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Weakness of Aggregate Demand to be Gradually Overcome

Economic Outlook for 2003 and 2004

The Austrian economy will only grow by about 0.7 percent in 2003. While retail sales and investment are proving relatively robust, exports and manufacturing output have not strengthened so far. Opinion surveys among firms and households across Europe indicate a tentative brightening of expectations. If the improvement in sentiment is confirmed by a recovery of production, GDP in Austria may expand by 1.4 percent in volume in 2004.

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In the first half of 2003, demand and output in Austria edged up by only 0.6 percent from the year-earlier period. Unlike in 2001 and 2002, domestic demand is now supporting activity, owing to a moderate but steady rise in consumption and limited gains in construction and equipment investment. Exports, however, have clearly lost momentum. For the third consecutive year, GDP growth in 2003 will fall below the long-term average.

Prospects for 2004 remain highly uncertain. In the euro area, clear signs of a business cycle upturn are still missing, with GDP stagnating on a seasonally-adjusted quarterly basis since the end of 2002 (up by 0.5 percent from last year in the first half of 2003). Hopes for a world-wide recovery have nevertheless gained ground over the last few months. Asia has become the growth pole of the global economy, and lively activity has lately spilled over even to the ailing Japanese economy. In the USA, GDP grew by 2¼ percent in the first semester, if mainly on the back of a substantial increase in military spending.

A rebound in world trade could give incentives to the euro area economy. During summer, business sentiment has improved slightly, and even in Germany developments are now seen with somewhat greater confidence. Still, a number of forces are holding back a speedy recovery: the continued high level of the dollar-euro exchange rate is weighing on exports and investment. Spending on new machinery and motor vehicles, a key element in the business cycle, remains sluggish due to the low degree of capacity utilisation. Stimulus from economic policy in the EU is lacking. As long as internal demand fails to pick up significantly, business activity will but hesitantly recover from the three-year-long stagnation. A vigorous upswing is not in sight. GDP growth in 2004 is projected at around 1½ percent for the euro area, and at 1 percent for Germany.

Demand for Austrian export goods is subdued, reflecting weak internal demand in the EU and in the accession countries, coupled with slight losses of foreign market shares. The rise in the real-effective exchange rate (+2 percent in 2003) cannot be offset in the short run by the sizeable productivity gains in manufacturing brought about by widespread cuts in personnel. Relative unit labour costs vis-à-vis trading partners are edging up, although over a longer period they have fallen markedly (1995 to 2002 –15 percent). Growth of merchandise exports is slowing down significantly, to a projected average real rate of 2 percent in 2003. Next year, a gradual

pick-up of demand in the main trading partner countries should accelerate export growth to 3¾ percent. Tourism, also suffering from sluggish business activity in Europe, may expect no increase in real foreign earnings in the current year.

Table 1: Main results

		1999	2000	2001	2002	2003	2004
		Percentage changes from previous year					
GDP							
Volume		+ 2.7	+ 3.5	+ 0.7	+ 1.1	+ 0.7	+ 1.4
Value		+ 3.4	+ 5.0	+ 2.3	+ 2.3	+ 2.6	+ 2.7
Manufacturing ¹ , volume		+ 3.0	+ 6.5	+ 1.3	+ 1.0	± 0.0	+ 2.0
Private consumption expenditure, volume		+ 2.3	+ 3.3	+ 1.5	+ 0.9	+ 1.3	+ 1.6
Gross fixed investment, volume							
Machinery and equipment ²		+ 2.1	+ 5.9	- 2.2	- 4.6	+ 1.7	+ 1.8
Construction		+ 4.9	+11.8	- 2.9	- 9.3	+ 2.0	+ 2.0
		+ 0.0	+ 1.2	- 1.5	- 0.5	+ 1.4	+ 1.7
Exports of goods ³							
Volume		+ 7.7	+13.1	+ 7.5	+ 4.2	+ 2.0	+ 3.8
Value		+ 7.0	+15.6	+ 6.5	+ 4.2	+ 2.0	+ 3.3
Imports of goods ³							
Volume		+ 6.9	+10.9	+ 5.7	- 1.2	+ 2.3	+ 3.8
Value		+ 6.7	+14.7	+ 5.0	- 2.0	+ 2.0	+ 3.3
Current balance							
	billion €	- 6.33	- 5.36	- 4.11	+ 0.95	- 0.03	- 0.39
As a percentage of GDP		- 3.2	- 2.6	- 1.9	+ 0.4	- 0.0	- 0.2
Long-term interest rate ⁴	in %	4.7	5.6	5.1	5.0	4.1	4.3
Consumer prices		+ 0.6	+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.2
Unemployment rate							
Eurostat definition ⁵	in %	4.0	3.7	3.6	4.3	4.3	4.4
National definition ⁶	in %	6.7	5.8	6.1	6.9	7.0	7.1
Dependent employment ⁷		+ 1.2	+ 1.0	+ 0.4	- 0.5	+ 0.2	+ 0.5
General government financial balance according to Maastricht definition							
As a percentage of GDP		- 2.3	- 1.5	+ 0.3	- 0.2	- 1.0	- 1.2

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.

