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# Euro Area Economy Drawing Lagged Benefits from Currency Depreciation and Buoyant Global Trade

## Economic Outlook for 2010 and 2011

**World trade rebounded further in the first few months of 2010, its volume meanwhile approaching the pre-crisis level. On the back of the boom in Asia, the recovery in the USA and the depreciation of the euro, euro area exports should make good headway. Nevertheless, the cyclical upturn will remain muted for still some time, due to sluggish internal demand. Major risks derive from macroeconomic imbalances and financial market volatility. For Austria, WIFO expects real GDP to grow by 1.2 percent in 2010 and 1.6 percent in 2011.**

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World trade rebounded further in the first few months of 2010, meanwhile nearly reaching the pre-crisis level of spring 2008. Restocking in the industrialised countries since autumn 2009 boosted commercial trade. Moreover, the unabated swift expansion in Asia kept import demand from the region at high levels. It is currently a major driver of the global recovery from which the economies of the USA and the euro area benefit through a revival of their exports.

In the USA, cyclical conditions have improved markedly since autumn 2009. Investment in machinery and equipment as well as private consumption picked up significantly. However, with the expiry of the government stimulus programmes the momentum may slow again 2011. In the euro area, internal demand has remained sluggish so far. Such time-lag vis-à-vis the USA has also been observed in earlier cyclical upturns. The trough in the euro area has typically been reached 2 to 4 quarters after the USA. This time again, the rebound in world trade and the depreciation of the euro, with the nominal-effective exchange rate down by 10 percent from the level at the beginning of the year, will sustain economic activity in the euro area.

The latest turbulences in bond markets, triggered by macroeconomic imbalances and high government debt in some countries, act as a further drag on a recovery that will be uneven across the euro area. Since early May, several countries have presented plans for fiscal retrenchment. In the Mediterranean deficit countries, these have been massive as dictated by events, weighing on growth prospects for 2010 and 2011. Nevertheless, the repercussions on the recovery in other euro area countries should remain limited.

In the other euro area countries, the rebound in world trade and the depreciation of the euro will foster the recovery. Measures of fiscal consolidation have generally been defined in only vague terms so far and are likely to turn out moderate in most cases. Consolidation measures announced in Germany amount to 0.5 percent of GDP in 2011, and should therefore not dampen aggregate demand substantially.

Despite strong exports, the cyclical recovery in the euro area will remain muted for still some time. WIFO projects real GDP growth at 0.9 percent for 2010 and 1.2 percent in 2011 – for Germany at 1.3 percent and 1.7 percent, respectively. One retarding factor is a weak recovery in private investment, which is dampened by the prevailing low capacity utilisation; another one is the persistent fragility on financial mar-

kets, which keeps uncertainty (as perceived by economic agents) high, and continues to pose downside risks. The forecast assumes that these risks will slow the momentum of recovery only to a small extent. As the global upswing proceeds and policy co-ordination among the euro area countries is improved, the danger of renewed turbulence should fade. Should private sector confidence return with progress in fiscal consolidation, the positive impulse from global growth may stimulate the euro area economy even sooner. At the same time, fiscal consolidation efforts should take into account the short-term effect on aggregate demand in the euro area, while also supposed to strengthen the long-run forces of growth.

Table 1: Main results

		2006	2007	2008	2009	2010	2011
		Percentage changes from previous year					
<b>GDP</b>							
Volume		+ 3.5	+ 3.5	+ 2.0	- 3.5	+ 1.2	+ 1.6
Value		+ 5.2	+ 5.7	+ 4.1	- 1.7	+ 2.1	+ 3.3
Manufacturing <sup>1</sup> , volume		+ 9.0	+ 7.3	+ 3.9	- 11.5	+ 3.5	+ 5.8
Wholesale and retail trade, volume		+ 0.8	+ 0.7	+ 0.6	- 3.1	+ 1.2	+ 0.7
Private consumption expenditure, volume		+ 1.8	+ 0.8	+ 0.8	+ 0.4	+ 0.9	+ 0.6
Gross fixed investment, volume		+ 2.4	+ 3.8	+ 1.0	- 8.1	- 3.2	+ 1.9
Machinery and equipment <sup>2</sup>		+ 2.0	+ 4.7	+ 0.1	- 10.6	- 6.0	+ 4.0
Construction		+ 2.8	+ 2.9	+ 1.8	- 6.0	- 1.0	+ 0.3
<b>Exports of goods<sup>3</sup></b>							
Volume		+ 6.4	+ 9.0	+ 0.3	- 18.2	+ 5.8	+ 6.6
Value		+ 9.5	+ 10.5	+ 2.5	- 20.2	+ 6.6	+ 7.9
<b>Imports of goods<sup>3</sup></b>							
Volume		+ 4.1	+ 7.6	+ 0.2	- 15.8	+ 2.8	+ 5.0
Value		+ 8.0	+ 9.6	+ 4.7	- 18.4	+ 5.4	+ 6.2
Current balance	billion €	+ 7.26	+ 9.62	+ 9.24	+ 6.32	+ 8.05	+ 10.73
As a percentage of GDP		+ 2.8	+ 3.6	+ 3.3	+ 2.3	+ 2.8	+ 3.7
Long-term interest rate <sup>4</sup>	in percent	3.8	4.3	4.4	3.9	3.2	2.8
Consumer prices		+ 1.5	+ 2.2	+ 3.2	+ 0.5	+ 1.8	+ 2.1
<b>Unemployment rate</b>							
Eurostat definition <sup>5</sup>	in percent	4.8	4.4	3.8	4.8	4.9	5.0
National definition <sup>6</sup>	in percent	6.8	6.2	5.8	7.2	7.2	7.3
Persons in active dependent employment <sup>7</sup>		+ 1.7	+ 2.1	+ 2.4	- 1.4	+ 0.5	+ 0.5
<b>General government financial balance according to Maastricht definition</b>							
As a percentage of GDP		- 1.5	- 0.4	- 0.4	- 3.4	- 4.6	- 3.8

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

In the Central and Eastern European countries, economic performance will be uneven. Neighbouring CEECs will continue to benefit from the recovery in the euro area. In the countries with high private household debt (as a percentage of GDP; e.g., Hungary, Romania, Baltic States) and in the Balkan region, GDP growth is expected to remain flat at least until the end of 2010.

