Robust Economic Activity in the Euro Area

Inflation Remains Moderate

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Global economic activity continued to look robust at mid-2007. In the U.S.A., however, it is currently uncertain how large the impact of the August 2007 crisis in the real estate sector on the real economy will be. Strong growth in the second quarter of 2007 was primarily characterized by dynamic net exports but also by a very modest rise in private consumption. The U.S. Federal Reserve System first reacted to short-term liquidity constraints by unexpectedly cutting its discount rate. After having identified risks to growth, it later reduced the federal funds rate and again cut the discount rate. Economic recovery is slowing in Japan.

The Bank of Japan is pursuing its supportive monetary policies and has injected additional liquidity into the money markets in the wake of the U.S. mortgage crisis. In Asia, the high pace of growth continues, with the Chinese economy in danger of overheating.

The euro area economy may have peaked. Somewhat weaker growth in the second quarter of 2007 was driven by domestic demand, in particular. Current forecasts indicate GDP growth for 2007 to be close to potential. In addition, the labor market is developing favorably for cyclical and structural reasons. The rate of inflation rose above the 2% mark recently after having been below 2% for one year. Now the base effects and currency effects that had moderated energy price increases despite high crude oil prices are dissipating. Similarly, the feedthrough of the increase in VAT into German consumer prices proved smaller than expected. Nevertheless, the ECB Governing Council's economic and monetary analysis indicates upside risks to price stability in the medium term.

In the first quarter of 2007, the economies of the new EU Member States grew again more dynamically than that of the euro area. This is primarily attributable to robust growth in domestic demand. In the first half of 2007, the region registered a slight increase in inflation rates.

The Austrian economy is currently experiencing a period of expansion. Growth continues to be led by net exports and investment. Although private consumption performed better in the second quarter of 2007, it still lags behind expectations. According to the current OeNB economic indicator, Austrian real GDP will amount to 0.8% and 0.7% in the third and fourth quarters of 2007 respectively. For 2007 as a whole, this would mean growth of 3.4%.

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1 Continued Global Economic Growth

1.1 U.S.A.: Key Interest Rate Cut Due to Mortgage Market Crisis

Following very sluggish economic momentum, real GDP growth accelerated in the second quarter of 2007 to 3.8% (year on year). This spurt of growth was owing to two factors: a marked increase in net exports and a rise in public expenditure. Private consumption, however, expanded at an extremely modest rate of 1.4%. The downturn in private residential construction slowed, but nevertheless dampened growth by 0.6 percentage point. While the consumer price index (CPI) – somewhat weaker in August than in July – increased by 2.0% year on year, the core rate (inflation excluding food and energy) rose by 2.1%, i.e. less strongly than in the previous 16 months.

In addition, the relatively favorable labor market situation is still keeping intact the prospects of a "soft landing." Nonetheless, despite positive signals from some short-term indicators, the downside risks to economic growth increased as a result of real estate and financial market turmoil.

Following the long-term uptrend in U.S. real estate prices, which was fueled by – initially – low key interest and mortgage rates as well as by very generous credit conditions, including subprime household lending, growth in U.S. house prices came to a halt. This and, above all, the markedly higher cost of some types of borrowing – exacerbated by the phasing out of temporarily low interest rates for borrowers – led to defaults and forced sales, particularly in the subprime segment, and caused difficulties for some financial institutions.

The homeowner mortgage market, which was primarily hit by this crisis, has a volume of some 75% of GDP. Approximately 15% – up to 25% when more cautiously defined – of these mortgage loans (i.e. 10% to 20% of GDP) can probably be classified as *subprime*.

Financial market participants lost confidence in the U.S. subprime market, pulled out of U.S. structured financial products and moved into international markets. Underlying this, no doubt, is the uncertainty about who has problem assets backed by securitized mortgage loans in their portfolio, and to what extent, as well as about whether these assets represent a solvency problem for the institutions concerned.

As a result, the U.S. Fed repeatedly increased liquidity in the U.S. money market and, on August 17, 2007, lowered the discount rate by 0.5 percentage point to 5.75% between two regular meetings. On September 18, the Federal Open Market Committee (FOMC) cut the key *federal funds rate* by 50 basis points to 4.75% in light of the increased risks to economic growth. In addition to this first key interest rate cut in four years, the FOMC reduced the discount rate by an additional 50 basis points to 5.25%. These measures helped to calm the markets to some extent.

Owing to the expected weakening of private consumption from more restrictive terms of credit and to the decline in residential construction investment, U.S. economic growth is likely to slow in 2007 and to remain restrained in 2008 as well. *Consensus Forecasts* recently predicted growth of 2.0% in 2007 and 2.4% in 2008. The curbing of the expansion should, in turn, contribute to reducing inflationary risks. The risks to this economic outlook are primarily in continued financial market turmoil.

1.2 Japan: Growth Leveled Off

In the second quarter of 2007, real GDP in Japan contracted for the first time in three quarters, dropping by 0.3% on the previous quarter. This decline is attributable to a significant slowdown in export momentum. Growth stimuli came from corporate investment; private consumption was also up. In its six-monthly Outlook for Economic Activity and Prices (Outlook Report) for the fiscal year 2007 beginning in April and for 2008, the Bank of Japan still considers the economy to be on track to modest growth, which is driven by domestic demand. Given favorable competitive conditions, real GDP is likely to expand by 2.1% in both 2007 and 2008. *Consensus Forecasts* sees growth at 2.3% in the calendar year 2007, which would signify an increase for the seventh year in a row. As downside risks, the Bank of Japan cites a sharp slowdown in the U.S.

economy and a detrimental impact of the turmoil in the U.S. mortgage market on the profitability of the Japanese banking system.

