Subdued Economic Activity in the Euro Area and in Austria despite International Recovery

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At the worldwide level, economic recovery appears to be picking up even more momentum. The U.S. has seen sharp increases in growth given the strong impetus from consumer spending and investment. In Asia, Japan seems to have ended its long period of economic recession, and the Chinese and Southeast Asian economies have continued to expand rapidly. The growth outlook has also improved for Eastern Europe. At the same time, however, economic recovery is still moderate in the euro area, and it appears that the risks have increased more than they have decreased. The positive effects of robust international demand are being offset by the subduing effect of the euro's rally, and domestic demand – especially consumer spending – has recently been less dynamic than expected. However, the inflation outlook is still assessed as favorable. Since the beginning of 2004 inflation in the euro area has been below 2% and is expected to remain at this low level.

For Austria, economic development in the first half of 2004 is currently forecast with cautious optimism, although the data recently released for the second half of 2003 clearly did not live up to expectations. This is another reason why the situation in the Austrian labor market is still tight and not expected to improve in the first half of this year. Inflation will remain at its current low level.

So far, the most striking event in 2004 has been the May 1 enlargement of the European Union to include ten new Member States. For most of the new members, acceding to the EU represents the climax of a political and economic transformation process, which had begun in 1989 and has generally been highly successful. The enlargement, adding another 74 million people to the EU's population, was also a unique event for the EU itself. In economic terms, we can expect the enlargement to have positive effects on medium-term growth throughout the EU. At the same time, new challenges have arisen regarding the monetary integration of these countries and the redefinition of the EU's policy on neighboring countries (proximity policy).

1 EU Takes on Ten New Member States

On May 1, 2004, ten new Member States – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia – joined the European Union (EU). This enlargement was the most significant ever in terms of the number of countries and their total population (74 million, or 20% of the EU-15). The nominal gross domestic product (GDP) of the new Member States, however, is only about 5% of the EU-15's GDP.

1.1 Successful Transformation in Central and Eastern Europe

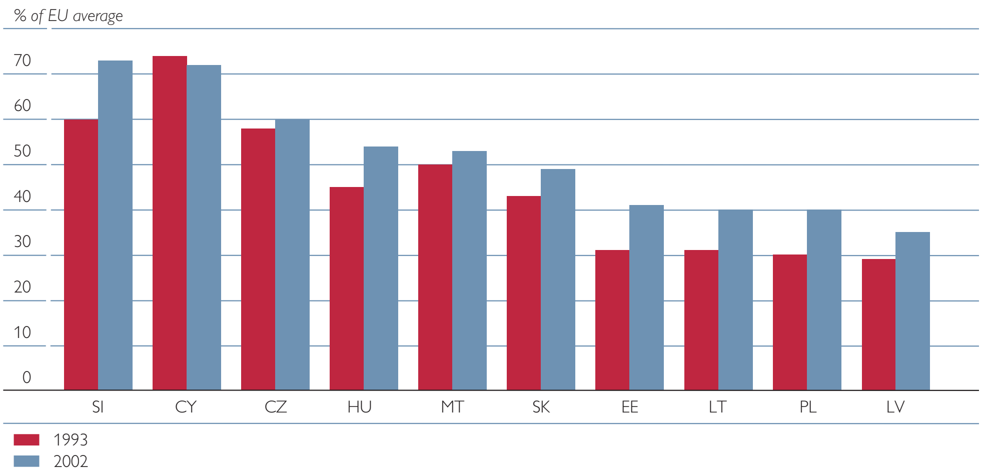
Since the fall of the Iron Curtain in 1989, the countries of Central and Eastern Europe (CEE) have been faced with a barrage of new challenges. Their governments have been confronted with the formidable tasks of implementing democratic political reforms and transforming those countries into market economies at the same time.

This political and economic upheaval gave rise to a profound shock due to reforms, which meant that the first years of transformation were characterized by shrinking economies. In the course of the ensuing economic catching-up process, the per capita income of Central and Eastern European countries (CEECs) has risen considerably in relation to the EU average (measured in terms of purchasing power parity), now reaching approximately 50%. In 2003, preliminary estimates put real economic growth in CEECs at +3.6%, which is markedly higher than the 0.6% GDP growth in the EU-15.

Likewise, inflation has also stabilized at a low level in most of the new Member States. At the beginning of the transformation process, some of these countries saw annual inflation rates as high as 70% (in 1990, Poland

Chart 1

GDP per Capita at Purchasing Power Parity



Source: European Commission, ECB.

Table 1

Economic Development Indicators in the New Member States

	Real GDP growth			Inflation (HICP)			Unemployment (LFS)		
	2001	2002	2003[1]	2001	2002	2003	2001	2002	2003[1]
	%								
Poland	1,0	1,4	3,3	5,4	1,9	0,7	18,5	19,9	20,6
Slovakia	3,8	4,4	3,8	7,0	3,3	8,8	19,4	18,6	17,7
Slovenia	2,9	2,9	2,1	8,6	7,5	5,7	5,8	6,0	6,4
Czech Republic	3,1	2,0	2,2	4,6	1,4	–0,1	8,0	7,3	7,8
Hungary	3,8	3,5	2,9	9,1	5,3	4,7	5,6	5,6	5,6
Estonia	6,5	6,0	4,4	5,6	3,6	1,4	11,8	9,1	8,6
Latvia	7,9	6,1	6,0	2,5	2,0	2,9	12,9	12,8	12,4
Lithuania	6,5	6,8	6,6	1,3	0,5	–1,0	16,1	13,1	12,3
Malta	–1,2	1,7	0,8	2,9	2,2	1,3	6,7	7,4	7,0
Cyprus	4,0	2,0	2,0	2,0	2,8	4,0	4,5	3,8	3,9
AC-10	2,4	2,4	3,1	5,8	2,7	2,0	14,5	14,8	14,3
EU-12	1,6	0,9	0,4	2,3	2,3	2,1	8,0	8,4	8,8
EU-15	1,7	1,0	0,6	2,2	2,1	2,0	7,4	7,7	8,0

