

# The Economy has Bottomed Out

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While Japan's economy is showing the first signs of a hesitant recovery, the upturn already gained a foothold in the U.S. economy in the second half of 2011 on the back of robust domestic demand. Conditions in the labor market relaxed perceptibly, while the real estate market is still waiting for a rebound. The U.S. Federal Reserve System and the Bank of Japan changed their respective monetary policies at the beginning of 2012 to communicate their inflation goal clearly. At the same time, both central banks decided to keep their key interest rates at a historically low level for the time being. By contrast, China's economy has lost momentum, prompting the Chinese central bank to start easing monetary policy.

After the euro area economy had started to revive in the first half of 2011, conditions clouded over from mid-2011. In the fourth quarter of 2011, real GDP weakened by 0.3% against the previous quarter. With the consolidation measures required in all sectors dampening economic activity, net exports remained the only stable support for growth. In the first quarter of 2012, GDP is anticipated to decline marginally as well, but leading indicators signal that it will recover thereafter. Ongoing tensions in the bond markets that progressively spread to other financial market segments called for new monetary policy measures – the reduction of interest rates, the provision of additional long-term liquidity and the relaxation of the eligibility criteria for collateral. These measures along with the EU and international rescue packages as well as EU economic governance reforms eased tensions in the financial markets at the beginning of 2012 and restored confidence.

Economic conditions deteriorated noticeably in the Central, Eastern and Southeastern European (CESEE) EU Member States until the turn of the year 2011 to 2012. In the fourth quarter of 2011, average growth in the region flagged markedly; many countries reported contracting growth. In recent months, signs of a trend reversal in the first quarter of 2012 have been mounting. However, if the rally continues beyond the first quarter of 2012, it will be very small.

In 2011, the Austrian economy expanded by a stronger than expected +3.0%, but successively lost momentum in the course of the year. GDP growth, still above average in the first half of 2011, contracted slightly in the fourth quarter. Quite likely, the economy has already bottomed out. The OeNB's Economic Indicator signals a stabilization of Austria's economy for the first half of 2012. Despite the high employment growth recorded in 2011, which lasted into the beginning of 2012, unemployment rose somewhat. After peaking in fall 2011, inflation is currently subsiding notably.

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## 1 Recovery in the U.S.A.; China, the Motor of Global Growth, Is Losing Steam

### 1.1 U.S. Economy Posts Clear Signs of a Comeback

At the end of 2011, the U.S. economy exhibited clear signs of revival. Real GDP expanded by 3.0% annualized in the fourth quarter of 2011. Domestic demand – above all gross fixed capital formation and consumer spending –

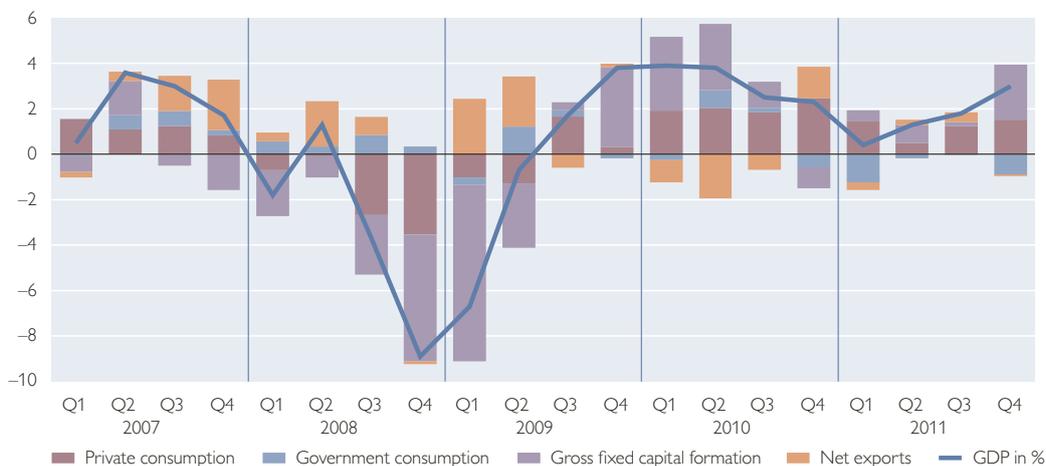
powered domestic demand, while public spending made a negative contribution to growth. A marginally negative contribution came from net exports as well. The recovery of the labor market continued: At the beginning of 2012, the unemployment rate came to 8.3%, the lowest value since spring 2009. Conversely, the recovery of the real estate market is still languishing. At the end of 2011, real estate prices as mea-

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### U.S.A.: Components of Real GDP Growth

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



Source: Bureau of Economic Analysis.

sured by the Case Shiller house price index were still 4% lower than one year earlier and were still receding.

Leading indicators point to a continuation of the upswing. The IMF is forecasting 1.8% growth for 2012 and an acceleration of the expansion to 2.2% in 2013. While domestic demand is expected to firm, global foreign demand will be sluggish. The future direction of fiscal policy remains a factor of uncertainty: The U.S. budget deficit will be close to 10% again in 2012, and government debt could burgeon to nearly 110% of GDP in 2013.

The strong reduction of unemployment could soon feed into higher inflationary pressure; at the current juncture, it has checked the downtrend in overall inflation. In its decisions and communications, the Federal Reserve System (Fed) will put greater emphasis on the development of inflation. For the first time in the existence of the Federal Open Market Committee (FOMC), this body at the end of January 2012 defined an official inflation target of 2% as measured by the annual change in the price index for personal

consumption expenditures, which is a goal that is in keeping with the targets of other central banks across the world. In January 2012, the rise in the price index for personal consumption expenditures in the U.S.A. came to 2.4%. Unlike for central banks pursuing a classical inflation targeting policy, the legislator prescribes that the Fed pursue not just price stability, but also maximum employment and moderate long-term interest rates. The Fed has announced that it would follow a balanced approach in promoting the objectives in case they are not complementary.

In addition to setting an explicit inflation target, the Fed took an additional step in January 2012 to increase transparency, namely by announcing that it would regularly publish the individual FOMC participants' detailed projections of the expected path for the target federal funds rate. The detailed projections for January 2012 showed that FOMC members' expectations diverged strongly and that the majority of participants expected interest rates to remain low at least until 2014. Based

on the information available, the FOMC decided to keep the target range for the federal funds rate at 0% to 0.25%.

