

WIFO

A-1103 WIEN, POSTFACH 91
TEL. 798 26 01 • FAX 798 93 86

 **ÖSTERREICHISCHES INSTITUT FÜR
WIRTSCHAFTSFORSCHUNG**

**The European Economy in
Recession – Domestic Policy
Action Cushioning the Downturn
Economic Outlook for 2009 and 2010**

December 2008

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

Economic Outlook for 2009 and 2010

December 2008

Austrian Institute of Economic Research

Abstract

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.

Please refer to: Marcus.Scheiblecker@wifo.ac.at

2008/435/SPE/WIFO project no: 28491

© 2008 Austrian Institute of Economic Research

Medieninhaber (Verleger), Herausgeber und Hersteller: Österreichisches Institut für Wirtschaftsforschung,
Wien 3, Arsenal, Objekt 20 • Postanschrift: A-1103 Wien, Postfach 91 • Tel. (+43 1) 798 26 01-0 • Fax (+43 1) 798 93 86 • <http://www.wifo.ac.at/> •
Verlags- und Herstellungsort: Wien

Verkaufspreis: 15,00 € • Download 15,00 €: http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=34839&typeid=8&display_mode=2

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.

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.

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.

17 December 2008

*For more details, please refer to Marcus Scheiblecker, Tel. (1) 798 26 01/245,
Marcus.Scheiblecker@wifo.ac.at.*

WIFO

Projections - December 2008

Main results

Percentage changes from previous year

		2005	2006	2007	2008	2009	2010
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
Manufacturing¹, 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 goods³							
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 goods³							
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	€ bn	+ 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 rate⁴	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	percent	5.2	4.8	4.4	3.5	3.9	4.1
National definition ⁶	percent	7.3	6.8	6.2	5.8	6.5	6.9
Persons in active dependent employment⁷		+ 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

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; break 2008.

⁶ Public Employment Service Austria, percent of total labour force excluding self employed.

⁷ Excluding parental leave, military service and unemployed persons in training.

WIFO

Projections - December 2008

Key policy indicators

	2005	2006	2007	2008	2009	2010
Fiscal policy						
	As a percentage of GDP					
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
Monetary policy						
	Percent					
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

¹ 10-year central government bonds (benchmark).

WIFO
Projections - December 2008

World economy

Percentage changes from previous year

	2005	2006	2007	2008	2009	2010
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 member states 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 growth²	+ 7.8	+ 11.1	+ 7.6	+ 4.8	- 1.0	+ 1.0
Primary commodity prices						
HWWI 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, USD per barrel	54.4	65.1	72.5	98	55	60
Exchange rate						
USD per euro	1.245	1.256	1.371	1.46	1.25	1.25

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

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

WIFO

Projections - December 2008

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
Household saving ratio						
As a percentage of disposable income	9.8	10.8	11.7	11.8	13.1	13.1
	Percentage changes from previous year					
Direct lending to domestic non-banks¹	+ 4.7	+ 4.5	+ 3.6	+ 6.0	+ 2.5	+ 3.5
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

¹ End of period.

² Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

Productivity

Percentage changes from previous year

	2005	2006	2007	2008	2009	2010
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

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.

WIFO*Projections - December 2008***Earnings and international competitiveness**

Percentage changes from previous year

	2005	2006	2007	2008	2009	2010
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
<i>Total economy</i>						
Unit labour costs	+ 0.7	+ 1.1	+ 0.8	+ 3.3	+ 3.2	+ 1.5
<i>Manufacturing</i>						
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

¹ Employees according to National Accounts definition.

