Economic Momentum Slows in the Euro Area

Energy Price Developments Have a Negative Impact

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The U.S. economy continued to expand in the first half of 2005 despite the strong impact of a further rise in oil prices. However, according to OECD estimates, Hurricane Katrina will dampen economic growth by 0.5 percentage point to 3.1% for the whole year 2005. The Japanese economy remained on its growth path in the second quarter of 2005. The other Asian economies – especially dynamic China – also expanded further.

Conversely, GDP growth in the euro area slowed down in the second quarter of 2005. Hit by energy price increases, private consumption generated a marginally negative contribution to growth, while foreign trade and investment made only small positive contributions to growth. Whereas the leading indicators had sent out positive signals since May, these signals recently reversed, so that the outlook for the second half of 2005 deteriorated. Once again, energy price developments are the main culprit; they are also the reason for the persistently high level of inflation.

Growth in most of the Central European new Member States (NMS) as well as the EU candidate countries slowed in the first quarter of 2005 compared to the full year 2004. Only in Bulgaria and in the Czech Republic did GDP growth accelerate somewhat. In the second quarter of 2005, economic activity picked up in all Central European NMS save Slovakia, where it remained stable at a high level. After the upward pressure on prices experienced in 2004 – largely as a consequence of EU accession – 2005 is marked by positive base effects, which have helped slow down inflation in the NMS.

The Austrian economy, which had enjoyed robust export-driven growth in 2004, lost momentum in the first quarter of 2005 but regained speed in the second quarter. The OeNB's short-term economic indicator points to 1.8% real GDP growth for the full year 2005, which corresponds to a downward revision by 0.2 percentage point compared with the forecast that the OeNB published in June. Despite elevated energy prices, inflation has been going down in 2005 so far. The unemployment rate (Eurostat definition) augmented to 5.1% in July 2005 even though employment surged.

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1 U.S. and Asian Growth Still Outpaces Euro Area Growth Substantially

1.1 U.S.A.: Hurricane Katrina Causes Temporary Dip in Growth

In the second quarter of 2005, real GDP widened by 3.3% on an annualized basis, following 3.8% growth in the first quarter. Second-quarter activity was propelled primarily by a 3.0% rise in consumption expenditure and a 13.2% jump in exports. Inventory changes, by contrast, dampened growth. Many companies' good quarterly results and the improvement on the labor market signal a pickup in investment and consumer spending. However, skyrocketing fossil fuel prices and the massive impact of Hurricane Katrina, in particular on oil and gas supply and on possible further price hikes thereof, have made it difficult to assess the further development of economic activity. Many experts feel that the hurricane will dent U.S. GDP growth in the second half of the year, but only temporarily, provided the oil price increases are also temporary. The healthy U.S. private real estate market has driven consumer spending so far, but the boom may be nearing its end, so that one of the main pillars of consumption may lose strength. According to OECD estimates, Hurricane Katrina will dampen real economic growth by 0.5 percentage point to 3.1% for the whole year 2005. The OECD expects the economy to expand by 3.4% in 2006; Consensus Forecasts pegs the figure at 3.3%.

The labor market situation brightened further in the U.S.A. in August: The jobless rate shrank further to 4.9% (high in June 2003: 6.3%); 169,000 new jobs (excluding agriculture) were created. All in all, 586,000 new jobs were established in June, July and August.

Consumer prices advanced by 3.2% in July 2005 year on year (highest cyclical rise: +3.5% in April 2005). The speedup in inflation can be pinpointed mostly to higher energy prices. The OECD sees inflation rising by 0.1 percentage point for the remainder of 2005 in the wake of Hurricane Katrina. Core inflation advanced by 2.1% in July, thus slightly exceeding the June reading (+2.0%) but remaining below the high for 2005 so far (February: +2.4%).

The Federal Open Market Committee (FOMC) hiked the official interest rate on August 9, 2005, by another 25 basis points to 3.5%. This increase represented the tenth successive key rate hike since mid-2004 and confirmed the U.S. Federal Reserve's repeatedly expressed intention of removing policy accommodation at a measured pace. The September FOMC meeting was scheduled for September 20, 2005.

The risks for the U.S. economy consist in high energy prices and economic imbalances, above all the high deficit of the external sector (current account deficit in 2005: around – 6% of GDP), elevated consumer debt and the low propensity to save. It is unlikely that these imbalances will be reduced in the near future, as the gap in growth between the U.S.A. and its trade partners will apparently remain for the time being.

1.2 Japanese Economic Growth Continues in the Second Quarter of 2005

Real GDP gained 0.8% quarter on quarter in the second quarter of 2005, marking the third consecutive quarter of growth. With wages having risen and the situation on the job market having improved, consumption expenditure went up by 0.6%. Japanese corporate investment enlarged by 3.6%, exports by 2.9%. Although industrial production dipped temporarily in July, it is expected to rebound. This supports the assessment that the lull in Japan's recovery has ended. High crude oil prices and uncertainty about the continuation of the market-oriented economic policy course after the parliamentary elections of September 11, 2005, represent downward risks to growth. The Japanese government and the Bank of Japan forecast a long-term upturn for the economy. The International Monetary Fund (IMF) considers structural reform is needed to raise productivity and announced that it would revise upward its growth forecast for 2005 and 2006 considerably. The OECD estimates economic growth to come to 1.8% in 2005. Nevertheless, core inflation has remained negative.

