Global Recession Deepens

Financial Crisis Unleashes Global Economic Downturn

Andreas Breitenfellner, Martin Schneider, Josef Schreiner[1]

The financial crisis, which has intensified since fall 2008, has led to deteriorated funding conditions, a decline in the confidence of economic players and a dramatic slump in world trade, thereby unleashing a global recession. Governments worldwide launched measures to stabilize the financial systems and stimulate economic activity, which helped prevent a further escalation of the financial crisis. Since economic stimulus measures require some time to take full effect, a deep recession must be anticipated for 2009.

In the U.S.A., an end to the recession is not in sight, despite comprehensive measures taken to support the economy. The Federal Reserve System (Fed) cut key interest rates to their lowest level historically and is now pursuing unconventional policies in a bid to revive lending.

In the euro area, recession also deepened in the fourth quarter of 2008, especially due to weakening export demand and investment; unemployment rose substantially. According to leading indicators and forecasts, the economic situation will continue to deteriorate in the first half of 2009. A glimmer of hope may be seen in the fact that a number of confidence indicators seem to have hit bottom at a low level in recent weeks, implying that the downturn may level out from the second half of 2009 and then come to an end. Driven particularly by falling energy, commodity and food prices, HICP inflation decelerated markedly in recent months and in both 2009 and 2010 is expected to remain significantly below the level of price stability as defined by the Eurosystem.

The past few months have also shown that the previously fast-growing emerging economies cannot escape the crisis. In particular, a number of Central, Eastern and Southeastern European countries have been hit severely. Other countries in the region, by contrast, are facing a worse, albeit still more upbeat outlook than the euro area average.

The global economic crisis also hit Austria in fall 2008, resulting in a steep slump in goods exports and industrial production in October 2008. The OeNB economic indicator currently predicts real GDP to contract by 1.5% in the first quarter of 2009 (seasonally and working-day adjusted, on a quarterly basis). The Austrian economy is expected to continue to shrink by 0.7% in the second quarter of 2009.

JEL classification: E2, E3, O1
Keywords: global outlook, euro area, central and (south-)eastern Europe, Austria

1 Global Economy in Deep Recession

1.1 U.S.A.: Federal Reserve Implements Unconventional Policies

The most recently released data on economic developments in the U.S.A. do not indicate that the U.S. recession may soon come to an end. In the fourth quarter of 2008, real GDP contracted far more sharply – by 6.3% – than anticipated. In particular, past outlooks had not expected such a strong decline in net imports in the final quarter of 2008. As a consequence, the current account deficit shrank to 3.7% of GDP, its lowest level in seven years (current account deficit at end-2005: 6.6% of GDP). At the same time, demand for capital goods and software declined notably, while government consumption remained the mainstay of economic activity.

In February 2009, industrial production was 11% below the comparative level a year ago. Auto production, which had slumped dramatically in previous months, recovered somewhat, but still trailed the level of February 2008 by 38%. GDP is generally

Cutoff date for data: March 31, 2009

[1] andreas.breitenfellner@oenb.at; martin.schneider@oenb.at; josef.schreiner@oenb.at

expected to continue to shrink in the first quarter of 2009.

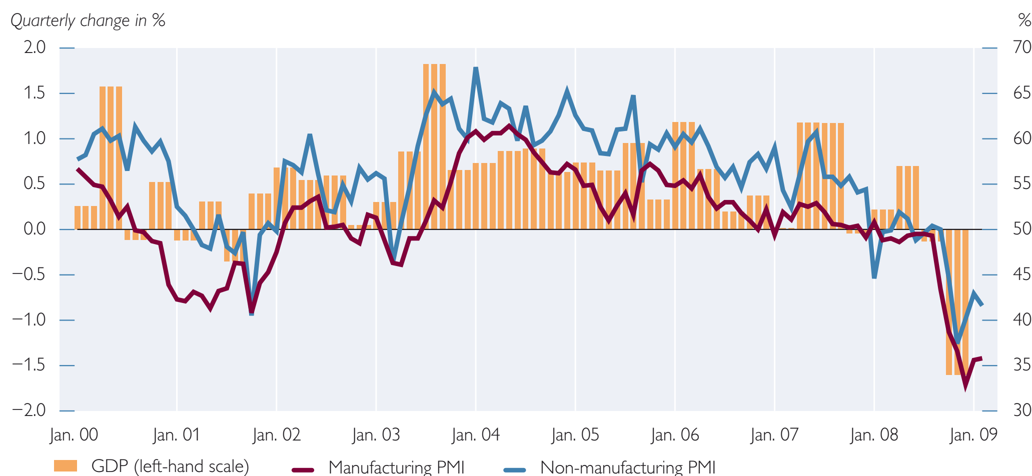
The labor market situation continued to deteriorate too. In February 2009, the rate of unemployment came to 8.1%; a total of 4.3 million jobs have been cut since the beginning of 2008. The layoffs resulted in a clear increase in the U.S. economy's productivity in the fourth quarter of 2008. Also, the high number of redundancies could indicate that businesses expect the recession to continue for some time. Private consumption is not likely to stabilize until the labor market situation improves and the U.S. real estate market bottoms out. The number of new home construction projects and permits, for instance, is continuing to slide, while the number of foreclosure sales contributes to the fall in real estate prices, which has even accelerated recently.

The leading indicators of economic growth do not lend much hope of an upcoming trend reversal. After a free fall in February 2009, the *Conference Board Consumer Confidence Index* stabilized somewhat in March. Although the present situation was perceived to be even more severe than in the previous month, the forward-looking expectations brightened up. While in February the Purchasing Managers' Index (PMI) for the services sector, which accounts for 80% of U.S. GDP, slumped again after improving for two consecutive months, purchasing managers in manufacturing provided more upbeat assessments for the second time in a row. Both indicators were however still considerably below the 50% level, signaling the continued contraction of the economy. At the same time, however, there was an unforeseen increase in orders for consumer durables in February.

All in all, the U.S. economy is not expected to start recovering until the second half of 2009 at the earliest. The Fed anticipates the economy will shrink by between 0.5% and 1.25% in 2009 and expand by between 2.5% and 3.3% in 2010, before reaching boom levels from 2011 on. This outlook is subject to a high degree of uncertainty, however. The Fed considers this scenario to be realistic only if the measures adopted by the U.S. government, Congress and itself achieve their desired effects.

Chart 1

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



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

Compared with the forecasts issued by the IMF, the European Commission and the World Bank at the turn of 2009, the OECD's outlook is more pessimistic, predicting a 4.0% contraction in GDP for 2009 and solely stagnation for 2010.

The new USD 787 billion stimulus package of the U.S. government has meanwhile been adopted by both houses of Congress. Two-thirds of the funds are to be invested in infrastructure, while one-third will be spent on tax cuts. The OECD expects the budget deficit will therefore widen to 10.2% in 2009 and continue to rise in 2010. U.S. President Barrack Obama announced his intention to more than halve the budget shortfall by the end of his term of office, which would require both tax hikes and cuts in spending.

