Edging Out of Recession

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The global slowdown appears to have come to an end during the summer of 2009. Most countries saw a smaller decline in economic activity in the second quarter, with some economies even recording positive growth rates once again.

In the U.S.A., the economic contraction moderated in the second quarter of 2009, with the government's economic stimulus packages and net exports making positive contributions to GDP growth, and the negative contribution from investment decreasing significantly vis-à-vis the previous quarter. With the household saving rate rising sharply, private consumption is making a negative contribution to growth. Although this development may help to reduce global imbalances, it could dampen the recovery in the U.S.A.

In the euro area, too, there are signs of a gradual improvement, with GDP declining by a mere 0.1% quarter on quarter in the second quarter of 2009. This growth was underpinned not only by a strong positive contribution from net exports, but also consumption. The likelihood of a further increase in consumption, however, is uncertain, as the labor market situation is set to deteriorate and because consumer demand has recently been bolstered by fiscal stimulus packages that were only temporary. Investment remained weak, as capacity utilization was extremely low. Current forecasts predict a gradual recovery in the euro area economy.

In the summer of 2009, euro area inflation bottomed out, with the HICP falling by 0.7% in July. This was due primarily to base effects stemming from commodity prices. The latest forecasts predict that there will be no risks to price stability until the end of 2010.

The Central, Eastern and Southeastern European countries also recorded considerable declines in GDP growth in the first half of 2009. However, the stabilization of the financial markets, as well as leading indicators, suggest that there will be an improvement over the rest of the year. In many countries, the recession brought about reductions in current account deficits.

After posting negative growth rates for four consecutive quarters, the Austrian economy is set to pick up again in the second half of 2009, mainly on the back of improved external conditions, fiscal stimulus packages and inventory cycle developments. The OeNB's latest short-term indicator results show real GDP growth at 0.4% in both the third and fourth quarters of 2009 (seasonally and working day-adjusted, on a quarterly basis). Owing to the sharp slump recorded at the beginning of the year, a 3.6% contraction is forecast for the full year 2009.

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1 Global Recovery on Shaky Foundations

1.1 U.S.A.: Pace of the Downturn Eases Significantly

In the second quarter of 2009, the downturn in the U.S. economy slowed considerably. Annualized quarterly real GDP growth fell by only –0.7%, after having been deep in negative territory for the previous three quarters. This improvement was due to a moderation in the decline in investment and the pace of destocking. Growth was also bolstered by government investment and net exports. Despite having recovered marginally in the first quarter of 2009, private consumption dropped slightly again in the second quarter: Whereas the massive fiscal stimulus packages triggered an increase in real disposable household income notwithstanding the fall in GDP, households used the extra income to bolster their savings, thus pushing the saving rate up

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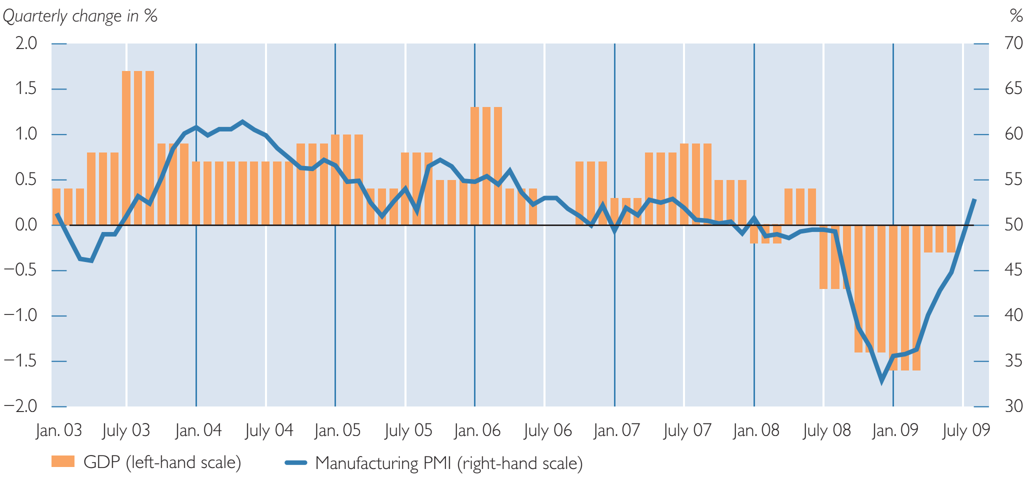
to 5.2% in the second quarter of 2009 (after 1.2% at the beginning of 2008). This reflects households' need to consolidate their finances. In August 2009, the U.S.A. also allocated USD 3 billion to a car scrapping incentive for motorists to buy new cars (Cash for Clunkers), which is expected to further boost consumption in the second half of 2009. The fragility of private consumption is highlighted, among other things, by the strong volatility in consumer confidence, which rose considerably in April and May 2009, fell in June and July and shot up once again in August. The level of consumer confidence remains relatively low. Although the sharp declines in retail sales recorded in 2008 may well be over, there is unlikely to be a marked recovery in the near future, owing to the ongoing tensions in the labor market. In September 2009, the unemployment rate rose to 9.8%, reaching its highest level since June 1983 and more than doubling since falling to its lowest level in 2007. Most forecasts predict a further increase to over 10%. Since the recession started at the end of 2007, almost seven million jobs have been lost.

Leading indicators of economic activity also suggest that the U.S.A. is on its way out of recession, with the composite leading indicator of The Conference Board research institute rising for the fourth time in a row in July 2009. Orders for consumer durables shot up unexpectedly in July. At 52.6 in September, the Purchasing Managers' Index for the manufacturing sector exceeded the threshold value of 50 for the second time since the end of 2007, thus signaling an upcoming acceleration in economic activity. The Purchasing Managers' Index for the service sector also improved in September 2009, outpacing the threshold value of 50 for the first time since May 2008. There has also recently been positive news on the U.S. residential real estate market, with tax incentives for homebuyers in particular being expected to contribute to a recovery in this market. In June 2009, the Case-Shiller Index of home prices in the U.S.A. rose for the first time in approximately three years. The revival of the housing market is essential for a sustainable recovery of the financial system and in turn the entire U.S. economy. By contrast, the com-

Chart 1

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



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

mercial real estate market is seeing a weaker recovery, with the number of empty business, office and industrial premises on the rise. A further indication that the end of the recession is nigh is the sharp 6.6% quarter-on-quarter increase in productivity in the second quarter of 2009. Companies reduced both their workforces and real wages in order to reduce unit labor costs and boost profit margins.

In the second quarter of 2009 – as in the first quarter – corporate profits in the U.S.A. rose by 5% on the previous quarter, but were nevertheless almost 11% lower than one year earlier. More than half of the increase was attributable to the financial sector, with central bank profits being a key factor. With regard to nonfinancial corporations, the pickup in profits was due primarily to the sharper decrease in labor costs on the back of the decline in value added. Wage costs were recently down 6% on the previous year.

At its last meeting on September 22 to 23, 2009, the Federal Reserve left the Federal Funds Rate unchanged; it intends to leave it at this low level for an extended period. In addition to the interest rate decision, the Federal Reserve also took the decision to extend its program to purchase mortgage-backed securities, a measure launched at the height of the financial crisis. The purchases, for an amount of USD 1,250 billion, are now to be executed by the end of the first quarter of 2010.

In August 2009, the CPI fell by 1.5% on the previous quarter – the sixth decline in a row – while the core rate rose by a moderate 1.4% in the same month.

