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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 is 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.

Table 1: Main results

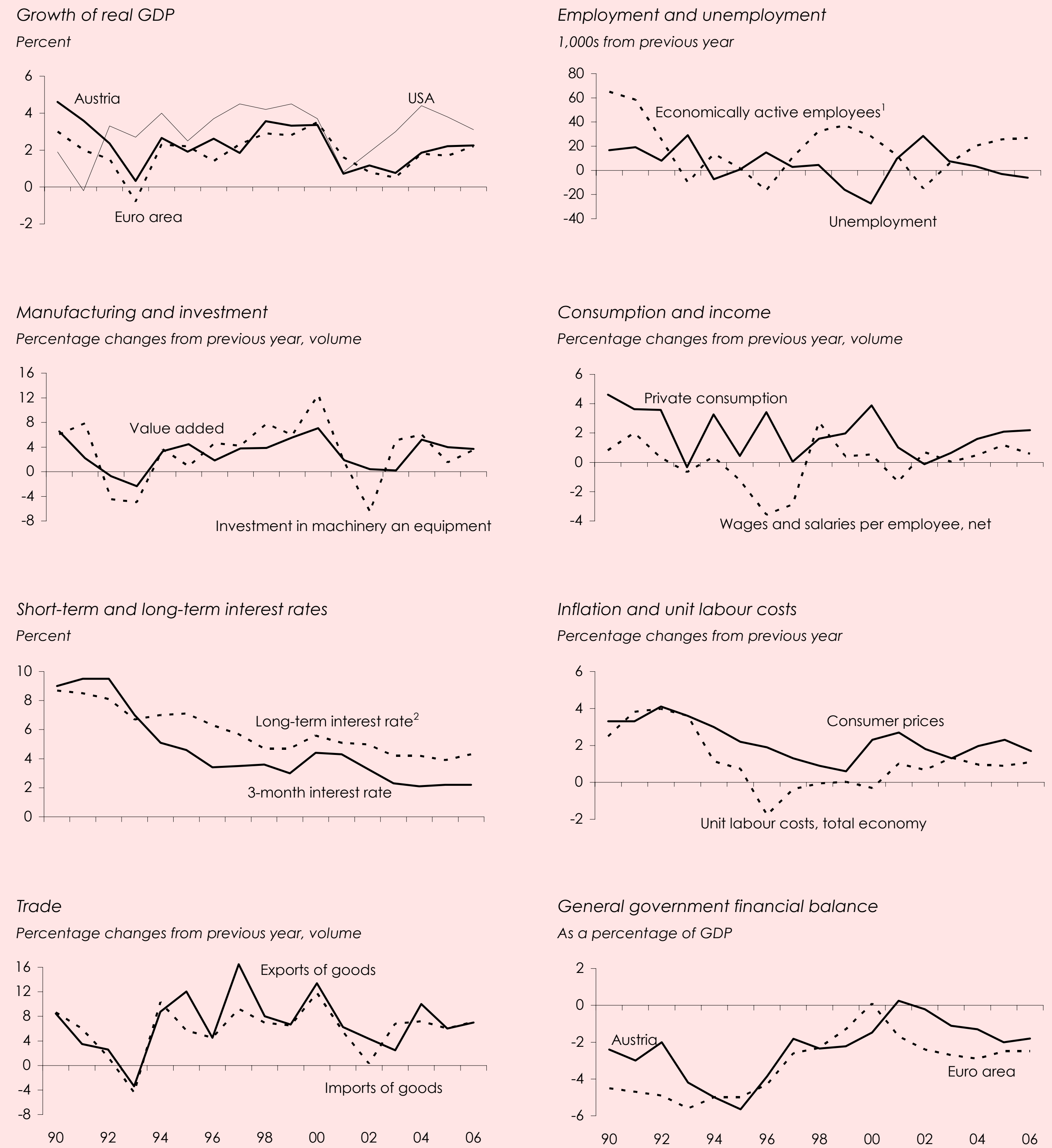
		2001	2002	2003	2004	2005	2006
		Percentage changes from previous year					
GDP							
Volume		+ 0.7	+ 1.2	+ 0.8	+ 1.9	+ 2.2	+ 2.3
Value		+ 2.5	+ 2.5	+ 2.3	+ 3.5	+ 4.5	+ 3.9
Manufacturing[1], volume		+ 2.2	+ 0.5	+ 0.2	+ 5.2	+ 4.0	+ 3.7
Wholesale and retail trade, volume		+ 2.4	+ 2.2	+ 0.4	+ 1.5	+ 2.4	+ 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]	in percent	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							
Eurostat definition[5]	in percent	3.6	4.2	4.3	4.5	4.4	4.2
National definition[6]	in percent	6.1	6.9	7.0	7.1	6.9	6.7
Economically active emplyees[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, as a percentage 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.