The core inflation rate (CPI excluding fresh foods), which is crucial for monetary decisions, stood just below zero on an annual basis in the first half of 2007, partly induced by falling oil product and telecoms prices. The Bank of Japan revised its expectations for Japan's core inflation downward: It now predicts a rise of only 0.1% in the fiscal year 2007 and does not expect a rise to 0.5% until the fiscal year 2008. The Bank of Japan pursued its highly supportive monetary policy in the first half of 2007 and, in the wake of the U.S. mortgage crisis, repeatedly injected additional liquidity into the money market.

1.3 Asia Booms, China in Danger of Overheating

In non-Japan Asia (NJA), the economy continued to grow vigorously in the first half of 2007. Both the domestic economy and the external sector remained, for the most part, pillars of growth. China adopted measures to counter the possible overheating of the economy and to stabilize inflation expectations. With the help of an "appropriately tight" budgetary policy and a less accommodative monetary policy, annual real GDP growth is to be restricted to some 9%. Despite these steps, growth in the second quarter of 2007 accelerated to 11.9% year on year, fueled by momentum in industry and the service sector. The consumer price index's steep rise in July 2007 (+5.6%) exceeded its target of 3% for the fifth month in a row, attracting considerable political attention, as periods of high inflation in the past have often been associated with political turmoil. The IMF sharply corrected its 2007 growth forecast upward to 11.2%, and the rating agency *Moody's* upgraded its credit rating for China. Stock prices on the strongly booming Chinese stock market plunged repeatedly in spring 2007 but then rallied rapidly, bringing the stock index to an all-time high at end-August 2007. The country's financial markets meanwhile remain vulnerable to any unexpected increase in global risk aversion. In addition, real estate business in Chinese conurbations may be witnessing signs of overheating.

The IMF expects the economic prospects for NJA to remain favorable on the whole, although growth rates are likely to slacken marginally until 2008.

2 Euro Area: Growth Has Peaked

2.1 GDP Growth Down Slightly

In the second quarter of 2007, euro area real GDP grew by 0.3% on the previous quarter and by 2.5% year on year, according to estimates. This signifies a slowdown compared with the very dynamic GDP growth of the previous quarters and represents the euro area's weakest performance since end-2004. Broken down into its GDP components, growth in the second quarter of 2007 differed markedly from that of the first quarter. Recently, the key pillar of economic growth was private consumption, while gross fixed capital formation and government consumption stagnated; net exports, which are now having a positive impact, were partly offset by changes in inventories.

Growth was down in all four major economies of the euro area, especially in Italy but also in Germany and France. Whereas the decline in German GDP growth as a result of the increase in VAT was in line with the figure predicted by the European Commission, other euro area countries lagged behind expectations. Investment growth appears to have paused, particularly in construction investment, which had previously benefited from the mild winter. The flagging investment cycle is also evident from the euro area's industrial capacity utilization, which may have peaked at 84.8% in the second quarter of 2007 according to a European Commission survey. Export growth is also likely to have peaked. This corresponds to the mature stage of the economic cycle but may also reflect either insufficient competitiveness or exchange rate effects. Consumer demand failed to assume the role of economic engine despite the favorable labor market situation, which may be traced back to modest growth in disposable income, in addition to a rising saving ratio and to rising lending rates.

In July 2007, the euro area's balance of trade registered a surplus of EUR 4.6 billion after also having shown a surplus in the previous months. In the second quarter of 2007, the euro area had a current account deficit of EUR 7 billion according to first estimates. Over the previous 12 months, the current account showed a cumulative surplus of EUR 2.6 billion until June 2007. However, if the trade and current account balances are seen as a ratio of GDP, both are nearly in balance.

The labor market situation continued to improve in light of the sustained economic momentum. Following its previous decline in May 2007, the euro area's seasonally adjusted jobless rate stood at 6.9%, i.e. a full two percentage points below its peak in mid-2004 and at its lowest level in more than a decade. However, this drop is not only the result of economic activity. The labor market and welfare reforms of the past few years have also reduced structural unemployment, which means that GDP growth is currently considerably more employment-intensive than it was a few years ago. In 2006 alone, two million jobs were created in the euro area as a result. In the second quarter of 2007, employment growth was 0.5%, i.e. higher than in the two previous quarters. The European Commission still has high expectations for employment in industry and the service sector.

