Global Economy Continues to Recover

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The economic recovery, which had started in Asia and then quickly spread to the U.S.A., recently lost momentum in both regions. In the second quarter of 2010, the U.S. economy recorded real GDP growth (in annualized terms) of a mere 1.7% quarter on quarter, following 3.7% in the first three months of 2010 and 5.0% in the final quarter of 2009. In Japan, quarterly real GDP dropped to 0.4% in the second quarter of 2010 from 1.2% in the first quarter. Meanwhile, the global economy continues to benefit most from the momentum of the Asian threshold countries. China, which has replaced Japan as the third largest economy (after the U.S.A. and the euro area), posted 10.3% growth in the second quarter of 2010, only slightly less than in the previous quarter. In light of its vibrant import performance, China's current account surplus is likely to be lower in 2010 than it was in 2009.

In contrast to global developments, the European economy saw a growth spurt in the second quarter of 2010 thanks to unexpectedly favorable developments in Germany, which compensated for problems in the southern and western periphery of the euro area. Growth was driven above all by international trade, with the low euro exchange rate recorded in spring supporting the pickup of exports. In the second quarter of 2010, real GDP in the euro area climbed by 1.0% on the previous quarter, i.e. more strongly than expected. All euro area countries, excluding Greece, posted an expansion, with Germany being the main driver (2.2%). According to the most recent forecasts, the euro area is expected to rebound more markedly than previously envisaged. At an unchanged 10.0%, the seasonally adjusted unemployment rate for the euro area recorded in July 2010 continued to mark the highest value in twelve years. At 1.8%, the inflation rate remained moderate in September 2010. The latest forecasts do not point to any threats to price stability up until end-2011.

The gradual economic recovery, which had become evident in the Central, Eastern and Southeastern European (CESEE) countries at end-2009, stabilized in the first six months of 2010, as the region, on balance, posted clearly positive quarter-on-quarter growth rates. Restocking and exports continued to buttress the economy, while consumption and investment did not foster growth in a sustainable manner. Despite a slight increase, inflation still remains at a relatively modest level. Financial markets have quieted for the time being after the turbulence of early summer 2010. In some countries, however, the situation remains highly uncertain.

After an exceptionally powerful economic revival in Austria mid-2010, the OeNB expects continued robust economic activity in the second half of 2010 and a slowdown in line with world trade developments toward the end of the year. In 2010 as a whole, the Austrian economy is expected to grow by almost 2% on the back of animated export demand. Considering that the recession was very pronounced, the current upturn is fairly restrained, and domestic demand is still too weak for a self-sustained upswing.

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1 Global Economic Growth Slows but Remains Robust

1.1 U.S.A.: Economic Sentiment Deteriorating

From January to June 2010, the U.S. economy grew at a solid pace, with real *GDP* increasing by 3.7% and 1.7% (annualized) quarter on quarter in the first and second quarter of this year. All expenditure components, excluding net exports, contributed to the robust increase in the second quarter, with particularly important contributions coming from inventory changes, gross fixed capital formation and private consumption.

Cutoff date for data:
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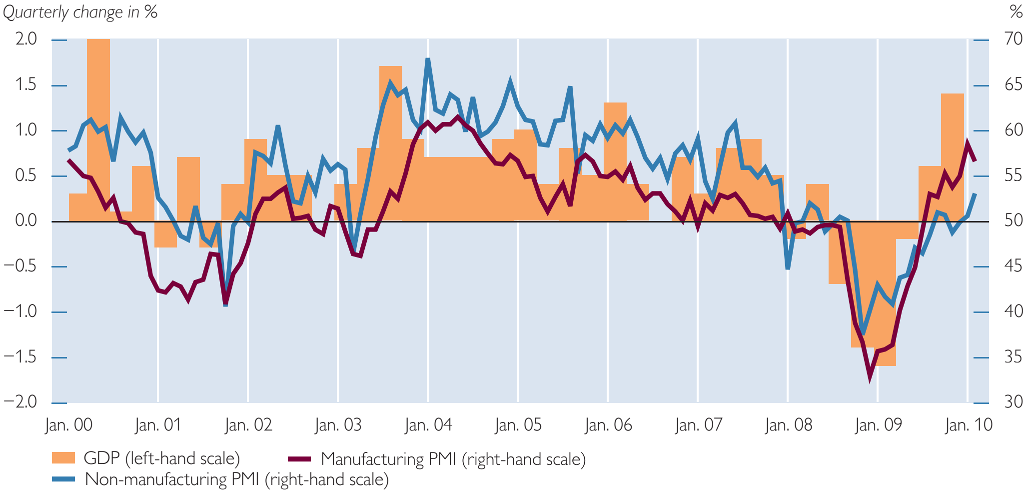
Chart 1

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



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

Increasing investment activity notwithstanding, numerous *leading indicators* point to an economic slowdown and a U-shaped recovery in the U.S.A. While in spring 2010 industrial production – and thus purchasing manager sentiment – had continuously risen, these figures started to downtrend in early summer. The U.S. Purchasing Managers' Index consequently dipped markedly from April to July 2010, yet stabilized again at least in August. In addition, while capacity utilization has started to improve, it does so at a very slow pace. In August 2010, it edged up slightly to 74.4%, continuing the modest increase since the beginning of the year, while still remaining at a historically low level. Further recent data likewise signal that the economic recovery is likely to lose speed. Moreover, consumer sentiment has weakened again considerably. More precisely, the *Conference Board* indicator on consumer sentiment had dropped by close to 10 percentage points from May to August 2010, when it rose again for the first time since May. Growth in the first half of 2010 was above all attributable to government stimulus packages that are now set to expire and to restocking activity.

Labor market developments will, as usual, be key in determining the fate of the U.S. economy. After the winter 2009/10 record high of 10% and modest declines in spring, unemployment climbed back up to 9.6% in August 2010. New claims for unemployment benefits, however, recently decreased again somewhat. Whether or not the labor market will rebound further will depend on the performance of the construction sector. The unexpected slide in *productivity* by 0.9% in the second quarter of 2010 is a red flag. This decline – the first one since the final quarter of 2008 – is a further sign of a weakened U.S. economy. Even though the U.S. labor market seems to have principally turned around in 2010, the for U.S. standards extremely high unemployment rate is not expected to decline significantly. Unemployment has stayed above 9% for 16 months in a row now, a record in the past 25 years.

In its September 2010 Federal Open Market Committee (FOMC) meeting, the Federal Reserve System concluded that the recovery of output and employment had lost momentum over the past months. While gradually on the rise, household expenditure remains weak owing to the high joblessness rate, modest income growth and other factors, such as credit constraints. The Fed forecasts GDP to grow between 3.0% and 3.5% in 2010 and between 3.5% and 4.2% in 2011. By contrast, *Consensus Forecasts* predicts much more pessimistic growth rates, namely 2.7% for 2010 and 2.4% for 2011. Most experts nevertheless do not expect the U.S. economy to slide back into recession.

The real estate market is unlikely to reemerge as a driver of growth for the troubled U.S. economy for the time being, as the recovery of *residential housing* seems rather sluggish and construction investment has shrunk to a mere 2.5% of GDP, from 6% before the crisis. The *Case-Shiller* price index for single-family homes rose four times in a row year on year in early summer 2010. In August 2010, the number of house sales declined on the previous month, but new home construction projects and permits increased more strongly than expected against the previous weak months. The August 2010 figures nevertheless underperform the values recorded in previous years.

