Euro Area Economy Gains Strength

Inflation Remains High Owing to Energy Component

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The world economy continues to expand, albeit at a slightly more subdued pace. In the U.S.A., the growth deceleration was primarily attributable to lower investment and weaker consumer spending. In response to these developments, the Federal Reserve kept the key interest rate steady in August 2006, after raising it 17 consecutive times over the past two years. In Japan, the economic recovery gathered enough steam for the Bank of Japan to hike interest rates in July for the first time in six years. China's and Southeast Asia's high growth rates remained broadly unchanged; inflationary pressures have increased in several countries of the region, above all because of the high oil price.

The euro area economy continued to recover, with GDP growth exceeding expectations in the second quarter of 2006. Recent forecasts suggest that growth – which was carried primarily by domestic demand – will exceed potential growth in 2006, and unemployment is expected to decline markedly. Even though the short-term outlook for price stability has deteriorated owing to an increase in indirect taxes in Germany, the upward pressure on consumer prices may be expected to ease, as the oil price has decreased significantly since mid-August after triggering a rise in inflation.

In the first half of 2006, GDP growth in the new EU Member States again outpaced growth in the euro area, which was attributable to a strong rise in domestic demand. In the EU acceding and candidate countries of Southeastern Europe, GDP growth strengthened in the first quarter of 2006 mainly on the back of buoyant investment.

Austria's economy is on a steady high-growth path driven by exports and increasingly also by domestic demand. According to the OeNB's short-term economic indicator, growth in Austria's real GDP (seasonally and working-day adjusted, quarter on quarter) will come to 0.8% in both the third and fourth quarters of 2006. For full-year 2006, growth is thus projected to climb to 3.2%. The labor market situation in Austria has eased markedly as a result.

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1 World Economic Growth Remains Robust

1.1 U.S. Growth Slows Down Slightly in the Second Quarter of 2006

Real GDP growth in the U.S.A. decelerated to 2.9% (annualized) in the second quarter of 2006, down from 5.6% in the previous quarter. This slowdown was mainly attributable to weak quarter-on-quarter consumer spending in the second quarter of 2006, whose contribution to GDP growth almost halved. The contribution of corporate investment was negative, and investment in residential construction diminished more than in the previous quarter.

Still, the Federal Reserve's growth forecast remains optimistic at 3.25% to 3.5% for the full year 2006 and 3% to 3.25% for 2007. According to Ben Bernanke, chairman of the Federal Reserve Board, the U.S. economy appears to be in a period of transition from robust growth to a pace more consistent with the underlying productive potential. The *Conference Board's* index of leading economic indicators declined in August, signaling slower economic growth over the next months. The International Monetary Fund (IMF) expects real GDP growth rates of 3.4% and 2.9%, respectively, for the years 2006 and 2007.

Cutoff date for data:
September 15, 2006

The unemployment rate fell slightly to 4.7% in August after increasing noticeably in July 2006. The number of newly created nonagricultural jobs came to 128,000 (seasonally adjusted), thus roughly matching the number recorded on average in the four previous months. This increase is considered sufficient to keep the unemployment rate stable at a low level. While the number of employees declined in the production sector, it expanded in the service sector.

In July 2006, consumer prices rose 4.1% year on year (somewhat less than in June 2006), whereas energy prices climbed 20.5% year on year. Even though the core inflation rate accelerated only slightly in July, coming to 2.7% year on year, it posted the strongest increase since December 2001.

In August 2006, the U.S. Federal Open Market Committee (FOMC) paused its so far longest cycle of raising the target level for the federal funds rate, which stood at 5.25% after 17 consecutive boosts by 25 basis points each over more than two years. In its press release, the FOMC pointed out that economic growth had moderated since the beginning of 2006. Moreover, it maintained that the high level of capacity utilization and the high prices of crude oil and other commodities had the potential to sustain inflationary pressures, but it expected these pressures to moderate over time.

The risks currently facing the U.S. economy include imbalances in the economy, the large (and probably still widening) current account deficit, the overindebtedness of consumers and their low propensity to save. Furthermore, higher interest rates are deterring consumers from taking out additional mortgage loans, thus dampening house price growth, which may well curb consumption.

1.2 Japan: First Key Rate Hike in Six Years

Real GDP grew for the sixth consecutive time in the second quarter of 2006. Driven by domestic demand, it increased by 0.2% quarter on quarter, albeit at a slower pace than before. This growth slowdown was attributable to lower investment in housing and nonhousing construction, weaker exports and diminishing inventories. Still, the medium-term economic outlook remains favorable. The *Bank of Japan* expects economic growth to equal potential growth (1.5% to 2%). The results of the Bank of Japan's quarterly Tankan survey show that businesses have revised investment plans for the fiscal year 2006 upward to double-digit rates. The Organisation for Economic Co-operation and Development (OECD) expects growth to continue on the back of robust domestic demand, which is supported by rising corporate profits and a reversal of the downward trend in employment and wages. This should help cut the unemployment rate further (July 2006: 4.1%). In its growth forecast for Japan, the IMF expects real GDP to climb by 2.7% in 2006 and by 2.1% in 2007.

In July 2006, the Bank of Japan raised its key interest rate from 0% to 0.25% in a widely anticipated move. This first increase in almost six years marked a significant shift in the central bank's monetary policy stance. Furthermore, the Bank of Japan decided to raise the official discount rate to 0.4%; the rate had stood at 0.1% since 2001. This move aimed at preventing an excessive increase in interest rates at the short end of the maturity spectrum. It did not come as a surprise to market participants, so that reactions were muted.

Following the revision of the consumer price index and its rebasement to 2005=100 at the beginning of 2006, core inflation was expected to decelerate by one-quarter percentage point. In fact, it decelerated by one-half percentage point in July 2006. Moreover, July 2006 was only the second consecutive month with positive core inflation readings, which dampened market expectations for a further key interest rate hike this year.

A medium-term plan for achieving a balanced primary surplus until 2011 was adopted in July 2006. It relies on cutting expenditure without including measures to increase revenues. However, this measure will only slightly reduce gross debt, which is mainly internally financed and exceeds 180% of GDP according to the IMF.

