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# Euro Area Debt Crisis Weighing Increasingly on Domestic Activity

## Economic Outlook for 2012 and 2013

**Economic policy in the euro area is confronted with major challenges. Against this background it is extremely difficult to project international and domestic economic developments. The present forecast is based on highly benign assumptions concerning the resolution of the current crisis. Subject to these assumptions, Austria's GDP should grow by 0.6 percent this year and by 1.3 percent in 2013, with uncertainty being particularly high for next year.**

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Latest developments of the sovereign debt crisis in the euro area and the reaction of economic policy currently overshadow the course of the business cycle. The outcome of the Greek elections and the swiftly installed new government have done little so far to reassure financial markets about the situation in the euro area. Interest rates on Italian and Spanish government bonds have increased once again, such that new credit taken up by the two countries aggravates the burden on their public finances, thereby undermining further the confidence of financial markets. At the same time, some euro area countries like Germany and Austria observe important inflows of financial funds which lower the yields on their government bonds. The sizeable differences between interest rates inside the Monetary Union give rise not only to economic frictions, but also to political tensions. The lingering uncertainty about a resolution of the crisis has a negative impact on decisions of both investors and consumers. The present forecast is based on assumptions that appear optimistic from the present perspective: Monetary Union is maintained in its present composition (other scenarios would have severe consequences for the banking system that are difficult to predict); the cross-country differences in interest rates on government bonds will diminish and the tight consolidation programmes in the countries concerned will be relaxed to some extent in order to reallocate funds to support investment-led growth on the international as well as the domestic front.

Under such conditions, the international economic environment should improve and allow upward-bound forces of demand and output to prevail also in Europe. This would be supported by the depreciation of the euro vis-à-vis the dollar.

In such a scenario, the Austrian economy may expand by 0.6 percent in 2012, with growth accelerating to 1.3 percent in 2013. Easing commodity prices would, notwithstanding the decline in the dollar/euro exchange rate, make for a deceleration of inflation to an annual rate of 2.3 percent in 2012 and 1.9 percent in 2013.

Relatively favourable has been the trend on the Austrian labour market since the beginning of the year, which suggests an increase in employment by 1.3 percent for the whole of 2012. In 2013, net job creation should abate to a modest rate of 0.4 percent. The unemployment rate on national definition is projected to rise to 7.1 percent and 7.4 percent in 2012 and 2013, respectively.

Table 1: Main results

		2008	2009	2010	2011	2012	2013
Percentage changes from previous year							
GDP							
Volume		+ 1.4	- 3.8	+ 2.3	+ 3.0	+ 0.6	+ 1.3
Value		+ 3.2	- 2.8	+ 4.1	+ 4.9	+ 2.8	+ 2.8
Manufacturing <sup>1</sup> , volume		+ 1.3	- 15.0	+ 7.2	+ 9.8	+ 1.0	+ 3.0
Wholesale and retail trade, volume		- 3.0	+ 0.7	+ 3.1	+ 0.1	+ 0.5	+ 0.8
Private consumption expenditure, volume		+ 0.8	- 0.3	+ 2.2	+ 0.5	+ 0.8	+ 0.9
Gross fixed investment, volume		+ 0.7	- 8.3	+ 0.1	+ 5.4	+ 1.1	+ 2.0
Machinery and equipment		- 0.7	- 9.7	+ 4.3	+ 10.5	+ 1.8	+ 3.5
Construction		+ 1.0	- 7.6	- 2.9	+ 2.4	+ 0.4	+ 0.6
Exports of goods <sup>2</sup>							
Volume		+ 0.5	- 16.8	+ 12.8	+ 7.5	+ 3.5	+ 6.2
Value		+ 2.5	- 20.2	+ 16.7	+ 11.7	+ 4.4	+ 7.8
Imports of goods <sup>2</sup>							
Volume		+ 0.6	- 14.3	+ 10.3	+ 8.0	+ 2.9	+ 5.6
Value		+ 4.7	- 18.4	+ 16.5	+ 15.1	+ 3.8	+ 7.8
Current balance	billion €	+ 13.76	+ 7.49	+ 8.62	+ 5.86	+ 7.32	+ 8.61
As a percentage of GDP		+ 4.9	+ 2.7	+ 3.0	+ 2.0	+ 2.4	+ 2.7
Long-term interest rate <sup>3</sup>	percent	4.4	3.9	3.2	3.3	2.5	2.5
Consumer prices		+ 3.2	+ 0.5	+ 1.9	+ 3.3	+ 2.3	+ 1.9
Unemployment rate							
Eurostat definition <sup>4</sup>	percent	3.8	4.8	4.4	4.2	4.5	4.8
National definition <sup>5</sup>	percent	5.9	7.2	6.9	6.7	7.1	7.4
Persons in active dependent employment <sup>6</sup>		+ 1.7	- 1.5	+ 0.8	+ 1.9	+ 1.3	+ 0.4
General government financial balance according to Maastricht definition							
As a percentage of GDP		- 0.9	- 4.1	- 4.5	- 2.6	- 2.9	- 2.3

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

Growth of the US economy stayed robust in the first and second quarter 2012, as GDP rose by 0.5 and 0.4 percent from the previous period. Industrial output data available until May show an upward trend which, however, has flattened since the beginning of 2012. Leading indicators suggest that benign conditions will last over the coming months, with both indicators of consumer confidence keeping high levels and no slackening indicated by the Index of Supply Management (ISM). The favourable business situation is mirrored by a moderate, but steady decline in the unemployment rate and a slight increase in employment.

