

EWALD WALTERSKIRCHEN

ECONOMIC RECOVERY SURROUNDED BY RISKS

ECONOMIC OUTLOOK FOR 2002 AND 2003

The Austrian economy is expected to grow by slightly over 1 percent this year, and by more than 2½ percent in 2003. This projection by WIFO has been upheld since last December. It is supported by a tentative rebound in activity in the first quarter and the recent trend in leading indicators. However, the risks deriving from international developments appear somewhat greater now than at the time of the last forecasting round in mid-April. The business cycle upturn in the EU has so far been hesitant, and in the USA the fragility of consumer confidence and the fall on stock markets are adding to uncertainty.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. E-mail address: Ewald.Walterskirchen@wifo.ac.at • Cut-off date: 25 June, 2002

Domestic activity is gradually recovering from its low. In the first quarter, real GDP edged up both from the year-earlier level and from the previous period (+0.1 percent), in line with the assumption embodied in the last forecast. For the second quarter, survey data and leading indicators are heading up, but the revival will first remain moderate, with an expected GDP growth rate of less than 1 percent. Subsequently, in the second semester, the rebound should gain momentum.

The pace of the upturn largely depends on the international cyclical trend. While the latter remains firmly upward bound, the risk of the recovery being delayed has increased. In the EU, and in Germany in particular, the revival of activity is making slow progress, not yet being self-sustained, but receiving its major stimulus from the USA. The US economy expanded strongly in the first quarter, due to lively stock-building, but private consumption showed signs of weakening in the following period. Consumer confidence is being overshadowed by the new bout of stock market falls.

The newly gained strength of the euro will put a lid on European inflation, but may dampen real growth with a lag of several quarters. For Austria, the direct dampening effect should not be overrated, since less than one-fifth of exports go overseas.

The rebound in exports on the back of the international business cycle upturn will stimulate investment in new equipment also in Austria by next year. In 2002, such investment is still depressed, having fallen by 10 percent in volume year-on-year in the first quarter. In an environment of uncertainty and low capacity utilisation, business capital formation tends to be deferred, but will be caught-up upon once expectations have stabilised.

Construction investment has been hit hardest by the business cycle slump. It dropped by 7½ percent in the first quarter, as building activity is particularly cyclically sensitive in the winter season. On annual average 2002, the decline is projected at around 2 percent, much as in 2001. Some relief may be expected for 2003, when new orders, notably for industrial and commercial structures, should pick up.

Demand for durable consumer goods is reacting to cyclical variations to a similar degree as investment. Particularly volatile are car purchases, with new car registrations undershooting the year-earlier level by one-tenth in the first five months of 2002. As overall activity strengthens, purchases of durables will bounce back. Total private consumption is projected to gain close to 1½ percent this year and 2¼ percent in 2003.

Table 1: Main results

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-------------------------------------------------------------------------|------------|---------------------------------------|-------|-------|-------|-------|-------|
| | | Percentage changes from previous year | | | | | |
| GDP | | | | | | | |
| Volume | | +3.5 | +2.8 | +3.0 | +1.0 | +1.2 | +2.8 |
| Value | | +4.1 | +3.5 | +4.2 | +2.6 | +2.3 | +4.0 |
| Manufacturing ¹ , volume | | +4.4 | +3.4 | +7.3 | +0.9 | +1.5 | +5.0 |
| Private consumption expenditure, volume | | +2.8 | +2.7 | +2.5 | +1.3 | +1.5 | +2.3 |
| Gross fixed investment, volume | | +3.4 | +1.5 | +5.1 | -2.7 | -0.7 | +4.1 |
| Machinery and equipment ² | | +6.4 | +4.3 | +11.1 | -3.8 | +0.7 | +7.6 |
| Construction | | +1.3 | -0.7 | +0.3 | -1.7 | -2.0 | +1.0 |
| Exports of goods ³ | | | | | | | |
| Volume | | +8.1 | +7.7 | +13.1 | +5.1 | +4.0 | +8.5 |
| Value | | +8.4 | +7.0 | +15.6 | +6.5 | +4.5 | +10.1 |
| Imports of goods ³ | | | | | | | |
| Volume | | +7.1 | +6.9 | +10.9 | +3.0 | +2.0 | +7.6 |
| Value | | +6.6 | +6.7 | +14.7 | +5.0 | +2.5 | +9.8 |
| Current balance | billion € | -4.68 | -6.33 | -5.04 | -4.57 | -4.54 | -4.81 |
| As a percentage of GDP | in percent | -2.5 | -3.2 | -2.5 | -2.2 | -2.1 | -2.2 |
| Long-term interest rate ⁴ | in percent | 4.7 | 4.7 | 5.6 | 5.1 | 5.4 | 5.7 |
| Consumer prices | | +0.9 | +0.6 | +2.3 | +2.7 | +1.7 | +1.4 |
| Unemployment rate | | | | | | | |
| Percent of total labour force ⁵ | in percent | 4.5 | 3.9 | 3.7 | 3.6 | 4.0 | 3.9 |
| Percent of dependent labour force ⁶ | in percent | 7.2 | 6.7 | 5.8 | 6.1 | 6.8 | 6.5 |
| Dependent employment ⁷ | | +1.0 | +1.2 | +1.0 | +0.4 | -0.2 | +0.8 |
| General government financial balance according to Maastricht definition | | | | | | | |
| As a percentage of GDP | in percent | -2.4 | -2.2 | -1.5 | +0.1 | -0.4 | ±0.0 |

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. – ⁶ According to Labour Market Service. – ⁷ Excluding parental leave and military service.

