Josef Baumgartner, Serguei Kaniovski, Ewald Walterskirchen

Repercussions of Financial Market Crisis Weighing on Medium-Term Growth

Projections for the Austrian Economy until 2013

Over the period from 2009 to 2013, real GDP in Austria is expected to grow by an annual average rate of 1.3 percent, about half the rate observed for the last five years. A deterioration of export opportunities in the Central and Eastern Europe will decrease Austria's growth lead over the euro area. A tax reform and two fiscal stimulus programmes will stimulate private consumption and construction over the next years, thereby mitigating the impact of the global economic crisis on the domestic economy.

Josef Baumgartner, Serguei Kaniovski, Ewald Walterskirchen are economists at WIFO. **The authors are grateful to Karl Aiginger and Markus Marterbauer for helpful and constructive comments. • The data were processed and analysed with the assistance of Christine Kaufmann.** **• E-mail addresses: Josef.Baumgartner@wifo.ac.at, Serguei.Kaniovski@wifo.ac.at, Ewald.Walterskirchen@wifo.ac.at**

The Austrian economy is expected to grow by an annual rate of 1.3 percent p.a. between 2009 and 2013, only half the pace recorded for the years from 2004 to 2008 (+2.7 percent p.a.)[1]. The annual growth rates are unevenly distributed over the projection period. In 2009 and 2010, the Austrian economy is sliding into recession, which is triggered by the international financial market and economic crisis. A recovery is expected in 2010, provided that confidence in financial markets will have returned by then. Even in the best years of the forecast period (from 2011 to 2013), GDP growth will not attain the average rate of the last five years, as the global economy will overcome the effects of the economic crisis only gradually and Austria's main trading partner, Germany, will suffer a severe economic slump. In addition, growing uncertainty prompted by the financial crisis will constrain private households' access to new debt for consumption and residential construction as well as private companies' access to capital.

Following the recovery, potential output growth to be remaining lower than in the past, mainly due to greater caution exerted by private households, companies and financial institutions. In the likely recovery phase from 2011 to 2013, Austrian GDP is expected to expand at an annual rate of 2 percent.

Austria's growth advantage vis-à-vis the euro area will narrow because exports to the Central and Eastern Europe will significantly lose momentum. Also tourism will suffer over-proportionally from sluggish growth worldwide.

The Austrian government is taking a determined action to mitigate the impact of the global economic and financial crisis. Cuts of direct taxes by € 2.2 billion will be brought forward into 2009, the second economic recovery programme is expected to trigger additional investment of € 1.9 billion, and higher spending on family benefits will boost household purchasing power by € 500 million. Together with the first economic recovery programme ("1 billion for small and medium-size companies") and lagged effects of inflation-compensating measures taken in 2008, a stimulus of nearly € 6 billion or around 2 percent of GDP will be provided. With these measures,

[1] The growth projection for the years 2009 and 2010 corresponds to the WIFO forecast of December 2008, which already includes the dampening effects of the financial market crisis. The figures for the subsequent years are based on estimated medium-term trends.

Austria intends to fight the recession more strongly than most of the countries in the euro area (*Saha – von Weizsäcker,* 2008, 2009).

In response to the tax cuts, private consumption should grow by about 1½ percent p.a. over the period from 2009 to 2013, nearly maintaining the pace recorded for the earlier five-year period. It is assumed that the private household saving ratio will increase markedly in the year of the tax reduction and decrease steadily thereafter. Investment will slump in 2009 and 2010 due to the low capacity utilisation and pessimistic business expectations, but recover gradually afterwards as exports regain momentum. Unlike in the last few years, the contribution of the net exports to the real GDP will be moderate. Exports and imports may grow by only 3¼ percent per year. The projection for exports rests on the assumption that the world economy manages to recover relatively quickly and trend output growth will return to growth rates around its long-term average by the end of the forecast period. Thus, a recovery of the global economy should set in already in 2010, supported by the co-ordinated economic stimulus programmes implemented worldwide and by low interest rates. Yet, a more pessimistic medium-term development cannot be ruled out if, for example, confidence of financial institutions among each other or in the credit standing of potential debtors remains unsettled over a longer period of time, or if some major car manufacturers go bankrupt.

