Slowdown in Global Economic Momentum

Asia and the U.S.A. To Remain Growth Drivers of World Economy in 2005

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In 2004, despite the sudden jump in oil prices and the ballooning trade deficit, the U.S. economy grew by 4.4%, or more robustly than ever since 1999. In the same year, growth in consumer prices peaked at 3.3% – the highest level in four years. In early February 2005, the U.S. Fed raised its key interest rates by 25 basis points for the sixth time since mid-2004. Whereas Japan slipped back into a period of recession, other Asian economies continued growing apace in 2004.

The second half of the year 2004 saw a slowdown in GDP growth momentum in the euro area. Despite positive stimuli from investments, growth rates declined, due to weaker net exports and still very subdued private consumption demand. Consumer restraint can partly be explained by the sluggish growth in real disposable income as a result of higher energy prices, which are also responsible for the rise in inflation.

In the first three quarters of 2004, most new Central European EU Member States expanded at a faster pace than in 2003 as a whole. The upward pressure on prices (partly induced by EU accession) was very strong in the new Member States in 2004. In Romania, an EU candidate country, growth rocketed to an outstanding 10.0% in the third quarter.

Following weak growth in the fourth quarter of 2004, Austria's economy is regaining steam, but is not immune to the current slowdown in growth in the euro area as a whole. The OeNB's short-term indicator forecasts 0.4% seasonally adjusted growth in Austria's real GDP for the first and 0.5% for the second quarter of 2005 (each compared with the previous quarter).

1 U.S.A. and Asia Remain Growth Drivers of World Economy

1.1 U.S.A.: Tightening of Monetary Policy Continues

For the last 18 months or so, the annualized gross domestic product (GDP) has been trending above the long-term average of 3.5% (quarter on quarter), with the exception of the second quarter of 2004 when the sudden jump in oil prices curbed the momentum of GDP growth to 3.3%. In the third quarter of 2004, real GDP growth accelerated to 4.0%, driven by the far greater pace of private consumption momentum (5.1%) and by unabated expansive growth in investment in plant and equipment (+13%). Marginally weaker GDP growth of 3.8% in the fourth quarter of 2004 is attributable primarily to a deterioration in net exports.

At 4.4%, real GDP growth in 2004 as a whole was the strongest ever since 1999. According to Consensus Forecasts, GDP growth is expected to slow to 3.5% in 2005 and 3.4% in 2006. Weaker private consumption, in particular, is likely to be responsible for this since the rescheduling of mortgage loans at ever more favorable terms is coming to an end, with interest rates now on the rise. In view of the tight budget scenario, moreover, further fiscal stimuli in the form of tax cuts cannot be expected. Besides, increased household debt will narrow the financial leeway available to consumers.

At 4.1%, the vigorous productivity growth of the past few years (2003: +4.4%) continued in 2004, albeit at a slower tempo. Toward year-end, however, the pace of growth slowed markedly, which could indicate largely exhausted gains in economic efficiency.

Labor market conditions are starting to ease. In January 2005, the unemployment rate fell from 5.4% to 5.2%. As a result, the huge job losses triggered in 2001 by the recession were offset in early 2005. However, the risk remains that the robust growth in consumer demand will slacken if the labor market's recovery does not accelerate in the coming months. Sluggish growth in industrial employment is responsible for the labor market's slow recovery. Some three million jobs have been lost since mid-2000. In early 2004, jobs stopped being axed.

In 2004, consumer prices rose at their fastest rate in four years. January 2005 saw a slight dip in inflation. Following a rise of 3.3% year on year in December 2004, the consumer price index edged down to 3% – owing, in particular, to the smaller increase in energy prices. In January 2005, core inflation rose by 2.3% year on year, or marginally (+0.1 percentage point) more steeply than in the previous two months (strongest growth since October 2002).

At its first meeting of 2005 (February, 1 and 2), the Federal Open Market Committee (FOMC) of the U.S. Federal Reserve System (Fed) raised its target for the federal funds rate by 25 basis points to 2.5%. This increase represented the sixth successive key rate hike since mid-2004 and confirmed the U.S. Fed's repeatedly expressed intention of removing policy accommodation at a measured pace. The statement accompanying this decision almost chimed with that issued at the previous meeting on December 14, 2004. The FOMC described U.S. GDP growth as robust, inflationary expectations as contained and the labor market as steadily improving, and deemed the current level of interest rates to be still stimulating the economy. The upside and downside risks to the attainment of sustainable growth and price stability in the near future were perceived to be roughly equal. As a result, the strategy of monetary policy tightening is likely to be pursued in a series of moderate measures.

Risks for the U.S. economy are the high energy prices, the deep deficits in the external sector (2004 current account deficit: almost –6% of GDP) and the general government budget (2004 budget deficit: –3.6% of GDP), as well as high consumer debt and consumers' low saving propensity.

1.2 Asia Still Fueling Growth despit "Technical" Recession in Japan

"Technically" speaking, the Japanese economy is back in a recession. Hit by private consumption and the external sector, real GDP in the fourth quarter of 2004 (based on the new chain indices for data of Japan's System of National Accounts – SNA) contracted by 0.1% quarter on quarter after registering a revised –0.3% in the third quarter and –0.2% in the second quarter. However, real GDP in 2004 as a whole increased by 2.6% thanks to extremely healthy growth in the first quarter. Although consumer confidence remained relatively high, the households surveyed reduced their real spending by 0.3% quarter on quarter, which might partly reflect concerns about future tax increases. However, extraordinary factors such as cyclones and a major earthquake in north Japan toward the end of the year also adversely affected consumption. Trading data reveal that company exports performed poorly, posting their slowest growth in a year in December 2004. The labor market, by contrast, was not in the least affected by the cooling economy. Since early 2003 the unemployment rate has fallen from 5.5% to 4.4% (in December 2004), the lowest level since 1998. High commodity prices and the relative strength of the Japanese yen are currently clouding Japan's economic outlook. Although the government and the Bank of Japan (BoJ) have forecast a deceleration in GDP growth to 1.5% in the fiscal year 2005 (ending March, 31, 2006), they believe the Japanese economy will continue to recover in the long term. Consensus Forecasts anticipates real GDP growth of 1.1% in calendar year 2005 and 1.8% in 2006.

