

Sovereign Debt Crisis Delays Economic Recovery

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The U.S. economic recovery lost steam in the first half of 2012. Whereas positive signals have been coming from the real estate sector in recent months, the uptrend in the labor market has not gained a stable foothold yet. Up to now, domestic demand has been the main engine of economic growth. However, the envisaged drastic fiscal consolidation could considerably dampen consumer spending and investment. Japan's economic growth also slowed down noticeably in the second quarter of 2012, which may be pinpointed to a large extent to the expiration of subsidies for the purchase of eco-friendly cars. In the next few years, Japan will have to tackle the reduction of its debt ratio (2013: 220% of GDP). The value added tax is already scheduled to be raised to 10%. The Chinese government and the People's Bank of China reacted to the significant cooling of the Chinese economy by taking expansionary fiscal and monetary policy measures. The IMF projects a "soft landing" for the Chinese economy.

In the euro area, economic output diminished by 0.2% in the second quarter. The economy has not moved into a recession yet, but the current decline in the leading indicators along with the available forecasts presage a slight drop in growth in the third quarter of 2012 as well. The recovery is expected to take hold no earlier than around the turn of the year 2012 to 2013. Developments within the euro area remain quite heterogeneous. The motor of growth so far, the German economy, is increasingly losing momentum. The downtrend in inflation came to a halt in August 2012. In addition to increases in taxes and fees, which drive inflation upward, world market prices for food have been surging recently. In July 2012, the Governing Council of the ECB cut key interest rates by 25 basis points, bringing the interest rate on main refinancing operations to a historical low of 0.75%. In early September 2012, the Governing Council of the ECB initiated a new government bond purchase program, so-called Outright Monetary Transactions (OMTs). Under the OMT program, the Eurosystem may make secondary market purchases, limited neither by volume nor by time, of sovereign bonds issued by countries that are eligible for and have applied for EFSF/ESM support for their macroeconomic adjustment programs. Together with the envisaged steps toward a banking union, this measure is an important element in calming the markets and thus in resolving the government debt crisis.

Quarter-on-quarter economic growth in the Central, Eastern and Southeastern European (CESEE) Member States was slightly positive in the first two quarters of 2012, and growth in the region is projected to quicken in 2013. Inflation was fueled most heavily by energy prices, but eased noticeably in the course of the first half of 2012. The region's external balances performed quite heterogeneously, but any deficits registered in the combined current and capital accounts were moderate in size. Conditions in the financial markets have stabilized noticeably in all countries except Slovenia since the beginning of June 2012.

The Austrian economy is increasingly affected by the economic slack in Europe. Whereas GDP growth was still surprisingly powerful in the first quarter of 2012, coming to 0.5% (seasonally and working-day adjusted, quarter on quarter), it came to a near standstill in the second quarter (+0.1%). Most of the leading indicators which have come in are negative and signal below-average growth in the next few months. Nevertheless, given the strong economic performance in the first quarter of 2012, the 0.9% growth forecast in the June 2012 economic outlook of the Oesterreichische Nationalbank (OeNB) for 2012 could yet hold true. The risks to economic activity in 2013 would, however, rise considerably if growth weakened further in the second half of 2012.

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1 The Global Economy Shows Signs of Further Weakness

1.1 Fiscal Consolidation Path as a Factor of Uncertainty for the U.S. Economy

In the U.S.A., economic growth has weakened compared with end-2011 levels. In the second quarter of 2012, real GDP growth ran to 0.4% quarter on quarter. Growth hinged on domestic demand (above all consumer spending and gross fixed capital formation), whereas net exports made a marginally negative contribution. According to the IMF's World Economic Outlook (WEO) update of mid-July 2012, the U.S. economy is set to expand by 2.0% in 2012 and by 2.3% in 2013. The main risk to this scenario is the drastic fiscal consolidation figuring in the current legislation, which could even result in stagnation in 2013. However, the planned consolidation is likely to be softened somewhat to prevent it from jeopardizing growth.

Positive signals have been coming from the real estate market has been

sending out positive signals, with real estate investment having delivered a positive contribution to growth for the past five quarters. As the Case-Shiller house price index has been on the rise for the past five months, house prices appear to have bottomed out, but their recovery will be a while in coming. Conversely, the labor market has given mixed signals: Employment growth accelerated in July 2012, but the unemployment rate also edged up to 8.3%. The dip to 8.1% in August primarily reflects the influence of discouraged workers who are no longer looking for employment. Initial claims for unemployment benefits exhibited a falling trend.

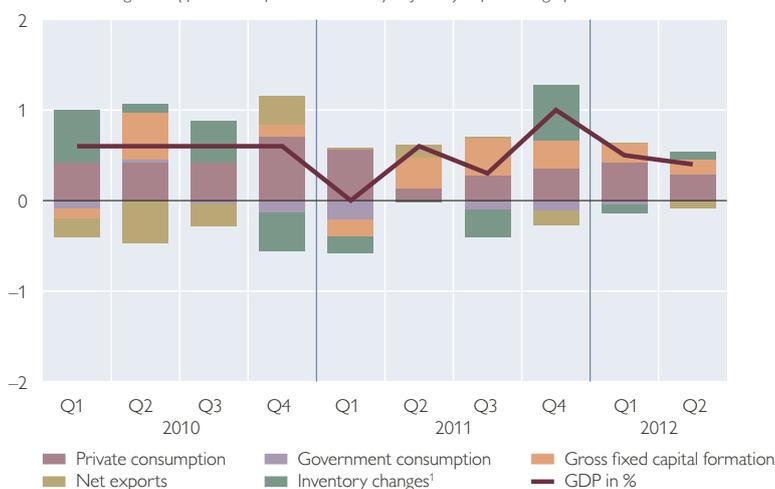
The rate of inflation has abated markedly in recent months and continued to decline to 1.4% in July 2012, down from 3.9% in September 2011.

As expected, at the most recent regular meeting of the Federal Open Market Committee on July 31/August 1, 2012, the Federal Reserve System (Fed) decided to keep the U.S. Federal Funds rate interest rate unchanged at 0% to 0.25%. The Fed also decided to extend until the end of 2012 the Operation Twist, the maturity extension program under which it sells or redeems shorter-term securities, using the proceeds to buy longer-term securities to put pressure on long-term interest rates and to signal a longer-term expansionary monetary policy course. As the maturity extension program simply involves an exchange of securities, the Fed's total assets have remained nearly unchanged over the past 12 months. A third round of quantitative easing ("QE3") was agreed for autumn 2012 should the economic recovery fail to materialize. The related transactions would, again, result in an expansion of the Fed's balance sheet.

Chart 1

U.S.A.: Components of Real GDP Growth

Contributions to growth (quarter on quarter, seasonally adjusted) in percentage points



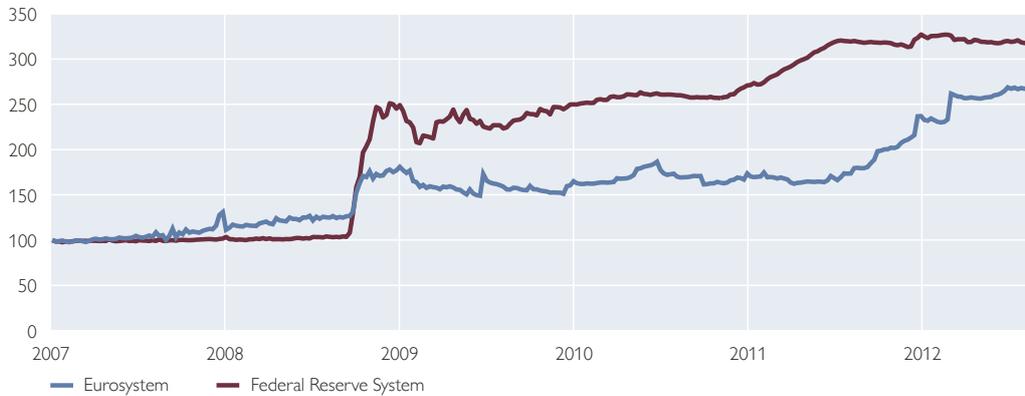
Source: Eurostat.