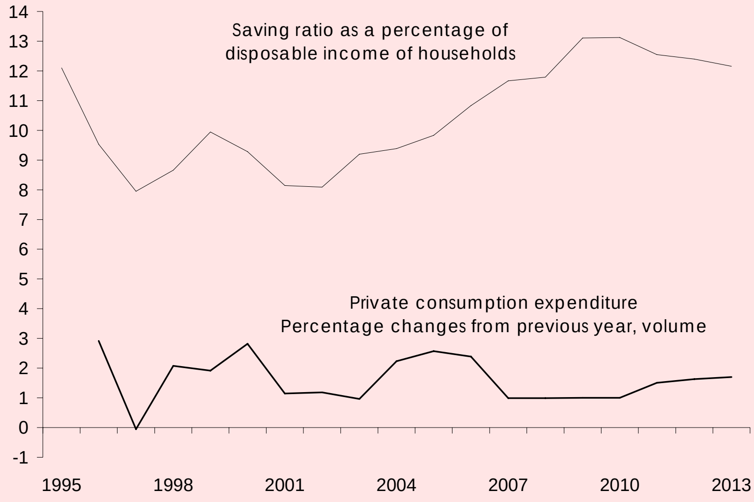
Table 1: Main results

	Ø1998-2003	Ø 2003-2008	Ø 2008-2013	2008	2009	2010	2011	2012	2013
				Year-to-year percentage changes					
Gross domestic product									
Volume	+ 2.0	+ 2.7	+ 1.3	+ 1.8	– 0.5	+ 0.9	+ 1.8	+ 2.3	+ 2.3
Value	+ 3.2	+ 4.8	+ 2.9	+ 4.1	+ 1.2	+ 2.2	+ 3.1	+ 3.9	+ 4.1
Consumer prices	+ 1.7	+ 2.2	+ 1.6	+ 3.2	+ 1.2	+ 1.5	+ 1.6	+ 1.8	+ 1.8
Gross wages and salaries per employee[1]	+ 2.0	+ 2.5	+ 2.5	+ 3.0	+ 3.0	+ 2.0	+ 2.2	+ 2.5	+ 2.6
Active dependent employment[2]	+ 0.5	+ 1.6	+ 0.5	+ 2.4	– 0.4	+ 0.2	+ 0.7	+ 1.0	+ 1.1
	Ø 1999-2003	Ø 2004-2008	Ø 2009-2013	2008	2009	2010	2011	2012	2013
				In percent					
Unemployment rate									
Eurostat definition[3]	3.9	4.6	4.0	3.5	3.9	4.1	4.2	4.0	3.7
National definition[4]	6.5	6.6	6.9	5.8	6.5	6.9	7.2	7.0	6.7
				As a percentage of GDP					
Net exports	2.7	4.9	5.5	5.9	5.7	5.5	5.3	5.4	5.6
General government financial balance (Maastricht definition)	– 1.2	– 1.7	– 2.7	– 0.5	– 2.8	– 3.2	– 3.0	– 2.5	– 1.9
				As a percentage of disposable income					
Household saving ratio	8.9	10.7	12.7	11.8	13.1	13.1	12.6	12.4	12.2

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; break 2008. – [4] According to Public Employment Service, percent of total labour force excluding self-employed.

Sluggish growth in the years to come will have negative consequences for the labour market and for public finances, while inflation risks abate. Fighting rising unemployment will return to be a key issue for economic and labour market policy. Over the period from 2009 to 2013, the unemployment rate (as defined by the public employment service) will average 6.9 percent, exceeding the 7 percent mark in several years. Besides the personal hardship of those affected, unemployment also adds to overall economic uncertainty and may provoke a rise in precautionary saving by private households, further depressing the GDP growth. Firms and government authorities are likely to resort to a greater extent to short-time work and job training to keep the rising unemployment in check. Under these assumptions, the number of registered jobseekers may increase by 42,000 between 2008 and 2013, somewhat less than following the 2001 recession. In the event of a more severe economic setback, unemployment would, however, increase considerably more. Overall employment will grow moderately, by an annual 0.5 percent between 2009 and 2013, with the number of full-time jobs only beginning to rise towards the end of the forecast period. The liberalised access of qualified labour from the new EU member states as from 2009 and the end of the transition period in 2011 will lead to higher inflow of workers and commuters. Nevertheless, the main factor for labour immigration will be the strength of domestic labour demand.

Figure 1: Private consumption and saving ratio



Source: Statistics Austria, WIFO calculations.

As a consequence of the recession and fiscal stimulate, the general government deficit will rise above 3 percent of GDP in 2010 and 2011. By 2013, the gap may narrow to a GDP-ratio of 2 percent if efforts at consolidation are taken.

In 2009, the world-wide recession will lead to a fall in prices for internationally-traded commodities, as demand for crude oil and other raw materials declines. In the outer years, oil and other commodity prices will recover gradually. The current projections are based on the assumption for the reference price of oil falling from $ 98 per barrel in 2008 to $ 55 in 2009 and rebounding to $ 72.7 by 2013. Largely determined by international commodity prices, headline inflation in Austria is expected to moderate to an annual average 1.6 percent over the period 2009 to 2013.