Tourism has developed altogether favourably in the last winter season. Smaller gains should be expected this summer and into next year, reflecting the weak economic performance in Germany. Moreover, many holidaymakers will revert to longer-distance air travel, which they have shied away from after the September 2001 terrorist attacks.

Inflation is decelerating, in spite of strengthening activity. Consumer prices are set to go up by 1.7 percent in 2002, less by 1 percentage point than in 2001, owing to stable energy prices. In 2003, the rate of inflation may abate further to 1.4 percent, as the impact of several one-off factors, e.g., price hikes for fruits and vegetables, wears off.

The labour market has weakened under the impact of slower growth. Total employment in 2002 will edge down by an estimated 5,000 from last year. Job cuts in manufacturing, construction, transport and the public sector will partly be offset by gains in services, even if the new jobs created are often not full-time, but rather part-time jobs for women. While the decline in employment corresponds to the pace of the cyclical slowdown, unemployment is rising disproportionately strongly. This discrepancy is explained by the shift towards part-time work and, more importantly, by a substantial increase in labour supply. The unemployment rate is projected to rise from 6.1 to 6.8 percent this year, before moderating to 6.5 percent in 2003, when demand for labour should resume.

The cyclical downturn is leading to a shortfall in public revenues in 2002, making for a general government deficit of nearly ½ percent of GDP. This figure hinges on the assumption that the federal states ("Länder") will be able to attain the envisaged aggregate budget surplus, and that the positive outcome will also be validated by Eurostat. Compared with other EU countries, notably Germany and France, the projected overall deficit is small. In 2003, public finances should be in balance, assuming stronger economic growth and no change in tax rates and non-wage labour costs. Any revenue losses due to tax cuts will thus have to be accompanied by commensurate restraint on expenditure, if budgetary policy is to stay on the "zero deficit" track.

The US economy expanded strongly in the last quarter 2001 and in early 2002. GDP in the first quarter rose by 1½ percent, both year-on-year and from the previous period, driven by substantial stock-building¹.

Leading indicators remain upward bound in the second quarter. However, consumer confidence has turned more fragile, following the continued decline on stock markets. Financial markets are apparently reconsidering their views on the resilience of the US economy. The dollar has depreciated markedly, partly due to the "crisis of the accounting standards" which the Enron case has brought to the forefront. Investors are probably also concerned about the sharp deterioration of the US current account on the back of lively domestic demand growth.

Recession in USA overcome, pace of recovery uncertain

Table 2: World economy

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-----------------------------------------------|---------------------------------------|-------|-------|-------|-------|------|
| | Percentage changes from previous year | | | | | |
| <i>Real GDP</i> | | | | | | |
| Total OECD | +2.8 | +3.1 | +3.9 | +1.0 | +1.5 | +2.8 |
| USA | +4.3 | +4.1 | +4.1 | +1.2 | +2.3 | +3.3 |
| Japan | -1.1 | +0.7 | +2.4 | -0.5 | -1.0 | +1.0 |
| EU | +2.9 | +2.7 | +3.4 | +1.6 | +1.3 | +2.8 |
| Euro area | +2.9 | +2.6 | +3.5 | +1.5 | +1.2 | +2.8 |
| Germany | +2.0 | +1.8 | +3.0 | +0.6 | +0.7 | +2.3 |
| Central and Eastern Europe ¹ | +3.6 | +3.2 | +3.9 | +2.3 | +1.6 | +3.0 |
| <i>World trade, volume</i> | | | | | | |
| OECD exports | +5.6 | +5.9 | +12.7 | ±0.0 | +3.5 | +7.8 |
| OECD imports | +5.5 | +5.4 | +12.0 | -0.8 | +2.0 | +7.5 |
| Intra-OECD trade | +8.3 | +7.8 | +11.4 | -1.4 | +1.5 | +6.5 |
| <i>Market growth²</i> | +11.3 | +7.3 | +13.0 | +3.0 | +3.0 | +7.0 |
| <i>Primary commodity prices, in US\$</i> | | | | | | |
| HWWA index, total, 1990 = 100 | -22.0 | +12.0 | +31.0 | -11.0 | -1.0 | +5.0 |
| Excluding energy | -13.0 | -8.0 | +1.0 | -7.0 | -3.0 | +3.0 |
| <i>Crude oil prices</i> | | | | | | |
| Average import price (cif) for OECD countries | US\$ per barrel | 12.6 | 17.3 | 28.0 | 24.5 | 26.0 |
| Exchange rate | US\$ per ECU or € | 1.121 | 1.067 | 0.924 | 0.896 | 0.98 |

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

A revival of investment is being supported by the very low level of interest rates. On the other hand, the slide in share prices erodes companies' capital base. Further gains in private consumption are uncertain, given the low household saving ratio, the shaky consumer sentiment and possible negative echo effects from the advance car purchases of the last few months. The last US recession was exceptional in so far, as it hardly affected private consumption. One explanation may be the massive cuts in interest rates during 2001. Such resilience may, however, imply that consumption will provide little additional stimulus to the recovery under way.

