Recovery of the Global Economy in the Second Half of 2009

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The world economy has overcome the cyclical trough. On the back of extensive economic stimulus programs, most economies returned to positive growth rates in the second half of 2009, with emerging countries taking the lead. The rate of the recovery, however, diverges strongly across the different regions.

Not only the emerging Asian countries grew at a vigorous pace; the U.S. economy, too, posted healthy quarter-on-quarter growth at a rate last seen six years ago. Yet, recent confidence indicators suggest that economic growth will continue at a slower pace.

While the world economic recovery gained momentum in the fourth quarter of 2009, the development of economic activity in the euro area remained below expectations. In comparison with the previous quarter, the economy of the single currency area grew by 0.1% in the fourth quarter of 2009, with growth driven exclusively by the positive contribution of net exports. Euro area domestic demand is unlikely to give growth a genuine boost in the quarters to come. Current forecasts generally point to a gradual recovery of economic activity in the euro area, which will, however, be weaker than the U.S. revival.

Euro area HICP inflation returned to positive levels in November 2009. This was due primarily to base effects stemming from commodity prices. The disinflation process of core items, however, is continuing. Given the sluggish recovery in economic activity, the annual core inflation rate fell to a record low of 0.8% in February 2010. The latest forecasts predict that there will be no risks to price stability until the end of 2011.

Especially thanks to a slight recovery in international demand, the Central, Eastern and Southeastern (CESEE) EU Member States entered a period of economic stabilization in the second half of 2009, recording – once again – moderately positive average growth rates (on a quarterly basis). However, cyclical developments still vary significantly across the countries of the region. The economic downturn caused current account balances to improve throughout the entire region and brought down inflation rates in several countries.

After undergoing the deepest and longest recession in post-war history, Austria registered moderate economic growth in the second half of 2009, supported by the revival of international economic activity, the Austrian government stimulus packages and the inventory cycle. According to recent results of the short-term economic indicator of the Oesterreichische Nationalbank (OeNB), growth is set to remain stable. Real GDP is expected to grow by 0.5% in both the first and the second quarters of 2010 (seasonally and working day adjusted, quarter on quarter). For the entire year 2010 the OeNB expects a real GDP growth rate of about 1½%.

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1 Pace of Global Recovery Decelerates

1.1 U.S.A.: Upswing with Uncertain Outlook

The U.S. economy has emerged from the recession. In the fourth quarter of 2009, real *GDP* grew at an annualized rate of 5.9% (quarter on quarter), the strongest performance in more than six years. All expenditure components contributed to this robust growth. For the first time, however, the most important factor – alongside the changes in inventories – was gross fixed capital formation.

Numerous *leading indicators* corroborate the signs of the economic recovery. Since spring 2009, purchasing managers' business sentiment has brightened continuously. Industrial production, too, has seen continued improvements for more than half a

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March 19, 2010

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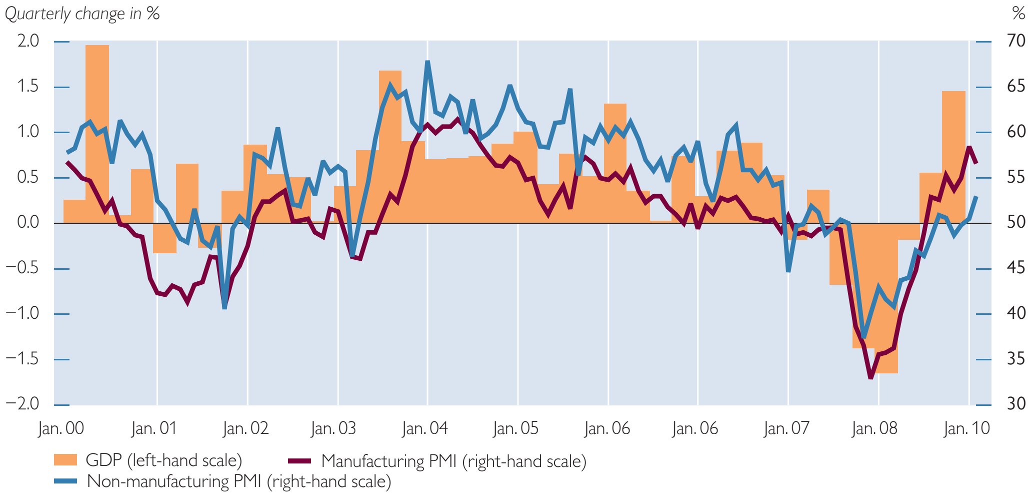
Chart 1

U.S.A.: Purchasing Managers' Index and GDP Growth



Source: Institute for Supply Management (ISM), Bureau of Economic Analysis (BEA).

year, with capacity utilization running at a one-year high in February 2010. However, recent data suggest that the economic expansion might soon lose momentum. The February U.S. purchasing managers' index value, for instance, suffered a clear setback. While the confidence indicator has remained above the 50% mark, which points to a continued expansion, it has probably peaked for the time being. Moreover, consumer sentiment has remained fragile. The *Conference Board* research institute, for instance, recorded a steep decline in the Consumer Confidence Index in February after several previous increases.

So far, private consumption has been supported by fiscal policy measures such as tax allowances and car scrapping premiums. *Labor market* developments, however, will be of special relevance for the progress of the economic recovery in the U.S.A. After topping out at over 10% in the fall of 2009, the unemployment rate has stabilized at 9.7% since the beginning of 2010, and the number of initial claims for unemployment benefits has fallen recently. The renewed surge in *productivity* during the fourth quarter of 2009 also sends out positive signals. These productivity gains can no longer be traced to layoffs, as the number of hours worked has recently been on the rise again. Overall, the tide may have turned on the labor market. However, unemployment cannot be expected to decline sharply yet in 2010, with joblessness remaining at unusually high levels by U.S. standards.

The U.S. Federal Reserve (Fed) recently announced that – although the economy was experiencing a moderate recovery phase – production, sales, income and employment still remained far below their respective precrisis levels. So far, 8.4 million jobs have been lost since the onset of the crisis, and unemployment is likely to stay high for several years to come. While recent labor market developments foreshadow an economic upswing, risks of a jobless recovery prevail. The Fed expects a GDP growth rate of around 3½% for 2010 and around 4½% for 2011. At 2½% to 3%, the 2010 *forecasts* of international institutions and the private sector are less optimistic.

The stabilization of the real estate market is an important precondition for a sustainable recovery of the financial system and the overall U.S. economy. The *residential property* market seems to have stabilized for the time being, albeit at a low level. It is true that the *Case-Shiller* Index of home prices slightly declined in the fourth quarter of 2009, after two positive quarters, and that the number of houses sold was down in January 2010, compared to the previous month. But then again, housing starts augmented more strongly than anticipated. Commercial property construction, in contrast, developed less well, with prices down by 40% since the beginning of the crisis. In February 2010, U.S. Congress experts warned that the slump in mortgage prices could result in high credit default rates.

The annual CPI inflation rate was measured at 2.1% in February 2010, while core inflation fell to 1.3%. In light of the sluggish economic recovery, the Fed expects inflation to fall to an average of 1% year on year. Since December 2008, the federal funds rate, i.e. the U.S. *key interest rate,* has been unchanged at 0% to 0.25%; the Fed intends to keep it at this level for some time. In February 2010, however, the Fed raised the discount rate by 25 basis points to 0.75% "as a further normalization of the Federal Reserve's lending facilities." Despite the carefully worded announcement of this measure, credit markets were temporarily unsettled, since they interpreted this step as an overture to monetary tightening. After the discount rate hike and the phasing out of most other liquidity programs for banks introduced during the crisis, the U.S. monetary environment has now almost been restored to precrisis conditions.

