Marcus Scheiblecker

The European Economy in Recession – Domestic Policy Action Cushioning the Downturn

Economic Outlook for 2009 and 2010

Starting from the USA, the economic downturn has meanwhile reached the entire world economy. The financial crisis is exacerbating the slackening of global business activity. In the euro area, demand and output are set to contract by 1.2 percent in 2009. In Austria, too, real GDP is likely to edge down by 0.5 percent, despite powerful stimulus provided by fiscal policy. The projection for growth picking up by 0.9 percent on annual average 2010 is based on the assumption that activity will gradually recover as from late 2009.

All staff members of the Austrian Institute of Economic Research contribute to the Economic Outlook. Data processing: Nora Popp, Roswitha Übl. • Cut-off date: 17 December 2008. • E-mail address: Marcus.Scheiblecker@wifo.ac.at

The global economic downturn gained considerable momentum towards the end of 2008. Whereas until recently the crisis was largely confined to the financial markets, its swift impact on the real economy which meanwhile has reached all parts of the globe, is surprising. The economies of the USA, Japan and the EU slipped into recession already in 2008, and in the emerging markets the pace of expansion has weakened substantially.

The burst of the price bubble on many countries' real estate markets was followed by a sharp fall in prices of industrial and agricultural commodities which had been to some extent exaggerated by speculation. Likewise, quotations for crude oil (Brent) fell from a peak of $ 144 per barrel in early July 2008 to $ 37 by the beginning of December, corresponding to a slump by around 75 percent. As a reflection of the general uncertainty about the further course of the world economy and the lack of "safe havens" for private savings, demand for US government bonds rose massively and triggered a strengthening of the dollar exchange rate from almost $ 1.60 per euro in July 2008 to $ 1.25 in October, equivalent to a euro depreciation by more than 20 percent.

At the beginning of 2008, the momentum of the euro area economy was still dynamic, growing by 0.7 percent in the first quarter from the previous period. Nevertheless, business confidence weakened markedly at the same time. In the second quarter, GDP started to decline (by 0.2 percent in volume) and receded further in the subsequent period. Business surveys suggest that the downward trend may accelerate towards the end of the year. With no turnaround yet in sight, the present WIFO projections assume a fall in euro area GDP by an inflation-adjusted 1.2 percent. Like in the USA, growth should resume as from the end of 2009, allowing GDP on annual average 2010 to edge up by a modest 0.5 percent.

As a small, export-oriented economy, Austria will not escape the forces of recession. New industrial orders, notably those from abroad, are caving in, and consumers which have been cautious throughout the last few years, are turning more and more reluctant to spend. Against this background, WIFO is revising its growth forecast for 2008 from 2 percent to 1.8 percent. Domestic leading indicators and the deterioration of the external environment point to a recession in 2009. However, policy is taking forceful counter-action through massive increases in public spending and tax cuts. In this way, private consumption should maintain its steady growth at a rate of 1 percent. Overall demand and output are nevertheless set to decline by 0.5 percent. The expected gradual international recovery will provide positive incentives also for the Austrian economy and lead to growth of GDP of 0.9 percent in 2010. If this projection materialises, the profile of the downturn would be somewhat milder and the ensuing recovery steeper compared with the euro area average.

Table 1: Main results

		2005	2006	2007	2008	2009	2010
		Percentage changes from previous year					
GDP							
Volume		+ 2.9	+ 3.4	+ 3.1	+ 1.8	– 0.5	+ 0.9
Value		+ 5.0	+ 5.3	+ 5.3	+ 4.1	+ 1.2	+ 2.2
Manufacturing[1], volume		+ 4.8	+ 9.6	+ 5.5	+ 3.0	– 2.8	+ 2.0
Wholesale and retail trade, volume		+ 2.2	– 1.0	+ 1.5	+ 1.0	+ 0.8	+ 1.0
Private consumption expenditure, volume		+ 2.6	+ 2.4	+ 1.0	+ 1.0	+ 1.0	+ 1.0
Gross fixed investment, volume		+ 2.4	+ 2.6	+ 4.7	+ 1.9	– 3.8	+ 0.3
Machinery and equipment[2]		+ 5.5	+ 0.9	+ 6.8	+ 2.0	– 7.0	± 0.0
Construction		– 0.4	+ 4.2	+ 2.8	+ 1.8	– 1.0	+ 0.5
Exports of goods[3]							
Volume		+ 3.2	+ 6.8	+ 8.7	+ 3.6	– 0.5	+ 1.5
Value		+ 5.4	+ 9.5	+ 10.5	+ 4.9	– 1.0	+ 1.7
Imports of goods[3]							
Volume		+ 2.9	+ 4.1	+ 8.0	+ 2.4	+ 0.3	+ 1.3
Value		+ 5.9	+ 8.0	+ 9.6	+ 5.3	– 0.7	+ 1.8
Current balance	billion €	+ 4.92	+ 7.26	+ 8.56	+ 8.72	+ 7.39	+ 6.93
As a percentage of GDP		+ 2.0	+ 2.8	+ 3.2	+ 3.1	+ 2.6	+ 2.4
Long-term interest rate[4]	in percent	3.4	3.8	4.3	4.3	3.1	3.0
Consumer prices		+ 2.3	+ 1.5	+ 2.2	+ 3.2	+ 1.2	+ 1.5
Unemployment rate							
Eurostat definition[5]	in percent	5.2	4.8	4.4	3.5	3.9	4.1
National definition[6]	in percent	7.3	6.8	6.2	5.8	6.5	6.9
Persons in active dependent employment[7]		+ 1.0	+ 1.7	+ 2.1	+ 2.4	– 0.4	+ 0.2
General government financial balance according to Maastricht definition							
As a percentage of GDP		– 1.5	– 1.5	– 0.4	– 0.5	– 2.8	– 3.2