At –0.2% year on year, core inflation for December 2004 (less fresh foods, including energy) remained slightly negative. In 2005, consumer prices are expected to largely stagnate. The BoJ is sticking to its zero interest rate policy. Choosing the right moment is key to an exit strategy. On the one hand, the BoJ should not tighten monetary policy too early if inflation rates are low, or Japan will return to the days of deflation. On the other, the BoJ should not maintain strong monetary growth for a protracted period, or the economy will be exposed to inflationary pressures.

In 2004, the emerging economies in non-Japan Asia (NJA) continued to recover thanks to strong external demand, China's investment boom and more robust domestic demand. Despite attempts to dampen the pace, China's economy grew by 9.5%. Regional integration strengthened, as indicated by rapid growth in intra-regional trade and by flows of investment. Toward end-2004, growth momentum started to decelerate owing to continued high oil prices. In 2005, growth momentum is likely to slacken – in particular, due to flagging export demand induced by globally weaker economic expansion.

2 Euro Area: Slowdown in Economic Momentum Continues

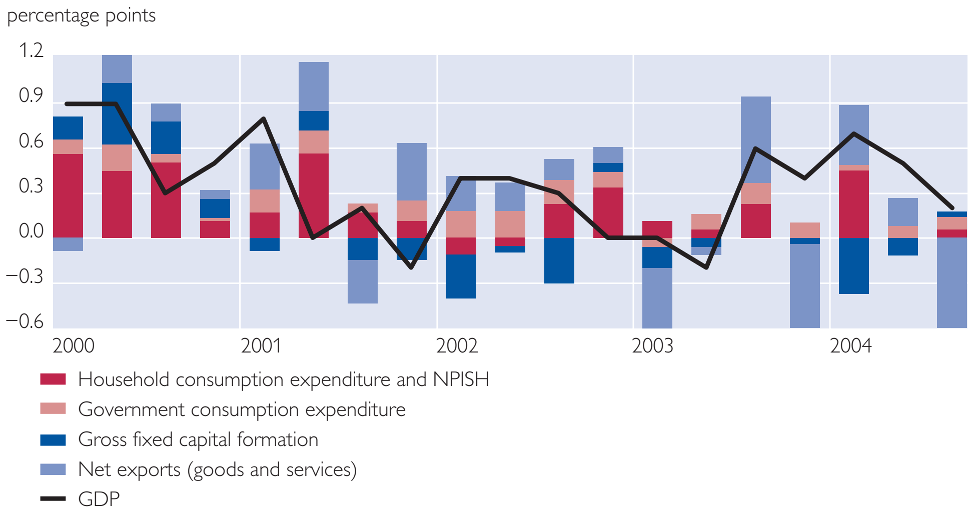
2.1 GDP Growth Driven by Gross Fixed Capital Formation in Third Quarter of 2004

According to Eurostat's first estimate for the fourth quarter of 2004, growth continued to slow to 0.2% and 1.6% on a quarterly and annual basis, respectively. This is primarily due to negative quarterly GDP growth in Germany (–0.2%) and Italy (–0.3%). As early as the third quarter of 2004, growth slowed in the euro area: Real GDP climbed by 0.3% quarter on quarter and 1.8% year on year. This was primarily attributable to

Chart 1

Contribution of Real GDP Components to Growth in the Euro Area

(quarter on quarter)



Source: Eurostat.

net exports, which were markedly negative owing to flagging export growth, with imports surging strongly at the same time. Real GDP growth in the third quarter was fueled by gross fixed capital formation, in particular.

Trends in gross fixed capital formation were positive. After this component dwindled by 0.2% in the first quarter of 2004, growth rates of 0.3% and 0.7% (quarter on quarter) were posted for the second and third quarters of 2004, respectively. The main reason for this is that gross fixed capital formation in the third quarter also generated positive growth in Germany. For instance, the decline in gross fixed capital formation in the first quarter was due primarily to the slump in construction investment in Germany. In countries such as Spain, France and Italy, by contrast, gross fixed capital formation already expanded in early 2004. At 0.9%, inventory build-up in the third quarter posted the highest growth in ten years, which meant that this component made by far the biggest contribution to GDP growth.

Following a relatively vigorous rate of 0.7% in the first quarter of 2004 (induced primarily by tax cuts in certain euro area countries), private consumption growth slowed significantly to 0.1% (quarter on quarter) in both the second and third quarter. This is likely to be due to the fact that real disposable income rose at a slower pace owing to the steep increase in energy prices. Other factors are the still unfavorable labor market conditions and the uncertainties about healthcare and pension system reforms. These uncertainties are also reflected in consumer confidence (as surveyed by the European Commission), which has been stagnating since February 2004. Overall, households are therefore consuming far less and saving instead. A study released by the *Gesellschaft für Konsumforschung*, a consumer research body, shows that Germany's retail industry has been badly hit by current "precautionary saving." For instance, the retail industry's share of nominal household spending in 1993 still exceeded 49%. By 2003, however, this had fallen (with a commensurate rise in the saving rate) to 41%. However, the recent improvement in the monthly indicators for private consumption – retail sales and new car registrations – suggests the sluggish consumption observed in the previous two quarters may have been merely of a temporary nature.