Growth of the US economy is not expected to abate in 2012. The business climate as reflected in the surveys and the upcoming presidential elections make for a stable environment that should benefit primarily private consumption. WIFO therefore projects real GDP growth at an annual 2 percent. In 2013, at least fiscal policy is likely to turn more restrictive in order to contain the persistently high budget deficits and the implicit increase in public debt. As a consequence, GDP growth may edge down to 1.8 percent.

Leading indicators for some Asian emerging markets point to a gradual deceleration of the so far strong momentum of business activity. The OECD Composite Leading Indicators for China and India have followed a downward trend since early 2011, even if the actual economic performance remained favourable until spring 2012. For the Chinese economy, both the official purchasing managers' index and the index of the HSBC Bank have dropped below their longer-term average. Most recently, the central government revised its growth projection for 2012 down to

### Continued expansion in the USA, slowdown in emerging Asian countries

*In some Asian emerging markets, leading indicators signal a slackening of business activity from its hitherto strong momentum.*

7.5 percent. WIFO expects a somewhat higher growth rate of 8 percent, but no acceleration of activity.

Demand and output in Japan surprised on the upside in early 2012, with a volume increase of 1.2 percent from the year-end quarter of 2011. Growth was almost entirely driven by private consumption, while investment and net external demand were broadly flat. Current survey results show a continued lack of confidence of private households and companies. Although GDP looks set to edge up only marginally over the remainder of the year, WIFO revises up its growth forecast for 2012 to slightly above 2 percent, on account of the strong result for the first quarter.

Table 2: World economy

	2008	2009	2010	2011	2012	2013
	Percentage changes from previous year					
<i>Real GDP</i>						
World	+ 2.8	- 0.6	+ 5.3	+ 3.9	+ 3.3	+ 3.7
USA	- 0.3	- 3.5	+ 3.0	+ 1.7	+ 2.0	+ 1.8
Japan	- 1.0	- 5.5	+ 4.4	- 0.7	+ 2.1	+ 1.7
EU 27	+ 0.3	- 4.3	+ 2.1	+ 1.5	± 0.0	+ 1.4
Euro area 16	+ 0.4	- 4.3	+ 1.9	+ 1.5	- 0.2	+ 1.1
Germany	+ 1.1	- 5.1	+ 3.7	+ 3.0	+ 0.7	+ 1.4
New EU countries <sup>1</sup>	+ 4.2	- 3.2	+ 2.3	+ 3.2	+ 1.6	+ 3.2
China	+ 9.6	+ 9.2	+ 10.4	+ 9.2	+ 8.0	+ 8.0
World trade, volume	+ 2.5	- 12.6	+ 14.9	+ 5.7	+ 4.0	+ 6.0
Market growth <sup>2</sup>	+ 3.0	- 11.4	+ 11.7	+ 6.1	+ 3.0	+ 5.7
<i>Primary commodity prices</i>						
HWWI index, total	+ 32.7	- 34.7	+ 28.9	+ 28.6	- 3	+ 3
Excluding energy	+ 18.7	- 28.4	+ 31.9	+ 19.2	- 10	+ 15
<i>Crude oil prices</i>						
Brent, \$ per barrel	97.0	61.5	79.5	111.3	110	110
<i>Exchange rate</i>						
\$ per euro	1.471	1.393	1.327	1.392	1.25	1.20

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

Like in the euro area, the economies of several East-Central European countries are close to stagnation. In Hungary and the Czech Republic, GDP actually contracted in the first quarter 2012, by 1.3 percent and 1.0 percent respectively. Apart from sluggish foreign demand from major euro area trading partners, fiscal restriction is weighing on activity, notably in Hungary. Moreover, the financial sector is inclined to reduce its exposure to risks by restraining credit growth, with a dampening impact both on consumption and investment.

The present forecast nevertheless expects for the seven EU member countries in East-Central Europe overall GDP growth of 1.6 percent on annual average 2012. Activity should pick up somewhat as from the second quarter, although remaining dampened by the persistent problems in the euro area. In 2013, real GDP growth is expected to accelerate to 3.2 percent, thereby maintaining a positive differential vis-à-vis the euro area.

