

Serguei Kaniovski, Markus Marterbauer, Josef Baumgartner

# Domestic Demand to Recover Gradually over the Medium Term

## Projections for the Austrian Economy until 2009

**The swift expansion of world trade, price competitiveness and an improvement in the domestic economic and regulatory framework will benefit Austrian exports in the medium term. This will provide incentives for higher investment. An expansion of transport infrastructure and a revival of housing construction activity will lead to higher construction output. The projections assume that private household consumption will gradually recover from an extended period of sluggishness. In such a scenario, the economy may grow by an average 2¼ percent per year until 2009. Such a pace should allow the government deficit to decline, but would not suffice for a sustained improvement in job prospects, due to the strong increase in labour supply.**

For technical reasons, the English version of the WIFO medium-term projections, which is based upon the WIFO short-term forecast of April 2005 (cut-off date May 2005), has not been published before the autumn of 2005. • Serguei Kaniovski, Markus Marterbauer and Josef Baumgartner are economists at WIFO. The authors are grateful to Fritz Breuss for useful and constructive comments. • The data were processed and analysed with the assistance of Christine Kaufmann • E-mail addresses: [Serguei.Kaniovski@wifo.ac.at](mailto:Serguei.Kaniovski@wifo.ac.at), [Markus.Marterbauer@wifo.ac.at](mailto:Markus.Marterbauer@wifo.ac.at), [Josef.Baumgartner@wifo.ac.at](mailto:Josef.Baumgartner@wifo.ac.at), [Christine.Kaufmann@wifo.ac.at](mailto:Christine.Kaufmann@wifo.ac.at)

Over the last five years, the Austrian economy grew by only 1.6 percent p.a. in real terms. For the coming five-year period, the WIFO medium-term projection foresees a gentle recovery of the business cycle, with growth possibly accelerating to an annual rate of 2.3 percent. This forecast is in line with the expected rate for the EU 25, but slightly exceeding the euro area average of 2.1 percent. Austria is benefiting over-proportionally from the catching-up process in the east-central European countries. Growth may also be stimulated by a shift in public and private spending towards education, innovation and information technology, as is foreseen in the EU Lisbon Process.

Domestic economic activity is receiving substantial stimulus from exports. World trade is set to remain lively, supported by dynamism in Asia, notably China, and in North America. This should yield increasing benefits also for the euro area, whose key problems remain the weakness of domestic demand and low consumer confidence. The projection is based upon the assumption that the over-valuation of the euro against the dollar will ebb over the medium term and that world market prices for oil will decline.

The Austrian economy stands to benefit particularly strongly from the expansion of global trade, since its competitive position is favourable and its institutional and regulatory framework has become more conducive to growth and investment. Strong productivity growth and moderate wage increases have led to a marked fall in unit labour costs since 1980, both in absolute terms and in relation to Austria's trading partners. While price competitiveness is high, domestic businesses have not yet raised their innovative capacity to a level appropriate for a high-income country. Exports are projected to rise by an inflation-adjusted 6½ percent per year until 2009. With a certain time lag, higher exports will lead to a pick-up in machinery and equipment investment. The latter should accelerate to a rate of 5 percent in 2007. For the whole period 2004-2009 the average increase is projected at 3½ percent.

Whereas between 2004 and 2009 exports and investment in machinery and equipment should grow at a similar pace as in the last five-year period, domestic demand is expected to recover. The weakness of consumer demand and construction investment has been largely responsible for the disappointingly slow overall growth during the last years. Private household spending is projected to pick up from +1.4 to +2.1 percent per year, due to rising employment, somewhat higher wage settlements and the tax reform 2005. The projection assumes that the increase in private household saving ratio, which, together with the narrow gains in disposable income, has held back private consumption since 2001, will give way to somewhat higher consumer spending as from 2007. Investment in infrastructure, such as in the context of the development of the Trans-European Networks, and rising housing demand due to a strong flow of immigration will stimulate construction output, which is expected to pick up from an average 1 percent in the last five years to 2 percent per year.

Table 1: Main results

	Ø 1999-2004	Ø 2004-2009	2004	2005	2006	2007	2008	2009
	Year-to-year percentage change							
Gross domestic product								
Real	+ 1.6	+ 2.3	+ 2.0	+ 2.2	+ 2.3	+ 2.4	+ 2.2	+ 2.4
Nominal	+ 3.3	+ 3.9	+ 3.9	+ 4.5	+ 3.9	+ 3.8	+ 3.5	+ 3.7
Consumer prices	+ 2.0	+ 1.7	+ 2.1	+ 2.5	+ 1.8	+ 1.6	+ 1.5	+ 1.4
Wages and salaries per employee <sup>1</sup>	+ 2.0	+ 2.3	+ 2.2	+ 2.3	+ 2.5	+ 2.2	+ 2.1	+ 2.2
Dependent active employment <sup>2</sup>	+ 0.3	+ 0.9	+ 0.7	+ 0.8	+ 0.9	+ 1.1	+ 1.0	+ 1.0
	Percent							
Unemployment rate								
As a percentage of labour force <sup>3</sup>	4.1	4.5	4.5	4.5	4.5	4.5	4.5	4.5
As a percentage of dependent labour force <sup>4</sup>	6.6	7.1	7.1	7.1	7.1	7.0	7.1	7.1
	As a percentage of GDP							
External growth contribution	3.5	5.0	4.8	4.8	4.7	4.9	5.1	5.5
General government balance, Maastricht definition	- 0.8	- 1.3	- 1.3	- 2.0	- 1.8	- 1.3	- 0.9	- 0.4
	As a percentage of disposable income							
Private household saving ratio	8.4	9.4	9.2	9.6	9.6	9.4	9.3	9.2

Source: Statistics Austria, WIFO calculations. – <sup>1</sup> Gross, excl. employers' contributions, per employment contract according to National Accounts. – <sup>2</sup> Excl. recipients of maternity and child-care benefits, excl. people in statutory military service, excl. unemployed in job-training included in employment statistics. – <sup>3</sup> According to Eurostat (Labour Force Survey). – <sup>4</sup> According to Labour Market Service.

