Markus Marterbauer

Business Cycle Recovery Gaining Shape

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.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 17 December 2003. • E-mail-address: Markus.Marterbauer@wifo.ac.at

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.

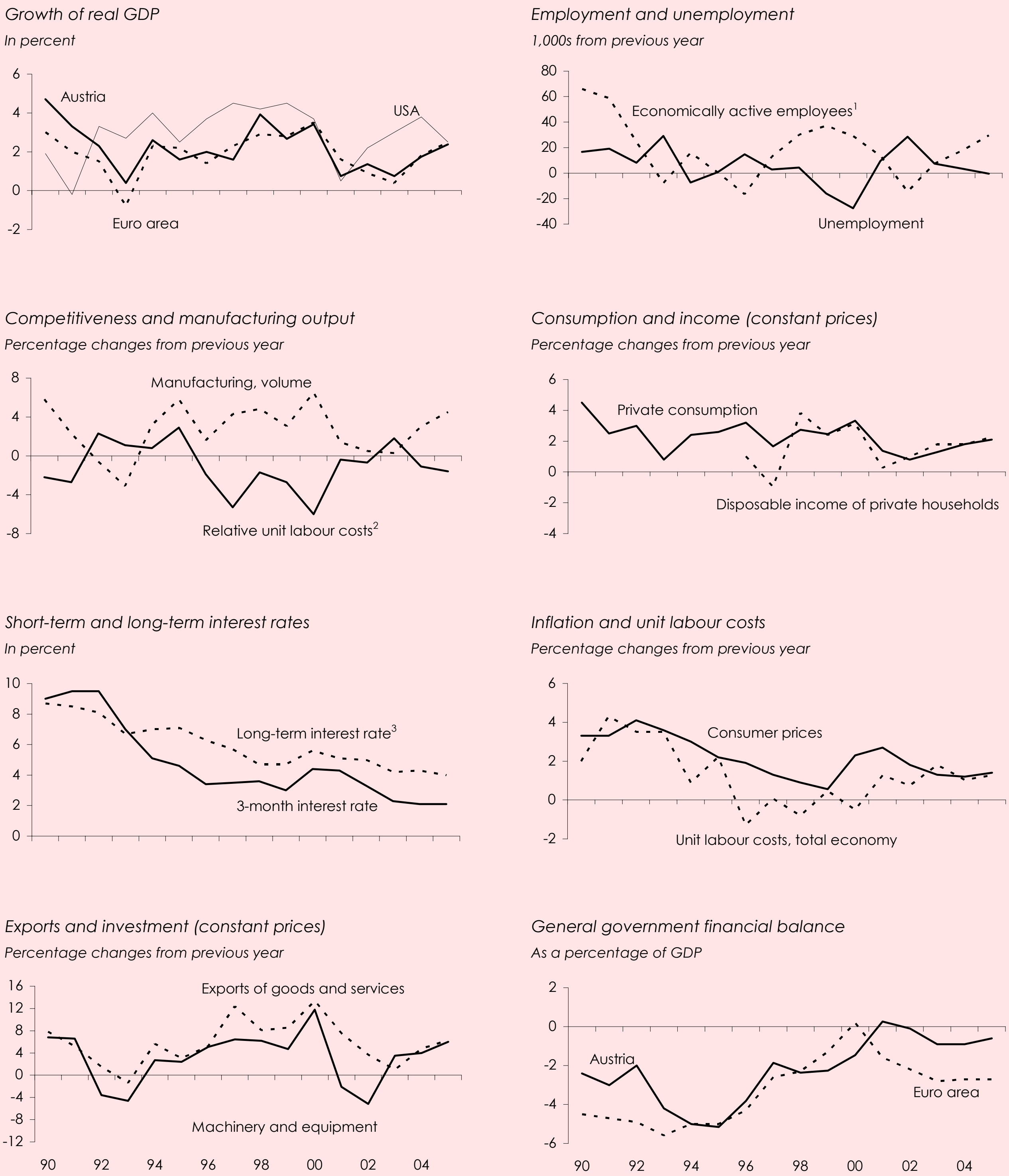
Table 1: Main results

		2000	2001	2002	2003	2004	2005
		Percentage changes from previous year					
GDP							
Volume		+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.7	+ 2.4
Value		+ 4.9	+ 2.8	+ 2.7	+ 2.5	+ 3.2	+ 3.9
Manufacturing[1], volume		+ 6.4	+ 1.5	+ 0.5	+ 0.3	+ 3.0	+ 4.5
Wholesale and retail trade, volume		+ 3.7	– 0.0	+ 1.2	+ 1.6	+ 2.1	+ 2.4
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 goods[3]							
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 goods[3]							
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	billion €	– 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 rate[4]	in %	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]	in %	3.7	3.6	4.3	4.5	4.5	4.5
National definition[6]	in %	5.8	6.1	6.9	7.0	7.1	7.0
Economically active emplyees[7]		+ 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.