Growth advantage vis-à-vis the euro area average narrowing

Over the period from 2004 to 2008, real GDP growth in Austria exceeded the euro area average by an annual 0.7 percentage points. This positive margin is expected to narrow for several reasons:

- Exports, which have given powerful impetus to domestic activity during the last years, will lose momentum due to a slackening in the world's economic growth;
- Austrian companies with strong exposure in the Central and Eastern European countries (*FIW,* 2008), will be particularly affected by the problems that countries in the region will face. The boom of the last few years has been largely driven by debt-financed spending and massive capital inflow from abroad. These drivers will at least become weaker;
- The expected downturn in Central and Eastern Europe will cause substantial loses for Austrian banks;
- Demand for tourism services, which plays a significant role in Austria, usually reacts highly sensitively to a cyclical downturn. A fall in real GDP by 1 percent typically leads to a loss in real earnings of the tourism industry by 2 percent (*Smeral,* 2008);

- The strengths of the German economy lie in manufacturing and export of motor cars and investment goods. These industries suffer particularly in the current crisis and Austrian suppliers with them.

A number of factors suggest nevertheless that the Austrian economy will maintain an – albeit small – positive growth margin:

- The tax cuts and the economic recovery programmes will give incentives to private consumption. The measures taken in Austria to fight the recession are not only more extensive in relation to the domestic economy, but will also take effect earlier then in most euro area countries (*Saha – von Weizsäcker,* 2008, 2009). For example, no counter-cyclical action has so far been envisaged in Italy, given the urgent need for budgetary consolidation. The German government has adopted a second package in January 2009, whose positive effects are likely to show up only towards the end of 2009.
- Austria's price competitiveness, as measured by relative unit labour costs, has improved substantially during the last ten years (*Guger – Leoni,* 2007). This trend will continue, benefiting export-oriented industries in the medium-term.
- In some countries of the euro area (notably in Spain, Ireland and France), growth was fuelled until mid-2007 by booming real estate markets. In the years to come, their decline as well as an increase in the private household saving ratio will weigh on consumption and residential investment.
- The sustained increase in spending on research and development (as a percentage of GDP) in Austria over the last years should have a growth-enhancing impact in the medium run. The target of raising the R&D ratio to 3 percent of GDP by 2010 may be attained.
- Increased investment in education and training will also strengthen economic growth in Austria, in particular the expansion of universities of applied sciences and the reinforcement of apprenticeship and job training programmes even in times of economic crisis.
- Potential labour supply will rise massively as from 2011, when the transition period for free labour market access from the new EU member states expires. Abundant availability of labour will favour growth and employment in the cyclical recovery in sectors suffering from shortages of workforce, but at the same time decrease job-prospects for the low-qualified.

Global growth shifting into lower gear

For 2009 and 2010, the present medium-term projections are based upon the WIFO short-term forecast of December 2008 (*Scheiblecker,* 2009). The calculations for the years 2011 to 2013 have been obtained using the WIFO macro-economic model (*Baumgartner – Breuss – Kaniovski,* 2005) on the assumption on external economic developments by *Schulmeister* (2009). The latter are therefore presented here in a summary fashion only.

The global economic crisis will dampen in particular Austrian exports and investment over the period from 2009 to 2013. Consumption by private households, supported by tax cuts, should barely lose momentum from the earlier five-year period.

This year and next, the recession in the USA will keep bearing down also on the euro area. Thereafter, the US economy is expected to recover. For the whole projection period 2009-2013, the pace of euro area growth of around 1 percent p.a. is likely to be distinctly lower than in the last five years. The estimated growth rate for the OECD area as a whole is 1 percentage point per year lower than in the previous period.

Due to its close economic ties with the new EU member states, Austria is more than other countries affected by the slowdown of growth in the region, where credit risks have mounted sharply, particularly for real estate assets. According to the *IMF* (2008), such risks are particularly acute in south-eastern Europe (Bulgaria and Romania) and in the countries of the CIS, due to the high level of private indebtedness.

While the Austrian economy will in the short run be hit by the world-wide recession, it should be able to fully participate in the subsequent cyclical upswing thanks to its strong competitive position. Volume exports are projected to advance by an average 3¼ percent p.a. between 2009 and 2013, but with markedly different results for the two sub-periods 2009-10 and 2011-13. Since imports are likely to rise in step with exports over the projection period, Austria will no longer enjoy an increasing growth contribution from net foreign trade. This is largely a consequence of reduced export opportunities in Central and Eastern Europe.

Table 2: International fundamentals

	Ø 1998-2003	Ø 2003-2008	Ø 2008-2013
		Year-to-year percentage changes	
Gross domestic product, volume			
Euro area	+ 2.1	+ 2.0	+ 1.1
23 OECD-countries[1]	+ 2.2	+ 2.3	+ 1.1
	Ø 1999-2003	Ø 2004-2008	Ø 2009-2013
		Dollar per ECU or Euro	
Exchange rate	0.99	1.31	1.23
		$ per barrel	
Oil price, Brent	24.9	65.7	65.9

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

Investment will slump in 2009 and 2010, but recover thereafter with a pick-up in export growth. Construction is unlikely to maintain the momentum of the previous five-year period when it was largely driven by activity in civil engineering.

Private consumption will be bolstered this and next year by tax cuts. The projection for household spending is for growth of 1½ percent per year in volume over the period 2009-2013, barely down from the +1¾ percent observed in the previous five-year period. This profile rests upon the assumption that the saving ratio will considerably increase in the year of the tax cut but subsequently decrease, implying that subdued business expectations and rebounding unemployment will not give rise to massive precautionary saving.