The annual CPI *inflation rate* was measured at 1.1% in August 2010, while core inflation came to 0.9%. In light of the economic slowdown expected for fall 2010, the Fed pegs annual inflation to drop to an average 1%. Since December 2008 the target range for the *federal funds rate,* i.e. the U.S. key interest rate, has been unchanged at 0% to 0.25% and the Fed intends to keep it on this level for an extended period. In September 2010, the FOMC signaled its readiness to make further adjustments, if need be, to support the recovery.

The Great Recession has led to a significant reduction in global imbalances. As a case in point, the U.S. *current account deficit* halved from 6.0% of GDP in 2006 to 2.9% of GDP in 2009. This development will, however, most likely not result in a structural change, even though President Obama has set the goal of doubling U.S. exports by 2015. The OECD expects higher deficits again for 2010 and 2011.

According to the most recent forecast of the House Committee on Budget, the U.S. *budget deficit* will run to 9.1% of GDP in the current fiscal year and net government debt will rise from 53% of GDP (2009) to some 66% in 2011. In September 2010, President Obama announced further economic stimulus packages and tax breaks for U.S. businesses. This way, USD 50 billion are to be invested into the public infrastructure, and Obama's plan will allow all companies that invest in plants and equipment to write off the full amount of capital investments made through the end of 2011. The latter measure would cut business taxes by nearly USD 200 billion over the next years.

In mid-July 2010, the U.S.A. unveiled new financial market regulations. The overhaul strengthens supervision in all areas of the financial market. The reforms are meant to reduce the risks bank take by either banning them from or limiting their involvement in particular high-risk operations. Moreover, the Fed will house a central consumer protection body for financial services and regulators will in the future be authorized to liquidate failing financial firms in an orderly fashion.

1.2 Japan: Economic Growth Lost Considerable Momentum

The Japanese economy is very likely to expand at a faster pace in 2010 than all major European countries, with the exception of Germany. In the second quarter of 2010, real *GDP* increased by 0.4% on the first quarter, when it still had grown by 1.1%. While in the first quarter all expenditure components had contributed to growth, in the second quarter, growth was driven only by exports, irrespective of the strength displayed by the Japanese yen. Domestic demand accounted for a negative contribution. In contrast to other industrial nations, the Japanese *labor market* proved surprisingly resilient in winter 2009/10, but as from spring 2010 unemployment rose again somewhat, yet dropped to 5.2% in July 2010. Joblessness thus lies 0.3 percentage points above the relatively low level recorded in February 2010.

Recent *leading indicators* suggest that the recovery is likely to continue in 2010, though at a reduced level. The quarterly *Tankan* survey, considered to be Japan's most important sentiment indicator, rose an unexpected 15 points according to the June 2010 results, thus returning to positive territory again for the first time in two years. In other words, businesses taking an optimistic view for the first time again outnumber the pessimists. The favorable economic conditions were also corroborated by industrial production growth in July 2010. In the same month, the weakening of the Japanese purchasing managers' index, of business sentiment and of machinery orders, however, reflected the uncertainty that prevailed.

Japan has yet to head off deflation. Even though up to June 2010, the price decline had slowed down clearly relative to January, in July, the annual CPI *inflation rate* again posted –0.9% and the core inflation rate –1.5%. At –1.8%, at least the GDP deflator showed a significant quarter-on-quarter improvement in the second quarter of 2010 (Q1 2010: –2.8%). The *Bank of Japan* (BoJ) nevertheless expects that the rate of price decline will slow down again over the course of 2010, which implies that it will maintain its highly accommodative monetary policy. International institutions expect prices to fall through the third quarter of 2011. In light of the strong yen, the BoJ once more increased its credit facility by EUR 90 billion in August 2010. Under continued pressure from the Japanese government, the central bank decided in August 2010 to maintain its key interest rate at 0.1% and has thus not changed the overnight call rate since December 2008.

At 217%, Japan's gross debt-to-GDP ratio was the highest among industrial nations in 2009, and according to the IMF, Japan's *debt* could rise to 248% of GDP by 2015. This notwithstanding, the country has so far not been sucked into a debt crisis. Japan's new prime minister, Naoto Kan, has thus pledged to rein in its massive public debt, citing this as one of his most important objectives. Since the beginning of 2010, the Japanese yen has appreciated significantly against the euro and less so vis-à-vis the U.S. dollar. This appreciation poses a great challenge to Japan's export-dependent industrial sector.

1.3 China: Growth Slowed Down, but Remains Very Solid

China's business cycle has already peaked once after the crisis. In the first half of 2010, real *GDP* expanded by 11.1% year on year (Q1 2010: 11.9%, Q2 2010: 10.3%). Consequently, China has eventually replaced Japan as the third largest economy in the world.

Industrial production jumped from January to June 2010, outperforming the respective year-earlier figures by one-sixth. For over a year the Chinese purchasing managers' index has stayed above the 50-point mark, but declined recently.

Following its deflation spell in 2009, China again clocked positive *inflation rates* in 2010. In August 2010, the annual CPI inflation reached 3.5%, the highest value in almost two years. Unlike counterparts in other emerging countries, the Chinese central bank has so far left its key interest rate unchanged at 5.3% in 2010. It has, however, raised minimum reserve requirements for large banks in three steps. In the first half of 2010, the four large state-run Chinese banks reported significantly higher profits with gains between 25% and 40%.

The *trade volume* of the People's Republic of China grew by more than 40% on the previous year in the first half of 2010, totaling over USD 1,300 billion. This increase was primarily attributable to imports (+52%), which expanded more markedly than exports (+35%). Owing to the strong performance of imports, China's overall 2010 current account surplus is estimated to shrink to 2.8% of GDP from 6.1% in 2009. The growth in China's *currency reserves* almost came to a halt in the second quarter of 2010, when they edged up by a mere USD 7 billion to a total of USD 2,454 billion. Since spring 2010 China has been slowly shifting its portfolio of currency reserves to include more assets denominated in Japanese yen.

In mid-June 2010, China discontinued *the renminbi yuan's peg to the U.S. dollar* and returned to the regime that had been in place up to July 2008. The *renminbi* is thus again pegged to an undisclosed basket of currencies, which is believed to be dominated by the U.S. dollar and the euro. The People's Bank of China sets a daily reference rate, and the daily trading band against the USD is +/–0.5% (September 21, 2010: USD/CNY 6.70). The renminbi did not, as expected by some experts, show a one-off abrupt increase in value; it gained less than 2% on the U.S. dollar from mid-June to mid-September 2010.

The real estate market in China is slowly cooling off, with the measures implemented by the government in spring 2010 seemingly taking effect. In April, the government raised down-payment requirements, curbed mortgages and announced that it would increase the land supply available for residential property. Under its Article IV consultation with the People's Republic of China, the IMF in July 2010 likewise concluded that, at a national level, property prices did not seem to be significantly above fundamentals.

