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# Financial Market Crisis Weighing on Economic Growth

## Economic Outlook for 2008 and 2009

**Economic growth in Austria is set to decelerate to an average 2.1 percent in volume this year. This is primarily the consequence of the international financial crisis that originated from US real estate markets. Scope and duration of that crisis can still not be reliably assessed at present. The projection for GDP growth in 2009 of 1.7 percent is therefore subject to considerable risk. Exports, industrial output and investment are slackening markedly. Private consumption is not gaining momentum, partly because inflation accelerated to 2.9 percent. While employment this year is rising even faster than expected, the decline in unemployment is likely to reverse as from 2009.**

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In 2006 and 2007, Austrian real GDP growth attained nearly 3½ percent per year. Activity remained lively also in early 2008, with companies enjoying a high degree of capacity utilisation and job creation remarkably strong. For the first semester, demand and output are thus likely to still rise by 2½ percent above the year-earlier level. Nevertheless, the global economic environment has weakened in a lasting way:

- A slump on real estate markets triggered a severe banking crisis in the USA which has so far not been defused despite massive policy intervention. Economic growth has almost stalled, with a modest 1 percent being expected for 2008 as a whole. A key factor for global demand has thereby ceased to operate.
- This shortfall can hardly be offset by continued lively expansion in the emerging markets which are likewise affected by slower global demand growth even if domestic demand is rising briskly. Growth in China is likely to moderate from 11½ percent in 2007 to 8½ percent in 2009.
- The liquidity and solvency crisis has spilt over to European and Asian financial markets. Credit conditions have deteriorated and business confidence has weakened. In the euro area, the appreciation of the common currency is weighing on activity, a levelling-off not yet being in sight. GDP growth, though exceeding that of the USA, is expected to decelerate to 1.6 percent in 2008 and 1.3 percent in 2009.

Because of the substantial clouding of the economic environment, WIFO expects GDP growth to slow also in Austria from the healthy pace observed until early this year. Exports of goods and services are projected to abate to 5 percent annual growth, thereby calming also the 2-year-long boom in manufacturing industry. Already in the cyclical upturn of the last years, investment in machinery and equipment was less buoyant than anticipated; meanwhile, the expansion has virtually come to an end. Somewhat more lively is investment in construction which in the areas of infrastructure and residential building benefits from higher government spending. Even there, though, the momentum that in the last two years had been at the verge of overheating, has slackened significantly.

Private household demand is not able to stabilise overall business activity. Although having expanded unusually slowly over the last seven years, an acceleration can still not be expected, despite higher wage settlements, since nominal income gains are neutralised by higher inflation. Headline inflation will rise to 2.9 percent this year, driven by massive hikes for energy and food, each accounting for about one-third of the year-on-year increase of the overall price level. Net real earnings per employee will therefore edge down by 0.1 percent. The lower income brackets will suffer marked losses in their real income because of their lower gains in nominal wages and the high share of food, housing and energy costs in their consumption basket. Together with the high rate of "perceived inflation" – as prices of daily items rise faster than those of durable consumer goods – this will weigh heavily on consumer spending. The latter is projected to rise by 1.6 percent in volume, and that only under the optimistic assumption of a slight decline in the household saving ratio.

Table 1: Main results

		2004	2005	2006	2007	2008	2009
		Percentage changes from previous year					
GDP							
Volume		+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.1	+ 1.7
Value		+ 4.4	+ 3.9	+ 5.1	+ 5.8	+ 4.8	+ 3.9
Manufacturing <sup>1</sup> , volume		+ 2.4	+ 3.1	+ 8.8	+ 7.1	+ 3.0	+ 2.8
Wholesale and retail trade, volume		+ 1.1	+ 0.2	+ 1.0	+ 0.7	+ 1.6	+ 1.5
Private consumption expenditure, volume		+ 1.8	+ 2.0	+ 2.1	+ 1.4	+ 1.6	+ 1.6
Gross fixed investment, volume		+ 0.1	+ 0.3	+ 3.8	+ 4.8	+ 2.2	+ 1.8
Machinery and equipment <sup>2</sup>		- 1.4	+ 0.7	+ 2.1	+ 6.3	+ 2.0	+ 1.0
Construction		+ 1.3	+ 0.1	+ 5.1	+ 3.7	+ 2.3	+ 2.3
Exports of goods <sup>3</sup>							
Volume		+ 12.5	+ 3.2	+ 6.8	+ 8.1	+ 5.7	+ 5.7
Value		+ 13.9	+ 5.4	+ 9.5	+ 10.1	+ 6.7	+ 6.2
Imports of goods <sup>3</sup>							
Volume		+ 11.7	+ 2.8	+ 3.8	+ 8.1	+ 5.8	+ 5.7
Value		+ 12.5	+ 5.9	+ 8.0	+ 9.2	+ 7.3	+ 6.5
Current balance	billion €	+ 4.94	+ 5.02	+ 6.31	+ 8.27	+ 8.55	+ 8.61
As a percentage of GDP		+ 2.1	+ 2.0	+ 2.4	+ 3.0	+ 3.0	+ 2.9
Long-term interest rate <sup>4</sup>	in percent	4.2	3.4	3.8	4.3	4.1	4.4
Consumer prices		+ 2.1	+ 2.3	+ 1.5	+ 2.2	+ 2.9	+ 2.3
Unemployment rate							
Eurostat definition <sup>5</sup>	in percent	4.8	5.2	4.7	4.4	4.2	4.3
National definition <sup>6</sup>	in percent	7.1	7.3	6.8	6.2	5.9	6.2
Persons in active dependent employment <sup>7</sup>		+ 0.7	+ 1.0	+ 1.7	+ 2.1	+ 1.8	+ 0.7
General government financial balance according to Maastricht definition							
As a percentage of GDP		- 1.2	- 1.6	- 1.4	- 0.7	- 0.7	- 0.6

Source: WIFO Economic Outlook. – <sup>1</sup> Value added, including mining and quarrying. – <sup>2</sup> Including other products. – <sup>3</sup> According to Statistics Austria. – <sup>4</sup> 10-year central government bonds (benchmark). – <sup>5</sup> According to Eurostat Labour Force Survey. – <sup>6</sup> According to Public Employment Service Austria, as a percentage of total labour force excluding self employed. – <sup>7</sup> Excluding parental leave, military service, and unemployed persons in training.

