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FAVOURABLE MEDIUM-TERM GROWTH PROSPECTS BUT SUSTAINED BUDGET PROBLEMS

MEDIUM-TERM PROJECTION FOR THE AUSTRIAN ECONOMY 2000 TO 2004

For the next five years, the good economic outlook for the European Union is expected to have a favourable impact on Austria as well. Dynamic growth of exports will help stimulate domestic demand. Nevertheless, economic growth on its own will not substantially alleviate the budget problems. Comprehensive structural measures will be required to comply with the targets of the stability programme determined by the Austrian government.

During the projection period of 1999-2004, the Austrian economy is expected to grow by 2.5 percent p.a., faster than in the second half of the 1990s (+2.1 percent)[1]. The boom should reach its apex in 2001 and is then assumed to be followed by an EU-wide dent for the next two years. Accelerated growth thereafter is similarly explained from an overall European economic context. Throughout the period, the Austrian economy is expected to expand on average at a marginally lower rate than the EU in general (2.6 percent), as a result of the slightly restrictive effects that the measures expected to be taken to consolidate the budget will have. Most EU member states have made better progress than Austria in their efforts to curtail the deficits of their public households. Inflation should continue at a very low rate (1 percent p.a. on average). This is mainly the result of moderate wage growth in response to increasing competition from the EU, an expected stabilisation of the relatively high crude oil prices as of 2000, and further liberalisation and price cuts in the telecommunications and power utility industries.

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[1] In contrast to earlier reports, this one shows only the annual averages for the projection period and for the period of 1995-1999, due to the shortness of available time series based on ESA 1995.

Table 1: Main results

	Ø 1995-1999	Ø 1999-2004	1999	2000	2001	2002	2003	2004
	Year-to-year percentage changes							
Gross domestic product								
Volume	+2.1	+2.5	+2.2	+2.8	+2.8	+2.5	+1.9	+2.4
Value	+3.1	+3.4	+2.9	+3.6	+3.9	+3.4	+2.9	+3.5
Consumer prices	+1.2	+1.0	+0.5	+1.1	+1.0	+0.9	+0.9	+0.9
Dependent employment[1]	+0.5	+0.8	+1.2	+1.0	+0.9	+0.7	+0.5	+0.6
	In percent							
Unemployment rate								
Percent of total labour force[2]	4.5	4.0	4.4	4.2	4.1	3.9	4.0	3.9
Percent of dependent labour force[3]	7.0	6.1	6.7	6.5	6.2	6.0	6.1	5.9
	As a percentage of GDP							
Current balance	–2.3	–2.0	–2.3	–2.3	–2.0	–1.9	–1.8	–1.9
General government financial balance	–2.6	–1.8	–2.1	–2.2	–1.9	–1.8	–1.8	–1.6

[1] Excluding parental leave and military service. – [2] According to Eurostat. – [3] According to Labour Market Service.

Driven by economic growth and, not least, by measures taken within the scope of the National Action Plan for Employment (NAP), the labour market situation will continue on its road to improvement. An accumulated total of about 90,000 jobs will be created between 2000-2004. The NAP's target of 100,000 new jobs in 1997-2002 will be achieved two years earlier than planned. The unemployment rate (as per EU definition), however, will drop only to 3.9 percent of total labour force. The target of 3.5 percent by 2002, as outlined by the NAP, appears to be unattainable, in view of current business cycle prospects, unchanged expenditure on labour market policies and a tight budget policy.

The tax reform of 2000 and the "family package" will impact negatively on the budget of 2000. The objective of the stability programme, i.e., reducing the deficit in the general government financial balance to 1.4 percent of GDP by 2002, will be clearly missed according to the projection (1.8 percent) unless additional structural consolidation measures are taken. Under the assumptions for the current projection, this target will not even be reached by 2004.

