Markus Marterbauer

Business Cycle Upturn not in Sight

Economic Outlook for 2003 and 2004

In 2003, the economy will grow by only 0.7 percent. Under the current conditions of deficient overall demand in the euro area and a marked depreciation of the dollar vis-à-vis the euro, prospects of a cyclical rebound remain elusive even for 2004. With GDP growth projected at an annual average 1.2 percent, economic sluggishness may enter its fourth year.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 25 June 2003. • E-mail-address: Markus.Marterbauer@wifo.ac.at

In the first quarter 2003, the Austrian economy grew by only 0.5 percent year-on-year. The rise in domestic demand remained moderate, goods exports stagnated, and investment in machinery and equipment failed to reach the year-earlier level. At present, there are no signs for a recovery of business activity. For the whole year 2003, GDP growth is unlikely to exceed 0.7 percent.

Prospects for 2004 continue to be vague. A cyclical impulse would have to come from exports and investment, but the conditions are unfavourable, given the widespread lack of aggregate demand in the euro area. Consumers are holding back spending on durable goods, while firms postpone the implementation of investment projects in view of weak sales prospects. A revival of demand would require stimulus from policy action, but the latter is not in sight. The marked depreciation of the dollar vis-à-vis the euro is complicating matters further, as it implies losses of foreign market shares for European exports, a dampening of US demand for foreign goods and services, and a lower attractiveness of Europe as a target of foreign investment. The present projections are based upon the assumption of an exchange rate of 1.13 $ per euro for 2003 and 1.16 $ per euro for 2004.

Demand for Austrian export goods is weak, not only within the EU Single Market, but also in East-Central Europe, because of numerous setbacks in the catching-up process. By contrast, Austrian companies are highly successful on south-eastern European markets. The rise in the real-effective exchange rate by an estimated 3 percent in 2003 is weighing on competitiveness; since this cannot be compensated in the short run by the fall in unit labour costs in manufacturing, some losses of market shares should be expected. Growth of merchandise exports is decelerating markedly, to a projected volume rate of only 2.5 percent this year and little more in 2004 (+3¼ percent). Tourism is also suffering from the undermined confidence of European consumers: following the good results over the past two years, 2003 is likely to see a decline in real foreign gross earnings by 1 percent.

Domestic companies continue to hold back with capital spending. The investment ratio is falling markedly, from 24 percent of GDP in 2000 to 21½ percent in 2003. The main reason is the slump in spending on machinery and equipment, which fell by a total 13 percent in nominal terms over the last two years. In the face of poor capacity utilisation and subdued sales expectations, a rebound in business fixed investment should not be expected for 2003 and 2004 either. Such a rebound would, however, be crucial for stronger GDP growth and a turnaround on the labour market.

Table 1: Main results

		1999	2000	2001	2002	2003	2004
		Percentage changes from previous year					
GDP							
Volume		+ 2.7	+ 3.5	+ 0.7	+ 1.0	+ 0.7	+ 1.2
Value		+ 3.4	+ 5.0	+ 2.3	+ 2.2	+ 2.3	+ 2.7
Manufacturing[1], volume		+ 3.0	+ 6.5	+ 1.3	+ 0.3	+ 0.3	+ 1.8
Private consumption expenditure, volume		+ 2.3	+ 3.3	+ 1.5	+ 0.9	+ 1.3	+ 1.6
Gross fixed investment, volume		+ 2.1	+ 5.9	– 2.2	– 4.6	+ 0.8	+ 1.8
Machinery and equipment[2]		+ 4.9	+11.8	– 2.9	– 9.4	± 0.0	+ 2.0
Construction		+ 0.0	+ 1.2	– 1.5	– 0.5	+ 1.4	+ 1.7
Exports of goods[3]							
Volume		+ 7.7	+13.1	+ 7.5	+ 4.3	+ 2.5	+ 3.3
Value		+ 7.0	+15.6	+ 6.5	+ 4.1	+ 2.0	+ 2.8
Imports of goods[3]							
Volume		+ 6.9	+10.9	+ 5.7	– 1.6	+ 1.7	+ 3.5
Value		+ 6.7	+14.7	+ 5.0	– 2.2	+ 0.9	+ 2.7
Current balance	billion €	– 6.33	– 5.36	– 3.94	+ 1.57	+ 0.80	+ 0.45
As a percentage of GDP		– 3.2	– 2.6	– 1.9	+ 0.7	+ 0.4	+ 0.2
Long-term interest rate[4]	in %	4.7	5.6	5.1	5.0	3.9	4.0
Consumer prices		+ 0.6	+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.3
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	+ 0.1	+ 0.3
General government financial balance according to Maastricht definition							
As a percentage of GDP		– 2.3	– 1.5	+ 0.3	– 0.6	– 1.1	– 1.2