At the beginning of the year, employment growth was unusually strong, with 100,000 new jobs being added from last year. This mirrors the lagged effects of lively business activity around mid-2007 as well as favourable weather conditions which supported construction activity and tourism during the winter season. However, a statistical effect may also be involved: since 1 January last, newly-hired employees have to be registered with the social security administration already before taking up work; for this reason, official employment figures may have jumped in some branches, but the size of such an effect cannot be quantified. The strong employment gain has been accompanied by a further decline in unemployment. In the course of the year, the

cyclical slowdown will also become visible on the labour market. As from the winter 2008-09, seasonally-adjusted jobless figures are likely to head up again. In 2009, registered unemployment is projected to average 224,000, up by 12,000 from this year. The jobless rate is expected at 4.3 percent of the labour force according to Eurostat, or 6.2 percent of the dependent labour force following the conventional national definition.

Owing to the strong momentum of economic activity over the last two years, the general government deficit has been cut by half, but the balance in Maastricht terms still stood at -0.7 percent of GDP in 2007. The imminent cyclical slowdown will dampen revenue growth with a lag, thereby preventing a further reduction of the deficit. The reaction of the budget balance to cyclical variations, i.e., move towards surplus in the upswing and towards deficit in the downturn, is an indispensable element of a stability-oriented fiscal policy.

Since neither the scope nor the duration of the international financial market crisis can be adequately assessed at present, the present projections are subject to a particularly large margin of uncertainty. It is assumed that the slowdown of activity will come to a halt towards the end of this year and give way to a tentative recovery in 2009. GDP growth in 2009 will drop below the projected 1.7 percent, if the liquidity and solvency crisis in the international financial system becomes protracted and the pick-up of the real economy is delayed. However, buoyant activity in Asian emerging markets, which also exhibit high saving ratios, may have a stabilising effect on the global economy.

After a five-year-long boom, when the world economy expanded by almost 5 percent per year, the momentum is now slowing down. WIFO expects growth of world GDP of less than 4 percent p.a. over the projection period. The origin of the slowdown is the crisis in the USA, where the real estate price bubble has burst and stock markets have seen a marked downward correction. The US financial system is hit by a severe crisis that affects other world zones as well, given the close integration of international capital markets.

Nevertheless, a global economic crisis remains unlikely from the present perspective. Admittedly, emerging markets are closely tied, directly and indirectly, with demand in the USA, and growth will therefore moderate gradually for them as well. However, domestic demand in the emerging markets and trade links between them have strengthened significantly in recent times. Thus, private consumption and public spending on infrastructure are rising briskly in China, which will cushion the slackening of foreign demand. The expansion of the Chinese economy which provided a major demand impulse to the global economy over the last years, is expected to slow down from 11½ percent in 2007 to 8½ percent in 2009. Russia and other oil exporters are benefiting from high oil prices. In India, domestic demand is providing key support to overall activity.

The slower pace of global activity and, implicitly, of demand for goods and services, has so far not been reflected in a stabilisation of commodity prices. Indeed, quotations for crude oil on world markets have risen to ever new highs. Prices for industrial metals and for agricultural commodities also continue drifting upward, due to unabated demand from emerging markets and, in the case of food items, also supply shortfalls. What can further be observed is a shift of speculative capital from real estate and stock markets towards commodity markets. The assumptions underlying the present WIFO forecast are for an average price of oil (Brent) of 95 \$ per barrel and for an increase in non-oil commodity prices of 13 percent on a euro basis.

At the focus of the credit crisis are real estate markets in the USA. For mortgages of lower and intermediate quality ("subprime" and "old-A"), defaults have risen substantially. This problem is likely to exacerbate in the months to come when for many of the mortgages granted in 2004 and 2005 the initial period of preferential conditions ("teaser rates") ends. Even the ratings of best-quality mortgages have deteriorated

## Global economy cooling down

*The international financial market crisis is weighing on economic growth worldwide. In the emerging markets in Asia and the commodity-exporting countries, business activity remains more robust than in the industrialised countries.*

## Financial crisis spreading

markedly. This has triggered the need for large-scale write-offs for banks in the USA, but also worldwide, as these credits were transformed into new forms of securities and sold internationally. Several banks have countered the massive write-offs with capital injections, e.g., from a number of foreign sovereign funds.

The danger of bankruptcies of banks and hedge funds has recurred of late. Acute liquidity crises have repeatedly emerged worldwide which have been mirrored by high interbank interest rates. Central banks have so far been successful in their reactions. They provided ample liquidity, and the Federal Reserve also cut short-term rates aggressively. While this has helped to prevent a still deeper crisis on financial markets, stabilisation has not yet been achieved. This can only be expected, once the fall in US real estate prices has ebbed and the mortgage crisis has run its course, which is unlikely to occur before 2009.