	Budget balance			Government debt			Current account		
	2001	2002	2003[1]	2001	2002	2003[1]	2001	2002	2003[1]
	% of GPD						%		
Poland	–3,5	–3,6	–4,3	37,3	41,7	45,1	–2,9	–3,5	–2,9
Slovakia	–6,7	–7,2	–5,1	47,1	42,6	45,1	–7,4	. .	–3,8
Slovenia	–2,7	–2,5	–2,2	26,5	27,4	27,4	0,1	1,7	0,5
Czech Republic	–6,4	–6,7	–8,0	26,1	27,1	30,7	–6,2	–5,3	–6,6
Hungary	–4,7	–9,4	–5,4	53,5	57,1	57,9	. .	–4,0	–6,2
Estonia	0,2	1,3	0,0	4,7	5,7	5,4	–6,0	–12,3	–15,2
Latvia	–1,6	–3,0	–2,7	15,7	15,1	16,7	–9,6	–7,8	–8,6
Lithuania	–1,9	–1,4	–2,6	23,4	22,8	23,3	–4,8	–5,4	–5,7
Malta	–6,8	–6,2	–7,6	65,9	66,5	66,4	. .	. .	–6,6
Cyprus	–3,0	–3,5	–5,2	64,3	58,6	60,3	–4,0	–5,3	–4,4
AC-10	–3,8	–4,8	. .	36,7	39,8	42,4	. .	. .	–4,6
EU-12	–1,6	–2,3	–2,8	69,2	0,7	70,4	–0,3	0,8	0,6
EU-15	–0,9	–1,9	–2,7	62,8	62,5	64,1	–0,4	0,5	0,2

Source: Eurostat, OeNB.

[1] *Forecasts: European Commission: autumn 2003 forecast.*

even recorded an inflation rate of 585%). Now the average annual inflation rate in the new Member States has reached the same level as in the euro area. In several countries, e.g. Poland, inflation is considerably lower, and some countries, including Lithuania and the Czech Republic, even post negative inflation rates.

The situation on the labor market is still difficult in some countries, with declining employment and rampant joblessness.

In addition, increased efforts to consolidate national budgets are necessary in a number of countries. One significant problem is that some of the new Member States have very high current account deficits, which, however, are largely covered by inflows of foreign direct investment. Even if this situation is typical of economies in transition, it also involves risks which should not be underestimated.

Overall, the new Member States have proven to be extremely successful in their ongoing process of transformation. By establishing democratic constitutional states, creating functioning market economies as well as adopting and implementing the EU's *acquis communautaire,* these countries have fulfilled the requirements for EU accession.

1.2 Future Proximity Policy

One important issue in the enlarged EU is that of defining its relations to neighboring countries after the enlargement.

A concrete schedule has been drawn up for Romania and Bulgaria, with accession targeted in 2007. Ongoing negotiations on the EU entry of these two countries should be completed in 2004. With regard to Turkey, the European Commission will submit its opinion to the European Council in October 2004. Should this opinion be favorable, the EU has assured the Turkish government that accession negotiations will begin immediately. The EU has also held out the prospect of membership to countries in the Western Balkans. Croatia is the most advanced of these countries and has already submitted an application for membership.

For relations with those countries which will not be offered EU membership in the foreseeable future, the European Commission has developed a new strategy under the title of "Wider Europe." These countries include Russia, the Ukraine, Moldavia and Belarus as well as the entire Mediterranean region. Given appropriate progress in reforms, these countries are to be allowed access to the Single Market.

EU Enlargement and the ESCB

On May 1, 2004, the central banks of the new Member States also joined the European System of Central Banks (ESCB), which now consists of the European Central Bank (ECB) and the 25 national central banks (NCBs). Therefore, the governors of the new Member States' NCBs are now members of the General Council of the ECB. The General Council will serve as a transitional body until all EU Member States have introduced the euro. Currently the General Council meets four times per year. The Eurosystem, on the other hand, which has not yet been affected by the enlargement of the EU, still comprises the ECB as well as the NCBs of those 12 Member States which have already adopted the euro. The new Member States will not be represented in the Governing Council of the ECB (the Eurosystem's main decision-making body) until they have introduced the euro in accordance with the relevant criteria.

1.3 Three Stages of Future Monetary Integration

The accession date of May 1, 2004, marked the beginning of the monetary integration process for the new Member States. These countries are generally obliged to strive toward the eventual adoption of the euro. However, they must first undergo a multi-stage process involving accession to the EU, participation in the new exchange rate mechanism ERM II, and finally the fulfillment of the Maastricht convergence criteria.

Stage 1: EU Accession

In acceding to the EU, the new Member States have also joined Economic and Monetary Union (EMU), even if they are not able to adopt the euro right away. This means cooperation in the coordination of EU economic policy, an obligation to draw up convergence programs, adherence to the Stability and Growth Pact (especially with regard to budgetary discipline) and membership of their NCBs in the ESCB.

The new Member States are obliged to treat their exchange rate policies as "a matter of common interest," which means avoiding excessive nominal fluctuations and distortions of the real exchange rate. A side from this obligation, decisions on monetary policy strategy and the exchange rate regime are left up to each individual Member State.

Stage 2: Exchange Rate Mechanism II (ERM II)

Since May 1, 2004 each new Member State has had the right – but not the obligation – to apply for membership in ERM II. ERM II is a multilateral arrangement in which currencies of non-euro area Member States are pegged to the euro. Its objectives include supporting stability-oriented economic policies, promoting convergence and protecting foreign exchange markets from unjustified pressure.

The main features of ERM II are a fixed but adjustable central rate against the euro, a standard fluctuation band of ±15%, the possibility of intervening within the band and a bilateral obligation to intervene at the margin as long as the primary objective of price stability is not compromised.

Country	Exchange rate regime	Monetary policy
Estonia Lithunia	Currency board to the euro	Exchange rate targets
Latvia Malta	Peg to currency baskets with narrow fluctuation bands: Latvia (SDR basket), Malta (euro, U.S. dollar, pound sterling)	Exchange rate targets
Cyprus Hungary	Peg to the euro with wide fluctuation bands (±15%).	Direct inflation targets
Czech Republic Slovakia Slovenia	Managed Float	CZ: direct inflation targets SK, SI: multi-indicator monitoring
Poland	Free Float	Direct inflation targets

The decision as to when to join ERM II is generally left to the discretion of the new Member States, and the appropriate time will be assessed individually for each country. Although there are no formal criteria for entry into ERM II, the central rate and the width of the fluctuation band are subject to multilateral agreement before a country can participate. However, the Eurosystem considers certain exchange rate regimes to be incompatible with ERM II, including free floating, crawling pegs and pegs against anchors other than the euro. Currency board arrangements[1] can be retained in the form of unilateral obligations.