1.3 China's Global Importance Rises Steadily

China stayed on the fast-growth track onto which it had changed at the outset of the 1990s. Real GDP was lifted by 9.5% in the first half of 2005, unchanged from 2004. In 2005 as a whole, the growth rate is liable to be only marginally lower despite efforts to reduce the pace. In June, the People's Bank of China announced a careful flexibilization of the exchange rate regime. China follows a managed floating exchange rate regime oriented on a currency basket containing e.g. the U.S. dollar, the Japanese yen and the euro in unknown weights. At the same time, the renminbi-yuan was revalued by 2.1% from 8.28 to 8.11 against the U.S. currency. The revaluation and planned spending caps are supposed to help rein in growth to below 9% in 2006. China has posted low inflation in recent years, in fact deflation was prevalent for long time periods. Inflation was reported at 1.8% in July 2005. The current account surplus for 2005 is likely to surpass the 2004 result of over 4% of GDP. Investment has gained great momentum. The investment ratio of 45% is unusually high in an international comparison, and although inward foreign direct investments represent only a small portion of this percentage, they nevertheless generate most of China's manufacturing exports. The export industry is focused on consumer goods; accordingly, Austrian imports from China consist predominantly of such products (e.g. consumer electronics, clothing, toys, bedding, lighting, and shoes and leather goods). Hence, China now competes with Austria's manufacturers for exports of such articles, as it does with countries with similar exports (e.g. Italy, Central and Eastern Europe).

2 Euro Area: Slowdown in Economic Momentum Continues

2.1 GDP Growth Slows in the Second Quarter of 2005

Eurostat's flash estimate of real GDP development in the euro area in the second quarter signals a renewed slight slowdown in growth. GDP edged up by 0.3% in real terms against the previous quarter; year-on-year growth came to 1.1%. This compares with a quarter-on-quarter advance of 0.4% in the first quarter of 2005.

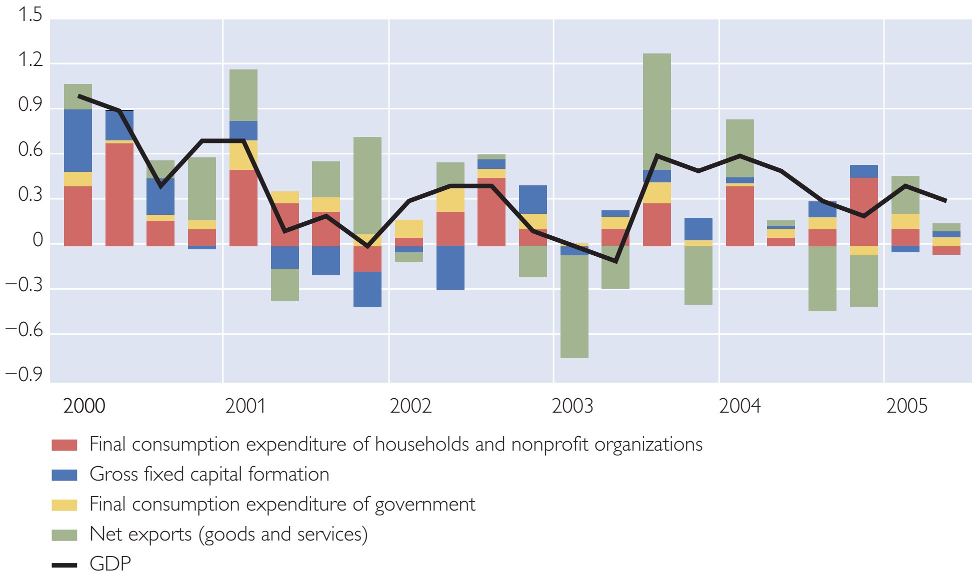
Whereas consumer spending had still made a positive contribution to growth in the first quarter of 2005, it acted as a slight damper again in the second quarter. One of the key reasons is the further rise in energy prices, compounded by the ongoing unfavorable labor market situation and uncertainty about health care and pension reform. In this vein, consumer confidence as measured by the European Commission has been below the long-term average since May 2005. Overall, households therefore consumed less and saved instead. Moreover, as confidence in the retail sector has been on the decline, consumer spending is unlikely to improve rapidly. The contribution of government consumption to growth diminished markedly, remaining positive, however.

The depreciation of the euro since the beginning of 2005 fed into export growth, which became positive again in the second quarter (+2.1% quarter on quarter). However, as imports advanced at the same pace, net exports contributed only very little to growth. By contrast, gross fixed capital formation again had a positive impact on growth following a negative contribution in the first quarter of 2005. It looks like companies reacted less sensitively to the rise in oil prices than households. While this may reflect the longer time lags of corporate investment decisions, very high demand growth allowed a number of particularly energy-intensive industries, such as aluminum or steel production, to pass the rising cost of inputs on to output prices. Moreover, years of wage moderation in Germany and other countries and the reduction in labor-related taxes have considerably dampened wage growth, giving enterprises more room to absorb rising energy costs through cuts in profit margins. Furthermore, European firms appear to benefit particularly strongly from the increase in demand for energy-saving technologies and alternative energy systems. Finally, European companies also have an advantage in attracting an above-average share of the rising demand from oil-producing countries. There is evidence that the rate at which oil revenue is recycled into the economy in the form of consumption demand has accelerated.

Chart 1

Contributions to Growth of the Components of Euro Area Real GDP (quarter-on-quarter change)

percentage points; quarterly data



Source: Eurostat.

The reasons are the sharp rise in demographic growth in the oil-producing countries, higher per capita income there and the ensuing increase in demand for quality goods alongside large budget surpluses that enable these countries to implement infrastructure programs rapidly.

2.2 Economic Forecasts Signal only Moderate Acceleration of Growth

Since mid-2004 industrial output growth has displayed a steady but volatile downtrend. Most recently, this downtrend has been flattening noticeably. Furthermore, the leading indicators for industrial production signal that the downward trend may have come to an end: According to the European Commission Business Survey, industrial confidence has brightened since May; incoming orders in industry have also been trending upward again.

