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 **ÖSTERREICHISCHES INSTITUT FÜR
WIRTSCHAFTSFORSCHUNG**

**Business Cycle Recovery
Gaining Shape**

Economic Outlook for 2004 and 2005

December 2003

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Austrian Institute of Economic Research

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Economic Outlook for 2004 and 2005

With economic activity picking up, growth of real GDP is set to accelerate from 0.7 percent in 2003 to 1.7 percent in 2004, supported by exports, manufacturing output and business investment in machinery and equipment. In the last few months, global economic conditions for a cyclical upturn have improved markedly. Certain risks remain, however, such as the sizeable appreciation of the euro that could put a brake on the recovery. The outlook for 2005, with a projected growth rate of 2½ percent is therefore still surrounded by a margin of uncertainty. Contrary to the experience with previous episodes, the strengthening of growth will not lead to a turnaround on the labour market. The rate of unemployment will remain at 4.5 percent of the labour force, due to a strong increase in foreign labour supply.

Economic growth in Austria, at 0.7 percent in real terms in 2003, remained well below its long-term average for the third year in a row. The economic crisis of the past years implied considerable welfare losses. At present, a number of indicators point to the stagnation being overcome. Stimulus is coming from the global economic upturn. China, in particular, with its booming economy, is becoming a growth pole providing incentives for large parts of Asia and beyond. In the USA, the upswing has been put on a firmer base, depending no longer from tax cuts and higher military spending only. The positive impulse will spill over to the euro area where growth is still being held back by the weakness of internal demand. Yet, the recovery of the EMU economies will follow a moderate pace, as the over-valued euro against the dollar is holding back growth of exports and investment and fiscal policy will keep a restrictive stance in the years to come. In Germany, exports will benefit from the rebound of world trade, and the crisis of the construction sector should bottom out; GDP growth should thereby revert to the euro area average over the medium term.

Supported by the revival of overall demand in the main trading partner countries, Austrian goods exports should gradually pick up, paving the way for an upswing of the whole economy. Nevertheless, exporters will suffer slight market share losses, owing to an increase in the real-effective exchange rate for manufactures (2003

+2¼ percent) and tighter conditions in the accession countries. Still, over a longer perspective, price competitiveness of exporting firms, as measured by unit labour costs relative to those of trading partners, has improved notably (by 10 percent between 1998 and 2002). With real export growth expected to accelerate from 2 percent (2003) to 5 percent in 2004, the share of merchandise exports in GDP is rising further and may attain 36 percent in 2004. Likewise, manufacturing production should pick up from two years of stagnation, gaining 3 percent in volume in 2004 and taking on further momentum thereafter.

Merchandise imports rose notably faster than exports in 2003, and the trade balance has weakened, as a result of a surprisingly strong increase in equipment investment. Demand for vehicles, machinery and electronic equipment jumped particularly in the second and third quarter, fuelled by the government investment premium. This is reflected also by lively turnover of wholesale trade. In 2004 and 2005, investment growth should be driven also by cyclical forces, posting projected real gains of 4 percent and 6 percent, respectively.

Among the domestic demand components, cyclical activity in 2003 received support from construction investment (+1¾ percent in volume), driven by the upgrading of road and railroad infrastructure. More recently, also residential construction has started heading up, reversing the marked decline between 1999 and 2002. From the trough of 42,000 dwellings completed in 2001, the rising number of building permits issued signals an imminent increase in output. The construction industry as a whole is expected to expand by close to 2 percent p.a. in 2004 and 2005.

The rise in private consumption expenditure over the last three years remained by more than 1 percentage point p.a. below the long-term average. Retailers and other service branches suffered from sluggish growth of households' net income and demand. For the next years, demand should follow a modest upward trend. While employment and per-capita incomes will go up, so will the private saving ratio. Household consumption is therefore expected to expand at an annual pace of 2 percent in volume over the projection period. Retail sales value added may gain 1½ percent to 2 percent per year, as will transport and telecommunication services. The recovery should be felt somewhat more strongly in the real estate business, which will benefit from stronger housing demand, while there is substantial excess capacity of office space. The hotel and restaurant sector can expect net output gains of over 2 percent per year, on account of higher demand from domestic cus-

tomers as well as a revival of cross-border tourism. The negative effect of the appreciation of the euro on the Austrian tourism industry should be more than offset by the positive impact of rising incomes in key foreign markets.