Stage 3: Adoption of the Euro

Before adopting the euro, Member States are required to demonstrate sustainable fulfillment of all convergence criteria, for example the requirements regarding inflation, budgetary discipline, interest and exchange rates. Compliance with the exchange rate criterion requires adherence to the normal bands of the European Monetary System's exchange rate mechanism without serious strains and without lowering the central rate for at least two years prior to the convergence assessment. Convergence assessments are subject to the principle of equal treatment (between the current and future euro area countries and among the future Member States themselves).

Challenges for Monetary Integration

The new Member States still have to complete their transformation processes and are thus in the midst of a long-term catching-up process. The challenge is twofold: On the one hand, it will be necessary to maintain the adaptability of the exchange rate, and on the other, to avoid excessive appreciation and exchange rate fluctuations which cannot be justified in real economic terms. The appropriate time of entry into ERM II is to be assessed individually in the light of each Member State's overall economic situation. The time of entry is likely to vary considerably from country to country. The general idea is to proceed with caution.

Effects of EU Enlargement on Austria

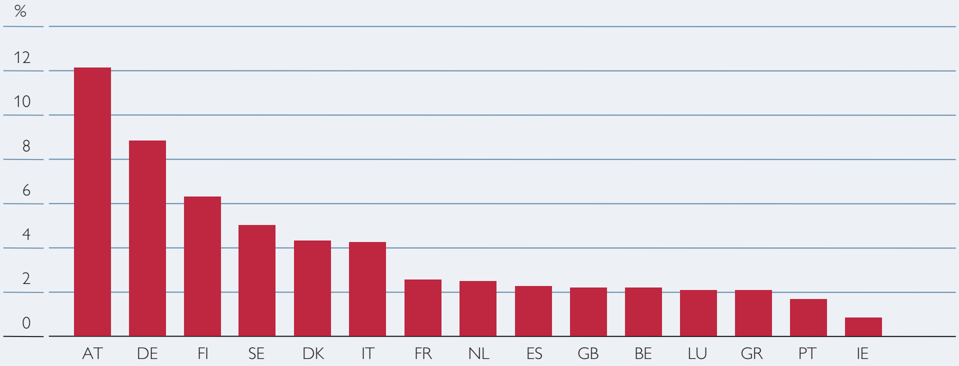
Given the relatively low economic weight of the new Member States, the enlargement is expected to have, on balance, positive (albeit slight) effects on economic growth in the EU in the medium term. In the course of the continued transition and convergence process, however, this economic area will gain considerable importance.

Owing to its geographical location, Austria will derive more growth impetus from the enlargement than other EU regions. As the new Member States already account for 12.6% of Austria's overall exports, Austria has the strongest ties of all Member States to this region. As far-reaching trade agreements have gradually liberalized trade between the EU and the accession countries, the majority of trade effects have already taken hold. With the exception of a few specific areas (e.g. agricultural goods), trade relations have already been intensified on the back of liberalization efforts. Therefore, additional positive trade effects generated by the enlargement of the EU will remain relatively slight for Austria. In contrast, efficiency gains induced by competition following the enlargement, also known as Single Market effects, can be expected to stimulate growth to a greater extent.

1 *A currency board arrangement is a currency regime in which the exchange rate is pegged to a reference currency (or anchor) and the monetary base must be covered completely by gold and foreign currency reserves at all times.*

Chart 2

Share of the Eight Central and Eastern European Member States in EU-15 Foreign Trade (2002)



Source: UN, Direction of Trade.

Central and Eastern Europe is an important destination for Austrian companies not only in terms of exports but also in terms of foreign direct investment. This manifests itself largely in banking, where Austria holds a market share of approximately one fifth in the new Central and Eastern European Member States (measured in terms of total assets). The EU enlargement will further reduce the risk faced by Austrian banks in these countries and serve to enhance growth opportunities.

Table 2

Change in Real GDP Following the EU Enlargement

	Trade effects	Single Market effects	FDI in new Member States	Migration into the EU	Budget effects	Overall effects
	% (cumulative)					
Austria	0.14	0.64	–0.20	0.16	0.01	0.66
EU-13[1]	0.05	0.33	–0.16	0.06	–0.03	0.26
Poland	2.47	2.07	0.45	–0.12	3.15	8.02
Hungary	4.20	1.25	0.81	–0.09	2.23	8.40
Czech Republic	2.84	0.54	0.37	–0.08	1.98	5.65

Source: Breuss, F.: Macroeconomic Effects of EU Enlargement for Old and New Members, WIFO Working Papers, No. 143, March 2001.
[1] Not including Luxembourg and Greece.

As regards the Austrian labor market, crowding-out effects can be expected in certain segments, which may lead to a slight increase in unemployment. However, the agreed seven-year transition periods with regard to the free movement of persons and services, as well as demographic developments in Austria and the economic transition process in the new Member States, will reduce the pressure on the Austrian labor market considerably. In addition, immigration should also result in positive effects on economic growth.

2 Worldwide Economic Recovery Accelerates

2.1 U.S. Projects Strong Economic Growth in 2004

In the international arena, the process of economic recovery appears to be taking hold. This acceleration of growth is especially visible in the U.S., where increases in consumer spending and a revival of private investment have created a strong impetus for growth. Consumer spending has been fueled by tax cuts as well as low interest rates, with private households increasingly refinancing their mortgage loans. Economic growth in the U.S. accelerated to 8.2% in the third quarter and to 4.1% in the fourth quarter of 2003 (annualized in relation to the previous quarter), thus amounting to 3.1% overall in the year 2003. The Federal Reserve Bank's expansive monetary policy and a significantly higher level of industrial confidence have led to a turnaround in corporate investment. In particular, investments in plants and equipment have demonstrated a pronounced upward trend. Due to very high (and partly cyclical) productivity growth, which averaged approximately 4.4% in the year 2003, the recovery has not yet boosted U.S. employment figures.

The immediate economic outlook for the U.S. is positive. The strong growth in private investment is likely to continue, and companies will probably not reduce their already low inventories any further, which means that industrial production should increase further. Consumer spending is expected to contribute further to economic growth if the waning tax effects are replaced by an increase in employment and higher aggregate real incomes. According to the latest consensus forecasts, this could lead to real GDP growth of approximately 4.6% in 2004, which would then gradually move back toward the trend by dropping to 3.7% in 2005.

The Federal Reserve Bank's monetary policy has been very expansive for some time now and is based on the low core inflation rate, which is just above 1%. However, the CPI inflation rate has remained just above that level, mainly because of considerable increases in energy prices. Nevertheless, the Federal Open Market Committee (FOMC) recently stated that tightening the U.S.'s accommodating monetary policy could be postponed in the light of the still-low level of capacity utilization and high productivity growth rates. In the financial markets, this has been interpreted as a signal that an increase in the federal funds rate (currently 1%) need not be expected until the second half of 2004 at the earliest – and possibly not until 2005.