*The international financial crisis is exacerbating further, banks and hedge funds in the industrialised countries are suffering from liquidity problems. An end to the crisis hinges upon a stabilisation of US real estate markets, which at present is not in sight.*

Table 2: World economy

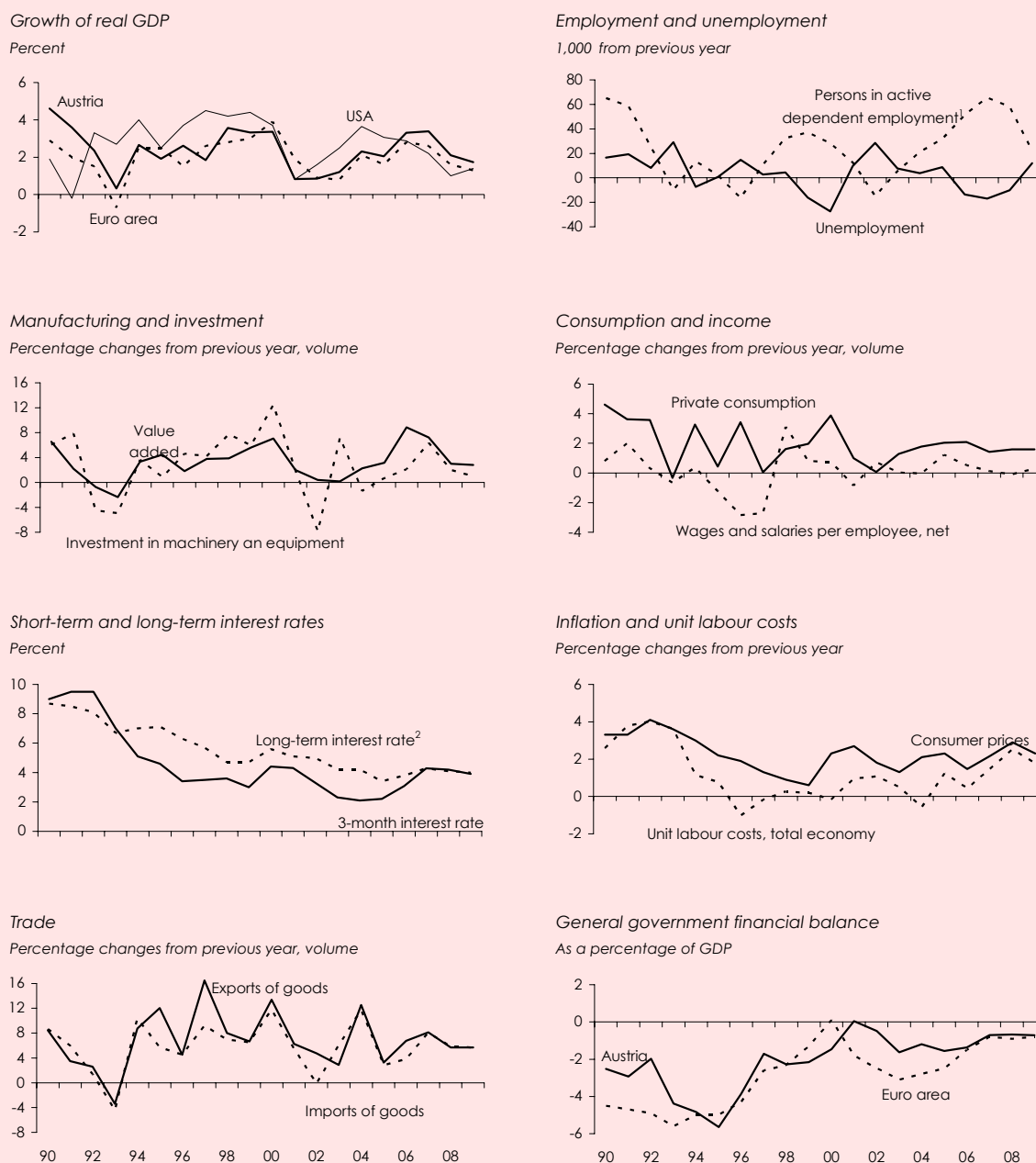
	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
<i>Real GDP</i>						
World total	+ 4.9	+ 4.4	+ 4.9	+ 4.7	+ 3.9	+ 3.6
Total OECD	+ 3.1	+ 2.5	+ 2.9	+ 2.4	+ 1.5	+ 1.6
USA	+ 3.6	+ 3.1	+ 2.9	+ 2.2	+ 1.0	+ 1.4
Japan	+ 2.7	+ 1.9	+ 2.4	+ 2.1	+ 1.3	+ 1.3
EU 27	+ 2.5	+ 1.9	+ 3.0	+ 2.9	+ 1.9	+ 1.6
EU area 15	+ 2.1	+ 1.6	+ 2.8	+ 2.6	+ 1.6	+ 1.3
New EU countries <sup>1</sup>	+ 5.5	+ 4.7	+ 6.4	+ 6.0	+ 5.3	+ 5.0
China	+10.1	+10.2	+11.1	+11.4	+ 9.5	+ 8.5
<i>World trade, volume</i>	+10.5	+ 7.2	+ 8.7	+ 5.8	+ 5.3	+ 5.0
<i>Market growth<sup>2</sup></i>	+ 9.4	+ 7.5	+11.0	+ 7.6	+ 5.8	+ 5.7
<i>Primary commodity prices</i>						
HWVA index, total	+18.5	+28.5	+19.7	+ 3.7	+14	+ 3
Excluding energy	+18.1	+ 5.6	+22.0	+ 9.5	+13	+ 5
<i>Crude oil prices</i>						
Brent, \$ per barrel	38.2	54.4	65.1	72.5	95.0	97.0
<i>Exchange rate</i>						
\$ per euro	1.243	1.245	1.256	1.371	1.60	1.60

Source: WIFO Economic Outlook. – <sup>1</sup> Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia. – <sup>2</sup> Real import growth of trading partners weighted by Austrian export shares.

