Economic Outlook Improves in Euro Area

Inflation Pressure Persists Due to High Energy Prices

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The world economy is chugging along, but its key engines may be changing. While the economies of the U.S.A. and China have reached more mature levels, economic activity is now gradually gaining momentum in Europe and Japan.

The growth of the U.S. economy was at least temporarily slowed by the hurricanes which hit the country last fall. Consumer price inflation climbed due to energy prices, while core inflation leveled off. The Federal Reserve continued to tighten its monetary policy, and the real estate market has already begun to show initial signs of cooling. Japan was able to discontinue its unusually expansive monetary policy as its economy remained on a steady growth track. The other Asian economies – especially that of China – are also expanding at an unabatedly high speed. This growth no longer relies on exports and (export-related) investments alone, it is also increasingly supported by consumer spending and residential investment.

Despite the recent deceleration of economic growth in euro area countries, both leading indicators and forecasts point to future GDP growth near its potential. While rising oil prices probably put a dent in net exports and consumer spending, investments made a positive contribution to growth in the first three quarters of 2005. Energy price developments are also the main driver behind the persistently high level of inflation. The European Central Bank responded to medium-term price stability risks by raising interest rates twice, in December 2005 and March 2006, by a total of 50 basis points. However, this has not altered the generally favorable business conditions for exports and investments. As a result of increasing income and employment levels, consumer demand is expected to climb.

The economies of most new EU Member States in Central and Eastern Europe as well as Bulgaria, Romania and Croatia enjoyed robust growth in the third quarter of 2005. Overall, the growth picture emerging for 2005 is dynamic (albeit not uniform), and this trend is likely to gain momentum in the coming years. At the same time, upward price pressure – especially in the new EU Member States – appears to be increasingly under control, which is one of the most important prerequisites for those countries' planned adoption of the euro in the coming years.

In Austria, economic growth over the year 2005 clearly regained momentum after a substantial but temporary slowdown in late 2004 and early 2005. Whereas previously economic growth was mainly driven by exports, it is now increasingly supported by domestic demand, too. Already in the second half of 2005, Austrian businesses visibly stepped up their investment activities, while recovery in consumer spending has been more hesitant. According to the OeNB's economic indicator, growth in Austria's real GDP (seasonally adjusted, compared to the previous quarter) will jump to 0.8% in both the first and second quarters of 2006. Despite high energy prices, inflation has abated considerably, thus supporting the real purchasing power of households. Finally, employment has risen, but the rate of unemployment remains elevated nonetheless.

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1 World Economy Continues Robust Growth

1.1 U.S.A.: Economic Revival after Short-Term Lapse

After climbing 4.1% in the previous quarter, real growth in the U.S. economy's gross domestic product (GDP) slowed to 1.6% (annualized) in the fourth quarter of 2005, thus falling to its weakest level in three years. Overall economic growth in 2005 came to 3.5%. The slowdown toward the end of 2005 can be attributed mainly to the consequences of the hurricanes which had hit the U.S.A. in the fall. In particular, a substantially weaker increase in consumer spending (+1.2%) – and especially the decline in car purchases within this category – as well as reduced government spending and the negative growth contribution of net exports resulting from heady growth in imports were responsible for the slowdown. However, this was probably only a temporary disruption in the growth of the U.S. economy, as is suggested by the positive business sentiment, the favorable labor market situation and the recent jump in the

Cutoff date for data:
End-March 2006.

U.S. leading index calculated by the *Conference Board,* among other developments. For the years 2006 and 2007, the Organisation for Economic Co-operation and Development (OECD) expects real GDP growth rates of 3.5% and 3.3%, respectively, and the February predictions published by *Consensus Forecasts* are only slightly lower.

Recovery on the U.S. labor market accelerated in early 2006. In February, the number of newly created nonagricultural jobs came to 243,000, while unemployment amounted to 4.8%. In the fourth quarter of 2005, labor productivity dropped 0.5%, the first decrease since the first quarter of 2001. For 2005 overall, productivity growth in U.S. businesses dropped 2.7% and thus deviated substantially from the above-average rates recorded in the three previous years. However, this figure is still on par with the average growth rates between 1995 and 2001, the period which is considered the height of the *New Economy*. Unit labor costs rose 2.4% for the overall year 2005; an increase of this magnitude has not been recorded since 2000.

The Consumer Price Index (CPI) increased 4.0% year on year in January 2006 and was markedly higher than in the two previous months (3.4% and 3.5%). The main driver behind this development was energy prices, which rose 24.7% and contributed 1.8 percentage points to the CPI increase. The core inflation rate (i.e. the rise in the Harmonized Index of Consumer Prices, or HICP, excluding energy and unprocessed foods), on the other hand, came to 2.1% in January 2006, which represents a decline compared to the previous year's figure. As recently as February 2005, core inflation had reached a high of 2.4% after the 38-year low of 1.1% measured at the end of 2003. The core inflation rate indicates that the high energy prices are currently not generating any second-round effects. Consensus Forecasts predicts inflation rates of 2.9% for 2006 and 2.3% for 2007.

On March 28, 2006, the U.S. *Federal Open Market Committee (FOMC)* raised the target level for the *federal funds rate* by 25 basis points to 4.75%, the fifteenth hike since mid-2004. Thus the target rate reached its highest level since May 2001. In its written statement justifying this decision, the FOMC pointed out that core inflation had stayed relatively low in recent months and that longer-term inflation expectations had remained contained. However, the FOMC also noted that possible increases in resource utilization had the potential to add to inflationary pressures, meaning that further interest rate hikes are still probable.

The risks currently facing the U.S. economy include high energy prices as well as imbalances in the economy – specifically the high trade deficit and budget deficit. Although the U.S. reported a decrease in the budget deficit to 2.6% of GDP for the fiscal year 2005, this is based on the one-off effect of a USD 100 billion increase in tax revenues. The overindebtedness of consumers and their low propensity to save can also be regarded as imbalances. However, the fact that signs of overheating have begun to subside on the housing market (declining purchases coupled with an increase in properties for sale) is likely to enhance the propensity to save in the future and suppress consumer spending. Last but not least, rising interest rates are also deterring consumers from taking out additional mortgage loans and using them for ongoing consumption.

1.2 Japan: Monetary Policy Change after Deflation Phase

With real GDP growth of 2.7%, Japan's rate of economic expansion in 2005 overall reached its highest level since the year 2000. In the first three quarters of 2005, domestic demand served as the primary engine of growth. In the fourth quarter, increased exports (buoyed by a weak yen) as well as high demand from the U.S.A. and China also helped boost growth by 1.3% compared to the previous quarter; consumer spending as well as investment in plants and equipment also rose. Imports, on the other hand, slipped for the first time in ten quarters.