At its meeting on December 16, 2008, the *Federal Open Market Committee (FOMC)* for the first time established a target range for the *federal funds rate*, reducing it to a range of 0% to 0.25%, its lowest level in U.S. history. At the same time, the Fed announced that it would keep interest rates at this low level for some time. Apart from that, the U.S. central bank has pursued unconventional policies since autumn 2008 in a bid to ease the financial crisis, aiming to supply banks with liquidity and support specific market segments, e.g. by purchasing securitized real estate loans.

At its meeting in mid-March 2009, the FOMC decided to expand its unconventional policy measures, announcing the purchase of up to USD 300 billion long-term Treasury securities. The Fed thus followed the example of the Bank of England, which had successfully introduced a similar measure a few days earlier. As a consequence, the ten-year government bond yield in the United Kingdom dropped below the yield on German Bunds for the first time in seven years. The Fed intends to bring down long-term interest rate levels, thereby helping improve the private lending situation since interest rates on loans are closely linked with government bond yields. The last time the Fed took similar action was in the 1960s.

1.2 Japan: Anti-Deflationary Fiscal and Monetary Measures

Japan has been particularly severely hit by the global economic and financial crisis. The economy has been in recession since the second quarter of 2008, and the situation further deteriorated in the fourth quarter of 2008. Real GDP shrank by 3.2%, which marked the steepest slump since the oil shock 35 years ago. This deterioration was above all due to tumbling exports (–13% in the fourth quarter of 2008), which suffered from the weakness of the global economy and the appreciation of the Japanese yen in the second half of 2008. The Japanese economy's strong reliance on exports is now putting a drag on the economy; formerly highly successful export products like cars and consumer electronic products are hardly in demand, and inventories are rising rapidly. However, domestic demand also declined in the fourth quarter of 2008.

All the latest economic data indicate that the recession will continue in the next few quarters. In February 2009, exports plummeted by 49% year on year, and, in January 2009, Japan recorded a current account deficit for the first time in 13 years. Business sentiment has hit the worst low since the deep banking crisis of 2002, while industrial production was down 30% (year on year) in January 2009. On the upside, unemployment was down slightly in January 2009. In its interim outlook

of end-March 2009, the OECD expects real GDP to shrink by 6.6% on the back of both the slump in exports and sluggish domestic demand and predicts a slight contraction by 0.5% in 2010.

In late 2008 and early 2009, nascent signs of deflation resurfaced: In February 2009, both CPI and core inflation were –0.1%, while consumer prices are projected to drop by 1.2% and 1.3% in 2009 and 2010 respectively, according to the OECD. The last time Japan experienced deflation was from 1999 to 2003, and to date the country has still not fully recovered from the repercussions of this period. It must be noted, nonetheless, that average annual deflation at the time did not exceed 0.9%.

However, the Japanese government and the Bank of Japan (BoJ) have both learned their lesson from this fairly recent period of deflation and recession and this time are taking decisive and far-reaching action to tackle the crisis. For the new financial year (starting from April 2009), the Japanese government has approved a record budget (6.6% higher than the previous fiscal year). For 2009, the OECD predicts a government deficit of 6.8%. As a consequence, the debt ratio – at 170% of GDP already the highest among major industrialized nations in 2007 – is set to deteriorate further.

At the same time, the BoJ eased its monetary stance, cutting the key interest rate to 0.1% in mid-December 2008. To strengthen financial institutions' capital base so as to improve their scope for lending, the BoJ is currently buying highly rated short-term debt securities as well as highly rated corporate bonds from commercial banks. In addition, since early March 2009, banks have had the opportunity to sell equity holdings to the BoJ but have not made much use of this option so far. The central bank is therefore considering whether to also accept bonds and loans with poorer ratings, which are difficult to sell to other buyers. Furthermore, the government has announced that it will use part of the country's foreign currency reserves – Japan holds the second largest amount of foreign currency reserves worldwide after China – to support liquidity-constrained businesses.

1.3 China: Extensive Stimulus Measures

China has also been hit by the global economic crisis. With GDP of only 6.8% in the fourth quarter of 2008, China may in fact have entered what can be interpreted as *growth recession*. Exports have suffered particularly severely from the global economic crisis, and investment in the real estate sector (accounting for 10% of GDP) also plummeted. The inflation concerns of the first half of 2008 have now been replaced by deflation expectations. February 2009 witnessed a drop in consumer prices (by 1.6% year on year) for the first time since the Asian crisis of 2002.

The government aims to keep growth consistently above 8%; otherwise, the economy would not provide enough jobs for school graduates and rural migrant workers, which, in turn, could spark social unrest. The Chinese central bank has therefore cut its key interest rate five times by a total of 216 basis points since autumn 2008. The government's stimulus package amounts to some 15% of GDP (for 2009 and 2010) and would be expanded further if necessary. Support measures on such a large scale are feasible thanks to the large amount of currency reserves and the balanced budgets achieved in the past few years. Export-oriented businesses are set to benefit from tax rebates. At the same time, the appreci-

ation of the country's currency was stopped to fuel exports. Banks, the majority of which are government-controlled, have been requested to provide loans on generous terms.

The Chinese Purchasing Managers' Index seems to reflect the first effects of the government's comprehensive support measures, improving three times in a row to a level only slightly below the point at which economic recovery is signaled. China may recuperate from the global crisis more quickly than other countries. Over the medium term, however, the Chinese economy will depend on the export demand of major industrialized economies. Exports account for 20% of China's GDP and about half go to the EU, the U.S.A. and Japan. In February 2009, exports decreased by 27% (year on year).

1.4 Global Economy Set to Contract in 2009

After spilling over to industrialized countries and emerging economies, the global economic crisis is now also adversely affecting developing countries. Both the IMF and the World Bank assume that the global economy will shrink in 2009 for the first time since the end of World War II. The World Bank forecasts global growth of at least 5 percentage points below potential growth; by mid-2009, industrial production may be 15% below the previous year's level. Thanks to expansive monetary and economic policies, global growth of 2.5% may be achieved in 2010, which, however, would still be considered a global recession as defined by the IMF (below +3%).

World trade has shrunk since the fourth quarter of 2008 and, in 2009, could experience the worst setback in 80 years. According to the OECD, global trade will decrease by 13.2% on the back of a slump in export demand and banks' increasing reluctance to provide trade credit.

2 Recession in the Euro Area

2.1 Economic Output Down Sharply

The recession that hit the euro area in the second quarter of 2008 deepened considerably in the fourth quarter as economic output contracted by 1.5% on the previous quarter. A decline of this magnitude has never been registered since the euro area came into being. The economies of the major EU Member States have never shrunk so sharply within a single quarter since 1990. Only a few smaller Member States (e.g. Finland) suffered a similar degree of economic contraction in the early 1990s.

