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 **ÖSTERREICHISCHES INSTITUT FÜR
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**Sovereign Debt Crisis Tightening
Its Grip on the Real Economy
Economic Outlook for 2012 and 2013**

December 2011



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Austrian Institute of Economic Research

Abstract

The sovereign debt crisis in the euro area prompted many EU countries to step up efforts at fiscal consolidation in order to stem the rise in interest rates on their government bonds. This will dampen internal demand in the years to come, in particular if budgetary retrenchment should lose sight of policies for long-term economic growth and labour market conditions. At the same time, business activity outside the euro area is losing momentum. As a consequence, GDP growth in Austria is projected to slow down to a modest 0.4 percent in 2012. In 2013, Austria will benefit from the expected global recovery, although growth will remain subdued at 1.6 percent in volume, given the continued restrictive stance of fiscal policy across Europe.

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2011/361/SPE/WIFO project no: 28491

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Verkaufspreis: 15,00 € • Download 15,00 €: <http://www.wifo.ac.at/wwa/pubid/43332>

Sovereign Debt Crisis Tightening Its Grip on the Real Economy

Economic Outlook for 2012 and 2013

The sovereign debt crisis in the euro area prompted many EU countries to step up efforts at fiscal consolidation in order to stem the rise in interest rates on their government bonds. This will dampen internal demand in the years to come, in particular if budgetary retrenchment should lose sight of policies for long-term economic growth and labour market conditions. At the same time, business activity outside the euro area is losing momentum. As a consequence, GDP growth in Austria is projected to slow down to a modest 0.4 percent in 2012. In 2013, Austria will benefit from the expected global recovery, although growth will remain subdued at 1.6 percent in volume, given the continued restrictive stance of fiscal policy across Europe.

The slowdown in world economic growth, already felt since last summer, is set to continue over the coming months. Given the high sovereign debt levels in several euro area countries, doubt about their sustainability has spread further across the area. In Italy, benchmark government bond yields have temporarily moved above 7 percent. Likewise, demand for French, Belgian and Spanish government bonds has slackened significantly. Meanwhile, minor increases in interest rates have been observed also in countries with below-average government debt levels like Austria or the Netherlands. Lack of confidence on the part of international financial markets has extended to almost the entire euro area.

Several years ago, extremely low short-term interest rates led many euro area countries to issue titles of short maturity. Thus, a large part of government debt will expire within the next few years and considerable amounts need to be rescheduled at high interest rates, weighing further on financial market confidence and countries' debt positions. More and more countries are therefore forced to tighten the course of fiscal restraint. Cuts in social spending and higher tax burdens will dampen domestic demand and output in the euro area.

For this reason, WIFO expects euro area GDP to stagnate in 2012. In 2013, while the Euro area should benefit from a pickup of global economic activity, fiscal restraint will continue to act as a drag on GDP growth. Austria will particularly be negatively affected by the restrictive policy stance pursued by Italy, its second-largest trading partner. The crisis in Hungary will also show adverse effects.

The present WIFO projections, like the previous ones of last autumn, rest on the assumption that the domestic as well as the international financial system remains stable overall. For the purpose of the projections, the risk of extremely tight bank lending (credit crunch) in the context of compliance with higher equity capital requirements is considered manageable for the euro area. It is further assumed that governments will succeed in servicing their debt in an orderly way and that current high interest rates on many euro area countries' government bonds will gradually abate to more sustainable levels.

Under these assumptions, the Austrian economy should expand by no more than 0.4 percent in 2012. Exports will provide less stimulus, growing just by 2.8 percent in volume. Firms will hardly increase investment in machinery and equipment, despite higher earnings and lower interest rates enjoyed last year, nor will they be strongly inclined to embark on new construction projects.

In view of the sluggish business activity, commodity prices should ease in the course of 2012. Domestic headline inflation may abate to 2 percent and prevent further losses of private household purchasing power. In this way, a projected increase in private consumption of 0.8 percent should come to support overall business activity.