The most recent confidence indicators of the European Commission, however, were slightly lower again. While it is still too early to judge whether this result represents a correction of too strong a rise or a change in trend, it is reasonable to assume that the weaker indicator values have been caused largely by the development of energy prices. In this respect it should be added that the last surveys did not yet reflect the most recent highs. The latest figures of the Ifo business climate index were down again as well, with the deterioration attributable only to the worsening sentiment about the current business situation; expectations about future business developments continued to improve. To sum it up, the outlook for the second half of 2005 has deteriorated, above all hopes of a self-sustained upswing have been reduced.

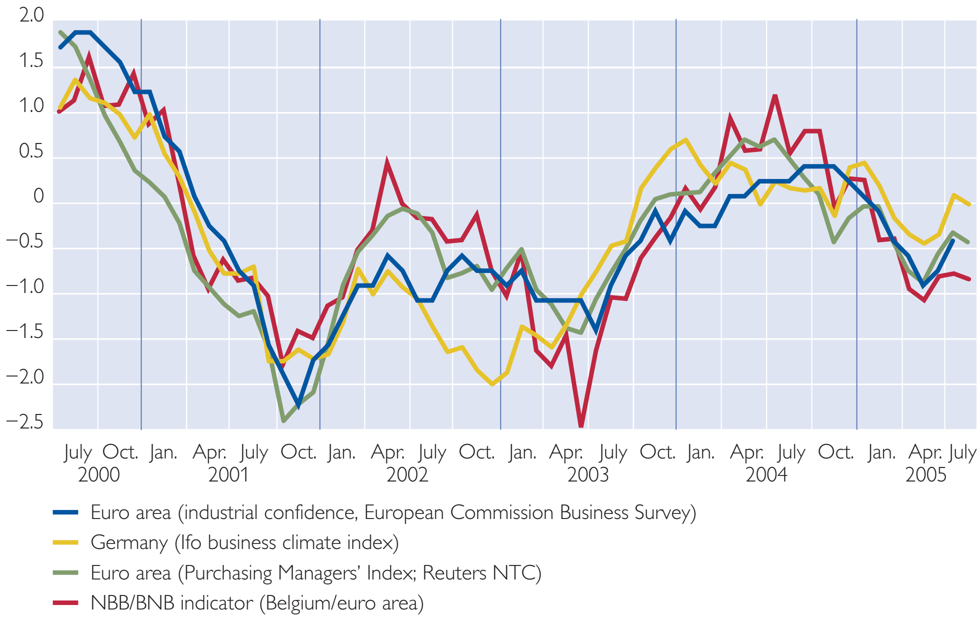
The European Commission's short-term economic forecast for the euro area anticipates a quarterly growth rate of between 0.2% and 0.6% for the third quarter of 2005. Growth is expected to accelerate to between 0.4% and 0.8%

in the fourth quarter reflecting exchange rate developments and the improvement of the international environment. The projections of the ECB's economic experts published September 1, 2005, paint a somewhat more pessimistic picture than the Eurosystem projections of June 2005. Energy price developments and the weak first quarter are cited as the reasons. Current projections place growth in a range of 1.0% and 1.6% for 2005 and 1.3% and 2.3% for 2006. External factors with a positive effect are the increase in world economic growth and the improved price competitiveness of the euro area. Within the euro area, excellent financing conditions and healthy corporate profits support investment. The balance of risks with regard to oil price developments and their consequences for consumer confidence is on the downside.

Chart 2

Business Climate Indicators

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



Source: European Commission, Ifo, Reuters NTC, OeNB.

2.3 Signs of Labor Market Improvement Strengthen

After the seasonally adjusted unemployment rate in the euro area had persisted at 8.8% around the turn of 2004/05, it sank to 8.6% in two steps from April 2005. At this level, the jobless rate is 0.3 percentage point below the high of 2004, which supports the impression of a gradual recovery on the labor market. Until April, unemployment had risen, above all in Germany, partly because of labor market reforms that led to the reclassification of welfare recipients to the unemployed. Since May, German unemployment has been on the decline again. The number of job openings as a percentage of the total working population in the euro area went up again in the third and fourth quarters of 2004 after having contracted steadily since the beginning of 2001. The number of vacancies has also been augmenting in countries for which data for 2005 have become available. Employment went up by 0.1% quarter on quarter in the first three months of 2005; job growth was concentrated in the service sector.

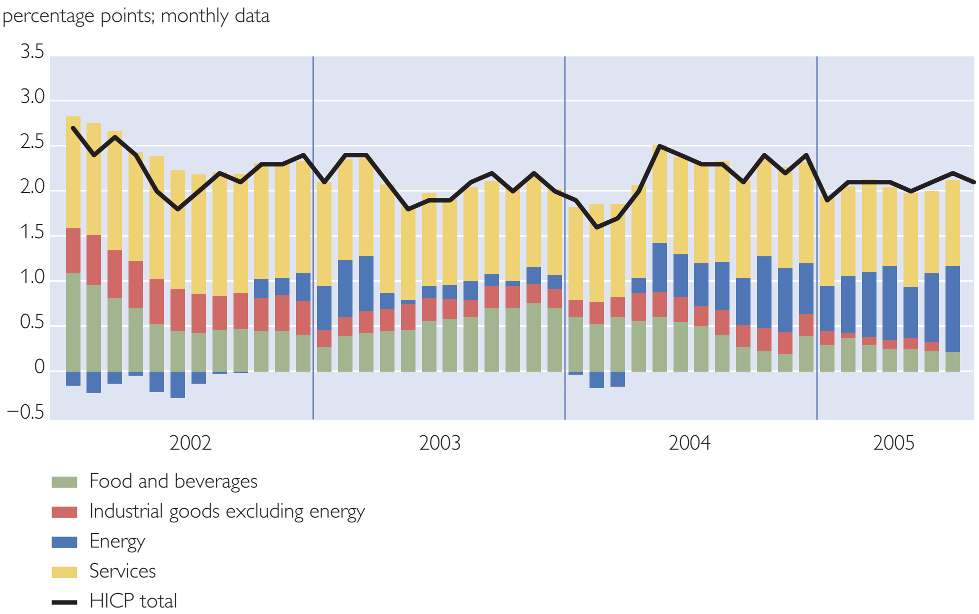
2.4 Energy Prices Continue to Predominate Inflation Developments

