, it is also a major factor behind the sluggishness of consumer demand.

Employment and tax revenues are boosted this year by the lively growth of GDP.

Stronger economic growth is boosting government revenues. The narrowing of the general government deficit in the euro area is thus mainly a result of the business cycle high. On aggregate for the area, the deficit will abate below 1 percent of GDP this year, down from 2.5 percent in 2005. Deficits in excess of 2 percent of GDP are still recorded only in Portugal, Greece, France and Italy. Germany may expect a general government account in small surplus in 2007, partly brought about by the increase in the standard VAT rate. In 2008, public finance developments in the euro area will largely be shaped by the strength of economic growth. Sizeable tax cuts in France may drive the national budget deficit up to 3 percent of GDP.

Inflation in the euro area may edge up somewhat in the second half of 2007. Given the jump in oil prices on world markets since the beginning of the year, the significant impact of the VAT raise in Germany (+0.3 percentage point) and the buoyant activity it is remarkable that headline inflation will remain slightly below 2 percent on annual average. The main reason for the high degree of price stability is the virtual stagnation of unit labour costs. In 2005, the European Central Bank started to raise short-term interest rates, to prevent inflation from rising above an annual rate of 2 percent. The refinancing rate doubled to a rate of 4 percent. WIFO assumes money market rates to remain stable on annual average. For the time being, the high uncertainty prevailing on financial markets is calling for a cautious stance in monetary management. The appreciation of the euro and the expected slowdown of GDP growth will further reduce upward pressure on interest rates.

Real estate and banking crisis in the EU?

Similar to developments in the USA, real estate prices have drifted up strongly in recent years also in several EU countries. Indeed, in Ireland, the UK, the Netherlands and Spain the rise was even steeper than in North America. The higher valuation of real estate assets generated expansionary effects for the construction industry and for demand by private households. Such price booms have proved unsustainable already in the past. In subsequent periods of sometimes sharp downward correction, real economic activity has been undermined to a significant degree.

Also in the EU, inflation on real estate markets has slowed or even turned around over the last few quarters, driven, i.a., by rising mortgage rates and emerging excess capacity, such as in Spain. A substantial correction appears likely. Independent from whether the "landing" turns out to be "hard" or "soft", the growth stimulus to construction and private consumption deriving from house prices will be lacking in the years to come in the countries concerned. In several other countries, such as Germany and Austria, an expansionary impulse from rising real estate values has been absent in the last few years.

Also in several EU countries, speculative bubbles on real estate markets are due for correction. This will dampen construction and consumer demand, and thus overall economic growth. Several banks have shown to be badly prepared for a crisis on financial markets.

Several banks in Germany and the UK could be rescued from insolvency only with the help of state guarantees or from partner institutions. Behind these difficulties was the drying-up of money markets, but also speculation fuelled by new financial instruments.

Lively growth in Austria set to slow down

Like last year, Austria's economy is growing by close to 3½ percent, driven by the export-oriented manufacturing industries. Investment is strong, as regards both construction as well as machinery and equipment. Growth of private consumption is clearly lagging behind the overall pace of activity.

The Austrian economy is growing by 3.4 percent in volume this year, at virtually the same pace as in 2006 (+3.3 percent), but above its medium-term growth potential estimated by WIFO at between 2½ percent and 3 percent. Activity, notably in manufacturing industry, continues to receive strong stimulus from goods exports, rising by 9 percent in real terms year-on-year. The business cycle has taken an important step forward only towards the end of 2006 when investment took on a major role. Corporate spending on machinery and equipment is going up by 8 percent in volume this year, somewhat less strongly than during the cyclical upswing between 1997 and 2000.

Because of the lively building activity for manufacturing industry as well as the solid demand for new homes, construction investment is also expanding rapidly this year (+5 percent in volume), considerably faster than in the last boom period.

The increases in wages and in private consumption are lagging clearly behind their respective profiles during the cyclical high of the late 1990s. Private households increase their spending only by an inflation-adjusted 1.9 percent. In particular the stagnation in net real incomes per head is weighing on household disposable income.