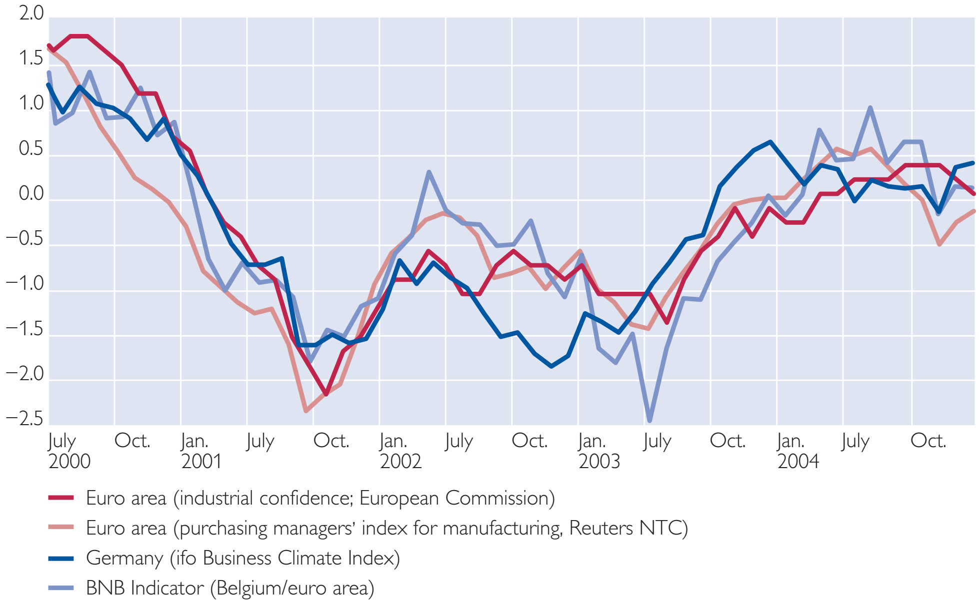
As for exports, their growth momentum slowed in the third quarter of 2004 as imports bounced back strongly. The contribution of net exports to growth was therefore distinctly negative in the third quarter. A reason for this decline in exports is the slight downturn in the growth of the world economy from mid-2004. Furthermore, the negative impact of the euro's appreciation, adversely affecting the competitiveness of euro area exports, is only now likely to take full, albeit delayed, effect. In view of the modest domestic demand, the strong surge in imports was unexpected.

The pace of public consumption picked up recently. After posting growth of just 0.1% in the first quarter of 2004 – in this case, public consumption is likely to have been curbed by the bleak budget situation in some countries (with deficits close to or above the budget deficit ceiling of 3%) – this component rose more steeply in the second and third quarter of 2004, up 0.4% and 0.5% (quarter on quarter), respectively.

Chart 2

Business Climate Indicators

Deviation from mean value of indicator relative to standard deviation



Source: European Commission, ifo, NTC, OeNB.

The leading indicators for GDP growth have been presenting a relatively changeable picture in the last few months, which nonetheless confirms the impression that the economy might have recently lost some steam.

2.2 Industrial Production Down, Unemployment Still Flat

Following a steady, albeit volatile, uptrend in growth until mid-2003, industrial production has been in decline since summer 2004. The leading indicators for industrial production also confirm this picture. Both the industrial confidence and economic sentiment indicator of the European Commission signaled a slight downturn in economic momentum.

As in previous months, the seasonally adjusted unemployment rate was just below 9% in December 2004. The tight labor market conditions can also be seen in the steadily falling share of job vacancies (since early 2001) as a percentage of the total working population in the euro area. In the third quarter of 2004, employment posted its highest rise in two years (+0.4%). In addition to the service sector, employment also increased in the construction industry.

2.3 Energy Prices Still Fueling Inflation

After peaking at USD 52.07 on October 22, 2004, the price for a barrel (Brent) tumbled sharply by more than USD 12. In the previous few months, oil price trends have been marked by high volatility. For instance, oil prices initially rose in mid-January 2005 – according to traders, investor concerns about potential new attacks on oil installations in Iraq before the elections and the cold wave in the U.S.A. depressed market sentiment. After falling in early February 2005 on account of OPEC maintaining output – OPEC refrained from cutting quotas at its previous meeting in

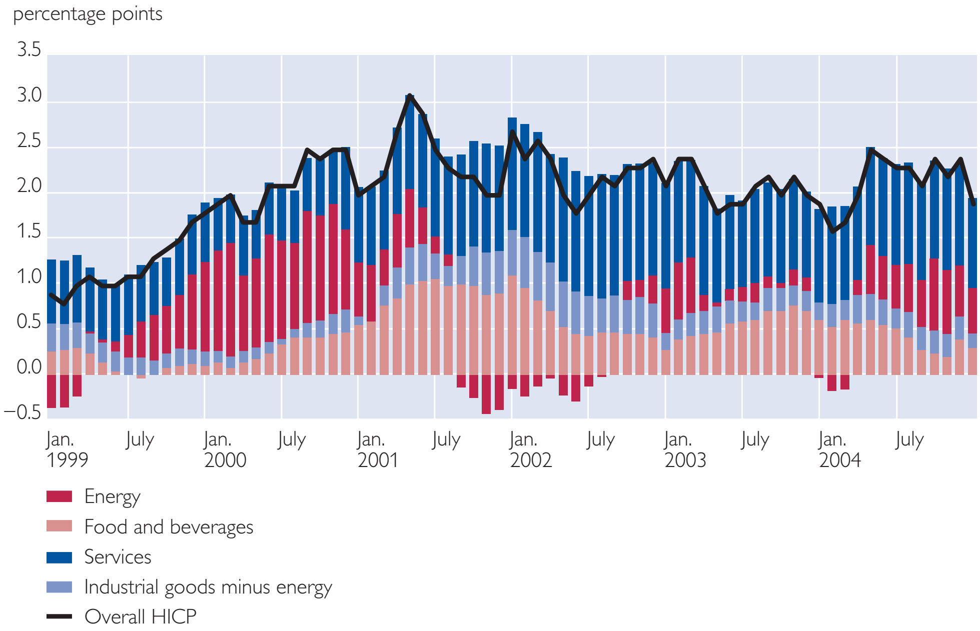
January 2005 – and of the absence of terrorist acts in Iraq, oil prices latterly climbed back in mid-February 2005 on fears of supply constraints. The fact that OPEC has maintained output attests to a certain willingness on its part to take currently high oil prices into account when controlling output.