2 Euro Area Economy Proves More Resilient than Expected

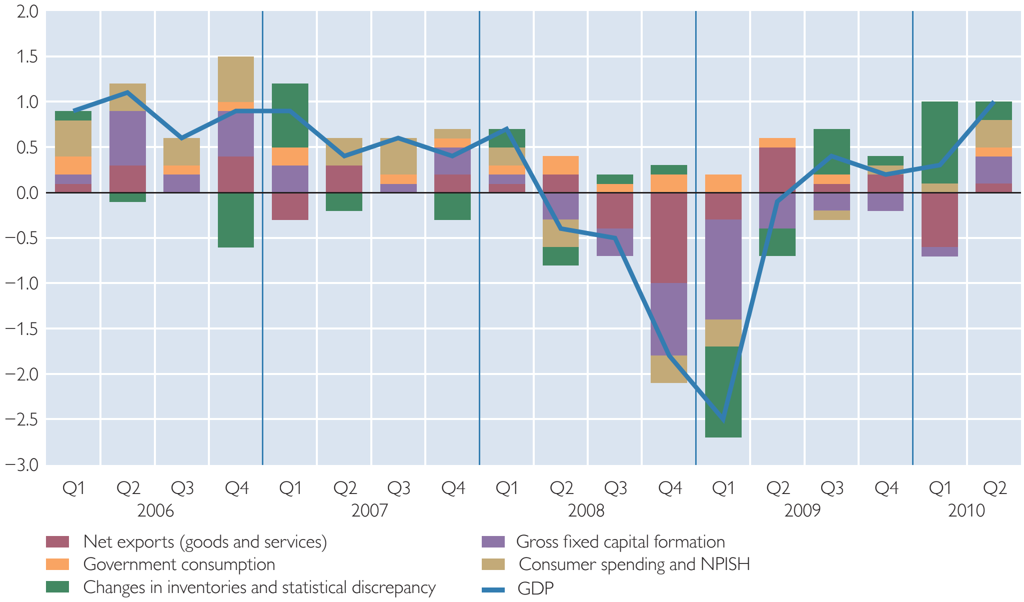
2.1 Growth Surprisingly High in Second Quarter 2010

While the recovery of the global economy picked up steam in spring 2010, that of the euro area progressed at a modest pace. After real *GDP* climbed by 0.3% in the first quarter of 2010, its growth accelerated to 1.0% in the subsequent quarter. From April to July 2010, economic output advanced by 1.9% quarter on quarter. The GDP *expenditure breakdown* paints the following picture: The subdued growth of the first quarter was mainly driven by short-term factors (restocking), while in the second quarter, all components – especially investment and private consumption – made a contribution.

Chart 2

Contribution to Real GDP Growth in the Euro Area

Quarterly changes in percentage points and in %



Source: Eurostat.

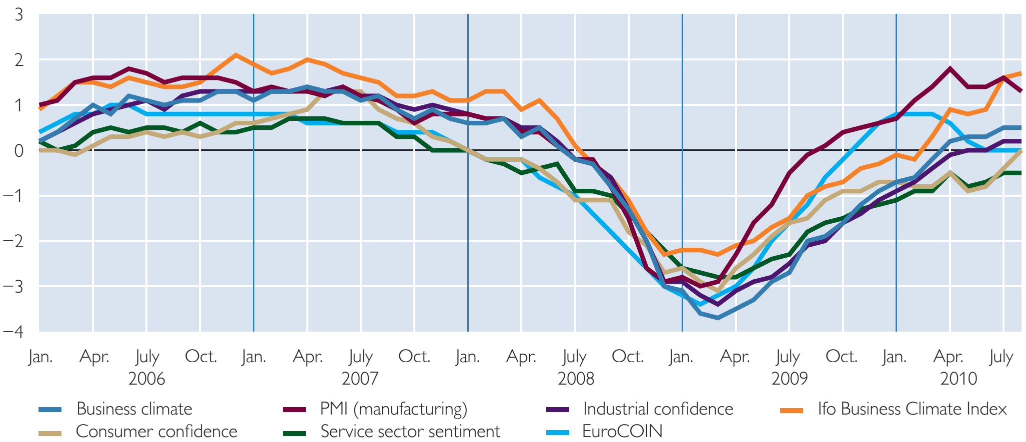
Private consumption increased in the second quarter of 2010 against the previous, still very subdued, quarter. Against the backdrop of high unemployment rates in the euro area, such growth is somewhat surprising. Gross fixed capital formation increased again considerably quarter on quarter (but not year on year) in the second quarter of 2010. Public spending grew both on the previous quarter and on the previous year in the second quarter of 2010. The momentum emanating from exports driven by the recovery in world trade is masked by rising imports, which is why the contribution of net exports to growth is marginal in the euro area.

The momentum of euro area growth reflects increasingly *heterogeneous developments in economic activity* across the single currency area. Since the economy hit bottom in the first quarter of 2009 euro area countries have been recovering at different rates. Posting a growth rate of 2.2% in the second quarter of 2010, the German economy expanded at a speed last seen in 1987; in addition, the first-quarter figures were revised upward to 0.5%. France's quarterly growth rate likewise attests to relatively robust growth (0.6%). At the euro area periphery, Italy advanced at a rate of 0.4% and Spain and Portugal each at 0.2%. Except for Greece (–1.5%), no euro area country continued to register negative growth rates in the second quarter of 2010 (the data for Ireland, Luxembourg and Malta were not yet available, though). These developments show that the structural imbalances in the euro area still exist. The peripheral EU countries continue to be faced with greater internal and external rebalancing needs than the core countries. Yield spreads for government bonds reflect these difficulties on international financial markets, which, in turn, aggravates the weakness in growth.

Chart 3

Business Climate Indicators in 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.

2.2 Leading Indicators Paint Heterogeneous, yet Positive Picture

The leading economic indicators continue to paint a heterogeneous, yet positive picture. While stagnating in June and July 2010 following months of solid growth, *industrial production* nevertheless posted high year-on-year growth rates. The recovery track of the industrial sector is therefore more solid than anticipated. On the other hand, the previous ascent of survey-based confidence indicators is flattening out after approximately one year of continuous growth. The European Commission's *Economic Sentiment Indicator* continued to improve, while the industrial confidence subindicator stabilized. The *purchasing managers' index* in the industrial sector decreased slightly, yet still remained at a high level. Consumer and service sector sentiment likewise brightened recently, while the outlook in trade and construction remained unchanged. According to the *Ifo Business Climate Index* of the ifo Institute for Economic Research, the majority of surveyed businesses in Germany (except for the construction industry) consider the current economic situation favorable, while business expectations flattened further recently.

2.3 Has Unemployment Reached Its Peak?

As if on cue from the brighter growth outlook, conditions in the labor market have slowly begun to ease. In July 2010, the unemployment rate in the euro area came to 10.0%, around 0.4 percentage points higher than a year earlier. With the exception of four countries (Germany, Austria, Finland, Malta), in most euro area countries unemployment has yet to peak. Compared with the previous month, Italy, Cyprus, Austria, Portugal and Slovenia managed to reduce the rate of joblessness in July 2010. In Germany, a relatively low number (6.9%) of the working-age population is out of work. In Spain, unemployment rose further and ran to 20.3% in July. Even though the unemployment rate in the euro area has remained at 10.0% since March 2010, it might not have peaked yet. In the face of recent data, the spring forecasts by the European Commission anticipating a further rise in unemployment to 10.3% (2010) and 10.4% (2011) seem to be too pessimistic.

2.4 Brighter, but More Mixed Forecasts

According to the latest *forecasts,* the recovery is set to progress at a slow pace in the next quarters. Growth predictions for 2010, which have mostly been revised upward since fall 2009, range from 0.9% to 1.7%. The European Commission's forecast lies at the upper end of this spectrum. The ECB staff projections of September 2010 contain a significant upward revision for the current year, compared with the June projections. For 2010, ECB forecasters expect real GDP gains in the range of 1.4% to 1.8%.

Increased export demand – most likely even above pre-summer expectations – will continue to buttress the economic recovery. The expansion of the global trade volume stayed on course in spring and summer 2010. On the other hand, considerable downside risks pertain to new tensions in financial markets, uncertainty about the growth outlook in some advanced economies and another hike in oil and other commodity prices. ECB experts forecast growth to be between 0.5% and 2.3% in 2011; this reflects a slight upward revision compared with the June 2010 projections.