However, the positive growth outlook in the U.S. contrasts with risks in the medium and long term. The U.S. current account deficit, already substantial in the 1990s, has increased even further in recent years (2003: 5% of GDP). The budget deficit has also surged due to massive tax cuts. Under these circumstances, it seems questionable whether foreign investors will still be willing to invest in the U.S. without demanding a risk premium in return. This would at least slow economic recovery in the U.S. amid worsening financing conditions. Another risk is that of stagnating employment (jobless growth) despite accelerated GDP growth. As long as companies continue to meet rising demand by increasing efficiency, thus not improving the employment situation, we cannot expect to see further increases in consumer spending.

2.2 Asia Driving Growth

The economic recovery has also continued in Asia. Even Japan seems to have left its years of recession behind, with GDP growing by 1.6% in the fourth quarter of 2003 (compared with the previous quarter). This accelerated growth can be attributed largely to domestic demand and to investment in particular. However, the contribution of net exports also increased in the fourth quarter of 2003 despite the strengthening of the yen in the previous months. Japan's exports mainly went to the expanding economies of East Asia: China and other countries in the region, such as Thailand, Singapore and Malaysia are currently profiting from rising demand in the U.S. In parallel, the increased consumer confidence in these countries should also lead to healthy growth in domestic demand.

2.3 Growth Accelerating in the EU's New Member States

After two fairly weak years, real GDP growth in the new EU Member States rose to an average of 3.6% in 2003, with – compared with 2002 – decidedly higher growth rates in Poland (3.6%) and the Czech Republic (2.9%), a fairly stable rate in Slovakia (4.2%), and slightly lower rates in Hungary (2.9%) and Slovenia (2.3%).

In Poland and Slovakia, vast improvements in net exports were key to accelerating (or maintaining high) growth rates. In Poland, decreasing unit labor costs and the continued slide of the zloty against the euro led to very rapid growth in exports, thus ending the decline in gross fixed capital formation which had persisted for several years. In Slovakia, the sudden jump in exports can be attributed to extensive foreign direct investment. The increase in exports was more than able to offset the sharp decrease in consumer spending and public consumption. The slump in consumer spending was mainly attributable to the drastic hike in consumer prices, with regulated prices rising particularly sharply in the run-up to liberalization.

In the Czech Republic and Slovenia, on the other hand, sharp decreases in inflation bolstered consumer spending, and low real interest rates buoyed gross fixed capital formation. While the increase in imports to the Czech republic was offset by stronger export growth due to declining unit labor costs, the slowdown in export growth was so significant in Slovenia that GDP growth fell despite a rise in domestic demand. Remarkably, this deterioration of real net exports did not manifest itself in Slovenia's balance of payments.

In Hungary, the high level of consumer spending growth dropped only slightly, thus causing imports to spike sharply. However, a drastic slump in growth triggered by the deterioration of net exports was prevented by a marked increase in inventory building.

3 Euro Area: Moderate Recovery Continues

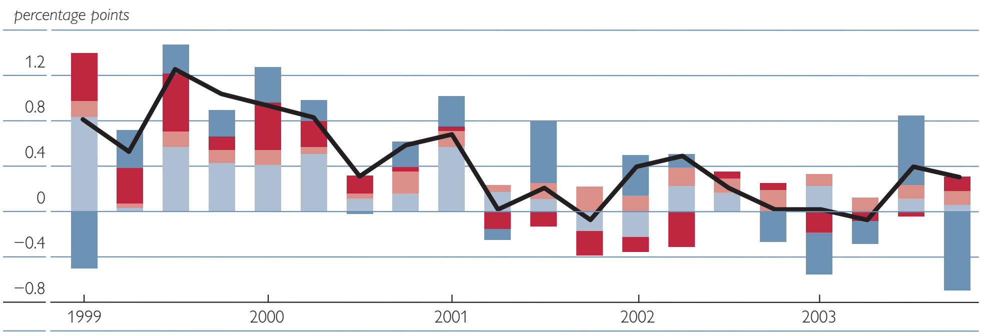
3.1 GDP Growth Increases in Fourth Quarter of 2003

Real GDP growth in the euro area for the fourth quarter of 2003 indicates that economic recovery is moderate but ongoing in this region. In the fourth quarter of 2003, real GDP grew by 0.3% compared with the previous quarter. Year on year, real GDP growth rose by 0.6%. While GDP growth was still mainly driven by the contribution of net exports in the third quarter of 2003, fourth-quarter GDP gained impetus from investments. Given the rise in investment, this quarter saw domestic demand reach its highest growth rate since late 1999.

The fourth quarter of 2003 also brought the first positive signals in fixed investments in a long time: These investments rose by 0.6% quarter on quarter, thus showing their highest growth rate since early 1998. Prior to that, periods of declining or stagnating fixed investments, prevailed mainly due to severe uncertainties in the corporate sector. Interest rates in the euro area, which have been very low on the long-term average, may also have contributed to the increase in investments. Various confidence indices reflected the increase in industrial confidence. For example,

Chart 3

Contribution of Real GDP Components to Growth in the Euro Area



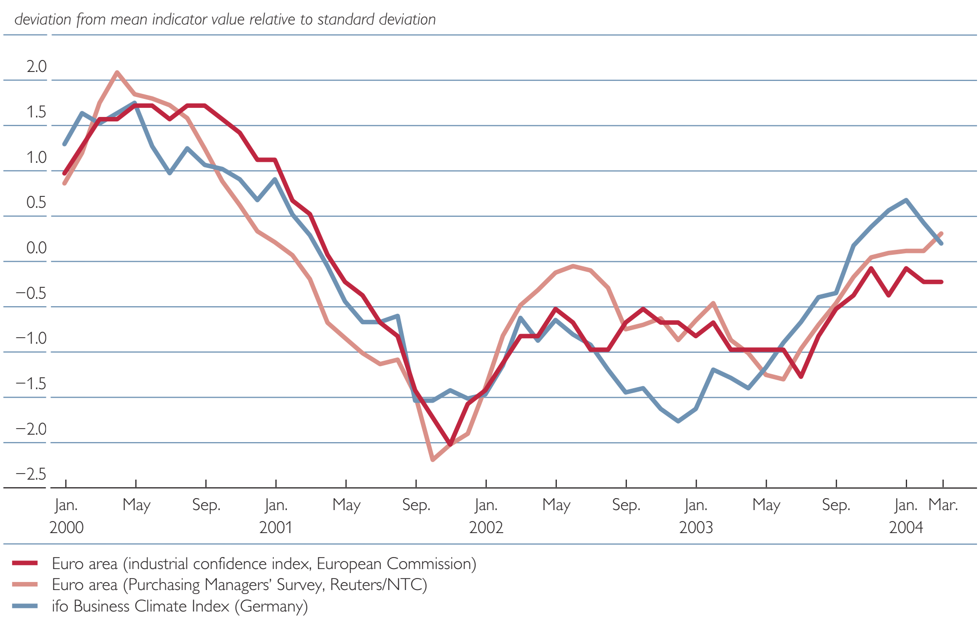
Source: Eurostat.