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).

Gradual slowdown in US growth

The world economy expanded by 4.2 percent in 2004, the highest rate in the last 1½ decades, and world trade grew by 9 percent. Particularly large contributions came from lively activity in the USA and from the integration of China into the global economy. Buoyancy in these areas provided incentives also to those export-oriented economies where activity in recent years had been depressed by stagnating domestic demand (Japan, Germany).

The swift expansion of the global economy has been accompanied by mounting imbalances: strong demand for crude oil, together with supply disturbances, pushed oil prices up, and the rising US current account deficit has been a major cause for the depreciation of the dollar. This, together with exchange rate volatility, should play a more prominent role in the economic policy debate in Europe and the USA; at the moment, such debate is focused on fiscal restriction in the USA and the possibility of influencing exchange rates rather than on incentives for domestic demand in Europe and Japan.

The US economy grew by 4½ percent in 2004. Investment rose strongly, as did residential construction, and also private consumption posted solid gains. In the year-end quarter, the pace may already have lost momentum and is set to decelerate further in 2005 and 2006. The high deficits in the current account and in public finances suggest that both monetary and fiscal policy will switch from a strongly expansionary towards a more restrictive stance.

The Japanese economy was pulled out of stagnation by lively demand for imports in China and the USA. Real GDP advanced by 4 percent in 2004, considerably faster than in Europe. However, the rise in the yen and the fragility of domestic demand will slow the pace to a projected +2 percent in both 2005 and 2006. Economic dynamism is much stronger in China (+9 percent), India and the "tiger" states in South-east Asia. China's integration into the world economy has been accelerated by the country's membership in WTO. The investment-spurred growth is likely to abate slightly in the coming years, as the government is seeking to dampen the boom in order to avoid overheating and a "hard landing". Yet, such efforts are counteracted by the yuan being tied to the dollar.

Strong euro appreciation holding back the recovery in the euro area

Among the major risks and uncertainties surrounding the present projections are the euro exchange rate and the oil price. In early December, the euro rose to a level of $ 1.33, some 10 percent higher than one year ago. The main reasons for the dollar decline are the high current account deficit of the USA, the stronger momentum of domestic demand compared with the euro area, and portfolio shifts (notably by central banks) from dollar towards euro assets.

The consequences of the strong euro are unfavourable on balance for the euro area economy[1]: exports to the dollar area are facing higher hurdles; moreover, higher costs of establishing or expanding production facilities are detracting from the euro area's attractiveness as a target for investment. At the present juncture, a rebound in investment would indeed be needed in order to generate a self-sustained cyclical upswing.

Imports are becoming cheaper with the upward drift of the euro. Without the currency appreciation, oil and other commodities would have become even more expensive. Also travels to dollar-area destinations (USA, Caribbean, China) are becoming more affordable. Thus, in the short run, consumers and tourists will benefit from the strong euro, until losses in export and employment opportunities bear down on private purchasing power.

Although oil prices came down markedly in the last weeks, they remain an element of uncertainty over the projection period. At $ 39.4 per barrel on annual average 2004, they exceeded the year-earlier level by around 40 percent. This jump has

[1] Schulmeister, S., "Weiterhin kräftiges Wachstum in Asien, Russland und den USA – Deutschland und Japan bleiben Nachzügler. Mittelfristige Prognose der Weltwirtschaft bis 2009", WIFO-Monatsberichte, 2005, 78(1), pp. 35-49, http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=2&pubid=25405.

been weighing on growth in the industrialised countries, particularly in the third quarter, even if second-round effects – wage increases and the pass-through to prices of manufactures – have been more limited this time than in earlier price hike episodes. The WIFO projections are based on the technical assumption of an average oil price of $ 42 per barrel in 2005 and of $ 38 in 2006. Should prices climb to new highs, growth would likely turn out lower than in the baseline scenario.

