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Business Activity Keeping Strong Momentum – Slowdown Expected Only in 2008

Economic Outlook 2006 to 2008

In 2006, the Austrian economy benefited from the cyclical upswing in Europe. The implicit growth impulse translated in the course of the year into higher investment demand. Domestic demand will drive activity also in 2007, even if the "echo effect" from the positive one-off factors at work in 2006 will dampen the year-on-year rate of growth. In 2008, the European business cycle is expected to lose momentum. Nevertheless, GDP growth in Austria should outpace the euro area average. Given the cyclical conditions, the stance of Austrian fiscal policy is expansionary.

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In the light of the favourable developments in 2006 and the still optimistic output expectations of firms towards end of the year, WIFO is revising upwards its projection for real GDP growth to a rate of 3¼ percent year-on-year for 2006 and 2¾ percent for 2007. In 2008, the expected cyclical slowdown in Europe will dampen economic growth in Austria to a rate of 2¼ percent.

In the regular WIFO business survey of last November, firms showed continued optimism as regards both the current situation and sales expectations for the coming months. In 2006, manufacturing and construction posted particularly strong gains. Apart from the generally favourable business conditions, both sectors benefited from a number of special factors. In anticipation of the VAT increase in Germany in early 2007, domestic producers notably of motor cars and suppliers of vehicle components enjoyed a demand boost towards the end of 2006, which will, however, be followed by a corresponding temporary setback in 2007. In the construction sector, unusually mild weather allowed many projects to be finalised earlier, leading to unusually strong output in the year-end quarter. Here also, the high carry-over may lead to a year-on-year decline in late 2007.

Export growth has been accelerating since mid-2005, to a projected year-on-year rate of more than 10 percent for volume merchandise exports in 2006. However, slackening demand from overseas, the rise in the euro exchange rate and the negative echo effect from the German VAT increase will moderate export growth to below 8 percent in 2007 and still further in 2008 when business activity also in the euro area is set to lose momentum.

Gross fixed investment is growing at a strong pace. After an increase by over 5 percent in volume in 2006, a similar rate should be attained in 2007. Although construction investment is expected to slow from an inflation-adjusted 5 percent to 3.7 percent, corporate spending on machinery and equipment will be reinforced (2006 +5½ percent, 2007 +6½ percent). In 2008, both investment components are projected to advance at a more moderate pace, overall by 3½ percent in real terms.

Because of only modest gains in wages and salaries, private consumption growth is not expected to pick up significantly, despite the robust cyclical activity and lively job creation. Adjusted for inflation, private household spending is projected to advance by 1.9 percent in 2006 and 2.1 percent in 2007, keeping a pace of 2 percent

in 2008. Against this background, inflation will remain subdued. Second-round effects from higher oil prices are still largely absent, and the strength of the euro is exerting downward pressure on import prices. Following an average rate of 1.4 percent in 2006, headline inflation is set to head up only marginally, to 1.6 percent in 2007 and 1.7 percent in 2008.

Table 1: Main results

		2003	2004	2005	2006	2007	2008	
		Percentage changes from previous year						
GDP								
Volume		+ 1.1	+ 2.4	+ 2.0	+ 3.2	+ 2.7	+ 2.3	
Value		+ 2.4	+ 4.2	+ 3.9	+ 4.5	+ 4.4	+ 4.0	
Manufacturing ¹ , volume		+ 0.1	+ 2.4	+ 2.4	+ 6.8	+ 5.0	+ 3.0	
Wholesale and retail trade, volume		+ 0.5	+ 1.3	+ 0.3	+ 1.4	+ 2.1	+ 1.9	
Private consumption expenditure, volume		+ 1.3	+ 1.9	+ 1.7	+ 1.9	+ 2.1	+ 2.0	
Gross fixed investment, volume								
Machinery and equipment ²		+ 5.9	+ 0.6	+ 0.3	+ 5.2	+ 4.9	+ 3.4	
Construction		+ 6.8	- 0.7	+ 0.1	+ 5.5	+ 6.5	+ 4.5	
		+ 5.1	+ 1.6	+ 0.4	+ 5.0	+ 3.7	+ 2.5	
Exports of goods ³								
Volume		+ 2.6	+12.9	+ 2.2	+10.4	+ 7.8	+ 6.8	
Value		+ 1.9	+13.9	+ 5.4	+13.2	+ 8.9	+ 7.3	
Imports of goods ³								
Volume		+ 6.5	+11.4	+ 2.3	+ 7.9	+ 8.2	+ 6.8	
Value		+ 5.0	+12.5	+ 5.9	+12.1	+ 9.5	+ 7.5	
Current balance		billion €	- 0.48	+ 1.08	+ 3.24	+ 4.90	+ 4.94	+ 5.33
As a percentage of GDP			- 0.2	+ 0.5	+ 1.3	+ 1.9	+ 1.8	+ 1.9
Long-term interest rate ⁴	in percent	4.2	4.2	3.4	3.8	3.8	4.1	
Consumer prices		+ 1.3	+ 2.1	+ 2.3	+ 1.4	+ 1.6	+ 1.7	
Unemployment rate								
Eurostat definition ⁵	in percent	4.3	4.8	5.2	4.9	4.6	4.5	
National definition ⁶	in percent	7.0	7.1	7.3	6.8	6.5	6.4	
Persons in active dependent employment ⁷		+ 0.2	+ 0.7	+ 1.0	+ 1.7	+ 1.3	+ 0.7	
General government financial balance according to Maastricht definition								
As a percentage of GDP			- 1.6	- 1.2	- 1.5	- 1.2	- 1.4	- 1.4