The slowdown of demand and output growth will leave its trace also on the labour market where the gain in overall employment may decelerate to 0.6 percent on average in 2012. The unemployment rate should climb back above 7 percent, close to its peak during the crisis of 2009.

The forecast assumes that policy in Austria will maintain the course of fiscal consolidation and, despite the quasi-stagnation of economic activity, underpin it by structural measures supporting growth over the medium term. The general government deficit should thereby edge down from 3.3 percent of GDP in 2011 to 3 percent of GDP in 2012. With growth picking up and structural consolidation measures showing effect, government net borrowing should decline to 2.8 percent of GDP in 2013.

Methodological Notes and Short Glossary

Period comparisons

Time-series comparisons with the previous period, e.g., the previous quarter, are adjusted for seasonal effects. They also include effects that result from a different number of working days in the period (e.g., Easter). In the text, reference is made to "seasonally and working day adjusted changes".

The phrase "changed compared with a year before . . .", on the other hand, describes a change compared with the same period a year before and refers to unadjusted time series.

The analysis of the seasonally and working day adjusted development provides more precise information about the actual course of economic activity and shows turning points sooner. However, the data are subject to additional revisions as seasonal adjustment is based on statistical methods.

Real and nominal values

In principle, the values shown must be understood as real values, i.e., adjusted for price effects. Whenever values are shown as nominal values (e.g., foreign trade statistics), this is specifically mentioned.

Production Sector

This term comprises the NACE-2008 sections B, C and D (Mining and Quarrying, Manufacturing, Energy Supply) and is here used in an international comparison.

Inflation, CPI und HICP

The inflation rate measures changes in consumer prices compared with a year before. The Consumer Price Index (CPI) is a measure of national inflation. The Harmonised Index of Consumer Prices (HICP) is the basis for comparable measurement of inflation in the EU and for the evaluation of price stability in the euro area (see <http://www.statistik.at/>).

Core inflation as a monetary policy indicator is not clearly defined. WIFO follows the common practice of using the inflation rate excluding the product categories unprocessed food and energy for core inflation. Thus just under 87 percent of the goods and services contained in the consumer price index (CPI 2010) are included in the calculation of core inflation.

WIFO Business Cycle Survey and WIFO Investment Survey

The WIFO Business Cycle Survey is a monthly survey in which around 1,100 Austrian firms are asked to assess their current and future economic situation. The WIFO Investment Survey is conducted twice a year, asking companies about their investment activity (<http://www.ikt.at/>). The indicators are balances between the positive and negative responses expressed as a percentage of the total number of firms sampled.

Unemployment rate

Austrian national definition: The number of persons registered as job seekers with the Public Employment Service expressed as a percentage of the dependent labour force. Labour force is the sum of the unemployed and the persons in dependent employment (measured in standard employment relationships). Database: registrations with the Public Employment Service (AMS) and Association of Austrian social insurance agencies.

Definition according to ILO and EUROSTAT: Any person who is not gainfully employed and is actively seeking work is considered unemployed. Gainfully employed persons comprise all persons who during the reference week worked for at least one hour in a self-employed capacity or in paid employment. Persons receiving child-care benefit and apprentices are classified as gainfully employed, whereas persons in military service or persons carrying out alternative service are not. The unemployment rate is the number of unemployed persons expressed as a percentage of the total labour force (unemployed persons plus gainfully employed persons). Database: data from household surveys ("Mikrozensus").

Terms used in connection with the national definition of the unemployment rate

Persons in training: Persons who at a set date are enrolled in AMS (Public Employment Service) training programmes. When calculating the unemployment rate, their number is not taken into account either in the denominator or in the numerator.

Persons in dependent active employment: "Persons in dependent employment" include persons receiving child-care benefit, as well as persons in military service or persons carrying out alternative service with a valid employment contract. By deducting their number one arrives at the number of "persons in dependent active employment".