Notwithstanding the strong rebound in GDP growth early this year, the upturn in the US now appears to be surrounded by greater uncertainty than at the time of the last forecasting round in mid-April.

Demand and output in Japan may weaken further in the current year. Yet, first signs of a pick-up are observed in Japan's manufacturing industry, following the depreciation of the yen. For next year, a return to modest growth may be expected, sustained by exports to the US market.

In Latin America, the financial crisis in Argentina has led to a severe slump in activity in that country. While the crisis has not triggered sweeping "contagion" effects on financial markets, other countries in the region are adversely affected by the shortfall in their external demand and the massive devaluation of the peso.

¹ See also Marterbauer, M., "Schleppende Belebung in der EU trotz kräftiger Impulse aus den USA", WIFO-Monatsberichte, 2002, 75(6), pp. 369-379.
http://titian.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=1&pubid=22160&pub_language=-1&p_type=0

While the slowdown of the European economy was highly synchronised with that in the USA, the upturn is lagging somewhat behind. GDP in the EU edged up by a mere 0.1 percent year-on-year in the first quarter, compared with +1.5 percent in the USA. The revival has been entirely due to rising demand from the US, whereas a self-sustained rebound of European investment has so far not come under way.

Leading indicators point to an acceleration of the upward trend in Europe. Major support is to come from endogenous forces (stock-building and investment cycles), but further developments in the USA and the stance of economic policy will also be important. Few expansionary incentives are to be expected from the policy side. Several major EU countries will follow a restrictive budgetary policy line, in order to converge towards the budgetary targets laid down in the Stability Programmes.

The EU economy is expected to expand by a modest 1.3 percent this year, accelerating to a growth rate of 2¾ percent in 2003. Such an acceleration hinges on the assumption of global activity gaining pace, which is not entirely certain.

Germany will continue to lag behind in the overall EU recovery, largely because of the still high financial burden from reunification, and the severe crisis in the construction sector. Nevertheless, industrial confidence has improved since January; in May, the ifo business climate index has risen further, followed by a slight weakening in June. While the German economy receives positive stimulus from the international recovery, domestic demand remains subdued. GDP is projected to gain ¾ percent in 2002 and 2¼ percent in 2003.

In the countries of Central and Eastern Europe, economic developments are mixed. While in Poland and the Czech Republic, activity is held back by real currency appreciation, Hungary is enjoying strong growth. In 2003, all countries in the region should benefit from the upturn in the EU.

European inflation proved relatively stubborn this year, partly as a consequence of the new rise in oil prices and the low euro exchange rate. It was only in May, when the euro appreciated markedly, that the overall EU inflation rate declined to around 2 percent.

The exchange rate gains, the downward trend of inflation and the still hesitant recovery in the EU are giving the European Central Bank some leeway to still hold back with raising interest rates. Such moves should rather be expected for 2003, when short-term interest rates may average 4.2 percent, some 75 basis points above the 2002 level.

The Federal Reserve is certain to raise the currently very low interest rates in the USA. Still, it is likely to wait, until the recovery is on a firm path and the decline on stock markets has run its course.

The value of the euro rose against the dollar to ever new highs over the last few weeks. Such a re-balancing of portfolios from the dollar towards the euro may reflect a more cautious assessment of the economic situation in the USA by financial markets. Irregularities in the balance sheets of several large companies have damaged investors' confidence. At the same time, the revival of domestic demand has further widened sharply the US current account deficit.

If the euro continues its upward trend, it will dampen inflation in the euro area and, with a lag of about three quarters, also real exports. However, the latter effect should not be overrated, since roughly 80 percent of Austrian exports go to other European countries. Firms supplying goods to the dollar area will likely see their profit margins squeezed.

The Austrian economy is being pulled by the international economic upturn. Real GDP in the first quarter slightly exceeded both the year-earlier and the previous-period level, by 0.1 percent, respectively. Over the next quarters, the seasonally-adjusted rise is expected to gather momentum. On a year-on-year basis, economic growth will still be modest in the second quarter (less than 1 percent), before posting stronger gains in the second semester and in 2003. The annual growth rate for 2003, projected at 2.8 percent, should be clearly above the medium-term trend. This projection is based on the assumption of a favourable international environment, which as yet is not entirely assured.

If the recovery proceeds along the projected path, there will be an "overhang" at the end of this year, enabling a high rate of growth to be achieved in 2003. Even if GDP were to

