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Private Consumption Becomes Strengthening Support to Growth due to Tax Cuts and Easing Inflation

Medium-term Projections for the Austrian Economy from 2008 to 2012

Between 2008 and 2012, real GDP in Austria will grow at an annual average rate of 2.3 percent. The main reason for economic growth in Austria being below average growth in the last five years is the current slackening of economic activity abroad. Nevertheless, a growth advantage to the euro area will be maintained. In 2010, tax cuts are expected to stimulate private consumption –and the growth rate in the euro area should also increase from 2010 onwards. This should benefit the Austrian economy given its strong competitive position.

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With a projected annual growth rate of 2.3 percent, demand and output in Austria will expand less than expected so far. The growth of real GDP will be slightly lower than the 2.4 percent observed between 2002 and 2007.

The current downturn in the US business cycle will continue to weigh on activity in the euro area in the second half of 2008 and throughout 2009. This will be partially offset by growth opportunities in the new EU countries in which Austrian exporters have acquired a strong market position. Given their competitiveness, Austrian exporters will take full advantage of the expected economic recovery in the euro area in 2010.

The current political intentions foresee a tax reform in 2010. Underlying the present medium-term forecast is the assumption of a € 3 billion tax cut. The resulting increase in household disposable income will boost real GDP growth by ½ percentage points in 2010, and by an average 0.3 percentage point p.a. from 2010 to 2012. Precise calculations on the effects will have to wait until the details of the tax reform have been decided.

Business investment will likely remain subdued in the near term. Corporate spending is likely to increase once the increased demand for exports and the increase in private consumption raises capacity utilisation rates. Capital formation is expected to increase by 2 to 3 percent per year.

Construction is unlikely to post gains as solid as over the last five years, when civil engineering profited from lively investment in new road and railroad infrastructure. However, residential building should recover due to strong immigration and a growing shortage of existing housing space.

Private consumption will pick up under the impact of the planned tax reform, except for car sales, which will be dampened by the high fuel prices. Apart from 2010, net real incomes per capita will rise rather moderately, but growing employment will boost aggregate private disposable income. The household saving ratio, which has risen markedly in the last few years due to uncertainty on the job market and the consequences of the pension reform, will edge up further in 2010 as a result of the tax reform. The expectation of a significant decline in the saving ratio after 2010 implies a stabilisation of consumer confidence.

Table 1: Main results

	Ø 1997-2002	Ø 2002-2007	Ø 2007-2012	2007	2008	2009	2010	2011	2012
					Year-to-year percentage changes				
Gross domestic product									
Volume	+ 2.4	+ 2.4	+ 2.3	+ 3.4	+ 2.1	+ 1.7	+ 2.5	+ 2.6	+ 2.3
Value	+ 3.6	+ 4.3	+ 4.3	+ 5.8	+ 4.8	+ 3.9	+ 4.5	+ 4.4	+ 3.9
Consumer prices	+ 1.6	+ 1.9	+ 2.3	+ 2.2	+ 2.9	+ 2.3	+ 2.1	+ 2.1	+ 2.0
Gross wages and salaries per employee[1]	+ 2.2	+ 2.3	+ 2.8	+ 2.7	+ 3.3	+ 3.0	+ 2.8	+ 2.7	+ 2.3
Active dependent employment[2]	+ 0.6	+ 1.1	+ 1.1	+ 2.1	+ 1.8	+ 0.7	+ 1.0	+ 1.2	+ 1.0
	Ø 1998-2002	Ø 2003-2007	Ø 2008-2012	2007	2008	2009	2010	2011	2012
					In percent				
Unemployment rate									
Eurostat definition[3]	4.0	4.7	4.1	4.4	4.2	4.3	4.2	4.0	3.8
National definition[4]	6.5	6.9	6.0	6.2	5.9	6.2	6.1	5.9	5.9
					As a percentage of GDP				
Net exports	2.3	5.0	6.4	6.8	6.7	6.6	6.3	6.2	6.4
General government financial balance (Maastricht definition)	− 1.4	− 1.7	− 0.6	− 0.5	− 0.7	− 0.7	− 0.9	− 0.4	− 0.1
					As a percentage of disposable income				
Household saving ratio	8.1	9.4	9.7	10.3	10.1	9.8	10.1	9.4	9.2

Source: Statistics Austria, WIFO calculations. – [1] Excluding employers' contributions, employees according to National Accounts definition. – [2] Excluding parental leave, military service, and unemployed persons in training. – [3] According to Eurostat Labour Force Survey, percent of total labour force. – [4] According to Public Employment Service, percent of total labour force excluding self-employed.