Table 2: World economy

		2001	2002	2003	2004	2005	2006
		Percentage changes from previous year					
Real GDP							
Total OECD		+ 1.0	+ 1.8	+ 2.1	+ 3.5	+ 2.8	+ 2.6
USA		+ 0.8	+ 1.9	+ 3.0	+ 4.4	+ 3.8	+ 3.1
Japan		+ 0.2	– 0.3	+ 1.3	+ 4.1	+ 2.1	+ 1.8
EU 25		+ 1.7	+ 1.1	+ 0.9	+ 2.2	+ 2.0	+ 2.3
EU 15		+ 1.7	+ 1.0	+ 0.7	+ 2.1	+ 1.9	+ 2.2
Euro area		+ 1.6	+ 0.8	+ 0.5	+ 1.8	+ 1.7	+ 2.2
Germany		+ 0.8	+ 0.1	– 0.1	+ 1.4	+ 1.3	+ 1.6
New member states[1]		+ 2.4	+ 2.4	+ 3.6	+ 5.0	+ 4.6	+ 4.1
China		+ 7.3	+ 8.0	+ 9.1	+ 9.2	+ 8.2	+ 7.2
World trade, volume		+ 0.3	+ 3.3	+ 4.1	+ 9.0	+ 7.2	+ 7.1
Market growth[2]		+ 2.4	+ 1.8	+ 4.4	+ 8.5	+ 6.5	+ 6.5
Primary commodity prices							
HWWA index, total		– 8	– 5	– 4	+25	– 1	– 1
Excluding energy		– 3	– 6	– 6	+19	– 1	+ 6
Crude oil prices							
Average import price (cif) for OECD countries	$ per barrel	23.6	24.1	28.4	39.4	42.0	38.0
Exchange rate							
$ per euro		0.896	0.945	1.131	1.24	1.34	1.28

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.

Interest rate cut may stem the rise in the euro exchange rate

In the face of the strong momentum of economic activity, the US central bank continued to raise policy-controlled interest rates in small steps. For the fourth time since the end of June 2004, it lifted the benchmark rate in December by 25 basis points, to a current level of 2¼ percent. The Fed reiterated its intention to apply further doses of measured monetary restraint in order to pre-empt inflationary pressure. Such concerns would, however, appear less pressing, as growth is expected to decelerate.

The European Central Bank is steering a "steady hand" course. It has left the basic rate unchanged since June 2003. Also in 2005, the ECB is likely to tread carefully, keeping rates at a low level. Should the euro exchange rate rise further, an interest rate cut for the euro area would lend itself as a means to counter-act. The risk of higher inflation appears less of a concern, in view of the strong euro and the calming on oil markets, than the danger of a relapse into stagnation. Inflation risks deriving from insufficient growth of potential output are not considered to be the key problem in Europe, given the massive excess supply of labour.

In spite of the increase in the central bank rate in the USA, long-term interest rates still follow a flat downward trend, keeping within a narrow band around just over 4 percent. The WIFO projections assume a further decline in 2005 and a turnaround only in 2006.

Activity in the euro area to remain disappointing

GDP growth in the euro area accelerated but slightly in 2004, to a rate of 1.8 percent. The sluggishness of the recovery is due to hesitant spending by households and firms, the negative impact of euro appreciation and rising oil prices, and the lack of fiscal stimulus (unlike in the USA and the UK).

Latest developments in the euro area were disappointing, with GDP in the third quarter edging up by a mere 0.3 percent from the previous period. Most likely, the high oil prices were the main reason for the lacklustre activity in autumn.

Even with oil prices stabilising, growth in the euro area is not expected to accelerate, given the continued dampening impact of the strong euro. Only in 2006, GDP growth is expected to exceed 2 percent.

The major cyclical stimulus should shift in the course of 2005 from exports towards internal demand. In a benign scenario, a slackening of activity in the USA and in Asia would then leave the moderate recovery in Europe unabated. However, a smooth translation of the export boom into higher investment and consumer spending is uncertain, constituting a negative risk for the projections.