¹ Including statistical discrepancy.

Chart 2

Central Banks' Balance Sheets

January 2007 = 100



Source: Thomson Reuters.

1.2 After a Strong Start in 2012, Japan's Economy Cools

In the second quarter of 2012, Japanese economic activity weakened considerably, contracting to 0.3% against the previous quarter from 1.3% in the first quarter. Growth was carried exclusively by domestic demand. One reason for the slowdown in growth was the expiration of subsidies for the purchase of eco-friendly cars. Consumer confidence also continued to decline. In July, the IMF raised its economic growth forecast for Japan to 2.4% for 2012 but at the same time projected that growth would flag to 1.5% in 2013. The continued reduction in the rate of unemployment (June 2012: 4.3%) can be pinpointed above all to a shrinking workforce.

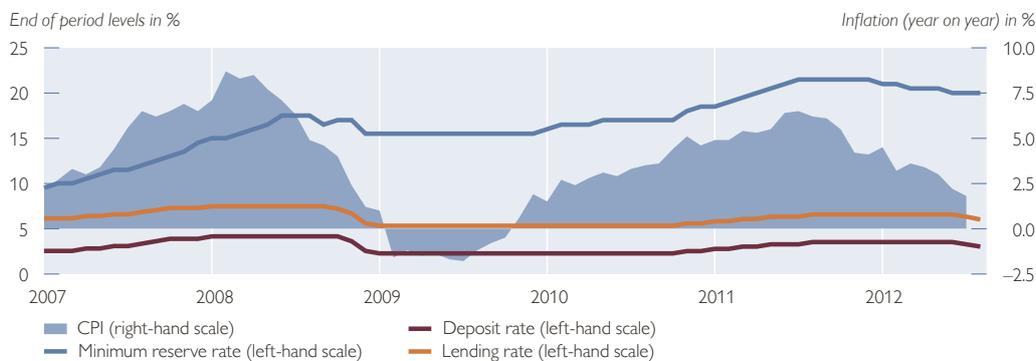
Japan's greatest challenge for the years to come will be to reduce its government debt ratio, which is set to exceed 220% of GDP in 2013. The cost of financing the debt has been low so far: At the beginning of September 2012, Japan was paying only some 0.8% interest on its ten-year bonds. The main reason is that 95% of the bonds are held by domestic investors –

commercial banks, the central bank, households – partly as a substitute for public pension schemes and partly in compliance with government provisions (compelling banks and pension funds to hold bonds). As the population ages and savings deposits dry up, the pressure on public financing will grow. The Japanese government plans to take consolidation measures from 2014, including a doubling of value added tax to 10%.

With inflation running to -0.4% and core inflation also negative at -0.6% in July 2012, Japan has still not overcome its deflationary phase. The strong appreciation of the Japanese yen against the world's main currencies since the outbreak of the global economic and financial crisis contributes to Japan's persistent deflation. In uncertain times, investors consider the yen a safe haven currency. Since mid-July 2012, the Japanese yen has lost some ground. The Bank of Japan has maintained interest rates unchanged in a range of 0% to 0.1%. The IMF recommends that Japan take further expansionary measures to address deflation.

Chart 3

Monetary Policy Decisions of the People's Bank of China



Source: Thomson Reuters.

1.3 Expansionary Monetary and Fiscal Policy in China

The pace of Chinese economic growth has cooled off further. In the second quarter of 2012, Chinese GDP advanced by 1.8% against the previous quarter. The government reacted by frontloading infrastructure measures and by subsidizing purchases of energy-efficient household appliances. The effect of these fiscal measures should become especially apparent in the second half of 2012. The IMF expects a

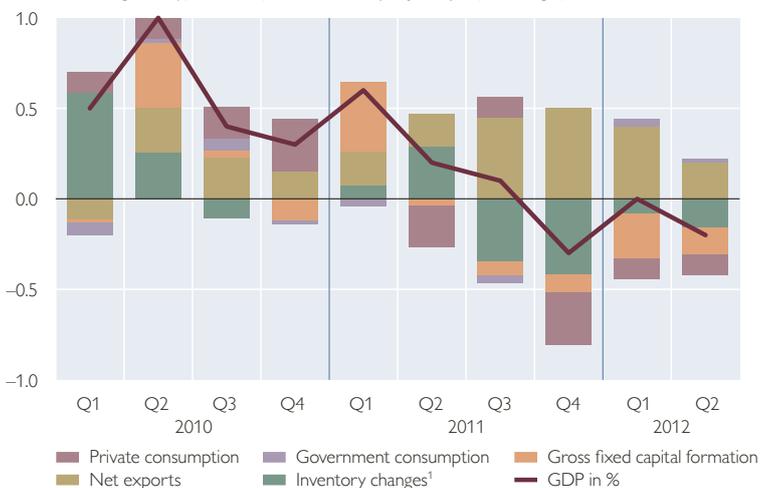
soft landing for the Chinese economy, with GDP augmenting by 8.0% in 2012.

As a result of the cooling down, inflation abated continuously to 1.8% in July 2012, which is far below the Chinese central bank's official inflation target of 4%. To stimulate growth, the People's Bank of China reduced the reference rates for deposit and credit interest rates for the first time since 2008, bringing them to 3% and 6%, respectively. The central bank had already lowered the minimum reserve rate for commercial banks, by 50 basis points in February and by another 50 basis points in May 2012. These measures were accompanied by a further liberalization of the interest rate market to spur competition among commercial banks.

Chart 4

Euro Area: Components of Real GDP Growth

Contributions to growth (quarter on quarter, seasonally adjusted) in percentage points



Source: Eurostat.

¹ Including statistical discrepancy.

2 Euro Area Economy Projected to Recover no Sooner than End-2012

2.1 Euro Area GDP Growth Weak and Highly Heterogeneous

In the euro area, real GDP shrank by 0.2% quarter on quarter in the second quarter of 2012. Following negative GDP growth in the fourth quarter of 2011 and stagnation in the first quarter of 2012, the euro area is not (yet) in

recession, defined as a decline in GDP for two or more consecutive quarters. However, GDP growth is very anemic. In June 2012, both industrial production and construction output continued to contract.

Net exports made the only significantly positive contribution to growth: Exports advanced by 1.3% on the previous quarter, surpassing the rise in imports. Conversely, domestic demand acted as a drag on GDP growth. Consumer spending is suffering from the partly drastic fiscal consolidation measures in the countries hit hardest by the sovereign debt crisis, and also made a negative contribution to growth, as did gross fixed investment, which was affected by the unfavorable economic climate and the high level of uncertainty. Considering the risks to the economy, in its latest assessment of economic developments in the euro area, the IMF warned the euro area about too much fiscal austerity and called on the countries with less pressure to take advantage of the remaining fiscal room for maneuver.

In general, growth patterns continued to be highly heterogeneous in the

euro area. Whereas the GDP of Spain declined by 0.4% and that of Italy fell by 0.7% in the second quarter compared to the first quarter, Germany's economy still posted 0.3% growth, with consumer spending and net exports contributing positively to growth. However, the most recent leading indicators show that German households are likely to tighten their purse strings. France's GDP continued to stagnate, with growth being dampened mainly by foreign trade, unlike in Germany and the remaining euro area.