Crude oil price trends are also reflected in the HICP (Harmonised Index of Consumer Prices) inflation rate: since April 2004 inflation has increased primarily because of the energy component. In December 2004, inflation rose to 2.4% (energy component: + 6.9%), with the contribution to inflation of the energy component equaling 0.6 percentage point. In January 2005, the HICP slipped back to 1.9% and was forecast to rise to 2.0% in February. In the past few months, food price increases have been very feeble, which has partly absorbed the energy price effect. For instance, the year-on-year rates of change for unprocessed food prices were negative from September to November 2004.

Since May 2004 core inflation (rise in the HICP excluding energy and unprocessed foods) has been fluctuating between 1.9% and 2.2% (January 2005: 1.8%). A sizeable proportion of core inflation comes from the "alcohol and tobacco" product group, which has been in excess of 7% since March 2004. Accordingly, the rise in the overall index excluding energy, food, alcohol and tobacco is a mere 1.7%. Furthermore, if the effects of health sector reforms in several countries are factored out of the core inflation rate, the latter is then likely to be only slightly more than 1.5%.

Chart 3

Components of HICP: Contributions to Inflation



Source: Eurostat.

2.4 Private Borrowing in Euro Area Continues to Expand

The upturn in total lending continued to show a positive trend. In particular, loans to the private sector have risen since mid-2003. Total lending growth stabilized due to flagging expansion in public sector lending. The upturn in private sector lending is basically attributable to an increase in home loans owing to low long-term interest rates. By contrast, consumer loans and loans to nonfinancial corporations continued to grow less dynamically, although recently a trend reversal might have occurred in an upward direction.

The three-month average of M3 growth rose to 6.3% for the period of November 2003 to January 2004, with a further resumption of the trend in accelerating growth since May 2004. This is due to the uptick in growth in other short-term deposits and in marketable financing instruments. Continued robust growth of currency in circulation and demand deposits is also attributable to strong foreign demand for euro banknotes and to low interest rates. Healthy demand for saving vehicles included in M3 can be explained by two factors: first, households' continued high degree of risk aversion and, second, the relatively flat yield curve and historically low long-term interest rates.

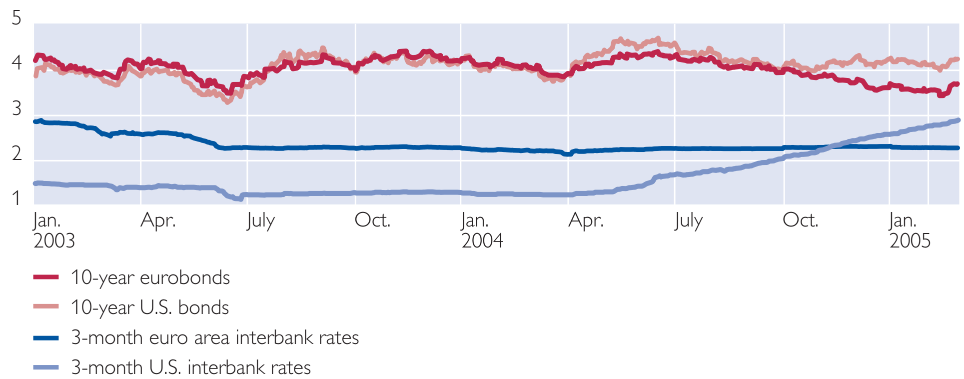
2.5 Euro Exchange Rate Peaks at End-2004

Since peaking at USD/EUR 1.36 on December 31, 2004, the U.S. dollar has recently made up lost ground. The somewhat greater strength of the greenback is attributable to favorable U.S. economic data, where industrial order intake and the purchasing managers' survey point to further buoyant growth. Relative to pound sterling and other currencies – in particular, the Japanese yen – the euro exchange rate was comparatively stable. EUR/USD exchange rate trends are currently generally being interpreted as U.S. dollar weakness. Concerns about financing the high current account deficit and, in this context, the high budget deficit in the U.S.A. are cited as one reason for the soft dollar.

Chart 4

Interest Rate Trends in the Euro Area and the U.S.A.

from January 1, 2003, to February 24, 2005



Source: Thomson Financial.

Until early February 2005, long-term interest rates in the euro area fell to 3.5% before bouncing back slightly. As a result, the downtrend in 10-year government bond yields since July 2004 has thus far continued. The spread vis-à-vis long-term interest rates in the U.S.A. has also widened. Above all, somewhat bleaker growth prospects are likely to have generated a strong demand for bonds. In addition, healthy demand for safe investment vehicles such as bonds is likely to reflect continued marked risk aversion amid ample liquidity supply.

2.6 Muted Optimism about Economic Growth

The economic outlook for 2005 is no longer considered to be as optimistic as in the first half of 2004. In its short-term target range forecast for the first half of 2005, the European Commission anticipates quarterly growth of 0.2% to 0.6%, which implies that economic momentum is not set to accelerate significantly. The ECB's projections released in December 2004 show that real GDP should increase by 1.4% to 2.4% in 2005 and by 1.7% to 2.7% in 2006. The February 2005 Consensus Forecasts predicts growth of merely 1.7% in 2005, followed by 2% in 2006. In the current forecasts, downside risks, consisting primarily in lagged effects of the euro's appreciation and in increased crude oil prices, are mostly emphasized.

3 Economic Performance in the New Central European Member States and in EU Candidate Countries

3.1 Rapidly Accelerating Growth in Most Countries in 2004

In Poland, Slovakia, Slovenia, Hungary and the Czech Republic, the economy in the first three quarters of 2004 grew at a weighted average rate of 4.9% (year on year), which was still far more dynamic than in the euro area (1.9%). In this period, growth in the new Central European EU Member States ranged between 3.7% (Czech Republic) and 5.9% (Poland) and, in most cases, was thus exceeded by GDP growth in the EU candidate countries Bulgaria (5.8%) and Romania (8.1%). With a growth rate of 3.9%, Croatia, also a candidate country, lagged behind most of these countries.