Since the slump in real GDP by 4.3 percent in 2009, the euro area economy has been struggling with severe problems. GDP has still not returned to the level held in 2007. The confidence crisis on financial markets forces policy to early restraint in public finances which in turn have a dampening effect on growth. In the fourth quarter 2011 demand and output edged down by 0.3 percent from the previous period. The following stagnation in the first quarter 2012 was entirely owed to a temporary revival in Germany (+0.5 percent), whereas most other euro area countries saw no improvement. Thus, Spanish GDP shrank in the first quarter 2012 by 0.3 percent in volume for the second time in a row. Italy, Austria's second-largest trading

**Neighbouring countries in East-Central Europe suffer from the recession in the euro area**

**Relapse of the euro area economy into deep crisis**

partner, suffered the third straight decline, at accelerating momentum (third quarter 2011  $-0.2$  percent, fourth quarter  $-0.7$  percent, first quarter 2012  $-0.8$  percent). The downward trend persisted also in France where activity stagnated in the first quarter.

The weakness of the euro area economy is mirrored by a decline in industrial output. Having been on a downward trend since September 2011, the index dropped markedly in April, and leading indicators suggest further declines for the months to come. The industrial confidence index, after a short-lived stabilisation around the turn of the year 2011-12, also fell significantly in April and May. Output expectations as well as order levels were judged very pessimistic.

Likewise, surveys on consumer confidence reveal a high degree of scepticism on the part of private households. The index dropped massively until autumn 2011 and has picked up only little since.

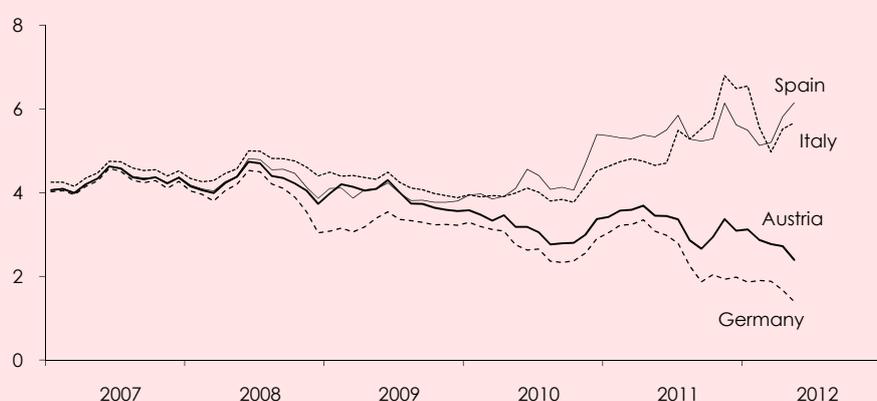
The present forecast therefore assumes that the short-term trend will remain heading down. Around the middle of the year, euro area GDP is likely to recede anew. For the year as a whole, WIFO expects a rate of  $-0.2$  percent (EU 27  $\pm 0$  percent).

Due to the unstable policy environment, the short-term cyclical outlook is particularly uncertain. Underlying the WIFO forecast are several benign assumptions:

- it is assumed that Monetary Union will be preserved in its current composition;
- it will be possible to reduce the substantial bond yield differentials across member countries in a timely and sustained manner;
- lately, Spain was forced to request financial support from the European Stabilisation Facility EFSF for the stabilisation of its distressed banking system. Current market rates on long-term government bonds imply a major increase in (re)financing cost. The pledge of rapid and large-scale financial aid from the EU failed, however, to reassure financial markets, as Spanish sovereign bond yields continued to climb, exceeding 7 percent in mid-June. A roll-over of maturing bonds at such interest rates would be very expensive, undermining efforts to reduce the government debt ratio. Italy, where bond yields were markedly above 6 percent in mid-June, may face a similar problem. In Germany, on the contrary, the government can currently obtain long-term financing at rates around 1.5 percent. Also in Austria, current interest rates on new long-term government bonds are at a low 2.3 percent.
- a further crucial assumption is that the strict fiscal adjustment programmes in the countries of the southern periphery of the euro area which have so far failed to convince financial markets will be somewhat relaxed in order to shift the emphasis towards a growth-friendly policy of investment.

Figure 1: Long-term government bond yield

Percent



Source: OeNB.

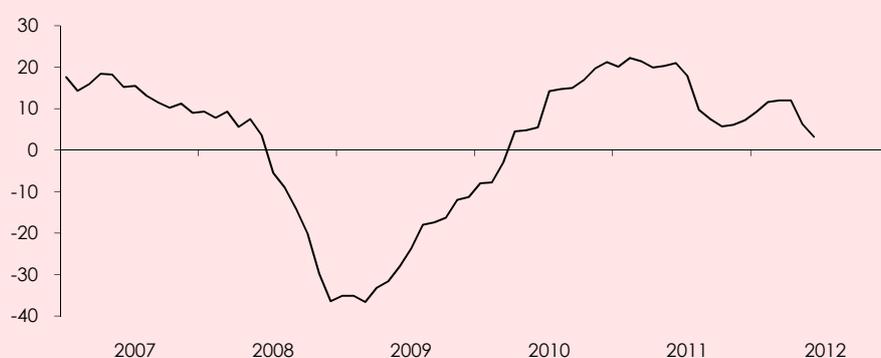
Under these assumptions, uncertainty of market participants in the euro area should abate and facilitate a gradual recovery, underpinned by a pick-up of activity at the global level and a lower euro exchange rate against the dollar. WIFO expects a tentative recovery for 2013, with euro-area real GDP rising by 1.1 percent. For the EU 27, growth should turn out somewhat higher at 1.4 percent.