In 2011, the Austrian federal government plans to introduce a consolidation package totalling € 4 billion or 1.4 percent of GDP. This will take the general government deficit ratio from 4.6 percent in 2010 to 3.8 percent in 2011. However, since the measures are not yet specified in detail, the present projections are based on tentative technical assumptions about the structure of consolidation moves.

For Austria, WIFO expects real GDP growth to accelerate from 1.2 percent in 2010 to 1.6 percent in 2011. The recovery will be driven by exports of goods as the economy

benefits from the benign international environment – mainly indirectly and thus with a certain lag via exports to Germany and other euro area countries.

The small downward revision of growth for 2010 from the earlier WIFO forecast of last March is due to the weak outcome in the first quarter. For the remainder of the year, GDP is expected to edge up by an average of 0.5 to 0.6 percent quarter-on-quarter.

The Austrian labour market has taken an encouraging development since the beginning of the year. Manufacturing employment has stopped falling in recent months, though being clearly down from year-earlier levels. The number of jobs keeps growing in public and quasi-public services (education and training, health and social services, administration). For the years 2010 and 2011, employment is expected to rise by 0.5 percent each. The unemployment rate will nevertheless keep shifting up somewhat until 2011, due to the simultaneous increase in labour supply.

Net real wages on a per-capita basis will edge down by 0.5 percent each in 2010 and 2011, as a result of moderate wage settlements as well as a pick-up in inflation. Mainly on account of higher import prices for crude oil, headline inflation will move up to 1.8 percent in 2010 and 2.1 percent in 2011. WIFO also assumes that in 2011 an increase in indirect taxes will add 0.4 percentage points to the inflation rate. Despite lower real wages and fiscal consolidation measures, private real disposable income may edge up slightly in both years, as a result of cyclically-induced gains in income from property and wealth. On the back of a declining saving ratio, private consumption should grow by an inflation-adjusted 0.9 percent in 2010 and 0.6 percent in 2011.

Corporate profits will normalise as the recovery gains ground. Nevertheless, the still low capacity utilisation suggests that investment will remain sluggish for some time. Firms' spending on machinery and equipment should no longer fall in the second half of the year, i.a., because of the imminent expiry of the accelerated depreciation allowance in December. The negative carry-over from 2009 and the weak first quarter will drag down the annual figure for 2010 to a 6 percent slump. Construction investment will remain subdued over the entire projection period.

In late 2009 and early 2010, world trade expanded by more than 5 percent quarter-on-quarter, respectively. In April, it was only 5½ percent (in volume terms) below its peak of April 2008. Euro area merchandise exports rose by 3.1 percent in the first quarter from the previous period, imports by a markedly weaker 1.2 percent<sup>1</sup>.

An important driver of the rebound in world trade is stockbuilding in the USA and, to a lesser extent, in the euro area which began in the early stage of the upswing in autumn 2009, leading to a swift revival of the exchange of goods. This is reflected by the jump in US foreign trade figures in the third and fourth quarter 2009.

Indeed, a large part of GDP growth in the USA as well as the euro area is explained by the change in inventories since the third quarter 2009. The sharp run-down in stocks in early 2009 has probably been largely corrected by now, with the stock/output ratio approaching its normal level. Thus, for the months to come, industrialised countries may expect a smaller, though still positive growth contribution from stockbuilding.

A second key driver of the recovery of global trade has been strong internal demand in Asia and Latin America. With import growth above 10 percent in the fourth quarter 2009 and the first three months of 2010, major incentives came from Asian countries where GDP growth eased only little in 2009 and the financial market crisis left domestic banks largely unaffected. China has stimulated domestic demand massively during the crisis. The expansion of productive capacities in the course of the long-term catching-up process provides incentives for the internal sources of growth and reduces the region's export dependency. Thus, GDP growth in Asia will

### World trade nearly back to pre-crisis level

*World trade volumes have expanded strongly since autumn 2009 and are now close to pre-crisis levels. Stocks are being replenished in the industrialised countries, and strong Asian demand for imports will continue to support global business activity.*

<sup>1</sup> World trade data according to the Netherlands' Centraal Planbureau.

be resting on a broad base in the years to come even after the expiry of fiscal stimulus in China. For the Chinese economy, WIFO projects demand and output to expand by an annual 9 to 10 percent in 2010 and 2011.