Forecasts by the nonpartisan Congressional Budget Office show the U.S. budget deficit for the current fiscal year (ending on September 30, 2009) to be USD 1,600 billion or approximately 11.2% of GDP, which equals approximately three and a half times the previous year's deficit of USD 459 billion. The government's longer-term forecast for 2019 was revised upward to USD 9,000 billion (up by USD 2,000 billion on the spring forecast) as a result of the deeper-than-expected recession, the recession-related economic stimulus packages and support measures for the banking system, and the additional expenditure on the government health and pension insurance scheme owing to demographic trends. Accordingly, U.S. government debt would rise from 54% of GDP in 2009 to 68% in 2019.

The Federal Reserve expects the economy to recover gradually in the second half of 2009. It holds the view that although the risks have subsided, the economy remains vulnerable to negative shocks. In its latest forecast, the OECD expects GDP to contract by 2.8% in 2009 and to grow slightly by almost 1% in 2010.

The financial market crisis has led to a partial reduction in global imbalances. For example, the U.S. current account deficit halved from its 50-year high of 6% of GDP in 2006 to 2.9% in the first quarter of 2009, and the IMF expects it to amount to 2.6% for the full year 2009. This marked decline can be attributed, in particular, to the sharp rise in private saving (by households and companies) of almost 15 percentage points of GDP between 2006 and 2009. By contrast, public borrowing went up by approximately 12% of GDP over the same period.

1.2 Japan: Return to Economic Growth

Having contracted for four consecutive quarters, Japan's economy grew again in the second quarter of 2009, rising by 0.9% (3.7% annualized). This growth was driven primarily by exports (above all to Asia) and by government investment programs, while private investment continued to decline rapidly. Private consumption went up by 0.8%, mainly on the back of the government's economic stimulus packages, which consisted of direct payments, as well as incentives to buy cars, electronic goods and household appliances, and are thus likely to have triggered a spate of buying. A similar level of growth is expected for the third quarter of 2009, but the outlook thereafter remains highly uncertain, especially since salaries are falling and the unemployment rate is rising further.

A government survey of corporates suggests that there has been a marked improvement in business sentiment, with above all companies in the automotive and in the electrical and optical equipment sector benefiting from the government measures. Consequently, the latest Tankan Report of October 1, 2009, which serves as Japan's most important economic indicator, also revealed a powerful increase in business confidence.

For the time being, the Bank of Japan (BoJ) plans to maintain a zero-rate policy and ample liquidity conditions, extending the most important of the programs launched during the crisis until the end of 2009. The financing situation of smaller firms remains difficult. Furthermore, the pace of the decline in prices continued to accelerate, standing at –2.2% in August. Nevertheless, the BoJ is not anticipating a deflationary downward spiral, as inflation expectations are stable.

Following the victory of the Democratic Party of Japan, the yen rallied. This strengthening of the yen is being seen as a way to boost domestic demand. The financial markets are unsure, however, that the new government will be able to fulfill its election pledges without a further increase in government debt. These pledges include an increase in child-care benefits, income support for farmers and the abolition of highway tolls. Many companies are worried about the cost of the undertaking to reduce carbon dioxide emissions by 25% below 1990 levels by 2020 and to introduce an emissions trading system.

1.3 Positive News from China Continues

For China, it appears that the global recession is already a thing of the past. The extensive stimulus measures, as well as the loose lending policies of most state banks, are clearly working. In the second quarter of 2009, GDP growth was back up to 7.9% and has already been predicted to reach 9% in the third quarter. In August 2009, industrial production stood 12% higher than a year earlier, retail sales 17%. The Purchasing Managers' Index has exceeded the threshold value of 50 since March 2009 and recently edged up slightly further. Consumer confidence, however, is recovering only slowly, after plummeting in late 2008 and early 2009. The decline in consumer prices bottomed out at –1.7% in July 2009, with inflation reentering positive territory in August at 1.2%.

Year on year, China's high current account surplus fell by one-third in the first half of 2009, but nevertheless amounted to 6.3% of GDP. This decrease stemmed primarily from a slowdown in external demand. In recent months, China's imports, including those from the EU and Japan, have risen once again, though it is still too early to take this as an indication that China is focusing more on its domestic economy. However, the higher the level of China's imports, the more likely it will be that China will assume a leading role in the recovery of the global economy.

At 18% of GDP, China's government debt is extremely low by international standards. In the first half of 2009, government revenues fell by 2.4% on the previous year owing to lower corporate tax revenues. The very high levels of public expenditure during 2009 will lead to a deterioration in government debt and the budget deficit. The People's Bank of China reacted to the crisis relatively late, implementing two interest rate cuts amounting to 1.35 percentage points in total. The interest rate level has remained at a low level since the beginning of 2009. By June 2009, China's new loans had surpassed the planned volume of USD 500 billion by 50%. However, the credit expansion, which started at the beginning of 2008, has not only triggered investment but will also bring about an increase in irrecoverable assets.

2 Stabilization in the Euro Area Economy

2.1 GDP Growth Falls Only Slightly in the Second Quarter of 2009

Having slumped by 2.5% quarter-on-quarter in the first quarter of 2009, euro area GDP growth came to only –0.1% in the second quarter. A significant contributing factor to this slowdown in the rate of contraction was the performance of net exports, as imports fell more markedly than exports during the second quarter. Overall, foreign trade saw a leveling off in the slump in demand: in the first quarter of 2009, exports contracted by 8.8% and imports by 7.8%, while in the second quarter, exports fell by only 1.1% and imports by 2.8%. This easing also reflects a certain degree of stabilization in the global economy.

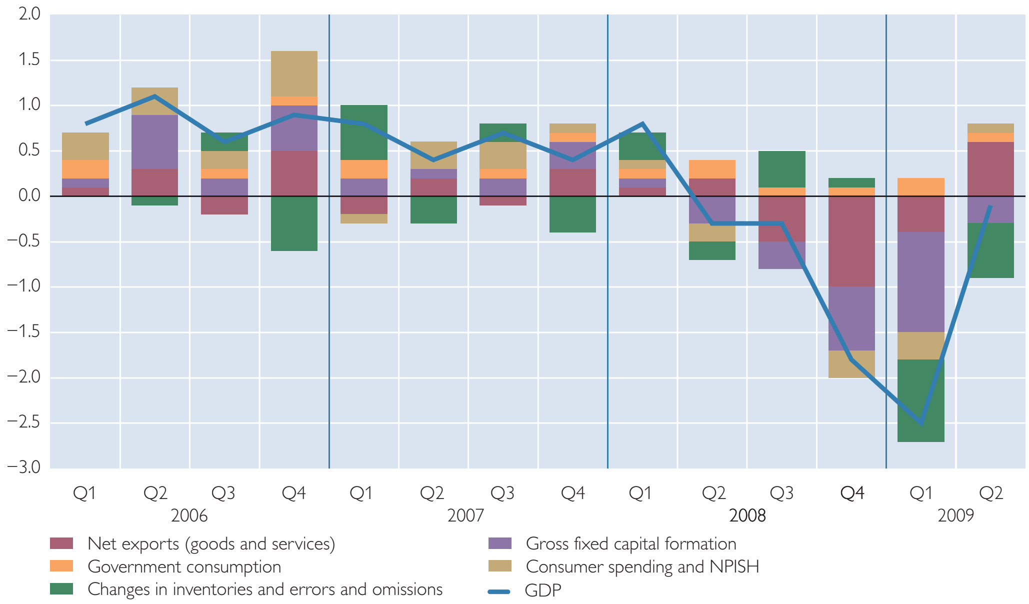
In addition to the contribution from net exports, there were positive growth stimuli from private and public consumption. Despite the deterioration in the labor market situation and the associated greater uncertainty of households about disposable income, private consumption went up by 0.2% in the second quarter of 2009, most likely largely because of the fiscal incentives introduced in many euro area countries. Countries that offered subsidies for new, more environmentally friendly cars, for example, recorded a sharp increase in car sales. Retail sales continued to fall in the second quarter of 2009; however, here too, there is likely to have been some substitution in consumer purchasing decisions. As the car scrapping incentives temporarily brought about a significant dip in the relative prices of cars, households probably eased back on their purchases in other areas, e.g. other durable goods. Since the majority of such schemes have already come to an end, car sales are likely to decline sharply over the coming months.