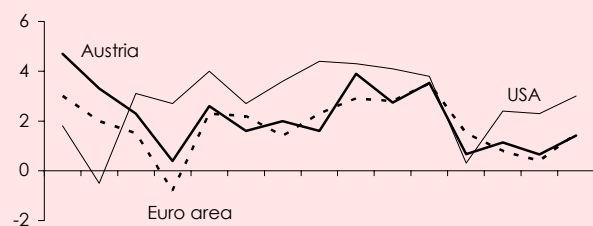
Conditions for an endogenous upturn of investment remain unfavourable for the time being. Capacity utilisation is clearly below its long-term average, and firms' sales expectations are not yet firmly heading up. Spending on business machinery and equipment should nevertheless gain 2 percent or more this year: the government premium granted to firms boosting investment beyond the level of the last years, while probably not leading to a sustained higher level of spending, may induce firms to carry forward projects envisaged for implementation in 2004.

Since the beginning of this year, no official data on manufacturing output are available. The regular WIFO business survey suggests a decline for the first semester; production is likely to have remained ½ percent below the year-earlier level. In view of the unfavourable trend of exports, stagnation should at best be expected on annual average. Firms report no further rundown in their inventories, which may be taken as a first hint for an imminent recovery of production. The projection for next year is for an increase in output by 2 percent. Since production is predominantly demand-constrained, the fact that in 2004 there are three more working days than in 2003 should not have a significant impact. In this regard, a slightly positive effect in manufacturing may be offset, on the overall economic level, by output losses in the tourism sector.

Figure 1: Indicators of economic performance

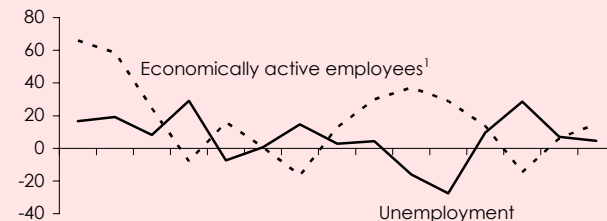
Growth of real GDP

In percent



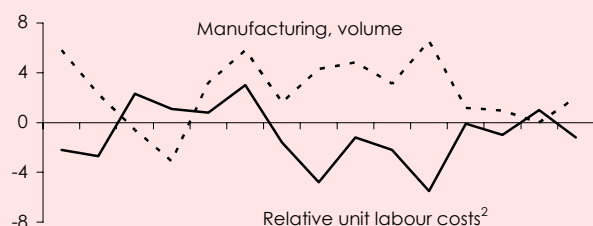
Employment and unemployment

1,000s from previous year



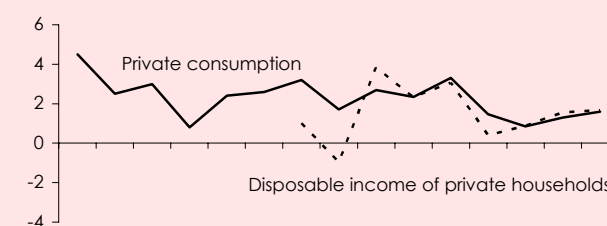
Competitiveness and manufacturing output

Percentage changes from previous year



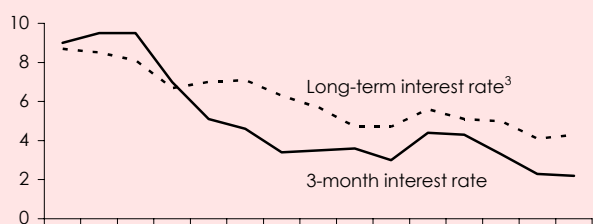
Consumption and income (constant prices)

Percentage changes from previous year



Short-term and long-term interest rates

In percent



Inflation and unit labour costs

Percentage changes from previous year



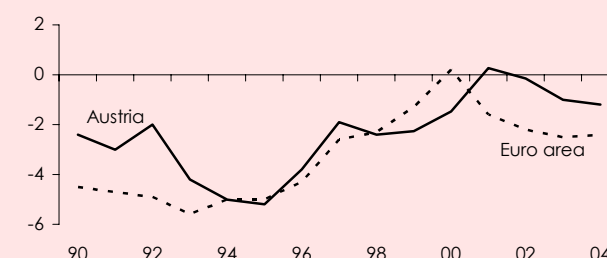
Exports and investment (constant prices)

Percentage changes from previous year



General government financial balance

As a percentage of GDP



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

Construction investment is more buoyant than last year. The enhancement of the financing capacity of the societies in charge of road and railroad infrastructure is reflected in an increase in civil engineering investment by 15 percent. Firms engaged in new-home building are also turning more optimistic, after an extended period of sluggishness. The need for new dwellings has grown, and permits for subsi-

dised residential building are heading up. Owing to the expansion in civil engineering, overall construction output has stopped receding this year and is expected to grow by an inflation-adjusted 1.4 percent on annual average and by 1.7 percent in 2004. The counter-cyclical timing of investment in better infrastructure is sustaining overall activity. However, with a view to the relatively large share of the construction sector in GDP, policy should take care to scale back public incentives in the next cyclical boom period.

Domestic demand, having dragged down overall economic growth in 2001 and 2002, is expected to provide positive incentives this year. Encouraging signs are coming not only from investment, but also from private consumption: the latter is gaining 1.3 percent in volume which, while remaining below its long-term trend rate of 2¼ percent, is markedly above the overall rate of growth. Employees' net real per-capita earnings will no longer decline, as they did in the last two years, and the gains in disposable income (including public transfers) are becoming somewhat more solid. Helpful in this regard is not only the low rate of inflation of 1¼ percent in both 2003 and 2004, but also the increase in transfer payments, notably child care benefits. The trade sector may expect real output gains of 2 percent in 2003 and 2¼ percent in 2004. Consumers are cutting down on foreign travel expenditure (-3 percent in 2003), but not on car purchases. The saving ratio, as a percentage of disposable income, is set to move up slightly.