Table 2: World economy

	2006	2007	2008	2009	2010	2011
	Percentage changes from previous year					
<i>Real GDP</i>						
World	+ 5.2	+ 5.2	+ 2.9	- 0.9	+ 3.9	+ 3.5
USA	+ 2.7	+ 2.1	+ 0.4	- 2.4	+ 3.0	+ 2.4
Japan	+ 2.0	+ 2.4	- 1.2	- 5.2	+ 2.5	+ 1.7
EU 27	+ 3.2	+ 2.9	+ 0.8	- 4.2	+ 1.0	+ 1.4
Euro area 16	+ 3.0	+ 2.8	+ 0.6	- 4.1	+ 0.9	+ 1.2
Germany	+ 3.2	+ 2.5	+ 1.3	- 5.0	+ 1.3	+ 1.7
New EU countries <sup>1</sup>	+ 6.5	+ 6.1	+ 3.8	- 3.0	+ 1.4	+ 2.7
China	+ 11.6	+ 13.0	+ 9.7	+ 8.7	+ 10.0	+ 9.0
World trade, volume	+ 8.9	+ 7.1	+ 2.1	- 12.9	+ 12.0	+ 8.0
Market growth <sup>2</sup>	+ 10.6	+ 7.1	+ 3.3	- 11.4	+ 5.6	+ 6.2
<i>Primary commodity prices</i>						
HWWI index, total	+ 19.7	+ 3.7	+ 22.4	- 29.2	+ 27	+ 10
Excluding energy	+ 22.0	+ 9.5	+ 15.6	- 22.7	+ 21	+ 11
<i>Crude oil prices</i>						
Brent, \$ per barrel	65.1	72.5	97.0	61.5	76	80
<i>Exchange rate</i>						
\$ per euro	1.256	1.371	1.471	1.393	1.30	1.25

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

The stabilisation of US business activity was initially supported by the massive fiscal stimulus in the first half of 2009. Since the third quarter 2009, also the other demand components have been picking up. With the rebound in business confidence, the incipient build-up of inventories (or the end of de-stocking) gave positive incentives to production. As firms have succeeded in substantially raising profitability since the second half of 2009, investment in machinery and equipment has returned to positive growth in the year-end quarter.

Private consumption is also reviving since the third quarter of last year. Optimism has apparently returned to private households, with consumer confidence rising in recent months, before falling back in June. With house prices stabilising, the tension on real estate markets eased somewhat and also the labour market has recently shown signs of a turnaround, even if the unemployment rate remains at a high 9.7 percent.

In 2009, monetary and fiscal policy were decidedly expansionary. The general government deficit rose to 11.0 percent of GDP, and the public debt ratio of 84.0 percent of GDP came to exceed that of the euro area. Meanwhile, the policy stance has moved to wait-and-see mode, with no measures to reduce the deficit being currently envisaged. According to OECD estimates, the expiry of the fiscal stimulus programmes will nevertheless reduce the structural deficit ratio for 2011 by 1.5 percentage points as compared with 2009.

Given these circumstances, WIFO expects US real GDP growth at 3.0 percent for 2010 and 2.4 percent for 2011. The cyclical upswing should continue even in the absence of further substantial fiscal stimulus, although the momentum may weaken again. High private household indebtedness and high unemployment remain factors of risk for the further path of private consumption. Nevertheless, the overall recovery should receive sufficient support from buoyant demand from Asia and Latin America.

## Recovery in the USA strengthening

*In the last few months, the cyclical upturn in the USA has become more broad-based. Economic policy has adopted a wait-and-see attitude. The risk remains that after the expiry of government stimulus programmes the recovery falters.*

A critical element for the cyclical recovery in the euro area in 2011 are the mutual repercussions of fiscal policy and internal demand. Deficit reduction requires appropriate timing in order to avoid a setback in the economic recovery and at the same time the maintenance of confidence in the sustainability of public finances.

The aggregated general government deficit of the euro area amounted to 6.3 percent of GDP in 2009, gross public debt stood at 78.7 percent of GDP. On the technical assumption of unchanged fiscal policies (taking only legally adopted fiscal measures into account), the European Commission projects the debt ratio to rise to 88.5 percent by 2011.

The Stability Programmes of the euro area countries provide for a stepwise reduction of deficits as from 2011. In order to ensure the servicing of sovereign debt, the deficit countries of the Mediterranean (Spain, Greece and Portugal) adopted sizeable consolidation measures in April and May 2010, parts of which will take effect still this year. Apart from high budget deficits, these countries also suffer from a loss of competitiveness over the last years and the resulting large current account deficits. Demand and output in the three countries are likely to decline further in 2010.

Model simulations suggest, however, that output losses in these countries have only a limited adverse effect on GDP growth in the rest of the euro area. This is explained by these countries' relatively small share in overall exports of Germany and France. Indeed, about half of the major euro area countries' exports go to EU third countries. In any case, the strong rebound of world trade and the depreciation of the euro will more than offset the dampening effects of the consolidation measures.

Likewise, the consolidation measures in other EU countries should, from today's perspective, dampen only moderately economic growth in the euro area. In Germany, the measures planned for 2011 add up to only 0.5 percent of GDP. Plans for France and Italy have not yet been defined in concrete terms, but are estimated at around 1 percent of GDP for 2011. However, the Czech Republic and Hungary plan more severe measures of fiscal restraint which would weigh on Austrian exports to the two countries. The government of the UK has announced a programme of pronounced fiscal retrenchment for the next two years.

Table 3: Shares of selected regions in goods exports of major EU countries, 2009

	Euro area		8 new EU countries	USA	Asia	Rest of the world
	North	South				
	In percent					
Germany	30.8	12.3	9.7	6.7	7.3	30.8
France	30.8	18.9	3.9	5.8	5.4	30.8
Italy	32.8	10.5	6.6	5.9	4.6	32.8
Spain	37.5	18.8	3.7	3.6	2.8	37.5
Austria	41.1	13.4	11.9	4.3	3.7	41.1

Source: WIFO. Euro area south . . . Italy, Spain, Portugal, Greece, Malta and Cyprus, euro area north . . . other Euro area countries.

The impacts of the loss of confidence following the turbulence on bond markets in May 2010 on the recovery are currently difficult to assess. Surveys conducted in June indicated a slight weakening in consumer sentiment and business expectations, while the actual level of company orders has further increased. Therefore, the WIFO projections assume only a minor easing of aggregate demand in the EU.