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 household 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 customers 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.

Figure 1: Indicators of economic performance



[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).

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 economically active employees 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 childcare benefits and partial 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.

Asia as a growth pole of the world economy

At an impressive speed, China is becoming not only a substantial player in the global economy, but also an important driver of the world-wide recovery.

World output and world trade each expanded by 3¾ percent in 2003, hardly more than the year before. Strength of activity has, however, been rather uneven among the major economic areas. Asia is the most important engine of growth, but also in the USA activity has clearly gained momentum in the second semester. The euro area economy has passed the lower turning point of the business cycle, but the recovery is advancing at a modest pace. Growth of world trade should accelerate markedly in 2004, to a projected rate of 6½ percent. For the euro area suffering from weak domestic demand, this will provide a major incentive for a cyclical upturn.

The Chinese economy has become a major factor for Asia and for world trade. While the recording of GDP and it rates of change is fraught with many difficulties and uncertainties in China, the official data nevertheless look impressive. GDP at purchasing power parities already accounts for 13 percent of world output, almost at a par with the euro area and nearly twice as large as the Japanese economy. In the beneficial environment of strict capital exchange controls and a fixed exchange rate vis-à-vis the dollar, the economy is growing steadily by close to 10 percent per year, even if growth differentials between regions and social groups are large. China's integration into the global trade system is advancing more rapidly still, with exports rising by some 30 percent each year and imports, fuelled by strong internal demand, having gained about 40 percent in 2003.

Driven by lively demand from China and the global recovery of the high-tech sector, the economies in South-East Asia are also picking up. Even the sluggish Japanese economy has been growing steadily over several quarters; strengthening export growth and a consolidation of domestic investment should have boosted real GDP by 2¼ percent in 2003. In 2004, the upturn may lose some momentum, due to the effective appreciation of the yen and persistent deflation holding back the revival of private consumption.

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	+ 2.0	+ 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 growth[2]	*+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 per barrel	28.0	23.6	24.1	29.0	27.0	27.0
Exchange rate						
USD per euro	0.924	0.896	0.945	1.13	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.

Sustainability of boom in the USA uncertain

The cyclical upturn in the USA accelerated markedly in the third quarter 2003 and has by now spread to all components of demand. Private households increased their spending considerably, on the back of tax cuts that took effect as from July. The stepping-up of military expenditure and of other items of public consumption also proved supportive to growth. Most promising from the point of view of cyclical revival is the heading-up of investment in machinery, equipment and software. Industrial enterprises have turned significantly more confident, and incoming orders and production are upward bound. In 2003, the US economy may have grown by 3 percent in volume. With currently no signs of an early end of the cyclical upswing, GDP may rise by nearly 4 percent in 2004.

However, there are certain risks to a sustained economic expansion. The most important one concerns the over-valuation of the real estate markets. Prices of residential dwellings have soared over the last ten years, thereby largely fuelling the boom in consumer as well as construction investment spending as the mainstay of rapid economic growth. If the speculative bubble on real estate markets were to burst, this could give rise to widespread financing and liquidity constraints across the economy. A second risk relates to government finances and the readiness of international investors to buy dollar assets. The general government deficit is likely to have widened to between 5 and 6 percent of GDP in 2003 and to rise further in 2004. After the presidential elections in November 2004, cuts in expenditure and tax increases will prove inevitable. Since this could dampen growth considerably, the projection for 2005 is for an increase in GDP of only 2½ percent.

Moderate cyclical recovery in the euro area

The euro area is lagging significantly behind the expansion of the world economy. Real GDP remained flat between the third quarter 2002 and the second quarter 2003; it was only in the subsequent period that exports picked up and GDP rose by 0.4 percent from the previous quarter. Still, internal demand remained anaemic, with investment in machinery and equipment continuing its downward trend. On annual average 2003, real GDP in the euro area edged up by only 0.4 percent.