### **1.2 Short-Lived Recovery in Japan after the Devastating Earthquake**

The severe earthquake that hit Japan in March 2011 induced a pronounced contraction of growth and led to a disruption of global value-added chains. In the third quarter of 2011, however, the reconstruction activities and the normalization of exports had a positive impact on growth, as expected. GDP widened by 1.7% on a quarterly annualized basis, buoyed nearly equally by domestic demand and net exports.

But this increase proved to be short-lived. Toward the end of 2011, the deteriorating global economy and the strength of the Japanese yen had a dampening effect on export demand. In the course of 2011, the Japanese yen firmed by 6% against the U.S. dollar and by 8% against the euro. Japan was also affected by the Thai flood crisis, which disrupted value-added chains once again. In the fourth quarter of 2011, real GDP shrank by 0.2%; the only negative growth contribution came from net exports. In 2011 as a whole, Japanese growth dropped by 0.7%. At the beginning of 2012, things began to pick up, with industrial output and consumer as well as business confidence rallying. The IMF anticipates 1.7% growth for the Japanese economy in 2012, and roughly the same pace of growth for 2013.

In mid-February 2012, the Bank of Japan (BoJ) decided to expand its Asset Purchase Program by JPY 10,000 billion to JPY 65,000 billion to stimulate the economy and to weaken the Japanese yen; it was successful on both counts. At the same time, only three weeks after the Fed had made public its new

communication strategy, the BoJ announced an explicit inflation target of 1% as its price stability goal. In January 2012, overall inflation was just barely positive at 0.1%, whereas core inflation was clearly negative at -0.9%. Given the development of exchange rates and the oil price, deflationary tendencies are not likely to last. The BoJ's target for the key interest rate has remained unchanged at 0% to 0.1% since the end of 2010.

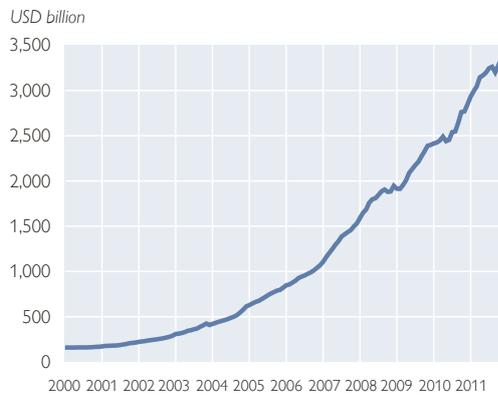
### **1.3 Chinese Economy Cools Markedly**

The pace of Chinese economic growth has eased considerably. The annualized growth rate of real GDP stood at 8.9% in the fourth quarter of 2011. For 2012, the IMF forecasts economic growth in China to abate to 8.2% in view of the weakening of global growth. The Chinese economy had performed more powerfully even during the crisis year 2009. In the meantime, the Chinese government has lowered its growth target for 2012 to 7.5%. High commodity prices, above all, are depressing economic activity. With imports augmenting at a rapid pace and export demand flagging at the same time, the trade balance switched into deficit. As the economy has slowed, inflation has subsided quickly as well. Having topped out at 6½% in mid-2011, inflation lessened to just over 4% at the end of 2011. The acceleration to 4.5% in January 2012 is primarily attributable to the scheduling of the Chinese New Year festivities in 2012, which traditionally drive up food prices.

To address flagging growth, in February 2012 the government announced the establishment of a fund to support small and medium-sized enterprises; moreover, tax relief measures were passed. At the beginning of December 2011, the Chinese central bank started

Chart 2

**China: Reserve Assets excluding Gold**



Source: Thomson Reuters, national source.

to loosen monetary policy, lowering the minimum reserve rate by 1 percentage point (to 20.5%). The interest rates have remained unchanged for the time being, but additional expansionary monetary policy measures are expected for 2012. In the fourth quarter of 2011, China's foreign currency reserves decreased (in U.S. dollar terms) for the first time since the 1998 Asian financial crisis. The main reason for this development is the decline in

the value of euro-denominated assets following the depreciation of the euro. The level of currency assets, however, also mirrors the flows of goods, services and capital between China and the rest of the world. Both China's current account surplus and net direct investment diminished substantially. The decline reflects the risk-averse behavior of international investors and the deterioration of China's fundamentals, but also China's opening up to international investment opportunities.

**2 Financial Market Tensions and the Weak Euro Area Economy Call for New Monetary Policy Measures**

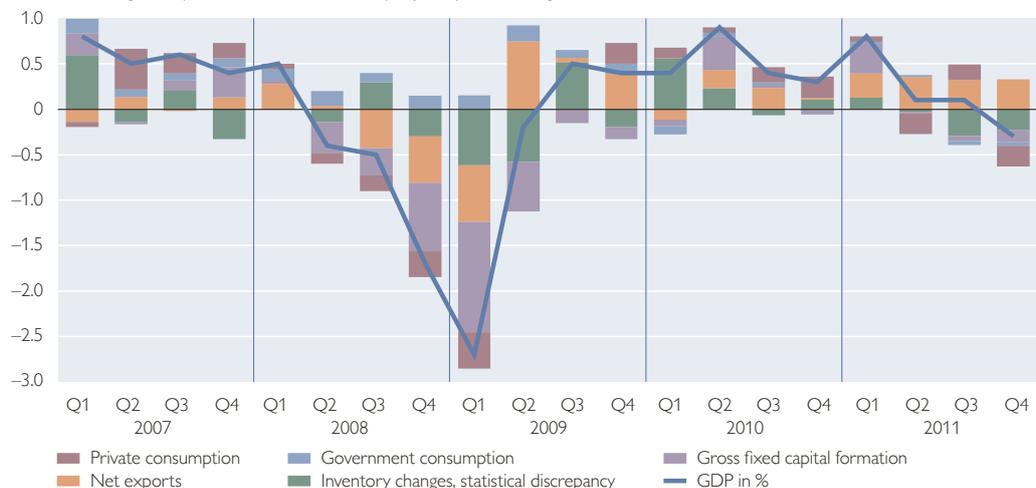
**2.1 First Signs of Recovery after Negative Economic Growth in the Fourth Quarter of 2011**

In the fourth quarter of 2011, euro area GDP contracted quarter on quarter for the first time in 2½ years, sinking by 0.3%. Domestic demand put a brake on growth. The austerity measures passed in many euro area countries reduced the contribution of public consumption

Chart 3

**Euro Area: Components of Euro Area Real GDP Growth**

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



Source: Eurostat.

to growth to virtually zero; consumer spending also declined more and more. The deterioration of the labor market situation, rising prices and fiscal consolidation measures burdened disposable incomes and dampened the propensity to consume. Declining business confidence and more unfavorable financing conditions quelled investment, which no longer made a positive contribution to growth from the second quarter of 2011. Construction output shrank by 1.8% in the fourth quarter. Inventories were drawn down in the second half of 2011, and capacities were cut. Net exports remained the only robust support of economic activity.