Consumer restraint in Germany

The strong increase in exports in 2004 boosted GDP growth in Germany to a rate of 1½ percent that exceeded expectations, although the recovery was held back by the slump in construction investment and weak consumer demand. A widespread lack of confidence induces both investors and consumers to step up precautionary saving. Households' willingness to spend is undermined, at least in the short perspective, by the still gloomy labour market situation and uncertainties relating to the reform of social welfare provisions.

In the third quarter, the economy almost fell back into stagnation, due in particular to the oil price increase. For the fourth quarter, leading indicators point to a stabilisation of expectations, as both the ifo business climate index and the ZEW indicator have been heading up.

GDP projections for Germany differ markedly. The DIW Institute in Berlin projects growth at 2 percent for 2005, assuming that the export boom will stimulate domestic demand. The Kiel Institute (IfW), for its part, sees GDP reverting to the path of potential growth around +1 percent in 2005, since the positive calendar effect of 2004 will not recur. Underlying the WIFO projections are growth rates for Germany of around 1½ percent both for 2005 and 2006.

Cyclical recovery in Austria continuing

Business activity in Austria has rebounded since last spring. Real GDP rose by a healthy 0.8 percent in the third quarter from the previous three months (adjusted for seasonal and irregular variations)[2], exceeding the year-earlier level by 2.7 percent. Growth currently appears to be lagging vis-à-vis the euro area by one quarter, as the marked slowdown there in the third quarter has not yet been reflected in the data for Austria. The regular WIFO business survey suggests that the earlier rise in business expectations has levelled off in October and November.

Statistics Austria last autumn has moved to the "chain index" method in computing the national accounts. The WIFO quarterly national accounts and the current projections are based upon the new method[3].

In 2004, the Austrian economy should have grown by nearly 2 percent, slightly above the euro area average. Pulled by strong export orders, manufacturing output gained more than 5 percent. Construction output (+1 percent) was less buoyant, as a large number of projects had been carried forward into 2003. Wholesale and retail trade also posted only modest gains of 1½ percent.

Unlike in previous cycles, the recovery remained subdued. The appreciation of the euro and relatively high oil prices weakened the forward momentum. For 2005, GDP growth in Austria is projected at 2.2 percent. From last September, the forecast has been revised down by ¼ percentage point, mainly on account of the strong euro

[2] Adjusted for statistical outliers; including the irregular component, GDP increased by a seasonally-adjusted 1.2 percent.

[3] The present projections are therefore not fully comparable with the preceding ones of October 2004, since also price-adjusted figures and weighting schemes have changed. Volumes are based on 2000 as the reference year (see Scheiblecker, M., "Umstellung der Preisbereinigung in der österreichischen VGR", WIFO-Monatsberichte, 2004, (77)10, http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=2&pubid=25296&pub_language=2).

and the resulting weaker outlook for the euro area. The tax reform is expected to raise GDP growth in Austria in 2005 above the average for the euro area. On the assumption of a moderation in both the euro exchange rate and oil prices, growth is expected to edge up to 2.3 percent in 2006. Nevertheless, the assumptions for such highly volatile variables are surrounded by considerable uncertainty.

Table 3: Productivity

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year					
Total economy						
Real GDP	+ 0.7	+ 1.2	+ 0.8	+ 1.9	+ 2.2	+ 2.3
Employment[1]	+ 0.6	− 0.1	+ 0.1	+ 0.6	+ 0.8	+ 0.9
Full-time equivalent	+ 0.4	+ 0.1	+ 0.0	+ 0.5	+ 0.7	+ 0.8
Productivity (GDP per employment)	+ 0.1	+ 1.3	+ 0.7	+ 1.2	+ 1.4	+ 1.4
Full-time equivalent	+ 0.3	+ 1.1	+ 0.7	+ 1.4	+ 1.5	+ 1.4
Manufacturing						
Production[2]	+ 1.9	+ 0.4	+ 0.2	+ 5.2	+ 4.0	+ 3.7
Employees[3]	+ 0.2	− 2.5	− 1.7	− 0.5	± 0.0	− 0.4
Productivity per hour	+ 2.1	+ 3.4	+ 1.7	+ 5.5	+ 4.2	+ 4.4
Working hours per day per employee[4]	− 0.4	− 0.5	+ 0.2	+ 0.2	− 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 "Konjunkturerhebung" of Statistics Austria.

