

JOSEF BAUMGARTNER, SERGUEI KANIOVSKI, MARKUS MARTERBAUER

CYCLICAL UPTURN, WITH STRUCTURAL PROBLEMS PERSISTING

MEDIUM-TERM PROJECTIONS FOR THE AUSTRIAN ECONOMY UNTIL 2006

The Austrian economy is about to enter a phase of cyclical upturn that should last until 2004, when growth may rise above 3 percent. For 2005 and 2006, a marked slowdown should be expected. The business cycle is determined primarily by international developments exerting a direct impact on exports and investment in machinery and equipment. The further course of the world economy also holds the major risks to the projections. Domestic demand, while initially lagging behind the growth of output, will lend increasing support to overall activity towards the end of the forecast horizon. Employment will post sizeable gains as the recovery proceeds, although a fall in unemployment may be held back by the ample supply of foreign labour. Financial scope in government households will remain tight, as policy is facing major challenges in shaping budgetary structures and in the areas of education and innovation.

Cut-off date: 8 August 2002. For further information on recent developments and a first assessment of flood costs see the Business Cycle Report "Firms Turning Still More Pessimistic – Unemployment Rising Further" (WIFO-Monatsberichte, 2002, 75(9)). • Josef Baumgartner, Serguei Kaniovsky and Markus Marterbauer are economists at WIFO. The authors are grateful to Fritz Breuss, Helmut Kramer and Gerhard Lehner for useful 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, Markus.Marterbauer@wifo.ac.at, Christine.Kaufmann@wifo.ac.at

The present medium-term projection 2001-2006 is based upon the short-term outlook 2002-03 presented by WIFO in June. There, WIFO has worked on the assumption of a smooth recovery of activity world-wide, while at the same time pointing to the risk for such a recovery being delayed. In Austria, the cyclical upturn may peak in 2004, at an annual growth in real GDP of 3¼ percent. Exports and investment in machinery and equipment are expected to be the main drivers of the rebound from the 2001 recession.

The Austrian economy may benefit particularly from a pick-up in demand from its major trading partners, as price competitiveness of domestic exporters has been boosted by a favourable trend in unit labour costs. The expected strong expansion of goods exports will give major incentives for investment in machinery, vehicles and immaterial goods. During the upswing, domestic demand will rather have a dampening impact on the pace of activity. Gains in private consumption may be held back somewhat by a rise in the household saving ratio towards its medium-term average. Growth in the construction sector will be subdued, as demand for new homes is set to remain sluggish.

The cyclical pattern underlying the projections points to a marked slowdown in 2005 and 2006. Once again, the driving forces will come from the most volatile components of demand, i.e., exports and equipment investment, which by then should both post only modest further gains. Domestic demand, for its part, should help sustain overall activity towards the end of the forecast period. Private consumption will keep rising by over 2 percent p.a., and construction activity should finally overcome its protracted recession, once investment in transport and communication facilities will receive incentives from EU enlargement and housing demand starts heading up.

Over the period 2001-2006, real GDP in Austria is expected to grow by 2¼ percent p.a., slightly below the EU average (2.4 percent) and keeping broadly the same pace as from 1996 to 2001. Nevertheless, a number of structural problems are becoming apparent: while the foreign contribution to growth is rising significantly, this is to be attributed, apart from favourable external cyclical conditions, to a moderate trend in wages rather than to strong productivity gains driven by a successful innovation strategy.

The business cycle upturn will give rise to stronger employment growth. The number of active workers and employees is set to increase by 19,000 or 0.6 percent per year. This

will not, however, reduce unemployment to the same extent. Although the population of working age, unlike in previous periods, will hardly rise, labour supply will be boosted substantially by the inflow of foreign workers, either on a seasonal basis or as a consequence of eastern enlargement of the EU as from 2004. The overall jobless figure is expected to just edge down to 205,000 by 2006, corresponding to a rate of 5.9 percent of the dependent labour force or 3.3 percent of the workforce according to Eurostat.

Table 1: Main results

	Ø 1996-2001	Ø 2001-2006	2001	2002	2003	2004	2005	2006
Year-to-year percentage changes								
Gross domestic product								
Volume	+2.4	+2.3	+1.0	+1.2	+2.8	+3.3	+2.4	+1.7
Value	+3.4	+3.6	+2.6	+2.3	+4.0	+4.7	+3.8	+2.9
Consumer prices ¹	+1.3	+1.7	+2.3	+1.7	+1.4	+1.9	+1.8	+1.6
Gross wages and salaries per employee ²	+2.3	+2.7	+3.1	+2.5	+2.5	+3.0	+2.8	+2.4
Dependent employment ³	+0.8	+0.6	+0.4	-0.2	+0.8	+1.1	+0.8	+0.5
In percent								
Unemployment rate								
Percent of total labour force ⁴	4.0	3.6	3.6	4.0	3.9	3.6	3.4	3.3
Percent of dependent labour force ⁵	6.6	6.3	6.1	6.8	6.5	6.2	6.0	5.9
As a percentage of GDP								
Net exports	-0.9	-0.2	-0.4	+0.1	+0.2	+0.1	-0.4	-1.0
General government financial balance ⁶	-1.6	+0.1	+0.1	-0.4	±0.0	+0.2	+0.5	+0.4
As a percentage of GDP								
Household savings ratio	7.1	6.8	6.2	6.4	6.8	7.2	7.0	6.8