A larger number of indicators suggest nevertheless that a gradual cyclical recovery in the euro area has actually started in the third quarter which over time will spread from exports to investment and eventually to other components of internal demand.

For the euro area, the recovery of the global economy will provide the only substantial cyclical impulse. The weakness of domestic demand over the last three years is also a reflection of the lacking counter-cyclical policy stance at the EU level.

The projections from the European Commission and from the "Euroframe" group expect a moderate, but steady increase in economic growth in the fourth quarter 2003 and the first quarter 2004. For the whole year 2004, real GDP growth in the euro area may attain 1¾ percent. Assuming a continuation of the moderate cyclical recovery, economic growth may accelerate to an average 2½ percent in 2005. The main driving forces behind the upswing in Europe are the demand impulses from North America and Asia. In addition, the decline in import prices will support real disposable income of private households, and monetary policy will exert no restraining impact on economic growth.

Unfavourable framework conditions will nevertheless weigh on the cyclical upswing. The continued appreciation of the euro vis-à-vis the dollar is the major retarding factor. Taking only the last three months, the euro has gained more than 10 percent against the dollar. With the exchange rate moving above 1.20 $ per € in early December, the European currency is over-valued, thereby bearing down on exports and investment. According to the "Eurogrowth" indicator, the strength of the euro has shaved 0.7 percentage point off GDP growth in the euro area in the second half of 2003. For the purpose of the short-term projections, WIFO relies on a technical exchange rate assumption providing for rates of 1.16 $ per € in 2004 and 1.14 $ per € in 2005.

Fiscal policy in the euro area is giving no stimulus to overcome the weakness in aggregate demand. On the national level, the stagnation of the last three years has been largely responsible for the rise in budget deficits. Many member states have reacted by trying to cut public expenditure, thereby adopting a pro-cyclical stance and dampening domestic demand further. The latest Ecofin Council decision to grant Germany and France additional time for the reduction of their government deficits is to be commended from the perspective of cyclical support. Still, it should not be overlooked that, apart from the cyclical weakness, the root causes for the excessive deficits are to be found in inadequate tax reductions and insufficient control over public expenditure in periods of better cyclical conditions. The political consequences of the violation of the Stability and Growth Pact remain to be seen.

The apparent failure of EU economic policy during the economic crisis over the period 2001 to 2003 has revealed once again that the co-ordination of member states' budgetary policies does not work in the desired way. Given the small size and the rigidity of the EU budget, the scope for counter-cyclical policy action at the EU level is limited as well. The "EU growth initiative" may at least give an important signal that policy is not only taking a "wait and see" attitude towards the stagnation of the economy. A pro-active policy stance ought to contribute towards improving the expectations of investors and consumers. In the third year of economic stagnation, the European Council of Brussels in mid-December has finally adopted the EU growth initiative. As a consequence, additional funds will be available from the EU budget and from the European Investment Bank (EIB) for the implementation of cross-border infrastructure investment projects. In the meantime, the economic and employment policy goals that the EU has set itself in the framework of the Lisbon strategy up to 2010, have largely moved out of sight. Despite the course of action adopted in Lisbon, EU economic policy is putting too little emphasis on growth, innovation and employment.

Crisis in the construction sector holding back growth in Germany

In the last few years, the German economy suffered mainly from the crisis of domestic demand. The key factor of sluggish overall activity was the renewed relapse of construction investment (2001 to 2003 –15 percent). Without the negative contribution from construction investment, German GDP in that period would have grown by an additional ¾ percent per year and thus at about the same rate as GDP in the euro area as a whole.

Because of its high price- and quality-determined competitiveness, the German export industry is a major beneficiary of the rebound in world trade. Exports will thus be the key driver of the cyclical upswing. Nevertheless, latest data for output and exports reaching until September and October, respectively, do not yet show an upward tendency. Domestic demand remains the retarding element of the German business cycle. Here and there, somewhat more positive signs may be observed: the fall in construction investment should have bottomed out in 2003, thereby removing the major brake to economic growth in Germany. Private consumption may rise by about 1 percent in 2004, despite a continued overall restrictive stance of budgetary policy. Public investment, however, is set to remain falling under the impact of tight saving targets, notably on the community level. In these circumstances, real GDP is projected to rise by some 1¼ percent in 2004. By 2005, with the crisis in the construction sector gradually overcome, the German economy should catch up towards the average rate of growth in the euro area.