Furthermore, most Central and Eastern European countries generated higher growth in the first nine months of 2004 than in 2003 as a whole. In the new Central European EU Member States, growth ticked up at the same rate as in the euro area (by 1.4 percentage points). In this group of countries, Poland and Slovenia posted the fastest acceleration, up by 2.2 and 2.0 percentage points, respectively.

Table 1

Real GDP Growth in Central and Eastern Europe

annual change in %

	2000	2001	2002	2003	Q1 04	Q2 04	Q3 04
Poland	4.0	1.0	1.4	3.8	6.9	6.1	4.8
Slovenia	3.9	2.7	3.3	2.5	3.9	4.7	4.9
Slovakia	2.0	3.8	4.6	4.0	5.4	5.5	5.3
Czech Republic	3.9	2.6	1.5	3.7	3.7	3.8	3.5
Hungary	5.2	3.0	3.5	3.0	4.3	4.2	3.7
Bulgaria	5.4	4.1	4.9	4.3	5.3	6.0	5.8
Croatia	2.9	4.4	5.2	4.3	4.2	4.0	3.9
Romania	2.1	5.7	5.0	4.9	6.1	7.0	10.0

Source: Eurostat, national statistical offices, WIIW.

At 3.2 percentage points, Romania registered the strongest pick-up in growth among the entire group of countries.

The demand-side growth momentum in the countries under review has interesting features in common. These countries are broken down into groups in terms of changes in the first three quarters of 2004 (compared with 2003) in the contribution of domestic and net external demand to growth.

– In Croatia and the Czech Republic, both with slightly flagging GDP growth, the contribution of net exports to growth was less sharply negative compared with 2003. However, this positive development was more than offset by a weaker contribution of domestic demand. The change in these contributions has consequently resulted in a more balanced pattern of growth in both countries.
– In Bulgaria, Slovenia and Hungary, where GDP growth accelerated in the first three quarters of 2004 (compared with 2003 as a whole), the negative contribution of net exports to growth also proved to be smaller. These three countries were marked not only by accelerated GDP growth but also by a more balanced pattern of growth.
– In Poland, Slovakia and Romania, the positive contribution of domestic demand to growth increased, resulting in a concomitant rise in GDP growth. However, the contribution of net exports to growth developed less positively in these three countries.

In each of the countries where the contribution of domestic demand to growth increased (i.e. in Poland, Slovakia and Romania) growth in gross fixed capital formation accelerated faster than consumer growth. In Hungary and the Czech Republic, growth in gross fixed capital formation accelerated rapidly whereas consumer growth declined. Bulgaria witnessed a slowdown in both growth in gross fixed capital formation and consumer growth, with the latter falling more sharply. In 2004, a relative shift from consumer growth to investment growth was seen in most countries. There were two exceptions to this rule: first, Slovenia, where both consumer growth and investment growth rose slightly, and, second, Croatia, where growth in gross fixed capital formation fell sharply from a high level and consumer growth remained almost unchanged.

In general, net export levels fluctuated less wildly than in the previous period – with the exception of Romania, where the negative contribution of net exports to growth remained unchanged. In each country except for Croatia, change was based on accelerated export growth. By contrast, import growth increased less rapidly or, in some cases, even decelerated.

The above-mentioned changes in the contributions of net exports to growth in the first three quarters of 2004 (compared with 2003 as a whole) implied a positive contribution of net exports to growth only in Poland, whereas the most negative contributions were observed in Bulgaria (despite a significant reduction) and in Romania. As a result, Poland improved its real net exports (smaller deficit), while the deficits of Bulgaria and Romania widened. Interestingly, contributions of net exports to growth were the most negative in the countries with the highest GDP growth (i.e. in Bulgaria and Romania). The contribution of domestic demand to growth was the highest in both these countries, indicating an unbalanced pattern of growth.

An analysis of the goods and services subaccounts shows that, in the first three quarters of 2004, Bulgaria and Romania (at 6.6% and 8.6% of GDP, respectively) had the deepest deficits. Slovenia is the sole Central and Eastern European country under review with a slightly positive, almost balanced goods and services subaccount. In Bulgaria and Romania, however, the results of the other subaccounts reduced the current account deficit, which the goods and services subaccount alone (4.0% and 5.9%, respectively) would have generated. In Hungary and the Czech Republic, by contrast, the negative income balance increased the goods and services subaccount deficit from 3.2% and 0.2% of GDP to a current account deficit of 9.1% and 5.5%, respectively.

3.2 Accelerating Inflation in 2004 – Partly a Result of EU Accession

Price trends in the region were extremely variable. In the new Central European Member States, inflation rates (year-on-year change in consumer prices in the fourth quarter of 2004) ranged between 2.7% in the Czech Republic and 6.0% in Slovakia. In the group of Central and Eastern European countries under review, Croatia had the lowest rate of inflation (2.3%) whereas Romania was the only country with inflation in double digits (10.0%). In November 2004, however, Romania registered single-digit inflation of 9.9% for the first time since the start of the transformation process.

Table 2

Inflation Trends in Central and Eastern Europe

annual change in HICP in %

	2002	2003	2004	Q1 04	Q2 04	Q3 04	Q4 04
Poland	1.9	0.7	3.6	1.8	3.4	4.8	4.5
Slovenia	7.5	5.7	3.6	3.7	3.8	3.6	3.5
Slovakia	3.5	8.5	7.4	8.2	8.0	7.2	6.0
Czech Republic	1.4	–0.1	2.6	2.0	2.4	3.0	2.7
Hungary	5.2	4.7	6.8	6.8	7.4	7.0	5.9
Bulgaria	5.8	2.3	6.1	6.4	6.7	6.7	4.8
Croatia	1.7	1.8	. .	1.9	2.3	1.9	2.3
Romania	22.5	15.3	11.9	13.6	12.3	11.9	10.0

Source: Eurostat, national statistical offices, WIIW..