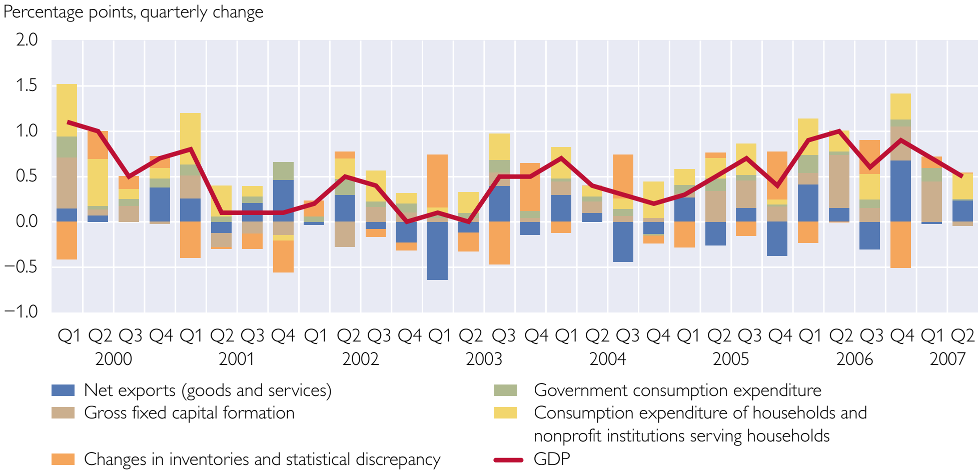
2.2 Upbeat Growth Prospects

Economic indicators suggest somewhat weaker confidence in the economy, thus signaling the possibility that economic activity in the euro area may have peaked. Both the European Commission's *Economic Sentiment Indicator* and *Ifo's Business Climate Index* for Germany deteriorated slightly since June 2007. Despite trending down since early 2007, most industrial sentiment indicators remain well above their long-term averages, thus still signaling growth close to potential. Although the European Commission's consumer confidence indicator, following a long-term uptrend, has been falling since May 2007, it remains at a high level.

For the third quarter of 2007, the European Commission's target range indicator projects slightly downward revised growth of between 0.3% and 0.8%. This target range is likely to widen only marginally in both directions until the first quarter of 2008. In its spring forecast of 2007, the European Commission had revised its

Chart 1

Contributions of Real GDP Components to Euro Area Growth

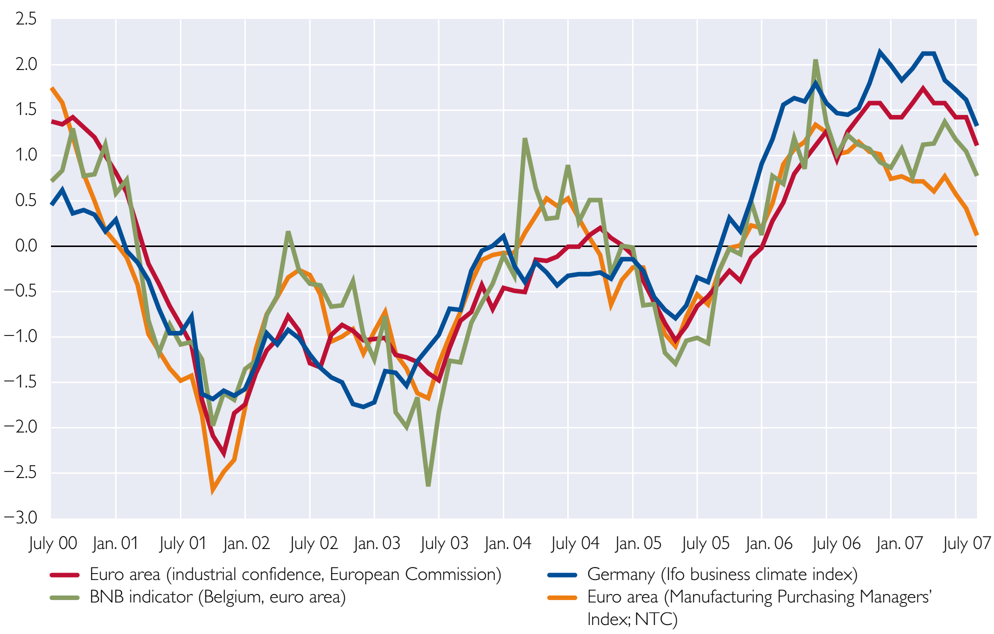


Source: Eurostat.

growth expectations for the full year 2007 up by 0.5 percentage point. However, the interim forecasts were revised marginally downward again to 2.5% recently. Eurosystem experts share this underlying optimism. According to their projections of September 2007, GDP growth in 2007 will range between 2.2% and 2.8%. In 2008, growth is expected to range between 1.8% and 2.8%. From the current perspective the euro area real

Chart 2

Business Climate Indicators



Source: European Commission, Ifo, NTC, BNB, OeNB.
Note: Deviation from the mean value of the indicator relative to the standard deviation.

economy appears to have been affected only marginally by the financial market turmoil.

2.3 Inflationary Pressure as Expected

In August 2007 the inflation rate measured by the Harmonised Index of Consumer Prices (HICP) decreased to 1.7%; for September, though, it is estimated to come to 2.1%. The fact that inflation was below the 2% mark for a year is attributable above all to energy prices, which benefited from a more favorable base effect, which is now coming to an end, however, as well as from the appreciation of the euro. In Germany, the impact of the VAT tax reform was not fully passed on to consumers, presumably because of strong competition and good corporate profits. In Germany itself, inflation rose at an above-average rate in the wake of the VAT reform and accelerated to 2.5% in September 2007 because of price increases for oil products as well as food, beverages and tobacco. By contrast, the HICP was lower than or in line with the euro area average in France and Italy in August. In August 2007, euro area inflation rose for the subcomponent food and stayed high for services. In August, core inflation (all-items index excluding energy and unprocessed foods) augmented to 2.0%, the highest level since end-2004.

After soaring by nearly 40% since the start of the year, at end-September 2007 the price of crude oil (Brent) reached an all-time high of over USD 80 per barrel. In August 2007, oil prices had fallen in the wake of the financial market turmoil. In the same month, energy prices in the euro area even made a negative contribution to inflation. This is because the price of oil denominated in euro had still been higher in the previous year and so had a favorable base effect, which will, however, become less significant from September 2007.