The financial market crisis has led to a partial reduction in global imbalances. As a case in point, the U.S. *current account deficit* halved from 6.0% of GDP in 2006 to 3.0% of GDP in the third quarter of 2009. So far, this decline has not been sufficiently persistent to speak of structural change, especially since the current account deficit rose again in the fourth quarter of 2009. The IMF, too, forecasts that deficits will rise again after a temporary decline in 2010.

According to the most recent U.S. Congress prognosis of March 2010, the U.S. *budget deficit* will hit a new post-World-War-II high at 10.3% of GDP in the current fiscal year as a consequence of the deep recession, the massive stimulus packages and rescue measures taken to support the banking system. Fueled by these developments, government debt is likely to balloon from 53% of GDP in 2009 to around 90% by 2020. Fiscal policy measures during and after the crisis, rising public health care and social security expenditure – boosted by demographic developments – are further driving up government debt. Accordingly, the net interest burden will more than double from 1.4% of GDP in 2010 to 4.1% in 2020.

1.2 Japan: Economy Grows Again, Prices Continue to Decline

Following the crisis-induced sharp economic contraction, which hit the country disproportionately hard by international comparison, Japan is presently experiencing a gradual economic recovery unfolding in an environment of global strengthening and recuperating international trade. Mounting by 1.1% quarter on quarter in the fourth quarter of 2009, real *GDP* growth exceeded expectations; from an annual perspective, however, economic performance continued to fall by 5% over the entire year 2009. While all components have recently contributed to this stabilization, the most important growth stimulus came from exports. Government stimulus packages have been the mainstay of domestic demand. However, labor market improvements and real income growth are likely to start playing a greater role in driving up private consumption. Unlike in other industrialized countries, the *labor market* in Japan had already reached rock bottom more than half a year ago. At the beginning of 2010, the unemployment rate declined unexpectedly to 4.9%, which means that it is now almost 1 percentage point below last summer's record peak.

Recent *leading indicators* suggest that the recovery is likely to continue in 2010. The *Tankan index,* considered Japan's most important confidence indicator, again showed a powerful increase when it was last published in December 2009. According to the report, the majority of businesspeople continue to be pessimistic about the state of the economy; however, expectations are improving. In February 2010, industrial production and machinery orders also corroborated the upward trend.

Deflationary risks, however, have not been fully headed off yet in Japan. Although the decline in prices is decelerating due to base effects in the energy component, the annual CPI *inflation rate* of January 2010 was still –1.3%. In the fourth quarter of 2009, the GDP deflator reached its lowest mark since 1955 at –3%. Even though the *Bank of Japan (BoJ)* expects the price decline to moderate in the course of 2010, it views the public's declining inflation expectations as a downward risk. International institutions expect prices to continue declining into the year 2011. Unexpectedly, the BoJ put in place a new funds-supply operation in December 2009 after it had started to reduce its extraordinary *liquidity supply* to banks earlier on in fall 2009. The BoJ has come under increasing pressure from the Japanese government, which is calling for a positive inflation rate. For the time being, the BoJ is likely to maintain its zero interest rate policy (the overnight interest rate has remained at 0.1% since December 2008).

With an estimated debt-to-GDP ratio of 192% in 2009, Japan has the highest level of *national debt* of all industrialized countries in the world. The IMF forecasts that Japanese government debt could rise as high as 246% of GDP by 2014. Nevertheless, the Japanese yen is considered a safe haven. Since the beginning of 2010, the Japanese yen has appreciated significantly against the euro and less so vis-à-vis the U.S. dollar.

1.3 China: Central Bank Takes Corrective Action against Economic Overheating

China's economy has emerged remarkably fast from the crisis. The extensive pump-priming measures, as well as the loose lending policies of the mostly state-owned banks, proved effective. The real *GDP* growth rate thus came to 8.7% for the entire year 2009 (in the fourth quarter of 2009, year-on-year GDP growth was 10.7%). Industrial output growth was particularly strong. At the end of 2009, production had grown by almost one-fifth year on year. The Chinese purchasing managers' index has remained above 50% for as long as a year now. Industrial sentiment, however, registered a clear setback in February 2010; this points to a slowdown in growth (as is the case in the U.S.A.).

Since November 2009, China has been faced with mounting *inflation rates* again, and annual CPI inflation reached 2.7% in February 2010.

Against this background, the Chinese central bank tightened its *monetary policy* in February 2010 for the second time this year. More specifically, the minimum reserve requirements for large banks were raised in two steps by a total of 1 percentage point and have now reached 16.5% of customer deposits. This tightening was probably triggered above all by concerns about a higher incidence of credit defaults, as the government massively supported new lending during the crisis. Interest rate policy has not been tightened; the key interest rate remains at 5.3%.

At 18% of GDP, China's 2009 *government debt* is low by international comparison. However, this figure must be interpreted with caution, given the issuance of local government debt, which has recently been boosted by investment companies established for this sole purpose.

Year on year, China's high *current account surplus* fell by one-third in the first half of 2009, but remained high at 6.3% of GDP. This decrease stemmed primarily from a slowdown in external demand. Against the backdrop of re-emerging export demand, the overall current account surplus for 2009 rebounded to an estimated 7.8% of GDP. According to the IMF, it will continue to grow in the years to come. However, Chinese imports also rose markedly in 2009, fueling hopes that China can take on a leading role in the recovery process of the world economy.

In April 2010 the U.S.A. will decide whether China will be labeled a "currency manipulator" in the Treasury Department's annual report. This increases the pressure to loosen the renminbi yuan's U.S. dollar peg and to eventually lift it in an orderly fashion.

2 Euro Area Economy Gradually Stabilizes

2.1 Growth Performance Was Disappointing in the Fourth Quarter of 2009

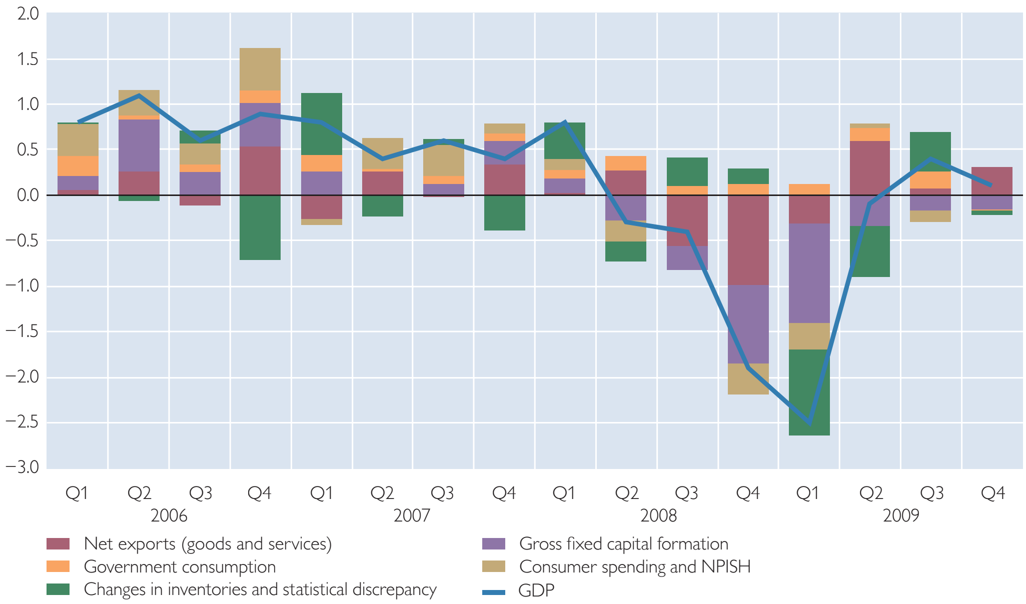
While the world economic recovery gained momentum in the fourth quarter of 2009, the development of economic activity in the euro area has recently remained below expectations. The fourth quarter of 2009 saw a decline in real GDP growth to 0.1%, down from 0.4% in the third quarter. Fourth-quarter economic performance shrank by 2.1% year on year. The GDP *expenditure breakdown* paints a mixed picture: While the strong growth in the third quarter of 2009 was primarily driven by short-term factors (government spending, end of destocking), the fourth quarter saw a slight rise in net exports and private demand.

