Growth Weakens Worldwide

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Substantial data revisions have shown that the U.S. recession in 2008 to 2009 was far more pronounced than originally estimated, and that the recovery has been slower than previously assumed. Leading indicators signal that growth will stay weak in the second half of 2011. With key interest rates already at a low level, monetary policymakers have resorted to new non-standard measures to support the economy.

Japan's economy has largely recovered from the severe consequences of the earthquake in March 2011. The reconstruction activities have given Japan's economy a boost, and global production chains have been largely reestablished. Japan's economic growth is likely to enter positive territory again already in the second half of 2011. For 2011 as a whole, the IMF sees Japanese GDP declining by 0.5%. Additionally, the strong appreciation of the Japanese yen may affect export growth. While China's economic growth has lost some steam, it will still come to some 9% in 2012.

Euro area growth slackened noticeably in the course of the first half of 2011. In the second quarter, real GDP edged up by only 0.2% on the previous quarter. Consumer spending diminished, and exports became the mainstay of growth. Euro area economic growth is anticipated to stay slow in the third quarter. Conditions in the labor market have been improving only hesitantly. The continued tension in the government bond market is creating uncertainty. Whereas Ireland's efforts to consolidate its government finances have resulted in a decline in yield spreads, the yields on Greek sovereign bonds rose to new heights in September 2011 following reports that the results of Greece's consolidation efforts have been insufficient.

In recent months uncertainties about the economic prospects in EU Member States in Central, Eastern and Southeastern Europe (CESEE) heightened significantly. The slowdown in growth in the second quarter of 2011 and the publication of adverse economic data for both Europe as a whole and the world economy lead to activity forecasts for the region having been revised downwards since early summer 2011. Price pressures, which were comparatively high in the first six months of 2011, passed their peak in the summer. In various countries the external position has gradually deteriorated of late. Thus the crisis-induced cyclical component of current account adjustment is slowly losing significance.

The Austrian economy continued to expand at a fairly robust pace in the first half of 2011 and, even at 0.7% growth in the second quarter, significantly outperformed Germany and the euro area as a whole. Meanwhile, however, there have been increasing signs of a sudden and substantive loss of economic momentum from mid-2011 onward. The weaker external environment and a high level of uncertainty in the corporate sector against the backdrop of the sovereign debt crisis have caused export and investment, previously the key growth drivers, to cool off visibly. For 2011 as a whole, GDP growth is still expected to average close to 3% given the strong start into the year. The outlook for growth in 2012, however, is rather weak, with the latest GDP growth projections, released in September 2011, lying within a range of 0.8% (Austrian Institute of Economic Research – WIFO) to 1.3% (Institute of Advanced Studies – IHS).

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1 Global Economic Growth: Considerable Loss of Momentum

1.1 U.S. Recovery Slows Down

The results of the most recent data revision of U.S. GDP indicate that the cumulative decline in growth during the recession of 2008 to 2009 was substantially higher than originally calculated. Moreover, the recovery has turned out to be weaker than originally assumed. With quarter-on-quarter an-

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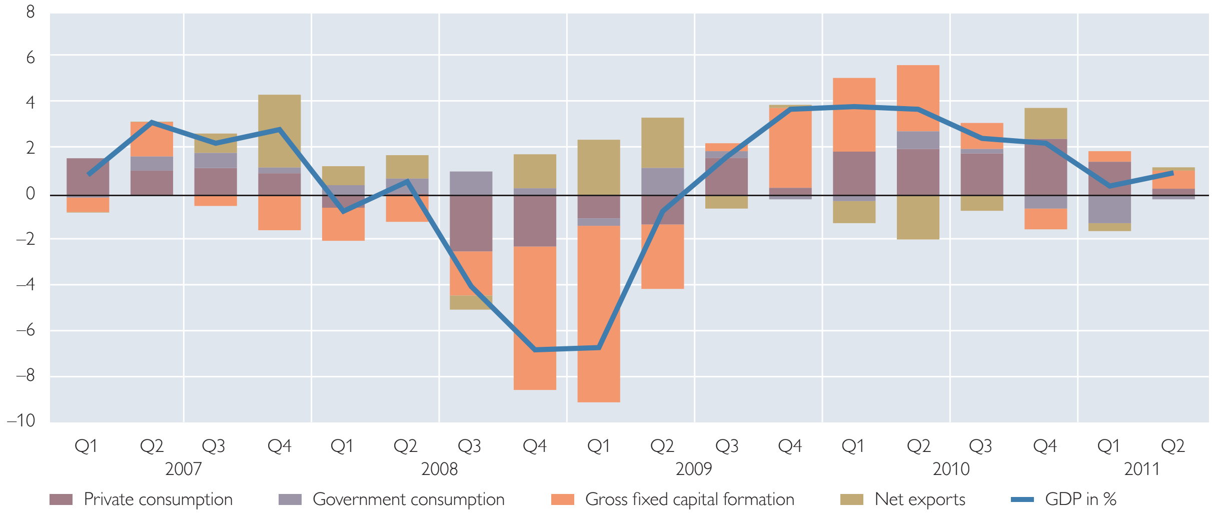
Chart 1

U.S.A.: Real GDP Growth

Contributions to GDP growth (quarter on quarter, seasonally adjusted, annualized) in percentage points



Source: Bureau of Economic Analysis.

nualized GDP growth at 0.4% in the first quarter of 2011 and at 1.3% in the second quarter, GDP growth has fallen short of expectations. Second-quarter growth was buoyed above all by investment. Consumer spending contributed considerably less to growth than in the first quarter, in particular on account of high energy prices.

Leading indicators signal that growth will remain tepid or weaken even further in the second half of 2011. For instance, the Industrial Purchasing Managers' Index has been just above the 50-point mark (below which a reading signals an oncoming contraction) since July. Over the summer, consumer confidence also slumped. Both indicators recovered slightly in September 2011. In light of these developments, the IMF in September 2011 sharply reduced its GDP growth forecast for the United States compared to June (2011: reduction by 1 percentage point to +1.5%, 2012: reduction by 0.9 percentage points to +1.8%.)

Anemic economic growth also weighs on the U.S. labor market. Since May 2011, the unemployment rate has hovered just above 9%; employment figures have remained unchanged. Conditions in the real estate market remain problematic. Real estate prices (measured using the S&P/Case-Shiller Home Price Index) were 4.1% lower than one year earlier in July 2011. Downside risks will remain in the next few months, above all as a consequence of the continued high numbers of foreclosures, restrictive mortgage loan qualification requirements, declining disposable incomes and higher saving ratios.

