Markus Marterbauer

Cyclical Recovery in Danger of Stalling

Economic Outlook for 2004 and 2005

Real GDP is projected to advance at a modest 1.5 percent in the current year. In the last few months, uncertainty has mounted about the further trend notably in manufacturing. The outlook for GDP growth of 2¼ percent in 2005 is particularly vague given the recent mixed signals from leading indicators. Employment growth remains insufficient against a strong increase in labour supply, with unemployment rising to a total of nearly 250,000.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 31 March 2004. • E-mail address: Markus.Marterbauer@wifo.ac.at

Since the beginning of this year, economic prospects have become more subdued for the euro area as well as for Austria. Leading indicators like the business surveys conducted by the European Commission, the ifo business climate index for Germany and the WIFO business survey for Austria suggest that the business climate in the cyclically sensitive manufacturing sector, after a short-lived upturn between mid-year and end 2003, is being judged less favourable. Firms see no further improvement in their order situation and are less upbeat than before about the short-term production outlook. Whether this represents only a short "pause" in the recovery or rather an early end of the tentative cyclical upturn of the second semester 2003, remains to be seen. Similarities to the situation of mid-2002 are evident, when the cyclical revival in the euro area ended rather abruptly after only a few months, due to falling stock market values, rising oil prices and a higher euro exchange rate.

In its current projections WIFO assumes that the business cycle recovery is losing momentum, without coming to a standstill. In such a scenario, real GDP in Austria may gain 1.5 percent this year. For 2005, a rate of growth of 2¼ percent has been retained, but the margin of uncertainty appears particularly wide.

Business activity in Europe will receive stimulus from external forces, as the global economy will expand strongly on the back of booming Asia and lively demand in North America, even if the latter is subject to downward risks. Dynamism is nevertheless slow in being transmitted to the euro area. This is partly on account of the sizeable appreciation of the euro exchange rate, partly – and more importantly – of the persistently sluggish internal demand: confidence in the business sector and of private households is weak, inducing them to postpone investment plans and step up precautionary saving. Economic policy in Europe is apparently not successful in generating incentives for higher rates of growth.

Weak economic activity in major trading partner countries is weighing on Austrian merchandise export growth, projected at +4½ percent in volume for 2004. Domestic firms would thereby see their foreign market shares decline, particularly (albeit from a high level) in the EU accession countries. Imports of goods should increase somewhat less in real terms than last year, given that part of planned corporate investment spending – a demand component of high import intensity – has been carried forward into 2003 for tax reasons. The merchandise trade and the current account balances will be in small deficit of around ½ percent of GDP. Most sensitive to cyclical variations is the manufacturing sector, for which the forecast is subject to an above-average degree of uncertainty. After a stagnation of real net output last year, WIFO expects a modest pick-up of 2¼ percent in 2004.

As in 2003, domestic demand should give firm support to activity over the forecast period. Construction should again grow strongly in 2004, by 2½ percent at constant prices, largely due to lively investment in infrastructure. In 2005, for the first time in four years, retail trade and private consumption should post gains above the long-term average of 2½ percent, thereby contributing importantly to overall GDP growth. Income tax cuts will boost disposable income markedly and add momentum to higher private consumption. At the same time, nevertheless, the household saving ratio and imports will also go up. The overall effect of the second instalment of tax cuts on GDP growth has been estimated by WIFO at +0.3 percentage point for the year 2005. The general government deficit is expected to widen by some ¾ percentage point to a ratio of around 1½ percent of GDP.