While the export-oriented sectors in the euro area take part in the revival of global trade since the third quarter 2009, internal demand remains lacklustre. In the first three months of 2010, corporate investment declined further and private consumption remained flat.

The strong rebound of world trade and the depreciation of the euro (with a fall in the nominal-effective exchange rate by some 10 percent since the beginning of 2010) have brightened the prospects for exports in 2010 and 2011. Therefore, in most

## Consolidation measures in deficit countries with limited impact on rest of euro area

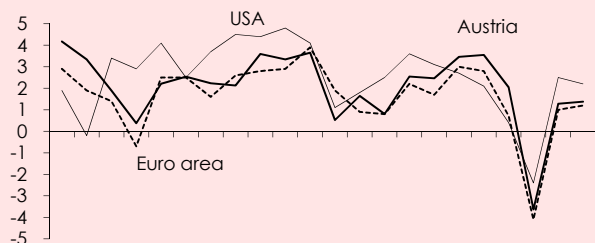
*Latest turbulences on secondary markets for sovereign bonds will weigh on the cyclical recovery in Mediterranean deficit countries. The consolidation packages adopted in these countries will, however, be of limited impact on the rest of the euro area. Other countries envisage for 2011, on current information, only moderate fiscal restraint (with the exception of the UK and Ireland). In designing consolidation measures, due regard should be given to their likely impact on domestic demand.*

## Upswing in the euro area delayed

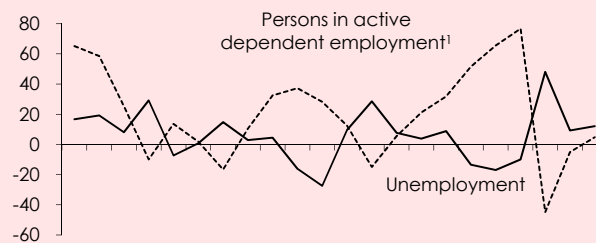
countries of the euro area an export-driven upswing should set in, notably in Germany.

Figure 1: Indicators of economic performance

Growth of real GDP  
Percent



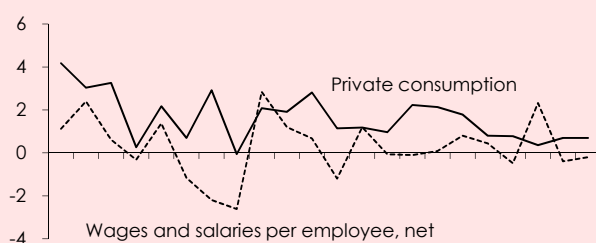
Employment and unemployment  
1,000 from previous year



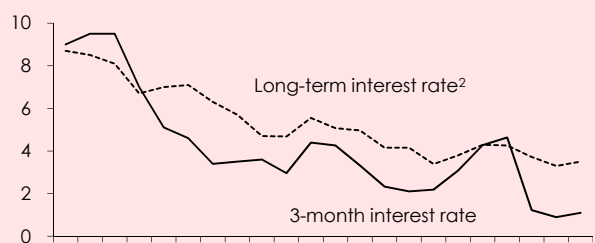
Manufacturing and investment  
Percentage changes from previous year, volume



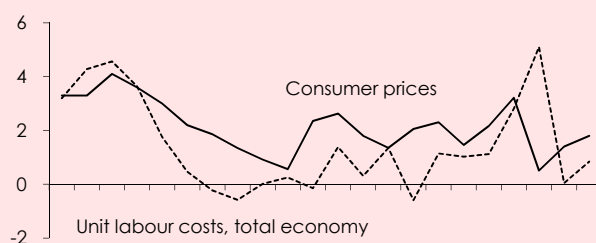
Consumption and income  
Percentage changes from previous year, volume



Short-term and long-term interest rates  
Percent



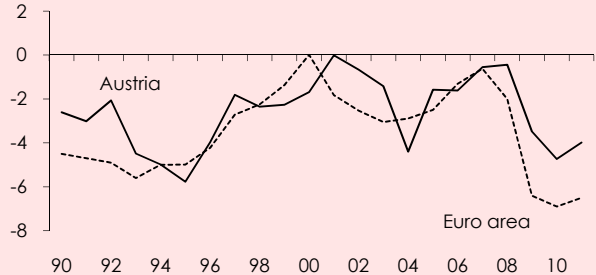
Inflation and unit labour costs  
Percentage changes from previous year



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).

Business surveys from spring 2010 actually show a continued improvement of order levels. Nevertheless, any conclusions from these qualitative survey data on the momentum of the upswing should be drawn with caution, as the data exaggerated actual developments in the second half of 2009 and early 2010.

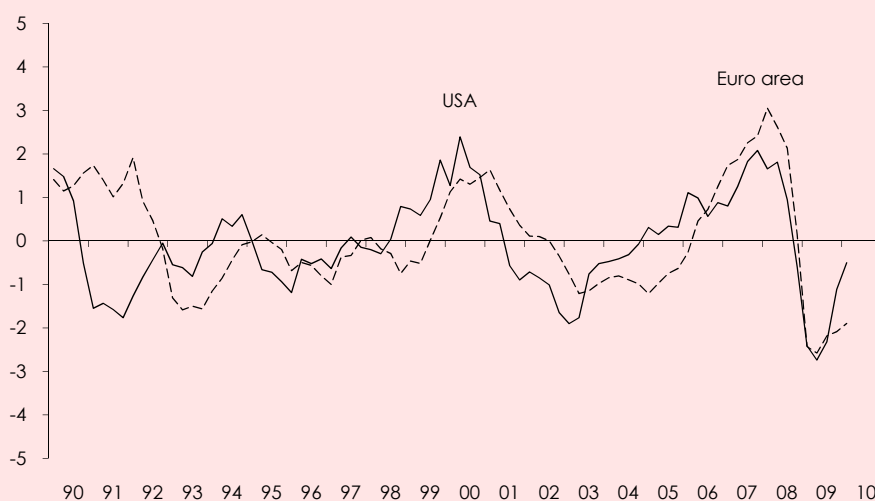
In particular internal demand is likely to remain subdued in 2010. Inflation in the euro area is set to go up from 0.3 percent in 2009 to around 1½ percent in 2010 on the back of currency depreciation, edging up somewhat further in 2011 due to lagged effects of a weaker euro and a number of tax increases. In many countries, labour market conditions will weaken once again. Employment is projected to fall by around 1 percent, before stabilising in 2011. Thus, personal incomes will post only small gains, despite fiscal restraint being moderate altogether.