But these euro area-wide figures mask significant differences across countries and industries. Some countries, for instance, succeeded in still posting markedly positive overall growth rates in the second half of 2011 (Austria, Finland, France and Germany). By contrast, real GDP started to contract quarter on quarter as early as the third quarter of 2011 in Ireland, Italy, the Netherlands and Portugal.

The unemployment rate in the euro area rose continuously, starting from 9.9% in April 2011 to reach 10.7% in January 2012. In the fourth quarter of 2011, employment diminished once again against the previous quarter. A strong divergence of unemployment rates was observable in the euro area: The jobless rate is at a 20-year low in Germany, whereas it rose steeply in Greece, Italy, Portugal and Spain.

## 2.2 The Economy Appears to Have Bottomed Out

Leading indicators signal that the economic cycle has bottomed out. Around the turn of the year 2012, national indicators had already pointed to an upturn in Germany; the positive signals are currently becoming stronger and more

broadly based. The European Commission's Economic Sentiment Indicator rose for the second month in a row in February 2012. At 94.4 points, it is still substantially below its long-term average of 100 points, but the subindex on industrial confidence, which accounts for 40% of the composite index, has already surpassed its long-term average. Confidence in construction improved greatly, but consumer confidence remained weak, as did consumers' willingness to make major purchases of durable consumer goods. This indicator has also been rising since the beginning of 2012.

Despite these encouraging signs, real GDP is expected to contract somewhat again in the second quarter of 2012. Technically speaking – assuming two successive quarters of negative growth – the euro area is thus in recession again, but the recession should be short and shallow. By the second half of 2012, growth rates should have turned positive again.

In its projections of March 2012, the ECB anticipates real GDP growth to come to between –0.5% and 0.3% in 2012 and to quicken to 0.0% to 2.2% in 2013. Very low short-term interest rates and a slight easing of financial market tensions will support the euro area economy. Financial market developments and the world economic environment represent downside risks to these forecasts. The European Commission tends toward greater caution in its forecast for 2012 (–0.3%). GDP is anticipated to contract most sharply in Greece (–4.4%), Italy (–1.3%), Portugal (–3.3%), Spain (–1.0%) as well as the Netherlands (–0.9%). For Portugal, it will be the second year of recession, and Greece is entering its fifth year. What is more, domestic demand is not expected to make a positive contribution to growth in the next quar-

ters precisely in the countries experiencing the greatest sovereign debt problems.

### 2.3 Inflation Will Remain Elevated

While external price pressure caused by higher energy and food commodity prices had predominated in the first half of 2011, in the second half the increase in indirect taxes and administrative prices under the consolidation packages fueled inflation additionally. In whole-year 2011, inflation at constant tax rates came to 0.3 percentage points less in the euro area than the actually measured HICP rate (2.7%). Whereas the price pressure in the earlier stages of the value-added production chain slowly ebbed in the course of 2011, the prices of consumer goods remained elevated. From September through November 2011, overall inflation peaked at 3.0%; in February 2012, the rate of price increase came to 2.7%. Core inflation (excluding energy and

unprocessed food) stood at 1.9% in January 2012.

The ECB staff projections of March 2012 expect an HICP increase of between 2.1% and 2.7% for 2012 as a whole. The rate of inflation is driven chiefly by energy prices and renewed boosts of indirect taxes. Inflation is not expected to subside to below 2% until the beginning of the year 2013. The medium-term outlook for inflation is favorable, given expectations of dampened growth, the recent recovery of the exchange rate of the euro to the U.S. dollar and stable inflation expectations.

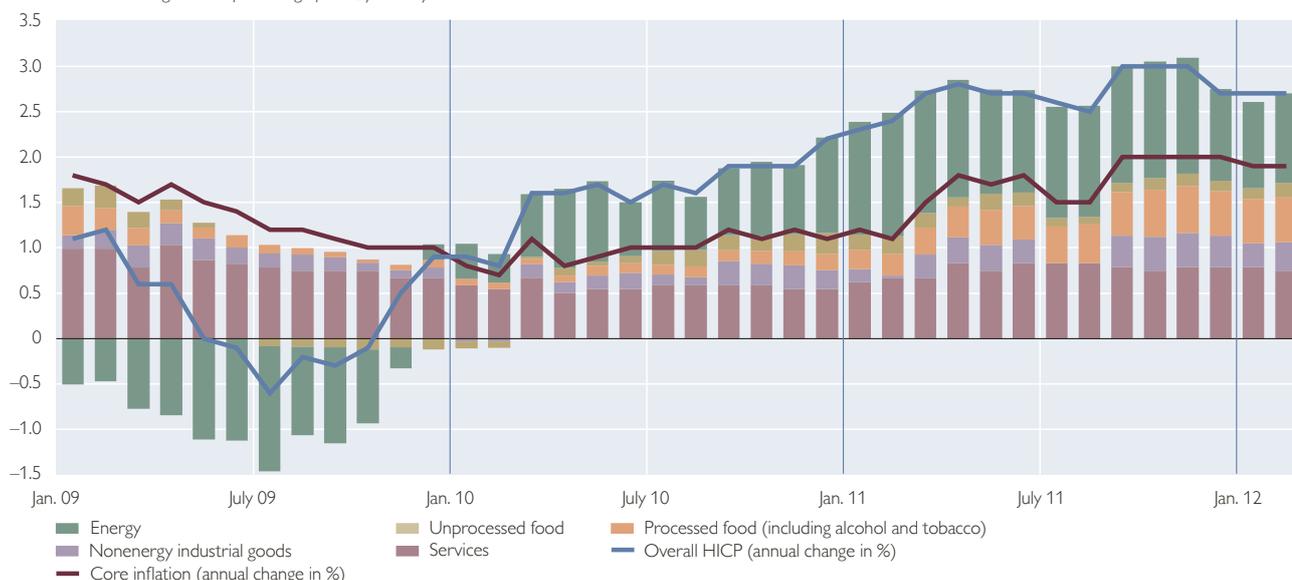
### 2.4 The Eurosystem Takes New Monetary Policy Measures

The continuing tensions in the government bond markets and the hike in risk premiums in the money markets made it necessary for the Eurosystem to take a number of monetary policy measures in the second half of 2011 to prevent

Chart 4

## Euro Area: HICP Components

Contributions to GDP growth in percentage points, year on year



Source: Eurostat.

the onset of tensions like those that occurred after the bankruptcy of Lehman Brothers investment bank in the U.S.A. The high risk premiums had a negative impact on banks' refinancing conditions and consequently on those of companies and households. To counteract the danger of the euro area sliding into recession again, the Governing Council of the ECB decreased its key interest rates by 25 basis points both in November and in December 2011 to a final 1%, the same level as at the beginning of 2011.