¹ Private consumption deflator. – ² Excluding employer contributions, employees according to National Accounts definition. – ³ Excluding parental leave and military service. – ⁴ According to Eurostat. – ⁵ According to Labour Market Service. – ⁶ According to Maastricht definition.

Assuming a restrictive stance for public spending, and abstracting from any cuts in taxes and non-wage labour costs as well as from the envisaged increase in defence spending, the model projections yield a balanced general government budget for 2003 and a small surplus for the following years (2005 +½ percent of GDP).

The forecast gives no indication for significant inflation risks. The average inflation rate over the period 2001-2006 is expected at 1.7 percent. Real wages per capita will rise by 1 percent per year, distinctly lagging behind labour productivity.

Table 2: International fundamentals

	Ø 1996-2001	Ø 2001-2006	2001	2002	2003	2004	2005	2006
Year-to-year percentage changes								
Real GDP EU	+2.6	+2.4	+1.5	+1.3	+2.8	+3.3	+2.5	+2.0
World trade prices, total	-3.3	+3.3	-3.6	+1.1	+3.6	+4.4	+4.6	+3.0
US\$ per ECU or Euro								
Exchange rate	1.028	0.945	0.896	0.95	0.98	0.93	0.93	0.93
In percent								
Euro area interest rates								
Long-term government bonds	5.1	5.4	4.9	5.2	5.5	5.5	5.5	5.2
3-month (Euribor)	4.1	4.2	4.3	3.3	4.5	4.5	4.5	4.0

The risks to the present medium-term projections are primarily located at the international level. In the USA, growth may turn out lower in the case of the macro-economic imbalances (low household saving ratio, high current account deficit, over-valuation of stocks and real estate assets) being corrected. In Europe, the different actions of the monetary, fiscal and wage-setting authorities may not in all instances yield the appropriate policy mix. Eastern enlargement of the EU has been assumed to take place in 2004. The successful integration of the candidate countries may have lasting positive effects on

growth not only for the new members, but also for western Europe. Potential risks remain nevertheless significant, such as in the event of a premature accession to monetary union.

The present medium-term projections for Austria have been established using the WIFO macro model. They are based upon WIFO's short-term forecast for 2002 and 2003 presented last June¹, and on the assumptions concerning the international environment presented in *Schulmeister (2002)*².

- The Austrian economy will grow by 1.2 percent in volume in 2002 and by 2.8 percent in 2003. The major impulse is expected from the business cycle recovery in the key trading partner countries, while domestic demand may remain sluggish. A delay in the recovery in the USA and in Europe constitutes the main risk to the upturn.
- Having overcome the 2001 recession, growth in the USA will gain further momentum, reaching a peak in 2004 with real GDP gaining 3½ percent.
- The EU economy will be driven mainly by exports. The cyclical upswing will follow the one in the USA with a lag and turn out less strong, given a more restrictive stance of monetary and fiscal policy. Over the whole period 2001-2006, average real GDP growth is estimated at 2.4 percent, ¼ percentage point less than between 1996 and 2001. The German economy will continue to grow slower than the EU average, at an annual 2 percent.
- Central and Eastern Europe will benefit from the recovery in the EU and, as from 2004, from the effects of EU membership. The latter consist primarily of incentives for direct investment and exports and should give fresh momentum to the catching-up process of the accession countries. Average GDP growth in the CEECs from 2001 to 2006 is projected to exceed the annual rate in western Europe by 1½ percentage points.
- The exchange rate of the euro to the dollar, an exogenous variable in the forecasting model, is assumed to stay close to the current parity level throughout the projection period.
- World trade prices will pick up markedly as the recovery gathers pace, although no large swings in commodity prices have been assumed.

Due to the close external ties, domestic economic developments are highly dependent from the European business cycle. Over the past decades, the Austrian economy fared relatively well notably in periods of international cyclical downturn. This should be attributed to the impact of domestic economic policy, and in particular to counter-cyclical fiscal action, which helped to stabilise expectations. In subsequent phases of cyclical upswing, growth has often been somewhat less dynamic than in other EU member states. Different from this pattern, the business cycle downturn in 2001 was more severe in Austria than for the EU as a whole, the negative growth differential amounting to ½ percentage point.