For the first time in U.S. history, Standard & Poor's (S&P) lowered the country's long-term sovereign credit rating one notch from AAA to AA+ on August 5, 2011, outlook negative. S&P justifies its rating by citing the high budget deficit, which is cause for concern, the insufficient planned savings measures, and the controversy over raising the statutory debt ceiling, which has eroded confidence and which indicates that the consolidation of public finances will remain a contentious process. In the days following the downgrading of U.S. sovereign debt, surprisingly, sales of U.S. Treasuries increased. This development may be linked to the growing uncertainty about other bond market segments or the portfolio shifts from stocks to bonds. Apparently, U.S. Treasuries are still considered a safe haven, especially considering that the two other big rating agencies, Moody's and Fitch, still rate the United States at AAA.

Inflation heated up to 3.8% in August 2011 on the back of higher energy prices. Since the beginning of 2011, core U.S. inflation has exhibited a rising trend. The most recent core inflation rate was measured at 2.0% (August). Nevertheless, the Federal Reserve System (Fed) left the Federal Funds Rate unchanged at 0% to 0.25% at its last meeting on September 21, 2011, the same level it has stood at for more than two-and-a-half years. To stimulate the economy, the U.S. central bank announced as early as in August 2011 that it would keep its key interest rate near zero through mid-2013, resorting to this unusual announcement to manage expectations after having largely exhausted monetary policy delivered through conventional channels.

At its meeting on September 20 and 21, 2011, the Fed decided to take another unconventional measure (dubbed "Operation Twist" after a similar measure taken in the early 1960s), namely to shuffle USD 400 billion of its portfolio from short-term bonds to long-term by July 2012 in an effort to keep long-term interest rates low. This measure is likely to be roughly as effective as the Fed's QE2 program to buy USD 600 billion in U.S. Treasury bonds, which ended June 30. Both measures – the long-term announcement of interest rate policy and Operation Twist – are controversial. In both cases, three of the ten voting members of the Federal Open Market Committee (FOMC) voted against the measure. No other decision had been received with as much dissent since 1992.

1.2 Japan Recovers from the Impact of the Earthquake

The devastating earthquake that hit Japan on March 11, 2011, and the consequential output disruptions tipped Japan into a recession in the first half of 2011. Annualized second-quarter real GDP sank by 2.1%. Investment in reconstruction and rising exports are likely to return Japanese GDP growth back into positive territory in the third quarter, though. The Tankan Index, a quarterly survey of business sentiment among large Japanese manufacturers, recovered to –9 points in the third quarter of 2011, thus returning to the first-quarter value after having dropped to –18 points in the second quarter. In its fall World Economic Outlook (WEO), the IMF sees Japanese whole-year GDP contracting by 0.5% in 2011. Conversely, in 2012, Japan's economy could expand by 2.3%. Japan's chance of recovery, however, hinges to a great extent on the development of exports. However, the renewed appreciation of the Japanese yen since the beginning of April 2011 in connection with the U.S. and euro area debt crises has put a damper on these growth expectations more recently. The higher yen represents a risk for Japan's export-oriented industry and thus for the entire recovery path after the recession triggered by the earthquake. The Bank of Japan (BoJ) reacted to the strong currency in August 2011 by intervening in the foreign exchange market. The BoJ's action weakened the Japanese yen only temporarily, however. The currency soon rebounded.

After Standard & Poor's had downgraded Japan's credit rating in January 2011, citing the country's high public debt (2010: 220% of GDP), Moody's followed in August, lowering its rating from Aa2 to Aa3. However, as some 95% of debt is held domestically and generally attracts very low yields, the immediate impact on refinancing costs is not very large.

At its last meeting, the BoJ left key interest rates at 0% to 0.1%. Core inflation (inflation excluding food and energy) ran to –0.5% in August 2011. The IMF expects rates of price increase to remain negative in 2012. Therefore, Japan will not reach its target of ending years of deflation anytime soon.

1.3 Chinese Growth Moderates at a High Level

The Chinese economy continues to grow at a brisk pace, with inflation remaining persistently high. Overall, China's real GDP surged by 9.7% year on year in the first quarter and by 9.5% in the second quarter of 2011. Industrial production soared by 13.5% on the previous month in August 2011. The newest UNCTAD (United Nations Conference on Trade and Development) data showed that in 2010, Chinese outward foreign direct investment (FDI) for the first time surpassed Japanese outward FDI. Chinese GDP, too, outpaced Japanese GDP in 2010. These figures underline the growing weight of the Chinese economy in the global economic system. But China's dynamic expansion does not come without problems. For example, inflation averaged 5.6% year on year from January through August 2011. In July, inflation peaked at 6.5% and eased marginally to 6.2% in August.

To bring inflation under control, the Chinese central bank has raised the minimum reserve ratio six times so far in 2011 and increased key interest rates three times in the same period. The risk of the Chinese economy overheating could diminish in the face of the rapid deterioration of the world economic outlook. For 2011, the IMF in its WEO forecasts Chinese growth of some 9.5%, followed by a dip to 9.0% in 2012. China's exchange rate system has come under pressure in the wake of the U.S. debt crisis and skittish financial markets. The Chinese government is considering a further easing of exchange rate policy.