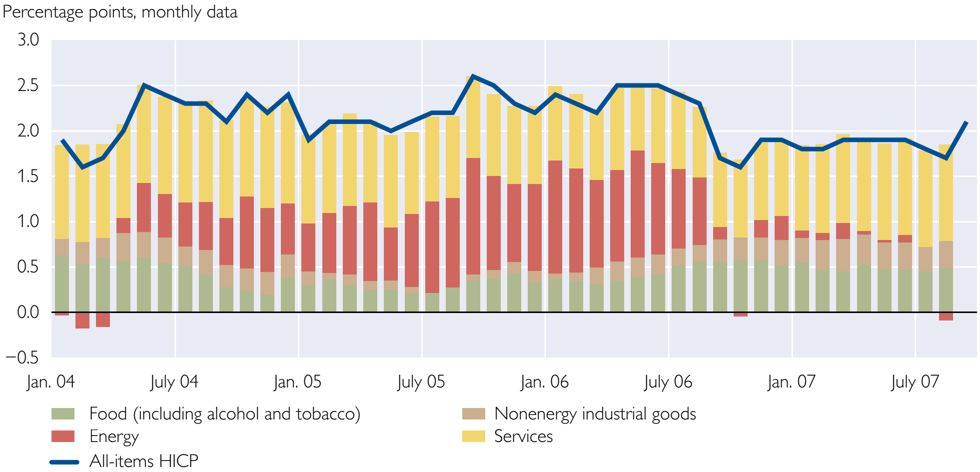
Inflation rose slightly for processed foods, meaning that the global uptrend in food prices (referred to as "agflation") is apparently feeding through to the euro area HICP now. However, significant global demand for food, beverages and tobacco, including the production of crude oil substitutes, has for months been reflected in consumer price inflation in, for instance, the U.S.A. and the U.K.

From early 2007 to July, import prices rose by 1.7%. Energy price effects, and possibly also a price increase in emerging Asian markets – the dissipation of the inflation-dampening effects of globalization, are at the heart of this rise. In August 2007, producer price growth in industry excluding construction continued to decline. Here, too, the development in energy prices, which have been exhibiting negative growth since April, play a key role. In addition, this trend is attributable to growth in intermediate goods prices, in which the past few months' development in commodity prices is reflected, albeit with a lag.

To date, the risks to the forecast diagnosed by the European Commission have not become reality either in the form of an increase in producer prices or in unexpectedly high wage settlements. Wages have so far risen modestly. After stagnating in the fourth quarter of 2006, unit labor costs in the euro area rose by 0.8% in the first quarter of 2007. The compensation of employees in the euro area rose more quickly in the second quarter than in the previous quarter. The favorable labor market situation

Chart 3

HICP Components: Contributions to Inflation



Source: Eurostat.

is likely to make higher wage settlements possible. Productivity growth went down slightly again in the second quarter. Since 2002, accelerating productivity growth has contributed considerably to falling unit labor costs in the euro area. Overall, however, hardly any significant second-round effects of the increase in oil prices on wages are identifiable.

According to projections published by experts at the European Central Bank (ECB) in September 2007, the HICP inflation rate will range between 1.9% and 2.1% in 2007 and between 1.5% and 2.5% in 2008. While they forecast that contributions to inflation from energy and raw materials, indirect taxes and profit margins will decline gradually, rising unit labor costs will have an inflation-boosting effect in line with forecasts. According to the Governing Council of the ECB, the risks to the inflation outlook currently are on the upside.

2.4 Monetary and Lending Growth at Record Levels

The three-month average of annual M3 growth came to 11.4% from June through August 2007, the highest level since 1999. In particular, an increase in short-term deposit growth underlies this trend. This may be for two reasons: first, the flight of investors into liquid funds given the recent financial market turmoil; second, increased interest rates for maturities up to two years that make investing in short-term assets more advantageous. In addition, sustained high risk aversion on the part of nonfinancial corporations and households is contributing to robust growth in monetary demand.

In August, lending growth expanded to 8.8%. Whereas lending to nonfinancial corporations accelerated, annual household lending growth continued to slow. Sustained high demand for credit reflects currently buoyant economic growth and fundamentally favorable financing conditions. Prior to the spillover of the U.S. mortgage market crisis, ad-

Chart 4

Euro Area: Development of M3 and Loans

Source: ECB.

ditional factors were banks' more relaxed lending practice and the increased confidence of market participants. Steep growth in merger and acquisition activities within the euro area may also have contributed to the rapid expansion in corporate borrowing.

2.5 Further Hike in ECB Key Interest Rate

On June 6, 2007, the Governing Council of the ECB decided to raise the minimum bid rate on main refinancing operations by 25 basis points to 4.0%. This means that it has increased its key interest rate by a total of 200 basis points since December 2005. The latest hike was justified on two counts: the favorable economic climate and potential risks to price stability.

At its meeting of August 2, 2007, the Governing Council of the ECB announced that it would follow economic and monetary developments with strong vigilance. This is an expression of implied upside risks to price stability over the medium term, which were identified in the ECB Governing Council's economic and monetary analysis. At the same time, the Council underlined that it would never precommit to monetary policy decisions that had to be taken.

The Governing Council of the ECB essentially expressed the same approach at its meeting of September 6. The Governing Council confirmed that the medium-term outlook for price stability remained subject to upside risks and that the monetary policy stance remained on the accommodative side, but considered it appropriate to gather additional information before drawing further conclusions for monetary policy, given increased uncertainty as a result of financial market volatility.

The markets had largely anticipated the key interest rate increase of June, having already factored it into the three-month interbank rates prior to the ECB Governing Council's decision. Since August 2007, the differences between the three-month Euribor and interest on September and December Euribor futures contracts have been negative, which may be seen as a sign of flagging expectations of further increases in key interest rates. However, owing to the current tensions in the money market, exceptional factors which limit this indicator's meaningfulness regarding expectations about the future level of key interest rates should be included in considerations.