The demand-dampening effects of fiscal restraint have been partly offset by a fall in private saving, expressed as a share of disposable income. This suggests, however, that the contribution of private consumption to the recovery in prospect will be limited, as households may want to restore their savings, bringing the ratio back towards its medium-term level. Domestic demand is further constrained by the persistent weakness of construction activity. Stronger overall activity will thus mainly be supported by exports and investment in machinery and equipment.

Small open EU economies have in the past been particularly successful by pursuing two different strategies. Finland, Sweden and to some extent Ireland have embarked on investing heavily in information and communication technology, thereby also boosting exports. The Netherlands, alternatively, resorted to wage moderation, thereby boosting their international competitiveness on the basis of low unit labour costs. Austria also rather opted for the second way. Spending on innovation and investment in information

Favourable international framework conditions

Austrian economy to grow only slightly below EU average

GDP in Austria is expected to grow by 2.3 percent per year between 2001 and 2006, slightly below the EU average. An increase in the household saving ratio, persistent weakness of construction activity, and a lag in innovation capacity are seen as holding back the expansion.

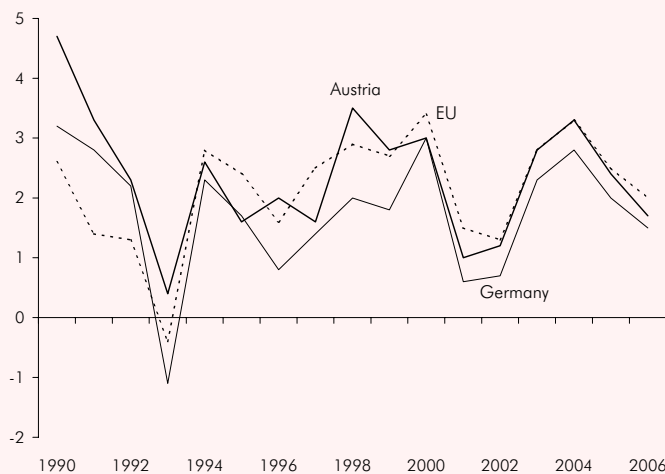
¹ Walterskirchen, E., "Economic Recovery Surrounded by Risks. Economic Outlook for 2002 and 2003", Austrian Economic Quarterly, 2002, 7(3) http://titon.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=1&pubid=22369&pub_language=-1&p_type=0

² Schulmeister, St., "Mittelfristige Prognose der Weltwirtschaft: Aktienmärkte dämpfen das Wachstum in den USA", WIFO-Monatsberichte, 2002, 75(8), pp. 513-524 http://titon.wsr.ac.at/wifosite/wifosite.get_abstract_type?p_language=1&pubid=22514&pub_language=-1&p_type=0

and communication technology (ICT), in research and development remain below the EU average. This is reflected by a deficit in the output share of technology-oriented sectors (in Austria 14 percent of GDP as compared with 23 percent for the whole EU) and knowledge-based services (12 percent against 19 percent). Rather than relying on an innovation-based strategy of competitiveness, Austria has been betting on moderate nominal wage settlements yielding cost advantages mainly to the export-oriented branches.

Figure 1: Growth of real GDP

Percentage changes from previous year



For the period 2001-2006 the projections assume that the Austrian economy, given its typical lag in cyclical upswings, the continuing problems in the construction sector and its weakness in innovative capacity, will grow along a path slightly below the overall EU trend, but significantly above that for Germany.

Driven by the recovery in the USA and in Europe, growth of merchandise exports is set to accelerate substantially in 2003 and 2004, exceeding 8 percent in volume per year. Domestic exporters will benefit particularly from strengthening demand in key foreign markets. Austrian exports are heavily concentrated on the European single market (61 percent of total exports) and particularly on Germany (33 percent). The persistent sluggishness of German internal demand is hitting Austrian firms only to some extent as the latter mainly rely on established supply relations with the German export industry that continues to enjoy healthy growth. Moreover, Austrian exporters have been able to steadily strengthen their position on the German market over the last decades.

The trade-creating effects of the opening of eastern markets have had a significant impact on overall economic developments in Austria already over the last decade. The share of the Central and Eastern European countries Hungary, Czech Republic, Slovakia and Poland in total exports doubled from 5 percent in 1990 to 10 percent in 2001. Deliveries to these countries went up by an average 15 percent per year, compared with 7 percent for total exports. EU accession of the transformation economies should provide further expansionary momentum, the size of which will nevertheless depend on the speed of the catching-up process.