Table 1: Main results

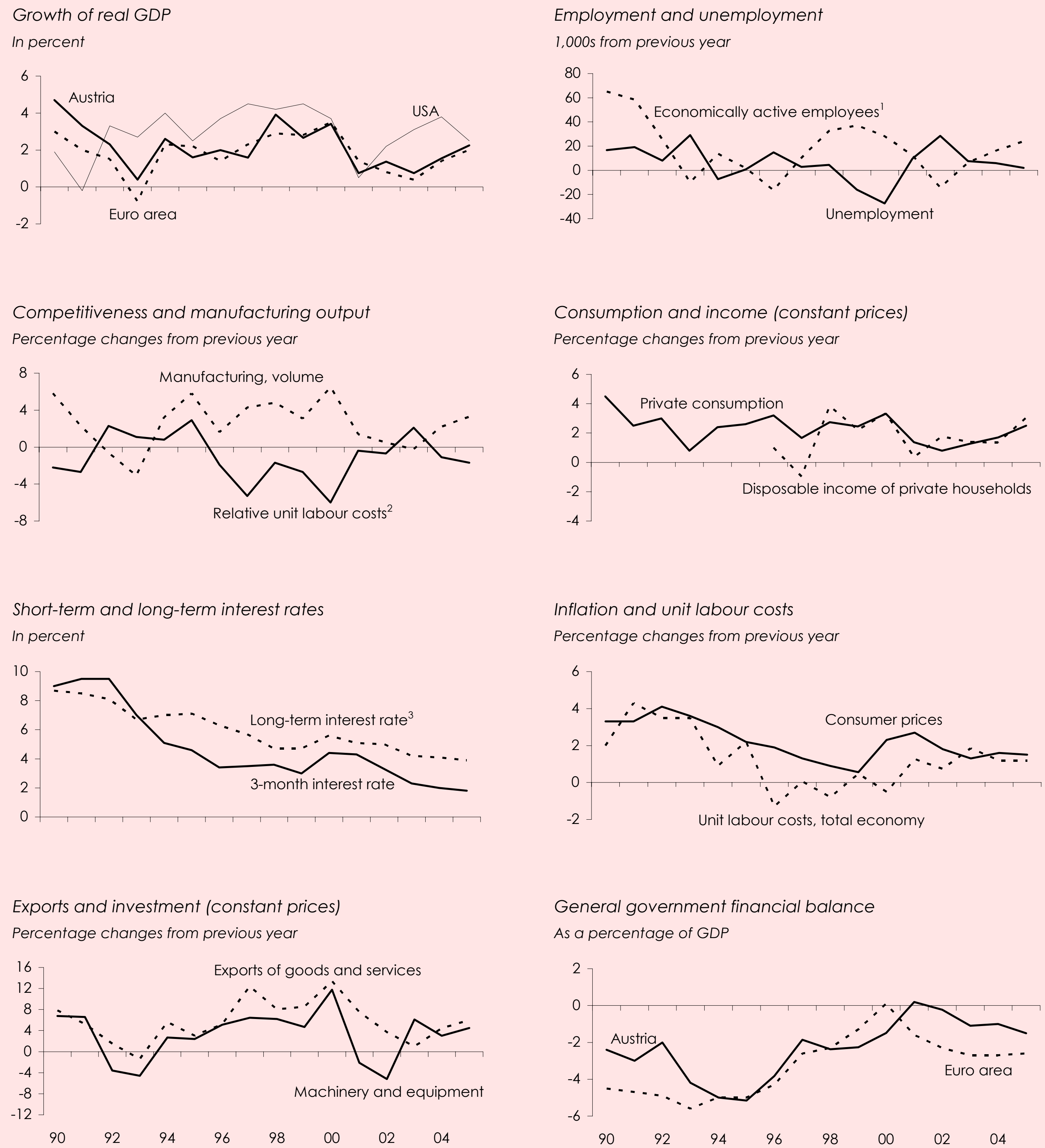
		2000	2001	2002	2003	2004	2005
		Percentage changes from previous year					
GDP							
Volume		+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.5	+ 2.3
Value		+ 4.9	+ 2.8	+ 2.7	+ 2.7	+ 3.4	+ 3.8
Manufacturing[1], volume		+ 6.4	+ 1.5	+ 0.5	– 0.2	+ 2.2	+ 3.3
Wholesale and retail trade, volume		+ 3.7	– 0.0	+ 1.2	+ 1.2	+ 1.7	+ 2.5
Private consumption expenditure, volume		+ 3.3	+ 1.4	+ 0.8	+ 1.3	+ 1.7	+ 2.5
Gross fixed investment, volume		+ 6.2	– 2.3	– 2.8	+ 4.3	+ 2.7	+ 3.2
Machinery and equipment[2]		+ 11.8	– 2.1	– 5.2	+ 6.1	+ 3.0	+ 4.5
Construction		+ 1.9	– 2.5	– 0.7	+ 2.8	+ 2.5	+ 2.0
Exports of goods[3]							
Volume		+ 13.1	+ 7.5	+ 5.2	+ 2.0	+ 4.5	+ 6.5
Value		+ 15.6	+ 6.5	+ 4.2	+ 1.4	+ 4.3	+ 7.0
Imports of goods[3]							
Volume		+ 10.9	+ 5.7	+ 0.8	+ 4.8	+ 4.0	+ 7.3
Value		+ 14.7	+ 5.0	– 2.0	+ 3.5	+ 3.5	+ 7.8
Current balance	billion €	– 5.36	– 4.13	+ 0.75	– 1.28	– 0.99	– 1.60
As a percentage of GDP		– 2.6	– 1.9	+ 0.3	– 0.6	– 0.4	– 0.7
Long-term interest rate[4]	in percent	5.6	5.1	5.0	4.2	4.1	3.9
Consumer prices		+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.6	+ 1.5
Unemployment rate							
Eurostat definition[5]	in percent	3.7	3.6	4.3	4.4	4.5	4.5
National definition[6]	in percent	5.8	6.1	6.9	7.0	7.2	7.2
Economically active emplyees[7]		+ 0.9	+ 0.4	– 0.5	+ 0.2	+ 0.5	+ 0.8
General government financial balance according to Maastricht definition							
As a percentage of GDP		– 1.5	+ 0.2	– 0.2	– 1.1	– 1.0	– 1.5

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

Unemployment is set to rise further over the projection period. On annual average 2005 it may reach a number close to 250,000, significantly above the level of 194,000 registered in 2000, before the protracted cyclical slowdown. This corresponds to an unemployment rate of 7.2 percent of the dependent labour force or 4.5 percent of the total labour force according to Eurostat definitions. The projected slight increase in the number of economically active of 0.5 percent in 2004 is accounted for by service sector jobs, most of them on a part-time basis.