The German economy, having expanded by a surprisingly strong 0.5 percent quarter-on-quarter in early 2012, is increasingly feeling the adverse repercussions from the euro area and the slackening of the boom in Asia.

The Ifo Business Climate Index was flat in April and dropped markedly in May, edging down further in June. Both the judgement of current business conditions and the balance of expectations receded significantly. For 2012, WIFO expects volume growth of German GDP at 0.7 percent, with a decline around mid-year not being excluded. In 2013, a gradual brightening of international business conditions should facilitate a strengthening of the growth momentum to a rate of 1.4 percent, again supported by the depreciation of the euro vis-à-vis the dollar.

Figure 2: Ifo Business Climate Index

Balance of positive and negative responses as a percentage of sampled firms, seasonally adjusted



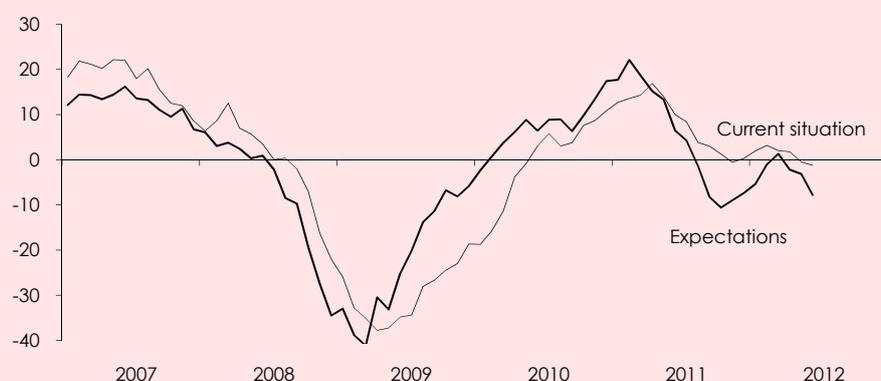
Source: Ifo.

Like in Germany, the Austrian economy has so far been somewhat sheltered from the crisis in the euro area. Nevertheless, leading indicators for both countries point to a substantial slackening of economic activity.

**Austria: slowdown  
from strong start  
into the year**

Figure 3: Results from the WIFO Business Cycle Survey

Indices for the assessment of current business conditions and for manufacturing firms' expectations for the next months



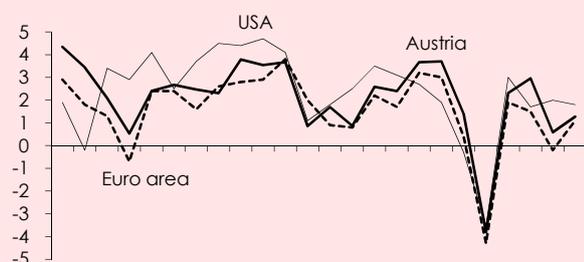
Source: WIFO Business Cycle Survey. Data refer to index points (percentage points) between +100 and -100. Values above 0 imply a positive assessment, values below 0 indicate a negative assessment.

After a steady slowdown of domestic activity during 2011, output growth rebounded temporarily in early 2012. In the first quarter, GDP gained 0.3 percent from the previous period. The year-on-year increase was even 2 percent, although the figure is biased upwards by the leap day and the early Easter date.