No trend reversal is in sight on the labour market. The number of unemployed is moving up to 239,000 this year and 244,000 in 2004, corresponding to jobless rates of 7.1 percent of the dependent (conventional national definition) and 4.4 percent of the total labour force (Eurostat).

The rise in the number of economically active employees by 6,000 and 15,000 this year and next is to a large part due to institutional factors: thus, it includes people in partial retirement ("Altersteilzeit") which have lumped and back-loaded their period out of work while still being registered as active with their employers; this raises nominally the total employment figure by 2,500 in 2003 and 5,000 in 2004. Moreover, the number of unemployed undergoing professional training is higher by roughly 8,000 this year than in 2002, part of whom are counted as employed. At the beginning of the year, the long-awaited decision was taken of granting foreigners residing in Austria easier access to the domestic labour market, which facilitates the taking up of a job particularly for women and young people. The number of foreign jobholders is going up by some 15,000 each in 2003 and 2004.

Despite higher revenues from V.A.T., the overall tax intake remains well below the growth rate of nominal GDP this year, while government expenditure is rising at a faster pace. The general government balance (Maastricht definition) is projected to be in deficit of 1 percent of GDP in 2003 and 1.2 percent in 2004.

The global economy and world trade are set to expand by 3 percent, respectively, in 2003, hardly more than last year and well below their long-term trend. However, differences in performance are large between the major zones. Asia is the major driver of world economic growth. The Chinese economy is growing at a pace of 7 to 8 percent per year. Strict control over capital movements is a key factor in the successful policy framework, as it has shielded the economy from external crisis phenomena.

South Korea, Taiwan and the other "tiger states" have also returned to rates of growth regularly achieved before the 1997-98 economic and financial crisis. In the first half of 2003, even the ailing Japanese economy for the first time in three years showed signs of a significant recovery of overall demand. Apart from a pick-up in investment and private consumption, this was due to lively exports to China and Southeast Asia. GDP looks set to rise by almost 2 percent this year. It nevertheless remains to be seen whether Japan will enjoy a sustained business cycle recovery, as deflation has not yet been overcome and a further appreciation of the yen vis-à-vis the dollar may undermine the upward trend in its early stages.

Asia as the growth pole of the world economy

Economies in Asia continue to grow rapidly. Most recently, even Japan has seen a revival of demand.

In the first semester, the US economy grew at a rate of 2¼ percent year-on-year. Forward-looking indicators have improved over the last few months, largely owing to the expansionary stance of fiscal and monetary policy. The general government deficit will rise to around 6 percent of GDP this year, for the major part as a consequence of a massive increase in military spending which in the second quarter accounted for two-thirds of growth of GDP from the previous period. While armament expenditure is distinctly less efficient than alternative uses of resources in terms of its effects on growth and welfare, it nevertheless provides stimulus to private demand and output. However, with a view to the critical situation of public households, it remains to be seen how long the high level of spending is maintained. The sizeable tax cuts are driving up the budget deficit; yet, their positive effects on demand may be limited by the fact that they are heavily concentrated on the upper income strata. The federal reserve, concerned about the danger of deflation, is keeping short-term interest rates at a historical low, implying negative real short-term rates. Long-term rates, on the other hand, have risen markedly in the last months. The positive effects of the expansionary policy stance are reflected in an improved consumer sentiment, continued lively private household demand and gains in industrial production.

So far, however, a self-sustained upturn in investment has not come underway. Profits and capacity utilisation are below their long-term averages. A particular risk for the business cycle derives from the over-valuation on real estate markets, as house prices have risen drastically and a correction not being in sight. If the speculative bubble were to burst, severe financing problems would be the consequence. The labour market has not yet reacted to the pick-up in production: employment has been on a downward trend for more than two years, and unemployment has risen to 6.2 percent of the labour force.

Cyclical recovery in the USA subject to risks

Aggregate demand in the USA has strengthened mainly on account of a massive step-up in military spending. GDP growth is projected at 2¼ percent this year and 3 percent in 2004, although the risks of a setback are substantial.

Table 2: World economy

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
<i>Real GDP</i>						
Total OECD	+ 3.2	+ 3.8	+ 0.8	+ 1.8	+ 1.4	+ 2.0
USA	+ 4.1	+ 3.8	+ 0.3	+ 2.4	+ 2.3	+ 3.0
Japan	+ 0.1	+ 2.8	+ 0.4	+ 0.1	+ 1.8	+ 1.3
EU	+ 2.8	+ 3.5	+ 1.6	+ 1.0	+ 0.5	+ 1.5
Euro area	+ 2.8	+ 3.5	+ 1.5	+ 0.8	+ 0.4	+ 1.5
Germany	+ 2.0	+ 2.9	+ 0.8	+ 0.2	± 0.0	+ 1.0
Central and Eastern Europe ¹	+ 3.3	+ 4.0	+ 2.1	+ 2.2	+ 2.5	+ 2.8
Asia (excluding Japan)	+ 6.7	+ 6.8	+ 4.9	+ 6.0	+ 4.5	+ 5.0
<i>World trade, volume</i>	+ 6.0	+12.7	± 0.0	+ 2.5	+ 3.3	+ 5.0
OECD exports	+ 5.7	+12.0	- 0.5	+ 2.7	+ 3.0	+ 4.5
Intra-OECD trade	+ 7.8	+11.4	- 0.9	± 0.0	+ 2.3	+ 3.5
Market growth ²	+ 7.4	+13.1	+ 2.9	+ 2.0	+ 2.5	+ 4.0
<i>Primary commodity prices, in USD</i>						
HWWA index, total	+ 9.0	+31.0	-10.0	+ 1.0	+14.0	- 9.0
Excluding energy	-10.0	+ 3.0	- 6.0	- 1.0	+ 3.0	-±0.0
<i>Crude oil prices</i>						
Average import price (cif) for OECD countries						
USD per barrel	17.3	28.0	23.6	24.1	29.0	25.0
<i>Exchange rate</i>						
USD per euro	1.067	0.924	0.896	0.945	1.10	1.10

¹ Poland, Slovakia, Slovenia, Czech Republic and Hungary. – ² Real import growth of trading partners weighted by Austrian export shares.