STRONG EXPORT GROWTH

The introduction of the euro as the EU's currency in 2002 will be the main institutional change during the projection period. In the short run, the change could create problems specifically for businesses which have not adequately prepared for it. In the medium term, the single currency will, however, have a positive effect on the economies of Austria and the EU. Austrian exporters should be able to further improve their price competitiveness over the next years because wage and price increases will remain below the EU average due to the social partnership system. This advantage will no longer be offset by currency devaluations within EMU. Improvements in the structural competitiveness will also depend on the progress made by Austrian technology policy. Additional positive momentum should be provided not just by the thriving economy in the EU but also by an upswing in Central and Eastern Europe. Under these assumptions, goods exports should rise by about 6.5 percent p.a. in real terms. Total exports will exceed 50 percent of GDP in 2004, the first time that this threshold will be surpassed (1999 +44 percent). The export performance is a result of European integration, increasing globalisation and accelerated growth in the EU. A similar trend should, however, be visible at the import side, although it will be weakened by slower growth of domestic demand for imports from the EU. The small rise of unit labour costs and export prices should improve the competitive position not only on international markets but also on the domestic market (vis-à-vis competition from importers), which in turn will reduce the trade deficit.

After plunging to its lowest level in 1997 the domestic tourism industry has been steadily regaining ground. The improvement in the services balance is expected to continue throughout the projection period. Income from tourist travel should on average rise by about 2.5 percent annually in real terms – a below-average growth on an in-

Assumptions and Methodological Problems

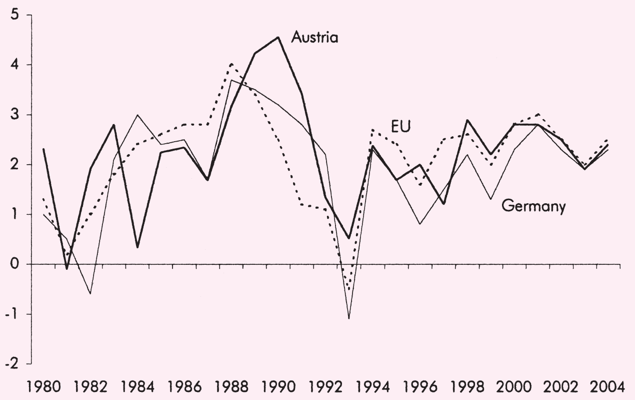
In developing this medium-term projection, WIFO was seriously handicapped by the change-over made in late 1999 by Statistics Austria from the ESA 1979 standard to ESA 1995 for calculating the national accounts. Because of the differences between the two concepts, results vary considerably, particularly with regard to consumption and investment expenditures and the public sector (see, i.a., *Scheiblecker,* 1999, *Schwarzl,* 1999, *Dannerbauer – Pfeifer – Stübler,* 1999).

The ESA 1995-based data published by Statistics Austria cover only the period of 1995-1998, a period which is too short for any model-supported medium-term projection. Accordingly, calculations were made using the WIFO macro-econometric model on the basis of the "old" national accounts (ESA 1979) and then converted to ESA 1995. The result matches the short-term WIFO projection of December 1999 for the period of 2000-2001 (*Marterbauer,* 2000).

The model calculations are based on the projection for the global economy (see *Schulmeister,* 2000) and on assumptions on fundamentals (in particular government expenditures).

Figure 1: Growth of real GDP

Percentage changes from previous year



ternational scale but in line with other EU countries. Austrian spending on tourist travel abroad should again rise slightly, after declining in 1995–1999 (*Smeral,* 1999).

A lower trade deficit and higher surpluses from tourist travel will combine to improve the current account, even though the balance on factor incomes and international transfer payments should continue to deteriorate.

MODERATE GROWTH OF DOMESTIC DEMAND

Throughout the projection period domestic demand will be fuelled by the sustained growth of private consumption (at least 2 percent p.a.). It will receive additional momentum from the year-2000 tax reform and the extension of family benefits during the first two years of the period. Thereafter, measures taken to consolidate the budget should act as a brake to the growth of private consumption.

Gross fixed capital formation will grow at a slower pace than in comparable previous upswings, because Austria's investment ratio is still at a comparatively high level and will gradually approach the EU average. With the country's economic growth about equal to the EU average, investments thus feature a relatively low productivity and are not optimal in their structure. Greater competitive pressure within the EU should raise the productivity of Austrian investments and thus help to align its investment ratio to the EU average. Gross fixed capital formation will therefore grow at a lower rate over the next years than would be expected from the economic expansion. On the other hand, the dampening effect will be rather moderate because the EU's impending eastern enlargement will make it necessary to take measures towards adjustment, restructuring and rationalisation.