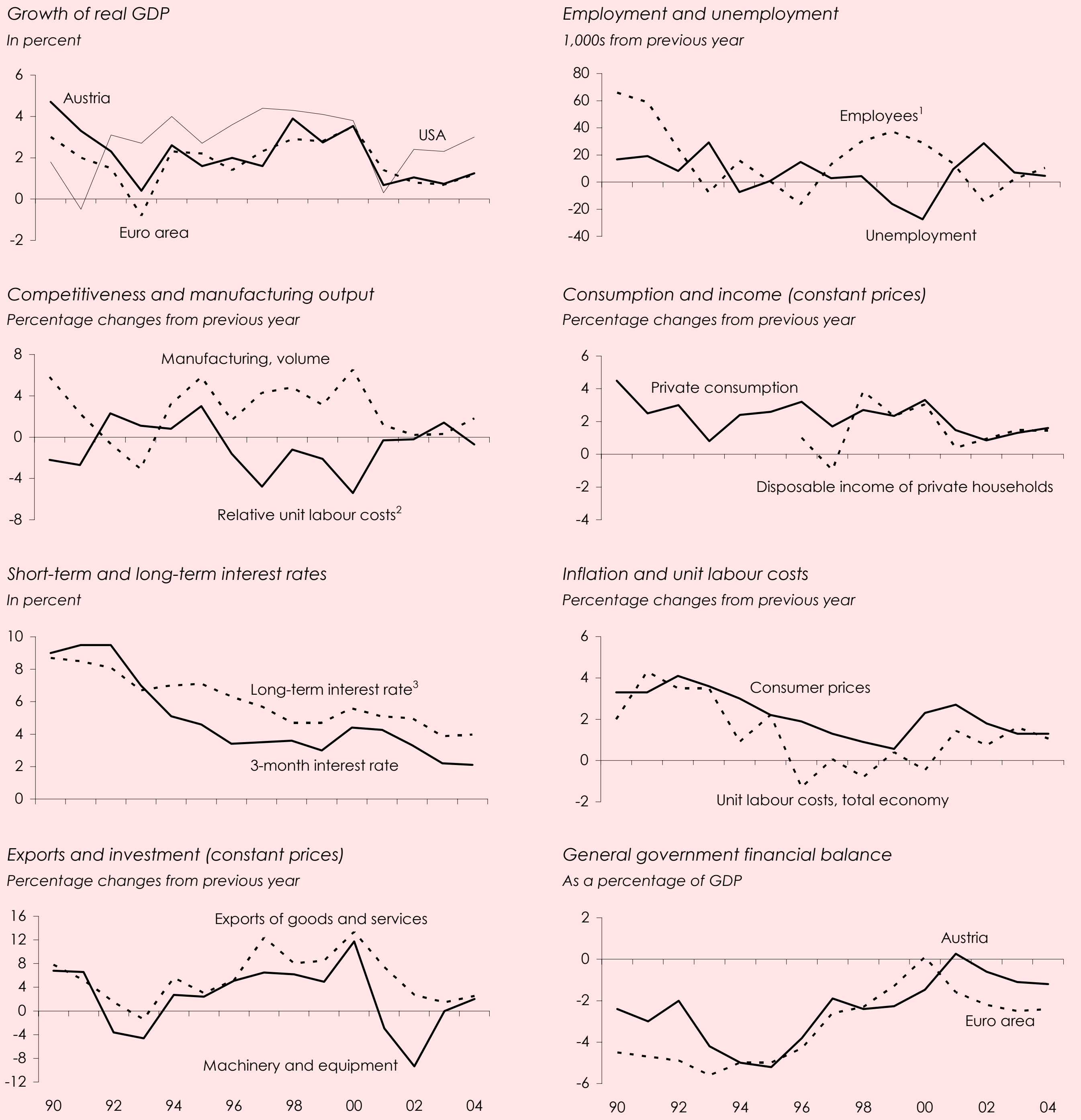
[1] Value added, including mining and quarrying. – [2] Including other products. – [3] According to Statistics Austria. – [4] 10-year central government bonds (benchmark). – [5] According to Eurostat Labour Force Survey. – [6] According to Labour Market Service, percent of total labour force excluding self employed. – [7] Excluding parental leave and military service.

Production in manufacturing is likely to continue its stagnation in 2003, in the absence of stronger demand, with the number of industrial jobs falling sharply. In construction, however, there are signs of a tentative recovery, as output growth of 1½ percent in 2003 and 1¾ percent in 2004 could, for the first time since 1996, exceed that of overall GDP. Since last summer, civil engineering has staged a recovery, owing to higher investment in road and railway infrastructure. The regular WIFO business survey now points to an imminent pick-up also in the building sector, notably new-home construction.

Growth of real disposable income is firming somewhat vis-à-vis 2001 and 2002, due not only to lower inflation, but also to higher child-care and retirement benefits. Still, income gains will not be strong enough to allow sizeable increases in private consumption. Household spending on durable consumer goods and travel may also be dampened by a rise in the saving ratio, which constitutes a considerable cyclical risk. The WIFO forecast assumes a slight increase in the saving ratio, from 7.5 percent of disposable income in 2002 to 8 percent in 2004, allowing real private consumption gains of 1.3 percent in 2003 and 1.6 percent in 2004, distinctly below the long-term average growth rate of 2¼ percent.

The high euro exchange rate is dampening price increases. Headline inflation is expected at only 1.3 percent, both this year and next. Prices of energy, industrial goods and food will stabilise the price level, while rents will exert upward pressure (+5 percent).

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).

Sluggish activity and the sustained strong increase in labour supply will drive unemployment further up, to a projected total of 239,000 this year and 244,000 in 2004. This corresponds to an unemployment rate of 7.1 percent of the dependent labour force according to the conventional national definition, or 4.4 percent of the total labour force (Eurostat definition). It is only the rising number of participants in labour market training and the "part-time retirement" programme that will cause the number of actively employed to edge up by 2,000 this year. A further gain of 10,000 projected for next year will again not be generated by a cyclical recovery, but by institutional changes in employment registration. The employment ratio in Austria, according to the labour force concept of Eurostat, is close to 68 percent of the working-age population and thus not much below the EU target for 2010. However, according to the traditional Austrian calculation following the means-of-living concept, it is only 62 percent, as only those people are counted as employed whose income exceeds a minimum threshold.

