

Markus Marterbauer

# Cyclical Recovery in Danger of Stalling

## Economic Outlook for 2004 and 2005

**Real GDP is projected to advance at a modest 1.5 percent in the current year. In the last few months, uncertainty has mounted about the further trend notably in manufacturing. The outlook for GDP growth of 2¼ percent in 2005 is particularly vague given the recent mixed signals from leading indicators. Employment growth remains insufficient against a strong increase in labour supply, with unemployment rising to a total of nearly 250,000.**

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. Cut-off date: 31 March 2004. • E-Mail Address: [Markus.Marterbauer@wifo.ac.at](mailto:Markus.Marterbauer@wifo.ac.at)

Since the beginning of this year, economic prospects have become more subdued for the euro area as well as for Austria. Leading indicators like the business surveys conducted by the European Commission, the ifo business climate index for Germany and the WIFO business survey for Austria suggest that the business climate in the cyclically sensitive manufacturing sector, after a short-lived upturn between mid-year and end 2003, is being judged less favourable. Firms see no further improvement in their order situation and are less upbeat than before about the short-term production outlook. Whether this represents only a short "pause" in the recovery or rather an early end of the tentative cyclical upturn of the second semester 2003, remains to be seen. Similarities to the situation of mid-2002 are evident, when the cyclical revival in the euro area ended rather abruptly after only a few months, due to falling stock market values, rising oil prices and a higher euro exchange rate.

In its current projections WIFO assumes that the business cycle recovery is losing momentum, without coming to a standstill. In such a scenario, real GDP in Austria may gain 1.5 percent this year. For 2005, a rate of growth of 2¼ percent has been retained, but the margin of uncertainty appears particularly wide.

Business activity in Europe will receive stimulus from external forces, as the global economy will expand strongly on the back of booming Asia and lively demand in North America, even if the latter is subject to downward risks. Dynamism is nevertheless slow in being transmitted to the euro area. This is partly on account of the sizeable appreciation of the euro exchange rate, partly – and more importantly – of the persistently sluggish internal demand: confidence in the business sector and of private households is weak, inducing them to postpone investment plans and step up precautionary saving. Economic policy in Europe is apparently not successful in generating incentives for higher rates of growth.

Weak economic activity in major trading partner countries is weighing on Austrian merchandise export growth, projected at 4½ percent in volume for 2004. Domestic firms would thereby see their foreign market shares decline, particularly (albeit from a high level) in the EU accession countries. Imports of goods should increase somewhat less in real terms than last year, given that part of planned corporate investment spending – a demand component of high import intensity – has been carried forward into 2003 for tax reasons. The merchandise trade and the current account balances will be in small deficit of around ½ percent of GDP. Most sensitive to cyclical variations is the manufacturing sector, for which the forecast is subject to an

above-average degree of uncertainty. After a stagnation of real net output last year, WIFO expects a modest pick-up of 2¼ percent in 2004.

As in 2003, domestic demand should give firm support to activity over the forecast period. Construction should again grow strongly in 2004, by 2½ percent at constant prices, largely due to lively investment in infrastructure. In 2005, for the first time in four years, retail trade and private consumption should post gains above the long-term average of 2½ percent, thereby contributing importantly to overall GDP growth. Income tax cuts will boost disposable income markedly and add momentum to higher private consumption. At the same time, nevertheless, the household saving ratio and imports will also go up. The overall effect of the second instalment of tax cuts on GDP growth has been estimated by WIFO at +0.3 percentage points for the year 2005. The general government deficit is expected to widen by some ¼ percentage point to a ratio of around 1½ percent of GDP.

<i>Main results</i>		2000	2001	2002	2003	2004	2005
		Percentage changes from previous year					
GDP							
Volume		+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.5	+ 2.3
Value		+ 4.9	+ 2.8	+ 2.7	+ 2.7	+ 3.4	+ 3.8
Manufacturing <sup>1</sup> , volume		+ 6.4	+ 1.5	+ 0.5	- 0.2	+ 2.2	+ 3.3
Whole sale and retail trade, volume		+ 3.7	- 0.0	+ 1.2	+ 1.2	+ 1.7	+ 2.5
Private consumption expenditure, volume		+ 3.3	+ 1.4	+ 0.8	+ 1.3	+ 1.7	+ 2.5
Gross fixed investment, volume		+ 6.2	- 2.3	- 2.8	+ 4.3	+ 2.7	+ 3.2
Machinery and equipment <sup>2</sup>		+ 11.8	- 2.1	- 5.2	+ 6.1	+ 3.0	+ 4.5
Construction		+ 1.9	- 2.5	- 0.7	+ 2.8	+ 2.5	+ 2.0
Exports of goods <sup>3</sup>							
Volume		+ 13.1	+ 7.5	+ 5.2	+ 2.0	+ 4.5	+ 6.5
Value		+ 15.6	+ 6.5	+ 4.2	+ 1.4	+ 4.3	+ 7.0
Imports of goods <sup>3</sup>							
Volume		+ 10.9	+ 5.7	+ 0.8	+ 4.8	+ 4.0	+ 7.3
Value		+ 14.7	+ 5.0	- 2.0	+ 3.5	+ 3.5	+ 7.8
Current balance	billion €	- 5.36	- 4.13	+ 0.75	- 1.28	- 0.99	- 1.60
As a percentage of GDP	%	- 2.6	- 1.9	+ 0.3	- 0.6	- 0.4	- 0.7
Long-term interest rate <sup>4</sup>	%	5.6	5.1	5.0	4.2	4.1	3.9
Consumer prices		+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.6	+ 1.5
Unemployment rate							
Percent of total labour force <sup>5</sup>	%	3.7	3.6	4.3	4.4	4.5	4.5
Percent of dependent labour force <sup>6</sup>	%	5.8	6.1	6.9	7.0	7.2	7.2
Dependent employment <sup>7</sup>		+ 0.9	+ 0.4	- 0.5	+ 0.2	+ 0.5	+ 0.8
General government financial balance according to Maastricht definition							
As a percentage of GDP	%	- 1.5	+ 0.2	- 0.2	- 1.1	- 1.0	- 1.5

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

Unemployment is set to rise further over the projection period. On annual average 2005 it may reach a number close to 250,000, significantly above the level of 194,000 registered in 2000, before the protracted cyclical slowdown. This corresponds to an unemployment rate of 7.2 percent of the dependent labour force or 4.5 percent of the total labour force according to Eurostat definitions. The projected slight increase in the number of actively employed of 0.5 percent in 2004 is accounted for by service sector jobs, most of them on a part-time basis.

Driven by higher energy prices, inflation has recently gained some momentum, still remaining however below an annual rate of 2 percent regarded as the ceiling of price stability. For 2004 and 2005, the projection foresees inflation rates of 1.4 percent and 1.3 percent on the Harmonised Index of Consumer Prices (HICP). According to the traditional Austrian consumer price index, the rates are higher by 0.2 percentage points, respectively.

In view of the considerable uncertainties concerning the further business trend, economic policy should press ahead with plans for higher forward-looking investment, both at the level of the enlarged European Union and of the member states. The current WIFO projections also imply a cut of the key short-term interest rate by the ECB.