Economic developments in Germany have been particularly unfavourable in the last years. A major factor has been the slump in construction investment. As from now, the construction sector may stage a gradual recovery. This should enable economic growth in Germany to catch up towards the euro area average in the medium term.

More favourable growth conditions outside the euro area

The economies of the EU member states outside EMU (UK, Sweden and Denmark) have been more dynamic in recent years than the euro area. While this is not directly related to the common currency, it nevertheless reflects a more nuanced perspective with regard to a pro-active policy stance and the greater leeway for fiscal policy. High investment and consumption spending by the public sector have proved to be important elements of a policy of cyclical stabilisation.

The ten accession countries have a considerable potential for strong economic growth. Their GDP per capita corresponds to only 20 percent of the EU-15 average, when measured at current exchange rates, and to some 40 percent in terms of purchasing power parities. Still, the catching-up process has been rather slow in the past: over the last seven years, the accession countries' economies grew by only 1 percentage point faster per year than the EU 15. In particular the financial constraints related to their high current account deficits required frequent corrective fiscal and monetary policy action. Poland has recently shifted towards a somewhat less restrictive policy stance. GDP of the accession countries rose by almost 3 percent in 2003. In Hungary, one of Austria's most important trading partners, a massive increase in interest rates is bearing down on growth. With the euro area in a cyclical recovery that will also entail a rise in imports, the new member states' economies will receive additional stimulus. Yet, for the catching-up process to be successful, public and private investment from the EU in the accession countries would have to be stepped up substantially.

Moderate cyclical upturn in Austria

The Austrian economy grew by 0.7 percent in 2003. Thus, the cyclical sluggishness lasted for an unusually long two-and-one-half years. Unlike in the two preceding years, activity was sustained by domestic demand in 2003. Construction investment picked up on account of sizeable new orders for road and railroad infrastructure. Investment in machinery and equipment also improved, even if not because of a cyclical strengthening but rather of tax incentives encouraging the carrying-forward of projects. The rise in private consumption and retail sales, while remaining below the respective long-term trend, nevertheless clearly exceeded the growth rate of GDP. Volume merchandise exports gained 2 percent at most, reflecting slack internal demand in trading partner countries; manufacturing net value added barely exceeded the year-earlier level.

Incentives for recovery may now be expected primarily from exports, since budgetary policy will follow a mildly restrictive line in 2004. Business expectations in the export-oriented branches of manufacturing are clearly for an imminent upturn of activity. The regular WIFO business survey confirms a marked improvement in sentiment since last September, in line with survey data for Germany and the euro area. Although no recent output and export figures are available that could confirm the cyclical recovery, the results from the WIFO survey suggest a pick-up in manufacturing output since last autumn.

Retaining the scenario of an export-led business cycle upswing that will gradually extend to equipment investment and the other components of domestic demand, WIFO projects growth of real GDP at 1.7 percent for 2004. A first preview for 2005, still surrounded by a considerable margin of uncertainty, is for growth accelerating to a rate of 2½ percent. This outlook is rather cautious, as the projected profile is flatter than that observed in previous cycles. A strong rebound of demand in Europe would lead to a faster pace of Austrian GDP.

A number of indicators suggest that the almost three-year-long economic stagnation in Austria is being gradually overcome. The business cycle upswing hinges on a continued strengthening of demand from major trading partners. In 2005, real GDP growth should accelerate towards the long-term average of 2¼ percent per year.

Two factors plead in favour of caution in the outlook: First, the euro has appreciated strongly against the dollar in recent months. An economic forecast based on exchange rate "fundamentals" is potentially undermined by high currency volatility. A further rise of the euro would, in any case, dampen exports and investment in the euro area as well as in Austria. An abrupt end to the cyclical upturn, similar to developments in 2002, should therefore not be entirely ruled out. Second, budgetary policy in the euro area will remain oriented towards consolidation in the years to come. Tax increases and cuts in public expenditure will in the short term weigh on households' disposable income, firms' sales expectations and therefore also on GDP growth.