No turnaround is in sight on the labour market. The continued rise in the number of unemployed (to almost 260,000 in 2009) remains the key economic problem of Austria. Over the whole projection period, employment is expected to grow by 0.9 percent per year. The recovery in the export industries and construction, while also raising the number of full-time jobs, will mainly lead to the creation of more part-time jobs. Even stronger, however, will be the expansion of labour supply, because of a high number of people being granted Austrian citizenship, strong inflow of foreign labour and the increase in the early retirement age. The average rate of unemployment is set to remain stuck at the level of 2005, i.e., 7.1 percent of the dependent labour force, or 4.5 percent of the total labour force as defined by Eurostat; these rates are clearly above those recorded for the period 1999-2004 of 6.6 percent and 4.1 percent, respectively.

Inflation is set to remain moderate, with annual average rates for consumer prices of around 1¾ percent until 2009. Although there are upside risks with regard to raw materials prices as well as indirect taxes and public charges, strong international competition and modest increases in nominal unit labour costs will keep a lid on inflation. The moderate wage gains will make for a further decline in the wage share as a proportion of national income.

The deficit in general government finances has been rising steadily since 2001. The projections assume this trend to be reversed, with the financing gap narrowing continuously to an eventual ratio of ½ percent of GDP in 2009. Underlying this assumption is the projected steady GDP growth which, once the dampening effect of the tax reform has faded out, should allow government revenues to increase by 3½ percent per year. Receipts from wage tax and from social security contributions should prove particularly dynamic. The projections also assume a restrictive stance on government expenditure. Subsidies and personnel outlays should show only little upward momentum, and social transfers should rise no more than over the last five years, despite higher spending on unemployment and child care benefits. A reform of the tax structure and of the composition of government expenditure constitute the major challenges for budgetary policy.

Key uncertainties surrounding the projections are the optimistic assumptions of the over-valuation of the euro vis-à-vis the dollar being corrected and of the high oil prices to abate. Furthermore, it is uncertain whether economic policy can effectively counter the sluggish consumer demand both in the euro area and in Austria. The assumption of a slight decline in the household saving ratio as from 2007 may prove too optimistic in the face of high unemployment and far-reaching reforms to social welfare systems. On the other hand, global economic growth may turn out more dynamic than anticipated, fuelled by the expansion in China, and for the EU the shift in public spending towards a more forward-looking agenda as implied by the Lisbon Process and the implementation of the Trans-European Networks may provide new stimulus to growth. On both accounts, Austria may draw above-average benefits due to the high degree of price competitiveness of its export-oriented industries. The speeding up of structural reform through greater efforts at education and innovation should also offer new opportunities for higher growth.

#### *On the Methodology Underlying the Projections*

The medium-term projections for the Austrian economy have been carried out using the April 2005 version of the WIFO macro-economic model, building upon the WIFO Economic Outlook of April 2005 (see *Scheiblecker – Walterskirchen, 2005*; an overview of the model structure and the simulation qualities of the WIFO macro-model is given by *Baumgartner – Breuss – Kaniowski, 2004*). The present version of the model is based upon the updated national accounts using chaining indices. The assumptions for the external economic developments are those of the WIFO medium-term projections for the world economy, as presented in *Schulmeister (2005)*; they have been slightly revised in the context of the elaboration of the April 2005 Economic Outlook.

During the last couple of years, business activity in Austria has been sustained mainly by exports, benefiting from the global economic boom. Also in the years to come the world economy should remain on a solid upward path, with growth of world trade estimated at or slightly above 6½ percent p.a. The economic development in Asia will be a driving force for the global economy, with rapid growth in China fueling the country's import demand. While the latter will keep commodity prices on world markets high, it will also allow for strong export gains in the rest of Asia and in Europe. Since China's accession to the WTO in 2001, the country's integration into the world economy has made rapid progress. Japan is receiving strong stimulus from lively demand in China, although weak domestic demand is holding a complete cyclical recovery. In spite of substantial risks, such as in the financial sector, and growing social and environmental problems, the macro-economic framework remains favourable for China. In particular, the strict control over capital transfers and the strategy of fixed exchange rates, which may nevertheless be adjusted if deemed necessary, exert a stabilising impact.

In North America, a gradual deceleration of growth is considered likely. The cyclical upswing of the last years in the USA has been supported by monetary and fiscal expansion. This policy stance is now being abandoned. Rising capacity utilisation and an inflation rate approaching 3 percent are prompting the Federal Reserve Board to raise short-term interest rates. The WIFO projections assume that by 2007-08 short-

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**China to remain major driver of world economic growth**

term rates will have gone up to around 5 percent and long-term rates to approximately 6 percent. The budget deficit climbed to over 4 percent of GDP in 2004. The coming years will be marked by a more restrictive fiscal policy. Both factors will weigh on domestic demand. The high current account deficit, expected at well over 6 percent of GDP this year should narrow somewhat as domestic demand slackens. At present, with the massive inflow of foreign capital, financing the external gap poses no major problem. If, however, the capital inflow were to lose momentum, an adjustment process full of risks would be set in motion. Over the projection period, the US economy is expected to grow by 3¼ percent per year, maintaining a clear advantage over the euro area.