After many years of stagnation, the Japanese labor market has also been inspired by this economic recovery. The number of full-time employees increased, as did average monthly wages. The rate of unemployment was 4.5% in January 2006, just above the seven-year low recorded in June 2005. Surveys and economic indicators such as business and consumer sentiment as well as business profits and lending growth point to a favorable economic situation.

Given increased demographic pressure due to an aging society, fiscal consolidation has taken priority in Japan. For the fiscal year 2006 (starting on April 1, 2006), the Japanese government budgeted higher tax revenues and mandated a course of austerity. Yet with public debt exceeding 150% of GDP, Japan will remain the most indebted among industrialized nations.

For five years, the *Bank of Japan (BoJ)* tried to remedy the problem of deflation by means of quantitative measures, with interest rates close to zero. In 2005, the core inflation rate (excluding unprocessed foods, including energy), which is relevant in this context, remained negative (–0.1%) for the seventh year running, but it did begin to edge up in November, even jumping to 0.5% in January 2006. In March, the BoJ announced that it would phase out its expansive policy of excessive liquidity. The new framework for the conduct of monetary policy aims to maintain medium- to long-term price stability, which is deemed consistent with inflation in consumer prices of 0% to 2% per year (as a guideline). This gentle change of course is in line with the opinions of the Japanese government, the OECD and the International Monetary Fund (IMF), which have issued warnings about excessively sudden shifts. At present, those institutions still see high risks of a relapse into a state of deflation, which would result in high costs. Moreover, a rapid increase in interest rates could also jeopardize the attainment of fiscal objectives.

1.3 China: Fourth-Largest Economy in the World

In its correction of GDP data for the period between 1993 and 2004, China revised its annual rate of real GDP growth upward by 0.5 percentage point to an average of 9.9%. By nominal comparison, this made China the fourth-largest economy in the world as of 2004 – behind the U.S.A., Japan and Germany, but now ahead of the United Kingdom. Prior to the revision, China conducted its first comprehensive survey of economic data for the year 2004. This survey showed that nominal GDP was almost 17% higher than previously reported. China's new five-year plan places greater emphasis on the fast-growing service sector in order to encourage more broad-based growth. The GDP growth rate reported for 2005 – once again 9.9% – will secure this rapid expansion due to robust demand from industrialized nations.

2 Euro Area: Optimistic Economic Expectations

2.1 Moderate GDP Growth fourth quarter 2005

According to initial estimates, the euro area's GDP growth in the fourth quarter of 2005 came to 0.3% after reaching 0.7% and 0.4% in the previous quarters. Regardless of this volatility, a consistent trend of expansion can be identified in the annual growth rates. Economic performance in the fourth quarter of 2005 rose by 1.7% year on year.

Two economically significant countries in the euro area appear to be pulling the most recent economic development in different directions. After many years of weak economic growth, the German economy has finally been approaching the euro area's average GDP growth rates since mid-2005. In addition to foreign demand and improved competitiveness in labor costs, the renewed optimism in Germany's business climate in the wake of extensive structural reforms also played an important role in this development. In contrast to this, Italy's contribution to growth completely disappeared in 2005, as the country has suffered from its unfavorable specialization in labor-intensive goods subject to price-elastic demand, such as clothing and leather products. Given increasing unit labor costs due to stagnant productivity, the Italian economy is hardly able to respond to the fierce competitive pressure from low-wage (Asian) countries.

Aside from inventory accumulation, the euro area's GDP growth in the fourth quarter of 2005 was exclusively supported by investments growing by 0.8%, slightly less than in the previous quarter. The relatively low negative impact of increasing oil prices can be explained on the one hand by the simultaneous growth in demand for energy-intensive goods as well as energy- saving technologies and alternative energy systems; the euro area is enjoying above-average profits due to heightened demand from oil-producing countries. On the other hand, the euro area's years of wage moderation have also improved its competitiveness.

The monthly statistics for incoming export orders in February 2005 as well as nominal exports in December 2005 confirmed the upward trend in exports from euro area countries thanks to robust demand from abroad. However, the contribution of net exports to GDP growth was still negative at –0.1%, as oil prices caused imports to grow faster than exports.

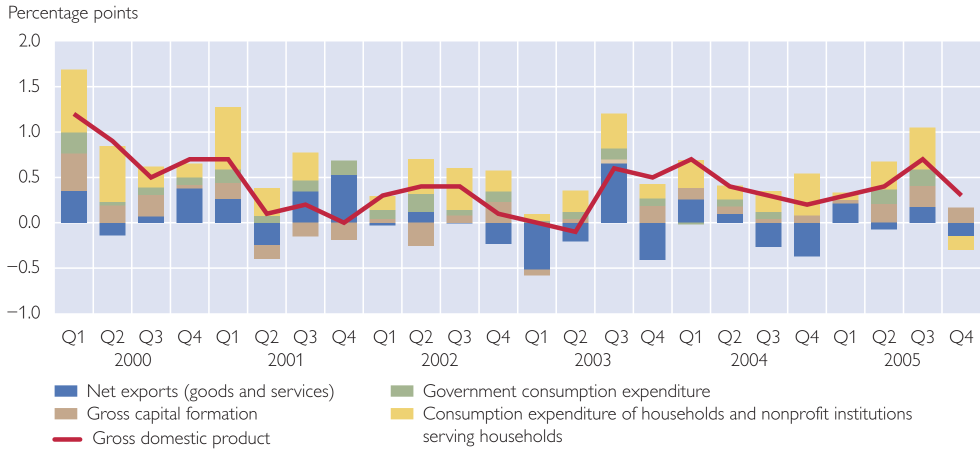
In December 2005, industrial production rose 2.5% year on year. Measured in terms of average growth rates over the last three months, growth in industrial production accelerated toward the end of the year. Likewise, the European Commission's industrial confidence indicator has shown continuous improvement since May 2005. Capacity utilization in industry rose slightly in the first quarter of 2006, but still remained below its long-term average.

At the moment, consumption in households is not making a steady contribution to growth. Consumer spending declined 0.2% in the fourth quarter of 2005, but the annual rate still indicates growth of 0.8%. The factors suppressing consumption include the rise in energy prices, the situation on the labor market as well as uncertainty about reforms in health care and pension systems. Similarly, the development of the international investment position and mortgage lending due to a potential slowdown in the housing boom remains a wild card in the economic outlook. Nevertheless, the European Commission's consumer confidence indicator has shown a slight upward trend since mid-2005. Sentiment among retail businesses has also climbed above its long-term average. In January 2006, sales volumes rose 0.8% compared to the previous month. Government spending did not make a contribution to growth in the fourth quarter of 2005.