Lively exports and investment in machinery and equipment

Table 3: Aggregate demand

In real terms

	Ø 1996- 2001	Ø 2001- 2006	2001	2002	2003	2004	2005	2006
	Year-to-year percentage changes							
Consumption expenditure								
Private households ¹	+2.2	+2.2	+1.3	+1.5	+2.3	+2.6	+2.6	+2.2
General government	+1.0	+0.6	+0.7	-1.0	±0.0	+1.9	+0.7	+0.9
Gross fixed investment	+1.8	+2.9	-2.7	-0.7	+4.1	+5.3	+3.7	+2.0
Machinery and equipment ²	+5.4	+4.8	-3.8	+0.7	+7.6	+9.3	+5.3	+1.5
Construction	-0.4	+1.0	-1.7	-2.0	+1.0	+1.3	+2.0	+2.6
Domestic demand	+1.9	+2.1	+0.2	+0.7	+2.2	+3.1	+2.5	+1.9
Exports of goods and services	+9.1	+6.4	+4.5	+4.3	+7.3	+8.3	+6.6	+5.5
Imports of goods and services	+8.1	+6.1	+2.9	+3.4	+6.5	+8.1	+7.0	+6.0
GDP	+2.4	+2.3	+1.0	+1.2	+2.8	+3.3	+2.4	+1.7

¹ Including private non-profit institutions serving households. – ² Including other products.

Another decisive element for export dynamism, next to the demand from foreign trading partners, is the competitiveness of exporting firms. The price component of the latter is determined, i.e., by relative unit labour costs in manufacturing. On the basis of past developments, a continuation of the favourable trend may be expected, with unit labour costs for the whole economy rising by only 1 percent p.a. between 2001 and 2006. This figure still overstates the cost pressure in the export sector where productivity gains are far above average and wage costs per unit of output may actually fall. Austrian firms should therefore be able to increase their foreign market shares.

In Austria, the link between goods exports and equipment investment is particularly strong. At the same time, spending on machinery, business vehicles and software represents the most volatile component of overall demand. The WIFO projections assume that such spending will pick up strongly in the coming upswing, gaining more than 9 percent in volume in 2004. Investment growth will abate thereafter, such that over the period 2001-2006 it may average 5 percent, slightly less than from 1996 to 2001.

Construction investment is set to be much less dynamic than equipment capital formation, with a projected annual increase of but 1 percent p.a. between 2001 and 2006. Sluggish demand for new homes will allow residential building to tentatively recover only towards the end of the period, once the current fall has bottomed out. Much more favourable are the prospects for non-residential building. While for office space there is still important excess capacity that may dampen activity for the next few years, the business cycle recovery will give fresh stimulus to the creation of new industrial structures. Moreover, there is strong need for new infrastructure, notably in view of the EU enlargement, as transport and communication facilities are not in all instances ready to cope with the increasing trade relations with the accession countries. The crucial uncertainty in this regard is the as yet largely unresolved issue of financing. The revenues from the road tax for heavy trucks about to be introduced will not be sufficient to cover the overall cost of the investment required.

Private consumption should rebound with the strengthening of business activity that will boost employment and real per-capita income. The average increase of real household consumption over the years 2001-2006 is estimated at 2.2 percent p.a. implying a certain lag vis-à-vis the growth of GDP and of disposable income. Underlying is the assumption that the savings ratio, having fallen to slightly above 6 percent of disposable income during the period of fiscal consolidation, will revert towards its medium-term level of around 7 percent.

**Domestic demand
lagging behind in the
cyclical upturn**

Growth of imports is set to trail that of exports. While on the one hand rising exports will pull along more primary inputs and equipment investment, both of high import content, the below-average expansion of private household demand and construction activity will hold back imports, on the other.

The positive foreign trade contribution to growth is set to rise over the projection period. While this is welcome from the point of view of the demand impulse and market share gains, it also raises a number of more problematic issues. The substantial external growth contribution is the result of strong business activity abroad and a relatively favourable unit labour cost position of the domestic economy. Export prices are seen rising distinctly more slowly than import prices. Whereas exporting firms facing highly price-elastic demand may benefit from a favourable cost situation, import prices are mainly determined by conditions on world commodity markets, with demand rather being price-inelastic. An improvement in the unit labour cost position achieved primarily through wage moderation may, however, lead to lower domestic welfare gains. More conducive to sustained and broader-based growth would be a rise in competitiveness based on strong productivity advances that would be generated by buoyant investment in information and communication technology and in innovation more generally.

The medium-term forecast does not point to any problems of inflation. In an open economy within the EU Single Market the European trend in costs and prices is of rising importance for domestic inflation. On the EU level, inflation expectations are modest and stable. Countries with above-average price rises are obliged to secure their competitiveness by pursuing restrictive wage and fiscal policies. International raw material prices will drift upwards with livelier demand in the cyclical recovery, without, however, exerting substantial and lasting inflationary pressure.

Domestic price determinants, for their part, do not give reason for inflationary concerns either. Stronger competition in formerly sheltered sectors is forcing prices down, at least for some time. Unit labour costs for the whole economy are expected to go up by an average 1 percent per year, thereby exerting a dampening effect on overall inflation. Headline inflation is projected to average 1.7 percent over the period 2001-2006.