Investment fell further in the second quarter of 2009, namely by 1.3%. According to a survey carried out by the European Commission, companies' capacity utilization hit a record low in the second quarter of 2009, which was accompanied by a corresponding drop in investment demand. Weak demand for goods on account of the recession is also curbing investment, with tight financing conditions also having a limiting effect on the supply side. Given that surveys suggest that capacity utilization will fall slightly further in the third quarter of 2009 and that there are no signs of a rapid increase in euro area demand, a substantial rise in investment activity is not in the cards.

Chart 2

Contribution to Real GDP Growth in the Euro Area

Quarterly changes in percentage points and in %



Source: Eurostat.

Changes in inventories are following a pattern that is typical for the current economic situation. At the start of the recession, businesses were caught unawares by the extent of the slump in demand and consequently built up unwanted inventories of goods in the second half of 2008. These inventories were increasingly reduced during the first and second quarters of 2009, which had a dampening effect on GDP growth.

From a country perspective, Germany and France in particular posted surprise quarter-on-quarter increases in GDP growth in the second quarter of 2009 coming to +0.3% in each case. In Germany, positive contributions to growth came from private consumption and net exports, with exports contracting by only 1.2% in the second quarter compared with 10.5% in the first quarter. In France, exports went up by as much as 1% in the second quarter of 2009. Spain, however, recorded a 1.1% decrease in GDP over the same period, as its economy is also suffering from the restructuring in the construction sector.

2.2 Leading Indicators Point to Moderate Growth

Industrial production stagnated in the months up to July 2009, when it fell by 0.3% month on month. Industrial new orders recovered over the same period, rising from May onwards to stand 6% higher in July than in April. Nevertheless, both indicators stood clearly below their levels in previous years. The construction output index fell further in July 2009, to the level it had reached in 1999.

All confidence indicators based on survey data have improved since April 2009. The Purchasing Managers' Index for industry has risen particularly sharply, reaching 49.3 points in September. Having hit its historic low in November 2008, the Purchasing Managers' Index posted the most powerful increases in May and July 2009.

The European Commission's Economic Sentiment Indicator also rose in September 2009, but nevertheless was still more than one and a half times its standard deviation below its long-term average. The increase was broad-based, stemming from all sectors except the retail sector. In France and the Netherlands, it went up considerably, but in Germany only marginally. In Spain and Italy, it fell once more in September 2009, after having risen in the previous month.

The Ifo Business Climate Index rose in September 2009 for the sixth time in a row, with businesses reporting an improvement in business conditions. The surveyed businesses reported improvements not only in the current situation but also in expectations. The majority, however, still assess the situation as poor. With regard to expectations for the next six months, the pessimists and the optimists are equal in number.

2.3 Labor Market Situation Deteriorates

With the usual lag, the financial crisis gradually penetrated the labor market too. In August 2009, euro area unemployment stood at 9.6%, up two percentage points from the previous year. The increase in unemployment was particularly pronounced in those countries plagued not only by the consequences of the international financial market crisis, but also by the restructuring in their construction sectors. Over the past 12 months, the unemployment rate in Ireland more than doubled (from 6% in July 2008 to 12.5% in July 2009) and in Spain it climbed from 11.4% to 18.5% over the same period.

In Germany, unemployment rose by only 0.5 percentage points year on year, to 7.7%. This can be attributed partly to the expansion of short-time working arrangements – the German government has extended the entitlement period for short-time working benefits from 12 to 18 months. Federal Employment Agency estimates reveal that there were 1.4 million people working shorter hours in July 2009.

According to the IMF forecast published on October 1, 2009, euro area unemployment will stand at 9.9% in 2009 and rise to 11.7% in 2010.

2.4 Forecasts Suggest a Gradual Recovery

The latest available forecasts predict a further improvement over the next few quarters. For 2009, GDP growth rates are predicted to be 4%, which is an improvement on the last forecasting round over the summer. This revision is due mainly to GDP growth during the second quarter, which was higher than predicted in earlier forecasts. According to the ECB staff projections, which are based on the information available up to August 21, 2009, GDP growth is projected to be between –4.4% and –3.8% in 2009 and between –0.5% and +0.9% in 2010. The recovery will depend primarily on an assumed increase in export demand and on whether the fiscal stimulus measures also boost domestic demand. In this regard, however, it should be noted that although the fiscal stimulus measures may bolster the upturn on a temporary basis, it is unlikely that they will have a lasting effect.

According to the IMF forecast published on October 1, 2009, GDP growth will stand at –4.2% in 2009 and at 0.3% in 2010. The IMF therefore also expects a somewhat more gradual recovery, continuing to cite tight bank lending conditions and rising unemployment as the main reasons for the weak growth.

2.5 Decline in Prices Bottoms Out

Falling by 0.7%, consumer prices recorded their largest year-on-year decline in July 2009. The following month, the HICP dropped by only 0.2%. The decline in HICP inflation over the summer was broadly in line with expectations, primarily reflecting base effects stemming from fluctuations in global commodity prices. The sign of the energy price base effect reversed in August 2009, with the result that the contribution of the energy component to inflation will increase over the coming months.

On the back of a downward base effect, energy prices fell by 10.2% year on year in August 2009, with sharp declines particularly in the prices of transport fuel, heating fuel and gas. However, the prices of the other energy components, e.g. electricity prices, also decreased.

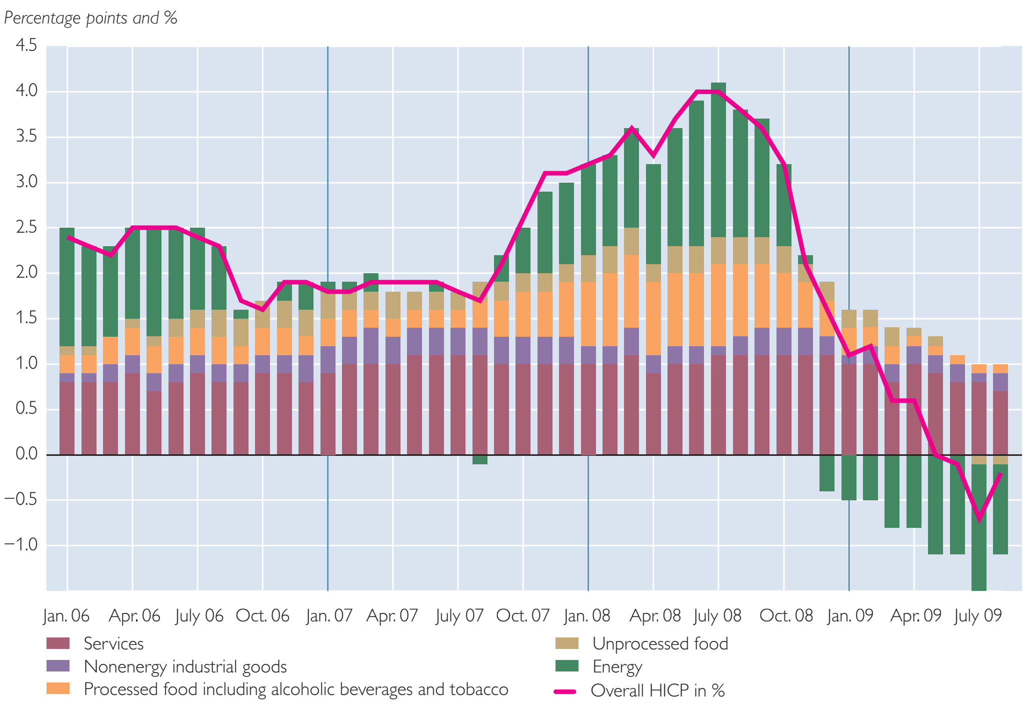
The rally in the price of crude oil that had begun in March 2009 temporarily came to a halt in July. However, during August, crude oil prices started to rise again. Oil prices were subject to marked volatility stemming from geopolitical tensions, production shortfalls and uncertainty about a rapid, sustained recovery of the global economy.