Source: WIFO Economic Outlook. – [1] Value added, including mining and quarrying. – [2] Including other products. – [3] According to Statistics Austria. – [4] 10-year central government bonds (benchmark). – [5] According to Eurostat Labour Force Survey; 2008: break. – [6] According to Public Employment Service Austria, as a percentage of total labour force excluding self employed. – [7] Excluding parental leave, military service, and unemployed persons in training.

The marked fall in commodity prices, the abolition of student fees and the cut in VAT for pharmaceuticals will all contribute to a substantial easing of inflation, from an annual rate of 3.2 percent in 2008 to a projected 1.2 percent in 2009. This will bolster real disposable income and thereby consumption by private households.

Private investment will slacken significantly on the back of the cyclical downturn and spreading corporate pessimism. Both spending on machinery and equipment (–7 percent in volume in 2009) and construction (–1 percent) will suffer. By 2010, the investment cycle should have passed its lower turning point.

A contraction is assumed also for merchandise exports, edging down by 0.5 percent in volume in 2009 (after a gain of 3.6 percent in 2008), followed by a pick-up of 1.5 percent in 2010. Imports should exhibit a similar pattern, even if the expected increase in private consumption will partly offset the slump in demand for investment goods.

The recession will be felt in almost all economic sectors, albeit to different extent and at different points in time. The slackening of external demand will depress notably manufacturing output in 2009 (almost –3 percent in volume). The fall in worldwide demand for tourism services will entail losses for domestic hotels and restaurants to the tune of 2.5 percent in real terms in 2009.

As demand for labour slackens, employment will edge down by an annual average of 13,000 or 0.4 percent in 2009. Since it can be assumed that labour supply will react in a very elastic way, that training opportunities for the unemployed will be increased by 7,000 and greater use will be made of short-time work, the rise in open unemployment will remain contained, at a projected 27,000. The unemployment rate will rise accordingly from 5.8 percent to 6.5 percent (according to conventional national definitions) in 2009, and further to 6.9 percent in 2010, given the usual reaction lag of labour market variables.

The planned income tax cuts, the agreed measures to stimulate economic activity, and the fiscal measures adopted in the forefront of the last general elections will burden the government balance to a heavy degree in the years to come. In 2009, the general government deficit is projected to widen to 2.8 percent of GDP, and in the absence of corrective measures to a ratio of 3.2 percent in 2010.

Economic growth stalling worldwide

Already in 2008, global economic growth decelerated from 5 percent in each of the previous two years to below 3 percent. In 2009, world demand and output are set to stagnate (+0.2 percent). Even in the hitherto booming emerging markets, activity will lose considerable momentum.

In the USA, fiscal policy stimulus succeeded in keeping up GDP growth at 1.3 percent. Apart from the implicit boost to private consumption, exports benefited from the remarkable weakness of the dollar. Going forward, however, policy action is likely to approach its limits, as the scope for interest rate cuts has been exhausted and fiscal counter-action will be constrained by the rapid rise in public debt. With policy incentives fading, the vulnerability of the US economy will become apparent. For 2009, WIFO expects GDP to shrink by 1.7 percent in volume, followed by stagnation in 2010.

The continuing fall in real estate values, the slump on stock markets and the still unresolved banking crisis will weigh on US growth for several years to come. Private households will restore their saving levels after an extended period of over-spending, leaving consumption depressed well beyond the present forecast horizon. Purchases of durable consumer goods in particular will be cut, hitting not only exports of US trading partners, but also domestic manufacturers such as the motor car industry which could not overcome its structural lack of competitiveness despite exchange rate shifts in its favour. Carmakers will shed labour to an important extent in coming months, thereby further exacerbating the steep rise in US unemployment.