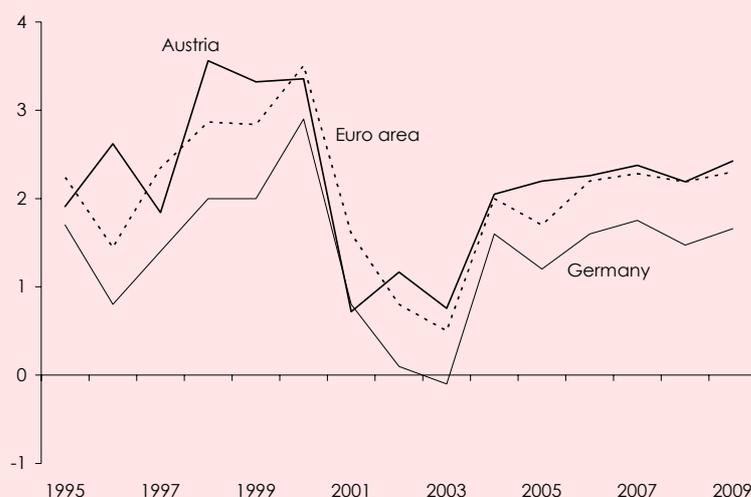
Table 2: International framework conditions

	Ø 1999-2004	Ø 2004-2009	2004	2005	2006	2007	2008	2009
Year-to-year percentage change								
Gross domestic product, real								
USA	+ 2.7	+ 3.3	+ 4.4	+ 3.8	+ 3.1	+ 2.8	+ 2.8	+ 3.7
EU 25	+ 1.9	+ 2.3	+ 2.4	+ 2.0	+ 2.3	+ 2.4	+ 2.4	+ 2.5
EU 15	+ 1.9	+ 2.2	+ 2.2	+ 1.9	+ 2.2	+ 2.4	+ 2.3	+ 2.4
Euro area	+ 1.7	+ 2.1	+ 2.0	+ 1.7	+ 2.2	+ 2.3	+ 2.2	+ 2.3
Germany	+ 1.1	+ 1.5	+ 1.6	+ 1.2	+ 1.6	+ 1.8	+ 1.5	+ 1.7
New EU member states <sup>1</sup>	+ 3.6	+ 4.4	+ 5.0	+ 4.6	+ 4.1	+ 4.2	+ 3.9	+ 5.0
Dollar per ECU or Euro								
Exchange rate	1.03	1.23	1.24	1.34	1.28	1.22	1.18	1.15
Dollar per barrel								
Oil price								
Average OECD import price(cif)	28.4	38.2	37.8	44.0	39.0	36.0	36.0	36.0
Percent								
Interest rates								
bond yields	4.8	4.3	4.2	3.9	4.3	4.5	4.5	4.4
3-months rate (EURIBOR)	3.3	2.8	2.1	2.2	2.2	3.1	3.4	3.2

Source: EU, OECD, WIFO calculations. – <sup>1</sup> Estonia, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Czech Republic, Hungary, Cyprus.

Figure 1: Growth of real GDP

Year-to-year percentage change



Source: EU, OECD, WIFO calculations.

Economic performance in the last few years has been rather uneven across the EU 15. Relatively strong economic growth was recorded in countries in which

- consumers and investors revealed high confidence in economic developments and economic policy, thereby creating a favourable basis for the implementation of reforms (Sweden, Finland; *Tichy*, 2003),
- investment in information and communication technology, as well as investment in education and research were on the rise (Sweden, Finland; *Aiginger*, 2003),
- real estate prices mounted, thereby fuelling private consumption and construction investment and contributing towards a decline in the saving/disposable income ratio (UK, Ireland, Spain, Sweden, Finland; *Marterbauer – Walterskirchen*, 2005),
- an expansionary fiscal policy stimulated domestic demand (UK, France, Sweden).

In the EMU member states, economic growth has been markedly slower than in the EU countries still keeping their national currency. Activity lagged behind notably in those countries where domestic demand stagnated and confidence was low. This is particularly the case in Germany, where despite rising corporate profits, investment has not rebounded because of low capacity utilisation and weak business sentiment. High unemployment and widespread scepticism among private households inhibit a recovery of private consumption. Until 2009, the German economy is expected to grow at an annual average rate of 1½ percent, a pace far too slow for a consolidation of public finances and a turnaround on the labour market.

Also in the euro area overall, GDP growth remains subdued at an average annual rate of around 2 percent over the projection period. Until 2007, growth should gradually pick up and stay at or slightly above 2¼ percent per year. While lively demand from Asia and the oil-exporting countries will provide positive stimulus, internal demand will hold the economy back. Economic policy remains generally geared towards maintaining price stability and the consolidation of government finances, rather than towards the promotion of growth and employment. Although the Lisbon Process is giving new impetus (*Breuss*, 2005), the determination with which it will be implemented remains to be seen.

The reform of the Stability and Growth Pact, while implying a meaningful adjustment to the budgetary framework, is unlikely to give a substantial impulse to aggregate demand. Among the reasonable elements of the reform are the emphasis on government expenditure conducive to higher medium-term growth, a wider fiscal room for manoeuvre in periods of cyclical weakness and stricter rules for expenditure restraint in boom periods. However, the euro area countries are still suffering under the impact of the high budgetary costs resulting from sluggish growth and high unemployment. Only with a solution for the latter problems would a sustained improvement of the budgetary situation be achieved.

The economies in East-central Europe are benefiting from their accession to the EU, as foreign direct investment in these countries becomes less risky and the transfers received from the EU structural funds may mobilise additional investment. Nevertheless, with the growth advantage vis-à-vis the EU 15 increasing from 1½ percentage point in the last years to 2 percentage points for the projection period 2004-2009, the momentum of the catching-up process should not be over-estimated<sup>1</sup>. The average rate of growth should thereby move up to 4½ percent p.a. Major risks derive from the real appreciation of exchange rates and from a premature accession to the monetary union. The latter may impede the catching-up process, since exchange rate adjustments will be necessary in order to maintain external competitiveness.