In June 2009, food prices remained unchanged for the first time in a long time. The slight positive contribution from processed food was canceled out by a negative contribution from unprocessed food. Despite the ebbing of the favorable base effect of the summer of 2009, food prices may fall further over the coming months according to leading indicators.

With the further normalization of the inflation-linked bond markets, the break-even inflation rate (BEIR) can be more easily interpreted. The current

Chart 3

HICP Components



Source: Eurostat.

term structure of both the BEIR and inflation-linked swaps suggests that despite some normalization since the crash in the fall of 2008, short-term inflation expectations are still significantly below the Eurosystem's inflation target. Long-term expectations (five-year forward five years ahead BEIR) remain at a level in line with the definition of price stability. Since April 2009, the exchange rate of the U.S. dollar against the euro has risen, and since June the pound sterling has also strengthened, although in recent weeks the appreciation of the euro against the pound sterling has been stronger. On September 24, 2009, the USD/EUR exchange rate stood at 1.48, while the exchange rates of the Japanese yen and Swiss franc against the euro remained unchanged. The nominal effective exchange rate of the euro has also risen since the beginning of September 2009, after having been relatively stable over the summer.

According to the ECB staff projections, average annual HICP inflation is expected to fall to between 0.2% and 0.6% in 2009, reflecting base effects stemming from past hikes in commodity prices. For 2010, an inflation rate of between 0.8% and 1.6% is expected. There is therefore no risk to price stability over the entire forecasting horizon.

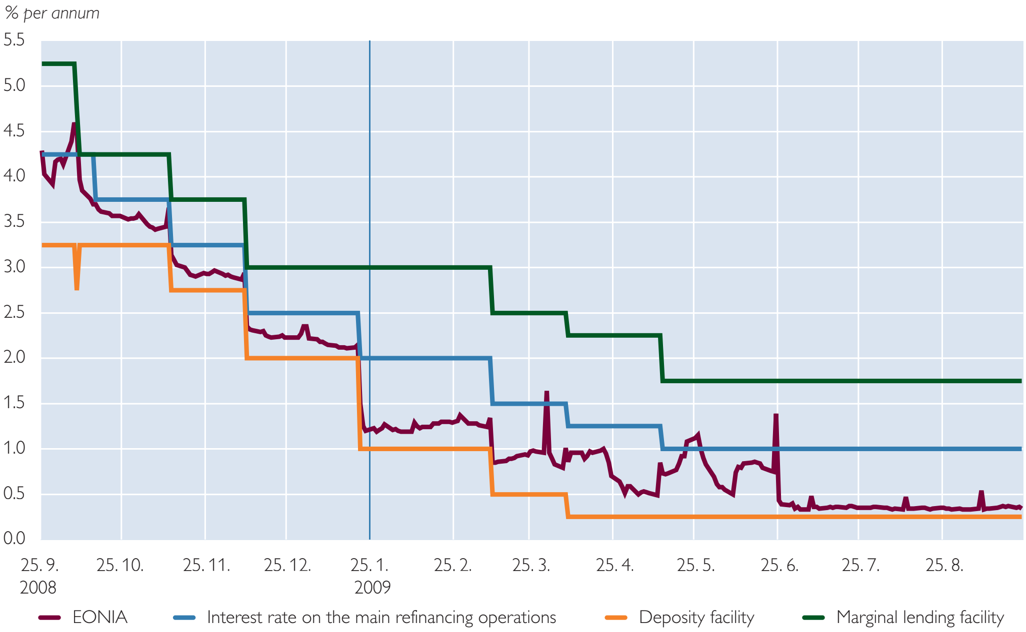
2.6 Interest Rates Remain at a Low Level

At its meeting on September 3, 2009, the Governing Council of the ECB decided to leave the interest rate on the main refinancing operations of the Eurosystem, as well as the interest rates on the marginal lending facility and the deposit facility, unchanged at 1.00%, 1.75% and 0.25%, respectively.

It also decided that the interest rate for the 12-month longer-term refinancing operation that was allotted on September 30, 2009, would be the prevail-

Chart 4

Money Market Rates and ECB Interest Rates



Source: Thomson Reuters.

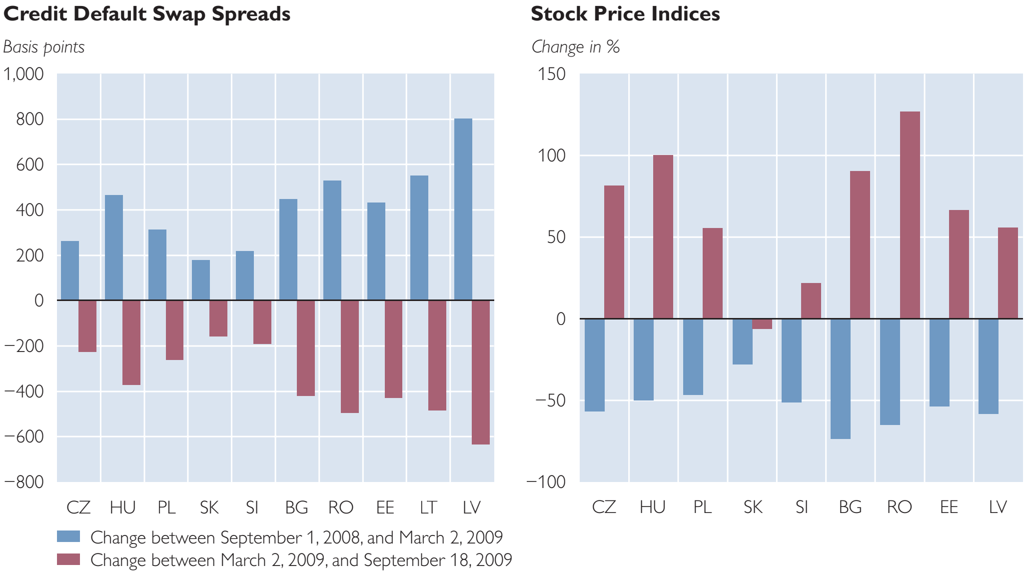
ing rate on the main refinancing operations. This decision, which facilitated continued liquidity support to the banking system of the euro area for an extended period at very favorable conditions, should promote the extension of credit to the euro area economy and thus further underpin its recovery.