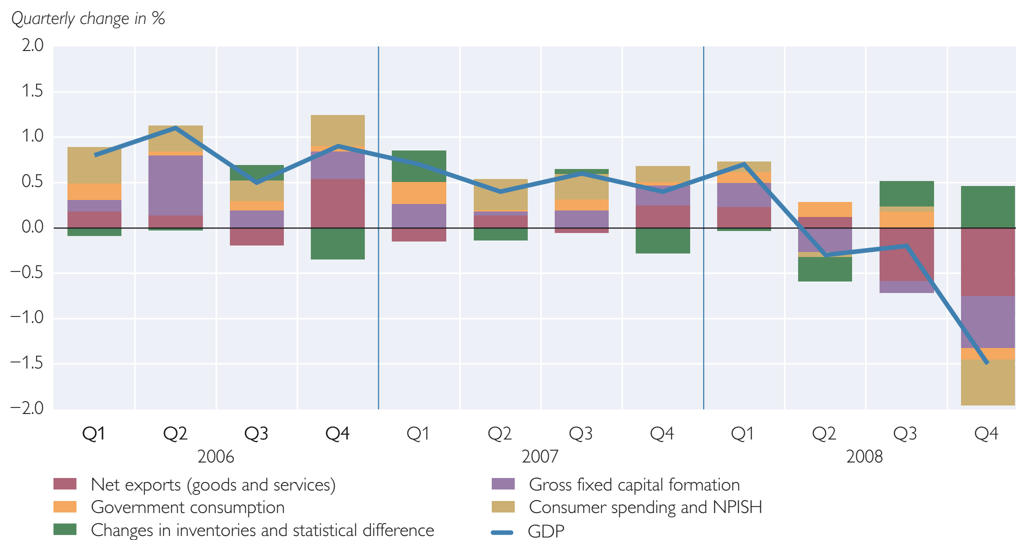
Almost all demand components – especially, net exports, gross fixed capital formation and private consumption – contributed to the contraction in the fourth quarter 2008. Even government consumption registered negative growth, as extensive economic stimulus programs had still not (fully) come into force. Only inventories made a positive contribution to growth. However, even this development is not a good sign in times of a steep decline in demand.

Sluggish investment activity is partly a reflection of shrinking use of existing production facilities. According to a survey conducted by the European Commission, industrial capacity utilization fell to 75.2% in January 2009. This level of industrial capacity utilization is not only the lowest ever registered in absolute terms but also marks the steepest decline within a single quarter in absolute terms.

Although every major euro area state is adversely affected by the recession, the extent to which this occurs is different in each case. In Germany and

Chart 2

Contribution to Real GDP Growth in the Euro Area



Source: Eurostat.

Italy, economic output shrank at a faster rate than the euro area average. In France and Spain, by contrast, it contracted somewhat less vigorously against this measure. The fall in German economic output (–2.1%) was almost solely attributable to exports. Clearly, the slump in export demand is hitting Germany particularly severely owing to its heavy reliance on its external sector, which is unusual for major economies (share of exports, including services: 47%).

2.2 Leading Indicators Slump to Record Lows

Current leading and confidence indicators, as well as the latest forecasts, suggest that the downturn will persist in the first half of 2009. Since September 2008, industrial production has been contracting sharply and at an increasingly rapid pace. In January 2009, euro area industrial production fell by 3.5% on the previous month and by 17.3% on an annual basis – several times the rate experienced in previous recessions. At the same time, industrial order intake has been in steady decline since summer 2008.

The European Commission's *Economic Sentiment Indicator (ESI)* further deteriorated in March 2009, hitting another record low. This decline affected every component except retail confidence, which continued to recover modestly, and construction confidence, which stagnated. The decline in industrial components was particularly pronounced in March, as in February. By contrast, the PMI for industry improved slightly in March from the record low of February. Output and orders climbed, while the employment component as well as the assessment of purchasing and selling prices deteriorated significantly.

Despite generally gloomier prospects, a number of indicators currently suggest that the economy will stabilize in the near future. Business expectations, which are surveyed as a component of the *Ifo Business Climate Index*, rose for the third time in succession in

March 2009, although the all-items index reached a new historical low in the same period. The *ZEW Indicator of Economic Sentiment* for Germany has been improving since fall 2008, suggesting that the German economy is likely to bottom out in summer 2009. The PMI for manufacturing discontinued its downtrend and has been fluctuating at a low level since December 2008. Since early March 2009, the *Dow Jones EURO STOXX 50 Index* has climbed by almost 17%.

Private consumption was very sluggish in the fourth quarter of 2008. In January 2009, although retail sales volumes were up by 0.2% (month on month), they fell by 2.2% on an annual basis. January 2009 also saw new car registrations slump by 20.5% on the previous year. However, this figure was a slight improvement on December 2008. In January 2009, Germany, France and Spain witnessed more new car registrations than in December 2008 – evidently as a result of scrapping incentives. Consumer confidence surveyed by the European Commission continued to worsen in February 2009, reaching a new historical low. Likewise, consumers' willingness to make major purchases in the next 12 months, which is surveyed quarterly, stagnated at historical lows or slightly above this level in the first quarter of 2009. As a result, private consumption cannot be expected to improve quickly. Downbeat consumer sentiment is at odds with real income, which latterly developed positively thanks to easing price pressures and relatively high nominal wage growth. At the same time, however, labor market outlooks have turned gloomier.

In the fourth quarter of 2008, employment fell by 0.3%, shedding around 450,000 persons compared with the previous quarter. In January 2009, the seasonally adjusted jobless rate rose to 8.2%, signifying that some 13 million people are presently unemployed. In Spain, the unemployment rate climbed by almost 5 percentage points within a single year to a current 14.8%. In almost all other EU Member States, unemployment has now started to trend up after having declined for many years. In many countries, labor policy measures are preventing unemployment from developing even more unfavorably. To avoid layoffs, many businesses are switching to short-time working. Under these schemes the performance of the workforce is reduced and the loss in earnings partly offset by government support. In Germany, more than 200,000 persons received partial unemployment compensation in December 2008.

The European Commission forecasts a euro area unemployment rate of 9.3% and 10.2% in 2009 and end-2010, respectively. In February 2009, employment expectations surveyed by the European Commission further deteriorated across all sectors of the economy.