Government tax revenues have developed favourably in the first semester 2003. On the expenditure side, however, the strong rise in family benefit payments is weighing on the budgetary balance. The general government deficit in the Maastricht definition is projected at 1.1 percent of GDP for the current year. The downward revision of the growth forecast is of little influence in this regard, as it is mainly due to weaker export growth. Next year, however, the cyclical impact should be felt more strongly, leading to an expected deficit of 1.2 percent of GDP.

Persistent sluggishness of overall demand in the euro area

The European economy is caught in stagnation, missing any impulse for a business cycle upswing. Output grew by 0.8 percent year-on-year in the first quarter 2003, but remained flat from the previous period on a seasonally-adjusted basis. The quarterly forecasts of the European Commission and the "eurogrowth" indicator suggest only modest year-on-year advances between ½ percent and ¾ percent for the second and third quarter. For the whole year 2003 as well, GDP growth in the euro area will only attain some ¾ percent. The growth crisis, now going into its third year, is quickly driving up unemployment and budget deficits. In April, the jobless rate rose to a seasonally-adjusted 8.8 percent, ¾ percentage point above the level of 2001. The cyclically-induced weakness in tax and social contribution revenues, together with rising unemployment compensation expenditure, are leading to widening government deficits.

Current business activity in Europe is characterised by weak corporate investment and spending restraint of consumers. The depreciation of the dollar vis-à-vis the euro is dampening export growth. GDP is projected to expand by only ¾ percent this year. At present, there are no signs for a business cycle upturn. Next year too, growth may remain at an anaemic 1¼ percent. Counter-cyclical stimulus from economic policy is lacking.

The growth crisis in the euro area is primarily due to a lack of internal demand. While the latter had expanded by an average 2¼ percent p.a. during the 1980s and 1990s, it gained only 1 percent in 2001 and a mere 0.3 percent in 2002. Firms have cut back markedly on their investment over the last two years, as the low capacity utilisation rate (80.8 percent in the second quarter 2003) and depressed sales expectations provide little incentive for adding to capital stock. Private households are very cautious in stepping up consumption, reflecting partly their concerns about job security and the further functioning of the social security provisions, and partly the moderate wage gains which for many years have been lagging behind productivity growth. No additional demand impulse is coming from the public sector. While deficits in government households are widening (to around 2½ percent of euro area GDP in 2003), this is simply a reflection of sluggish business activity. A pro-active stance of cyclical stimulus is nowhere adopted in the euro area. In some countries, such as Germany or Portugal, the fiscal policy reaction is indeed pro-cyclical, as government expenditure on investment and transfers are being cut or taxes increased, thereby exacerbating the lack of demand. Outside EMU, Sweden and the UK have substantially reinforced public investment.

The weakness of investment and consumption is now being compounded by slackening exports as a consequence of a depreciating dollar vis-à-vis the euro. While as recently as last January, the exchange rate had been 1.06 $ per euro, it rose to 1.16 $ per euro by May. This sharp decline of the dollar is having a particularly adverse effect on business activity in Europe, as the only significant forces of growth have until now come from abroad. The appreciation of the euro is inhibiting growth in Europe in several regards:

- it reduces price-competitiveness of European goods on world markets, leading to losses of market shares;
- the impulse of somewhat stronger demand growth in the USA will only to a limited extent be transmitted to Europe;
- corporate earnings are being squeezed, thereby dampening investment;
- Europe may lose attractiveness as a target destination for foreign direct investment.

Table 2: World economy

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
Real GDP						
Total OECD	+ 3.2	+ 3.8	+ 0.8	+ 1.8	+ 1.4	+ 1.8
USA	+ 4.1	+ 3.8	+ 0.3	+ 2.4	+ 2.3	+ 3.0
Japan	+ 0.1	+ 2.8	+ 0.4	+ 0.3	+ 0.8	+ 0.8
EU	+ 2.8	+ 3.5	+ 1.5	+ 0.9	+ 0.8	+ 1.2
Euro area	+ 2.8	+ 3.5	+ 1.4	+ 0.8	+ 0.7	+ 1.2
Germany	+ 2.0	+ 2.9	+ 0.6	+ 0.2	± 0.0	+ 0.8
Central and Eastern Europe[1]	+ 3.3	+ 4.0	+ 2.1	+ 2.1	+ 2.5	+ 2.8
Asia (excluding Japan)	+ 6.7	+ 6.8	+ 4.9	+ 6.0	+ 4.5	+ 4.5
World trade, volume	+ 6.0	+12.7	± 0.0	+ 2.5	+ 3.3	+ 4.5
OECD exports	+ 5.7	+12.0	– 0.5	+ 2.7	+ 3.0	+ 4.0
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*	*+ 3.8*
Primary commodity prices, in USD						
HWWA index, total	+12.0	+32.0	–11.0	+ 1.0	+ 6.0	–11.0
Excluding energy	– 8.0	+ 1.0	– 7.0	± 0.0	+ 3.0	– 3.0
Crude oil prices						
Average import price (cif) for OECD countries — USD per barrel	17.3	28.0	23.6	24.1	26.0	22.0
Exchange rate						
USD per euro	1.067	0.924	0.896	0.945	1.13	1.16

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

The unfavourable exchange rate move will impact on output with a lag of two or three quarters. The "eurogrowth" indicator is signalling an output loss of ¼ percent of GDP for the first semester 2003 and of ½ percent for the third quarter.