Vienna, 21 December 2011

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WIFO
Projections - December 2011

Main results

Percentage changes from previous year

		2008	2009	2010	2011	2012	2013
GDP							
Volume		+ 1.4	- 3.8	+ 2.3	+ 3.2	+ 0.4	+ 1.6
Value		+ 3.2	- 2.8	+ 4.1	+ 5.5	+ 2.7	+ 3.2
Manufacturing¹, volume		+ 1.3	- 15.0	+ 7.2	+ 8.0	± 0.0	+ 3.5
Wholesale and retail trade, volume		- 3.0	+ 0.7	+ 3.1	+ 0.6	+ 0.5	+ 1.0
Private consumption expenditure, volume		+ 0.8	- 0.3	+ 2.2	+ 0.8	+ 0.8	+ 1.0
Gross fixed investment, volume		+ 0.7	- 8.3	+ 0.1	+ 5.6	+ 0.9	+ 1.5
Machinery and equipment		- 0.7	- 9.7	+ 4.3	+ 11.0	+ 1.5	+ 2.0
Construction		+ 1.0	- 7.6	- 2.9	+ 1.0	+ 0.4	+ 1.0
Exports of goods²							
Volume		+ 0.5	- 16.8	+ 12.8	+ 7.8	+ 3.5	+ 6.4
Value		+ 2.5	- 20.2	+ 16.7	+ 11.5	+ 3.5	+ 7.5
Imports of goods²							
Volume		+ 0.6	- 14.3	+ 10.3	+ 8.0	+ 3.7	+ 5.9
Value		+ 4.7	- 18.4	+ 16.5	+ 13.2	+ 3.2	+ 7.5
Current balance	€ bn	+ 13.76	+ 7.49	+ 8.46	+ 7.59	+ 7.49	+ 8.35
	as a percentage of GDP	+ 4.9	+ 2.7	+ 3.0	+ 2.5	+ 2.4	+ 2.6
Long-term interest rate³	percent	4.4	3.9	3.2	3.3	3.0	3.0
Consumer prices		+ 3.2	+ 0.5	+ 1.9	+ 3.3	+ 2.1	+ 1.9
Unemployment rate							
Eurostat definition ⁴	percent	3.8	4.8	4.4	4.2	4.5	4.7
National definition ⁵	percent	5.9	7.2	6.9	6.8	7.1	7.4
Persons in active dependent employment⁶		+ 1.7	- 1.5	+ 0.8	+ 1.9	+ 0.6	+ 0.4
General government financial balance							
according to Maastricht definition							
as a percentage of GDP		- 0.9	- 4.1	- 4.4	- 3.3	- 3.0	- 2.8

¹ Value added, including mining and quarrying. ² According to Statistics Austria. ³ 10-year central government bonds (benchmark). ⁴ According to Eurostat Labour Force Survey. ⁵ Public Employment Service Austria, percent of total labour force excluding self employed. ⁶ Excluding parental leave and military service.

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Key policy indicators

	2008	2009	2010	2011	2012	2013
Fiscal policy						
	As a percentage of GDP					
General government financial balance						
according to Maastricht definition	- 0.9	- 4.1	- 4.4	- 3.3	- 3.0	- 2.8
according to National accounts	- 1.0	- 4.1	- 4.4	- 3.3	- 3.0	- 2.8
General government primary balance						
	+ 1.7	- 1.3	- 1.7	- 0.6	- 0.3	- 0.2
Monetary policy						
	Percent					
3-month interest rate	4.6	1.2	0.8	1.4	1.1	1.1
Long-term interest rate ¹	4.4	3.9	3.2	3.3	3.0	3.0
	Percentage changes from previous year					
Effective exchange rate						
Nominal	+ 1.2	+ 0.9	- 2.5	+ 0.3	- 0.6	± 0.0
Real	+ 0.6	+ 0.4	- 2.7	+ 0.9	- 0.5	+ 0.1

¹ 10-year central government bonds (benchmark).