## Sticky cyclical recovery in the euro area

*The euro area economy is benefiting from buoyant world trade; however, a genuine cyclical recovery will unfold only once the weakness of consumer demand is overcome.*

<sup>1</sup> For further detail on developments in East-central Europe see *Astrov, V.*, "Unterschiedliche Einflüsse beschleunigen Wachstum in den MOEL", WIFO-Monatsberichte, 2005, 78(5), pp. 353-372 [http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo\\_search.get\\_abstract\\_type?p\\_language=1&pubid=25557](http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=1&pubid=25557).

The appreciation of the euro against the dollar, while not substantially undermining the strength of EU exports, has led to market share losses, squeezed export earnings and diminished the EU's attractiveness for foreign direct investment. The euro is clearly over-valued against the dollar, as measured by purchasing power parities for tradeable goods. A forecast for the exchange rate is difficult to make, as speculative elements have a strong influence giving rise to strong variations in the further trend. Over the last ten years, the ECU and euro first lost 40 percent against the dollar, before rebounding by 30 percent. The WIFO projections assume a gradual correction of the current under-valuation of the dollar, from \$ 1.34 to \$ 1.15 per euro.

Crude oil prices reached a peak of \$ 55 per barrel in March 2005. Part of the increase was driven by special factors such as the Iraq crisis, which may ebb in the medium run. Moreover, the prospective deceleration of world growth and the assumed appreciation of the dollar should both facilitate a decline in oil prices to \$ 36 per barrel by 2007. Experience shows that oil prices are difficult to predict over the medium term. In the last two years, oil prices on world markets have more than doubled without such a jump having been anticipated by any forecast. A sustained higher level of prices for internationally traded oil would constitute a significant cyclical risk for Europe. This risk would be somewhat mitigated by higher demand of the oil-exporting countries for industrial goods ("the re-cycling of the petrodollars"), from which Europe would benefit more than the USA. The dampening impact of higher oil prices on growth is lower nowadays than in the 1970s, as the oil intensity of output has fallen by one-half since then.

The Austrian economy may grow by an average 2.3 percent per year in real terms until 2009. Although the period of stagnation of the last few years would thereby be overcome, no robust cyclical upswing of the kind observed in the past is in sight. The assumption of an acceleration in the pace of growth from the period 1999-2004 hinges on the expectation that both private consumption and construction investment will overcome the stagnation. In addition, structural change of demand and supply in favour of education, innovation and information technology could provide new stimulus to growth.

Table 3: Components of aggregate demand, volume

	Ø 1999/ 2004	Ø 2004/ 2009	2004	2005	2006	2007	2008	2009
Year-to-year percentage change								
Consumption								
Private households <sup>1)</sup>	+ 1.4	+ 2.1	+ 1.5	+ 2.0	+ 2.2	+ 2.1	+ 2.1	+ 2.1
Government	+ 0.3	+ 0.4	+ 1.2	+ 0.5	+ 0.8	+ 0.2	+ 0.0	+ 0.4
Gross fixed investment	+ 2.1	+ 2.6	+ 3.8	+ 1.8	+ 2.7	+ 3.3	+ 2.7	+ 2.3
Equipment <sup>2)</sup>	+ 3.7	+ 3.5	+ 7.1	+ 1.5	+ 3.5	+ 5.3	+ 3.9	+ 3.2
Construction	+ 0.8	+ 1.8	+ 1.1	+ 2.0	+ 2.0	+ 1.7	+ 1.7	+ 1.5
Domestic demand	+ 1.0	+ 2.0	+ 0.6	+ 2.1	+ 2.2	+ 2.0	+ 1.8	+ 1.8
Exports	+ 6.2	+ 6.4	+ 9.0	+ 5.4	+ 6.1	+ 7.2	+ 6.5	+ 6.8
Imports	+ 5.2	+ 6.3	+ 6.6	+ 5.6	+ 6.4	+ 7.0	+ 6.3	+ 6.2
Gross domestic product	+ 1.6	+ 2.3	+ 2.0	+ 2.2	+ 2.3	+ 2.4	+ 2.2	+ 2.4

Source: Statistics Austria, WIFO calculations. – <sup>1)</sup> including private non-profit organisations. – <sup>2)</sup> including other investment.

In the past couple of years growth in Austria was slightly lagging behind the EU and the euro area average. Until 2009, this gap vis-à-vis the euro area may turn positive. First, Austria draws above-average benefits from the speedy catching-up process of the new EU member states in East-central Europe. Second, greater efforts at structural adjustment embracing new technologies may find early resonance in Austria whose economy has in the past proved flexible and responsive to new developments. Third, average GDP growth in the euro area will be held back by the protracted sluggishness of consumer demand and construction investment.

