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Economic Growth Remaining Subdued

Economic Outlook for 2003 and 2004

For the third year in a row, the Austrian economy will grow by only around 1 percent in 2003. Adding to the persistent weakness of domestic demand are the economic repercussions of geo-political instability. For 2004, uncertainties are particularly large, with growth projected to stay below the long-term average (1.7 percent). Weak overall economic conditions will lead to a further rise in unemployment and a widening budget deficit.

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The Austrian economy grew by 1 percent in real terms in 2002, a rate close to what WIFO had expected as early as December 2001 (1.2 percent). Yet, in the third and fourth quarter, GDP remained flat on a seasonally adjusted basis, with stagnation likely to continue this year. The main reasons are the consequences of geo-political instability for the economy as well as continued sluggishness of domestic demand. GDP growth in 2003 is currently put at 1.1 percent, remaining close to a modest 1 percent for the third consecutive year. Such an extended period of weak activity has not been observed to date.

Prospects for 2004 are necessarily vague at this stage, given the great uncertainty surrounding geo-political developments and the reaction of economic policy. At present, growth is projected at 1.7 percent, remaining again clearly below the long-term trend. Both in 2003 and 2004, the pace of expansion would thereby correspond to the euro area average. A cyclical upswing in Europe appears unlikely, unless world-wide uncertainty subsides and commodity prices ease markedly. Underlying the present projection are the assumptions of a reference price of 29 \$ per barrel for crude oil in 2003 and of 23 \$ per barrel in 2004, and an exchange rate of 1.08 \$ per euro.

The real-effective appreciation of the euro is holding back the rise in Austrian exports. Merchandise exports are seen rising by 4.3 percent in volume this year, and by 7.5 percent in 2004. As in the past two years and despite the weak international environment, exports will remain the main driving force of Austria's economic growth. The weak momentum of foreign demand is dampening investment in the export-oriented business sector. Spending on machinery, vehicles, electronic equipment and software may pick up by an inflation adjusted 3 percent this year, after having fallen by a cumulated 13 percent since 2000. Towards the end of the year, some positive effects may be expected from spending being carried forward in view of the expiration of the temporary investment premium. A genuine cyclical recovery of investment may set in by 2004, with expenditure on new equipment projected to gain 5.5 percent. Growth of manufacturing output, 1.8 percent in volume in 2003 and 3 percent in 2004, will also be constrained by weak demand. This will not suffice to prevent further substantial job losses in manufacturing.

The rise in domestic demand is likely to remain below the long-term average. After a decline in 2001 and 2002, a slight pick-up may be expected for the current year. Spending of private households is held back by the unsatisfactory labour market situation and the modest gains in net incomes. Nevertheless, private consumption is

set to increase by nearly 1½ percent, while public consumption will remain flat. Construction investment in civil engineering is benefiting from higher spending on road and railroad infrastructure, whereas the building sector lacks stimulus.

Consumer price increases are slightly gaining momentum, with the rate of inflation projected at 1.9 percent. Upward pressure is being exerted by energy and services prices, notably related to housing, and by prices of manufactured goods. Next year, inflation should moderate to a rate around 1½ percent. The appreciation of the euro will dampen the rise in import prices, and unit labour costs should be of stabilising influence.

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	+ 1.1	+ 1.7	
Value		+ 3.4	+ 5.0	+ 2.3	+ 2.3	+ 2.4	+ 3.5	
Manufacturing ¹ , volume		+ 3.0	+ 6.5	+ 1.3	+ 0.2	+ 1.8	+ 3.0	
Private consumption expenditure, volume		+ 2.3	+ 3.3	+ 1.5	+ 0.9	+ 1.4	+ 1.9	
Gross fixed investment, volume								
Machinery and equipment ²		+ 4.9	+11.8	- 2.9	- 8.9	+ 3.0	+ 5.5	
Construction		+ 0.0	+ 1.2	- 1.5	- 1.2	+ 1.2	+ 1.5	
Exports of goods³								
Volume		+ 7.7	+13.1	+ 7.5	+ 5.5	+ 4.3	+ 7.5	
Value		+ 7.0	+15.6	+ 6.5	+ 4.1	+ 5.3	+ 7.7	
Imports of goods³								
Volume		+ 6.9	+10.9	+ 5.7	- 0.9	+ 4.6	+ 7.5	
Value		+ 6.7	+14.7	+ 5.0	- 2.2	+ 6.5	+ 7.0	
Current balance		billion €	- 6.33	- 5.36	- 4.65	- 0.91	- 1.90	- 1.82
As a percentage of GDP			- 3.2	- 2.6	- 2.2	- 0.4	- 0.9	- 0.8
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	+ 1.9	+ 1.4	
Unemployment rate								
Percent of total labour force ⁵	in %	3.9	3.7	3.6	4.1	4.2	4.2	
Percent of dependent labour force ⁶	in %	6.7	5.8	6.1	6.9	7.0	7.0	
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	- 1.2	- 1.0

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.