Even with brighter export prospects, the prevailing low degree of capacity utilisation will hold back a pick-up in private investment throughout 2010. Although capacity utilisation in manufacturing has increased noticeably since autumn 2009, at 75.5 percent in the second quarter 2010 it was far below its long-term average of 82 percent and still somewhat lower than at the troughs during the recessions of 1993 and 2003 respectively.

*The euro area economy will benefit from the strong rebound in global trade and the depreciation of the euro. Yet, sluggish internal demand will make for another muted cyclical recovery in the EU.*

Figure 2: Business cycles

Deviation of real GDP from trend, in percent



Source: WIFO. Estimation of cyclical component with Hodrick-Prescott filter.

For these reasons, the cyclical recovery in the euro area promises to be rather hesitant and uneven during 2010 and 2011. WIFO expects GDP growth at 0.9 percent for 2010 and 1.2 percent for 2011. The German economy, major beneficiary of better export opportunities, is set to grow above the average in both years, at 1.3 percent and 1.7 percent respectively.

A lagging recovery in the euro area would be in line with the pattern observed in earlier cycles. The beginning and the end of a recession tend to occur in the USA two to four quarters ahead of the euro area. Moreover, the US economy typically recovers more quickly from recessions, probably for two major reasons: first, since corporate profits become more quickly restored due to higher flexibility of structural and labour market adjustment, US companies start stepping up investment relatively earlier; second, US economic policy traditionally takes a more pro-active stance than policy in the euro area. Both features can also be observed in the present context.

Prospects for the Central and Eastern European countries (CEECs) are also somewhat mixed. While exports of the new EU member countries will rebound across the board in 2010 and 2011, the strength of domestic demand will be uneven. Overall, WIFO projects real GDP growth for eight new EU member countries at 1.4 percent in 2010 and 2.7 percent in 2011.

## Central and Eastern European countries

The Polish economy has weathered the crisis best of all in 2009 and expects GDP growth of nearly 3 percent this year. Likewise, the Czech and Slovak economies will stage a gradual recovery already in 2010, with projected growth rates of around 1½ percent and 3 percent respectively.

In countries with high current account deficits and high private household indebtedness (Hungary, Romania, Bulgaria, Baltic States), internal demand should take a further setback in 2010, before petering out in 2011. High interest rates and weak competitiveness weigh on economic performance of these countries which in 2009 suffered an above-average fall in real GDP. In order to prevent the euro area debt crisis from spilling over to them, some countries took measures of fiscal retrenchment in recent months. Also in other countries in Southern Europe and in the CIS, demand and output should advance at a rather modest pace.

For 2011, the federal government envisages a fiscal consolidation programme to the tune of € 4 billion or 1.4 percent of GDP, some € 800 million of which to be contributed by the Länder. Details of the programme have not yet been announced. Some 40 percent of the overall consolidation amount are to be provided by revenue-side measures. The WIFO projections rest on the technical assumption that half of the additional revenue will be generated by higher indirect taxes (e.g., on energy consumption), the other half by increases in direct taxes and social contributions. The planned expenditure restraint is tentatively allocated between cuts of material purchases, personnel outlays, social transfers in cash and public investment.

On these assumptions, the WIFO forecast yields a decline in the general government deficit from 4.6 percent of GDP in 2010 to 3.8 percent in 2011. A favourable employment trend and low bond yields will support the consolidation efforts.

For Austria, WIFO projects real GDP growth of 1.2 percent for 2010 and 1.6 percent for 2011. The recovery is driven by merchandise exports which are heading up since the third quarter 2009. After a deceleration in early 2010, stronger advances may be expected in the further course of the year.

Export markets will expand at a solid pace of 5.6 percent and 6.2 percent in 2010 and 2011 respectively. In both years, goods exports, rising 5.8 percent and 6.6 percent in volume, will outpace market growth. The direct impact of euro depreciation on Austrian exports will be small: since the CEEC currencies and the Swiss Franc have largely followed the decline of the euro, the nominal-effective exchange rate for Austrian manufactures will likely edge down in 2010 by only 0.7 percent from the previous year.

Exports benefit less from internal demand in the euro area itself than indirectly from buoyant demand in Asia and other major zones. Exports to neighbouring CEECs (Slovakia, Slovenia, Hungary, Czech Republic) also picked up in the last few months and should keep lively forward momentum. However, deliveries to the other CEECs have remained sluggish so far and may not revive before 2011.

Merchandise imports will rise markedly less than exports in 2010. While higher exports will also raise demand for imported inputs, subdued demand for consumer durables and the sharp year-on-year fall in machinery and equipment investment will limit the increase in goods imports to 2.8 percent in volume. As private investment recovers and exports post further gains, imports are expected to increase by 5.0 percent in 2011.

Net exports are therefore set to provide a major contribution of 1.2 percentage points to GDP growth in 2010, before edging down to 0.9 percentage points on the back of stronger imports.