Dynamic growth will allow employment to expand at 1 percent per year, which is comparable to the pace of the last five years. The unrestricted access of qualified labour from the new EU countries from 2009 together with the termination of the transition period for labour mobility in 2011 will reinforce the inflow of commuters and migrants. The size of immigration is difficult to foresee, but it may exceed what has been retained for the present forecast. Also the domestic component of labour supply will increase. However, the unemployment rate will moderate as from 2010 due to the growth impulse from the tax reform, to a projected 5.9 percent of the dependent labour force in 2012. Over the whole projection period, the unemployment rate will average 6 percent (according to the public employment services definition), implying still important labour reserves among the low-qualified and poor opportunities for (low-qualified) older workers to find a new job.

Strong price hikes for food and energy in 2008 will be reflected in higher headline inflation and rising wage pressure. For the period from 2008 to 2012, nominal per-capita earnings are expected to rise by close to 3 percent p.a., after +2.3 percent over the last five-year period. Oil prices are assumed to follow an only moderate upward trend from 95 $ per barrel in 2008 to 104 $ in 2012. Under these assumptions, overall inflation should gradually ease over the years to come, averaging 2¼ percent over the entire forecast period.

The tax reform envisaged for 2010 will widen the general government deficit to nearly 1 percent of GDP. The degree of self-financing of the tax cuts (through higher tax revenues as a result of the induced stronger economic growth) is approximately one-third by the end of the forecast period. Once the effect of the tax reform has faded, the budget deficit should steadily decline. However, the development of public finances over the medium term cannot be reliably assessed in the absence of budget proposals and with the details of the tax reform still undecided. The WIFO medium-term projections further assume that policy measures in the areas of research, education and infrastructure will raise Austria's growth prospects over the medium and longer term. Any financial burden possibly arising for the private or the public sector from the likely non-compliance with the goals laid down in the Kyoto protocol has not been incorporated into the forecast.

Growth above the euro area average

Over the period from 2003 to 2007, the average annual growth of real GDP in Austria exceeded the growth in the euro area by 0.5 percentage points. Several arguments suggest that a growth advantage of similar magnitude will be maintained between 2008 and 2012:

- Austrian companies enjoy a particularly strong market position in the rapidly growing economies of the new EU countries in East-Central Europe as well as in the EU accession candidates in south-eastern Europe (*FIW,* 2007).
- Austria's competitiveness, as measured by unit labour costs, has strengthened substantially in the last ten years (*Guger – Leoni,* 2007). This trend will continue to reinforce the country's export capacity.
- In Austria, the tax reform will provide incentives to private consumption, whereas the latter will be constrained in some of the larger European countries (France, Italy) by the pressing need to consolidate government finances.
- The increase in spending on research and development observed in Austria over the last years should yield returns for economic growth in the medium term. The target of raising such spending to 3 percent of GDP by 2010 is within reach.
- Sluggish growth in Germany during the last decade also has held back economic expansion in Austria. The brighter outlook for Germany should benefit the Austrian economy, notably in the tourism sector.
- In some of the euro area countries (particularly in Spain and Ireland), growth has been fuelled until mid-2007 also by booming real estate prices. In the years to come, an expected increase in the household saving ratio should dampen private consumption and construction investment.
- In the UK and Scandinavia, growth has been driven partly by the buoyant activity in the USA because of particularly close trade relations. This factor will be missing in the next few years.
- Supply of domestic as well as foreign labour will continue to grow strongly. This will support growth and employment in sectors where labour is scarce, while at the same time reducing the prospects for a decline in unemployment among the low-qualified.
- Labour market reforms recently agreed by the social partners will enhance flexibility on the Austrian labour market, while largely preserving existing social security ("flexicurity"). This should have a positive medium-term impact on economic growth.
- Policy efforts undertaken in the area of education during the last years, notably the expansion of vocational tertiary education, will further boost the supply of qualified labour.

Less favourable international trends

The present medium-term projections for the Austrian economy are based up to the year 2009 on the WIFO short-term forecast of March 2008 (*Marterbauer,* 2008). Calculations for the years beyond have been carried out with the WIFO macroeconomic model (*Baumgartner – Breuss – Kaniovski,* 2005) on the basis of the assumptions for the international trends by *Schulmeister* (2008).

In 2008 and 2009, the cyclical slowdown in the USA will continue to negatively affect growth in the euro area, thereafter the US economy is expected to recover. Over the whole projection period 2008-2012, growth in the euro area should attain nearly 2 percent p.a., matching the average rate for the last five-year period. GDP for the whole OECD area, however, is likely to expand ½ percentage point less per year than during the last five years, mainly owing to slower growth in the USA.

Table 2: International fundamentals

	Ø 1997-2002	Ø 2002-2007	Ø 2007-2012
	Year-to-year percentage changes		
Gross domestic product, volume			
Euro area	+ 2.5	+ 1.9	+ 1.8
23 OECD countries[1]	+ 2.3	+ 2.5	+ 1.9
	Ø 1998-2002	Ø 2003-2007	Ø 2008-2012
	Dollar per ECU or Euro		
Exchange rate	0.99	1.25	1.60
	Dollar per barrel		
Oil price, Brent	21.7	51.8	99.3

Source: EU, OECD, WIFO calculations. - [1] EU 15 (excluding Austria), Iceland, Norway, Switzerland, Turkey, Australia, Japan, Canada, New Zealand, USA.