the Purchasing Managers' Index for the euro area as well as the European Commission's industrial confidence index and the ifo's Business Climate Index increased sharply in the second half of 2003. The latter two indicators more or less stagnated in the first quarter of 2004.

Household expenditure is still lackluster. Since the first quarter of 2001 increases in consumer spending have remained at a very low level (fourth quarter of 2003: 0.0% quarter on quarter). This slump in demand, which also showed itself in the downward trend in retail growth rates in 2003, can be linked to both slow growth in disposable income and the still-low level of consumer confidence. This is made clear in the Euro-

Chart 4

Business Climate Indicators



Source: European Commissionn, ifo, NTC, OeNB.

pean Commission's survey of consumer confidence, which is still very weak by historical comparison. Private households do assess the general state of the economy more positively, but they do not anticipate any improvements in their own financial situation. The reasons for this can be found in the persistently unfavorable situation in the labor market: Despite increased GDP growth, the unemployment rate has not gone down, and employment figures have remained stagnant in the last few quarters. Moreover, uncertainty about the future of social security systems in the areas of health care and pensions have also suppressed consumer demand.

The contribution of public consumption remained positive, edging up by 0.6% in the fourth quarter of 2003 (compared with the previous quarter). The contribution of net exports to growth shrank in the fourth quarter of 2003 against the previous quarter. Exports stagnated, changing at a rate of only 0.2%, while imports increased by 2.1%. While export sales decreased in every month of 2003 except January, export volumes increased starting in May 2003. As the euro exchange rate rose in the same period, this probably had unfavorable effects on the profit margins of exporters in the euro area.

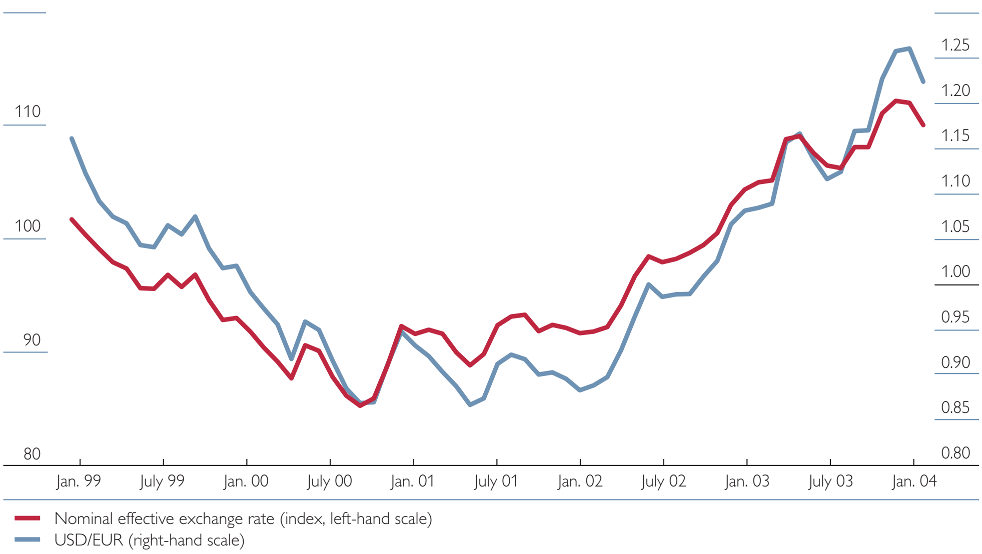
3.2 Industrial Production Recovers, Unemployment Remains Stagnant

In February 2004, seasonally adjusted industrial production in the euro area rose by 0.6% year on year. This continued the recovery which began in mid-2003, although it was weaker than in the fourth quarter of 2003. This growth was brought about by an increase in intermediate and consumer goods manufacturing. In the fourth quarter of 2003, industrial production rose by 0.7% year on year. Industrial orders in the euro area declined by 3.2% in January 2004 compared with the previous month. Year on year the contraction amounted to 1.8%.

The seasonally adjusted rate of unemployment remained stable at 8.8%

Chart 5

Euro Exchange Rate Development



Source: Eurostat, ECB.

between March 2003 and February 2004. The strained situation in the labor market can also be seen in the ratio of job vacancies to the overall economically active population, which has been falling continuously since early 2001. Employment has largely remained stagnant since the second quarter of 2002. Once again, the expansion in service-sector employment was just able to offset job reductions in other areas in the fourth quarter of 2003. In total, employment only rose slightly (by 0.2%) in 2003, and this increase was carried exclusively by the service sector. Having stagnated for two quarters, labor productivity rose by 0.4% in the fourth quarter of 2003. The increase in GDP growth was thus generated by increases in productivity, not in employment.

3.3 Exchange Rate Shapes General Financial Climate

On February 17, 2004, the euro exchange rate reached a new high of USD 1.29. In the ensuing weeks, it dropped back down approximately 7% to 1.19 by mid-April. Although economic growth in the U.S. has increased far more sharply than in the euro area, market participants apparently do not expect the Fed to raise interest rates in the short term. The U.S.'s high current account deficit is probably also responsible for the U.S. dollar's current weakness. While the EUR/USD exchange rate had advanced by 10.1% in the previous 12 months, the increase in the nominal effective euro exchange rate in February 2004 was 7.9% year on year.

Long-term interest rates in the euro area dropped from 4.3% to 3.9% between early January and late March 2004. As at mid-April, they stood at 4.15% again. Therefore, market participants do not expect an interest rate hike in the coming months. However, the increase in the exchange rate is currently offsetting any inflationary effects or stronger impetus for GDP growth.

