

Markus Marterbauer

Global Economic Boom Gradually Spreading to the Euro Area and to Austria

Economic Outlook for 2004 and 2005

Growth of GDP is set to attain 1.7 percent this year. Notably demand from Germany has picked up significantly over the last few months. Assuming that the moderate recovery in the euro area will continue, growth may accelerate to 2.5 percent next year, providing a boost to private consumption. Employment will be stimulated by stronger growth. Despite the cyclical recovery, special factors will nevertheless prevent unemployment from falling and drive the government deficit upwards.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. • Cut-off date: 30 June 2004. • E-mail address: Markus.Marterbauer@wifo.ac.at

In the first quarter 2004, GDP growth in the euro area (+2 percent in volume year-on-year) and notably in Germany (+1.5 percent) was stronger than expected by most analysts. In Austria, the expansion remained rather modest, at +0.7 percent. Many indicators suggest that the positive trend in the world economy, supported by the boom in China and the upswing in North America, will gradually strengthen the forces of growth also in Europe. The more than three-year-long economic stagnation in the euro area may now have given way to a tentative business cycle recovery. The German export industry will benefit particularly from its close ties with the world economy.

According to the business surveys for Germany, Austria and the euro area at large, manufacturing firms see current business conditions distinctly more positive than one year ago, even if they do not expect a speedy recovery as it was typical for previous cycles. The high euro exchange rate, the price hikes for internationally traded commodities, and particularly the persistent weakness of consumer demand in the euro area hold risks for the further strengthening of business activity.

Due to its close supply relations, Austrian manufacturing industry benefited mainly from the swift revival of German exports. In spring, merchandise exports have probably picked up strongly. For the whole year, volume export growth is expected at 5½ percent, even if the effective appreciation of the euro and a stronger competitive climate in the new EU member states may lead to some losses in foreign market shares. Over the medium term, price competitiveness of Austrian manufacturing industry has significantly improved, as unit labour costs relative to those of the main trading partners have declined by 6 percent since 1999. Manufacturing value added is set to gain 2.8 percent in volume in 2004, clearly more than on average over the last three years. The upward trend in sales expectations and capacity utilisation will also give incentives to investment this year. It has to be noted, however, that for tax reasons investment spending, notably for business vehicles, has been carried forward to an important extent into 2003.

The rise in energy prices has led to substantial terms-of-trade losses, keeping the current account deficit at around € 2 billion. It is also being passed on to the consumer level, where it will boost headline inflation by ¼ percentage point on average in 2004 and 2005 to rates of close to 2 percent, respectively. Growth of real disposable income will thereby be dampened, to a projected rate of 1¼ percent in 2004. For

the fourth year in a row, real net income per employee will hardly increase this year. The higher energy costs, while slightly dampening private consumption, will be accommodated mainly by a lower household saving ratio. Only in 2005 will per-capita incomes gain substantially, due to the cuts in direct taxes. This will allow private household spending to revert, for the first time in four years, towards its long-term trend growth of 2½ percent in volume. The household saving ratio is expected to move up to almost 9 percent of disposable income.

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	+ 2.5	
Value		+ 4.9	+ 2.8	+ 2.7	+ 2.7	+ 3.1	+ 4.2	
Manufacturing ¹ , volume		+ 6.4	+ 1.5	+ 0.5	- 0.2	+ 2.8	+ 4.0	
Wholesale and retail trade, volume		+ 3.7	- 0.0	+ 1.2	+ 1.3	+ 1.4	+ 2.5	
Private consumption expenditure, volume		+ 3.3	+ 1.4	+ 0.8	+ 1.2	+ 1.6	+ 2.5	
Gross fixed investment, volume								
Machinery and equipment ²		+ 6.2	- 2.3	- 2.8	+ 4.6	+ 3.2	+ 3.7	
Construction		+ 11.8	- 2.1	- 5.2	+ 6.2	+ 4.0	+ 6.0	
		+ 1.9	- 2.5	- 0.7	+ 3.3	+ 2.5	+ 1.7	
Exports of goods³								
Volume		+ 13.1	+ 7.5	+ 5.2	+ 2.7	+ 5.5	+ 6.8	
Value		+ 15.6	+ 6.5	+ 4.2	+ 1.9	+ 6.4	+ 7.3	
Imports of goods³								
Volume		+ 10.9	+ 5.7	+ 0.8	+ 6.2	+ 3.8	+ 7.1	
Value		+ 14.7	+ 5.0	- 2.0	+ 5.0	+ 6.0	+ 7.8	
Current balance		billion €	- 5.36	- 4.13	+ 0.36	- 2.04	- 1.80	- 2.02
As a percentage of GDP			- 2.6	- 1.9	+ 0.2	- 0.9	- 0.8	- 0.8
Long-term interest rate ⁴	in percent	5.6	5.1	5.0	4.2	4.3	4.5	
Consumer prices		+ 2.3	+ 2.7	+ 1.8	+ 1.3	+ 1.9	+ 1.8	
Unemployment rate								
Eurostat definition ⁵	in percent	3.7	3.6	4.3	4.4	4.5	4.4	
National definition ⁶	in percent	5.8	6.1	6.9	7.0	7.1	7.0	
Economically active employees ⁷		+ 0.9	+ 0.4	- 0.5	+ 0.2	+ 0.6	+ 0.9	
General government financial balance according to Maastricht definition								
As a percentage of GDP			- 1.5	+ 0.2	- 0.2	- 1.3	- 1.2	- 1.7

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, as a percentage of total labour force excluding self employed. – ⁷ Excluding parental leave, military service, and unemployed persons in training.