2 Euro Area Growth Weakens

2.1 GDP Growth Slows Markedly in the Second Quarter of 2011

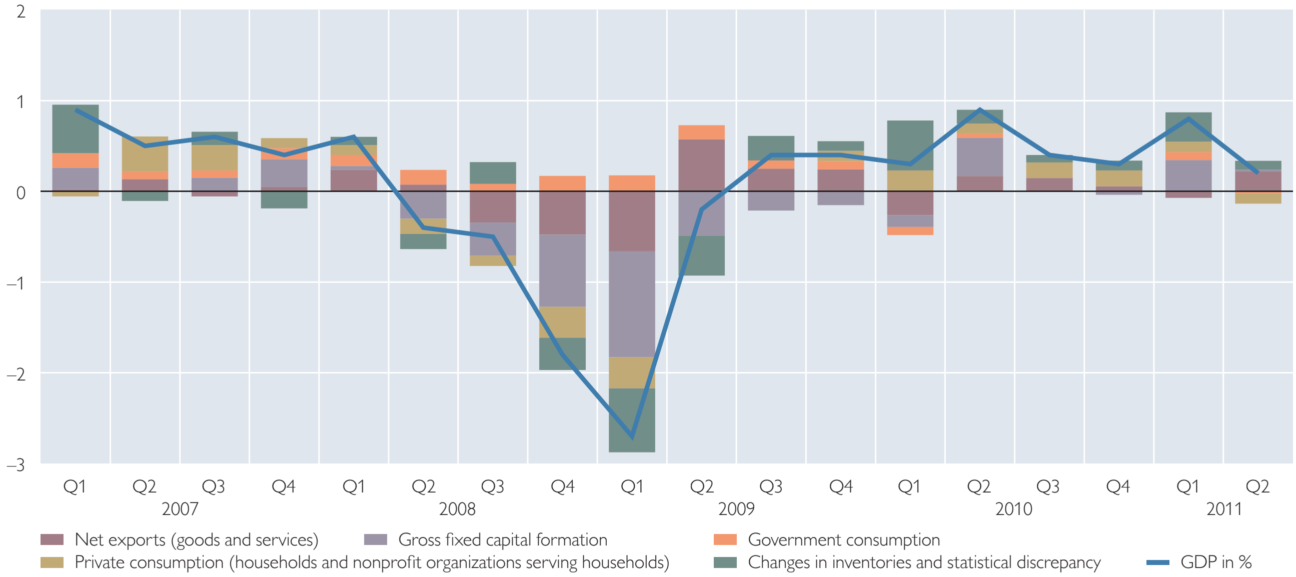
Euro area real GDP growth weakened markedly in the first half of 2011. After having expanded by 0.8% quarter on quarter in the first quarter of 2011, the euro area economy posted only 0.2% growth in the second quarter. Growth came to 1.6% compared to the second quarter of 2010. The slowdown had been expected, as performance in the first quarter was strongly influenced by catching-up effects after a harsh winter season. Consumer spending dropped compared to the previous quarter, a development foreshadowed by the decline in retail sales. The drop in spending can be traced on the one hand to required debt repayments by the households and the public sector as well as the contraction of real disposable incomes as a consequence of high commodity prices. On the other hand, uncertainty in connection with the debt crisis in some peripheral euro area countries may also have weighed on consumers' willingness to spend. Foreign trade made the biggest contribution to GDP growth.

The slump in economic growth in the second quarter of 2011 was most pronounced in Germany, where GDP growth tumbled from 1.3% in the first quarter to 0.1% in the second quarter. France posted zero growth in the second quarter following 0.9% in the first quarter of 2011. GDP hardly expanded in Italy or Spain, either. The euro area construction sector stagnated. Capacity

Chart 2

Euro Area: Components of Euro Area Real GDP Growth

Contributions to GDP growth (quarter on quarter, seasonally adjusted) in percentage points



Source: Eurostat.

utilization shrank in the third quarter of 2011 and, at 80.9%, has slipped below the long-term average again.

2.2 Forecasts See GDP Growth Losing Pace in 2011 and 2012

In the third quarter of 2011, the pace of growth is anticipated to remain weak. Leading indicators and sentiment indicators signal a slowdown in GDP growth as early as in the third quarter of 2011. The Purchasing Managers' Index, for example, fell to 49.0 points in August 2011, which is below the 50-point mark separating expansion and contraction. In September, it deteriorated further to 48.5 points. The European Commission's Economic Sentiment Indicator fell to the lowest level since end-2009. Important national indicators such as the German Ifo Business Climate Index or the ZEW Index have been declining sharply recently.

In its fall WEO, the IMF forecasts GDP growth of 1.6% in the euro area for 2011 as a whole, down by 0.4 percentage points from the spring WEO. For 2012, the IMF expects euro area output to grow by only 1.1%. At the same time, the downside risks of the GDP forecasts for the euro area have increased. Uncertainty about the highly indebted euro area countries' ability to repay their debts is a key drag on reestablishing consumer and investor confidence. At the same time, the further development of U.S. economic activity represents a risk factor for euro area growth.

2.3 Sluggish Labor Market Recovery

The seasonally adjusted unemployment rate has more or less persisted at 10.0% since December 2010, some 0.2 percentage points below the peak measured during the financial crisis. However, this figure masks a continuous improvement in the labor market, as the participation rate has risen. Moreover, the number of hours worked is returning to normal levels. During the recession, a reduction of working hours in individual cases prevented numerous layoffs. In the first half of 2011, the decline in construction employment was offset by job growth in the manufacturing and service sectors. Surveys indicated that employment growth should remain positive in the third quarter of 2011. A country-level comparison in the euro area shows that labor market developments are very heterogeneous across countries. Whereas the German unemployment rate has contracted by 1.9 percentage points from its high during the crisis to stand at 6.0% currently, joblessness is still on the rise in Spain and in Ireland, for example. Spain is faced with 21.2% unemployment, albeit with positive employment growth.

2.4 Important Decisions Taken to Ease the Debt Crisis in the Euro Area

Prior to summer 2011, it became apparent that the previously agreed bilateral financial support for Greece would not suffice to ensure the country's solvency in the short run. When the discussion about a possible restructuring of Greek debt came up, the risk premiums on Greek bonds climbed to record heights. The yield spread over German government bonds stood at 1,500 basis points in July 2011.

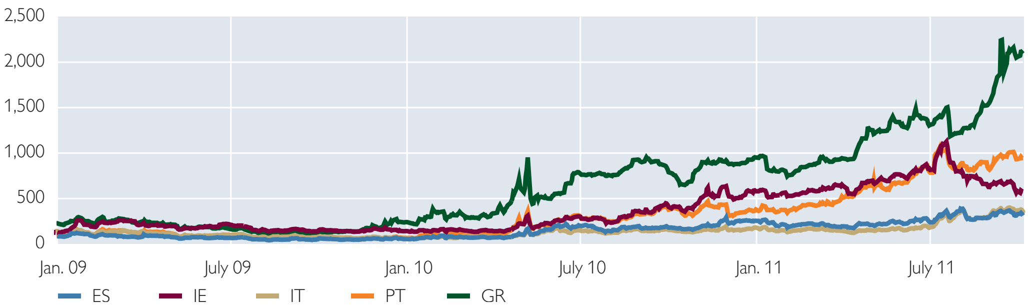
These dynamics spread to Ireland and Portugal, although unlike Greece, these countries have scored success in their efforts to achieve fiscal consolidation. The contagion also spread to Italy and Spain. Following the decisions of the European Council of July 21, 2011, encompassing among other things a new assistance program to support Greece that includes private sector involvement and measures to increase the effectiveness of the European Financial Stability Facility (EFSF), Greek, but also Portuguese and Irish, sovereign yield spreads over German government bonds shrank.