The present projections are subject notably to two risks. First, the appreciation of the euro is assumed to level off, although the exchange rate may overshoot the projected level. Second, the export boom is expected to smoothly feed into domestic demand. However, firms may use extra profits to reduce debt levels or, indeed, the strong euro may induce them to invest in areas with lower cost levels or more promising sales opportunities. Moreover, private households may shy away from incurring major expenditures, because of the uncertainties related to the current reforms of social welfare schemes.

Export dynamism losing momentum in 2005 and 2006

Due to the rising euro exchange rate, exports reacted to the international cyclical upturn with a longer lag than usual. Eventually, a boom set in last spring that lasted at least until autumn. For the whole year 2004, Austrian companies raised their exports by about 10 percent in volume. The strongest gains were recorded in the USA, Asia and Southeast Europe, whereas deliveries to the new EU member states fared below average. The USA has become the third most important market for Austrian goods, behind Germany and Italy, but ahead of Hungary and Switzerland. Exports to Germany flourished as well. In terms of commodity structure, foreign demand for motor vehicles and components as well as machinery expanded at an above average rate.

Austrian merchandise exports rose by 10 percent in volume in 2004. Firms benefited in particular from the recovery among German export-oriented industries and the boom in the USA. Because of the expected deceleration in world economic growth, exports will advance at a somewhat slower pace in 2005 and 2006.

Despite the significant appreciation of the euro in 2003, Austria managed to raise its share on world markets in 2004. This is partly explained by the improvement in the relative costs position of the Austrian manufacturing sector: unit labour costs fell by 3.2 percent in 2004, compared with a decline by 2 percent for the euro area as a whole.

Because of the price boom on international commodity markets, Austrian import prices rose substantially, and the terms-of-trade weakened by some ½ percent in 2004. The lively demand for investment goods and consumer durables raised import volumes by 7.2 percent, more strongly than anticipated last October. Earnings from foreign tourism, adjusted for inflation, increased by a mere 0.7 percent in 2004. Although the number of overnight stays was virtually no higher from January to October than one year ago, receipts per capita were higher, largely due to the lively demand for urban destinations. The current account deficit widened in 2004 to an estimated € 2.4 billion or 1 percent of GDP, the weakening being concentrated on the transfer balance and the non-classified items.

The global economic boom is set to abate in 2005 and 2006. Volume growth of world trade is expected to slow from 9 percent in 2004 to around 7 percent. Austrian exports, struggling with the appreciation of the euro, are projected to expand by 6 percent in 2005, and by 7 percent in 2006, broadly in line with overall world trade.

Investment carried forward into 2004

In 2003 and 2004, investment was stimulated by the investment premium ("Investitionszuwachsprämie"). In both years, corporate spending on machinery and equipment rose markedly faster in Austria than in the euro area (in 2004 by 6 percent). The impact on domestic GDP growth was nevertheless limited, as investment goods are for the larger part imported. Ahead of the expiry of the investment premium at the end of 2004, purchases of vehicles and machinery were front-loaded into 2004. For 2005, weaker investment activity should therefore be expected, an assessment that is confirmed by the results of the latest WIFO investment survey, where manufacturers plan to reduce capital spending by 1½ percent in 2005. For the whole economy, the projection is for a modest increase in investment by 1½ percent. By 2006, the cyclical recovery should make for a sufficiently high utilisation of productive capacities as to provide additional stimulus for investment. Further supportive elements are expected from higher net export earnings and a lower tax burden.

Construction activity has strengthened since last summer, following a lacklustre first semester. In the regular WIFO business survey, firms were until November increasingly upbeat in their assessment of the order situation. On annual average 2004, construction output is estimated to have gained 1 percent. The sluggish recovery is related to the fact that a number of investment projects had been front-loaded into 2003, before the expiry of the accelerated depreciation rule. Thereby, construction output had jumped by 7 percent in 2003. Activity is expected to rebound in 2005 and 2006. Orders have increased not only in civil engineering, but also for residential building and the creation of new office space. For industrial and commercial buildings, however, the results of the WIFO investment survey suggest a decline.

