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Subdued Economic Growth, High Unemployment and Fiscal Consolidation Shaping the Economic Outlook

Medium-term Forecast for the Austrian Economy until 2018

Subdued Economic Growth, High Unemployment and Fiscal Consolidation Shaping the Economic Outlook. Medium-term Forecast for the Austrian Economy until 2018

After the slump in economic growth between late 2012 and the middle of 2013, the Austrian economy is expected to follow a moderate upward trend, with GDP growth averaging 1.8 percent p.a. over the period 2014-2018. Private consumption in particular will remain subdued, as private households seem inclined to further increase their savings. While the gradual pace of expansion will lead to more jobs (2014-2018 +0.8 percent p.a.), unemployment is unlikely to decline significantly, given the parallel increase in both domestic and foreign labour supply. From a peak of 7.9 percent (as defined by the public employment service) in 2015, the unemployment rate is projected to decline only slightly to 7.7 percent by the forecast horizon. Inflationary pressure remains weak over the medium term, with headline inflation anticipated at an average 1.9 percent. A balanced general government budget (in structural terms as well as in accordance to the "Maastricht" definition) will not be achieved by the structural consolidation scenario underlying the forecast (€ 2 billion as from 2014 and a further € 1 billion from 2015 onwards).

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For definitions used see "methodological references and glossary of terms", http://www.wifo.ac.at/wwadocs/form/WIFO-BusinessCycleInformation-Glossary.pdf

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1. Growth in Austria staying above the euro-area average

Over the 15 years since the creation of European Economic and Monetary Union, growth of Austria's real GDP has significantly exceeded the euro-area average, by ½ percentage point p.a. (*Breuss,* 2013). Likewise, the downturn during the recession of 2009 was less sharp. Over the forecast period from 2014 to 2018, the Austrian economy is projected to grow by 1.8 percent p.a., maintaining a positive growth differential of ¼ percentage point p.a. vis-à-vis the euro area.

The sustained growth advantage over the euro area has several reasons:

- Growth of the EU economies in east-central and south-eastern Europe is likely to rebound in the years to come (*Schiman,* 2013). Austrian companies enjoy firm positions in these markets and should draw above-average benefits from their recovery.

- Whereas the population of working age is heading down in the euro area (–0.3 percent p.a. over the forecast horizon), it will still increase slightly in Austria, by 0.1 percent p.a. according to the projections of Statistics Austria[1].

Table 1: Main results

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
				Year-to-year percentage changes					
Gross domestic product									
Volume	+ 2.8	+ 0.4	+ 1.8	+ 0.3	+ 1.7	+ 1.7	+ 1.9	+ 1.9	+ 1.8
Value	+ 4.7	+ 2.1	+ 3.5	+ 2.3	+ 3.5	+ 3.6	+ 3.6	+ 3.6	+ 3.5
Consumer prices	+ 2.2	+ 2.0	+ 1.9	+ 2.0	+ 1.8	+ 1.9	+ 1.9	+ 1.9	+ 1.8
Gross wages and salaries per employee, volume[1]	+ 0.4	– 0.3	+ 0.5	– 0.1	+ 0.3	+ 0.5	+ 0.5	+ 0.5	+ 0.5
Employees[2]	+ 1.6	+ 0.9	+ 1.0	+ 0.7	+ 1.0	+ 1.0	+ 1.1	+ 1.1	+ 1.0
Persons in active dependent employment[3]	+ 1.4	+ 0.7	+ 0.8	+ 0.6	+ 0.8	+ 0.8	+ 0.9	+ 0.8	+ 0.8
				In percent					
Unemployment rate									
Eurostat definition[4]	4.6	4.5	5.1	4.9	5.2	5.2	5.1	5.1	5.0
National definition[5]	6.7	7.1	7.8	7.6	7.9	7.9	7.8	7.7	7.7
				As a percentage of GDP					
Net exports	4.9	3.9	5.4	4.7	5.0	5.2	5.4	5.6	5.8
General government financial balance (Maastricht definition)	– 1.9	– 3.1	– 1.4	– 1.9	– 2.0	– 1.6	– 1.4	– 0.9	– 1.0
Cyclically-adjusted budget balance	– 2.2	– 2.6	– 1.2	– 1.5	– 1.8	– 1.4	– 1.2	– 0.8	– 0.9
Structural budget balance	–	– 2.4	– 0.9	– 1.7	– 1.3	– 0.8	– 0.8	– 0.7	– 0.8
Gross public debt	63.1	72.5	73.6	74.1	74.2	74.2	74.0	73.2	72.6
				As a percentage of disposable income					
Household saving ratio	10.5	8.1	7.9	6.4	7.1	7.6	7.9	8.3	8.7
				Year-to-year percentage changes					
Trend output, volume	+ 2.1	+ 0.9	+ 1.6	+ 1.2	+ 1.4	+ 1.6	+ 1.7	+ 1.7	+ 1.7
				As a percentage of trend output					
Output gap, volume	+ 0.7	– 0.9	– 0.3	– 0.8	– 0.6	– 0.5	– 0.3	– 0.2	– 0.2

Source: Statistics Austria, WIFO calculations. – [1] Excluding employers' contributions, employees according to National Accounts definition, deflated by CPI. – [2] According to National Accounts definition. – [3] Excluding parental leave and military service. – [4] According to Eurostat Labour Force Survey, percent of total labour force. – [5] According to Public Employment Service Austria, percent of total labour force excluding self-employed.

Table 2: International fundamentals

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018
	Year-to-year percentage changes		
Gross domestic product, volume			
Euro area	+ 2.1	– 0.4	+ 1.5
23 OECD countries[1]	+ 2.1	+ 0.6	+ 2.3
	Dollar per Euro		
Exchange rate	1.32	1.35	1.25
	Dollar per barrel		
Oil price			
Brent	65.5	94.5	108.6

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

- Since 1995, spending on research and development in Austria has been raised by 1.3 percentage points to 2.8 percent of GDP in 2012. Within the euro area

[1] According to the population projections of Eurostat, the working-age population of Austria will also start declining as from 2017 (–0.1 percent p.a.), albeit less than the euro-area average.