Household consumption stagnated in the fourth quarter of 2009 after declining in the previous quarter. Against the backdrop of weakening employment and the phasing out of important fiscal stimuli such as car scrapping premiums, personal consumption expenditure can hardly be expected to genuinely propel growth in 2010. Gross fixed capital formation continued to decline, albeit at a slower pace than before. In this area too, there is little hope of the rebound starting soon, given firms' ongoing balance sheet adjustments, low capacity utilization and the decline in construction activity. In the fourth quarter of 2009, public spending declined for the first time since 1999. Only net exports made a positive contribution to euro area growth.

Chart 2

Contribution to Real GDP Growth in the Euro Area

Quarterly changes in percentage points and in %



Source: Eurostat.

The slow pace of euro area growth derives from increasingly *heterogeneous developments in the economic activity* of the single currency area. Euro area countries have been recovering at different rates since the economy hit bottom in the first quarter of 2009. Germany and France were the first to pull out of recession in the second quarter of 2009. In the third quarter of 2009, growth seemed to pick up, particularly in Germany, and in the fourth quarter, euro area growth was most dynamic in France. Overall, Germany and France have grown at similar rates since the economic trough (around 1.1% and 1.2% respectively); whereas Italy, Spain and Greece have not yet emerged from recession. Lately, Spanish GDP has contracted at a significantly slower pace, whereas GDP in Greece slipped more rapidly after the second quarter of 2009. These developments are related to a number of factors. On the one hand, the growth engines – either exports or domestic demand – differ from country to country. On the other hand, different schedules of government stimulus programs (such as scrapping premiums) have an impact on the timing of the economic recovery. Furthermore, the European peripheral countries are facing greater internal and external rebalancing needs than the core countries.

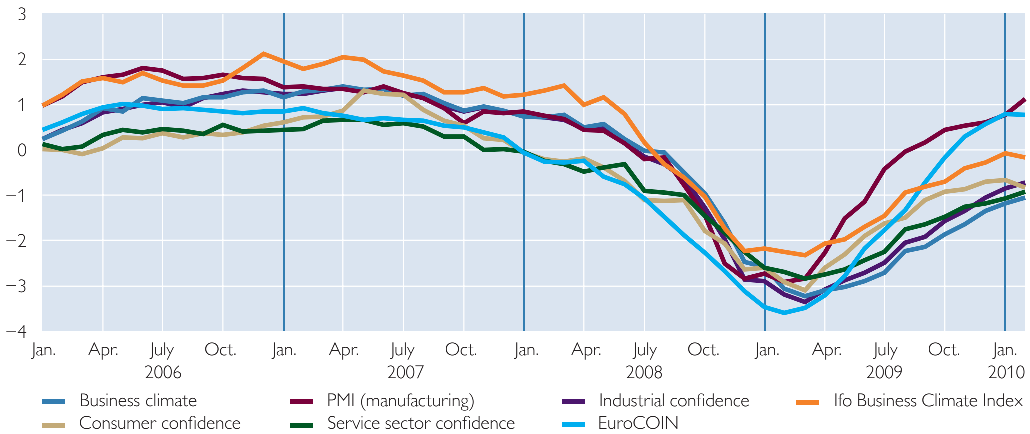
2.2 Leading Indicators Paint a Mixed Picture

Whereas the leading indicators of economic activity confirm that a trend reversal took place in spring 2009, recent signs are sending a mixed message. On the one hand, the recent rise in *industrial production* as well as upward revisions of previous data releases suggest that the industrial recovery in the euro area is more resilient than expected. The European Commission's *Economic Sentiment Indicator* and the manufacturing sector's *Purchasing*

Chart 3

Business Climate Indicators for the Euro Area

Deviation from the mean value of the indicator relative to the standard deviation



Source: European Commission, NTC, Ifo, FTD, CEPR, Eurostat, OeNB.

Managers' Index also confirm that sentiment among manufacturers brightened further in February 2010.

On the other hand, the previous ascent of survey-based confidence indicators in nonmanufacturing sectors is flattening out. Especially consumer and retail confidence worsened again in February.

According to the *Business Climate Index* of the Ifo Institute for Economic Research, the majority of surveyed businesses (especially in the retail sector) consider the current situation unfavorable, but businesses were increasingly upbeat regarding the future.

2.3 Unemployment Has yet to Peak

The repercussions of the crisis have reached the *labor market* with the usual time lag. The unemployment rate in January 2010 was 9.9%, around 1½ percentage points higher than a year earlier. The rise in unemployment was particularly strong in countries undergoing construction sector restructuring: In Spain, the seasonally adjusted unemployment rate has doubled over the past 1½ years (to 18.8%); in Ireland it has almost tripled since the beginning of 2008 (to 13.8%). By contrast, the German labor market has so far remained relatively stable: Mainly thanks to flexible *working time reduction schemes,* unemployment has hardly risen (currently 7.5%) in spite of the above-average decline in GDP. Especially the government-subsidized short-time working scheme proved effective, alongside companies' individual arrangements. Although unemployment growth has recently eased in the euro area, joblessness is likely to peak only in the course of 2011. According to its latest forecast, the European Commission expects unemployment to amount to 10.7% in 2010 and to 10.9% in 2011.

2.4 Forecasts Predict a Slow and Uneven Recovery

Recent *forecasts* predict an ongoing revival of economic activity in the euro area over the next few quarters, but at a slow and uneven pace. Growth predictions for 2010, which have mostly been revised upward since fall 2009, range from +0.7% to +1.3%. At the lower bound of the range, there is the current *interim forecast* of the European Commission, which has remained unchanged from fall 2009 in spite of an improved international environment. Nor have ECB experts revised upward their March 2010 projections for the year 2010 from the December 2009 projections. For 2010, ECB forecasters expect real GDP gains in the range of +0.4% to +1.2%. Forecasts of economists in the private banking sector are also unlikely to be revised further upward any time soon.

Export demand will continue to rise, further buoying the recovery. In the short run, fiscal stimuli will also strengthen domestic demand, but they are unlikely to have a lasting effect. Moreover, the need to adjust private sector balance sheets and the consolidation of public finances will act as a damper on domestic demand. All economic institutes consider that the *risks* surrounding the respective forecasts are largely balanced, while stressing that uncertainty is significant. ECB experts forecast growth to be between +½% and +2½% in 2011; this reflects a slight upward revision compared to the December 2009 projections.

2.5 Start of Fiscal Consolidation Planning

According to available stability programs, the *budget deficit* within the euro area will increase from 2.0% of GDP in 2008 to 6.1% in 2009 and 6.5% in 2010. In 2010, none of the Member States will be able to keep budget deficit growth below the Maastricht threshold of 3% of GDP. The European Council has determined that excessive deficits must be reduced below the 3% mark by 2013. In the meantime, the corresponding excessive deficit procedures have been initiated and are being negotiated in detail. Developments in the budget deficit of *Greece* have turned out to be particularly problematic. The financial markets' strong reaction to the Greek government's acknowledgement of repeated irregularities in reporting key statistical data to Eurostat showed two things: first, that there is a need for unwavering consolidation of Greek public finances – according to the Greek stability program, the budget deficit of 12.7% of GDP in 2009 will be reduced to 8.7% of GDP in 2010 and below the 3% ceiling as soon as 2012 – and second, that refinancing problems of a Monetary Union member state will ultimately entail difficulties for the euro area as a whole.