The rise in stock prices at euro area exchanges continued in the first month of 2004, but considerable market losses followed the terrorist attack in Madrid on March 11, 2004. By early April the prices had stabilized again.

3.4 Oil Price Eases HICP Inflation

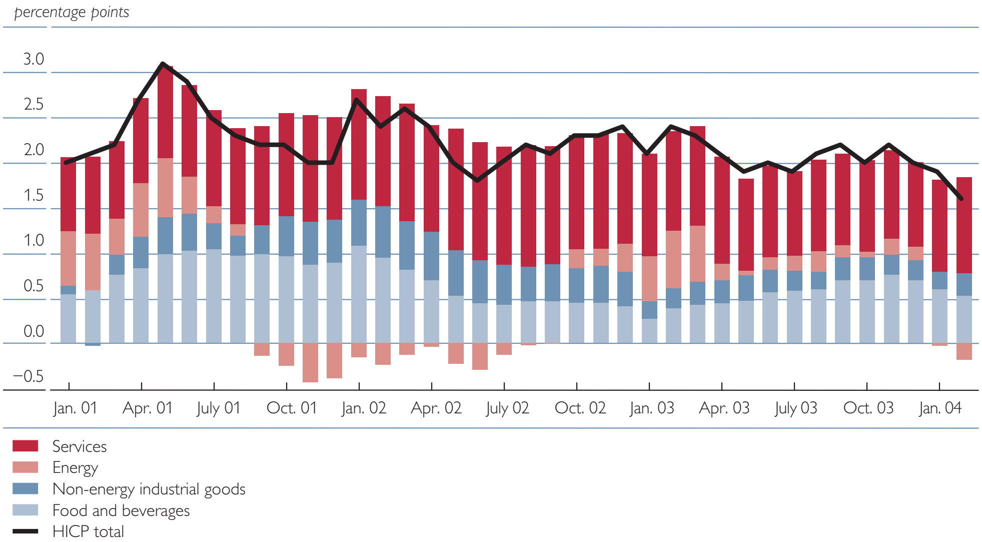
After rising by 1.6% in February 2004, HICP inflation increased by 1.7% in March. This was attributable mainly to the dampening effect of the energy component: Year on year, energy prices fell considerably in the first quarter of 2004. The effect of the exchange rate also manifested itself in this context. Whereas the price of oil in the first quarter of 2004 was at approximately the same level in U.S. dollar as in the first quarter of 2003, it was considerably lower in euro. As the oil price dropped sharply in the second half of March 2003, the energy component will probably cause the inflation rate to climb in the coming months. In addition to this base effect, OPEC's agreement to reduce extraction quotas, which has already led to an increase in oil prices, could also result in higher inflation. The increase in the euro exchange rate is also having a moderating effect on inflation in other areas, as import prices are lower than they were in 2003 due to the euro's increased value.

3.5 Lending Still on the Rise in the Euro Area

The growth rate of loans to the private sector in the euro area was 5.5% in February 2004. Lending to the public sector showed dynamic development,

Chart 6

HICP Components: Contributions to Inflation



Source: Eurostat.

a fact which can be attributed to higher budget deficits. This continues the trend of a gradual increase in lending which has persisted since early 2003.

This credit growth is mainly due to an increase in the number of loans granted for housing purposes, while consumer loans and loans to nonfinancial corporations are still only growing slowly. The most likely reason for the expansion of housing loans is the currently low level of long-term interest rates.

M3 growth contracted further to 6.3% in February 2004 (January 2004: 6.5%), with growth slowing especially in miscellaneous short-term deposits and in marketable financial instruments. The unchanged high level of M1 growth can be ascribed to the low interest rates, among other things. The small spread between short-term and long-term interest rates is currently making investments in longer-term instruments less attractive.

3.6 Cautious Optimism for the Euro Area

The economic outlook for the euro area still points to gradual improvement. The European Commission's Economic Sentiment Indicator, having indicated an upward trend since mid-2003, stagnated in the first quarter of 2004. The European Commission forecasts quarterly growth rates between 0.3% and 0.7% for the euro area in the first two quarters of 2004. Vibrant growth of the euro area's trading partners should counteract the effects of the strong euro on net exports. Likewise, favorable financing conditions in the euro area should boost domestic demand – which has not lived up to expectations so far – throughout 2004.

The outlook for price stability is also positive. Current forecasts show an HICP inflation rate of less than 2% for the year 2004. In some countries, however, increases in indirect taxes will drive prices up in 2004. Due to the low level of industrial capacity utilization and the current out-put gap, economic recovery will not necessarily lead to an immediate rise in inflation in the euro area.

4 Austria: A Cautious Upturn with Stable Prices

4.1 OeNB Economic Indicator: Moderate Recovery in the First Half of 2004

The OeNB economic indicator forecasts 0.4% seasonally adjusted growth in Austria's real GDP for the first and second quarter of 2004 (each compared with the previous quarter). Compared with the corresponding quarters in the previous year, this puts growth at 0.6% and 1.0%. The OeNB thus remains cautiously optimistic in its prognosis of economic developments in the first half of 2004, although hard facts which point to economic recovery are still missing. According to seasonally adjusted SNA figures, the Austrian economy stagnated almost completely in the second half of 2003. The seasonally adjusted real GDP growth rates in the third and fourth quarters of 2003 were each 0.1% compared with the previous quarter.

The current quarterly SNA data, however, are characterized by high uncertainty and should only be interpreted with caution. For example, a number of indicators point to a revival of economic activity already in the second half of 2003 and show that this recovery has continued into early 2004 – despite the moderating effects of the strong euro. These indicators include the latest external macroeconomic conditions, especially the revival of economic growth in the U.S. and the new Member States of the EU, the recovery of important financial market indicators, economic agents' increased confidence, highly favorable financing conditions, the low rate of inflation, and the economic support measures of the Austrian federal government.