International stock markets have seen sizeable corrections since the beginning of the year, with share prices falling by around one-fifth on a euro basis. Real estate values are receding not only in the USA, but also in other countries where speculation had driven them up massively, like in Spain, Ireland or the UK. The combination of low share prices and falling real estate values is dampening consumer demand. These wealth effects are traditionally larger in the Anglo-Saxon countries than in continental Europe. The real economy is hit furthermore by the restraint and price hikes for credit, which deteriorate the conditions for investment financing. With the economic outlook turning highly uncertain, firms will tend to defer planned investment projects.

The financial market crisis manifests itself most clearly on foreign exchange markets. The dollar is falling markedly against the euro and the yen; since the beginning of this year, the dollar has depreciated vis-à-vis the euro by 7 percent, since early 2007 by 16 percent. While the strong euro is reining in the negative repercussions of the commodity price boom, it undermines at the same time the price competitiveness of European exports. Given the slump in the USA and the markedly different monetary stance between the Federal Reserve and the ECB, the dollar is set to remain weak. The WIFO assumption is for an exchange rate of 1.60 \$ per euro by the forecast horizon.

Figure 1: Indicators of economic performance



Source: WIFO Economic Outlook. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> 10-year central government bonds (benchmark).

The US economy barely expanded towards the end of 2007, as GDP in the fourth quarter edged up by only 0.2 percent from the previous period, implying a year-on-year increase by 2.5 percent. Although exports and commercial building advanced briskly, the retarding factors gained ground: residential investment fell by 19 percent year-on-year and by almost one-third from its last peak of end-2005. Housing starts for single- and multi-family homes and building permits were down by some 30 percent year-on-year in early 2008. The continued decline in house prices (by 8 percent year-on-year in the fourth quarter according to the Case-Shiller Index) also points to a further fall in residential construction. The implicit negative wealth effects, together with the downward trend in employment since the beginning of the year, will be reflected in a marked slackening of private household demand.

## US economy on the verge of recession

Real GDP is unlikely to grow at least during the first two quarters of 2008. In the third trimester, tax rebates to an overall amount of nearly 1 percent of GDP will take effect. While the fiscal stimulus will boost disposable income, it is difficult to project to what extent the additional funds will be translated into higher spending rather than being used for higher saving. WIFO assumes a stabilisation of the business cycle as from the middle of the year. The Federal Reserve is following an expansionary stance, steering key interest rates down from 5¼ percent in mid-2007 to 2¼ percent of late. In such conditions, US GDP is expected to edge up by 1 percent in 2008 and 1½ percent in 2009. Nevertheless, the downturn may turn out longer and deeper, should the financial market crisis exacerbate further. Even if business activity should regain firm hold, no genuine upswing may be expected. After the end of the credit boom, the private household saving ratio will rise markedly over the medium term, dampening consumer demand and GDP growth.

*Growth in the USA has come to a standstill, with considerable risks of the financial and banking crisis becoming still deeper. Monetary and fiscal policy have each swung towards a powerful expansionary stance.*

Real GDP in the euro area rose by a seasonally-adjusted 0.4 percent in the fourth quarter 2007 from the earlier three-months period and by 2.2 percent from one year ago. Business surveys conducted by the European Commission show a weakening of confidence indicators in manufacturing industry since early summer 2007. New orders have been clearly heading down, notably those from abroad, although the stock of manufacturing orders in early 2008 was still above its long-term average, particularly in Germany. Hence, capacity utilisation in manufacturing industry was satisfactory overall. Nevertheless, sluggish demand in the USA is increasingly weighing on activity and can hardly be offset by rising orders from emerging market countries.

### **Activity in the euro area in early 2008 still robust**

Consumer demand was disappointing in 2007, with an estimated increase of only 1½ percent. Once again, pre-Christmas sales did not provide the hoped-for stimulus. One reason is that income gains trailed markedly behind the pace of inflation. Per-capita wages in the euro area rose by 2½ percent year-on-year in the fourth quarter, as compared with the 2.9 percent increase of consumer prices. If household real disposable income grew nevertheless, it was because of higher employment. In early 2008, the rise in the Harmonised Index of Consumer Prices accelerated to 3¼ percent. Also this year, therefore, a strengthening of consumer demand seems rather unlikely, despite a further decline in unemployment. While in Germany, the fading impact of the VAT increase and better labour market conditions should allow consumer demand to pick up, a marked slackening is to be expected in other countries. In Spain, the slump on the real estate market will hold back residential investment and private consumption, such that GDP growth is projected to drop from almost 4 percent to 2 percent. The comfortable budget surplus would nevertheless offer scope for substantial counter-cyclical fiscal action. In Italy, the consumer confidence indicator fell particularly sharply. The economy has probably stopped growing already in the second half of 2007, and GDP is likely to stagnate throughout 2008.

*Internal demand in the euro area is not strong enough as to offset the imminent weakening of the external environment and the dampening effects from euro appreciation.*

The relatively strong demand and output growth last year facilitated a steady decline in euro area unemployment, to a seasonally-adjusted rate of 7.1 percent of the labour force in January 2008. The downward trend may persist throughout the first half of the year, given the typical lagged reaction of the labour market to a cyclical slowdown. As from 2009, however, unemployment is likely to head up again.

With inflation exceeding the benchmark defined by the European Central Bank (ECB) on the one hand, the international financial market crisis, euro appreciation and the imminent cyclical slowdown on the other, monetary policy is faced with a difficult challenge. Underlying the present WIFO forecast is the assumption that the ECB will not cut its key refinancing rate before the second half of 2008, by which time also inflation should have eased somewhat.