Yet the decisions did not succeed in fully calming financial markets. Massive sales of Spanish and Italian government bonds caused these securities' yields to increase sharply, bringing them to record levels at the beginning of August 2011. To calm the bond markets and to ensure the full effectiveness of monetary policy decisions, the ECB reactivated the Securities Markets Programme (SMP) in August and purchased sovereign debt of countries with high bond spreads in the secondary market. As a consequence, the yield spreads of Spanish and Italian government bonds over German bonds narrowed.

Chart 3

Yield Spreads on Ten-Year Government Bonds

Basis points, compared to German government bonds



Source: ECB.

Greece's insufficient progress toward fiscal consolidation brought renewed doubts about Greek solvency in September 2011, and yield spreads shot up to over 2,000 basis points. Greece will be unable to refinance itself via the financial markets in the next few months. Conversely, Ireland's fiscal consolidation progress appears to have convinced the financial markets, and yields on Irish sovereign debt eased noticeably. The introduction of a debt brake in several countries, notably Spain, has decisively contributed to preventing a pronounced debt accumulation during the crisis, e.g. in Switzerland, but also in Sweden.

According to the IMF, the euro area deficit ratio will average 4.1% in 2011, which is 1.9 percentage points below the 2010 value, and will contract to 3.1% in 2012. The debt ratio, however, will not top out until at least in 2012.

2.5 Inflation Declines as Commodity Prices Abate

Euro area HICP inflation came to 2.5% in July and August 2011. These relatively high rates of price increase had their origins above all in surging commodity prices. The commodity price index of the Hamburg Institute of International Economics (HWWI) peaked in April 2011 and has since fallen by 8%. Core inflation (excluding energy and unprocessed food) stood at 1.5% in July and August. The rise in the HICP inflation rate to 3.0% in September (flash estimate) is attributable to statistical effects, e.g. the change in the method for the calculation of seasonal products, and to the increase in the VAT rate in Italy from 20% to 21%.

For 2012, the IMF forecasts inflation to sink to 1.5%. The longer-term inflation expectations (for 2016) peg inflation at 1.9%, a level that is in line with price stability. However, medium-term inflation developments are subject to upside risks related to higher commodity prices and indirect tax increases that might be taken to implement fiscal consolidation measures and that have not yet been factored in.

2.6 Short-Term and Medium-Term Money Market Rates to Decline

At its meetings at the beginning of April and at the beginning of July 2011, the Governing Council of the ECB adopted a key interest rate increase of 25 basis points to counteract risks to price stability. Thus, the interest rate on the main refinancing operations has run to 1.5% since July 13, 2011. To meet banks' needs for more liquidity, the Governing Council of the ECB decided at the beginning of August to conduct a six-month longer-term refinancing operation. Moreover, the Governing Council of the ECB announced at the beginning of October 2011 that two longer-term tender operations, one with a maturity of 12 months, one with a maturity of 13 months, would be conducted at the beginning of October 2011. All tenders will be conducted with full allotment for as long as necessary. Like during the height of the economic and financial crisis, banks redeposited a growing share of the liquidity allotted at the ECB's deposit window. This behavior is a sign of increased distrust among banks and of the difficulties banks have experienced in interbank refinancing. At the beginning of October, the Governing Council of the ECB decided to launch a new Covered Bond Purchase Programme along the lines of the program conducted in 2008. Purchases will be for an intended amount of EUR 40 billion, will begin in November 2011, and are expected to be completed by the end of October 2012.

The Euro OverNight Index Average (EONIA) has been relatively stable at

1% since the end of July 2011. Markets expect a cut in key interest rates in the next few months and thus a drop in the EONIA to 0.5% until the beginning of 2012. In the course of the summer, expectations for short- and long-term money market rates subsided markedly.

3 Economic Developments in EU Member States in Central, Eastern and Southeastern Europe

3.1 Economic Recovery Loses Momentum

In recent months uncertainties about the economic prospects in EU Member States in Central, Eastern and Southeastern Europe (CESEE) heightened significantly. Whereas in the first quarter of 2011 economic growth still accelerated at an average quarterly rate of 0.9%, more and more signs pointing toward an economic slowdown have emerged since the early summer. For instance, several high frequency, leading and confidence indicators have deteriorated of late. This is particularly true of industry, where the annual production rate has halved since the start of 2011 and reached approximately 5% of late, and confidence ratings have declined markedly.

This development was also reflected in the figures for the second quarter of 2011. Economic activity slowed down in most countries. The seasonally adjusted growth rates (quarter on quarter) in Hungary, Slovenia, Romania and the Czech Republic came to a mere 0.0% to 0.2%. However, the region as a whole was still able to benefit from the continued robust growth in Poland (+1.1% against the same quarter of the previous year).

Although net exports' contributions to growth already went down as a result of weaker international demand in the second quarter of 2011, the economy is still being driven by the external sector and changes in inventories. Moreover, domestic demand has recently tended to pick up again. This is the case for Poland and the Baltic States, in particular, where private consumption as well as investments have boosted economic growth considerably. Of late, investment activity has slightly accelerated in the Czech Republic and Slovakia, too. This might mainly be attributable to the fact that a certain investment demand has built up because investment expenditure had been sinking for several quarters during the crisis. However, CESEE states with the weakest economic performance – i.e. Slovenia, Hungary, Romania and Bulgaria – report that domestic demand's contribution to growth is still consistently negative. In these countries hesitant lending, the necessity to further reduce household debt (and in the case of Slovenia, also corporate debt), the increased need to consolidate public finances and limp construction activity put brakes on economic growth.