(2.1 percent of GDP, +0.4 percentage point), Austria is nowadays among the most research-intensive countries, which should further support its innovative capacity and international competitiveness going forward.

Figure 1: Growth of real GDP

Percentage changes from previous year

Source: Statistics Austria, WIFO calculations.

2. Continued restraint in private consumption

The present medium-term forecast for the Austrian economy is based, up to 2015, on the WIFO short-term forecast of December 2013 (*Schiman,* 2014). The medium-term projections have been carried out with the WIFO macroeconomic model (*Baumgartner – Breuss – Kaniovski,* 2005), building upon the external assumptions of *Schiman* (2013, 2014). The key international trends underlying the forecast for Austria can be summarised as follows:

International business activity is set to pick up somewhat in 2014 and 2015. Over the entire forecast period 2014-2018, GDP growth will average 2.9 percent p.a. in the USA and 1.5 percent in the euro area.

Germany, thanks to gains in its export market shares, achieved a current account surplus averaging 5.8 percent of GDP over the last decade. Austrian manufacturers drew indirect benefits from strong supply chains with the German industry. The assumed growth acceleration for Austria's major trading partner (+¼ percentage point p.a. 2014-2018 from the period 2004-2013) and a further increase in Germany's current account surplus by ¾ percent of GDP should also stimulate Austrian exports.

Since the end of 2011, Italy has plunged into a second recession within few years; but also between 2001 and 2007, the economy grew by only 1.2 percent per year. Over the last ten years, GDP shrank by an overall 2½ percent. Italy nevertheless remains Austria's second-most-important export market, and the projected rebound to an annual 1.1 percent GDP growth rate should allow to reverse the latest negative export trend.

In the new EU countries of east-central Europe, the slump of 2009 and the downturn of 2012-13 have held back the catching-up process (2009-2013 +0.8 percent p.a.) towards the more advanced EU economies. For the next five years, GDP growth is expected at an average 3.1 percent p.a., offering better export opportunities for Austrian firms.

Short-term interest rates in the euro area should start heading up only towards the end of the forecast horizon.

Figure 2: Expenditure on GDP and income

As a percentage of GDP, at current prices

Source: Statistics Austria, WIFO calculations.

Oil prices are projected to edge up from nearly $ 109 per barrel in 2013 to $ 116 by 2018. It is further assumed that the euro exchange rate vis-à-vis the dollar will weaken from $ 1.33 in 2013 to $ 1.24 in 2018.

Due to the close external linkages of the economy, a cyclical recovery in Austria is largely driven by international developments. Exports (in volume terms) are expected to expand by an annual 5.7 percent in the next five years, allowing exporters to maintain their foreign market position. With imports volume projected to move at a slightly lower pace of 5.5 percent p.a., the Austrian economy should continue to enjoy external surpluses, reaching about 5.8 percent of GDP by the forecast horizon.

Owing to the revival of world trade, Austrian exports are expected to gain 5.7 percent on annual average, driving domestic GDP growth of 1.8 percent p.a. Trend output growth (in volume terms) will not exceed 1.7 percent per year, with the output gap narrowing from –0.8 percent in 2013 to –0.2 percent by the end of the forecast period.

Investment in machinery and equipment is projected to rebound (+3.7 percent p.a.), fuelled by easy financing conditions and rising prospects for sales abroad. Residential investment, for its part, will be supported by population growth (of 2 percent cumulated over the period 2014-2018), the rising number of private households (cumulated +3.1 percent) and improving cyclical conditions. The medium-term outlook is less benign for civil engineering, where public demand will be constrained by fiscal consolidation efforts. Growth of overall construction investment will thus remain modest (2014-2018: +1.0 percent p.a.).

Table 3: Components of aggregate demand, volume

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
				Year-to-year percentage changes					
Consumption expenditure									
Private households[1]	+ 1.5	+ 0.8	+ 1.1	– 0.1	+ 0.9	+ 1.0	+ 1.2	+ 1.1	+ 1.2
General government	+ 2.3	+ 0.3	+ 0.7	+ 0.0	+ 0.5	+ 0.3	+ 0.8	+ 0.9	+ 1.0
Gross fixed capital formation	+ 1.2	– 0.2	+ 2.3	– 1.4	+ 3.0	+ 2.1	+ 2.1	+ 2.4	+ 1.9
Machinery and equipment	+ 1.9	+ 0.5	+ 3.7	– 3.5	+ 5.0	+ 3.0	+ 3.8	+ 4.1	+ 2.8
Construction	+ 0.4	– 1.2	+ 1.0	+ 0.5	+ 1.2	+ 1.3	+ 0.7	+ 0.8	+ 1.0
Domestic demand	+ 1.8	+ 0.3	+ 1.5	– 1.0	+ 1.4	+ 1.4	+ 1.5	+ 1.5	+ 1.4
Exports	+ 7.1	+ 0.4	+ 5.7	+ 2.6	+ 5.3	+ 5.8	+ 5.9	+ 5.7	+ 5.6
Imports	+ 5.7	+ 0.3	+ 5.5	+ 0.3	+ 5.0	+ 5.7	+ 5.6	+ 5.5	+ 5.5
Gross domestic product	+ 2.8	+ 0.4	+ 1.8	+ 0.3	+ 1.7	+ 1.7	+ 1.9	+ 1.9	+ 1.8

Source: Statistics Austria, WIFO calculations. – [1] Including private non-profit institutions serving housholds.