After a relatively strong performance at the beginning of the year, activity in the euro area is set to slacken markedly in the further course of the year. Scope and duration of the slowdown are difficult to predict at present. The projections expect the lower turning point of the cycle to be reached at the end of 2008, whereby GDP

growth would abate to an average 1.6 percent this year and 1.3 percent in 2009. Nevertheless there is a considerable risk that the downward trend may last longer before turning around.

For the time being, the new EU countries are relatively little affected by the international financial market crisis and the slowdown of global activity. Growth is primarily sustained by the strong momentum of consumer demand and investment. Growth of real GDP should thus moderate only gently, from over 6 percent in 2007 to 5 percent in 2009, staying rather robust in the Czech Republic, Slovakia and Poland. In Hungary it might even pick up as the dampening impact of fiscal restriction evaporates.

Inflation rates have strongly drifted upwards in recent months. In some countries, this is due to the cyclical overheating and upward pressure from unit labour cost, but more generally also a consequence of the jump in food prices on world markets (food items have a much higher weight in the consumer basket than they have in Western Europe). A further risk originates from the swift rise in private household debt. While the rush for credit over the last years has fuelled consumer demand and construction, default risks are now increasingly becoming the focus of policy concern. This goes particularly for Romania and Bulgaria, partly also for the Baltic States, where current account deficits easily exceed 10 percent of GDP. Such massive macro-economic imbalances leave the economies vulnerable to turbulences on international capital markets.

Austria's economy is projected to expand by 2.1 percent in volume in 2008, clearly less than in the two years before, but again above the euro area average. Supported by high capacity utilisation in manufacturing and commercial services, activity should stay robust in the first half of the year, with GDP gaining around 2½ percent year-on-year. Still, the weaker international environment will increasingly weigh on exports, industrial output and investment in machinery and equipment. Because of the only slim gains in real incomes, private consumption will hardly be able to compensate the fading dynamism of foreign demand. Although settlements in last autumn's wage round were higher than in the years before, income gains are neutralised by inflation that is expected to reach 2.9 percent on annual average 2008.

For 2009, WIFO expects real GDP to advance by 1.7 percent. This hinges upon the assumption that the slowdown of business activity in Europe can be arrested as from early 2009. Since neither duration nor deepness of the international financial market crisis can be reliably assessed at present, the risks surrounding the present forecast are unusually high. GDP growth in 2009 may turn out significantly lower than assumed here. In the event, developments on the labour market as well as in public finances would be still less benign.

According to the present projections, output growth will fall below its long-term trend, notably in 2009. Using different statistical methods, WIFO estimates the rate of potential output growth within a range between 2.2 percent and 2.7 percent p.a.

Exports have been booming over the last few years. In 2007, merchandise exports rose by 8 percent in volume from the previous-year level and by around 60 percent from that of 2000. Austria benefited to a particularly high degree from the cyclical upswing in trading partner countries, since no less than half of domestically manufactured goods are exported and price competitiveness is high due to strong advances in labour productivity. At the same time, Austria is exposed also to a weakening of external conditions. Thus, external market growth as measured by the weighted average of trading partners' imports, is expected to abate from 7½ percent last year to 5¼ percent over the projection period.

### **Strong internal demand in the new EU countries**

*Buoyant private consumption as well as investment is sustaining activity in the East-central European economies during the international cyclical downturn. Major risks derive from the high indebtedness of private households and the strong upward drift of prices.*

### **Substantial risks for domestic activity in 2009**

*The Austrian economy has performed well recently, with both capacity utilisation and employment high. The international financial market crisis is set to dampen growth notably during the second half of 2008. The duration of the cyclical slowdown is difficult to predict at present.*

### **Successful export industries**

The international cyclical downturn will affect Austria only with a lag, since the direct impact is bound to be small: although exports to the USA are already heading down, they account for only 5 percent of total exports. More important are indirect effects such as deriving from lower German exports. In addition, the appreciation of the euro implies an increase in the real-effective exchange rate in trade of industrial manufactures by 2.5 percent in 2008 (after +0.8 percent in 2007). Some, albeit limited, market share losses should therefore be expected. Such losses were observed already in 2007 on the US and the German market, but were offset in the aggregate by gains in the Czech Republic, Poland, Hungary, Slovenia and (as suggested by less reliable data) Bulgaria. Further market share losses this year are likely to be concentrated on the USA. WIFO projects merchandise exports to expand by 5.7 percent p.a. in volume over the projection period. While exports to the USA will fall sharply, the trend remains firmly upward bound for deliveries to the new EU countries and the emerging markets.

*Domestic exporters benefited importantly from the global economic boom of the last years. Latest signs are for a significant slowdown in export and output growth.*

The performance of manufacturing output is closely linked to that of merchandise exports. Value added has increased by an inflation-adjusted 17 percent during the last two years. The index of manufacturing output for 2007 was 34 percent above its level of 2000. Austria is thereby among the EU countries with the strongest gains in industrial output, even ahead of Germany. In contrast, production has been broadly flat for years in France and Italy. The situation in Austria's industrial sector stayed favourable until the turn of the year 2007-08: order levels were more than 10 percent higher than one year earlier and companies should have enjoyed high earnings. The slower pace of exports will, however be transmitted to manufacturing in the further course of the year. For the year as a whole, WIFO predicts a volume increase in output by 3 percent. With the usual time lag, this will also impact on employment. In 2007, industry created, in net terms, 15,000 new jobs (+2.6 percent) and further gains were recorded early this year. Going forward, labour demand is set to slacken and by 2009, industrial employment is forecast to fall by an average 7,000 from this year.