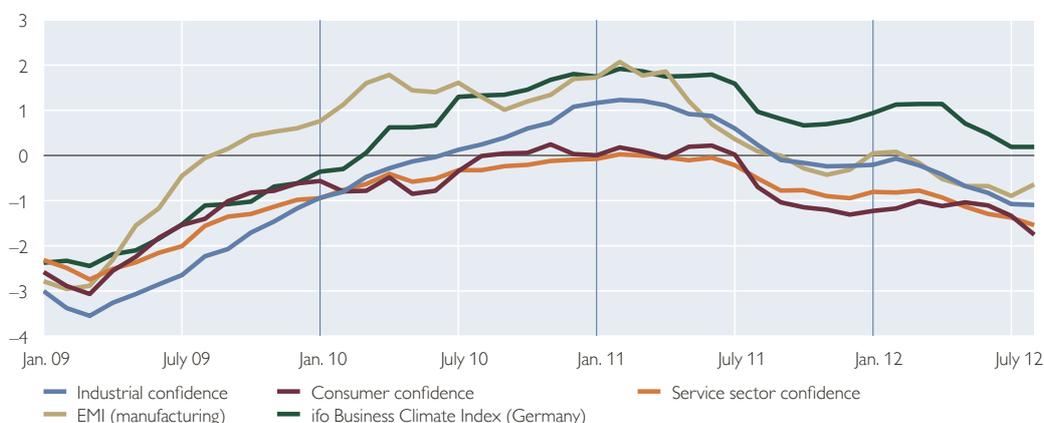
Great heterogeneity may also be observed in the labor market. The euro area unemployment rate stabilized at 11.3% in July 2012, but individual countries' rates diverged sharply, ranging from a record high of 25.1% in Spain to stagnation at a historical low of 5.5% in Germany. At 4.5%, Austria's unemployment rate remained the lowest among euro area countries.

2.2 Leading Indicators Signal Recovery from the Fourth Quarter of 2012 at the Earliest

No recovery is in the offing yet in the next few months. Most sentiment indi-

Chart 5

Euro Area: Business Confidence Indicators



Source: European Commission, Markit, ifo, OeNB.

Note: Deviation from the mean value of the indicator relative to the standard deviation.

cators are pointing steeply downward, signaling renewed negative GDP growth in the third quarter of 2012. For example, the Economic Sentiment Indicator released by the European Commission dropped by another 1.8 points for the euro area in August 2012 to 86.1 points, the lowest level since autumn 2009. All subindexes lost ground, but the loss of confidence was particularly strong among consumers and construction managers. The HSBC Emerging Markets Index (EMI), a composite indicator derived from the Purchasing Managers' Index, began to rise again in August 2012. In the past, this index often flagged a trend shift earlier than other indicators. At 45.3 points, the index remains well below the 50 point mark designating the watershed between an expansion and a contraction. All sentiment indicators for Germany are currently pointing to the downside.

According to the European Commission's survey, capacity utilization in the euro area fell from 79.7% to 77.8%

in the third quarter of 2012, noticeably below its long-term average. Hence, no expansion of manufacturing capacities is to be expected anytime soon. All leading indicators presage manifest consumption restraint and a low propensity of industry to invest in the next few months.

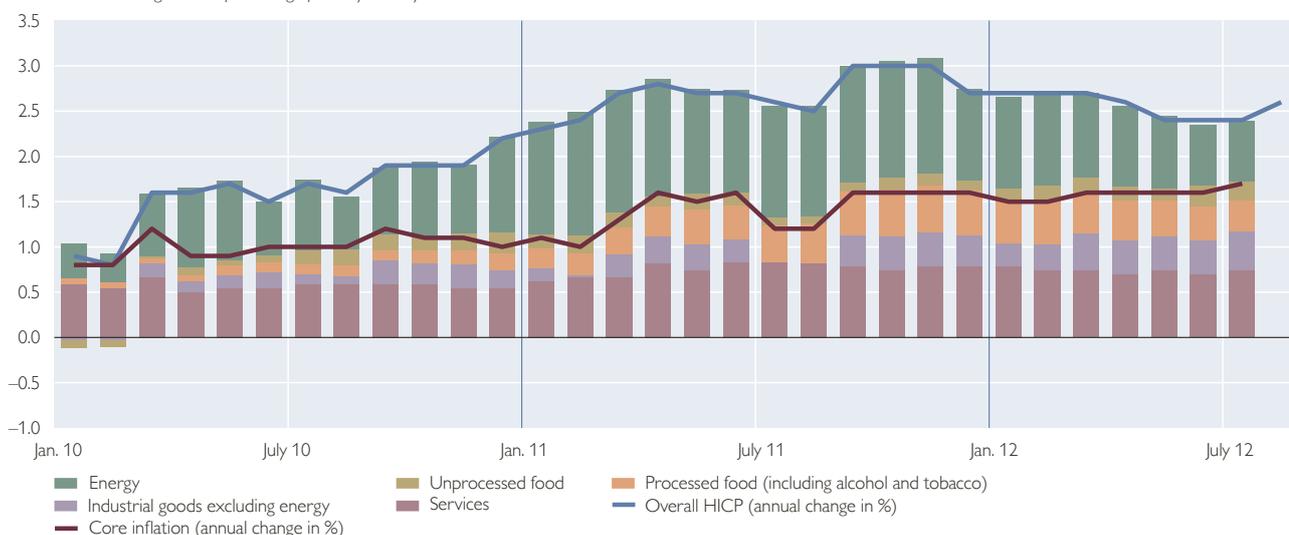
The short-term forecasts of Consensus Forecasts, EuroCoin and the OECD all confirm the assumption that GDP growth will again be negative in the third quarter of 2012. This would technically define the euro area as temporarily being in a recession. In the fourth quarter of 2012, quarter-on-quarter growth should be zero or just below zero.

For whole-year 2012, the GDP forecasts released before and during summer see euro area GDP growth at about -0.3% . The ECB staff macroeconomic projections issued in early September 2012 provide a bandwidth of -0.6% to -0.2% for euro area GDP growth in 2012. In 2013, most forecasters expect economic growth to

Chart 6

Euro Area: HICP Components

Contribution to GDP growth in percentage points, year on year



Source: Eurostat.

accelerate to a moderate 0.7% to 1.0%. The ECB's forecast covers a range of -0.4% to +1.4%. Overall, uncertainty remains high, and the risk of a renewed recession or of a long period of zero or low growth is on the rise.

2.3 Higher Taxes and Fees Feed Inflation

The rate of HICP inflation has diminished steadily in the course of 2012 so far. In particular, the energy component of the price index has lost importance as an inflation driver. The main reason inflation remains high is that many countries have raised taxes and fees: Administered prices have jumped by nearly 4% year on year. In August 2012, inflation rose again according to Eurostat's flash estimate, widening to 2.6%, probably because of rising energy prices and seasonal factors. The heterogeneity of inflation developments across individual euro area countries mirrors the different speed of fiscal consolidation in the Member States and the divergent focus of austerity measures. If the inflation effects of higher taxes and fees are factored out, the country profile takes on a different cast, revealing that unit labor costs have contracted above all in the crisis countries, but have gone up in the more stable euro area countries, such as Germany and Austria.

The inflation forecasts released before and during summer report inflation expectations of 2.3% to 2.4% for 2012. In 2013, the rate of price increase could ease to well below 2%, i.e. some 1.7% to 1.8%. More recently, though, the upside risks for these forecasts have mounted considerably as a consequence of the drought during the summer and the burgeoning world market food prices in its wake. More expensive grain, corn and oilseed prices will be transmitted to consumer prices, first to

the directly affected foods, and then, in a trickle-down effect, to meat and dairy products as well. The ECB's macroeconomic projections of early September take this recent phenomenon into account. Inflation estimates for 2013 range from 1.3% to 2.5%.