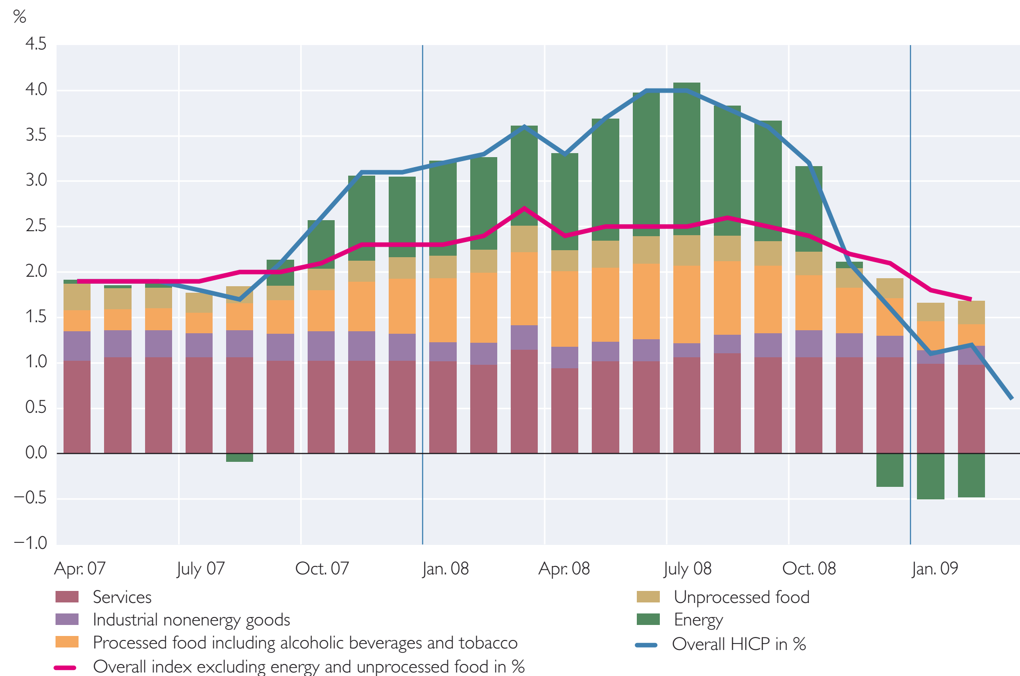
2.3 Very Low Inflation

With the bursting of the energy and commodity price bubbles, the problem of surging inflation dissolved more quickly than expected. After peaking at 4% in summer 2008, HICP inflation plummeted quickly on a monthly basis to reach 1.1% in January 2009, only to then edge up slightly to 1.2% in February 2009 before halving to 0.6% in March 2009 (preliminary first estimate).

The steep drop in inflation is attributable primarily to developments in commodity prices and, above all, crude oil prices. Since peaking at a record high of some USD 145 per barrel in mid-July 2008, the price of North Sea crude oil per barrel *(Brent)* fell to around

Chart 3

HICP Components



Quelle: Eurostat.

USD 45 by year-end. Crude prices hovered around this value in the weeks thereafter, but recently exhibited a slight uptrend, rising to more than USD 50 per barrel. The main reason for the overall relatively low level of energy and commodity prices is the global slump in demand for energy and commodities in the wake of the recession.

Since fall 2008, core inflation (HICP excluding energy and unprocessed food, the most volatile inflation components) has also been falling, albeit less sharply, and amounted to a mere 1.7% in February 2009. This inertia of core inflation attributable primarily to services prices, which – induced by the lagged effects of higher wage settlements in fall 2008 – rose by 2.4% in February 2009. In particular, the prices of transport services, travel, as well as food and beverages services climbed relatively steeply. Compared with services, industrial goods are more exposed to international competition and increased price pressures. The inflation rate for nonenergy industrial goods is correspondingly low although, despite falling automotive prices, it edged up marginally to 0.7% in February 2009.

The EUR/USD exchange rate has been fluctuating strongly in recent months. From a peak of just under EUR/USD 1.60 in summer 2008, it fell to around EUR/USD 1.25 in the fall of that year – a level to which it returned after briefly rallying in early March 2009. Ever since then it has stabilized at above EUR/USD 1.30. As for the EUR/JPY exchange rate, it initially softened in fall 2008 and the winter months before, however, firming again in February 2009. In effective terms (i.e. relative to 21 trade-weighted currencies), the euro exchange rate has fluctuated as strongly. Its sudden plunge from summer to end-October 2008

was wholly offset by the index until year-end (+12%). In early February 2009, the index depreciated by almost 7%, which has however been largely offset since then.

2.4 Continuous Downward Revision of GDP Forecasts

GDP forecasts have been gradually corrected further down in recent months. In its macroeconomic projections for the euro area prepared in March 2009, the ECB expects annual real GDP growth to range between –3.2% and –2.2% in 2009 and between –0.7% and +0.7% in 2010. In both years, annual GDP growth will be dampened by negative carry-over effects from the preceding year. Internationally coordinated economic stimulus programs and measures to restore the functionality of the financial system are key to the gradual recovery projected for 2010. In addition, lower oil prices should boost disposable income and thus gradually bring consumer restraint to an end. However, uncertainty levels remain high. On the one hand, the internationally coordinated economic and financial stabilization measures could foster confidence in economic players. On the other, the financial crisis might make the recession worse, growing protectionism may further impede world trade and adjusting global current account imbalances could entail extreme exchange rate fluctuations.

Furthermore, the forecasts of the European Commission, the IMF or *Consensus Economics* all indicate that the euro area economy will contract by at least 2% in 2009. The OECD's interim forecasts are significantly more downbeat, expecting the euro area's economic output to shrink by 4.1% in 2009. Of the major euro area economies, Germany will be the hardest hit (–5.3%), followed by Italy (–4.3%) and then France (– 3.3%). In 2010, euro area GDP is predicted to decline by a further 0.3%.

Like GDP forecasts, inflation outlooks have also been continuously revised down. According to the ECB's forecast, HICP inflation will range between an unusually low 0.1% and 0.7% in 2009 and between an ever so slightly higher 0.6% and 1.4% in 2010. Basis effects induced by previous energy price developments may temporarily push annual aggregate inflation rates into negative territory until mid-2009. Current forecasts of international organizations confirm an outlook of extremely modest inflation in both forecast years.

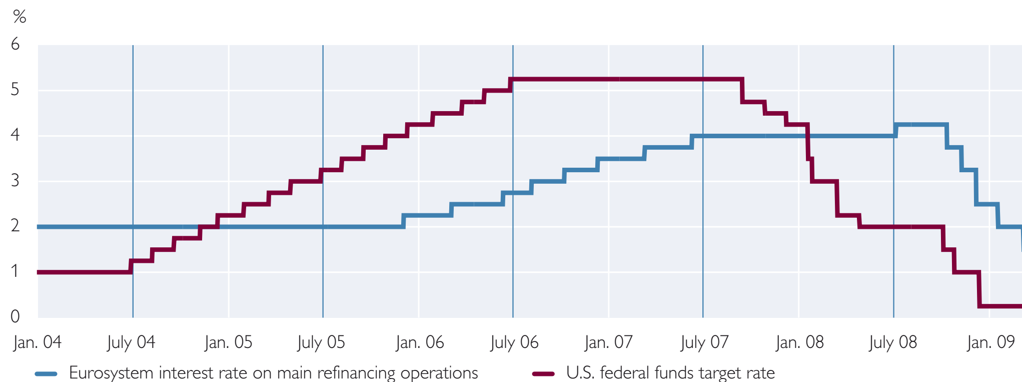
2.5 Governing Council of the ECB Cuts Policy Interest Rates Sharply

On March 5, 2009, the Governing Council of the ECB, on the basis of its regular economic and monetary analyses, decided to lower its interest rate on the main refinancing operations of the Eurosystem as well as its marginal lending rate and deposit rate by 50 basis points in each case to 1.5%, 2.5% and 0.5%, respectively. Thus, the interest rate on the main refinancing operations of the Eurosystem has been cut four times in all by a total of 275 basis points since October 8, 2008.