Hit by recession is also the Japanese economy. Total output receded both in the second and the third quarter 2008 from the previous period. While GDP should still grow in 2008 (+0.5 percent), it is projected to shrink in 2009 (–1.2 percent), followed by a gentle recovery of +0.4 percent in 2010.

Even the fast-growing emerging market economies like China and Russia cannot escape the repercussions of the global crisis. While share prices in Europe and the USA declined by around 50 percent, they fell in China by over 60 percent and in Russia by 75 percent. Apart from the financial market crisis, Russia also suffers from the slump in oil prices.

China appears not so much affected by the financial market crisis itself, but rather by the fading worldwide demand for consumer goods. In October, Chinese exports went down for the first time in seven years. WIFO has therefore revised down its forecast of last autumn for GDP in 2009 from over 8 percent to 5.6 percent.

After the speculative bubble on real estate markets had burst, prices of raw materials and agricultural commodities have also fallen sharply since last May. The present projections rest on the assumption of a reference oil price of $ 55 per barrel on annual average 2009 and of $ 60 for 2010. Uncertainty on financial markets has led to a flight of capital into US government bonds that has boosted the dollar exchange rate against the euro. Underlying the forecast is a constant exchange rate of $ 1.25 per euro.

Table 2: World economy

	2005	2006	2007	2008	2009	2010
	Percentage changes from previous year					
Real GDP						
World	+ 4.5	+ 5.1	+ 5.0	+ 2.8	+ 0.2	+ 1.7
Total OECD	+ 2.5	+ 3.0	+ 2.5	+ 1.2	– 1.3	+ 0.4
USA	+ 2.9	+ 2.8	+ 2.0	+ 1.3	– 1.7	+ 0.2
Japan	+ 1.9	+ 2.4	+ 2.1	+ 0.5	– 1.2	+ 0.4
EU 27	+ 2.0	+ 3.1	+ 2.9	+ 1.4	– 0.8	+ 0.7
Euro area 16	+ 1.7	+ 2.9	+ 2.6	+ 1.0	– 1.2	+ 0.5
Germany	+ 0.8	+ 3.0	+ 2.5	+ 1.3	– 1.2	+ 0.4
New EU countries[1]	+ 4.7	+ 6.5	+ 6.0	+ 4.8	+ 2.5	+ 2.5
China	+ 10.4	+ 11.1	+ 11.9	+ 9.4	+ 5.6	+ 6.7
World trade, volume	+ 7.6	+ 8.8	+ 6.2	+ 4.0	+ 0.6	+ 4.0
Market growth[2]	+ 7.8	+ 11.1	+ 7.6	+ 4.8	– 1.0	+ 1.0
Primary commodity prices						
HWWA index, total	+ 28.5	+ 19.7	+ 3.7	+ 27	– 22	+ 6
Excluding energy	+ 5.6	+ 22.0	+ 9.5	+ 23	– 6	+ 2
Crude oil prices						
Brent, $ per barrel	54.4	65.1	72.5	98	55	60
Exchange rate						
$ per euro	1.245	1.256	1.371	1.46	1.25	1.25

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

Global downturn leading to recession also in the euro area

Euro area GDP has been heading down since the second quarter 2008. With the negative trend continuing into 2009, total output is set to shrink by 1.2 percent on annual average, followed by a tentative rebound of 0.5 percent in 2010.

The sharpness of the downturn surprises, given the altogether small economic imbalances as compared with the USA. Thus, the euro area saving ratio was relatively high in the last few years and the accumulation of private and public debt rather low. Net foreign trade yielded slight surpluses and, taken together for the whole euro area, no bubble of real estate prices has been observed.

Although real estate prices collapsed only in a few countries of the euro area, financial markets were severely strained on a wider scale. In addition, economic performance in Europe is undermined by the slackening on export markets.