European economy recovering slowly in 2002

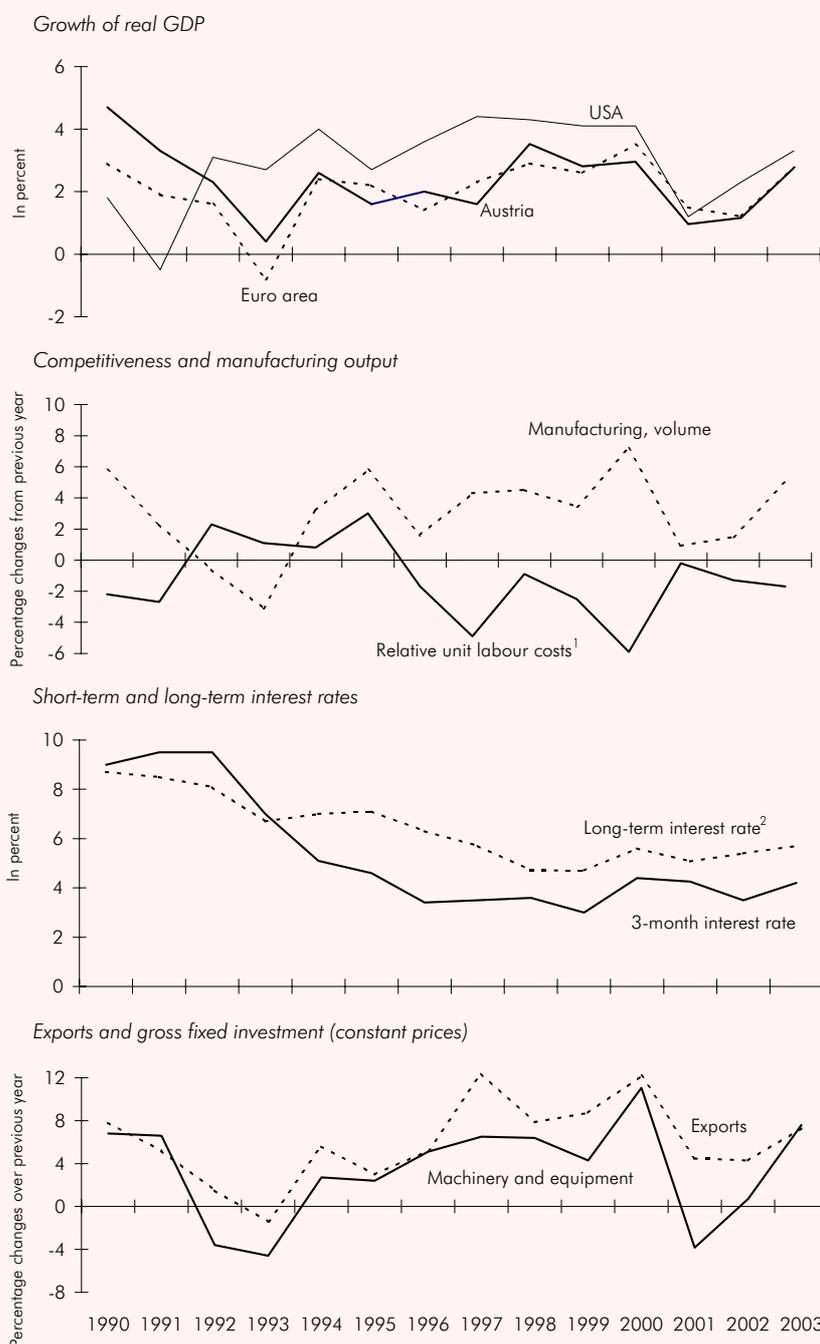
Less pressure for early monetary policy action

Euro appreciating against the dollar

Stronger GDP growth expected as from the second half of 2002

remain constant at the fourth quarter 2002 level, on a seasonally adjusted basis, the implicit average growth rate of GDP in 2003 would be 1½ to 2 percent.

Figure 1: International context



¹ Manufacturing; in a common currency vis-à-vis trading partners. – ² 10-year central government bonds (benchmark).

Merchandise export growth on an annual basis will be modest in the first half of 2002. For the whole year, it is expected at around 4 percent in volume terms, accelerating to over 8 percent in 2003. Imports this year are set to be even weaker, gaining an inflation-adjusted 2 percent, with demand for investment goods and consumer durables receding. Thus, the contribution of real net exports will be a major source of GDP growth in 2002.

Exports lively in 2003

Table 3: Productivity

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-------------------------------------------------|---------------------------------------|------|------|------|------|------|
| | Percentage changes from previous year | | | | | |
| <i>Total economy</i> | | | | | | |
| Real GDP | +3.5 | +2.8 | +3.0 | +1.0 | +1.2 | +2.8 |
| Employment ¹ | +0.7 | +1.2 | +0.5 | +0.2 | -0.1 | +0.7 |
| Full-time equivalent | +0.8 | +1.0 | +1.3 | +0.1 | -0.3 | +0.6 |
| Productivity (GDP per employment) | +2.8 | +1.5 | +2.5 | +0.7 | +1.2 | +2.1 |
| Full-time equivalent | +2.7 | +1.8 | +1.6 | +0.9 | +1.5 | +2.1 |
| <i>Manufacturing</i> | | | | | | |
| Production ² | +4.5 | +3.4 | +7.2 | +0.9 | +1.5 | +5.0 |
| Employees ³ | +0.1 | -0.7 | +0.0 | +0.2 | -1.6 | -0.1 |
| Productivity per hour | +4.3 | +4.8 | +7.3 | +1.3 | +3.3 | +5.0 |
| Working hours per day per employee ⁴ | +0.1 | -0.6 | -0.1 | -0.6 | -0.1 | +0.1 |

¹ Dependent and self-employed according to National Accounts. – ² Value added. – ³ According to Federation of Austrian Social Security Institutions. – ⁴ According to "Konjunkturerhebung" of Statistics Austria.