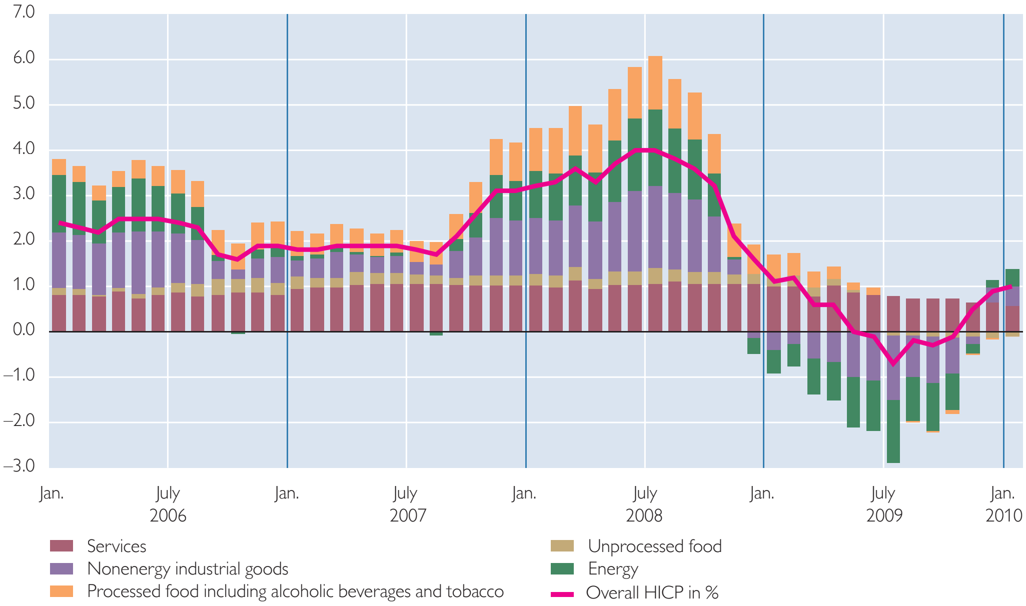
2.6 Positive Inflation Rates Return; Core Item Prices Fall Further

Annual HICP *inflation* turned positive in November 2009 as a result of upward base effects in commodity components and was registered at 0.9% in February 2010. However, the disinflation process of HICP core items (HICP excluding energy and unprocessed food items) has continued. In February 2010, core inflation fell to 0.8% against the previous year. Much of this substantial decline can generally be explained by the growing output gap, which was caused by the marked recession during the first half of 2009 and subdued growth perspectives, low capacity utilization as well as mounting unemployment. If the hoped-for revival of economic activity materializes, the output gap will gradually close, raising the pressure on the price of core components. In the immediate future, however, the supply chain is unlikely to exert any upward pressure on the core inflation rate. Although slightly weaker than in 2009, the base effects in commodity components will probably make a nonneglectable contribution to headline inflation in 2010.

Chart 4

HICP Components

Percentage points and %



Source: Eurostat.

As conditions on the inflation-linked bond markets increasingly return to normal, the *inflation expectations* of financial markets can be more readily interpreted. Taking into account persisting disruptions, the current yield curve suggests that although the crisis has amplified volatility, it has not caused a shift in longer-term inflation expectations, which have remained in line with the ESCB's objective of price stability. Consumers' short-term inflation expectations (survey-based price expections for the next 12 months; European Commission) have been continuously mounting after bottoming out in August 2009. In February 2010, the index value was zero, which implies that the number of respondents who expected prices to fall or remain unchanged was about equal to the number of those who expected them to rise.

In line with current forecasts of international institutions, HICP inflation is expected to be slightly above 1% in 2010; in 2011 it might accelerate to 1.5%. In its latest forecast, the European Commission expects the 2010 inflation rate for the euro area to remain unchanged at 1.1%; the ECB's forecasts range between 0.8% and 1.6%. Overall, there are neither pronounced inflation nor deflation risks in the foreseeable future. Downside risks relate in particular to the outlook for economic activity, while upside risks relate to higher-than-expected commodity prices. The crude oil price has only moved marginally since October 2009, and crude oil futures suggest that the oil price will remain within the range of USD 70 to USD 80 per barrel also in 2010. Furthermore, increases in indirect taxation and administered prices may be stronger than currently expected owing to fiscal consolidation. Recently, price pressure from the external environment, too, has increased somewhat. Thus, the *euro* lost some of its strength against the U.S. dollar in recent months, given the financial markets' concerns about Greece and the sluggish economic developments. The euro's exchange rate against the U.S. dollar is currently down by 10% from its record marks of early December 2009. The single currency also lost ground against the Japanese yen and the Swiss franc while remaining stable vis-à-vis the pound sterling since the beginning of 2010. Overall, the nominal effective exchange rate of the euro has depreciated over the recent months, which will probably help strengthen European exports. In comparison with recent years, however, the single currency's exchange rate is still at a very high level.

2.7 Interest Rates Remain at a Low Level

At its last meeting on March 4, 2010, the Governing Council of the ECB decided to leave the *interest rate* on the main refinancing operations of the Eurosystem, as well as the interest rates on the marginal lending facility and the deposit facility, unchanged at 1.00%, 1.75% and 0.25%, respectively. Furthermore, the Governing Council decided to continue to gradually phase out its *special liquidity policy measures*. On the one hand, main refinancing operations and refinancing operations with a maturity of one month[2] will continue to be conducted as fixed rate tenders with full allotment for as long as necessary, and at least until October 2010. On the other hand, as of April 28, 2010, regular longer-term refinancing operations with a maturity of three months (LTROs) will be conducted as variable rate tenders again. In accordance with the decision on the 12-month LTRO of December 2009, the Governing Council of the ECB decided that the next six-month operation will be conducted with a path-dependent rate, the average minimum bid rate of the main refinancing operations conducted during the lifetime of this six-month operation. Thanks to this decision, the euro area banking system will continue to receive liquidity for a prolonged time at very favorable conditions, in turn promoting lending to the euro area economy and therefore further supporting the economic recovery. At the same time, the decision preempts distortions which could arise from an unduly long maintenance of extraordinary liquidity measures.

In light of the high levels of excess liquidity, the *EONIA* rate has followed the interest rate on the deposit facility since the first longer-term refinancing operation was conducted. This caused the overnight rate to drop clearly below the rate on the main refinancing operations (0.34% on March 19, 2010).

Growth of the *monetary aggregate M3* has slowed continuously since the onset of the crisis and had even turned negative by the end of 2009. In January 2010, annual M3 growth turned positive again at 0.1%. However, the underlying pace of monetary expansion is likely to remain moderate or to return to negative levels. This development stemms from the current yield curve. The low remuneration of short-term deposits as well as the recovery of stock and capital markets have made investments outside M3 more appealing. The small interest rate spreads between the different kinds of short-term deposits favored a reshuffling inside this aggregate toward the most liquid components of M1.

Yield differentials for government bonds in the ten-year segment between Germany and other euro area countries have widened, above all reflecting concern about the fiscal situation in Euro-

[2] *Refinancing operations with a special term of one reserve maintenance period.*

pean peripheral countries – especially in Greece, Ireland, Spain and Portugal (in Greece, the spread even exceeded 300 basis points). In view of the austerity packages announced by the Greek government and the many support measures taken, risk premiums diminished again in the middle of March 2010.

3 Economic Developments in Central, Eastern and Southeastern Europe

3.1 Economies Stabilize in the Second Half of 2009

Following a serious economic downturn at the beginning of 2009, the Central, Eastern and Southeastern European (CESEE) EU Member States entered a period of economic stabilization in the second half of the year, recording marginally positive average growth rates in both the third and fourth quarters of 2009 (on a quarterly basis).

