

RISE IN DOMESTIC DEMAND BUT SLOWDOWN IN EXPORTS

The economic and financial crises in Asia and in Russia have had a marked impact on the economic development in Austria. Weaker export growth and, given the economic uncertainties, a feeble propensity to invest dampened GDP growth in the third quarter of 1998 to a low 2.7 percent on a year-on-year basis, following a buoyant growth of 4.4 percent in the first half of 1998. The strong expansion in real disposable income continued to boost consumer demand; consumer spending, rising at a rate of 2 percent in real terms, again proved to be an important component of aggregate demand. Employment gains remained strong at the end of the year; in January 1999, for the first time in many years, the year on year change in unemployment was negative.

The international financial markets continue to be characterised by great uncertainty. In the middle of January Brazil was forced to abandon its peg to the U.S. dollar; since then the Brazilian currency has lost about half of its value. In the USA, economic activity accelerated again in the fourth quarter of 1998. According to preliminary estimates, economic growth surged to 5.6 percent on a year-on-year basis, following a gain of 3.7 percent in the third quarter. In Europe pessimism prevails, however, most clearly in manufacturing. In Germany, Denmark, the U.K., and Sweden, the outlook for production is now significantly less favourable than in the early summer of 1998. In Austria, the basic-goods sector has probably passed the cyclical peak and is now suffering from the collapse of prices brought about by cheap exports from Asia. WIFO's business survey shows, however, that expectations have stabilised, albeit at a low level, in the chemical and construction materials industries.

In Europe as well as in Austria, consumers remain optimistic. According to the most recent EU survey, the indicator of consumer confidence has again risen and has attained a record level since the end of the 1980s. Domestic demand has become the major expansionary factor driving economic activity in Europe, partly offsetting the effects of the slump in exports on economic growth.

In Austria, retail sales in October and November expanded by only 1¾ percent compared with the same months last year, mainly a result of weaker demand for food and textiles. Given the slack in exports, wholesale trade suffered a setback in turnover.

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Inflation in Austria eased further to 0.7 percent in December. The only major price increases since November 1998 concerned packaged tours to foreign destinations, vacations in Austria, and housing rents. The sharpest drop in prices was recorded for energy.

Given the slackening pace of economic activity, the labour market has performed surprisingly well. As growth is shifting to domestic demand, it is becoming more labour intensive.

In January 1999, dependent employment (excluding persons in military service and on parental leave) substantially exceeded the level of the same month last year (+1.1 percent). The increase was particularly strong in the service sectors, where part-time work plays an important role. In January, the number of jobless fell by 900 on a year-on-year basis. According to the traditional Austrian method of calculation, the unemployment rate declined slightly to 7.1 percent of the dependent labour force.

PERSISTENT UNCERTAINTIES ON INTERNATIONAL FINANCIAL MARKETS

International economic prospects continue to be dampened by financial turbulence. After the sharp devaluation of the Brazilian real, the Chinese yuan has come under growing pressure.

Despite Brazil's persistent efforts to maintain the fixed exchange rate between the real and the dollar, the Brazilian national bank was forced in mid-January to let the Brazilian currency float. Since then the real lost almost half of its value against the dollar. Despite a rise in inter-bank interest rates to more than 30 percent and interventions in support of the currency worth some USD 800 million by the national bank, the pressure on the currency of the world's eighth largest economy has continued unabated. This devaluation will have a severely negative impact on Brazil's trading partners in Mercosur, Argentina in particular, and might trigger a wave of devaluations on the whole South American continent. Such a development would surely also affect the economic development in the USA. For the present, however, the U.S. economy is in excellent shape. In the fourth quarter of 1998, the percent change from four quarters earlier was as high as 5.6 percent; thus, the economy, unexpectedly for many observers, showed itself in a better state than in the third quarter (3.7 percent). The acceleration in the fourth quarter was mainly based on the strong demand by private households for consumer durables, rising exports, and a pick-up in investment in machinery and equipment; higher imports and a drop in inventories tended to dampen the economic expansion.

The destabilising forces driving the financial markets could easily contribute to a further deterioration in the business climate in Europe as well. While the danger of further devaluations in South America raises uncertainties regarding future economic developments, the healthy state of the U.S. economy is likely to stimulate the European economies.

The business climate surveys of the EU Commission have reflected the low confidence prevalent among the manufacturing sector. In all member states of the EU, entrepreneurs at the end of 1998 were far less optimistic than in previous months. The confidence index in manufacturing declined in November and remains below the long-term average despite a slight recovery in December which was related to the stabilisation on the stock exchanges. In December, current production was again viewed with more pessimism; production expectations improved slightly in December, however, after a dip in November. The assessment of the order stock and of foreign orders in manufacturing was again more negative than in earlier surveys.

The December Survey by the Ifo Institute in Munich indicated a worsening of current economic conditions in Germany. The business climate continued to deteriorate in December, with the most pessimistic responses coming from manufacturing, the investment goods sector in particular. The business climate improved slightly in the construction sector and in retail trade, but the balance of responses remains in the negative range.

In contrast to the gloom prevailing in the business community, European consumers view the present and future economic conditions with great optimism. The index of consumer confidence rose again, and for the first time the economic outlook surpassed the record level posted at the end of the 1980s. The strength of domestic demand is increasingly determining the cyclical position of the European economies, thus at least partly offsetting the adverse effects of the slump in exports.

The EU economies participating in the Monetary Union managed a smooth transition to the euro. The repo rate was set by the European Central Bank at 3 percent.

The introduction of the euro at the beginning of the year was well received by the financial markets. The exchange rate between the schilling and the euro was fixed at 13.7603 ATS on 31 December 1998. One euro is worth 1.16 USD or 131 yen. During the course of January, the euro slipped slightly against the dollar, mainly a result of the buoyancy of the U.S. economy. With the European System of Central Banks taking over the monetary operations at the beginning of the year, the lombard and the discount rate are no longer set by the Austrian National

Bank. Their functions are now fulfilled by the benchmark and the base interest rates, which were set by the European Central Bank at 4.75 and 2.5 percent, respectively. Another innovation is the replacement of the Vienna Interbank Offered Rate (VIBOR) by the European Inter-

bank Offered Rate (Euribor). The 3-month Euribor is currently at about 3.13 percent and the corresponding day-to-day money rate at 3.14 percent.

Cut-off date: 8 February 1999.