Table 4: Deflators

	Ø 1991-1996	Ø 1996-2001 Year-to-year percentage changes	Ø 2001-2006
<i>Implicit price deflators</i>			
Private consumption	+2.8	+1.3	+1.7
Exports of goods and services	+1.0	+0.9	+1.3
Imports of goods and services	+1.0	+1.4	+1.7
GDP	+2.6	+1.0	+1.2

Real wages per capita may advance by 1 percent p.a., the same pace as between 1996 and 2001. Once again, this rate is well below the anticipated growth of labour productivity (+1½ percent in real terms). The further widening of the real wage gap is a reflection of persistent high unemployment that undermines the unions' bargaining position, as well as of the generally more competitive climate. This also implies that the share of wages in national income will decrease further.

Cyclical upswing stimulating employment and productivity growth With the cyclical upturn in prospect, the labour market situation should improve markedly over the medium term, the link between the pace of economic expansion and employment growth still being relatively close and stable. A rise in the demand for goods and services will generate additional demand for labour. In a longer-term perspective, the employment intensity of economic growth has even become somewhat higher. The number of actively employed workers and employees is forecast to rise by an average 0.6 percent per year from 2001 to 2006, corresponding to an annual net gain of 19,000 jobs. These new jobs will entirely be created in the private sector, while public sector employment is set to remain flat.

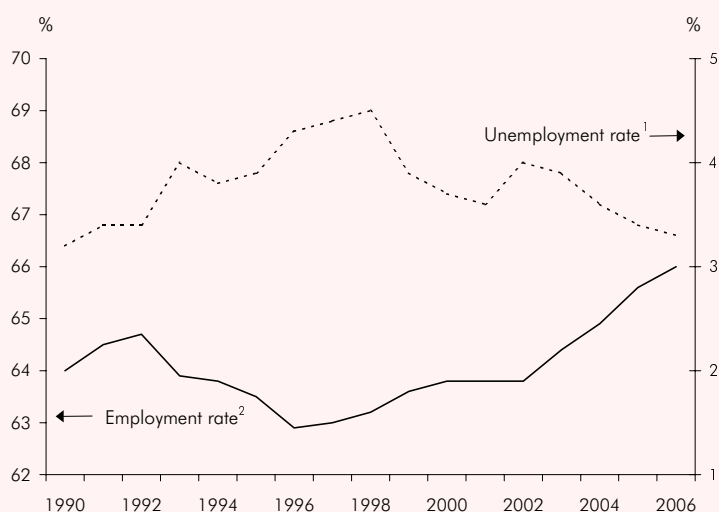
External sector providing substantial contribution to growth

Assuming an international business cycle upturn, conditions for export growth should be favourable. The rise in the foreign contribution to GDP growth is, nevertheless, brought about by moderate wage cost developments rather than by special efforts of investment in areas at the frontier of innovation. In the longer run, this may set a constraint to the increase in overall welfare.

Little inflationary pressure, wage ratio declining further

Unemployment slow to decline

Figure 2: Labour market trends



¹ As a percentage of total labour force (according to Eurostat). – ² Economically active as a percentage of population of working age (15 to 64).

The projections imply an increase in labour productivity for the total economy of 1½ percent p.a., approximately the same rate as observed for the last two five-year periods. Empirical evidence shows labour productivity being pro-cyclical to a higher degree than in other industrialised countries: in a cyclical upswing, more intensive use is made of the employed workforce and of overtime, while additional labour is hired only at a later stage. Moreover, in the phase of accelerating expansion, the export sector is particularly dynamic, where measured productivity gains are at least twice as high as for the whole economy.

Table 5: Labour market and income

	Ø 1991-1996	Ø 1996-2001 Year-to-year percentage changes	Ø 2001-2006
Dependent employment	+0.3	+0.7	+0.8
Excluding parental leave and military service	+0.1	+0.8	+0.6
Registered unemployed	+4.5	-2.4	+0.1
Unemployment rate as a percentage of total labour force ¹	3.9	4.0	3.6
as a percentage of dependent labour force ²	6.6	6.6	6.3
Labour productivity (GDP per employee ³)	+1.4	+1.3	+1.5
Gross wages and salaries ⁴	+3.6	+3.4	+3.4
Per employee ³	+3.3	+2.3	+2.7
Unit labour costs, total economy	+1.7	+0.5	+1.0

¹ According to Eurostat. – ² According to Labour Market Service. – ³ According to National Accounts definition. – ⁴ Excluding employer contributions.

In a medium-term perspective, the increase in labour productivity is determined by two forces working in opposite direction:

- On the one hand, the trend towards more part-time jobs dampens productivity as measured by output per capita. The share of part-time work will rise further, due to the above-average employment growth in the service sector, but also because of rising earnings ceilings to which the entitlement to child-care benefits is being subject. Expressed in full-time equivalents, productivity advances would therefore be higher than reflected in the present projections. This effect is reinforced by the secular shift towards the service sector, where productivity rises more slowly than in manufacturing.
- On the other hand, greater efforts on the part of public authorities as well as the corporate sector to boost research and development, notably the role of information

and communication technologies, may move productivity growth onto a faster track in the medium term.