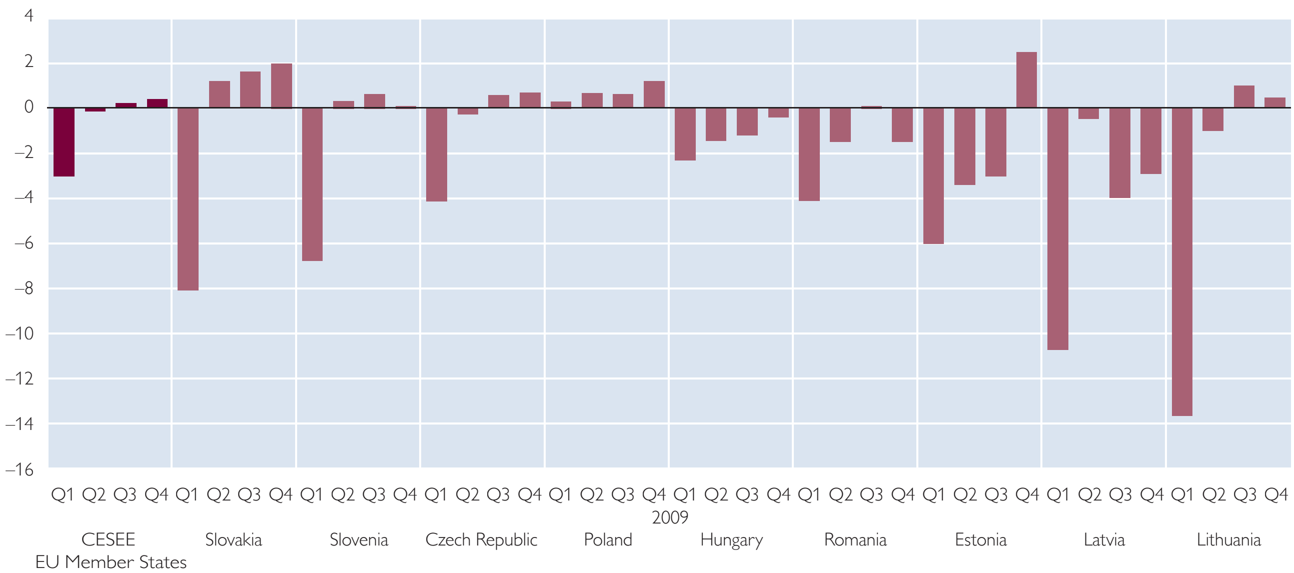
The stabilization was primarily driven by a turnaround in the inventory cycle as well as by external sector developments. Net exports benefited from a pronounced slump in import demand (particularly demand for capital goods) owing to weak domestic activity and a marginal revival of exports-to-GDP ratios against the background of slightly increasing international demand. The other GDP components hardly made positive contributions to growth – with a few exceptions such as, in particular, consumption, which moderately supported growth in Poland and Slovakia.

Thus, across large parts of the region, economic recovery strongly depends on temporary factors and on developments in the euro area, which is their most important trading partner. Therefore, the economic outlook for the CESEE region continues to be surrounded by uncertainty, as confirmed by the latest growth figures on Romania, where growth decelerated in

Chart 5

GDP Growth on a Quarterly Basis

Percentage points, seasonally adjusted

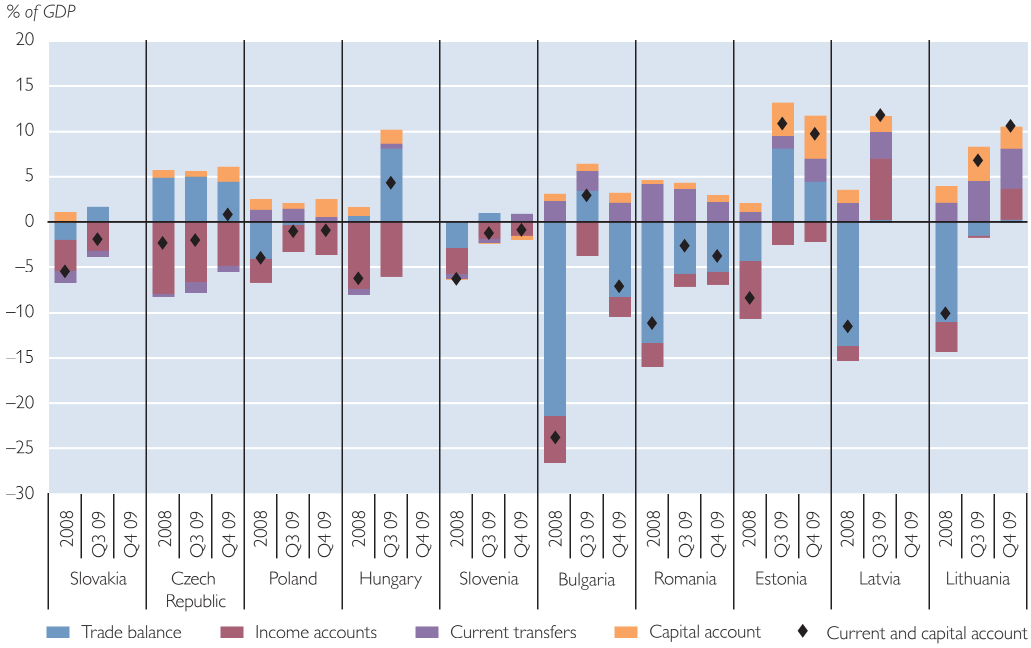


Source: Eurostat.

Note: Eurostat does not publish seasonally adjusted data on Bulgaria, which is therefore not included in the CESEE EU Member States aggregate.

Chart 6

Developments in the Current and Capital Accounts



Source: National central banks.

the fourth quarter of 2009, resulting in a significantly negative growth rate. Both in Slovenia and Lithuania, economic activity lost some of its momentum as well.

In general, cyclical developments differ widely across the region: Poland, for example, was the only country in the CESEE region – and indeed in the EU – to post a positive growth rate for 2009 as a whole. Conversely, the recession was particularly strong in the three Baltic countries, whose economic performance for the entire year of 2009 contracted by well over 10% (by as much as 18% in Latvia), marking the sharpest recession within the EU by far. The reason for these heterogeneous developments is above all to be found in the varying extent of internal and external imbalances that have built up over the past few years; as a consequence, the individual countries' vulnerability to sudden changes in international framework conditions varies as well.

3.2 Economic Imbalances Diminish Markedly

In all CESEE EU Member States, the above-mentioned imbalances decreased significantly during the recession. Particularly the high current account deficits of some countries went down markedly in the course of 2009 and in some cases, current accounts even closed with a surplus. Current account balances were boosted by improved trade balances, which in turn reflect the trends in net exports as stated in the national accounts. To a lesser extent, income accounts played a role as well, recording the favorable effects of a decline in outflows of direct investment income.