The present projections do not include the tax cuts envisaged for 2005, since too little is as yet known about their scope and design. Assuming that the targeted lowering of the tax burden by € 2½ billion in net terms will benefit private income tax-payers to 75 percent and corporate tax-payers to 25 percent, and that only a small part of the foregone revenue will be offset by expenditure restraint or tax increases elsewhere, GDP growth may be boosted by ½ percentage point in the short term. WIFO will submit a more in-depth assessment of the short- and medium-term effects on growth, once the details of the tax reform become known.

Higher exports, despite decline in market shares

According to foreign trade statistics, Austria's merchandise exports in nominal terms slightly exceeded the year-earlier level over the period from January to September. This does not yet reflect a recovery, even if the most recent data may be revised upwards. Demand from within the Internal Market has been lacklustre. Exports to East-Central Europe, and notably those to the Czech Republic, picked up during summer; nevertheless, Austrian firms are losing market shares in the accession countries. By contrast, demand from Southeast Europe is booming, and Austria is strengthening its market position in the region.

The upswing of the world economy and the recovery in major trading partner countries accelerate the expansion of Austrian exports. Price competitiveness of domestic exporters, as measured by relative unit labour cost, is favourable; it is temporarily dampened, though, by the strength of the euro, leading to slight losses of market shares.

On annual average 2003, merchandise exports rose by up to 2 percent in volume from the previous year. For 2003 and 2004, slight losses of market shares should be expected, mainly owing to the increase in the real-effective exchange rate for manufactures. Price competitiveness of Austrian exports remains nevertheless high. Relative unit labour costs (compared with those of the trading partners) went up by nearly 2 percent in 2003 on account of the exchange rate shift, but are still some 10 percent lower than at the end of the 1990s.

Domestic exporters should benefit substantially from the imminent rebound of demand in Western Europe. The pace of merchandise volume export growth could accelerate to 5 percent in 2004 and 7 percent in 2005. The appreciation of the euro will, however, leave no scope for increases in export prices.

Imports of goods, rising by 3¼ percent in volume, were more dynamic than exports in 2003. The main reason has probably been lively demand for equipment investment whose import content is estimated at 60 percent. The appreciation of the euro is holding down import prices, making for slight terms-of-trade gains. The trade balance weakened slightly from last year, to a deficit of € ½ billion. Livelier goods exports and investment in machinery and equipment will make for a swift increase in imports in 2004 and 2005.

Table 3: 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	+2.2	+2.0	+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
Total economy						
Unit labour costs	−0.5	+1.3	+0.7	+1.8	+1.0	+1.3
Manufacturing						
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.

Strong increase in investment in machinery and equipment

According to preliminary data from the national accounts, investment in machinery and equipment gained some 5 percent in volume year-on-year in the second and third quarter 2003. Purchases of motor vehicles rose particularly strongly, but firms also bought more machinery and electronic equipment. The increase in equipment investment was clearly stronger than could be expected in a situation of low capacity utilisation. It was the result of some catching-up following two years of investment decline, and of tax incentives encouraging the carrying-forward of investment plans. The "cyclical stimulus package" of November 2003 provided for an extension of the investment premium until the end of 2004. While this will support investment activity also towards the end of 2004, deadweight losses will also be important as by that time the major stimulus for higher investment should come from the business cycle recovery. WIFO projects an increase in machinery and equipment investment of 3½ percent to 4 percent p.a. in 2003 and 2004, with a further acceleration likely in 2005.

Recovery in manufacturing industry

The analysis of cyclical developments in the manufacturing sector is particularly difficult at the present juncture, since Statistics Austria has been able to provide output data only up to June 2003. More recent information can be gathered from the regular WIFO business survey. The opinion survey reveals that production weakened until last summer, but should have rebounded markedly since September. The preliminary national accounts data show a decline of real value added by 2 percent year-on-year in the first semester, followed by a gain of over 1 percent in the third quarter. For the whole year 2003, WIFO expects manufacturing output to have stagnated at the year-earlier level. Strengthening demand from abroad should, however, allow production to gain momentum over the projection period, to annual rates of growth of 3 percent in real terms in 2004 and 4½ percent in 2005. Employment in manufacturing is on a clear downward trend that may bottom out only in 2005 with the projected strong output gains. By that time, hourly productivity should have resumed advancing by 4 percent per year.

Table 4: Productivity

	2000	2001	2002	2003	2004	2005
	Percentage changes from previous year					
Total economy						
Real GDP	+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.7	+ 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.