Chart 1

Growth Contribution of Real GDP Components in the Euro Area

Quarter-on-quarter changes



Source: Eurostat.

2.2 Leading Indicators and Economic Forecasts Point Upward

The leading indicators for economic growth have trended upward since May 2005 and thus point to an economic recovery. In January 2006, the European Commission's *economic sentiment indicator* reached its highest level since mid-2001. The *ifo business climate index* for Germany rose again in February 2006 and has now reached its highest level since the early 1990s. The *Belgian National Bank's economic barometer (BNB indicator)* saw a substantial jump in February, with especially large improvements in industrial and trade confidence. The smoothed trend in this indicator points to continued recovery. Despite a slight decline in January 2006, the Purchasing Managers' Index for manufacturing also still encourages expectations of improvement in industrial production.

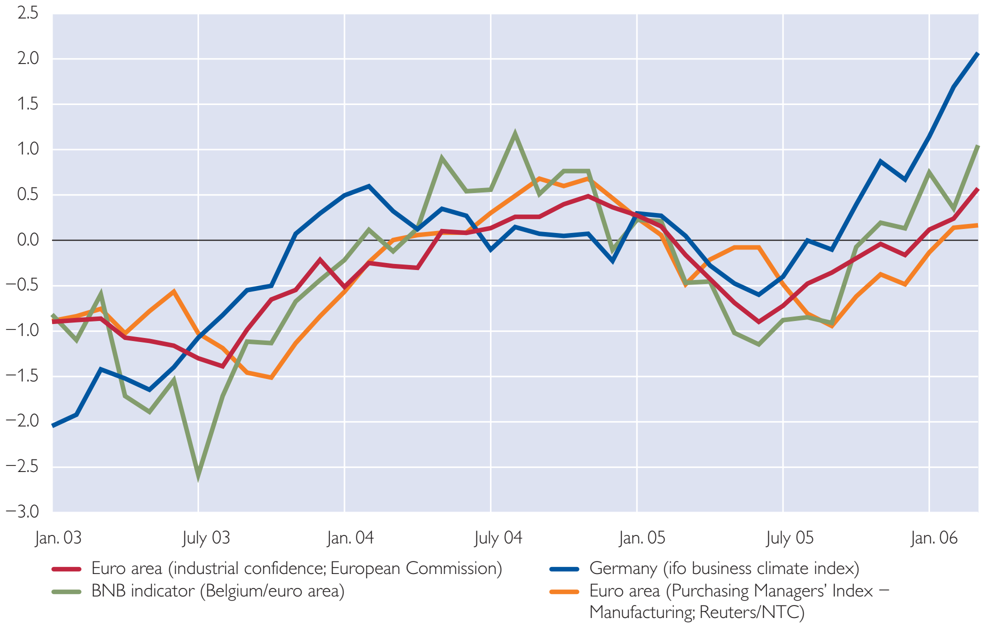
The European Commission's short-term economic forecast, which was revised slightly upward, projects GDP growth rates for the first three quarters of 2006 to be between 0.4% and 0.9% compared to the respective previous quarter.

The latest two-year-ahead projections of macroeconomic developments in the euro area compiled by staff experts of the European Central Bank (ECB) are based on information available until February 7, 2006. Assuming relatively stable oil price levels, euro exchange rates and global growth, the ECB predicts economic growth between 1.7% and 2.5% for 2006 and between 1.5% and 2.5% for 2007. According to the ECB, the favorable external environment will have a posi-

Chart 2

Business Climate Indicators

Deviation from mean of indicator relative to standard deviation



Source: European Commission,, ifo, Reuters/NTC, BNB, OeNB.

tive impact on export demand. Investment activity is expected to benefit from excellent financing conditions, a sound profit situation in businesses and a promising outlook for demand. In line with real disposable income and advances in employment, consumer spending is expected to grow, albeit dampened by increased energy prices and tax hikes. Compared to the Eurosystem staff projections from December 2005, the ECB now sees GDP growth at a slightly higher level, buoyed by higher investment activity. The risks of these projections point downward and refer to a potential strengthening of the euro, a further increase in oil prices, and higher long-term interest rates.

2.3 Steady Improvement on the Labor Market

The seasonally adjusted rate of unemployment in the euro area came to 8.4% in January 2006, which represents an estimated 12.1 million unemployed people. One year earlier, the corresponding figure came to 8.9%. Current forecasts indicate that this favorable trend will persist. The number of job openings as a percentage of the labor force in the euro area contracted slightly in the first quarter of 2006, but still remains at a relatively high level. In parallel, employment is slowly expanding: In the third quarter of 2005, 0.6% more people were employed than one year earlier.

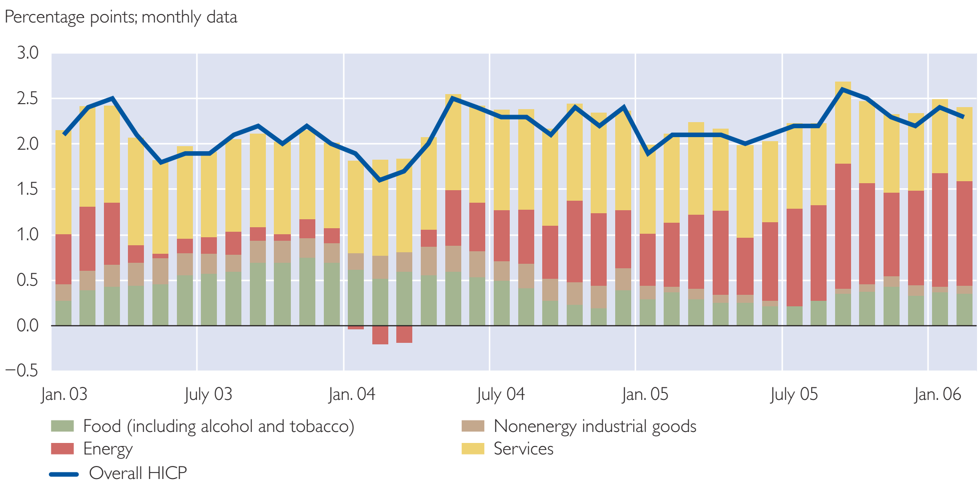
2.4 Energy Prices Still Weighing on Inflation

The price of crude oil remained at a high level. As of March 15, 2006, the price of Brent crude was USD 63.36 per barrel, which was below the all-time high of USD 67.18 reached in August 2005. In addition to the general trend in demand from booming economies (China and the U.S.A.), the widely varied reasons for the high price of oil include supply-side shocks as well as news which arouse fears of such bottlenecks. The conflict surrounding the nuclear program in Iran (the fourth-largest oil producer in the world) has repeatedly inspired speculations of this nature. Finally, supply disruptions due to unrest in Nigeria have also boosted the price of oil. Prior to that, problems were caused by the hurricanes in the Atlantic and the Gulf of Mexico, temporary production and transport disruptions in Iraq, terrorist attacks on Saudi Arabian refineries and strikes in Ecuador. OPEC countries are already extracting quantities in excess of the currently agreed quotas. The OPEC members' crude oil production capacities are to be expanded by 10% to 33 million barrels a day by the end of 2006 and to 38 or 39 million barrels a day by 2010. At the same time, production growth is shrinking substantially in non-OPEC countries.