The job market situation is determined not only by the demand for labour and by productivity growth, but importantly also by variations in labour supply. As regards the latter, a trend reversal is discernible as from 2004 that will be of decisive influence on the long-run labour market balance. The population of working age (men of age 15 to 64 and women 15 to 59) will no longer increase between 2004 and 2006. This marks a notable difference vis-à-vis the last decade when the demographic component still added to labour excess-supply.

The demographic turnaround implies that firms ready to hire will have to resort more than in the past to existing labour reserves. There is considerable scope, as far as women, older workers and, even more, unemployed are concerned. In order to mobilise these reserves, education policy will carry a key responsibility. A reinforcement of private and public training measures for women seeking to return to work and for long-term unemployed is a crucial requirement for securing the employability of the additional workforce. Raising the employment ratio of women, older workers and the unemployed is to be preferred to a further increase in foreign labour, i.e., with regard to the financial constraints facing the social welfare system. Foreign employment is currently being raised substantially, mainly via the inflow of seasonal workers, such that in some sectors (e.g., restaurants, commercial services) both employment and the number of jobless are rising in parallel.

For the present projections it has been assumed that the accession of foreign workers to the Austrian labour market will increase markedly as from 2004, in the context of EU enlargement and notwithstanding the agreed transition periods for the full implementation of labour mobility. Thus, overall labour supply is expected to rise by 0.7 percent p.a. from 2001 to 2006.

Because of the considerable increase in labour supply, and despite lively business activity and healthy job growth, unemployment is set to abate only gradually from its peak in 2002. By 2006, the jobless figure may still be around 205,000, somewhat higher than in 2001. This corresponds to a rate of unemployment of 5.9 percent of the dependent labour force, or 3.3 percent of the total workforce on the basis of the EU labour force survey. The reduction of the jobless rate to 3½ percent, as envisaged for 2002 in the framework of the National Action Plan for Employment, will only be achieved by 2005.

The consolidation of government finances represents the primary economic policy goal of the federal government. As early as 2001, one year ahead of schedule, a balanced budget for the whole public sector has been achieved: a deficit of the federal household was offset by surpluses in the accounts of the federal states and municipalities. For 2002, however, the general government balance will again drop to a deficit of at least 0.4 percent of GDP. This is largely to be attributed to the lagged impact of the cyclical downturn on revenues and expenditure. Moreover, revenues from income and corporate tax are depressed by echo effects, some revenues having been carried forward into 2001. Over the next few years, public finances should benefit from the strengthening of business activity as presented by the projections. The elasticity of total revenues with respect to nominal GDP is estimated at an average 0.9 percent. Public expenditure should advance at a relatively slower pace, in view of positive cyclical effects on the level of unemployment and the hypothesised spending restraint.

On the assumption of a restrictive policy stance for expenditure, the model projections suggest that overall budget balance may actually be achieved. However, a number of likely spending obligations will make it difficult to meet this target. Among these are higher public service personnel costs (a compensation of last year's modest settlements), another increase in family subsidies (a raise in the newly-introduced child-care benefits as well as an upward adjustment in the "regular" family allowance) or the swiftly rising cost of part-time retirement benefits ("Altersteilzeit").

If the business cycle reaches its peak in 2004, as assumed here, the general government balance should improve quasi-automatically, provided that firm control over expenditure is maintained. According to the model projections, the fiscal balance should gradually move into surplus, reaching ½ percent of GDP by the end of the projection period. This would broadly meet the intentions of the Ministry of Finance, as laid down in the medium-term Stability Programme of autumn 2001. It should be noted, however, that such

Significant increase in employment of foreign workers holding back the decline in unemployment

Demographic developments will ease future supply pressures on the labour market. Policies in the area of education and health are called upon to help mobilise labour reserves among women, older workers and the unemployed. With a view to the financing capacity of the welfare system, such forms of supply growth are to be preferred to a further increase in foreign labour.

Budgetary room for manoeuvre to remain tight

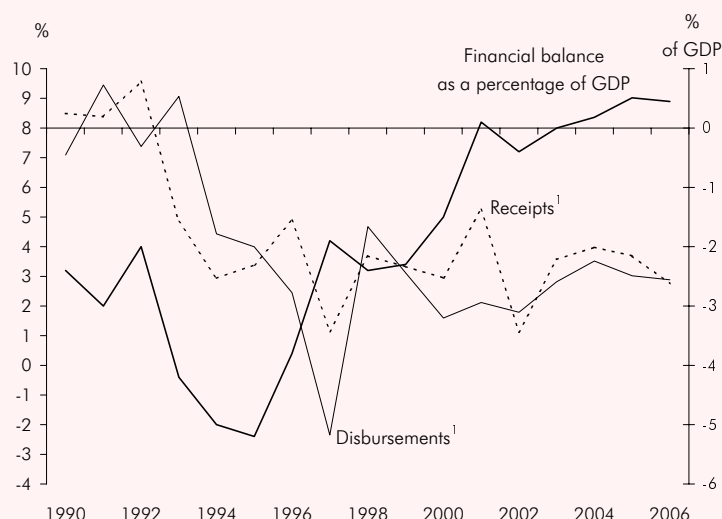
Lowering of tax burden requires accompanying expenditure cuts