Since the start of the financial market turmoil, the yield curve has flattened, with long-term interest rates having fallen most pronouncedly. While short-term money market rates edged up temporarily in the wake of the turmoil, short-term government bond rates fell at the same time, signaling temporarily higher credit risk premia in interbank trading.

2.6 ECB Stabilizes Money Markets and Financial Markets

At the start of the U.S. mortgage market crisis, the Governing Council of the ECB announced at its meeting of August 2, 2007, that it would follow market events with close attention. When the financial market turmoil subsequently led to strains in the euro area interbank market, the ECB injected the necessary liquidity into the money market. At the same time, the ECB President Jean-Claude Trichet appealed to market participants to keep calm. He said that the current period of nervousness and volatility in many markets should be interpreted as a reappreciation of risks.

On August 22 and September 6, 2007, the Governing Council decided to carry out supplementary longer-term refinancing transactions with a maturity of three months – a purely technical measure designed to facilitate the functioning of the euro money market. This injection of liquidity did not affect the routine longer-term refinancing transactions that are carried out on a monthly basis. Conditions in European financial markets have since eased to some extent. While quick tenders brought back the overnight rate close to the minimum bidding rate, the trend in longer-term money market rates indicated somewhat greater uncertainty in the money markets, as well as increased risk premia.

In the wake of these developments, both euro area and U.S. stock markets suffered severe setbacks, which, however, could be partly recouped in September. The *DJ EURO STOXX 50* and the *S&P 500* have fallen by 6% and 2%, respectively, since then. Implied volatilities of options on both stock indices rose substantially, and yields on long-term government bonds declined markedly, to recover marginally since then. Both euro area and the U.S. earnings, which are calculated on the basis of broad stock indices, remain close to their historical average since 1990.

These developments highlight investors' heightened uncertainty. According to market reports, the U.S. mortgage crisis, concerns about potential negative repercussions on the U.S. economy and the reduced availability of credit for corporate takeovers are depressing stock markets.

Foreign exchange markets are also currently suffering from the financial market turmoil. Although the U.S. dollar firmed against the euro at the start of the crisis, it has recently moved firmly in the opposite direction. At the end of September, the EUR/USD exchange rate surpassed the symbolic mark of 1.40. The Japanese yen, too, was subject to extreme price movements, which may be attributed to the liquidation of *carry trades* (speculation on the interest rate movements of foreign exchange loans). In nominal effective terms, i.e. trade-weighted by the 24 main trading partner countries (narrow group of euro area trading partners), the euro was only marginally higher than the comparable 2006 level.

3 GDP Growth in Central and Eastern Europe

3.1 Robust Economic Activity in the First Half of 2007

In the first quarter of 2007, average real GDP growth in the new EU Member States Bulgaria, Poland, Romania, the Slovak Republic, Slovenia, the Czech Republic and Hungary stood at 6.2% year on year. Growth is likely to be only marginally weaker in the second quarter. Following average GDP growth of 6% in 2006 as a whole, this means that economic momentum gathered pace in early 2007. GDP growth was particularly robust in the Slovak Republic and in Slovenia. In addition, Poland's GDP grew at a more than average rate. Only in Hungary, where consolidation measures to reduce an especially high budget deficit (2006: 9.2% of GDP) substantially dampened growth, was growth well below average. The first quarter of 2007 saw considerable acceleration in Croatian GDP growth.

In the first quarter of 2007, GDP growth in most Central, Eastern and Southeastern European countries (CESEEs) was fueled by dynamic domestic demand, although both private consumption and investment activity also provided significant stimuli. Only in Hungary and in the Slovak Republic did net exports constitute the largest component of growth. In the other CESEEs, the contribution of net exports to growth was insignificant, and even strongly negative in Bulgaria and Romania.

In all the countries currently under review (except for Hungary), private consumption made a significant contribution to growth, and in fact the largest contribution in Poland and Romania. Several factors favored this particularly healthy development in household spending. In addition to rapid lending growth, above all labor market indicators improved in these countries. Over the past 12 months, dynamic GDP growth led to rising employment rates and falling jobless numbers. In some countries, such as Poland and the Slovak Republic, the initial signs of an incipient labor shortage in certain sectors (primarily, construction and industry) are already evident. In conjunction with

Table 1

GDP Growth in Selected Central, Eastern and Southeastern European Economies

Annual change in real GDP growth in %

	2005	2006	Q2 06	Q3 06	Q4 06	Q1 07
Bulgaria	6.2	6.1	6.4	6.7	5.7	6.2
Poland	3.5	5.8	5.5	5.8	6.4	6.9
Romania	4.1	7.6	7.8	8.3	7.7	6.0
Slovak Republic	6.0	8.3	6.7	9.8	9.6	9.0
Slovenia	4.0	5.2	4.7	5.6	5.5	7.2
Czech Republic	6.5	6.4	6.5	6.3	6.1	6.1
Hungary	4.2	3.9	3.7	3.9	3.3	2.7
Croatia	4.3	4.8	3.6	4.7	4.8	7.0

Source: Eurostat, national statistical offices.

this, the first quarter of 2007 witnessed an increase in real wages, which exceeded the long-term average by a wide margin in most cases (particularly in Romania and Bulgaria, but also in Poland).