The HICP inflation rate was 2.3% in February, down from 2.4% in January 2006. As in the previous months, the energy component remained the primary factor influencing inflation. The transportation component also rose in January, likewise in connection with the increase in oil prices. One half of a percentage point in the HICP inflation rate can be attributed to engine fuels; heating oil, gas and district heating together are responsible for the same amount. In addition, major price increases were recorded for apartments and (to a lesser extent) for beverages and tobacco products as well as education. Declining prices could be observed in the communication and clothing components. In January 2006, core inflation fell once again to 1.3%, down from 1.4% and 1.5% in December and November 2005, respectively. This is rooted in relatively low inflation of the prices of nonenergy industrial goods. Among other things, moderate wage settlements and increased competition in some groups of goods are responsible for the low rate of core inflation.

Chart 3

HICP Components: Contributions to Inflation



Source: Eurostat.

ECB staff experts project an HICP inflation rate of between 1.9% and 2.5% for 2006, and a range of 1.6% to 2.8% for 2007. As no further severe increases in the oil price are expected, the energy component's share of HICP will shrink but still remain at a high level. The inflation rate will not decrease in 2007 due to the forecast rise in administered prices and indirect taxes. A large part of this can be attributed to the value-added tax hike in Germany.

Wages will also begin to rise again in line with economic recovery. As a result, growth in unit labor costs will return to its average level after the very moderate values seen in recent years. Profit margins are expected to record fairly small increases, not least because the higher administered prices and indirect taxes cannot be completely passed on to consumers. Overall, risks are on the upside in the case of inflation and primarily comprise the higher price of oil, further increases in administered prices and indirect taxes as well as more robust growth in wages.

2.5 High Growth in Money Supply and Lending

The three-month average of the broad money aggregate M3 showed an upward trend between mid-2004 and the third quarter of 2005. Although this trend has since reversed, M3 growth in January 2006 remained at a high level (7.5%). The ample supply of liquidity reflects persistently high demand for relatively liquid funds, such as sight deposits or other short-term deposits. In addition to the transaction motive behind holding cash, the overall structure of interest rates (i.e., lower opportunity costs associated with liquid investments) is probably also driving the expansion of the money supply. The strong demand for cash can be explained in part by heightened foreign demand for euro banknotes. Another important monetary expansion factor is the robust growth in lending to households as well as nonfinancial corporations. Lending growth is favored by the low level of interest rates as well as a shift in bank policies toward more relaxed credit approval conditions. In particular, demand for mortgages has been dynamic, especially in those euro area countries where housing markets have seen high inflation.

2.6 Increasing Interest Rates, Recovering Euro Exchange Rate

On December 1, 2005, and March 2, 2006, the ECB's Governing Council announced key rate increases of 25 basis points, with the more recent hike bringing the official rate to 2.5%. Prior to the rise in December, interest rates had remained stable since June 2003. The structure of interest rates on the money market, which remained relatively flat until October 2005, has since steepened and shifted upward. This reflects the two hikes in key interest rates as well as expectations of another moderate increase in the coming quarters.

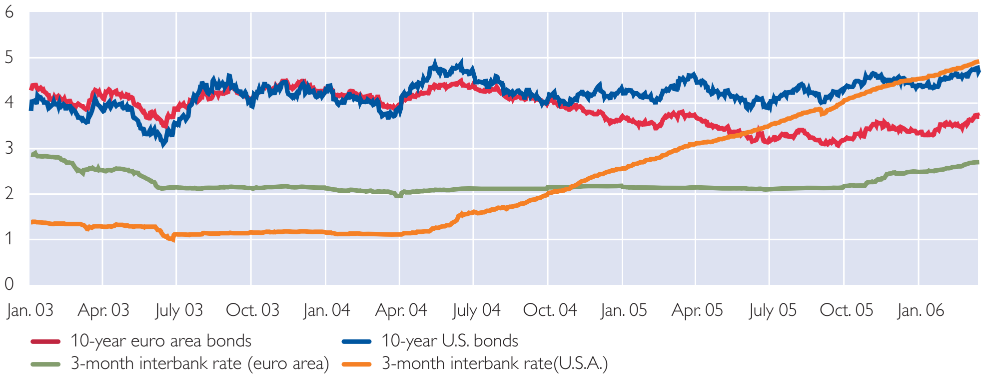
On March 28, 2006, the U.S. federal funds rate was raised to 4.75%. Rates on the money market rose largely in parallel to the prime rate, which has been raised 15 times since June 2004. Obviously the course of constant tightening in monetary policy was anticipated accurately by the markets. In early March 2006, money market rates in the U.S.A. signaled further key rate hikes in the ensuing six months.

The yields on 10-year government bonds in the euro area and in the U.S.A. have risen by 30 to 40 basis points since the third quarter of 2005; this increase is mainly due to higher real interest rates (measured against the yields of inflation-indexed government bonds). In contrast, inflation risk premiums have largely remained constant. In euro area countries, the term structure of real interest rates has clearly flattened – along with the development of the money market – since the third quarter of 2005, as real yields on inflation-protected bonds with a three-year residual term increased by just over 50 basis points, while ten-year maturities saw a less sharp increase. By historical comparison, long-term interest rates are still rather low – especially in the U.S.A., where the interest rate structure has become inverted. Since the end of 2004, a substantial difference in both short- and long-term interest rates has materialized between the euro area and the U.S.A.; however, this difference has not expanded further in recent months.

Chart 4

Development of Interest Rates in the Euro Area and the U.S.A.

up to March 15, 2006



Source: Thomson Financial.