These moves were justified above all by the fact that inflation rates had markedly fallen and that they were expected to remain well below 2% in 2009 and 2010. The main reasons for these inflation prospects are the drop in commodity prices as well as the price effects from the slackening in overall economic activity. The latest economic data and survey findings provide further proof for the ECB Governing Council's assessment that both global and euro area demand are likely to be

Chart 4

Key Interest Rates in the Euro Area and the U.S.A.



Source: Thomson Reuters.

very sluggish in 2009. The economy is expected to recover gradually in 2010. At the same, current indicators of medium- to longer-term inflation expectations remain firmly anchored at a level that is in line with the ECB's aim of keeping inflation below, but close to 2% in the medium term. A cross-check with the outcome of the monetary analysis confirms that inflationary pressures have been diminishing.

The ECB Governing Council's decision reflects its expectation that price stability will be maintained in the medium term, supporting the purchasing power of euro area households. The Governing Council will continue to ensure that medium-term inflation expectations remain firmly anchored at a level that supports sustained GDP growth and employment and contributes to financial stability. Accordingly, the Governing Council of the ECB intends to monitor very closely all developments over the period ahead.

2.6 Economic Policy Measures to Stabilize Economy

Around the world, economic policy efforts have been reinforced in recent months to stabilize the financial system and the economy. In the EU, not only took individual Member States measures but the EU itself assumed an important role in this endeavor. A comprehensive economic program was launched at the European level to ensure a coordinated approach to supporting the real economy, thereby enhancing the benefits of the national stimulus measures by triggering multiplier effects and supplementing monetary policy measures.

In mid-October 2008, the EU adopted a common strategy to combat the financial crisis. The bank support packages now in existence in 18 EU countries basically include an increase in guarantee limits within the framework of deposit insurance, the possibility of government guarantees for interbank loans as well as capital injections for banks provided by the government. This common framework has since been implemented by EU Member States in the form of national implementation measures.

One of the key components of this framework was a change in deposit insurance, which was proposed by the European Commission on October 15, 2008. The new provisions aim to improve depositor protection and maintain depositor confidence. It was speci-

fically agreed to increase the minimum deposit cover from EUR 20,000 to EUR 50,000 and, within a year, to raise this amount to at least EUR 100,000. Some Member States, including Austria, chose to set an even higher level of coverage. Similarly, the new provisions ensure that deposits are reimbursed up to the coverage level without a deductible, and the period within which depositors must be paid in the event that a bank fails was reduced to three days. Until then, the payout period had been three months with the option of extending it to nine months.

Another important measure was the European Economic Recovery Plan for Growth and Jobs, which was approved by the European Council on December 11 and 12, 2008. This program was designed as a targeted and temporary fiscal stimulus of some EUR 200 billion, i.e. 1.5% of the EU's GDP. These funds are to be mobilized from national budgets (around EUR 170 billion, i.e. 1.2% of the EU's GDP) and EU and European Investment Bank (EIB) budgets (some EUR 30 billion, i.e. 0.3% of the EU's GDP). The aim of this package is to finance both short-term measures to boost demand, save jobs and help restore confidence in the economy as well as other investment measures to promote long-term sustained growth.

The EU's contribution to this plan includes advanced payments of EUR 1.8 billion by the European Social Fund to support employment; another EUR 5 billion will be mobilized to improve energy interconnections and Internet broadband infrastructure. Furthermore, the EIB is to increase its annual interventions in the EU by some EUR 15 billion, and the European Cohesion Fund is to frontload investment of EUR 4.5 billion. The scope of the *European Globalization Adjustment Fund* is to be expanded, enabling a faster drawdown of funds and focusing on support for labor market policies. In addition, the European Commission recommends reducing employers' social security contributions (for lower incomes) and permanently cutting VAT rates in labor-intensive services.

3 Central, Eastern and Southeastern European Countries Hit by the Crisis

3.1 Financial Crisis Reaches Eastern Europe in Fall 2008

In view of growing international risk aversion, the risk profile of Central, Eastern and Southeastern European (CESEE) EU Member States has undergone reassessment since the second half of 2008. Factors that have led to the economic situation being perceived in a considerably worse light are gloomy growth and export outlooks, dwindling capital inflows, high external financing requirements, currency and maturity mismatching as well as risks as regards common creditors of the region's banking sector.

Accordingly, the CESEE group of countries has been particularly severely hit by the aggravation of the financial crisis since mid-September 2008. Previously, these countries had appeared relatively resilient to global events since the outbreak of disruption in international financial markets in mid-2007. Now, every financial segment registered a marked deterioration, with especially certain equity and bond markets performing far worse than in comparable emerging economies. While share prices in European emerging economies have been falling since mid-September 2008 by an average 46%, the comparable value in Asian and Latin American emerging economies has been 23.6% and 22%, respectively. The spreads of euro-de-

Chart 5

Exchange Rates of Selected Currencies Relative to the Euro

(Uptrend signifies nominal depreciation)

January 1, 2008 = 100

Source: Thomson Reuters.

nominated Eurobonds showed similar developments. While European spreads widened by 453 basis points, they increased by merely 105 and 264 basis points in Asia and Latin America, respectively.

Furthermore, the currencies of countries with a flexible exchange rate regime suffered sharp depreciation relative to the euro. For instance, relative to the euro the Polish zloty has lost some 29% against the euro, the Hungarian forint more than 23% and the Romanian leu some 16% since September 2008. Nominal effective exchange rate depreciation was less pronounced, as the euro appreciated relative to the currencies of other trading partners of CESEE countries (e.g. the U.K. or Russia) in the same period.

The reasons for the tight situation in the foreign exchange markets were multiple. The rating of the CESEE region awarded by international rating agencies was considerably more pessimistic. Fresh outlooks for 2009 for the first time anticipated a recession not only for individual countries but also for the entire region on average. Moreover, key interest rates were cut in every country in this region (although, in Hungary, only after a sharp hike at end-October 2008). In addition to these factors, which resulted in a generally worse perception of the situation in the region, developments in Poland were also partly attributable to the liquidation of foreign currency positions, which were created in economically better times to hedge against the zloty's possible further appreciation. In Hungary, there were also uncertainties about the country's high financing requirements.

Since the second half of February 2009, the situation has eased somewhat however. The Czech koruna staged a strong rally, and the Polish zloty and

Hungarian forint have appreciated since early March 2009.

The impact of currency depreciation in CESEE is twofold: On the one hand, it makes domestic production cheaper and as a result counters the slump in international demand, which tends to have particularly negative effects on the economy owing to the region's heavy reliance on exports. On the other hand, it increases the debt burden due to the high level of foreign currency loans, which in turn results in a dampening effect on private demand. This applies particularly to Hungary and Romania, whose share of (especially, euro-denominated) foreign currency loans accounts for considerably more than half of total lending.

