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Sluggish Recovery in 2003

Economic Outlook for 2003 and 2004

The Austrian economy grew by slightly less than 1 percent in 2002. For 2003, only a gradual recovery of activity should be expected, given the subdued business climate world-wide. GDP growth for Austria, as well as for the euro area, is projected at 1¾ percent, below the medium-term trend. Expectations of firms and consumers are brightening up only slowly, as risks on international financial, real estate and energy markets remain high. The weak momentum of the recovery will prevent both unemployment and the budget deficit from falling in 2003.

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Since last summer, economic prospects for Europe have turned gloomier. Unlike in the USA, the economy has still not overcome the cyclical low. Business and consumer confidence is particularly low in Germany, with adverse consequences not only for the Austrian export and tourism industries, but also for the investment climate. The projection for GDP growth in 2003 has therefore been taken down by ½ percentage point, both for Austria and the euro area as a whole.

In the first nine months of 2002, demand and output in Austria rose by 0.8 percent from last year. While the trend was still positive in the first semester, with seasonally-adjusted real GDP gaining some ½ percent from quarter to quarter, business sentiment weakened as from last summer, reflecting the stock market fall and doubts about the robustness of global business conditions. Output losses caused by the summer flood damages had a further, if temporary, dampening effect on confidence.

Firms' readiness to invest hit a low in 2002. Spending on machinery and equipment dropped by over 10 percent from a year earlier, much more sharply than on average for the EU. Private consumption, however, continued to hold up better than, say, in Germany. Households spent by almost 1 percent more in real terms than in 2001, though cutting substantially on investment-like items such as motor cars and housing. Exports and tourism also proved fairly resilient to the cyclical sluggishness abroad. On markets outside Europe, exporting firms managed to gain market shares.

GDP growth in 2002, at nearly 1 percent, was close to the figure WIFO had projected as early as December 2001 (1.2 percent). However, in the second half of 2002 signs of a stronger pace have largely been absent, such that growth in 2003 is unlikely to exceed 1.7 percent. The WIFO projection is thus virtually identical with that of the Austrian National Bank, the OECD and the European Commission. The underlying scenario implies that activity will pick up markedly as from next summer at the latest. It is underpinned by a tentative consolidation on stock markets in the fourth quarter 2002 and the expectation that the need for replacement will put an end to the restraint on spending on investment and durable consumer goods. The recent interest rate cut by the ECB should further contribute to an alleviation of debt burdens and an improvement in private sector confidence. However, fiscal retrenchment in some of the larger EU countries may exert a dampening influence in 2003, providing a major risk in a period of cyclical fragility. The extent of uncertainty is underlined by

the fact that all positive elements cited (catching-up on investment, low interest rates, etc.) would have been in place for an upturn already in 2002. A crucial factor for the timing and strength of such an upturn is confidence in the business outlook – confidence that has been undermined by the decline in share prices now lasting for two years¹.

Table 1: Main results

		1999	2000	2001	2002	2003	2004	
		Percentage changes from previous year						
GDP								
Volume		+2.7	+ 3.5	+0.7	+ 0.9	+1.7	+2.3	
Value		+3.4	+ 5.0	+2.3	+ 1.9	+3.0	+3.7	
Manufacturing ¹ , volume		+3.0	+ 6.5	+1.3	+ 0.5	+2.5	+3.5	
Private consumption expenditure, volume		+2.3	+ 3.3	+1.5	+ 0.9	+1.7	+2.2	
Gross fixed investment, volume								
Machinery and equipment ²		+2.1	+ 5.9	-2.2	- 4.6	+2.9	+3.5	
Construction		+4.9	+11.8	-2.9	-10.0	+5.0	+6.0	
		+0.0	+ 1.2	-1.5	± 0.0	+1.2	+1.5	
Exports of goods³								
Volume		+7.7	+13.1	+7.5	+ 2.5	+5.5	+8.5	
Value		+7.0	+15.6	+6.5	+ 2.5	+6.6	+9.6	
Imports of goods³								
Volume		+6.9	+10.9	+5.7	- 3.5	+5.8	+8.0	
Value		+6.7	+14.7	+5.0	- 3.5	+6.9	+9.1	
Current balance		billion €	-6.33	- 5.36	-4.65	- 0.25	-0.64	-0.95
As a percentage of GDP			-3.2	- 2.6	-2.2	- 0.1	-0.3	-0.4
Long-term interest rate ⁴	in %	4.7	5.6	5.1	5.0	4.5	4.7	
Consumer prices		+0.6	+ 2.3	+2.7	+ 1.8	+1.5	+1.4	
Unemployment rate								
Percent of total labour force ⁵	in %	3.9	3.7	3.6	4.1	4.2	4.0	
Percent of dependent labour force ⁶	in %	6.7	5.8	6.1	6.8	7.0	6.7	
Dependent employment ⁷		+1.2	+ 1.0	+0.4	- 0.5	+0.1	+0.5	
General government financial balance according to Maastricht definition								
As a percentage of GDP			-2.3	- 1.5	+0.2	- 1.5	-1.5	-1.2

¹ Value added, including mining and quarrying. – ² Including other products. – ³ According to Statistics Austria. – ⁴ 10-year central government bonds (benchmark). – ⁵ According to Eurostat. – ⁶ According to Labour Market Service. – ⁷ Excluding parental leave and military service.