Compared to the exchange rate level in mid-2005, the euro continued to slide against the U.S. dollar in the second half of the year. After falling to USD 1.18 in November 2005 – the euro's lowest level since November 2003 – the exchange rate then recovered slightly, standing at USD/EUR 1.20 on March 29, 2006. In recent months, the development of the USD/EUR exchange rate has been closely correlated to the interest rate differential between the euro area and the U.S.A., a difference which is heavily influenced by monetary policy on either side. In addition, the markets still regard the U.S. current account deficit as a risk factor which could place strain on the U.S. dollar in the future. Despite growing expectations of a speedy end to the BoJ's zero-interest policy, a dynamic economic recovery and the reform of China's exchange rate regime, the yen lost even more ground against the U.S. dollar and also depreciated against the euro as a result. The JPY/EUR exchange rate is currently close to its all-time highest level. Announced in the summer of 2005, the reform of China's exchange rate regime to ensure greater flexibility has led to moderate appreciation (approximately 3%) of the yuan renminbi against the U.S. dollar. The yuan's appreciation against the euro was also around 3% over the same period.

3 Economic Developments in Central, Eastern and Southeastern Europe

3.1 Catching-Up Process Continues

At 4.3% in the third quarter of 2005, average economic growth in the new

EU Member States of the Czech Republic, Hungary, Poland, Slovenia and Slovakia increased substantially compared to the rate of 3.5% seen in the first half of 2005. The Polish and Slovakian economies recorded the highest increases, while expansion in the Czech Republic and Slovenia was somewhat less dynamic. According to preliminary growth figures for the fourth quarter of 2005, the positive developments in Poland and especially in Slovakia and the Czech Republic continued. However, a year-on-year comparison shows that GDP for 2005 is likely to be slightly weaker compared to 2004 in Hungary, Poland and Slovenia, but substantially stronger in the Czech Republic and Slovakia.

In the acceding countries of Bulgaria and Romania, growth dropped off significantly – in both cases by about 1.5 percentage points – in the third quarter of 2005. Compared to the overall year 2004, this growth slowdown is especially prominent in the case of Romania, where growth was almost halved in the first nine months of 2005 (from 8.6% in 2004 to 4.6%). In both countries, this slowdown in growth is essentially due to a drastic reduction in agricultural production (floods, storms) as well as textile production. Croatia, another candidate country, got off to a relatively slow start in the year 2005. However, the Croatian economy then showed noticeable signs of recovery, expanding robustly in the second and third quarters of 2005 with growth rates clearly higher than in 2004.

The catching-up process is increasingly based on high domestic demand resulting from successful structural reforms and income growth. Compared to the first half of 2005, growth in consumer spending accelerated substantially in Poland and Slovakia in the third quarter. In the Czech Republic and Slovenia, growth rates remained nearly unchanged.[1] Higher real growth in wages, a higher rate of employment as well as more dynamic lending growth probably boosted consumer spending compared to 2004, especially in Slovakia. Consumer spending in Romania saw double-digit growth rates in the first six months of 2005. The subsequent decline to 6.3% in the third quarter probably reflects, to some extent, a decline in real lending growth in the private sector following restrictive measures taken by the Romanian central bank.

Table 1

Real GDP Growth in Central and Eastern Europe

Annual real GDP growth rate (%)

	2004	2005[1]	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Q4 05[1]
Poland	5.3	3.2	4.8	3.9	2.1	2.8	3.7	4.2
Slovakia	5.5	6.0	5.3	5.8	5.1	5.1	6.2	7.6
Slovenia	4.2	3.9	4.7	3.8	2.7	5.5	3.6	3.7
Czech Republic	4.4	6.2	4.9	5.0	5.0	5.2	4.9	6.9
Hungary	4.6	4.1	4.3	4.5	3.2	4.5	4.5	4.3
Bulgaria	5.6	×	5.8	6.2	6.0	6.4	4.6	×
Romania	8.6	×	11.6	8.3	6.6	4.4	3.5	×
Croatia	3.8	×	3.6	3.6	1.8	5.1	5.2	×

Source: Eurostat, national statistics offices.
[1] Preliminary figures.

[1] Hungary's data on growth in private consumption during the third quarter of 2005 are not yet available.

While growth in gross fixed capital formation was lower in Slovenia in the third quarter than in the first half of 2005, the Czech Republic, Hungary, Poland and especially Slovakia saw higher growth rates. Slovenia's slowdown in investment activity was primarily a result of sluggish growth in housing construction and equipment investments. In Slovakia, investment growth jumped from 8.6% in the first half of 2005 to 16.5% in the third quarter. The erection of two automobile factories as well as road construction projects are probably among the reasons behind this development. In the three nonmember countries, gross fixed capital formation also rose – in some cases substantially – compared to the first half of 2005. Due to reconstruction efforts after the flood disaster, investment growth in Bulgaria was especially high (25.4% in the third quarter compared to 13.4% in the first half of 2005).

In the third quarter of 2005, the contributions of net exports to growth were clearly positive in all new EU Member States under review here. At the same time, these contributions were generally lower than in the first half of the year; only in Slovakia did the growth contribution rise from –1.0 to 4.1 percentage points, which can be put down to the acceleration of export growth to 16.1% in the third quarter. In contrast, import growth was generally higher than in the first half of 2005, with the exception of Poland. Among the EU acceding countries, Romania and Bulgaria both recorded a negative growth contribution. In Romania, however, this contribution improved from –6.7 percentage points in the first half of 2005 to –3.5 percentage points in the third quarter of the year. In contrast, Bulgaria's net contribution deteriorated from –6.8 to –15.4 percentage points. Here the growth rate in exports dropped by some 10 percentage points to almost 1%, while imports grew by 19%. In Croatia, slightly increased exports coupled with declining import growth brought about a contribution of 2.0 percentage points.

Box 1

Economic Outlook for Central and Eastern European Countries

The OeNB compiles on a biannual basis forecasts of economic developments in the Czech Republic, Hungary and Poland and as well as Russia. Taken together, the three new EU members account for more than 75% of the ten new EU Member States' overall GDP and are thus representative of trends in this region of the EU.[2]

In the ***three new EU Member States discussed here,*** *GDP growth for 2005 overall ranged from just over 3% (Poland) to 6% (Czech Republic). Compared to 2004, growth for the year 2005 overall was substantially lower in Poland and slightly lower in Hungary, while it was markedly stronger in the Czech Republic. In all three countries, annual growth in GDP and in domestic demand – for both consumption and investments (excluding inventory changes) – accelerated noticeably from quarter to quarter in the course of 2005. At the same time, all three countries recorded high positive growth contributions from net exports in 2005, ranging from 1.5 percentage points (Poland) to some 4.5 percentage points (Czech*

2 *These forecasts are based on preliminary global growth projections and technical assumptions about oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem by means of broad macroeconomic projection exercises. These assumptions are central to the current outlook for two reasons: first, the sizeable export links of these three new EU countries with the euro area, and second, the fact that Russia is one of the world's largest oil-producing nations and that energy sources account for some 60% of the country's total exports. (In the case of Russia, the forecast is established in collaboration with Suomen Pankki, Finland's central bank.)*

Republic, Hungary). In reality, the contribution of net exports to growth was probably not that large: In all three countries, the contribution of inventory changes to GDP growth was highly negative in 2005.[3] A substantial part of these inventory changes can probably be attributed to imports, which are not recorded as such due to data entry problems in connection with accession to the EU's Single Market. The (partial) inclusion of this value in overall imports would considerably reduce the positive growth contribution of net exports, especially in Hungary and Poland.