Table 3: Productivity

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 2.3	+ 2.0	+ 3.3	+ 3.4	+ 2.1	+ 1.7
Employment <sup>1</sup>	+ 0.2	+ 0.8	+ 1.2	+ 2.2	+ 1.1	+ 0.5
Productivity (GDP per employment)	+ 2.2	+ 1.2	+ 2.1	+ 1.2	+ 1.0	+ 1.2
<i>Manufacturing</i>						
Production <sup>2</sup>	+ 2.3	+ 3.2	+ 8.8	+ 7.2	+ 3.0	+ 2.8
Employees <sup>3</sup>	- 0.6	- 0.8	+ 0.2	+ 2.6	+ 0.3	- 1.2
Productivity per hour	+ 2.1	+ 4.6	+ 8.4	+ 4.2	+ 3.0	+ 4.0
Working hours per day per employee <sup>4</sup>	+ 0.8	- 0.6	+ 0.2	+ 0.3	- 0.3	± 0.0

Source: WIFO Economic Outlook. – <sup>1</sup> Dependent and self-employed according to National Accounts definition. – <sup>2</sup> Value added, volume. – <sup>3</sup> According to Federation of Austrian Social Security Institutions. – <sup>4</sup> According to "Konjunkturerhebung" of Statistics Austria.

The decline in capacity utilisation should induce firms to greater caution in their investment spending. In the semi-annual WIFO investment survey of autumn 2007, manufacturers reported an increase in investment plans by only half the size of last year. Still fewer projects may actually be implemented, given the greater uncertainty about the international outlook. WIFO expects an increase in capital formation with regard to machinery and equipment by 2 percent in 2008. Of some concern is the fact that during the last cyclical upswing 2005-2007 machinery and equipment investment rose only half as much as during the boom 1997-2000, despite buoyant exports and ample corporate earnings<sup>1</sup>.

A deceleration of export growth will also dampen imports, the import content of exports being around one-third. Imports will be further held back by a slackening of equipment investment, where 80 percent of supplies are imported. Merchandise

<sup>1</sup> See in this context Ederer, St., Marterbauer, M., Scheiblecker, M., "Konjunkturaufschwung 2005/2007 kürzer als im letzten Zyklus", WIFO-Monatsberichte, 2008, 81(3), pp. 175-189, [http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=31581&typeid=8&display\\_mode=2](http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=31581&typeid=8&display_mode=2).



imports in 2008 and 2009 should thus grow at broadly similar rates as exports. In nominal terms, imports are set to rise relatively more strongly, resulting in a deterioration in the terms of trade.

Over the last few months, headline inflation remained stuck above 3 percent (in February 3.2 percent) on account of sustained hikes in prices for food, housing and fuel. About two-thirds of the upward drift are due to the items of energy and food and are largely exogenous. Crude oil of the type Brent was quoted at above 95 \$ per barrel in February, an increase by 60 percent year-on-year. The HWWI index for food items shows an annual increase of more than 50 percent on a dollar basis for January and February 2008. The high commodity prices are the result of a steady rise in demand notably from the emerging markets in Asia, of supply shortages due to drought in Australia, and of growing demand for commodity funds.

### High inflation sterilises real income gains

*Driven by high energy and food prices, headline inflation is becoming entrenched around 3 percent. This implies stagnation for employees' net real incomes per capita.*

Table 4: Earnings and international competitiveness

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year					
Gross earnings per employee <sup>1</sup>	+ 1.8	+ 2.3	+ 2.7	+ 2.7	+ 3.3	+ 3.0
Gross real earnings per employee <sup>1</sup>	- 0.0	+ 0.6	+ 1.1	+ 0.6	+ 0.4	+ 0.7
Net real earnings per employee <sup>1</sup>	- 0.0	+ 1.2	+ 0.5	+ 0.1	- 0.1	+ 0.3
<b>Total economy</b>						
Unit labour costs	- 0.6	+ 1.2	+ 0.4	+ 1.5	+ 2.5	+ 1.8
<b>Manufacturing</b>						
Unit labour costs	- 0.7	- 0.0	- 4.2	- 1.8	+ 0.8	- 0.8
Relative unit labour costs <sup>2</sup>						
Vis-à-vis trading partners	+ 2.0	+ 0.8	- 2.4	- 0.4	+ 0.4	- 1.1
Vis-à-vis Germany	+ 2.4	+ 2.6	- 1.5	+ 1.2	+ 0.5	- 0.4
<b>Effective exchange rate, manufactures</b>						
Nominal	+ 1.5	- 0.6	+ 0.2	+ 1.2	+ 2.6	± 0.0
Real	+ 1.1	- 0.9	- 0.5	+ 0.8	+ 2.5	+ 0.1

Source: WIFO Economic Outlook. – <sup>1</sup> Employees according to National Accounts definition. – <sup>2</sup> In a common currency; minus sign indicates improvement of competitiveness.

For the months to come, no substantial relief for consumer price inflation is in sight. WIFO expects prices of processed food to go up by 7 percent this year and energy prices by somewhat more. Higher commodity prices also feed through to prices of manufactures which have picked up to an annual increase of over 2 percent. Prices of services, whose weight accounts for almost half in the consumer price index, are drifting up only moderately. Under the assumption of a gradual deceleration in the rise of world market commodity prices in the course of the year, WIFO expects consumer price inflation at 2.9 percent for 2008 and 2.3 percent for 2009.

In spite of higher settlements in the wage round of last autumn, yielding per-capita wage increases of 3¼ percent on average in gross terms, net real wages remain flat this year (-0.1 percent). Real disposable income of private households goes up only because of the higher number of people employed, with a projected year-on-year increase by 1.1 percent in 2008.