The cyclical weakness and tax payments carried forward into 2001 have led to a shortfall in public revenues of around € 2 billion. Mainly for this reason, the general government account exhibited a deficit of some 1½ percent of GDP, as estimated by WIFO. A gap of the same order of magnitude is to be expected for 2003, with the positive impact of somewhat stronger growth likely to be offset by additional spending on counter-cyclical measures and repair of last year's flood damages.

The slackening of economic activity led to an unusually strong increase in unemployment in 2001 and 2002. While demand for labour weakened more or less in line with the cyclical profile, labour supply increased considerably. By the second half of 2002, the rise in the labour force and the jobless figure levelled off somewhat. The projected gradual recovery in 2003 should put an end to overall job losses and make for but a small further increase in unemployment.

With activity picking up only gradually in 2003, inflation may still decelerate for some time. In this regard, the rising euro exchange rate will play a major role. Underlying the projections is the assumption of parity to the dollar on average in 2003, corresponding to an appreciation of some 10 percent vis-à-vis 2001. The stronger euro not only holds down prices of imports from the dollar area, but also from euro area

¹ Kramer, H., "Österreichs Wirtschaft – Betrachtungen zur Jahreswende 2002/03", WIFO Lectures, 2002, (89), http://titian.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=1&pubid=23200.

countries as their inflation is also dampened by the exchange rate effect. Roughly 60 percent of Austria's goods imports are from the euro area. The projections make no allowance for a possible jump in oil prices in the event of a war against Iraq.

Given the uncertainties of the short-term outlook, the scenario for 2004 is necessarily vague at this stage. Growth is deemed most likely to be in the range of 2 to 2½ percent for Austria as well as for the euro area. However, an analysis of past projections shows² that projections for the second consecutive year are hardly more accurate than trend extrapolations. However, the December forecast for the following year exhibits a relatively high degree of accuracy – as confirmed also by the WIFO December 2001 forecast.

While the US economy has been on an upward trend for the last 12 months or so, confidence in the strength and robustness of the upturn is missing. The further slump in share prices last summer and autumn may be regarded as reflecting the fact that hopes in the cyclical revival have been frustrated. Although the situation on stock markets has stabilised over the last months, latest data have cast new doubt on the sustainability of the recovery: the purchasing managers index and the labour market data of November were below expectations, and consumer sentiment remains fragile.

Cyclical upturn in the USA still fragile

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	+2.0	+2.5	
USA	+ 4.1	+ 3.8	+ 0.3	+2.3	+2.6	+3.0	
Japan	+ 0.7	+ 2.8	+ 0.3	- 1.0	+1.0	+1.5	
EU	+ 2.8	+ 3.5	+ 1.6	+1.0	+1.8	+2.5	
Euro area	+ 2.8	+ 3.5	+ 1.5	+0.7	+1.8	+2.5	
Germany	+ 2.0	+ 2.9	+ 0.6	+0.3	+1.3	+2.3	
Central and Eastern Europe ¹	+ 3.2	+ 3.9	+ 2.3	+1.5	+2.8	+3.5	
<i>World trade, volume</i>	+ 6.0	+12.7	± 0.0	+2.5	+7.0	+8.5	
OECD exports	+ 5.7	+12.0	- 0.4	+1.0	+6.5	+8.0	
Intra-OECD trade	+ 7.8	+11.4	- 0.9	±0.0	+5.0	+7.0	
Market growth ²	+ 7.4	+12.8	+ 2.2	+1.0	+5.5	+7.5	
<i>Primary commodity prices, in USD</i>							
HWWA index, total	+12.0	+32.0	-11.0	+2.0	+3.0	+2.0	
Excluding energy	- 8.0	+ 1.0	- 7.0	-3.0	+4.0	-2.0	
<i>Crude oil prices</i>							
Average import price (cif) for OECD countries	USD per barrel	17.3	28.0	23.5	24.5	25.0	25.0
<i>Exchange rate</i>							
USD per euro	1.067	0.924	0.896	0.94	1.00	1.00	