Table 3: Productivity

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year					
Total economy						
Real GDP	+ 1.2	+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.4
Employment[1]	– 0.0	+ 0.2	+ 0.8	+ 1.2	+ 0.9	+ 0.7
Productivity (GDP per employment)	+ 1.3	+ 2.2	+ 1.2	+ 2.1	+ 2.5	+ 1.7
Manufacturing						
Production[2]	+ 0.2	+ 2.3	+ 3.2	+ 8.8	+ 7.3	+ 3.0
Employees[3]	– 1.7	– 0.6	– 0.8	+ 0.2	+ 1.5	– 0.7
Productivity per hour	+ 1.5	+ 2.1	+ 4.6	+ 8.4	+ 5.8	+ 4.2
Working hours per day per employee[4]	+ 0.3	+ 0.8	– 0.6	+ 0.2	– 0.1	– 0.5

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.

2008 is likely to see a deceleration in economic growth. First, the external environment is clouding as activity in the USA slackens and also the upswing in the euro area is losing steam. Second, because of the persistent weakness of private consumption domestic demand cannot take over the role as a growth driver it normally plays in a cyclical boom period. Nevertheless, the profile of the slowdown is difficult to predict at the present stage. The WIFO projection is for GDP growth of 2.4 percent in 2008.

Export industry stepping up investment substantially

The driving forces behind the upswing should have extended from exports towards business fixed investment. The outward-oriented sector of the Austrian economy demonstrates its strong competitiveness and performance.

Goods exports provided strong stimulus to overall business activity also during the first half of 2007, with export values rising 10 percent above the year-earlier level. Demand from the euro area and in particular from the main trading partner Germany, but also from the 12 new EU countries, from Southeast Europe and the oil-exporting countries was unabated, whereas deliveries to the USA and the UK levelled off. Austrian exporters are benefiting from the lively demand for investment goods and manufactures. For the whole year, exports are projected to increase by 9 percent in volume, abating to +6.5 percent in 2008 in view of the slower growth of foreign markets.

Booming exports are giving incentives to manufacturing output, with net value added rising by 8½ percent from last year in the first six months of 2007. With such strong gains in production, the number of jobs is going up as well – an unusual feature in the industrial sector characterised by strong productivity gains. Firms taken by surprise by such developments are facing shortages of qualified labour.

The results from the regular WIFO business survey confirm the positive sentiment in the manufacturing sector until last summer. Output expectations and the opinions on the further business outlook are stable at a high level, and only order levels have been judged somewhat less positive in recent months after the extraordinary high ratings last spring. Companies report a satisfactory degree of capacity utilisation and expect no change for the months to come. The positive sentiment in the manufacturing sector warrants the assumption that output growth will abate only gradually until the end of the year from the strong pace observed in the first six months. For 2007 as a whole this would imply an increase by 7.3 percent in volume from last year.

High capacity utilisation, strong growth of corporate earnings and confidence about further sales prospects induce firms to invest massively in new machinery and equipment this year. According to the WIFO investment survey of spring 2007, plans for capacity-enhancing capital formation have been strongly revised upwards. Some 75 percent of all investment goods are traditionally imported. Yet, official foreign trade data for the first semester do not show a strong increase of imports for this category. WIFO assumes that Statistics Austria will substantially revise upwards the data for merchandise imports in the coming months.

In spite of the boom in export industries there are indications that the business cycle may have passed its peak. According to preliminary national accounts data, the growth of value added in manufacturing moderated to a seasonally-adjusted 1.5 percent into the second quarter, compared with +2.5 percent in the fourth quarter 2006. Forward-looking expectations expressed in the context of the WIFO business survey are slightly heading downwards. Uncertainty about the repercussions of the financial market crisis and deteriorating financing conditions may prompt companies in the euro area to postpone planned investment projects. WIFO therefore expects manufacturing output to lose steam in 2008, to a projected growth of real value added of around 3 percent.

Rise in imports underestimated

Merchandise imports in the first half of 2007 were less lively than buoyant domestic corporate investment would have suggested. Moreover, spending on foreign travel by Austrian residents dropped markedly. Both figures are likely to be corrected upwards ex-post.

Nominal imports of goods rose by only 7¾ percent year-on-year in the first semester 2007, significantly less than strong industrial output growth and lively investment would have suggested. Sluggish consumer demand, particularly for motor cars, is weighing on overall import growth. For the year as a whole, WIFO expects merchandise imports to gain 8½ percent at constant prices, making for a further increase in the foreign trade surplus.