Driven by higher energy prices, inflation has recently gained some momentum, still remaining, however, below an annual rate of 2 percent regarded as the ceiling of price stability. For 2004 and 2005, the projection foresees inflation rates of 1.4 percent and 1.3 percent on the Harmonised Index of Consumer Prices (HICP). According to the traditional Austrian consumer price index, the rates are higher by 0.2 percentage point, respectively.

Figure 1: Indicators of economic performance



[1] Excluding parental leave, military service, and unemployed persons in training. – [2] Manufacturing; in a common currency vis-à-vis trading partners. – [3] 10-year central government bonds (benchmark).

In view of the considerable uncertainties concerning the further business trend, economic policy should press ahead with plans for higher forward-looking investment, both at the level of the enlarged European Union and of the member states. The current WIFO projections also imply a cut of the key short-term interest rate by the ECB.

Strong expansion of demand in Asia

In 2002, a recovery of global economic activity and world trade has set in, which is gradually gaining strength. The expansion of world trade will accelerate further, to a projected average rate of 7½ percent in 2004. Yet, dynamism is rather uneven across the major economic zones. In the euro area, the recovery is but slowly gaining ground. In the USA, while demand is rising briskly, there are legitimate doubts about the sustainability of the expansion. Only in Asia, the pace of the upswing is unabated.

Buoyant economic growth in China exerts a demand-pull effect in the global economy and notably in Asia. Prices of raw materials and basic commodities are heading up markedly.

A major driving force behind the latter is the Chinese economy, which under the favourable circumstances of strict capital exchange controls and fixed exchange rates is growing by 8 percent per year. Lively import demand from China is providing major incentives for the whole South-East Asian region, for Japan and for world trade. China's swiftly rising demand for raw materials and semi-manufactures is adding importantly to the world-wide price hikes of such goods. Crude oil prices of currently over $ 30 per barrel are well above the price band targeted by OPEC. According to the HWWA index, commodity prices on a dollar basis may be around 25 percent higher this year than in 2002.

US growth lively for the time being

The US economy has staged a recovery, which by now has extended to all demand components. Private households are markedly stepping up consumption, in spite of stagnating employment and modest real wage gains, but supported by tax cuts. Public consumption is posting sizeable gains, driven by military and other government spending. The pick-up in investment in business equipment and software has strongly gained momentum in the second semester 2003, as business confidence has improved with higher output and order volumes. GDP is expected to gain some 4 percent in real terms in 2004.

Table 2: World economy

		2000	2001	2002	2003	2004	2005
		Percentage changes from previous year					
Real GDP							
Total OECD		+ 3.9	+ 0.9	+ 1.9	+ 2.1	+ 2.8	+ 2.4
USA		+ 3.7	+ 0.5	+ 2.2	+ 3.1	+ 3.8	+ 2.5
Japan		+ 2.8	+ 0.4	– 0.4	+ 2.7	+ 2.7	+ 2.5
Asia (excluding Japan)		+ 6.8	+ 5.2	+ 6.0	+ 6.5	+ 7.0	+ 6.5
EU 25		+ 3.6	+ 1.7	+ 1.2	+ 0.8	+ 1.8	+ 2.2
EU 15		+ 3.5	+ 1.7	+ 1.1	+ 0.7	+ 1.7	+ 2.1
Euro area		+ 3.5	+ 1.4	+ 0.8	+ 0.4	+ 1.4	+ 2.0
Germany		+ 2.9	+ 0.8	+ 0.2	– 0.1	+ 1.0	+ 1.7
Acceding countries[1]		+ 4.1	+ 2.4	+ 2.3	+ 3.6	+ 3.5	+ 3.8
World trade, volume		+12.3	+ 0.3	+ 3.4	+ 4.0	+ 7.5	+ 6.0
Market growth[2]		+12.2	+ 2.2	+ 1.8	+ 4.2	+ 5.0	+ 6.0
Primary commodity prices							
HWWA index, total		+31.0	–10.0	+ 1.0	+14.0	+10.0	+ 2.0
Excluding energy		+ 3.0	– 6.0	– 1.0	+13.0	+10.0	+ 6.0
Crude oil prices							
Average import price (cif) for OECD countries	$ per barrel	28.0	23.6	24.1	28.2	31.0	31.0
Exchange rate							
$ per euro		0.924	0.896	0.945	1.13	1.22	1.22

[1] Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia. – [2] Real import growth of trading partners weighted by Austrian export shares.