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

Nevertheless, the US economy expanded by 2¼ percent in 2002, twice the rate for the EU. In the third quarter, year-on-year growth was more than 3 percent. Notably investment in business equipment is gaining strength, which could lay the foundations for a self-sustained business cycle upturn. For 2003, most forecasters expect GDP growth in the order of 2½ to 3 percent. Risks for a durable upswing derive not only from financial market fragility, but also from the hike in real estate prices that mainly fuel private consumption growth. Since investors have shifted their portfolios from shares towards real estate assets, the bursting of that bubble could seriously undermine confidence and household spending. With rising economic prosperity, gains and losses of private wealth are of increasing importance for the real sector of the economy. A higher level of wealth raises the potential for taking on debt, and

² Baumgartner, J., "Evaluation of Macro-economic Forecasts for Austria in the 1980s and 1990s", Austrian Economic Quarterly, 2002, 7(4), pp. 191-206, http://titan.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=1&pubid=23471.

the ups and downs of stock market values, reported daily by the media, influence private sector sentiment and real economic developments more nowadays than during past economic cycles. They can substantially prolong an upswing as well as a downturn and, indeed, financial market booms or busts and confidence of consumers and investors are proving mutually reinforcing. It is therefore warranted to consider share prices as a short-term leading economic indicator.

Asia is showing increasing economic strength. This holds particularly for China and the Southeast-Asian "tigers", whereas in Japan the recovery is still hesitant and confined to the export sector. South America is still suffering from the repercussions of the Argentina crisis and their unwinding is set to take considerable time.

Developments in the euro area have been disappointing, with real GDP rising by only $\frac{3}{4}$ percent in 2002. Such modest growth, half the rate observed in 2001, has almost entirely been accounted for by a higher foreign contribution: non-EU exports increased, while weak internal investment and consumer demand led to a marked fall in import.

Economic performance of the EU in 2002 was much weaker than that of the USA. The EU economy benefited little from the recovery in the USA and Asia, with notably the rise in exports not spilling over to domestic demand. One should moreover bear in mind that the USA, given the more widespread ownership of stock market assets there, has been much more negatively affected than Europe by the slump in share prices and the uncovering of illegal accounting practices. A major difference between the USA and the EU lies in the conduct of economic policy, with fiscal and monetary policy in the US reacting forcefully to the recession. The budget balance swung from a surplus in 2000 to a deficit of around 3 percent of GDP. Key interest rates have been cut to such an extent that real rates have turned negative. On a critical note, one may point out that thereby policy is now being left virtually without any further room for manoeuvre. In the EU, policy has reacted only half-heartedly to the recession, strictly adhering to its longer-term budgetary and inflation targets, and with the stability criteria not allowing for explicit growth targets. While the EU has more scope for counter-cyclical policy action than the USA, it is making less use of it. The proposal of a reduction in structural budget deficits by $\frac{1}{2}$ percent of GDP per year ought to be welcome as a medium-term strategy; however, in a period of pronounced cyclical weakness such a strategy runs counter to the operation of automatic stabilisers.

The leading business indicator of the European Commission points to a deceleration in the first quarter 2003 of the already weak upward tendency. For the whole year, most forecasters see growth in the euro area only in the range between $1\frac{1}{2}$ and 2 percent. Risks for business activity are deemed emanating from the restrictive stance of budgetary policy in several larger EU countries.

In Germany, real GDP expanded by only $\frac{1}{4}$ percent in 2002, the lowest rate among the EU countries. Main reasons for the poor performance are the financial burden related to reunification, the deep crisis in the construction industry and the backlog of structural reform. The German government currently envisages the introduction of a withholding tax on interest income, as Austria has done ten years ago. Another matter of concern is the crisis in the German banking sector: banks have been compelled to write off an important number of bad loans, and the former high-return business of investment funds and shares has collapsed. The downward adjustment of asset values and a profit squeeze in securities trading led to a sharp fall in the value added of the banking sector in 2002, as in Austria. Insurance companies are also negatively affected by the slide of stock market values, as well as by high claims for compensation following the flood damages.

Economic developments are uneven in the countries of Central and Eastern Europe. Activity in Poland and the Czech Republic is held back by real currency appreciation, whereas in Hungary it remains upward bound. Growth in the area is expected at $2\frac{1}{2}$ to 3 percent for 2003. The prospect of EU enlargement, as decided last December, is reducing investor risks in the accession countries.

Sluggish recovery of the European economy

In December, the European Central Bank (ECB) cut key interest rates by ½ percentage point, reacting to the reduced inflation prospects in the face of disappointingly weak activity in Europe. The lower rates are an important signal, intended to strengthen confidence and stabilise financial markets. Yet, even a string of rate cuts should not give rise to hopes for a quasi-automatic upswing of the business cycle. The lags of demand to lower interest rates are by no means stable over the cycle. When exactly firms and consumers adjust their spending in response to the move by the monetary authorities depends importantly on psychological factors, i.e., confidence in further economic developments. However, the latter is determined also by other factors, such as stock market values, real estate prices or unemployment. Thus, the Euroframe indicator delivered excellent results over two years, before breaking down last year as a forecasting tool for short-term quarterly GDP growth. The indicator over-estimated the annual growth rate by almost 1 percentage point, because of the decline in interest rates that enter its calculation as a major component. Actually, however, domestic demand did not pick up, as consumer confidence even weakened markedly.