In 2006, the latest acceleration of growth in private consumer demand will be further stimulated by tax cuts as well as increases in minimum wages and social transfers (partly as a result of ex post indexing). The resulting expectations of higher demand among households as well as higher projected foreign demand (resulting from an acceleration of import growth in the euro area) are likely to boost companies' sales expectations and thus also growth in fixed investments in 2006. The acceleration of investment growth is also supported by the cost side (declining unit labor costs in manufacturing) as well as the financing side. The latter is characterized by transfers from the EU's Structural Funds, strong growth in housing loans to households and in business loans (with the exception of Poland), as well as the inflow of direct investments. In Hungary, investment projects reorganized as public-private partnerships in 2005 will add to gross fixed capital formation growth also in 2006. This higher growth in investment should sustain the rise in employment which began in 2005. The improved employment situation, the absence of high inflationary pressure in the Czech Republic and Poland, as well as the temporary further decline in inflation in Hungary will provide additional stimuli for growth in consumer spending. The acceleration of growth in domestic demand – and especially in potentially import-intensive gross fixed capital formation – will boost imports substantially. Given the strengthening of exchange rates in recent months (with the exception of the Hungarian forint) and the abatement of the EU accession effect, the contribution of net exports to growth is thus likely to drop slightly despite expectations of higher demand from abroad. Overall, GDP growth in Hungary and especially in Poland (mainly due to its relatively low starting point) can be expected to accelerate in 2006. In the Czech Republic, we can expect the high level of growth to decrease moderately, but it will still remain higher than in Hungary and Poland.

In 2007, the high levels of GDP growth in the Czech Republic and Hungary are likely to slacken, while further (albeit only slight) acceleration is most likely in Poland. Whereas GDP growth in the Czech Republic will be slowed by another decline in the (still positive) contribution of net exports, Hungary's growth in domestic demand is likely to be subdued by moderate steps toward fiscal consolidation. In contrast, we can expect an additional (slight) acceleration of growth in consumer spending in Poland. Together with increased growth in public spending, this will probably more than compensate for the fact that the growth contribution of net exports is likely to be negative.

The risks in the outlook for these three new EU members include deviations from assumptions regarding growth in the euro area and regarding oil prices, as well as more severe exchange rate fluctuations, which would affect foreign demand. Beyond that, uncertainty still prevails about the speed and design of planned budget consolidation measures, despite the convergence programs presented.

*In **Russia,** economic growth slipped from 7.2% in 2004 to 6.4% in 2005, as growth in gross fixed capital formation declined in 2005 despite high energy prices, which usually favor investments and consumption in Russia. Real net exports are still positive, but they fell even faster in 2005 than in 2004, thus generating a stronger negative contribution to GDP growth. The deceleration of investment and export growth can mainly be attributed to uncertainties in the investment climate arising from the persistent intervention of tax and justice authorities, to the drastic tightening of the tax regime for the energy sector, and to growing bottlenecks in capacity. At the same time, consumer spending, which is still developing dynamically and supported by a boom in lending, represents the driving force behind the economy. Under this forecast's assumption that the price of oil will not rise substantially, one can expect annual GDP growth to edge down again in 2006 and 2007. While investment growth will probably recover slightly, expansion in*

[3] *Inventory changes in these three countries in 2005 made negative contributions to GDP growth in the amount of 1 to 5 percentage points. If inventory changes are added entirely to domestic demand (as is the usual practice), then the growth contribution of overall domestic demand (including inventory changes) is only between 0 and 2 percentage points, with the remaining part of GDP growth arising from the contribution of net exports.*

consumer spending is likely to lose some momentum compared to its currently high level. On the other hand, an easing of fiscal policy is likely – especially in 2007 – in the run-up to the elections in 2008. Major efforts to revitalize bogged-down structural and institutional reforms cannot be expected before the elections. A persistently high inflation differential compared to other countries as well as nominal upward pressure will lead to another real strengthening of the ruble, which will impair the competitiveness of manufactured goods. Coupled with the import pull generated by growth in domestic demand, this will squeeze net exports even further and dampen GDP growth.

The risks in this outlook include the increased dependence of the Russian economy on energy sources (and thus on the price of oil), a higher real strengthening of the Russian ruble, and continued uncertainty about the course of reform policies and its effects on the overall economy.

Table 2

Three New EU Member States and Russia: March 2006 Forecast

Annual change at constant prices (%)

Gross domestic product	2002	2003	2004	2005[1]	2006[2]	2007[2]
Poland	1.4	3.9	5.3	3.2	4.4	4.6
Czech Republic	1.5	3.2	4.7	6.0	5.0	4.6
Hungary	3.8	3.4	4.6	4.1	4.5	4.1
Russia	4.7	7.3	7.2	6.4	6.2	5.5

Source: Eurostat, national statistics offices, OeNB, Soumen Pankki.
[1] *Estimate.*
[2] *Forecast.*

3.2 Inflation Rates Still Declining

In all new EU Member States in Central and Eastern Europe, inflation for the overall year 2005 decreased in comparison to the previous year. This decline was most pronounced in Slovakia (–4.7 percentage points) and in Hungary (–3.3 percentage points). This can be explained in part by a positive base effect, as inflationary factors related to EU accession (e.g., the adjustment of value-added tax rates) were eliminated. Moreover, stronger currencies, high competition in retailing as well as low inflation expectations (among other things) had a dampening effect on prices. Over the year as a whole, inflation rates were relatively stable in most countries. The fourth quarter of 2005 brought increased acceleration especially in Slovakia, while the inflation rate declined steadily in Poland. The increased inflation in the Slovakian economy, which is especially energy-intensive, can largely be attributed to an increase in gas prices by some 20% in October 2005 and to higher prices for other energy supplies.

In the Southeastern European countries, inflation in 2005 ranged from a relatively moderate 3.4% in Croatia to a comparatively high rate of 9.1% in Romania. However, the disinflation process in Romania continued in 2005, falling just short of the inflation target for the year (7.5% ±1 percentage point). In Bulgaria, inflation accelerated substantially in the fourth quarter, mainly as a result of the floods in the summer of 2005 and the resulting increases in food prices.