The German economy has slipped into recession for the second time since 2001, as a consequence of deficient domestic demand.

Germany's export sector is particularly affected by the strengthening of the euro. Germany belongs to the countries that are most successful in their exports and that benefit from the implementation of advanced technology. It was only the good export performance that prevented GDP from contracting in the last two years. Nevertheless, export growth has clearly lost momentum over the last few months. Thus, problems in three key areas of domestic demand have come to the fore: construction investment remains on a clear downward trend; spending of private households fell in volume terms last year, with the rise in the saving ratio being of particular concern in a period of cyclical weakness; public investment has been cut, notably at the level of local communities, which are struggling with severe financial problems. On account of the weakness of domestic demand that is exacerbated by slackening exports, the German economy has entered a recession. GDP for the whole of 2003 may not rise above the level of last year.

External stimulus remaining subdued

European economic policy over the last two years was confident that a demand impulse from abroad would pave the way to a business cycle recovery. This strategy has proved unsuccessful as the European economy has entered its third year of stagnation. Strong cyclical incentives from outside the euro area are unlikely for the time being: first, the rise of the euro is shielding the Single Market from external forces of growth; second, such forces of expansion appear to be fragile.

Incentives from the USA for a resumption of growth remain weak. The US economy is expected to grow by 2 to 3 percent p.a. in 2003 and 2004. Any demand spill-overs to Europe are blunted by the depreciation of the dollar against the euro.

In the USA, a self-sustained upswing has still not come under way, despite the strong expansionary incentives from monetary and fiscal policy. The economy is set to grow by 2¼ percent this year, with no clear acceleration in sight. Although consumer confidence has firmed somewhat since the end of the Iraq war, actual consumer demand has hardly strengthened. Crucial factors in this context are the adverse developments on the labour market – with the unemployment rate rising to a seasonally-adjusted 6 percent last May – and of per-capita incomes. Demand for durable consumer goods is slackening. In view of the attractive financing conditions, car sales had soared in 2001 and 2002, but this boom is now coming to an end. Corporate investment in equipment and software, after having rebounded markedly in the second half of 2002, suffered an unexpected setback in early 2003, as low capacity utilisation and squeezed profits induced firms to tread more cautiously. A particular cyclical risk derives from the over-valuation of real estate markets. Prices of houses and apartments have jumped in the last years. A slower pace from now on will constrain the possibility of private households to take on further debt. Were this speculative bubble to burst, severe financing problems could be the consequence.

There are nevertheless also some positive signs. Stock market values have passed the trough and have climbed steeply since April. If this were to continue, it could lead to a revival of private consumption and investment. Yet, price-earnings ratios appear to have risen quite high already, such that setbacks may not be excluded. Mainly because of the rebound on stock markets, the composite index of leading indicators has advanced strongly in May. At the same time, incoming orders and industrial output have stabilised.

With the exception of Japan, Asia remains a growth pole in the world economy. GDP in the region is expanding by nearly 5 percent per year, considerably faster than in the major advanced economies. The Chinese economy, in particular, has proved highly resistant over the last years to crises affecting the global economy. The country's strict control over foreign capital transactions has been helpful in this regard. But also South Korea, Taiwan and the other "tiger states" are recovering from the economic and financial crisis of 1998-99. Yet, the emergence of the SARS lung disease has come as a severe temporary shock to the tourism business which has played an increasing role in recent years.

Challenge for EU economic policy

The appreciation of the euro leaves little hope for an economic upturn in the EU to be driven entirely by external forces. Economic policy in Europe is called upon to promote growth and stimulate demand. Monetary conditions are relatively favourable, as the ECB has recently cut its key short-term rate by ½ percentage point. The adjustment of the inflation target ("close to 2 percent"), in combination with a marked, largely exchange-rate-induced deceleration of inflation, offers further room for manoeuvre for the months to come. Nevertheless, the potential for monetary policy to stimulate spending by firms and households is limited in a cyclical phase characterised by fragile expectations. For the corporate sector, the sombre sales outlook constitutes the major barrier to investment. Private households, for their part, defer purchases of durable goods in view of adverse prospects for employment and income.

In this situation, fiscal action impacting directly on demand is required. Public investment should be given priority over tax cuts, as the latter boost directly disposable income and company profits, but not expenditure on consumption and investment. The intention of the European Commission to initiate, together with the European Investment Bank, an increase in public investment is welcome. Higher public investment which in recent years has fallen below an adequate level from a long-term perspective, would not only give a timely boost to overall demand, but also raise expectations of firms and households. An improvement of the European transportation network is undoubtedly the right target, with a view to the imminent EU enlargement.

In addition, the goals set by the European Council of Lisbon should serve as a guideline for a forward-looking investment programme. There is considerable scope for Europe to catch up in the area of information and communication technology. Education and training systems need upgrading, and special emphasis should be given to research and development. Both, the unfavourable cyclical outlook and the Lisbon goals call for a pro-active stance of economic policy that combines early demand stimulus with an orientation towards long-term economic growth.

No cyclical upturn in sight

In Austria, the sluggish pace of growth of 2001 and 2002, when GDP rose by 0.7 percent and 1 percent, respectively, is continuing this year. As for next year, the margin of uncertainty is wide, but at present there are few indications for a business cycle recovery. Over the last two years, foreign trade provided a significant growth contribution without which GDP would have contracted. Such stimulus from abroad is now fading, due to weak overall demand in the key trading partner countries and also to the direct and indirect effects of the dollar depreciation vis-à-vis the euro.