Despite this positive trend in overall demand, there are cyclical risks. Of immediate concern is the fact that the upswing has so far by-passed the labour market: employment remains flat, and the fall in the jobless rate is entirely due to the withdrawal of discouraged jobseekers from the labour force. Once the expansionary effects of the tax cuts fade, private household spending may lose momentum. The high general government deficit will make tax increases and cuts in public expenditure inevitable, as soon as the presidential elections in November are over. This will weigh significantly on economic growth. A second risk concerns the over-valuation of real estate markets, as the unabated price increases for houses and dwellings is fuelling private consumption and construction investment. If this speculative bubble were to burst, the cyclical upturn could also be seriously undermined.

Wait-and-see attitude by investors and consumers in the euro area

Activity in the euro area has picked up slightly in the third and fourth quarter 2003. Exports and investment in machinery and equipment headed up, while keeping a moderate pace. Private household spending remained sluggish. On annual average, GDP gained a modest 0.4 percent in volume, prolonging stagnation by a third year in a row. In early 2004 there are still few encouraging signs for a speedier recovery. The business surveys conducted by the European Commission suggest that sentiment is weak, particularly in the corporate sector. The industrial confidence indicator rebounded from mid-2003 until November but has remained flat ever since. Capacity utilisation in manufacturing has been rated weaker in the first quarter 2004, reversing the previous trend. While consumer confidence is strengthening slowly, this has so far hardly translated into higher spending, as retail traders report no improvement in their situation.

The business sector in the euro area has lost confidence in a speedy recovery. Private households have also turned sceptical, and precautionary saving is on the rise. With stimulus from internal demand lacking, the euro area is unable to transform the positive incentives from the global economy into a genuine business cycle upturn.

According to latest information, the recovery in the euro area may proceed more sluggishly still than assumed by WIFO last December. GDP is expected to increase by 1½ percent this year and by 2 percent in 2005. Still, one should not exclude a scenario similar to 2002 when the upward trend levelled off after only a few months. Parallel features to the situation of 1½ years ago are the marked increase in the euro exchange rate against the dollar, the high and further rising oil prices on world markets and the correction of stock market values. Firms are apparently turning more sceptical about the short-term outlook and are holding back with investment plans. Private households are using their modest income gains for higher saving rather than for consumption. Precautionary saving seems to gain ground in the face of rising concerns about job security and the continued functioning of social welfare schemes.

The euro area economy shows only limited reaction to the incentives deriving from the strong expansion in North America and Asia. This runs counter to the experience of the last decades when cyclical upturns in Europe were mostly instigated by a recovery of the global economy. Currently, however, two dampening factors are at work. First, the strong appreciation of the euro is weakening the positive incentives from the global rebound. Second, the three-year-long weakness of internal demand is bearing down on overall economic activity. No sustained upswing will be set in motion, as long as the revival of the world economy does not induce private agents to higher consumer and investment spending.

Finally, unlike in the USA, the EU economy is lacking expansionary policy stimulus. At the present juncture of widespread uncertainty and weak confidence among firms and households, a timely and co-ordinated approach towards higher public investment would be appropriate. The WIFO projections are based upon the assumption of a further cut in short-term interest rates by the ECB.

Consumer demand in Germany lacking strength

Economic activity in Germany has not recovered in 2003. Nevertheless, signs of a tentative revival of investment became apparent in the second half of the year. Notably the sustained fall in construction investment that has been holding back GDP growth for years, should have bottomed out. This could, however, be due to some extent to the carrying-forward of building projects ahead of cuts in the public homeowner subsidy, since incoming construction orders have slackened again in early 2004.

As in the previous years, private consumption was subdued in 2003. Preliminary data on retail sales in early 2004 do not indicate a pick-up despite a further stage of income tax cuts taking effect. The weakness of consumption is caused by quasi-stagnating incomes and a rise in the private household saving ratio. Reforms in the labour market and of social welfare schemes have probably induced households to step up precautionary saving. An increase in saving as a proportion of disposable income is unusual in a cyclical downturn and weighs heavily on economic performance.

The German economy has been in stagnation over the last three years. This year too, GDP may barely rise, by a projected 1 percent in real terms. Factors behind the crisis are the persistent weakness in construction investment and consumer demand.

In a difficult environment of a low dollar exchange rate and relatively high real interest rates, German exports are holding up well. Between mid-2003 and early 2004, the ifo business climate index as the key indicator of business confidence also followed an upward trend. In February and March, however, the business climate weakened considerably. WIFO therefore expects real GDP growth at only 1 percent in 2004, a rate somewhat lower than projected by the German economic research institutes. The more cautious outlook is motivated by negative reports on the business climate in manufacturing and on retail sales at the beginning of the year, as well as by the assumption of this year's calendar effect having only a limited impact on growth. Indeed, against the background of economic expansion being constrained from the demand side, the impact of the higher number of working days on GDP is deemed to be rather small. While the sluggish economic activity will inhibit an improvement on the labour market, institutional adjustments may lead to a slight reduction in the official unemployment rate.