### High uncertainty surrounding exchange rates and oil prices

### Growth in Austria slightly above the euro area average

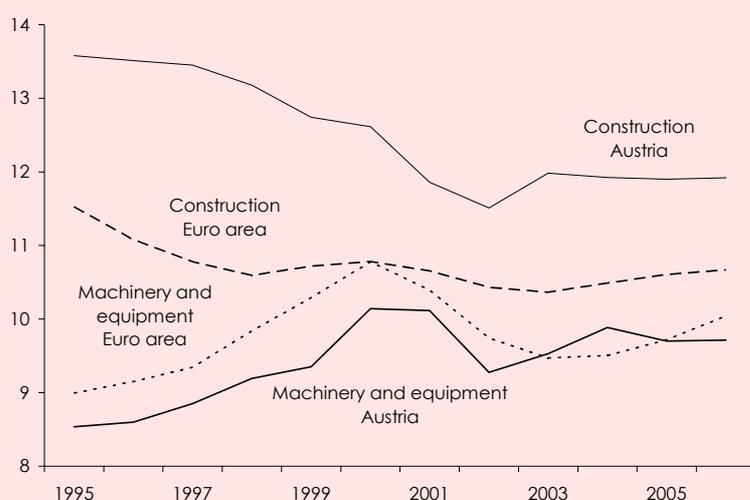
*The high degree of price competitiveness creates favourable prospects for exports. Subsequently, also investment in machinery and equipment should pick up.*

Due to its high degree of openness, the Austrian economy is highly dependent on the European business cycle. Austria will benefit in particular from the gentle cyclical recovery in the euro area and the slight acceleration of the catching-up process of the new EU member states, as 60 percent of domestic merchandise exports go to the euro area and 15 percent to East-central Europe. With the recovery in demand, exports of goods and services should gather momentum, rising by just above 7 percent in volume in 2007. Price competitiveness of Austrian exports is proving high. Over the last ten years, unit labour costs in manufacturing declined by 15 percent against the average for Austria's trading partners (with the exception of the years of strong currency appreciation, such as 2003). In order to improve its competitiveness, Austria is rather relying on wage moderation (like the Netherlands) than on innovation (like the Scandinavian countries).

**Exports and equipment investment are the major drivers of business activity in Austria**

Figure 2: Gross fixed capital formation

As a percentage of GDP, at current prices



Source: EU, Statistics Austria, WIFO calculations.

An acceleration of export growth in Austria is usually followed, with a certain time lag, by a pick-up in investment. The currently good earnings situation improves the prospects for an upswing in investment from the financing point of view. Higher spending on research, innovation and new technologies should also translate into stronger investment in machinery and equipment which, in all, is projected to reach a cyclical peak at a growth rate slightly above 5 percent in volume by 2007, moderating thereafter.

The projections assume a noticeable recovery of internal demand, whose weakness had largely shaped overall economic developments from 2001 to 2004. While private consumption expanded by only 1.4 percent p.a. in real terms between 1999 and 2004 (2000-2004 +0.7 percent), it should accelerate to an average 2.1 percent over the projection period, only slightly below its long-term average. Disposable income will be boosted by the cyclical recovery and better employment prospects. Assuming wage settlements of around 2½ percent on average per year, the increase in employment will yield a gain in total wages and salaries of 3¼ percent p.a. in nominal terms. Moreover, as from 2006, lower inflation will strengthen real disposable income. Real earnings per capita may edge up by slightly more than ½ percent per year over the projection period. In addition, the tax reform 2004-05 is adding to disposable income. The cumulative positive effect of the tax reform on private consumption has been estimated at around 1½ percent (Breuss – Kaniowski – Schratzenstaller, 2004), most of it accruing in 2005 and 2006.

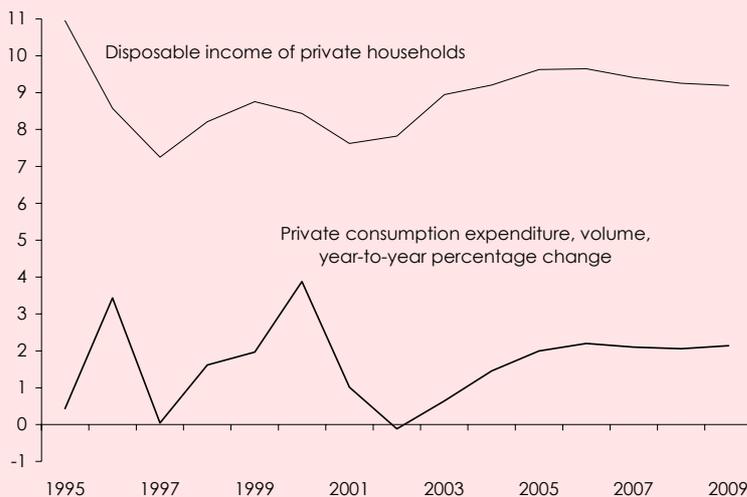
**Recovery of domestic demand subject to risks**

However, the WIFO simulations do not include any "counter-financing" measures, e.g., potential cuts in public transfers which, if actually implemented, would weigh on household disposable income and therefore on private consumption. The larger income gains will translate into higher consumption, but also an increase in the saving ratio. The latter is expected to rise to 9½ percent of disposable income in 2006, 2 percentage points above the level it held five years ago, before abating slightly in the subsequent years.

The projections also expect construction investment to strengthen to an annual pace of 2 percent, after having virtually stagnated over the period from 1999 to 2004 (+1 percent in volume on annual average). With the steady expansion of the EU there is a need for a timely reinforcement of the transport and communication infrastructure. The Austrian economy may benefit more than other member states from a carrying-forward of projects in the context of the Trans-European Networks, as envisaged by the European Commission. Austria would be directly involved in five out of the 30 priority projects. The establishment of public-private-partnership arrangements would also facilitate an accelerated implementation of construction works, even if such arrangements usually do not imply more favourable financing conditions in a longer-term perspective. Apart from civil engineering, residential construction may expect to enjoy stronger output growth, since immigration creates additional demand for subsidised housing.

*Consumption and construction investment should gradually overcome their protracted stagnation. This is a crucial condition for the overall economy to enter into a cyclical recovery.*

Figure 3: Private consumption and saving ratio



Source: Statistics Austria, WIFO calculations.