The cyclical upswing will take strain off government finances, both from the revenue and the expenditure side. This, however, will not by itself create scope for tax cuts. Any "self financing" capacity of a reduction in public taxes and charges is deemed small. Revenue losses will therefore have to be accompanied by cuts in public expenditure.

an outcome is contingent upon the explicit assumption of no discretionary changes being made to either revenues or expenditure. It should thus by no means be taken as offering "leeway" for possible tax cuts. In the projections, no allowance has been made for a reduction in income or corporate taxes, nor for a lowering of non-wage labour costs, nor indeed for the envisaged marked increase in government defence spending. In addition, the objective of a balanced budget over the business cycle implies that in a cyclical boom period sufficient fiscal room for manoeuvre be created as to allow automatic stabilisers to fully operate in a recession, i.e., to tolerate such cyclically-induced deficits as are necessary in order to prevent unemployment from rising.

Over the medium term, policy should aim at reducing the overall fiscal burden which in 2001 reached a peak at 45.9 percent of GDP. Until 2006, the model projections yield an "automatic" fall in the revenue ratio by less than 1 percentage point, the revenue elasticity being below 1 percent. In a comparison among EU countries, Austria exhibits relatively large shares of social security contributions, payroll taxes and indirect taxes in total revenues. Conversely, revenue shares of declared income tax, corporate and wealth taxes are rather low. Any plan for a reduction of the fiscal burden would, nevertheless, have to be accompanied by additional cuts in public expenditure, in order to meet the commitment of medium-term budget balance according to the Stability and Growth Pact.

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



¹ Percentage changes from previous year.

A full "self financing" of possible tax cuts via the thereby induced acceleration of growth should be assumed neither for the short nor for the medium term. Even a partial self-financing effect will be of limited importance in the short run, because, first, economic growth in 2003 and 2004 is expected above the long-term average and would therefore not require an additional fiscal impulse; second, experience in Austria and elsewhere in Europe has shown that tax cuts, while raising disposable income, will in the first round mainly boost the household saving ratio, providing little early stimulus to private consumption. A tax cut not accompanied by lower expenditure will therefore, by way of a direct effect, widen the government deficit. In the longer run, some positive impact on growth may be expected, although the latter should be associated more with the design of the reform, in terms of incentive and redistribution effects, rather than with the amount of fiscal exoneration.

Since the middle of the 1990s, Austrian budgetary policy has been characterised by strong variations that can no longer be seen within the framework of a counter-cyclical stance. In times of favourable conditions spending was driven up (repeatedly in the area of family subsidies) and taxes were lowered, in many instances quickly followed by consolidation "packages". In 2001, a period of fiscal restriction even coincided with the international cyclical downturn. Simulations with the WIFO macro model have shown that

the expansionary impact of higher transfers and tax cuts on the one hand, and the restrictive effect of the subsequent consolidation measures on the other, have offset each other with regard to GDP growth. A medium-term-oriented fiscal strategy ought to ensure that automatic budgetary stabilisers operate to their full effect over the cycle; at the same time, the structure of government households should be improved in the light of resource allocation and distribution criteria. This area represents a key domain for action still left to the responsibility of economic policy at the national level.

Over the medium term, a number of problems relating to the structure of the public sector are becoming apparent. One of them is the strikingly low elasticity of indirect taxes whose revenues are falling well behind the rate of growth of nominal private consumption. This suggests that there are many ways to avoid such taxes and that avoidance is becoming more widespread. Since Austria shares this problem with several other EU countries, the issue should be taken up also at the European level.

Another problem is the sustained increase in public subsidies. In the federal government household, the bulk of them goes to the Austrian Federal Railways and to the agricultural sector; for the lower levels of government, a large part is accounted for by transfers to off-budget institutions. Because of the rising level of interest rates, interest payments on government debt also remain on an upward trend. Public investment is the only component set to decrease over the next few years, reflecting the moves "off budget" in the area of road and railroad construction as well as of building activities (Federal Real Estate Corporation).