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Projections - December 2011

World economy

Percentage changes from previous year

	2008	2009	2010	2011	2012	2013
Real GDP						
World	+ 2.8	- 0.7	+ 5.1	+ 3.8	+ 3.2	+ 4.2
USA	- 0.3	- 3.5	+ 3.0	+ 1.6	+ 1.3	+ 1.6
Japan	- 1.0	- 5.5	+ 4.4	- 1.0	+ 1.5	+ 2.3
EU 27	+ 0.3	- 4.3	+ 1.9	+ 1.7	+ 0.3	+ 1.7
Euro area 16	+ 0.4	- 4.2	+ 1.9	+ 1.7	± 0.0	+ 1.3
Germany	+ 1.1	- 5.1	+ 3.7	+ 3.1	+ 0.5	+ 1.6
New member states ¹	+ 4.1	- 3.2	+ 2.4	+ 3.1	+ 1.4	+ 3.1
China	+ 9.6	+ 9.2	+ 10.4	+ 9.5	+ 8.2	+ 9.2
World trade , volume	+ 2.7	- 12.8	+ 15.0	+ 6.0	+ 4.2	+ 6.5
Market growth ²	+ 2.9	- 11.5	+ 11.4	+ 7.5	+ 3.0	+ 6.0
Primary commodity prices						
HWI Index, total	+ 31.7	- 34.4	+ 29.0	+ 35	- 12	+ 6
Excluding energy	+ 18.3	- 28.0	+ 31.5	+ 25	- 5	+ 10
Crude oil prices						
Brent, USD per barrel	97.0	61.5	79.5	110	95	100
Exchange rate						
USD per euro	1.471	1.393	1.327	1.40	1.30	1.30

¹ Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania.

² Real import growth of trading partners weighted by Austrian export shares.

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Private consumption, income and prices

	2008	2009	2010	2011	2012	2013
Percentage changes from previous year, volume						
Private consumption expenditure	+ 0.8	- 0.3	+ 2.2	+ 0.8	+ 0.8	+ 1.0
Durables	+ 3.7	+ 0.9	+ 5.8	+ 0.4	- 0.3	+ 0.3
Non-durables and services	+ 0.5	- 0.4	+ 1.8	+ 0.8	+ 0.9	+ 1.1
Household disposable income	+ 0.9	- 1.7	- 0.3	- 0.0	+ 0.5	+ 1.4
As a percentage of disposable income						
Household saving ratio¹	11.5	10.7	8.3	7.5	7.3	7.6
Household saving ratio²	11.4	10.1	7.8	7.1	6.8	7.1
Percentage changes from previous year						
Direct lending to domestic non-banks³	+ 7.4	- 1.3	+ 2.9	+ 2.3	+ 2.4	+ 2.5
Inflation rate						
National	3.2	0.5	1.9	3.3	2.1	1.9
Harmonised	3.2	0.4	1.7	3.5	2.3	2.0
Core inflation ⁴	2.4	1.5	1.2	2.7	2.1	1.9

¹ Including adjustment for the change in net equity of households in pension fund reserves.

² Excluding adjustment for the change in net equity of households in pension fund reserves.

³ End of period.

⁴ Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

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Projections - December 2011

Productivity

Percentage changes from previous year

	2008	2009	2010	2011	2012	2013
Total economy						
Real GDP	+ 1.4	- 3.8	+ 2.3	+ 3.2	+ 0.4	+ 1.6
Employment ¹	+ 2.1	- 0.9	+ 0.8	+ 2.0	+ 0.8	+ 0.7
Productivity (GDP per employment)	- 0.7	- 2.9	+ 1.5	+ 1.2	- 0.4	+ 0.8
Manufacturing						
Production ²	+ 0.9	- 15.3	+ 7.4	+ 8.0	± 0.0	+ 3.5
Employees ³	+ 1.7	- 5.3	- 1.3	+ 1.9	- 1.5	- 0.5
Productivity per hour	- 0.3	- 7.3	+ 5.6	+ 5.5	+ 2.3	+ 3.8
Working hours per day per employee ⁴	- 0.5	- 3.6	+ 3.0	+ 0.5	- 0.8	+ 0.2

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.