In addition, the financial crisis is taking its toll on the real economy owing to difficulty in gaining access to debt financing. Widening spreads, asset losses triggered by tumbling stock markets, but partly also quantitative lending restrictions on the part of credit institutions, induced by a deterioration in the risk structure of bank assets, new risk assessments or the decrease in intra-group capital flows in the banking sector are all impairing investment activity. In addition, a decline in lending growth, which fueled private consumption in many countries in recent years, is reflected in reduced consumer demand. These developments are reinforced by falling asset prices, in some countries due to the bursting of real estate bubbles, inter alia.

3.2 No Recovery in Sight in the Short Term

Against the background described above, the general economic situation in CESEE countries, after years of dynamic growth (in some countries, this situation even led to overheating), has significantly deteriorated particularly since the fourth quarter of 2008. Growth weakened markedly and slumped to just below an average 1% (third quarter of 2008: 4.8%). Besides the Baltic countries, Hungary and Slovenia registered a contraction in economic output in the fourth quarter of 2008.

The decline in the fourth quarter of 2008 covers all GDP components. Aver-

Table 1

GDP Growth in Central, Eastern and Southeastern European EU Member States

	2008	2009[1]	Q1 08	Q2 08	Q3 08	Q4 08
	Real GDP growth rate (annual change in %)					
Bulgaria	6.0	0.0	7.1	7.1	6.8	3.5
Estonia	−3.6	−7.0	0.2	−1.1	−3.5	−9.7
Latvia	−4.6	−8.0	0.5	−1.9	−5.2	−10.3
Lithuania	3.1	−5.0	7.0	5.2	2.9	−2.0
Poland	4.8	1.5	6.2	5.8	5.2	2.3
Romania	7.1	0.0	8.2	9.3	9.2	2.9
Slovakia	6.4	2.0	9.3	7.9	6.6	2.5
Slovenia	3.5	0.0	5.7	5.5	3.9	−0.8
Czech Republic	3.2	0.4	4.4	4.4	4.0	0.2
Hungary	0.5	−3.0	1.7	2.1	0.8	−2.3
Entire region	4.2	0.0	5.6	5.5	4.8	0.9
Euro area	0.9	−1.9	2.1	1.4	0.6	−1.3

Source: Eurostat, European Commission, Vienna Institute for International Economic Studies.

[1] *Forecast; CESEE: Vienna Institute for International Economic Studies (February 2009), euro area: European Commission (January 2009).*

age private consumption growth in the region is however slowing at a somewhat less vigorous pace than that of other GDP components and is frequently found in positive territory. This phenomenon is primarily attributable to the still relatively robust trend in Central European countries, where consumption growth slackened significantly only in Hungary but merely stagnated in the other countries. This situation is probably connected with two factors: first, still fairly favorable real wage growth (induced by falling inflation rates) in the fourth quarter of 2008 and, second, vigorous household lending growth in the same period. However, this growth is partly attributable to value adjustments to foreign currency loans, which account for a large share in total lending in the region, on the back of the latest exchange rate depreciations.

Of greater evidence was the decline in gross fixed capital formation. In almost all the countries in this region, this GDP component performed worse in the fourth quarter of 2008 than in the previous quarter and, in five countries, even shrank significantly. This development is primarily attributable to industry, which was hit by the crisis particularly severely. The decline in external demand and the general deterioration in economic conditions worldwide resulted in a steep decline in industrial production due to this sector's heavy reliance on exports. In December 2008, industrial production slumped by an average 13.8% and, in many countries, by more than 20%. Capacity utilization numbers are likewise pointing south, and surveys on export expectations for the coming months currently indicate an even more downbeat assessment of the situation. These factors have led to substantially lower investment demand, and deteriorating financing conditions have further aggravated this development. For instance, corporate lending growth in the region almost came to a standstill in December 2008 compared with the previous month.

The fourth quarter of 2008 witnessed a sharp slump in external demand. Average exports shrank by some 5%, with only Lithuania registering an increase. The average downturn in export growth amounted to some 10 percentage points, with Romania even suffering a decline in excess of 20 percentage points. Currency depreciation in some countries countered this development only to some extent, as it did not get into full swing until end-2008 or early 2009. As with exports, import growth also slowed, with average growth registering some 10 percentage points lower than in the previous quarter. As a result, a regional analysis showed that the contribution of net exports to growth was slightly positive and, in some cases, even rose to a certain degree. However, the situation in certain countries varied widely. While the contribution of net exports to growth was slightly negative in Central European countries, they made a strongly positive contribution to growth in the Baltic states and in Romania. Since the Baltic region, in particular, has so far been hardest hit by the economic crisis and domestic demand in these countries contracted significantly in the fourth quarter of 2008, imports have slowed at a faster pace than exports.

Current leading indicators suggest that the bleak economic situation will persist in the first half of 2009. Above all, both industrial and consumer confidence in the economy stand at historical lows. Current forecasts confirm the negative assessments of economic players. In its February outlook, the Vienna Institute for International Eco-

nomic Studies predicted that the region as a whole would stagnate in 2009 (growth forecast in November 2008: +2.7%). It still stands that the countries of this region are or will be affected by the economic downturn to a varying extent. In 2009, the Czech Republic, Poland and Slovakia should continue to experience modest growth (ranging between 0.4% and 2.0%). In Bulgaria, Romania and Slovenia, the economy will stagnate; in Hungary and, especially, in the Baltic countries, it will contract. All in all, the CESEE EU Member States will however register better growth rates than the euro area in 2009 and 2010, with the growth differential likely to range between 1 and 2 percentage points in both years according to most of the latest forecasts.

3.3 International Institutions Extend Financial Assistance

Owing to the tight situation in international financial markets, CESEE countries found it considerably more difficult to cover current external financing requirements. To solve this problem, some countries were forced to turn to the IMF and conclude Stand-By Agreements.

For instance, on November 6, 2008, a 17-month Stand-By Agreement totaling EUR 12.5 billion was concluded between Hungary and the IMF. The IMF funds were part of a larger package of support measures, to which the EU and the World Bank contributed EUR 6.5 billion and EUR 1 billion, respectively. In return, Hungary undertook to carry out extensive fiscal consolidation, setting a government deficit target of 3.4% of GDP for 2008 and, what is more, attaining it according to preliminary estimates. In 2009, Hungary intends to reduce its government deficit to 2.5% of GDP. This agreement also calls for the maintenance of sufficient liquidity and capital adequacy in the banking sector.

On December 23, 2008, the IMF approved a 27-month Stand-By Agreement totaling EUR 1.7 billion for Latvia to strengthen its ongoing program to consolidate the economy, restore confidence and support the pegging of its currency to the euro. In addition, the EU extended a loan of EUR 3.1 billion, and the World Bank, the EBRD and bilateral donor countries together provided a further EUR 7.5 billion. The agreement includes measures to restore confidence in the Latvian banking system, improve competitiveness and strengthen fiscal consolidation.