2.5 Budget Consolidation Started in Most Countries

According to the European Commission's spring forecast, the *budget deficit* in the euro area will increase to an average 6.6% in 2010. The year 2011 should see the turnaround at 6.1%; these figures may even be revised downward, given most Member States' profound consolidation efforts. The budget deficit in 2010 will not be below the Maastricht criterion of 3% of GDP in any of the euro area Member States, with the exception of Luxembourg. In 2011, deficits are expected to at least decline in most countries owing to fiscal consolidation measures.

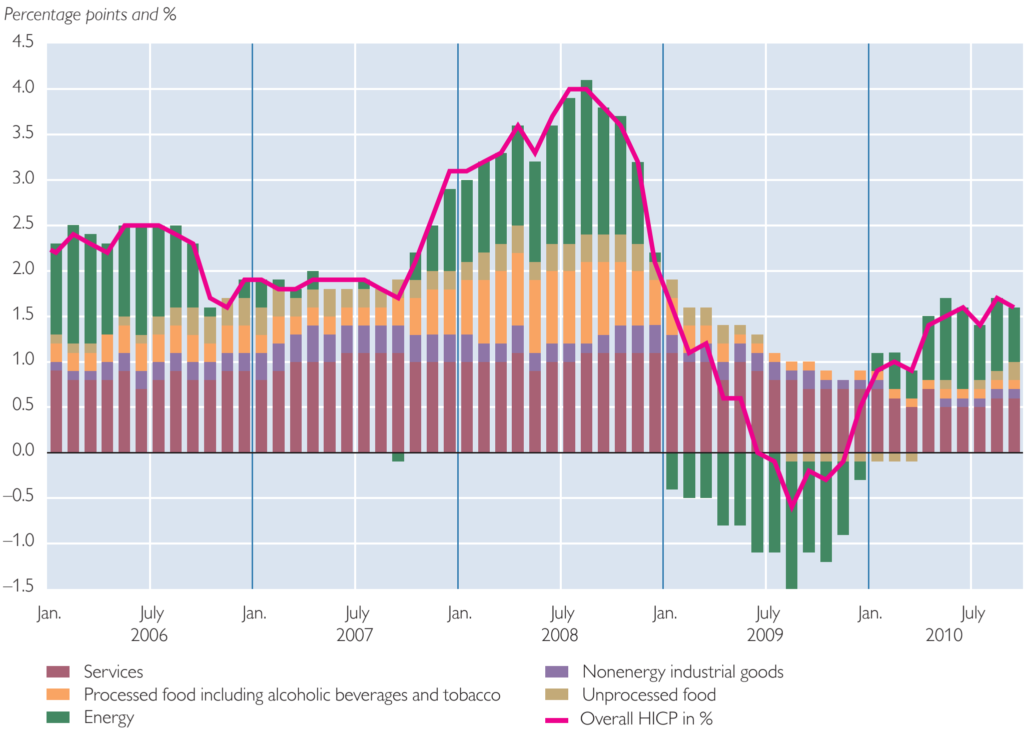
Recently, the countries at the euro area periphery generally showed a positive fiscal policy trend. As a case in point, budget consolidation has to date progressed quite well in Greece. By contrast, Ireland's budget deficit revision over the summer of 2010 gives cause for concern. In its recent quarterly report, the *Central Bank of Ireland* anticipates the general government deficit (Maastricht definition) to rise to between 17% and 19% of GDP in 2010. This expected upward revision (which contrasts with a planned deficit ratio of 11½% of GDP) is ascribable to capital injections for *Anglo Irish Bank* and maybe also for *Irish Nationwide,* which may have to be reclassified as capital transfers with the effect of increasing the budget deficit.

2.6 Inflation Remains Modest

In 2010, annual *inflation* (HICP) ranged between 0.9% and 1.8% (September). HICP core items (excluding energy and unprocessed food items) have continued to contribute to disinflation. In August 2010, the core inflation rate remained at 1.0% year on year. This very modest increase over the past few months is in part attributable to the gradually contracting output gap (robust growth, capacity utilization increased to 77.4% in the third quarter and unemployment stabilized). More dynamic activity in the euro area is likely to increase price pressures on the core HICP items. For the time being, however, labor costs and producer prices are still rising at a moderate pace. Likewise, weak money and credit growth suggests that inflationary pres-

Chart 4

HICP Components



Source: Eurostat.

sures will remain contained in the medium term.

The yield curve of inflation-linked bonds indicates that inflation expectations in the financial markets are decreasing. Longer-term inflation expectations, which have been more volatile since the crisis, are still in line with the Eurosystem's objective of price stability. Short-term consumer inflation expectations surveyed by the European Commission again turned positive in March 2010, continued to rise until May and stabilized in the summer, which implies that the majority of respondents expects prices to rise.

In its most recent staff macroeconomic projections, the ECB slightly revised upward its inflation forecast to between 1.5% and 1.7% for 2010 and between 1.2% and 2.2% for 2011. Equally, the current projections issued by international institutions and *Consensus Forecasts* show that HICP inflation is likely to hover around 1.5% in 2010 and 2011. Overall, there are still neither pronounced inflation nor deflation risks. According to the ECB Governing Council, risks are currently on the upside (due to higher commodity prices and indirect taxes) rather than on the downside (due to weak domestic cost dynamics).

Having remained fairly stable in the winter of 2009/10, crude oil prices turned more volatile in spring 2010. The price for one barrel of crude reached a level of more than USD 87 for a short time in early May 2010 but fell to USD 75 by mid-September and to an even lower level afterwards. The prices of crude oil futures suggest that the oil price will remain below the USD 80 per barrel level for the rest of 2010. External price pressures eased during the summer, with the *euro* regaining some ground against the U.S. dollar over the past few months. At present, the euro's exchange rate against the U.S. dollar is still some 20% below its relative record levels of early December 2009. In historical terms, however, the euro continues at a high level against the U.S. dollar. The euro fell sharply against the Japanese yen and the Swiss franc and less so against the pound sterling in 2010. Overall, the euro's nominal effective exchange rate stabilized during the summer but is likely to continue to provide support to European exports.

2.7 Euro Area Interest Rate Level Remains Low

At its last (September 2, 2010) meeting before the cutoff date for data, 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 keep its *extraordinary liquidity support measures* in place as long as necessary. The main refinancing operations and one-month refinancing operations[2] will continue to be conducted as fixed-rate tender procedures with full allotment until at least January 2011. The fixed-rate tender procedure with full allotment will also be used for the regular 3-month longer-term refinancing operations scheduled for October, November and December 2010.

These decisions ensure that the euro area banking system will continue to receive liquidity over extended periods at very favorable conditions, promoting lending to the euro area economy and, consequently, further supporting the recovery. At the same time, the decisions pre-empt distortions that might arise from an unduly long maintenance of the extraordinary liquidity measures.

The Euro Overnight Index Average (EONIA) stood at an average 40 basis points over the past six months (with the exception of the fluctuations seen in the last few days of the maintenance periods), that is slightly above the level of September 2009. In an environment of relatively ample liquidity, the *monetary aggregate* M3 resumed expansion after having contracted in the winter 2009/10 and in the spring of 2010.

In July 2010, annual monetary growth returned into positive territory (0.2%), the underlying pace of monetary expansion is expected to remain moderate, however. At 1.2%, the monthly growth rate was slightly positive in July but clearly lower than in the previous month. The M3 growth rates indicate that the influence of the still steep yield curve has been gradually waning. Still, adjustments in monetary assets accumulated in the past continue to weigh on monetary growth. The inflows recorded in July were mostly confined to M1 and M2.