The crude oil price stayed on an uptrend, reaching nominal highs of around USD 67 per barrel of Brent in August 2005. This represents a 75% rise from the beginning of 2005. Compounded by the depreciation of the euro, this translates into an oil price rise of about 80% in euro terms. There are many reasons for soaring oil prices, ranging from the hurricanes in the Atlantic and the Gulf of Mexico to political tension between the West and Iran, temporary production outages and transport failures in Iraq, strikes in Ecuador and oil stock developments. At the beginning of September, the U.S.A. requested that the International Energy Agency permit its member countries to sell strategic oil reserves to alleviate bottlenecks in the wake of Hurricane Katrina. Several countries announced that they would market part of their emergency stock, which immediately elicited the hoped-for dampening of oil prices. OPEC countries are currently producing 30.3 million barrels a day, with reserve capacities at 2 million barrels a day. As production already exceeds the agreed quota of 28 million barrels, the discussion about a widening of quotas has been relegated to the background. By the end of 2006, OPEC members' crude production capacities are to be expanded by 10% to 33 million barrels a day and to 38 to 39 million barrels a day by 2009/10. By contrast, production growth is shrinking substantially in non-OPEC countries.

For months, the development of crude oil prices has been responsible for the faster rise in the Harmonised Index of Consumer Prices (HICP). From June through August 2005, the rate of

Chart 3

HICP Components: Contributions to Inflation



Source: Eurostat.

inflation came to between 2.1% and 2.2%. The energy price component rose by roughly 10%. By contrast, the price of unprocessed food merely edged up in the past few months, as did the price of industrial goods excluding energy. Core inflation (the rise in the HICP excluding energy and unprocessed food) has stood at about 1.5% since the beginning of 2005, roughly ½ percentage point below the average for 2004. The unwinding of the base effect of the health reform in several countries is mainly responsible for the decline at the turn of 2004/05. The development of prices for processed foods remains influenced by various base effects of past and recent tobacco tax hikes.

In the coming months, inflation should stagnate at the current level. Hence, the base effect of the oil price will remain the primary inflation driver; it was this effect that prompted ECB experts to revise upward their projections. Currently, inflation is forecast to average between 2.1% and 2.3% in 2005 and between 1.4% and 2.4% in 2006. In view of continued labor market tightness, wage settlements and thus domestic pressures on prices should remain moderate. Hence, the forecast risk can be pinpointed primarily to unexpected second-round effects of oil price developments and unanticipated fiscal policy measures.

2.5 Monetary Growth Accelerates Further

The three-month average of the annual growth rate of M3 has been on an uptrend since mid-2004. In the period from May to July 2005, M3 growth stood at 7.6%. The continuous acceleration of monetary growth stems from the sustained heavy demand for fairly liquid funds. This development may be traced to households' unbroken risk aversion, the flat structure of interest rates and the historically low level of interest rates. The strong demand for cash may be explained among other things by the higher demand from abroad for euro banknotes.

The upturn in total lending continued to show a positive trend. In particular, loans to the private sector have risen since mid-2003. Total lending growth stabilized due to the flagging expansion of lending to the public sector. The upturn in private sector lending is basically attributable to an increase in home loans owing to low long-term interest rates. By contrast, consumer loans advanced less dynamically.

2.6 The Effects of Hurricane Katrina Sap the U.S. Dollar's Strength

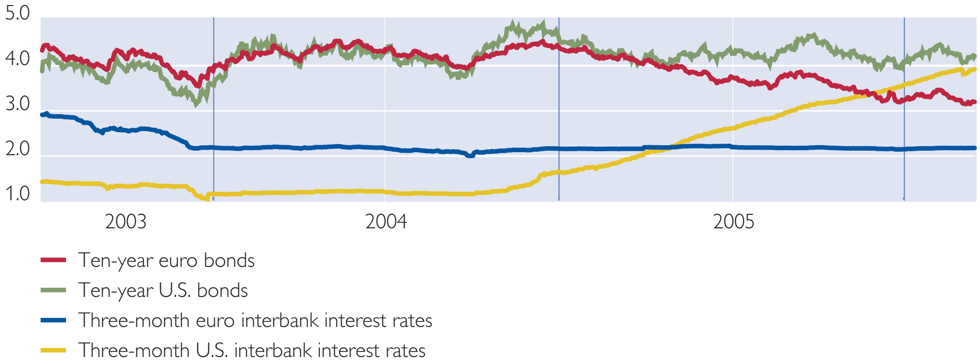
In the second quarter, the euro slipped against the U.S. currency, mainly because more powerful U.S. economic activity and the developments of interest rate differentials on the money market in an environment of heightened political uncertainty in the EU after the rejection of the EU Constitutional Treaty by referendum in France and the Netherlands. In June and July 2005, the USD/EUR exchange rate remained largely stable at low trading volumes; the announcement of Chinese exchange regime reform has no significant influence on this currency pair. From the beginning of August 2005, the euro started to gain strength despite the growing U.S. interest rate advantage. This uptrend was probably started by the publication of positive euro area economic data and was reinforced by the reports about the dramatic damage wreaked by Hurricane Katrina.

A spate of reports of more positive economic data from the end of June led

Chart 4

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

From January 1, 2003 to September 14, 2005



Source: Thomson Financial.

to a steeper interest rate structure on euro area money markets. Long-term interest rates in the euro area increased by 25 basis points to roughly 3.4% at the beginning of August 2005. Rises in nominal interest rates were triggered above all by higher real interest rates; inflation risk premia remained largely constant despite high oil prices. From mid-August, long-term interest rates reversed course; the interest curve flattened again as a consequence of unfavorable economic reports and especially of the development of oil prices. Long-term interest rates signal that money market players expect key interest rates in the euro area to remain unchanged.