The Austrian economy is set to grow by only 0.7 percent this year. For 2004, no strong pick-up of activity is to be expected either, GDP being projected to gain 1.2 percent. If this projection were confirmed, growth would stay close to 1 percent for the fourth consecutive year.

The updated WIFO projections suggest that in 2004, GDP growth would hover around a modest 1 percent for the fourth year in a row. Such a pattern would deviate markedly from a "normal" cycle, implying welfare losses on a par with the three recessions of the last decades. In the past, recessions in Austria lasted for between one-half and one year, giving way subsequently to a vigorous rebound of activity. The upswing in Austria typically starts in the export-oriented sector, spreading in the following to business equipment investment and, with some lag, to the other components of domestic demand.

Such a benign scenario may not be ruled out for 2004. Driven by a further recovery of stock market values, growth in the USA may gain considerable momentum. This could in turn strengthen the dollar on foreign exchange markets and make Europe more attractive for foreign investors. A revival of European exports and investment could, together with an expansionary policy stance, provide the badly-needed incentives for the lacklustre domestic demand. However, from today's perspective, such a scenario is not very likely to materialise.

More realistic would seem a scenario, whereby a moderate demand recovery in the USA is only partially transmitted to exports and investment in Europe. The assumed exchange rate of 1.13 $ (2003) and 1.16 $ per € (2004) would have a significant dampening impact. Still, the persistent weakness of internal demand remains the overriding problem of the European economy.

In Austria, too, domestic demand cannot muster sufficient strength for initiating a cyclical upturn. Private consumption keeps expanding at a real rate around 1½ percent per year. While construction investment is staging a tentative recovery, domestic demand overall remains well below its long-term pace. Thus, the risks to the present forecast are deemed to have some downward bias.

Export sector facing difficult tasks

Last year, the major incentives to economic growth came from merchandise exports, which rose by 4¼ percent in volume from 2001. Austrian companies markedly raised deliveries to eastern and south-eastern Europe as well as to Asia, often gaining substantial market shares. Demand from Croatia, Serbia, Romania and Bulgaria remained lively until early this year. In these "niche" markets, Austrian exporters have acquired a strong position.

Restrained demand in western and eastern Europe and the effective appreciation of the euro are weighing on export opportunities, making losses of market shares likely. The weakness in the import-intensive components of demand and falling import prices lead to small surpluses in the trade and the current account balances.

However, exports to Central and Eastern European countries have slackened. The catching-up process of the EU accession candidates follows a moderate pace and is repeatedly suffering setbacks. In Poland, the Slovak Republic, Slovenia, the Czech Republic and Hungary, GDP growth over the last five years has been only ¾ percentage point higher on average than in the euro area. In some accession countries, effective currency appreciation vis-à-vis the euro held back the expansion. Prevailing current account deficits point to the fact that the catching-up process is highly dependent upon capital imports from western Europe.

Austrian exporting companies are facing difficult times. Exports within the EU Single Market remained below the year-earlier level at the beginning of the year, as a result of sluggish demand in the major trading partner countries. The appreciation of the euro is affecting in particular the German export industries, to which Austrian companies maintain close supply relationships. The exchange rate shift thus affects Austrian companies mainly indirectly, as 83 percent of Austrian exports are denominated in euro and only 14 percent in dollar. The real-effective exchange rate in 2003 is expected to rise by 3 percent from last year. This amount corresponds to the one of 1995, when the Italian lira and a number of other currencies devalued markedly against the DM.

Because of the effective euro appreciation, relative unit labour costs will rise this year for the first time since 1995, by a projected 1½ percent. Austrian firms' foreign market shares are therefore expected to remain constant this year, before declining slightly in 2004. Strong productivity gains in the export-oriented sector, forecast at 3 percent on an hourly basis in 2003, will likely be able to compensate the exchange rate effect only in the longer run.

The weakness of demand in trading partner countries and the effective euro appreciation are weighing on export growth: merchandise exports are expected to rise by only 2½ percent in volume year-on-year in 2003, accelerating to +3¼ percent next year. Because of the modest increase in producer prices and a highly competitive business climate, export prices are likely to edge down in both years, by ½ percent each.

Merchandise imports declined last year by 1.6 percent in real terms, reflecting weak domestic demand, and in particular the slump in investment in machinery and equipment. In the current year, imports are unlikely to gain more than 1¾ percent, given that the demand components of high import content, i.e., goods exports, equipment investment and spending on durable consumer goods, are close to stagnation. At the same time, import prices are falling markedly as a consequence of the euro appreciation. The terms of trade are improving slightly.

The trade balance was in equilibrium last year, for the first time in decades, as a consequence of lacklustre domestic demand. This year and next, the trade balance may register a small surplus, as import demand is set to remain weak and import prices to decline. The current account should also stay in small surplus. Net earnings from tourism services should remain broadly stable around € 2 billion. Austrian travellers are cautious in raising their spending abroad. In the 2002 summer season and last winter, tourism in Austria took a highly positive development. As from now, however, the outlook is less encouraging. While Austrian tourism should benefit from customers, particularly German holidaymakers, turning away from long-distance travel, spending by German tourists will likely be constrained by income losses. For next year, no substantial improvement of the tourism business should be expected.