The *yield spread* between German 10-year *government bonds* and other euro area government debt of the same maturity moderated temporarily as the euro's external value rebounded but widened considerably in the past few weeks, not least because the German yields contracted by about 1 percentage point on spring 2010. The 10-year government yield spread between Germany and the euro area peripheral states in mid-September ranged from less than 200 basis points (Spain) to

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

under 400 basis points (Portugal and Ireland) and over 900 basis points (Greece).

3 Economic Developments in Central, Eastern and Southeastern Europe

3.1 Gradual Recovery Taking Hold

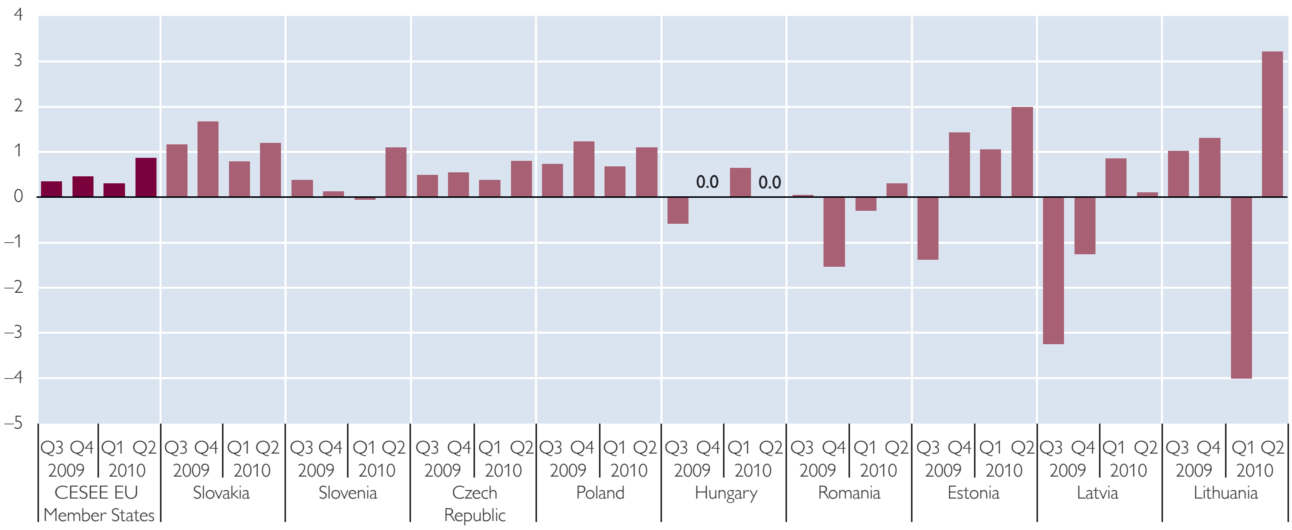
The gradual recovery of the economies of the EU Member States in Central, Eastern and Southeastern Europe (CESEE) continued in the first half of 2010. In the second quarter of 2010, seasonally adjusted growth averaged 0.9% (quarter on quarter) in the countries under review, and in none of these countries did the economy contract. The growth differentials between these countries are still fairly considerable, however. The mainstay of growth across the region has been the buoyant economic activity observable in the majority of central European economies for several quarters. Poland has been playing a key part: The region's largest economy by far, it was the only country under review that did not slide into recession in 2009, and it continued to post positive growth rates in 2010 so far. The dynamics in the Baltic states, in Southeastern Europe and in Hungary, in contrast, were significantly weaker and more volatile. By and large, the situation seems to stabilize gradually also in these countries, which are likely to return onto a moderate growth path.

These current developments have been driven in particular by restocking and exports. Exports started to contribute positively to growth in all countries in the fourth quarter of 2009 or the first quarter of 2010. In the latest readings, many countries posted even two-digit export growth (e.g. Slovakia, the Czech Republic, Hungary, Romania and Estonia). These dynamic developments are attributable to rising international demand against the background of strong global growth in the first half of 2010 and expanding world trade. The region has particularly benefited from favorable developments in the euro area, especially in Germany,

Chart 5

GDP Growth on a Quarterly Basis

%, seasonally adjusted



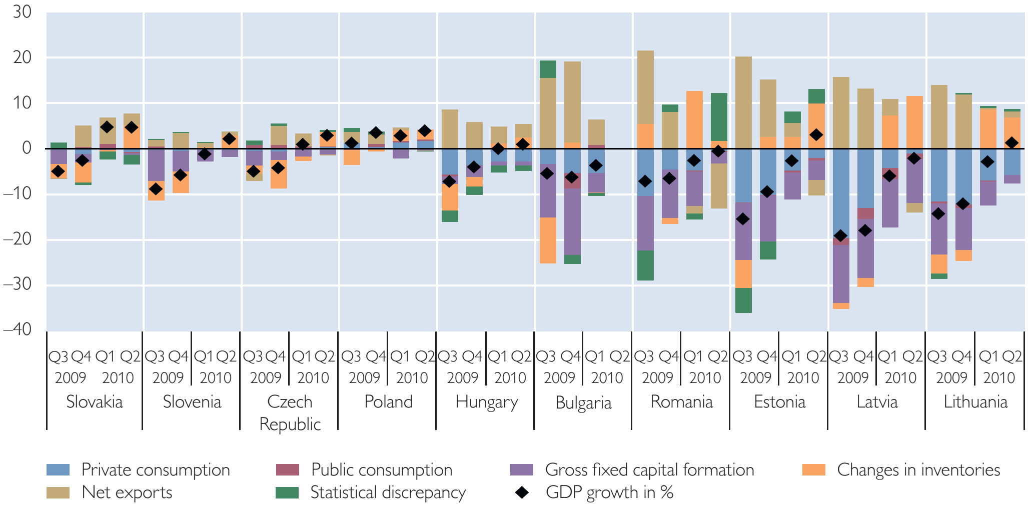
Source: Eurostat.

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

Chart 6

GDP Growth on an Annual Basis

Percentage points and %, not seasonally adjusted



Source: Eurostat.

in the period under review. Thanks to the region's close integration in the European production chain, strong export growth stimulated imports too (due to the import of intermediate goods), which notably dampened the contribution of net exports in some countries.

At the same time, neither consumption nor fixed capital formation have visibly contributed to growth in any of the CESEE countries (with the exception of Poland) recently, which is due to the continuously adverse labor market situation, very moderate wage dynamics, weak loan growth and persistently below-average capacity utilization. Compared with the previous quarter, however, domestic demand started to provide some positive impetus in the Czech Republic and Lithuania, with, in particular, investment activity gathering momentum.

Key leading and sentiment indicators confirm the ongoing recovery. All sectors saw – in part substantial – improvement in the past few months, but so far industry, as a particularly export-oriented sector, has clearly benefited most from the recovery. Industrial production, orders and sales have rebounded to levels well above their long-term averages, industrial confidence has recovered to its long-term average level and capacity utilization is on the rise again. In retail trade and construction, on the other hand, the upswing has been only subdued. Cold winter weather was one of the reasons why construction had a particularly bad first quarter of 2010, but the situation improved visibly in the spring. Retail trade sales are still feeling the impact of persistently subdued consumer demand.