Table 3: Components of aggregate demand, volume

	Ø 1998-2003	Ø 2003-2008	Ø 2008-2013	2008	2009	2010	2011	2012	2013
				Year-to-year percentage changes					
Consumption expenditure									
Private households[1]	+ 1.6	+ 1.8	+ 1.4	+ 1.0	+ 1.0	+ 1.0	+ 1.5	+ 1.6	+ 1.7
General government	+ 1.0	+ 1.5	+ 0.9	+ 1.0	+ 1.0	+ 1.0	+ 0.8	+ 0.8	+ 0.7
Gross fixed capital formation	+ 0.9	+ 2.4	+ 1.0	+ 1.9	– 3.8	+ 0.3	+ 1.8	+ 3.3	+ 3.6
Machinery and equipment[2]	+ 2.6	+ 2.9	+ 1.3	+ 2.0	– 7.0	± 0.0	+ 2.6	+ 5.5	+ 5.8
Construction	– 0.4	+ 2.0	+ 0.8	+ 1.8	– 1.0	+ 0.5	+ 1.2	+ 1.5	+ 1.7
Domestic demand	+ 1.4	+ 1.9	+ 1.2	+ 1.1	– 0.1	+ 0.9	+ 1.5	+ 1.9	+ 2.0
Exports	+ 6.1	+ 7.3	+ 3.3	+ 3.1	– 0.5	+ 1.4	+ 4.1	+ 5.7	+ 5.9
Imports	+ 4.9	+ 6.1	+ 3.3	+ 2.1	+ 0.2	+ 1.5	+ 3.8	+ 5.4	+ 5.7
Gross domestic product	+ 2.0	+ 2.7	+ 1.3	+ 1.8	– 0.5	+ 0.9	+ 1.8	+ 2.3	+ 2.3

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

Even during the favourable cyclical phase expected for 2012-13, GDP growth may fall short of the average for the period 2004-2008. Towards the end of the projection period, the growth rate should broadly match that of potential output.

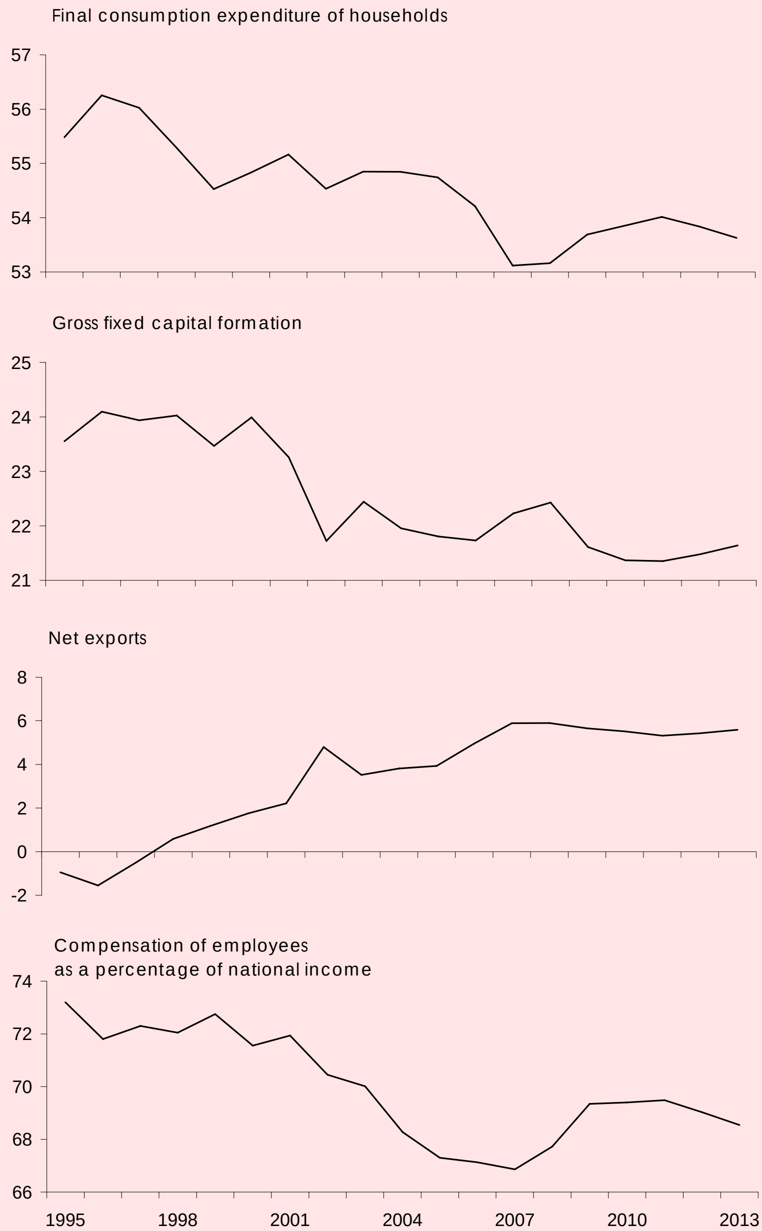
Since 2000, Austria's general government deficit has been reduced to a rate of 0.5 percent of GDP in 2008. In parallel, the public revenue to GDP ratio has seen a downward trend. In an international comparison, the situation of Austrian public finances is favourable. However, ample recourse to off-budget financing has led to high stocks of accumulated debt with the agencies in charge of funding highway, railroad and public real estate infrastructure investment (ASFINAG, SCHIG and BIG, respectively).