Import prices for crude oil and other commodities will jump as a result of the weakening of the euro against the dollar in 2010. The prices for other import goods will be little affected, as suggested by the small change in Austria's nominal-effective exchange rate. Foreign trade prices will move up somewhat in 2010, mainly through indirect effects via the European trading partners.

### **Austria: fiscal consolidation in 2011**

*The planned fiscal consolidation, coupled with the cyclical recovery, will allow the general government deficit to fall from 4.6 percent of GDP in 2010 to 3.8 percent in 2011.*

### **Merchandise exports driving the recovery**

*Exports of goods to other euro area countries and to neighbouring CEECs should exhibit strong momentum in 2010 and 2011.*



Despite the rise in import prices, the trade balance will improve in both years of the projection period.

Gross fixed capital formation slumped by 8.1 percent in 2009. Despite a tentative rebound in the course of 2010, it will fall by a further 3.2 percent on annual average due to the negative carry-over from last year. For 2011, WIFO expects an increase by 1.9 percent.

Corporate spending on machinery and equipment is particularly volatile over the business cycle, as it is determined primarily by sales expectations in relation to spare productive capacity. In the recession, machinery investment caved in, down by an inflation-adjusted 13.2 percent in 2009 from the year-earlier level. A further decline by a seasonally-adjusted 2.4 percent from the previous period was recorded in the first quarter 2010.

Even though the cyclical outlook has brightened meanwhile, machinery and equipment investment may revive only gradually, given the persistent under-utilisation of production capacities. Similar to the euro area average, capacity utilisation in manufacturing according to the WIFO investment survey stood at 79.2 percent in the second quarter 2010, roughly corresponding to the low points of earlier recessions. Industrial output in April was 10 percent below the last peak of January 2008. Whereas demand for commodities and intermediate goods bounced back quickly, in line with the replenishment of inventories, demand for consumer durables and investment goods trailed somewhat behind.

### Investment to revive only gradually

*Investment in machinery and equipment will pick up only step by step, given the low capacity utilisation. Also the sluggishness in construction is likely to persist.*

Table 4: Productivity

	2006	2007	2008	2009	2010	2011
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 3.5	+ 3.5	+ 2.0	- 3.5	+ 1.2	+ 1.6
Employment <sup>1</sup>	+ 1.5	+ 1.7	+ 2.3	- 1.1	+ 0.6	+ 0.7
Productivity (GDP per employment)	+ 2.0	+ 1.8	- 0.2	- 2.4	+ 0.6	+ 0.9
<i>Manufacturing</i>						
Production <sup>2</sup>	+ 9.2	+ 7.5	+ 3.9	- 11.7	+ 3.5	+ 5.8
Employees <sup>3</sup>	+ 0.2	+ 2.6	+ 1.7	- 6.0	- 2.0	- 0.4
Productivity per hour	+ 8.8	+ 5.1	+ 2.7	- 2.5	+ 4.1	+ 5.7
Working hours per day per employee <sup>4</sup>	+ 0.2	- 0.3	- 0.5	- 3.6	+ 1.5	+ 0.5

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.

With the rebound in global trade, machinery and equipment investment should nevertheless pick up from its low level in the course of 2010. The return of confidence should gradually improve financing conditions and ease potential credit restrictions. Moreover, towards the end of the year some investment projects could be front-loaded into 2010 in view of the expiry of tax subsidies. Due to the negative overhang from 2009 and the weak results for the first quarter 2010, the annual average will nevertheless show a further decline by 6 percent in real terms. For 2011, the projection is for an increase of 4 percent.

Value added of the construction sector fell by 5.6 percent at constant prices in 2009. Whereas in the past, construction activity has proved to be a stabilising force during recessions, it actually exacerbated the slump in economic activity in the current crisis. In particular industrial construction shrank as a consequence of the steep fall in corporate investment. Non-subsidised residential construction for its part will be held back by financing constraints.

Within the framework of the fiscal stimulus packages, the construction sector benefited from several measures, as for example the subsidies for energy-saving renovation of private buildings. Additional expenditure by the Federal Real Estate Agency, the Road Financing Agency (ASFINAG) and the Austrian Federal Railways will mostly take effect only this year. Given these conditions, WIFO expects sluggish construc-

tion activity to continue, with value added falling by another 1 percent in 2010 and hardly picking up (+0.3 percent) in 2011.

The labour market has been surprisingly resilient in recent months. The number of people in dependent active employment, having fallen by 1.4 percent in 2009, has been up year-on-year since March 2010.

For 2010 and 2011, WIFO expects an increase in dependent active employment by 0.5 percent each, despite moderate GDP growth. The benign trend of the last few months, with employment as recorded by the social security administration up by 17,400 or 0.5 percent from last year in May 2010, and the upbeat expectations are explained by structural employment features during the crisis:

- Manufacturing employment in May 2010 was down by 14,400 or 2.5 percent from last year. At the same time, the number of contract workers rose by 11,800 year-on-year, most of which were probably posted in manufacturing. In view of the prevailing high uncertainty, capacity bottlenecks are apparently addressed mainly by resorting to contract workers. Of late, job prospects have brightened in manufacturing, with employment likely having stopped declining on a seasonally-adjusted monthly basis since the beginning of the year.
- In the quasi-public services (categories O to Q in the ÖNACE classification), employment in May 2010 was 22,700 or 2.7 percent higher than one year ago. In particular the sectors "education and teaching" and "social services" posted strong gains. Thus, in the public domain the upward employment trend continued unabated, notably for female employment. The spreading of part-time work is deemed to account for a large part of the jobs newly created.
- In the other sectors, employment was still heading slightly down overall in May. In the sectors of "transport and stocking" (-4,000) and "financial and insurance services" (-1,600) it fell more markedly, but increased in the "hotels and restaurants" category (+5,000).