Germany, Austria's most important trading partner, appears to have largely overcome the heavy financial burden of re-unification. In the coming years, the pace of growth will lag behind the euro-area average only by a small margin. Nevertheless, certain weaknesses in investment conducive to a higher growth potential have not yet been completely overcome.

Austria's economy is receiving positive stimulus from the new EU countries in East-Central Europe (*Breuss*, 2006), where EU accession has accelerated GDP growth to about twice the rate recorded in the euro area. The strong activity is boosting imports of these countries, foreign direct investment has become less risky than before EU accession, subsidies from the EU structural funds lend support to the catching up process, and competitive pressure is driving productivity. Due to its close economic ties, Austria is a prime beneficiary from the strong growth momentum in the new EU countries. The likely deceleration of global growth in 2008 and 2009 will only moderately affect economic activity in East-Central Europe, since the latter is firmly supported by domestic demand. However, credit risks are rising markedly in the area, notably for real estate assets. According to the *International Monetary Fund* (2008), the risks deriving from high indebtedness are particularly acute in Romania and Bulgaria.

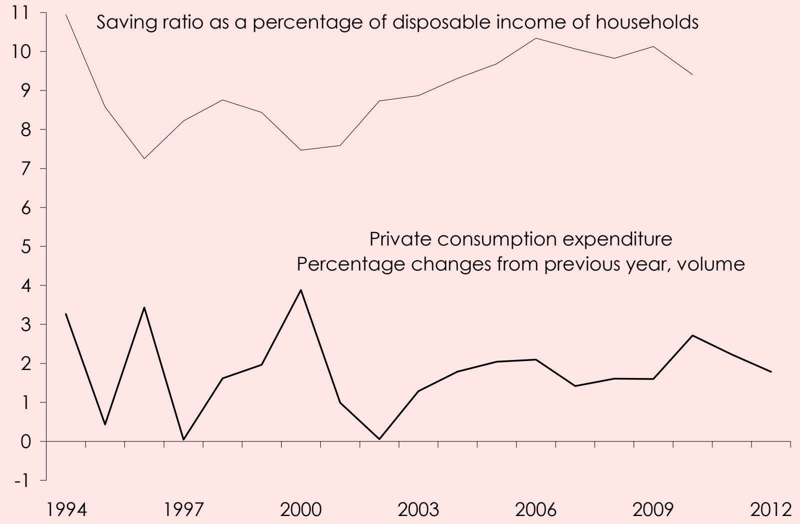
Medium-term projections for Austria

The Austrian economy will be affected by the slowdown of global economic growth, but will fully benefit from the subsequent recovery, due to its strong competitiveness. Volume exports are projected to expand by 5½ percent per year over the period from 2008 to 2012. Following the usual pattern, rising exports will lead to stronger investment in machinery, commercial vehicles and immaterial capital goods. Investment growth is expected to average 2¾ percent over the projection period and to be back loaded to the years from 2010 to 2012.

By raising real disposable income via higher employment and productivity, investment will also give stimulus to private consumption. In addition, household spending will be boosted by the tax reform. Private consumption is projected to gain an average 2 percent per year from 2008 to 2012, more than the 1.7 percent p.a. recorded for the period from 2002 to 2007. This projection hinges on the (optimistic) assumption that the household saving ratio will decline until 2012 by almost 1 percentage point from its present high level. A crucial condition in this regard is a strengthening of consumer confidence followed by lowering of precautionary saving.

Demand for new housing will pick up, partly due to high net immigration, and lead to a rebound in residential construction. Plans have been set up for a substantial extension and upgrading of the railroad infrastructure. For road construction, on the other hand, the expansion is set to gradually level off. Construction investment overall is projected to grow by about 2½ percent in volume.

Figure 1: Private consumption and saving ratio



Source: Statistics Austria, WIFO calculations.

The expected slowdown of global economic growth will moderate the momentum of Austrian exports over the period from 2008 to 2012. However, private consumption is set to grow faster than during the last five years, as net incomes will be boosted by tax cuts. Construction output will slacken only marginally from the present pace, owing to the planned expansion of the railroad infrastructure and the expected recovery of residential building. With GDP growth projected at 2.3 percent per year, the unemployment rate will decrease.