Companies restraining investment markedly

The slump in machinery and equipment investment exacerbated importantly the cyclical slowdown in 2001 and 2002. In view of underutilised capacities and uncertain sales prospects, no rebound of investment should be expected in 2003 and 2004. Such a rebound would, however, be a key precondition for a revival of GDP growth and a turnaround on the labour market.

The slump in investment in machinery, vehicles and electronic equipment had a significant impact on business cycle developments during the last two years. Between 2000 and 2002, machinery and equipment investment fell by a cumulated 13 percent in nominal terms. In the first six months of 2003, domestic firms continued to hold back with capital spending, with equipment investment falling by about 1 percent in volume year-on-year in the first quarter, according to preliminary results from the WIFO quarterly National Accounts calculations. The semi-annual WIFO investment survey of last June suggests that firms in manufacturing plan to cut their investment outlays further in 2003 compared with the previous year, by 1.1 percent in current values. In view of the low capacity utilisation rate and the considerable uncertainty about the cyclical outlook, the implementation of many investment projects is being further postponed. It is only in the motor car industry that productive capacities are being increased on a larger scale. A carrying forward of investment spending is to be expected for the fourth quarter, in view of the expiry of the 10 percent investment premium at the end of the year. Despite this one-off effect, equipment investment for the whole year 2003 is unlikely to exceed the low level of last year.

For 2004, a strong rebound of investment is not expected. While replacement of obsolete equipment may gain in importance, there is hardly any need for additional productive capacity in view of the output gap and the subdued outlook. Although the low interest rates are a positive signal, provided that the cut in policy rates is passed on to credit customers, a revival of investment will only materialise, once overall demand strengthens markedly and business confidence improves.

What is eye-catching is the significant decline of the overall investment ratio in the last years. While in 2000, total gross fixed capital formation accounted for 24 percent of GDP, this ratio is set to fall to 21½ percent in the current year. This mirrors the marked loss of corporate confidence in further economic developments. Investment is the key variable in the macro-economic scenario. Without a revival of capital formation, no return to healthy rates of economic growth nor a turnaround on the labour market can be expected.

Industrial production stagnating

In the regular WIFO business survey for the Austrian manufacturing sector, firms' judgements on current production and the business situation have turned more pessimistic since the end of 2002. Slackening external demand is hitting particularly the producers of primary products. Timely output data are no longer available since the beginning of this year, because the relevant survey by Statistics Austria can only be carried out with a long delay, which severely complicates the analysis of the business cycle. Going by the WIFO survey data, value added in the first quarter would have matched the year-earlier level.

Table 3: Productivity

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
Total economy						
Real GDP	+ 2.7	+ 3.5	+ 0.7	+ 1.0	+ 0.7	+ 1.2
Employment[1]	+ 1.4	+ 0.8	+ 0.7	– 0.4	+ 0.2	+ 0.3
Full-time equivalent	+ 1.3	+ 0.9	+ 0.5	– 0.6	– 0.2	+ 0.2
Productivity (GDP per employment)	+ 1.3	+ 2.8	+ 0.0	+ 1.5	+ 0.6	+ 0.9
Full-time equivalent	+ 1.5	+ 2.6	+ 0.2	+ 1.7	+ 0.9	+ 1.0
Manufacturing						
Production[2]	+ 3.1	+ 6.5	+ 1.2	+ 0.2	+ 0.3	+ 1.8
Employees[3]	– 0.7	+ 0.0	+ 0.2	– 2.5	– 2.2	– 1.0
Productivity per hour	+ 4.5	+ 6.6	+ 1.4	+ 3.5	+ 3.0	+ 3.1
Working hours per day per employee[4]	– 0.6	– 0.1	– 0.4	– 0.7	– 0.4	– 0.3

[1] 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.

For 2003, no cyclical revival of manufacturing output should be expected. Firms are suffering from a lack of demand, inducing them to large-scale lay-offs of personnel. As in 2002, production is set to remain flat. Output growth will only resume, once orders from abroad pick up.

Recovery in the construction sector broadening its base

The fall in construction investment exacerbated the cyclical slowdown in the last two years. Now signs for a tentative recovery of the construction industry are becoming more frequent. Since mid-2002, activity has been picking up in civil engineering, as more determined action is being taken for the badly-needed upgrading of infrastructure. The mobilisation of additional public financial resources has given incentives to both road and railroad construction. Nevertheless, outstanding debt of the financing companies (ASFINAG and SCHIG) has become rather high, such that constraints may arise in a medium-term perspective. The introduction of a road toll for lorries as from 2004 can only be a partial solution.

After an improvement in civil engineering, a gradual recovery in the building sector appears imminent.

The latest WIFO business survey suggests that confidence is rising also among firms in commercial construction. While demand for industrial structures remains subdued, new orders for residential and office buildings are heading up. However, the higher demand for office space is hardly sustainable, given the considerable excess capacity already existing in this area. More genuine is the need for new homes, as reflected in price increases for rented dwellings and the rising number of construction permits.

With projected growth rates of 1½ percent and 1¾ percent for 2003 and 2004, respectively, construction will outpace GDP growth for the first time since 1996. Employment in the sector will nevertheless keep falling.

Subdued private consumption – possible rise in the saving ratio

Real per-capita incomes are developing better this year than foreseen, owing to the declining rate of inflation. Net of taxes and social charges, workers and employees may enjoy a slight increase of ½ percent, the first one since 2000. Including social transfers, real net incomes may go up by 1 percent, due to higher child-care benefits and an adjustment of retirement pensions. On both accounts, income gains are likely to be somewhat smaller in 2004: wage settlements will be more modest, reflecting low inflation and sluggish activity, and the boost from budgetary policy to disposable income will wane.