Investment became more important as an engine for growth. In Slovenia and Bulgaria, it represented the key component of growth. In Poland, investment also registered extraordinarily buoyant growth (+28%). A critical factor may have been the mild winter, which triggered unusually high levels of construction investment. Another factor was, of course, the positive impact of the prevailing industrial boom, which is evident from high (and still growing) levels of capacity utilization and industrial production. Foreign direct investment (FDI) stimulated investment activity primarily in the two newest EU Member States, Bulgaria and Romania. However, Hungary and the Czech Republic no longer fit the picture of increased investment momentum in the region. As in the previous quarters, investment expenditure shrank in Hungary. This decline was entirely attributable to a substantial decline in construction investment. By contrast, investment in plant and equipment recovered, notching up positive growth in early 2007 for the first time in three quarters. In the Czech Republic, gross fixed capital formation advanced far more slowly than in the fourth quarter of 2006. This development was, however, more than offset by a particularly robust buildup in inventories, which contributed 3.5% to growth.

The contribution of net exports to GDP growth developed in divergent ways across the region. Whereas net exports made the largest contribution to growth in the Slovak Republic and in Hungary, in Bulgaria and Romania their contribution to GDP growth was strongly negative. In the Slovak Republic, high production capacity levels in export-related industries have been created in recent years (frequently financed via inward FDI), giving a vigorous boost to exports. In Hungary, a competitive industrial sector contrasts with falling domestic demand. The contribution of net exports to growth has therefore soared in recent quarters. In Bulgaria and Romania, extremely dynamic domestic demand generated high import growth. In both countries, furthermore, export activity lost momentum, which – in Romania – was primarily a result of the strong currency. In Bulgaria, several sector-related temporary factors may have taken their toll, although import/export data should be interpreted carefully and will probably have to be revised owing to the change in the way the country’s statistics are now recorded in the wake of the country’s accession to the EU.

Economic growth in Croatia, an EU accession candidate, was driven by buoyant domestic demand. The contributions of investment and, above all, private consumption to growth increased significantly. The latter is ascribable to robust wage growth and higher total household lending. In the first quarter of 2007, the contribution of net exports to growth was slightly negative. Both import and export growth weakened to some extent.

3.2 Somewhat Higher Inflation

In the first half of 2007, a trend in rising inflation was evident in CESEE; in the summer, though, inflation could be reined in again.

Table 2

Price Developments in Selected Central, Eastern and Southeastern European Economies

Annual change of the HICP in %

	2005	2006	Feb. 07	Mar. 07	Apr. 07	May 07	June 07	July 07
Bulgaria	6.0	7.4	4.6	4.4	4.4	4.5	5.3	6.8
Poland	2.2	1.3	1.9	2.4	2.2	2.3	2.6	2.5
Romania	9.1	6.6	3.9	3.7	3.8	3.9	3.9	4.1
Slovak Republic	2.8	4.3	2.0	2.1	2.0	1.5	1.5	1.2
Slovenia	2.5	2.5	2.3	2.6	2.9	3.1	3.8	4.0
Czech Republic	1.6	2.1	1.7	2.1	2.7	2.4	2.6	2.5
Hungary	3.5	4.0	9.0	9.0	8.7	8.4	8.5	8.3
Croatia[1]	3.4	3.2	1.2	1.8	2.3	2.2	1.9	2.1

Source: Eurostat, national statistical offices.
[1] CPI.

The Slovak Republic succeeded in continuing the disinflation process. Services and (processed and unprocessed) foods accounted for the largest share of inflation measured in the region, with the latter being responsible for a good portion of the HICP rise in the Czech Republic, in Poland, Slovenia and, in recent months, in Bulgaria as well. Energy, the key price driver in 2006, did not have a significant impact on price developments at the start of 2007. The drop in inflation in the Slovak Republic was attributable to two factors. First, unprocessed foods made a smaller contribution to inflation. Second, deflation again became stronger in the segment of nonenergy industrial goods. Furthermore, the appreciation of the Slovak koruna also had an inflation-dampening effect. Among the CESEE countries currently under review, Hungary remains the country with the highest rate of inflation. However, inflation – which had surged after administered prices and taxes were raised within the framework of the aforementioned budget restructuring measures – may have peaked in early 2007. Since April 2007, contributions to inflation have been stable or in decline in most categories.

In July 2007, core inflation (all-items index adjusted for energy and unprocessed foods) ranged between 1.7% in the Slovak Republic and 7.3% in Hungary. In the first six months of 2007, a modest rise in this indicator was evident in most CESEE countries, perhaps signaling increasing inflationary risks in future. Such risks are given, above all, by already high (and rising) levels of capacity utilization, rising employment, falling unemployment and, in this connection, increasingly dynamic wage growth.

Slovenia was the first new EU Member State of the 2004 enlargement round to introduce the euro in January 2007. According to Eurostat, the introduction of the euro increased inflation by 0.3 percentage point in the changeover period to March 2007. Apparently euro-related price increases in some goods and services categories (e.g. restaurants and hotels, personal services) were evident particularly in December 2006 and January 2007. However, the rise in inflation seen in recent months was primarily attributable to soaring food prices.

In March and April 2007, the Slovak central bank (Národná banka Slovenska) cut its key interest rate by 25 basis points in two equal steps to a current 4.25%. In June 2007 and on September 24, 2007, its Hungarian counterpart (Magyar Nemzeti Bank) followed suit, lowering its key interest rate by a total of 50 basis points to 7.5%. Declining interest rates as well as the key interest rate cut by the Federal Reserve provided Magyar Nemzeti Bank with the room for maneuver to take this step.