Slow economic growth has pushed up the number of unemployed by a cumulated 38,000 in 2001 and 2002. The negative trend is unlikely to reverse during the forecast period. In 2003, the number of actively employed will fall again slightly, with job losses being concentrated in manufacturing, construction and trade. The public sector is planning further cuts in personnel. Unemployment is likely to increase by 8,000 people to an annual average of 240,000 in 2003, yielding a jobless rate of 7 percent of the dependent labour force (national definition) or 4.2 percent of the total labour force (Eurostat concept). While in 2004 employment may pick up somewhat, unemployment is unlikely to decline, as both the initial steps towards the abolition of early retirement and the expected large inflow of foreign workers will add to labour supply.

The general government account recorded a deficit of € 1.2 billion or 0.6 percent of GDP last year, according to the Ministry of Finance and Statistics Austria. For 2003, no draft Federal budget has yet been submitted. WIFO expects an increase in the overall deficit to about € 2¼ billion or 1.2 percent of GDP, as a result of the cyclical trough in tax revenues, the deferred payments for flood relief, and additional outlays

such as for family subsidies. Also in 2004, adverse cyclical conditions will leave their mark on the budget in the form of revenue shortfalls and high outlays for unemployment benefits. The general government deficit may amount to 1 percent of GDP.

At the time of establishing the present forecast, an unusual degree of uncertainty is affecting the world economy. The sources of such uncertainty are the war in the Middle East and its repercussions on geo-political developments on the one hand, and the protracted decline on international stock markets, on the other.

Major uncertainties facing the global economy

Table 2: World economy

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
<i>Real GDP</i>						
Total OECD	+ 3.2	+ 3.8	+ 0.8	+ 1.3	+ 1.5	+ 2.1
USA	+ 4.1	+ 3.8	+ 0.3	+ 2.4	+ 2.3	+ 2.8
Japan	+ 0.1	+ 2.8	+ 0.4	+ 0.3	+ 0.8	+ 1.3
EU	+ 2.8	+ 3.5	+ 1.5	+ 0.9	+ 1.2	+ 1.8
Euro area	+ 2.8	+ 3.5	+ 1.4	+ 0.8	+ 1.1	+ 1.8
Germany	+ 2.0	+ 2.9	+ 0.6	+ 0.2	+ 0.5	+ 1.5
Central and Eastern Europe ¹	+ 3.2	+ 3.9	+ 2.3	+ 1.5	+ 2.5	+ 3.3
<i>World trade, volume</i>	+ 6.0	+12.7	± 0.0	+ 2.5	+ 5.5	+ 6.3
OECD exports	+ 5.7	+12.0	- 0.4	+ 1.0	+ 4.8	+ 6.0
Intra-OECD trade	+ 7.8	+11.4	- 0.9	± 0.0	+ 3.5	+ 5.5
Market growth ²	+ 7.4	+12.8	+ 2.2	+ 1.0	+ 4.3	+ 6.5
<i>Primary commodity prices, in USD</i>						
HWWA index, total	+12.0	+32.0	-11.0	+ 1.0	+13.0	-15.0
Excluding energy	- 8.0	+ 1.0	- 7.0	± 0.0	+ 5.0	- 3.0
<i>Crude oil prices</i>						
Average import price (cif) for OECD countries						
USD per barrel	17.3	28.0	23.5	24.5	29.0	23.0
<i>Exchange rate</i>						
USD per euro	1.067	0.924	0.896	0.945	1.08	1.08

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

The Iraq crisis has been weighing on the world economy over the last weeks and months:

- The weakening of confidence of financial investors, consumers and business led to a postponement of spending on durable consumer goods and corporate investment projects.
- At the same time, oil prices rose markedly, to a level of \$ 34 per barrel by mid-March, before subsiding noticeably once the war had started. The worsening of the terms-of-trade implies real income losses for the industrialised countries, dampening overall demand.
- A further adverse effect resulted from the appreciation of the euro. In early March, the European currency stood at \$ 1.10, some 16½ percent above the annual average for 2002. The upward drift is determined by two basic factors, namely the short-term interest rate differential between the USA and Europe, and the growing US current account deficit reaching 5 percent of GDP last year. Forces working into the opposite direction are the persistent growth advantage and the high budget deficit in the USA, potentially leading to an inflow of foreign capital. The exchange rate is, however, also influenced by geo-political developments. The appreciation of the euro, while dampening the rise in commodity prices in Europe, is weakening price competitiveness of European exports on world markets.