The medium-term projections do not signal any inflation risks. Price increases at the consumer level are expected at around an annual average 1¼ percent over the period from 2004 to 2009. In an open economy closely integrated with its trading partners, import prices play an important role for the course of inflation. Strong competition within the EU should become even stronger with enlargement. This, together with moderate aggregate demand, will keep inflation under firm control. Risks to price stability derive mainly from developments on commodity markets.

Domestic inflation determinants should not exert any significant upward pressure. Some uncertainty relates to the role of indirect taxes and public charges, which were raised repeatedly in the last years as a short-term measure for reining in the government deficit. Nominal unit labour costs for the whole economy will increase by only about 1 percent per year, thereby holding overall inflation in check. Real wages per capita will edge up by an average 0.5 percent p.a., lagging behind labour productivity (+1¼ percent). The sustained decline in the wage share (as a pro-

**Little inflationary pressure, decline of the wage share to continue**

portion of national income) observed since the early 1980s will thereby continue. The fall in real unit labour costs will boost the price competitiveness of Austrian exports on the one hand, but restrain consumers' disposable income on the other.

Table 4: Prices

	Ø 1999-2004	Ø 2004-2009	2004	2005	2006	2007	2008	2009
	Year-to-year percentage change							
Implicit price indices								
Private consumption	+ 1.8	+ 1.7	+ 2.0	+ 2.5	+ 1.8	+ 1.6	+ 1.5	+ 1.4
Exports	+ 0.8	+ 1.0	+ 1.1	+ 0.7	+ 0.7	+ 1.4	+ 1.2	+ 1.1
Imports	+ 0.6	+ 1.2	+ 2.0	+ 0.8	+ 0.8	+ 1.7	+ 1.4	+ 1.3
Gross domestic product	+ 1.6	+ 1.6	+ 1.9	+ 2.2	+ 1.6	+ 1.4	+ 1.3	+ 1.3

Source: Statistics Austria, WIFO calculations.

With business activity picking up, employment growth should also gather momentum. The positive correlation between the rate of economic growth and the number of jobs remains strong and highly stable. The number of persons in dependent active employment is expected to expand by 0.9 percent per year between 2004 and 2009, which corresponds to an annual gain of almost 30,000 jobs. Job opportunities in the private sector may increase even more rapidly, while those in the public sector will decline due to the administrative reform and the further outsourcing of activities.

The projected advance in labour productivity by an average 1¼ percent p.a. will fall clearly short of the benchmark of the 1980s and 1990s. The lower figure can be explained by the substantial increase in part-time employment, which lowers productivity as measured by output per head. The growing number of part-time jobs is largely a consequence of the structural shift of demand and output towards services, also accommodating the employees' preferences to an extent. Part-time employment in Austria is still largely confined to the female labour supply.

### No turnaround on the labour market until 2009

Due to the strong inflow of foreign labour, unemployment is set to increase further, despite employment following an upward trend. A turnaround in unemployment is not in sight.

Table 5: Labour market, income

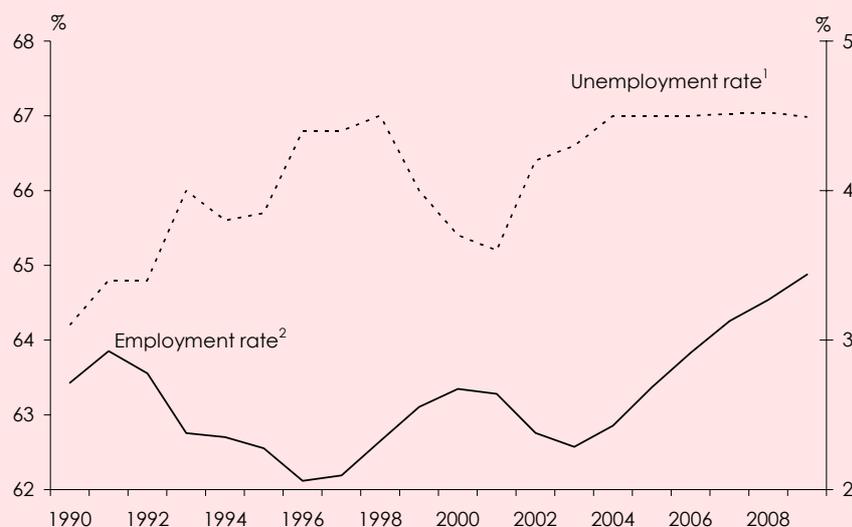
	Ø 1999-2004	Ø 2004-2009	2004	2005	2006	2007	2008	2009
	Year-to-year percentage change							
Dependent active employment <sup>1</sup>	+ 0.3	+ 0.9	+ 0.7	+ 0.8	+ 0.9	+ 1.1	+ 1.0	+ 1.0
Number of unemployed	+ 1.9	+ 1.1	+ 1.6	+ 1.2	± 0.0	+ 0.6	+ 2.1	+ 1.4
Unemployment rate								
As a percentage of labour force <sup>2</sup>	4.1	4.5	4.5	4.5	4.5	4.5	4.5	4.5
As a percentage of dependent labour force <sup>3</sup>	6.6	7.1	7.1	7.1	7.1	7.0	7.1	7.1
Productivity <sup>4</sup>	+ 1.1	+ 1.4	+ 1.1	+ 1.4	+ 1.4	+ 1.3	+ 1.3	+ 1.5
Wages and salaries <sup>5</sup>	+ 2.6	+ 3.3	+ 3.0	+ 3.2	+ 3.5	+ 3.4	+ 3.2	+ 3.3
Per employee <sup>6</sup>	+ 2.0	+ 2.3	+ 2.2	+ 2.3	+ 2.5	+ 2.2	+ 2.1	+ 2.2
Unit labour cost, whole economy	+ 0.8	+ 0.9	+ 1.2	+ 0.9	+ 1.1	+ 0.8	+ 0.8	+ 0.7

Source: Federation of Austrian Social Security Institutions. Statistics Austria, WIFO calculations. – <sup>1</sup> Excl. recipients of maternity and child-care benefits, excl. people in statutory military service, excl. unemployed in job-training included in employment statistics. – <sup>2</sup> According to Eurostat (Labour Force Survey). – <sup>3</sup> According to Labour Market Service. – <sup>4</sup> Real GDP per employee (employment contracts plus self-employed according to National Accounts). – <sup>5</sup> Gross, excl. employers' contributions. – <sup>6</sup> Per employment contract according to National Accounts.