1.3 Asia, Led by China, Remains the Motor of Global Growth

In mid-2005, the countries of non-Japan Asia (NJA) embarked on a period of dynamic growth, which continued in the first half of 2006. Growth was powered by exports and robust domestic demand. The IMF expects the economic upswing to continue in NJA in the full year 2006 and in most economies also in 2007. Inflationary pressures have intensified in certain parts of the region (India, Indonesia, Hong Kong) owing to the higher crude oil price. Raising service sector productivity remains the biggest challenge in several economies; high energy prices pose the biggest risk to economic growth.

In the first half of 2006, real GDP growth in China skyrocketed to 10.9% year on year (full year 2005: 10.2%), which is the highest increase in more than ten years. Consumption remained robust and investment was buoyant, supported by strong growth in lending and money supply. The People's Bank of China lifted its key interest rate in three steps between April and mid-August 2006. The credit standards for house purchase loans were tightened at the beginning of June 2006 to curb the sharp rise in house prices. Reserve ratios were raised across the board in mid-June and mid-July and for foreign currency deposits in September 2006. This tightening of China's monetary stance was aimed at withdrawing liquidity from the market and curbing persistently high loan growth so as to bring the Chinese economy on track to sustainable growth.

2 Euro Area: GDP Growth and Inflation Increase Further

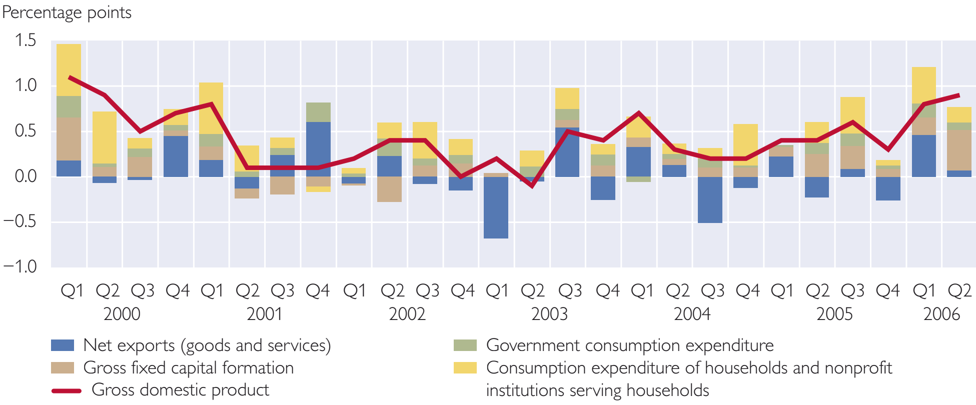
2.1 Growth Accelerates in the First Half of 2006

The recovery in the euro area gained momentum in the first half of 2006; both quarterly growth rates were significantly higher than the respective values for 2005. In the second quarter, GDP growth at 0.9% was increasingly carried by domestic demand, whose contribution came to 0.8 percentage point in that period. In particular investment activity climbed steeply, with gross fixed capital formation augmenting by 2.1% quarter on quarter in the second quarter of 2006. Private and public consumption growth in this period lagged behind that observed in the previous quarter. After dampening GDP growth in the first quarter of 2006, inventory changes contributed positively to growth in the second

Chart 1

Growth Contribution of Real GDP Components in the Euro Area

Quarter-on-quarter changes



Source: Eurostat.

quarter. Net exports also made a positive contribution to GDP growth, even though their share was slightly lower in the second quarter of 2006. While GDP growth accelerated especially in Germany and France, Spain continued to post high growth.

In the first half of 2006, industrial production (excluding construction and energy production) posted rising growth rates, continuing a trend that started in mid-2005. Capital goods production again recorded stronger increases than consumer goods production, probably because economic activity was largely supported by investment demand in the previous quarters. According to a survey conducted by the European Commission, capacity utilization in industry rose to 83.6% in the third quarter of 2006, thus exceeding its long-term average.

Retail sales continued to rise modestly in real terms in July 2006, which points to persistently moderate advances of private consumption. The European Commission's survey of consumer confidence – which is another leading indicator of consumption growth – reached the highest value in years in July and remained unchanged in August 2006.

2.2 Forecasts Suggest Ongoing Growth

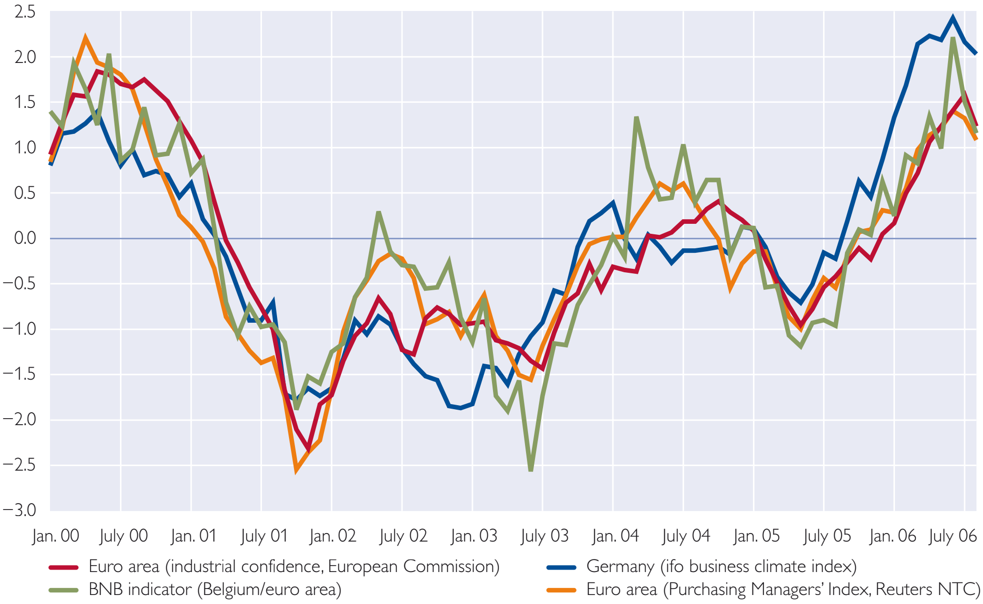
The various business climate indicators all pointed to a strong upswing from mid-2005; this trend was interrupted in mid-2006. While declining somewhat, most indicators remained on a relatively high level.