The length of the Iraq war, the question whether geo-political instability will end with the war, and the extent of the implicit obstacles to global economic growth are all uncertain to date. WIFO is therefore basing its projections upon technical assump-

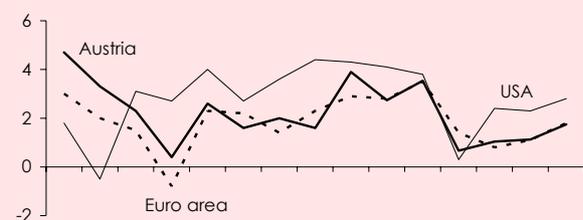
The Iraq crisis has been weighing heavily on the world economy, even before the outbreak of war. Prices of raw materials have jumped and exchange rates shifted markedly, while stock market values have continued their long decline.

tions as far as key parameters of international economic developments are concerned. They retain the scenario of a "short Iraq war", assuming the world market price of oil averaging \$ 29 per barrel in 2003 and abating to \$ 23 per barrel next year, i.e., within the OPEC target price band. For the euro exchange rate, a value of \$ 1.08 has been assumed.

Figure 1: Indicators of economic performance

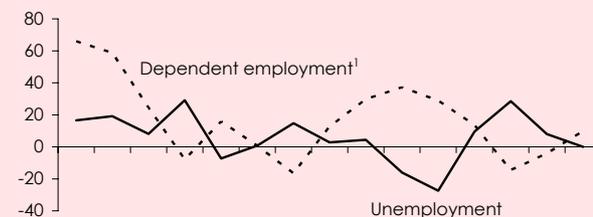
Growth of real GDP

In percent



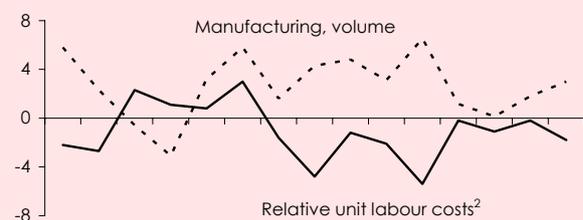
Employment and unemployment

1,000s from previous year



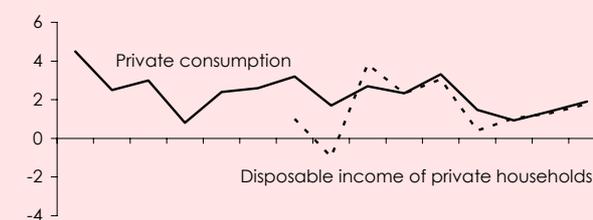
Competitiveness and manufacturing output

Percentage changes from previous year



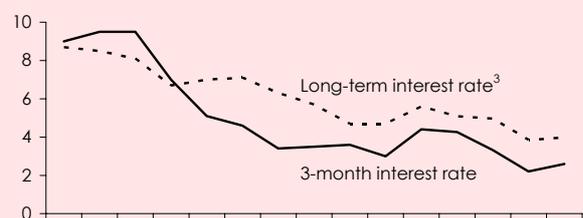
Consumption and income (constant prices)

Percentage changes from previous year



Short-term and long-term interest rates

In percent



Inflation and unit labour costs

Percentage changes from previous year



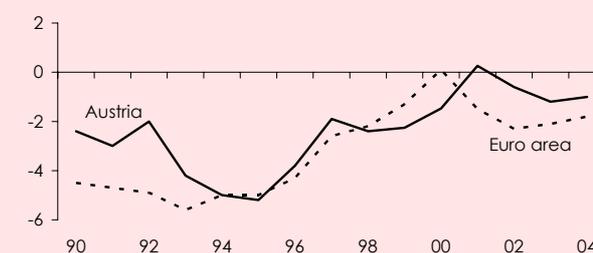
Exports and investment (constant prices)

Percentage changes from previous year



General government financial balance

As a percentage of GDP



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

Apart from the Iraq crisis, the protracted losses on international stock markets over the last years have been weighing on the global economy. Since the outbreak of the war, prices have tentatively stabilised. Nevertheless, the S&P Composite 500 index has dropped by one-half since September 2000. In the UK, where the stock market fall had started later, the slump was particularly severe. The German DAX is down by two-thirds from its peak. What is remarkable with stock market developments is not only the size of the fall, but also the duration of the decline. The reper-

cussions are manifold: banks and insurance companies, as major holders of financial assets, are particularly affected and many of them have seen their own shares falling over-proportionally; pension funds have to cut down on their disbursements, which in the Anglo-Saxon countries has more severe consequences on the disposable income of private households than in continental Europe; firms and private households, holding shares themselves, may be induced by the losses in their financial wealth to hold back with investment and consumer spending.

In the USA and the UK, a shift of funds from stocks to real estate markets has been observed, leading to speculative over-valuation of the latter. Latest data suggest that the real estate boom in the USA has passed its peak. Of considerable concern is the under-capitalisation of the two major mortgage re-financing institutions. A burst of the real estate bubble could have dangerous repercussions for the economy at large, in particular for consumers' willingness to spend, but also on equity markets.