Table 3: Components of aggregate demand, volume

	Ø 1997-2002	Ø 2002-2007	Ø 2007-2012	2007	2008	2009	2010	2011	2012
	Year-to-year percentage changes								
Consumption expenditure									
Private households[1]	+ 1.7	+ 1.7	+ 2.0	+ 1.4	+ 1.6	+ 1.6	+ 2.7	+ 2.2	+ 1.8
General government	+ 1.2	+ 1.9	+ 1.3	+ 2.5	+ 2.5	+ 1.0	+ 1.1	+ 1.1	+ 0.6
Gross fixed capital formation	+ 0.9	+ 3.0	+ 2.6	+ 4.8	+ 2.2	+ 1.8	+ 3.1	+ 3.2	+ 2.7
Machinery and equipment[2]	+ 3.8	+ 2.9	+ 2.7	+ 6.3	+ 2.0	+ 1.0	+ 3.5	+ 3.9	+ 3.1
Construction	− 1.2	+ 3.0	+ 2.5	+ 3.7	+ 2.3	+ 2.3	+ 2.9	+ 2.7	+ 2.4
Domestic demand	+ 1.4	+ 1.9	+ 2.0	+ 2.3	+ 1.9	+ 1.6	+ 2.5	+ 2.3	+ 1.8
Exports	+ 7.2	+ 6.4	+ 5.6	+ 8.1	+ 5.2	+ 5.0	+ 5.7	+ 6.2	+ 6.1
Imports	+ 5.1	+ 5.9	+ 5.6	+ 6.6	+ 5.3	+ 5.2	+ 6.0	+ 6.0	+ 5.7
Gross domestic product	+ 2.4	+ 2.4	+ 2.3	+ 3.4	+ 2.1	+ 1.7	+ 2.5	+ 2.6	+ 2.3

Source: Statistics Austria, WIFO calculations. – [1] Including private non-profit institutions serving households. – [2] Including other products.

Tax reform in 2010

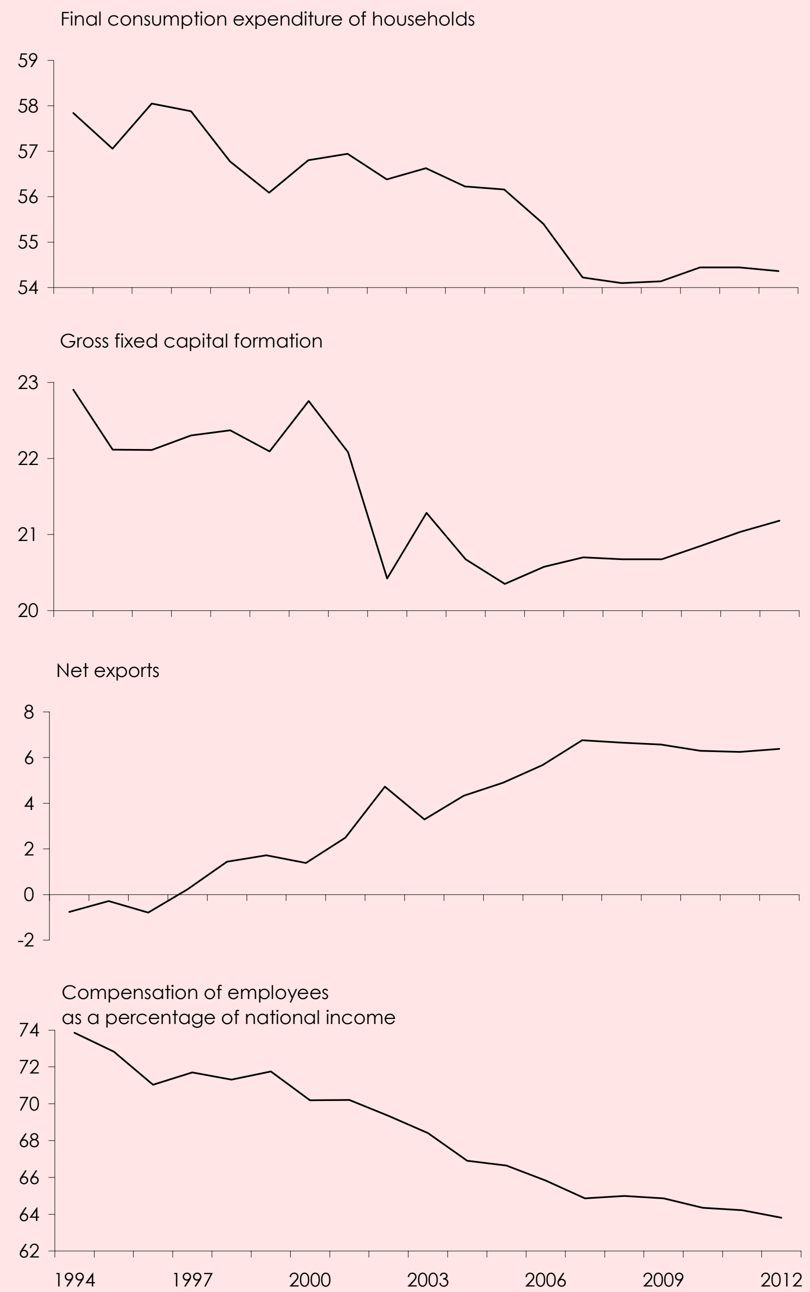
In an international comparison, the budgetary situation of Austria is favourable. The general government deficit has declined since 2000 to a ratio of 0.5 percent of GDP in 2007, The government revenue/GDP ratio has also declined. On the other hand, the high amounts of debt incurred by ASFINAG and SCHIG (i.e., the companies in charge of financing the road and railroad infrastructure) and high public spending on health will exert a drag on public finances in the future.