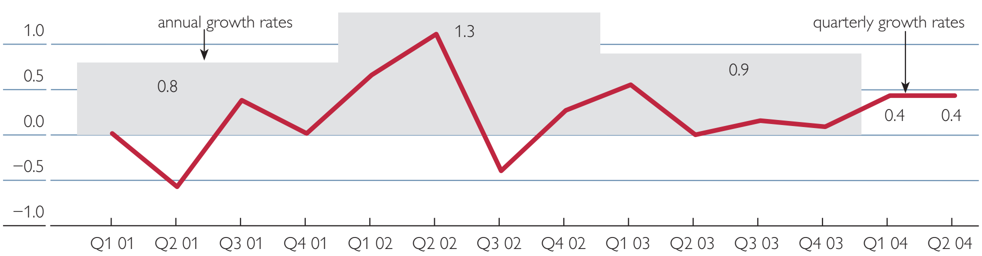
4.2 Growth in 2003 above Euro Area Average but Near Stagnation in Second Half of Year

According to the available seasonally and workday adjusted quarterly data, Austrian economic growth (0.9%) is half a percentage point higher than that of the overall euro area in 2003. The dynamics throughout the year, however, depict a surprising development scenario. At the beginning of 2003, growth was generated by domestic demand, and especially investment activity boomed in the first quarter of 2003 (5.7% seasonally adjusted over the previous quarter). Investment growth was especially high in the categories of machines and equipment (+9.3%), but also all of the other

Chart 7

Development of the OeNB's Economic Indicator

change from previous quarter/previous year in %, seasonally adjusted



Source: WIFO, OeNB.

Table 3

Short-Term Real GDP Forecast for the First and Second Quarter of 2004

	2002				2003				2004	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
	%, seasonally adjusted									
Change from same quarter in previous year	0,5	2,0	1,3	1,5	1,4	0,4	0,9	0,8	0,6	1,0
Change from previous quarter	0,6	1,0	–0,4	0,3	0,5	0,0	0,1	0,1	0,4	0,4
Change from previous year	1,3 (1,4[1])				0,9 (0,7[1])				×	

Source: OeNB economic indicator values (April 2004), WIFO, Statistics Austria.
[1] Value based on non-seasonally adjusted data.

important investment components expanded at above-average rates in that quarter.

Against the trend in the euro area, consumer spending and investments in Austria dropped in the second half of 2003. Real GDP rose by 0.1% in the third as well as the fourth quarter, but only due to net exports. However, as the current seasonally adjusted SNA data are characterized by a high level of uncertainty, this picture could still change pronouncedly in future data revisions.

In the first half of 2004, exports will play an important role in Austria's economic upswing (in line with the ongoing international recovery) despite the strength of the euro. The highly favorable financing conditions and the strong need for replacement investments are having a reviving effect on corporate investment activity. In addition, the public sector is also providing impulses with the investment tax allawance and increased infrastructure spending. Overall, a palpable revival of investment activity is thus expected despite the still-low level of capacity utilization. Consumer spending, in contrast, will develop moderately in the short term. The retail sector, which was still developing relatively well in the first half of 2003, has been faced with declining revenues since mid-2003. Employment adjusted for persons on parental leave, in compulsory military service or undergoing training in an Austrian Public Employment Service Program stagnated in January and February 2004, and wage settlements remain moderate for the year 2004. In this situation, the low rates of inflation become even more important as they increase the purchasing power of households and make a substantial contribution to stabilizing consumer spending.

Table 4

Components of Real GDP in Austria (seasonally adjusted)

	2003		2003			
			Q1	Q2	Q3	Q4
	percentage		*change from previous period*			
Gross domestic produc	100,0	0,9 (0,7[2])	0,5	0,0	0,1	0,1
Domestic deman	97,5	2,0	1,3	0,3	0,1	–0,1
Household expenditure and NPISH[1] expenditure	56,3	1,4	0,1	0,4	–0,3	–0,1
Public consumption	18,2	0,7	0,0	0,1	0,1	0,3
Gross fixed capital formation	23,1	4,4	5,7	0,2	1,0	-0,4
Exports	55,3	0,8	0,9	–2,1	2,1	0,3
Imports	53,2	2,5	3,1	–0,9	0,0	–0,3

Source: Eurostat.
[1] NPISH: non-profit organization servicing households.
[2] Value not seasonally and workday adjusted.

4.3 Deterioration of Confidence Indicators not yet Interpreted as Sign of Sustained Trend Reversal

The increase in important international confidence indicators in the second half of 2003 reflects improvements in external macroeconomic conditions, which have made a substantial contribution to brightening Austria's economic outlook. Consequently, Austria's domestic indicators have also shown increased optimism in all areas of the economy. In recent months, however, these important national and international confidence indicators have not continued to increase; in fact, several have even declined. In particular, uncertainty about future economic developments has mounted again, while assessments of the current situation have stabilized. In Austrian industry, production expectations were again slightly more pessimistic in early 2004. Assesment of orders was also down slightly, with foreign orders being assessed with particular caution given the euro's rally. Confidence in the construction industry has stabilized at its 2003 level, thus remaining considerably higher than in 2001 und 2002. However, this indicator has not pointed to a further upward trend in the last 12 months. Confidence in the retail sector and among consumers has not increased any further due to the persistently unfavorable situation in the labor market. Overall, in March 2004 the European Commission's economic sentiment indicator for Austria (93.1 points) was 0.4 point below the average value for the fourth quarter of 2003, but still at the average value for the year 2003.

4.4 Positive Signals from the Financial Markets

In early 2004, Austria's financial markets showed positive developments. By mid-April 2004, the ATX was over 60% higher than in the previous year. While the lending volume in the second quarter of 2003 was lower year on year, lending growth accelerated continuously in the second half of 2003 and in early 2004. According to the latest bank lending survey, banks expected a slight increase in demand for loans on the part of businesses and households in the first quarter of 2004.