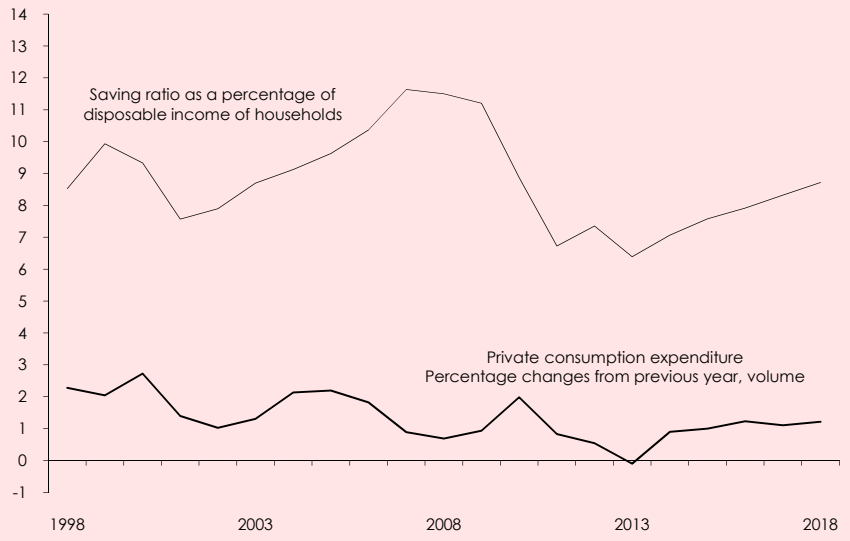
Real disposable household income is projected to increase by 1.6 percent per year over the forecast period, higher by 2 percentage points than between 2009 and 2013. A major driver is the stronger dynamics of corporate earnings which are cyclically more sensitive and have fallen significantly during the crisis. But also wages and salaries, expected to gain 0.5 percent p.a. in real terms on a per-capita basis after declining 0.3 percent p.a. during the period 2009-2013, and incomes of self-employed will on average fare better than in the last five years.

Household restraint on private consumption observed since the onset of the financial market crisis and the Great Recession is expected to continue, with spending in real terms projected at +1.1 percent p.a. over the period from 2014 to 2018. The increase in family allowances planned for 2016 and 2018 should provide some stimulus to private consumption which is nevertheless unlikely to rise in step with disposable income as households will be inclined to restore their savings. Indeed, from 2009 to 2011, households had cushioned real income losses by lower savings in order to maintain accustomed consumption standards. During that period, the household saving ratio dropped by 4.5 percentage points, from 11.2 percent to 6.7 percent of disposable income. With the projected marked rebound it will reach 8.7 percent in 2018, closer to the long-term average.

After the "soft patch" of 2012-13 (2013 +0.3 percent), real GDP is forecast to grow by an average 1.8 percent over the next five years, compared with +0.4 percent p.a. observed for the period 2009-2013. In nominal terms, GDP is set to rise by an annual 3.5 percent (2009-2013 +2.1 percent p.a.).

Output growth will be supported to about one-third each by the contributions from private consumption, private investment and net exports. Thus, while the cyclical recovery appears to be only gradual, it seems to be broader-based and more balanced than during the crisis period 2009-2013 when private consumption was the only stabilising force.

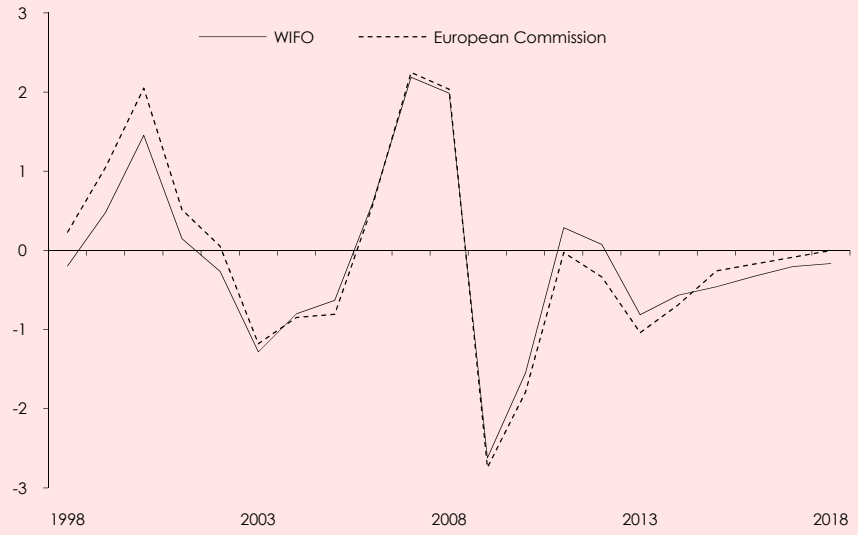
Figure 3: Private consumption and saving ratio



Source: Statistics Austria, WIFO calculations.

Figure 4: Output gap, volume

As a percentage of trend output



Source: European Commission, Statistics Austria, WIFO calculations.

Trend growth is projected to revive as inertially as actual GDP (for the methodology of estimating trend growth using a production function approach see Box "Trend Output"). According to WIFO, trend output will increase by 1.6 percent annually, higher by 0.7 percentage point than during the five years following the financial market crisis, but still below the pace recorded before the crisis up to 2008. The European Commission, in its autumn projection[2], expects trend output growth of 1.4 percent per year.

[2] https://circabc.europa.eu (menus "search categories", "Economic and Financial Affairs", "Output gaps", "Library", "1. Autumn 2013 Forecast Exercise", "Results").

Trend Output

"Trend output" or the natural output level is defined as the level of output attained at an average degree of utilisation of the input factors. Keynesian theory denotes a degree of utilisation as average if inflation pressure is absent. Cyclical over-utilisation is associated with an increase in prices and wages. In New-Keynesian models trend output is regarded as the level of output achieved without nominal rigidities and with perfect information. Hence, deviations from trend output are explained by market imperfections. The normal utilisation of supply capacities is defined as the average degree of capacity utilisation over the business cycle. Likewise, a normal degree of utilisation may be characterised by equilibrium prevailing on financial markets (*Borio,* 2012, *Borio – Disyatat – Juselius,* 2013). Thus, imbalances caused by non-sustainable price developments on financial markets may give rise to misallocation of consumption and investment that drives GDP growth beyond its sustainable path (the concept of trend output is further discussed e.g. by *Horn – Logeay – Tober,* 2007 and by *Bilek-Steindl et al.,* 2013).