In 2003, prices came under strong upward pressure. In addition to the rise in energy prices worldwide, increases in indirect taxes and agricultural producer price adjustments – both factors are attributed to EU accession – generated inflationary pressures in the new Member States. In Bulgaria, the rise in energy prices worldwide was further increased by regulated energy price adjustments. Food prices continued to climb steeply in this country, partly as a result of a period of drought. The subindices of the HICP reveal that the inflationary pressures induced on the demand side in the new EU Member States merely played an insignificant role. In Bulgaria and Romania, demand-side factors (also in conjunction with a massive credit expansion) definitely contributed to inflation.

Compared with the average rate of inflation in 2003, prices in four of the eight countries soared in 2004 (Bulgaria, Poland, the Czech Republic and Hungary), although annual inflation rates in the fourth quarter were lower than those posted in the second and third quarter. Despite strong pricing pressures, inflation fell in three countries (Slovakia, Slovenia and Romania). In Slovakia, relatively low core inflation (some 2%) depressed the overall inflation rate, which rising administered prices and tax cuts had accelerated. Furthermore, the positive base effect (due to sharp increases in administered prices in 2003) and fierce retail competition by foreign suppliers helped. In Slovenia, the relatively small degree in unit wage cost increases due to the gradual de-indexation of the economy led to a decline in inflation.

3.3 Improved Ratings in Second Half of 2004 for EU Candidate Countries and Slovakia

Both Moody's and Standard & Poor's continued to award Slovenia the best ratings for long-term foreign currency liabilities. The two agencies gave the Czech Republic and Hungary the second-best rating. In December 2004, Standard & Poor's upgraded Slovakia, which means that the country now has exactly the same rating from this agency as Hungary and the Czech Republic. Moody's continues to rank Poland third, followed closely by Slovakia (which has had a promising outlook since October). Since Standard & Poor's upgraded Croatia in December, both agencies rate the country just behind the new Member States (i.e. still ahead of Bulgaria and Romania). Bulgaria and Romania's ratings have also improved in the past few months. For instance, Moody's upgraded Bulgaria in November following Standard & Poor's upgrade of Romania in September.

Table 3

Ratings for Long-Term Foreign Currency Liabilities

Currency	Moody's			Standard & Poor's		
	Old rating	Latest change	Current rating	Old rating	Latest change	Current rating
PLN	Baa1	12. 11. 2002	A2	BBB	15. 05. 2000	BBB+
SIT	A2	12. 11. 2002	Aa3	A+	13. 05. 2004	AA–
SKK	Baa3	12. 11. 2002	A3	BBB+	13. 12. 2004	A–
CZK	Baa1	12. 11. 2002	A1	A	05. 11. 1998	A–
HUF	A3	12. 11. 2002	A1	BBB+	19. 12. 2000	A–
BGN	Ba2	17. 11. 2004	Ba1	BB+	24. 06. 2004	BBB–
HRK	. .	27. 01. 1997	Baa3	BBB–	22. 12. 2004	BBB
ROL	B1	11. 12. 2003	Ba3	BB	14. 09. 2004	BB+

Source: Bloomberg.

Economic Outlook for Central and Eastern European Countries

The OeNB compiles on a biannual basis forecasts of economic developments in Poland, Hungary, the Czech Republic as well as in Russia. The above-mentioned three new EU countries together account for more than 75% of the GDP of the ten new EU Member States and are thus representative of trends in this region of the EU.[1]

In 2004, the euro area's current economic recovery and, possibly, an EU accession effect helped annual GDP growth increase moderately in the Czech Republic and accelerate sharply in Hungary and Poland compared with 2003. In the Czech Republic the contribution of net exports to growth was significantly less negative than in 2003, and in Hungary this component even changed from negative to positive. This improvement in foreign trade more than offset sluggish growth in domestic demand. In Poland, despite accelerated growth in domestic demand, the contribution of net exports to growth was again positive, albeit to a lesser extent than in 2003.

Compared with the OeNB's fall outlook for 2004 GDP growth in these three countries, Poland's figure for 2004 is a tad lower, as the rapid acceleration of investment growth commenced somewhat later than anticipated. In Hungary GDP growth for 2004 is slightly higher than predicted, as private consumption growth slowed somewhat less than expected.

In 2005, the uptick in domestic demand is likely to continue in Poland. In the Czech Republic and Hungary domestic demand is anticipated to rise again. In all three countries, consumer price inflation can be expected to fall due to a base effect, among other factors. In addition, all three countries should see a modest increase in employment together with relatively high investment growth. In Hungary, furthermore, tax cuts and changes in the social transfer system, which are designed to favor low-income households, were implemented in early 2005. At the same time, however, a slowdown in growth of lending to households is anticipated in Hungary for several reasons.[2] *Overall, these factors are likely to generate far stronger private consumption growth in all three countries. Whereas gross fixed capital formation in Poland is expected to expand far more vigorously in 2005 thanks to high corporate profits, relatively low real long-term interest rates in historical terms and effects arising from structural funds transfers from the EU, it is likely to contract (from the, in part, very high level of the previous year) moderately in the Czech Republic and significantly in Hungary. Nonetheless, relatively high investment growth will also be attained in these two countries, especially as transfers from the EU's structural funds will fully take effect in 2005.*

In Poland the złoty's marked appreciation in the last twelve months as well as the anticipated rapid acceleration of growth in import-intensive gross capital formation may lead to imports growing more steeply than exports in real terms. This is likely to imply a deceleration in GDP growth in 2005. By contrast, weaker investment expansion in Hungary should dampen the rise in imports. Nevertheless the contribution of net exports to GDP growth is projected to be markedly less positive than in 2004, which is set to dampen GDP growth somewhat.

In 2006, Hungary and the Czech Republic could witness a slight acceleration in consumption growth in connection with their parliamentary elections. By contrast, in Poland higher indexed-based social transfers will buttress private consumption growth. Combined with stronger investment activity and main trading partners' improved growth prospects, this is likely to result in slightly higher GDP growth in all three countries.

In addition to euro area growth and oil prices diverging from built-in expectations to a greater extent, the risks for the outlook of these three new EU countries include unexpectedly sharp exchange rate movements and upcoming elections in all three countries.