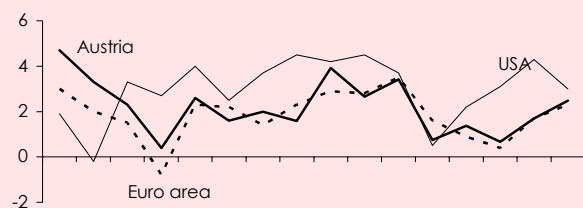
Construction, a driver of growth already in 2003, is projected to expand by a further healthy 2½ percent in volume this year. Orders remain on a high level in civil engineering, while demand is set to slacken in the building sector. Rising excess capacity will hold back the creation of new office space, and sluggish demand for housing has led to a fall in building permits for subsidised dwellings by 4,000 or 10 percent in 2003.

Employment is reacting in the usual way to the recovery of business activity. The number of people in active employment is seen rising by 0.6 percent this year and 0.9 percent in 2005. The increase may now extend also to domestic employees, the number of which has gone down by 30,000 over the last two years. The inflow of foreign labour remains strong. As a consequence of the sizeable increase in labour supply, unemployment will show little reaction to the friendlier business situation, remaining at around 240,000 on annual average 2005.

Figure 1: Indicators of economic performance

Growth of real GDP

In percent



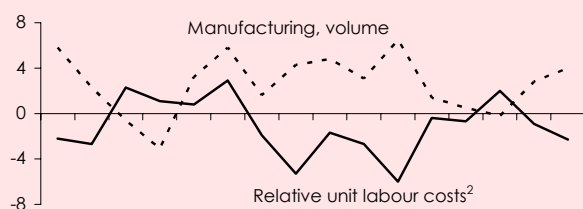
Employment and unemployment

1,000s from previous year



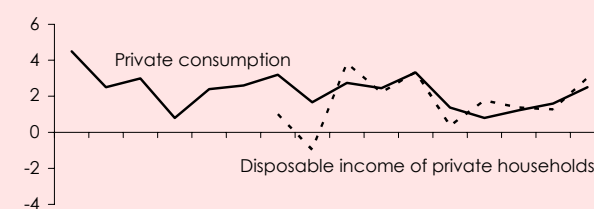
Competitiveness and manufacturing output

Percentage changes from previous year



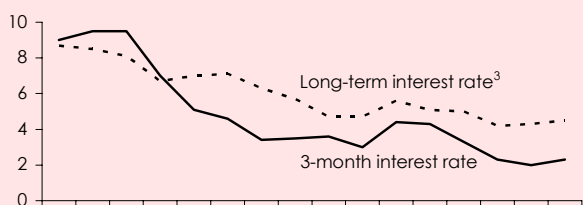
Consumption and income (constant prices)

Percentage changes from previous year



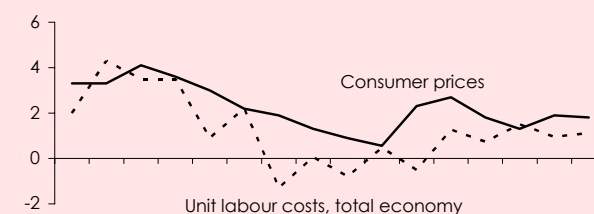
Short-term and long-term interest rates

In percent



Inflation and unit labour costs

Percentage changes from previous year



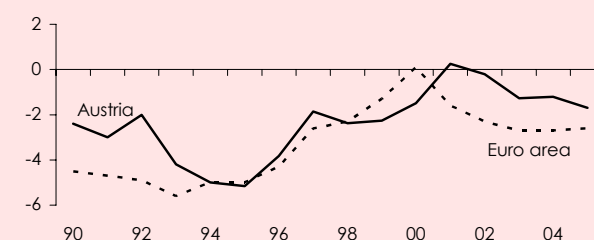
Exports and investment (constant prices)

Percentage changes from previous year



General government financial balance

As a percentage of GDP



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

Likewise, the public sector financial balance will hardly improve, despite the cyclical recovery. The general government deficit in the Maastricht definition is projected at € 3 billion or 1¼ percent of GDP this year, rising to € 4 billion or 1¾ percent of GDP in 2005. The prolongation of tax concessions for investors and rising outlays for social transfers, such as child care and partial retirement benefits, are exerting a drag on the 2004 budget, while in 2005 the sizeable cuts in direct taxes will lead to shortfalls in revenues.