In fall 2011, the allocation of long-term liquidity was additionally supported by the announcement of two one-year longer-term refinancing operations (LTROs). The purpose of this measure was to reduce banks' uncertainty about refinancing and to help boost lending to corporations and households. The first of the one-year LTROs was settled in October 2011; the second was changed into a three-year tender in December 2011. At the same time, an additional three-year LTRO was announced for end-February 2012. The demand for long-term liquidity was high and was fully satisfied. The liquidity provided to the banking sector amounted to EUR 900 billion at the end of 2011 and widened to EUR 1,200 billion in the first months of 2012. An additional measure taken in December 2011 to ease banks' refinancing was to increase the list of eligible collateral for Eurosystem tender operations. The rating threshold for certain asset-backed securities was reduced. Moreover, national central banks were permitted to temporarily accept as collateral additional performing credit claims that satisfy specific minimum standards. However, the Eurosystem applies a haircut to the value of all collateral to factor in potential default of the underlying securities.

Finally, the minimum reserve ratio was reduced from 2% to 1%.

In addition, the Eurosystem launched a second covered bond purchase program (CBPP2) under which an intended nominal amount of EUR 40 billion of euro area bonds may be purchased until October 2012. Moreover, the Securities Markets Programme (SMP) was reactivated to prevent bond market tensions from affecting other segments of the financial market. When the tensions in the euro area sovereign bond markets eased at the beginning of 2012, the Eurosystem was in a position to scale back bond purchases again.

Chart 5

### Securities Markets Programme



Source: ECB.

## 2.5 Tensions in Bond Markets Addressed by EU-Wide Measures

Thanks to the consolidation measures launched as early as in 2010 and to the temporary economic recovery in the first half of 2011, the average budget deficit in the euro area declined by some 2 percentage points in 2011. As a consequence, government debt grew at a substantially slower pace. In a breakdown by countries, the public finances of the individual euro area countries developed very heterogeneously. Therefore, despite the fiscal improvement overall, the bond markets

### Yield Spreads on Ten-Year Government Bonds

Basis points, comparison with Germany



Source: ECB.

were buffeted by disruptions. Moreover, rating downgrades led to a further rise in the risk premiums on government bonds. The establishment of the financial backstops – including the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) – and the bailouts for Greece, Ireland and Portugal did not have a lasting effect in strengthening investors' confidence. By mid-2011 bond market tensions had spread to Italy and Spain as well. To prevent the crisis of confidence from coming to a head, euro area governments announced that they would enlarge the scope for action of the EFSF. The enlarged EFSF is empowered to buy bonds in the secondary market and to grant credits to banks.

In addition, a second rescue package totaling EUR 130 billion was announced in fall 2011 for Greece, as the original expectations for growth and fiscal developments proved too optimistic. This bailout for the first time provided for private creditors' involve-

ment in reducing debt. After protracted negotiations between private sector bondholders, the financial package was finally concluded in February 2012. The Greek debt exchange operation was successful, with a high overall participation share – 83.5% – of holders of Greek government bonds (participation in Greek law bonds was 85.9%). Once the Collective Action Clause (CAC) on Greek law bonds has been activated, total participation may reach 95.6%. The activation of the CAC will extend the validity of agreements to all bondholders once a majority has agreed to them. This debt swap represents a major step in bringing the Greek debt ratio to 120.5% of GDP by 2020. The debt exchange will have to be accompanied by further austerity measures and structural economic reforms. Fitch rating agency reacted to the successful haircut with a significant improvement of the rating for new Greek government bonds to B–, and risk premiums diminished substantially.

In most other euro area countries, yields on ten-year government bonds have also subsided noticeably since the beginning of 2012, above all in Belgium, Italy and especially in Ireland. The bond market recovery is attributable on the one hand to progress with EU economic governance reform and the restructuring of Greek debt, but on the other hand may also have benefited from banks' increased demand for sovereign bonds in connection with the ample long-term liquidity provided by the Eurosystem. To further strengthen confidence in the financial markets, it will be important to maintain the fiscal consolidation course and to complement it by structural reforms. The current discussions about Spain's fiscal course have demonstrated just how quickly a trend can reverse. Most recently, the risk premiums for Spanish bonds exceeded those on Italian sovereign debt, as Italy's consolidation resolve has obviously convinced the markets.

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

Economic developments in the Central, Eastern and Southeastern (CESEE) EU Member States can be broken down into two phases within the review period (mid-September 2011 to mid-March 2012). Whereas economic conditions deteriorated noticeably until the turn of the year 2011 to 2012, sideways movements predominated thereafter. Signs that the economic cycle reached a turning point during the first quarter of 2012 recently increased, although any revival is likely to remain subdued throughout the rest of the year.

#### **3.1 Tensions in the European Financial Markets Increasingly Affected CESEE Markets in the Second Half of 2011 ...**

Tensions in the euro area related to the sovereign debt crisis intensified in the second half of 2011 and spilled over to the CESEE EU Member States. As a case in point, since roughly mid-September 2011, credit default swap (CDS) premiums and eurobond yield spreads augmented, peaking at the turn of the year. At the same time, stock prices and exchange rates dropped sharply. Sovereign debt auctions had to be canceled or postponed in several countries – e.g. Hungary, Slovakia and Slovenia – and credit rating agencies (CRAs) downgraded several countries: a number of CRAs lowered their ratings of Slovakia and Slovenia, for instance. Conversely, prior to September 2011, upgrades of CESEE countries had predominated.

Moreover, many observers feared that the bank recapitalization passed by the euro area Heads of State or Government at their summit on October 26, 2011, could lead to lower lending growth, or even reduced lending altogether, by Western European or Western European-owned banks in the CESEE countries. The most recent credit development data indicate that after recovering somewhat at mid-2011, credit growth in fact weakened again. How much of this decline is attributable to demand factors and how much to supply factors is difficult to estimate. Credit growth has principally been slow in the CESEE region since the spread of the crisis to the European emerging markets in fall 2008.