Inflation in the euro area is set to abate further this year. The European Commission in its latest forecast projected a rate of 2 percent and a still lower rate for 2004. As business activity will remain very weak until mid-2003, the ECB may cut interest rates further. Long-term interest rates should also continue their downward trend on annual average 2003, largely supported by portfolio re-adjustment from shares towards bonds.

Real GDP in Austria grew by slightly less than 1 percent in 2002. Strength was lacking particularly in the second half, when the upswing did not get underway as expected. Without the positive external contribution, activity would have stagnated last year. Investment in business equipment was particularly disappointing, although the impact on overall economic growth was largely offset by more lively construction activity and a sharp fall in imports.

Cut in interest rates

GDP growth in Austria slow in gathering momentum

Table 3: Productivity

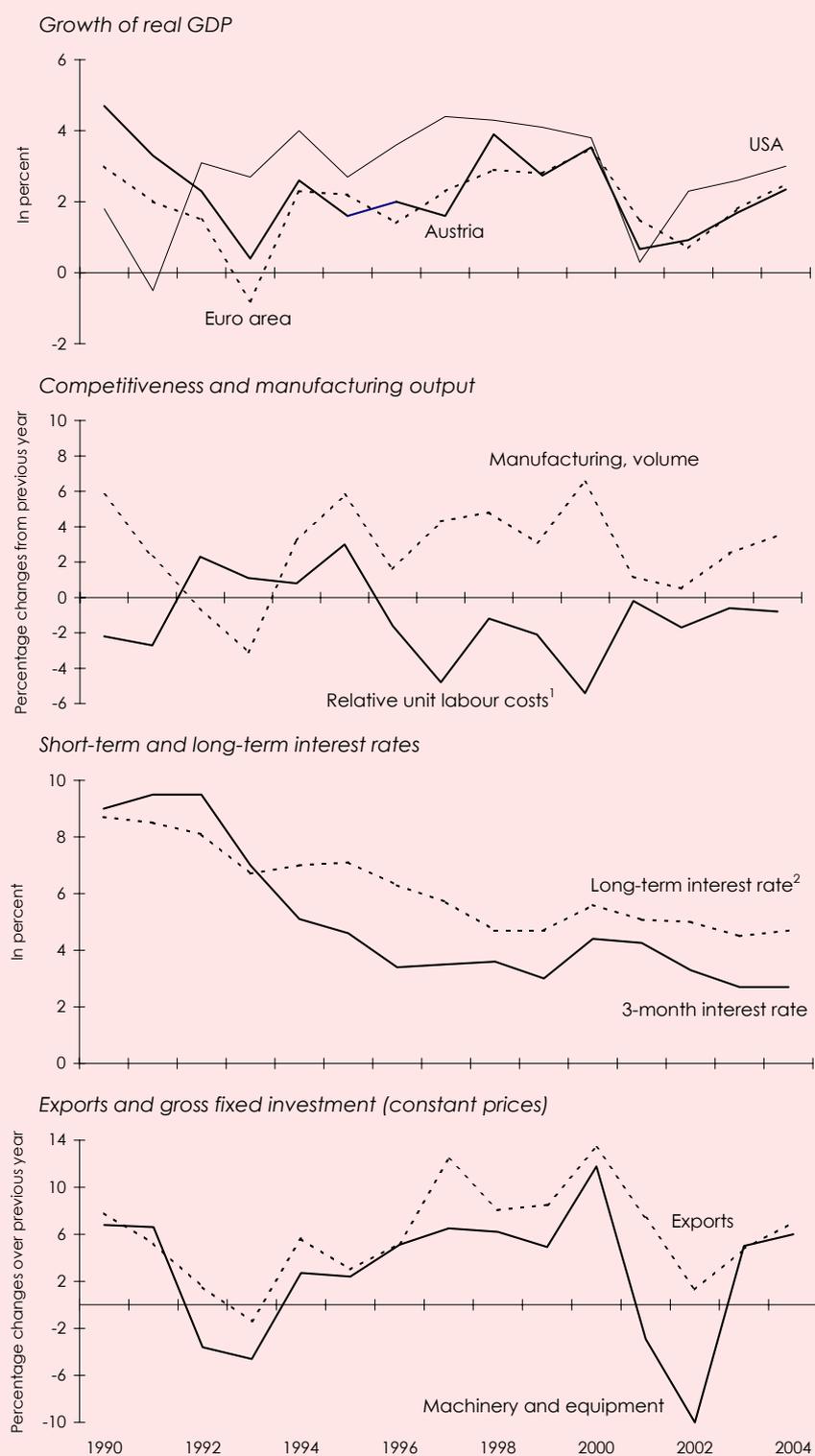
	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+2.7	+3.5	+0.7	+0.9	+1.7	+2.3
Employment ¹	+1.4	+0.8	+0.7	-0.1	+0.3	+0.7
Full-time equivalent	+1.3	+0.9	+0.5	-0.4	+0.1	+0.4
Productivity (GDP per employment)	+1.3	+2.8	+0.0	+1.1	+1.4	+1.7
Full-time equivalent	+1.5	+2.6	+0.2	+1.3	+1.6	+1.9
<i>Manufacturing</i>						
Production ²	+3.1	+6.5	+1.2	+0.5	+2.5	+3.5
Employees ³	-0.7	+0.0	+0.2	-2.5	-1.3	-0.5
Productivity per hour	+4.5	+6.6	+1.4	+4.1	+3.7	+3.5
Working hours per day per employee ⁴	-0.6	-0.1	-0.4	-1.0	+0.1	+0.5