## Employment trend above expectations

Overall employment is set to increase by 0.5 percent each in 2010 and 2011 thanks to persistently strong labour demand in public and quasi-public services. In manufacturing, prospects will be more subdued after the rather minor job losses in relation to the sharp fall in output. The unemployment rate will edge up slightly in 2011.

Table 5: Labour market

		2006	2007	2008	2009	2010	2011
		Changes from previous year, in 1,000					
<i>Demand for labour</i>							
Persons in active employment <sup>1</sup>		+ 56.1	+ 68.6	+ 84.2	- 38.6	+ 20.7	+ 20.8
Employees <sup>2</sup>		+ 51.5	+ 65.5	+ 76.7	- 44.8	+ 15.9	+ 18.0
Percentage changes from previous year		+ 1.7	+ 2.1	+ 2.4	- 1.4	+ 0.5	+ 0.5
Nationals		+ 35.0	+ 43.6	+ 53.2	- 39.2	+ 11.4	+ 12.5
Foreign workers		+ 16.5	+ 21.9	+ 23.5	- 5.6	+ 4.5	+ 5.5
Self-employed <sup>3</sup>		+ 4.6	+ 3.1	+ 7.5	+ 6.2	+ 4.8	+ 2.8
<i>Labour supply</i>							
Population of working age							
15 to 64 years		+ 12.8	+ 15.5	+ 27.7	+ 17.3	+ 26.3	+ 30.6
15 to 59 years		+ 47.3	+ 17.1	+ 17.6	+ 11.1	+ 12.3	+ 15.9
Labour force <sup>4</sup>		+ 42.6	+ 51.7	+ 74.2	+ 9.4	+ 23.4	+ 26.8
<i>Surplus of labour</i>							
Registered unemployed <sup>5</sup>		- 13.5	- 16.9	- 10.0	+ 48.1	+ 2.7	+ 6.0
In 1,000		239.2	222.2	212.3	260.3	263.0	269.0
Unemployed persons in training <sup>5</sup>		in 1,000	57.5	52.7	50.5	64.1	73.0
In percent							
Unemployment rate							
Eurostat definition <sup>6</sup>		4.8	4.4	3.8	4.8	4.9	5.0
As a percentage of total labour force <sup>5</sup>		6.1	5.6	5.2	6.4	6.5	6.6
National definition <sup>5,7</sup>		6.8	6.2	5.8	7.2	7.2	7.3
<i>Employment rate</i>							
Persons in active employment <sup>1,8</sup>		63.9	64.9	66.1	65.2	65.3	65.3
Total employment <sup>6,8</sup>		70.2	71.4	72.1	71.6	71.7	71.7

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, without self-employed. – <sup>8</sup> As a percentage of population of working age (15 to 64 years).

For the projection period, WIFO expects job creation in the quasi-public services to advance at a somewhat slower pace, but a tentative pick-up in manufacturing and private services employment, according to the usual cyclical pattern. Supported by public short-time-work programmes, manufacturers were circumspect in cutting personnel in 2009, in order to keep firm-specific human capital. This suggests for 2010 and 2011 an altogether cautious hiring behaviour. Sectors most in need of structural adjustment will suffer permanent job losses.

The rate of unemployment, on national definition, will edge up from 7.2 percent in 2009 to 7.3 percent in 2011. After a pause, labour supply will resume growing in 2010 and 2011, albeit more slowly than before. The number of people enrolled in public job training programmes is expected to decline.

The composition of employment growth also impacts on wage developments. In manufacturing, given the sizeable margin of idle capacity, wage settlements will likely be moderate. Many of the jobs newly created in quasi-public services are of rather low productivity and to a substantial amount part-time, leaving also only narrow scope for wage increases.

For the whole economy, gross nominal wages per capita are projected to rise by 1.5 percent in 2010 and 1.8 percent in 2011. In view of the acceleration in inflation, this implies a decline in net real per-capita wages by 0.5 percent each year.

In 2009, headline inflation was no higher than 0.5 percent. In 2010 and 2011, consumer prices are expected to go up by 1.8 percent and 2.1 percent respectively. The acceleration in 2011 is mainly due to higher energy prices. Admittedly, inflation in 2009 was unusually low, as the fall in oil prices dampened hikes at the consumer level. With oil prices bouncing back to around \$ 80 per barrel, this effect is being reversed in 2010.

For 2011, the WIFO forecast rests on the technical assumption that hikes of indirect taxes and public charges in the context of fiscal consolidation will push the inflation rate up by 0.4 percentage points. In addition, the depreciation of the euro against the dollar will boost import prices and thereby also consumer prices in 2011 somewhat. Despite this increase in the inflation rate, price pressure will still be weak since the effects of higher energy prices and tax hikes are temporary as long as business activity remains subdued. Only with high capacity utilisation and a stronger drift in unit labour cost would inflation accelerate over a longer time horizon.