The euro area economy grew by only ½ percent year-on-year in the first semester 2003 (EU 15 +¾ percent). On a seasonally adjusted basis compared with the previous period, GDP has remained flat since the fourth quarter 2002. This is due to a large part to the persistent slack in investment. Capacity utilisation, profits and sales expectations are too weak as to induce firms to higher capital spending, despite the relatively low nominal interest rates. In the face of declining producer prices, few

Europe persistently lagging in growth

sectors of production find the level of real interest rates attractive. In addition, the appreciation of the euro is increasingly bearing down on economic activity. The exchange rate of around 1.1 \$ per euro is approximately 15 percent above the annual average in 2002, which is putting a brake on European exports and investment. According to the eurogrowth indicator, the high exchange rate is taking 0.6 percentage point off euro-area GDP growth in the second half of 2003. Extrapolating the level recorded in August yields an average exchange rate assumption of 1.1 \$ per euro for 2003-04. This is some 4 percent lower than underlying the WIFO forecast of last June. Because of this slight improvement, euro area exports, investment and GDP for 2004 are now judged somewhat more optimistic than three months ago.

Unlike exports and investment, retail sales were lively in the first half of this year. Consumer confidence, as surveyed by the European Commission, has recovered during recent months, particularly in the large EU countries. While remaining well below its long-term average, private consumption growth constitutes a crucial element in supporting an overall lacklustre economic activity.

Lately, signs of an improvement in corporate sentiment have become more frequent. The ifo business climate index has been heading up for the last two months also for the component of current business conditions in Germany. Reuters' purchasing managers index for the euro area is also tentatively pointing upward. However, it remains to be seen whether the pick-up in confidence will actually translate into increases in orders, production and investment. Clear signs in this regard have been lacking so far, particularly in Germany. The German economic research institutes are optimistic for next year, expecting GDP to expand by 1½ to 2 percent. In support, they cite

- positive demand effects of up to ¼ percent of GDP from the carrying-forward of income tax cuts into 2004;
- additional investment prompted by the reforms in the context of the Agenda 2010;
- a positive effect on output of ½ percent of GDP or more due to the higher number of working days.

Still, question marks should be put behind all of these arguments: the tax cuts are likely to be accompanied by expenditure reductions of similar magnitude and will benefit mainly the upper income groups, such that overall no additional demand stimulus should be expected; reforms of the social welfare systems will rather dampen private demand in the short run; and the higher number of working days should not give any substantial boost to GDP of an economy currently constrained rather from the demand side.

The quasi-stagnation of economic activity is putting strain on the labour market and on public finances. The rate of unemployment is climbing steadily in the euro area, reaching a seasonally adjusted 8.9 percent in July. The upward trend will continue as long as the pace of economic growth remains below 2 percent p.a. Government deficits are rising markedly. The deterioration of the budgetary situation notably in France, Germany and Italy will push the general government deficit of the euro area beyond the mark of 3 percent of GDP this year. This is not so much the result of debt-financed active stimulation measures as of shortfalls in tax revenues and higher outlays for unemployment support.

Economic policy in the euro area has so far not been able to develop an effectively co-ordinated strategy towards countering the protracted weakness of demand since the end of 2000. Policy efforts concentrated on expenditure restraint in the areas of government personnel, infrastructure investment and social welfare programmes. In addition, introducing greater flexibility and market liberalisation form conspicuous elements of a European policy strategy. However, lack of demand and raising the trend of growth are not regarded as challenges by policymakers. Policy of the euro area countries is partly constrained by the obligations of the Stability Pact and the openness of the national economies. The non-members of the euro

In the euro area, economic activity has entered its third year of sluggishness, gaining only ½ percent year-on-year in 2003. Somewhat more favourable sentiment indicators may signal a recovery for next year. Still, several retarding forces will continue to operate.

Challenge to EU economic policy

area in the EU have taken effective expansionary action: the UK markedly increased public consumption in order to modernise the education and health care systems; and the Swedish government has significantly stepped up public investment. Both measures have stemmed the slump in aggregate demand. In both countries, GDP growth is exceeding the EU average, as it did in the past years.

At the EU level, the scope for expansionary policy action is markedly wider than at the national level. The intention of the European Commission to initiate an increase in public investment on the basis of suggestions from the "Van Miert Group" and in co-operation with the European Investment Bank is geared towards a sustained improvement of the economic framework conditions. In that context it will be important to secure that investment in education, research and social cohesion that was particularly emphasised by the "Lisbon Strategy" will not be ranked second to investment in physical infrastructure. In the short term, investment in transport and communication infrastructure may provide meaningful incentives. An EU growth initiative would convey the important message that economic policy is no longer reacting to the crisis in a passive way – a pro-active policy stance may contribute towards stabilising the expectations of companies and households alike. In addition, planning and preparations have been completed for many investment projects, such that the timely waiving of financing constraints may trigger early demand effects.