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Earnings and international competitiveness

Percentage changes from previous year

	2008	2009	2010	2011	2012	2013
Wages and salaries per employee¹						
Gross earnings	+ 3.2	+ 1.6	+ 1.2	+ 2.7	+ 2.9	+ 1.8
Gross real earnings²	- 0.0	+ 1.1	- 0.7	- 0.6	+ 0.8	- 0.1
Net real earnings²	- 0.7	+ 2.9	- 0.9	- 0.9	+ 0.6	- 0.4
<i>Total economy</i>						
Unit labour costs	+ 3.7	+ 4.7	- 0.3	+ 1.4	+ 3.3	+ 0.8
<i>Manufacturing</i>						
Unit labour costs	+ 5.2	+ 15.1	- 5.7	- 2.8	+ 1.7	- 2.7
Effective exchange rate - manufactures						
Nominal	+ 1.1	+ 0.7	- 2.6	+ 0.3	- 0.7	± 0.0
Real	+ 0.6	+ 0.4	- 2.7	+ 0.9	- 0.5	+ 0.1

¹ Employees according to National Accounts definition.

² Deflated by CPI.

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Labour market

Changes from previous year (1,000^s)

		2008	2009	2010	2011	2012	2013
Demand for labour							
Persons in active employment ¹		+ 66.0	- 44.0	+ 31.3	+ 68.3	+ 26.0	+ 20.0
Employees ²		+ 55.6	- 48.5	+ 25.5	+ 62.8	+ 21.0	+ 15.0
<i>Percentage changes from previous year</i>		+ 1.7	- 1.5	+ 0.8	+ 1.9	+ 0.6	+ 0.4
Nationals		+ 31.1	- 43.0	+ 5.8	+ 25.3	+ 10.0	+ 7.0
Foreign workers		+ 24.5	- 5.5	+ 19.7	+ 37.5	+ 11.0	+ 8.0
Self-employed ³		+ 10.4	+ 4.5	+ 5.8	+ 5.5	+ 5.0	+ 5.0
Labour supply							
Population of working age	(15 to 64 years)	+ 27.7	+ 17.3	+ 21.6	+ 32.8	+ 15.0	+ 6.7
	(15 to 59 years)	+ 17.6	+ 11.1	+ 8.9	+ 16.8	+ 14.7	+ 10.8
Labour force ⁴		+ 56.0	+ 4.0	+ 21.8	+ 65.3	+ 41.2	+ 31.5
Surplus of labour							
Registered unemployed ⁵		- 10.0	+ 48.1	- 9.5	- 3.0	+ 15.2	+ 11.5
	1,000 ^s	212.3	260.3	250.8	247.8	263.0	274.5
Unemployed persons in training	1,000 ^s	50.5	64.1	73.2	63.2	63.2	63.2
Unemployment rate							
Eurostat definition ⁶	percent	3.8	4.8	4.4	4.2	4.5	4.7
Percent of total labour force ⁵	percent	5.3	6.5	6.2	6.0	6.4	6.6
National definition ^{5,7}	percent	5.9	7.2	6.9	6.8	7.1	7.4
Employment rate							
Persons in active employment ^{1,8}	percent	65.7	64.7	65.0	65.9	66.1	66.4
Total employment (Eurostat) ^{6,8}	percent	72.1	71.6	71.7	72.2	72.4	72.5

¹ Excluding parental leave and military service. ² According to Federation of Austrian Social Security Institutions.

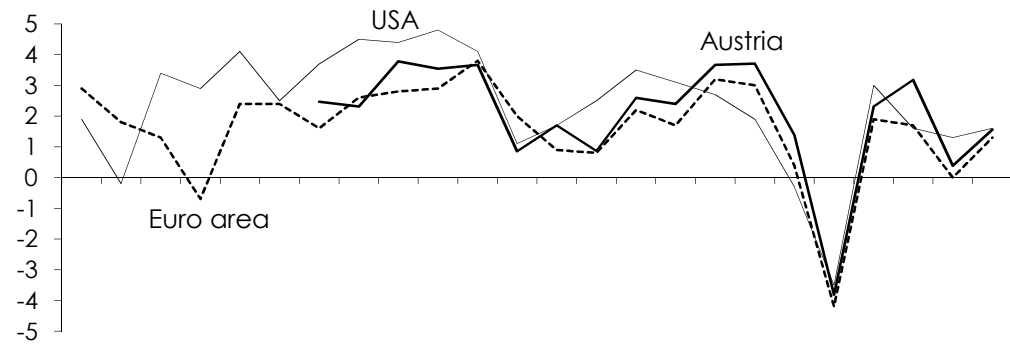
³ According to WIFO. ⁴ Persons in active employment plus unemployment.