In the past few months, monetary growth has steadily gained speed. In July 2012, M3 was expanding by 3.8%, a pace last seen mid-2009. The reason for this trend is the sharp rise in investors' liquidity preference as a result of uncertainty in the stock and bond markets and of low interest rates. But as faster monetary growth has not impacted correspondingly on credit growth, it is unlikely to have any immediate consequences for inflation. Tepid credit growth is primarily driven by the demand side, but the need of banks to redress their balance sheets also plays a role. The pace of growth is especially weak for corporate loans. This development could affect economic activity, as an upturn is unlikely to be sustainable without credit growth.

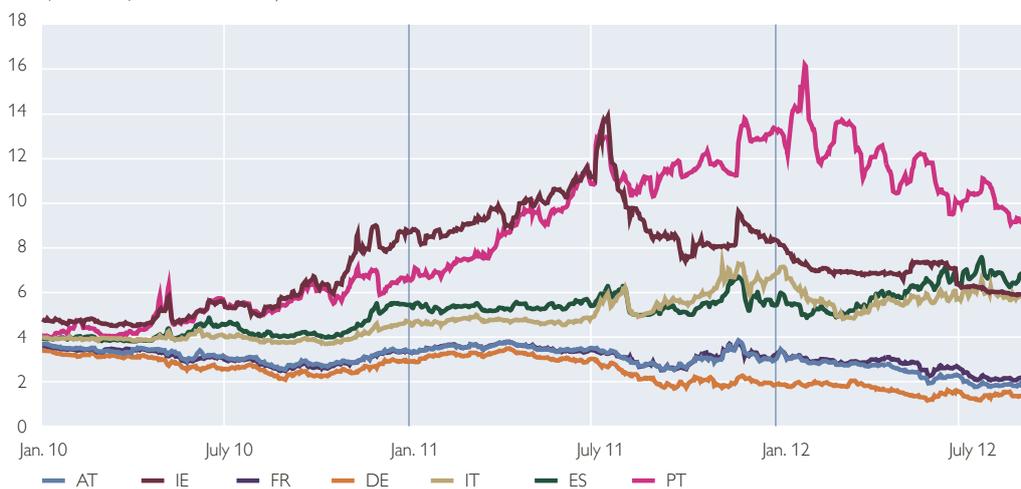
2.4 Government Bond Markets Remain Very Heterogeneous

Since March 2012, bond yield developments have diverged sharply in individual euro area countries. Yields in e.g. Germany, the Netherlands, Austria and France have receded by between ½ percentage point and 1 percentage point. In times of a government debt crisis, these countries are viewed as safe havens and benefit from capital inflows as well as declining financing costs. Ten-year government bond yields in Germany were still the lowest in the euro area at just under 1.4% in early September 2012. Yields on two-year bonds are in fact slightly negative.

The yields on ten-year government bonds of Ireland, Portugal and Greece,

Ten-Year Government Bonds of Selected Countries

Basis points, comparison with Germany



Source: Thomson Reuters.

which have embarked on economic adjustment programs, have gone down substantially since March 2012. The European Commission and the IMF determined that Ireland and Portugal had made progress with fiscal and structural reforms, so that these countries have been able to regain investors' confidence. At the end of July 2012, Ireland succeeded in issuing five-year bonds, marking an important step in the country's return to the financial market.

At the same time, Italy and Spain found their ten-year government bond spreads surging by roughly 100 basis points (Italy) or 200 basis points (Spain). After the yields on Spain's ten-year government bonds surpassed the critical mark of 7%, above which government debt is considered unsustainable in the long term, Spain applied for support under the EFSF at the end of June 2012. The EU finance ministers announced that they would supply up to EUR 100 billion of EU support earmarked to shore up the banking sector. The conditions in the Memorandum of

Understanding also concentrate on the banking sector, which is suffering from the bursting of the real estate price bubble. In the past weeks, Spain has made progress with implementing broadly based financial sector reform, which includes the establishment of an external asset management company to which impaired assets are transferred and strengthening of the Bank of Spain and the public Fund for Orderly Bank Restructuring (FROB) by endowing them with additional powers. The Spanish banks are to be recapitalized in fall 2012, once the external auditors have evaluated individual banks' viability and capital needs.

Immediately following ECB President Draghi's announcement of July 26, 2012, in which he signaled that the ECB would provide support for the crisis countries of the euro area, Spanish bond yields fell by 80 basis points and Italian bond yields by 60 basis points. This decline continued after the ECB's Governing Council initiated a new government bond purchase program (Outright Monetary Transactions; see

below) for financially ailing euro area countries in early September. Yields on Spanish, Italian and Irish bonds dropped to well below 6%. Great uncertainty about the true extent of the Spanish banking crisis remains. This is one reason the country has been contending with massive capital outflows since mid-2011. While Italy is mired in a deep recession, the markets appear to have greenlighted the measures the interim government has implemented so far as progress. Italy's debt ratio is high at over 120% of GDP, but the country does not have to grapple with a massive correction of house prices or high private debt levels.

To sum it up, the debt crisis continues in some euro area countries. Whereas the steps to establish a banking union and to support countries with excessive financing costs temporarily restored calm in the markets, these steps have yet to be implemented. Mid-June 2012, the U.S. rating Agency Moody's downgraded Spain three notches to Baa3 status. In early September 2012, it lowered the EU's long-term issuer rating outlook from stable to negative, citing above all negative outlooks for Germany, France and the United Kingdom.

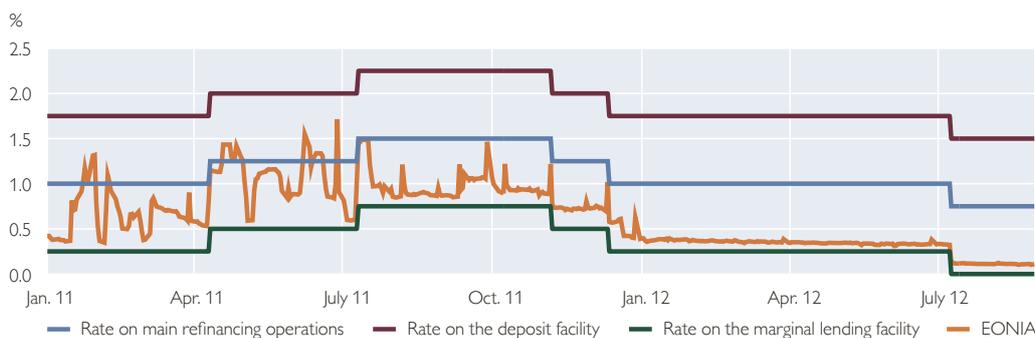
2.5 Key Interest Rates at a Historical Low

After the two key interest rate increases in spring and summer 2011 by 25 basis points each had been reversed in fall 2011, the key ECB interest rate for main refinancing operations again stood at 1% in the first half of 2012. In view of the economic slowdown and the continued reluctance of banks to lend despite the provision of ample long-term liquidity by the Eurosystem (through long-term refinancing operations with a maturity of three years), the Eurosystem cut the key interest rate further by 25 basis points to 0.75% in July 2012. The interest rate on the marginal lending facility has remained at 1.50% since then, the interest rate on the deposit facility at 0.00%.

With excess liquidity levels high, the overnight rate in the interbank market, the EONIA, has been determined mainly by the interest rate on the deposit facility. When the rate on the deposit facility was lowered, the EONIA subsided as well, going down by roughly 25 basis points to a level of 0.11%. Money market rates have also followed the cut in the rate on the deposit facility, dropping by 25 basis points; longer-term rates even declined

Chart 8

ECB Interest Rates and the Overnight Interest Rate



Source: Thomson Reuters.

by up to 35 basis points. The ECB Survey of Professional Forecasters currently expects an average rate on main refinancing operations of 0.70% in 2013 which will edge up to 1.00% in 2014.