The business cycle upturn in the USA that had started in the fourth quarter 2001 lost momentum in autumn 2002, under the impact of sluggish foreign demand, but also of weakening private sentiment as a consequence of the marked decline on stock markets and the preparations for war in Iraq. Industrial production fell markedly in autumn, partly due to slackening demand for durable consumer goods such as motor cars. Employment is receding, with unemployment rising to a seasonally adjusted rate of 5.8 percent of the labour force in February. Higher energy costs are also squeezing disposable incomes to an increasing extent. The last few months saw a slump in consumer confidence, with private consumption driving GDP growth less than during the past years.

Some positive signs and factors can nevertheless be noted: investment in machinery, electronic equipment and software has staged a turnaround since the second quarter 2002, exceeding the year-earlier level by 3½ percent in the fourth quarter. The low level of short-term interest rates, which in real terms are clearly negative, eases the burden of private households in servicing their mortgage debt. Fiscal policy is markedly expansionary, with the general government balance swinging from a surplus of 1½ percent of GDP in 2000 to a deficit in the order of 4 to 5 percent in 2003, due to large-scale tax cuts as well as to higher public spending. Additional military expenditure by itself amounts to \$ 100 billion or 1 percent of GDP vis-à-vis 2001, to which should be added the cost of the Iraq war that is estimated still higher. Growth of GDP attained 2.4 percent last year which, while significantly exceeding the rate of the EU, was nevertheless moderate when considering the expansionary stance of monetary and fiscal policy. A rate of growth in the same order of magnitude is projected for the current year.

In the euro area, any impulse for a cyclical upturn is lacking. In 2002, the economy grew by only 0.8 percent, the lowest rate since 1993. In the fourth quarter, GDP rose by 1.3 percent year-on-year, corresponding to a meagre 0.2 percent from the previous period, on a seasonally adjusted basis. The quarterly projections by the European Commission and the "eurogrowth" indicator point to an expansion of only around 1 percent from the year-earlier level for the first semester. Seasonally adjusted GDP may continue to stagnate on a quarter-to-quarter basis. On annual average 2003, growth is projected to remain close to 1 percent. The quasi-stagnation is leading to a marked increase in unemployment and to higher budget deficits. The seasonally adjusted rate of unemployment rose to 8.6 percent of the labour force in January, ½ percentage point above the level a year ago. Germany, France, Italy and Portugal are expected to register budget deficits above the ceiling of 3 percent of GDP in 2003, due to the cyclical sluggishness of tax revenues coupled with rising outlays for unemployment compensation. If budgetary policy were to try and compensate these deficits by raising revenues or cutting expenditure, overall demand would be squeezed further, with the danger of the economies sliding into recession. The intention of the European Commission is thus welcome to consider the

Fragile private sector sentiment, but expansionary policy stimulus in the USA

Already before the Iraq war, stock market losses have been weighing on consumer confidence in the USA. Monetary and fiscal policy are following a decidedly expansionary course. The economy should keep growing faster in 2003 and 2004 than in the EU. A burst of the speculative real estate bubble constitutes a major risk for the short-term outlook.

No economic recovery in prospect in Europe

"exceptional circumstances" of the Iraq war, when judging the budgetary position of certain member states. The European Central Bank is holding back with substantial interest rate cuts, leaving short-term nominal and real interest rates markedly higher than in the USA.

The surveys conducted by the Commission confirm the weakening of the business climate also in Europe. Industrial confidence has deteriorated moderately so far, with low capacity utilisation leading to a further decline in investment in the fourth quarter 2002. Consumer sentiment has dropped considerably in recent months, as unfavourable employment prospects, further expenditure restraint of public authorities, the stock market fall and geo-political risks have taken their toll. The only substantial positive contribution to growth in Europe came from foreign trade last year. However, export growth levelled off in the fourth quarter (from the previous period), the marked appreciation of the euro increasingly holding back the only driving force remaining.

At present, the European economy is lacking stimulus. A revival may set in, once the Iraq crisis has been overcome, enabling the removal of uncertainty and a fall in commodity prices. However, the beginning and strength of the upswing still remain vague. A possible recovery in Europe will be constrained by the appreciation of the euro vis-à-vis the dollar and the restrictive stance of fiscal policy. The countries of the euro area have agreed to achieve balanced budgets by 2006. The present stagnation is acting as a substantial drag on public finances, driving deficits above target levels. The stability programmes of autumn 2002 reflect the intention of the euro area countries to counter the cyclically-induced increase in deficits by reinforced consolidation efforts in the short term. Such efforts, taking effect in the early stages of a recovery in 2004, could seriously dampen the strength of the upturn.