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 labour market is responding markedly to the cyclical improvement, with total employment increasing by 50,000 in 2006 and a further 40,000 jobs likely to be added in 2007, before subsiding to +21,000 in 2008. Although labour supply remains strongly upward bound, unemployment will decline. The bulk of the newly created jobs will be filled by new entrants to the labour market. In 2006, the jobless figure fell by 13,400, 8,800 of which are accounted for by the reinforcement of job training activities. In 2007, the number of unemployed is projected to moderate by a further 10,000, before levelling off in 2008. The unemployment rate (according to national definitions) is set to head down over the entire projection period, from 6.8 percent in 2006 to 6.4 percent in 2008.

The lively cyclical activity is boosting government revenues to an unexpected extent. The shortfall in corporate tax revenues expected to emerge with a lag as a consequence of the 2004-05 tax reform has so far not materialised. In 2006, the general government deficit narrowed to 1.2 percent of GDP. Despite the continued cyclical strength, the deficit looks set to edge up to 1.4 percent of GDP on the basis of government expenditure committed so far. The projection of an unchanged deficit ratio of 1.4 percent for 2008 is still subject to considerable political uncertainty.

After another year of strong economic growth in 2006 (+5 percent), global economic activity will advance at a more moderate pace in 2007. World GDP is projected to increase at an annual 4½ percent both in 2007 and 2008. Leading indicators for the USA point to a cyclical slowdown in 2007, continuing the deceleration of growth since early 2006. Although consumer confidence remains unshaken, residential investment declined markedly in the second and third quarter 2006. Declining industrial orders and the trend in the ISM Purchasing Managers' Index confirm the expectation of a further slowdown. Against this background, GDP growth is expected to abate from 3¼ percent in 2006 to 2¼ percent in 2007. In 2008, the sustained fall in the dollar exchange rate should stimulate US exports and allow GDP growth to pick up to 2¾ percent. However, the persistent macro-economic imbalances (high deficits in the current account and in government finances, along with a negative private household saving ratio) may weigh on growth in the medium and longer run.