At the beginning of September 2012, the Governing Council of the ECB initiated a new government bond purchase program for bonds from financially distressed euro area countries. These purchases, referred to as Outright Monetary Transactions (OMTs), allow the Eurosystem to acquire an unlimited volume of government bonds with a residual maturity of up to three years for an unlimited time in the secondary sovereign bond markets. OMTs are limited to the bonds of countries that are eligible for and have applied for EFSF and ESM support. As an amount equivalent to that created by the OMTs will simultaneously be withdrawn from the financial system, the transactions will not have a direct impact on euro area money supply. The program represents an important step in calming financial markets and thus supports the smooth functioning of the single monetary policy.

3 Economic Developments in Central, Eastern and South-eastern European EU Member States

3.1 Growth Remains Tepid

In the second quarter, real GDP edged up by only 0.3% on the previous quarter in Central, Eastern and South-eastern Europe (CESEE) as a whole. Latvia topped the region's results, with growth running at 1.0%. Conversely, GDP contracted in Slovenia, the Czech Republic and Hungary. Compared to the first quarter of 2012, the quarterly expansion accelerated marginally in the second quarter of 2012, both for the region as a whole and in the majority of the countries in the region. The rise in GDP in Romania following a recession during the preceding quarters had a positive effect on the region as a whole. The slowdown in the pace of recession in the Czech Republic and in Hungary also had a favorable impact on the development of the region, whereas the deceleration of the relatively high growth in Poland acted as a brake.

The most recent forecasts see GDP growth in the region at between 1% and 1.5% for the whole year 2012; growth is anticipated to quicken to 2% to 2.5% in 2013.

The contributions to GDP growth development of individual components as compared to 2011 are not yet available for the second quarter of 2012. In the first three months of 2012, the regional economy expanded by 1.9% year on year. Private consumption accounted for 1 percentage point of growth, whereas public consumption stagnated. Gross fixed capital formation added 0.7 percentage points to growth; this aggregate was positive in nearly all countries except Slovakia, Slovenia and the Czech Republic. Growth was reduced by the 0.4 percentage points decline in inventory in-

Table 1

CESEE EU Member States: Economic Growth

	2010	2011	Q3 11	Q4 11	Q1 12	Q2 12
<i>Real GDP growth in % against the previous period, seasonally and working-day adjusted</i>						
Bulgaria	0.4	1.7	0.1	0.1	0.0	0.3
Estonia	2.3	7.6	1.4	0.1	0.3	0.4
Latvia	-0.3	5.5	1.4	1.0	1.1	1.0
Lithuania	1.4	5.9	1.2	0.8	0.3	0.5
Poland	3.9	4.3	0.9	1.0	0.8	0.4
Romania	-1.7	2.5	1.0	-0.2	-0.1	0.5
Slovakia	4.2	3.3	0.7	0.8	0.7	0.7
Slovenia	1.4	-0.2	-0.3	-0.6	0.2	-1.0
Czech Republic	2.7	1.7	0.0	-0.2	-0.8	-0.2
Hungary	1.3	1.6	0.0	0.0	-1.2	-0.2
CESEE total	2.3	3.2	0.6	0.4	0.2	0.3
Euro area	2.0	1.5	0.1	-0.3	0.0	-0.2

Source: Eurostat.

vestment. Although external demand was anemic, exports made a positive contribution of 2.9 percentage points to growth, with net exports also making a positive addition of 0.9 percentage points.

3.2 Inflation Subsidies in Most Countries

Annual inflation in individual CESEE countries ranged between 1.8% and 5.5% in the second quarter of 2012. Hungary posted by far the highest inflation rate due to the increase in the value added tax by 2 percentage points to 27% in January 2012. The lowest inflation rates in CESEE were measured in Bulgaria and Romania. Compared to the first quarter of 2012, annual inflation abated in most countries, above all in Latvia, Lithuania, Romania and Slovakia.

In most countries, the biggest year-on-year inflation driver in the basket of goods was energy in the second quarter of 2012. In Bulgaria and Slovakia, energy as an inflation factor was topped

by services, in Hungary by processed foods (including alcohol and tobacco) as the main force in augmenting year-on-year inflation. In some countries, the surge in the price of processed foods and in services reflects revenue-side fiscal consolidation measures.

In July 2012, year-on-year inflation rates stayed fairly constant, except in Bulgaria and Romania, where they advanced by 0.8 percentage points on the preceding month in both cases. This spike in inflation was traceable to the burgeoning prices of unprocessed foods in both countries, which in Bulgaria was compounded by the rise in energy prices.

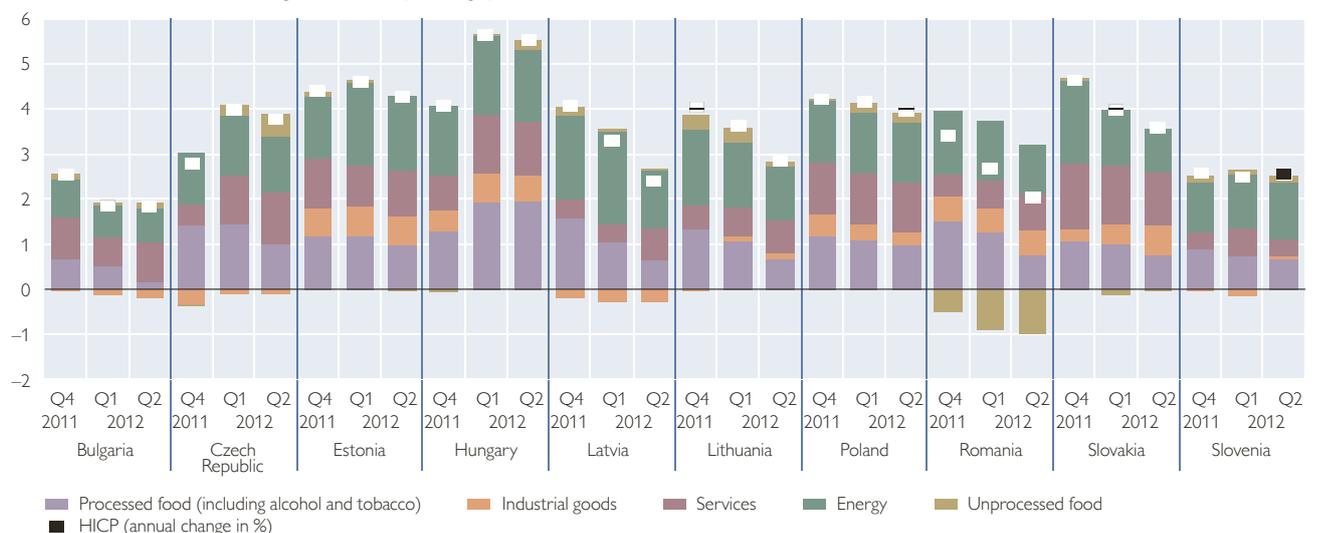
In its spring economic forecast, the European Commission expected inflation in the region to ease substantially in 2013.