EU enlargement by 10 new member states will take effect on 1 May, 2004. While in the short run, a substantial boost to growth may not be expected from this event, the potential over the longer term should be important. The latter derives from the new member states' necessity of modernising the capital stock and from the hitherto unsatisfied needs of consumers. A speedy catching-up process would provide considerable demand impulses also for the "old" EU members. However, in the last few years, the accession countries' economies expanded only moderately, with GDP growing about 1 percentage point faster p.a. than the EU average. At present, growth particularly in the Czech Republic is well below the rates observed in the other countries of Central and Eastern Europe.

In the accession countries, average GDP per capita is lower than half the EU level. Measures to accelerate the catching-up process could form an important element of a growth-oriented EU strategy. This would require an increase in public and private investment from the EU in the new member states.

Following the distinct lag in 2001, the Austrian economy has probably grown somewhat above the EU average in 2002. This was entirely due to a positive external contribution. While domestic demand and imports receded, exports performed relatively well, according to the data available. Statistics Austria reports an improvement by almost € 5 billion in the trade balance between 2001 and 2002, turning to a surplus for the first time. Nevertheless, the apparent buoyancy of exports in Austria comes rather as a surprise, when set against the sluggish manufacturing output or the much more subdued export trend in other countries. Also the large "statistical discrepancy" item points to inconsistencies in the current account. Difficulties in collecting foreign trade data within the EU Internal Market, as well as the acceleration of the process of data collection may undermine the reliability of the statistics. Thus, the information base for the projections for 2003 and 2004 is rather shaky – also due to the fact that output data for the cyclically sensitive sectors of manufacturing and construction continue to be lacking for the current year.

WIFO continues to expect growth of real GDP at 0.7 percent for 2003, largely reflecting the slackening of activity in Europe. The anaemic expansion of demand in trading partner countries is weighing on Austrian exports and manufacturing output. Activity continues being sustained by domestic demand. Apart from private consumption and retail sales, construction activity is providing support, the latter (as well as equipment investment) being stimulated by counter-cyclical policy measures. On account of these measures of investment promotion, the Austrian economy is growing by about ¼ percentage point more strongly than the euro area average. How-

Economic policy in Europe has not reacted sufficiently to the cyclical weakness since end-2000. What is needed primarily are measures stimulating investment in physical and human capital that could boost economic growth in the short term as well as over a longer horizon.

Economic potential of EU enlargement not exploited to full extent

Subdued growth to continue

ever, part of this advantage are carry-forward effects that will eo ipso depress demand in 2004.

Next year, the major cyclical stimulus should come from foreign demand. While the strength of a recovery in European trading partner countries is as yet difficult to foresee, WIFO's assumptions are rather cautious in this regard. Admittedly, confidence is generally on the rise, extending also to stock markets; yet, the euro exchange rate against the dollar remains high and the need for consolidation of government households will lead to a fall in public sector demand. Thus, Austrian exports will recover only gradually, investment and manufacturing production likewise. Private household demand is also projected to grow below its long-term average, yielding an overall increase in GDP by 1½ percent, too small as to provide substantial relief for either the labour market or public finances.

A more optimistic scenario may be set up on the basis of a more vigorous-than-expected rebound of the US economy. This could strengthen the dollar on foreign exchange markets, thereby boosting Europe's competitive position on world markets and the attractiveness of the EU for foreign investors. A more growth-oriented policy stance in the EU would have substantial scope to provide internal demand with the much-needed incentives. Such a scenario should not be ruled out, even if it is currently deemed less likely.

Austrian merchandise exports still exceeded the year-earlier level by 5 percent in value in the first quarter. For the second quarter, the preliminary figure by Statistics Austria suggests a decline by 4 percent. Even if the latest monthly figures were to be revised upwards, they clearly signal a slackening of exports. Deliveries to the EU Internal Market are flat as a consequence of sluggish domestic demand in key trading partners (Germany and Italy). The appreciation of the euro vis-à-vis the dollar is weighing on the export-oriented sector mainly in an indirect way, as it directly affects the German export industry with which Austrian firms maintain close supply linkages.

Table 3: Earnings and international competitiveness

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
Gross earnings per employee ¹	+1.8	+2.5	+1.4	+2.2	+2.2	+2.0
Full-time equivalent	+2.2	+2.7	+1.7	+2.6	+2.6	+2.2
Gross real earnings per employee ¹	+1.0	+0.9	-0.6	+0.3	+0.9	+0.8
Net real earnings per employee ¹	+0.5	+1.5	-1.0	-0.5	+0.2	+0.6
Net wages and salaries	+3.7	+4.5	+1.9	+2.4	+2.5	+2.3
Total economy						
Unit labour costs	+0.4	-0.5	+1.4	+0.6	+1.8	+1.0
Manufacturing						
Unit labour costs	-1.2	-4.5	+1.8	-0.9	-0.3	-0.8
Relative unit labour costs ²						
Vis-à-vis trading partners	-2.2	-5.5	-0.1	-1.0	+1.0	-1.2
Vis-à-vis Germany	-0.8	-1.8	+0.1	-0.7	-1.2	-1.4
Effective exchange rate – manufactures						
Nominal	+0.6	-2.7	+0.9	+1.3	+2.6	+0.5
Real	-1.3	-3.3	+0.5	+0.8	+2.2	+0.4

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

Since the beginning of the year, also exports to Central and Eastern Europe are losing steam. In a number of transition countries, real-effective exchange rate appreciation is holding back economic expansion and thereby demand for imported goods. In addition, Austrian companies are likely to lose market shares in the region, since following the large early gains they now face a growing number of competitors from other countries. Temporarily, substitution of foreign direct investment for

Real GDP is set to rise by 0.7 percent this year. For the first time after two years, growth is supported by domestic demand. With sluggishness in western Europe coming to an end, economic activity should pick up in 2004. Considerable uncertainty remains as to the speed of the recovery.