Private household consumption disappointed once again in 2007, edging up by only 1.4 percent after adjusting for inflation. No recovery may be expected for 2008, as real disposable income growth will slow to only half the rate of the previous year. Moreover, inflation is particularly strong for goods and services needed on a daily basis. "Perceived" inflation is therefore higher than the one statistically recorded and should dampen households' readiness to spend. The increase in overall consumption will be further constrained by the fact that higher inflation will hit most severely the low-income- low-saving groups where food, housing and energy claim a particularly high share in the individual consumption basket.

### Consumption remaining sluggish

WIFO projects private consumption to edge up by 1.6 percent, but this only under the rather optimistic assumption of a slight decline in the household saving ratio to 10 percent of disposable income. Consumer demand would thereby fall below its long-term average for the eighth year in a row. The weakness of consumption remains one of the problems facing the Austrian economy in the medium term.

*The long-standing weakness of private consumption is unlikely to be overcome. It is explained by only modest income gains, unequal distribution and high inflation.*

Table 5: Private consumption, income and prices

	2004	2005	2006	2007	2008	2009
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 1.8	+ 2.0	+ 2.1	+ 1.4	+ 1.6	+ 1.6
Durables	+ 4.0	+ 2.5	+ 1.9	+ 2.5	+ 3.0	+ 2.0
Non-durables and services	+ 1.5	+ 2.0	+ 2.1	+ 1.3	+ 1.4	+ 1.6
Household disposable income	+ 1.9	+ 2.6	+ 2.7	+ 2.2	+ 1.1	+ 1.3
	As a percentage of disposable income					
Household saving ratio	8.9	9.3	9.7	10.3	10.1	9.8
	Percentage changes from previous year					
Direct lending to domestic non-banks <sup>1</sup>	+ 5.0	+ 4.7	+ 4.5	+ 3.6	+ 3.5	+ 3.5
	Percentage changes from previous year					
Inflation rate						
National	2.1	2.3	1.5	2.2	2.9	2.3
Harmonised	2.0	2.1	1.7	2.2	2.9	2.3
Core inflation <sup>2</sup>	1.6	1.5	1.3	1.9	2.2	2.1

Source: WIFO Economic Outlook. – <sup>1</sup> End of period. – <sup>2</sup> Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

Construction activity picked up strongly in the last cyclical upswing and became a key driver of overall GDP growth. In 2007, output expanded by 3.3 percent. High capacity utilisation was reflected in substantial upward price pressure at a pace around 5 percent year-on-year. Employment in the construction sector rose markedly: in early 2008, it may have been boosted not only by mild weather, but also by the new regulations for the registration of newly-hired workers with the social security authorities.

In the regular WIFO business cycle survey, construction firms keep reporting satisfactory order levels, civil engineering firms were even more optimistic at the beginning of 2008 than three months earlier, partly because of new government plans to upgrade the railroad infrastructure. Lively demand for new homes induces the *Länder* to step up subsidised homebuilding. The outlook is less favourable for industrial construction, which will feel the impact of weaker investment in machinery and equipment. In all, WIFO expects construction activity to abate gradually, whereby output growth of 2¼ percent would nevertheless exceed the pace of GDP.

The tourism industry achieved positive results in the last winter season. Overnight stays of both domestic and foreign visitors increased substantially. Earnings per customer and day were also boosted further, reflecting the successful strategy of the industry to offer premium quality. Also for the whole year 2008, WIFO expects a healthy increase in tourism exports to a total € 17.7 billion, implying a volume increase by 3.8 percent from last year. Contrary to expectations from many sides, the European soccer championship, co-hosted by Austria, will hardly contribute substantially to the increase, as it will rather lead to substitution effects in the high-season month of June. The event may, however, raise Austria's profile on foreign markets and stimulate demand from new customer segments.

The good performance of tourism is mirrored by the job situation. In 2007, 211,000 persons were employed in tourism, 1.3 percent more than one year before. Nevertheless, earnings in this sector are still comparatively low.

## Construction operating close to full capacity

*After two strong years, construction activity is moderating only gently, as public investment will cushion the expected slackening in industrial and commercial building.*

## Strong expansion in tourism

*After the good results for the last winter season, prospects for tourism remain favourable also for the rest of the year.*

Total employment rose strongly at the beginning of the year, exceeding the year-earlier level by 100,000. The gain was thus more than one-third higher than in autumn 2007, a rather unusual development. It is normal that the labour market reacts with a lag of at least six months to cyclical GDP variations, and the results for early 2008 should reflect the boom of mid-2007. Moreover, the public debate about possible scarcities of qualified labour may have prompted firms to refrain from layoffs in response to declining orders. Nevertheless, both factors hardly explain the increase in employment vis-à-vis autumn 2007. Admittedly, the weather last winter was particularly employment-friendly, as it favoured both construction activity and seasonal tourism.

The jump in employment is believed to have also statistical-administrative reasons: since the beginning of the year, newly-hired workers have to be registered for social security purposes already before actually taking up work. This may have triggered a jump in official job registrations, notably in the construction and the tourism sector, without the size of this effect being quantifiable. An assessment of recent employment developments is complicated also by the fact that due to the changeover to the new OeNACE classification, no recent sectoral breakdown of unemployment data is currently available.