The European Commission's indicator for quarterly GDP growth forecast a range of 0.5% to 0.9% for the third quarter of 2006 and 0.4% to 0.9% for the fourth quarter of 2006. This means that the Commission revised upward expectations for the third quarter (which is, among other reasons, probably ascribable to the fact that estimates of economic growth had previously been too low), while slightly revising downward its forecast for the fourth quarter of 2006. The European Commission expects GDP growth to be in a range of 0.2% to 0.8% in the first quarter of 2007.

Chart 2

Business Climate Indicators

Deviation from the mean value of the indicator relative to the standard deviation



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

The Eurosystem staff projections of August 2006[1] foresee GDP growth in a range between 2.2% and 2.8% in 2006 and between 1.6% and 2.6% in 2007. While the risks to the forecast are balanced in the short run, they are on the downside in the medium term owing to global imbalances and the negative growth effects associated with increased protectionism. The IMF's forecasts of August 2006 predict GDP growth to rise to 2.4% this year and to decline again to 2.0% in 2007. The fast acceleration in 2006 is attributed to stronger-than-anticipated investment activity; the contribution of private consumption is expected to be only modest, despite anticipation effects resulting from a VAT increase in Germany.

2.3 Labor Market Situation Improves Further

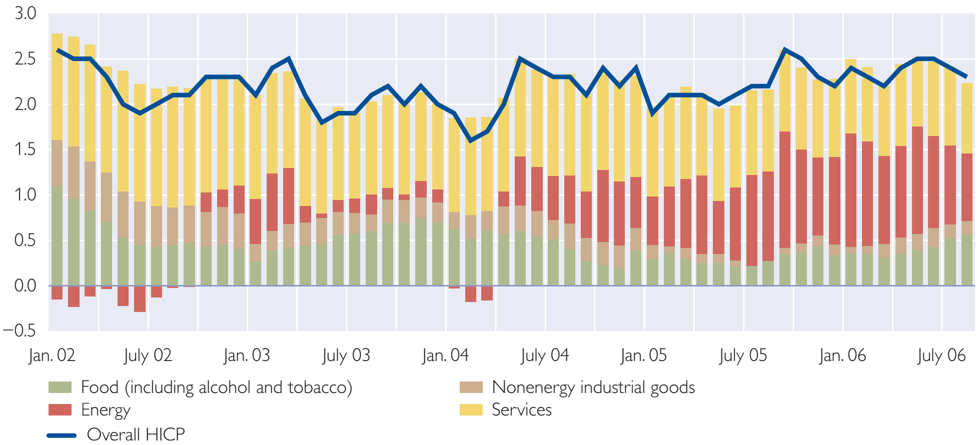
As a consequence of the protracted downturn between 2001 and 2003, the unemployment rate peaked at 8.9% in 2004. It has declined gradually since then, coming to 7.8% in July 2006. The labor market situation has thus improved markedly thanks to the economic recovery. In the fourth quarter of 2005 and in the first quarter of 2006, quarter-on-quarter employment growth was considerable at 0.3% in each quarter. Data on employment expectations until July 2006 for the industrial sector, the retail sector and the construction industry suggest that employment growth in the euro area remained dynamic. In its fall forecast, the IMF as-

[1] *The forecast of euro area aggregate data for the first time also included projections of economic developments in Slovenia, which will join the euro area on January 1, 2007.*

Chart 3

HICP Components: Contributions to Inflation

Percentage points, monthly data



Source: Eurostat.

sumes an unemployment rate of 7.9% in 2006 and 7.7% in 2007.

2.4 Rising Energy Prices Keep Inflation Above 2%

After peaking at 2.5% in May and June 2006, respectively, the inflation rate measured by the Harmonised Consumer Price Index (HICP) eased to 2.4% in July and further to 2.3% in August 2006. As in the previous quarters, it thus remained above the Eurosystem's definition of price stability. The high inflation rate was mainly attributable to the direct impact of high crude oil and petroleum product prices on the energy component of the HICP, which is, however, expected to decline in the near future, given the recent oil price developments: The price of Brent crude has dropped by more than 20%, after reaching an all-time high of USD 78.3 per barrel on August 9, 2006. At 1.5%, the core inflation rate (i.e., excluding energy and unprocessed food) was again lower in August 2006 than in the previous month. The inflation rates in the nonenergy industrial goods sector remained particularly low (0.5% according to the most recent data) owing to strong international competition. All in all, the indirect effects of the high oil price have been moderate so far. However, given the increased upward pressure on producer prices, consumer prices are also likely to climb more sharply in the future. Available data on wage developments show that wages have continued to rise moderately, with employee compensation increasing by 2% in the first quarter of 2006. Owing to productivity gains, unit labor cost growth remained subdued at around 1%. As a result, no significant second-round effects of the high oil price have been observed yet.

The ECB staff projections of August 2006 anticipate HICP inflation to be in a range between 2.3% and 2.5% in 2006 and between 1.9% and 2.9% in 2007. The VAT increase in Germany is expected to drive up inflation markedly in 2007. The upside risks to these projections of higher oil prices never materialized, as the oil price has dropped noticeably since the preparation of these projections.

Chart 4

M3 and Loan Developments in the Euro Area

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

2.5 Monetary and Loan Growth Reach All-Time Highs

In the second quarter of 2006, M3 growth came to 8.7%, the highest level observed since the start of monetary union. It was almost as strong in 2003, when geopolitcal uncertainty in combination with weaker stock markets had induced portfolio shifts into liquid and safe assets. After slowing down to 7.8% in July 2006, M3 growth accelerated again in recent months, essentially because cash holdings and overnight deposits that are subsumed in the monetary aggregate M1 augmented. In addition to the transaction motive behind holding cash, the overall structure of interest rates (i.e., lower opportunity costs associated with liquid investments) is probably also driving the expansion of the money supply. The growth rate of deposits with a maturity of up to two years increased noticeably between the fourth quarter of 2005 and the second quarter of 2006, climbing from 6.5% to 15.4%.

In the period from May to July 2006, the growth rate of loans to other non-MFIs in the euro area also reached the highest levels since the beginning of monetary union (around 11.2%). The strong uptrend was observed for loans to both nonfinancial corporations and households; it may be attributable to continued favorable financing conditions, high real estate prices in several euro area countries, a brighter outlook for income growth resulting from strengthened economic activity and an improvement of the labor market situation. The current high monetary growth is thus very different from the previous period of high monetary growth in 2003 – loan growth and economic activity had been subdued then.