3.3 Further Recovery in 2010 Expected to Be Gradual

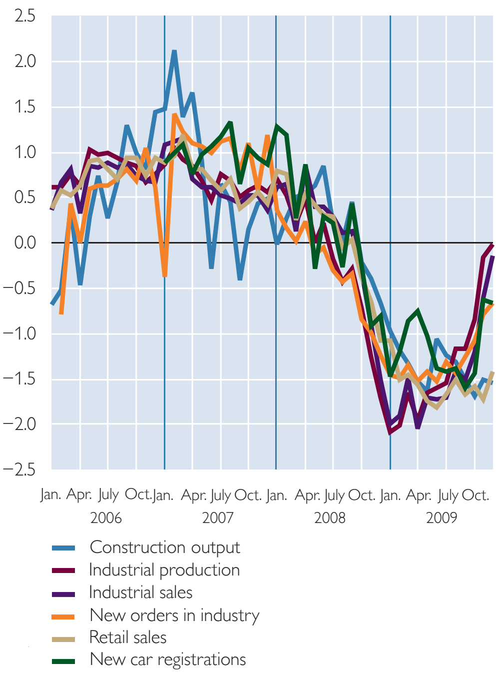
Key leading and confidence indicators suggest a further – but most likely only gradual – improvement of economic activity in the coming quarters. With exports beginning to pick up again and

Chart 7

Development of Key Leading and Confidence Indicators for the CESEE EU Member States

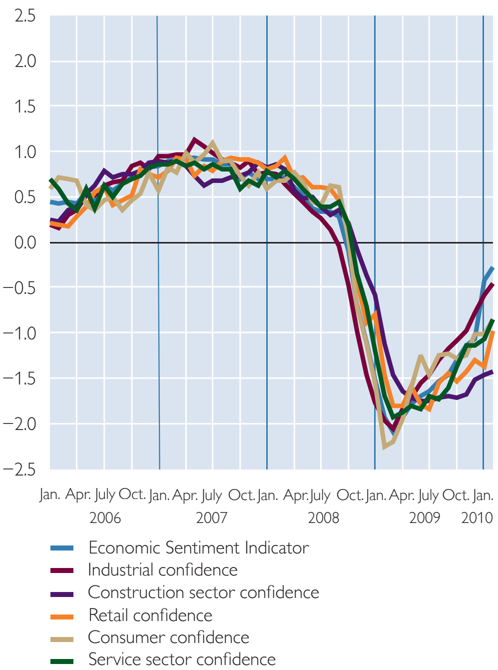
Leading Indicators

Deviation from mean indicator value relative to the standard deviation



Confidence Indicators

Deviation from mean indicator value relative to the standard deviation



Source: Eurostat, European Commission, OeNB.

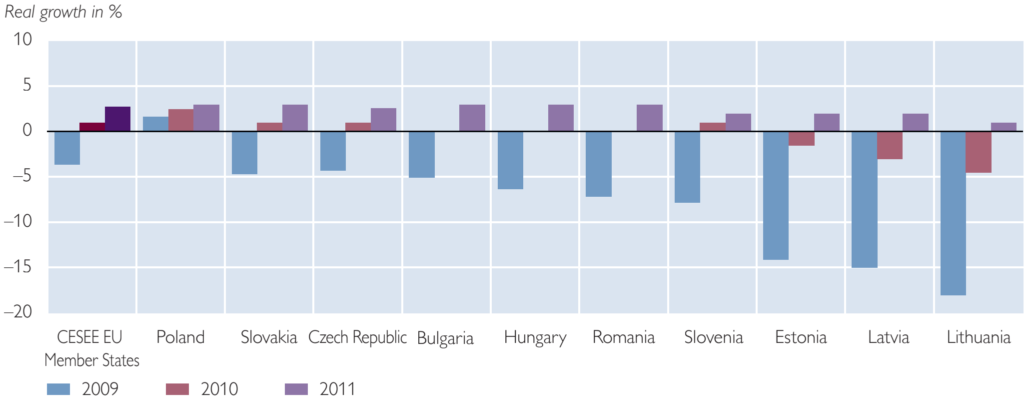
inventories starting to be replenished once more, industry, in particular, has recovered from the severe slowdown registered in early 2009. Retail trade and construction, however, have clearly seen a below-average performance.

Moreover, numerous indicators have remained below their long-term average, some of them significantly so. What may be expected, therefore, is a subdued recovery (at least in the short term), but not a strong, self-sustained upswing. Still weak international demand as well as – in part – more difficult financing conditions continue to impair investment activity. The persistent deterioration of the labor market situation, partly falling real wages and higher private household debt are dampening private consumption. Moreover, heightened uncertainty about the real economic impact of the significant recession-induced deterioration in the quality of CESEE banks' credit portfolios prevails.

Therefore, current forecasts expect GDP to grow by no more than around 1% on average in 2010. Growth is likely to proceed at different speeds, however: While GDP will go up moderately in most Central European countries in 2010, economic developments are prone to stagnate in Bulgaria, Romania and Hungary. Economic activity in the Baltic countries, however, is expected to keep contracting. Positive economic growth in all countries of the region is forecast for no sooner than 2011; most outlooks agree that the average growth across the entire region is then likely to be close to 3% (as long as the global – and especially Western

Chart 8

Current GDP Forecasts for the CESEE EU Member States



Source: Eurostat, wiiw.

European – economic environment is characterized by a gradual recovery).

It is unlikely, however, that growth rates in the CESEE region will reach precrisis levels in the medium term. The IMF forecasts average growth to come to around 4% for the 2012 to 2014 period compared to more than 6% in the boom years before the crisis. Nevertheless, after a temporary interruption, the region's economic catching-up process will continue from 2011 onward, and the growth differential to the euro area will widen to around 2 to 2.5 percentage points according to IMF forecasts.

While the crisis hardly impaired the process of income convergence with the EU average for Poland, Slovakia and the Czech Republic – against the background of the recession in Western and Southern Europe, the catching-up process even accelerated in Poland – the Baltic countries in particular were thrown back for several years in their economic development.

3.4 Inflation Declines Significantly in the Region

In all countries across the region, price pressures have decreased in the last few months, significantly in some cases. Average annual inflation went down from 6.2% for 2008 as a whole to 2.7% in February 2009. This subdued price development is primarily attributable to the economic slump and the related, increasingly negative output gap. Thus, the decline in core inflation roughly matched that in headline inflation; disinflation was not equally pronounced across countries, however. In countries with a fixed exchange rate regime (i.e. in Bulgaria and the Baltic countries), inflation fell significantly more strongly than in the other countries in the region. While the first group of countries recorded a decline in inflation by more than 10 percentage points (almost 20 percentage points in Latvia) against 2008, the comparable reduction for the remaining countries in the region came to no more than 4 to 6 percentage points. Most likely, these differences can be traced both to the particularly strong economic downturn in most of the countries with a fixed exchange rate regime and to exchange rate effects.

Poland and Hungary are the only countries under review that did not register a significant drop in inflation:

Table 1

Price Developments in the CESEE EU Member States

	2008	2009	Sep. 09	Oct. 09	Nov. 09	Dec. 09	Jan. 10	Feb. 10
	Annual rate of change in the HICP in %							
Bulgaria	12.0	2.5	0.2	0.3	0.9	1.6	1.8	1.7
Estonia	10.6	0.2	–1.7	–2.1	–2.1	–1.9	–1.0	–0.3
Latvia	15.3	3.3	0.1	–1.2	–1.4	–1.4	–3.3	–4.3
Lithuania	11.1	4.2	2.3	1.0	1.3	1.2	–0.3	–0.6
Poland	4.2	4.0	4.0	3.8	3.8	3.8	3.9	3.4
Romania	7.9	5.6	4.9	4.3	4.6	4.7	5.2	4.5
Slovakia	3.9	0.9	0.0	–0.1	0.0	0.0	–0.2	–0.2
Slovenia	5.5	0.9	0.0	0.2	1.8	2.1	1.8	1.6
Czech Republic	6.3	0.6	–0.3	–0.6	0.2	0.5	0.4	0.4
Hungary	6.0	4.0	4.8	4.2	5.2	5.4	6.2	5.6
Entire region	**6.2**	**3.4**	**2.9**	**2.5**	**2.9**	**3.0**	**3.1**	**2.7**
Euro area	**3.3**	**0.3**	**–0.3**	**–0.1**	**0.5**	**0.9**	**1.0**	**0.9**

Source: Eurostat.

In Poland, the national currency depreciated particularly strongly at the end of 2008 and the beginning of 2009; moreover, the economic crisis clearly did not hit Poland as hard as it hit the other CESEE countries, and in Hungary, a rise in indirect taxes (inter alia of the value added tax, from 20% to 25%) as of July 2009 caused an additional upsurge in prices. In Estonia, Latvia, Lithuania and Slovakia, price levels fell in February 2010 (year on year).