Table 2: Aggregate demand

In real terms

	Ø 1995-1999	Ø 1999-2004
	Year-to-year percentage changes	
Final consumption expenditure		
Households[1]	+1.8	+2.2
General government	+0.8	+0.5
Gross fixed investment	+3.2	+3.2
Gross domestic final expenditure	+1.8	+2.1
Exports, goods and services	+7.2	+5.8
Goods	+8.3	+6.6
Travel	+0.0	+2.6
Imports, goods and services	+6.6	+5.2
Goods	+6.9	+5.8
Travel	−1.7	+0.6
GDP	+2.1	+2.5
In nominal terms	+3.1	+3.4
Current balance		
As a percentage of GDP	*−2.3*	*−2.0*

[1] Including private not-profit institutions serving households.

The projections for demand components point at an average real GDP growth rate of 2.5 percent p.a. for 1999–2004. It will be 2.8 percent up to 2001 and will then slacken markedly (to 1.9 percent in 2003), before picking up again in 2004. Thanks to its close foreign trade ties, the Austrian economy is essentially determined by developments in the EU (*Schulmeister,* 2000). Its slightly lower growth rate (trailing the EU by 0.1 percentage point p.a.) is explained by expected restrictions in government expenditure.

STABLE PRICES

The projection assumes that wage agreements by the social partners will take into account price trends, increasing international competition and unemployment. In view of the low inflation rate and moderate decline in unemployment, WIFO expects increases in wages to be restrained. Gross earnings per employee will rise by about 2.25 percent annually on average, which will exceed the average growth of the past four years. From a statistical point of view, wage rises per employee will be depressed by an expansion of part-time work, which will contribute to most of the new jobs. The wage ratio will continue to diminish during the projection period; wages will thus grow at a lesser rate than productivity.

Prices will again rise at a lower rate than the long-term average. Inflation, as measured on the basis of the consumption deflator, after declining steadily will hit its lowest point in 1999 and will average about 1 percent per year over the next five years. International competitive pressure and deregulation will keep inflation at its low level. After plummeting prices in the telecoms sector, some pruning is also expected in the energy industry. This will translate into

Table 3: Deflators

	Ø 1995-1999	Ø 1999-2004
	Year-to-year percentage changes	
Consumer prices	+1.2	+1.0
Implicit price deflators		
Exports, goods and services	+0.7	+1.2
Imports, goods and services	+1.1	+1.3
GDP	+1.0	+1.0

a major locational improvement for all other sectors of the economy, but will also make for major adjustment problems in the sectors directly concerned. As to the crude oil price, the projection assumes that it will stabilise at the level reached in 1999. Other causes for the restrained inflation rate are the modest growth of unit labour costs and a policy of price stability pursued by the ECB.

CHALLENGES FOR LABOUR MARKET POLICY

One of the goals of the National Action Plan for Employment (NAP) was to achieve 100,000 new jobs between 1997 and 2002. This target will be met earlier than planned when it is based on the official number of employees. According to our projection, dependent employment (excluding parental leave and military service) will grow by 146,000 in 1997-2002, and by almost 100,000 by 2000.

When calculated at full time equivalents, however, this target will not be achieved. Actual employment growth over the next years will depend not just on the economic development, but – to a significant extent – on the scope of redistribution of the work volume, i.e., the proportion of part-time workers.

The NAP had been very ambitious in its goal of reducing unemployment: the target had been to reduce the unemployment rate to 3.5 percent by 2002. Today it is already obvious that this target is not likely to be achieved because the supply of labour is found to be highly elastic. A major reason is the fact that the new jobs created are mainly part-time jobs while most jobless people look for full-time jobs. As a consequence, unemployment could not be significantly reduced in the past – if we ignore the massive step-up of active labour market policy measures in 1999.

In our projection, the unemployment rate (according to Eurostat) will decrease to 3.9 percent of total labour force by 2002, thus missing out on the NAP target of 3.5 percent. When we use the method of calculation customary in Austria, the rate will be reduced to 6.2 percent of dependent labour force in 2004, always assuming that labour market policy measures will stabilise at their current level.

Figure 2: Labour market

In percent

[1] Percentage of total labour force (according to Eurostat). – [2] Employment as a percentage of active population (15 to 64).