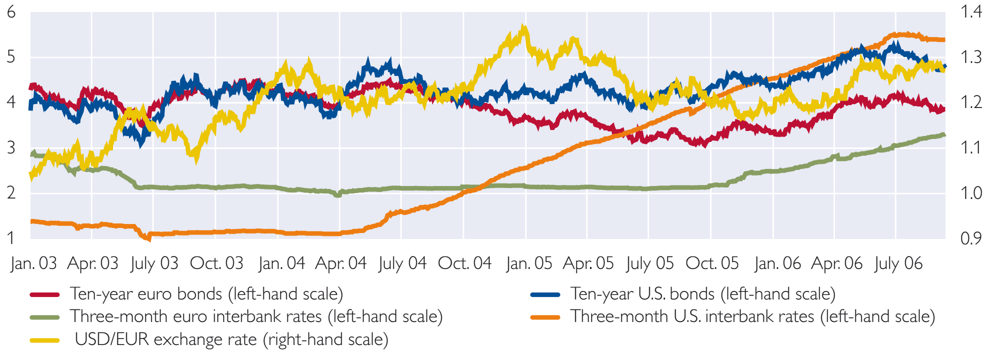
2.6 Euro Area Interest Rates Increase Amid Stable Inflation Expectations

On August 3, 2006, the Governing Council of the ECB decided to further raise the key interest rates by 25 basis points to 3.00% and announced that, if the baseline scenario for future economic developments continued to be confirmed, a progressive withdrawal of monetary accommodation would be warranted. Since December 2005, the key interest rates have been increased by a total of 100 basis points. Over the past three

Chart 5

Interest Rate Developments in the Euro Area and in the U.S.A., USD/EUR Exchange Rate

From January 1, 2003, to September 12, 2006



Source: Thomson Financial.

months, the term structure of euro area money market interest rates has flattened noticeably. While short-term interest rates (for deposits with a maturity of up to six months) rose along with the key interest rates, forward rates at the long end of the money market yield curve (6 to 12 months) have been relatively constant at around 3.75% since the beginning of July.

In the U.S. and euro area *government bond markets*, ten-year bond yields have dropped slightly in recent months, after having increased steadily since the fourth quarter of 2005. This may be attributable to two factors, among others: First, the key interest rate hikes are expected to come to an end soon and second, the U.S. economy has cooled somewhat. Still, inflation expectations based on inflation-indexed ten-year bonds have been largely constant in the U.S.A. and in the euro area despite the high oil price. This is likely to be connected to continued low (albeit slightly increasing) core inflation rates and central banks' sustained credibility in guaranteeing price stability. By anchoring inflation expectations, central banks have contributed significantly to mitigating the effects of the oil price shock. The interest rate differential between the euro area and the U.S.A. has stabilized since the ECB started raising interest rates and has even decreased recently, notably for deposits with a maturity of up to two years.

After experiencing severe losses owing to global risk aversion in May 2006, stock markets rebounded, supported by continued sound corporate profits and declining long-term interest rates. According to recent data, the Dow Jones EURO STOXX index was around 7% higher than in early 2006. Stock market uncertainty, as measured by implicit volatility, declined again after increasing in May 2006.

In the *foreign exchange markets*, the strengthening of the euro exchange rate, which had started in November 2005, continued until May 2006. On June 5, 2006, the EUR/USD exchange rate stood at 1.2958, which means it increased by about 10% within six months. It has since remained just below this level, which is relatively high compared with the long-term average. The euro appreciated against a number of other currencies, most markedly against the Japanese yen, but not against the pound sterling. Since the beginning of 2006, the euro's nominal effective exchange rate has appreciated around 4%.

3 Economic Developments in Central and Eastern Europe

3.1 Economic Activity Gains Momentum in the First Quarter of 2006

At 5.4%, average economic growth in the new EU Member States of the Czech Republic, Hungary, Poland, Slovenia and Slovakia was marginally lower in the second quarter of 2006 than the very high average rate of 5.6% observed in the first quarter. This decline was primarily attributable to slightly slower growth in the Czech Republic and Hungary. Still, given the value for the full year of 2005 (4.3% on average), economic activity has been increasing, which is mainly ascribable to the upswing in the (large) Polish economy: its annual growth rate accelerated by 1.2 percentage points against 2005 as a whole. In the second quarter of 2006, economic growth was especially pronounced in Slovakia (+6.7%) and thus significantly higher than the country group average. The Czech and the Polish economies also posted above-average growth, whereas the performance of the Hungarian and the Slovenian economies was slightly below average.

The EU acceding and candidate countries of Southeastern Europe (SEE) also posted solid growth. The development in Romania was especially remarkable: After the country was hit by a series of floods in 2005, its growth rate increased considerably in the first quarter of 2006. The economic situation in the EU candidate country Croatia also improved clearly. Despite a very solid economic performance, no substantial growth acceleration was observed in Bulgaria.

The developments of GDP components outlined below draw on first-quarter data of 2006, as more recent figures were not available for all countries at the cutoff date for data.

In the first quarter of 2006, private consumption was a key driver of economic growth in all new EU Member States, especially in Poland, where the growth rate of this GDP component almost doubled. This development implies an improvement of the labor market situation, which is reflected in higher employment and lower unemployment rates on the one hand, and in strong growth in real wages on the other. A similar trend

Table 1

Real GDP Growth in Central, Eastern and Southeastern Europe

Annual real GDP growth rate in %

	2002	2003	2004	2005	Q4 05	Q1 06	Q2 06
Poland	1.4	3.9	5.3	3.4	4.3	5.2	5.5
Slovakia	4.1	4.2	5.4	6.1	7.4	6.3	6.7
Slovenia	3.5	2.7	4.2	3.9	3.7	5.1	4.9
Czech Republic	1.9	3.6	4.2	6.1	6.9	7.1	6.2
Hungary	3.8	3.4	5.2	4.1	4.3	4.6	3.8
Bulgaria	4.9	4.5	5.7	5.5	5.5	5.6	×
Romania	5.2	5.2	8.4	4.1	4.3	6.9	×
Croatia	5.6	5.3	3.8	4.3	4.8	6.0	×

Source: Eurostat, national statistical offices.

was observed in Slovakia, which benefited from a more favorable labor market situation as well. Private consumption growth was more modest in the Czech Republic, Hungary and Slovenia. While this development was attributable to the government's efforts to moderate wage growth in Slovenia, it was ascribable to longer-term developments in the Czech Republic and in Hungary.