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.

In the first three quarters, real GDP rose by an average 0.8 percent (+0.9 percent in the third quarter). On a seasonally adjusted basis, growth came to a halt in the third quarter after a marked increase in the first semester. This can be explained mainly by the effects of the stock market falls and the flood-induced output losses.

Latest results from the regular WIFO business survey show for the manufacturing sector a slight positive tendency, as far as judgements on the current situation are concerned. Exaggerated expectations for the future have been brought more closely in line with reality.

Figure 1: International context



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

For 2003, growth in Austria is projected at 1.7 percent, marginally below the average for the euro area, due to negative spill-overs from sluggishness in Germany. A clear pick-up in exports is a key requirement for a new investment cycle being set in motion. The increase in GDP would thereby remain below the medium-term trend and

also deviate from the pattern of a "normal" cyclical upswing. Underlying the projection for 2003 is the assumption that as from next summer at the latest the stagnation will be overcome, followed by a marked recovery in business activity. Such a scenario is still surrounded by major risks deriving mainly from the international cyclical profile, financial and real estate markets as well as a possible war against Iraq.

In 2002, Austrian exports proved rather resilient to weak foreign demand. Volume merchandise exports rose by 2½ percent, exceeding market growth by more than 1 percentage point. Austrian exporting firms thus succeeded in gaining foreign market shares. Stronger sales to the USA, Asia and Central and Eastern Europe compensated for the stagnation of exports to the euro area. However, operating in those markets is usually subject to higher risks.

The external sector provided the major contribution to economic growth in 2002. Real merchandise imports fell markedly, due to the slump in demand for investment goods and motor cars. The trade and the current account balances thereby improved substantially, with the current account deficit virtually closing for the first time since 1991.

With the projected revival of global activity in 2003, exports to the EU should gain fresh momentum. Goods exports may thus rise by 5 to 6 percent in volume. The current account is nevertheless likely to weaken, as imports may outpace exports with the resumption of investment spending.

The tourism sector held up well to the international cyclical downturn in 2002. Value added of hotels and restaurants rose by 2 percent in real terms from the previous year. Gains are set to be smaller in 2003, as weak private sector sentiment in Germany is likely to leave its mark on the sector.

Private consumption expenditure, rising by nearly 1 percent in volume in 2002, had a stabilising effect on the business cycle over the last two years. Nevertheless, many households deferred purchases of durable goods or new homes in the light of the uncertain business outlook. In 2003, consumer confidence should strengthen, allowing a catching-up on such spending. Private consumption is therefore expected to go up by 1½ to 2 percent.

Real disposable income of private households should increase at about the same pace in 2003 as real GDP. The savings ratio would thus pick up further from its historical low of 4.6 percent in 2001.

Investment in machinery and equipment has been cut since 2001, and at an accelerated pace in 2002. Declining capacity utilisation and uncertain expectations led to a fall in capital spending by some 10 percent year-on-year in 2002. The marked restraint in purchases of business vehicles is confirmed by the data on new registrations of lorries and trucks. Since investment goods come to a large extent from abroad, the slump in demand has been reflected in a similar fall in imports.