On September 29, 2009, the Euro Overnight Index Average (EONIA) stood at 0.35%. Since the first longer-term refinancing operation with a maturity of one year was settled on June 25, 2009, the EONIA has hovered around a lower level than before, with lower volatility too. In the ten-year segment, the yield spreads between government bonds in Germany and other euro area countries have narrowed slightly, although long-term government bond yields have risen marginally in Germany.

Over the last few months, M3 growth has declined considerably, down from 8.9% in August 2008 to a mere 2.5% in August 2009. This development was due to the extremely low levels of short-term interest rates. On the one hand, fixed-term deposits, which had attractive interest rates up to the summer of 2008 and constituted major contributing factors to M3 growth, became less appealing compared with demand deposits, with the annual growth rate of fixed deposits consequently falling from 13.6% in December 2008 to –4.1% in August 2009. On the other hand, there were also noticeable portfolio shifts from marketable financial instruments, which are not covered by a government guarantee, into liquid assets that are subject to such a guarantee. As a result, the growth rate of marketable instruments has been negative for several months, standing at –10% in August 2009. Overall, the decline in M3 growth can be attributed to weaker contributions from fixed-term deposits and marketable financial instruments. These developments have had a positive impact on the more liquid components of M3, in particular demand deposits. In August 2008, M1 growth hit a low of

Chart 5

Development of Selected Financial Market Indicators



Source: Thomson Reuters.

0.2%, but by August 2009 it had risen to 13.6%.

3 Economic Developments in Central, Eastern and Southeastern Europe

3.1 Financial Markets Show Improvement During the Second and Third Quarters of 2009

The financial market situation in the countries of Central, Eastern and Southeastern Europe (CESEE) improved considerably during the second and third quarters of 2009, bolstered by returning confidence and a growing appetite for risk on the international financial markets. The intense stabilization action carried out by international financial organizations and the EU played a crucial role in this development. The recovery was evident in all financial market segments, in particular credit default swap spreads, Eurobonds and stock markets. Despite these improvements, most countries have not yet seen a return to precrisis levels.

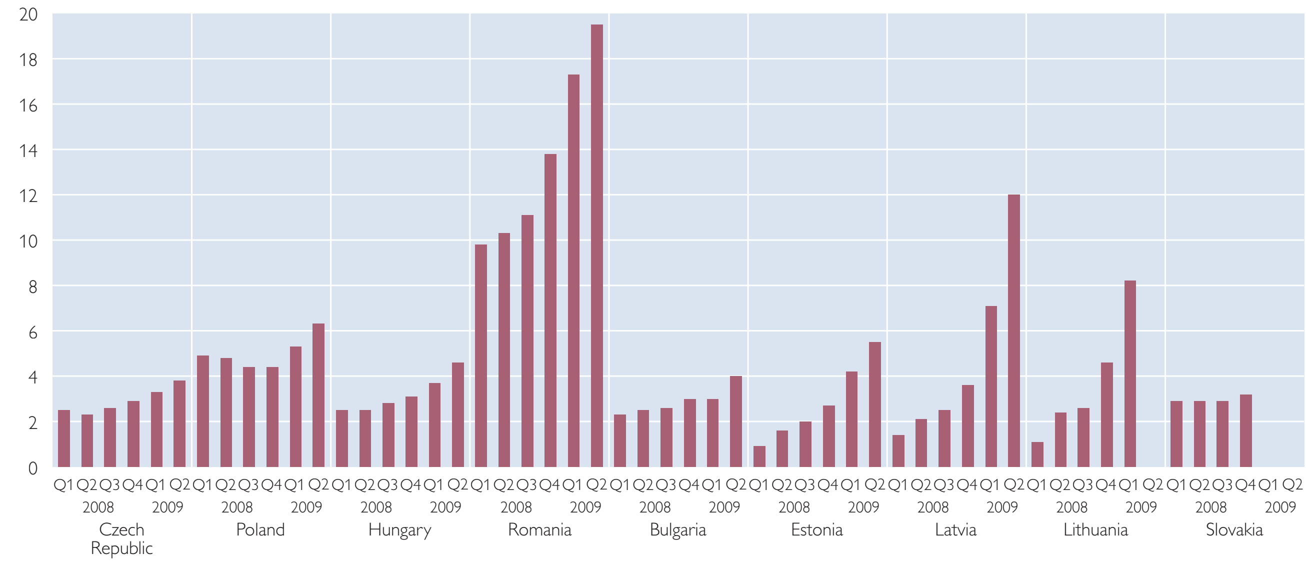
At the same time, the macrofinancial risk profile of the CESEE countries has, on balance, improved somewhat, following a considerable deterioration during the last few months of 2008 and at the beginning of 2009, albeit to varying extents from country to country. International financial aid bestowed upon the region was instrumental in raising the risk profile. Nevertheless, the risks in many areas remain somewhat higher than in the late fall of 2008, primarily due to the sharp deterioration in the global economic situation.

In particular, macroeconomic and cyclical risks were significantly affected by the slump in external demand and a reduction in domestic demand. Slovakia and Slovenia mitigated these risks slightly in the short term by their entry into the euro area. In the medium term, however, they may suffer losses in competitiveness vis-à-vis major competitors in the region, namely Poland, Hungary, Romania and the Czech

Chart 6

Nonperforming Loans

% of total lending



Source: National central banks.

Republic, especially if the real depreciation of the national currencies against the euro that occurred at the end of 2008 through the beginning of 2009 persists. Government balances will deteriorate in all countries, and in some cases considerably, primarily due to cyclical factors. Anticyclical fiscal measures will reach critical mass in only a few countries.

Owing to the dramatic downturn in the real economy, credit risks and risks to the banking sector have increased in all countries. Furthermore, the depreciation, particularly in the first quarter of 2009, of those currencies operating under a flexible exchange rate regime as well as the widespread prevalence of loans denominated in foreign currency have heightened the credit risk of banks. In the meantime, currency markets have stabilized, with some countries' currencies recovering some of their loss in value. Nevertheless, the currencies are still trading below or far below their values during the summer of 2008. This increase in credit risk is also clearly evident, for example, from the growing proportion of nonperforming loans in total lending.

By contrast, external economic risks and exchange rate risks have been kept in check by the significant improvement in current account balances over the last few months (section 3.4) and by the rapid and extensive international financial aid that has been granted to those countries particularly hard hit by the crisis.

3.2 Growth Declines Sharply in the First Half of 2009

While financial markets were stabilizing and the region's risk profile was showing signs of improvement vis-à-vis late fall 2008, the crisis was having a growing negative impact on the real economy. The overall economic situation in the CESEE countries deteriorated considerably in the first half of 2009. GDP growth in the region fell dramatically, standing on average at –4.8% in the second quarter of 2009 (compared with the same quarter of 2008). All countries except Poland posted negative growth; the Baltic states even recorded double-digit negative growth. The recession deepened further in most countries, with only Slovakia registering a slight slowdown in the downturn.