WIFO

Projections - December 2008

Labour market

Changes from previous year (1,000^s)

	2005	2006	2007	2008	2009	2010
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
<i>Percentage changes from previous year</i>	+ 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
1,000 ^s	252.7	239.2	222.2	210.6	237.6	252.6
Unemployed persons in training	1,000 ^s 48.6	57.5	52.7	50.6	57.6	62.6
Unemployment rate						
Eurostat definition ^{6,7}	percent 5.2	4.8	4.4	3.5	3.9	4.1
Percent of total labour force ⁵	percent 6.5	6.1	5.6	5.2	5.9	6.2
National definition ^{5,8}	percent 7.3	6.8	6.2	5.8	6.5	6.9
Employment rate						
Persons in active employment ^{1,9}	percent 62.8	63.6	64.5	65.8	65.3	65.1
Total employment (Eurostat) ^{6,9}	percent 68.6	70.2	71.4	72.3	71.7	71.5

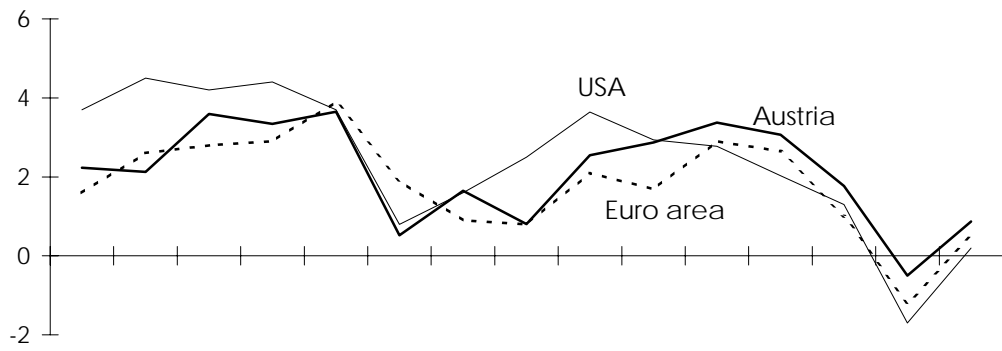
¹ Excluding parental leave, military service, and unemployed persons in training. ² According to Federation of Austrian Social Security Institutions. ³ According to WIFO. ⁴ Economically active employment plus unemployment.

⁵ According to Public Employment Service Austria. ⁶ According to Eurostat Labour Force Survey. ⁷ Break 2008.

⁸ Percent of total labour force excl. self-employed. ⁹ Percent of population of working age (15 to 64 years).