The cyclical upturn is unlikely to give rise to higher inflation. With projected headline inflation rates of 1¼ percent in 2004 and no more than 1½ percent in 2005, price stability will be broadly maintained.

The economic crisis of the last three years has been reflected most clearly by the strong rise in unemployment by a seasonally-adjusted 58,000 since January 2001. Despite the projected gradual recovery of activity, no trend reversal is in sight on the labour market. While the number of actively employed is rather elastic with regard to the increase in output of goods and services, unemployment does not fall because of a substantial increase in labour supply. Apart from a less restrictive practice of admission of foreign workers who have been resident in Austria for a longer time, this is explained by a more generous granting of permits for seasonal workers. The total number of jobless people is expected at 243,000 for 2005, corresponding to an unemployment rate of 7 percent of the dependent labour force or 4.5 percent of the total workforce according to Eurostat.

In 2003, the general government deficit, estimated at 0.9 percent of GDP, rose significantly, due to cyclically-induced revenue shortfalls and rising outlays for child-care benefits and part-time retirement ("Altersteilzeit"). For 2004, a deficit of the same order of magnitude is expected, before the recovery will boost tax revenues in 2005, leading to a somewhat smaller deficit of 0.6 percent of GDP. This projection does not include government tax cuts announced for 2005, details for which are as yet unknown. Should the tax reform lead to a reduction in the overall tax burden by € 2½ billion, extending to wage, income and corporate tax, and a widening of the government deficit to a similar extent, GDP growth may be boosted by some ½ percentage point in the short term, and the general government deficit may be raised by nearly 1 percent of GDP, according to first estimates. WIFO will submit a more in-depth assessment of the macro-economic effects of the tax reform, as soon as more ample information on its content, financing and re-distributive implications becomes available.

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Projections - December 2003

Main results

Changes from previous year

		2000	2001	2002	2003	2004	2005
GDP							
Volume		+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.7	+ 2.4
Value		+ 4.9	+ 2.8	+ 2.7	+ 2.5	+ 3.2	+ 3.9
Manufacturing¹ , volume		+ 6.4	+ 1.5	+ 0.5	+ 0.3	+ 3.0	+ 4.5
Private consumption expenditure , volume		+ 3.3	+ 1.4	+ 0.8	+ 1.3	+ 1.8	+ 2.1
Gross fixed investment , volume		+ 6.2	- 2.3	- 2.8	+ 2.5	+ 2.7	+ 3.8
Machinery and equipment ²		+ 11.8	- 2.1	- 5.2	+ 3.5	+ 4.0	+ 6.0
Construction		+ 1.9	- 2.5	- 0.7	+ 1.7	+ 1.7	+ 1.9
Exports of goods³							
Volume		+ 13.1	+ 7.5	+ 5.2	+ 2.0	+ 5.0	+ 7.0
Value		+ 15.6	+ 6.5	+ 4.2	+ 1.5	+ 5.0	+ 7.5
Imports of goods³							
Volume		+ 10.9	+ 5.7	+ 0.8	+ 3.3	+ 5.0	+ 7.0
Value		+ 14.7	+ 5.0	- 2.0	+ 2.5	+ 5.0	+ 7.5
Current balance	€ bn	- 5.36	- 4.13	+ 0.75	+ 0.19	+ 0.36	+ 0.52
As a percentage of GDP	%	- 2.6	- 1.9	+ 0.3	+ 0.1	+ 0.2	+ 0.2
Long-term interest rate⁴	%	5.6	5.1	5.0	4.2	4.3	4.0
Consumer prices		+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.2	+ 1.4
Unemployment rate							
Eurostat definition ⁵	%	3.7	3.6	4.3	4.5	4.5	4.5
National definition ⁶	%	5.8	6.1	6.9	7.0	7.1	7.0
Economically active employees⁷		+ 1.0	+ 0.4	- 0.5	+ 0.2	+ 0.6	+ 1.0
General government financial balance							
according to Maastricht definition							
As a percentage of GDP	%	- 1.5	+ 0.3	- 0.1	- 0.9	- 0.9	- 0.6

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 and military service.