The German economy continues to lag behind the overall EU trend. 2003 could well be the third year of stagnation in a row. The weakness of demand is concentrated in three areas: first, the fall in construction investment by an estimated 14 percent from 2000 to 2003; second, the spending restraint of private households, leading to the first decline in real consumption in twenty years, the accompanying rise in the savings ratio being particularly worrying in the present conjuncture; third, the squeeze in public investment, particularly of the local communities struck by severe financing problems. The lack of dynamism of the German economy is due to deficient domestic demand, while the continued increase in exports has effectively helped to avert a recession over the last three years. As prospects for public investment and for private households' disposable income remain poor, the business cycle outlook for Germany continues to be clouded. The relatively favourable trend of unit labour costs and thus of price competitiveness cannot offset the persistent weakness of internal demand.

Real GDP in Austria rose by 1 percent in 2002. While activity was lively in the first semester (seasonally adjusted, compared with the previous period), it slackened markedly in the second half of the year. The rise in merchandise exports decelerated, manufacturing output rose barely, and investment in machinery and equipment failed to rebound from the earlier slump. Retail sales remained flat. Only construction activity provided some relief. Overall GDP growth was sustained by a marked decline in imports that reflected the weakness of domestic demand. Without the positive growth contribution from the external sector, the economy would have contracted both in 2001 and 2002.

The WIFO business surveys among domestic firms do not point to an imminent recovery. Firms judge current production as subdued, having revised their earlier, more optimistic, expectations downwards, and are postponing the implementation of investment plans due to the unstable outlook. A cyclical upturn would have to be set in motion by additional stimulus from exports, extending to investment in machinery and equipment. This is unlikely to occur still this year. As a result, GDP growth is set to remain around 1 percent for the third consecutive year, thereby deviating markedly from a "normal" cycle.

In Europe, the current economic situation is characterised by sluggish private household expenditure and business investment. Export growth, still lively in 2002, is being undermined by the strength of the euro. Unemployment is rising and the budgetary deficit is widening markedly as a consequence of the subdued business activity. Economic policy is making little effort to actively stimulate growth.

Stagnation of GDP, high cyclical risks

The Austrian economy is projected to expand by only 1.1 percent this year. Uncertainties for 2004 are high, from today's perspective. The present growth forecast of 1.7 percent is based upon a cautiously optimistic scenario.

Uncertainty is particularly large as regards the medium-term outlook. A cyclical up-swing may get under way, if the crisis in the Middle East is brought to an early end, commodity prices abate, international financial markets stabilise, and economic policy refrains from following a restrictive course. However, in the event of the international conflicts heating up, a recession in Europe cannot be ruled out. The present projections, based upon a benign scenario, foresee a pick-up in GDP growth to 1.7 percent, a rate that, however, clearly remains below the long-term average of 2¼ percent.

Last year, the major stimulus to economic growth came from exports, with deliveries of goods rising by 5½ percent in volume from 2001. While exports to EU markets edged up only slightly, firms posted solid gains in south-eastern and eastern Europe and in Asia, partly implying hefty increases in market shares. The momentum of exports is being slowed by continued anaemic activity in key foreign markets and, even more, the real-effective appreciation of the euro. Merchandise exports are expected to expand by 4 percent or slightly more this year, demand strength coming mainly from eastern Europe where the economies continue growing at twice the EU rate. Exports to the EU will once more be held back by below-average demand growth in Germany and Italy, the two major trading partners. The real-effective appreciation of the euro (by a projected 1¾ percent this year) is weighing on exports directly – through the reduced price competitiveness on world markets – and indirectly, via fewer export opportunities of those companies that are suppliers to the German export industry.

Merchandise imports dropped by nearly 1 percent in 2002, reflecting feeble domestic demand, in particular the slump in equipment investment, whose import content is relatively high. In the current year, imports should pick up again, with equipment investment no longer falling. The expected increase is distinctly higher in nominal than in real terms (6½ percent versus 4½ percent). The rise in import prices is largely determined by the cost of internationally traded raw materials. The terms of trade are likely to deteriorate by some ¾ percentage point this year. In 2004, they should swing back in Austria's favour by the same amount, due to the strength of the euro and the expected decline in oil prices.

The current account should exhibit a deficit in the order of € 2 billion, both in 2003 and 2004. While the incomes and transfer balances may weaken, the surplus on tourism services should rise. The heightened geo-political tensions exert a discouraging effect on overseas travel. German holidaymakers will turn to destinations accessible by car or train, and Austrian customers should feel confirmed in their revealed shift in preferences towards the domestic market.