The central banks in the region reacted to recent inflation developments and the reduced medium-term inflationary risks as well as to declining risk premiums by easing monetary policy. Thus, in 2009 Hungary reduced the key interest rate by 375 basis points, Romania by 225, Latvia by 200, Poland by 150, and the Czech Republic by 125 basis points, respectively.[3] Since the beginning of 2010, Hungary (–50 basis points), Romania (–100 basis points) and Latvia (–50 basis points) have eased monetary policy further.

4 Austria's Economy to Remain on a Robust Growth Path in the First Half of 2010

4.1 The Austrian Economy Contracted by 3.5% in 2009

According to national accounts data, in the fourth quarter of 2009 Austrian economic activity picked up 0.4% against the previous quarter (in real terms, seasonally and working day-adjusted). For 2009 as a whole, Austrian GDP growth posted a 3.5% contraction against the previous year (–3.6% in unadjusted terms).

Broken down by demand components, Austria's quarterly national accounts data show that the economic downturn – reflected in negative GDP growth rates since the third quarter of 2008 – was primarily triggered by a strong decline in exports and exacerbated by a significant reduction of investment. Featuring low but positive growth rates, by contrast, private consumption acted as a pillar of growth. Thus, the two halves of the year showed opposing growth trends: In the first

[3] *The key ECB interest rate applies in Slovenia and Slovakia; no key interest rates apply in Bulgaria, Lithuania and Estonia because these countries operate currency boards.*

Table 2

Results of the National Accounts for the Fourth Quarter of 2009

	GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports
	Quarterly change in %					
Q1 08	1.2	0.1	–1.0	1.2	1.4	–0.5
Q2 08	0.2	0.1	2.7	0.4	–0.5	–0.0
Q3 08	–0.6	0.1	–0.8	–1.5	–2.7	–3.0
Q4 08	–1.3	0.1	1.6	–2.9	–5.9	–4.2
Q1 09	–2.2	0.2	–1.5	–3.3	–7.3	–5.7
Q2 09	–0.5	0.3	0.3	–1.2	–2.9	–2.7
Q3 09	0.5	0.3	1.6	–1.1	0.7	0.4
Q4 09	**0.4**	**0.2**	**0.1**	**–1.6**	**1.6**	**1.1**
	Annual change in %					
2006	3.4	1.9	2.5	0.7	7.8	5.5
2007	3.4	0.8	2.0	3.2	9.1	6.7
2008	1.9	0.5	3.0	0.4	0.6	–1.6
2009	–3.5	0.7	0.9	–7.7	–14.1	–11.6

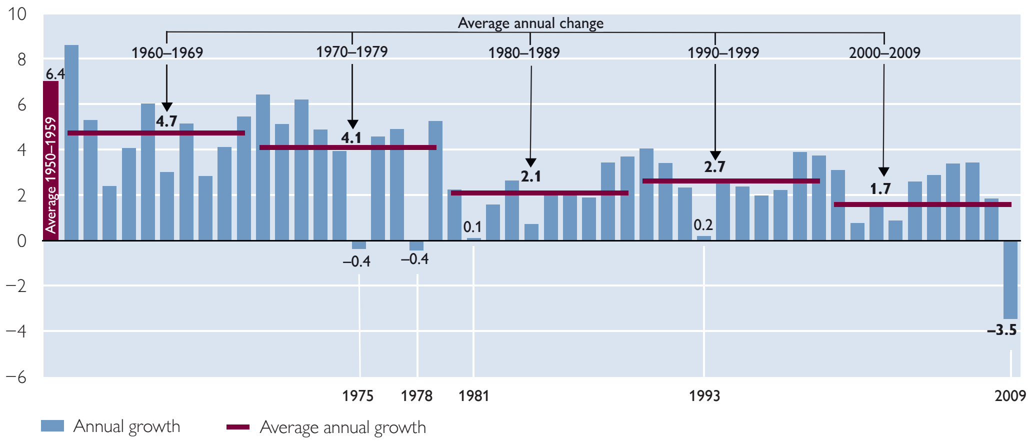
Source: Eurostat.

half of 2009, economic performance slowed down markedly in the wake of the global financial and economic crisis. In the second half of 2009, however, the Austrian economy posted robust growth rates just below the long-term average. Still, developments in the second half of the year did not suffice to offset the severe year-on-year slump in GDP, as shown in chart 9, which displays both the real annual GDP growth rates recorded in Austria since 1960 and average GDP growth per decade. It also shows the unusual extent of the current crisis, given that from the end of the Second World War until 2009, Austria had only twice recorded a fall in real GDP growth in annual terms (in 1975 and in 1978), and even then the contraction had been very moderate.

Chart 9

Economic Growth in Austria since 1950

Annual change in real GDP in %



Source: Eurostat, WIFO.

Results of the OeNB Short-Term Economic Indicator of March 2010[1]

The robust development of the Austrian economy is likely to continue in the first half of 2010. According to the OeNB's latest short-term indicator results of March 2010, real GDP growth in Austria can be expected to come to 0.5% in both the first and second quarters of 2010 (seasonally and working day-adjusted, on a quarterly basis). Thus the Austrian economy will remain on the growth path it embarked on in the third quarter of 2009.

Short-Term Outlook for Austria's Real GDP in the First and Second Quarters of 2010 (seasonally and working day-adjusted)

2008				2009				2010	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Year-on-year quarterly change in %									
3.1	2.9	1.9	–0.5	–3.8	–4.6	–3.5	–1.9	**0.8**	**1.9**
Quarterly change in %									
1.2	0.2	-0.6	–1.3	–2.2	–0.5	0.5	0.4	**0.5**	**0.5**
Annual change in %									
1.9				–3.5				×	

Source: OeNB – Results of the OeNB short-term economic indicator of January 2010, Eurostat.

The majority of leading indicators are clearly pointing upward, suggesting robust economic growth. An analysis of demand components reveals the following: Currently available monthly data on retail sales, new car registrations and developments in tourism point toward continued moderate growth in private consumption, despite the dampening effect of rising unemployment. At the time being, low capacity utilization, the still difficult financing conditions and high medium-term risks to economic growth indicate that investment activity will remain subdued also in 2010. Owing to the negative carryover effect from 2009, gross fixed capital formation will – at best – stagnate in 2010 as a whole. The current economic momentum is primarily based on export developments, which are benefiting from the renewed uptrend in the international economy. Moreover, the depreciation of the euro recorded over the past few weeks will buoy export activity in the coming quarters. If Austrian economic growth maintains its current momentum, GDP can be expected to climb by around 1½% during 2010 as a whole. It cannot be excluded, however, that growth will slow down markedly toward the end of the year as temporary growth factors unwind.