Table 4: 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	+ 0.7
Net real earnings per employee[1]	+ 0.5	+ 1.5	− 1.0	− 0.5	+ 0.4	+ 0.3
Net wages and salaries	+ 3.7	+ 4.5	+ 1.9	+ 2.4	+ 2.3	+ 2.0
Total economy						
Unit labour costs	+ 0.4	− 0.5	+ 1.4	+ 0.7	+ 1.6	+ 1.1
Manufacturing						
Unit labour costs	− 1.2	− 4.5	+ 1.8	− 0.2	− 0.5	− 0.6
Relative unit labour costs[2]						
Vis-à-vis trading partners	− 2.1	− 5.4	− 0.3	− 0.2	− 1.4	− 0.7
Vis-à-vis Germany	− 0.8	− 1.8	+ 0.1	± 0.0	− 1.4	− 1.2
Effective exchange rate – manufactures						
Nominal	+ 0.6	− 2.7	+ 0.9	+ 1.3	+ 3.2	+ 0.6
Real	− 1.3	− 3.3	+ 0.5	+ 0.8	+ 2.9	+ 0.5

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

The prospective income gains are too feeble to allow for a substantial increase in private consumption. In addition, the saving ratio is probably trending slightly upwards. Error correction models of the consumption function suggest that consumers will not react to the third year of sluggish income growth in a row by a lower saving ratio, but rather by restraining consumption. Against the background of the pension reform debate, households may defer spending on durable consumer goods and holiday travel and, instead, put a larger part of their income to private provision for old age. In a period of deficient demand, such behaviour would constitute a substantial business cycle risk. Actual data on the trend of saving as a share of disposable income are not yet available for the current year. The present projections assume a moderate increase from 7.5 percent in 2002 to 8.0 percent in 2004, in which case real private consumption would gain 1.3 percent in 2003 and 1.6 percent in 2004.

Stable price level

Price increases at the consumer level have clearly abated in April and May. Whereas early this year the rate of inflation stood at 1.7 percent, it had come down to 1.1 percent lately. The deceleration was mainly owed to large price cuts for energy products. World market commodity prices on a dollar basis have fallen slightly below the year-earlier level, and the appreciation of the euro accentuates the decline even more. The lower prices will be felt at the consumer level only with the usual lag.

While prices of energy, manufactures and food have a dampening effect on overall inflation, some categories of services continue to exert upward pressure. This holds in particular for rents, which are projected to go up by 5 percent on annual average 2003. In all, the consumer price index as well as the HICP is forecast to increase by 1.3 percent from last year.

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	+0.7	+2.0
Non-durables and services	+1.6	+3.2	+1.4	+1.0	+1.4	+1.5
Household disposable income	+2.3	+3.1	+0.4	+0.9	+1.5	+1.5
Household saving ratio						
As a percentage of disposable income	8.5	8.3	7.4	7.5	7.8	8.0
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+5.2	+6.7	+3.5	+1.2	+3.3	+3.7
	In percent					
Inflation rate						
National	0.6	2.3	2.7	1.8	1.3	1.3
Harmonised	0.5	2.0	2.3	1.7	1.3	1.3
Core inflation[2]	0.7	0.9	2.3	2.0	1.4	1.5

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

Inflation is likely to keep its slow pace of 1.3 percent in 2004. Weak demand and a modest increase in unit labour costs will set narrow limits to price increases. Dampening effects also derive from the assumptions on oil prices and the euro exchange rate. The only significant increases are expected from housing costs.

The marked fall in inflation has over the last months sparked off a debate about potential dangers of deflation. While general deflation in the sense of a fall in the overall price level is not in sight for the euro area, such tendencies cannot be ruled out for particular countries. What is true, however, is that the European economy is characterised by a "deflationary gap", i.e., a considerable lack of aggregate demand.

Unemployment rising further

The cyclical weakness has important negative repercussions on the labour market, which is mainly reflected in employment figures. Stagnating output in manufacturing is causing a marked decline in employment. From January to May, the number of jobs in industry fell by 13,700 or 2¼ percent below the level of the same period one year ago. Despite slight output gains, jobs have also been lost in construction (–3,500 year-on-year in the period from January to May). While the number of full-time jobs is declining markedly, part-time jobs are on the rise. The service sector overall is generating some more jobs, although the trade, transport and communication sectors continue to lay off personnel. Other service branches are hiring new staff, in particular tourism, commercial services (including personnel service agencies) and education and health services. More employees than one year ago are also registered in public administration, which is due to the fact that part of the unemployed undergoing training offered by the labour market service are counted as employed in the public sector.

Unemployment continues to rise, because of protracted sluggish activity and the unabated expansion of labour supply. The overall jobless figure will likely rise to 244,000 in 2004, up by 50,000 from its trough in 2000.

The number of economically active employees (i.e., excluding recipients of childcare benefits/parental leave and people in regular military service) also includes those unemployed who receive training on a longer-term basis. It also includes people receiving "part-time retirement" benefits who have actually fully retired while still being registered with their last employer. Due to these institutional particularities, the number of economically active employees has slightly exceeded the year-earlier level, by 1,100, in the first five months of this year.