In spite of the robust growth of employment, the jobless figure is set to keep rising over the entire projection period, reaching a level of almost 260,000 by 2009. With the number of people employed rising in parallel, the jobless rate will remain largely unchanged at 7.1 percent of the dependent labour force (national definition) or 4.5 percent of the total labour force (Eurostat). The reduction to a rate of 3½ percent targeted (for 2002) by the National Action Plan for Employment will therefore not be achieved within the current decade.

The population of working age (15 to 64 year olds) will edge up by an average 0.3 percent p.a. until 2009, mainly as a result of the substantial number of people acquiring Austrian citizenship. In addition, the inflow of foreign labour will stay lively, with the number of foreign workers in 2009 expected to exceed the level of 2004 by over 10 percent. This strong increase occurs notwithstanding the transition periods for the free movement of workers from the 10 new EU member states. It is driven mainly by a growing number of seasonal workers, inflow from the EU 15 (in particular from Germany and Italy) and a more generous issue of work permits for foreigners who have been resident in Austria for some time. Furthermore, the rise in the early retirement age in the context of the pension reform is adding to labour supply. The labour force is projected to grow by 0.9 percent per year until 2009.

Figure 4: Labour market trends



Source: EU, WIFO calculations. – <sup>1</sup> As a percentage of total labour force (according to Eurostat). – <sup>2</sup> Economically active as a percentage of population of working age (15 to 64).

A shortage of labour is therefore unlikely to emerge within the projection period. On the contrary, the excess of labour supply over demand is set to widen markedly. The substantial labour reserve from high unemployment and the rather low participation rates of women and older workers will therefore not be mobilised.

The government balance has weakened significantly since 2001, when a "zero deficit" was achieved. Reasons for the deterioration were the high costs of rising unemployment, cuts in several business taxes in the context of the cyclical stimulus "packages" of 2002 and 2003, and the tax reform of 2004-05. For 2005, the general government deficit is expected at around € 4½ billion, equivalent to 2 percent of GDP.

Since 2003, the budgetary stance has had a stabilising impact on the business cycle. Apart from the operation of automatic stabilisers and the expansionary effects of higher infrastructure investment carried out by off-budget entities, economic activity is receiving support from the tax reform 2005. WIFO has estimated that the cuts in income and corporate taxes will raise GDP by 0.3 percent in 2005 and 0.2 percent in 2006 from the baseline (Breuss – Kaniovski – Schratzenstaller, 2004).

Until 2009, WIFO projects a gradual decline of the budget deficit to eventually around ½ percent of GDP. One reason for the improvement is the assumed steady economic growth, allowing government revenues to increase by 3½ percent per year between 2007 and 2009; a cautious stance on government expenditure, another. Recent decisions at the EU level have somewhat increased the scope for national fiscal policy. The structural reforms to be undertaken under the Lisbon Agenda call for greater government involvement in areas considered crucial for medium-term economic and social development, such as education and training and a na-

### Gradual decline in the government deficit

At a ratio of 2 percent of GDP, the general government deficit will reach a peak in 2005. Growing tax revenues in the course of the cyclical recovery and restraint on government expenditure will make for a steady decline of the financing gap to ½ percent of GDP by 2009.

tional investment strategy. The reform of the Stability and Growth Pact implies a stronger focus on the medium term and on the composition of government expenditure.

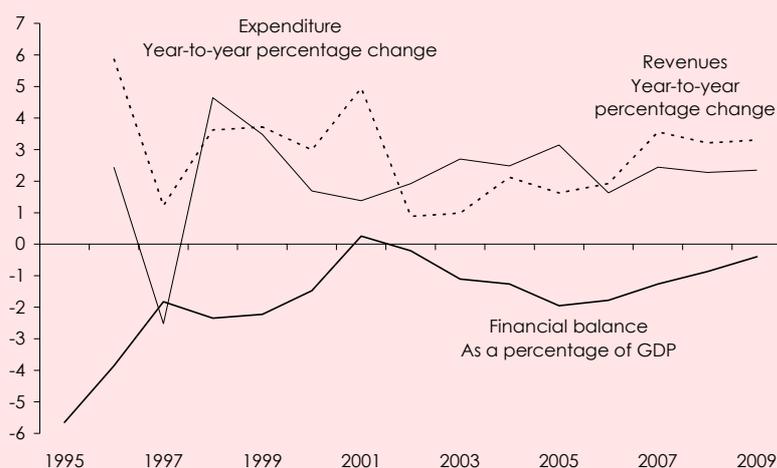
Table 6: General Government

	Ø 1999-2004	Ø 2004-2009	2004	2005	2006	2007	2008	2009
	Year-to-year percentage change							
Current revenue	+ 2.4	+ 2.7	+ 2.1	+ 1.6	+ 1.9	+ 3.6	+ 3.2	+ 3.3
Current expenditure	+ 2.0	+ 2.4	+ 2.5	+ 3.1	+ 1.6	+ 2.4	+ 2.3	+ 2.3
Gross domestic product, nominal	+ 3.3	+ 3.9	+ 3.9	+ 4.5	+ 3.9	+ 3.8	+ 3.5	+ 3.7
	As a percentage of GDP							
General government balance, Maastricht definition	- 0.8	- 1.3	- 1.3	- 2.0	- 1.8	- 1.3	- 0.9	- 0.4

Source: Statistics Austria, WIFO calculations.

