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## Heightened Cyclical Risks

### Economic Outlook for 2005 and 2006

**The short-term business outlook in the euro area is surrounded by considerable uncertainty. Recent gains in exports and profits have so far not translated into higher investment and consumer spending. High oil prices constitute a further risk element. Owing to the positive incentives from the tax reform, the Austrian economy is performing better than the euro area as a whole. GDP is projected to expand at a steady 2¼ percent p.a. in 2005 and 2006. The rate of unemployment is nevertheless unlikely to decline, given the massive increase in labour supply.**

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Economic growth in Austria is expected to edge up to around 2¼ percent in 2005 and keep the same pace in 2006. The expansion is driven mainly by private consumption and construction activity. Private households, benefiting from tax cuts and rising employment this year, should spend at least part of their net income gains on consumer goods. Construction will also grow notably faster than last year, as suggested by the high order volumes in civil engineering and some segments of the building sector. However, stimulus from foreign demand is set to slacken with global growth shifting into lower gear. Also investment in machinery and equipment will decelerate from last year when spending was upward biased by the imminent expiry of the investment tax premium ("Investitionszuwachsprämie"). Overall, economic growth in Austria is likely to outpace that in the euro area both this year and next.

The cyclical risks in the euro area have mounted significantly over the last months. The already cooling boom from the external side has spurred domestic demand only to a limited extent so far. In spite of sharply rising profits, investment in the euro area is lacking momentum. Large companies are reducing their debt and employment levels, while private households, growing more sceptical about their situation notably in Germany, restrain their spending on residential building and current consumption. This is the key factor for the sluggishness of activity in the euro area.

The major retarding element for business activity in Europe is not the high euro exchange rate: exports are performing strongly, and weak internal demand is not related to the euro exchange rate. Neither can high oil prices be taken for the main obstacle, since the USA and the Asian economies are growing fast despite the high oil price. Nor is activity being held back by the monetary regime in the euro area, which has followed an expansionary stance since 2001, albeit not to the same degree as in the USA. Substantial differences exist with regard to fiscal policy and real estate prices. In the USA and the UK, the distinctly expansionary budgetary stance, together with swiftly rising real estate prices, have lent firm support to domestic demand. In the euro area, the course of budgetary policy has been broadly neutral, with rising deficits being tolerated in the face of persistently sluggish activity. Unlike in the Anglo-Saxon countries, real estate prices remained flat in most euro area member states, providing little stimulus for residential construction and consumption.

Among the risks to the present projections one should include the oil price rather than the euro exchange rate. The former is the main determinant of headline inflation, which in 2004 rose to an average 2.1 percent in Austria, some ½ percentage

point being accounted for by higher oil prices. A further acceleration to a rate of 2.5 percent should be expected for 2005, driven by higher prices for energy, housing and cigarettes. Underlying this projection is the assumption of an average price of \$ 44 per barrel of crude oil (Brent) in 2005. Next year, inflation should abate markedly to a rate of 1.8 percent, with energy prices assumed receding and administered prices broadly stable.

<i>Main results</i>		2001	2002	2003	2004	2005	2006	
		Percentage changes from previous year						
GDP								
Volume		+0.7	+1.2	+0.8	+2.0	+2.2	+2.3	
Value		+2.5	+2.5	+2.3	+3.9	+4.5	+3.9	
Manufacturing <sup>1</sup> , volume		+2.2	+0.5	+0.2	+4.8	+4.0	+3.7	
Whole sale and retail trade, volume		+2.4	+2.2	+0.4	+1.2	+2.2	+2.4	
Private consumption expenditure, volume		+1.0	-0.1	+0.6	+1.5	+2.0	+2.2	
Gross fixed investment, volume		-2.1	-3.4	+6.2	+3.8	+1.8	+2.7	
Machinery and equipment <sup>2</sup>		+1.6	-6.5	+5.1	+7.1	+1.5	+3.5	
Construction		-5.0	-0.8	+7.0	+1.1	+2.0	+2.0	
Exports of goods <sup>3</sup>								
Volume		+6.3	+4.3	+2.5	+12.2	+6.0	+7.0	
Value		+6.5	+4.2	+1.9	+13.0	+6.5	+7.5	
Imports of goods <sup>3</sup>								
Volume		+5.5	+0.3	+6.8	+8.4	+6.0	+7.1	
Value		+5.0	-2.0	+5.0	+10.4	+6.8	+7.8	
Current balance		billion €	-4.13	+0.75	-1.11	-1.25	-1.59	-1.09
As a percentage of GDP		%	-1.9	+0.3	-0.5	-0.5	-0.6	-0.4
Long-term interest rate <sup>4</sup>		%	5.1	5.0	4.2	4.2	3.9	4.3
Consumer prices			+2.7	+1.8	+1.3	+2.1	+2.5	+1.8
Unemployment rate								
Percent of total labour force <sup>5</sup>		%	3.6	4.2	4.3	4.5	4.5	
Percent of dependent labour force <sup>6</sup>		%	6.1	6.9	7.0	7.1	7.1	
Dependent employment <sup>7</sup>			+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. – <sup>1</sup> Value added, including mining and quarrying. – <sup>2</sup> Including other products. – <sup>3</sup> According to Statistics Austria. – <sup>4</sup> 10-year central government bonds (benchmark). – <sup>5</sup> According to Eurostat Labour Force Survey. – <sup>6</sup> According to Labour Market Service, percent of total labour force excluding self employed. – <sup>7</sup> Excluding parental leave, military service, and unemployed persons in training.

Employment has already reacted significantly to the cyclical recovery. In 2004, the number of economically active employees increased by 21,000. For 2005 and 2006, gains of more than 25,000 per year are expected, the bulk of them in full-time jobs, and particularly for commercial services, trade and health services. In spite of the healthy increase, the rate of unemployment is unlikely to decline, remaining at 7.1 percent (or 4.5 percent on Eurostat definitions). The main reason is a massive increase in labour supply: the domestic labour force is growing for demographic reasons, a high number of people acquiring Austrian nationality and as a consequence of the pension reform; additional foreign labour is coming mainly from Germany, the effects of the social reforms ("Hartz IV") further reinforcing the inflow. At the same time, the number of Austrians working in Germany is steadily declining.

The second stage of the tax reform will raise the general government deficit to around 2 percent of GDP in 2005. High receipts from VAT and corporate tax at the beginning of the year and rising inflation are bringing within reach the government target of keeping the deficit below 2 percent of GDP. In 2006, net government borrowing should decline somewhat, as foreseen in the stability programme. While the expiry of the investment premium will have a positive impact on the government balance, the tax reform carries shortfalls in income and corporate tax revenues.