Exports lacking strength

Growth of merchandise exports has lost considerable momentum in the last months. Persistently weak demand in major trading partner countries is one reason, but also the effect of the rising exchange rate is increasingly felt.

goods exports may also play a role. By contrast, Austrian exporters continue to be successful in south-east Europe, gaining market shares in Croatia, Serbia, Romania and Bulgaria.

Price competitiveness of Austrian exports remains satisfactory, although it is currently strained by the appreciation of the euro. The real-effective exchange rate for manufactures is rising by over 2 percent from last year, an impact that cannot be easily offset even by the strong advance in productivity of 3 percent. Relative unit labour costs are rising by 1 percent this year, but still remain some 15 percent below the level of the mid-1990s.

On annual average 2003, goods exports are projected to rise by 2 percent year-on-year in real terms, accelerating to a rate of 3¼ percent next year. Subdued producer prices and stiff competition will make it difficult for firms to raise their export prices.

According to preliminary data from the national accounts, investment in machinery and equipment gained 1.5 percent year-on-year in volume in the first semester, supported mainly by purchases of motor vehicles. This was more than could be expected from the results from the WIFO investment survey of last June. Although the motor vehicles industry reported a substantial increase in its productive capacity, other branches were less confident and rather deferred investment projects, in the face of the currently low capacity utilisation. Investment in business equipment will nevertheless be supported by the investment premium offered by the government until the end of 2003, the effect of which will be more visible in the second half of the year. However, the premium will only to a smaller extent actually encourage firms to increase capital spending, but rather to use it for replacing obsolete equipment. The carrying-forward of investment plans is estimated to boost GDP by around ¼ percent this year. Spending on machinery and equipment is set to rise by 2 percent or more in volume. In 2004, this will produce a negative "echo effect". Indeed, a strong upturn of investment will only set in if overall demand strengthens significantly, which is unlikely from the present perspective. More likely is that equipment investment will hardly pick up from this year's moderate pace.

Gross fixed capital formation has fallen markedly as a share of GDP in the last years, from 24 percent in 2000 to below 22 percent this year. A strong revival of investment holds the key to healthy and sustained growth being restored and to an improvement on the labour market.

Because of the expected carrying-forward of investment plans, merchandise imports will also rise somewhat more strongly than assumed so far. Imports may increase by over 2 percent in volume, slightly outpacing exports. Notwithstanding the appreciation of the euro, import prices are not falling substantially, as oil prices remain high. The terms of trade will thereby hardly improve. The foreign trade balance is set to change little from the positive result of last year that remains somewhat of a surprise.

An assessment of manufacturing output is particularly difficult, because no data have been provided by Statistics Austria since the beginning of the year. In the past, the regular WIFO business survey has proved to be a good proxy for the trend of production. Latest results from the survey suggest that output has weakened further since early this year, after having barely expanded in the last two years, i.e., by little more than 1 percent p.a.

For the first half of 2003, the provisional national accounts established by WIFO show a loss of manufacturing output by an inflation-adjusted ½ percent from last year. Firms suffer from persistent sluggish demand. Those sampled report that until last summer they have run down their inventories to a low level, which they have kept constant thereafter, indicating that production may not decline further. On annual average, output may thus remain flat, implying a further reduction of employment and average hours worked. The number of manufacturing jobs in 2003 is expected

Equipment investment stronger than expected

The tax premium offered until the end of the year induces companies to carry forward part of their investment projects. While low capacity utilisation is likely to hold back a genuine rebound of investment, the need for replacement may become more important.

Stagnation of manufacturing output

to fall by a further 15,000 from last year, and the negative trend looks set to continue into 2004.

Table 4: Productivity

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 2.7	+ 3.5	+ 0.7	+ 1.1	+ 0.7	+ 1.4
Employment ¹	+ 1.4	+ 0.8	+ 0.7	- 0.4	+ 0.3	+ 0.4
Full-time equivalent	+ 1.3	+ 0.9	+ 0.5	- 0.6	+ 0.1	+ 0.3
Productivity (GDP per employment)	+ 1.3	+ 2.8	+ 0.0	+ 1.5	+ 0.4	+ 1.0
Full-time equivalent	+ 1.5	+ 2.6	+ 0.2	+ 1.8	+ 0.6	+ 1.1
<i>Manufacturing</i>						
Production ²	+ 3.1	+ 6.5	+ 1.2	+ 1.0	± 0.0	+ 2.0
Employees ³	- 0.7	+ 0.0	+ 0.2	- 2.5	- 2.2	- 1.0
Productivity per hour	+ 4.5	+ 6.6	+ 1.4	+ 4.2	+ 2.8	+ 3.3
Working hours per day per employee ⁴	- 0.6	- 0.1	- 0.4	- 0.7	- 0.5	- 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.

Next year, there will be three more working days than in 2003. In a period of cyclical high, the longer working time may lead to an increase in output, but given the still weak demand outlook such an effect is considered to be small in 2004. On an overall economic level, any positive effects in industry will partly be offset by negative ones in tourism due to the correspondingly lower number of public holidays.

Unlike in the last years, construction investment is providing a significant contribution to GDP growth in 2003. This is chiefly due to higher priority being given to the upgrading of high-performing transportation infrastructure urgently needed with a view to EU enlargement. The increase in budgetary resources has led to additional investment in road and railroad construction since the middle of last year. Total construction output in transportation infrastructure rose by 12 percent in 2002 and is projected to gain a further 15 percent this year.