Table 3

Development of Inflation in Central and Eastern Europe

Annual change of HICP (%)

	2004	2005	Q1 05	Q2 05	Q3 05	Q4 05
Poland	3.6	2.2	3.6	2.2	1.7	1.2
Slovakia	7.5	2.8	2.8	2.6	2.2	3.7
Slovenia	3.6	2.5	2.8	2.2	2.3	2.6
Czech Republic	2.6	1.6	1.4	1.2	1.6	2.2
Hungary	6.8	3.5	3.5	3.6	3.5	3.2
Bulgaria	6.1	5.0	3.8	4.9	4.8	6.6
Romania	11.9	9.1	8.9	9.9	9.0	8.5
Croatia	2.1	3.4	3.1	3.1	3.5	4.0

Source: Eurostat.

3.3 Continued Relief on Most Labor Markets

The situation on the labor markets has been influenced by sustained economic expansion, the success of structural reforms, as well as high foreign direct investment, which results in job creation. At the same time, enhancing productivity by labor shedding appears to have reached its limit, which has also brought about increases in overall employment. However, unemployment is still high. While the rate of unemployment in Slovenia (6.5%) was well below the euro area average in the third quarter of 2005, unemployment in Poland was 17.6%. Nevertheless, positive developments can be identified. Compared to the reference quarter in 2004, all of these countries except Hungary and Slovenia were able to reduce their unemployment rates. Unemployment is also declining or stable in the other countries. In Croatia, the unemployment rate dropped over the year 2005, but compared to the reference period it remained at roughly the same high level.

Table 4

Unemployment in Central and Eastern Europe

% of labor force

	2003	2004	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05
Poland	20.0	19.3	18.5	18.3	19.1	18.3	17.6
Slovakia	17.6	18.3	17.6	17.3	17.6	16.3	15.7
Slovenia	6.8	6.5	6.1	6.6	6.9	5.9	6.5
Czech Republic	7.9	8.4	8.3	8.2	8.4	7.8	7.8
Hungary	5.9	6.1	6.1	6.3	7.1	7.1	7.3
Bulgaria	13.9	12.2	11.1	12.0	11.5	10.1	9.3
Romania	7.5	8.5	8.0	8.5	8.9	7.5	6.5
Croatia	19.5	18.2	17.3	18.4	19.2	18.0	17.0

Source: Eurostat.

3.4 2005: Bulgaria's Rating Upgraded

Both Moody's and Standard & Poor's upgraded their ratings of the security of Bulgaria's long-term foreign-currency debt. Both rating institutions still assign Slovenia the best rating in the group of countries in question, followed closely by the Czech Republic and Hungary. However, the two agencies have determined divergent ratings for Poland and Slovakia. While Moody's places the two countries at the same level, Standard & Poor's assigns Slovakia a better rating. Among the three candidate countries, Croatia and Bulgaria have been in the same category since Bulgaria's upgrade, while Romania is still bringing up the rear.

On March 9, 2006, Moody's announced a positive outlook for the future ratings of five ERM II participants (Estonia, Cyprus, Latvia, Malta and Slovenia) as well as a review of the ratings assigned to Lithuania and Slovakia.

Table 5

Ratings of Long-Term Foreign-Currency Debt

Currency	Moody's		Standard & Poor's	
	Current rating[1]	Last change (old rating)	Current rating[2]	Last change (old rating)
Polish zloty	A2	Nov. 2002 (Baa1)	BBB+	May 2000 (BBB)
Slovak koruna	A2	Jan. 2005 (A3)	A–	Dec. 2004 (BBB+)
Slovenian tolar	Aa3	Nov. 2002 (A2)	AA–	May 2004 (A+)
Czech koruna	A1	Nov. 2002 (Baa1)	A–	Nov. 1998 (A)
Hungarian forint	A1	Nov. 2002 (A3)	A–	Dec. 2000 (BBB+)
Bulgarian lev	Baa3	March 2006 (Ba2)	BBB	Oct. 2005 (BBB–)
Romanian leu	Ba1	March 2005 (Ba3)	BBB–	Sep. 2005 (BB+)
Croatian kuna	Baa3	Jan. 1997	BBB	Dec. 2004 (BBB–)

Source: Bloomberg.

[1] *Aaa (best), Aa, A, Baa, Ba, B, Caa, Ca, and C (worst); 1, 2 and 3 are used to subdivide each grade.*

[2] *AAA (best), AA, A, BBB, BB, B, CCC, CC, C and D (worst); + and – are used to subdivide each grade.*

4 Austria: Economic Growth More Broad-Based

4.1 Gradual Acceleration of Growth, Domestic Demand Gains Momentum

In 2005, Austria's seasonally and workday adjusted real GDP rose by 2.0%. After slowing down in the first quarter due to weak demand for exports, Austria's economic growth gradually accelerated over the rest of the year. Starting in the second quarter of 2005, export activities recovered in line with the improved foreign demand, and domestic demand also regained momentum. Austria's growth, which had primarily been supported by exports in 2004, is therefore enjoying an increasingly broad basis.

Box 2

2005 Current Account (on a Cash Basis)

Balanced Despite Higher Oil Expenditure

The OeNB's current account statistics show a slight improvement in the 2005 current account compared to the previous year. Austria's current account balance went from EUR –0.8 billion in 2004 to EUR +0.3 billion in 2005, meaning that it can be described as balanced.

The deficit recorded for trade in goods increased by EUR 0.8 billion as a result of high energy prices. A similar development can be derived from the foreign trade statistics compiled by Statistics Austria, which reports an increase of EUR 0.25 billion in Austria's import surplus compared to the previous year. Imports of oil and natural gas alone increased by EUR 2 billion in 2005. This is also reflected in the regional composition of trade in goods. The surplus vis-á-vis countries outside the EU declined by EUR 0.75 billion despite high export growth rates, while the deficit in trade with EU-25 countries dropped by EUR 0.50 billion.

The higher deficit in the trade of goods was more than compensated for by the EUR 1.8 billion increase in the services account surplus. Approximately half of the improvement in the services account can be explained by higher surpluses in tourist travel.

The other subaccounts showed no major changes. The slightly higher deficit in the income account was offset by reduced outflows in the transfer account. Overall, this resulted in an improvement of EUR 1.1 billion in the current account balance (on a cash basis) in 2005.