Figure 4: Indicators of economic performance

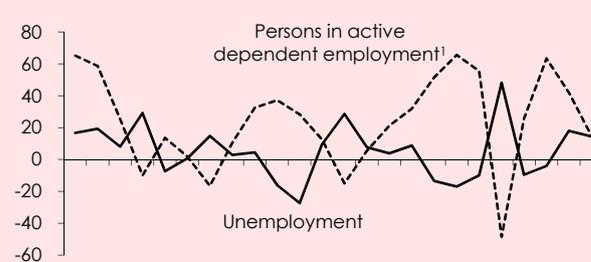
Growth of real GDP

Percent



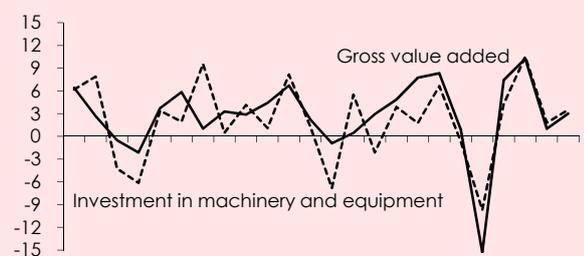
Employment and unemployment

1,000 from previous year



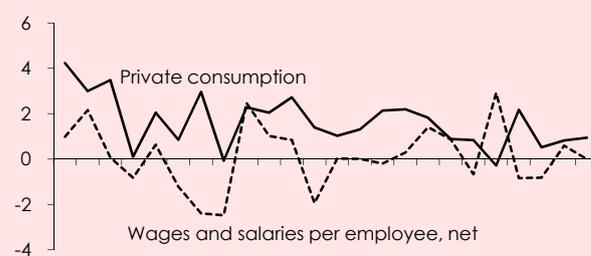
Manufacturing and investment

Percentage changes from previous year, volume



Consumption and income

Percentage changes from previous year, volume



Short-term and long-term interest rates

Percent



Inflation and unit labour costs

Percentage changes from previous year



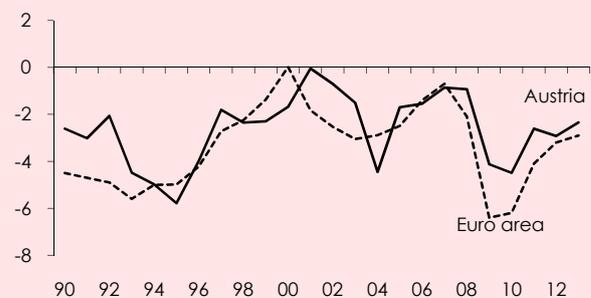
Trade

Percentage changes from previous year, volume



General government financial balance

As a percentage of GDP



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).

Net exports which had weighed on growth in the second half of 2011 turned significantly positive in the first quarter 2012. Gross fixed investment also contributed importantly to growth, although rising less than in late 2011, by 0.6 percent in volume after 0.9 percent.

Industrial production, retail sales and foreign trade fared relatively well until March. In April, the manufacturing output index remained flat (–0.2 percent), according to Statistics Austria. Leading indicators are signalling a slowdown: the regular WIFO Business Cycle Survey conducted on behalf of the European Commission is pointing clearly down, in parallel with the survey data for Germany. The assessment of the current situation by domestic manufacturers is weakening since February 2012, with the index dropping to a negative reading in May, back to the level of autumn 2011. Also companies' expectations for the next months turned more pessimistic in May and June, with the index predicting a fall in production. Firms are unsatisfied in particular with their orders from abroad. The Bank Austria Purchasing Managers Index fell in May for the third consecutive month, likewise announcing an imminent slowdown or stagnation of economic activity.

Against this background, WIFO expects Austria's real GDP growth for 2012 at 0.6 percent. From the previous forecast of last March this corresponds to an upward revision by 0.2 percentage point that is entirely due to the strong performance early this year. The future outlook, for its part, is less benign than at the time of the last revision as the policy environment has not improved, with the euro area debt crisis and the related financial sector problems still being unresolved. For this reason, also the GDP forecast for 2013 is taken down slightly to 1.3 percent. As illustrated by the underlying assumptions, WIFO nevertheless believes in the euro area countries taking effective measures both for the short and the medium term to cope with the most pressing problems, such that current market uncertainty will subside and give way to a pick-up of economic activity.

Merchandise goods production, which still fared comparatively well in early 2012, will be the most affected by weakening business conditions. Nevertheless, manufacturers apparently believe that the recession in the euro area will worsen their own situation only to a limited degree. Companies added significantly to their permanent staff in the first quarter 2012 (by 1.5 percent year-on-year according to the statistics of the social insurance agencies), partly by giving hired workers permanent contracts. In Germany, manufacturing employment even grew by 2.3 percent, much more than current business conditions would suggest.

Table 3: Productivity

	2008	2009	2010	2011	2012	2013
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 1.4	– 3.8	+ 2.3	+ 3.0	+ 0.6	+ 1.3
Employment <sup>1</sup>	+ 2.1	– 0.9	+ 0.8	+ 1.7	+ 1.2	+ 0.6
Productivity (GDP per employment)	– 0.7	– 2.9	+ 1.5	+ 1.2	– 0.6	+ 0.7
<i>Manufacturing</i>						
Production <sup>2</sup>	+ 0.9	– 15.3	+ 7.4	+ 10.2	+ 1.0	+ 3.0
Employees <sup>3</sup>	+ 1.7	– 5.3	– 1.3	+ 1.9	+ 1.3	– 0.2
Productivity per hour	– 0.3	– 7.3	+ 5.6	+ 8.4	+ 0.7	+ 2.9
Working hours per day per employee <sup>4</sup>	– 0.5	– 3.5	+ 3.0	– 0.1	– 1.0	+ 0.3

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.