Table 4: Private consumption and prices

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.0	− 0.1	+ 0.6	+ 1.6	+ 2.1	+ 2.2
Durables	− 0.1	− 2.4	+ 3.6	+ 4.0	+ 4.7	+ 3.8
Non-durables and services	+ 1.2	+ 0.1	+ 0.3	+ 1.3	+ 1.8	+ 2.0
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+ 3.5	+ 1.2	+ 1.6	+ 3.4	+ 3.9	+ 4.0
	Percent					
Inflation rate						
National	2.7	1.8	1.3	2.0	2.3	1.7
Harmonised	2.3	1.7	1.3	1.9	2.2	1.6
Core inflation[2]	2.3	2.0	1.3	1.6	2.0	1.7

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

Tax cuts to boost purchasing power in 2005

Private households increased their spending markedly in the third quarter, and pre-Christmas sales also took a good start. According to preliminary calculations, private consumption expanded by 1.6 percent in volume in 2004. Sales of durable consumer goods, notably motor cars, rose significantly. The higher energy costs amounted to something like "forced consumption" that potentially lowers the saving ratio. (Data on the saving ratio and on disposable income are currently not available, due to the methodological revision of the national accounts.)

The lowering of wage and income tax in 2005 will contribute importantly towards raising private purchasing power. Growth of private consumption is thus set to accelerate to a rate slightly above 2 percent.

In 2005, the cuts in wage and income tax (though partly offset by higher social security contributions) and the expected increase in employment will make for substantial gains in net disposable income of private households. Employees' per-capita net income is expected to rise by 1¼ percent, employment by 1 percent. Private consumption should advance at an annual pace slightly above 2 percent over the projection period. Demand for durable consumer goods is likely to rise above the overall average, although the larger part of it will be covered by imports.

Inflation relatively high in 2005, clearly subsiding in 2006

Price developments are being shaped by quotations on international oil markets. Having climbed to ever new highs, oil prices calmed in December, moderating to around $ 41 per barrel for Brent. Oil price movements are related to variations in the global business cycle, which trigger speculative behaviour. With the momentum of world economic growth slowing, oil prices also move to a steadier pace.

Table 5: Earnings and international competitiveness

	2001	2002	2003	2004	2005	2006
	Percentage changes from previous year					
Gross earnings per employee[1]	+ 1.3	+ 2.1	+ 2.0	+ 2.2	+ 2.3	+ 2.5
Full-time equivalent	+ 1.6	+ 1.9	+ 2.1	+ 2.4	+ 2.5	+ 2.7
Gross real earnings per employee[1]	– 0.6	+ 0.9	+ 0.5	+ 0.2	± 0.0	+ 0.8
Net real earnings per employee[1]	– 1.3	+ 0.7	+ 0.0	+ 0.5	+ 1.2	+ 0.6
Unit labour costs						
Total economy						
Austria	+ 1.0	+ 0.7	+ 1.3	+ 1.0	+ 0.9	+ 1.1
Euro area	+ 2.5	+ 2.3	+ 2.0	+ 0.6	+ 1.2	+ 1.2
Manufacturing						
Austria	+ 1.1	– 0.6	– 0.6	– 3.2	– 1.7	– 1.7
Euro area	+ 2.5	+ 1.0	+ 0.7	– 1.8	– 0.3	+ 0.6
Effective exchange rate, manufactures						
Nominal	+ 0.9	+ 1.3	+ 3.7	+ 1.1	+ 0.7	– 0.3
Real	+ 0.5	+ 0.8	+ 2.9	+ 0.9	+ 1.0	– 0.4

Source: WIFO Economic Outlook. – [1] Employees according to National Accounts definition.

Headline inflation in Austria attained 2.6 percent in October and November, with 0.6 percentage points in October being accounted for by higher energy prices. On annual average 2004, the consumer price index moved up by 2.0 percent. The projection for 2005 is for an inflation rate of 2.3 percent, the reason for the acceleration being the repercussions of the higher oil price on prices of electricity, gas and some manufactures, as well as rising rental costs and the increase in the tobacco tax. Unlike in the previous years, food prices will also rise markedly.

For 2006, inflationary pressure may be expected to ease significantly, to an annual rate of 1.7 percent, assuming lower prices of some energy products and little overall change in administered prices. Underlying this projection is the assumption of oil prices falling from $ 42 per barrel in 2005 to $ 38 in 2006.