The role of private consumption for GDP growth in the SEE countries reviewed was by no means uniform in the first quarter of 2006. While GDP growth outpaced consumption growth in Croatia and Bulgaria – which was probably mainly traceable to the weaker expansion of lending in both countries – private consumption growth in Romania regained double-digit rates after flagging slightly in previous quarters, despite only modest increases in real wages.

The dynamic growth trend in gross fixed capital formation in the new EU Member States, which materialized at the end of 2005, continued throughout the first quarter of 2006. Growth rates ranged from 7.1% (Czech Republic) to 16.1% (Slovakia). Beside the Czech Republic, Hungary posted the largest increases. The strength of investment was traceable to a broadly-based rise in corporate investment, investment in residential construction and investment in public infrastructure. While the contribution of gross fixed capital formation to GDP growth was also considerable in Slovenia and Slovakia, it was less pronounced in Poland, partly because investment projects were postponed owing to harsh winter conditions.

In the first quarter of 2006, investment increased considerably in the SEE countries reviewed, with growth rates coming to 11.4% (Romania), 18.1% (Croatia) and 21.4% (Bulgaria). While this rise was linked to the uninterrupted high inflow of foreign direct investment and continued strong construction activity in Bulgaria and Romania, Croatia seems to have profited from higher investor confidence connected with the start of accession negotiations with the EU.

Looking at the entire year 2005, the contribution of net exports to GDP growth declined in all new EU member countries under review except Hungary, which is ascribable to a substantial expansion of imports that was not matched by – albeit robust – export growth. In the first quarter of 2006, however, the contribution of net exports started improving quarter on quarter in Hungary, Poland, Slovenia and Slovakia. In Poland, stronger export growth exceeded import growth (which was fueled by stronger domestic demand), so that trade once again made a positive contribution to Polish GDP growth after having made a negative contribution in the fourth quarter of 2005. While export growth was increasingly dynamic in Slovakia, import growth remained high primarily owing to technology imports and the high oil price, so that the contribution of net exports to growth, while negative, nevertheless improved. In Hungary, growth was primarily supported by sharply rising exports, which were to some extent linked to the depreciation of the forint. A decline in the (positive) contribution of net exports to growth was only observed in the Czech Republic, where imports mounted faster than exports.

The contribution of net exports to GDP growth was negative in all SEE countries under review. After declining in the second half of 2005, Bulgarian exports picked up again in the first quarter of 2006, but export growth still lagged behind import growth.

Box 1

Economic Outlook for Central and Eastern European Countries

The OeNB compiles semiannual forecasts of economic developments in Poland, Hungary, the Czech Republic as well as Russia. Taken together, the three new EU members account for more than 75% of the ten new EU Member States' overall GDP and are thus representative of trends in this region of the EU.[1]

In the ***three new EU Member States discussed here****, real GDP growth for 2006 is expected to range from 3.7% (Hungary) to 6% (Czech Republic). Compared to 2005, economic growth will accelerate by nearly 2 percentage points to 5.2% in Poland, whereas it will remain stable at a high level in the Czech Republic and will decline by about ½ percentage point in Hungary. The more dynamic euro area import growth and these three countries' higher export competitiveness (through lower unit labor costs) will boost real annual export growth from a range of 8% to 10% in 2005 to between 12% and 15% in 2006. Poland and the Czech Republic will see export growth speed up even though their currencies have appreciated in real terms. Hence, in all three countries, exports will be the demand component with the biggest contribution to GDP growth – perceptibly higher than that of consumer spending. Robust export growth in recent years has, moreover, helped revive the labor market since 2005, as will be apparent in 2006 in the noticeable increase in average real wages as well as (in the Czech Republic and Poland) in the rise in the employment ratio and the decline in unemployment. Strong increases in minimum wages and/or social transfers in all three countries, income tax cuts in the Czech Republic and Hungary, and the drop in inflation in Poland and Hungary will also strengthen real disposable incomes in 2006. Together with the unabatedly dynamic rise in household lending, these factors will accelerate private consumption growth in all three countries in 2006 as a whole. However, in Hungary annual consumer spending growth will remain considerably below first-half growth in the second half of 2006 following the upward adjustment of (administered) gas prices and of the middle VAT rate (e.g. on food, energy and some services), and in anticipation of further fiscal consolidation measures from 2007, which weakened consumer confidence. Following the cooling of residential and road construction activity and with consumer spending set to flag, investment growth in Hungary will be slower in 2006 compared to 2005. Conversely, in Poland and in the Czech Republic, both the powerful expansion of exports and higher consumer spending growth as well as the positive outlook for sales will sharply lift investment growth. The rise in investment will be sustained further by the decline in nominal unit labor costs in industry, pronounced corporate profitability and liquidity, high capacity utilization in industry, the stepped-up absorption of transfers from EU structural funds and the vigorous expansion of housing loans to households. Greater investment growth will, in turn, enhance labor market performance and additionally fuel private consumption. Stepped-up export production in all three countries and the accelerated rise in investment in Poland and the Czech Republic will lift import growth from a range of 5% to 7% in 2005 to between 11% and 13% in 2006 and will shrink or even fully eliminate the positive contribution to growth of net exports.*

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

In 2007, real GDP growth will ease moderately at a high level in the Czech Republic and in Poland, whereas it will drop markedly to only about 2½% in Hungary following fiscal consolidation efforts. While set to remain at the double-digit level, export growth will be marginally lower in all three countries. Domestic demand growth will stay high in the Czech Republic and in Poland, as the substantial increase of real average wages and of employment will boost consumer spending, and robust export and consumption demand hand in hand with a further decline of nominal unit labor cost (due to solid advances in productivity) will strengthen investment. High growth of both export and domestic demand will, however, cause imports to rise faster than exports, so that the contribution of net exports to growth will sink to zero in the Czech Republic and will even be slightly negative in Poland. In Hungary, by contrast, the announced fiscal consolidation measures, which have not yet been fully implemented, will trigger a real reduction of domestic demand. Public sector reform (job cuts and a nominal wage freeze amid rising inflation) will dampen public and private consumption (despite severance payments). Higher taxes and social contribution rates will weaken consumer spending even more, and will also depress investment growth. Moreover, the slump in consumer spending and the decrease in households' residential building activity will add to the decline in investment growth. However, these developments will also result in a sharper slowdown in import compared to export growth, so that the positive contribution of net exports to growth will climb moderately.