World economy to expand at a somewhat slower pace in 2007

Table 2: World economy

	2003	2004	2005	2006	2007	2008	
	Percentage changes from previous year						
<i>Real GDP</i>							
World total	+ 4.1	+ 5.3	+ 4.9	+ 5.0	+ 4.6	+ 4.6	
Total OECD	+ 2.0	+ 3.2	+ 2.7	+ 3.1	+ 2.6	+ 2.6	
USA	+ 2.5	+ 3.9	+ 3.2	+ 3.3	+ 2.3	+ 2.8	
Japan	+ 1.4	+ 2.7	+ 1.9	+ 2.0	+ 1.9	+ 1.6	
EU 25	+ 1.3	+ 2.4	+ 1.7	+ 2.8	+ 2.5	+ 2.2	
EU 15	+ 1.1	+ 2.2	+ 1.5	+ 2.7	+ 2.4	+ 2.1	
Euro area	+ 0.8	+ 1.9	+ 1.3	+ 2.7	+ 2.4	+ 2.1	
Germany	- 0.2	+ 1.2	+ 0.9	+ 2.5	+ 1.9	+ 1.7	
New member states ¹	+ 3.8	+ 5.1	+ 4.6	+ 5.2	+ 5.0	+ 4.8	
China	+10.0	+10.1	+10.2	+10.4	+ 9.8	+ 9.2	
<i>World trade, volume</i>	+ 5.0	+10.3	+ 7.2	+ 9.6	+ 7.7	+ 6.9	
<i>Market growth²</i>	+ 5.6	+ 9.1	+ 6.8	+ 9.5	+ 7.3	+ 6.5	
<i>Primary commodity prices</i>							
HWWA index, total	- 4	+18	+29	+27	-13	- 4	
Excluding energy	- 6	+18	+ 6	+22	- 7	- 4	
<i>Crude oil prices</i>							
Average import price (cif) for OECD countries	\$ per barrel	28.4	36.3	50.3	65.0	60.0	61.0
<i>Exchange rate</i>							
\$ per euro		1.131	1.243	1.245	1.25	1.35	1.42

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.

With regard to latest developments on international oil markets, WIFO builds its projections on the assumption of an average import price for the industrialised countries of \$ 60 per barrel of crude oil in 2007, down by almost 8 percent from 2006. For 2008, by way of a technical assumption, oil prices are held constant. On the euro-dollar exchange rate, the recent depreciation of the dollar is taken to reflect the need for correction of the huge US current account deficit and that therefore the started trend will continue. Thus, underlying the projections is the assumption of the euro appreciating to \$ 1.35 on average 2007 and \$ 1.42 in 2008.

As a consequence of the slower growth of global economic activity, the strong momentum of world trade will also abate somewhat. Slower growth in the USA will also weigh on China, where despite some deceleration over the forecast period demand and output growth remains remarkably strong by international standards. Latest business surveys among Japanese firms confirm the solid upward path of the Japanese economy. With the continuation of the positive trend, the danger of a relapse into stagnation is becoming more remote, and the episode of deflation should by now have been definitively overcome.

The global economy will expand at a somewhat slower pace in 2007. Activity is set to slacken both in the USA and in China. Nevertheless, growth will stay robust in 2007 and 2008.

Lively activity in the euro area is fuelling growth in the countries of Central and Eastern Europe, where aggregate GDP went up by 5.2 percent in 2006, the highest rate in recent history. Apart from the process of catching up towards the higher per-capita income levels in the EU 15, this is also the result of the EU-wide stronger cyclical momentum. Demand and output have gathered pace also in the larger economies of Hungary and Poland. In line with the projected slowdown in the euro area in 2008, growth is set to abate in 2008, although the positive gap will remain, such that the convergence process should continue over the entire projection period.

In the first half of 2006, economic activity strengthened substantially in the euro area. In the third quarter, the increase in the seasonally- and working-day-adjusted GDP moderated to 0.5 percent quarter-on-quarter in volume; nevertheless, business surveys suggest that activity has been buoyant towards the end of the year. Both foreign demand and the rebound of investment have fuelled growth in 2006. In 2007, consumer demand will be reduced by the amount of purchases carried forward into 2006 in view of the VAT increase in Germany. While the rate of growth will thereby be dampened, the cyclical upturn will not be interrupted. Until November, firms remained highly optimistic about their order levels for the months to come.

The present projections assume that cyclical activity will start slackening as from mid-2007. One key factor is the strength of the euro, which will weigh on exports to the dollar area. In 2008, growth of euro area GDP is projected to moderate to just over 2 percent, still clearly above the rates recorded in 2004 and 2005.

In spite of the prospect of a further strengthening of the upswing, WIFO does not see the danger of rising inflationary pressure in the euro area. While the cyclical upturn will improve labour market conditions, unemployment remains at high levels in most EU member states, and strong competitive pressure on international markets should set narrow limits to the increase in earnings. In addition, the appreciation of the euro and its implicit terms-of-trade effects will hold inflation down. Notwithstanding the favourable cyclical situation and the persistent strong expansion of the money supply (+8.5 percent in September 2006), the present projections assume that the ECB will cut the key intervention rate by 25 basis points in 2007, namely during the second half of the year. A further cut by the same amount is assumed for 2008.