Investment in machinery and equipment fell sharply, by an aggregate 13 percent, from 2000 to 2002. The uncertain economic outlook and the low capacity utilisation are being mirrored by the regular WIFO investment survey: industrial firms continue holding back with investment spending this year, with the exception of major projects being implemented by the motor car industry. While weak overall demand offers little incentive for enhancing productive capacity, replacement of obsolete physical capital may gain importance. Some projects are likely to be carried forward into the final quarter of 2003, before the 10 percent investment premium expires that had been introduced as part of the 2002 cyclical stimulus programme. Taking into account such effects, machinery and equipment investment is projected to go up by 3 percent this year. Although interest rate cuts and tax reliefs may improve the overall business climate, a pick-up in investment can only be expected once demand rebounds strongly and industrial confidence returns.

Firms in manufacturing do not anticipate a strengthening of output growth, according to the WIFO business survey. Net output is expected to gain 1.8 percent this year. With a recovery abroad, output growth should attain 3 percent in 2004. At the same time, employment in manufacturing should continue to decline, by 1.9 percent and

Exports remaining the driving force

Without the positive growth contribution from foreign trade, the Austrian economy would have contracted in 2001 and 2002. The less encouraging assumptions for the world economy and the strength of the euro are now dampening the prospects for export growth. Still, exporting firms continue to benefit from lively demand from eastern and south-eastern Europe, as well as from the favourable trend in unit labour costs.

Recovery of investment and industrial production delayed

1 percent in 2003 and 2004, respectively, with firms also likely to resort heavily to short-time work.

Table 3: Productivity

	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 2.7	+ 3.5	+ 0.7	+ 1.0	+ 1.1	+ 1.7
Employment ¹	+ 1.4	+ 0.8	+ 0.7	- 0.4	+ 0.1	+ 0.4
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	+ 1.4	+ 1.0	+ 1.4
Full-time equivalent	+ 1.5	+ 2.6	+ 0.2	+ 1.6	+ 1.3	+ 1.5
<i>Manufacturing</i>						
Production ²	+ 3.1	+ 6.5	+ 1.2	+ 0.1	+ 1.8	+ 3.0
Employees ³	- 0.7	+ 0.0	+ 0.2	- 2.5	- 1.9	- 1.0
Productivity per hour	+ 4.5	+ 6.6	+ 1.4	+ 3.6	+ 4.0	+ 4.1
Working hours per day per employee ⁴	- 0.6	- 0.1	- 0.4	- 0.9	- 0.2	- 0.1

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.

Differences in demand for construction explain a non-negligible part of the overall growth differential among the industrialised countries. Thus, a substantial part of Germany's sluggish growth over the last years was due to the steep fall in construction investment.

In Austria, the crisis in the construction sector was considerably less severe. Real construction investment barely rose between 1997 and 2002 (+0.8 percent), but more than 26,000 jobs were lost over the same period. Last year, construction output remained flat. Recent data suggest a cautious recovery, particularly due to strengthening activity in civil engineering. The much-needed improvement of physical infrastructure is gaining momentum. In the building sector, however, activity remains weak, given the excess capacity of office space and lacking demand for new homes. The bottoming-out of real estate prices and a few other signs for a pick-up in demand warrant the assumption of a rising trend for the years to come. In all, construction output is expected to grow by 1¼ percent this year and 1½ percent in 2004, closely in line with overall GDP.

Employees' per-capita income, net of taxes and adjusted for inflation, will shrink for the third year in a row in 2003, by ½ percent. On a full-time-work basis, the decline should be somewhat smaller. Reasons for the real income losses are the moderate wage settlements, rising taxes and social charges, and price rises exceeding expectations. While wages and salaries in the private sector will rise more slowly in 2003 than last year, the upward drift of public sector earnings will accelerate, partly due to an ex-post adjustment for higher costs of living. Real net income from employment and social transfers will remain at the low level of 2001. Real disposable income, which also includes revenues from property and entrepreneurial activity, will develop somewhat better.

The small income gains will allow only a modest increase in private consumption, following the rise by 0.9 percent in real terms in 2002. Some expenditure, notably for durable consumer goods (-0.2 percent), has been deferred in the face of uncertain expectations. In 2003, private household demand is set to increase by almost 1½ percent from last year, implying a constant savings ratio of 7½ percent of disposable income. Retail sales will continue to increase slowly, albeit somewhat more than last year. Spending on durable consumer goods may rise slightly above average, reflecting the recovery of motor car sales. Wholesale trade is expected to stay lively, continuing last year's performance. These trends might become stronger in the year 2004. With somewhat higher income gains, private demand should strengthen in 2004, to a rate of increase close to 2 percent.

Tentative improvement in the construction sector

Consumption and trade suffering from narrow income gains

Net incomes from employment and social transfers, adjusted for inflation, are set to remain at the low level of 2001 in the current year. This narrows the scope for any increase in consumer spending and retail sales. The savings ratio remains at its low level.