Current IMF forecasts expect average economic growth in the region at 1.6% in 2010 and an increase to 3% in 2011. The IMF's most recent prediction for 2011 is less upbeat than the one of spring 2010, however, as the growth outlook for Romania, where fiscal consolidation measures (including a hike in the value-added tax rate from 19% to 24%) linked with the provision of IMF and EU aid will significantly curb growth, had to be revised downward. At the same time, however, the IMF

Chart 7

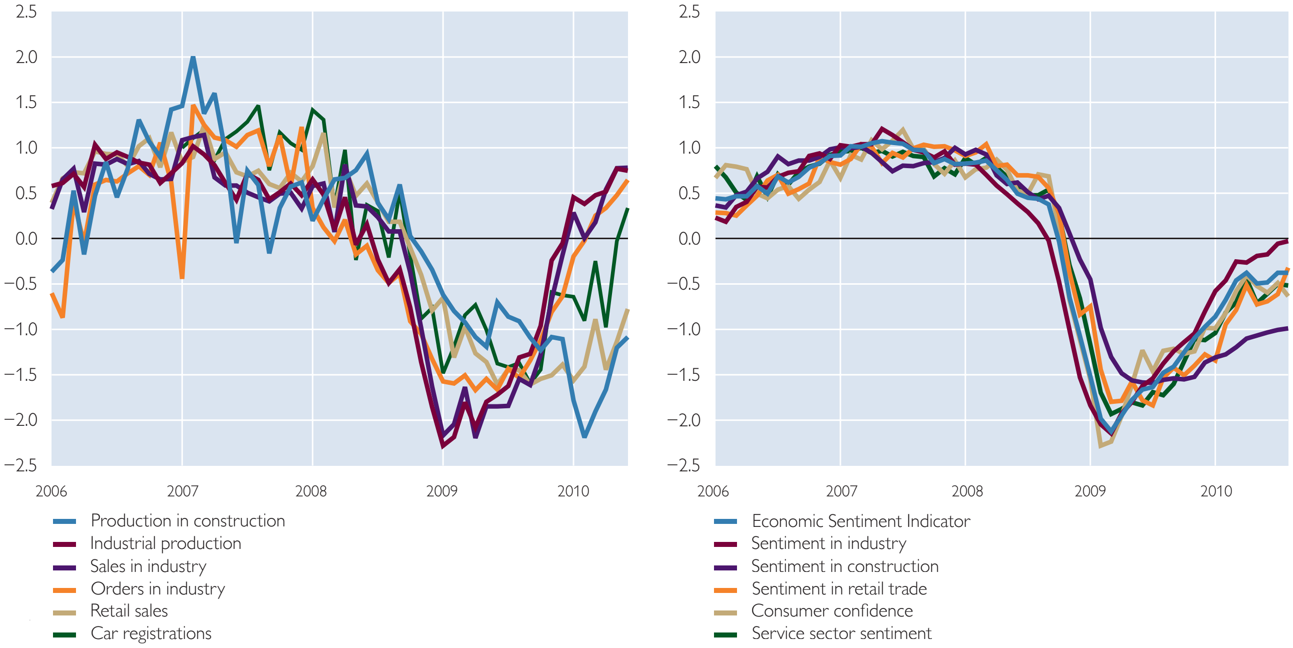
Key Leading and Sentiment Indicators for CESEE EU Member States

Leading indicators

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

Sentiment indicators

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



Source: Eurostat, European Commission, OeNB.

revised upward the outlook for 2011 for a number of smaller countries.

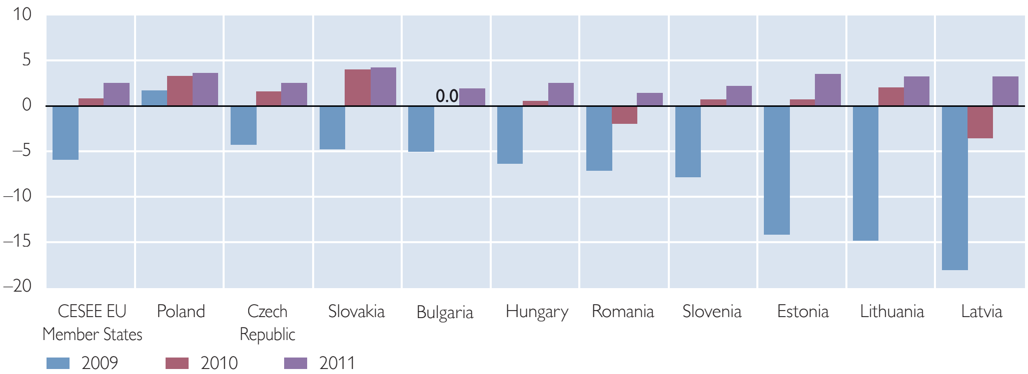
3.2 Inflation Slightly Up but Still at Relatively Low Levels in Most Countries

Inflation had been very low or even negative in early 2010 on the back of the recession but gathered pace in most CESEE countries in the early summer. The acceleration was mainly attributable to higher prices for processed food (including alcohol and tobacco) and energy. In Romania, a hike in the value-added tax rate triggered a surge in prices from July. Cyclical price growth

Chart 8

Current GDP Forecasts for the CESEE EU Member States

Real GDP growth in %



Source: IMF.

remained rather subdued, however. Core inflation accelerated notably less than headline inflation across the region and was even declining in some countries. Inflation rates were decreasing in Poland and Hungary. Both countries had seen accelerating price growth in mid-2009 against the general trend in the region. In Hungary, this was due to a hike in the value-added tax rate; in Poland, a fairly strong economy and the devaluation of the currency shortly before contributed to the rise in inflation. Therefore, a large part of the fall in inflation seen in these countries at present can be attributed to base effects. In Poland, the strong recovery of the złoty since the second half of 2009 has created an additional drag on prices.

Despite the recent rise in many countries, inflation remains generally fairly moderate across the region, averaging 3.0% in August 2010 after hitting a low at 2.5% in May. Current forecasts expect average inflation for the entire year 2010 at 2.8%; only Hungary and Romania, are expected to report considerably higher rates owing to the special factors mentioned above (value-added tax hikes in 2009 and 2010 respectively).

3.3 Financial Markets: Uncertainty Remains Elevated in Some Countries after Turbulence in Early Summer

The situation in Hungary has dominated financial market developments in CESEE in the past few months. The IMF and the EU suspended negotiations with the Hungarian government about a review of the national support program on July 17, 2010, as no agreement could be reached about the consolidation measures to achieve the budget targets for 2010 and 2011 (3.8% and below 3.0% of GDP respectively). The suspension of the talks and the adoption of a bank levy in Hungary did not have a major direct impact, neither on the Hungarian forint nor on the regional financial markets. Owing to uncertainty relating to the economic and fiscal policy plans of the new Hungarian government, however, the forint had already lost about 5% and the Budapest stock index about 10% since early May. At the same time, credit default swap (CDS) premiums on