Owing to the region's weak performance in the second quarter of 2011 and the negative data for Europe as a

Table 1

CESEE EU Member States: Economic Growth

	2009	2010	Q3 10	Q4 10	Q1 11	Q2 11
	Real GDP growth in % against the previous period, seasonally and working day-adjusted					
Bulgaria	–5.5	0.2	0.7	0.5	0.6	0.3
Estonia	–14.3	2.3	1.2	2.5	2.4	1.7
Latvia	–17.7	–0.3	1.1	0.8	1.1	2.0
Lithuania	–14.7	1.3	0.3	1.8	3.5	0.4
Poland	1.6	3.8	1.3	0.9	1.1	1.1
Romania	–7.1	–1.3	–0.2	0.4	0.5	0.2
Slovakia	–4.8	4.0	0.8	0.8	0.9	0.9
Slovenia	–8.0	1.4	0.3	0.5	0.1	0.1
Czech Republic	–4.1	2.3	0.8	0.5	0.9	0.1
Hungary	–6.7	1.2	0.8	0.2	0.3	0.0
CESEE total	**–3.4**	**2.1**	**0.7**	**0.6**	**0.9**	**0.6**
Euro area	**–4.3**	**1.8**	**0.4**	**0.3**	**0.8**	**0.2**

Source: Eurostat.

whole as well as for the global environment, activity forecasts have been deteriorating since early summer. It is true that the IMF currently expects economic activity in the region to accelerate from 2.2% in 2010 to approximately 3% in 2011, but as early as in 2012, it is assumed to lose momentum and to grow at a slightly reduced rate of 2.8%. Compared with the IMF forecast of April 2011 (when growth was still assumed to reach 3.5% in 2012), this represents a significant downward revision. In all CESEE countries but Estonia the economy is weakening. The balance of risks of this forecast is generally tilted to the downside; risks refer mainly to the uncertainties surrounding developments in the euro area.

3.2 Inflation Passed its Peak in Summer 2011

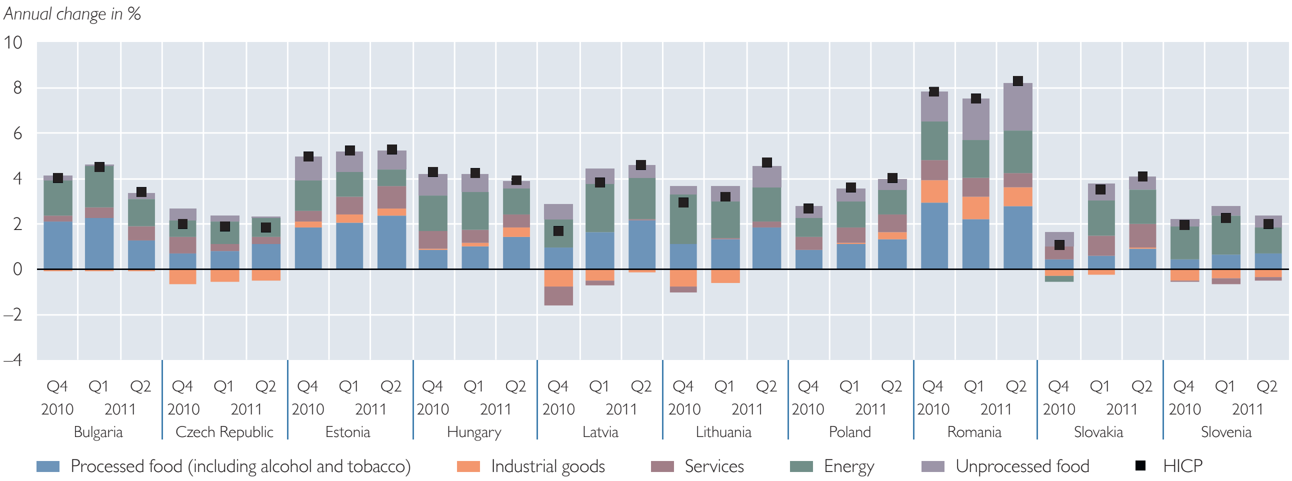
With the exception of the Czech Republic and Slovenia, price pressures in CESEE countries were comparatively strong in the first half of 2011 and sometimes even intensified later on. This development was first and foremost driven by price surges for food items as a result of bad harvests in 2010. Furthermore, high prices for energy and other commodities and not least tax increases also pushed up inflation in a number of countries. The latter effect was particularly marked in Poland, Slovakia and Latvia, where VAT rates were all raised in early 2011.

Several central banks in the region have reacted to mounting inflationary pressure by increasing interest rates. For example, Magyar Nemzeti Bank (MNB) raised its policy rate by 25 basis points to 6% in January 2011. Narodowy Bank Polsky (NBP) increased its key policy rate in January, April, May and June 2011 in four steps of 25 basis points each to 4.5% most recently. Of the countries under review, Slovenia, Slovakia and Estonia are members of the Euro area for which the ECB raised key interest rates in April and July, respectively.

Price pressures were strongest in the summer of 2011. Since then, inflation has abated in most countries. On the one hand, this development owes to base effects (for instance in connection with the increase of VAT rates in Roma-

Chart 4

CESEE EU Member States: Inflation Developments



Source: Eurostat.

nia in July 2010). On the other hand, this year's harvests had a dampening effect on prices for food items. Combined with relatively moderate core inflation rates, only gradual improvements in the labor market and below-average capacity utilization ratios, these factors should contribute to running down inflation in 2012, too. Recent forecasts for 2012 predict prices to rise by about 3% at a regional average, compared with about 4% for 2011 as a whole.

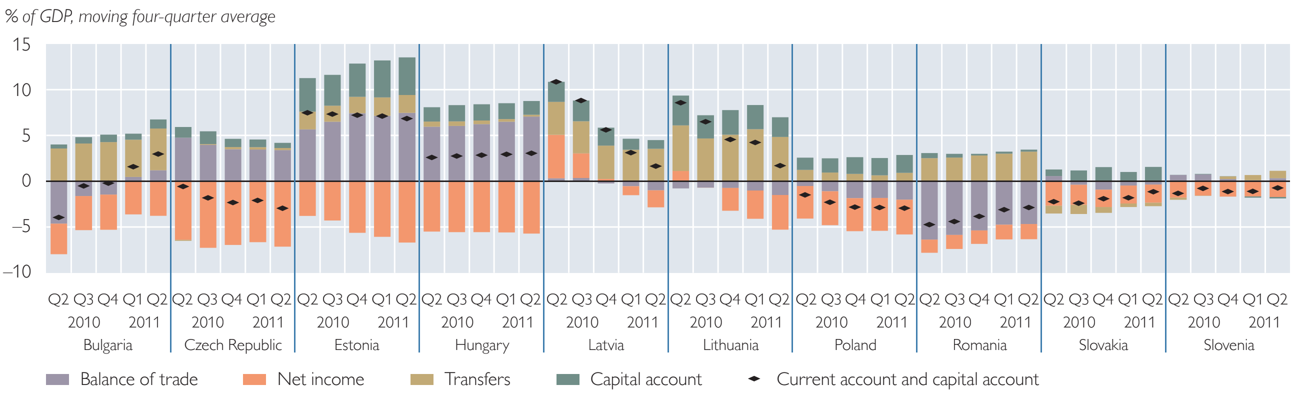
3.3 Current Account Adjustment Phase Over in Many Countries