In August 2007, by contrast, the central banks of Poland (Narodowy Bank Polski) and the Czech Republic (Česká národní banka) increased their interest rates by 25 basis points to 4.75% and 3.25%, respectively. As anticipated, Narodowy Bank Polski raised its key interest rates. The growing pressure on wages and demand justified this increase. For the same reasons, Česká národní banka unexpectedly raised its key interest rates for the second time since June 2007. Above all, robust private consumption and falling unemployment may mean that the central bank might miss the inflation target of 3% by ±1 percentage point (as measured by the CPI).

3.3 Divergent Current Account Performances, Volatile Exchange Rates

At the start of 2007, Poland, the Slovak Republic, Slovenia and the Czech Republic saw an improvement in their respective current accounts, primarily on the back of major advances in their goods and services balances, which were positive in Slovenia and the Czech Republic and only slightly negative in Poland and the Slovak Republic. There were two reasons for this improvement: first, more vigorous economic activity in the euro area and the related higher demand for goods and services, and second, a high degree of competitiveness (which is evident from these countries' dynamic productivity growth in industry, falling unit labor costs and improvements in the terms of trade). The income balance is the biggest strain on these countries' current accounts. In most CESEE countries, the income balance is in strongly negative owing to high profit repatriation levels.

Current account deficits widened in Hungary, Bulgaria and Romania. In particular, Bulgaria and Romania have large shortfalls in their respective current accounts. In both coun-

Table 3

Current Account Developments in Selected Central, Eastern and Southeastern European Economies

% of GDP

	2005	2006	Q2 06	Q3 06	Q4 06	Q1 07
Bulgaria	−12.0	−15.8	−12.5	−5.1	−25.4	−27.3
Poland	−1.6	−2.3	−2.0	−1.4	−3.5	−2.9
Romania	−8.6	−10.4	−11.1	−9.8	−11.6	−15.3
Slovak Republic	−8.7	−8.3	−9.6	−10.3	−6.9	0.9
Slovenia	−2.0	−2.5	−0.7	−2.8	−5.6	−2.6
Czech Republic	−2.1	−4.2	−5.7	−5.3	−6.0	−1.6
Hungary	−6.9	−5.8	−6.6	−5.1	−4.4	−4.8
Croatia	−6.4	−7.8	−15.3	−21.8	−17.4	−24.0

Source: National central banks.

tries, the dynamic economy, growing consumer confidence and high lending growth are spurring a boom in consumption and are thus deepening the deficit in the goods and services balance. In both Bulgaria and Romania, current account trends should be seen against a backdrop of healthy investment demand, but also partly as a reflection of brisk residential construction activity. A positive point is that the net FDI inflows (including intracompany loans) in both countries are significantly helping to narrow the financing gap, although the export-import ratio fell in the first quarter of 2007 compared with previous quarters.

The development of Croatia's current account has a strongly cyclical nature, which is primarily attributable to the country's services balance and, in this context, to tourism. Croatia's particularly high deficit in the first quarter of 2007 should be viewed in this light.

Owing to the latest financial market turmoil in connection with the U.S. mortgage crisis, the currencies of the new EU Member States temporarily depreciated somewhat against the euro before firming marginally in September. The Hungarian forint was most severely affected, whereas the Czech koruna continued to appreciate, unaffected by the crisis. The reason was above all the liquidation of carry trades using the Czech koruna as an investment currency.

Although stock markets in Poland, the Czech Republic and Hungary fell sharply in value in August 2007, they had staged a recovery by the end of September.

4 Austria: The Economy Continues to Expand for Another Year

4.1 OeNB Economic Indicator: Strong Economic Growth in 2007

The Austrian economy is currently experiencing a period of expansion. At +3.1% (seasonally and working-day adjusted), real GDP growth proved to be very vigorous in 2006. In the first half of 2007, this trend continued unchecked, with growth amounting to 0.9% in both the first and second quarters of the year (seasonally and working-day adjusted, quarterly).

Table 4

Results of the National Accounts (in real terms)

	2005	2006	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07
	Annual change in %[1]		Quarterly change in %[1]					
GDP	+2.3	+3.1	+0.7	+0.8	+0.8	+0.8	+0.9	+0.9
Private consumption	+2.0	+2.0	+0.5	+0.4	+0.4	+0.4	+0.3	+0.4
Government consumption	+1.8	+2.0	+0.6	+0.5	+0.4	+0.3	+0.1	+0.2
Gross fixed capital formation	+1.3	+3.1	+0.4	+1.1	+1.5	+1.5	+1.4	+0.9
Exports	+6.8	+7.3	+1.6	+1.7	+2.0	+2.1	+1.6	+1.3
of which: goods	*+7.2*	*+7.8*	*+2.7*	*+0.5*	*+2.0*	*+2.4*	*+1.5*	*+0.9*
services	*+5.5*	*+6.4*	*+1.5*	*+1.6*	*+1.7*	*+1.6*	*+1.6*	*+1.6*
Imports	+6.1	+4.5	+0.9	+1.3	+1.6	+1.5	+0.9	+0.5
of which: goods	*+6.5*	*+5.6*	*+1.4*	*+1.4*	*+1.4*	*+1.6*	*+1.5*	*+0.6*
services	*+2.3*	*+5.2*	*+1.3*	*+1.7*	*+1.6*	*+0.9*	*+0.2*	*+0.3*

Source: WIFO.

[1] *Seasonally and working-day adjusted.*

In the first six months of 2007, growth was led by net exports, in particular. Although export growth became sluggish, the simultaneous decline in the growth in imports stabilized the contribution of net exports to growth. Exports therefore appear to have passed their cyclical peak. The same goes for investment, which advanced appreciably more slowly in the second half of 2007 (+0.9%).