The federal government estimates a balanced general government household by 2010. This would accommodate the revenue losses incurred by the tax reform. At the same time, the relatively high living standards in Austria will only rise further or even be maintained if investment in areas like research and development, education, infrastructure, information and communication technology is increased. It is in this area where key foundations for dynamic growth in the future are laid (*Aiginger – Tichy – Walterskirchen,* 2006).

The federal government programme of 2007 announces a reform of wage and income taxation to be implemented towards the end of the current legislation period; the Austrian Stability Programme (*Federal Ministry of Finance,* 2007) cites 2010 as the year of implementation. In an attempt to mitigate the consequences of high inflation rates, a number of measures are carried forward. Thus, as from mid-2008, the employees' contribution to unemployment insurance will be abolished for gross incomes up to € 1,000 per month and reduced for incomes above up to € 1,350 per month. The adjustment of retirement benefits will take effect two months earlier than originally envisaged[1].

Figure 2: Expenditure on GDP and income

As a percentage of GDP, at current prices



Source: Statistics Austria, WIFO calculations.

The tax reform planned to take effect in 2010 shall increase disposable income by € 3 billion. The required budgetary leeway is to be created by expenditure restraint. On present information, the deficit would widen to almost 1 percent of GDP in the year of the tax reform. With the short-term impact of the tax reform fading, the deficit should narrow gradually to a rate of 0.1 percent of GDP by 2012.

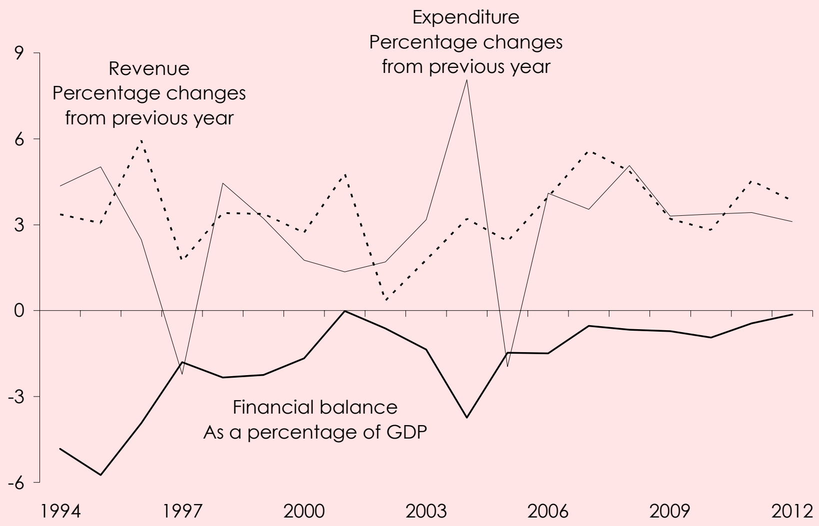
Political aims of the tax reform are quite ambitious. The reform is supposed to lower the tax burden for small- and medium-income earners, and in particular for families. In addition, the top marginal tax rate is to be lowered or else to apply only to signifi-

[1] For these measures, some € 150 million each have been budgeted for 2008. In 2009, the cut in unemployment insurance contributions may burden the budget by € 300 million. For the years as from 2010, this amount is included in the projected "cost" of the tax reform of € 3 billion.

cantly higher income brackets. Furthermore, non-wage labour costs are to be cut to make investment in Austria more attractive. In the absence of more detailed plans, the present projections assume increase the disposable income by a total € 3 billion.

WIFO expects the general government deficit to rise to close to 1 percent of GDP in the year of implementation of the tax reform, declining thereafter to 0.1 percent of GDP by 2012, yielding a government household close to balance.

Figure 3: Revenue, expenditure and financial balance (according to Maastricht) of general government



Source: Statistics Austria, WIFO calculations.

Future developments in government expenditure can only be sketched, as no budget estimates have yet been submitted and details of the tax reform remain unknown. It is assumed that the second stage of the administrative reform will be timely implemented. Public expenditure will rise only moderately, while raising public sector efficiency will be a priority. Reaching budgetary targets is complicated by the fact that significant spending items have been outsourced from the government budget during the last ten years. In the longer run, these off-budget items, such as lease financing or liabilities of ASFINAG and SCHIG, will weigh on the government balance. Upward pressure on spending should be expected notably in the areas of education and health. It is unlikely that the deficits in the social health insurance funds can be covered by expenditure moderation alone.