In 2004, Russia posted GDP growth at almost the same high levels as in 2003, driven by the high price of oil and other commodities. In addition, prudent monetary and fiscal policies, domestic stability and, to a certain extent, previously implemented structural reforms fueled growth. However, the investment climate in the fourth quarter of 2004 deteriorated in conjunction with increased interventions by the tax and judicial authorities and the further aggravation of the Yukos affair.

In 2005 and 2006, however, GDP growth is likely to slacken. Private consumption growth will remain robust due to wage and pension increases and, to a lesser extent, to high corporate profits, and modest fiscal easing will take place (reduction of the budget surplus). However, uncertainty about future policies *of reform could dampen hitherto strong investment growth. Above all, however, Russia's persistently high inflation differential with the rest of the world and nominal upward pressure will result in the ruble's continued appreciation in real terms. Consequently, in addition to the demand for imports on the back of vigorously growing domestic demand, there will increasingly be cost-induced import competition, which, although also likely to accelerate restructuring, will very probably trigger a further decline in net exports initially.*

The Russian economy's even greater dependency on sources of energy in the last few years remains a key risk factor for both growth and this forecast. In addition to a potential sharp drop in prices, capacity constraints (e.g. in oil pipelines) could also lead to a shrinkage in net exports over and above the volume predicted. Furthermore, there is the risk that the ruble will appreciate excessively rapidly in real terms, which would adversely affect the competitiveness of industrial goods. Finally, it is also currently difficult to assess the macroeconomic consequences of the continuing uncertainty about the course of reform and the respect for property rights by the authorities.

Table 4

Three New EU Member States and Russia: March 2005 Forecast

annual change at constant prices (%)

GDP	2001	2002	2003	2004	2005f	2006f
Poland	1.0	1.4	3.8	5.3	4.5	4.7
Czech Republic	2.6	1.5	3.7	4.0	4.4	4.6
Hungary	3.8	3.5	3.0	4.0	3.8	4.0
Russia	5.1	4.7	7.3	7.1	5.7	4.5

f = forecast

[1] *These forecasts (Russia's, in particular, is compiled in collaboration with Suomen Pankki, Finland's central bank) are based on preliminary global growth projections and technical assumptions about oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem by means of broad macroeconomic projection exercises. These assumptions are central to the current outlook owing to two factors: first, the sizeable export links of these three new EU countries with the euro area and, second, the fact that Russia is one of the world's biggest oil-producing nations.*

[2] *For instance, subsidies for home loans were cut, which means households will require a higher share of self-financing for this purpose.*

4 Austria: OeNB Revises Economic Outlook for First Half 2005 Slightly Downward – Austrian Economy Withstands Euro Area Slowdown Rather Well

Booming exports chiefly carried the economy in the first half of 2004. In the light of the decelerating global economy, the high oil prices and the strong euro, exports, however, started to slow in the remaining months of 2004. At the same time, economic growth was driven increasingly by domestic demand, in particular by the very lively investment activity. In the fourth quarter of 2004, real exports were down 0.6% quarter on quarter. For 2004 as a whole, exports nevertheless expanded by a solid 9%. Yet businesses' assessment of order books implies that exports are unlikely to match the year-earlier expansion in the first half of 2005.

The years 2003 and 2004 saw exceptionally robust investment growth owing to brisk demand for replacement investment and to the stimulus provided by a subsidy granted for investment that exceeds the average investment level of the previous three years. Meanwhile, an investment share of GDP that has outperformed the figures posted in the record year 2000 points to a forthcoming slowdown in investment activity. The expiration of the above-mentioned investment growth subsidy at year-end 2004 and current survey data corroborate the assessment that investment activity has already peaked.

Table 5

Breakdown of Real GDP Growth in Austria

	Change from previous period (year; quarter) in %					Contributions to GDP growth in percentage points[1])				
	Q1 04	Q2 04	Q3 04	Q4 04	2004	Q1 04	Q2 04	Q3 04	Q4 04	2004
GDP	0.6	0.8	0.8	0.3	2.0	0.6	0.8	0.8	0.3	2.0
Private consumption	0.4	0.3	0.2	0.3	1.5	0.2	0.2	0.1	0.2	0.8
Public consumption	0.2	0.3	0.3	0.2	1.1	0.0	0.1	0.1	0.0	0.2
Gross fixed capital formation	0.7	1.0	1.6	1.2	4.8	0.2	0.2	0.4	0.3	1.1
Exports	2.7	3.4	1.8	–0.6	9.0	1.4	1.8	1.0	–0.3	4.5
Imports	1.2	1.5	1.4	1.0	5.7	–0.6	–0.7	–0.7	–0.5	–2.7
Domestic demand	×	×	×	×	×	0.4	0.4	0.5	0.5	2.1
Net exports	×	×	×	×	×	0.8	1.1	0.3	–0.8	1.8
Statistical discrepancy[2])	×	×	×	×	×	–0.6	–0.8	–0.1	0.6	–1.8

Source: Eurostat.

[1]) Based on chain indices, for which contributions to growth can only be approximated.

[2]) Including changes in inventories.

Economic development in 2005 will depend essentially on the extent to which households step up their consumption expenditure. The second stage of the tax reform coupled with ongoing employment growth – irrespective of the moderate wage settlements – translate into a tangible increase in nominal household income. The higher inflation, however, is dampening purchasing power. At the same time, subdued consumer confidence suggests sustained consumer restraint. Overall, the OeNB nonetheless expects the positive momentum to carry the day and private consumption growth to accelerate in 2005.

Labor market conditions – one of the reasons for the rather low consumer confidence – are marked by vigorous employment growth amid sustained high unemployment. The greater influx of foreign workers and the pension reforms of the previous few years are at the root of the exceptional rise in the labor supply. As the number of registered job vacancies is increasing further, robust employment growth is expected to continue in 2005 and subsequently to ease the situation on the labor market somewhat.