The German economy has apparently shaken off the crisis of the past years. Following the modest growth of GDP by 0.3 percent quarter-on-quarter in the last three months of 2005, the pace accelerated to 0.8 percent in the first quarter and to 1.1 percent in the second quarter 2006. Although the third quarter saw a slight deceleration to 0.6 percent, business surveys suggest that economic activity is still very strong.

In particular the judgements on the current business situation as sampled by the ifo Institute show an upward trend unabated since the middle of 2005, with the indicator currently at its highest level in more than ten years. One-off factors may, however, play a certain role. Thus, demand for passenger cars has probably been boosted in 2006 in anticipation of the VAT increase as from the beginning of 2007. This is reflected also by business expectation of retailers in the ifo survey: while the current situation is rated excellent by shop-owners, the partial index for the more forward-looking expectations signalled a slump in November after a steady decline in the months before. Moreover, the unusually mild weather in large parts of Europe may have boosted expectations in the construction sector beyond the benign cyclical component.

After the decline in the forward-looking expectations for the overall economy, the last two monthly surveys show a rebound, confirming the robust cyclical conditions. For this reason, WIFO revises its projection for German GDP growth in 2007 up to 1.9 percent, more strongly than for 2006 (up to 2.5 percent). A moderation of cyclical development is expected to set in in the second half of 2007. For the latter, the

Activity in the euro area providing stimulus to East-central Europe

Euro area to enjoy continued strong business activity in 2007

GDP growth in the euro area accelerated to 2.7 percent in 2006, corresponding to twice the rate of the previous year. Apart from lively exports, investment picked up markedly. Demand and output will keep strong forward momentum in 2007, even if one-off factors in Germany have a dampening effect. A cyclical slowdown is expected to set in only in 2008.

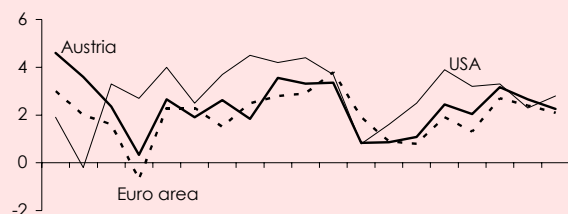
German economy becoming a driver of growth

Having been sluggish for several years (+0.9 percent in volume in 2005), economic growth in Germany picked up significantly, to a rate of 2.5 percent in 2006. Despite business conditions remaining favourable, one-off effects related to the VAT increase will dampen GDP growth to an average 1.9 percent in 2007.

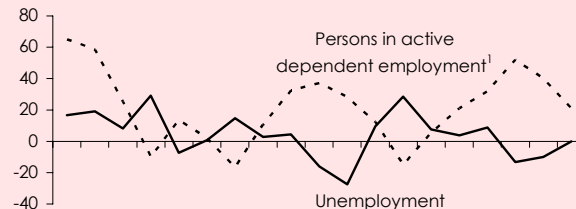
more difficult export outlook, with the euro appreciating against the dollar, will play a role.

Figure 1: Indicators of economic performance

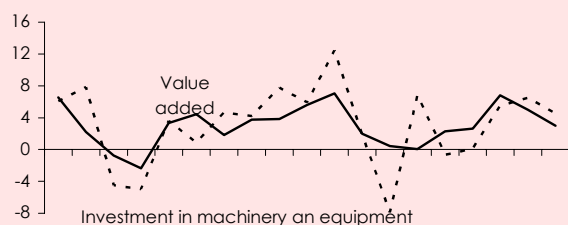
Growth of real GDP
Percent



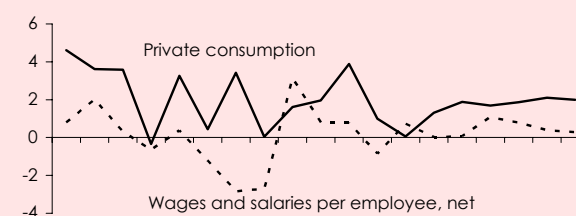
Employment and unemployment
1,000 from previous year



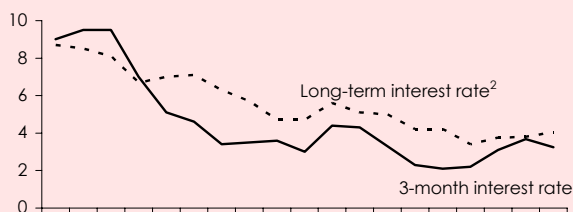
Manufacturing and investment
Percentage changes from previous year, volume