Table 6: Labour market

		1999	2000	2001	2002	2003	2004
		Changes from previous year (1,000s)					
Demand for labour							
Economically active employment[1]		+38.2	+ 30.8	+15.1	– 11.2	+ 4.8	+ 12.3
Employees[2]		+37.2	+ 28.9	+13.6	– 14.6	+ 2.0	+ 10.5
Percentage changes from previous year		*+ 1.2*	*+ 1.0*	*+ 0.4*	*– 0.5*	*+ 0.1*	*+ 0.3*
Nationals		+29.4	+ 15.5	+ 4.2	– 19.7	– 6.4	+ 2.5
Foreign workers		+ 7.8	+ 13.4	+ 9.5	+ 5.1	+ 8.4	+ 8.0
Self-employed[3]		+ 1.0	+ 1.9	+ 1.5	+ 3.4	+ 2.8	+ 1.8
Labour supply							
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	+11.8	+ 16.9
Surplus of labour							
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					
Unemployment rate							
Eurostat definition[6]	in %	4.0	3.7	3.6	4.3	4.3	4.4
Percent of total labour force[5]	in %	6.0	5.3	5.5	6.2	6.3	6.4
National definition[5, 7]	in %	6.7	5.8	6.1	6.9	7.0	7.1
Employment rate							
Economically active employment[1, 8]	in %	62.3	62.5	62.5	62.0	61.9	62.1
Total employment[6, 8]	in %	68.5	68.4	68.4	68.3	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).

For this reason, the number of economically active employees should also post an increase for the whole year 2003, by an estimated 2,000 from last year. Whereas the number of foreign workers will rise by 8,000, that of nationals is expected to fall further, by 6,000. The marked increase in foreign employment is due to the more generous granting of work permits, such as for seasonal workers. It is a major reason for the fact that labour supply no longer exhibits a pro-cyclical pattern, but increases even in a period of weak activity. The number of unemployed is set to rise by 7,000 from last year, averaging 239,000 in 2003. This corresponds to an unemployment rate of 7.0 percent according to the conventional national calculation method and 4.3 percent on Eurostat definitions. Again not counted as unemployed will be participants in training activities organised by the labour exchange services, whose number is expected to rise by 8,000 from last year and by 15,000 when compared with the level in 2000.

Economic activity will be too anaemic also in 2004 as to generate substantial employment growth. If the number of jobs will still rise by a marginal 0.3 percent, it is because of the "part-time retirement" effect (+5,000). The number of foreign workers will continue to increase markedly, as labour market access for family members of foreign workers will be made less restrictive. Unemployment is projected to go further up to an average 244,000 in 2004, equivalent to jobless rates of 7.1 percent on national definitions or 4.4 percent according to Eurostat. The latter figure is clearly above the target rate of 3.5 percent as defined by the federal government in the context of the National Action Plan for employment.

In assessing the labour market situation, Eurostat follows the "labour force concept", whereby all self-employed and employees are counted as employed, including people in mini-jobs or assistant workers (family members) in agriculture. According to this concept, the employment ratio is just over 68 percent of the population of working age, slightly below the target level of 70 percent envisaged for 2010 by the EU Lisbon Agenda. According to the traditional Austrian calculation method, known as the "means of living" concept, the employment ratio is currently close to 62 percent; in this case only people are counted as employed who earn incomes above a minimum threshold.

Government budget reflecting the cyclical weakness

Early this year, tax revenues developed rather favourably. Notably revenues from indirect taxes exhibited year-on-year growth rates which markedly exceeded the increases in nominal consumer expenditure or trade figures. This may point to an early success of a reinforced fight against tax fraud. While yields from wage tax rose broadly as expected, business tax revenues remained well below target. Direct tax revenues overall may well undershoot again the year-earlier level. On the expenditure side, the strong increase in funds for family support is making itself felt. The general government deficit for 2003 is projected at 1.1 percent of GDP, somewhat lower than budgeted by the Ministry of Finance. The downward revision of the economic projections is of only little impact on this year's government budgets, as it is motivated mainly by weaker exports.

Table 7: Key policy indicators

	1999	2000	2001	2002	2003	2004
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	−2.3	−1.5	+0.3	−0.6	−1.1	−1.2
According to National Accounts	−2.4	−1.6	+0.1	−0.8	−1.3	−1.4
General government primary balance	+1.3	+2.2	+3.8	+2.9	+2.2	+2.1
	In percent					
Monetary policy						
3-month interest rate	3.0	4.4	4.3	3.3	2.2	2.1
Long-term interest rate[1]	4.7	5.6	5.1	5.0	3.9	4.0
	Percentage changes from previous year					
Effective exchange rate						
Nominal	+1.5	−2.5	+1.0	+1.4	+3.6	+0.7
Real	−1.1	−3.4	+0.3	+0.6	+3.0	+0.5

[1] 10-year central government bonds (benchmark).

The prolonged cyclical weakness is weighing on government households. The general government deficit is projected at close to 1 percent of GDP for 2003 and 2004, respectively.

In 2004, cyclical developments will have a stronger impact on the budget. Sluggish growth will dampen direct tax revenues, while the high costs of unemployment will drive up expenditure. In 2004, the first instalment of a tax reform will take effect, which provides for exoneration of wage earners and of undistributed corporate earnings, but for higher energy taxes and social contributions to health and work accident insurance.

As the experience of recent years has shown, there is a sizeable margin for influencing the deficit through one-off measures, moving items "off budget" and statistical re-classifications. In its budgetary projection, WIFO focuses primarily on the cyclical determinants. On that basis, it arrives at a general government deficit of € 2¾ billion or 1.2 percent of GDP for 2004, higher by ½ percentage point than envisaged by the Ministry of Finance.