BUDGET CONSOLIDATION: A CORE ISSUE OF ECONOMIC POLICY

In the medium run, the government budget will constitute the greatest problem for Austrian economic policy. In 2000, the tax reform and the second part of the "family package" will provide for a major burden which cannot be fully compensated by the currently planned cuts in discretionary spending. According to present estimates, Austria will have a general government financial balance of –2.2 percent of GDP in 2000, and its deficit will thus be among the highest of the EU member states. Given these circumstances, Austria would thus expect to receive a notification from the EU to take stricter measures to consolidate its budget.

According to our projection, government revenues in 2002-2004 will grow by 2.8 percent p.a., in line with the projected economic growth, which is slightly less than the growth of its nominal GDP (+3.2 percent). The revenue elasticity with respect to GDP is 0.9.

Given the existing tax rates, the projection of revenues is essentially obtained endogenously in the model, whereas exogenous assumptions have to be made for the expenditure side. In our projection we assume that the pressure emanating from the stability programme and EU budget targets will require a restrictive fiscal policy throughout the projection period. On average, the public wage bill will lag behind nominal GDP growth. In addition, we also assume a policy of frugal investment activity and subsidies. Another assumption is that items shifted out of the public budget will generate no relevant burden over the next years. In addition our projections do not include a comprehensive austerity package or measure to reduce non-wage labour costs (such discretionary actions will be included in the projection only when adopted by the government).

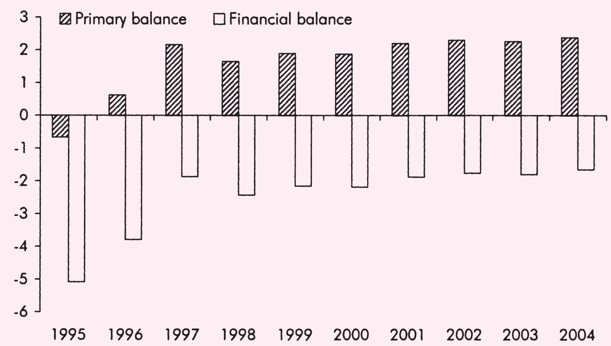
Table 4: Labour market and incomes

	∅ 1995-1999	∅ 1999-2004
	Year-to-year percentage changes	
Dependent emploment	+0.3	+0.7
Excluding parental leave and military service	+0.5	+0.8
Registered unemployed	+0.8	–1.9
Unemployment rate		
Percent of total labour force[1]	4.5	4.0
Percent of dependent labour force[2]	7.0	6.1
Productivity (GDP per employment)	+1.6	+1.8
Gross wages and salaries[3]	+2.4	+2.9
Per job[4]	+1.6	+2.2
Unit labour costs, total economy	+0.4	+0.4

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

Figure 3: General government

As a percentage of GDP



Under these assumptions, the deficit in general government financial balance will be reduced to 1.8 percent of GDP by 2002, which is still distinctly above the target of 1.4 percent of GDP set in the Federal government's stability programme. Achieving this target would require additional measures. Given these assumptions (an expenditure elasticity of 0.8 with respect to GDP), the deficit is expected to decline further, to about 1.5 percent between 2002 and 2004.

The projection also shows that the gap between social expenditures and revenues will continue to widen – partly as a result of the growing number of retirees. An increase of federal contributions and/or rise in social security contributions can be avoided only when structural reforms are implemented on the expenditure side.

Interest payments on the government debt will increase over the next years, impeding measures to consolidate the budget. The government debt is expected to be stabilised in terms of GDP, but not in absolute terms.

RISKS AND UNCERTAINTIES OF THE MEDIUM-TERM PROJECTION

The further a projection reaches into the future the more uncertain it will naturally become. Our projection is, however, less subject to uncertainties than the previous year's forecast. The medium-term development of the Austrian economy – a growth of 2.5 percent in 1999-2004 – is very much determined by the international economy, which is generally agreed to have a positive outlook: recent turbulences on international financial markets have calmed down. The countries of South-East Asia (with the exception of Japan and Indonesia) are back on the road to recovery, and the Russian economy has stabilised thanks to a rise in crude oil prices. Nevertheless, a lesson from the past is that financial market risks are extremely difficult to calculate in the medium term.