Consumption and income
Percentage changes from previous year, volume



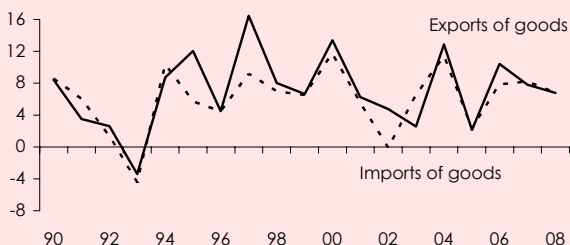
Short-term and long-term interest rates
Percent



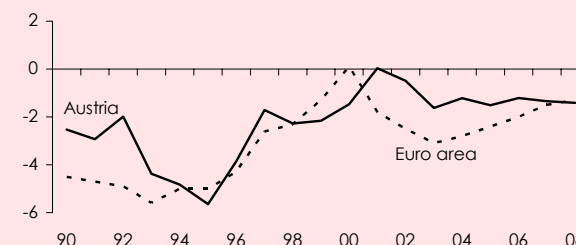
Inflation and unit labour costs
Percentage changes from previous year



Trade
Percentage changes from previous year, volume



General government financial balance
As a percentage of GDP



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

The business cycle started heading up already in 2005 and gained considerable momentum in 2006. While foreign demand provided the main growth incentives in the first semester, investment increasingly took over the role as a growth driver in the second half of the year. Already in the first quarter, GDP adjusted for seasonal and calendar effects rose strongly, by 0.7 percent in volume, accelerating to 0.9 percent

Cyclical upturn in Austria to continue

in the second quarter and keeping that pace in the third period. Results from the regular WIFO business survey suggest that growth remained robust also in the year-end quarter. For the whole year 2006, economic growth is likely to have exceeded a rate of 3 percent for the first time since 2000.

Table 3: Productivity

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 1.1	+ 2.4	+ 2.0	+ 3.2	+ 2.7	+ 2.3
Employment ¹	- 0.0	- 0.0	+ 0.5	+ 1.2	+ 0.9	+ 0.4
Productivity (GDP per employment)	+ 1.1	+ 2.5	+ 1.6	+ 2.0	+ 1.8	+ 1.9
<i>Manufacturing</i>						
Production ²	+ 0.1	+ 2.3	+ 2.6	+ 6.8	+ 5.0	+ 3.0
Employees ³	- 1.7	- 0.6	- 0.8	+ 0.1	± 0.0	- 0.1
Productivity per hour	+ 1.4	+ 2.0	+ 4.0	+ 6.1	+ 4.8	+ 2.7
Working hours per day per employee ⁴	+ 0.3	+ 0.8	- 0.6	+ 0.6	+ 0.2	+ 0.4

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.

Apart from the cyclical dynamics, the Austrian economy has probably benefited in 2006 from the front-loading of demand in Germany in view of the VAT increase. Austrian suppliers of motor vehicle components report a marked increase in their order levels, while domestic car sales advance only at a sluggish pace. This one-off effect is estimated to have boosted GDP in 2006 by approximately 0.2 percentage point, which will likely be offset by a corresponding demand shortfall in 2007. GDP growth in 2007 is nevertheless projected at 2¼ percent, as business survey responses point to activity remaining robust beyond the turn of the year.

When after two years of swift expansion activity in the euro area shifts into lower gear in 2008, Austrian GDP growth will abate to 2¼ percent, still remaining above the euro area average, like in the last five years.

In 2006, Austrian merchandise exports benefited in particular from the cyclical rebound in Germany and strengthening demand from Italy. Trade flourished with the major markets in East-Central Europe, like Hungary, Slovenia and Poland. It was also highly satisfactory, with the OPEC countries and the OECD member countries overseas (Canada, USA).

While goods exports in the first three quarters of 2006 rose considerably from the year-earlier level, their pace slowed gradually during the year in a quarter-on-quarter comparison. In the fourth quarter, car exports should have staged a rebound in view of the imminent VAT increase in Germany. The projection for exports for the whole of 2006 is an increase by 10½ percent in volume.

2007 will see the corresponding shortfall of consumer demand carried forward into 2006. Apart from this "echo effect", the slackening of overseas demand and the strength of the euro vis-à-vis the dollar will weigh on export growth, likely to remain below 8 percent. In 2008, the cyclical slowdown in the euro area and the appreciation of the euro against the dollar are expected to dampen export growth further to below 7 percent.