In all CESEE EU Member States, the crisis prompted a (sometimes significant) improvement in the external position. This uniform trend has given way to a larger heterogeneity as regards current account developments in the past few months. While countries like Bulgaria and Romania – who exhibit a somewhat slower economic growth – lack domestic demand and are therefore still able to benefit from improving current account balances, countries with stronger economic growth (Poland, the Baltic states) as well as the Czech Republic have registered deteriorating current account balances in the past quarters. In addition to a pick-up in domestic demand, this can mainly be attributed to a rising income gap. In the wake of economic recovery, foreign-owned companies are back in the profit zone and re-transfer part of their profits to their parent companies. Thus the crisis-induced cyclical component of current account adjustment is slowly losing significance. However, part of the post-crisis currency adjustment was of a structural nature and should therefore have a longer-lasting effect. For instance, unit labor costs in the Baltic states have improved considerably against the euro area since mid-2009, which is why recent forecasts predict that in 2012 the average current account deficit in the region will still be 2% lower than pre-crisis GDP and will stabilize at around 3% of GDP.

On the payments side, portfolio investments (Poland, Slovenia) and foreign direct investments (Bulgaria, Czech Republic, Baltic states, Romania) are the key components. In times of heightened financial market volatility, the latter are of particular importance. While direct investments followed an upward trend in many countries in recent quar-

Chart 5

CESEE EU Member States: Current Account Developments



Source: National central banks.

ters, it is still too early to speak of a broad-based recovery taking place in the region. With the exception of Estonia (which seems to have benefited from the introduction of the euro in this respect), inflows of foreign direct investments into all CESEE countries are (sometimes significantly) lower than the average of the precrisis years. What is more, FDI inflows into several countries have either not yet managed to improve substantially from their lows (e.g. in Slovakia and Romania) or are still decreasing (e.g. in Poland and Bulgaria). This might owe to other emerging markets' having posted stronger growth rates in recent quarters and enjoying a better economic outlook in the medium run.

3.4 CESEE Countries Not Untouched by the Turmoil in International Markets

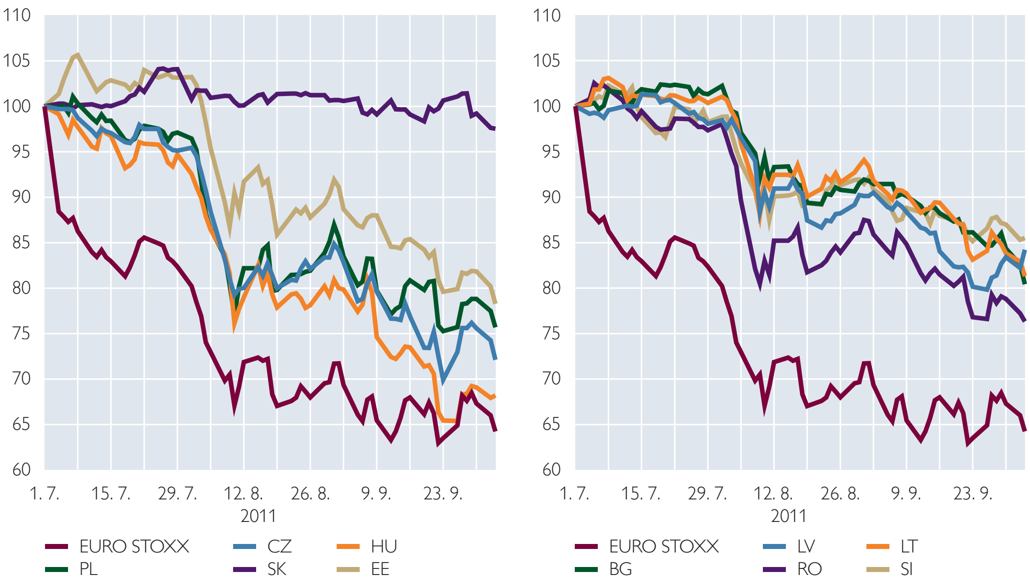
Stock markets in CESEE countries were severely hit by sell-offs in the past few weeks. Compared with prices at the beginning of July, losses of up to 25% (Hungary, Poland) were registered up to the first peak on August 10, 2011. Stock markets in the Baltic countries and in Slovenia fared slightly better (losses of about 10%). Only Slovakia was not substantially affected by the recent turmoil. Since then, some countries have suffered losses, some of them (e.g. Hungary) even substantial ones.

At present, stock market prices have reached the level of May/June 2010, when tensions were high owing to the Greek debt crisis. From a longer-term perspective, today only the indices in Estonia and Poland have regained the level they stood at prior to the bankruptcy of Lehman Brothers. In all other CESEE states stock markets were not yet able to recover from the severe losses they suffered in autumn/winter 2008, and until to date prices are still up to 60% below their level

Chart 6

CESEE EU Member States: Stock Price Developments

Index: July 1, 2011 = 100



Source: Thomson Reuters.

of September 2008 (for instance in Bulgaria and Slovenia). In spite of these substantial price decreases, CESEE countries were slightly less affected by the current turbulences than countries in Western Europe. For example, the Dow Jones EURO STOXX lost 35% of its value against the beginning of July.

The current tensions in the financial markets and slightly gloomier economic prospects in CESEE countries have not yet influenced rating agencies' assessments for the region. On the contrary, ratings (Long-Term Foreign-Currency Sovereign Debt Ratings) for Bulgaria, Romania, Estonia and the Czech Republic were raised in July and August, 2011, respectively. From May to August 2011 the sovereign ratings for Hungary, Latvia, Lithuania and Slovakia improved.[2] Only the rating for Slovenia was downgraded in September 2011.

4 Austria: Marked Economic Slowdown in Mid-2011

4.1 First Full Release of National Accounts Data for the Second Quarter of 2011

The Austrian economy grew at a quarterly rate of 0.7% (in real terms, seasonally and working day-adjusted) in the second quarter of 2011 according to the first release of national accounts data for that period. At this rate, the Austrian economy significantly outperformed the euro area (+0.2%) and its most important trading partner, Germany (+0.1%).