Manufacturing output is to an important extent determined by export developments. As with exports, year-on-year gains in manufacturing will remain small in 2002 (+1½ per cent), before rising to an anticipated 5 percent in 2003.

This assessment is being corroborated by results from the regular WIFO business survey. Industrial firms judge the situation in the second quarter 2002 more favourable than in the previous period, with the majority of firms expecting production gains. Particularly the suppliers of primary goods have expressed greater confidence. However, in April and May, firms' judgements on the current situation have not improved further.

Tourism took a positive development in the last winter season (from November to April), with earnings rising by 4½ percent year-on-year at current prices, according to preliminary calculations. Ski travel destinations fared relatively better than the big cities, which are more dependent on demand from overseas. In the upcoming summer season, growth is set to slacken, as the cyclical weakness in Germany is increasingly weighing on demand for travel. Moreover, pent-up demand for air-package tours that had been postponed after the 11 September terrorist attacks, is beginning to be satisfied.

Earnings of the tourism industry will continue to increase but moderately in 2003, as the world-wide cyclical weakness will still exert lagged dampening effects on the propensity to travel. Output growth of hotels and restaurants is expected to broadly correspond to overall GDP growth.

The surplus in the foreign travel balance will rein in the deficit in the current account. The latter fell by an estimated € ½ billion in 2001 and should remain stable in 2002 and 2003.

Construction activity is much more severely affected by the cyclical downturn and public expenditure cuts than manufacturing output. Investment in construction fell by 1.7 percent in 2001. Following the negative results of the first quarter 2002 (-7½ per cent), the projection for the whole year 2002 is being revised downwards. Construction investment is now seen contracting by some 2 percent, and firms will scrap more capacity and jobs. The adverse trend will not be confined to residential building, but will extend to the creation of new office space and to civil engineering.

A tentative recovery of construction investment is expected for 2003. The cyclical upturn should give incentives for the creation of new production facilities, while the civil engineering sector will benefit from currently envisaged projects by the road and railroad investment companies. Overall construction output will nevertheless lag behind GDP growth for still some years to come.

Private consumption, while not rising above the high level of last year in the first quarter, is projected to advance by nearly 1½ percent on annual average. Demand for non-durable consumer goods is exerting a stabilising influence in the current period of cyclical weakness. The more volatile purchases of durable goods are expected to remain lacklustre, and new car registrations are falling sharply.

Growth of tourism to lose momentum

Construction output declining further

Consumer spending acting as cyclical stabiliser

Table 4: Private consumption, earnings and prices

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---------------------------------------------------|-----------------------------------------------|------|------|------|------|------|
| | Percentage changes from previous year, volume | | | | | |
| Private consumption expenditure | +2.8 | +2.7 | +2.5 | +1.3 | +1.5 | +2.3 |
| Durables | +5.8 | +9.4 | +3.9 | -2.6 | ±0.0 | +3.5 |
| Non-durables and services | +2.3 | +1.8 | +2.3 | +1.9 | +1.7 | +2.1 |
| Household disposable income | +3.6 | +2.2 | +1.8 | +0.1 | +1.6 | +2.2 |
| Household saving ratio | | | | | | |
| As a percentage of disposable income | 8.0 | 7.7 | 6.7 | 6.2 | 6.4 | 6.8 |
| | Percentage changes from previous year | | | | | |
| Direct lending to domestic non-banks ¹ | +3.7 | +5.2 | +6.7 | +3.5 | +3.8 | +5.0 |
| | In percent | | | | | |
| Inflation rate | | | | | | |
| National | 0.9 | 0.6 | 2.3 | 2.7 | 1.7 | 1.4 |
| Harmonised | 0.8 | 0.5 | 2.0 | 2.3 | 1.6 | 1.4 |
| Core inflation ² | 1.2 | 0.6 | 1.0 | 2.3 | 2.0 | 1.6 |

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

Rising disposable income in the course of the cyclical revival should allow private consumption growth to accelerate to 2.3 percent in 2003. Spending on durable consumer goods should rise particularly strongly (+3.5 percent). The private household saving ratio is set to rise marginally this year, and more substantially in 2003, moving back towards its long-term average.

Unlike private household spending, which is smoothing the cycle, investment is the cyclically most sensitive component of demand. In the first quarter 2002, investment in machinery and equipment was cut by some 10 percent in volume from last year. In the semi-annual WIFO investment survey, firms have revised downwards their plans for capital formation, suggesting that spending will remain flat on annual average 2002. An uncertain business outlook induces firms to call off projects, but as soon as an export-led upswing is firmly entrenched, a jump in capital spending may be expected. In 2003, the partly deferred investment plans will finally be implemented, making for an increase in expenditure of 7½ percent.