Toward the end of 2011, Hungary moved into the limelight of international reports. After investor confidence had deteriorated markedly following the implementation of several

controversial political measures, the value of the Hungarian forint against the euro plummeted by some 20% from July to December 2011 and was traded at a historical low at the beginning of January 2012. In the meantime, the currency has recapped some of its losses. Reacting to rising risk premiums and price pressures, the Hungarian central bank increased its key interest rate by 50 basis points both in November and in December 2011 to 7% most recently. All three major rating agencies – Standard & Poor’s, Moody’s and Fitch – downgraded Hungarian bonds to speculative grade status. Problems placing new bond issues increased uncertainties about financing Hungary’s government debt. In response, Hungary entered into talks with the EU and the IMF about the possibility of financial backing. The negotiations were stopped against the background of the adoption of a new constitution in Hungary and a new central bank law that restricted the independence of Magyar Nemzeti Bank. In January 2012, the Hungarian government was forced to backtrack on some of the contentious provisions, and the

EU began to examine whether these concessions were large enough to warrant the resumption of negotiations. A positive conclusion of this examination is contingent on the actual amendment by Hungary’s parliament of the legal provisions that do not conform to European Union law. Furthermore, the European Council stepped up the excessive deficit procedure (EDP) against Hungary in January 2012 after having noted that the country had made insufficient progress with fiscal consolidation. If Hungary did not take sufficient action by September 2012 to correct its excessive deficit, the EUR 500 million (0.5% of Hungarian GDP) scheduled commitments from the EU’s cohesion fund would be suspended as of January 1, 2013, according to the March 2012 decision of the ECOFIN Council.

### 3.2 ... and Leading and Confidence Indicators Worsened in the Second Half of 2011

Economic sentiment indicators deteriorated substantially during the review period. This development had been observable since spring 2011, accelerated during summer and concerned mainly industrial confidence and somewhat thereafter service and retail sector confidence. Consumer confidence has not revived since the crisis began in 2009. In recent years, it has consistently been measured below its long-term average.

In contrast, the real economic leading indicators performed fairly well. However, even the leading indicators worsened notably, especially at the beginning of 2011. Industrial output growth shrank from roughly 10% to only 5%, where it has hovered since summer 2011. New orders in industry exhibit a similar pattern. Construction reports constant positive growth rates, but this may well stem from the base

Chart 7

#### CESEE EU Member States: Leading Indicators



Source: Eurostat.

effects and partly from better weather conditions in the fourth quarter of 2011. Most of all, construction linked to the 2012 European Football Championship lifted building growth in Poland. Only the leading indicators of private consumption remained persistently negative. Retail sales in the CESEE EU Member States have been stagnating since May 2011 year on year; in December 2011 new car registrations were 21% below the comparable year-earlier value.

### 3.3 Economic Growth Weakens in Most Countries in the Fourth Quarter of 2011

After having been quite powerful, for the most part, during the third quarter of 2011 – CESEE growth rose by an average of 0.7% quarter on quarter – economic activity cooled in line with expectations in the fourth quarter. Average growth diminished to 0.5%; half the countries under review posted negative growth (table 1). This slippage may be ascribable to weaker demand in the euro area and thus smaller growth contributions by net exports, but the most recent data showing the development of GDP components signal a drop in private consumption growth in many countries. This development was already foreshadowed by the respective leading indicators. Growth remained vibrant only in Poland and Slovakia; without these two countries, the aggregate regional growth rate would be far lower.

### 3.4 Confidence and Leading Indicators Signal Improved Conditions

While most financial market segments are still weaker or much weaker than in summer 2011, tensions in many CESEE countries' financial markets have eased considerably since the turn of the year.

Table 1

#### CESEE EU Member States: Economic Growth

	2010	2011	Q1 11	Q2 11	Q3 11	Q4 11
<i>Real GDP growth in % against the previous period, seasonally and working-day adjusted</i>						
Bulgaria	0.4	1.7	0.5	0.5	0.2	0.3
Estonia	2.3	7.6	2.8	1.6	0.9	-0.2
Latvia	-0.3	5.5	1.1	2.0	1.5	1.1
Lithuania	1.4	5.9	1.4	1.7	1.3	1.0
Poland	3.9	4.3	1.0	1.2	1.0	1.1
Romania	-1.7	2.5	1.1	0.2	1.1	-0.2
Slovakia	4.2	3.3	0.8	0.8	0.8	0.9
Slovenia	1.4	-0.2	-0.3	-0.1	-0.4	-0.7
Czech Republic	2.7	1.7	0.5	0.3	-0.1	-0.1
Hungary	1.3	1.7	0.7	0.1	0.4	0.3
<b>CESEE total</b>	<b>2.3</b>	<b>3.2</b>	<b>0.9</b>	<b>0.8</b>	<b>0.7</b>	<b>0.5</b>
Euro area	1.9	1.4	0.8	0.1	0.1	-0.3

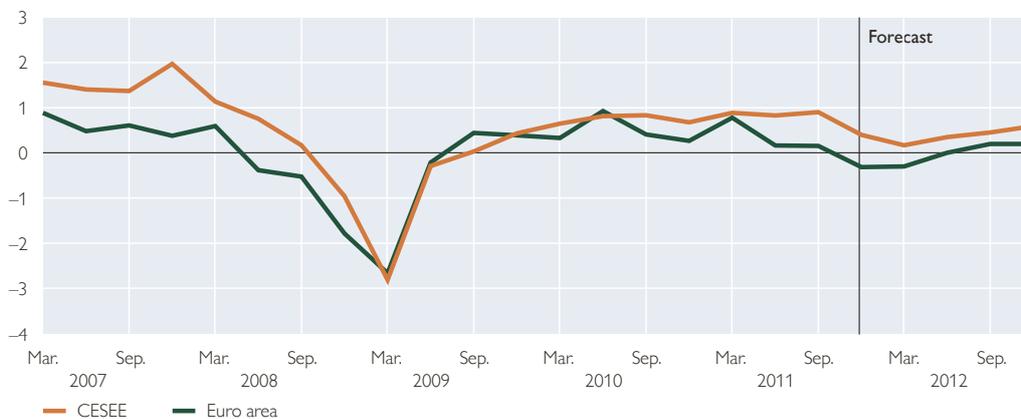
Source: Eurostat.

The improvement seems to be due to a slight reduction of international risk aversion, falling yield spreads on euro area sovereign debt and last but not least the ECB's long-term refinancing operations, which had a positive impact on the liquidity conditions of euro area banks as well as their CESEE subsidiaries. CESEE currencies gained against the euro (Hungarian forint: +5.5%, Polish zloty: +6.5%); stock prices advanced (Poland: +7.5%, Romania: +17.5%), and both eurobond spreads and CDS premiums fell (by over 100 basis points each in Bulgaria, Lithuania and Romania).

