

■ FIRMS TURNING STILL MORE PESSIMISTIC – UNEMPLOYMENT RISING FURTHER

Firms' judgements on the current order situation are still signalling no improvement of business conditions. Output expectations for the months to come have become still more pessimistic. In addition, the flood disaster has led to huge losses in private wealth and considerable shortfalls in production, which the ongoing repair works will take time to make up for.

According to the regular WIFO business survey conducted in co-operation with the EU, the overall judgement on the current order situation has hardly changed in August from the previous months. However, production expectations have weakened further, even if the sample was largely taken ahead of the flood disaster. Only a small number of firms were able to include an assessment of the consequences of the floods in their late response.

The floods have damaged private dwellings, commercial buildings and public infrastructure such as roads and railway tracks. Still, latest information suggests that the losses in private and public wealth may remain rather at the lower end of the range given in WIFO's early estimate, i.e., 2.5 to 3.5 percent of GDP¹). The impact on economic growth deriving from production shortfalls on the one hand, and from repair works on the other, may be altogether small (see box). Most negatively affected are the tourism and the insurance sectors, whereas the construction business will benefit from reconstruction efforts.

The business surveys conducted in Austria convey a message that is similar to those in Germany. The latest survey among German companies carried out by the ifo Institute in Munich suggests that the recovery has stalled, if not reversed: the monthly index for the business climate has gone down for the third time in a row in August.

The business cycle weakness is putting heavy strain on German public finances. Hence, it will be difficult for the authorities to keep the general government deficit for 2002 below the ceiling of 3 percent of GDP, as provided for by the Stability and Growth Pact. Balancing the budget by 2004, as foreseen, would

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Report.

¹) Kramer, H., Budgetpolitik und wirtschaftspolitische Strategie (Budgetary Policy and Economic Strategy), WIFO, Vienna, August 2002, http://titon.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=2&pubid=22581&pub_language=-1&p_type=0.

The economic consequences of the flood disaster

Heavy rainfall in mid-August led to disastrous inundation of parts of Upper and Lower Austria. The floods caused severe damage to infrastructure, industrial and residential buildings. Agricultural areas, transport facilities and mobile equipment were also adversely affected. In assessing the economic effects, a distinction has to be made between production foregone and losses of assets. In some instances, it is difficult to quantify the effects. As for the total impact on economic growth in 2002, it is not even possible to determine the sign with reasonable certainty. In order to estimate that impact, the production losses have to be set against the reconstruction-induced output gains:

Production losses

- Evaluating the damage to the *agricultural areas* concerned by last year's harvested quantities and producer prices, the harvest shortfall ranges from € 14 to 30 million (concerning mainly sugar beets and maize). The upper limit quoted here should be relatively robust, since it is not in every case that the total harvest will have been destroyed. The damage corresponds to between 0.6 and 1.2 percent of total plant production or 0.25 to 0.5 percent of total Austrian agricultural output.

By way of comparison, and applying the same evaluation method, the expected damage of some 10 percent to cereal production caused by drought in autumn 2001 and spring 2002 is estimated at some € 50 million, thus clearly exceeding that of the floods. Nevertheless, for some farms the flood disaster has taken away almost the whole harvest.

- The *tourism* sector has been particularly severely hit by the flood disaster, which occurred in August, the most important month for travel in the whole year. The shortfalls will not be made up for during the rest of the year. The news about the disaster are having a negative impact also on destinations in Austria not directly affected, as many vacationers shy away from spending their holidays in a „devastated area“. Moreover, some home areas of visitors (in Germany and the Czech Republic) were also struck by the floods, and at least part of household income that would have been spent on holidays will now go to repair works.
- The indemnities paid by *insurance companies* figure as a negative item in the calculation of GDP, unless they are covered by re-insurance companies abroad themselves or financed through liquidation of reserves. While in the case of flood damages insurance payments are generally limited, they may nev-

ertheless amount to several hundred millions of euros. Some insurance companies have advanced estimates in the order of € 500 million. Via re-insurance, damages in the Czech Republic will also show up in the financial accounts of Austrian insurance companies.

- Output losses in the areas concerned are extending to *many sectors*, with some companies having seen the largest part of their assets destroyed.
- The *aid and assistance provided for free by volunteers* cannot be appropriately quantified in economic terms and is therefore not included in national output. Absence from the workplace can nevertheless show up in production foregone.

Production gains

- The necessary repair works to buildings and roads are adding to output of the *construction* sector, which has been particularly affected by the cyclical weakness of total economy. Possible price effects of the additional demand should remain small, given the existing spare capacities in the sector.
- The size of the positive effect on *output and trade* with durable consumer goods will depend on the amount and kind of damages on the one hand, and on the willingness to replace the destroyed assets, on the other. The financial constraint facing those who have to restore their dwellings is unlikely to allow complete replacement in the near future.
- Overtime hours worked and paid by the *professional help services and aid organisations* also raise measured overall economic output.

The losses of private wealth and productive capital are undoubtedly many times higher than those incurred in current production. In instances such as this, GDP proves to be an inadequate welfare indicator that does not allow for a destruction of wealth, but indeed includes its replacement. The municipalities have estimated the damages to local infrastructure at around € 500 million. To these should be added those (considerably smaller ones) to be taken over by the federal and by states governments. In Lower Austria alone, some 10,000 private houses have been hit. The losses in value of residential and commercial buildings due to humidity remaining for still a number of years are difficult to quantify. Shortfalls have occurred in current production and in tourism demand. While most firms were able to resume production in relatively short time, the negative consequences for tourism may still be felt for some time.

require a distinctly restrictive fiscal policy stance, which may weigh on economic activity not only in Germany, but also in Austria and Europe as a whole.

The delay in the EU recovery is giving the ECB more leeway in steering interest rates. Headline inflation in the euro area is close to 2 percent and should abate further over the coming months. While the growth of money supply has clearly exceeded the reference value in recent periods, this can largely be explained by a number of one-time influence factors.

The weaker dollar exchange rate will, via cheaper imports, facilitate the deceleration of inflation in the euro

area, but may also reduce export opportunities for European goods. The negative real effects of currency appreciation typically show up with a lag of between two and three quarters. Such dampening effects constitute a risk factor at the present juncture, the external contribution being currently the major growth-supportive element in the face of sluggish domestic demand. Indeed, the euro area trade surplus rose to a total € 42 billion for the first half of 2002, compared with just € 4.3 billion in the year-earlier period.

Cut-off date: 9 September 2002.