The European Commission approach to calculating the trend output

The European Commission computes real GDP using an aggregated Cobb-Douglas production function with physical capital and hours worked as input factors. Total factor productivity (TFP) is measured by that part of output not being explained by capital and labour input (Solow residual). The trend component of the input factors, like the trend output, cannot be observed and has to be estimated. To this end, the European Commission uses both purely statistical methods like the Hodrick-Prescott filter and structural models. The latter are applied for the cyclical adjustment of total factor productivity and for the identification of the structural unemployment rate (NAWRU). The structural models are formulated as state-space models and estimated by recursive methods (Kalman filter; see also *D'Auria et al.,* 2010, *Planas – Rossi,* 2009, *Bilek-Steindl et al.,* 2013. For a critical assessment of the European Commission approach see *Schulmeister,* 2012, and *Klär,* 2013).

As a result of the financial market crisis and the Great Recession 2008-09, economic growth moved to a flatter trend, mainly due to a slower advance of total factor productivity (TFP). Compared with the period 2004-2008, more than three-quarters of the total setback to economic growth in the wake of the crisis are attributed to lower TFP growth, while the rest are due to the restraint on investment. Growth of total factor productivity, while set to gradually recover, will nevertheless lag behind the momentum recorded during the pre-crisis period from 2004 to 2008. The contributions from capital accumulation and labour input to trend growth have stabilised and meanwhile match their pre-crisis values (Table 4).

Table 4: Growth contributions of the input factors to trend output

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
					Percentage points				
Trend output growth	+ 2.1	+ 0.9	+ 1.6	+ 1.2	+ 1.4	+ 1.6	+ 1.7	+ 1.7	+ 1.7
Labour	+ 0.1	+ 0.1	+ 0.3	+ 0.3	+ 0.3	+ 0.4	+ 0.4	+ 0.3	+ 0.2
Capital	+ 0.6	+ 0.4	+ 0.5	+ 0.4	+ 0.5	+ 0.5	+ 0.5	+ 0.5	+ 0.5
Total factor productivity	+ 1.4	+ 0.4	+ 0.8	+ 0.5	+ 0.7	+ 0.8	+ 0.9	+ 0.9	+ 0.9

Source: WIFO calculations.

The Austrian economy still remains in a cyclical phase of under-utilised capacities over the entire forecast horizon. The WIFO projections imply a consistently negative output gap (i.e., the deviation of actual from trend output), though narrowing from –0.8 percent of trend output in 2013 to –0.2 percent in 2018. A comparison of the output gap in the current WIFO forecast with European Commission calculations of autumn 2013 suggest broad agreement (Figure 4). Differences since 2013 are explained by different forecasts for GDP growth and for trend output until 2018, whereas differences in the trend output deviations result from different assumptions concerning the estimation procedure (a-priori density in Bayesian bi-variate state-

space models), but also from different definitions of unemployment (*Bilek-Steindl et al.,* 2013). As regards GDP growth for 2016-2018, the European Commission infers a constant annual rate of 1.5 percent.

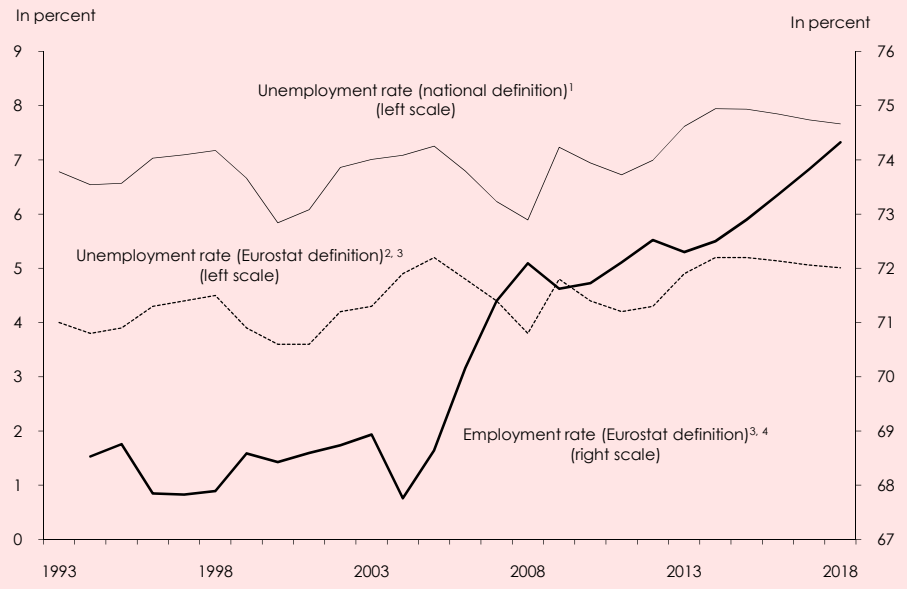
3. Moderate improvement on the labour market

The expected GDP growth of 1.8 percent on annual average over the period 2014-2018 will allow employment to increase by 0.8 percent per year. Yet, job creation will not suffice as to reduce further the rate of unemployment, especially since supply of both domestic and foreign labour will increase markedly in parallel.

Job growth will be confined to the private sector, while the number of public sector employees is likely to edge down by 0.1 percent p.a. (implying an overall cut of 1,800 jobs over the forecast period) as part of the fiscal consolidation measures.