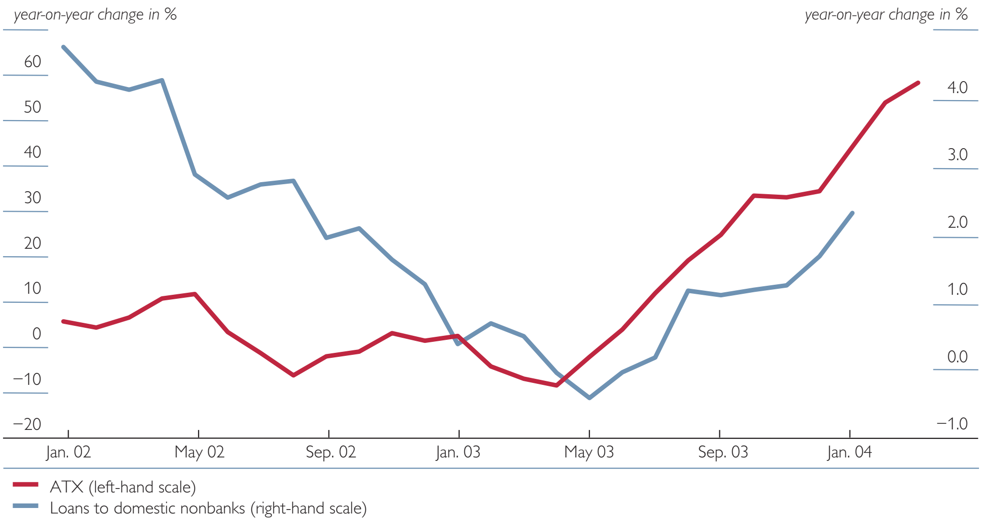
4.5 Labor Market Situation Remains Weak

Currently, a trend reversal in the Austrian labor market is not yet in sight. The year-on-year increase in employment has declined markedly in the last two months and was only 0.1% in March 2004 according to the Central Association of Austrian Social Insurance Institutions. Employment adjusted for persons on parental leave, in compulsory military training or registered in a training program of the Austrian Public Employment Service, dropped by almost 7,500 (–0.2%) in March 2004. As some participants in the Employment Service's training programs are now no longer counted as employed (as of January 2004), the figures mentioned above are subject to downward statistical distortion. The size of this effect is estimated at approximately 13,000 persons, that is, 0.4% of overall employment. Transposing this onto the data for March 2004 yields a relative change in active employment of just under +0.2%.

Given the labor supply increase, which is high for a period of moderate economic growth, employment growth is not sufficient to reduce unemployment. An initial positive signal has appeared in the number of job vacancies, which is a good leading indicator for the labor market. In Feb-

Chart 8

Financial Market Indicators



Source: Datastream, WIFO, OeNB.

ruary 2004, the number of reported job vacancies increased year on year for the first time since late 2000. However, this development will have to solidify in the next few months before one can speak of an upcoming trend reversal. No relief in the labor market is expected in the coming months.

4.6 Inflation to Remain at Low Level

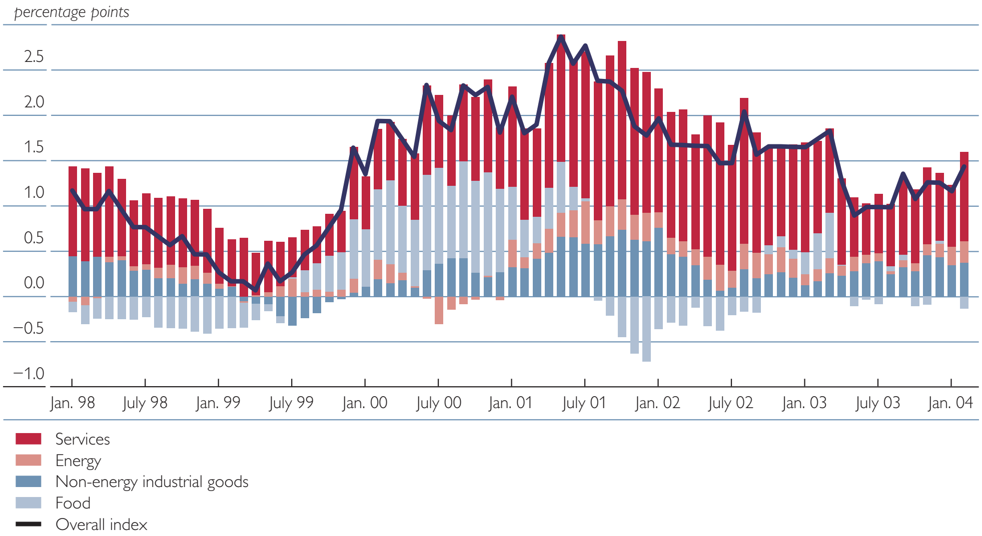
In the first half of 2003, inflation clearly slowed down. In mid-2003, inflation rates were as low as 1.0% according to the Harmonised Index of Consumer Prices (HICP). Only in the last four months of 2003 did inflation begin to rise slightly. In December 2003, the rate of inflation was 1.3%, precisely equal to that year's average, once again placing Austria among the euro area countries with the highest level of price stability. A look at the individual components yields a very uniform picture for the second half of 2003. The main factor responsible for inflation was the development of prices for food, alcoholic beverages and tobacco as well as services. Below-average inflation rates were recorded in the areas of industrial goods and energy. Since the beginning of 2004, Austrian federal government measures, such as the energy tax increase and the introduction of truck tolls, have also caused additional price growth. The energy tax alone will contribute approximately 0.2 percentage point to the inflation rate in 2004. These effects were offset by countervailing base effects in the energy subcomponent at the beginning of the year.

4.7 2003 Current Account on Cash Basis almost Balanced

As expected in the OeNB's overall economic forecasts from spring 2003 and fall 2003, the current account deteriorated slightly in 2003 compared with the previous year. This can be attributed almost exclusively to the decreased surplus in the trade balance. As a result of the lively domestic economy in early 2003, demand for imports increased more sharply, while exports remained almost stagnant at the previous year's level due to the

Chart 9

HICP for Austria: Inflation Rate and Contributions to Inflation



Source: OeNB, Statistics Austria, ECB.

rather poor external macroeconomic conditions and the strength of the euro. The subaccounts for services (with the important subcategory of tourism) as well as income and transfers changed only slightly from the previous year. On a cash basis, Austria's current account went from a surplus of EUR 0.81 billion in 2002 to a deficit of EUR 0.97 billion (0.4% of GDP) in 2003.

This deterioration of the trade balance is also reflected in the preliminary foreign trade statistics compiled by Statistics Austria. The balance changed from a surplus of EUR 0.3 billion in 2002 to a deficit of EUR 1.4 billion in 2003. While trade in goods with other EU Member States continued to slacken, the surplus against non-EU countries actually increased slightly. Simulations with the OeNB's macro model showed that the euro's rally in 2003 only worsened Austria's current account by EUR 0.31 billion. The negative effect of higher demand growth, in particular for investments in equipment with especially high imported content, was substantially larger.

4.8 Above-Average Uncertainty in Forecasting

Given a lack of hard facts indicating an upturn in the Austrian economy, and due to disappointing economic growth in the second half of 2003, the level of uncertainty in this short-term forecast is above average. The majority of risks appear to point downward. Any further strengthening of the euro would delay the recovery in the euro area and in Austria. Furthermore, due to the historically unique duration of this economic slump (three years), the ability of the econometric models underlying the indicator to produce meaningful statements could be limited. A further downward risk can be found in raw materials prices, which have risen sharply lately. Finally, the recovery of the equities markets in recent months could be interpreted as the correction of an excessive drop in prices after the end of the bull market.