With crude oil prices already at a relatively high level, another inflation thrust should be unlikely from this side. Similarly, markets for industrial raw materials are expected to be well supplied in the medium term, which will keep price increases within limits. The risk of wage-induced inflation had already been quite low in the past decade and was further dampened by intensified competition in the euro zone. The euro should pick up against the dollar over the next years, counteracting any risk of inflation.

One of the chief risks that could threaten global economic growth over the next years are disequilibria associated with the expansion in the USA. Over the past years, its economy boomed without showing any inflationary tendency. Recently the economy has expanded at an accelerated pace and bottlenecks are threatening on the labour market. Friedrich von Hayek argued that "the only reason for a recession is a previous boom". Keynesians agree that the risk of excess capacities rises with the scope of the previous investment boom. According to these theories, the risk of recession in the USA has risen because the upswing has greatly accelerated its pace. In addition, the boom in the USA is to a large extent based on a substantially decreasing saving ratio, correlated with rising share prices. If the bull market should reverse due to uncertainties or a rise in interest rates, it might be too optimistic to expect a soft landing for the USA, which in turn would impact on the global economy.

The main challenges faced by economic policy in Austria over the next years will again be fighting unemployment, consolidating the budget and promoting technological innovation.

There will be a strong rise in the number of employees, yet this indicator will become increasingly irrelevant as work is being redistributed to part-time jobs. If the decline of full-time jobs as observed in 1995-1998 should continue over the next years, then the unemployment rate will not be reduced as desired.

Table 5: General government

	Ø 1995-1999	Ø 1999-2004	1999	2000	2001	2002	2003	2004
	Year-to-year percentage changes							
Current receipts	+2.9	+2.5	+2.9	+1.2	+2.6	+3.0	+2.6	+3.0
Current disbursements	+1.5	+2.3	+2.3	+1.3	+2.1	+2.7	+2.7	+2.7
GDP, value	+3.1	+3.4	+2.9	+3.6	+3.9	+3.4	+2.9	+3.5
	As a percentage of GDP							
Primary balance	1.6	2.2	1.9	1.9	2.2	2.3	2.3	2.4
Financing balance	–2.6	–1.8	–2.1	–2.2	–1.9	–1.8	–1.8	–1.6

Uncertainties also abound with regard to how the public budget will develop in Austria. Future government revenues can be deduced from the growth projections with sufficient precision, given current tax laws. Expenditures, on the other hand, will depend greatly on decisions to be made by the future government. Budget figures identified in the stability programme and EU targets certainly call for a restrictive expenditure policy. The design of this policy has still to be agreed upon. The medium-term projection for the general government financial balance presented here – a reduction of its deficit to 1.6 percent in 2004 – is based on the assumption that government expenditures will grow at a lower rate than government revenues. Concrete "austerity packages" or a reduction of non-wage labour costs are not included in the projection as long as there are no government decisions to this end.

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Favourable Medium-term Growth Prospects but Sustained Budget Problems

Medium-term Projection for the Austrian Economy in 2000 to 2004 – Summary

The improving economic environment in the European Union also has a positive impact on Austria. In the forecasting period of 1999 to 2004, its real GDP is expected to grow by 2.5 percent p.a. on average, slightly less than the European average. According to the international scenario for Austria, growth will accelerate and reach its peak in 2001. After weakening for the next two years, it should pick up again in 2004.

Backed by a good competitive position, exports are expected to develop dynamically and to make increasing contributions to GDP growth. Expenditure for private consumption should continue to rise by about 2 percent p.a.

Employment will continue to expand at a substantial pace, the consequence of good growth prospects as well as measures taken under the National Action Plan for Employment. Nevertheless, unemployment rates will decline only moderately.

Increased competition and deregulation will keep prices low. The crude oil price is assumed to remain at its current high level. Wage increases will be modest only. Inflation will thus average just 1 percent p.a.

The positive growth prospects will not suffice to solve the budget problems faced by the Austrian government. The fiscal reform (an increase in family allowances and income tax cuts) will place an additional burden on government finances in 2000. Projections assume a restrictive expenditure policy pursued by the government, resulting in a deficit of 1.6 percent of GDP in 2004. The objectives defined in the Austrian government's stability programme have thus been clearly missed, which calls for additional policy measures.