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Projections - December 2003

Key policy indicators

	2000	2001	2002	2003	2004	2005
Fiscal policy						
	As a percentage of GDP					
General government financial balance						
according to Maastricht definition	- 1.5	+ 0.3	- 0.1	- 0.9	- 0.9	- 0.6
according to National accounts	- 1.6	+ 0.1	- 0.4	- 1.0	- 1.0	- 0.6
General government primary balance	+ 2.2	+ 3.8	+ 3.2	+ 2.5	+ 2.4	+ 2.6
Monetary policy						
	In percent					
3-month interest rate	4.4	4.3	3.3	2.3	2.1	2.1
Long-term interest rate ¹	5.6	5.1	5.0	4.2	4.3	4.0
	Percentage changes from previous year					
Effective exchange rate						
Nominal	- 2.5	+ 1.0	+ 1.4	+ 3.2	+ 0.5	- 0.1
Real	- 3.4	+ 0.3	+ 0.6	+ 2.3	+ 0.1	- 0.4

¹ 10-year central government bonds (benchmark).

WIFO*Projections - December 2003***World economy**

Percentage changes from previous year

	2000	2001	2002	2003	2004	2005
Real GDP						
Total OECD	+ 3.9	+ 0.9	+ 1.9	+ 2.0	+ 2.7	+ 2.4
USA	+ 3.7	+ 0.5	+ 2.2	+ 3.0	+ 3.8	+ 2.5
Japan	+ 2.8	+ 0.4	- 0.4	+ 2.3	+ 1.5	+ 1.8
Asia (excluding Japan)	+ 6.8	+ 5.2	+ 6.0	+ 6.0	+ 6.5	+ 6.8
EU 25	+ 3.6	+ 1.7	+ 1.2	+ 0.9	+ 2.1	+ 2.6
EU 15	+ 3.5	+ 1.7	+ 1.1	+ 0.8	+ 2.0	+ 2.5
Euro area	+ 3.5	+ 1.6	+ 0.9	+ 0.4	+ 1.8	+ 2.5
Germany	+ 2.9	+ 0.8	+ 0.2	± 0.0	+ 1.3	+ 2.2
Acceding Countries ¹	+ 4.1	+ 2.4	+ 2.3	+ 2.8	+ 3.5	+ 4.0
World trade, volume	+ 12.4	+ 0.2	+ 3.4	+ 3.8	+ 6.5	+ 6.0
Market growth²	+ 13.1	+ 2.9	+ 2.0	+ 2.8	+ 5.5	+ 6.5
Primary commodity prices						
HWWA Index, total	+ 31.0	- 10.0	+ 1.0	+ 17.0	- 3.0	+ 2.0
Excluding energy	+ 3.0	- 6.0	- 1.0	+ 12.0	+ 4.0	+ 4.0
Crude oil prices						
Average import price (cif)						
for OECD countries	USD/barrel	28.0	23.6	24.1	29.0	27.0
Exchange rate						
USD per euro		0.924	0.896	0.945	1.13	1.16
					1.16	1.14

¹ Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia.

² Real import growth of trading partners weighted by Austrian export shares.

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Projections - December 2003

Private consumption, income 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	+ 1.8	+ 2.1
Durables	+ 3.9	+ 1.8	+ 3.6	+ 0.5	+ 3.2	+ 4.5
Non-durables and services	+ 3.2	+ 1.3	+ 0.4	+ 1.4	+ 1.6	+ 1.7
Household disposable income	+ 3.1	+ 0.3	+ 1.0	+ 1.8	+ 1.8	+ 2.3
Household saving ratio						
As a percentage of disposable income	8.3	7.4	7.4	7.9	8.3	8.5
	Percentage changes from previous year					
Direct lending to domestic non-banks¹	+ 6.7	+ 3.5	+ 1.2	+ 2.3	+ 2.7	+ 2.8
	Percent					
Inflation rate						
National	2.3	2.7	1.8	1.3	1.2	1.4
Harmonised	2.0	2.3	1.7	1.2	1.1	1.3
Core inflation ²	0.9	2.3	2.0	1.3	1.1	1.4

¹ End of period.

² Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

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Projections - December 2003

Productivity

Percentage changes from previous year

	2000	2001	2002	2003	2004	2005
Total economy						
Real GDP	+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.7	+ 2.4
Employment ¹	+ 0.8	+ 0.6	- 0.2	+ 0.3	+ 0.6	+ 1.0
Full-time equivalent	+ 1.0	+ 0.6	- 0.0	+ 0.2	+ 0.4	+ 0.8
Productivity (GDP per employment)	+ 2.6	+ 0.1	+ 1.6	+ 0.4	+ 1.1	+ 1.4
Full-time equivalent	+ 2.4	+ 0.1	+ 1.4	+ 0.5	+ 1.3	+ 1.6
Manufacturing						
Production ²	+ 6.5	+ 1.4	+ 0.5	+ 0.3	+ 3.0	+ 4.5
Employees ³	+ 0.0	+ 0.2	- 2.5	- 1.9	- 0.5	+ 0.2
Productivity per hour	+ 6.6	+ 1.6	+ 3.8	+ 2.8	+ 3.5	+ 4.0
Working hours per day per employee ⁴	- 0.1	- 0.4	- 0.7	- 0.5	± 0.0	+ 0.3

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.

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Projections - December 2003

Earnings and international competitiveness

Percentage changes from previous year

	2000	2001	2002	2003	2004	2005
Gross earnings per employee ¹	+ 2.5	+ 1.4	+ 2.2	+ 2.2	+ 2.2	+ 2.7
Full-time equivalent	+ 2.6	+ 1.4	+ 2.1	+ 2.4	+ 2.5	+ 3.0
Gross real earnings per employee ¹	+ 1.0	- 0.8	+ 1.0	+ 0.9	+ 1.0	+ 1.3
Net real earnings per employee ¹	+ 1.6	- 1.1	+ 0.8	+ 0.6	+ 0.7	+ 1.1
Net wages and salaries	+ 4.5	+ 2.1	+ 2.5	+ 2.6	+ 2.3	+ 3.2
<i>Total economy</i>						
Unit labour costs	- 0.5	+ 1.3	+ 0.7	+ 1.8	+ 1.0	+ 1.3
<i>Manufacturing</i>						
Unit labour costs	- 5.0	+ 1.6	- 0.7	+ 0.2	- 0.7	- 0.8
Relative unit labour costs ²						
Vis-à-vis trading partners	- 6.0	- 0.4	- 0.7	+ 1.8	- 1.1	- 1.6
Vis-à-vis Germany	- 2.3	+ 0.1	- 0.5	+ 0.3	- 1.1	- 1.4
Effective exchange rate - manufactures						
Nominal	- 2.7	+ 0.9	+ 1.3	+ 3.0	+ 0.4	- 0.2
Real	- 3.3	+ 0.5	+ 0.8	+ 2.3	+ 0.1	- 0.3

¹ Employees according to National Accounts definition.

² In a common currency; minus sign indicates improvement of competitiveness.

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Projections - December 2003

Labour market

Changes from previous year (1,000^s)

	2000	2001	2002	2003	2004	2005
Demand for labour						
Economically active employment ¹	+ 30.8	+ 15.1	- 11.2	+ 10.5	+ 20.7	+ 32.7
Employees ²	+ 28.9	+ 13.6	- 14.6	+ 7.5	+ 17.5	+ 29.5
<i>Percentage changes from previous year</i>	+ 1.0	+ 0.4	- 0.5	+ 0.2	+ 0.6	+ 1.0
Nationals	+ 15.5	+ 4.2	- 19.7	- 9.0	± 0.0	+ 10.5
Foreign workers	+ 13.4	+ 9.5	+ 5.1	+ 16.5	+ 17.5	+ 19.0
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	+ 3.4	+ 24.7	+ 17.3	+ 18.0	+ 24.3	+ 32.2
Surplus of labour						
Registered unemployed ⁵	- 27.4	+ 9.6	+ 28.5	+ 7.5	+ 3.6	- 0.5
1,000 ^s	194.3	203.9	232.4	239.9	243.5	243.0
Unemployment rate						
Eurostat definition ⁶	% 3.7	3.6	4.3	4.5	4.5	4.5
Percent of total labour force ⁵	% 5.3	5.5	6.2	6.3	6.3	6.3
National definition ^{5,7}	% 5.8	6.1	6.9	7.0	7.1	7.0
Employment rate						
Economically active employment ^{1,8}	% 63.5	63.5	63.0	62.8	63.1	63.7
Total employment ^{6,8}	% 68.5	68.5	69.3	69.3	69.4	69.5

¹ Excluding parental leave and military service. ² According to Federation of Austrian Social Security Institutions.