Tax cuts and fiscal stimulus measures cushion the downturn, but widen the budget deficit

As a consequence of the recession and of fiscal counter-action, the general government deficit will average 2¾ percent of GDP during the period from 2009 to 2013.

Figure 2: Expenditure on GDP and income

As a percentage of GDP, at current prices

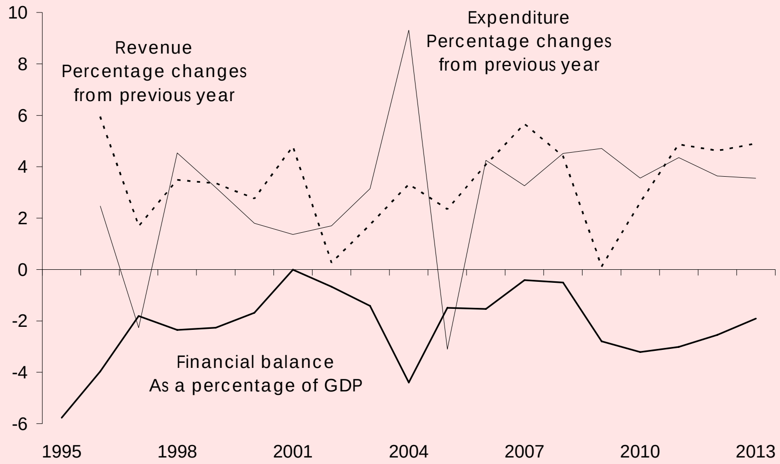


Source: Statistics Austria, WIFO calculations.

In the light of the imminent recession, the Federal government has stipulated a cut in direct taxes in 2009. The tax cut will exonerate private households by a total € 2.2 billion. In addition, families will receive € 500 million in additional transfers. The first economic recovery programme provided financial support for medium-sized companies and higher investment in infrastructure (loans and guarantees) to an amount of € 1 billion. The second recovery programme is expected to provide a stimulus of

€ 1.9 billion, while burdening the budget by only € 600 million in the short term. The impact on growth and employment of these measures will be spread over several years.

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



Source: Statistics Austria, WIFO calculations.

Furthermore, several measures that had been taken already in 2008 will largely remain effective in 2009. Thus, as from mid-2008, the part of the unemployment insurance contribution paid by the employee has been abolished up to gross monthly earnings of € 1,000 and reduced up to an earnings ceiling of € 1,350. The kilometric fiscal allowance for car drivers and the commuter tax credit were revalued. The regular revalorisation of social retirement benefits was carried forward by two months. Finally, the inflation-compensating government action of September 2008 included an increase in family subsidies (by introducing a 13th monthly instalment per year), the virtual abolition of student fees and a 50 percent-cut in the VAT rate for pharmaceuticals.

Table 4: General government

At current prices

	Ø 1998-2003	Ø 2003-2008	Ø 2008-2013	2008	2009	2010	2011	2012	2013
					Year-to-year percentage changes				
Current revenue	+ 2.6	+ 4.0	+ 3.4	+ 4.4	+ 0.1	+ 2.6	+ 4.9	+ 4.6	+ 4.9
Current expenditure	+ 2.2	+ 3.6	+ 4.0	+ 4.5	+ 4.7	+ 3.6	+ 4.3	+ 3.6	+ 3.6
Gross domestic product	+ 3.2	+ 4.8	+ 2.9	+ 4.1	+ 1.2	+ 2.2	+ 3.1	+ 3.9	+ 4.1
	Ø 1999-2003	Ø 2004-2008	Ø 2009-2013	2008	2009	2010	2011	2012	2013
					As a percentage of GDP				
General government financial balance (Maastricht definition)	– 1.2	– 1.7	– 2.7	– 0.5	– 2.8	– 3.2	– 3.0	– 2.5	– 1.9

Source: Statistics Austria, WIFO calculations.

The fiscal leeway required for the financing of the tax cuts and the other fiscal stimulate is to be generated over the medium term by savings in public administration costs. The general government deficit will nevertheless increase to 2¾ percent of GDP on average for the period 2009-2013. In 2010 and 2011, the deficit ceiling of 3 percent of GDP will be exceeded not only because of the tax reform and the recovery programmes, but also on account of shortfalls in tax and social contribution revenues due to cyclical sluggishness.