The oil-price induced inflation has been passed onto wages only to a minor extent in the current episode. Contractual wages rose by 2.1 percent year-on-year on annual average 2004; gains in effective wages per capita were somewhat higher, as average working hours rose from the previous year, due to the cyclical recovery and the higher number of working days. The autumn wage round yielded an increase in contractual wages and salaries by 2.5 percent for metal workers, by 2.3 percent in the public service, and by 2.0 percent in the trade and retail sector. Against an expected rate of inflation of 2.3 percent, these settlements imply stagnating gross real earnings in 2005. Owing to the tax cuts, net real earnings per employee will nevertheless rise by 1¼ percent, thereby providing additional scope for higher consumption.

Significant rise in employment, slight decline in unemployment

Demand for labour reacted relatively quickly to the cyclical recovery. The number of dependent employees in active employment increased by 20,000 on annual average in 2004 (November +30,000). While new job opportunities concentrated on sectors where part-time jobs are frequent (trade, tourism, health services, commercial services), job losses from the previous year diminished also in manufacturing and construction. Employment growth is somewhat upward biased as it includes people in partial retirement who are no longer "active" in the later stage if they have front-loaded the period of active work.

The cyclical recovery is leading to higher employment, offering also new full-time job opportunities. Since labour supply is rising markedly at the same time, the number of unemployed will fall only to a small extent.

The slight acceleration of growth in 2005 will result in a net increase in employment by 26,000 or 0.8 percent, more than half of which will be taken up by foreign workers. In 2006, employment should grow at a similar pace as in 2005. The employment rate (on Eurostat definitions) stood at close to 67.5 percent in 2004, according to the new calculation method which makes greater allowance for seasonal influences (still including recipients of child care benefits). By 2006, the employment rate is expected to reach 68.4 percent. In the framework of the Lisbon strategy, the EU has set a target of 70 percent for the employment rate by 2010.

Table 6: Labour market

		2001	2002	2003	2004	2005	2006
		Changes from previous year, in 1,000					
Demand for labour							
Economically active employment[1]		+13.9	−11.6	+ 8.5	+23.8	+29.0	+30.9
Employees[2]		+12.4	−15.0	+ 5.5	+20.3	+25.5	+26.9
Percentage changes from previous year		*+ 0.4*	*− 0.5*	*+ 0.2*	*+ 0.7*	+ 0.8	*+ 0.9*
Nationals		+ 3.0	−20.1	− 10.4	+ 8.7	+ 9.4	+ 9.9
Foreign workers		+ 9.5	+ 5.1	+ 15.9	+11.6	+16.1	+17.0
Self-employed[3]		+ 1.5	+ 3.4	+ 3.0	+ 3.5	+ 3.5	+ 4.0
Labour supply							
Population of working age	15 to 64 years	+27.5	+27.0	+ 29.1	+11.7	− 4.0	+ 1.4
	15 to 59 years	−13.8	− 1.2	+ 12.3	+14.3	+26.3	+31.9
Labour force[4]		+23.5	+17.0	+ 16.1	+27.3	+26.0	+24.9
Surplus of labour							
Registered unemployed[5]		+ 9.6	+28.5	+ 7.7	+ 3.5	− 3.0	− 6.0
In 1,000		203.9	232.4	240.1	243.6	240.6	234.6
		Percent					
Unemployment rate							
Eurostat definition[6]		3.6	4.2	4.3	4.5	4.4	4.2
As a percentage of total labour force[5]		5.5	6.2	6.3	6.4	6.2	6.1
National definition[5,7]		6.1	6.9	7.0	7.1	6.9	6.7
Employment rate							
Economically active employment[1,8]		63.3	62.8	62.6	62.9	63.5	64.0
Total employment[6,8,9]		–	–	–	67.5	68.0	68.4

Source: WIFO Economic Outlook. – [1] Excluding parental leave, military service, and unemployed persons in training. – [2] According to Federation of Austrian Social Security Institutions. – [3] According to WIFO. – [4] Economically active employment plus unemployment. – [5] According to Labour Market Service. – [6] According to Eurostat Labour Force Survey. – [7] As a percentage of total labour force, without self-employed. – [8] As a percentage of population of working age (15 to 64 years). – [9] New survey method.