Lack of data is complicating the analysis around the cyclical turning point. The WIFO business survey points to a recovery in the industrial sector since autumn 2003. Its pace should accelerate markedly over the next two years on the back of rising external demand.

Current account in equilibrium, higher tourism revenues

Although data recorded according to the accrual principle are as yet available for the first semester only, the current account surplus has probably been somewhat smaller in 2003 than in the year before. Lively merchandise imports, notably of investment goods, have led to a weakening in the trade balance, whereas the surplus in the tourism services balance increased. Growth of tourism exports is set to gain momentum, from nearly 2 percent in volume in 2003 to 3 percent in the following years. The lower competitiveness due to the appreciation of the euro should be more than offset by the improving economic and private income situation in customers' home countries. Together with the more favourable prospects also for domestic incomes, this augurs well for the Austrian tourism sector, whose real net output should grow by over 2 percent p.a. in real terms over the projection period. Travel spending by Austrians abroad, having slumped by 4 percent in real terms in 2002, are recovering only slowly.

Steady expansion of construction activity

With output volumes up by 1¾ percent year-on-year, construction in 2003 clearly outpaced overall economic growth. This is primarily owed to higher priority being given to the upgrading of transportation infrastructure. The increase in the financing capacity of the companies in charge (Asfinag and SCHIG, outsourced from the public sector) allowed public construction investment to expand substantially, without putting a burden on the government budget in the short term. Investment in infrastructure will remain buoyant in 2004 and 2005, even if growth rates abate somewhat.

Residential construction, for its part, will gather momentum. The last years have seen a demand-induced fall in the number of dwellings completed from almost 60,000 in 1999 to 42,000 in 2002. Over the last few quarters, demand for housing has been heading up again, leading to a rising number of building permits issued and firms turning more optimistic in the regular WIFO business survey. Additional demand for subsidised dwellings is mainly generated by the rising number of immigrants. Residential construction will therefore rebound in 2004 and 2005. The non-residential building sector is facing divergent trends: there is considerable excess capacity of office space leading to fierce competition for higher quality and a fall in the creation of new units; on the other hand, the cyclical recovery and higher investment in equipment should give stimulus to industrial construction. Overall construction output is expected to rise by nearly 2 percent at constant prices both in 2004 and 2005.

The pick-up of activity, first registered in civil engineering, is now extending to residential building. In the course of the general recovery, also industrial construction is set to revive. Overall construction output is expected to rise by an inflation-adjusted 2 percent p.a. in the next two years.

Consumption heading up despite a rising saving ratio

In the first nine months of 2003, value added in the trade sector, according to data from the national accounts, rose by 1.6 percent in volume from the year-earlier level. Wholesale trade posted above-average gains, as it benefited from lively investment activity. Retail trade remained below expectations, rising by less than 1 percent. The available data appear less than reliable, however, on account of the unusually big difference between nominal and real values. For the whole year 2003, WIFO expects value added of the trade sector to have gained 1.6 percent. The recovery over the next two years should improve the situation, such that annual growth rates of trade volumes slightly above 2 percent are within reach.

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	+1.8	+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-banks[1]	+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.

The weakness in private consumption now lasting for three years will be overcome only gradually. Gains in employment and incomes are a precondition for higher household spending. The saving ratio has fallen significantly during the economic crisis, and is now expected to rebound to 8½ percent of personal disposable income. One reason for the upward tendency are higher provisions for retirement.

Like retail sales, private consumption also fared poorly, rising by a mere 1.3 percent from a year ago in 2003. Consumption growth thereby remained below its long-term trend for the third year in a row, despite real disposable household income gaining more than 1½ percent. The saving ratio has probably increased by ½ percentage point to a level of 8 percent of personal disposable income. It is set to rise somewhat further in the next two years, gradually reverting to the level before the crisis of the last years. The upward trend can also be explained by higher provisions for retirement in the "second" and "third" pillar. The rebound in disposable income should nevertheless allow real private consumption to increase by some 2 percent per year. In a cyclical recovery, demand for durable consumer goods should expand more than proportionally.

In the stagnation period of the last three years, the financial and insurance sector suffered from the subdued growth of incomes and investment, such that its value added was some 1 percent lower at constant prices than in 2000. In the transport and communication sector, jobs were lost while turnover increased modestly. Both sectors should benefit from the cyclical upswing over the projection period and attain growth rates between 1 ½ percent and 2 percent. Also the real estate business should return to more "normal" growth rates, on the back of the pick-up in construction activity and lively demand for commercial services.