Domestic investment is unlikely to rise further in 2012. In the regular WIFO Investment Survey of spring 2012, 44 percent of sampled manufacturing firms envisaged cuts from last year's spending on new machinery and equipment, 48 percent an increase and 8 percent wanted to keep it broadly unchanged. For the current year, WIFO expects equipment investment to expand by 1.8 percent, picking up to +3.5 percent in 2013.

The construction sector also enjoyed a significant demand increase in early 2012, by 3.1 percent in volume from one year ago and by 0.4 percent from the previous quarter after adjustment for seasonal and calendar effects. Growing uncertainty about the short-term outlook is weighing notably on demand for new commercial buildings, whereas civil engineering will feel the impact of cuts in new infrastructure projects in the context of fiscal consolidation. WIFO therefore expects overall investment in construction to edge up by only 0.4 percent in real terms in 2012 and continued sluggishness (+0.6 percent) in 2013.

In the first quarter 2012, private consumption rose by an inflation-adjusted 1.4 percent year-on-year. The figure is upward-biased by the leap day and the early Easter date. The outlook for the second quarter is in for a marked slowdown. In April, retail sales (excluding motor cars) dropped by 4.6 percent in volume; new car registrations also fell below the year-earlier level in April and May.

### Private consumption stabilising overall activity in 2012

Table 4: Private consumption, income and prices

	2008	2009	2010	2011	2012	2013
	Percentage changes from previous year					
Private consumption expenditure	+ 0.8	- 0.3	+ 2.2	+ 0.5	+ 0.8	+ 0.9
Durables	+ 3.7	+ 0.9	+ 5.8	+ 0.9	- 0.5	+ 0.5
Non-durables and services	+ 0.5	- 0.4	+ 1.8	+ 0.5	+ 1.0	+ 1.0
Household disposable income	+ 0.9	- 1.7	- 0.3	- 0.3	+ 0.6	+ 1.1
	As a percentage of disposable income					
Household saving ratio <sup>1</sup>	11.5	10.7	8.3	7.5	7.4	7.5
Household saving ratio <sup>2</sup>	11.4	10.1	7.8	7.0	6.8	7.0
	Percentage changes from previous year					
Direct lending to domestic non-banks <sup>3</sup>	+ 7.4	- 1.3	+ 2.9	+ 2.6	+ 2.6	+ 2.4
	Percentage changes from previous year					
Inflation rate						
National	3.2	0.5	1.9	3.3	2.3	1.9
Harmonised	3.2	0.4	1.7	3.6	2.4	1.9
Core inflation <sup>4</sup>	2.4	1.5	1.2	2.8	2.2	1.8

Source: WIFO Economic Outlook. – <sup>1</sup> Including adjustment for the change in net equity of households in pension fund reserves. – <sup>2</sup> Excluding adjustment for the change in net equity of households in pension fund reserves. – <sup>3</sup> End of period. – <sup>4</sup> Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

Table 5: Earnings and international competitiveness

	2008	2009	2010	2011	2012	2013
	Percentage changes from previous year					
Gross earnings per employee <sup>1</sup>	+ 3.2	+ 1.6	+ 1.2	+ 2.7	+ 3.2	+ 2.2
Gross real earnings per employee <sup>2</sup>	- 0.0	+ 1.1	- 0.6	- 0.5	+ 0.9	+ 0.3
Net real earnings per employee <sup>2</sup>	- 0.7	+ 2.9	- 0.8	- 0.8	+ 0.6	± 0.0
<i>Total economy</i>						
Unit labour costs	+ 3.7	+ 4.7	- 0.3	+ 1.4	+ 3.8	+ 1.4
<i>Manufacturing</i>						
Unit labour costs	+ 5.2	+ 15.1	- 5.7	- 4.5	+ 3.6	- 0.8
Effective exchange rate, manufactures						
Nominal	+ 1.1	+ 0.7	- 2.6	+ 0.0	- 1.3	- 0.5
Real	+ 0.6	+ 0.4	- 2.7	+ 0.7	- 1.4	- 0.7

Source: WIFO Economic Outlook. – <sup>1</sup> Employees according to National Accounts definition. – <sup>2</sup> Deflated by CPI.

On the back of strong employment gains and wage increases (by a projected nominal 3.2 percent per head), gross labour incomes rise markedly this year. With inflation receding, real disposable incomes expand faster than last year. Assuming a

broadly unchanged private household saving ratio of around 7.5 percent, private consumption in real terms should increase by a robust 0.8 percent and 0.9 percent in 2012 and 2013, respectively, thereby lending firm support to the stabilisation of activity.

While the major domestic credit institutions meet the enhanced equity capital requirements of "Basel III", problems in their foreign operations are weighing on earnings. Signs of a credit crunch continue to be absent: given the weakening growth outlook, sluggish credit growth in Austria is probably due to slackening demand. For 2012, WIFO assumes credit expansion of 2.4 percent, a rate broadly similar to last year's.