The regular WIFO business survey has indicated growing confidence also in the building sector over the last few quarters. In residential construction, this reflects rising demand for rented apartments which has already led to an increase in building permits. Construction of new office space is only slowly losing momentum, which is somewhat surprising given the important excess capacity and points to the danger of an abrupt fall.

Without the additional investment in civil engineering, the construction sector would continue its decline. Instead, growth rates exceeding those of GDP are expected for 2003 and 2004, namely 1½ percent and 1¼ percent, respectively. With regard to the comparatively large share of construction in domestic GDP, policy should take care to withdraw stimulus for construction investment in future boom periods. Counter-cyclical allocation of resources in this area is deemed the appropriate stance.

Employees' real per-capita income net of taxes and social contributions has fallen by 1½ percent since 2000. The current year should bring an end to the downward trend (+¼ percent). The increase in a number of transfers (in particular child care benefits) will also boost real net incomes (excluding earnings of self-employed) by 1¼ percent from last year.

However, the income gains are too small as to allow private consumption to rise significantly. Moreover, the private saving ratio is trending slightly upwards. The third year in a row of sluggish income growth and the policy debate about cuts of retirement benefits should make consumers more cautious in incurring major expenditures. Private consumption is projected to grow by 1.3 percent and 1.6 percent this year and next, well below the long-term average of 2¼ percent.

Following two years of sluggish growth, manufacturing output is set to remain flat in 2003, reflecting the stagnation of demand. Industrial employment is falling markedly. Prospects for next year are not decisively better. The impact of the higher number of working days on net output is likely to be small.

Growth impulse from construction activity

Additional investment in infrastructure will prevent a fall in construction and give a non-negligible boost to GDP. The counter-cyclical implementation of public investment should be maintained during the next boom period with a then more restrictive handling of orders and subsidies.

Consumption and trade sustaining business activity

Net output of the trade sector rose by an inflation-adjusted 2½ percent in the first semester, according to preliminary data. Retail sales volumes gained 1¾ percent, in line with expectations. Last summer's heat wave may have had a dampening effect on demand. For wholesale trade, Statistics Austria reports gains of 3 percent for the first six months, a figure considered doubtful given the stagnation of exports and imports. For the whole year, a net gain of trade volumes by 2 percent seems likely, with the prospect of some acceleration in 2004.

Private consumption expenditure rose by 1.3 percent in the first semester, output of the trade sector even by 2½ percent. The outlook for next year is equally benign, even if the pace of expansion remains well below the long-term average.

Table 5: Private consumption, earnings and prices

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year, volume					
Private consumption expenditure	+2.3	+3.3	+1.5	+0.9	+1.3	+1.6
Durables	+7.3	+3.8	+2.0	-0.2	+1.5	+3.0
Non-durables and services	+1.6	+3.2	+1.4	+1.0	+1.3	+1.4
Household disposable income	+2.3	+3.1	+0.4	+0.9	+1.6	+1.7
Household saving ratio						
As a percentage of disposable income	8.5	8.3	7.4	7.4	7.8	8.2
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+5.2	+6.7	+3.5	+1.2	+1.5	+2.5
	In percent					
Inflation rate						
National	0.6	2.3	2.7	1.8	1.3	1.2
Harmonised	0.5	2.0	2.3	1.7	1.2	1.1
Core inflation ²	0.7	0.9	2.3	2.0	1.2	1.1

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

Net earnings from cross-border tourism are projected to rise above € 2 billion in 2003. Austrian nationals will likely restrain spending on foreign travel, in the face of the depressed economic and labour market situation. Expenditure may thus recede by a further 3 percent in real terms in 2003, following the fall by almost 4 percent last year. Spending by foreign visitors in Austria will remain flat. While Austrian suppliers of tourism services will benefit from German customers turning away from long-distance travel, daily average outlays of German visitors are on a downward trend. For next year, some recovery in the tourism sector appears likely.

Stagnation in tourism

Since last May, the year-on-year increase in consumer prices has been a modest 1.1 percent. The decline in the rate since the beginning of the year mainly mirrors lower import prices on account of the appreciation of the euro. Prices of manufactures were only 0.6 percent higher in August than a year ago, and energy prices edged up by 0.8 percent. Headline inflation for the whole year is expected at 1.3 percent.

Continued high price stability

At present, there are no signs of a revival of inflation. Prices of energy imports may fall slightly next year, if the political situation in Iraq stabilises. However, the marked increase in energy taxes is working in the opposite direction, adding 0.1 to 0.2 percentage point to the consumer price increase.

Table 6: Labour market

		1999	2000	2001	2002	2003	2004
		Changes from previous year (1,000s)					
<i>Demand for labour</i>							
Economically active employment ¹		+38.2	+30.8	+15.1	-11.2	+8.8	+17.2
Employees ²		+37.2	+28.9	+13.6	-14.6	+6.0	+15.0
Percentage changes from previous year		+1.2	+1.0	+0.4	-0.5	+0.2	+0.5
Nationals		+29.4	+15.5	+4.2	-19.7	-8.0	-1.0
Foreign workers		+7.8	+13.4	+9.5	+5.1	+14.0	+16.0
Self-employed ³		+1.0	+1.9	+1.5	+3.4	+2.8	+2.2
<i>Labour supply</i>							
Population of working age	15 to 64 years	+19.8	+25.2	+28.1	+22.9	+19.1	+1.0
	15 to 59 years	-2.6	-17.5	-14.2	-5.5	+3.1	+3.0
Labour force ⁴		+22.2	+3.4	+24.7	+17.3	+15.8	+21.8
<i>Surplus of labour</i>							
Registered unemployed ⁵		-16.1	-27.4	+9.6	+28.5	+7.0	+4.6
In 1,000		221.7	194.3	203.9	232.4	239.4	244.0
In percent							
<i>Unemployment rate</i>							
Eurostat definition ⁶		in %	4.0	3.7	3.6	4.3	4.4
Percent of total labour force ⁵		in %	6.0	5.3	5.5	6.2	6.4
National definition ^{5,7}		in %	6.7	5.8	6.1	6.9	7.1
<i>Employment rate</i>							
Economically active employment ^{1,8}		in %	62.3	62.5	62.5	62.0	62.3
Total employment ^{6,8}		in %	68.5	68.4	68.4	68.3	68.4