Total exports, including tourism and other services, are set to rise by 8¾ percent at constant prices from the previous year in 2006, with growth expected to moderate to slightly above 7 percent in 2007 and 6 percent in 2008.

Due to the close link between merchandise exports and imports, the latter are expected to have increased by almost 8 percent in volume in 2006. In the current year, imports should stay robust (+8¼ percent), given the likely strengthening of both equipment investment and consumer demand. It is only in 2008 that import growth is projected to decelerate to 6¾ percent in real terms.

Demand and output in Austria rose by 3¼ percent in 2006, the highest rate in six years. Activity should stay lively in 2007, before moderating in 2008. Investment is expected to become the major force supporting growth in 2007.

Strong export growth to slacken in 2008

In the first half of 2006, foreign demand provided the main support to the domestic cyclical upturn. In addition, one-off effects reinforced the growth of exports. With the boom overseas and in the euro area losing steam, growth of Austrian exports will gradually decelerate in 2007.

After the stagnation in 2004 and a decline in 2005, gross fixed investment is projected to expand by 5 percent each in 2006 and 2007. The assumption of a strong rebound is motivated by the need for replacement of outdated equipment as well as by the bottlenecks emerging as the cyclical upswing proceeds.

Construction spending in 2006 was markedly higher (+5 percent adjusted for inflation) than the year before, when it had remained broadly flat (+0.4 percent). Especially residential building picked up. Apart from cyclical factors, the good performance was due to clement weather conditions in the year-end quarter. In 2007, construction will again post a healthy increase (+3.7 percent in volume), before gradually decelerating to an average +2.5 percent in 2008.

Demand for machinery and equipment, for its part, should see a further strengthening from the increase by 5.5 percent in volume in 2006. The regular WIFO investment survey for the manufacturing sector suggests that firms will step up spending by 6.5 percent in real terms. In 2008, the pace is expected to slow down to 4.5 percent, reflecting the overall cyclical profile.

Private household consumption benefited in 2006 from the improvement in overall cyclical conditions and in the labour market situation. Following an increase by an inflation-adjusted 1.7 percent in 2005, spending has probably edged up to 1.9 percent in 2006. While such an increase appears in line with the early stage of a cyclical upswing, growth in retail sales has not strengthened significantly in the course of 2006, and also new car registrations are broadly flat. Gains in net wages and salaries remain modest even in the face of better labour market conditions. Since the saving ratio rose at the same time, private consumption edged up only slightly in 2006.

Table 4: Private consumption, income and prices

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.3	+ 1.9	+ 1.7	+ 1.9	+ 2.1	+ 2.0
Durables	+ 3.1	+ 5.1	+ 2.2	+ 1.8	+ 2.8	+ 2.3
Non-durables and services	+ 1.1	+ 1.5	+ 1.6	+ 1.9	+ 2.0	+ 2.0
Household disposable income	+ 2.1	+ 2.0	+ 2.1	+ 2.2	+ 2.1	+ 1.5
	As a percentage of disposable income					
Household saving ratio	8.6	8.8	9.1	9.4	9.3	9.0
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+ 1.6	+ 5.0	+ 4.7	+ 5.9	+ 5.0	+ 5.0
	Percentage changes from previous year					
Inflation rate						
National	1.3	2.1	2.3	1.4	1.6	1.7
Harmonised	1.3	2.0	2.1	1.7	1.8	1.9
Core inflation ²	1.3	1.6	1.5	1.3	2.0	2.0

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

In 2007, the saving ratio is expected to decline somewhat, while growth of household disposable income remains broadly constant. Against this background, consumption by private households is projected to go up by 2.1 percent at constant prices. Such a rate falls short of the typical pattern observed in past episodes of cyclical upswing, implying that the current upswing receives only limited support from this major demand component. In 2008, private consumption growth is expected to edge down to 2 percent, in line with the overall cyclical slowdown.

Public consumption follows a steady, but moderate upward trend. For this component, the projection becomes rather uncertain towards the forecast horizon, since it depends to some extent on the budgetary plans of the incoming government yet to be formed.

Investment lending firm support to business activity

In the course of 2006, the demand stimulus triggered by exports was transmitted to domestic capital formation. Both investment in construction and in machinery and equipment is showing strong momentum in 2006 and 2007, whereas demand is set to slow down in 2008.