Financing conditions from the supply side thus remain rather favourable. Short-term interest rates for 3-months interbank credit remain very low in a long-range perspective, at 0.9 percent in 2012 and 1.0 percent in 2013; however, banks' actual refinancing cost is even lower since in many cases recourse is made to the low-cost funds supplied by the ECB. The forecast assumes no interest rate moves by the ECB over the entire horizon. Should the tensions in the euro area (sovereign bonds) and in the banking sector persist or exacerbate, the ECB may envisage a further cut in its key intervention rate.

For the Austrian sovereign, current refinancing conditions are extremely favourable. Until May, yields on Austrian 10-year government bonds averaged 2.9 percent, with a clear downward trend (May average: 2.5 percent). With the deepening of the euro area government debt crisis, demand for domestic government bonds increased further, driving down the market return to a historically low 2.0 percent by early June. For the whole of 2012 as well as for 2013, WIFO expects an average yield of 2.5 percent.

In May, consumer prices were up by 2.1 percent from the previous year, whereby the rate eased again from the preceding months (March +2.4 percent, April +2.3 percent). Strong upward pressure keeps being exerted by fuels and fossil car-burants. Although oil prices have recently declined markedly in dollar terms, the euro has at the same time depreciated against the dollar. On average 2011, one barrel of crude oil of type Brent cost \$ 111 or € 80 at an exchange rate of \$ 1.4 per €. The present forecast assumes for 2012 a broadly unchanged reference price of \$ 110 and a decline of the euro by 10 percent vis-à-vis the dollar (from \$ 1.39 per euro to \$ 1.25), implying an increase in oil prices in euro by about the same rate. The implicit increase in energy prices overall is nevertheless significantly smaller than last year.

Apart from the weaker dynamics of energy prices, headline inflation is dampened by the cyclical weakness and the slower upward drift of food prices. The latter rose by 3.8 percent in 2011. By May 2012, the rate had moderated to 2.1 percent, matching the rate of headline inflation. Against this background, WIFO expects an increase in consumer prices (as measured by the national index) by 2.3 percent in 2012 and 1.9 percent in 2013. Likewise, core inflation (according to the EU-wide Harmonised Index of Consumer Prices) is set to decelerate from 2.8 percent in 2011 to 2.2 percent in 2012 and 1.8 percent in 2013.

The number of persons employed has been rising at a steady pace ever since the recession of 2009 had been overcome, and despite the slackening of activity during 2011. Indeed, even as GDP edged down towards the end of last year firms continued to add to their personnel. According to the statistics by the Austrian social insurance agencies, the number of persons in dependent active employment rose by nearly 2 percent year-on-year throughout 2011. Also in the first quarter of 2012, job creation maintained a similar pace of +1.8 percent from one year ago. The increase in labour supply following the opening of the Austrian labour market for workers from the new EU countries in East-central Europe in May 2011 may have played a role. Yet, this does not explain the strong demand for workers from domestic companies in nearly all sectors, notably trade, tourism, health services and manufacturing.

## Financial conditions for Austria remaining favourable

## Inflation set to abate

*The cyclical weakness and the associated downward pressure on commodity prices should allow for a gradual moderation of inflation. In Austria, the annual increase in consumer prices is forecast to decelerate to 2.3 percent in 2012 and further to 1.9 percent in 2013.*

## Diverging trends on the labour market

In manufacturing, the number of persons in dependent active employment rose by 1.5 percent year-on-year in the first quarter 2012. Apparently, a substantial number of temporary staff from personnel service agencies was given regular contracts by their employers. In spite of such lively demand, overall manufacturing employment is still down from its pre-recession level of 2008. A similar trend has been observed in Germany: in spite of the marked slackening of activity during 2011 to a year-on-year increase of GDP of only 1.7 percent in the first quarter 2012, jobs in manufacturing were up by 2.3 percent in early 2012.

As the cyclical slowdown continues, job creation should also lose momentum. Due to the positive trend until May, WIFO expects the 2012 annual increase in the number of persons in dependent active employment at 1.3 percent, followed by a small 0.4 percent gain in 2013.

*Despite the weakening cyclical conditions, employment growth has been unabated so far. In the coming months, however, job creation is set to lose momentum and unemployment will rise further over the forecast period.*