With inflation subsiding, several central banks reduced their key interest rates, especially the central bank of Romania, which cut its main policy rate in three increments of 25 basis points each in January, February and

Chart 9

CESEE EU Member States: Inflation Rate

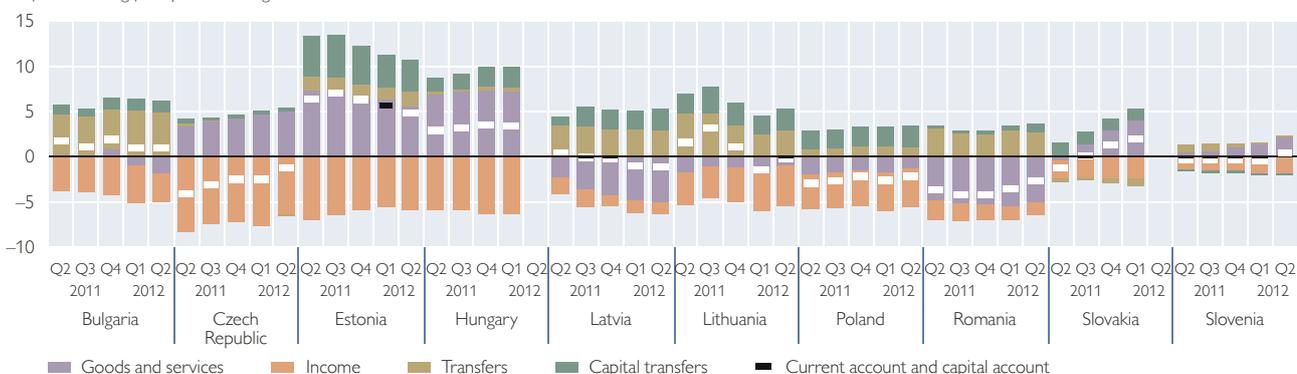
Contribution to the annual rate of change in the HICP in percentage points



Source: Eurostat.

CESEE EU Member States: Development of the Current and Capital Accounts

% of GDP, moving four-quarter average



Source: national central banks, Eurostat.

March, 2012, to 5.25%. The Czech central bank trimmed the key interest rate by 25 basis points to 0.5% in June 2012. Latvia followed in July 2012 (cut by 50 basis points to 3.0%), Hungary in August 2012 (cut by 25 basis points to 6.75%). In the euro area CESEE countries, i.e. Estonia, Slovakia and Slovenia, the ECB lowered the key policy rate by 25 basis points to 0.75% in July 2012.

Poland was the single outlier, as the Polish central bank raised the key interest rate by 25 basis points to 4.75% in May 2012.

3.3 Heterogeneous Performance of the Region's External Balances

The external balances of the CESEE EU Member States continued to perform very differently. In the period from mid-2011 to mid-2012, the combined current and capital account balance was positive in half the countries and (moderately) negative in the other half. The surplus of the combined current and capital account balance was highest in Estonia (4.8% of GDP), followed by that in Hungary (3.5%) and

that in Slovakia (2%).² The largest deficit was measured in Romania (2.7% of GDP), followed by Poland (2.1%) and the Czech Republic (1.2%).

Net goods and services posted a surplus for the region as a whole (0.4% of GDP), but the individual countries' balances differed sharply. The capital account posted a net surplus for the CESEE region as a whole (1.7% of GDP), as did transfers (1.2%), whereas outflows of 4.1% of GDP were measured on the income account.

In its spring forecast, the European Commission assumed a reduction of the regional current account deficit from 2.6% (2012) to 1.6% (2013).

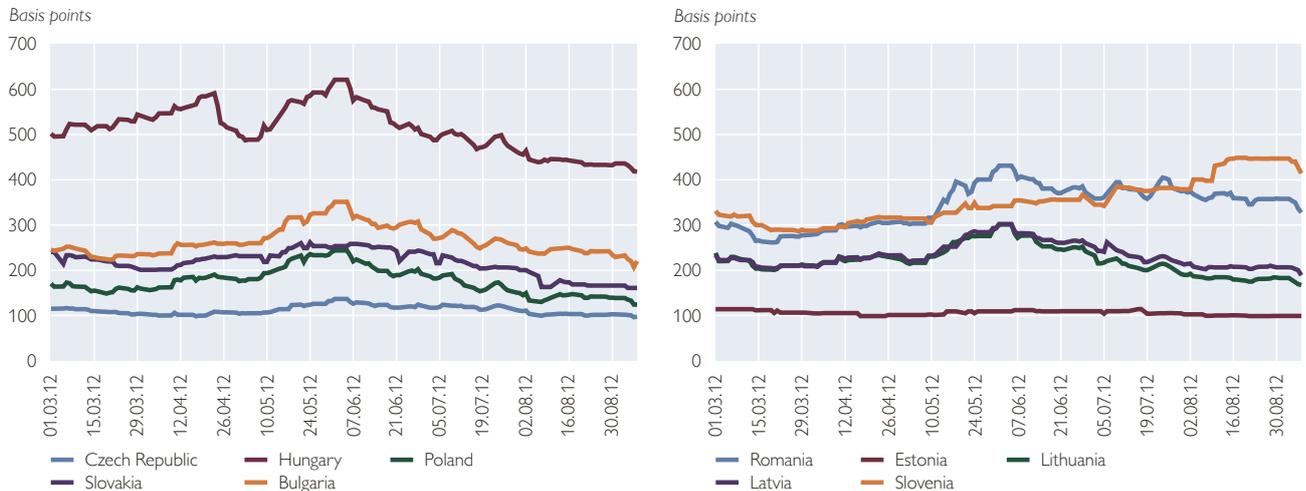
Looking at the financing side, from mid-2011 to mid-2012, the region recorded substantial inflows of foreign direct investment and portfolio investment.

Net direct investment posted a surplus in all countries, the largest being in Estonia at 4.7% of GDP. In the case of portfolio investment, net inflows were most pronounced in Lithuania at 7.2% of GDP. Conversely, net outflows

² The data for Hungary and Slovakia refer to the period from Q2 11 to Q1 12.

Chart 11

Development of Premiums for Credit Default Swaps (CDS)



Source: Thomson Reuters.

were measured in Bulgaria, Lithuania and especially in Slovenia.

The basic balance of payments – the combined current and capital account balance plus net direct investment inflows – showed a surplus of 1.1% of GDP for the CESEE region. Of the countries with a current and capital account deficit, the basic balance was positive in Latvia, Lithuania and in the Czech Republic, as net direct investment inflows more than offset the above-mentioned deficit. By contrast, the basic balance was moderately negative in the other countries with a current and capital account deficit, i.e. Poland (−0.4% of GDP) and Romania (−1.6% of GDP).

3.4 Financial Markets Stabilize in All CESEE Countries Except Slovenia

The exchange rates of the CESEE EU member countries' currencies, which maintain a regime of flexible exchange rates against the euro, are currently at roughly the same level as at the beginning of March 2012. In spring 2012, the currencies lost between 3% (Czech koruna) and 7% (Polish zloty) against

the euro, but between the beginning of June and the end of August, most of the currencies appreciated again (by 4% to 7%). The depreciation phase of the Romanian leu lasted longer on account of domestic policy turbulences. The currency lost 7% of its value between early March and early August 2012, but since then the exchange rate has partly recovered (+4% to date). Since the beginning of September 2012, the Czech koruna has been observed to continue its rise, whereas the Polish zloty and the Hungarian forint lost some ground.

Credit default swap (CDS) premiums are highest in Slovenia and Hungary at this time, coming to over 400 basis points, which is far above the regional average of 222 basis points. Estonia and the Czech Republic are at the lower end – financial markets consider their probability of default to be low. In the course of 2012, the regional average CDS premiums peaked at 309 basis points in early June 2012 (up from 250 basis points in early March). They have since tumbled. Slovenia represents an exception, as CDS premiums rose

by more than 80 basis points from the beginning of March to the cutoff date for data; Slovenian CDS premiums have now reached the same level as in Hungary.