Table 1

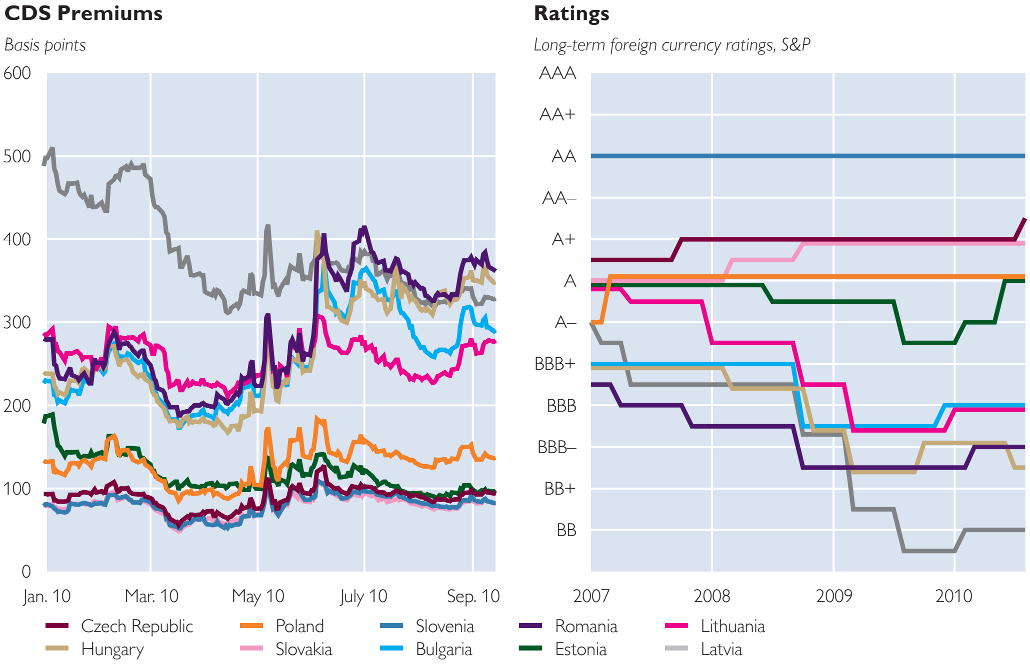
Price Growth in CESEE EU Member States

	2009	2010	Mar. 10	Apr. 10	May 10	June 10	July 10	Aug. 10
	Annual rate of change in the HICP in %							
Bulgaria	2.5	2.2	2.4	3.0	3.0	2.5	3.2	3.2
Estonia	0.2	0.8	1.4	2.5	2.8	3.4	2.8	2.8
Latvia	3.3	–2.0	–4.0	–2.8	–2.4	–1.6	–0.7	–0.4
Lithuania	4.2	0.1	–0.4	0.2	0.5	0.9	1.7	1.8
Poland	4.0	2.5	2.9	2.7	2.3	2.4	1.9	1.9
Romania	5.6	5.9	4.2	4.2	4.4	4.3	7.1	7.6
Slovakia	0.9	0.7	0.3	0.7	0.7	0.7	1.0	1.1
Slovenia	0.9	1.5	1.8	2.7	2.4	2.1	2.3	2.4
Czech Republic	0.6	1.6	0.4	0.9	1.0	1.0	1.6	1.5
Hungary	4.0	4.7	5.7	5.7	4.9	5.0	3.6	3.6
CESEE EU Member States	**3.4**	**2.8**	**2.6**	**2.7**	**2.5**	**2.6**	**2.9**	**3.0**
Euro area	**0.3**	**1.3**	**1.4**	**1.5**	**1.6**	**1.4**	**1.7**	**1.6**

Source: Eurostat, IMF.

Chart 9

Developments in Selected Financial Market Indicators in CESEE EU Member States



Source: Thomson Financial, Bloomberg.

Hungarian sovereign debt increased by some 150 basis points before stabilizing at around 350 basis points in the summer. In addition, Standard&Poor's (S&P) downgraded its outlook on Hungary from "stable" to "negative", and Moody's placed Hungary's ratings (currently Baa1; S&P: BBB–) on review for possible downgrade.

The situation in some financial market segments deteriorated also in a number of other CESEE countries in early May: Romania and Ukraine saw falling stock prices, CDS premiums expanded in Romania and Bulgaria, and the Polish złoty and the new Romanian leu lost some ground. These are not regional trends, however, or spillover effects from Hungary. First, the markets stabilized within a few weeks, and the situation in Romania was essentially the result of uncertainties persisting at that time as regards EU and IMF support for the country. Second, the situation in a number of countries in the region (especially in Central Europe) was stable or even improving (e.g. in the Czech Republic); some countries (e.g. Estonia and the Czech Republic) received rating upgrades; and progress was made under current international aid programs. Nevertheless, the most recent expansion of CDS premiums shows that the financial environment remains relatively uncertain in particular in Southeastern Europe and the Baltic states, i.e. the countries whose macroeconomic recovery is lagging behind the one seen in other CESEE countries.

4 Austrian Economy Continues to Recover in the Second Half of 2010

4.1 Economy to Grow by 2% in 2010, Weakening Expected Toward Year-End

After the severe recession in the wake of the global financial and economic crisis, the Austrian economy began to post positive growth rates again from mid-2009 but surprisingly stagnated at the beginning of 2010, which was out of step with the European trend. The weakness was related to poor weather conditions – the cold winter dampened construction activity – and temporarily subdued industrial activity. After this brief dip, the revival resumed a vigorous pace from mid-year 2010. According to the most recent national accounts results, the Austrian economy expanded by 1.2% quarter on quarter in the second quarter of 2010 (in real terms, seasonally and working day-adjusted). Year-on-year growth accelerated to just under 2½%, a level at which the rate of unemployment typically begins to fall.

The main impulses for economic activity in Austria emanated from the global recovery and above all from robust growth in Germany, Austria's main trade partner. Foreign trade has proved to be a mainstay of the current upswing. In the second quarter of 2010, seasonally adjusted real exports rose by 5% quarter on quarter. According to the most recent figures of the OeNB's export indicator, which is based on truck toll data, this trend is set to slow down only minimally in the third quarter. Toward the end of 2010, growth is likely to lose some steam in Austria's export markets, but by then, the nominal volume of goods exports will have returned nearly to the precrisis level.

Industry has benefited most from the dynamic pace of export activity. Half of the slump in output triggered by the crisis (around –20%) had been recouped by mid-2010. While the confidence indicators signal slightly sagging momentum, industrial growth should remain strong in the second half as well. In view of the high ratio of new orders to inventories, the inventory cycle, too, should provide growth impulses in the next few months.

In the wake of vigorous export and industrial activity, the contractionary phase of the investment cycle also came to an end in the second quarter of 2010. During that quarter, gross capital investment growth became positive again

Table 2

Real Economic Growth and Demand Components

	GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports
	Change on previous period in %					
Q1 08	1.3	0.2	–0.7	2.5	1.4	–0.6
Q2 08	0.4	0.2	2.8	1.2	–1.0	0.0
Q3 08	–0.6	0.2	–0.8	–1.8	–3.8	–3.2
Q4 08	–1.5	0.3	1.5	–3.2	–6.3	–4.8
Q1 09	–2.3	0.3	–1.6	–4.4	–6.5	–5.8
Q2 09	–0.8	0.4	0.2	–1.8	–3.2	–2.7
Q3 09	0.6	0.3	1.3	–0.3	1.7	1.0
Q4 09	0.4	0.2	–0.5	–1.2	2.1	0.8
Q1 10	0.0	0.2	0.2	–2.0	1.0	1.4
Q2 10	**1.2**	**0.2**	**0.2**	**0.5**	**5.0**	**3.4**
2006	3.5	1.8	2.5	0.9	7.9	5.5
2007	3.7	0.9	2.4	3.5	8.5	6.5
2008	1.9	0.7	3.7	2.8	–0.4	–1.7
2009	–3.8	1.1	0.5	–8.9	–13.9	–11.9

Source: Eurostat.

(+0.5%), bolstered by investment in plant and equipment (+3.6%). As manufacturing companies have been reporting above-average capacity utilization levels once again, and as machine imports have recently risen sharply, companies are likely to keep expanding their plant and equipment spending in the second half of the year. However, construction investment posted a disappointing performance. Investment in residential construction (–1.3%) and civil engineering construction (–2.4%) both continued to contract in the second quarter of 2010. The falling number of construction permits indicates that this trend is unlikely to reverse in the near future, at least not in the case of residential construction.