EU accession countries catching up at a moderate pace

Economic growth in the accession countries has accelerated to an average 3½ percent in 2003, clearly outpacing the rate of ¾ percent in the EU 15. The main reason was the recovery in Poland, where budgetary policy has moved towards a less restrictive posture. However, frequent recourse to fiscal and monetary tightening in order to rein in the severe current account imbalances remains the key constraint on growth in the accession countries. Hungary, one of Austria's most important trading partners, is likely to see its economy losing steam this year following massive hikes in interest rates. GDP growth in the new EU member states, projected at 3½ percent per year for 2004 and 2005, will remain well above the average rate in the EU 15. Nevertheless, the catching-up process is too slow as to allow the new members to attain within the next decades the level of GDP per capita of the current member states. A faster increase in public and private foreign direct investment in the accession countries over the next few years may mitigate the current account problems and thereby ease somewhat the constraints on growth.

Gradual recovery in Austria with downward risks

The Austrian economy expanded by ¾ percent in volume in 2003, in line with the EU average. Unlike in the two years before, activity was sustained by domestic demand. Notably construction investment boomed, benefiting from lively demand for new infrastructure. Consumer spending, while remaining below its long-term trend, rose faster than total demand.

As in the last three years, real GDP in Austria is set to rise at the same pace as the EU average. Construction investment and private consumption provide the main support to activity. Growing uncertainty in the manufacturing sector points to the substantial risks that surround the projections.

As from mid-2003, a revival of activity in the cyclically sensitive manufacturing sector became visible. Production expectations and order levels were judged significantly better in the WIFO business survey, and firms turned again more optimistic on the forward-looking indicators. Since the beginning of 2004, however, the improvement of the business climate has been interrupted, with output expectations being corrected downwards. At present it is not quite clear whether this signals just a pause in the recovery following the further appreciation of the euro exchange rate in late 2003, or whether the incipient upswing has come to a standstill. Firms seem to have lost confidence in a swift upturn of the kind observed in previous cycles.

Assuming that the recovery is losing steam without ending abruptly, WIFO expects real GDP growth at 1.5 percent for 2004. The gradual export-led pick-up of manufacturing output will be accompanied by lively construction activity, particularly in civil engineering, and some strengthening of private consumption. In 2005, economic growth may accelerate to a rate of 2¼ percent. The cuts in direct taxes will give incentives to household spending which, rising by a projected 2½ percent, will underpin the rebound in overall demand. However, in view of the great uncertainty about the further trend in manufacturing industry, the projection for 2005 should be taken as being subject to a considerable margin of error.

Table 3: Productivity

	2000	2001	2002	2003	2004	2005
	Percentage changes from previous year					
Total economy						
Real GDP	+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.5	+ 2.3
Employment[1]	+ 0.8	+ 0.6	– 0.2	+ 0.3	+ 0.6	+ 0.8
Full-time equivalent	+ 1.0	+ 0.6	– 0.0	+ 0.2	+ 0.3	+ 0.7
Productivity (GDP per employment)	+ 2.6	+ 0.1	+ 1.6	+ 0.5	+ 1.0	+ 1.4
Full-time equivalent	+ 2.4	+ 0.1	+ 1.4	+ 0.5	+ 1.2	+ 1.5
Manufacturing						
Production[2]	+ 6.5	+ 1.4	+ 0.5	– 0.2	+ 2.2	+ 3.3
Employees[3]	+ 0.0	+ 0.2	– 2.5	– 1.7	– 1.2	– 0.7
Productivity per hour	+ 6.6	+ 1.6	+ 3.6	+ 1.5	+ 3.4	+ 3.8
Working hours per day per employee[4]	– 0.1	– 0.4	– 0.5	– 0.0	± 0.0	+ 0.2

[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.

Moderate revival of foreign trade

In 2003, Austrian merchandise exports, according to foreign trade statistics, rose by a mere 1¼ percent in value above the year-earlier level, with deliveries to the EU Internal Market being particularly weak. Exports to the accession countries fared somewhat better, although Austrian firms are clearly losing market shares in the region, albeit from a high level.

Austrian exports are being negatively affected by sluggish demand in key trading partner countries. The appreciation of the euro implies a weakening of price competitiveness and losses of market shares. However, prices of imported goods are declining faster than those of exports.