Consumer demand picking up only slightly

Private consumption picked up only marginally in 2006. Although growth is set to accelerate further in 2007, the profile remains somewhat flatter than in a normal cyclical upswing.

The oil price hikes of the last few years have so far not led to second-round effects to be identified in domestic inflation rates. Most recently, the price jump for internationally traded oil has levelled off. Towards the end of 2006, the rise in the dollar-euro exchange rate has also helped to keep a lid on inflation. Therefore, on annual average 2006, the national consumer price index went up by a moderate 1.4 percent.

The rise in employment accompanied by a decline in unemployment, both triggered by the cyclical upturn, will not lead to significantly higher wage claims in 2007. It is further assumed that oil prices on a dollar basis will remain constant and that the euro will continue to rise against the dollar. On these assumptions, headline inflation in 2007 will remain under firm control, at a rate of 1.6 percent. In 2008 also, inflation should remain well below 2 percent.

Likewise, inflation as measured by the Harmonised Index of Consumer Prices (HICP) will edge up only marginally from 1.7 percent in 2006, remaining below 2 percent over the entire forecast period. Nevertheless, the business cycle strength will be reflected by a marked increase in the core inflation rate (excluding energy and unprocessed food items), moving from 1.3 percent in 2006 to 2 percent in both 2007 and 2008.

Inflation remaining low even during the cyclical upswing

Inflation has been subdued in 2006 and is likely to remain so in the next few years, since wage rises stay moderate despite the improving labour market situation. Moreover, the oil price jump has levelled off and the euro has appreciated.

Table 5: Earnings and international competitiveness

	2003	2004	2005	2006	2007	2008
	Percentage changes from previous year					
Gross earnings per employee ¹	+ 1.9	+ 1.9	+ 1.7	+ 2.8	+ 2.5	+ 2.5
Gross real earnings per employee ¹	+ 0.3	- 0.0	+ 0.0	+ 1.4	+ 0.9	+ 0.8
Net real earnings per employee ¹	+ 0.0	+ 0.1	+ 1.1	+ 0.8	+ 0.4	+ 0.3
Total economy						
Unit labour costs	+ 0.7	- 0.8	+ 0.2	+ 0.8	+ 0.7	+ 0.6
Manufacturing						
Unit labour costs	+ 0.8	- 0.8	- 0.6	- 3.5	- 2.1	- 0.4
Relative unit labour costs ²						
Vis-à-vis trading partners	+ 3.7	+ 1.8	+ 0.6	- 2.1	- 1.4	- 0.8
Vis-à-vis Germany	+ 2.4	+ 2.2	+ 3.0	± 0.0	± 0.0	+ 0.1
Effective exchange rate, manufactures						
Nominal	+ 3.7	+ 1.2	- 0.5	+ 0.2	+ 0.0	+ 0.3
Real	+ 2.9	+ 1.0	- 0.5	- 0.6	- 0.2	+ 0.1

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

The number of persons in dependent active employment rose by 52,000 in 2006 from the previous year, the rate of increase of 1.7 percent being the highest since 1991. Part-time employment keeps expanding at an above-average pace. However, new jobs were also created in branches that usually hire full-time workers, notably manufacturing and construction. Apart from lively cyclical activity, demand for labour was boosted by the unusually warm weather in the fourth quarter.

In spite of labour supply growing further, the number of unemployed declined markedly, by over 13,000. This was due not only to the cyclical upturn, but also to the sizeable rise of persons in labour market training activities. The rate of unemployment (on national definitions) came down from 7.3 percent of the dependent labour force in 2005 to 6.8 percent in 2006.

In 2007, dependent active employment is projected to go up by a further 40,000, before moderating to a gain of 21,000 with the cyclical slackening in 2008. Labour market policy is expected to continue to hold constant the large number of people in training modules such that the cyclical influence will feed through, leading to a decline in the number of unemployed by 10,000. In 2008, the downward trend is likely to bottom out, leaving total unemployment broadly unchanged at 229,000. Since, however, employment will keep growing, the unemployment rate according to the conventional national calculation method should keep heading down over the entire projection period, reaching 6.4 percent in 2008.

Significant recovery on the labour market

The strong pick-up in economic activity and the mild weather towards the end of the year allowed overall employment to rise markedly in 2006. This, together with reinforced training activities organised by the labour market service, led to a decline in unemployment. The outlook for this year and next is for a further positive development on the labour market.