[1] *The next release of the OeNB's short-term economic indicator is scheduled for July 2010.*

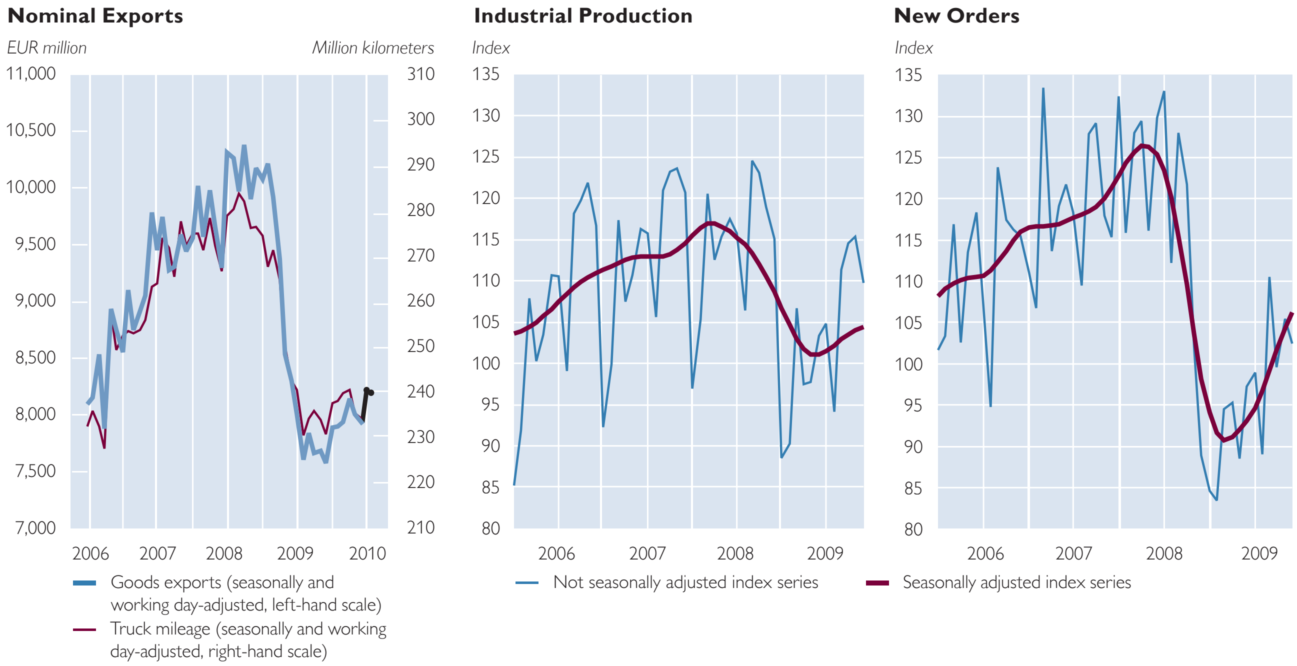
4.2 Export, Industrial and Confidence Indicators Point to Strong Growth

The factors that had been driving the Austrian economy in the fourth quarter of 2009 continue to play a key role in the persistently robust growth expected for the first half of 2010. Having reduced their inventories during the crisis, Austrian enterprises are now building them up again. Moreover, exports picked up swiftly as the international economy gathered steam, with Austrian exporters benefiting from the declining external value of the euro and from improving order book levels.

Based on these developments, the current results of the OeNB's export indicator for January and February 2010 point to a rise in goods exports in nominal terms (chart 10, left-hand panel) by 1.2% and 2.4%, respectively

Chart 10

Development of Selected Economic Indicators for Austria



Source: ASFINAG, Statistics Austria, OeNB.

Note: The last two values for goods exports are forecast values.

(seasonally and working day-adjusted, quarter on quarter). On a year-on-year basis, the growth of seasonally adjusted goods exports will accelerate from 2.9% in January 2010 to 7.6% in February 2010. Apart from the economic recovery, this uptrend is primarily attributable to base effects, however. In February 2010, the level of goods exports will remain close to 20% below the peak value recorded in April 2008. Nevertheless, this corresponds to an almost 10% rise against the low of June 2009.

Echoing the development of exports, the curves of industrial production and new orders are U-shaped and V-shaped, respectively, reaching a low in early summer 2009 (chart 10, middle and right-hand panels). Despite the recovery recorded over the past six months, both industrial production and new orders are far from their reaching precrisis high. Moreover, setbacks have been reducing the speed of the recovery process again and again. Posting a decline against the previous month (quarter on quarter) in December 2009, industrial production was especially hard hit. For the first time in many months, new orders, by contrast, showed a pronounced increase again in December 2009 (year on year). While this upturn was above all attributable to new orders from abroad, new domestic orders also increased for the first time since August 2008 (year on year). Developments in both cases were attributably primarily to a pronounced base effect, since order books had already deteriorated strongly in December 2008.

4.3 Rise in Unemployment Rate (Eurostat Definition) Slows Down

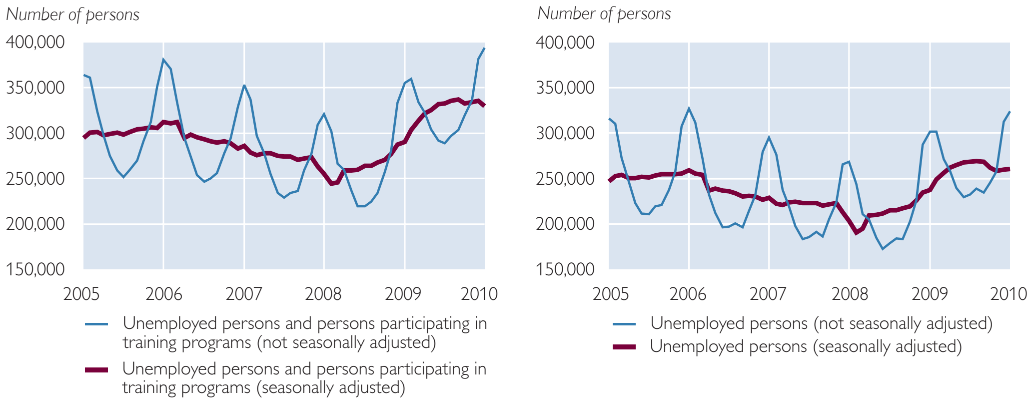
Currently, Austrian labor market data do not indicate a clear trend: On the

Chart 11

Unemployment Developments in Austria

Registered Unemployment as Recorded by the AMS and Number of Persons Participating in AMS Training Programs

Registered Unemployment as Recorded by the AMS



Source: Statistics Austria.

one hand, the unemployment rate as defined by Eurostat went down from 5.6% in October 2009 to 5.3% in January 2010. On the other hand, seasonally adjusted registered unemployment as recorded by the Austrian Public Employment Service (AMS) has been increasing slightly, coming to 7.4% in January 2010, up from 7.3% recorded between August and December 2009. The number of registered unemployed also conveys mixed signals. As chart 11 shows, seasonally adjusted unemployment had peaked by summer 2009, went down slightly after that and has been moving sideways since December 2009. However, the number of unemployed persons, including those participating in AMS training programs, continued to rise.

Weather conditions caused the number of unemployed persons (including persons participating in AMS training programs and persons placed on short-term working schemes, on a pro-rata basis) to peak at 412,490 in absolute terms in January 2010. Over the past few months, enterprises relied on short-term working schemes to an ever lesser extent. Mid-2009, around 55,000 persons in approximately 320 enterprises were reported to have been put on a short-term working contract. By March 2010, their number had halved to around 24,700 in 217 enterprises.

4.4 HICP Inflation Rises Slightly in Early 2010

Coming to 0.9% in February 2010 (compared with 1.2% in January 2010), HICP inflation in Austria went down marginally for the first time after the uptrend recorded since September 2009. This recent reduction is mainly attributable to a fall in food, garment and footwear prices. Moreover, fuel prices climbed at a slower pace in February than in January 2010.

In February 2010, like in the two previous months, fuel prices were among the key drivers of inflation, although their contribution went down from 0.4 percentage points in January to 0.3 percentage points in February. Housing rents augmented by 4.7% year on year in February, i.e. at a rate that was also slightly lower than before (5.5% in January). By contrast, developments in prices for food, nonalcoholic beverages, natural gas (gas providers in three Austrian provinces had reduced prices in November 2009) and education (university tuition fees had been abolished in March 2009 and a free kindergarten year had been introduced as of September 2009) had a dampening effect on inflation in February 2010. Moreover, substantial month-on-month price reductions for garments and footwear were measured in February 2010, which might be attributable to a base effect of the delayed clearance sale period in winter 2009.