The expansion of labour supply by 0.8 percent or 30,500 persons per year over the forecast period is largely driven by the inflow of foreign labour (by 23,700 persons per year), the lasting increase in female labour force participation and the restrictions on access to early retirement and invalidity pensions. New entrants to early retirement are anticipated to fall by a cumulated 8,500 persons during 2014-2018.

Figure 5: Labour market trends



Source: Eurostat, Public Employment Service Austria, WIFO calculations. – [1] As a percentage of total labour force excluding self-employed; according to Public Employment Service Austria. – [2] As a percentage of total labour force. – [3] According to Eurostat Labour Force Survey. – [4] Persons in employment as a percentage of population of working age (15 to 64 years).

As from 1 January 2014, with a seven-year transition period having expired, workers from Bulgaria and Romania enjoy unrestricted access to the Austrian labour market. *Landesmann et al.* (2013) expect an inflow of additional 5,500 workers each in the first two years after liberalisation. Similar transition regulations as for the new member countries that acceeded in 2004 and 2007 will apply to Croatia which joined the EU on 1 July 2013. During the forecast period, Croatian workers therefore have only limited access to the Austrian labour market. In a medium-term perspective, the inflow of foreign workers is set to moderate, from 26,300 persons in 2014 to 22,000 in 2018. Already in 2013, the number of new entrants declined markedly, notably from the accession countries of 2004, for which labour market access had been liberalised in May 2011. The cyclical recovery in neighbouring countries of east-central Europe should also have a dampening impact on labour migration.

The unemployment rate (national definition) will rise to a peak of 7.9 percent in 2015 and abate marginally thereafter to 7.7 percent. By the end of the forecast period, the number of registered unemployed will still be slightly above 300,000.

For demographic reasons, growth of the population of working age remains very slow in the medium term, at 0.1 percent per year. With the strong age-cohorts of the early post-war period now approaching the age of retirement, the gap between the active and retired population will widen further.

Table 5: Labour market, income

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
				In percent					
Unemployment rate									
Eurostat definition[1]	4.6	4.5	5.1	4.9	5.2	5.2	5.1	5.1	5.0
National definition[2]	6.7	7.1	7.8	7.6	7.9	7.9	7.8	7.7	7.7
				Year-to-year percentage changes					
Employees[3]	+ 1.6	+ 0.9	+ 1.0	+ 0.7	+ 1.0	+ 1.0	+ 1.1	+ 1.1	+ 1.0
Persons in active dependent employment[4]	+ 1.4	+ 0.7	+ 0.8	+ 0.6	+ 0.8	+ 0.8	+ 0.9	+ 0.8	+ 0.8
Self-employed[5]	+ 1.3	+ 1.6	+ 1.1	+ 2.0	+ 1.0	+ 1.1	+ 1.1	+ 1.1	+ 1.1
Registered unemployed	– 2.4	+ 6.2	+ 0.9	+ 10.2	+ 5.4	+ 0.7	– 0.4	– 0.7	– 0.2
Productivity[6]	+ 1.3	– 0.4	+ 0.8	– 0.3	+ 0.8	+ 0.9	+ 0.8	+ 0.8	+ 0.7
Gross wages and salaries[7]	+ 4.3	+ 2.7	+ 3.4	+ 2.7	+ 3.1	+ 3.4	+ 3.4	+ 3.4	+ 3.4
Per employee, volume[8]	+ 0.4	– 0.3	+ 0.5	– 0.1	+ 0.3	+ 0.5	+ 0.5	+ 0.5	+ 0.5
Unit labour costs, total economy	+ 1.2	+ 2.2	+ 1.5	+ 2.2	+ 1.3	+ 1.5	+ 1.5	+ 1.5	+ 1.6

Source: Federation of Austrian Social Security Institutions, Statistics Austria, WIFO calculations. – [1] According to Eurostat Labour Force Survey, percent of total labour force. – [2] According to Public Employment Service Austria, percent of total labour force excluding self-employed. – [3] According to National Accounts definition. – [4] Excluding parental leave and military service. – [5] According to WIFO. – [6] Real GDP per employment (dependent and self-employed according to National Accounts definition). – [7] Excluding employers' contributions. – [8] Employees according to National Accounts definition, deflated by CPI.

The number of unemployed is projected to rise to nearly 305,000 until 2015 (+17,400 from 2013), implying an unemployment rate of 7.9 percent of the dependent labour force (public employment service definition) or 5.2 percent of the total labour force (Eurostat definition). By 2018, the unemployment rate should edge down to 7.7 percent, with the total number out of work still remaining high, slightly exceeding 300,000.

4. Moderate inflation

Price developments in recent years have been largely determined by variations in international oil price quotations as well as in food and agricultural commodity prices. The projections assume that the reference oil price of $ 108.7 per barrel will head up only moderately to $ 116 in 2018, and that the euro will slightly depreciate against the dollar, from $ 1.33 in 2013 to $ 1.24 in 2018, i.e., a decline of 1.4 percent per year. World marker prices for industrial commodities are assumed to edge up by only 1.2 percent p.a. on a dollar basis.

Apart from energy and commodity prices, wage cost and changes of indirect taxes and public charges are driving inflation. For 2014 it is assumed that excises on tobacco, sparkling wine and alcohol as well as car registration and insurance taxes will be raised as foreseen in the draft Act on tax adjustments 2014 ("Abgabenänderungsgesetz 2014") of 9 January this year. Further increases of the tobacco tax are likely to take effect in 2015, 2016 and 2017. Altogether, these tax hikes are expected to push up the annual inflation rates for 2014 to 2017 by 0.1 percentage point each.

Nominal wages per capita will go up by 2.3 percent. Unit labour costs for the total economy, the key determinant of domestic cost pressure, will rise by 1.5 percent per year over the period 2014-2018, gross real per-capita wages by 0.5 percent. The gap vis-à-vis the advance of labour productivity thereby narrows from 0.4 percent in 2014 to 0.2 percent in 2018. In such an environment, inflation should remain subdued. For

the period 2014-2018, the GDP deflator is projected at an annual 1.7 percent, the consumer price index at 1.9 percent.