Moreover, a certain positive momentum of leading and confidence indicators may be noted (chart 7). In December 2011, industrial production as well as construction output mounted slightly faster than in the previous months. Business confidence strengthened by 3 points from December 2011 to February 2012, mainly because consumers and service providers displayed more optimism about economic prospects.

## GDP Development

Change on previous quarter in %, seasonally and working-day adjusted



Source: Eurostat, European Commission.

### 3.5 Turning Point to End Economic Downswing in the First Quarter of 2012

The substantial worsening of international framework conditions in the second half of 2011 led to a significant downward revision of the forecasts for the CESEE region. All key forecasters successively marked down their growth predictions for 2012. Expectations for CESEE growth had still been pegged at between 3.5% and 4% in the first half of 2011, but have been slashed to a final value of around 1.5% most recently.

According to the most recent Interim Economic Forecast of the European Commission of February 23, 2012, the turning point in the economic cycle may have already been reached. The pace of economic activity will decline further in the first three months of 2012, but from the second quarter, growth should begin to rebound slowly but surely. In the fourth quarter, it is anticipated to come to 0.6% quarter on quarter. For 2012 as a whole, therefore, CESEE expansion is assumed to come to 1.5% – i.e. 0.4 percentage points less than expected in the European Commission's fall 2011

forecast. In a breakdown by countries, the increase is calculated to be highest in Latvia (+2.1%), Lithuania (+2.3%) and Poland (+2.5%). Stagnation or even a marginal dip is anticipated for Slovenia, the Czech Republic and Hungary, however.

In 2013, the revival is supposed to pick up more speed, bringing average growth to about 2.5%. In Slovenia and Hungary, economic growth is projected to remain sluggish at just over 1%, while Latvia, Lithuania and Poland will remain at the head of the group, with growth running to just over 3% in all three countries.

Both in 2012 and in 2013, the CESEE region is thus set to grow by 1.5 to 2 percentage points faster than the euro area.

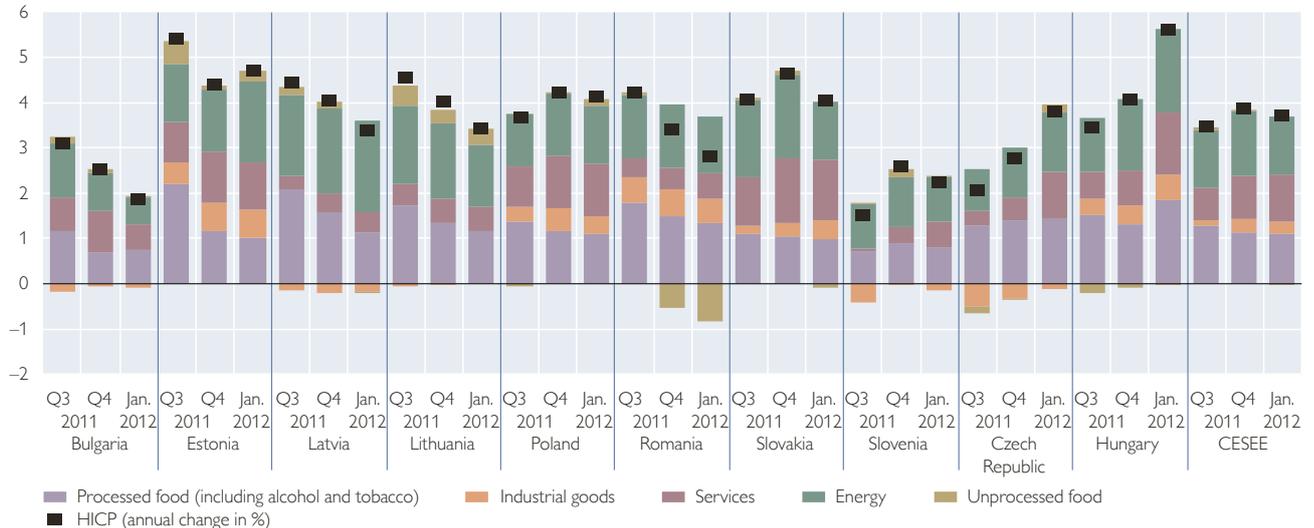
### 3.6 Inflation Passes Its Peak in Summer 2011 in Most CESEE Countries

The CESEE EU Member States' inflation rates averaged a steady 3.5% to 4% in recent months. Regional trends may be distinguished, namely the disinflationary effect of food prices in connection with a base effect and good har-

Chart 9

## CESEE EU Member States: Inflation Rate

Contributions to GDP growth in percentage points, year on year



Source: Eurostat.

vests in 2011 along with a stronger inflation of prices in the services sector. Both effects more or less canceled each other out.

Among the different countries, inflation developments varied: Inflation subsided sharply in Bulgaria and Romania, but in the Czech Republic and Hungary, it accelerated by roughly the same degree. Bulgaria and Romania benefited particularly from the favorable development of food prices, partly because food accounts for such a large share of these countries' basket of goods, whereas costlier services (and to a lesser extent a rise in industrial goods prices) pushed up inflation markedly in the Czech Republic and Hungary. Price pressures in these countries may be traced partly to tax increases that took effect on January 1, 2012. The value-added tax rate was raised from 25% to 27% in Hungary, and the reduced tax rate in the Czech Republic went up from 10% to 14%. Moreover, energy price increases were higher than the regional average in both countries, not

least because of the depreciation of the Hungarian forint and the Czech koruna since mid-2011.

In its most recent forecast, the European Commission projects inflation to recede in the region in 2012. The regional average is expected to come to 3.3%, some 0.7 percentage points below the 2011 inflation value. The disinflation process is assumed to be most pronounced in the Baltic countries, Romania and Slovakia. Because of the value-added tax increases in the Czech Republic and Hungary, these two countries are liable to be the only ones in which inflation will rise in 2012 compared to 2011.