The discretionary fiscal measures to the tune of 2 percent of GDP (nearly € 6 billion) to stabilise economic activity will dampen the downturn in GDP growth by an estimated ¾ percentage point in 2009.

The future trend of government expenditure is subject to a considerable margin of uncertainty since no budget proposals have yet been submitted for the next few years. The projection implies that the cost-saving second leg of administrative reforms will be implemented without delay.

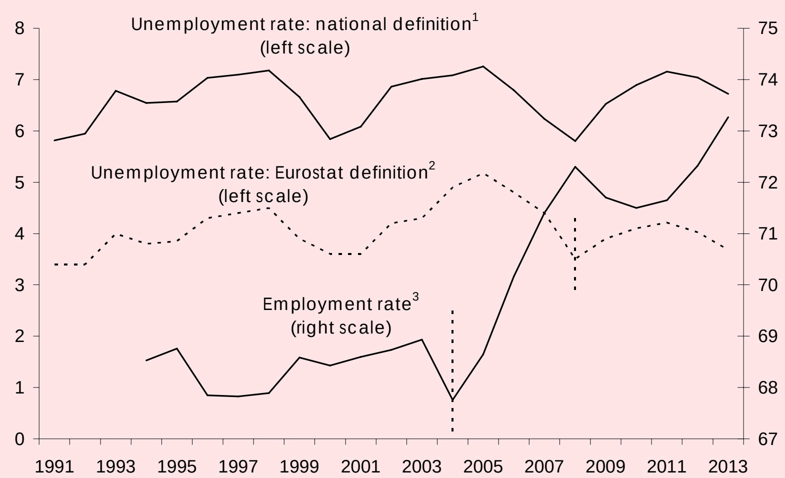
Rising unemployment rate as potential risk

In the next few years, unemployment will return to the fore as a major challenge for macro-economic and labour market policy. The unemployment rate (as defined by the public employment service) will average 6.9 percent for the period 2009-2013, rising above 7 percent at times. Apart from the personal hardship for those concerned, unemployment may add to general economic uncertainty and encourage private households to increase precautionary saving.

Total employment showed strong upward momentum (+1.6 percent per year) during the cyclical upswing of 2003 until 2008. The number of full-time jobs grew markedly, and the hitherto relatively low proportion of part-time employment rose above the EU average.

Against the backdrop of weak economic growth, the projections draw a pessimistic picture for employment prospects in the next five years. The expected average rate of 1.3 percent real GDP growth will allow overall employment to advance by only 0.5 percent p.a., with the number of full-time jobs picking up only towards the end of the forecast horizon. The Lisbon targets for 2010 will be reached for the total employment ratio and for the female ratio, but missed for the employment of older workers.

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; break 2008. – [3] Persons in employment as a percentage of population of working age (15 to 64); changed survey method since 2004.

The expected momentum of growth will be insufficient in preventing an increase in unemployment, particularly as the supply of both domestic and foreign labour will increase. The present projections anticipate a rebound in the number of unemployed to 253,000 by 2013, an increase by 42,000 from 2008. Such an increase would nevertheless be smaller than in the last recession, assuming that this time labour market policy will react more strongly via more widespread recourse to short-time work and job training.

The unemployment rate for the period 2009-2013 is expected to average 6.9 percent of the dependent labour force or 4.0 percent of the total labour force as defined by Eurostat. On the national (public employment service) definition, the unemployment rate is thus some 1 percentage point higher than in the last forecast (*Baumgartner – Kaniovski – Walterskirchen*, 2008). The fact that the unemployment rate according to Eurostat, at 3.5 percent, was significantly lower in 2008 than expected also has a dampening effect on the projected level[2]. The government target of an unemployment rate of 4 percent (Eurostat definition) has thereby been met already in 2008.

Towards the end of the projection period, unemployment should start heading down. In an international comparison, Austria's labour market continues to perform remarkably well.

Starting from 2011, workers from the new EU member states (except from Romania and Bulgaria) will be granted unrestricted access to the Austrian labour market. Already in 2009 the inflow from accession countries has been liberalised for certain categories of skilled labour. Thus far, official immigration has been rather low due to the administrative restrictions in force. By how much it will actually increase from now on will largely depend on economic activity and job opportunities in Austria (especially in the tourism and the construction sector). Wage differentials between Austria and the new EU member states are still large enough for Austria being an attractive place to work. Wage-gaps have become wider after the recent currency depreciations in Hungary and other Central European countries.