The world economy is showing strong forward momentum, driven by the boom in China and the upswing in North America. Growth of world trade may exceed 8 percent this year, with little deceleration likely in 2005. Global strength is spilling over also to those areas where weak internal demand has kept economies in protracted stagnation. Especially in Japan, the recovery of exports is now being followed by a pick-up in investment and private consumption. Lively external demand is also boosting the European economies. The export-oriented economies with traditionally strong international ties, notably Germany, have already registered a strong increase in exports in the first quarter 2004.

Global economic activity expanding strongly

Table 2: World economy

	2000	2001	2002	2003	2004	2005	
	Percentage changes from previous year						
<i>Real GDP</i>							
Total OECD	+ 3.9	+ 1.0	+ 1.8	+ 2.1	+ 3.3	+ 2.7	
USA	+ 3.7	+ 0.5	+ 2.2	+ 3.1	+ 4.3	+ 3.0	
Japan	+ 2.8	+ 0.4	- 0.4	+ 2.5	+ 3.5	+ 2.8	
Asia (excluding Japan)	+ 6.8	+ 5.2	+ 6.0	+ 7.2	+ 7.0	+ 6.5	
EU 25	+ 3.6	+ 1.7	+ 1.1	+ 0.9	+ 2.1	+ 2.5	
EU 15	+ 3.6	+ 1.7	+ 1.1	+ 0.8	+ 2.0	+ 2.4	
Euro area	+ 3.5	+ 1.6	+ 0.9	+ 0.4	+ 1.7	+ 2.3	
Germany	+ 2.9	+ 0.8	+ 0.2	- 0.1	+ 1.4	+ 1.8	
New member states ¹	+ 4.1	+ 2.5	+ 2.4	+ 3.6	+ 4.0	+ 4.0	
<i>World trade, volume</i>	+12.4	+ 0.3	+ 3.3	+ 4.1	+ 8.5	+ 7.0	
<i>Market growth²</i>	+12.2	+ 2.2	+ 1.8	+ 4.4	+ 6.0	+ 6.8	
<i>Primary commodity prices</i>							
HWVA index, total	+51.0	- 8.0	- 5.0	- 4.0	+14.0	+ 4.0	
Excluding energy	+19.0	- 3.0	- 6.0	- 6.0	+12.0	+10.0	
<i>Crude oil prices</i>							
Average import price (cif) for OECD countries	\$ per barrel	28.0	23.6	24.1	28.4	34.5	34.5
<i>Exchange rate</i>							
\$ per euro		0.924	0.896	0.945	1.13	1.20	1.20

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

The strong expansion of global economic activity and of world trade is now providing incentives also to those economies long caught in stagnation by weak internal demand. At the same time, it is strongly driving up inflation on international commodity markets.

The swift expansion of the world economy is accompanied by strong demand and price pressure for internationally traded raw materials. Imports of crude oil, metals and semi-manufactures by China are rising particularly strongly. Commodity prices are heading up markedly also on a euro basis. All international assessments suggest that the high raw materials prices will dampen, but not seriously undermine growth in the industrialised countries.

Commodity prices, as measured by the HWWA Index, have rebounded by 36 percent on a euro basis over the last 12 months from their trough in May 2003. Especially China's demand for imported raw materials is unabated, but also the cyclical recovery in the industrialised countries is adding to the upward pressure on prices. Some deceleration is nevertheless in sight: the Chinese government has announced a "soft landing" of the economic boom, which should discourage speculative buying on commodity markets; at the same time, supply of commodities is being stepped up substantially.

Difficult to assess is the situation on world oil markets. WIFO is revising upwards its assumption for crude oil prices from \$ 31 per barrel on annual average 2004 and 2005 to \$ 34.5. Current prices include a high risk premium, because of the acute danger of further terrorist attacks in oil-exporting countries. The further price trend is therefore highly uncertain and closely related with the geopolitical situation. A further heightening of political instabilities in the Middle East would lead to further sizeable mark-ups on oil prices. The high risk premium can hardly be removed by an increase in

Jump in commodity prices will slow the pace of recovery

output, due to scarce refinery capacities in the USA. Excess demand is being exacerbated by the replenishment of strategic inventories in the USA and by speculative purchases.

The negative repercussions on inflation and GDP in the industrialised countries have nevertheless been limited so far. Dependency on oil of the advanced economies is lower today than in the past, and the strength of the euro vis-à-vis the dollar has long dampened the price hike. Since May, however, inflationary pressure is mounting in the euro area, so far mostly on account of higher fuel prices. The impact of higher oil prices is likely to push up the overall consumer price level by around ¼ percent each in 2004 and 2005.

Model simulations by international organisations suggest that a 10 percent jump in oil prices takes 0.1 percentage point off GDP growth in the industrialised countries. For Austria, the oil price increase is likely to cut the rate of growth by some 0.15 percentage points in the short term. More generally, an oil price increase implies a change in the terms-of-trade and a redistribution of income from oil-importing to oil-exporting countries. If oil producers spend their additional revenues on higher imports, the negative shock for the industrialised countries is reduced over the medium run.

On the back of a rapidly expanding world economy, economic growth in the euro area picked up in the first quarter 2004, with real GDP gaining ½ percent seasonally adjusted from the previous period and 2 percent year-on-year, according to preliminary estimates by the European Commission. On a quarter-to-quarter basis, this was the highest increase since the first quarter 2001. Higher output has mainly been generated by rising external demand. For the first time in three years there has also been a recovery of investment, even if held back by the sizeable margin of free production capacities.