The rating agencies' assessments of the creditworthiness of most countries in the region remained unchanged. In May 2012, the rating agency Standard&Poor's lifted Latvia's rating from BB+ to BBB-, citing the more stable political environment and greater fiscal discipline. This upgrade returned Latvia's bonds to investment grade for the first time since February 2009. After Slovenia's sovereign bonds had been downgraded by the three largest rating agencies at the beginning of 2012, a further downgrade followed at the beginning of August 2012. Moody's lowered the rating by three levels from A2 to Baa2, Fitch by one level (from A to A-) and Standard&Poor's by one level (from A+ to A), each agency assigning a negative outlook as well. The rating agencies justified the step with ongoing problems in the Slovenian banking sector, the rising cost of refinancing government debt and the weak economy. Moody's downgraded Romania's debt rating from Baa3 with a

stable outlook to Baa3 with a negative outlook at the end of June 2012, citing the country's strong dependence on the euro area and its high foreign debt.

Currently, the CESEE EU countries' stock market indexes are just below the levels at which they had stood at the beginning of March 2012. In some countries – Poland, Romania, the Czech Republic and Hungary – stock market prices fell first and then recovered again from early June 2012, whereas prices in other countries did not fluctuate significantly.

4 Austria

4.1 Economic Activity Slows Markedly toward Mid-2012

Although Austria's economic fundamentals are solid, the economy is increasingly feeling the reverberations of the sluggish European economy. As Austria is an export-oriented economy, the intensification of the crisis impacts Austria above all through the external trade channel. Consequently, economic activity lost considerable momentum in Austria in the first half of 2012. After aggregate output could – surprisingly – be boosted substantially in the first quarter of 2012 (+0.5%, seasonally and

Table 2

Austria: Real Gross Domestic Product and Demand Components (in real terms, seasonally and working-day adjusted)

	GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports	Domestic demand	Net exports	Changes in inventories	Statistical discrepancy	
	<i>Change on previous period in %</i>						<i>Contributions to GDP growth in percentage points</i>				
Q3 11	0.0	0.1	0.4	1.1	0.4	0.4	0.4	0.0	-0.1	-0.2	
Q4 11	0.2	0.1	0.3	0.6	0.0	-0.4	0.2	0.2	-0.0	-0.2	
Q1 12	0.5	0.0	0.4	0.3	0.4	0.1	0.2	0.2	0.0	0.1	
Q2 12	0.1	0.0	0.2	0.2	0.4	0.3	0.1	0.0	0.0	-0.1	
2009	-3.5	1.1	0.9	-6.4	-15.4	-11.8	-0.6	-2.9	-0.6	0.7	
2010	2.2	1.6	0.0	0.7	8.9	8.0	1.1	0.8	0.5	-0.2	
2011	2.7	0.9	0.5	6.3	7.2	6.9	1.8	0.5	0.5	-0.1	

Source: Austrian Institute of Economic Research (WIFO), OeNB.

working-day adjusted, quarter on quarter), it virtually stagnated in the second quarter (+0.1%).

Foreign trade has recently provided very few impulses to economic activity. In the second quarter of 2012, net exports did not contribute to GDP growth. The results of the OeNB's export indicator, which is based on truck toll data collected by the Austrian highway authority ASFINAG, show that Austria's export weakness is particularly pronounced in the goods segment. Nominal goods exports have been stagnating since the second quarter of 2011 and have been contracting in real terms. This trend continued at mid-2012. Deliveries of goods abroad are expected to speed up to 3.0% (seasonally and working-day adjusted, year on year) in the forecast month July 2012, but they will shrink by 1.0% in August. The tepid pace of exports continues to hinge on the weak performance of Austrian deliveries to key Austrian export markets, such as Italy, Hungary, Slovenia, Spain or Croatia, which the crisis has hit especially hard. Exports to Germany and non-EU countries are

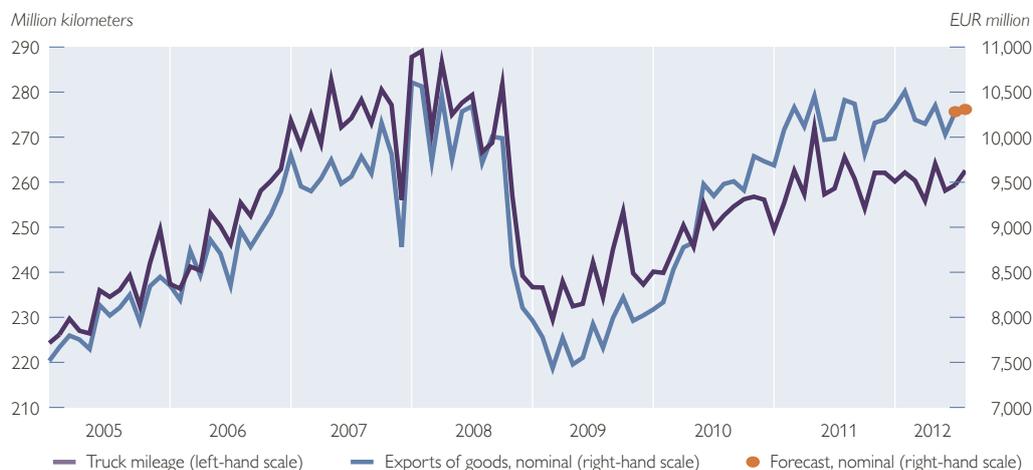
growing more briskly, though. Service exports developed comparatively favorably. In the first half of 2012, Austria recorded the second-best result ever for overnight stays by tourists from abroad.

Like foreign trade, private consumption provided no impulses for economic growth in the second quarter of 2012. Although employment continued to expand at a lively pace, real consumer spending stagnated for the second period in a row. Negative wage drift as a result of the increase in part-time jobs and shifts to jobs in the low-wage sectors as well as inflation, which is still just above 2%, though falling, act as a drag on household incomes. In addition, consumer confidence is very low as a result of the current debt crisis, prompting consumers to save rather than spend and thus raising the saving rate.

Companies were also very reluctant to invest in the second quarter of 2012. Construction investment stagnated, and investment in plant and equipment strengthened by 0.3% on the first quarter of 2012. Public spending, which edged up by 0.2%, was also weaker in

Chart 12

OeNB Export Indicator of September 2012 (Seasonally and Working-Day Adjusted)



Source: ASFINAG, OeNB.

the second quarter than in the first quarter.

The outlook for the second half of 2012 has worsened tangibly since the last OeNB economic outlook was released at the beginning of June. Most national and international leading indicators have dropped to new lows recently. The current confidence indicators of the European Commission are consistently below average for Austria in all sectors but the construction sector. The Purchasing Managers' Index of Bank Austria signals a contraction of manufacturing output. Thus, in the second half of 2012, the economy will grow very moderately, if at all. Nevertheless, given the strong economic performance in the first quarter of 2012, the 0.9% growth forecast in the OeNB's June 2012 economic outlook

could yet hold true. The risks to economic activity in 2013 would, however, rise considerably if growth weakened further in the second half of 2012.

4.2 Unemployment Rises despite Record Employment Figures

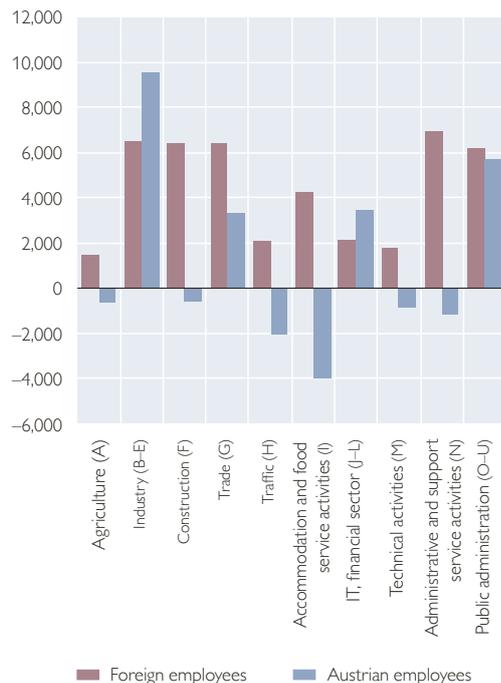
In a European comparison, the situation in the Austrian labor market is still excellent. With the rate of unemployment coming to 4.5% in July 2012, Austria posted the lowest jobless rate of all EU countries. Moreover, the low youth unemployment rate of 8.9% is the second-best EU rate after that of Germany. The total number of payroll employees attained a record high of 3.55 million in August 2012 compared to the August figures of previous years. Since August 2011, Austria has created over 51,000 or +1.5% new jobs.