The steep decline in investment, together with rising unemployment, prompted the federal government to adopt a set of counter-cyclical measures. The introduction of an investment premium of 10 percent until end-2003 should provide incentives for the carrying-forward of investment projects. Taking into account such effects, investment in machinery and equipment may expand by roughly 5 percent in 2003. The WIFO investment survey of last autumn suggested for the manufacturing sector a decline in nominal capital spending by 9½ percent for 2002, followed by a rebound of 5½ percent in 2003. Possibly, firms may also postpone some purchases from 2002 to early 2003, in order to obtain a higher investment premium³. However, a genuine turnaround in investment spending will only occur with the expected improvement of business confidence at home and abroad. Lower interest rates and

Current account close to balance

Rising sales of durable consumer goods

Rebound in investment in 2003

³ The investment premium is granted for amounts exceeding the average for the years 2000 to 2002.

tax relieves for investment, while being helpful and necessary, do not always provide incentives strong enough to offset the negative influences from financial and real estate markets.

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	+1.7	+2.2
Durables	+7.3	+3.8	+2.0	-2.0	+2.8	+4.2
Non-durables and services	+1.6	+3.2	+1.4	+1.3	+1.5	+1.9
Household disposable income	+2.1	+1.9	-0.2	+1.2	+1.6	+2.1
Household saving ratio						
As a percentage of disposable income	7.9	6.2	4.6	5.0	5.4	5.7
	Percentage changes from previous year					
Direct lending to domestic non-banks ¹	+5.2	+6.7	+3.5	+2.8	+3.8	+4.0
	In percent					
Inflation rate						
National	0.6	2.3	2.7	1.8	1.5	1.4
Harmonised	0.5	2.0	2.3	1.8	1.6	1.5
Core inflation ²	0.6	0.9	2.2	2.1	1.9	1.6

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

Table 5: Earnings and international competitiveness

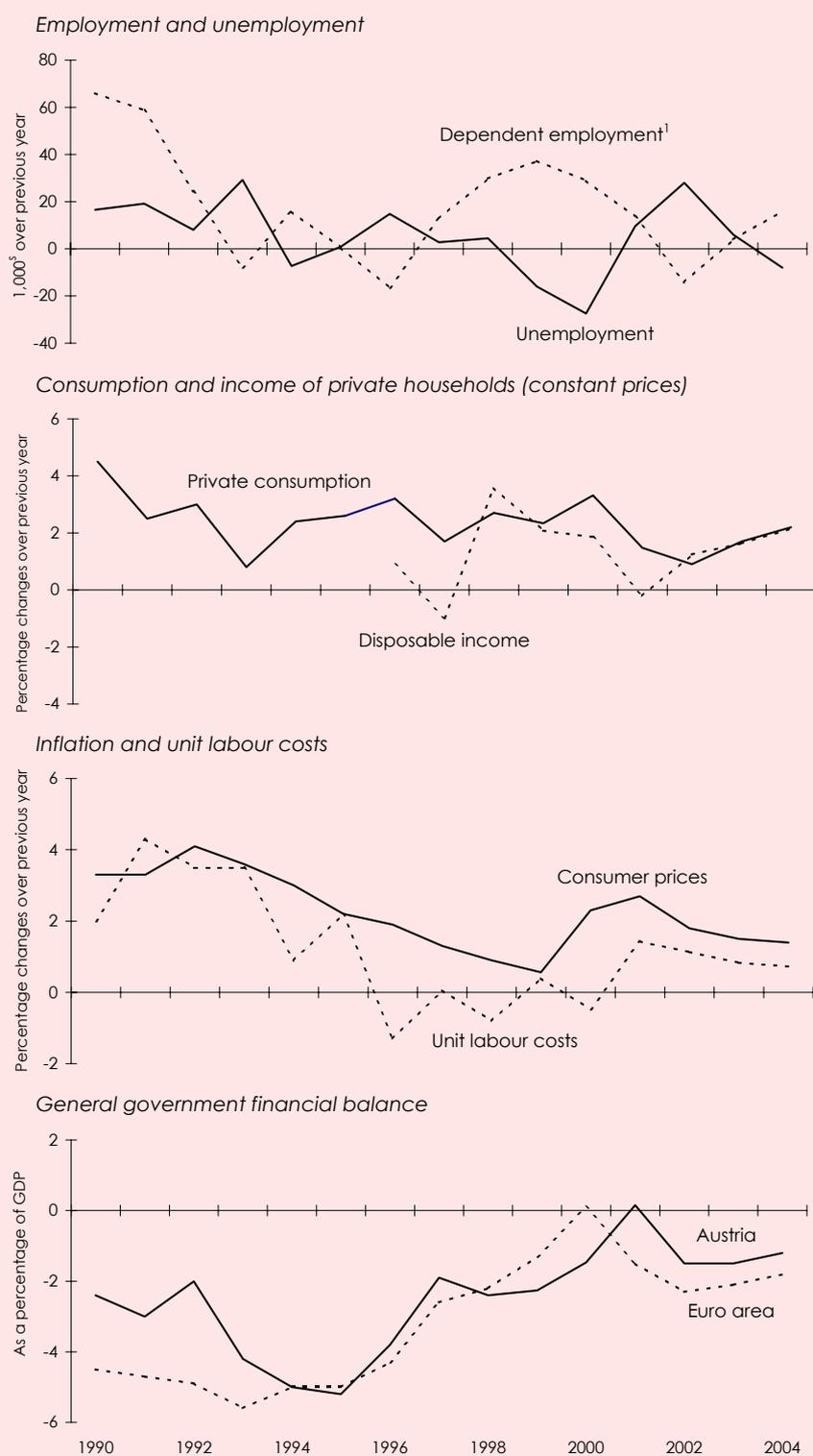
	1999	2000	2001	2002	2003	2004
	Percentage changes from previous year					
Gross earnings per employee ¹	+1.8	+2.5	+1.4	+2.2	+2.2	+2.4
Full-time equivalent	+2.2	+2.7	+1.7	+2.5	+2.4	+2.7
Gross real earnings per employee ¹	+1.0	+0.9	-0.6	+0.4	+0.7	+1.0
Net real earnings per employee ¹	+0.5	+1.5	-1.0	-0.3	+0.2	+0.5
Net wages and salaries	+3.7	+4.5	+1.9	+2.3	+2.2	+2.5
Total economy						
Unit labour costs	+0.4	-0.5	+1.4	+1.1	+0.8	+0.7
Manufacturing						
Unit labour costs	-1.2	-4.5	+1.8	-0.7	-0.5	-0.0
Relative unit labour costs ²						
Vis-à-vis trading partners	-2.1	-5.4	-0.2	-1.7	-0.6	-0.8
Vis-à-vis Germany	-0.8	-1.8	+0.3	-1.7	-0.6	-0.7
Effective exchange rate – manufactures						
Nominal	+0.6	-2.7	+0.9	+0.6	+0.7	+0.1
Real	-1.3	-3.5	+0.3	+0.3	+0.2	-0.1