On March 25, 2009, a two-year Stand-By Agreement between Romania and the IMF totaling EUR 12.95 billion was negotiated but still awaits approval by the IMF Board. This agreement aims to mitigate the negative effects of rapidly dwindling private capital inflows, to support the implementation of measures countering current external and fiscal imbalances and to consolidate the financial sector. Furthermore, Romania will receive EUR 5 billion from the EU and EUR 1 billion apiece from the World Bank and from the EBRD and other multilateral donors.

At the same time, Stand-By Agreements were concluded with some other European countries, including Ukraine (USD 16.4 billion), Belarus (USD 2.46 billion) and Serbia (USD 500 million).

In light of these already approved packages, the European Council, after protracted debate, decided at its spring summit held on March 19 and 20, 2009, to increase the EU's support facility for balance of payments assistance for EU Member States outside the euro area. Where necessary, the countries in this group can now receive assistance of up to EUR 50 billion

(instead of EUR 25 billion) in individual cases. In line with this decision, it was noted that macrofinancial stability was a key factor for the resilience of the European economy as a whole and that solidarity between Member States represents a fundamental value of the EU.

3.4 Rapidly Falling Inflation

As in the euro area, inflation in CESEE EU Member States eased considerably in recent months. In addition to general economic gloom and some favorable basis effects arising from energy and food prices, falling commodity prices were primarily responsible for this situation. Accordingly, contributions to inflation from its energy and food components have fallen exceptionally steeply in almost all the countries in this region. As a result, services in some countries (primarily in Central Europe) now make up the largest component of inflation in relative terms.

Price pressures will continue to ease in 2009 as a whole and be mirrored in annual inflation rates for 2009, according to the latest forecast of the Vienna Institute of International Economic Studies. Average inflation in the region will fall from 6.4% (2008) to a mere 3.0% (2009).

4 Contraction of the Austrian Economy to Deepen

4.1 Economy Skidded Off the Tracks in October 2008

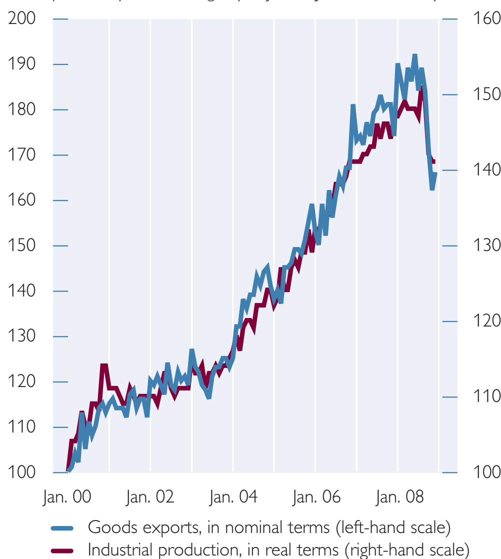
The global economic crisis hit Austria in fall 2008, resulting in a steep slump in goods exports and industrial production in October 2008. Exports collapsed by 7.1% against the previous month (seasonally and working-day adjusted) and continued to decrease in November. Industrial production trended in tandem with exports, contracting by 5.6% in October against the previous month. In none of the most recent economic crises has there been

Chart 6

Austria: Severe Slump in Goods Exports and Industrial Production

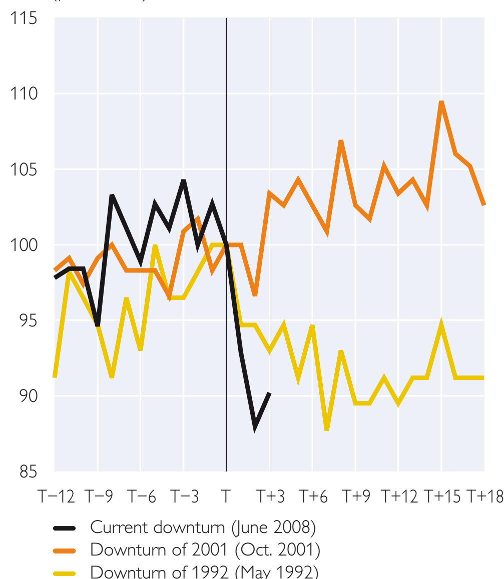
Goods Exports and Industrial Production

Index (seasonally and working-day adjusted; Jan. 2000 = 100)



Goods Exports during Various Downturns

Index (peak = 100)



Source: Statistics Austria, author's calculations.

such a sudden slump of this magnitude and speed (chart 6).

National accounts data for the fourth quarter of 2008 do not yet sufficiently reflect these developments, suggesting that goods exports in nominal terms declined by a mere 0.7% in the fourth quarter against the previous quarter, whereas the data published by Statistics Austria indicate a 13.1% decrease (seasonally and working-day adjusted) during the same period.[2] The 0.2% contraction of the Austrian economy calculated for the fourth quarter of 2008 (against the previous quarter) will also very likely have to be revised in the light of international developments.

The sharp downturn in external orders points to a further plunge in exports in the first quarter of 2009. The marked decline in freight transport on Austrian roads – which is highly correlated with goods exports – measured in January and February 2009 confirms this conclusion. Also, the recession is starting to spill over from export-oriented sectors to upstream sectors. In the light of uncertain sales prospects, businesses are downscaling investment.

While private consumption remained fairly robust in the fourth quarter of 2008 (+0.2% against the previous quarter), the sharp rise in unemployment as well as fears of job loss have

Results of the OeNB Economic Indicator of March 2009[1]

Austria began to feel the full force of the global economic crisis in early 2009. The OeNB economic indicator predicts real GDP to contract by 1.5% in the first quarter of 2009 (seasonally and working-day adjusted, on a quarterly basis). The Austrian economy is expected to continue to shrink by 0.7% in the second quarter of 2009, which implies a considerable acceleration of the downturn against the fourth quarter of 2008 (−0.2% according to preliminary data released).

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

2007				2008				2009	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Year-on-year quarterly change (%)									
3.3	3.1	2.9	2.7	2.5	2.1	1.4	0.6	**−1.4**	**−2.3**
Quarterly change (%)									
0.7	0.6	0.7	0.7	0.5	0.2	0.0	−0.2	**−1.5**	**−0.7**
Annual change (%)									
3.0				1.6				×	

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

[1] *The next publication of the OeNB economic indicator is scheduled for July 2009.*

[2] *Seasonal adjustment methods generally suffer from end-point problems, since they frequently use symmetrical filters. The observations missing at the end of the time series are forecast, which means that in the current situation, the slump in exports is reflected in three observations in the monthly seasonal adjustment and in only one observation in the quarterly seasonal adjustment. Therefore, monthly seasonal adjustment provides more reliable results.*