Chart 13

Labor Market Developments from April 2011 to April 2012 by Sectors

Payroll Employment

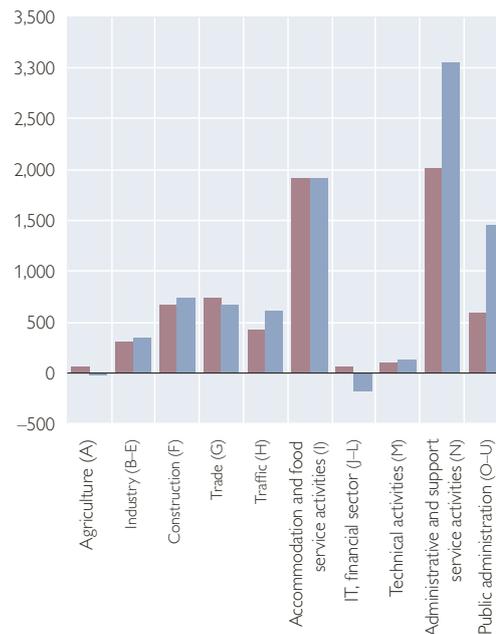
Change in the number of persons



Source: HSV, OeNB.

Registered Unemployed

Change in the number of persons



Austria's labor market has developed remarkably in recent months. Considering the difficult economic environment, payroll employment figures rose unusually strongly. In recent years, employment growth of 1.5% could only be attained if economic growth was at least 2%, but currently, the economy is nearly stagnating. Yet the exceptionally powerful job growth is not strong enough to reduce the unemployment rate. Quite the opposite: In the past 12 months, the jobless rate enlarged from 3.8% to 4.5%, reflecting economic developments. In the past years, employment gains of over 1% had usually sufficed to reduce the rate of unemployment.

The uncommonly lively employment growth may be explained by the complete liberalization of Austria's labor market in May 2011, which resulted in a rise in the registered labor force. In July 2012, foreign employees (more than 40,000) were responsible for some two-thirds of the increase in employment. Nearly 27,000 of these employees came from the EU-8, i.e. the Baltic countries, the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The data do not indicate whether these figures correspond to real employment growth or whether they simply resulted from the legalization of employees that had not been registered previously. A disaggregated view by sectors (chart 13) shows that the rise in foreign employees outpaced that of Austrian employees in particular in construction (NACE section F), transportation and storage (H), accommodation and food service activities (I) and administrative and support service activities (N). Austrians found more new jobs in industry (B–E) than their foreign counterparts.

The data which have become available so far do not show any perceptible crowding-out effects in the first

12 months after the liberalization of the labor market. The slight uptick in the overall unemployment rate since May 2011 does not come as a surprise, given the struggling economy, and unemployment has not advanced faster than average even in industries in which nonresident employment has expanded especially robustly (chart 13). The comparatively pronounced year-on-year increase in joblessness among hotel and restaurant employees in April 2012 may be pinpointed to the early Easter holidays in 2012. The rise in unemployment among administrative and support service workers, which includes workers on leasing contracts, signals above all that conditions in the labor market will deteriorate in the next few months, as workers on a contract basis are typically given notice before all other employees.

The available leading indicators herald a slowdown in the pace of employment growth in the second half of 2012. To corroborate this, the number of vacancies reported by companies so far in 2012 has been sinking, whereas the number of people undergoing training and the number of planned layoffs according to the early warning system is climbing. Most recently, the leading indicators deteriorated only marginally, however. Therefore, the labor market is not expected to experience a massive slump.

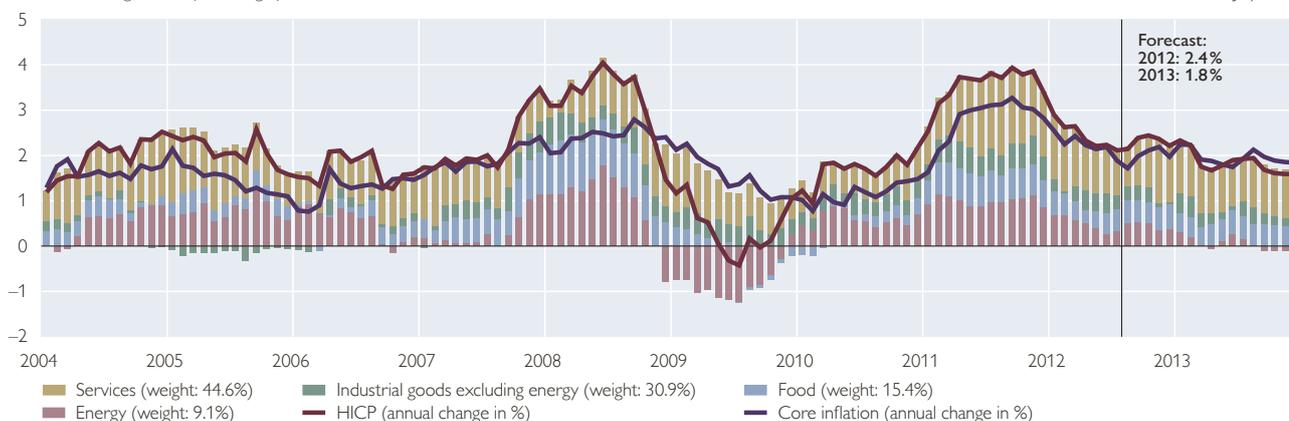
4.3 HICP Inflation to Fall below 2% in 2013

In July 2012, the HICP inflation rate in Austria ran to 2.1%, down by 1.6 percentage points on the November 2011 rate, which had been marked by a peak of 3.7%, nearly as high as in June 2008 (4.0%). The notable easing of inflation could be traced mainly to the cheaper price of energy, but also to services, food and industrial goods excluding

HICP Inflation and Contributions by Subcomponents

Contributions to growth in percentage points

Last observation: July 2012



Source: OeNB, Statistics Austria.

energy, with the decline in cost pressures in global commodity markets until recently relieving the pressure on both food and energy prices. In addition, favorable base effects dampened inflation: The boost in petroleum and tobacco taxes in 2011 no longer fed into annual inflation in 2012. In the service sector, where prices had shot up in 2011, the pace of price increase has subsided markedly in recent months. Lower energy costs and the slower momentum of food price increases have contributed above all to the decline in the inflation of transport service prices and of accommodation and food service prices. While industrial goods excluding energy are largely driven by the surge in the seasonal prices of apparel and footwear, since fall 2011, the drop in the price of a broad range of products (especially consumer electronics and furniture) has caused the average

rate of inflation of industrial goods to let up slightly.

The recently observed rapid reduction of the HICP inflation rate is set to soften somewhat. In the upcoming months, the rise in agricultural commodity prices in the world market and faster wage increases will temporarily push up inflation. The annual average HICP inflation rate for 2012 is forecast to come to 2.4%, after which inflation is to moderate to an average of 1.8% in 2013. The key factors in this scenario are markedly falling rates of price increase for energy and the drop in wage costs in 2013, which are assumed to have a dampening impact especially on service price inflation.

After coming to 2.8% in 2011, core inflation is anticipated to subside to 2.1% in 2012 and to continue to fall, though only little, to an average of 2.0% in 2013.