Continued price stability

The rate of inflation looks set to remain at a low 1¼ percent in 2003 and 2004. The cyclical upswing may give rise to somewhat stronger price increases in 2005, although a high degree of overall price stability will still be maintained.

For some time now, inflation has been below 2 percent. In October, consumer prices were only 1.0 percent higher than a year ago. At present, there are no signs for mounting inflationary pressure. The strength of the euro has a dampening effect on import prices of energy. Thus, energy prices for the consumer will go up by only 2 percent despite the substantial increase in energy taxes in early 2004 that will boost the overall rate of inflation by about ¼ percentage point. Prices of food and beverages, having gone up above average recently, should move at a slower pace in 2004. Lower import prices and declining unit labour costs in manufacturing allow prices of manufactures to remain stable. Moderate wage settlements also help keeping prices of services down.

No reduction in unemployment in sight

The cyclical sluggishness now lasting for two-and-one-half years has serious negative repercussions on the labour market. The seasonally adjusted rate of unemployment has gone up since January 2001 from 5.6 percent of the dependent labour force to

7.2 percent of late. In absolute terms, this corresponds to a seasonally adjusted increase by 58,000 persons. In addition, there is a growing number of job-seekers undergoing job training who are not registered as unemployed. A turnaround on the labour market towards lower unemployment is unlikely to occur until 2005. On annual average, the number of people out of work may rise to a total 243,000 in 2004 and remain at that level in 2005. The rate of unemployment thereby stands slightly above 7 percent of the dependent labour force or at 4.5 percent of the total labour force on Eurostat definitions.

Table 6: Labour market

		2000	2001	2002	2003	2004	2005
		Changes from previous year (1,000s)					
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
Percentage changes from previous year		*+ 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	+ 7.0	+ 3.6	– 0.5
In 1,000		194.3	203.9	232.4	239.4	243.5	243.0
		In percent					
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. – [7] Percent of total labour force exclusive self-employed. – [8] Percent of population of working age (15 to 64 years).

With the usual time lag, the cyclical recovery will lead to an increase in the number of economically active employees. However, due to a marked rise in foreign labour supply, unemployment is unlikely to fall before 2005.

The persistent high level of unemployment should, however, not be seen as casting doubt on the close correlation between economic growth and developments on the labour market. The cyclical recovery will lead to a healthy increase in the number of economically active employees by ½ percent or more in 2004 and by a further 1 percent in 2005. Yet, the aggregate of people "economically active employed" also includes people receiving partial retirement benefits ("Altersteilzeitgeld") who already enjoy their back-loaded period out of work while still being registered with their former employer, as well as unemployed people participating in extended training courses.

Despite rising employment, the jobless figure is not declining, because of a massive increase in foreign labour supply to the tune of nearly 20,000 per year from 2003 to 2005. This reflects, on the one hand the access to the official labour market having been facilitated for foreign women and youth having lived in Austria for more than four to five years, and the more generous admission of seasonal workers.

Budget balance improving slightly in the cyclical upturn

The general government balance deteriorated markedly in 2003, with the deficit likely to have risen to 0.9 percent of GDP. This mirrors to some extent the cyclically-induced slowdown of revenue growth; profit tax revenues in particular fell clearly short of their year-earlier level. In addition, government expenditure rose relatively strongly, notably child-care benefits and compensation for partial retirement. Given the substantial costs of these two programmes and the high level of unemployment, a decline in social cash transfers appears unlikely also for 2004 and 2005. Government revenues should revive, however, with the recovery of incomes, employment and consumer demand. Higher revenues are expected notably for direct taxes, following their decline in the last two years. The general government deficit should remain close to 1 percent of GDP in 2004.

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	+0.3	−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
	In percent					
Monetary policy						
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).

For 2005, the government plans a tax reform that, according to the announcements, should reduce the tax burden by € 2½ billion in net terms. Details on the design of the tax reform are as yet unknown. Abstracting from the tax reform, the government deficit would narrow to about ½ percent of GDP. Official statements so far suggest that only the smaller part of the tax cuts will be "financed" by expenditure restraint which, in the event, would push up the general government deficit by nearly 1 percent of GDP.