Table 6: Labour market

	2003	2004	2005	2006	2007	2008
	Changes from previous year, in 1,000					
<i>Demand for labour</i>						
Persons in active employment ¹	+ 8.5	+25.1	+37.2	+57.5	+45.0	+25.5
Employees ²	+ 5.5	+21.1	+31.9	+52.0	+40.0	+21.0
Percentage changes from previous year	+ 0.2	+ 0.7	+ 1.0	+ 1.7	+ 1.3	+ 0.7
Nationals	- 10.4	+ 9.2	+20.0	+35.9	+27.3	+10.3
Foreign workers	+ 15.9	+11.9	+11.9	+16.1	+12.7	+10.7
Self-employed ³	+ 3.0	+ 4.0	+ 5.3	+ 5.5	+ 5.0	+ 4.5
<i>Labour supply</i>						
Population of working age						
15 to 64 years	+ 37.7	+34.4	+15.6	+21.2	+20.3	+25.8
15 to 59 years	+ 21.2	+35.6	+48.5	+52.2	+24.9	+16.1
Labour force ⁴	+ 16.1	+28.9	+45.9	+44.1	+35.0	+25.5
<i>Surplus of labour</i>						
Registered unemployed ⁵	+ 7.7	+ 3.8	+ 8.8	-13.4	-10.0	± 0.0
In 1,000	240.1	243.9	252.7	239.3	229.3	229.3
	Percent					
<i>Unemployment rate</i>						
Eurostat definition ⁶	4.3	4.8	5.2	4.9	4.6	4.5
As a percentage of total labour force ⁵	6.3	6.4	6.5	6.1	5.8	5.8
National definition ^{5,7}	7.0	7.1	7.3	6.8	6.5	6.4
<i>Employment rate</i>						
Persons in active employment ^{1,8}	62.2	62.3	62.8	63.6	64.1	64.3
Total employment ^{6,8,9}	-	67.8	68.6	69.3	69.7	69.8

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

The highly favourable cyclical conditions in 2006 will more than offset the revenue shortfalls expected from the 2004-05 tax reform. Especially the corporate tax revenues continue to rise briskly, despite the cut in the tax rate in the previous year. Although the government reinforced spending on labour market policy and research, WIFO is revising its projection for the general government deficit down to 1.2 percent of GDP.

The revenue-dampening effect from the tax reform may be felt to a greater extent in 2007. Moreover, budgetary allocations for labour market promotion will probably be maintained at the high level attained in the previous year. Thus, the government deficit is projected to rebound to 1.4 percent of GDP, even if the strengthening of domestic demand will support revenue growth. This projection includes the expenditure-dampening effects from the "administrative reform II" at all levels of government, but no new measures possibly to be taken by the new Federal government.

Budgetary developments in 2008 will depend to an important degree on the measures taken by the new government in the area of economic and social policy. Therefore, the present projection based upon the no-policy-change assumption is subject to considerable uncertainty for that year.

A balanced budget as foreseen for 2008 in the last update of the Austrian Stability Programme will probably be reached only at a later stage, notwithstanding the positive cyclical influence. While fiscal policy has supported economic growth in 2006, the deficit remains relatively high, notably in 2007, against the medium-term policy target.

Government deficit reduced by higher tax revenues, but rising again in 2007

The positive cyclical development is mirrored by a comfortable increase in government revenues, more than offsetting the impact of the tax cuts 2004-05. The revenue shortfalls from the tax reform, expected to materialise with a lag, have so far not become manifest. They may, however, burden the government balance in 2007. While the projection for 2008 is highly uncertain in the absence of government plans, a substantial reduction of the deficit appears unlikely.

Table 7: Key policy indicators

	2003	2004	2005	2006	2007	2008
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	-1.6	-1.2	-1.5	-1.2	-1.4	-1.4
According to National Accounts	-1.8	-1.3	-1.6	-1.3	-1.4	-1.5
General government primary balance	+1.3	+1.6	+1.3	+1.5	+1.4	+1.3
	Percent					
<i>Monetary policy</i>						
3-month interest rate	2.3	2.1	2.2	3.1	3.7	3.3
Long-term interest rate ¹	4.2	4.2	3.4	3.8	3.8	4.1
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+3.8	+1.2	-0.6	+0.2	+0.6	+0.4
Real	+2.8	+0.9	-0.7	-0.7	-0.2	±0.0

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