## Headline inflation rising to 2 percent

*Higher energy prices will drive the annual rate of inflation up to 1.8 percent in 2010. In 2011, the increase in indirect taxes may lead to a further temporary rise. Over the medium term, the subdued business activity will nevertheless keep inflationary pressure low.*

Table 6: Key policy indicators

	2006	2007	2008	2009	2010	2011
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 1.5	- 0.4	- 0.4	- 3.4	- 4.6	- 3.8
According to National Accounts	- 1.6	- 0.5	- 0.5	- 3.4	- 4.6	- 3.8
General government primary balance	+ 1.3	+ 2.3	+ 2.1	- 0.7	- 1.9	- 1.0
	In percent					
<i>Monetary policy</i>						
3-month interest rate	3.1	4.3	4.6	1.2	0.8	1.0
Long-term interest rate <sup>1</sup>	3.8	4.3	4.4	3.9	3.2	2.8
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	+ 0.2	+ 1.1	+ 1.2	+ 0.9	- 0.7	- 0.4
Real	- 0.5	+ 0.7	+ 0.6	+ 0.4	- 0.9	- 0.2

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

Private consumption expenditure contributed importantly to sustain business activity in 2009, edging up by 0.4 percent from the previous year despite receding employment. Real disposable income decreased by 1.1 percent. On the positive side, it was supported by the tax reform and by real wage increases that turned out rela-

## Stable consumption despite sluggish income growth

tively strong due to an unexpected easing of inflation. The fact that real disposable income fell nevertheless is explained by the steep fall in income from property and wealth which is traditionally sensitive to cyclical variations and was additionally squeezed by the financial market crisis.

In 2010 and 2011, projected real disposable income growth of 0.5 percent and 0.1 percent will clearly lag behind GDP growth. The main reason is the reversal of factors that helped sustain incomes in 2009, now making for some decline in per-capita real wages over the projection period: apart from rising inflation, fiscal consolidation will take its toll on disposable income. Income from property and wealth, for its part, will make good on some of its earlier losses.

*Real disposable income will edge up only marginally in 2010 and 2011. Still, private households have some leeway to offset the income constraint by lower savings, as they did in earlier periods of fiscal retrenchment. Private consumption should therefore prove resilient. The yet undisclosed details of fiscal consolidation measures create an element of uncertainty for the consumption forecast for 2011.*

Table 7: Private consumption, income and prices

	2006	2007	2008	2009	2010	2011
	Percentage changes from previous year					
Private consumption expenditure	+ 1.8	+ 0.8	+ 0.8	+ 0.4	+ 0.9	+ 0.6
Durables	+ 5.6	+ 3.6	+ 2.2	+10.9	- 0.4	- 0.3
Non-durables and services	+ 1.4	+ 0.5	+ 0.6	- 0.7	+ 1.0	+ 0.8
Household disposable income	+ 3.0	+ 1.7	+ 1.7	- 1.1	+ 0.5	+ 0.1
	As a percentage of disposable income					
Household saving ratio <sup>1</sup>	10.8	11.3	12.0	11.0	10.6	10.2
Household saving ratio <sup>2</sup>	10.2	11.0	11.8	10.5	10.2	9.8
	Percentage changes from previous year					
Direct lending to domestic non-banks <sup>3</sup>	+ 4.5	+ 3.6	+ 7.4	- 1.3	+ 1.6	+ 3.7
	Percentage changes from previous year					
Inflation rate						
National	1.5	2.2	3.2	0.5	1.8	2.1
Harmonised	1.7	2.2	3.2	0.4	1.8	2.1
Core inflation <sup>4</sup>	1.3	1.9	2.4	1.5	1.3	1.6

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 8: Earnings and international competitiveness

	2006	2007	2008	2009	2010	2011
	Percentage changes from previous year					
Gross earnings per employee <sup>1</sup>	+ 3.2	+ 3.1	+ 2.7	+ 2.3	+ 1.5	+ 1.8
Gross real earnings per employee <sup>1</sup>	+ 1.0	+ 0.5	+ 0.0	+ 1.1	- 0.3	- 0.3
Net real earnings per employee <sup>1</sup>	+ 0.8	+ 0.4	- 0.5	+ 2.3	- 0.5	- 0.5
<i>Total economy</i>						
Unit labour costs	+ 1.0	+ 1.1	+ 2.8	+ 4.9	+ 0.9	+ 0.9
<i>Manufacturing</i>						
Unit labour costs	- 4.2	- 1.7	+ 1.0	+ 9.6	- 2.9	- 3.5
Effective exchange rate, manufactures						
Nominal	+ 0.2	+ 1.2	+ 1.1	+ 0.7	- 0.7	- 0.4
Real	- 0.4	+ 0.8	+ 0.6	+ 0.3	- 0.8	- 0.2

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

On the back of a declining saving ratio, private consumption should nevertheless stay upward bound, rising by a projected 0.9 percent in real terms in 2010 and 0.6 percent in 2011. The saving ratio, though falling from 11.0 percent in 2009 to 10.2 percent in 2011, will still remain relatively high. A decline of similar magnitude has been observed in earlier periods of fiscal consolidation. The impact on incomes and savings will nevertheless depend on the details of consolidation measures to be adopted, which creates a certain margin of uncertainty for consumption performance in 2011.

The relatively benign trend of private consumption was mirrored by the retail sales data for 2009. Yet, net output of wholesale traders and car dealers declined markedly, yielding a net real output loss of 3.1 percent for the trade sector overall. Owing to the rebound in foreign trade and manufacturing, conditions will turn significantly better this year, with real output gaining 1.2 percent and somewhat less in 2011.

Demand for tourism services eased markedly during the global recession in 2009. Earnings from foreign customers dropped significantly, although Austria gained market shares due to its attractiveness for short-distance travellers from neighbouring countries. Likewise, Austrian travellers abroad turned more cautious in spending, such that real tourism service imports edged down in volume terms, while preferences for domestic holiday destinations increased.

## Gradual stabilisation of tourism demand

### *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, this is referred to as "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.

#### *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/>).

#### *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".

In 2010, tourism exports are likely to decline by another 1 percent in real terms, matching the level attained in 2007.

The net surplus on foreign tourism services is set to stay at an annual € 6 billion. Receding demand from both foreign and domestic customers is mirrored by the slump in net real output of the hotel and restaurant sector by 6.4 percent in 2009 compared with the previous year. Another small loss of 0.5 percent is expected for 2010, followed by a tentative recovery in 2011.