The surveys conducted by the European Commission among the cyclically sensitive manufacturing firms suggest a continuation of the recovery into the second quarter, even if the pace has probably not accelerated substantially. It is therefore premature to assume a cyclical upturn of the usual pattern and a similar profile. Real GDP is projected to increase by some 1¾ percent this year and 2¼ percent in 2005.

The major concern at the present juncture relates to the sluggishness of private consumption in the euro area. The tentative rebound in consumer confidence in 2003 came to a halt in early 2004. In particular the poor labour market situation and growing doubts about the sustainability of social welfare systems are undermining confidence of private households, inducing them to save their small income gains rather than afford higher consumption. Weak internal demand accompanied by healthy export growth is driving up the current account surplus of the euro area, projected to attain some ¾ percent of GDP this year.

The pace of growth this year remains below what would be required for a turnaround on the labour market. On annual average, unemployment will climb to a rate of 8.8 percent of the labour force, some 1 percentage point higher than in early 2001. This corresponds to an increase by over 1 million people out of work over the three-year-long stagnation period. Likewise, the marked increase in general government indebtedness is primarily the result of sluggish public revenues and rising outlays as a consequence of the protracted weakness of economic activity. The aggregate general government deficit for the euro area will move close to 3 percent of GDP this year, almost twice the ratio recorded in 2001.

The massive increase in raw material prices will keep euro area inflation, as measured by the Harmonised Index of Consumer Prices (HICP), above a rate of 2 percent in 2004, thereby exceeding the ceiling of price stability, as defined by the ECB, for the fifth consecutive year. Yet, a temporary rise in inflation induced by higher import prices should not give rise to policy reaction by the monetary authorities, particularly since price stability is not jeopardised from the domestic side. Real wages per capita have edged up by less than 1 percent p.a. over several years, lagging even behind

Incipient recovery in the euro area, but unemployment and government deficits remaining high

The euro area economy is reaping early benefits from the booming world economy. A cyclical recovery of exports has set in, but a higher momentum of investment is still held back by low capacity utilisation. GDP is projected to grow by 1¾ percent in 2004, accelerating to 2¼ percent in 2005. The surplus on current account is rising steadily.

The revival of economic growth is too timid for the time being as to improve the situation on the labour market or of government finances. Euro area unemployment is set to rise to nearly 9 percent of the labour force this year, and the general government deficit will edge up to close to 3 percent of GDP. The increase in the consumer price index is likely to be revised upwards to over 2 percent.

output, with real unit labour costs declining steadily. Short-term interest rates in the euro area are still above those in the USA, despite the markedly stronger growth of the US economy.

In Germany, GDP growth in the first quarter 2004, at 0.4 percent from the previous period and 1½ percent year-on-year, was well above expectations of national and international observers. It was entirely supported by exports, whereas domestic demand remains on a downward trend. More than other economies, Germany is benefiting from the recovery of global demand, lending little support to concerns about its lacking competitiveness in terms of price or quality.

The swift expansion of worldwide demand will benefit the German economy more than others. Healthy export gains should also spark off a recovery of investment in machinery and equipment. Construction investment and private consumption, will, however, act as a drag on the recovery. In the construction sector, incoming orders have been declining since the beginning of the year, following a temporary stabilisation in the second semester 2003. A major dampening factor is the reservation of local communities in issuing new investment orders. Sluggishness of private consumption is due to the slow pace of income growth and to a widespread increase in precautionary saving. A further round of income tax cuts since the beginning of the year has failed to give major impetus to consumption by private households.

Results from the ifo business climate survey confirm the assessment of a gradual cyclical recovery threatened by setbacks. Since the middle of 2003, judgements on the current business situation in Germany have gradually become more positive, though without taking on the momentum that characterised the cyclical upswings of 1993-94 or 1999-2000. While the marked improvement in long-term business expectations in the second half of 2003 was at first clearly in line with the pattern of a swift upturn, such expectations have been significantly revised downwards since the beginning of this year.

The favourable circumstances for the export sector suggest that GDP growth in Germany will pick up to around 1½ percent this year and further to almost 2 percent in 2005, the external environment remaining favourable. Such a pace is, nevertheless, insufficient for making substantial inroads into the high unemployment, projected to exceed 9 percent of the labour force this year. Neither will the early recovery provide relief for the budgetary situation. Despite plans for sales of a large number of public assets, the general government deficit in 2005 is likely to exceed once again the mark of 3 percent of GDP. A clear improvement on the labour market and of public finances will only materialise if growth accelerates more strongly.

The new EU member states all exhibit faster rates of growth than those of the EU 15. In 2003, the average was slightly above 3½ percent, and it may rise to 4 percent in the current year. This reflects the catching-up process which is, however, coming along more slowly than expected by the population. In the majority of the new member states, GDP per capita will reach the EU-15 average only in a couple of decades. Growth of the Polish economy is particularly strong, though from a relatively low level, mainly as a result of the devaluation of the zloty and a more expansionary stance recently adopted by the central bank. In Slovakia also, for a long time a laggard in the catching-up process, growth is gaining momentum. However, it remains rather modest in Hungary, Austria's main trading partner among the new EU member states. The major reasons are monetary restriction in order to stabilise the currency and a slackening of foreign direct investment.