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. – ⁷ As a percentage of total labour force exclusive of self-employed. – ⁸ Percent of population of working age (15 to 64 years).

The cyclical weakness now lasting for two-and-a-half years is leaving negative marks on the labour market. The seasonally-adjusted rate of unemployment has been rising from 5.6 percent of the dependent labour force in January 2001 to 7.1 percent of late, corresponding to an additional 55,000 jobless people. To this figure should be added the increase in the number of job-seekers participating in training courses, who are not counted as unemployed. A positive turnaround on the labour market is not in sight. It would require an acceleration of economic growth to an annual rhythm of around 2 percent. From the current growth perspectives, unemployment is likely to rise further until after mid-2004, if policy takes no preventive action.

Employment on a seasonally-adjusted basis has moved to a mild upward trend since last spring. However, this is not a reflection of a cyclically-induced strengthening of labour demand, but of several institutional factors. First, the number of people actively employed includes people in partial retirement ("Altersteilzeit") who have lumped and back-loaded their period out of work, but are still registered as employed with their former employer. Second, also included are job-seekers engaged in extended forms of job training. Third, at the beginning of the year, a new regulation on labour market access of foreigners has entered into force, enabling in particular foreign women and young people having lived in Austria for more than 4 to 5 years to take up a legal job. Due to this measure, welcome from a social policy point of view, and of more generous regulations for seasonal workers, the number of employed foreigners is expected to increase by an average 14,000 this year. The number of persons actively employed is projected to go up by 6,000, and by a further 15,000 next year.

No fall in unemployment in sight

Unemployment will rise to an average 7.0 percent of the dependent labour force in 2003 and to 7.1 percent in 2004, an increase by 1½ percentage point since early 2001. Employment has started heading up in recent months. This is largely due to a number of institutional factors and should not be taken as a trend reversal on the labour market.

In 2002, the financing gap of the general government was a small 0.2 percent of GDP, lower than expected. The more favourable budgetary situation was brought about, on the federal level, by higher V.A.T. revenues and a higher surplus in the insolvency fund. As regards the federal states (Länder) and municipalities, the entire repair cost related to the summer 2002 floods were offset by savings in other areas.

In 2003, some significant increases in expenditure become effective. These concern in particular child care and partial retirement benefits, but also increases in government salaries and pensions. The rise in public expenditure is higher than that of nominal GDP. Government revenues, for their part, are depressed by sluggish activity. Notably direct tax revenues are set to decline again this year, with company taxes clearly falling below the year-earlier level. More favourable are revenue developments for the wage tax and for V.A.T. The direct budgetary cost of the counter-cyclical stimulus packages is rather small, the additional investment in infrastructure being financed "off-budget", via the special road and railroad financing agencies. The tax premium for companies' incremental investment will reduce company tax revenues to the amount of 0.1 percent of GDP. The tax subsidies for spending on research and education should have a relatively smaller budgetary effect. WIFO projects for 2003 a general government deficit of 1 percent of GDP that is somewhat below the deficit ratio of 1.3 percent notified to the European Commission by the Ministry of Finance.

Table 7: Key policy indicators

	1999	2000	2001	2002	2003	2004
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	-2.3	-1.5	+0.3	-0.2	-1.0	-1.2
According to National Accounts	-2.4	-1.6	+0.1	-0.4	-1.1	-1.3
General government primary balance	+1.3	+2.2	+3.8	+3.2	+2.4	+2.2
	In percent					
<i>Monetary policy</i>						
3-month interest rate	3.0	4.4	4.3	3.3	2.3	2.2
Long-term interest rate ¹	4.7	5.6	5.1	5.0	4.1	4.3
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+1.5	-2.5	+1.0	+1.4	+2.8	+0.6
Real	-1.1	-3.4	+0.3	+0.6	+2.1	+0.3

¹ 10-year central government bonds (benchmark).

In 2004, the first part of a reform of taxes and social contributions will enter into force. It will include cuts in taxes on earned income and on undistributed profits of unincorporated enterprises, but also increases in energy taxes and in health and work accident insurance contributions. In all, the public sector balance should thereby slightly improve. The last few years have shown that the room for manoeuvre in influencing the budget balance via one-off measures, off-budget transfers of items and statistical re-classification is relatively large. The WIFO budgetary projections are based primarily on the cyclical determinants of revenue and expenditure. Tax revenues are likely to continue growing at a slower pace than nominal GDP. On that basis, the general government balance in 2004 is likely to exhibit a deficit in the order of € 2¾ billion, corresponding to 1.2 percent of GDP.

Weak economic activity and significantly higher expenditure weighing on public finances

The general government deficit is expected to correspond to 1 percent of GDP both in 2003 and 2004, higher than in the last two years. This reflects, on the expenditure side, mainly higher child care benefits, and on the revenue side the cyclical weakness.