Following changes in the methodological framework underlying the national accounts system, current national accounts data now exhibit a visibly higher degree of volatility than in the past, which complicates analysis. Unlike the flash estimate of GDP growth, the national accounts data on the demand components of GDP show exports to

Table 2

Real GDP and Demand Components
(in real terms; seasonally and working day-adjusted)

	GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports	Total domestic demand (excluding inventories)	Net exports	Inventories	Statistical discrepancy
	Change on previous period in %						*Contribution to GDP growth in percentage points*			
Q1 10	–0.9	2.0	0.5	0.0	0.4	0.8	1.2	–0.2	–1.6	–0.3
Q2 10	1.4	–0.8	–0.5	0.6	5.6	5.1	–0.4	0.6	1.3	–0.1
Q3 10	1.4	1.7	–0.1	2.1	2.1	3.2	1.3	–0.4	0.4	0.1
Q4 10	0.6	–0.4	–0.2	1.8	0.7	–0.3	0.1	0.6	0.4	–0.4
Q1 11	0.8	–0.4	0.6	1.3	3.1	3.6	0.2	–0.0	–0.5	1.2
Q2 11	**0.7**	**0.4**	**0.8**	**0.9**	**0.1**	**0.3**	**0.5**	**–0.1**	**1.0**	**–0.8**
2008	1.4	0.8	4.4	0.6	1.3	0.0	1.4	0.8	–0.5	–0.3
2009	–3.8	–0.2	0.4	–8.3	–14.3	–13.9	–1.8	–1.2	–0.9	0.1
2010	2.3	2.2	–0.2	0.1	8.3	8.0	1.2	0.7	0.5	–0.1

Source: WIFO, OeNB.

[2] *Hungary was upgraded (by Fitch) in June 2011. Recent developments – such as the weak economic performance in the second quarter, a higher than expected budget deficit and the announcement of controversial steps in favor of a government-backed redemption of loans in foreign currency by private households (to the detriment of banks doing business in Hungary) – have not yet been taken into consideration.*

have ceased to be the key engine of growth in the second quarter of 2011. Exports in fact virtually stagnated as a result of the global slowdown in growth. Investment, in contrast, remained strong, even though growth slowed down somewhat. The growth of private consumption turned positive again, after two quarters in negative territory. Given the volatile pattern of individual demand components and the high statistical discrepancy, the individual quarterly measures need, however, be interpreted with caution.

4.2 Austria's Economy Stagnates in Second Half of 2011

The Austrian economy kept growing at a strong pace until mid-2011 but is expected to stagnate in the second half of the year. The OeNB's latest economic indicator, released in October 2011, shows quarterly real GDP growth at 0.1% in the third quarter and at 0.0% in the fourth quarter of 2011 (seasonally and working day-adjusted). The reasons for the anticipated growth slowdown include the global economic downturn, the weakness of the domestic economy, the waning impetus of cyclical pillars of growth and a loss of confidence on account of the unresolved debt crisis.

Uncertainty about the future development of the global economy has undermined the confidence of both consumers and businesses. Bank Austria's Purchasing Managers' Index, for instance, signals a stagnation of industrial activity in Austria from mid-2011 onward. In the same vein, Austrian businesses now consider the intake of both domestic and cross-border orders to be significantly slower than just recently; the latest figures are below the long-term averages.

Exports have already been hit by the economic slowdown. Following disproportionately high nominal growth of goods exports in the first quarter of 2011 (+5.0% seasonally adjusted, against the previous quarter), growth decelerated visibly in the second quarter, to just 1.1%. Measured against the second quarter of 2010, growth continued to be strong, however, at +12.0% (after +23.7% in the first quarter). The results of the OeNB's export indicator released in October 2011 suggest that in August goods exports were 0.6% lower in nominal terms than in May, but that they rebounded in September, being 3.4% higher again than in June. Quarterly export growth thus rose slightly, by 0.8%, in the period from July to September. Annual export growth, as evidenced by the the export indicator, was below the long-term precrisis average of approximately 8% in September 2011. Whereas the individual monthly indicators are subject to a relatively high degree of uncertainty on account of sizable working-day effects, the general downward trend to which they are pointing is in fact a very stable result.

Furthermore, the growth outlook has also deteriorated significantly for domestic demand. Investment would have had to accelerate at a much stronger pace during the economic upturn in order to support economic growth on a sustained basis, given the sharp contraction during the financial and economic crisis. The low level of gross fixed capital formation implies that the bulk of recent investment was aimed at retaining existing production capacity rather than expanding production capacity. Weaker external conditions and the high degree of debt crisis-related uncertainty in the corporate sector cause businesses to postpone investments further. This means that the momentum created by the two key engines of growth of the past few months – strong industrial activity and robust exports – is going to be significantly lower than in the past, whereas the outlook bodes well for a higher contribution to growth from building construction.

In addition, another important cyclical pillar of growth is going to disappear, as the exceptionally strong inventory cycle will bottom out in the second half of 2011. The fact that the ratio of new order assessments and inventories has now been below the critical measure of 1 for four months in a row is a sign that restocking should be complete in the second half of 2011. Likewise, any growth impetus created by private consumption is going to be limited in the months ahead. Despite favorable developments in the labor market – close to 3.5 million dependently employed persons are a new employment record for September – real disposable household income is going to rise only slightly. The necessary budgetary consolidation measures and the dynamics of inflation, which is still at an elevated level, leave little room for additional spending.

This notwithstanding, real GDP growth for 2011 as a whole will reach 2.9% owing to vigorous activity at the start of the year. At the same time, growth expectations for 2012 had to be revised downward significantly. Most recently the Austrian Institute of Economic Research (WIFO) and the Institute of Advanced Studies (IHS) have revised downward their forecasts for 2012 to 0.8% and 1.3%, respectively. Moreover, the risks to the growth forecasts continue to be overwhelmingly on the downside. Apart from global imbalances, these risks include the weakness of the U.S. economy and the unre-

Box 1

Results of the OeNB Economic Indicator of October 2011[1]

Following disproportionately strong growth in the first half of 2011, the Austrian economy stands to lose considerable momentum from the second half onward. The OeNB's latest short-term indicator results show quarterly real GDP growth at 0.1% in the third quarter and at 0.0% in the fourth quarter of 2011 (seasonally and working day-adjusted). Hence, the annual growth rates against the corresponding periods of 2010 are expected to lie at 2.2% in the third quarter and at 1.6% in the fourth quarter of 2011. For 2011 as a whole, GDP growth is still expected to average 2.9% given the strong start into the year.