The risks in the outlook for these three new EU members include deviations from assumptions regarding euro area growth and regarding oil prices, as well as more pronounced exchange rate fluctuations, which would affect investment as well as both exports and imports. In addition, the design and implementation of the budget consolidation plans and households' and enterprises' reactions to them are fraught with a degree of uncertainty.

*In **Russia**, assuming that oil prices will no longer rise substantially, GDP growth is anticipated to stagnate or to dip slightly at a relatively high level in 2006 and 2007. Therefore, as in the past few years, GDP growth will not gain speed despite high oil prices. Consumer spending, buoyed by export receipts, public sector wage increases and a credit boom, remains the driving force of economic activity. In fact, with fiscal policy loosening measures before the parliamentary and presidential elections (at the end of 2007 and at the beginning of 2008, respectively), for which the 2007 budget has provided already some hints, private consumption in 2007 should even outpace the high 2005 result of +11.1%. Animated domestic demand and ample liquidity as a result of high nominal export receipts and powerful credit growth will also reinforce investment. Investment will probably be directed in particular to the alleviation of capacity bottlenecks in the primary sector. These bottlenecks and the drastically higher taxes imposed on the energy sector in 2005 are dampening output and real export growth in the commodity sector. In view of the existing uncertainties regarding the investment climate and little progress in administrative and judicial reform, though, investment growth is not expected to accelerate strongly. Moreover, major efforts to revitalize bogged-down structural and institutional reforms cannot be expected before the elections. The manufacturing industry faces the challenge of nominal upward pressure on the currency and a high inflation differential compared to other countries as a result of persistently high commodity prices and revenues (danger of the so-called Dutch disease), whereas robust domestic demand growth triggers a powerful import pull. Therefore, strong real net exports (13.6% of GDP in 2005) will contract further, so that net exports will once again make a negative contribution to GDP growth and will thus dampen GDP growth.*

The risks to this forecast include oil price changes given Russia's increased dependence on energy deliveries abroad, a stronger than expected real appreciation of the Russian currency (including the possibility that budget expenditure may mount substantially and *may thus heat up inflation in the run-up to the election), as well as continued uncertainty about the course of reform policies.*

Table 2

Three New Member States and Russia: Forecast of September 2006

Annual change at constant prices (%)

Gross domestic product	2002	2003	2004	2005	2006[1]	2007[1]
Poland	1.4	3.9	5.3	3.4	5.2	4.8
Czech Republic	1.5	3.6	4.2	6.1	6.0	5.2
Hungary	3.8	3.4	5.2	4.1	3.7	2.4
Russia	4.7	7.3	7.2	6.4	6.4	6.1

Source: Eurostat, national statistical offices, OeNB, Suomen Pankki.

[1] Forecast.

3.2 Inflation Developments Differ across Eastern Europe

While inflation rates in the new Member States had trended downward in 2005, partly strongly, no clear trend could be discerned during the first half of 2006. In Hungary and in Poland, price dynamics slowed; by contrast, inflation quickened in Slovenia, the Czech Republic and above all in Slovakia. Generally, inflation momentum speeded up somewhat in the second quarter of 2006 and now ranges between 1.4% in Poland and 4.6% in Slovakia. The rise in inflation is primarily attributable to the powerful rise in energy prices, as reflected by the relative stability of core inflation rates. So far in 2006, no major second-round effects of the higher energy prices on wage growth have been discernible.

Inflation developments in Southeastern Europe have also been different across countries. Whereas the rate of inflation remained nearly unchanged from 2005 in Croatia, Romania was able to continue its disinflation course. In Bulgaria, though, inflation rose sharply. The introduction of new or higher alcohol and tobacco taxes had a greater effect on the general price level than in Romania, where the decline in food prices offset upward price pressure.

Table 3

Inflation Developments in Central, Eastern and Southeastern Europe

Annual change of the HICP (%)

	2001	2002	2003	2004	2005	Q1 06	Q2 06
Poland	5.3	1.9	0.7	3.6	2.2	0.9	1.4
Slovakia	7.2	3.5	8.4	7.5	2.8	4.2	4.6
Slovenia	8.6	7.5	5.7	3.7	2.5	2.3	3.1
Czech Republic	4.5	1.4	−0.1	2.6	1.6	2.4	2.5
Hungary	9.1	5.2	4.7	6.8	3.5	2.4	2.8
Bulgaria	7.4	5.8	2.3	6.1	5.0	8.0	8.3
Romania	34.5	22.5	15.3	11.9	9.1	8.7	7.2
Croatia[1]	5.0	1.7	1.8	2.1	3.4	3.5	3.8

Source: Eurostat, wiiw.

[1] CPI.

Table 4

Ratings of Long-Term Foreign Currency Debt

Currency	Moody's		Standard & Poor's	
	Current rating[1]	Last change (old rating)	Current rating[2]	Last change (old rating)
Polish zloty	Aa1	May 2006 (A2)	BBB+	May 2000 (BBB)
Slovak koruna	Aa1	May 2006 (A2)	A	Dec. 2005 (A–)
Slovenian tolar	Aaa	May 2006 (Aa3)	AA	May 2006 (AA–)
Czech koruna	Aa1	May 2006 (A1)	A–	Nov. 1998 (A)
Hungarian forint	Aa1	May 2006 (A1)	BBB+	June 2006 (A–)
Bulgarian lew	A1	May 2006 (Baa3)	BBB	Oct. 2005 (BBB–)
Romanian leu	A2	May 2006 (Ba1)	BBB–	Sep. 2005 (BB+)
Croatian kuna	A1	May 2006 (Baa3)	BBB	Dec. 2004 (BBB–)

Source: Bloomberg.

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

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

3.3 Ratings Improve in 2006

Following a review of Moody's rating methodology, Slovenia, Slovakia, Poland, the Czech Republic, Bulgaria, Romania and Croatia have all been upgraded. Slovenia's rating was upgraded also by Standard & Poor's, from AA– to AA. With Hungary's fiscal policy lacking sustainability and given its substantial need for external funding, Standard & Poor's downgraded Hungary from A– to BBB+. Of all countries covered in this section, Slovenia received the best rating (Aaa/AA) from both agencies. Moody's placed all other new Member States in the very next category (Aa1), whereas Standard & Poor's gave more divergent ratings. Both agencies produced identical ratings (A1/BBB) for Bulgaria and Croatia, ahead of Romania (A2/BBB–). With regard to the latter, Moody's announced a review whereas Standard & Poor's stated a positive outlook.