Table 1

Economic Growth in the CESEE EU Member States

	2008	2009[1]	2010[1]	Q3 08	Q4 08	Q1 09	Q2 09
	Real GDP growth rate (annual change in %)						
Bulgaria	6.0	−6.5	−2.5	6.8	3.5	−3.5	−4.9
Estonia	−3.6	−14.0	−2.6	−3.2	−9.2	−15.0	−16.1
Latvia	−4.6	−18.0	−4.0	−5.2	−10.3	−18.0	−18.7
Lithuania	3.0	−18.5	−4.0	2.9	−2.2	−13.3	−20.2
Poland	4.9	1.0	2.2	5.5	2.4	1.1	1.1
Romania	7.1	−8.5	0.5	9.2	2.9	−6.2	−8.7
Slovakia	6.4	−4.7	3.7	6.6	2.5	−5.6	−5.3
Slovenia	3.5	−4.7	0.6	3.9	−0.8	−8.3	−9.3
Czech Republic	3.0	−4.3	1.3	3.9	0.0	−4.4	−5.8
Hungary	0.6	−6.7	−0.9	1.3	−2.5	−6.7	−7.5
Entire region	**4.2**	**−4.4**	**0.9**	**5.0**	**0.9**	**−3.8**	**−4.8**
Euro area	**0.9**	**−4.2**	**0.3**	**0.5**	**−1.7**	**−4.9**	**−4.7**

Source: Eurostat, IMF, national statistical institutes.

[1] *IMF forecast (October 2009).*

The decline was due primarily to strong negative contributions from gross fixed capital formation and extensive destocking. This development can be attributed to the plight of the region's industrial sector, which has been particularly hard hit by the crisis. The fall in external demand and the general deterioration in the international climate resulted in a steep decline in industrial production owing to this sector's heavy reliance on exports. In July 2009, industrial production slumped by an average 11.3% and, in some countries, by more than 20%. The figures for capacity utilization and industrial confidence were also down. These factors led to a reduction in investment that was exacerbated by the high levels of uncertainty surrounding the development of the global economy. Consequently, inventories were drawn down, which made a strong negative contribution to growth in most countries in the second quarter of 2009. Financing conditions for companies in the region deteriorated, and growth in lending to the corporate sector (compared with the previous month) came to a standstill in February 2009 and has since been negative.

Further negative growth stimuli came from exports, which fell sharply in all countries of the region as a result of weak international demand. However, as weak domestic activity (owing mainly to sluggish investment) meant that imports in the CESEE countries declined more dramatically than exports, net exports made a positive contribution to growth in almost all countries – and in some cases this contribution was quite large.

Average private consumption growth in the region slowed at a somewhat less vigorous pace than that of other GDP components and was still in positive territory in some Central European countries. There were, however, strong negative contributions from the component, particularly in the Baltic states, Romania, Bulgaria and Hungary, owing to declining employment and falling wages. Furthermore, unemployment went up in all countries of the region as a result of weak economic growth and to a certain extent also due to the rise in remigration from western European countries (e.g. in Poland). Growth in lending to the household sector slowed sharply, with lending volumes starting to dwindle in July 2009.

3.3 Is There a Silver Lining on the Horizon?

Notwithstanding the weak economic conditions in the second quarter of 2009, there are now tentative signs of a stabilization in the economic situation. This is evident from a closer look at current growth figures. Although growth rates continued to fall in most countries in the second quarter of 2009, the decline was less sizable than in the first quarter (–3.8% in the first quarter of 2009 to –4.8% in the second quarter compared with +0.9% in the fourth quarter of 2008 to –3.8% in the first quarter of 2009). It should also be noted that the Czech Republic, Slovenia, Slovakia and Poland posted positive growth rates again in the second quarter of 2009 compared with the previous quarter. In Slovakia, growth even came to 2.2%, probably due to the pronounced trade integration with Germany and the +0.3% quarter-on-quarter recovery in Germany.

Furthermore, GDP fell significantly in those countries exhibiting considerable economic imbalances prior to the crisis. Hungary, the Baltic states and Romania were characterized by a high external debt burden, loans denominated in foreign currency accounting for a large proportion of total lending and, in some cases, excessive lending growth and high current account deficits. Consequently, these countries are particularly vulnerable to changes in the international economic environment. At the same time, especially the Central European countries entered the crisis with comparatively sounder fundamentals, which is now clearly reflected in their better economic performance. There are therefore marked differences between the countries of the region, with current growth figures showing that the Central European countries appear to be emerging from the recession more quickly (and not only compared with the rest of the region, but also the whole of Europe). Current forecasts also confirm this development, with Poland, the Czech Republic and Slovakia set to grow more quickly than the euro area in 2010. For the region as a whole, the growth differential to the euro area is forecast to rise to 0.6 percentage points from –0.2 percentage points in 2009.

In recent months, important activity indicators have also improved somewhat. For example, the average size of the contraction in industrial production fell significantly from 17.1% in March to 11.3% in July 2009. In July and August 2009, survey data also pointed to a slight pickup in export orders. Furthermore, the confidence indicators for the countries of the region improved significantly. Having reached its lowest level in years in the first quarter of 2009, economic confidence went up quite markedly between May and August 2009, the increase being more pronounced in industrial confidence than in consumer confidence.

Other factors pointing to a recovery in the economy in the second half of the year include the stabilization in international financial markets during the second and third quarters, as well as positive base effects stemming from the downturn at the end of 2008, which will materialize as of the fourth quarter of 2009. Furthermore, subdued investment and massive destocking since the beginning of 2009 should, in the meantime, have created a certain level of investment demand that will be realized over the next few quarters.

3.4 Economic Crisis Triggers Decline in External Deficits

The financial crisis and the associated slump in growth have triggered a sharp reduction in external imbalances in the region, with some countries' deficit even becoming a surplus. Only in Slovakia did the combined current and capital account balance decline year on year in the first quarter of 2009 (the figures for the second quarter are not yet available).

With the exception of Lithuania, net FDI flows dropped in all countries in the second quarter of 2009. In the first quarter, net FDI flows in the region were still positive, but in the second quarter they turned negative in the Czech Republic, Poland, Estonia and Latvia. By contrast, net inflows of portfolio investment improved somewhat in the second quarter compared with the first quarter, with many countries posting inflows again after the negative levels of the first quarter. This could also be viewed as an indication that the economic crisis has spilled over more into the real economy, as confidence has returned to the financial sector after the fall 2008 shocks.

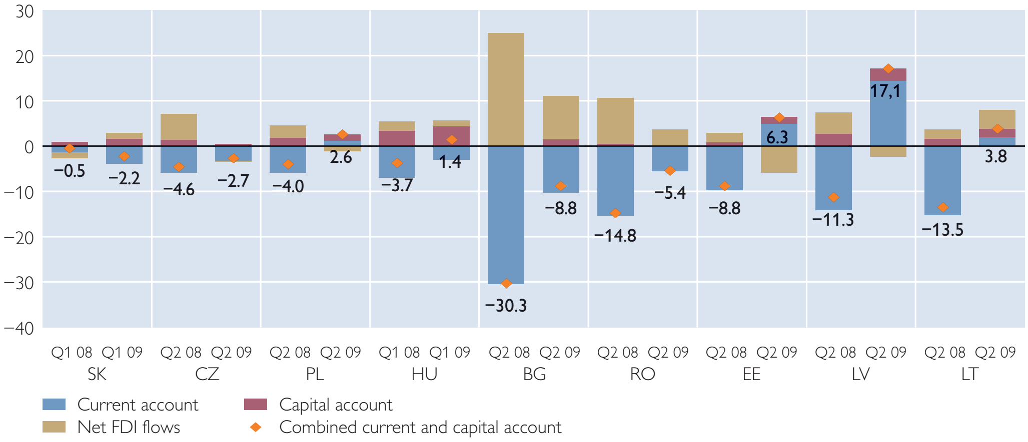
3.5 Inflation Falls Rapidly in the Region

As in the euro area, inflation in the CESEE EU Member States has eased considerably in recent months. Over the year until August 2009, inflation

Chart 7

Balance of Payments Developments

% of GDP



Source: National central banks.

fell on average by 3.2 percentage points compared with the annual average for 2008. However, the overall decline masks significant differences between the countries: While inflation remained more or less at the same level in Poland (partly due to the considerable depreciation of the Polish zloty at the beginning of the year) and has even risen in Hungary in recent months (following the VAT increase in July 2009), it was on a rapid downward trend particularly in Bulgaria, Estonia, Latvia and Lithuania. Estonia, Slovenia and the Czech Republic slid into deflation in July 2009. However, only in Estonia did prices continue to fall in August too.