Short-Term Outlook for Austria's Real GDP for the Third and Fourth Quarters of 2011 (seasonally and working day-adjusted)

	2009				2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Year-on-year quarterly change in %	–5.0	–5.6	–3.9	–0.7	0.4	2.8	3.6	2.5	4.3	3.5	**2.2**	**1.6**
Quarterly change in %	–1.9	–0.9	0.6	1.6	–0.9	1.4	1.4	0.6	0.8	0.7	**0.1**	**0.0**
Annual change in %	**–3.8**				**2.3**				**2.9**			

Source: Results of the OeNB's Economic Indicator of October 2011, Eurostat.

[1] *The next release of the OeNB's short-term indicator is scheduled for January 2012.*

solved debt crises of several European countries.

4.3 Labor Market Growth Peaks in the Second Quarter of 2011

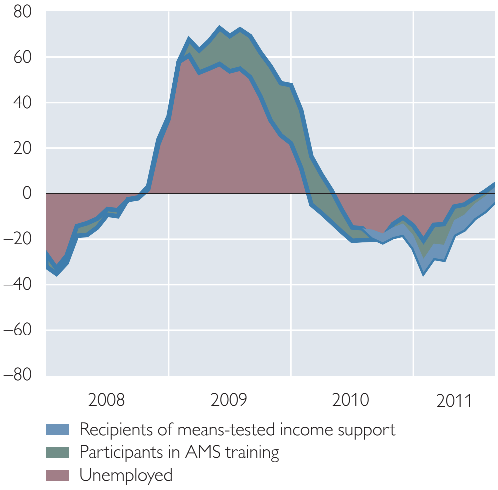
Austria's labor market still looks in excellent health thanks to the booming economy in recent quarters. Employment has grown dynamically: Payroll employment statistics showed an increase by more than 60,000 persons in September 2011 over the same month of 2010. Most of this growth was, however, achieved in the earlier quarters of the current year, as job growth has gradually lost momentum in recent months. Judging from the number of job vacancies, which has been contracting slightly since April, labor market growth may have peaked in the second quarter of 2011. Likewise, the number of temporary workers registered as unemployed, which anticipates general labor market developments by roughly one quarter, has been going up again since the beginning of the second quarter; this trend is likely to strengthen as the economy slows down in the months ahead.

Annual unemployment growth was back on the rise by a small margin, at a first glance, for the first time again in August 2011. In September 2011, the number of people registered as unemployed was also higher than a year earlier. However, this increase (+4,000 unemployed in September) masks an upward bias driven by two factors. First, persons participating in training events organized by the Austrian Public Employment Service (AMS) do not qualify as unemployed by definition. Given that in September 2011 the number of persons enrolled in AMS courses was lower by 7,500 than in September 2010, the unemployment count in fact decreased by 3,500 persons in that month when adjusted for AMS training participants. Second, the unemployment statistics include all those recipients of means-tested income support – which replaced the former social assistance scheme in September 2010 – who are found to be able to work. This fact might have driven up the unemployment count of September 2011 – by as many as 6,400 persons at the utmost; the exact figure cannot be established as it is not known how many of those persons were registered as unemployed with the AMS before the regime change. Taking into account those two factors, unemployment in fact went down in September 2011 (the maximum number by which it may have gone down would be 9,900 persons).

Chart 7

Unemployed Persons, Participants in AMS Training and Recipients of Means-Tested Income Support

Annual change in 1,000



Source: Austrian Public Employment Service (AMS).

4.4 Inflation in Austria Still Significantly Above Euro Area Average

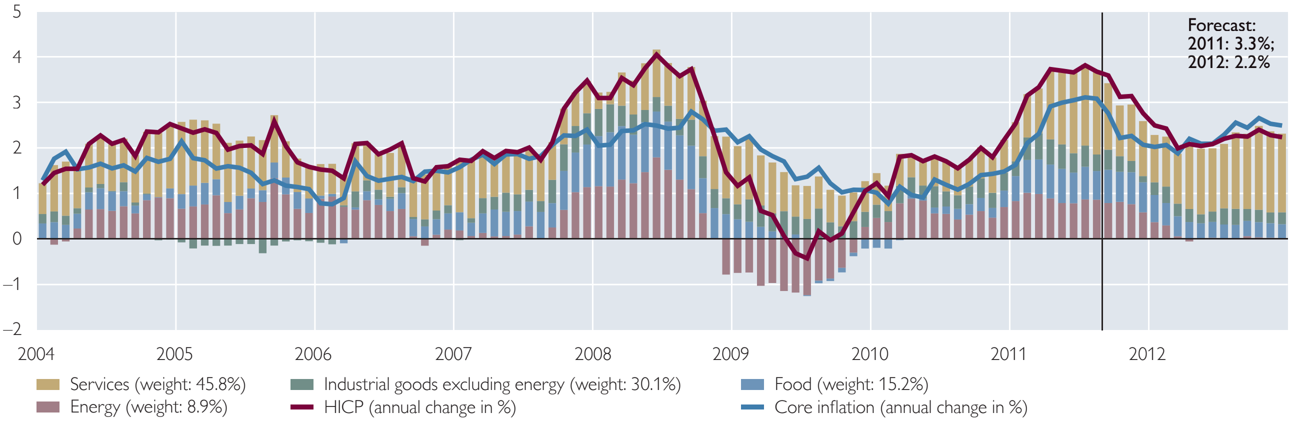
HICP inflation remained at high levels during the summer months and reached 3.7% in August, slightly down from 3.8% in July. The major drivers of inflation in August, as in 2011 so far, were the sharp rise in the prices for fuels, other sources of energy, and food. These three product groups accounted for two-fifths of the inflation rate. Moreover, travel and accommodation also created above-average inflationary pressures, whereas housing rental prices rose in line with headline inflation. Core inflation (HICP excluding energy and unprocessed food) meanwhile remained at 3.1% in August, the same as in July 2011. The OeNB now expects inflation to reach 3.3% in 2011 and 2.2% in 2012. On current expectations, the Austrian inflation rate should go down continually in the remaining months of 2011 and in early 2012 (see chart 8). Within the euro area, only Estonia and Slovakia reported higher inflation rates than Austria in August 2011; in Luxembourg, Finland and Belgium inflation was as high or almost as high as in Austria. The euro area countries with the lowest inflation rates were Ireland, Slovenia and Greece. On balance, inflation averaged 2.5% in the euro area and 2.9% across all EU countries.

Chart 8

HICP Inflation and Contributions by Subcomponents

Annual change in percentage points for contributions to inflation

Last observation: August 2011



Source: OeNB, Statistics Austria.