Recent data on imports of tourism services for the first half of 2007, showing a fall in spending by Austrian residents abroad, are also believed to be distorted downwards. Such an apparent fall seems unlikely, given the favourable business cycle situation. For the whole year 2007, WIFO expects an increase by 1.9 percent in real terms. Tourism exports are expected to go up at a similar rate. Foreign visitors privilege the major cities in Austria, with demand notably from Russia and Asia expanding strongly.

Sluggish income growth weighing on private consumption

Demand by private households remains disappointing in 2007. Spending in the second quarter, adjusted for inflation, edged up by 0.4 percent from the previous period and was 1.6 percent higher than one year ago. On annual average, volume growth is expected at 1.9 percent, implying an undershooting of the long-term trend for the seventh year in a row. With private consumption being the largest component of aggregate demand, this also has a strong dampening effect on GDP growth. As long as consumption does not stage a vigorous rebound, the current episode cannot be considered as a cyclical high. In 2000, the last year of cyclical boom, private consumption recorded an increase by 3.9 percent in volume (albeit additionally boosted by cuts in direct taxes).

Growth of consumer demand continues to fall short of its long-term benchmarks.

The current weakness of household demand has several reasons. A major factor is sluggish income growth. Private disposable income is expected to gain only 2.0 percent in volume this year, compared with +3.4 percent in 2000. Per-capita income per employee (not adjusted for hours worked) is rising by 2.6 percent in gross terms, leaving no increase on a net basis (2000 +0.8 percent). Household income is therefore boosted primarily via higher employment. A more unequal distribution of incomes and an increase in individual provisions for income in retirement contribute towards an increase in the household saving ratio. The latter is projected at 10 percent of disposable income for 2007, rising steadily since 2001.

Table 4: Private consumption, income and prices

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.3	+ 1.8	+ 2.0	+ 2.1	+ 1.9	+ 2.1
Durables	+ 3.8	+ 4.0	+ 2.5	+ 1.9	+ 2.8	+ 3.2
Non-durables and services	+ 1.0	+ 1.5	+ 2.0	+ 2.1	+ 1.8	+ 2.0
Household disposable income	+ 2.2	+ 1.9	+ 2.6	+ 2.7	+ 2.0	+ 1.9
	As a percentage of disposable income					
Household saving ratio	8.7	8.9	9.3	9.7	9.9	9.8
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+ 1.6	+ 5.0	+ 4.7	+ 4.5	+ 2.8	+ 3.8
	Percentage changes from previous year					
Inflation rate						
National	1.3	2.1	2.3	1.5	1.9	2.0
Harmonised	1.3	2.0	2.1	1.7	1.9	2.0
Core inflation[2]	1.3	1.6	1.5	1.3	1.8	1.9

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

For 2008, only a tentative pick-up in consumer demand may be expected. Although WIFO expects income per employee (unadjusted for hours worked) to rise slightly faster than this year (+3 percent compared with +2.6 percent), net real income gains will be only marginal (+0.3 percent). Moreover, employment growth will lose some momentum with the projected cyclical slowdown. Thus, even assuming a slight decline in the household saving ratio, there will be little leeway for stronger consumption growth.

Weak consumer demand is mainly felt in retail trade. Sales in the first six months were only 1.8 percent higher, when adjusted for inflation, than one year ago. Sales of motor cars (including turnover of petrol stations) edged up by a mere 0.1 percent. Demand for passenger cars remains subdued, as confirmed by the data on new car registrations (–2.8 percent in the first semester). The persistently lacklustre demand for motor cars is in stark contrast with the strength of consumer confidence. The latter refers, however, primarily to the general economic situation, while individual income expectations remain subdued.

Table 5: Earnings and international competitiveness

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year					
Gross earnings per employee[1]	+ 1.9	+ 1.8	+ 2.3	+ 2.7	+ 2.6	+ 3.0
Gross real earnings per employee[1]	+ 0.3	– 0.0	+ 0.6	+ 1.1	+ 0.7	+ 1.0
Net real earnings per employee[1]	+ 0.0	– 0.0	+ 1.2	+ 0.5	± 0.0	+ 0.3
Total economy						
Unit labour costs	+ 0.5	– 0.6	+ 1.2	+ 0.4	+ 0.1	+ 1.4
Manufacturing						
Unit labour costs	+ 1.2	– 0.7	± 0.0	– 4.2	– 2.8	– 0.4
Relative unit labour costs[2]						
Vis-à-vis trading partners	+ 4.4	+ 1.7	+ 1.5	– 1.9	– 1.7	– 1.2
Vis-à-vis Germany	+ 2.5	+ 2.2	+ 4.4	– 0.2	± 0.0	– 0.9
Effective exchange rate, manufactures						
Nominal	+ 4.3	+ 1.5	– 0.6	+ 0.2	+ 1.0	+ 0.6
Real	+ 3.4	+ 1.1	– 0.9	– 0.5	+ 0.6	+ 0.5

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

Strong investment in new construction

Construction activity is currently much stronger than during the last cyclical boom from 1998 to 2000. Major support comes from publicly financed investment in civil engineering and residential building.