The Austrian economy expanded by an inflation-adjusted 0.7 percent in 2003, slightly below the EU average of 0.9 percent. In the first quarter 2004, GDP edged up by only 0.7 percent year-on-year according to preliminary WIFO calculations, falling clearly behind the EU-15 average of +2.3 percent. Nevertheless, in spring there has been a revival of merchandise exports, notably to Germany, which is set to con-

Strong rebound in German exports

In Germany, exports picked up vigorously in the first quarter, giving rise to unexpectedly strong GDP growth. The German export industry is benefiting notably from the global economic boom, revealing its high competitiveness in price as well as qualitative terms. Nevertheless, the sluggishness of construction investment and private consumption is holding back the recovery.

Uneven developments in the new EU member states

Gradual business cycle recovery

tinue. The regular WIFO business survey among manufacturing firms does not point to a strong cyclical upturn. In April and May, production expectations brightened somewhat, but the longer-term outlook is judged distinctly more sceptical than at the end of 2003. Companies apparently had to correct downwards their expectations of a speedy upturn as it was typical for past cycles. The recovery may thus proceed at a slower pace in the export-oriented sector than in previous periods.

After two years of pronounced weakness, domestic demand in Austria is performing better since last year than in other EU countries. This is mainly due to construction activity, which is benefiting from many new public orders in civil engineering. Private consumption is also picking up slowly, and the income tax cuts in 2005 will provide additional momentum. GDP growth may accelerate from 1.7 percent in 2004 to 2½ percent in 2005. On a seasonally-adjusted basis, the recovery is shifting into higher gear in the second quarter, driven by exports, hovering between ½ percent and ¾ percent quarter-on-quarter up to the forecast horizon.

The risks to the present forecast appear evenly balanced. A stronger acceleration of export growth in Germany on the back of the global economic boom, particularly if it were to stimulate investment, may add to the forces of expansion also in Austria. On the other hand, the business surveys in the euro area and notably in Germany suggest that the recovery is being held back by the high euro exchange rate and further cuts in public expenditure. A particular risk surrounds the oil price, which may climb still significantly higher if geo-political uncertainties were to increase further. In Austria, a major factor of uncertainty is the very weak performance of sales in trade as reported by Statistics Austria. Part of the explanation is probably exaggerated deflators for retail and even more for wholesale turnover.

After a weak start early this year, Austrian exports rebounded strongly in spring. In March, nominal exports according to preliminary figures from Statistics Austria rose 12½ percent from the year-earlier level (first quarter +4½ percent). The lacklustre export performance of last year, when nominal values gained only 1.9 percent on annual average, should now be overcome. Demand strengthened in particular from Germany, rising by 7 percent in the first quarter 2004. Once again, Austria is benefiting from the strong supply ties with the German export industries, which is also being reflected by the commodity composition of exports, where deliveries of machinery and vehicles posted above-average gains.

WIFO expects growth of merchandise export volumes at 5½ percent in 2004, implying slight market share losses due to an exchange-rate induced weakening of competitiveness and intensifying competition in the new EU member states. Exports towards the latter are nevertheless lively, gaining a nominal 10 percent year-on-year in the first quarter. In 2005, goods exports should keep pace with market growth, as price competitiveness of Austrian suppliers should improve with the effect of currency appreciation wearing off. Unit labour costs in manufacturing will decline further relative to those of the trading partners, undershooting their level of 1999 by around 6 percent despite the effect of euro appreciation in 2003 and 2004.

Growth of volume imports is lagging behind that of exports. While higher exports always pull imports as well, given an import content of exports of roughly 33 percent, this year's imports are dampened by institutional factors, apart from weak domestic demand: the investment premium that was originally to be phased out by the end of 2003 prompted many firms to carry forward purchases of machinery and notably motor vehicles (with an import share of 74 percent) into 2003. The corresponding echo effect is holding back merchandise import growth this year.

The terms-of-trade are weakening by more than 1 percent this year, as import prices are driven up by the hikes on international commodity markets. The trade and the current account balances will therefore hardly improve, despite the substantial export gains. The current account deficit is projected at around € 2 billion, equivalent to nearly 1 percent of GDP. The surplus on cross-border tourism services is edging up to a total slightly above € 2 billion. Growth of tourism exports is set to accelerate from 1¼ percent in volume in 2004 to 3.3 percent in 2005, as the effect of higher activity

Like over the last few years, real GDP in Austria is growing slightly below the EU average and at about the same pace as in the euro area. The recovery is mainly driven by developments in the trading partner countries, although domestic construction and private consumption have provided substantial growth contributions since last year. The revival of activity has not yet been firmly enough established as to be considered as a cyclical upturn.