Table 6: Prices

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
				Year-to-year percentage changes					
Consumer prices	+ 2.2	+ 2.0	+ 1.9	+ 2.0	+ 1.8	+ 1.9	+ 1.9	+ 1.9	+ 1.8
Implicit price indices									
Private consumption	+ 2.3	+ 2.1	+ 1.9	+ 2.2	+ 1.8	+ 1.9	+ 1.9	+ 1.9	+ 1.8
Exports	+ 1.9	+ 1.0	+ 1.5	+ 0.0	+ 1.3	+ 1.3	+ 1.4	+ 1.7	+ 1.7
Imports	+ 2.7	+ 1.5	+ 1.6	– 0.5	+ 1.2	+ 1.4	+ 1.5	+ 1.9	+ 1.9
Gross domestic product	+ 1.9	+ 1.7	+ 1.7	+ 2.0	+ 1.8	+ 1.8	+ 1.7	+ 1.7	+ 1.7

Source: Statistics Austria, WIFO calculations.

Budget Balances Explained

Fiscal policy coordination in the new EU governance framework sets the structural budget balance as a key target of general government fiscal management, next to the nominal balance in the Maastricht definition. The structural budget deficit mirrors a lasting discrepancy between the level of government revenue and expenditure. It thus indicates a need for consolidation more clearly than the government balance according to the Maastricht definition. The latter includes, apart from cyclical influences, also one-off effects of only transitory budgetary impact.

Government balance in the Maastricht definition

The government balance in the Maastricht definition is obtained from the general government financial accounts according to the European System of National Accounts of 1995 (ESA 95). The government balance is the difference between government revenue and expenditure, both adjusted for special financial transactions like borrowing on capital markets or the purchase of securities. In the case of revenue exceeding expenditure, the government runs a financial surplus (positive balance), in the reverse case a financial deficit (negative balance). The Maastricht definition of the government balance deviates slightly, however, from the ESA 95 definition with regard to the calculation of government interest payments. Derivative financial transactions (interest flows due to forward rate agreements and swaps) are taken as asset income in the Maastricht definition and are included in the assessment of government interest liability.

Cyclically-adjusted government balance

The cyclically-adjusted government balance abstracts from cyclical variations in revenue and expenditure in the Maastricht balance. Purely cyclical influences are identified via estimation of the output gap (deviation of actual from trend output; see Box "Trend Output") and by assessing the cyclical sensitivity of the budget balance. The cyclically-adjusted balance, like the structural balance, is therefore not derived directly from the National Accounts data, but is rather an estimated variable.

Structural government balance

Conceptually, the level of the structural government balance is determined by lasting measures only, and not by one-off effects. The structural balance is thus the cyclically-adjusted balance excluding one-off factors. The latter are changes in expenditure or revenue with only transitory impact on the Maastricht government balance which do not alter the budget situation in a permanent way. Examples are capital transfers to nationalised banks in distress or one-time revenues from bilateral tax agreements. Hence, as a key variable for fiscal policy action, the structural balance is equal to the Maastricht government balance adjusted for cyclical variations and one-off effects.

The increase in the cyclically-adjusted budget deficit to around 4 percent of GDP in 2004, as shown in Figure 7, was caused by the debt relief and the recapitalisation by the federal government in the context of the reorganisation of the Austrian Federal Railways (ÖBB). Both the debt relief (around € 6.1 billion) and the recapitalisation (€ 1.4 billion) were ex-post classified by Eurostat as one-off capital transfers to Austrian Federal Railways. As one-off operation, these transactions raise both the Maastricht balance and the cyclically-adjusted budget balance, but not the structural balance. The difference between the structural and the cyclically-adjusted deficit to be observed for the last few years is essentially due to capital transfers for distressed banks that have been nationalised. For 2013, these one-off expenditures are more than offset by one-off revenues from the auction of mobile phone frequencies and from the bilateral tax agreement with Switzerland.

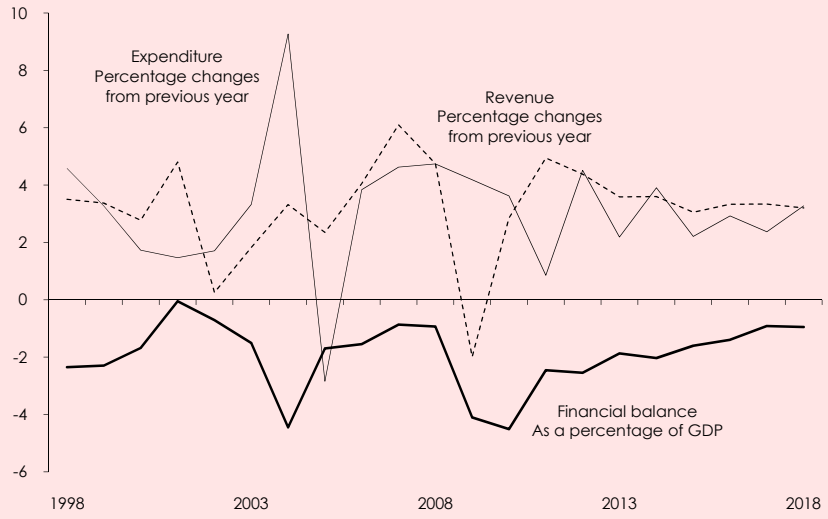
5. Goal of structural budget balance as from 2016 is guiding fiscal policy

The goal of a general government account close to balance in structural terms (defined as a structural deficit of 0.45 percent of GDP at most) by 2016 will be guiding fiscal policy during the years from 2014 to 2018. A systematic assessment of the federal budget trend up to 2018 reveals that this goal will not be achieved without further consolidation steps. Underlying the WIFO forecast is a consolidation scenario whereby the structural deficit is cut by € 2 billion in 2014 and an additional € 1 billion p.a. as of 2015. With this trajectory, however, a balanced general government budget will be reached neither in the Maastricht definition nor in structural terms. Rather, the forecast yields a structural deficit of 0.8 percent of GDP by 2016.