Since 2006, construction output and investment has been expanding much faster than in the years before and also more strongly than during the boom period from 1998 to 2000. For the current year, WIFO expects an increase in the sector's value added by 4.5 percent in volume. A major contribution comes from lively industrial and commercial building which benefits from higher investment in machinery. Demand for new homes remains strong due to unabated immigration flows. Civil engineering, for its part, is stimulated by investment in new infrastructure. The swift growth of construction output is accompanied by lively job creation, with employment in the period from January to August rising by 4 percent year-on-year.

In the regular WIFO business survey, construction firms recently reported a slackening of new orders and were more cautious in their output expectations for the next few months. Output growth may therefore decelerate to around 3 percent on annual average 2008.

No further decline in unemployment in 2008

Developments this year illustrate once again the close connection that exists between economic growth and employment. The strong increase in output is leading to a massive rise in the number of people in dependent active employment (since January +28,000 seasonally adjusted). For the whole year 2007, 60,000 (+1.9 percent) new jobs will be created on a net basis. Thanks to buoyant activity in manufacturing and construction, also the number of full-time jobs is now increasing markedly, after it had fallen by almost 60,000 between 2000 and 2005. In both sectors taken together, some 17,000 more people are being employed this year than last. The particularly strong job growth in the metal industry confirms the remarkable export performance of Austrian firms. At the same time, many of the jobs newly created are being filled by personnel service agencies and are thus formally classified in the service sector.

While employment continues to grow strongly, the number of new entrants to the labour force is keeping pace. The chances of low qualified (long-term) unemployed to find a job among those newly created are poor.

Around one-third of the new jobs is accounted for by foreign workers newly entering the Austrian labour market. While the increase is particularly strong for nationals from the EU 15, also those from the new EU countries are posting strong gains, notwithstanding the existing legal restrictions on their access to the domestic labour market. Only one out of ten foreigners taking on a job in Austria is recruited from the pool of registered unemployed.

Overall, only one-third of the jobs newly created are being taken by people formerly unemployed. In spite of the strong employment growth the decline in unemployment has clearly lost momentum since the beginning of the year and is disappointingly slow. For the whole of 2007, the number of jobseekers is falling by an average 15,000 year-on-year (including people in job training –20,000). The cyclical upswing has a direct positive impact on the job opportunities of short-term unemployed. For young entrants to the labour force, older and low-qualified people, the situation would only improve if job training and qualification measures as well as subsidies to facilitate the insertion of people into the labour force were reinforced. If inroads into unemployment cannot be achieved in times of cyclical upturn, the further outlook on the labour market would appear gloomy. For the average of 2007, WIFO expects a total of 224,000 people unemployed, corresponding to a ratio of 6.3 percent of the dependent labour force (national definition) or 4.3 percent of the total labour force (according to the EU Labour Force Survey).