Demand from Germany driving domestic merchandise exports

Domestic exports of goods, projected to increase by 5½ percent in volume, are likely to profit from this year's recovery in the German export-oriented sector. This forecast would nevertheless imply slight losses of market shares. The external sector's contribution to real GDP growth of ½ percentage point is high. Yet, the hefty increase in import prices will keep the current account deficit close to its present level of € 2 billion.

and incomes in the major countries of origin of Austria's customers should prevail over the reduced competitiveness following the euro appreciation.

Investment in machinery and equipment, including the component of "other" equipment, gained over 6 percent in real terms in 2003, according to preliminary calculations by WIFO. Such an increase is clearly higher than what could be expected in a situation of poor capacity utilisation. One explanation is the need for replacement after a cumulative slump in investment by 7 percent in 2000-2002, another the carrying forward of spending in view of the termination originally envisaged for end-2003 of the investment premium.

In WIFO's assessment, an "endogenous" recovery of the investment cycle has not been set in motion in 2003. The base effect from the special factor operating in 2003 complicates the projection for 2004. Stronger exports and the greater optimism expressed in the WIFO investment survey of spring 2004 suggest, however, that firms will step up spending further, this time for cyclical reasons. The projection is for investment to grow by 4 percent in 2004, gaining momentum in 2005.

The manufacturing sector is particularly sensitive to cyclical variations and heavily dependent on foreign demand. The production index, reaching as far as last March, yields a nominal output increase of almost 4½ percent year-on-year for the first quarter. The preliminary National Accounts calculations by WIFO show an increase in value added by 1¾ percent for the same period. More recent information on industrial activity can be gathered from the WIFO business survey. The companies sampled report on balance a clear improvement in the business climate from the middle to end-2003, followed, however, by widely spreading uncertainty on the further outlook during the first few months of 2004. The latter could have been triggered by a new bout of euro appreciation. In April and May, output expectations headed up again, if only tentatively. According to the WIFO business survey, manufacturing output will remain upward bound without accelerating markedly. WIFO therefore expects an increase in real value added by 2.8 percent in 2004 and by some 4 percent in 2005.

Cyclical stimulus to investment in machinery and equipment

Industrial output growth gaining pace only gradually

Table 3: Productivity

	2000	2001	2002	2003	2004	2005
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 3.4	+ 0.8	+ 1.4	+ 0.7	+ 1.7	+ 2.5
Employment ¹	+ 0.8	+ 0.6	- 0.2	- 0.1	+ 0.5	+ 0.9
Full-time equivalent	+ 1.0	+ 0.6	- 0.0	+ 0.1	+ 0.3	+ 0.7
Productivity (GDP per employment)	+ 2.6	+ 0.1	+ 1.6	+ 0.8	+ 1.2	+ 1.6
Full-time equivalent	+ 2.4	+ 0.1	+ 1.4	+ 0.6	+ 1.4	+ 1.8
<i>Manufacturing</i>						
Production ²	+ 6.5	+ 1.4	+ 0.5	- 0.2	+ 2.8	+ 4.0
Employees ³	+ 0.0	+ 0.2	- 2.5	- 1.7	- 0.5	± 0.0
Productivity per hour	+ 6.6	+ 1.6	+ 3.6	+ 1.3	+ 3.3	+ 3.8
Working hours per day per employee ⁴	- 0.1	- 0.4	- 0.5	+ 0.2	± 0.0	+ 0.2

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.

The WIFO business survey has confirmed a gradual recovery of output in manufacturing; however, the sentiment of a broad-based upswing has not yet taken hold.

Employment in manufacturing in the first five months of 2004 fell by almost 5,000 or ¾ percent below the level one year ago. On annual average, output per employee is expected to advance by around 3½ percent. Such healthy productivity gains, together with moderate wage settlements will make for a decline in unit labour costs by about 1 percent per year. Relative unit labour costs, vis-à-vis the trading partners, should fall by 1 percent this year and roughly 2 percent in 2005. As in the past, the Austrian export-oriented sector is steadily gaining external price competitiveness, unless this is counter-acted by currency appreciation.

Road and railroad construction activity remains lively this year. In the WIFO business survey, civil engineering firms consider their order levels satisfactory. The increasing number of projects carried out in the form of Public Private Partnership, while hardly offering better financing conditions, provides for unabated activity despite tighter government budgets. In particular the local communities have cut their investment outlays for reasons of budgetary consolidation.

The situation is less favourable in the building sector. Although industrial construction may profit from higher investment in production plants and facilities, the creation of residential and office space is receding. The proportion of unoccupied office space is exceptionally high, leading to cuts in new construction. In residential building, the recovery seen last year is subsiding. The falling number of building permits for new homes (2003 –4.000) suggests a further weakening of output in 2005. Given the fall in demand, the projected number of 42,000 dwellings completed would amount to a fall by almost one-third from the peak of 1997.

Construction employment continues to decline, albeit at a slower pace. From January to May, the number of workers was nearly 2,500 or 1 percent below the year-earlier level. Over the last five years, 27,000 construction jobs have been lost, bringing the total down to 237,000. This has largely contributed to the serious deterioration of job prospects for low-qualified men.