Table 4: Earnings and international competitiveness

	2000	2001	2002	2003	2004	2005
	Percentage changes from previous year					
Gross earnings per employee[1]	+2.5	+1.4	+2.2	+2.3	+2.2	+2.6
Full-time equivalent	+2.6	+1.4	+2.1	+2.5	+2.4	+2.8
Gross real earnings per employee[1]	+1.0	–0.8	+1.0	+0.5	+0.6	+1.1
Net real earnings per employee[1]	+1.6	–1.1	+0.8	+0.2	+0.9	+2.5
Net wages and salaries	+4.5	+2.1	+2.5	+2.6	+2.4	+4.1
Total economy						
Unit labour costs	–0.5	+1.3	+0.7	+1.8	+1.2	+1.2
Manufacturing						
Unit labour costs	–5.0	+1.6	–0.7	+0.3	–1.2	–1.3
Relative unit labour costs[2]						
Vis-à-vis trading partners	–6.0	–0.4	–0.7	+2.1	–1.1	–1.7
Vis-à-vis Germany	–2.3	–0.1	–0.5	+0.4	–1.6	–1.8
Effective exchange rate – manufactures						
Nominal	–2.7	+0.9	+1.3	+3.7	+1.3	–1.1
Real	–3.3	+0.5	+0.8	+2.9	+1.2	–0.9

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

Market share losses by Austrian firms registered across the board also derive from weakening price competitiveness as a consequence of the appreciation of the euro. The real-effective exchange rate index for manufactures lost more than 5 percent between 2000 and 2004, which could not be offset by the marked decline in relative unit labour costs.

WIFO expects goods exports to gradually gain momentum with the cyclical recovery in the trading partner countries, rising by 4½ percent in volume on annual average. The sizeable appreciation of the euro is narrowing the scope for price increases by firms. Merchandise import prices should decline even more, on account of the exchange rate, than export prices, resulting in better terms-of-trade. Goods imports in 2004 are unlikely to rise faster than last year, when an investment boom towards the end of the year fuelled imports. The trade balance, while improving slightly, will remain in small deficit. The current account deficit will change little over the projection period from the ratio of ½ percent of GDP recorded in 2003.

Uneven pattern of investment in machinery and equipment

According to preliminary national accounts data, investment in machinery and equipment rose by an inflation-adjusted 12 percent year-on-year in the fourth quarter 2003. Such an increase is clearly higher than could have been expected against the background of generally low capacity utilisation. It probably reflects the carrying forward of investment projects ahead of the expiration of an investment tax premium, which was originally scheduled for the end of 2003. The underlying cyclical pattern of investment is better illustrated by the WIFO investment survey, results from which do not suggest a broad-based recovery of investment for 2004. WIFO therefore projects an increase of only 3 percent from last year in corporate spending on machinery and equipment.

Weakening of industrial business climate in early 2004

Manufacturing represents the cyclically most sensitive part of the production sector. Output data as published by Statistics Austria go as far as November 2003. They show for the period from January to November an increase in the nominal production index by almost 2 percent year-on-year. According to the preliminary national accounts data, real value added of the manufacturing sector remained virtually flat (–0.2 percent) in 2003. More recent evidence for developments in industry is provided by the regular WIFO business survey. Firms sampled report on balance a steady improvement of the business climate since mid-2003. On the basis of an increasing inflow of foreign orders, firms' output expectations have strengthened markedly.

The business climate in manufacturing has clouded in the first quarter. While this does not signal an end to the recovery, risks have become higher. WIFO assumes a very shallow upward trend in industrial output, with an increase by 2¼ percent at constant prices in 2004.

However, the situation turned weaker again towards the end of 2003. The stock of orders increased no longer, and output expectations in the March survey, on a seasonally adjusted basis, relapsed markedly from the previous month. Such a correction comes at an unexpectedly early stage. It remains to be seen whether the weaker sentiment is only short-lived. WIFO expects only a modest increase of 2¼ percent in real terms in manufacturing value added for 2004, following its stagnation last year. Should the negative tendency in industry, as signalled by the WIFO business survey since last January, be confirmed in coming months, output projections would have to be revised downwards. In that case, industrial employment would also fall more strongly than currently expected, i.e., by 7,000 persons.

Lively investment in civil engineering

Value added of the construction sector gained 2½ percent in volume in 2003, distinctly more than expected last December. Activity was particularly buoyant in civil engineering. The relaxation of financing constraints for the road and railroad investment agencies (Asfinag and SCHIG) paved the way for a strong increase in transportation infrastructure investment. Activity in this area is set to expand further in the current year. In the WIFO business survey, the order situation and output developments were judged positively until the end of 2003.

Demand for housing is picking up from the trough recorded in 2002. Higher immigration is adding to demand for subsidised dwellings. Nevertheless, the federal states (Länder) are cautious in granting more permits for new-home building. Their budgets seem to be increasingly squeezed from the revenue side, making the authorities more hesitant in adopting new investment projects.

Relatively more favourable has been the trend in industrial building since the middle of 2003, on the back of booming investment in machinery and equipment. The creation of new office space, however, is still suffering from the existence of large excess capacity. Overall construction investment and output may again rise by 2½ percent in real terms this year, with some deceleration likely in 2005.