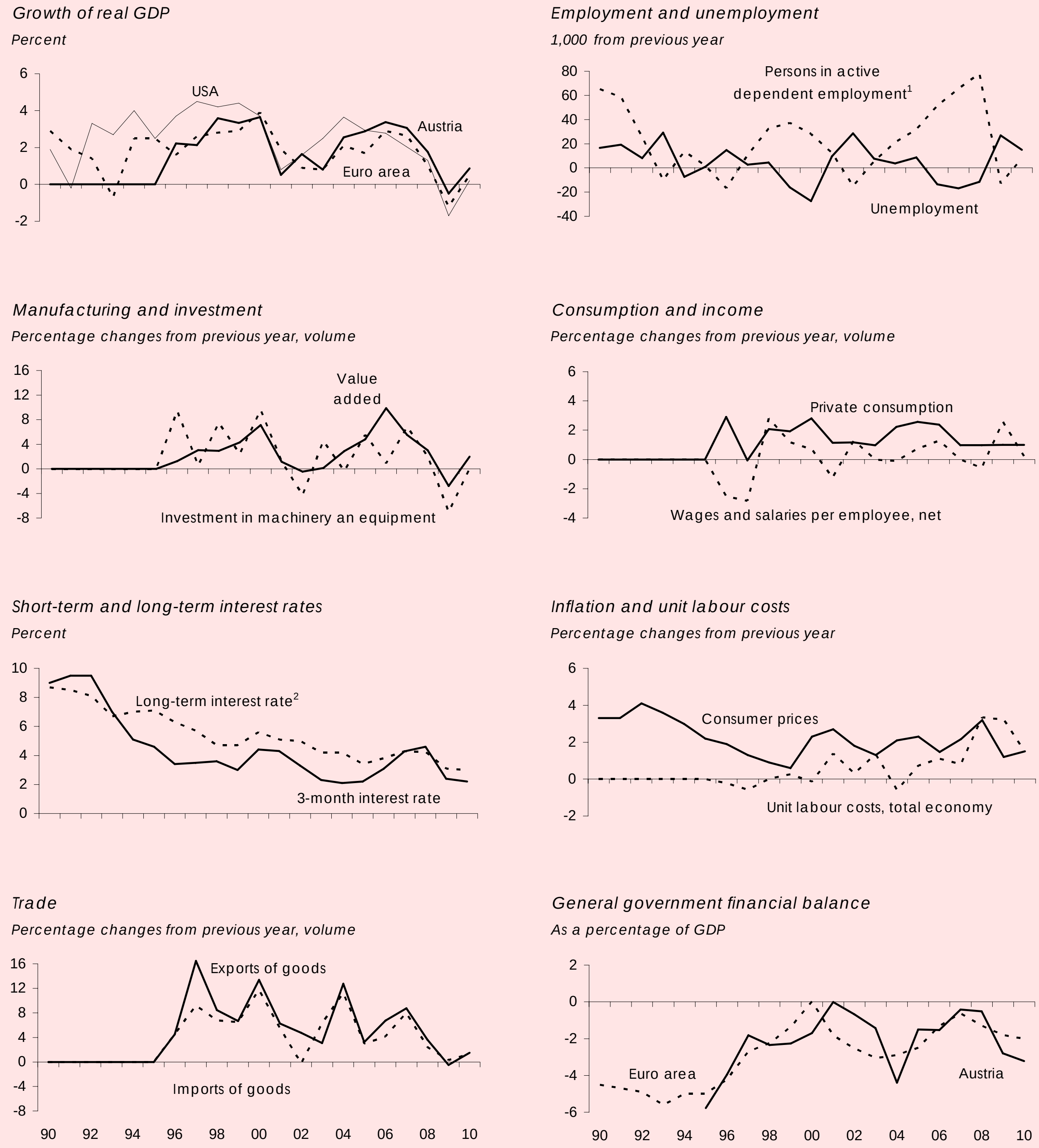
One reason is that it was to a large part investors from the EU who suffered losses on financial markets. European financial institutions such as banks, insurance companies and pension funds had supplied large amounts of capital to mortgage loan takers in the USA through securitised assets – claims that have now defaulted. As a result, a credit squeeze has developed also in the EU and interbank lending has virtually come to a standstill. First signs of credit rationing can already be observed, with negative implications for private consumption and investment.

Another reason is that monetary and fiscal policy in the USA has taken early and determined counter-action that should sustain activity at least in the short run. In the euro area, attempts to stimulate demand and output have so far been more hesitant and poorly co-ordinated. In the longer run, however, growth prospects are substantially better for the EU than for the USA due to macro-economic imbalances being largely absent.

Activity in east-central Europe: continued risks for the euro area

A squeeze in financial resources poses severe problems in particular for the economies in East-central Europe. The catching-up process has been financed to a large part by ample capital imports. Both the corporate sector and private households have raised their debt levels to an important extent over the last years. Growing distrust by financial markets has been reflected by the latest devaluation of the Hungarian currency: in October, the forint lost 7.5 percent of its value against the euro within a month. Some countries in the region have by now entered a recession.

Figure 1: Indicators of economic performance



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

For the Austrian economy, developments in East-central Europe are of crucial importance, since domestic banks are heavily involved in the extension of credit. Potential default on financial claims would therefore hit Austrian financial institutions in the first place.

The financial market crisis dampens the expansion also in East-central Europe significantly. From a pace of nearly 5 percent in 2008, growth in the new EU member countries outside the euro area will drop to half that rate in 2009 and 2010.