Headline inflation has increased markedly since the beginning of the year, from a rate of 1.1 percent in January to 2.1 percent in May. Higher energy costs have been the main driving force. Prices of food (January to April +2 percent year-on-year) and of meals in restaurants (+2¼ percent) continue heading up briskly. On annual average 2004, the rate of inflation will move close to 2 percent. The higher energy prices will add to consumer price inflation well into 2005, keeping the annual inflation rate close to 2 percent. The Harmonised Consumer Price Index (HCPI) calculated on the basis of uniform EU standards is projected to increase by 1.9 percent this year and 1.6 percent in 2005.

Lively demand in civil engineering, but slackening residential construction

Road and railroad construction enjoys comfortable levels of orders. In the building sector, however, demand is slack as mirrored by the falling number of building permits for subsidised dwellings. Construction output is projected to grow by 2½ percent in volume in 2004 and 1¾ percent in 2005.

Energy price hikes adding to inflation

Higher oil prices will push up the annual inflation rates for 2004 and 2005 by ¼ percentage point each. In both years, consumer price inflation will be slightly below 2 percent. Once again, net real earnings per capita will barely rise this year, before tax cuts in 2005 will make for the first significant increase since 2000.

Table 4: 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	+2.3	+2.2	+2.7
Full-time equivalent	+2.6	+1.4	+2.1	+2.5	+2.6	+3.1
Gross real earnings per employee ¹	+1.0	-0.8	+1.0	+0.5	+0.3	+0.9
Net real earnings per employee ¹	+1.6	-1.1	+0.8	+0.2	+0.6	+2.2
Net wages and salaries	+4.5	+2.1	+2.5	+2.7	+2.5	+4.2
Total economy						
Unit labour costs	-0.5	+1.3	+0.7	+1.5	+1.0	+1.1
Manufacturing						
Unit labour costs	-5.0	+1.6	-0.7	+0.3	-1.1	-1.3
Relative unit labour costs ²						
Vis-à-vis trading partners	-6.0	-0.4	-0.7	+2.0	-0.9	-2.3
Vis-à-vis Germany	-2.3	-0.1	-0.5	+0.2	-1.5	-1.8
Effective exchange rate, manufactures						
Nominal	-2.7	+0.9	+1.3	+3.7	+1.1	-0.1
Real	-3.3	+0.5	+0.8	+2.9	+1.1	-0.5

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

Higher inflation is weighing on real disposable income which is expected to increase by 1¼ percent this year. The energy price hikes, while dampening somewhat private consumption growth, should primarily be accommodated by a lower household saving ratio. Employees' net earnings plus social transfers after tax ("Nettomasseneinkommen"), when adjusted for inflation, will only edge up by ½ percent this year, by about the same rate as net real per-capita income. A more substantial increase in

income per employee may be expected for 2005, when cuts in the wage tax will make for an increase in per-capita income after tax by 2¼ percent in real terms.

The current situation in the trade sector is difficult to assess, due to the high uncertainty surrounding the official data. After a marked fall in nominal sales in January and February, solid gains were recorded for March and April. Notably wholesale trade has staged a turnaround, which would be consistent with the trend in foreign trade. The recovery is, however, not adequately reflected by the inflation-adjusted data, which for the period from January to April show a decline of sales by 2½ percent compared with the same period of last year. The possible over-estimation of price rises in retail trade has been largely reduced recently. In its preliminary National Accounts calculations, WIFO has arrived at a decline by nearly 1 percent year-on-year for value added of the trade sector in the first quarter. In the light of this figure, the forecast of an increase by 1¼ percent for the whole year 2004 should be considered optimistic.

Sluggish sales in trade, but consumption to benefit from 2005 tax cuts

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	+1.2	+1.6	+2.5
Durables	+3.9	+1.8	+3.6	+0.8	+2.5	+5.5
Non-durables and services	+3.2	+1.3	+0.4	+1.3	+1.5	+2.0
Household disposable income	+3.3	+0.4	+1.8	+1.4	+1.3	+3.0
Household saving ratio						
As a percentage of disposable income	8.4	7.5	8.2	8.4	8.3	8.8
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+6.7	+3.5	+1.2	+1.6	+2.8	+3.0
	Percent					
Inflation rate						
National	2.3	2.7	1.8	1.3	1.9	1.8
Harmonised	2.0	2.3	1.7	1.3	1.9	1.6
Core inflation ²	0.9	2.3	2.0	1.3	1.5	1.6

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

Real value added and turnover in the trade sector early this year fell clearly short of their levels one year ago. Private consumption is faring somewhat better, with a projected gain of 1½ percent or more in 2004. Higher outlays for energy consumption will lower the household saving ratio this year, before it will bounce back strongly under the impact of the income tax cuts.

More lively than net output of the trade sector is demand by private households. In the first quarter, it rose by 1 percent in volume from last year, while for the whole year a gain of 1½ percent may be expected. Growth of real disposable income will accelerate markedly in 2005 (+3 percent), on account of the cuts in direct taxes taking effect. Private consumption growth could thereby rise to its long-term trend rate of +2½ percent, for the first time since 2000. Demand will likely concentrate on durable consumer goods, projected to move up by 5½ percent in real terms. Yet, a substantial part of the additional spending will go to imported goods and foreign travel.