Consumer spending becoming major cyclical support in 2005

Cuts in direct taxes will boost budgets of private households in 2005. The increase in disposable income by an inflation-adjusted 3 percent will add to consumer demand, notably for durable goods. At the same time, the household saving ratio will rise significantly, attaining 9 percent of disposable income.

National accounts data show value added of the trade sector for 2003 a moderate 1.2 percent in real terms above the year-earlier level. Particularly weak was activity in retail trade which remained flat year-on-year in the second semester. However, the reliability of the official data released by Statistics Austria seems doubtful given the unusually large difference between nominal and real values that may overestimate inflation by around 1 percentage point. Sales of motor cars performed somewhat better, as well as wholesale trade due to the lively investment activity.

Table 5: Private consumption, earnings and prices

	2000	2001	2002	2003	2004	2005
	Percentage changes from previous year, volume					
Private consumption expenditure	+3.3	+1.4	+0.8	+1.3	+1.7	+2.5
Durables	+3.9	+1.8	+3.6	+0.8	+3.0	+5.5
Non-durables and services	+3.2	+1.3	+0.4	+1.3	+1.5	+2.0
Household disposable income	+3.3	+0.4	+1.8	+1.4	+1.4	+3.0
Household saving ratio						
As a percentage of disposable income	8.4	7.5	8.2	8.4	8.5	9.0
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+6.7	+3.5	+1.2	+1.6	+2.6	+2.8
	Percent					
Inflation rate						
National	2.3	2.7	1.8	1.3	1.6	1.5
Harmonised	2.0	2.3	1.7	1.3	1.4	1.3
Core inflation[2]	0.9	2.3	2.0	1.3	1.2	1.4

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

Preliminary data for early 2004 suggest hardly any increase in sales from last year. In the further course of the year, gains in retail sales may again lag behind those in wholesale trade. This also reflects the ongoing trend towards higher private saving as a proportion of disposable household income. From its low of 7.5 percent in 2001, the saving ratio went up to 8.4 percent in 2003 and is likely to edge up further this year, leaving scope for a 1.7 percent increase in real private consumption. In 2005, saving and consumption behaviour will largely be affected by the cuts in wage and income tax. The saving ratio may rise by another ½ percentage point, and private consumption growth is expected to accelerate to 2½ percent in real terms. Demand will be strongest for durable consumer goods, sales of which are projected to gain 5½ percent in volume. A substantial part of additional spending will, nevertheless, leak into imported goods and foreign travel.

Output growth in 2003 remained subdued not only in trade, but also in other private services sectors. Thus, banking and insurance continued to suffer from the sluggish advances of private incomes and investment activity. Activity was lacklustre also in the transport and communication sector, leading to non-negligible job losses. Output of hotels and restaurants gained only 1¼ percent in volume, as both foreign (+1½ percent) and domestic customers restrained their spending. Tourism exports are likely to pick up somewhat in 2004 and 2005, benefiting from Austria's comparative advantage of being deemed a safe travel destination.

Moderate acceleration of inflation

Prices may rise somewhat faster than expected last December, mainly on account of higher energy prices following the hikes for crude oil on world markets and the hefty increase in energy taxes at the beginning of 2004. While the higher energy costs will to some extent be passed through to the prices of manufactures, their increase will be dampened by the declines in unit labour costs and of import prices. Some upward pressure is also expected on prices for food and seasonal goods. Headline inflation is projected at 1.6 percent for 2004 and 1.5 percent for 2005 according to the national consumer price index; on the Harmonised Consumer Price Index (HICP) developed by Eurostat, the respective rates are 1.4 and 1.3 percent.

Gross wages and salaries per employee (full-time equivalents) are set to rise by some 2½ percent in 2004, broadly the same as last year. The wage round for 2005 will take place against the background of a slightly improved cyclical situation and the upward trend in inflation. WIFO assumes an average increase of 2¾ percent for wage settlements. After four years of sluggishness, growth of real net earnings will pick up in 2005, to a rate of 2½ percent per capita, owing also to the cuts in direct taxes. Broadly the same rate of increase should apply to real net income from employment and social transfers.

Unemployment to rise further

Over the entire projection period, no turnaround may be expected on the labour market. The number of dependent employees as recorded by the Federation of Austrian Social Security Institutions is strongly influenced by institutional changes. Nearly the whole increase from 2000 to 2003 was accounted for by the higher number of child care benefit recipients, participants in job training and people in part-time retirement (Altersteilzeit). The number of economically active[1] rose hardly at all, expressed in full-time equivalents it actually declined. In 2004 and 2005, the number of economically active should increase slightly, edging up for dependent employment by 0.5 percent in 2004 and 0.8 percent in 2005. The share of economically active (dependent and self-employed) in the total population of working age is set to rise from 62.6 percent in 2003 to 63.3 percent in 2005.

The number of jobless people will rise to a total 248,000 in 2005. The substantial increase in labour supply, not least by additional foreign workers, continues to outpace the cyclically-induced sluggishness of employment growth.