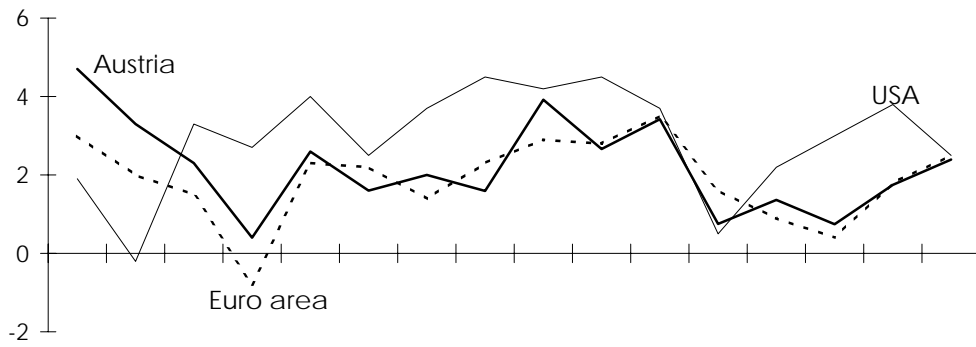
³ According to WIFO. ⁴ Economically active employment plus unemployment.

⁵ According to Labour Market Service. ⁶ According to Eurostat Labour Force Survey. ⁶

⁷ Percent of total labour force excl. self-employed. ⁸ Percent of population of working age (15 to 64 years).

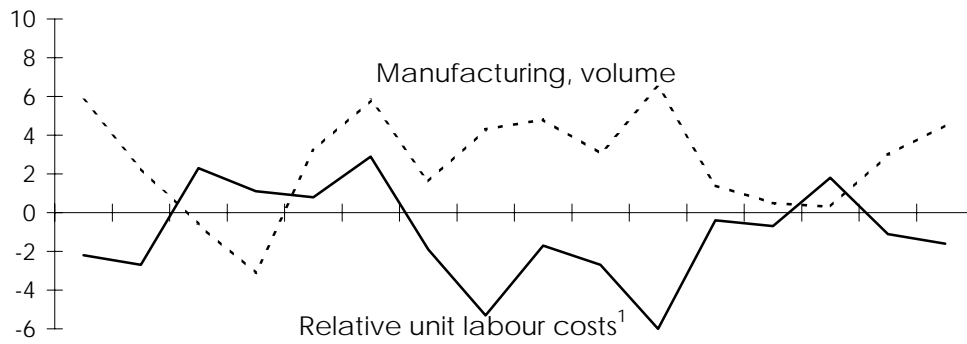
Growth of real GDP

In percent



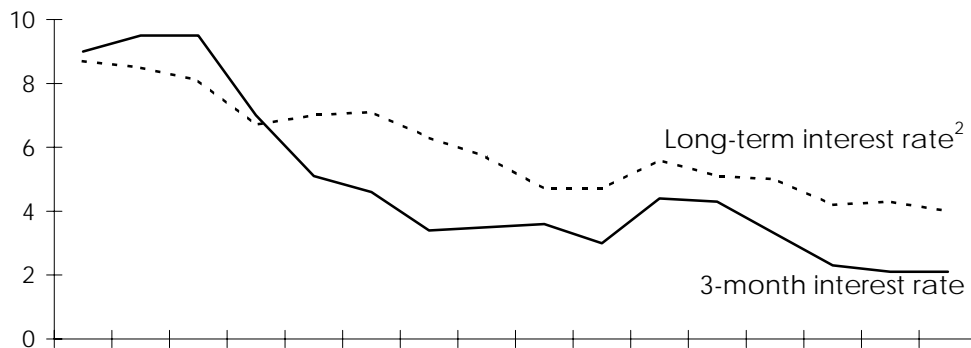
Competitiveness and manufacturing output