## 4 Austria

### 4.1 Economic Activity to Stabilize in the First Half of 2012

Economic activity in Austria successively lost momentum in the course of 2011. Whereas GDP advanced at an above-average rate in the first half of 2011, it contracted marginally in the fourth quarter of 2011 in the wake of a

Table 2

### Austria: Real Gross Domestic Product and Demand Components (in real terms, seasonally and working-day adjusted)

GDP	Private consumption	Government consumption	Gross fixed capital formation	Exports	Imports	Domestic demand	Net exports	Changes in inventories	Statistical discrepancy	
Change on previous period in %						Contributions to GDP growth in percentage points				
Q1 11	0.8	-0.1	1.0	1.4	2.2	1.9	0.3	0.2	0.4	0.1
Q2 11	0.5	0.1	0.9	1.0	1.2	1.1	0.5	-0.1	0.1	0.2
Q3 11	0.2	0.2	0.5	0.9	0.3	0.3	0.5	0.0	0.1	0.1
Q4 11	-0.1	0.3	0.1	0.7	-0.4	0.3	0.2	0.0	0.2	-0.2
2009	-3.6	0.2	0.7	-7.4	-13.7	-12.5	-1.4	-1.7	-0.6	-0.1
2010	2.5	1.7	0.0	0.0	8.3	7.4	0.9	0.9	0.7	0.0
2011	3.0	0.8	2.4	5.2	6.8	6.6	1.7	0.4	1.3	0.3

Source: Austrian Institute of Economic Research (WIFO), OeNB.

decline in export growth and the downturn phase of the investment cycle. What is more, government consumption lost considerable steam. Since summer 2011, goods exports have been moving sideways. In the fourth quarter, they even declined quarter on quarter.

But by the time the OeNB published its last economic outlook for Austria at the beginning of December 2011, conditions had improved noticeably. Most national and international leading indicators bottomed out in November, and since December 2011, surveys have shown a continuous improvement of company and household sentiment. The negative sentiment gauged in fall 2011 and the current improvement may, however, be overstated on account of the media reports on political officials' handling of the crisis at the time. Even in a conservative interpretation, the indicators clearly signal an end to the global slowdown.

The results of the OeNB's Economic Indicator suggest a stabilization of economic activity in the first and second quarters of 2012. Whereas no significant increase in exports of goods

is to be expected – the OeNB's Export Indicator of March 2012 shows a constant sideways movement for January and February – investment is likely to edge up, drawing on improved order books and favorable financing conditions. Most likely, consumer spending will not be able to fulfill its role as a support for economic activity in the first quarter of 2012. Diminishing retail sales and a drop in the number of new car registrations signal a stagnation, perhaps even a reduction, in private consumption in the first quarter of 2012. The excellent employment situation and the current downtrend in inflation should provide for a stable development of real incomes. The currently observable surge in crude oil prices represent a distinct downside risk for economic activity, however.

Given recent progress in solving the Greek debt crisis, the European sovereign debt crisis is not expected to worsen during the forecasting period until the end of the second quarter of 2012. Nevertheless, the European debt crisis represents an important risk factor for the Austrian economy as well.

Box 1

### Results of the OeNB's Economic Indicator of March 2012<sup>1</sup>

The results of the OeNB's Economic Indicator for the first and second quarters of 2012 project growth of 0.2% and 0.3%, respectively, which signals a stabilization of economic activity. Thus, a recession as defined in technical terms (two successive quarters of contraction) is not to be expected. This forecast, however, applies only under the assumption that the European debt crisis does not take a turn for the worse. The positive growth outlook is ascribable above all to the significant improvement of business sentiment. The growth forecast for the first quarter of 2012 has remained unchanged compared to the last release of the OeNB's Economic Indicator results.

### Short-Term Outlook for Austria's Real GDP in the First and Second Quarters of 2012 (seasonally and working-day adjusted)

2010				2011				2012	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Year-on-year quarterly change in %									
0.9	2.4	3.2	3.4	4.2	3.9	2.6	1.4	0.8	0.6
Quarterly change in %									
0.0	0.7	1.5	1.1	0.8	0.5	0.2	-0.1	0.2	0.3
Annual change in %									
2.5				3.0				x	

Source: Results of the OeNB's Economic Indicator of March 2012, Eurostat.

<sup>1</sup> The next release of the OeNB's Economic Indicator is scheduled for July 2012.

## 4.2 Dynamic Employment Developments Powered by Complete Liberalization of the Labor Market in May 2011

The Austrian labor market thrived in 2011. In view of high economic growth, businesses were on a hiring spree. Payroll employment widened by 61,000 persons or 1.8%. The largest share of new jobs was created in goods production (+10,400). In addition to the number of directly employed persons, the number of leased workers went up considerably (+9,100). However, employment was raised in the retail/wholesale industry as well (+10,700).

The robust pace of employment growth continued until the beginning of 2012 despite the deterioration of the economic situation in the course of 2011. Since the second quarter of 2011,

though, the leading indicators have pointed toward a slowdown. The number of vacancies reported by companies has been declining already since the second quarter of 2011, for example.

Much of the high pace of job growth in 2011 can be attributed to the full liberalization of the Austrian labor market in May 2011. The number of jobholders from the eight countries for which restrictions were lifted (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) has been soaring since May 2011. Between April 2011 and February 2012, employment from these countries jumped by 30,200 persons in seasonally adjusted terms. This rise accounts for two-thirds of the entire increase in employment by 47,900 persons.

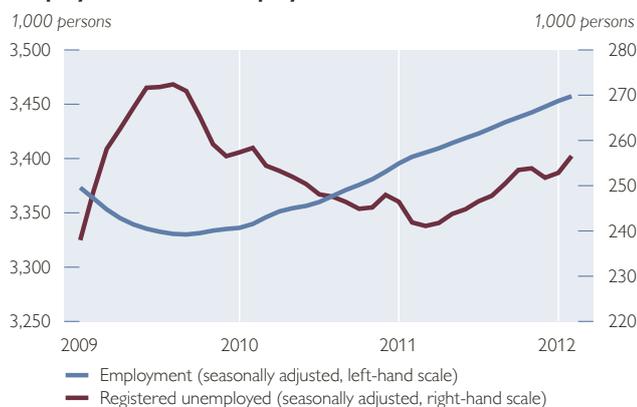
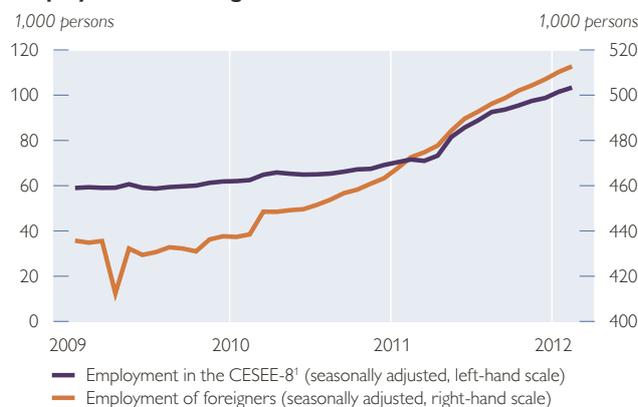
Table 3