Unemployment has passed its cyclical peak. In November, the jobless figure fell slightly below the year-earlier level, partly owing to a higher number of people enrolled in training activities. The rate of unemployment, according to the national definition, averaged 7.1 percent in 2004. With the cyclical recovery continuing, it may decline to 6.7 percent by 2006. However, the number of registered unemployed is difficult to predict, since it is influenced by labour market policy measures such as participation in training courses or receipt of advance payments in the case of retirement and other social transfers. The rate of unemployment according to Eurostat definitions is projected to fall from 4.5 percent in 2004 to 4.2 percent in 2006[4].

[4] The new survey method has raised the unemployment rate for 2004 by around 0.3 percentage point.

Tax reform 2005 boosting growth, but raising also the budget deficit

Lower tax revenues and smaller central bank profits, coupled with some expenditure overruns for unemployment subsidies and civil servants' early retirement benefits, widened the general government deficit in the Maastricht definition to a preliminary 1.3 percent of GDP in 2004. This compares with an original deficit target of 0.7 percent of GDP. The revenue shortfalls were concentrated on income and corporate tax, where the investment premium accounted for € 600 to 700 million revenues foregone in 2004. The premium has a noticeable positive impact on investment; however, with the bulk of vehicles and machinery being imported, the GDP-supporting effect remained limited.

On account of the tax reform, the general government deficit will rise to around 2 percent of GDP in 2005. With the cyclical recovery continuing, it should moderate somewhat in 2006.

Sales tax revenues also remained below expectations in 2004. The cyclical recovery hardly improved the government balance, since it was mainly driven by higher exports, which are not subject to sales tax.

The second step of the tax reform is taking effect at the beginning of 2005. It provides for tax cuts to the amount of € 2.6 billion. The lowering of the corporate tax implies an exoneration of € 1.1 billion for firms, whose impact on the budget will largely show up only in 2006. Wage and income tax are being cut by € 1.4 billion in the second reform step. The tax reform 2005 will weaken the general government balance by around ¾ percent of GDP in 2005, and by a further ½ percent of GDP from baseline in 2006[5].

Table 7: Key policy indicators

	2001	2002	2003	2004	2005	2006
			As a percentage of GDP			
Fiscal policy						
General government financial balance						
According to Maastricht definition	+0.3	−0.2	−1.1	−1.3	−2.0	−1.8
According to National Accounts	+0.1	−0.4	−1.3	−1.4	−2.1	−1.9
General government primary balance	+3.7	+3.0	+1.9	+1.7	+0.9	+0.9
			Percent			
Monetary policy						
3-month interest rate	4.3	3.3	2.3	2.1	2.2	2.2
Long-term interest rate[1]	5.1	5.0	4.2	4.2	3.9	4.3
			Percentage changes from previous year			
Effective exchange rate						
Nominal	+1.0	+1.4	+3.8	+1.2	+0.9	−0.3
Real	+0.3	+0.6	+2.8	+0.9	+1.0	−0.5

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

The weaker business outlook will make it difficult to keep the general government deficit below 2 percent of GDP in 2005. Wage tax revenues will turn out lower than expected so far, given that the projection for per-capita earnings has been revised downwards significantly. A general government deficit below 2 percent of GDP for 2005 can probably only be achieved via recourse to one-off measures (e.g., special dividends), the amount of which is difficult to anticipate. The tax reform is expected to boost GDP growth in 2005 by roughly 0.25 percentage point (including also the reform measures concerning the financing of hospitals), and by 0.2 percentage point in 2006, giving Austria a clear positive margin vis-à-vis the euro area average.

In 2006, the general government deficit should decline to around 1¾ percent of GDP, in line with the target laid down in the stability programme. Shortfalls in income and corporate tax revenue on account of the tax reform have to be set against the positive effects of the projected cyclical recovery. Moreover, foregone revenues from the investment premium expiring at the end of 2004 will only be marginal by 2006.

[5] See Breuss, F., Kaniovski, S., Schratzenstaller, M., "Steuerreform 2004/05 – Maßnahmen und makroökonomische Effekte", WIFO-Monatsberichte 2004, 77(8), pp. 627-643, http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=2&pubid=25204&pub_language=2.