Table 5: Earnings and international competitiveness

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-----------------------------------------------|---------------------------------------|------|------|------|------|------|
| | Percentage changes from previous year | | | | | |
| Gross earnings per employee ¹ | +3.0 | +2.0 | +2.5 | +3.1 | +2.5 | +2.5 |
| Full-time equivalent | +3.2 | +2.4 | +2.3 | +3.4 | +2.9 | +2.8 |
| Gross real earnings per employee ¹ | +2.5 | +1.2 | +1.0 | +0.7 | +0.8 | +1.1 |
| Net real earnings per employee | +2.3 | +4.3 | +1.7 | -0.1 | +0.3 | +0.6 |
| Net wages and salaries | +3.3 | +3.7 | +4.3 | +2.6 | +2.3 | +2.8 |
| Total economy | | | | | | |
| Unit labour costs | -0.2 | +0.4 | -0.1 | +2.3 | +1.4 | +0.4 |
| Manufacturing | | | | | | |
| Unit labour costs | -1.7 | -1.5 | -5.1 | +2.1 | -0.3 | -1.6 |
| Relative unit labour costs ² | | | | | | |
| Vis-à-vis trading partners | -0.9 | -2.5 | -5.9 | -0.2 | -1.3 | -1.7 |
| Vis-à-vis Germany | +0.4 | -1.1 | -2.4 | +0.2 | -2.1 | -2.2 |
| Effective exchange rate – manufactures | | | | | | |
| Nominal | +2.5 | +0.6 | -2.7 | +0.9 | +0.5 | +0.5 |
| Real | +0.5 | -1.3 | -3.5 | +0.3 | ±0.0 | -0.2 |

¹ According to National Accounts. – ² Manufacturing, in a common currency; minus sign indicates improvement of competitiveness.

Headline inflation decelerated somewhat during the first five months of 2002, in May the rate stood at 1.9 percent. The changeover to euro cash money has hardly added to overall inflation in Austria, but higher prices for seasonal goods exerted upward pressure early in the year.

The moderation of energy prices is a key factor behind the expected slowdown of inflation, from an annual average 2.7 percent in 2001 to 1.7 percent in 2002. Prices of imported goods are set to remain virtually flat (+0.4 percent), and little pressure is also coming from wages. Much as last year, per-capita earnings are projected to go up by some 2½ percent.

Crude oil prices are assumed at an average \$ 24.5 per barrel in 2002, close to their level last year, before rising moderately in 2003. The price risks deriving from political developments are deemed less serious now than at the time of the last forecast revision. However, a possible sharp fall of the dollar may trigger a reaction from the OPEC cartel, as has been observed in the past.

Next year, the rise in the overall price level should abate further, to a rate of 1.4 percent. Core inflation (excluding food and energy items) should also decelerate, from 2 to 1.6 percent. A number of transitory factors (price hikes for fruits and vegetables) will have disappeared by 2003, and the strength of the euro will have a dampening impact. In addition, the upturn will make for higher productivity growth and a slower upward drift of unit labour costs. Only at a later stage will the recovery impinge on wage settlements.