Table 4: 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	+1.4	+1.9
Durables	+7.3	+3.8	+2.0	-0.2	+1.8	+3.1
Non-durables and services	+1.6	+3.2	+1.4	+1.1	+1.3	+1.7
Household disposable income	+2.3	+3.1	+0.4	+1.0	+1.3	+1.8
Household saving ratio						
As a percentage of disposable income	8.5	8.3	7.4	7.5	7.5	7.7
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+5.2	+6.7	+3.5	+2.8	+2.4	+2.5
	In percent					
Inflation rate						
National	0.6	2.3	2.7	1.8	1.9	1.4
Harmonised	0.5	2.0	2.3	1.7	2.0	1.5
Core inflation ²	0.7	0.9	2.3	2.0	2.2	1.7

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

The upward drift of consumer prices remains modest. Nevertheless, the inflation forecast for 2003 is raised slightly to 1.9 percent. The smaller part of this correction is due to the increase in oil prices, which is mitigated by the appreciation of the euro. On annual average, energy prices are projected to go up by just 2 percent from last year. More substantial is the increase in housing-related costs, with rents rising 5 percent above the year-earlier level. The price increase for manufactures is accelerating (+1.5 percent), whereas seasonal goods prices are returning to more normal levels following last year's hikes. Food prices are broadly stable overall. In 2004, inflation is projected to abate to a rate of 1½ percent, under the impact of barely rising unit labour costs and lower import prices.

Inflation edging up

The rise in consumer prices remains below 2 percent. Upward pressure is exerted by energy costs as well as services prices. Stable unit labour costs and declining import prices will dampen inflation next year.

Table 5: 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	+2.4
Full-time equivalent	+2.2	+2.7	+1.7	+2.6	+2.3	+2.7
Gross real earnings per employee ¹	+1.0	+0.9	-0.6	+0.3	+0.1	+1.0
Net real earnings per employee ¹	+0.5	+1.5	-1.0	-0.5	-0.4	+0.4
Net wages and salaries	+3.7	+4.5	+1.9	+1.9	+2.1	+2.1
Total economy						
Unit labour costs	+0.4	-0.5	+1.4	+0.7	+1.0	+1.0
Manufacturing						
Unit labour costs	-1.2	-4.5	+1.8	-0.2	-1.2	-1.1
Relative unit labour costs ²						
Vis-à-vis trading partners	-2.1	-5.4	-0.2	-1.1	-0.2	-1.8
Vis-à-vis Germany	-0.8	-1.8	+0.3	-1.2	-1.3	-1.7
Effective exchange rate – manufactures						
Nominal	+0.6	-2.7	+0.9	+1.3	2.0	+0.3
Real	-1.3	-3.4	+0.3	+0.8	+1.8	+0.2

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

The cyclical weakness has significantly deteriorated the labour market situation in the last two years. In 2002, the number of jobs fell by 15,000 from the previous year. With output in manufacturing and construction almost stagnating, employment fell markedly in both sectors, by 15,000 and 7,000, respectively. For the first time since 1996, jobs were also lost in the trade sector (-3,000). In the public sector, the cut in personnel by 5,000 was mainly accommodated via retirements. Additional jobs were created in the health sector and in commercial services, often with personnel ex-

No turnaround on the labour market

change agencies on a part-time basis. The number of mini-jobs (not registered by the employment statistics of the social security board, but included in the National Accounts) increased strongly once again. The rise in unemployment went beyond the purely cyclical effect, as labour supply increased again, as in 2001, due to a higher number of foreign workers as well as the rise in the statutory early retirement age. Female labour supply was contained, however, by the extension of the entitlement period for maternity and child-care benefits. On annual average 2002, registered unemployment went up by 28,500 from the previous year, yielding jobless rates of 6.9 percent of the dependent labour force or 4.1 percent of the total labour force (Eurostat definition).

Table 6: Labour market

	1999	2000	2001	2002	2003	2004
Changes from previous year (1,000s)						
<i>Demand for labour</i>						
Civilian employment ¹	+38.2	+30.8	+15.1	-11.2	-1.2	+11.5
Dependent employment ^{1 2}	+37.2	+28.9	+13.6	-14.6	-4.0	+10.0
Percentage changes from previous year	+1.2	+1.0	+0.4	-0.5	-0.1	+0.3
Foreign workers	+7.8	+13.4	+9.5	+5.1	5.0	+6.0
Self-employed ³	+1.0	+1.9	+1.5	+3.4	+2.8	+1.5
<i>Labour supply</i>						
Economically active population						
aged 15 to 64	+19.8	+25.2	+28.1	+22.9	+19.1	+1.0
aged 15 to 59	-2.6	-17.5	-14.2	-5.5	+3.1	+3.0
Total labour force ¹	+22.2	+3.4	+24.7	+17.3	+6.8	+11.5
<i>Surplus of labour</i>						
Registered unemployed ⁴	-16.1	-27.4	+9.6	+28.0	+8.0	± 0.0
In 1,000	221.7	194.3	203.9	232.4	240.4	240.4
In percent						
<i>Unemployment rate</i>						
Percent of total labour force ⁵	3.9	3.7	3.6	4.1	4.2	4.2
Percent of total labour force ⁴	6.0	5.3	5.5	6.2	6.3	6.3
Percent of dependent labour force	6.7	5.8	6.1	6.9	7.0	7.0
Participation rate ^{1 6}	66.3	66.1	66.2	66.2	66.1	66.3
Employment rate ^{1 7}	62.3	62.5	62.5	62.0	61.8	62.0