The financial market crisis and the Great Recession led to a substantial deterioration of government finances. A broad range of consolidation measures (*Schratzenstaller,* 2013) and changes to the institutional budgetary framework – notably a reform of the Stability and Growth Pact, the implementation of the Fiscal Compact and the national "debt brake" – providing for a structural balance with a deficit no higher than 0.45 percent of GDP from 2017 onwards – have shaped Austrian fiscal policy already during the last few years. The Austrian Stability Programme of April 2013 foresaw a balanced general government budget to be reached by 2016. In December 2013, a thorough evaluation of the federal budget outlook up to 2018, carried out by the Federal Ministry of Finance, revealed that the budgetary path outlined in the Stability Programme could not be complied with, unless the fiscal reins were further tightened over the period 2014-2018.

The WIFO short-term forecast of December 2013 (*Schiman,* 2014) anticipates for 2014 a consolidation amount of € 2 billion in structural terms for the general government. For 2015, additional structural measures to the amount of € 1 billion are assumed. The measures envisaged for 2014 consist to one-half each of tax increases (for tobacco products, sparkling wine and new car registrations) and expenditure restraint (wage moderation and an extension of the freeze on hiring in the public sector, cuts in outlays not subject to legal commitment, reform of subsidies etc.). In 2015, measures on the expenditure side are assumed to dominate. For the period from 2016 to 2018 it is inferred that all revenue hikes and spending cuts will be fully maintained.

Figure 6: Revenue, expenditure and financial balance (according to Maastricht) of general government



Source: Statistics Austria, WIFO calculations.

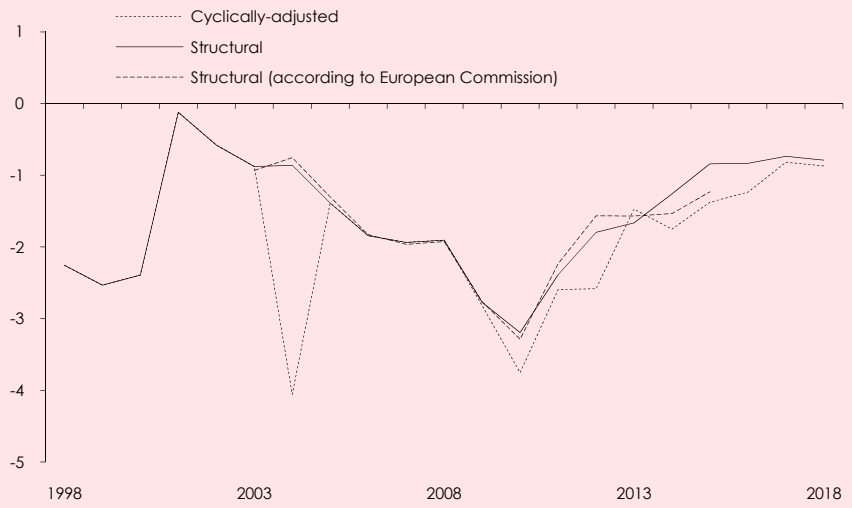
Apart from the structural consolidation efforts, the Austrian general government balance in the Maastricht definition will also be significantly influenced over the forecast horizon by capital transfers to distressed banks that have been nationalised (assumed at a total € 5.8 billion up to 2018), and by one-off revenues as a result of the bilateral tax agreement with Liechtenstein (about € 0.5 billion in 2014). The forecast also allows for the impact of an increase in family allowances in 2014, 2016 and 2018 (totalling € 0.83 billion)[3]. It is further assumed that any revenues from a financial

[3] The forecast assumes that in 2014 and 2015 the higher outlays due to the raise in the family allowance as from July 2014 will be offset by additional expenditure cuts.

transaction tax (which in the Stability Programme of April 2013 were set at € 0.5 billion per year starting from 2014) will not materialise over the entire forecast period.

Figure 7: Cyclically-adjusted and structural budget balance

As a percentage of GDP



Source: European Commission, WIFO calculations.

Against the background of the fiscal framework conditions (consolidation in structural terms, one-off revenue and expenditure, higher family allowances) and the medium-term economic prospects, both the deficit in the Maastricht definition and the structural general government deficit are projected to narrow until 2017 (2017: Maastricht deficit 0.9 percent of GDP, structural deficit 0.7 percent of GDP), before edging up in 2018 due to the envisaged increase in family allowances. The balanced budget in structural terms sought by the federal government for 2016 will therefore not be achieved under the underlying growth outlook and the fiscal policy assumptions.

Table 7: General government

Current prices

	Ø 2004-2008	Ø 2009-2013	Ø 2014-2018	2013	2014	2015	2016	2017	2018
				Year-to-year percentage changes					
Current revenue	+ 4.1	+ 2.7	+ 3.3	+ 3.6	+ 3.6	+ 3.1	+ 3.3	+ 3.3	+ 3.2
Current expenditure	+ 3.9	+ 3.1	+ 2.9	+ 2.2	+ 3.9	+ 2.2	+ 2.9	+ 2.4	+ 3.3
Gross domestic product	+ 4.7	+ 2.1	+ 3.5	+ 2.3	+ 3.5	+ 3.6	+ 3.6	+ 3.6	+ 3.5
				As a percentage of GDP					
General government financial balance (Maastricht definition)	– 1.9	– 3.1	– 1.4	– 1.9	– 2.0	– 1.6	– 1.4	– 0.9	– 1.0
Cyclically-adjusted budget balance	– 2.2	– 2.6	– 1.2	– 1.5	– 1.8	– 1.4	– 1.2	– 0.8	– 0.9
Structural budget balance	–	– 2.4	– 0.9	– 1.7	– 1.3	– 0.8	– 0.8	– 0.7	– 0.8
Gross public debt	63.1	72.5	73.6	74.1	74.2	74.2	74.0	73.2	72.6

Source: Statistics Austria, WIFO calculations.