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

3.1 Economy Weakens in the First Quarter; Signs of a Revival of Activity in the Second Quarter

In the first quarter of 2005, year-on-year economic growth in the Central European New Member States (NMS) ranged from 2.1% (Poland) and 5.1% (Slovakia). This means that growth rates were perceptibly weaker than in 2004 as a whole. The candidate countries posted stronger growth at 6.0% (Bulgaria) and 5.9% (Romania) than the

Table 1

Real GDP Growth in Central and Eastern Europe

Year-on-year change in %

	2001	2002	2003	2004	Q4 04	Q1 05	Q2 05
Poland	1.0	1.4	3.8	5.4	4.0	2.1	2.8
Slovenia	2.7	3.3	2.5	4.6	4.3	2.6	5.2
Slovakia	3.8	4.6	4.5	5.5	5.8	5.1	5.1
Czech Republic	2.6	1.5	3.2	4.4	4.6	4.7	5.1
Hungary	3.8	3.5	2.9	4.2	4.1	2.9	4.1
Bulgaria	4.1	4.9	4.5	5.6	6.2	6.0	. .
Croatia	4.4	5.2	4.3	3.8	3.6	1.8	. .
Romania	5.6	5.1	5.3	8.4	9.7	5.9	. .

Source: Eurostat, national statistical institutes, wiiw.

NMS. However, Croatia (1.8%) lagged far behind the other candidate countries.

Among the Central and Eastern European countries (CEECs), first-quarter growth slowed most by comparison to whole-year 2004 growth in Poland (–3.3 percentage points), Slovenia (–2.0 percentage points), Croatia (–2.0 percentage points) and Romania (–2.5 percentage points). Growth accelerated marginally only in the Czech Republic and in Bulgaria.

In most CEECs, consumption expenditure diminished in the first quarter of 2005 by comparison to the previous year. The decline was most pronounced in Poland (–1.7 percentage points to 1.7%) and Croatia (–1.5 percentage points to 2.4%) and can be attributed to low (or decreasing) real wage growth in the economy as a whole in the second half of 2004 and at the beginning of 2005. Indeed, the rise in inflation which had been triggered in 2004 by the impact of EU accession and the oil price rise was not or only marginally reflected by additional nominal wage rises. By contrast, Slovakia, Bulgaria and Romania reported higher consumption expenditure growth in the first quarter of 2005 than in 2004, with growth especially strong in Slovakia and Bulgaria. Romania topped the list, with consumption expenditure growth in the double digits once again (12.5%). In these countries, real wage increases had speeded up noticeably already at the end of 2004. Moreover, at the beginning of 2005 private-sector disposable income surged in Romania as a result of the introduction of a uniform corporate and income tax rate of 16%, far lower than the rates it replaced.

Gross fixed capital formation growth slackened in all CEECs except Slovakia, in some countries quite substantially. In Slovenia, the rate of increase dropped by 7.3 percentage points to –0.5%; it fell by more than 4 percentage points in Croatia (to 0.3%) and Romania (to 5.5%). Gross fixed capital formation lost momentum in these countries as a result of slower consumer spending and foreign demand growth. In Slovakia, the rise in gross fixed capital formation accelerated by 2.8 percentage points to 5.8%; GDP growth decreased despite higher domestic demand because inventory changes made a smaller contribution to GDP growth.

The interplay of weakening domestic demand and diminishing export growth on account of more tepid euro area growth and a perceptible appreciation in some countries resulted in a faster slowdown of import growth than of export growth. Hence, the contribution of net exports to GDP growth improved in most of the reviewed countries. In the Czech Republic, the growth contribution widened from just 0.4 percentage point in 2004 as a whole to nearly 6 percentage points in the first quarter of 2005, offsetting the slump in domestic demand growth and preventing GDP growth from declining. However, all three EU candidate countries posted negative growth contributions of net exports, with a rising trend. In Romania, the negative contribution enlarged from –2.8 percentage points in 2004 to –8.5 percentage points in the first quarter of 2005; in Bulgaria and Croatia, the figures deteriorated somewhat to –5.4 and –0.8 percentage points, respectively.

A look at the region's trade balances shows that in the first quarter of 2005, Bulgaria, Croatia and Romania recorded the highest deficits at –14.7%, –23.5% and –7.8% of GDP, respectively. The Czech Republic was the only country to achieve a surplus

(+2.8% of GDP). The current account shortfall in Croatia (19.8% of GDP) and Romania (6.4% of GDP) was lower than the trade deficit, as other subbalances posted surpluses. In Bulgaria and the Czech Republic, however, the negative income subaccount in particular worsened the current account balance to –15.9% of GDP and 0.2% of GDP, respectively.

The first second-quarter economic growth figures for the NMS covered in this section have become available. They show that except in Slovakia, annual GDP growth was markedly stronger in the second quarter than in the first quarter of 2005. Poland registered 2.8%, Slovenia 5.2%, the Czech Republic 5.1% and Hungary 4.1% growth. The stepped-up momentum can be traced to higher export growth coupled with low import growth in Poland, Slovenia and Hungary and to the more rapid drop in import growth than in export growth in the Czech Republic. In all four countries, lower import growth was attributable to shrinking domestic demand (in Slovenia, stagnating domestic demand). The (higher) GDP growth in these countries therefore was fueled exclusively by the (higher) contribution of net exports. Slovakia posted unchanged annual GDP growth on the previous quarter, with export growth losing pace and gross fixed capital formation growth surging. Second-quarter GDP data for the candidate countries have not yet become available, but Romania is likely to post a much smaller quarterly year-on-year growth following the flood disaster of early summer.