## High employment increase

*At the beginning of the year, more jobs were created than the benign cyclical and weather conditions would have suggested. Part of the explanation may be administrative changes.*

Table 6: Labour market

	2004	2005	2006	2007	2008	2009	
	Changes from previous year, in 1,000						
<i>Demand for labour</i>							
Persons in active employment <sup>1</sup>	+ 25.1	+ 37.2	+ 55.9	+ 66.9	+ 62.0	+ 24.0	
Employees <sup>2</sup>	+ 21.1	+ 31.9	+ 51.5	+ 65.5	+ 58.0	+ 22.0	
Percentage changes from previous year	+ 0.7	+ 1.0	+ 1.7	+ 2.1	+ 1.8	+ 0.7	
Nationals	+ 9.2	+ 20.0	+ 35.0	+ 43.6	+ 38.0	+ 12.0	
Foreign workers	+ 11.9	+ 11.9	+ 16.5	+ 21.9	+ 20.0	+ 10.0	
Self-employed <sup>3</sup>	+ 4.0	+ 5.3	+ 4.4	+ 1.4	+ 4.0	+ 2.0	
<i>Labour supply</i>							
Population of working age	15 to 64 years	+ 34.4	+ 15.6	+ 18.5	+ 15.5	+ 19.8	+ 20.2
	15 to 59 years	+ 35.6	+ 48.5	+ 52.8	+ 17.0	+ 10.2	+ 13.7
Labour force <sup>4</sup>		+ 28.9	+ 45.9	+ 42.4	+ 50.0	+ 52.0	+ 36.0
<i>Surplus of labour</i>							
Registered unemployed <sup>5</sup>	+ 3.8	+ 8.8	- 13.5	- 16.9	- 10.0	+ 12.0	
In 1,000	243.9	252.7	239.2	222.2	212.2	224.2	
Percent							
<i>Unemployment rate</i>							
Eurostat definition <sup>6</sup>	4.8	5.2	4.7	4.4	4.2	4.3	
As a percentage of total labour force <sup>5</sup>	6.4	6.5	6.1	5.6	5.3	5.5	
National definition <sup>5,7</sup>	7.1	7.3	6.8	6.2	5.9	6.2	
<i>Employment rate</i>							
Persons in active employment <sup>1,8</sup>	62.3	62.8	63.6	64.6	65.4	65.6	
Total employment <sup>6,8,9</sup>	67.8	68.6	70.2	71.4	72.1	72.3	

Source: WIFO Economic Outlook. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> According to Federation of Austrian Social Security Institutions. – <sup>3</sup> According to WIFO. – <sup>4</sup> Economically active employment plus unemployment. – <sup>5</sup> According to Public Employment Service Austria. – <sup>6</sup> According to Eurostat Labour Force Survey. – <sup>7</sup> As a percentage of total labour force, without self-employed. – <sup>8</sup> As a percentage of population of working age (15 to 64 years). – <sup>9</sup> Changed survey method.

WIFO now predicts the number of persons in dependent active employment to go up by 58,000 or 1.8 percent in 2008 from last year. In the course of the year, the momentum should decelerate, in line with the profile of output growth. Employment in manufacturing industry and construction should henceforth edge up only marginally, thereby limiting also a further increase in full-time jobs. Job creation will be concentrated in services where part-time work dominates. The healthy employment gains should nevertheless allow unemployment to decline further, by an estimated 10,000 on annual average 2008.

2009 may see a turnaround on the labour market. Employment growth is set to decelerate markedly (+22,000) and no longer allows further inroads into unemployment. Thus, registered unemployment, after having trended down for the last three years, will head up again. WIFO projects an increase by 12,000 to a total 224,000 on

average 2009, which will take the jobless rate to 6.2 percent of the dependent labour force (national definition) or 4.3 percent of the total labour force (Eurostat definition).

The strong pick-up in GDP growth during the period from 2005 to 2007 has been reflected also in the government accounts. Owing to buoyant tax revenues, notably for wage tax, social contributions, capital gains taxes and corporate tax, the general government deficit in the Maastricht definition was cut by half, from 1.6 percent of GDP in 2005 to 0.7 percent in 2007.

No further improvement of the government balance is to be expected for 2008. Although tax revenues may stay lively for the next few months, they will tend to level off with the cyclical slowdown, notably as far as profit taxes and wage-related taxes are concerned. Moreover, a number of additional expenditure will raise the deficit, such as transfers for child care and those designed to guarantee a basic income.

For 2009, the Federal government has not yet submitted a budget proposal, nor have planned savings in public administration at all territorial levels been specified. The outlook for the government budget therefore remains vague at this stage. Revenues will be determined primarily by the strength of business activity. With the projected slowdown of growth, WIFO expects the general government balance to stay broadly unchanged at -0.7 percent of GDP. Should economic activity turn out weaker than assumed here, the deficit is bound to increase. A deceleration of GDP growth by 1 percentage point is estimated to burden the budget balance in the short term by roughly ¼ percent of GDP.

### Government balance at -¾ percent of GDP

*After a cyclically-induced improvement in the general government balance in the last few years, the deficit is now set to stabilise around ¾ percent of GDP. A more pronounced cyclical downturn would, however, burden also the government household.*

Table 7: Key policy indicators

	2004	2005	2006	2007	2008	2009
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 1.2	- 1.6	- 1.4	- 0.7	- 0.7	- 0.7
According to National Accounts	- 1.3	- 1.7	- 1.5	- 0.8	- 0.8	- 0.8
General government primary balance	+ 1.6	+ 1.3	+ 1.4	+ 2.0	+ 2.0	+ 2.0
	Percent					
<i>Monetary policy</i>						
3-month interest rate	2.1	2.2	3.1	4.3	4.2	3.9
Long-term interest rate <sup>1</sup>	4.2	3.4	3.8	4.3	4.1	4.0
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+ 1.5	- 0.7	+ 0.2	+ 1.1	+ 2.6	± 0.0
Real	+ 1.0	- 1.0	- 0.6	+ 0.8	+ 2.5	± 0.0

Source: WIFO Economic Outlook. – <sup>1</sup> 10-year central government bonds (benchmark).