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

The construction sector was initially more severely affected by the cyclical slow-down than manufacturing. During 2002, however, the negative trend came to a halt, particularly in civil engineering. The WIFO projection for construction output can therefore be revised upwards. Total construction investment remained flat in 2002, compared with the year-earlier level. While civil engineering (road and railroad construction) posted gains, residential building receded further. Still, the stabilisation of real estate prices is an early indication for a turnaround in the years to come. Overall construction employment was reduced further, as the ailing residential sector is more labour-intensive than civil engineering. For 2003, a small increase in construction output is expected, partly on account of continued effects from the stimulation measures taken by the government last year. Given the possibility of accelerated depreciation (by 7 percent) granted until end-2003, some investment projects will likely be carried forward – as it is expected for spending on business equipment. Due

to sluggish residential building, overall construction output will nonetheless lag behind GDP growth, as in the years before.

Figure 2: Economic performance



¹ Excluding parental leave and military service.

Inflation has been on a downward trend for approximately two years. Consumer prices rose by 1.8 percent in 2002, almost 1 percentage point less than in 2001, owing to a stabilisation of energy prices. In 2003, the rate of inflation should moderate to 1.5 percent. The rising euro exchange rate will dampen import prices, and prices of seasonal goods should return to more normal levels, following the strong upward drift last year. Because of the slackening inflation pressure, wage settlements in the private sector were lower than in the year before, thereby further allaying concerns about a cost-push. Earnings per employee are projected to rise by 2¼ percent, much as in 2002. However, while the growth of private-sector earnings should moderate, the pace will markedly accelerate in the public sector. Oil prices constitute a major element of uncertainty: in the event of a war in Iraq, prices may ratchet up sharply for a time that will probably depend on the duration of the military conflict.

The cyclical weakness led to a significant deterioration of labour market conditions in 2001 and 2002. Overall employment fell by around 14,000 or 0.5 percent last year⁴, with manufacturing, construction and eventually commercial trade being the sectors most affected by job losses. In the public sector and in transport (postal and telecom services, railways), jobs were cut mainly by retiring personnel. The number of minimal-job holders, included in the National Accounts, rose again strongly in 2002.

While the number of jobs fell more or less to the extent that could be expected from the deceleration of activity, the rise in unemployment went beyond, from a rate of 3.6 percent in 2001 to 4.1 percent (Eurostat definition). More relevant for public finances is the number of unemployed according to the labour market services, since it corresponds to the number of people receiving insurance or assistance benefits. That number increased by 28,000 in 2002. Since many firms resorted to a freeze in hiring, young people are increasingly affected by unemployment.

Inflation decelerating gradually

Unemployment to edge up slightly

The cyclical downturn led to an unusually strong increase in unemployment in 2002, as labour supply rose in parallel. With recovery gradually taking hold, employment should remain flat in 2003, while the rate of unemployment may edge up further.