3.2 Inflation Eases Markedly in the First Half of 2005

In most CEECs, inflation flagged in the first quarter of 2005 by comparison to the previous year. Except in Hungary, the rise in the HICP in the NMS covered in this report continued to lose pace in the second quarter of 2005, amounting to between 1.2% and 3.6% year on year. Accession-related factors propelling inflation in 2004, such as tax increases, caused a positive base effect in 2005 and thus a decline in price increases, as no significant second-round effects occurred. Moreover, despite the upward pressure of international energy price developments, stronger currencies, falling unit labor costs in industry and dampened inflation expectations bolstered the disinflation process.

Table 2

Inflation Developments in Central and Eastern Europe

Year-on-year change of the HICP in %

	2000	2001	2002	2003	2004	Q1 05	Q2 05
Poland	10.1	5.3	1.9	0.7	3.6	3.6	2.2
Slovenia	8.9	8.6	7.5	5.7	3.6	2.8	2.2
Slovakia	12.2	7.2	3.5	8.5	7.4	2.6	2.4
Czech Republic	3.9	4.5	1.4	–0.1	2.6	1.4	1.2
Hungary	10.0	9.1	5.2	4.7	6.8	3.5	3.6
Bulgaria	10.3	7.4	5.8	2.3	6.1	3.8	4.9
Croatia[1])	6.4	5.0	1.7	1.8	2.1	3.1	3.1
Romania	45.7	34.5	22.5	15.3	11.9	8.9	9.9

Source: Eurostat, national statistical institutes, wiiw.

[1]) CPI.

3.3 Slovak and Romanian Ratings Improve in 2005

Standard & Poor's as well as Moody's again gave Slovenia the top rating (AA–/Aa3) for long-term foreign currency debt among all countries covered in this section. Both agencies rank the Czech Republic and Hungary second (A–/A1). Standard & Poor's rates Slovakia the same as the Czech Republic and Hungary; Moody's sees it in third place, alongside Poland, ever since it was upgraded in January 2005. Both agencies rate Croatia (BBB/Baa3) right behind the NMS and before Bulgaria and Romania (both BBB–/Ba1). Moody's upgraded Romania in March 2005; Standard & Poor's followed with an upgrade in September.

Table 3

Rating for Long-Term Foreign Currency Debt

Currency	Moody's			Standard & Poor's		
	former rating	latest change	current rating	former rating	latest change	current rating
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
SKK	A3	12.01.05	A2	BBB+	13.12.04	A–
CZK	Baa1	12.11.02	A1	A	05.11.98	A–
HUF	A3	12.11.02	A1	BBB+	19.12.00	A–
BGN	Ba2	17.11.04	Ba1	BB+	24.06.04	BBB–
HRK	. .	27.01.97	Baa3	BBB–	22.12.04	BBB
ROL	Ba3	02.03.05	Ba1	BB+	06.09.05	BBB–

Source: Bloomberg.

Economic Outlook for Central and Eastern European Countries

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

In the three NMS covered here, whole-year GDP growth in 2005 is expected to be virtually unchanged, perhaps a bit higher than in 2004 in the Czech Republic, somewhat weaker in Hungary and noticeably weaker in Poland. The renewed uptick in international energy prices since the second quarter of 2005 and their persistence at a fairly high level is liable to rein in consumer spending growth in the third and fourth quarters. However, it appears unlikely for inventories in Hungary to be drawn down much more than in the second half of 2004 in the remainder of 2005. As the negative contribution to GDP growth of inventories shrinks, GDP growth should gain pace in the second half of 2005. In Poland, too, GDP growth, which starts from relatively low level, should be much stronger in the rest of 2005 than in the second quarter. Arguments which support this assumption are the further pickup in gross fixed capital formation (high corporate profits along with dropping unit labor costs in manufacturing, transfers from EU structural funds) and the moderate improvement on the labor market (rising employment). The rapid formation of a consolidation-oriented government after parliamentary elections at the end of September 2005 would probably further support investment both in the remainder of 2005 and in the coming year. At the same time, the accelerating growth of gross fixed capital formation, which tends to be import-intensive, is likely to marginally reduce the contribution of net exports to growth.

Robust export growth is anticipated for 2006, provided euro area growth quickens as expected. This would also add to gross fixed capital formation and its positive repercussions for the labor market and consumer spending. This development will be accompanied by a parallel rise in import growth, leading to a more balanced structure of growth. In Poland, consumer spending will be reinforced by a hike in social transfers because of the surpassing of an indexation threshold. However, possible additional consolidation *measures of the new government could act as a damper. Both in Hungary and in the Czech Republic, parliamentary elections in 2006 may provide growth impulses in the form of tax cuts or additional public expenditure, or of wage increases.*

The risks to the forecasts for these three NMS include the marked deviation of euro area growth and oil prices from expectations and stronger exchange rate fluctuations, which would detract from the additional demand effects expected to emanate from the widely anticipated acceleration of euro area growth.

In Russia, economic growth lost momentum in the first half, declining to 5.6% year on year according to estimates of the economics ministry compared to 7.2% annual growth in 2004. This slowdown may be pinpointed to sagging gross fixed capital investment and consumer spending growth as well as a sharp decline in real export growth. However, with import growth also weakening in turn, the contribution of net exports to GDP growth was no more negative than in 2004 as a whole. The deceleration of growth despite high energy prices is attributable above all to the deterioration of the investment climate in the wake of the Yukos affair, to persistent intervention by the tax and judicial authorities and the drastic tightening of the tax regime for the energy sector. While economic activity appears to have gained some momentum in the summer of 2005 on the back of record-level oil prices, whole-year growth in 2005 and 2006 is nevertheless expected to slide. Capital formation may recover, but consumer spending is expected to slacken further from its current robust level. On the other hand, the upcoming elections may induce moderate fiscal easing in 2006 (reduction of the budget surplus). Major efforts to restart bogged-down structural and institutional reform are not in the cards in 2005 and 2006.