Table 5: Labour market, income

		Ø 1998-2003[1]	Ø 2003-2008[1]	Ø 2008-2013[1]	2008	2009	2010	2011	2012	2013
						Year-to-year percentage changes				
Persons in active employment[2]		+ 0.5	+ 1.6	+ 0.5	+ 2.4	– 0.4	+ 0.2	+ 0.7	+ 1.0	+ 1.1
Registered unemployed		+ 0.2	– 2.6	+ 3.7	– 5.2	+12.8	+ 6.3	+ 4.7	– 0.8	– 3.8
Unemployment rate										
Eurostat definition[3]	in percent	3.9	4.6	4.0	3.5	3.9	4.1	4.2	4.0	3.7
National definition[4]	in percent	6.5	6.6	6.9	5.8	6.5	6.9	7.2	7.0	6.7
Productivity[5]		+ 1.2	+ 1.4	+ 0.8	– 0.1	– 0.2	+ 0.5	+ 1.0	+ 1.3	+ 1.2
Gross wages and salaries[6]		+ 2.7	+ 4.1	+ 3.1	+ 5.3	+ 2.7	+ 2.4	+ 3.0	+ 3.6	+ 3.9
Per employee[7]		+ 2.0	+ 2.5	+ 2.5	+ 3.0	+ 3.0	+ 2.0	+ 2.2	+ 2.5	+ 2.6
Unit labour costs, total economy		+ 0.6	+ 1.1	+ 1.7	+ 3.3	+ 3.2	+ 1.5	+ 1.2	+ 1.2	+ 1.4

Source: Federation of Austrian Social Security Institutions, Statistics Austria, WIFO calculations. – [1] Unemployment rate: Ø 1999-2003, Ø 2004-2008, Ø 2009-2013 – [2] Excluding parental leave, military service, and unemployed persons in training. – [3] According to Eurostat Labour Force Survey, percent of total labour force; break 2008. – [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.

Inflation moving at slow pace

Variations in headline inflation largely reflect commodity prices on international markets, which is largely determined by global economic growth and occasional supply shortages. The world-wide recession is leading to sharp price declines in 2009 since demand for oil and other raw materials slackens Going forward, market prices for internationally-traded commodities are expected to recover gradually.

The projections are based on the assumption of the reference price for crude oil falling from $ 98 per barrel in 2008 to $ 55 in 2009 and subsequently picking up to $ 72.7 by 2013 (*Schulmeister,* 2009). Also the prices for agricultural and industrial raw materials will decrease significantly from their 2008 level. Since oil and food prices are extremely volatile, the medium-term inflation outlook is subject to a wide margin of uncertainty. Crude oil prices are shaped not only by economic variables, but also by political events like war in the Middle-East, or by decisions of the OPEC cartel. The, developments of food prices also reflect policy strategies as e.g. the use of grain for the production of bio fuels.

In the last five years during which the world economy grew relatively strongly, headline inflation in Austria averaged 2.2 percent, slightly exceeding the 2 percent target the European Central Bank tries to maintain over the medium-term. The upward shift of the price level was ½ percentage point stronger than in the previous five-years.

[2] As from 2008, the method of calculating the Eurostat unemployment rate has been changed (*Gumprecht,* 2008A, 2008B).

Also in the euro area inflation was above 2 percent on average, although wage pressure remained moderate even in the cyclical boom, due to the effect of globalisation and a persistent hard core of unemployment.

The current decline in world prices for agricultural commodities and crude oil in the wake of the financial market crisis suggests a substantial easing of price pressures in 2009. In the following years, inflation is expected to regain some momentum, yielding an average rate for the whole period 2009-2013 of 1.6 percent. Inflation will thus be lower by over ½ percentage point than between 2004 and 2008.

Apart from energy and commodity prices, the domestic price level is influenced by unit labour costs, indirect taxes and social charges and the competitive climate in the economy. Also these factors should not exert substantial inflationary pressure in the years to come.

Wages are likely to react to the slowdown in inflation. Per-capita earnings are projected to go up by an average 2½ percent per year between 2009 and 2013, the same pace as in the previous period. Unit labour cost, the most important determinant of domestic cost pressure, will nevertheless edge up 1.7 percent p.a. over the forecast period, somewhat faster than over the last five years as productivity gains will be leaner in a period of subdued demand and output growth (lower capacity utilisation, weaker incentives for productivity-enhancing investment).

Table 6: Implicit price indices

	Ø 1998-2003	Ø 2003-2008	Ø 2008-2013	2008	2009	2010	2011	2012	2013
	Year-to-year percentage changes								
Private consumption	+ 1.4	+ 2.3	+ 1.7	+ 3.2	+ 1.2	+ 1.5	+ 1.9	+ 1.9	+ 2.0
Exports	+ 0.5	+ 1.9	+ 0.9	+ 1.6	– 0.1	+ 0.5	+ 2.4	+ 1.1	+ 0.5
Imports	+ 0.4	+ 2.4	+ 1.1	+ 2.7	– 0.5	+ 0.7	+ 3.4	+ 1.4	+ 0.6
Gross domestic product	+ 1.2	+ 2.0	+ 1.5	+ 2.3	+ 1.7	+ 1.3	+ 1.3	+ 1.6	+ 1.8

Source: Statistics Austria, WIFO calculations.