The saving ratio will decline somewhat this year. Higher energy costs will hardly lead to lower demand, but rather to a reduction in saving as a proportion of disposable income. In 2005, the saving ratio is expected to jump to nearly 9 percent of disposable income, as probably half of the income gains from the tax reform will go to saving accounts.

The gradual recovery of output is being reflected, with some lag, on the labour market. In manufacturing and construction, where growth is stronger than elsewhere, the fall in employment is losing momentum, and the service sector is hiring additional personnel. The number of economically active employees is set to increase by 0.6 percent (+17,000 people) this year and 0.9 percent in 2005. The share of economically active employed in the population of working age could thereby reach 63.4 percent by 2005.

Employment reacting to strengthening activity

In 2002 and 2003, domestic employment had fallen by more than 30,000; this year it may start heading up again (+4,000). Foreign employment, for its part, has been growing strongly for years and is expected to continue doing so in 2004 (+13,000) and 2005 (+21,000). The marked increase in foreign labour supply is a major reason for the stronger economic growth not being translated into lower unemployment. The jobless total is projected to stay above 240,000 on annual average 2005, corresponding to a rate of unemployment of 7.0 percent of the dependent labour force or 4.4 percent of the total labour force on EU Survey definitions.

The improvement of cyclical conditions is leading to an increase in employment. However, this is not mirrored in a decline in unemployment, because of a continued substantial increase in foreign labour supply.

Table 6: Labour market

	2000	2001	2002	2003	2004	2005
	Changes from previous year (1,000s)					
<i>Demand for labour</i>						
Economically active employment ¹	+ 30.1	+13.9	- 11.6	+ 8.5	+20.7	+ 31.5
Employees ²	+ 28.2	+12.4	- 15.0	+ 5.5	+17.5	+28.1
Percentage changes from previous year	+ 0.9	+ 0.4	- 0.5	+ 0.2	+ 0.6	+ 0.9
Nationals	+ 14.8	+ 3.0	- 20.1	- 10.4	+ 4.5	+ 7.0
Foreign workers	+ 13.4	+ 9.5	+ 5.1	+ 15.9	+13.0	+21.1
Self-employed ³	+ 1.9	+ 1.5	+ 3.4	+ 3.0	+ 3.2	+ 3.4
<i>Labour supply</i>						
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	+ 2.7	+23.5	+ 17.0	+ 16.1	+24.6	+29.5
<i>Surplus of labour</i>						
Registered unemployed ⁵	- 27.4	+ 9.6	+28.5	+ 7.7	+ 3.9	- 2.0
In 1,000	194.3	203.9	232.4	240.1	244.0	242.0
	In percent					
<i>Unemployment rate</i>						
Eurostat definition ⁶	3.7	3.6	4.3	4.4	4.5	4.4
As a percentage of total labour force ⁵	5.3	5.5	6.2	6.3	6.4	6.3
National definition ^{5,7}	5.8	6.1	6.9	7.0	7.1	7.0
<i>Employment rate</i>						
Economically active employment ^{1,8}	63.3	63.3	62.8	62.6	62.8	63.4
Total employment ^{6,8}	68.5	68.5	69.2	69.2	69.4	69.6

¹ Excluding parental leave, military service, and unemployed persons in training. – 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, without self-employed. – ⁸ As a percentage of population of working age (15 to 64 years).

In spite of the incipient business cycle recovery, public finances are set to weaken. The general government account will be in deficit in 2004, to the amount of an estimated € 3 billion or 1¼ percent of GDP. In the early months of this year, V.A.T. revenues were surprisingly low, falling clearly short of the budgeted figures. The sluggishness of private consumption towards the end of 2003 offers only a partial explanation in this regard. Income and corporate tax revenues were also lacklustre, due partly to more companies than anticipated taking advantage of the investment premium. High unemployment and increasing claims to child-care benefits and partial retirement allowance ("Altersteilzeitgeld") are exerting upward pressure on social transfer expenditures. The major impact on public finances in 2005 will be the cuts in wage and profit taxes, which will weaken the budget balance by an estimated ¾ percent of GDP. The general government deficit will thereby rise above € 4 billion to a ratio of 1¾ percent of GDP.

Budget deficit rises despite stronger cyclical activity

Table 7: Key policy indicators

	2000	2001	2002	2003	2004	2005
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	-1.5	+0.2	-0.2	-1.3	-1.2	-1.7
According to National Accounts	-1.7	+0.1	-0.4	-1.4	-1.4	-1.8
General government primary balance	+2.2	+3.8	+3.1	+1.9	+1.8	+1.3
	In percent					
<i>Monetary policy</i>						
3-month interest rate	4.4	4.3	3.3	2.3	2.0	2.3
Long-term interest rate ¹	5.6	5.1	5.0	4.2	4.3	4.5
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	-2.5	+1.0	+1.4	+3.8	+1.2	±0.0
Real	-3.4	+0.3	+0.6	+2.8	+1.1	-0.4

¹ 10-year central government bonds (benchmark).