Russia's persistently high inflation differential with the rest of the world and nominal upward pressure will most likely result in the ruble's continued appreciation. Around mid-2005, the real effective exchange rate of the ruble reattained the level it had stood at immediately prior to the severe economic and financial crisis of 1998. The upshot is that the import pull caused by burgeoning domestic demand will be compounded by the growing competition of cheaper goods from abroad; this will further reduce net exports.

The Russian economy's even greater dependency on sources of energy in the last few years remains a key risk factor for both growth and this forecast. Furthermore, there is the risk that the ruble will appreciate excessively and rapidly in real terms, which would adversely affect the competitiveness of industrial goods. Finally, it is also difficult to currently assess the macroeconomic consequences of the continuing uncertainty about the course of reform and the respect for property rights by the authorities.

Three New Member States and Russia: Forecast of September 2005

Year-on-year change at constant prices in %

GDP	2001	2002	2003	2004	2005[1])	2006[1])
Poland	1.0	1.4	3.8	5.4	3.8	4.3
Czech Republic	2.6	1.5	3.2	4.4	4.7	4.6
Hungary	3.8	3.5	2.9	4.2	3.9	4.3
Russia	5.1	4.7	7.3	7.2	6.0	5.8

Source: Eurostat, national statistical institutes, OeNB.
[1]) Forecast.

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

4 Austria: Exports Sustain Growth – Domestic Activity Remains Subdued

4.1 Growth in 2004 Robust on the Back of Healthy Exports; Weakening in the First Half of 2005

Healthy exports brought real GDP growth to 2.4% in Austria in 2004, which surpassed the euro area average of 1.8%. The torrid pace of world economic growth in 2004 boosted Austrian exports. However, export growth peaked in the first half of 2004 – from the second half of the year, export activity began to slow down, a trend which continued throughout the first quarter of 2005. In the second quarter, exports recovered again, with goods exports developing especially dynamically.

Domestic activity did not provide any significant impulses, though. Consumer confidence is marked by growing uncertainty caused by social reforms already implemented and in the pipeline and the fear of job losses. Uncertainty has also prompted consumers to save more. The development is clearly reflected in the European Commission's survey of consumer confidence, which has stagnated at a below-average level since its sharp decline at the beginning of 2003. Figures for the saving rate in 2004 have not yet become available, but the rise of net financial investment as shown by financial accounts data by 4.8% in 2004 indicates an increase in the saving rate, a trend which is likely to have continued throughout the first half of 2005. Sluggish imports since the start of 2005 aptly mirror weak domestic activity.

Consumer spending has been on the decline since 2003. Despite impulses emanating from the second stage of Austria's tax reform, consumer spending did not gain momentum in the first half of 2005, either. The quickening of inflation as a result of rising oil prices noticeably dampened households' purchasing power.

Table 4

National Accounts Figures for Austria (in Real Terms)

	2003	2004	Q1 05	Q2 05
	Year-on-year change in % (not seasonally adjusted)		Quarter-on-quarter change in % (seasonally adjusted)	
GDP	1.4	2.4	0.1	0.4
Consumer spending	1.7	0.7	0.2	0.1
Public spending	1.7	1.0	0.3	0.3
Gross fixed capital formation	6.1	0.6	–1.1	–0.9
Exports	2.3	9.0	0.2	1.1
Imports	5.6	6.2	–0.3	0.3

Source: 2003, 2004: Statistics Austria (published July 2005); 2005: WIFO (quarterly annual accounts data).

In 2003, the investment backlog stemming from declining investment activity in 2001 and 2002 and temporary investment subsidy fueled powerful gross fixed capital formation growth. In 2004, investment stagnated at the year-earlier level.[1] The drop in investment observed in the first half

[1] *However, the gross fixed capital formation growth figure for 2004 is surrounded by considerable uncertainty. According to the estimate WIFO made in the quarterly national accounts release of June 2005, growth came to 3.6%. The results of WIFO's investment survey of the spring of 2005 also point toward stepped-up growth. Moreover, imports of machinery and transport equipment, a key capital goods category, jumped in 2004 (+15.8% in nominal terms) but has been on the decline since January 2005 (January to June 2005: –4.5% year on year).*

of 2005 may be attributed to the unwinding of the investment subsidy at the end of 2004. The subsidy is likely to have motivated above all the manufacturing industry to frontload investment.

Data Revision Markedly Changes Assessment of Economic Activity

In July 2005, Statistics Austria published first annual data for 2004 and the revision of 2003 data. These newly released data represent a major revision of the preliminary data. Whereas the initial data had indicated a slump in growth from 2001 to 2003 with a slight recovery in 2002, the data released in July indicate that growth was actually quite strong at +1.4% in 2003 (as compared to the obsolete value of +0.8%). Accordingly, the period of sluggishness was shorter and less pronounced than previously assumed.

Revisions of the National Accounts Figures for Austria

Year-on-year change in %

	2003			2004		
	July 05	Oct. 04	Revision	July 05	June 05[1])	Revision
BIP	1.4	0.8	0.6	2.4	2.2	0.2
Consumer spending	1.7	0.6	1.1	0.7	1.5	–0.7
Public spending	6.1	6.2	–0.1	0.6	3.6	–2.9
Gross fixed capital formation	1.7	0.4	1.3	1.0	1.1	–0.1
	2.3	1.4	0.9	9.0	8.9	0.1
Imports	5.6	4.8	0.8	6.2	6.4	–0.2

Source: Statistics Austria.
[1]) WIFO (quarterly national accounts data).

Turning to the demand components, the revision showed important changes only for consumer spending and investment. While it had been assumed that the weakness of consumption expenditure displayed from 2001 to 2003 had been overcome in 2004; the revised figures show that Austrians stepped up spending fairly strongly in 2003, but saved more in 2004. Moreover, investment activity stagnated in 2004. Hence, domestic demand rose at a much weaker rate in 2004 than previously supposed.