As far as social welfare expenditure is concerned, a further marked increase should be expected, arising from higher family allowances and the introduction of child-care benefits. The full cost will show up as from 2004, the family burden sharing fund ("Familienlastenausgleichsfonds") thus probably remaining in deficit up to 2005. Unemployment-related expenditure is unlikely to fall significantly even with the overall jobless figure expected to decline; this is due to the rapidly rising cost of part-time retirement, a rather generous benefit scheme that is becoming increasingly popular. Once fully implemented, its cost could rise to nearly € 500 million p.a., roughly two-thirds of the outlays for active labour market and training policy measures. The special emphasis that is given to the reduction of labour supply as compared with the upgrading of qualifications of the unemployed appears highly problematic with a view to the growth and employment prospects over the longer term. In the retirement insurance scheme, demographic developments make for a strong upward drift in expenditure, with the pension reform of 2000 providing only limited relief. Spending will increase over-proportionally also in the health insurance system, due to population ageing as well as to technical innovation driving up the average cost of medical treatment.

Domestic economic developments are to a high degree determined by global activity, since exports account for more than half of all goods and services produced. In this way, demand prospects for Austria's major trading partners are of major importance, along with aspects of Austria's external competitiveness in terms of price and quality. The major uncertainties surrounding the present forecast are therefore mainly located at the international level.

In the EU, given the persistent weakness of domestic demand, activity since the mid-1990s has been driven by developments in the USA. This holds particularly for the 2000-01 downturn, but also for the current recovery. A substantial part of the risks to the recovery therefore derives from the macro-economic imbalances in the USA manifesting themselves in a low private saving ratio (only 1 ½ percent of disposable income in 2001) and a high current account deficit (over 4 percent of GDP in 2001). A further fall in share prices or a slump in the over-valued real estate market may well provoke a restraint in consumer spending and undermine the incentives to invest in the USA, leading to a further weakening of the dollar exchange rate. A marked appreciation of the euro vis-à-vis the dollar therefore constitutes a further risk for the EU business cycle.

**Substantial challenges
arising from budgetary
structures**

**Important risks
originating from
international cyclical
developments**

Within the EU, the interplay between the different policy instruments in a monetary union will be put to a test over the next years. Due to the strong self-commitment of the ECB to a rather narrow inflation target and due to a certain rigidity of the Stability and Growth Pact, EU economic policy has reacted too late and not sufficiently to the global cyclical slowdown of 2001. Emphasis in the current upswing should be put on regaining the necessary fiscal room for manoeuvre without jeopardising growth, employment and price stability. This requires better co-ordination between European monetary policy, national fiscal policy and wage policy conducted by the social partners.

The trend in relative unit labour costs is of great significance in a monetary union. In this regard, significant differences between EU countries have recently emerged. The swift rise in unit labour costs in Ireland and the Netherlands over the last years would not appear particularly worrying, since it only offsets competitive gains obtained earlier on. In Portugal and Spain, however, such problems of international competitiveness are somewhat more serious, posing major challenges for economic policy.

Eastern enlargement of the EU is scheduled to fall within the second half of the projection period. If it proves successful, it will be an important economic opportunity both for western Europe and for Austria, given the large amount of unsatisfied demand for goods and services in eastern Europe. However, eastern enlargement also carries a certain number of risks. These could materialise in particular in the event of the eastern countries' catching-up process being held back. In some countries, economic growth has recently been dampened by an overly restrictive interest rate policy and by appreciation of the national currency vis-à-vis the euro. Particularly a loss in competitiveness of eastern European countries, such as in the event of premature participation in EMU, could prove dangerous.

Macro-economic imbalances in the USA, a lack of co-operation in economic policy matters in the EU, and uncertainty as to the pace of the catching-up process in Central and Eastern Europe constitute the external risks to the present projections. On the domestic front, uncertainty relates to the extent to which policy will be able to meet the structural challenges in the budgetary, the education and innovation domain.

Table 6: General government

	Ø 1996-2001	Ø 2001-2006	2001	2002	2003	2004	2005	2006
	Year-to-year percentage changes							
Current receipts	+3.3	+3.0	+5.3	+1.1	+3.6	+4.0	+3.7	+2.8
Current disbursements	+1.8	+2.8	+2.1	+1.8	+2.8	+3.5	+3.0	+2.9
GDP at current prices	+3.4	+3.6	+2.6	+2.3	+4.0	+4.7	+3.8	+2.9
	As a percentage of GDP							
General government financial balance ¹	-1.6	+0.1	+0.1	-0.4	±0.0	+0.2	+0.5	+0.4

¹ According to Maastricht definition.

The domestic risks to the forecast should be seen in a number of structural issues. First, a pro-cyclical stance of fiscal policy, consolidating in a general cyclical downturn and turning expansionary in the recovery, may substantially restrain the potential for growth and job creation in the medium run. Second, the strategic significance of education and qualification for the long-term growth path may be under-estimated, as exemplified by the strong rise in outlays for part-time retirement coupled with a freeze in resources for active labour market policy. A well-developed and high-quality education and training system is a key requirement for meeting the challenges posed by the demographically-determined long-term decline in labour supply. Third, greater emphasis should be put on innovation policy which can boost competitiveness and give stronger impetus to growth on a lasting basis than has been brought about by wage moderation only.