Table 6: Labour market

	1999	2000	2001	2002	2003	2004	
	Changes from previous year (in 1,000 ²)						
<i>Demand for labour</i>							
Civilian employment ¹	+38.2	+30.8	+15.1	-13.1	+5.9	+18.0	
Dependent employment ^{1 2}	+37.2	+28.9	+13.6	-14.2	+4.0	+16.0	
Percentage changes from previous year	+1.2	+1.0	+0.4	-0.5	+0.1	+0.5	
Foreign workers	+7.8	+13.4	+9.5	+5.0	+6.0	+12.0	
Self-employed ³	+1.0	+1.9	+1.5	+1.1	+1.9	+2.0	
<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	+14.9	+11.9	+10.0
<i>Surplus of labour</i>							
Registered unemployed ⁴		-16.1	-27.4	+9.6	+28.0	+6.0	-8.0
In 1,000		221.7	194.3	203.9	231.9	237.9	229.9
Unemployment rate							
In percent							
Percent of total labour force ⁵		3.9	3.7	3.6	4.1	4.2	4.0
Percent of total labour force ⁴		6.0	5.3	5.5	6.2	6.3	6.0
Percent of dependent labour force		6.7	5.8	6.1	6.8	7.0	6.7
Participation rate ^{1 6}		71.2	71.5	72.2	72.6	72.8	72.9
Employment rate ^{1 7}		66.9	67.7	68.2	68.0	68.1	68.4

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 economically active population (aged 15 to 59 years). – ⁷ Employment as a percentage of economically active population (aged 15 to 59 years).

⁴ Excluding minimal-job holders and recipients of child-care benefits.

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	+0.2	-1.5	-1.5	-1.2
According to National Accounts	-2.4	-1.6	+0.0	-1.7	-1.7	-1.4
General government primary balance	+1.4	+2.2	+3.8	+1.9	+1.8	+2.0
	In percent					
<i>Monetary policy</i>						
3-month interest rate	3.0	4.4	4.3	3.3	2.7	2.7
Long-term interest rate ¹	4.7	5.6	5.1	5.0	4.5	4.7
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+1.5	-2.5	+1.0	+0.8	+0.9	+0.2
Real	-1.1	-3.6	+0.1	+0.2	+0.3	-0.1

¹ 10-year central government bonds (benchmark).

The above-average increase in unemployment was due to the substantial growth in labour supply (+15,000), that contrasted with past experience of its pro-cyclical behaviour. The main reasons for the rise in the labour force were the inflow of foreign labour or the granting of citizenship to foreigners resident in Austria, as well as the discretionary raise of the age limit for early retirement. In the second semester 2002, the increase in labour supply and in unemployment abated markedly, suggesting a levelling-off of unemployment in the course of 2003. The significant increase in the number of jobless people is also explained by the fact that employment fell particularly in sectors (manufacturing, construction) where job losses typically lead to an increase in the registered unemployment figure.

The federal government, reacting to the weakening of labour market conditions, adopted counter-cyclical measures last September. A temporary investment premium until end-2003, a prolongation of measures targeted to young entrants to the labour market, and premia for the hiring of apprentices are all designed to stem the fall in labour demand.

In 2003, the gradual recovery of activity should allow the number of jobs to rise, if only marginally (+4,000). The new labour market policy measures should also help to contain the increase in unemployment. However, the labour market outlook is very sensitive to possible revisions to the prospects for economic growth.

The general government balance in 2002 is estimated to have been in deficit to the amount of 1½ percent of GDP, compared with the targeted "zero deficit". The main reason for the slippage is the cyclical weakness leading to shortfalls in tax and social contribution revenues as well as to higher unemployment benefit payments. The shortfalls in tax revenues alone amount to some € 2 billion.

The repair of flood damages and the compensation of victims will burden the budget to a greater extent in 2003 than in 2002. The same holds true for the counter-cyclical measures adopted last autumn, providing inter alia for a 10 percent premium for investment exceeding the average for the last three years.

The general government deficit for 2003 is projected at 1½ percent of GDP, the same figure as for 2002. The forecast for nominal GDP, a crucial variable for the estimation of tax revenues, has been taken down by more than ½ percentage point from the last forecast. This is the major reason for the deficit projection being revised upwards from 1 to 1½ percent of GDP for 2003. However, this projection is subject to considerable uncertainty, a federal government budget 2003 not yet having been adopted following last autumn's general elections.

Government deficit of 1½ percent of GDP also in 2003

The cyclical downturn led to substantial shortfalls in tax revenues, such that the general government budget swung to a deficit of 1½ percent of GDP in 2002, according to the WIFO projection. The modest growth of GDP will not allow the deficit to be reduced in 2003, as new budgetary burdens arise from counter-cyclical measures and the repair of flood damages.