The main reason for the falling inflation rate was the general weakening of economic activity, which had a dampening impact on all components of inflation. In addition, inflationary pressures were curbed by favorable

Table 2

Price Developments in the CESEE EU Member States

	2008	2009[1]	2010[1]	Apr. 09	May 09	June 09	July 09	Aug. 09
	Annual rate of changes in the HICP in %							
Bulgaria	12.0	2.7	1.6	3.8	3.0	2.6	1.0	1.3
Estonia	10.6	0.0	−0.2	0.9	0.3	−0.5	−0.4	−0.7
Latvia	15.3	3.1	−3.5	5.9	4.4	3.1	2.1	1.5
Lithuania	11.1	3.5	−2.9	5.9	4.9	3.9	2.6	2.2
Poland	4.2	3.4	2.6	4.3	4.2	4.2	4.5	4.3
Romania	7.9	5.5	3.6	6.5	5.9	5.9	5.0	4.9
Slovakia	3.9	1.5	2.3	1.4	1.1	0.7	0.6	0.5
Slovenia	5.5	0.5	1.5	1.1	0.5	0.2	−0.6	0.1
Czech Republic	6.3	1.0	1.1	1.3	0.9	0.8	−0.1	0.0
Hungary	6.0	4.5	4.1	3.2	3.8	3.7	4.9	5.0
Entire region	**6.3**	**2.9**	**0.2**	**3.8**	**3.5**	**3.4**	**3.2**	**3.1**
Euro area	**3.3**	**0.3**	**0.8**	**0.6**	**0.0**	**−0.1**	**−0.6**	**−0.2**

Source: Eurostat, IMF.

[1] *IMF forecast (October 2009).*

base effects stemming from energy and food prices, as well as by falling commodity prices (primarily due to the decline in the global price of crude oil associated with the low level of activity in the world economy).

Central banks in the region responded to this development and to the decrease in inflation risks in the medium term (owing to the weakening of economic activity) by cutting their key interest rates (by 200 basis points in Hungary, 175 basis points in Romania, by 150 basis points in Poland and 175 basis points in the Czech Republic since the beginning of the year).

4 Austrian Economic Growth to Turn Positive in Second Half of 2009

4.1 Austrian Economy Shows Signs of Bottoming Out

The Austrian economy saw the worst slump of the post-war period in the first quarter of 2009, contracting by 2.7% in real terms vis-à-vis the previous quarter (seasonally and working day-adjusted). Against the backdrop of an improved global outlook, the downward spiral slowed considerably and the economy shrank by 0.5% in the second quarter (–4.5% year on year). Consumer spending growth (+0.4%) cushioned the downturn, as exports and imports declined at a much slower pace than in the previous quarters (–2.3% and –1.5% respectively). However, at –1.9%, the decrease in investment continued almost unabated compared with the previous quarters.

The release of the national accounts data for the second quarter has prompted a major revision of historical GDP rates. Contrary to earlier data, the economy contracted earlier and more strongly than previously believed (by –0.4% in the third and –1.0% in the fourth quarter of 2008). These figures suggest that the path of the Austrian economy during the crisis – calculated ex post – is increasingly following that of the euro area and the German economies. It seems that the lagged downturn of the Austrian economy discussed after initial data releases was actually a statistical error rather than a fact.

Table 3

Results of the National Accounts for the Second Quarter of 2009

	GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports
	Quarterly change in %					
Q1 08	1.1	0.2	–1.2	0.3	1.3	–0.6
Q2 08	0.3	0.1	2.8	–0.2	–0.9	–0.4
Q3 08	–0.4	0.1	–0.7	–1.3	–3.2	–3.1
Q4 08	–1.0	0.1	1.8	–2.1	–5.4	–3.9
Q1 09	–2.7	0.1	–1.3	–2.3	–7.4	–4.5
Q2 09	–0.5	0.4	0.4	–1.9	–2.3	–1.5
	Annual change in %					
2005	2.9	2.0	1.7	2.0	7.6	7.1
2006	3.4	1.9	2.5	2.3	7.7	5.5
2007	3.4	0.9	2.0	2.7	9.3	6.7
2008	1.9	0.6	3.1	–0.6	0.7	–1.8

Source: Eurostat.

Box 1

Results of the OeNB Short-Term Indicator of October 2009[1]

The economic outlook for the second half of 2009 has improved considerably recently. The OeNB's latest short-term indicator results show real GDP growth at 0.4% in both the third and fourth quarters of 2009 (seasonally and working day-adjusted, on a quarterly basis). This means that, after contracting for four consecutive quarters, the Austrian economy will return to a path of positive growth. Owing to the sharp slump recorded at the beginning of the year, a 3.6% contraction is forecast for the full year 2009. The swifter recovery of the global economy is the main reason for the more upbeat outlook for the second half of 2009. Two additional factors are expected to underpin growth: First, the fiscal stimulus measures launched in Austria and many other countries are contributing to a stabilization of demand, and second, the pronounced destocking seen over the past months is an indication that inventory investment is set to pick up in the second half of 2009. The unwinding of temporary factors, however, implies the danger of a setback to the recovery during 2010.

Short-Term Outlook for Austria's Real GDP in the Third and Fourth Quarters of 2009 (seasonally and working day-adjusted)

2007				2008				2009			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Year-on-year quarterly change in %											
4.0	3.7	3.1	2.9	3.0	2.8	2.0	−0.1	−3.8	−4.5	**−3.8**	**−2.4**
Quarterly change in %											
1.0	0.4	0.5	1.0	1.1	0.3	−0.4	−1.0	−2.7	−0.5	**0.4**	**0.4**
Annual change in %											
3.4				1.9				**−3.6**			

Source: OeNB – Results of the OeNB economic indicator of October 2009, Eurostat.

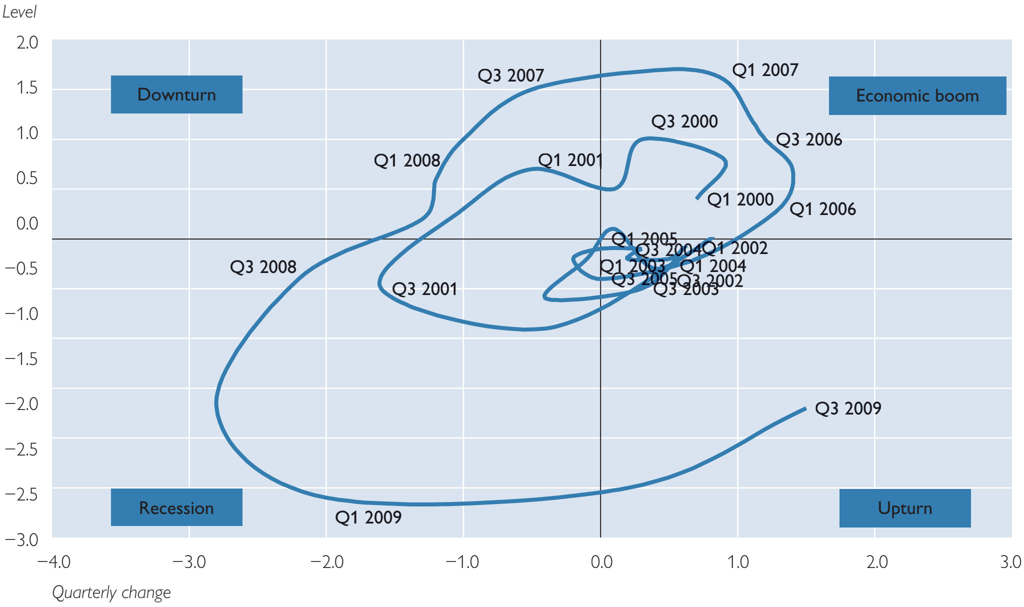
[1] *The next release of the OeNB's short-term indicator is scheduled for January 2010.*