⁵ According to Public Employment Service Austria ⁶ According to Eurostat Labour Force Survey.

⁷ Percent of total labour force excl. self-employed. ⁸ Percent of population of working age (15 to 64 years).

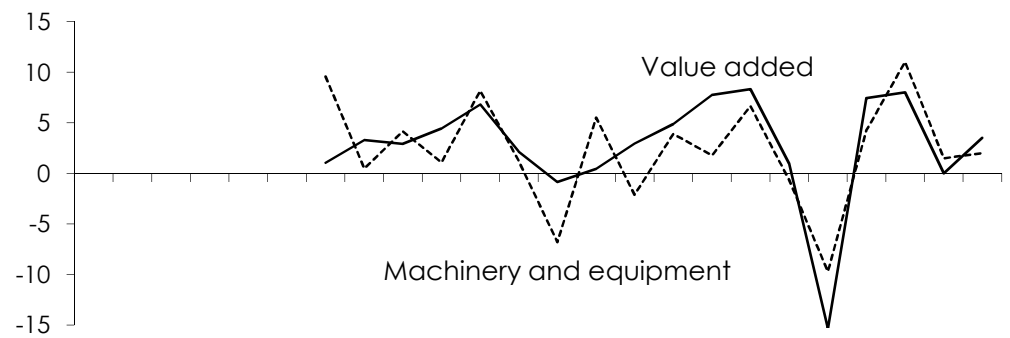
Growth of real GDP

Percent



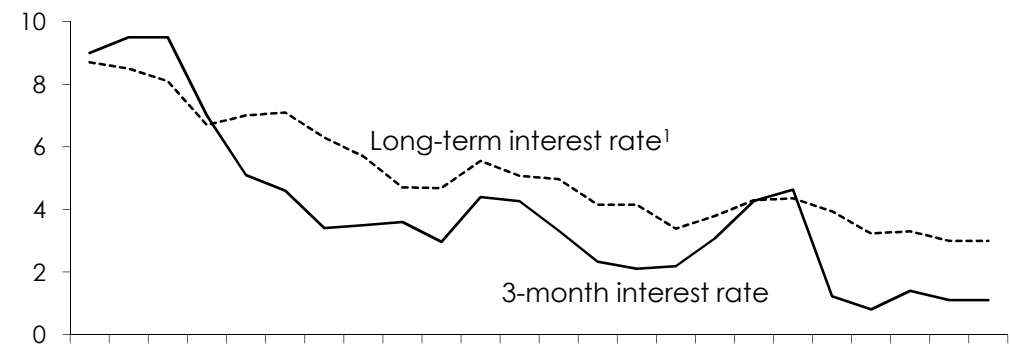
Manufacturing and investment

Percentage changes from previous year, volume



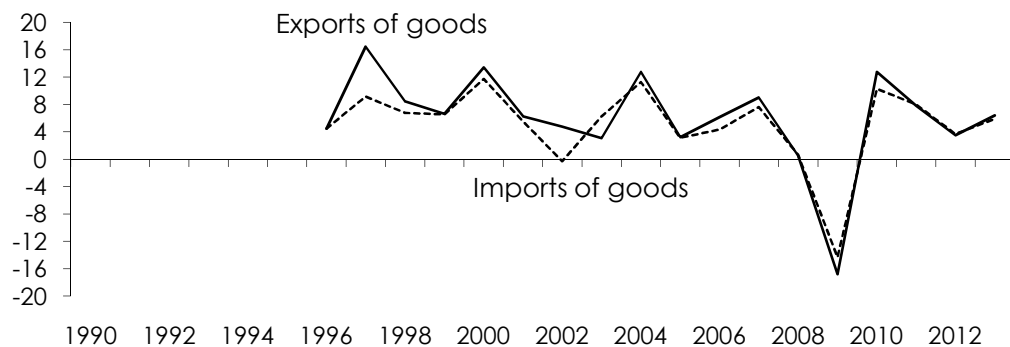
Short-term and long-term interest rates

Percent



Trade

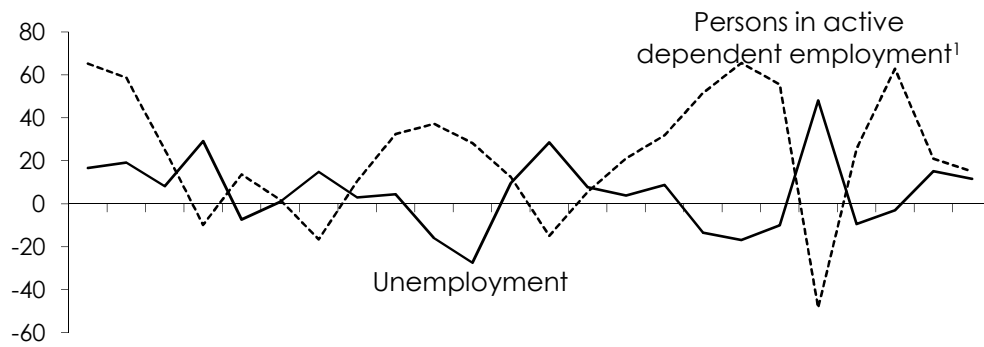