Consumer spending emerged as a stabilizing demand component during the crisis, albeit at a fairly low level. In recent quarters, households upped spending by only 0.2% quarter on quarter in real terms. In the next few months, consumer spending could accelerate slightly. Most recently, real retail sales augmented quite dynamically; new car sales also increased noticeably from mid-2010, after having plummeted when the car scrapping incentive expired. Furthermore, payroll employment has been making gains again since February 2010. Overall, however, with real wages posting only subdued growth, private consumption cannot be expected to stimulate activity at an above-average rate.

Real economic growth is forecast to come to roughly 2% for the whole year 2010, with the pace of growth slowing toward the end of the year. Animated export demand will remain the key impetus to growth. Considering the strength of the recession, the current upturn is fairly restrained, and domestic demand is still too weak for a self-sustained upswing. As growth is heavily dependent on exports, uncertainties surrounding external developments pose the biggest risk to the further course of economic activity in Austria. Factors that could dampen growth in Austria are, among others, a deterioration of the debt crises, a worsening of the U.S. economy or the prospect of economic overheating in China and its repercussions.

Results of the OeNB Economic Indicator of October 2010

After an exceptionally powerful economic revival mid-2010, the OeNB expects continued robust economic activity in the second half of 2010. Growth is set to stay above the long-term average in the third and fourth quarters of 2010 and to weaken somewhat toward the end of the year. The OeNB's latest economic indicator results put real GDP growth at 0.9% in the third and 0.6% in the fourth quarter of 2010 (seasonally and working day-adjusted, on a quarterly basis). This should bring economic growth to just under 2% for the whole year. Compared to the previous results of the economic indicator, which were published in June 2010, the growth forecast for the third quarter of 2010 was raised slightly by 0.2 percentage points.

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

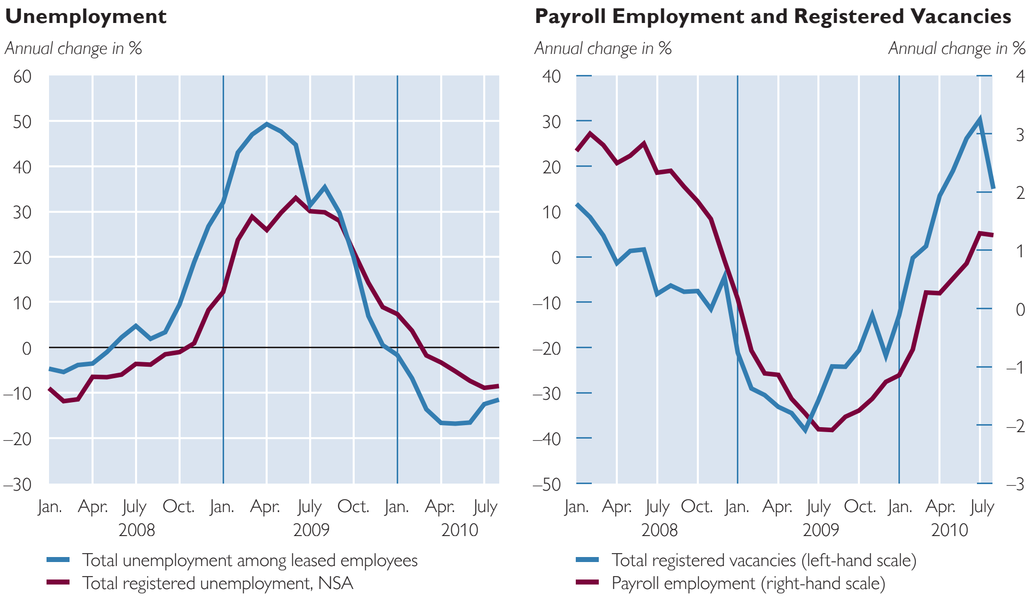
2008				2009				2010			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Year-on-year quarterly change in %											
2.8	3.0	2.2	–0.4	–3.9	–5.1	–4.0	–2.1	0.2	2.3	**2.6**	**2.7**
Quarterly change in %											
1.3	0.4	–0.6	–1.5	–2.3	–0.8	0.6	0.4	0.0	1.2	**0.9**	**0.6**
Annual change in %											
1.9				–3.8				2.0			

Source: Results of the OeNB Economic Indicator of October 2010, Eurostat.

The next release of the OeNB's economic indicator is scheduled for January 2011.

Chart 10

Austrian Labor Market Developments



Source: Austrian Public Employment Service, Main Association of Austrian Social Security Institutions, Statistics Austria.

4.2 Labor Market Recovers

The situation in the Austrian labor market improved noticeably in the course of 2010. The unemployment rate (Eurostat definition) sank to 4.4% in the second quarter, and the seasonally adjusted jobless rate according to the national definition dropped to 6.8% in August 2010, the lowest value since the beginning of 2009. In the first quarter of 2010, payroll employment growth became positive again and topped out at 1.3% in August, a temporary high.

For the remainder of the year, the available leading indicators signal a continuation of the recovery on the labor market, albeit most likely at a somewhat weaker rate in the upcoming months. For instance, the development of unemployment among leased workers, which has led total unemployment by one quarter up to now, signals a further, if marginally slower decline in unemployment. Although the rise in registered vacancies has leveled off somewhat more recently, it remains strong enough to indicate a continuation of employment growth.

4.3 Inflation Remains Subdued

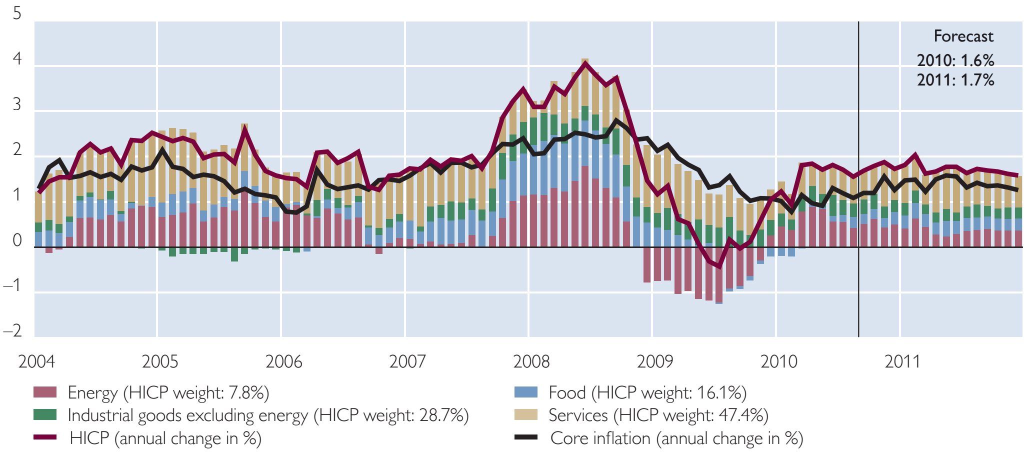
In August 2010, the year-on-year rate of HICP inflation in Austria diminished again slightly, dropping to 1.6% from 1.7% in the preceding month. Since the sharp uptick from February to March 2010, inflation has thus been on a slow downtrend in Austria. Core inflation (HICP excluding energy and unprocessed food) also edged down in August, coming to 1.1% most recently, which was mainly attributable to the development of the price of oil products.

The current inflation forecast of the OeNB stands at 1.6% for 2010 and 1.7% for 2011, with core inflation persisting at below 1.6% over the entire forecast horizon. In line with market expectations for the price of crude oil, the contribution of the energy component to inflation will recede slightly. By contrast, service inflation is expected to rise moderately owing to marginally higher wage inflation and the delayed transmission of various past energy price increases.

Chart 11

HICP Inflation and Contributions from Subcomponents

Contributions to growth in percentage points — *Final observations: August 2010*



Source: OeNB, Statistics Austria.