**Developments in the Austrian Labor Market (seasonally adjusted)**

	Payroll employment (1,000)		Unemployed (1,000)		Persons in training programs (1,000)		Unemployment rate in %		Registered vacancies (1,000)	
		Change on previous period		Change on previous period			AMS	Eurostat		Change on previous period
Oct. 11	3,438	4.5	253	3.0	65.4	-0.1	6.8	4.2	30.4	-0.0
Nov. 11	3,443	4.5	254	0.4	68.0	0.3	6.8	4.3	30.3	-0.1
Dec. 11	3,448	5.2	252	-2.1	55.8	-0.5	6.8	4.2	30.6	0.4
Jan. 12	3,453	5.3	253	1.1	66.3	0.9	6.8	4.0	29.5	-1.2
Feb. 12	3,457	4.3	257	3.7	70.4	1.1	6.9		29.7	0.3
Q1 11	3,401	19.3	243	-2.9	69.4	-3.7	6.7	4.4	33.8	0.7
Q2 11	3,414	13.3	243	0.3	64.0	-2.2	6.7	4.1	33.6	-0.2
Q3 11	3,428	14.0	248	4.8	56.4	0.6	6.8	3.9	31.0	-2.6
Q4 11	3,443	14.5	253	4.8	63.1	-0.2	6.8	4.2	30.4	-0.6
2009	3,342	-45.2	262	49.8	64.1	14.0	7.3	4.8	27.2	-10.2
2010	3,360	18.5	250	-11.4	73.2	8.7	6.9	4.4	30.9	3.7
2011	3,422	61.1	247	-3.5	63.2	-9.9	6.7	4.2	32.2	1.3

Source: Austrian Public Employment Service (AMS), OeNB, Eurostat, Main Association of Austrian Social Security Institutions.

Chart 10

**Complete Liberalization of the Labor Market in May 2011 Determines Employment Developments****Employment and Unemployment****Employment of Foreigners**

Source: Austrian Public Employment Service, Statistics Austria.

¹ Estonia, Latvia, Lithuania, Poland, Slovakia, Slovenia, the Czech Republic and Hungary.

Despite animated employment growth, seasonally adjusted unemployment rose by 15,400 persons from a low in March 2011. The number of AMS (Austrian Public Employment Service) training participants – these persons are not registered as unemployed but are part of labor supply – grew only minimally (+2,600) during the same period. The Austrian unemployment rate (national definition) edged up in the course of 2011 and in

the first two months of 2012, whereas it was on a downtrend according to the Eurostat definition.

**4.3 Inflation Eases Perceptibly**

Currently, inflation is subsiding noticeably in Austria. In 2011, the HICP mounted by 3.6% in Austria, more than the euro area average of 2.7%. The rise in inflation was propelled above all by energy and food prices in the first quarter of 2011, while services

were the main inflation drivers during the remainder of the year. Toward the end of 2011, inflation began to cool off; it came to 2.6% in February 2012. This represents a drop by 0.3 percentage points from January 2012. Therefore, for the first time in a year, the Austrian rate of price increase slipped below the euro area average.

The decline in overall inflation was attributable primarily to a slowdown in the inflation of energy prices as well as of nonenergy and nonfood industrial goods, for which the inflation rate had fallen to just 0.2% in February 2012. The most recent reduction of inflation for these products is traceable above all to the fall in the prices of clothing and footwear. However, most recently, the prices of audio-visual, photographic and information processing equipment also fell.

The rate of inflation for food (including alcohol and tobacco) came to 3.2% in February 2012, also down from the January rate of 3.5%. The price of processed foods, in particular, showed a significant downtrend. The rate of price increase of unprocessed foods sank only marginally.

While energy price inflation exhibited a downward movement, it was still high in February 2012 at 7.5%. The most recent powerful expansion of crude oil prices fed into burgeoning motor fuel prices. Utility gas prices were also on the rise. By contrast, the prices of fuel oil, solid fuels and electricity were growing more slowly recently. In February 2012, the annual rate of inflation in services prices remained unchanged from the January rate at 3.2%. The recent deceleration of the prices for hotel services, administered service prices (above all those of hospital and dental services, education and school services) and housing service prices was offset by accelerating prices of package holidays and recreational as well as sports services.

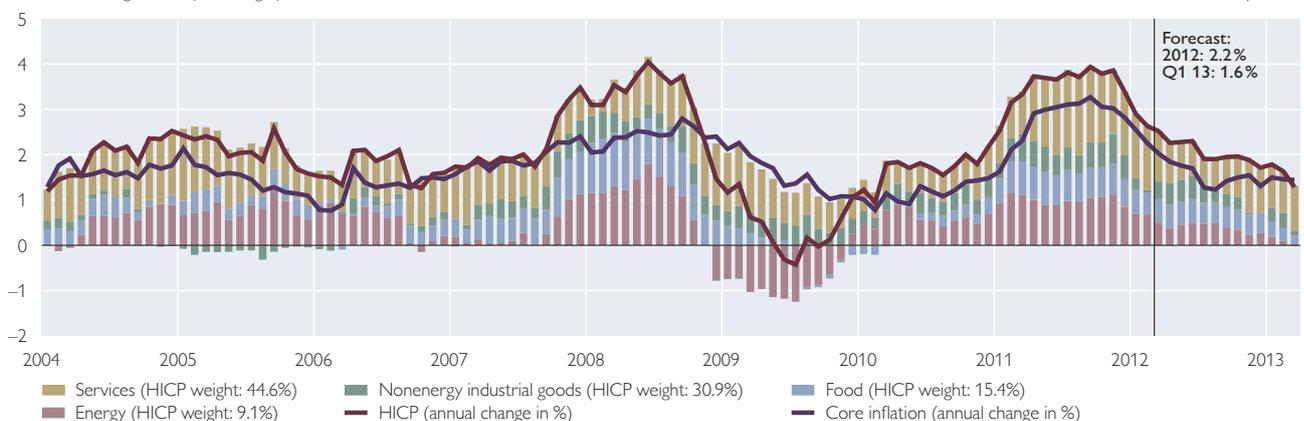
In its current inflation forecast, the OeNB assumes that inflation will decline continuously. Full-year inflation is expected to run to 2.2% in 2012, with the rates of price increase anticipated to drop below the 2% mark from mid-year.

Chart 11

## HICP Inflation and Contributions by Subcomponents

Contributions to growth in percentage points

Last observation: February 2012



Source: OeNB, Statistics Austria.