4 Austria: OeNB Short-Term Economic Indicator Predicts 3.2% Growth in 2006

4.1 Solid Export Activity and Vigorous Investment Buoy Growth

In the first half of 2006, Austrian exports developed very dynamically. Although the quarterly record of first-quarter results showed a decline in exports, this reduction is the result of a change in the reporting of services.[2] Exports of goods continued to expand dynamically. The ongoing strength of the world economy and, above all better than expected euro area economic activity – in the second quarter of 2006, euro area growth even outpaced U.S. growth – support expectations that Austrian exports will advance robustly in the second half of 2006. The current strong enlargement of incoming export orders and export order books confirm this assessment.

[2] *On January 1, 2006, the reporting system for the Austrian balance of payments (the basis for services in the quarterly national accounts) was adjusted in line with international trends: cross-border payments are no longer reported by banks but are collected directly from economic agents. This change has caused a break in the time series.*

Table 5

Results of the National Accounts (in real terms)

	2004	2005	Q3 05	Q4 05	Q1 06	Q2 06
	Annual change in % (seasonally adjusted, annualized)		Quarterly change in % (seasonally adjusted, annualized)			
Gross domestic product	+2.3	+2.6	+0.9	+0.8	+0.6	+0.9
Consumer spending	+2.0	+1.6	+0.5	+0.5	+0.5	+0.4
Public spending	+1.4	+1.9	+0.4	+0.3	+0.5	+0.2
Gross capital formation	+0.2	+0.9	+0.4	+0.9	+1.3	+2.2
Exports	+9.5	+6.9	+2.0	+1.8	–2.0	+2.2
of which: goods	*+0.3*	*+2.1*	*+2.4*	*+1.7*	*+2.1*	*+2.8*
services	*+1.7*	*+1.9*	*+1.8*	*+1.6*	*–16.8*	*+1.3*
Imports	+8.3	+6.1	+1.5	+1.3	–2.9	+1.7
of which: goods	*+0.7*	*+1.1*	*+1.6*	*+1.1*	*+1.3*	*+1.5*
services	*+0.5*	*+0.8*	*+1.1*	*+1.2*	*–16.9*	*+1.8*

Source: WIFO (quarterly national accounts data).

Corporate investment is on a roll: After investment had slumped for five years – taking until the fourth quarter of 2005 to regain the level of 2000 – investment became a driving force of economic activity again in the first half of 2006. External impulses, above all, stimulated equipment investment. The business cycle survey of the Austrian Institute of Economic Research WIFO for the third quarter of 2006 showed capacity utilization to stand at 84%, signaling continued powerful investment, especially in capacity-increasing investment. The order situation and employment figures are expected to improve also in the construction sector.

Consumer spending growth has stabilized at about ½% in recent quarters. Although the rise in real wages remains moderate, sturdy employment growth is boosting household purchasing power. Moreover, retail trade confidence and consumer confidence are trending upward and are bolstering consumer spending in the second half of 2006.

The smooth transmission of external impulses to domestic demand points to increasingly self-sustained economic growth. This scenario also underlies the OeNB's short-term outlook based on the OeNB short-term indicator for the third and fourth quarters of 2006 (see box 2). Currently, the outlook is sustained by solid economic activity in Europe and in Austria. Volatile energy and commodity prices, a slowdown in the U.S. economy, slower growth in Germany as a result of the value added tax increase scheduled for the beginning of 2007 and a stronger appreciation of the euro are seen as the current risks to the economy.

4.2 Dynamic Development of Industrial Output

The manufacturing sector (Austrian Statistical Classification of Economic Activities, sections C through F) succeeded in raising output by 6.9% in the first half of 2006 compared with the same period of 2005. In more detail, capital goods (+8.1%) and intermediate goods (+8.0%) performed best. These figures underline the picture of strong investment activity. The least pronounced rise by comparison was noted in the category of consumer nondurables (+3.7%).

Industry's assessment of manufacturing output in the last few and in

Box 2

The OeNB's short-term indicator of September 2006

Signals Robust, Self-Sustained Economic Growth[1]

According to the most recent calculation of the OeNB's short-term economic indicator, Austria's real GDP will expand by 0.8% (seasonally and working-day adjusted, compared to the previous quarter) in both the third and fourth quarters of 2006. For full-year 2006, growth thus comes to 3.2%. Compared to the last short-term economic indicator results published in June 2006, the growth forecast for the third quarter of 2006 was raised marginally by 0.1 percentage point.

Table 6

Short-Term Outlook for Austrian Real GDP for the Third and Fourth Quarters of 2006 (seasonally and working-day adjusted)

	2004	2005	2006	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06
Quarterly year-on-year change (%)	×	×	×	2.5	2.5	2.7	2.9	3.1	3.3	3.1	3.2
Change from previous quarter (%)	×	×	×	0.4	0.7	0.9	0.8	0.6	0.9	**0.8**	**0.8**
Change from previous year (%)	2.3	2.6	3.2	×	×	×	×	×	×	×	×

Source: OeNB – Results of the OeNB short-term indicator of September 2006, Eurostat.

[1] *Since the first quarter of 2003, the short-term indicator of the OeNB has been published four times a year. It forecasts real GDP growth for the current and the next quarter (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 January 2007.*

the next few months (chart 6) illustrate the favorable development of industrial activity. Both indicators are moving clearly above their averages of the past five years. As expectations of manufacturing developments in the upcoming months are clearly positive and do not show any tendency to decline, industrial activity is anticipated to remain powerful throughout the next few months.