¹ Excluding parental leave and military service. – ² According to Federation of Austrian Social Security Institutions. – ³ According to WIFO. – ⁴ According to Labour Market Service. – ⁵ According to Eurostat. – ⁶ Total labour force as a percentage of the economically active population (aged 15 to 64 years). – ⁷ Employment as a percentage of the economically active population (aged 15 to 64 years).

The same tendencies will prevail in 2003. The number of actively employed will again fall below the year-earlier level, by a projected 4,000. Labour supply no longer exhibits a pro-cyclical pattern as it did in past periods of cyclical weakness, but is boosted by several economic and social policy measures. Unemployment is set to go up by 8,000 to an average level of 240,000, corresponding to unemployment rates of 7.0 percent on the traditional national calculation method, or 4.2 percent according to Eurostat.

Next year, employment incentives from higher GDP growth will still be limited, the number of jobs being expected to edge up by 0.3 percent. At the same time, the minimum age for early retirement will be raised in a further stage, boosting labour supply by 5,000 on annual average. On these terms, the rate of unemployment should remain unchanged. However, the rate is highly sensitive to a further increase in labour supply and to cyclical developments. The projections make no allowance for a possible conversion of unemployment assistance benefits into a new form of social assistance or for the introduction of a "transitional benefit" (between labour force participation and retirement). Such measures would significantly reduce benefit levels for the long-term unemployed, but may also lower the registered jobless figure.

The strong rise in unemployment is set to continue, due to persistently weak economic growth and an unusually strong increase in labour supply (restrictions on early retirement, substantial inflow of foreign workers). The number of job-seekers in 2003 will exceed the level of the year 2000 by 46,000.

Government finances are highly sensitive to the business cycle, particularly on the revenue side and with regard to unemployment insurance. The present period of cyclical weakness is therefore weighing on the budgetary balance. For 2002, the Ministry of Finance notified to Eurostat a general government deficit of 0.6 percent of GDP, which is lower than the deficit projected by WIFO in December 2002 (-1.5 percent). The better-than-expected outcome is to a large part explained by significantly lower outlays for flood relief and reconstruction (around € 150 million in net terms, instead of € 1 billion). The shortfall in tax revenue of € 1.8 billion, rather than € 2.1 billion, was also somewhat lower than anticipated. Moreover, some statistical effects improved the budget balance, e.g., the re-classification of interest payments and tax revenues over time, as well as budgetary results exceeding projections for the social security funds, the Länder and municipalities, for which detailed data are not yet available.

Budget balance reflecting the cyclical weakness

Table 7: Key policy indicators

	1999	2000	2001	2002	2003	2004
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	-2.3	-1.5	+0.3	-0.6	-1.2	-1.0
According to National Accounts	-2.4	-1.6	+0.0	-0.8	-1.3	-1.1
General government primary balance	+1.4	+2.2	+3.8	+2.8	+2.2	+2.2
	In percent					
<i>Monetary policy</i>						
3-month interest rate	3.0	4.4	4.3	3.3	2.2	2.6
Long-term interest rate ¹	4.7	5.6	5.1	5.0	3.9	4.0
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+1.5	-2.5	+1.0	+1.4	+2.2	+0.4
Real	-1.1	-3.5	+0.1	+0.6	+1.8	+0.2

¹ 10-year central government bonds (benchmark).

The sluggishness of demand and output is weighing on government households via shortfalls in tax revenues and high costs of unemployment compensation. The general government deficit is set to rise slightly above 1 percent of GDP. The ratio of government revenues to GDP will moderate to 44 percent by 2004.

For 2003, a federal budget draft has not yet been submitted. From the perspective of the cyclical framework conditions, a general government deficit of € 2¼ billion or 1.2 percent of GDP should be expected. The increase from last year is caused by the sluggish performance of direct tax revenues and the high budgetary cost of unemployment. Some other expenditure items post strong increases, such as family subsidies. The projections assume that in 2004 the first part of a comprehensive tax reform will enter into force, comprising cuts in personal income taxes and in social charges, as well as in the tax on retained corporate earnings. The lower tax burden will be partly offset by increases in energy taxes and health insurance contributions. The general government deficit for 2004 is projected at 1 percent of GDP. Because of sizeable shortfalls, the public revenue ratio has declined markedly already in 2002. In 2003 and 2004, it will hover around 44 percent of GDP.