Table 6: Labour market

		2008	2009	2010	2011	2012	2013
		Changes from previous year, in 1,000					
<i>Demand for labour</i>							
Persons in active employment <sup>1</sup>		+ 66.0	- 44.0	+ 31.3	+ 70.5	+ 47.0	+ 20.0
Employees <sup>2</sup>		+ 55.6	- 48.5	+ 25.5	+ 63.3	+ 42.0	+ 15.0
Percentage changes from previous year		+ 1.7	- 1.5	+ 0.8	+ 1.9	+ 1.3	+ 0.4
Nationals		+ 31.1	- 43.0	+ 5.8	+ 25.7	+ 11.0	+ 6.0
Foreign workers		+ 24.5	- 5.5	+ 19.7	+ 37.7	+ 31.0	+ 9.0
Self-employed <sup>3</sup>		+ 10.4	+ 4.5	+ 5.8	+ 7.2	+ 5.0	+ 5.0
<i>Labour supply</i>							
Population of working age							
	15 to 64 years	+ 27.7	+ 17.3	+ 21.6	+ 37.0	+ 15.0	+ 6.7
	15 to 59 years	+ 17.6	+ 11.1	+ 8.9	+ 17.1	+ 14.7	+ 10.8
Labour force <sup>4</sup>		+ 56.0	+ 4.0	+ 21.8	+ 66.4	+ 65.0	+ 34.5
<i>Surplus of labour</i>							
Registered unemployed <sup>5</sup>		- 10.0	+ 48.1	- 9.5	- 4.1	+ 18.0	+ 14.5
In 1,000		212.3	260.3	250.8	246.7	264.7	279.2
Unemployed persons in training <sup>5</sup>							
	in 1,000	50.5	64.1	73.2	63.2	67.2	70.2
In percent							
Unemployment rate							
Eurostat definition <sup>6</sup>		3.8	4.8	4.4	4.2	4.5	4.8
As a percentage of total labour force <sup>5</sup>		5.3	6.5	6.2	6.0	6.4	6.7
National definition <sup>5,7</sup>		5.9	7.2	6.9	6.7	7.1	7.4
Employment rate							
Persons in active employment <sup>1,8</sup>		65.7	64.7	65.0	65.9	66.5	66.8
Total employment <sup>6,8</sup>		72.1	71.6	71.7	72.1	72.4	72.5

Source: WIFO Economic Outlook. – <sup>1</sup> Excluding parental leave, military service. – <sup>2</sup> According to Federation of Austrian Social Security Institutions. – <sup>3</sup> According to WIFO. – <sup>4</sup> Persons in 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, excluding self-employed. – <sup>8</sup> As a percentage of population of working age (15 to 64 years).

Whereas labour demand has so far been resilient to the weaker cyclical outlook, unemployment has been clearly heading up since spring 2011. By May 2012, the number of jobless registered at the labour market service exceeded the year-earlier level by almost 10,000 or 4.4 percent. With the rising trend set to continue, the increase for the whole of 2012 is projected at 18,000 persons or 7.3 percent. Also in 2013, subdued economic growth will provide no relief for the labour market, as unemployment will move up by a further 14,500 persons or 5.5 percent.

Due to the favourable employment trend, the increase in the unemployment rate remains contained. The WIFO projection is for a rate of 7.1 percent in 2012 (after 6.7 percent in 2011) and 7.4 percent in 2013. According to the harmonised Eurostat statistics, the unemployment rate will move up from 4.2 percent in 2011 to 4.5 percent in 2012 and 4.8 percent 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.

### Average rates of change

The time given refers to the initial and the final value of the period of computation: hence the average rate 2005-2010 comprises as the first rate of change that from 2005 to 2006, and as the last that from 2009 to 2010.

### 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.itkt.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".

The measures adopted by the federal government for the consolidation of public finances will lead to a significant reduction of the budget deficit. For the current year, the consolidation target amounts to € 500 million, rising to € 1.7 billion in 2013.

In parallel, the unexpectedly strong employment gains lead to additional revenues in taxes and social security contributions. For Austrian government bond yields, WIFO now expects an even more marked decline than in the forecast of last March, i.e., from 3.3 percent in 2011 to 2.5 percent in 2012 and 2013. This significantly reduces the refinancing cost of maturing bonds and exonerates the budget balance without – unlike the consolidation measures – weighing on demand and output growth.

Under the above assumptions, WIFO projects the general government deficit at 2.9 percent of GDP for 2012, moderating to 2.3 percent in 2013. Here also, the uncertainties surrounding the present projections constitute a downside risk. In the event of a more negative course of events, policy should not try to lean against the implicit widening of the fiscal deficit. Rather, policy should accept a widening fiscal gap via the operation of automatic stabilisers and at the same time continue with medium-term structural reform. This holds not only for Austria, but even more for those countries in the euro area which currently suffer from particularly severe economic problems.

**Consolidation programme, employment gains and low financing cost will improve the budget balance**

Table 7: Key policy indicators

	2008	2009	2010	2011	2012	2013
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 0.9	- 4.1	- 4.5	- 2.6	- 2.9	- 2.3
General government primary balance	+ 1.7	- 1.3	- 1.8	- 0.0	- 0.3	+ 0.2
	Percent					
<i>Monetary policy</i>						
3-month interest rate	4.6	1.2	0.8	1.4	0.9	1.0
Long-term interest rate <sup>2</sup>	4.4	3.9	3.2	3.3	2.5	2.5
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+ 1.2	+ 0.9	- 2.5	+ 0.1	- 1.3	- 0.5
Real	+ 0.6	+ 0.4	- 2.7	+ 0.7	- 1.4	- 0.7

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