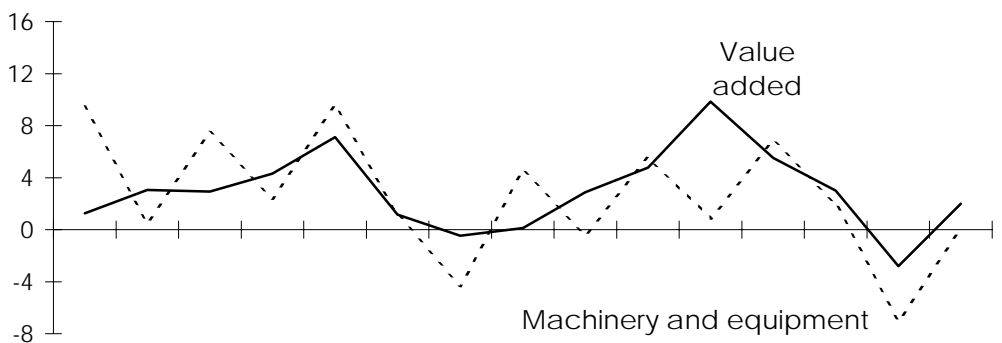
Growth of real GDP

Percent



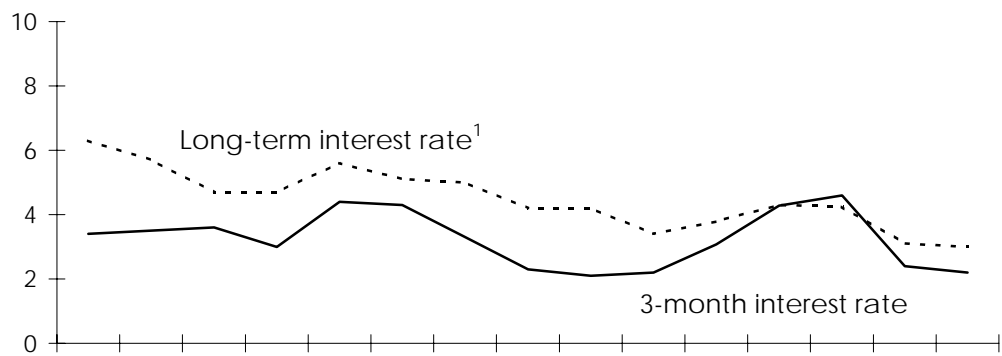
Manufacturing and investment

Percentage changes from previous year, volume



Short-term and long-term interest rates

Percent



Trade

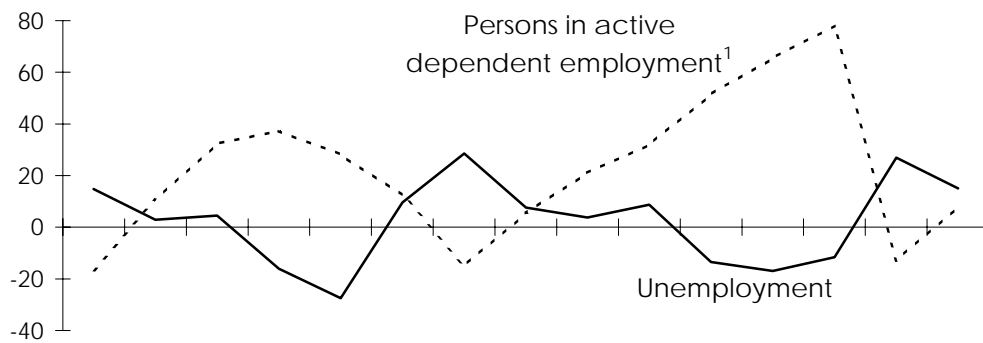
Percentage changes from previous year, volume



¹ 10-year central government bonds (benchmark).

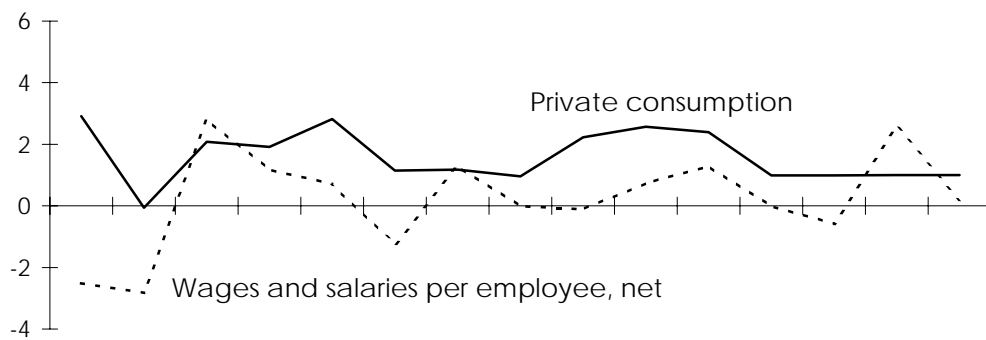
Employment and unemployment

1,000^s from previous year



Consumption and income

Percentage changes from previous year, volume



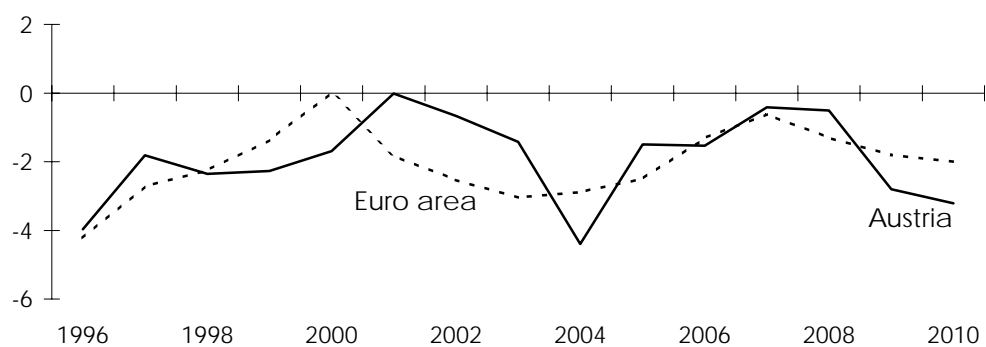
Inflation and unit labour costs

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.