4.2 Confidence Indicators Improve Notably

Over the past months, all confidence indicators have picked up from their historical lows. Most indicators, however, continue to stand at levels significantly below their long-run averages. One of the few exceptions is the Purchasing Managers' Index (PMI) for new orders, which has been above the 50-point threshold between economic expansion and contraction for two months. At 1.4, the ratio of new orders to inventories reached one of its highest ever levels, indicating an imminent acceleration in industrial activity, driven to a large extent by the inventory cycle. The European Commission's Economic Sentiment Indicator for Austria has improved by 14.3 points since hitting its historic low in April 2009 and reached 80.1 points in August. This is the largest increase ever to be recorded over a period of four months. Apparently, economic sentiment has improved in all sectors surveyed. Despite the marked improvement, the current level is still far below its long-run average of 100. The surge in confidence over the past few months can be partly explained as a correction of the previous excessive drop. It is therefore

Chart 8

Business Cycle Clock – Confidence Indicator[1]



Source: Eurostat.

[1] The confidence indicator in the chart is an unweighted average of the data on business and consumer confidence compiled by Eurostat. The values of both levels and of rates of change are standardized at around zero.

still too early to ascertain the sustainability of the upswing as indicated by the business cycle clock (chart 8).

4.3 Labor Market Tensions Set to Continue

The crisis has led to a marked deterioration in the labor market. In August 2009, the number of jobs was down by 67,000 from August 2008, and the number of unemployed had risen by 55,000. Employment policy measures have to some extent cushioned the impact of the crisis on the labor market: First, the extension of the range of training programs offered by the Austrian Public Employment Service (AMS) has prevented a steeper rise in unemployment. In August, almost 58,000 unemployed persons participated in AMS training programs, 17,000 more than one year earlier. Second, enterprises have been making extensive use of short-time working schemes[2], which had been extended gradually as the crisis unfolded, with over 54,000 persons working shorter hours in August (chart 9). The unemployment rate (national definition, seasonally adjusted) rose to 7.6% in August 2009 vis-à-vis 5.9% one year earlier. Unemployment as defined by Eurostat was 4.4% in July, up 0.7 percentage point from the rate recorded in July 2008. A breakdown by sectors shows that manufacturing has been particularly hard hit, accounting for about two-thirds of the job losses.

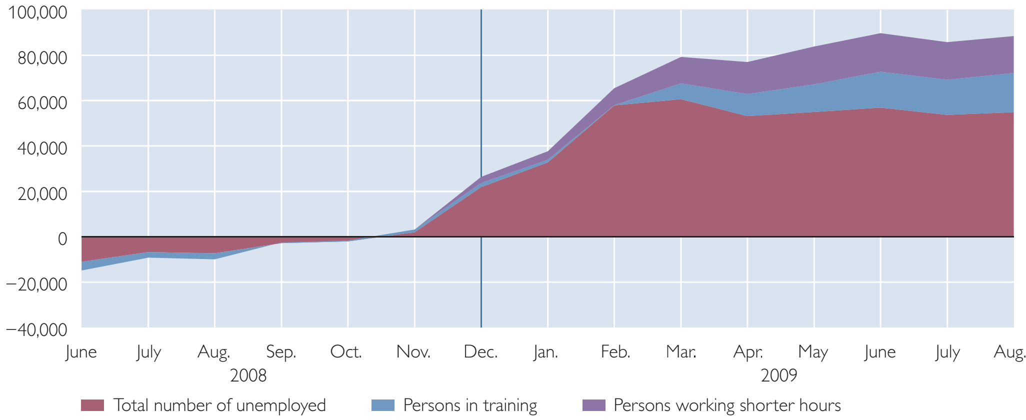
Developments in the real economy feed through to the labor market with a lag of a few months. Labor market conditions can therefore be expected to

[2] On average, employees placed on short-term working schemes work about 70% of their regular working hours.

Chart 9

Unemployment, Training and Short-Time Work Developments[1]

Persons, annual change



Source: AMS, Eurostat, Statistik Austria.

[1] *According to AMS, the average reduction in working hours is 30%. The number of persons working shorter hours was therefore multiplied by a factor of 0.3.*

tighten further in the second half of the year. The decrease in the number of reported vacancies – a leading indicator of labor market developments – came to almost 10,000 in August 2009 (year on year), thus supporting this prediction. In view of the subdued growth outlook and the delayed effects of business cycle developments on the labor market conditions cannot be expected to improve in 2010.

4.4 Inflation to Stabilize at a Low Level

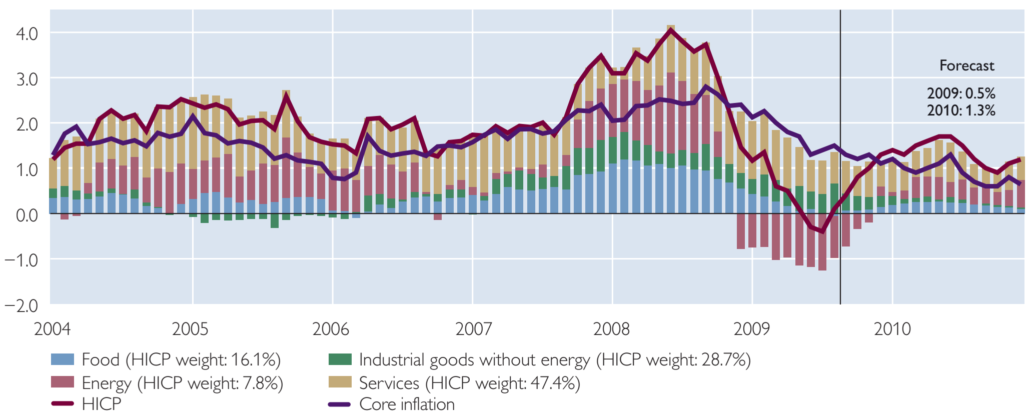
HICP inflation stood at 0.1% in August 2009 (CPI: +0.3%), marking the return of price growth to positive territory after two months of negative rates in the summer. Fuel and heating oil prices continue to play a primary role in determining the course of inflation.

Owing to the rise in commodity prices over the past few months, infla-

Chart 10

HICP Inflation and Contributions from Subcomponents

Percentage points *Last observation: August 2009*



Source: OeNB, Statistik Austria.

tion rates can be expected to pick up somewhat in 2010. However, with growth expected to be weak, price growth will remain well below the 2% target. HICP inflation for the full year 2009 is set at 0.5% and is expected to accelerate to 1.3% in 2010. Core inflation (excluding energy and unprocessed food) is anticipated to be 1.5% in 2009 and to drop to just below 1% in 2010 because of developments in nonenergy industrial goods prices and low inflation in services.