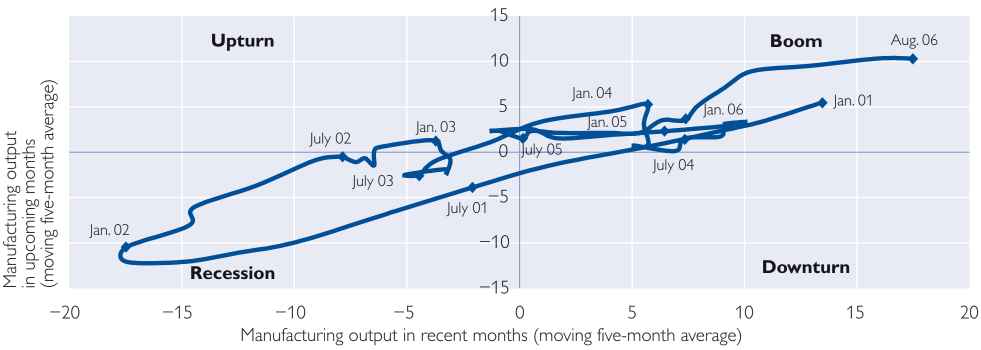
4.3 Inflation Will not Exceed 2% despite Rising Energy Prices

HICP inflation has been on the increase again since March 2006, when it had bottomed out so far in 2006 at +1,3% and has been hovering around the 2% mark since April 2006 (August 2006: 2.1%). In an international comparison, Austria thus belongs to the group of countries with the most stable prices. In the euro area, only Finland (+1.3%) and the Netherlands (+1.9%) had lower rates of inflation in August 2006.

The category "energy" contributed substantially to overall inflation; its rate of price increase averaged 9.3% from January through August 2006. However, services – above all the recent rise in inflation in the categories "restaurants and hotels" and "transport services" – had an especially strong impact on intrayear changes in the overall price index. Inflation as measured by the national consumer price index (CPI) is somewhat more moderate, coming to only 1.8% in August 2006. The discrepancy compared to the HICP is rooted mainly in the difference between the

Chart 6

Assessment of Manufacturing Output in Recent and Upcoming Months[1]



Source: European Commission.

[1] *Both series were centered around their average of the period from M1 01 to M8 06.*

baskets of goods. Negotiated standard wages advanced by 2.6% in the first eight months of 2006 year on year and thus by 0.8% more that the HICP.

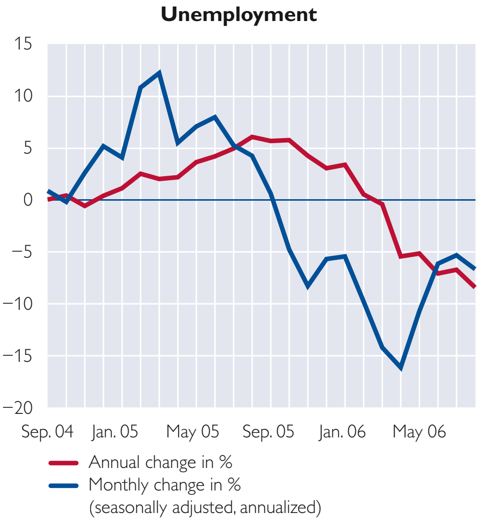
4.4 Strong Employment Growth Entails a Drop in Unemployment

The situation on the Austrian labor market has improved substantially in the course of 2006 so far. Employment growth has accelerated steadily, reaching +1.8% year on year in August 2006, a value last recorded in the early 1990s. Employment growth is thus strong enough to produce a decline in unemployment figures.

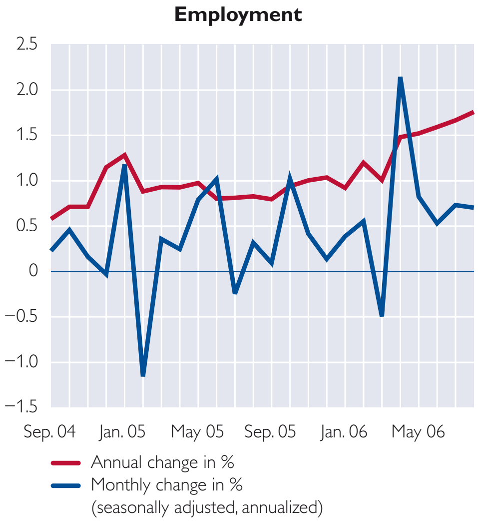
The unemployment rate (Eurostat definition) peaked at 5.3% in October 2005 and has been declining continuously since to reach 4.8% in August 2006. The development of registered vacancies signaled the drop in unemployment at an early point in time: 19.7% more vacancies were registered in the first eight months of 2006 than in the same period of 2005. The ratio of registered unemployed to registered vacancies has been diminishing, reflecting the positive situation on the Austrian labor market.

Chart 7

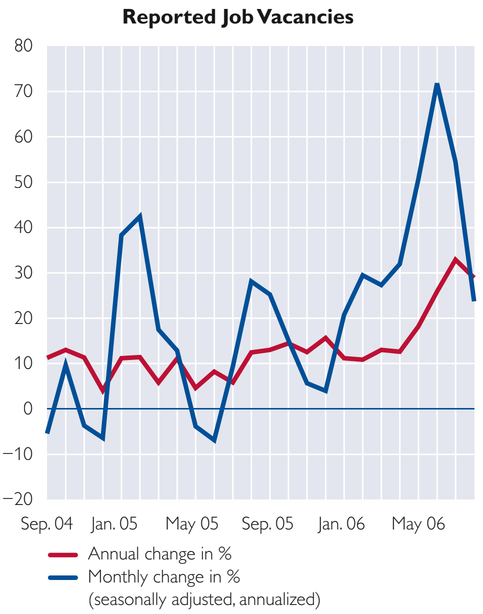
Labor Market Developments in Austria



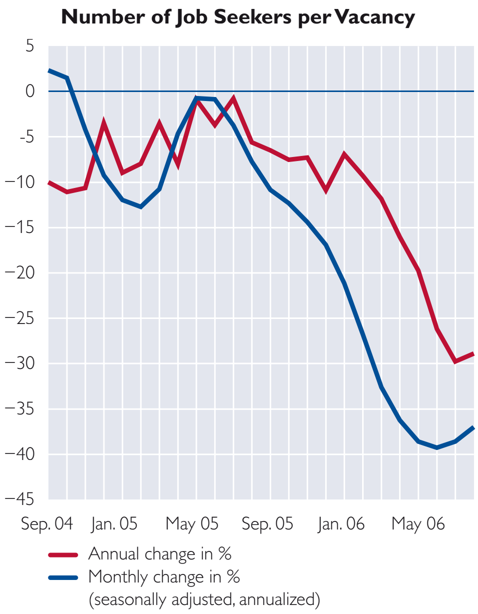
Source: Statistics Austria.



Source: Statistics Austria.



Source: Statistics Austria.



Source: Statistics Austria.