Loans taken up by ASFINAG and the Federal Railways (OeBB) for the purpose of financing high investment in road and railroad infrastructure helped to counter the sluggishness of growth in Austria in the last years. While the investment in the road infrastructure did not immediately result in a budgetary burden, it will have to be financed through an increase in road tolls. The investment in railroad infrastructure will begin to have an impact on public finances: the cancellation of Federal Railway debt in 2004 has been classified by Eurostat as deficit-enhancing, leading to a sharp upward correction of the general government deficit for 2004 from 1.2 percent to 3.7 percent of GDP.

The trend of government revenues is set predominantly by the dynamics of the nominal GDP and its components. Assuming tax cuts of about 1 percent of GDP, the government revenue ratio will fall from 47.5 percent of GDP in 2007 to 46.5 percent in 2012.

Table 4: General government

At current prices

	Ø 1997-2002	Ø 2002-2007	Ø 2007-2012	2007	2008	2009	2010	2011	2012
				Year-to-year percentage changes					
Current revenue	+ 2.9	+ 3.4	+ 3.8	+ 5.6	+ 4.9	+ 3.2	+ 2.8	+ 4.5	+ 3.8
Current expenditure	+ 2.5	+ 3.3	+ 3.7	+ 3.5	+ 5.1	+ 3.3	+ 3.4	+ 3.4	+ 3.1
Gross domestic product	+ 3.6	+ 4.3	+ 4.3	+ 5.8	+ 4.8	+ 3.9	+ 4.5	+ 4.4	+ 3.9
	Ø 1998-2002	Ø 2003-2007	Ø 2008-2012	2007	2008	2009	2010	2011	2012
				As a percentage of GDP					
General government financial balance (Maastricht definition)	− 1.4	− 1.7	− 0.6	− 0.5	− 0.7	− 0.7	− 0.9	− 0.4	− 0.1

Source: Statistics Austria, WIFO calculations.

Employment rising strongly, jobless rate slightly down

Unemployment has been a major problem for economic and labour market policy during the last decade. The unemployment rate (as measured by the public employment service) of 6.9 percent on average for the period 2003-2007 was unusually high for Austria. With the cyclical upswing of the last years it declined to 6.2 percent in 2007. The higher growth due to the lower tax burden on private incomes will further reduce the rate of unemployment to 5.9 percent by 2012.

The number of people in active employment increased by 1.1 percent p.a. between 2002 and 2007. In the last five years, Austria advanced from a laggard within the EU in terms of part-time employment to a country with an above-average share of part-time jobs. Even more striking was the increase in the number of mini-jobs as a result of the lower tax burden. The cyclical upswing of the last few years also led to a marked increase in full-time employment.

The labour market projections for the next five years draw a favourable picture for job prospects. The expected growth of real GDP by 2.3 percent per year will be accompanied by an increase in the number of active employees by over 38,000 or 1.1 percent p.a. The Lisbon targets for 2010 will be met in terms of the overall employment ratio of 70 percent and the female employment ratio of 60 percent. In contrast, the employment ratio for older workers will fall short of the target of 50 percent, although the growing scarcity of qualified labour should favour an increase in the effective retirement age.

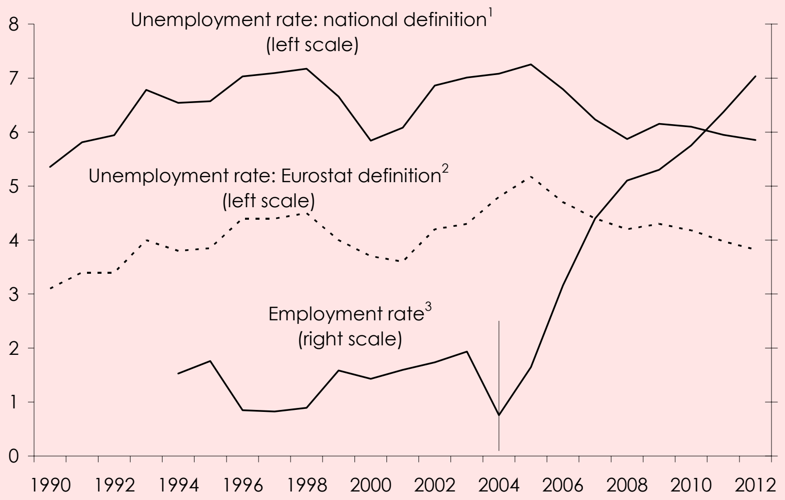
Efforts are being made to make the labour market more flexible. Upon an agreement between the social partners, the regular and the maximum daily working time were each raised by two hours. At the same time, employers have been obliged to register newly-hired employees with the social security before they take up work and not, as required so far, within the first three working days. As a consequence, the number of registrations rose sharply at the beginning of 2008.