Percentage changes from previous year, volume



¹ 10-year central government bonds (benchmark).

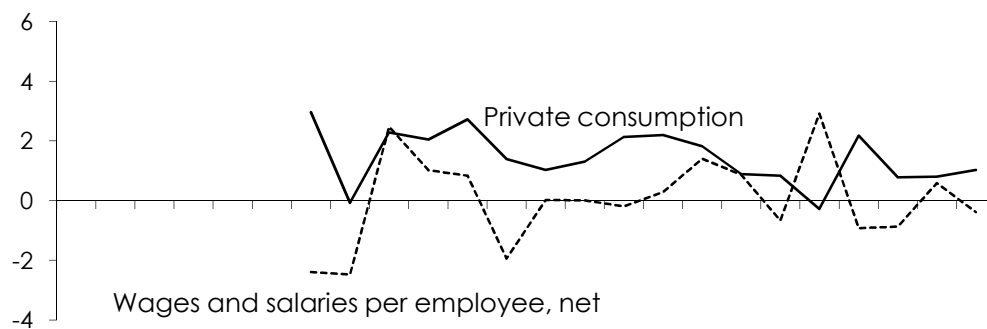
Employment and unemployment

1,000^s from previous year



Consumption and income

Percentage changes from previous year, volume



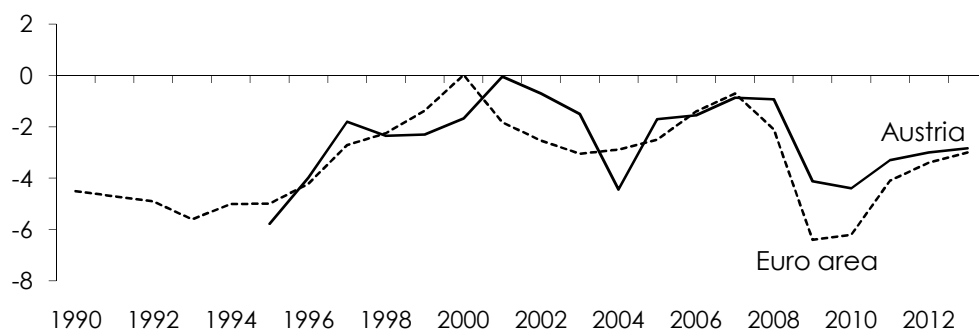
Inflation and unit labour costs

Percentage changes from previous year



General government financial balance

As a percentage of GDP



¹ Excluding parental leave, military service, and unemployed persons in training.