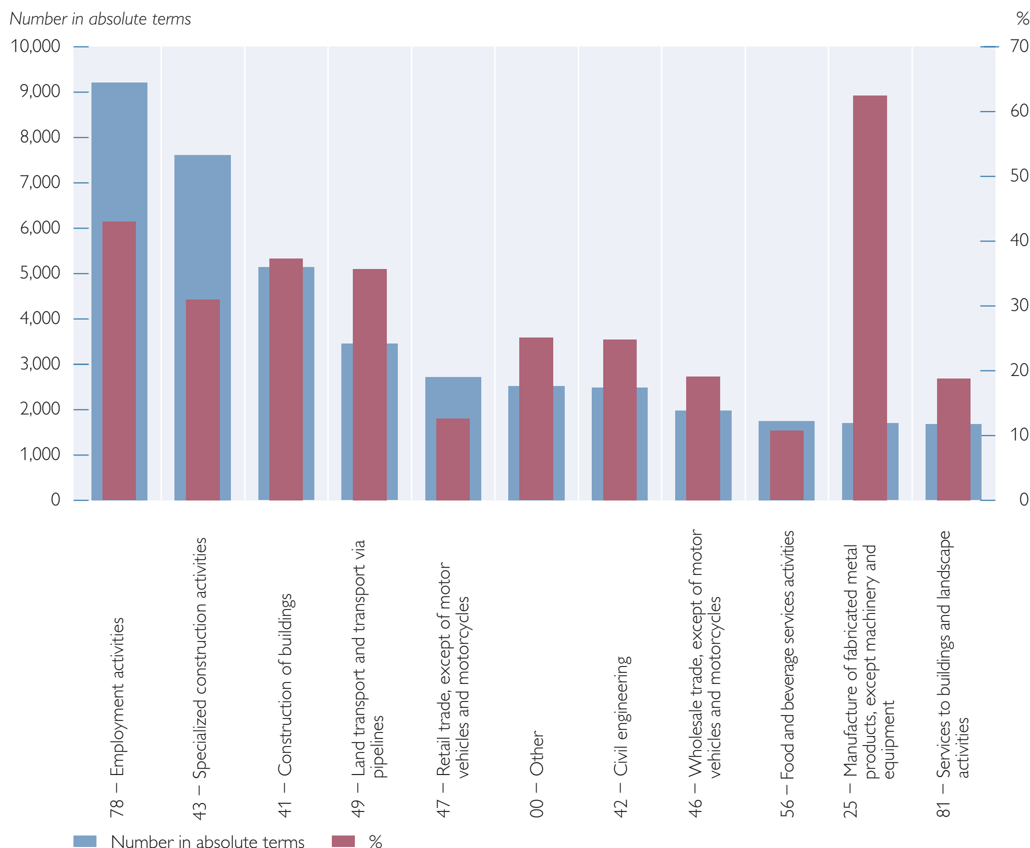
more recently weighed on households' propensity to spend. Durable consumer goods, in particular, confirm this trend; new car registrations, for instance, have been falling sharply since November 2008.

4.2 Downturn Reached Labor Market

The economic downturn has already had a deep impact on the labor market. In March 2009, the number of people out of work was by 61,000 higher than the comparable month a year earlier. Compared with previous downturns, the unemployment rate this time rose extraordinarily quickly, which can be attributed not only to the intensity of the current crisis but also to the flexibilization of the labor market. The reduction in current employment overcapacity built up during the boom years from 2005 to early 2008 is taking place at a high pace. The decline in jobs is most severe in employee contracting, as in bad times businesses tend to lay off leased staff first. The construction sector too saw a marked increase in unemployment, much of which, however, is due primarily to the colder weather in early 2009 compared with 2008. Since manufacturing has been the sector hardest hit by the crisis so far, men are much more affected by layoffs than women. By federal provinces, the increase in joblessness was

Chart 7

Rise in Unemployment in February 2009 by Divisions[1] (year on year)

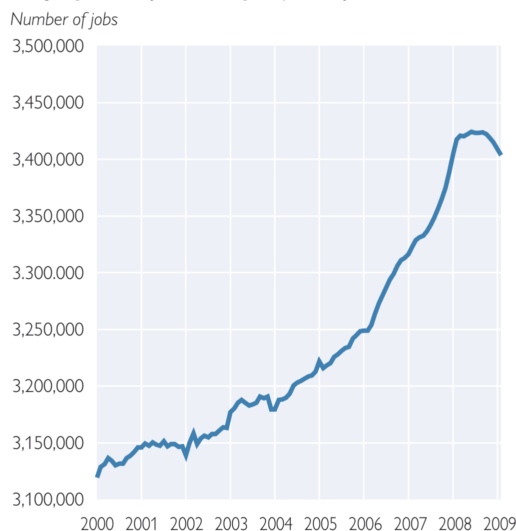


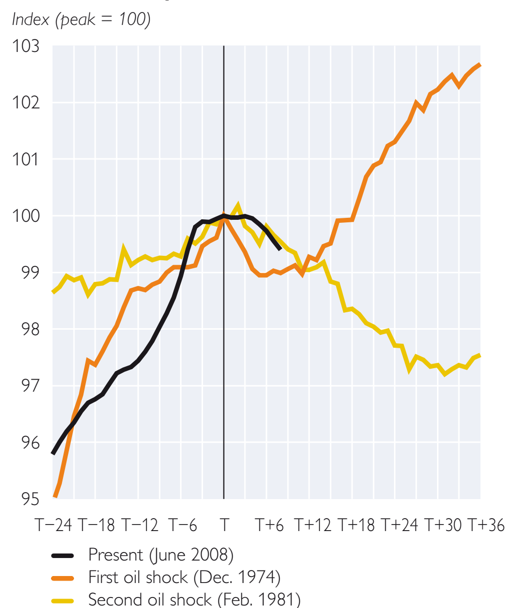
Source: AMS (Public Employment Service).

[1] *According to the Austrian Statistical Classification of Economic Activities (ÖNACE 2008).*

Chart 8

Current Decrease in Employment by Historical Comparison





Source: Statistics Austria.

steepest in those with the highest share of industrial enterprises (Upper Austria, Salzburg and Styria).

A historical comparison shows that the pace of the decline in employment since the peak recorded in June 2008 generally mirrors the developments during the second oil shock. Both before the current downturn and before the first oil shock, the labor market had seen an extremely steep increase in employment (chart 8).

The 29% decrease in reported vacancies as well as the 74% surge in the number of job seekers per vacancy recorded in February 2009 (both figures year on year) indicate a further deterioration of the labor market situation in the months to come.

4.3 Sharp Fall in Inflation

Price growth has decelerated visibly in recent months, with HICP inflation falling from its high of 4.0% in June 2008 to 1.2% in January 2009 and edging up only slightly to 1.4% in February. This decrease was mainly driven by the decline in the price of oil products. There were also counterbalancing movements, however. While prices of fuels and light heating oil plummeted by 20% and 24% respectively year on year in February 2009, household energy prices increased notably (gas: +15%, electricity: +5%, communal heating: +4%) due to the lagged effect of price adjustments. Core inflation (excluding energy and unprocessed food) remained broadly unchanged, however, at slightly above 2%. Wholesale prices, by contrast, declined sharply owing to their higher volatility compared with the HICP. The 6.3% fall recorded in February 2009 is therefore a rebound of the average 10% rise (year on year) in wholesale prices seen in the first half of 2008, which was driven by strong demand.