Higher economic growth should allow the unemployment rate to decline gradually over the next years, despite a market rise in the domestic as well as foreign labour supply. According to the present projections, the number of unemployed will edge down to 219,500 by 2012. For the entire period from 2008 to 2012, the average jobless rate is expected at 6.0 percent of the dependent labour force or 4.1 percent of the total labour force according to the Eurostat definition. The target of an unemployment rate of 4 percent (Eurostat) is unlikely to be met already in 2010, as envisaged by the government, but rather towards the end of the projection period in 2011-12.

Unemployment is proving persistent mainly because labour supply is rising strongly due to immigration, the increase in the statutory early retirement age and the rise in female labour force participation. Net immigration will remain sizeable over the coming years, due to family members following the breadwinner, asylum seekers and foreign workers.

Further changes on the Austrian labour market will occur when, as a consequence of the 2004 EU enlargement, the transition period towards full labour mobility for the new EU countries ends. So far, the inflow of official workers from this region has been relatively small. In 2009, access of qualified labour will be liberalized, followed by a phase out of the remaining restrictions in 2011 (except for Romania and Bulgaria). From that time, immigration may turn out higher than assumed in the projections.

Figure 4: Labour market trends



Source: Public Employment Service, WIFO calculations. – [1] As a percentage of total labour force exclusive self-employed; according to Public Employment Service. – [2] As a percentage of total labour force; according to Eurostat Labour Force Survey. – [3] Persons in employment as a percentage of population of working age (15 to 64); changed survey method since 2004.

Table 5: Labour market, income

		Ø 1997-2002[1]	Ø 2002-2007[1]	Ø 2007-2012[1]	2007	2008	2009	2010	2011	2012
						Year-to-year percentage changes				
Persons in active employment[2]		+ 0.6	+ 1.1	+ 1.1	+ 2.1	+ 1.8	+ 0.7	+ 1.0	+ 1.2	+ 1.0
Registered unemployed		− 0.1	− 0.9	− 0.3	− 7.1	− 4.5	+ 5.7	+ 0.1	− 1.5	− 0.7
Unemployment rate										
Eurostat definition[3]	in percent	4.0	4.7	4.1	4.4	4.2	4.3	4.2	4.0	3.8
National definition[4]	in percent	6.5	6.9	6.0	6.2	5.9	6.2	6.1	5.9	5.9
Productivity[5]		+ 1.5	+ 1.6	+ 1.3	+ 1.2	+ 1.0	+ 1.2	+ 1.6	+ 1.4	+ 1.3
Gross wages and salaries[6]		+ 3.1	+ 3.4	+ 4.1	+ 4.9	+ 5.2	+ 3.8	+ 3.9	+ 4.0	+ 3.4
Per employee[7]		+ 2.2	+ 2.3	+ 2.8	+ 2.7	+ 3.3	+ 3.0	+ 2.8	+ 2.7	+ 2.3
Unit labour costs, total economy		+ 0.5	+ 0.6	+ 1.5	+ 1.5	+ 2.5	+ 1.8	+ 1.1	+ 1.2	+ 1.0

Source: Federation of Austrian Social Security Institutions, Statistics Austria, WIFO calculations. – [1] Unemployment rate: Ø 1998-2002, Ø 2003-2007, Ø 2008-2012 – [2] Excluding parental leave, military service, and unemployed persons in training. – [3] According to Eurostat Labour Force Survey, percent of total labour force. – [4] According to Public Employment Service, percent of total labour force excluding self-employed. – [5] Real GDP per employment (dependent and self-employed according to National Accounts definition). – [6] Excluding employers' contributions. – [7] Employees according to National Accounts definition.

Higher inflationary pressure

In the last five years, headline inflation averaging 1.9 percent has been remarkably low in a longer-term perspective. Volatility was caused mainly by changes in the prices of oil and other sources of energy. Correct trends in food and energy prices suggest that the overall price increase will accelerate in the coming years. For the period from 2008 to 2012, we expect an average rate of inflation of 2.3 percent.

The main determinants of the future inflation trend are:

- import prices, notably of energy and other raw materials,
- unit labour costs,
- indirect taxes and public charges,
- competition policy.

In a small open economy, the overall rate of inflation strongly depends on the price of imports. Our projections are based on the assumption of an average oil import price rising from $ 95 per barrel in 2008 to $ 104 in 2012 (see *Schulmeister,* 2008). This increase in energy prices will be followed by a moderate increase in food prices. The use of agricultural commodities for fuel production and the rising demand for food in the emerging markets as well as global population growth will put a lasting upward pressure on food prices. Given the high volatility of world market prices for oil and food, inflation forecasts for the medium term are subject to great uncertainty. On the one hand, the strong demand from fast-growing emerging markets is driving up the prices of energy and other commodities; on the other hand, imports of low-cost manufactures and intermediate goods from these countries have a moderating effect on inflation in the industrialised world.