Percentage changes from previous year



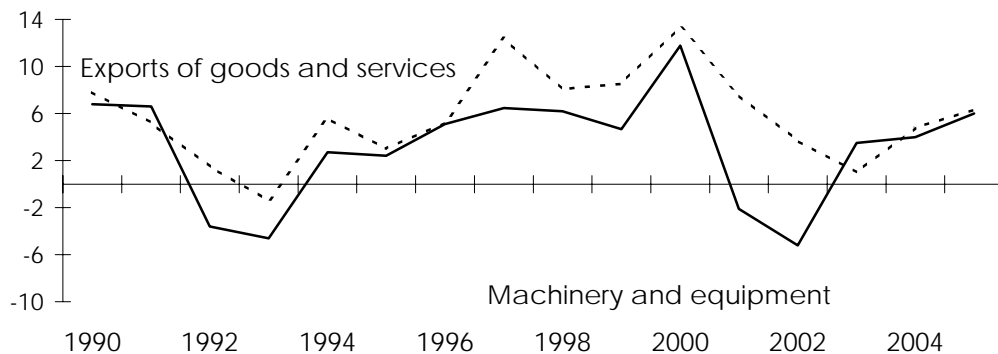
Short-term and long-term interest rates

In percent



Exports and investment (constant prices)

Percentage changes from previous year

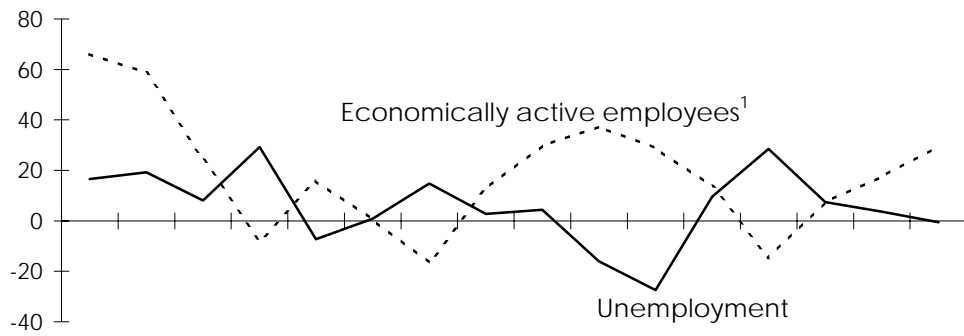


¹ Manufacturing; in a common currency vis-à-vis trading partners.

² 10-year central government bonds (benchmark).

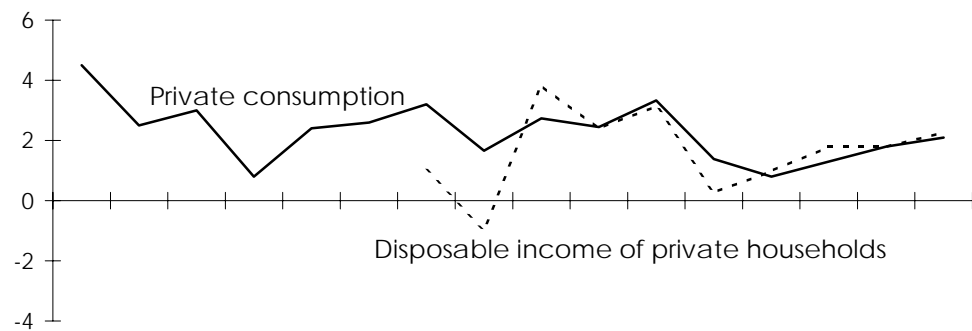
Employment and unemployment

1,000s from previous year



Consumption and income (constant prices)

Percentage changes from previous year



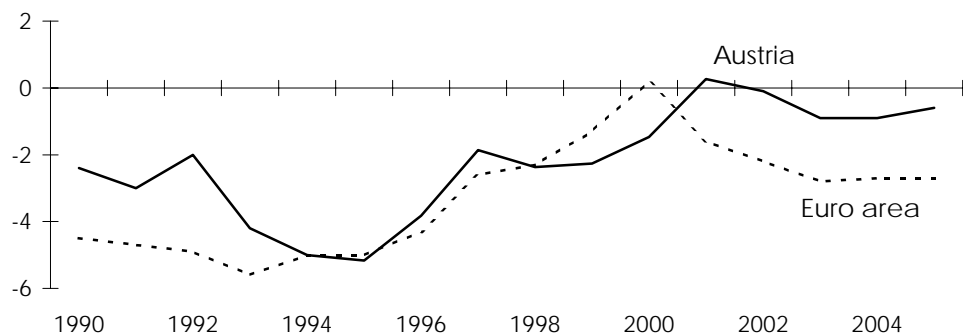
Inflation and unit labour costs

Percentage changes from previous year



General government financial balance

As a percentage of GDP



¹ Excluding parental leave and military service.

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Verkaufspreis: 15,00 €, Download 15,00 €:

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