Apart from the financial risks, the region represents a key export market for domestic companies. The projected slowdown to 2.5 percent GDP growth in 2009 will weigh also on activity in Austria. Since economic growth in neighbouring eastern countries hinges crucially upon foreign financial capital and uncertainty in these markets is likely to persist for some time, GDP growth will remain subdued also in 2010.

Recession in Austria cushioned by policy action

The Austrian economy cannot escape the global downward trend. Despite domestic fiscal policy taking massive counter-action, GDP is expected to decline by 0.5 percent in volume in 2009. A recovery is likely to take hold in 2010, with growth resuming at a rate close to 1 percent.

The impact of the international economic crisis is already felt in Austria. Whereas in the 1st quarter 2008 GDP still grew by 0.5 percent from the previous period, the advance slowed down markedly in the further course of the year. Although the slackening concentrated on exports, private consumption and investment also lost momentum.

Like in other countries, the pace of growth had moderated somewhat already as from the middle of 2007, but only to an extent observed in earlier episodes of cyclical weakening. Yet, in autumn 2008, the downward trend accelerated sharply, as business confidence collapsed. With a certain lag, the international financial market crisis is tightening its grip on the Austrian economy more firmly than assumed in the WIFO forecast of last autumn. The current projections for 2009 therefore imply a downward revision of GDP growth by almost 1½ percentage points, now expecting a decline in demand and output by 0.5 percent.

The fall in foreign demand will push exports in 2009 below the level of last year. The significant weakening of confidence in the economic outlook, as revealed by business surveys, will weigh on demand for investment goods. According to the usual pattern, private consumption reacts only in the later stages of the cycle and plays therefore a stabilising role in an incipient slowdown. However, the last cyclical boom has hardly been reflected in private household demand, edging up by only 1 percent in volume in 2007 and 2008, respectively. Despite the gloomy environment, the same rate should be achieved this year and next, since expansionary fiscal measures and easing inflation will give a strong boost to private disposable income.

At the same time, the general government deficit will widen markedly. In 2009, the gap is expected to rise to 2.8 percent of GDP, and further to 3.2 percent in 2010.

Heavy losses in foreign orders weighing on export sector

The regular WIFO business survey points to heavy losses in orders from abroad. 2009 may therefore see the first decline in exports since 1993.

Austrian merchandise export growth has been losing momentum for some time already. Until early 2008, it was mainly the unfavourable exchange rate vis-à-vis the dollar that dampened foreign demand for Austrian goods. With the downturn in the euro area becoming steeper, the adverse trend was substantially reinforced. For the months to come, the decline in exports is likely to gather pace such that the 2009 level will fall below that for 2008.

Table 3: Productivity

	2005	2006	2007	2008	2009	2010
	Percentage changes from previous year					
Total economy						
Real GDP	+ 2.9	+ 3.4	+ 3.1	+ 1.8	– 0.5	+ 0.9
Employment[1]	+ 1.1	+ 1.5	+ 1.7	+ 1.8	– 0.3	+ 0.4
Productivity (GDP per employment)	+ 1.7	+ 1.9	+ 1.3	– 0.1	– 0.2	+ 0.5
Manufacturing						
Production[2]	+ 4.8	+ 9.9	+ 5.5	+ 3.0	– 2.8	+ 2.0
Employees[3]	– 0.8	+ 0.2	+ 2.6	+ 1.6	– 2.5	– 1.5
Productivity per hour	+ 6.2	+ 9.5	+ 3.2	+ 1.9	+ 0.2	+ 3.3
Working hours per day per employee[4]	– 0.6	+ 0.2	– 0.3	– 0.5	– 0.5	+ 0.2

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

The manufacturing sector is affected most by the international business cycle downswing. The regular WIFO business survey shows for nearly all branches sampled, a slump in the inflow of new orders. For the suppliers of motor car components, the situation has worsened considerably as firms are compelled to lay off workers or move to short-time work arrangements. Conditions are hardly better for car manufacturers in Germany, France and the USA. Austrian manufacturing value added is projected to drop by 2.8 percent at constant prices. In spite of cuts in working time and government-sponsored programmes to sustain employment, the workforce in the sector is likely to shrink by 2.5 percent.

The cyclical recovery projected to set in around the turn of the year 2009-10 should benefit also the Austrian export sector. Goods export volumes are anticipated to gain 1.5 percent in 2010 and manufacturing value added to edge up by 2 percent in real terms. This should allow effective hours worked to increase or the number of hired personnel to pick up, while regular employment will continue to recede.

Substantial cuts in investment spending

In view of the unfavourable business outlook and the rapidly falling capacity utilisation, firms will cut their investment plans to an important extent. Even the planned introduction in 2009 of an accelerated depreciation schedule is unlikely to trigger an early turnaround.