Table 6: Implicit price indices

	Ø 1997-2002	Ø 2002-2007	Ø 2007-2012	2007	2008	2009	2010	2011	2012
	Year-to-year percentage changes								
Private consumption	+ 1.3	+ 1.7	+ 2.3	+ 2.1	+ 2.9	+ 2.3	+ 2.3	+ 2.1	+ 2.0
Exports	+ 0.7	+ 1.6	+ 1.3	+ 1.6	+ 1.2	+ 0.8	+ 1.5	+ 1.5	+ 1.4
Imports	+ 0.7	+ 1.7	+ 1.7	+ 1.4	+ 1.5	+ 1.0	+ 2.0	+ 2.1	+ 1.9
Gross domestic product	+ 1.2	+ 1.8	+ 2.0	+ 2.3	+ 2.6	+ 2.1	+ 1.9	+ 1.7	+ 1.6

Source: Statistics Austria, WIFO calculations.

Our medium-term projections indicate rising risks of inflation. Wages already began to react to the stronger inflationary momentum. Over the period from 2008 to 2012, average per-capita wages are projected to go up by close to 3 percent per year, compared with +2.3 percent in the last five years. Unit labour costs, the key factor of domestic cost pressure, will increase by 1.5 percent p.a.

While real wages per capita will continue to lag behind the rise in labour productivity, the gap will narrow. As a consequence, the sustained decline in the wage share (as a proportion of national income) observed since the early 1980s will decelerate. The decrease in real unit labour costs by a projected 0.8 percent p.a. will improve the competitive position of Austrian goods and services abroad. The projections rest on the technical assumption of the exchange rate of the euro to the dollar remaining unchanged from the 2008 level.

A freeze or even a below-average increase in administered prices and public charges may make a small contribution towards a deceleration of inflation. The implicit fiscal burden in terms of substantial revenue losses would fall on the *Länder* and local communities. For them it would become more difficult to abide by the rules of the domestic Stability Pact as agreed in the federal fiscal revenue sharing agreement for the period 2008-2013. In a medium-term perspective, an increase in traffic charges indented to services the debt incurred by ASFINAG is likely. Competition policy may take on a more active role in reining back the domestic component of inflation (*Böheim,* 2007).

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Private Consumption becomes Strengthening Support to Growth due to Tax Cuts and Easing Inflation

Medium-term Projections for the Austrian Economy from 2008 to 2012 – Summary

With a projected annual rate of 2.3 percent the Austrian economy will grow less than expected so far. Real GDP growth will lag slightly behind the mark of 2.4 percent observed between 2002 and 2007.

The present downturn of the US business cycle will continue to weigh on activity in the euro area in the second half of 2008 and throughout 2009. This downward trend will be partially offset by growth opportunities in the new EU countries, where Austrian exporters have acquired a strong market position. We expect a recovery for the euro area starting from 2010, from which Austrian exporting firms should be able to take full advantage given their high degree of competitiveness.

According to current political intentions, a tax reform will take effect in 2010. Underlying the present medium-term forecast is the assumption of a € 3 billion tax cut. The resulting increase in household disposable income will boost real GDP growth by ½ percentage point in 2010.

Business investment will likely remain subdued in the near term. Corporate spending is likely to increase once the increased demand for exports and the increase in private consumption raises capacity utilisation rates. Capital formation is expected to increase by 2 to 3 percent per year.

Private consumption will pick up under the impact of the planned tax reform. The household saving ratio, which has risen markedly in the last few years due to uncertainty on the job market and the consequences of the pension reform, will edge up further in 2010 as a result of the tax reform. The expectation of a significant decline in the saving ratio after 2010 implies a stabilisation of consumer confidence.

Dynamic growth will allow employment to expand at 1 percent per year, which is comparable to the pace of the last five years. The unrestricted access of qualified labour from the new EU countries from 2009 together with the termination of the transition period for labour mobility in 2011 will reinforce the inflow of commuters and migrants. Also the domestic component of labour supply will increase. However, the unemployment rate will moderate as from 2010 thanks to the growth impulse from the tax reform, to a projected 5.9 percent of the dependent labour force in 2012.

Strong price hikes for food and energy in 2008 will be reflected in higher headline inflation and rising wage pressure. For the period from 2008 to 2012, nominal per-capita earnings are expected to rise by almost 3 percent p.a., after +2.3 percent over the last five-year period. Oil prices are assumed to follow an only moderate upward trend from 95 $ per barrel in 2008 to 104 $ in 2012. Under these assumptions, overall inflation should gradually ease over the years to come, averaging 2¼ percent over the entire forecast period.

The tax reform envisaged for 2010 will widen the general government deficit to nearly 1 percent of GDP. The degree of self-financing of the tax cuts (through higher tax revenues as a result of the induced stronger economic growth) is approximatly one-third by the end of the forecast period. Once the effect of the tax reform has faded, the budget deficit should steadily decline.