4.2 Export-Led Growth to Continue in the Second Half

The lull in growth in the first quarter of 2005 resulted both from the stagnation of exports and from the weakness of domestic demand. The strengthening of activity in the second quarter, which drew on more dynamic export activity, should continue throughout the second half of 2005. Exports will continue as the mainstay of growth; domestic activity is expected to be subdued.

Investment fell in the first half because companies had invested heavily in 2004 to take advantage of the temporary investment subsidy before it ended; it is expected to rise again in the second half, but the available indicators signal that the rise will be meager. This is also what the WIFO investment survey of the spring of 2005 indicates. The surveyed manufacturing companies expect nominal investment to stagnate in 2005; marginal increases in construction investment are expected. Only the surveyed power, transport and other utility companies plan to hike investment substantially. New capital goods orders as compiled by Statistics Austria plummeted during the first half of 2005. WIFO's business cycle survey of August 2005 confirms this trend. The surveys indicate that manufacturing companies have seen their orders books deteriorating continuously since the second half of 2004. The assessment of current business conditions has also become increasingly gloomy.

Construction investment, which had been picking up since mid-2004, lost momentum at the end of 2004 and stagnated in the first half of 2005. This decline reflects the unfavorable weather conditions during the first quarter of 2005. The measures to stimulate growth passed at the beginning of May 2005 hold out hope of positive impulses, especially for rail and road construction. The short-term outlook for consumer spending is not very rose, considering the sharp rise in oil prices and low consumer confidence. Both sagging consumer confidence and persistently low retail confidence signal an unchanged consumer spending growth trend.

Results of the OeNB Short-Term Indicator of October 2005:

OeNB expects 1.8% growth for the whole of 2005[1]

The OeNB expects the pace of GDP growth observed in the second quarter of 2005 to be sustained throughout the second half of 2005. The OeNB's short-term indicator forecasts 0.4% seasonally adjusted growth in Austria's real GDP for the third and 0.5% for the fourth quarter of 2005 (each compared with the previous quarter). For full-year 2005, growth thus comes to 1.8%. This represents a decline by 0.2 percentage point compared to the June forecast of the OeNB.

Short-Term Outlook for Austrian Real GDP

for the Third and Fourth Quarters of 2005 (Seasonally Adjusted)

	2003				2004				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Quarterly year-on-year change in %	1.3	1.3	1.4	1.5	1.5	2.2	2.9	2.9	2.4	1.8	**1.4**	**1.5**
Quarter-on-quarter change in %	0.7	0.3	0.1	0.4	0.7	1.0	0.9	0.4	0.1	0.4	**0.4**	**0.5**
Year-on-year change in %	1.4				2.4				1.8			

Source: OeNB.

[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 quarter and the next (in each case, on a quarterly basis, using seasonally adjusted data). The figures are based on the results of two econometric models: a stochastic state space model and a dynamic factor model. Further details on the models employed can be found at www.oenb.at in the Monetary Policy and Economics section. The next publication is scheduled for January 2006.

The course of oil prices is crucial for the further development of the economy. The current oil price high is the result of a combination of supply and demand factors. With demand powerful, even small uncertainties about production capacities suffice to drive up prices. Apart from immediate demand, the demand scenario is affected by speculative purchases.

4.3 Rate of Inflation Declines in the Course of 2005 despite High Energy Prices

Inflation has slowed down noticeably in the course of 2005. August 2005 marked the lowest rate of increase – 1.9% – in the Harmonised Index of Consumer Prices (HICP) so far in 2005. In the first quarter of 2005, the rate of price increase had still averaged

2.4%. The drop in inflation can be attributed to the development of unprocessed food prices. Low and falling core inflation (rise in the HICP excluding energy and unprocessed foods) of 1.4% most recently in July above all reflects the decline in prices of industrial goods excluding energy. The cost of energy and housing is currently exerting the biggest upward pressure on prices. As before, no price pressure is forthcoming from wages. Negotiated standard wages advanced by 2.2% in the first eight months of 2005 and thus by the same rate as the HICP in the same period. Measured in terms of the national CPI (+2.5%), employees in fact suffered a real wage loss.

4.4 Unemployment Continues to Rise

Conditions on the Austrian labor market have been driven by the concurrent rise in employment and unemployment for some time now. In more detail, payroll employment widened by 1.1% year on year from January through August 2005 despite the weak cyclical conditions. An increase of this size was last registered during the boom year 2000. The reason is probably the delayed effect of the fairly robust economic growth of the second half of 2004. It must be said, however, that a large share of theses 35,000 new jobs are part-time jobs, which is corroborated by the perceptible rise in employment among women. In spite of this solid employment growth, joblessness, which had come to a temporary halt in the second half of 2004, expanded further. In September 2005, 11,800 persons were registered unemployed, a rise by 5.7% year on year that brought unemployment (Eurostat definition) to 5.2%.

Revision of the Austrian Rate of Unemployment

Eurostat has revised the values of the harmonized unemployment rate for Austria upward from January 2004. For example, the value for June 2005 was revised upward from 4.6% to 5.1%. This puts Austria on fifth place in the EU, behind Ireland (4.3%), the United Kingdom (4.7%), Denmark and the Netherlands (both 4.8%). Still, Austria's jobless rate is well below the EU average of 8.8%. The reason for the revision is that Statistics Austria introduced a new continuous labor force survey concept with regular household surveys in January 2004. The new method is better suited to capturing seasonal fluctuations of employment and unemployment.

The surge in unemployment has its origins in the sharp rise in labor supply. Burgeoning labor supply is largely caused by the pension reforms of 2000 and 2003, which lifted the minimum retirement age, and the increase in the employment of foreigners.