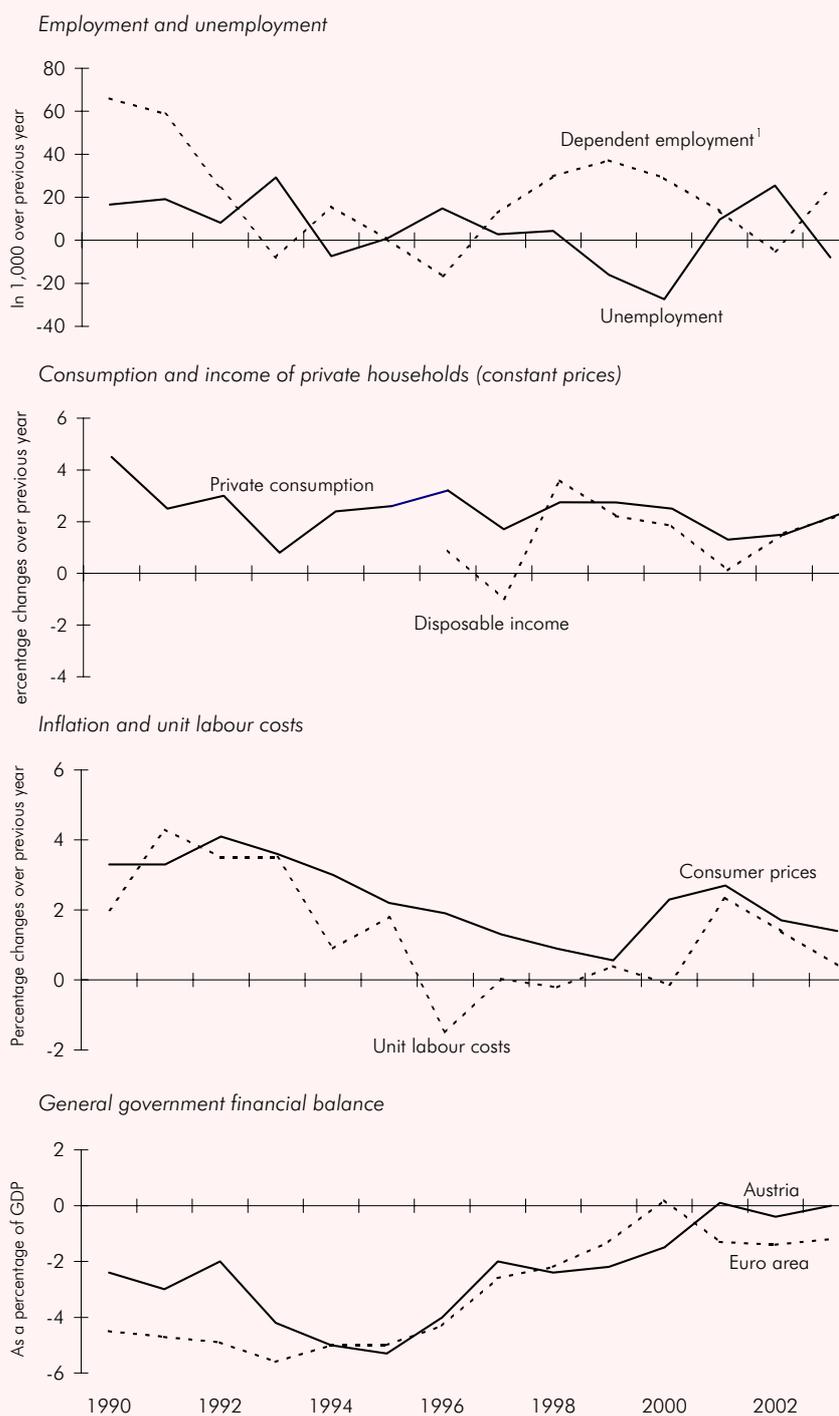
Inflation slowing down

Table 6: Labour market

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | |
|------------------------------------------------------------|---------------------------------------|-------|-------|-------|-------|-------|------|
| | Changes from previous year (in 1,000) | | | | | | |
| <i>Demand for labour</i> | | | | | | | |
| Civilian employment | +22.1 | +32.2 | +27.7 | +15.9 | +17.3 | +41.3 | |
| Excluding parental leave and military service | +30.8 | +38.2 | +30.8 | +15.1 | -2.9 | +26.3 | |
| Dependent employment ¹ | +21.1 | +31.2 | +25.8 | +14.4 | +15.2 | +39.0 | |
| Excluding parental leave and military service | +29.8 | +37.2 | +28.9 | +13.6 | -5.0 | +24.0 | |
| Percentage changes from previous year | +1.0 | +1.2 | +1.0 | +0.4 | -0.2 | +0.8 | |
| Parental leave and military service ¹ | -8.7 | -6.0 | -3.1 | +0.8 | +20.2 | +15.0 | |
| Foreign workers | -0.2 | +7.8 | +13.4 | +9.5 | +5.0 | +14.0 | |
| Self-employed ² | +1.0 | +1.0 | +1.9 | +1.5 | +2.1 | +2.3 | |
| <i>Labour supply</i> | | | | | | | |
| Economically active population | | | | | | | |
| aged 15 to 64 | +11.0 | +19.8 | +25.2 | +26.1 | +22.9 | +19.1 | |
| aged 15 to 59 | +10.9 | -2.6 | -17.5 | -15.6 | -5.5 | +3.1 | |
| Total labour force | +26.5 | +16.2 | +0.3 | +25.5 | +42.8 | +33.3 | |
| Excluding parental leave and military service | +35.2 | +22.2 | +3.4 | +24.7 | +22.6 | +18.3 | |
| Foreign | +0.7 | +6.6 | +12.0 | +14.3 | +9.5 | +10.0 | |
| Migration of nationals | +3.9 | +3.0 | +1.0 | ± 0.0 | ± 0.0 | ± 0.0 | |
| Indigenous | +21.9 | +6.6 | -12.7 | +11.2 | +33.3 | +23.3 | |
| Excluding parental leave and military service | +30.6 | +12.6 | -9.6 | +10.4 | +13.1 | +8.3 | |
| <i>Surplus of labour</i> | | | | | | | |
| Registered unemployed ³ | +4.4 | -16.1 | -27.4 | +9.6 | +25.5 | -8.0 | |
| In 1,000 | 237.8 | 221.7 | 194.3 | 203.9 | 229.4 | 221.4 | |
| Unemployment rate | | | | | | | |
| Percent of total labour force ⁴ | in percent | 4.5 | 3.9 | 3.7 | 3.6 | 4.0 | 3.9 |
| Percent of total labour force ³ | in percent | 6.5 | 6.0 | 5.3 | 5.5 | 6.1 | 5.8 |
| Percent of dependent labour force ³ | in percent | 7.2 | 6.7 | 5.8 | 6.1 | 6.8 | 6.5 |
| Participation rate ⁵ | in percent | 67.6 | 67.6 | 67.3 | 67.5 | 68.0 | 68.3 |
| Excluding parental leave and military service ⁶ | | 70.7 | 71.2 | 71.5 | 72.2 | 72.8 | 73.1 |
| Employment rate ⁷ | in percent | 63.2 | 63.6 | 63.8 | 63.8 | 63.8 | 64.4 |
| Excluding parental leave and military service ⁶ | | 66.1 | 66.9 | 67.7 | 68.2 | 68.2 | 68.7 |

¹ According to Federation of Austrian Social Security Institutions. – ² According to WIFO. – ³ According to Labour Market Service. – ⁴ According to Eurostat. – ⁵ Total labour force as a percentage of active population (aged 15 to 64). – ⁶ As a percentage of population aged 15 to 59. – ⁷ Employment as a percentage of active population (aged 15 to 64).

Figure 2: Economic performance

¹ Excluding parental leave and military service.