After the wearing-off of the dampening impact of the tax reform, wage tax revenues are expected to rebound strongly, gaining 4¼ percent per year. Thus, the wage tax/GDP ratio will resume its strong upward trend after the decline in 2005 and 2006. With rising employment, also employers' and employees' social contributions will grow quickly, by 3¼ percent p.a. VAT revenues are projected to progress by an average 2¾ percent, clearly lagging behind the nominal growth rate of private consumption. The revenue elasticity of indirect taxes is low, which points to widespread tax avoidance. Since other member states are faced with the same experience, the problem should be addressed at the EU level. The structure of the Austrian tax system is unfavourable compared with other European countries. The share of social security contributions and payroll taxes is particularly high in Austria, whereas that of income, wealth and business taxes is relatively low. From the perspectives of growth, employment and distributive equity, a reform of the public revenue structure would be advisable.

Figure 5: Revenues, expenditure and financial balance (according to Maastricht) of general government



Source: Statistics Austria, WIFO calculations.

The WIFO projection for the general government balance rests on the assumption of a restrictive stance for public expenditure. The growth of personnel cost will be dampened by further cuts in the number of government employees. The total amount of subsidies is assumed to remain flat on average over the period from 2004 to 2009. Public investment has fallen as a share of GDP from 3 percent to 1 percent

over the last ten years, due partly to outsourcing and partly to real cuts. For social transfers in cash it has been assumed that they will not grow faster than the 3¼ per cent p.a. recorded in the previous period, in spite of the upward pressure exerted by rising unemployment and the full implementation of the new child care benefit. The ageing of the population is driving up spending of the retirement and health insurance institutions.

Also the government expenditure side is facing severe challenges for structural adjustment. In the debate on the results of the OECD "PISA study", the need for reform of the education system has become evident. Moreover, the structural indicators selected by the European Commission suggest that further education and training are rather poorly developed in Austria. The sustained increase in unemployment clearly shows the need for additional spending on training and professional qualification. Expenditure on education belongs to the key determinants driving economic growth in the longer run. Public and private outlays for research have been raised from a low level in the mid-1990s to the EU average, accounting for some 2.2 percent of GDP in 2004. Particular emphasis should be given to promoting the implementation of information and communication technologies. As a reaction to the demographic shift, economic policy should take back the very costly fiscal incentives for early retirement and long maternity leaves as a means to reduce labour supply.

WIFO's previous medium-term projections have had a tendency to over-estimate economic performance. The present projections 2004-2009 imply that towards the projection horizon economic growth will close the gap vis-à-vis its long-term average. With regard to the experience of the most recent period of stagnation, this scenario may once again prove too optimistic. The uncertainties surrounding the projection therefore appear to be biased towards a weaker rather than a more favourable overall economic performance.

Downward risks may derive primarily from a more pessimistic international scenario. A possible further appreciation of the euro against the dollar would dampen economic growth in the euro area. A continued upward drift of commodity prices on world markets would have the same effect. Within the euro area there is a risk that economic policy cannot effectively address the key problem of sluggish domestic demand. In a number of EU member states, a slackening of real estate prices from currently exaggerated levels may hold back private consumption and construction investment.

On the other hand, economic developments in Asia – and notably in China which has become a growth engine for the world economy – give reason for optimism. In the EU, the greater emphasis now given to the Lisbon Process and its implicit forward-looking agenda may give fresh momentum to business activity. At the political level, there seems to be renewed interest in developing the Trans-European Networks of transport and communication infrastructure. These would help the new EU member states in catching up and trigger for the EU as a whole the badly needed impulses for higher growth.

For Austria, the present projections are optimistic in assuming a speedy recovery of consumer spending and construction investment. They imply in particular that private households give up their wait-and-see attitude and refrain from increasing their saving further as they gain confidence on the prospects for the economy as a whole as well as for their personal situation. Admittedly, the high level of unemployment makes this prospect less likely. Policy action should therefore give priority to the creation of new jobs. Further measures to reduce the budget deficit would in the short term weigh on growth and employment.

If, however, global and euro area economic performance were to turn out better than expected, Austria would benefit more than other countries. Its strong external competitive position would be confirmed by greater efforts to raise education levels and speed up innovation, which would also yield positive spill-overs for domestic demand.

### **Cyclical outlook holding risks and opportunities**

*The further trend of internal demand in the EU as well as in Austria constitutes a downward risk to the forecast. On the other hand, a stronger expansion of global economic activity and early benefits from investments in education and innovation may provide the decisive stimulus for higher growth.*

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### *Domestic Demand to Recover Gradually over the Medium Term*

#### *Projections for the Austrian Economy until 2009 – Summary*

Growth of the Austrian economy may accelerate to an annual 2.3 percent in volume in the next five years. The average rate would thereby be markedly higher than the 1.6 percent recorded over the period from 1999 to 2004. Activity is receiving substantial stimulus from exports. Given their high price competitiveness, Austrian firms should draw major benefits from lively world trade. A crucial requirement for growth moving to a higher pace is that the weakness of both consumer demand and construction investment can be overcome. In spite of the cyclical recovery, no turnaround is in sight on the labour market. The strong increase in labour supply will keep unemployment on an upward trend until 2009. Inflation will remain subdued. On the assumption of a steady pace of economic growth and a restrictive stance for government expenditure, the general government deficit will moderate to around ½ percent of GDP by 2009.