Having increased by nearly 5 percent in volume in 2007, gross fixed capital formation lost momentum already in 2008. The swift decline in new industrial orders depresses capacity utilisation and reduces the need for new equipment. In addition, companies' pessimistic judgement on the further business outlook weakens their readiness to embark on new investment projects. Finally, banks' greater caution in extending new credit in the context of the financial market crisis complicates the financing of new construction or business facilities. WIFO therefore expects that gross fixed capital formation will be cut by almost 4 percent in real terms in 2009, whereby equipment investment will suffer more (–7 percent) than construction (–1 percent) which can still rely on satisfactory order levels in civil engineering. Some of the measures included in the fiscal stimulus packages I and II (frontloading of railway and public real estate investment, insulation of buildings, public guarantees for small and medium-sized enterprises, creation of new child care facilities) should take effect already in 2009. This will support construction activity, partly offsetting demand shortfalls in private residential and industrial building.

The introduction of an accelerated depreciation schedule planned for 2009 and 2010 offers the possibility of reducing capital cost by shifting tax obligations into the future. However, these incentives are unlikely to encourage the currently widely pessimistic companies to increase their productive capacities. Investment in machinery and equipment will fall by 7 percent in volume in 2009 and remain flat in 2010.

Economic crisis weighing on domestic and foreign demand for travel

In 2008, the Austrian tourism industry enjoyed excellent results, with sales rising by 6 percent in nominal and 2.5 percent in real terms. Developments should still remain satisfactory in the first half of the current winter season. However, the trend will clearly head down during the first quarter 2009 as the domestic tourism industry will not escape the international downturn. In particular demand for long-distance travel destinations will recede, whereas destinations in Austria that can be reached by car will suffer less. Tourism service exports will nevertheless fall by 3.5 percent at constant prices in 2009 and a further 0.5 percent in 2010[1].

Since disposable household income will be supported over the projection period by the 2008 wage settlements for 2009 and tax cuts, the shortfall of domestic tourism demand of a projected 1 percent in volume will be much lower than that from foreign customers. In all, value added of the Austrian hotel and restaurant sector will shrink by 2.5 percent in 2009 and 0.5 percent in 2010.

Private consumption mitigating the downswing

Despite a gain in gross earnings per capita of 3 percent in 2008, disposable income of households hardly edged up when adjusted for inflation. Indeed, net of price increases and fiscal drag, incomes after tax edged down by 0.6 percent from 2007. This situation will reverse in 2009, when headline inflation eases markedly to a rate just above 1 percent and the tax reform reduces the fiscal burden. While gross earnings per capita will again rise by 3 percent in 2009, households will be left with a real gain of 2.6 percent year-on-year, after adjustment for inflation and taxes.

In addition to this increase in earned income, disposable household income will be boosted by different kinds of transfers in the period from 2008 to 2010, such as the introduction of a 13th annual instalment of the family allowance. Although households will want to use part of these social benefits for higher saving, consumer demand is expected to strengthen by 1 percent in real terms in 2009, unabated from

[1] Smeral, E., Mögliche Auswirkungen der Finanz- und Konjunkturkrise auf den österreichischen Tourismus, WIFO, Vienna, 2008, http://www.wifo.ac.at/wwa/jsp/index.jsp?fid=23923&id=34879&typeid=8&display_mode=2.

2007 and 2008, despite falling employment and rising unemployment. In 2010, consumption growth should keep its moderate upward trend.

Table 4: Earnings and international competitiveness

	2005	2006	2007	2008	2009	2010
	Percentage changes from previous year					
Gross earnings per employee[1]	+ 2.4	+ 3.2	+ 2.3	+ 3.0	+ 3.0	+ 2.0
Gross real earnings per employee[1]	+ 0.1	+ 1.4	+ 0.1	– 0.2	+ 1.8	+ 0.5
Net real earnings per employee[1]	+ 0.7	+ 1.3	– 0.0	– 0.6	+ 2.6	+ 0.2
Total economy						
Unit labour costs	+ 0.7	+ 1.1	+ 0.8	+ 3.3	+ 3.2	+ 1.5
Manufacturing						
Unit labour costs	– 0.9	– 4.4	– 0.6	+ 1.6	+ 3.3	– 1.3
Effective exchange rate, manufactures						
Nominal	– 0.6	+ 0.2	+ 1.2	+ 1.2	– 2.2	± 0.0
Real	– 0.9	– 0.4	+ 0.8	+ 0.5	– 2.9	– 0.3

Source: WIFO Economic Outlook. – [1] Employees according to National Accounts definition.

Wage settlements for 2009, the rapid deceleration of inflation and income tax cuts make for a significant increase in real disposable household income in 2009. This will sustain private consumption, allowing it to maintain its moderate upward trend of the past years.