The business cycle slowdown has clearly weakened labour market conditions. In the first five months of the year, employment (excluding recipients of child care benefits and people in military service) fell by 8,000 year-on-year, much as expected. Most affected were again the construction and the public sector as well as the postal service, but increasingly also manufacturing. Job losses in manufacturing and construction are leading primarily to an increase in unemployment benefit payments, whereas a fall in employment in transport (postal service, telecom, railways) and the public sector is largely accommodated by higher retirement expenditure.

On annual average 2002, the number of dependent employees is projected to fall by 5,000 or 0.2 percent, which implies somewhat smaller year-on-year losses in the second semester. In 2003, the business cycle upturn will boost demand for labour (+24,000). Productivity growth of 1.2 percent in 2002 (according to National Accounts figures) is almost as subdued as last year. It is depressed not only by the low degree of capacity utilisation, but also by the rising number of short-time workers recorded in the National Accounts framework.

The National Action Plan (NAP) for employment provided for a rise in the number of jobs by 100,000 until 2002. This target has been virtually met already in 2000 and will still be met despite the decline in 2002. What has not been achieved is the ambitious NAP objective of lowering the unemployment rate (according to Eurostat) to 3.5 percent by 2002. While in 2001, the rate of 3.6 percent missed the target only by little, the jobless rate is going up again to 4 percent in 2002 and 2003.

In the first five months of 2002, unemployment rose strongly from last year, although employment fell only slightly. The discrepancy is explained by substantial gains in labour supply, as both the domestic population of working age and the foreign labour force increased. Moreover, labour force participation among older workers went up, as a consequence of the raise in the early-retirement age.

The unemployment rate (as calculated by the labour market service) will rise from 6.1 percent in 2001 to 6.8 percent in the current year, representing a slight upward revision from the forecast last April. The number of registered unemployed is expected to average 229,000 in 2002. The cyclical recovery should allow the jobless rate to moderate to around 6.5 percent next year, assuming no cuts in active labour market policy measures and a limited increase in admissions of foreign workers.

For the first time since 1973, the general government account was not in deficit in 2001. This was achieved mainly through higher public revenues. Pre-emptive payment of income and corporate tax in the face of a newly introduced interest liability (of 5¼ percent) on tax obligations played a major role.

The fiscal impact of the business cycle downturn will make for a general government deficit in the order of ½ percent of GDP this year. Underlying is the assumption that the federal states will be able to attain an aggregate budget surplus of ¾ percent of GDP, as planned.

Reflecting the cyclical downturn, consumption and wage tax revenues are turning out much lower than budgeted for this year. Sluggishness in V.A.T. revenues in the first five months is not only caused by weak private consumption (+1.9 percent in nominal terms in the first quarter), but also by a low revenue elasticity with respect to the tax base, a phenomenon observed also in other EU countries.

The rise in unemployment from a rate of 6.1 to 6.8 percent this year is putting another heavy burden on government finances. Costs of part-time work as a transition to retirement are rising rapidly. Cyclically-induced shortfalls in social security contributions are eating up the surplus in earmarked public funds, which has been used for consolidation purposes over the last years.

Assuming real GDP growth of 2.8 percent (4 percent in nominal terms), a balanced budget may be achieved next year. Such a projection neither allows for a tax reform, nor for a cut in non-wage labour costs. A "zero budget deficit" may be maintained only, if any revenue losses on account of a tax reform will be offset by additional cuts in expenditure. The growth-enhancing effect of lower taxes coupled with reduced public expenditure may be limited in the short run.

Sharp rise in unemployment in 2002

The last cyclical downturn has led to an unusually steep rise in unemployment, as labour supply is growing strongly at the same time. In 2002, some 5,000 jobs will be lost from last year, while unemployment is expected to go up by 25,000. Once the recovery is on course, the labour market should improve. Employment should rise markedly in 2003, the jobless rate may go down to 6.5 percent.

Public finances in deficit in 2002

The business cycle downturn has led to a substantial shortfall in public revenues, making for a general government deficit of close to ½ percent of GDP this year. In 2003, public finances should be in balance, assuming favourable business conditions and no tax reform being introduced.

Table 7: Key policy indicators

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--------------------------------------|------|------|---------------------------------------|------|------|------|
| <i>Fiscal policy</i> | | | | | | |
| | | | | | | |
| | | | As a percentage of GDP | | | |
| General government financial balance | | | | | | |
| According to Maastricht definition | -2.4 | -2.2 | -1.5 | +0.1 | -0.4 | ±0.0 |
| According to National accounts | -2.5 | -2.4 | -1.7 | -0.1 | -0.4 | ±0.0 |
| General government primary balance | +1.4 | +1.3 | +2.0 | +3.5 | +3.0 | +3.3 |
| <i>Monetary policy</i> | | | | | | |
| | | | | | | |
| | | | In percent | | | |
| 3-month interest rate | 3.6 | 3.0 | 4.4 | 4.3 | 3.5 | 4.2 |
| Long-term interest rate ¹ | 4.7 | 4.7 | 5.6 | 5.1 | 5.4 | 5.7 |
| | | | Percentage changes from previous year | | | |
| <i>Effective exchange rate</i> | | | | | | |
| Nominal | +2.8 | +1.5 | -2.5 | +1.0 | +0.7 | +0.6 |
| Real | +0.3 | -1.1 | -3.6 | +0.1 | ±0.0 | -0.2 |

¹ 10-year central government bonds (benchmark).