The most pronounced improvement can be found in the investment activities of businesses. While investments still stagnated in early 2005 due to the discontinuation of Austria's special investment tax credit and due to declining capacity utilization levels, investment activities already exceeded their long-term average in the second half of the year. The available leading indicators justify expectations of another noticeable revival in the first half of 2006. According to the WIFO investment test, manufacturing companies plan to increase their investments by 8.3% (in nominal terms) in 2006. In light of the currently only average assessment of capacity utilization (81.9%), replacement investments and streamlining measures are probably the main motive behind a vast majority of these investment projects. With additional impetus from the government's growth packages, the outlook for construction investments remains positive.

Table 6

Results of the National Accounts (in real terms)

	2004	2005	Q1 05	Q2 05	Q3 05	Q4 05
	Change from previous year in % (seasonally adjusted)		Change from previous quarter in % (seasonally adjusted)			
Gross domestic product	2.6	2.0	0.2	0.5	0.6	0.7
Consumer spending	1.0	1.4	0.4	0.4	0.4	0.4
Public spending	1.0	1.3	0.3	0.4	0.4	0.4
Gross capital formation	1.9	1.7	0.0	0.4	0.7	0.8
Exports	8.6	4.1	0.6	1.2	1.2	1.0
Imports	6.4	2.8	0.2	0.5	0.7	0.8

Source: WIFO (quarterly SA data).

Despite relief provided in the second stage of Austria's tax reforms, recovery in private consumer spending is still relatively moderate. Growth in consumer spending accelerated from 1.0% in 2004 (real, seasonally adjusted) to 1.4% in 2005, but the trend in the course of the year remained fairly weak. Quarterly growth rates stagnated at around 0.4% compared to each previous quarter. The still-low propensity to consume also manifests itself in consumer confidence, which has not shown a clear upward trend due to persistently high unemployment. However, retail sales recently saw a robust increase (fourth quarter of 2005: +2.1% year on year in real terms), and the mood in retailing – which is a sound leading indicator for consumer spending – has improved continuously since mid-2005. The fact that quarterly growth rates for consumer spending did not accelerate in the course of 2005 was mainly due to disappointing results in car sales. New car registrations stagnated in 2005, even showing a decline of 9% in the fourth quarter of the year. For the first half of 2006, however, one can expect a further gradual revival in consumer spending. The fact that price pressure has abated continuously since reaching a high in September 2005 supports the purchasing power of households, and persistently robust lending growth should also have a stimulating effect on demand.

Box 3

Results of the OeNB Economic Indicator, March 2006:

Economic Growth Gaining a Broader Basis[4]

According to the current OeNB economic indicator, growth in Austria's real GDP (seasonally adjusted, compared to the previous quarter) will accelerate to 0.8% in both the first and second quarters of 2006. Compared to the last economic indicator results published in January 2006, the growth forecast for the first quarter of 2006 was raised by 0.2 percentage point.

Table 7

Austria's Short-Term Real GDP Outlook for Q1/Q2 2006 (seasonally adjusted)

	2004	2005	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06
Quarterly year-on-year change (%)	×	×	2.6	1.9	1.6	1.9	2.5	2.9
Change from previous quarter (%)	×	×	0.2	0.5	0.6	0.7	0.8	0.8
Change from previous year (%)	2.6[1]	2.0[1]	×	×	×	×	×	×

Source: OeNB - Results of OeNB Economic Indicator, March 2006; Eurostat.
[1] *Statistics Austria reports 2.4% real GDP growth for 2004 and 1.9% for 2005 (nonseasonally and working-day adjusted data).*

With the transmission of foreign trade stimuli to domestic demand, economic recovery is expected to become increasingly self-perpetuating. This scenario also underlies the OeNB's short-term outlook based on the OeNB economic indicator for the first half of 2006 (see Box 3). Uncertainties with regard to the extent and sustainability of transmission represent the main risk in this forecast. Moreover, whether or not the nascent recovery in Germany materializes as expected will also influence the further development of the Austrian economy. In the short term, oil prices will remain the primary risk on the supply side in this forecast.

[4] *Since the first quarter of 2003, the economic indicator of the OeNB has been published four times a year. It forecasts real GDP growth for the current quarter and the next (in each case, on a quarterly basis, using seasonally adjusted data). The figures are based on the results of two econometric models: a stochastic state space model and a dynamic factor model. Further details on the models employed can be found at www.oenb.at in the Monetary Policy and Economics section. The next publication is scheduled for July 2006.*

4.2 Waning Inflation Supports Purchasing Power of Households

Inflation has weakened steadily in recent months. After 2.6% in September 2005, the increase in the HICP in February 2006 amounted to a mere 1.5%. The main driver of inflation was still the development of energy prices (+11.4%), whereas inflation in housing costs slowed down. Especially the development of prices for unprocessed foods (–1.0%) and for industrial goods excluding energy (–0.4%) had a dampening effect on prices. The inflation rate for processed foods including alcoholic beverages and tobacco saw a marked decrease in early 2006 due to a base effect. After averaging 1.5% in 2005, core inflation (excluding energy and unprocessed foods) dropped to 0.8% in February.

Given slackening inflation, we can expect 2006 to bring a noticeable increase in real wages, which have stagnated for the last two years. The index of agreed minimum wages rose 2.7% in each of the first two months of 2006, thus increasing by 1 percentage point more than prices. This unexpected level of growth in real wages will provide an important stimulus for the revival of consumer demand.

4.3 High Unemployment despite Increasing Employment Rates

The situation on the Austrian labor market remains ambivalent: Payroll employment has attained record highs, but so has unemployment. In 2005, the number of employed people rose by 35,843 to 3,236,343 (+1.1%), but at the same time the number of people registered as unemployed increased by 8,774 to 252,654 (+3.6%). Under the Eurostat definition, the rate of unemployment came to 5.2%. This trend continued into early 2006, but the increase in unemployment slowed in February. The number of people registered as unemployed increased by 1,736 compared to the same month in the previous year, thus reaching the lowest value since late 2004. In February, the rate of unemployment came to 5.0%. However, it is still too early to speak of a reversal in this trend.

The increasing figures for payroll employment may well exaggerate growth on the Austrian labor market. Currently no reliable data are available on hours worked in Austria. Part-time employment probably accounts for a substantial share of the newly created jobs, as suggested by above-average growth in the employment of women and in the service sector. In contrast, employment is stagnating or declining slightly in those industries where jobs are predominantly full-time, such as manufacturing and construction.

The increase in unemployment stems from the sharp rise in the labor supply, which was largely generated by the pension reforms of 2000 and 2003 (i.e., the increased early retirement age), demographic effects, increasing levels of employment among women, and the inflow of workers from abroad.

The number of job openings – which is a sound indicator of future employment developments – points to continuously high employment growth in 2006. However, as the labor supply is also likely to see considerable growth again, we cannot expect to see noticeable relief on the labor market in 2006.