Inflation abating swiftly

After an acceleration of headline inflation to almost 4 percent, driven by higher prices for raw materials and agricultural products, the trend is now starting to reverse.

In the course of 2008, international speculation swung away from real estate assets towards raw materials and agricultural commodities. Oil prices rose until early July by almost 50 percent to a peak of $ 144 per barrel (Brent), followed by a steep decline as in December the lowest daily quotation was at $ 37 per barrel. Prices of industrial raw materials (such as metals) and agricultural commodities followed a similar, albeit less extreme pattern. In the wake of the "imported" price hikes, domestic headline inflation rose to a high of 3.9 percent in June and only eased markedly by October, to a rate of 3.1 percent. Towards the end of the year, inflation should drop below 3 percent year-on-year. On annual average 2008, the expected rate of 3.2 percent would be the highest in 15 years.

Table 5: Private consumption, income and prices

	2005	2006	2007	2008	2009	2010
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 2.6	+ 2.4	+ 1.0	+ 1.0	+ 1.0	+ 1.0
Durables	+ 5.9	+ 7.0	+ 6.2	– 1.0	– 1.8	+ 1.2
Non-durables and services	+ 2.2	+ 1.9	+ 0.4	+ 1.2	+ 1.3	+ 1.0
Household disposable income	+ 3.1	+ 3.5	+ 2.2	+ 1.2	+ 2.5	+ 1.0
	As a percentage of disposable income					
Household saving ratio	9.8	10.8	11.7	11.8	13.1	13.1
	Percentage changes from previous year					
Direct lending to domestic non-banks[1]	+ 4.7	+ 4.5	+ 3.6	+ 6.0	+ 2.5	+ 3.5
	Percentage changes from previous year					
Inflation rate						
National	2.3	1.5	2.2	3.2	1.2	1.5
Harmonised	2.1	1.7	2.2	3.2	1.2	1.5
Core inflation[2]	1.5	1.3	1.9	2.4	1.5	1.4

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

Price pressure should continue to ease until the middle of 2009. At times, the monthly rates may fall below 1 percent (year-on-year). Apart from lower raw materials prices, the abolition of student fees and the cut of VAT for pharmaceuticals play a role, each having a dampening effect of 0.1 percentage point on the annual inflation rate.

According to the assumption on the further trend of oil prices, headline inflation will remain subdued, at 1.2 percent in 2009 and 1.5 percent in 2010. Core inflation, the more important indicator for underlying price pressure and for monetary policy action, should moderate from 2.4 percent in 2008 to 1.5 percent in 2009 and 1.4 percent in 2010. The downward trend offers, for the time being, no cause for concern about a possible slippage into deflation.

Trend towards growing employment and lower unemployment set to reverse

Having fallen between 2005 and 2008 by more than 40,000, the number of unemployed has already started to pick up month-on-month since spring 2008, a trend that is bound to be reinforced by the cyclical downturn. However, the increase will be contained by the planned measures to support employment, such as possible subsidies for new short-time work arrangements, or an extension of job training opportunities. In this way, the loss of important qualifications of persons threatened by lay-off will be prevented which in a subsequent business cycle upswing may give rise to shortages of qualified labour. The WIFO projection is for an increase in registered unemployment by 27,000 in 2009 (+13 percent) and at the same time for 7,000 more persons participating in job training programmes.

Table 6: Labour market

		2005	2006	2007	2008	2009	2010
		Changes from previous year, in 1,000					
Demand for labour							
Persons in active employment[1]		+ 37.2	+ 55.9	+ 66.9	+ 86.0	– 15.0	+ 8.0
Employees[2]		+ 31.9	+ 51.5	+ 65.5	+ 78.0	– 13.0	+ 8.0
Percentage changes from previous year		*+ 1.0*	*+ 1.7*	*+ 2.1*	*+ 2.4*	*– 0.4*	*+ 0.2*
Nationals		+ 20.0	+ 35.0	+ 43.6	+ 54.2	– 12.0	+ 5.5
Foreign workers		+ 11.9	+ 16.5	+ 21.9	+ 23.8	– 1.0	+ 2.5
Self-employed[3]		+ 5.3	+ 4.4	+ 1.4	+ 8.0	– 2.0	± 0.0
Labour supply							
Population of working age	15 to 64 years	+ 15.6	+ 18.5	+ 17.4	+ 24.9	+ 20.2	+ 27.6
	15 to 59 years	+ 48.5	+ 52.8	+ 18.8	+ 15.7	+ 13.6	+ 13.7
Labour force[4]		+ 45.9	+ 42.4	+ 50.0	+ 74.4	+ 12.0	+ 23.0
Surplus of labour							
Registered unemployed[5]		+ 8.8	– 13.5	– 16.9	– 11.6	+ 27.0	+ 15.0
In 1,000		252.7	239.2	222.2	210.6	237.6	252.6
Unemployed persons in training	In 1,000	48.6	57.5	52.7	50.6	57.6	62.6
		Percent					
Unemployment rate							
Eurostat definition[6, 7]		5.2	4.8	4.4	3.5	3.9	4.1
As a percentage of total labour force[5]		6.5	6.1	5.6	5.2	5.9	6.2
National definition[5, 8]		7.3	6.8	6.2	5.8	6.5	6.9
Employment rate							
Persons in active employment[1, 9]		62.8	63.6	64.5	65.8	65.3	65.1
Total employment[6, 9]		68.6	70.2	71.4	72.3	71.7	71.5