Table 6: Labour market

		2000	2001	2002	2003	2004	2005
		Changes from previous year (1,000s)					
Demand for labour							
Economically active employment[1]		+ 30.1	+ 13.8	− 10.9	+ 9.2	+ 19.2	+ 27.2
Employees[2]		+ 28.2	+ 12.3	− 14.3	+ 6.2	+ 16.0	+ 24.0
Percentage changes from previous year		*+ 0.9*	*+ 0.4*	*− 0.5*	*+ 0.2*	*+ 0.5*	*+ 0.8*
Nationals		+ 14.7	+ 2.9	− 19.5	− 9.7	± 0.0	+ 5.5
Foreign workers		+ 13.4	+ 9.5	+ 5.1	+ 15.9	+ 16.0	+ 18.5
Self-employed[3]		+ 1.9	+ 1.5	+ 3.4	+ 3.0	+ 3.2	+ 3.2
Labour supply							
Population of working age	15 to 64 years	+ 27.0	+ 27.5	+ 27.0	+ 29.1	+ 11.7	− 4.0
	15 to 59 years	− 16.5	− 13.8	− 1.2	+ 12.3	+ 14.3	+ 26.3
Labour force[4]		+ 2.6	+ 23.4	+ 17.6	+ 16.9	+ 25.1	+ 29.2
Surplus of labour							
Registered unemployed[5]		− 27.4	+ 9.6	+ 28.5	+ 7.7	+ 5.9	+ 2.0
In 1,000		194.3	203.9	232.4	240.1	246.0	248.0
		In percent					
Unemployment rate							
Eurostat definition[6]		3.7	3.6	4.3	4.4	4.5	4.5
Percent of total labour force[5]		5.3	5.5	6.2	6.3	6.4	6.4
National definition[5, 7]		5.8	6.1	6.9	7.0	7.2	7.2
Employment rate							
Economically active employment[1, 8]		63.5	63.5	62.8	62.6	62.8	63.3
Total employment[6, 8]		68.5	68.5	69.3	69.7	69.9	69.9

[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).

Employment will increase primarily in the public and semi-public sector, notably for education and health services. New jobs are also created in the broad area of commercial services, reflecting the continued practice of outsourcing from industry or the government sector. The fall in construction employment should decelerate as output posts healthy gains, whereas the recovery in manufacturing will not prove strong enough as to bring job losses to an end.

[1] Dependent employees excluding people on parental leave or receiving child-care benefits, people in statutory military service, and unemployed people taking part in active labour market policy measures who are statistically registered as "employed".

Sluggish business activity will make for only modest employment gains. Since at the same time labour supply increases markedly, the rate of unemployment will rise further. Labour supply is largely driven by an increase in the number of foreign workers, due to a generous arrangement for seasonal workers on the one hand, and easier access for family members of foreign workers resident in Austria, on the other. Adjustments in the social retirement system are also adding to labour supply, as the effective retirement age is moving up steadily.

The rate of unemployment will amount to 7.2 percent of the dependent labour force in 2004 and 2005, corresponding to an annual average number of almost 250,000 out of work, compared with 194,000 in 2000. According to the EU Labour Force Survey, the rate of unemployment in Austria stands at 4.5 percent of the total labour force.

Budget balance reflecting the "cost" of the tax reform

In 2003, the general government balance recorded a deficit of around 1 percent of GDP. In the current year, the gap may be of similar magnitude. While indirect tax revenues develop favourably, those of direct taxes are rising only slowly. The carrying forward of parts of the second instalment of the tax reform will lead to shortfalls in revenues. Expenditure on monetary social transfers remains on a strong upward trend, due to high unemployment and the rising benefit cost for child care and part-time retirement. In 2005, the government budget will be largely shaped by cuts in income and profit taxes. The tax reform is expected to weaken the general government balance by some ¾ percent of GDP, leading to a deficit of around 1½ percent of GDP. Moreover, a substantial part of the revenue losses from corporate tax will only show up in the budgets of subsequent years.

Table 7: Key policy indicators

	2000	2001	2002	2003	2004	2005
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	−1.5	+0.2	−0.2	−1.1	−1.0	−1.5
According to National Accounts	−1.6	+0.1	−0.4	−1.2	−1.0	−1.5
General government primary balance	+2.2	+3.8	+3.2	+2.2	+2.3	+1.8
	In percent					
Monetary policy						
3-month interest rate	4.4	4.3	3.3	2.3	2.0	1.8
Long-term interest rate[1]	5.6	5.1	5.0	4.2	4.1	3.9
	Percentage changes from previous year					
Effective exchange rate						
Nominal	−2.5	+1.0	+1.4	+3.8	+1.4	−1.3
Real	−3.4	+0.3	+0.6	+2.8	+1.2	−1.2

[1] 10-year central government bonds (benchmark).