Both government revenue and expenditure are expected to increase less than nominal GDP, implying a decline in the revenue- and expenditure-to-GDP ratios over the forecast period. The only modest increase in government expenditure mirrors the emphasis on consolidation driven by expenditure restraint assumed in the forecast. The low growth rate of expenditure in 2013 and the strong increase in 2014 are distorted by one-off factors, i.e., high revenues in 2013 from the auction of mobile phone licenses which in the National Accounts are recorded as negative ex-

penditure, and high capital transfers to nationalised banks in 2014. Buoyant revenues in 2013 and 2014 are boosted inter alia by one-off receipts from the tax agreements with Switzerland and Liechtenstein (2013: € 0.7 billion, 2014: € 0.5 billion) and the assumed revenue-based consolidation measures taking effect in 2014.

Total government debt will continue rising in absolute terms over the forecast period, but start declining as percent of GDP as from 2015, to a ratio around 73 percent of GDP by 2018 (calculated according to ESA 95 rules in force until 2014).

5.1 Uncertainty of the budgetary projections

The present budget projections, like those of the last years, are subject to considerable uncertainty. It remains an open question whether the assumed consolidation measures will be implemented to full extent. Likewise, the design of the consolidation measures on the expenditure side and the distribution of the consolidation effort over time have not yet been fixed in detail. The draft Revenue Adjustment Act 2014 ("Abgabenänderungsgesetz 2014") of 9 January 2014 suggests that the additional revenue accruing in 2014 will fall short of the € 1 billion assumed in the forecast. Conversely, higher revenues of more than € 1 billion are foreseen for the years starting from 2015. Changes in the consolidation path (i.e., a higher deficit-to-GDP ratio in 2014 and lower ratios as from 2015) can therefore not be ruled out.

It is assumed that up to 2018 no revenues will be generated from a tax on financial transactions. Should an agreement be reached nevertheless at the EU level, the deficit ratio may be cut by almost 0.2 percentage point per year as from 2016.

Particularly high uncertainty surrounds the assumption for the financial need of distressed banks that have been nationalised. If an agreement could be reached on the resolution of Hypo Alpe-Adria-Group via a "Bad Bank", this would have substantial impact on the level of public debt as well as the financial balance (Maastricht definition).

The structural budget balance is derived from the Maastricht balance essentially by determining the (non-observable) potential output and the output gap for the overall economy. If the European Commission, in assessing Austria's fiscal policy, were to arrive at a less negative or even positive output gap, the consolidation efforts that the EU requires from Austria would turn out higher than assumed in the present forecast.

In the event of the abrogation of the current Excessive Deficit Procedure (EDP), the rules of the reformed Stability and Growth Pact for the reduction of the government debt-to-GDP ratio will take effect: EU countries with a government debt ratio exceeding 60 percent of GDP will be obliged to converge towards the 60 percent-ceiling in an appropriate way. Convergence is deemed appropriate if the difference vis-à-vis the 60 percent-of-GDP reference value has been reduced by an annual average of one-twentieth over the last three years. After the abrogation of the EDP, a transition period of three years is granted; thus, assuming abrogation of the EDP for Austria in the first half of 2014, the European Commission would assess compliance with the required debt reduction path for the first time in 2016[4]. Pressure for a speedier reduction of the debt ratio may therefore increase.

Starting of autumn 2014, member countries are liable to implement the revision of the European System of National Accounts (ESA). On the one hand, the revised ESA will yield a higher level of nominal GDP; on the other hand, it provides for a stricter distinction between market and non-market production and for the inclusion of part of extra-budget debt into the government sector. On the basis of this systemic revision, the official public debt ratio is expected to ratchet up by 2 to 3 percentage points, with implications for the "appropriate path" of debt reduction[5].

[4] In addition, progress towards an appropriate reduction of the debt ratio must become visible during the transition period, which will also be examined by the Commission.

[5] Due to the ESA revision, the impact on the general government balance as percent of nominal GDP will turn out lower.

Refraining from tax cuts or expenditure increases that are not counter-financed is key to achieving the projected budgetary path. However, a reform of the tax system in favour of more growth- and employment-friendly taxation could raise Austria's growth potential and help reaching the budgetary objectives. Similarly, a shift in the composition of public expenditure away from administrative spending towards more forward-looking items could provide a stimulus to economic growth.

6. Risks to the medium-term forecast

Future economic developments in the euro area, especially in the southern periphery, remain subject to high uncertainty. The impact of the new and in part stricter fiscal rules in the context of the Fiscal Compact for debt reduction and their reception by market participants remains to be seen.

The problem of mutual dependence between financial intermediaries and government authorities has just started being tackled. It is uncertain if lasting solutions that will effectively reduce the cost of financial market crises for public budgets will be found. The governance framework for the euro area remains fragile in a medium-term perspective and the vulnerability to external shocks high, adding to the uncertainty surrounding the forecast.

Should, however, a change in the institutional policy framework (e.g., the creation of a Banking Union) lead to an earlier resolution of the confidence crisis, business activity in the euro area may well rebound sooner than anticipated. This would boost demand for Austrian exports and stimulate domestic investment and growth of GDP.

Finally, the forecast is subject to methodological constraints arising from the use of an econometric model. The WIFO Macromod reproduces the empirical relations that have shaped economic developments in Austria over the last three decades (*Baumgartner – Breuss – Kaniovski,* 2005). It therefore does not capture the consequences of potential lasting changes in the behaviour of economic agents (that cannot be excluded given the novelty of the recession 2008-09) or in the framework conditions for economic action. Allowance for such changes can only be made by judgement on the part of the forecaster.