Real per capita wages should advance in accordance with labour productivity. The secular downward trend in the wages to GDP ratio as observed since the early 1980s could thereby come to a temporary halt. In periods of sluggish activity there is less scope for significant increases in profits, which are also held down by capacity utilisation falling below its long-term average.

Real unit labour costs will remain broadly unchanged over the period 2009-2013 which likely strengthens further the competitive position of Austrian companies. However, this depends also on wage and exchange rate developments of major trading partners and competitors, respectively.

It is assumed that no changes will be made to indirect taxes and public fees over the projection horizon. In a medium-term perspective it is nevertheless likely that road transport charges will be increased in order to cover the debt incurred by the highway construction agency ASFINAG.

Risks and uncertainties

The present medium-term forecast assumes a swift recovery of the world economy. The growth rates converge to their long-term trend growth rates towards the end of the forecast period. While it will take some time to restore confidence in financial markets, the global economy should set to recover in 2010, benefiting from coordinated economic stimulus plans in most of the largest economies and low interest rates.

However, a less favourable medium-term outturn cannot be ruled out. The current steep decline in industrial orders and business confidence may become protracted if a number of large international companies file for bankruptcy, leading to a (sharp) increase in unemployment and private households precautionary saving. Confidence of banks *vis-à-vis* each other and in the credit standing of potential debitors may remain undermined for a protracted period of time. Moreover, the real estate and financial crisis in the USA, the UK and Spain may translate into an extended sluggishness of economic activity – as it did in the 1990s in Japan and some of the Scandinavian economies. Lastly, the expected downturn in Central and Eastern Europe may turn out more severe than assumed in our scenario, given the high indebtedness (in foreign currency) of private households and firms in these countries. In the event of such adverse external conditions, prospects for the Austrian banking sector and for export-oriented manufacturers, notably in the automotive-supply industry, would be even more pessimistic.

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Medium-term Growth Subdued by Effects of the Financial Crisis

Forecast for the Austrian Economy until 2013 – Summary

At 1.3 percent p.a. the Austrian economy will expand only half as rapidly in 2009-2013 than in 2004-2008 (2.7 percent per year). The current forecast period is characterised by very heterogeneous developments: During 2009 and 2010 the Austrian economy will be fully hit by the international economic crisis. From 2010 onwards a recovery is expected, if confidence in the financial markets is restored by then. Even during the peak years of the cycle (2011-2013) GDP growth will not regain its average of the five most recent years. This development is due to the fact the world economy will only gradually overcome of the consequences of the housing and financial crisis. In addition, Austria's main trade partners in Germany will suffer severely from the slump in the capital goods and automotive industries. Furthermore, the growing uncertainty will make it difficult for private households to incur new debt for consumption and dwellings and due to the financial crisis businesses will face limited access to venture capital.

Even after the economy will have recovered from the recession and entered a "normal period", potential output will remain lower than in the past. The cautiousness of private households, entrepreneurs and banks will depress trend output in the medium run. During the expected recovery starting from 2011, the Austrian economy will expand by about 2 percent per year.

Austria's growth performance will retain its lead over the euro area, but the margin will shrink, as exports to Central and Eastern Europe are likely to lose momentum, and the important tourism sector will suffer disproportionately from the worldwide slump.

The Austrian federal government is taking measures to counteract the effects of the world financial and economic crisis. A tax cut amounting to € 2.2 billion euros will come in effect in 2009, the second economic recovery package is expected to trigger additional investment of € 1.9 billion and the extra expenditures for families will raise purchasing power by € 500 million. Including the first economic recovery package and other measures of 2008, the overall stimulus to the economy will amount to about € 5 to 6 billion (1½ percent to 2 percent of GDP). With these measures to fight the recession Austria is doing more than the average euro area country.

The tax cut is expected to stimulate private consumption. Its growth rate of approximately 1 percent per year between 2009-2013 is only slightly lower than in the preceding five years. It is assumed that the savings ratio of the private households will surge in 2009, and decline steadily thereafter. Due to diminishing capacity utilisation and unfavourable expectations, investment will decline sharply in 2009 and in 2010, but recover gradually as exports will gain momentum afterwards. In contrast to recent years, real net exports will not significantly contribute to economic growth. Exports are expected to increase by merely 3¼ percent per year and thus at a similar pace as imports. The export forecast is based on the assumption that the world economy will overcome the consequences of the financial crisis relatively quickly. Accordingly the recovery of the world economy is expected to begin already in 2010 supported by coordinated worldwide economic fiscal stimulus measures and low interest rates. A more unfavourable medium-term trend cannot be ruled out, if, for example, banks' mutual trust and the credit standing of potential debtors remain shattered for a protracted period or several large automobile groups have to file for bankruptcy.

The slow growth of the coming years will have a negative effect on the labour market and public finances. By contrast, inflation risks will diminish. Unemployment will again become a central issue of economic and labour market policies. The unemployment rate (definition of the Public Employment Service, AMS) is expected to surge to 6.9 percent on average in 2009-2013, exceeding the benchmark of 7 percent during a couple of years.

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