Table 6: Labour market

		2003	2004	2005	2006	2007	2008
		Changes from previous year, in 1,000					
Demand for labour							
Persons in active employment[1]		+ 8.5	+ 25.1	+ 37.2	+ 55.9	+ 65.0	+ 34.5
Employees[2]		+ 5.5	+ 21.1	+ 31.9	+ 51.5	+ 60.0	+ 30.0
Percentage changes from previous year		*+ 0.2*	*+ 0.7*	*+ 1.0*	*+ 1.7*	*+ 1.9*	*+ 0.9*
Nationals		– 10.4	+ 9.2	+ 20.0	+ 35.0	+ 41.2	+ 19.3
Foreign workers		+ 15.9	+ 11.9	+ 11.9	+ 16.5	+ 18.8	+ 10.7
Self-employed[3]		+ 3.0	+ 4.0	+ 5.3	+ 4.4	+ 5.0	+ 4.5
Labour supply							
Population of working age	15 to 64 years	+ 37.7	+ 34.4	+ 15.6	+ 18.5	+ 22.9	+ 25.8
	15 to 59 years	+ 21.2	+ 35.6	+ 48.5	+ 52.8	+ 24.3	+ 16.1
Labour force[4]		+ 16.1	+ 28.9	+ 45.9	+ 42.4	+ 50.0	+ 33.5
Surplus of labour							
Registered unemployed[5]		+ 7.7	+ 3.8	+ 8.8	– 13.5	– 15.0	– 1.0
In 1,000		240.1	243.9	252.7	239.2	224.2	223.2
		Percent					
Unemployment rate							
Eurostat definition[6]		4.3	4.8	5.2	4.8	4.3	4.2
As a percentage of total labour force[5]		6.3	6.4	6.5	6.1	5.7	5.6
National definition[5, 7]		7.0	7.1	7.3	6.8	6.3	6.2
Employment rate							
Persons in active employment[1, 8]		62.2	62.3	62.8	63.6	64.5	64.8
Total employment[6, 8, 9]		–	67.8	68.6	70.2	70.8	70.9

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.

In 2008, unemployment is unlikely to recede much further, the jobless rate remains at 4.2 percent of the total labour force. Due to slower GDP growth, the increase in employment will diminish to 30,000 (+0.9 percent). Accession to the labour force will be unabated, and nearly half of the jobs newly created may be filled by foreigners (including such with specific qualifications, for whom restrictions to accede to the Austrian labour market have been relaxed).

Inflation accelerating slightly

Price increases for energy and food induce WIFO to revise the forecast for inflation upwards. At a projected headline rate around 2 percent, a high degree of price stability is nevertheless preserved.

In 2006 and 2007, inflation has hardly gained momentum, despite the strength of economic activity. The effective appreciation of the euro put a lid on import prices, while lean wage gains held back the rise in unit labour cost. For the current year, WIFO expects the annual inflation rate (national definition) at 1.9 percent. Most recently, food prices drifted up faster than anticipated last summer. Strong demand for corn and food on world markets entailed also an increase in domestic prices of unprocessed food. The price push will be passed on to processed food items in the months to come, with a knock-on effect on headline inflation. WIFO projects an increase in consumer prices by 2.0 percent on annual average 2008. The EU Harmonised Index of Consumer Prices (HICP) is also expected to go up by 2 percent.

Low budget deficit

Strong economic growth also alleviates public finances substantially this year. High corporate earnings are boosting revenues from corporate tax and capital tax on dividends. Employment growth is generating additional revenues from wage tax and social security contributions. Although expenditure is also somewhat above the budgetary target, the general government balance will turn out significantly better than assumed last spring at the time the federal budget was drafted. WIFO expects for the current year a government deficit (according to Maastricht definitions) equivalent to 0.4 percent of GDP. In line with a counter-cyclical stance of fiscal policy, the higher tax revenues should primarily be used for a lowering of the deficit. At the same time it will be important to create budgetary leeway for the early implementation of investment projects deemed crucial for further growth. Adherence to the government plans for general expenditure restraint can make a contribution to this end.

Strong profits and growing employment are boosting government revenues above budgetary targets.

Table 7: Key policy indicators

	2003	2004	2005	2006	2007	2008
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	−1.6	−1.2	−1.6	−1.1	−0.4	−0.5
According to National Accounts	−1.8	−1.3	−1.7	−1.2	−0.5	−0.6
General government primary balance	+1.3	+1.6	+1.3	+1.6	+2.3	+2.2
	Percent					
Monetary policy						
3-month interest rate	2.3	2.1	2.2	3.1	4.1	4.4
Long-term interest rate[1]	4.2	4.2	3.4	3.8	4.3	4.5
	Percentage changes from previous year					
Effective exchange rate						
Nominal	+4.3	+1.5	−0.7	+0.2	+1.0	+0.6
Real	+3.3	+1.0	−1.0	−0.5	+0.6	+0.5

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

Profit tax revenues should continue to grow strongly next year, given the normal time lag involved between the accrual and assessment of the implicit tax liabilities and payments. Higher wage settlements, coupled with further employment gains, would add to wage tax and social contribution revenues. On the other hand, a number of government decisions will lead to additional expenditure in 2008, such as concerning educational reform, retirement payments or the purchase of military aircraft. WIFO expects the general government deficit for 2008 at around ½ percent of GDP.