Source: WIFO Economic Outlook. – [1] Excluding parental leave, military service, and unemployed persons in training. – [2] According to Federation of Austrian Social Security Institutions. – [3] According to WIFO. – [4] Economically active employment plus unemployment. – [5] According to Public Employment Service Austria. – [6] According to Eurostat Labour Force Survey. – [7] 2008: break. – [8] As a percentage of total labour force, without self-employed. – [9] As a percentage of population of working age (15 to 64 years).

The decline in demand and output is now having repercussions on the domestic labour market. In the next two years, unemployment is likely to rebound, even if the increase may be contained by counter-cyclical policy action.

A further reason for an only limited increase in unemployment is the high elasticity of labour supply from abroad. Notably in the construction and the tourism sector, fewer foreign workers will seek a job, given the difficult economic situation, thereby keeping the rise in domestic unemployment limited.

The number of persons in dependent active employment rose by around 200,000 over the period from 2005 to 2008; as a consequence of the recession, it will go down by an estimated 13,000 or 0.4 percent in 2009. With the recovery projected for 2010, employment may pick up again by 8,000 (+0.2 percent).

In such a scenario, the rate of unemployment, on conventional national definitions, will go up from 5.8 percent in 2008 to 6.5 percent in 2009, and further to 6.9 percent in 2010.

Pro-active fiscal policy stance – budget deficit widening markedly

The fiscal policy measures taken for the purpose of cyclical stabilisation will weigh heavily on the general government balance in the years to come.

The excellent cyclical conditions of the last few years allowed the general government deficit to narrow in 2007 and 2008 to a ratio of ½ percent of GDP. In a period of cyclical downturn tax revenues usually decline, while social transfers increase due to rising unemployment. This quasi-automatic increase in the budgetary burden mitigates the downturn. By countering the current recession through pro-active action, fiscal policy is ready to accept a much more severe deterioration of the budget balance. The stimulus "packages" adopted, tax cuts and the measures taken in the forefront of the last general elections will push the general government deficit up to 2.8 percent of GDP in 2009. In 2010, the deficit is even likely to exceed the ceiling of 3 percent of GDP foreseen by the European Stability and Growth Pact. A more determined approach towards budgetary consolidation in the years 2006 and 2007 would have allowed providing the same amount of fiscal stimulus while still respecting the deficit ceiling.

The fiscal stimulus measures to the tune of around 2 percent of GDP (some € 5 billion) are projected to sustain economic activity in 2009 by roughly ¾ percent of GDP. Thus, part of the positive effect will leak either into private saving or abroad via imports of consumer goods. The fiscal measures will nevertheless provide an important contribution to support demand and output in Austria and will moderate losses of human and physical capital in the cyclical downturn.

Table 7: Key policy indicators

	2005	2006	2007	2008	2009	2010
	As a percentage of GDP					
Fiscal policy						
General government financial balance						
According to Maastricht definition	– 1.5	– 1.5	– 0.4	– 0.5	– 2.8	– 3.2
According to National Accounts	– 1.6	– 1.7	– 0.5	– 0.6	– 2.8	– 3.3
General government primary balance	+ 1.4	+ 1.2	+ 2.3	+ 2.3	+ 0.2	– 0.3
	Percent					
Monetary policy						
3-month interest rate	2.2	3.1	4.3	4.6	2.4	2.2
Long-term interest rate[1]	3.4	3.8	4.3	4.3	3.1	3.0
	Percentage changes from previous year					
Effective exchange rate						
Nominal	– 0.7	+ 0.2	+ 1.1	+ 1.3	– 2.1	± 0.0
Real	– 1.0	– 0.5	+ 0.7	+ 0.5	– 2.9	– 0.4

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

Next to manufacturing, the hotel and restaurant sector is in 2009 severely affected by the cyclical downswing. Non-negligible losses are to be expected in tourism demand from abroad, but also domestic customers will be more cautious in their spending on holidays. Besides gross fixed capital formation, tourism will be the component of aggregate demand suffering the largest setback.