Results of the OeNB Economic Indicator of March 2005:

OeNB Revises Expectations for Economic Developments in the First Half of 2005 Slightly Downward[1]

The OeNB now assesses the growth prospects for the first half of 2005 somewhat more cautiously than indicated by the OeNB's economic indicator published in January 2005. The slowdown in economic growth is, however, expected to be of a temporary nature only; the economic outlook for the remainder of 2005 is more optimistic. The OeNB's economic indicator forecasts 0.4% seasonally adjusted growth in Austria's real GDP for the first and 0.5% for the second quarter of 2005 (each compared with the previous quarter). Compared with the most recent release of January 2005, the growth expectations for the first quarter 2005 were reduced by 0.2 percentage point. Year on year, this points to a slight contraction of economic growth in the first two quarters of 2005 from 2.2% to 2.0%.

Table 6

Short-Term Outlook for Austrian GDP in the First and Second Quarter of 2005 (Seasonally Adjusted)

2003				2004				2005	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
change from same quarter a year ago in %									
0.6	0.5	0.8	1.1	1.4	1.9	2.5	2.4	2.2	2.0
change from previous quarter in %									
0.3	0.3	0.2	0.4	0.6	0.8	0.8	0.3	0.4	0.5
annual change in %									
0.8				2.0					

Source: OeNB – Results of the OeNB Economic Indicator of March 2005, WIFO.

[1] *Since the first quarter of 2003, the economic indicator of the OeNB has been published four times a year. It forecasts real GDP growth for the current quarter and the next (in each case, on a quarterly basis, using seasonally adjusted data). The figures are based on the results of two econometric models: a stochastic state space model and a dynamic factor model. Further details on the models employed can be found at www.oenb.at in the Monetary Policy and Economics section. The next publication is scheduled for June 2005.*

4.1 Slight Deterioration of Confidence Indicators

Current confidence indicators reflect the uncertainty over the future economic development in Austria. The European Commission's economic sentiment index, on a steady rise last year, posted its highest level to date in October 2004. Since then this confidence indicator retreated four times in a row, plummeting to the lowest level in 12 months in February 2005. This slide is likely to be ascribable to the worsened growth prospects for Italy and Germany, Austria's two main trading partners, the euro's appreciation and the continued high unemployment ratio.

The subcomponents of this economic sentiment index are only modestly indicative of the further development of the expenditure-side GDP components in 2005. The weaker order book assessment for exports suggests a deceleration of shipments abroad over the course of this year. With capacity utilization in the fourth quarter of 2004 continuing to be at high levels, the demand for capacity-enhancing investment may safely be assumed to be still high irrespective of the sizeable investment share in GDP. This, however, conflicts with the results of the WIFO Investment Survey and the sliding industrial as well as service sector confidence. On balance, evidence of a slowdown in investment activity prevails. In addition, a sharp uptick in private consumption does not seem to be on the horizon. In early 2005, retail confidence stabilized at the low level of the second half of 2004, whereas consumer confidence has remained unchanged for some time now.

4.2 Higher Inflation owing to Oil Price Surge

In 2004, average annual HICP inflation stood at 2.0% and thus markedly above the 2003 level of 1.3%. Inflation progressively rose over the course of 2004, climaxing at 2.5% in December. Subsequently, it edged down to 2.4% in January 2005 and to 2.3% in February. Price trends were basically determined by the increase in crude oil prices. An analysis of the HICP subcomponents shows that inflation was particularly high in energy and housing costs, but it also remained above average in the services sector, unchanged from the previous years. Conversely, the trend of below-average price growth of industrial goods likewise continued. Energy prices will determine the path of inflation in 2005. On the assumption that the oil price will more or less move in synch with the forward rates, the surge of the oil price over the past few months – sporadically to above USD 50 per barrel Brent – is likely to keep inflation high until mid-2005 or so. After that, the base effect of the previous oil price spike will dampen the inflation rate. Core inflation is expected to remain below the 2% mark.

In terms of the Negotiated Standard Wage Rate Index, wages augmented by 2.1% in 2004, basically mirroring the increase in consumer prices. In the second half of 2004, consumers suffered real income losses. This trend continued into 2005 but is likely to cease in the first half of this year.

4.3 2004 Current Account on Cash Basis almost Balanced

Austria's current account was virtually balanced in 2004, with the deficit (based on payment flows) coming to EUR 0.8 billion or 0.3% of GDP. Compared with 2003, the current account improved slightly by EUR 0.2 billion. This improvement is entirely ascribable to the vigorous export activity yielding, as expected, a pronouncedly higher surplus of the goods and services subaccount in 2004. The shortfall of the goods subaccount was reduced from 1.7% of GDP in 2003 to 1.1% in 2004, while the surplus of the services subaccount climbed from 2.4% to 2.5%. The deficits of the income and current transfer subaccounts, by contrast, widened to 0.6% and 1.1% of GDP, respectively.

The export boom of 2004 is also reflected in the foreign trade statistics compiled by Statistics Austria. The merchandise trade balance improved from –0.9% of GDP in 2003 to –0.1% in 2004. Goods exports expanded by 13% against 2003. An analysis of the intrayear trend of annual growth rates does not yet point to a perceptible slowdown in export activity. Seasonally adjusted monthly data, however, show that exports peaked in the second quarter of 2004 and noticeably decelerated in the second half of the same year, especially in the fourth quarter. Real export figures, taken from the national accounts, confirm this pattern. An analysis of the merchandise trade by geographic region reveals that the deficit vis-à-vis the EU-15 mounted to –2.8% of GDP (2003: –2.5%), while the surplus vis-à-vis the new Member States remained more or less unchanged at 0.6% of GDP. Merchandise trade with countries outside the EU was very robust, with the surplus rising by 1 percentage point to 2.0% of GDP. In particular, the dynamic growth of shipments to the U.S.A. (+32% in the first 11 months of 2004) came as a surprise, not least because of the gradual appreciation of the euro against the U.S. dollar since mid-2001 and the concomitant deterioration of price competitiveness. Part of this surge may, however, be explained by a statistical effect. Automobile industry exports, which used to be shipped via Germany, now increasingly go directly to the U.S.A.