Consumption growth still lags behind expectations. In recent months, however, the European Commission's consumer confidence indicator has settled at very high levels. In the first half of 2007, government consumption developed very sluggishly, almost stagnating.

Economic risks increased owing to the international financial market turmoil originating in the U.S. real estate market. Indicators published recently still do not allow clear conclusions to be drawn about how large an impact the turmoil has on the Austrian economy. However, it is an

Box 1

OeNB Economic Indicator of September 2007 Signals Continued Robust Growth in the Second Half of 2007[1]

According to the current OeNB economic indicator, Austrian real GDP will grow by 0.8% and 0.7% in the third and fourth quarters of 2007, respectively (seasonally and working-day adjusted, quarterly). For 2007 as a whole, this means growth of 3.4%. The growth forecast for the third quarter of 2007 remained unchanged from the OeNB economic indicator published in June 2007.

Table 5

Short-Term Real GDP Forecast for Austria in the Third and Fourth Quarters of 2007 (seasonally and working-day adjusted)

2004				2005				2006				2007			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Quarterly year-on-year change in (%)															
1.6	2.3	2.8	2.6	2.3	2.2	2.2	2.7	3.2	3.1	3.0	3.3	3.4	3.5	3.4	3.3
Quarterly change in (%)															
0.6	1.0	0.8	0.1	0.3	0.9	0.9	0.6	0.7	0.8	0.8	0.8	0.9	0.9	0.8	0.7
Annual change in (%)															
2.3				2.3				3.1				3.4			

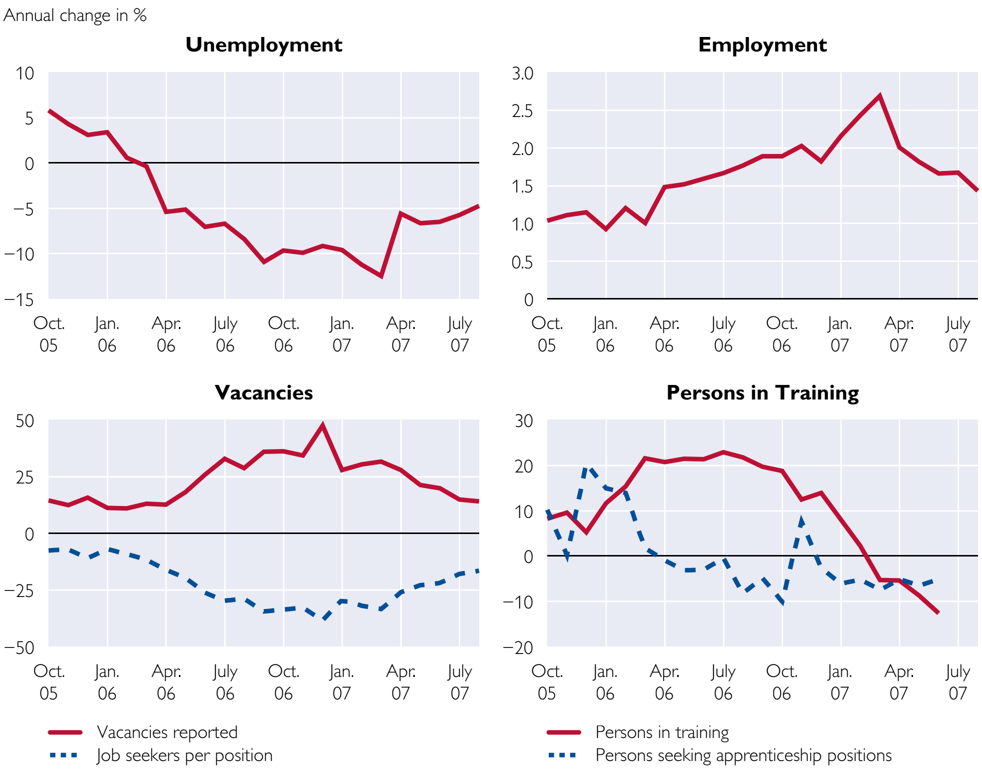
Source: Findings of the OeNB economic indicator of September 2007, Eurostat.

At +3.4%, annual growth in 2007 exceeds the OeNB's forecast of June 2007 by 0.2 percentage points. This increase is primarily attributable to the revision of historical data. Growth in the fourth quarter of 2006 and the first quarter of 2007 was revised upward from 0.5% to 0.8% and from 0.8% to 0.9%, respectively. The values registered by the OeNB economic indicator for the third and fourth quarters of 2007 remained unchanged on the OeNB's forecast of June 2007. To date, the international financial market turmoil originating in the U.S. real estate market has not been reflected in leading indicators and thus in the current values of the forecast.

[1] *The OeNB economic indicator has been published four times a year since the first quarter of 2003. It forecasts real GDP growth for the current quarter and the next (in each case, quarterly, using seasonally and working-day adjusted data). The forecast's values are based on the results of two economic models, a stochastic decision space model and a factor model. Further details on the models used can be found at www.oenb.at under Monetary Policy and Economy/Forecasts. The next publication is due in January 2008.*

Chart 5

Labor Market Developments in Austria



Source: Statistics Austria.

indisputable fact that, in addition to high oil prices and the strong euro, the U.S. real estate crisis represents an additional risk factor for the economy.

4.2 Food and Energy Prices Fuel Inflation

In the first half of 2007, Austrian inflation (HICP) advanced from 1.7% in January to 2.0% in July. The rise in inflation in the first half of 2007 was attributable to two factors: first, high crude oil prices and, second, strong inflationary pressures in the separate category of food prices.

The price of crude oil (Brent) climbed from about USD 59 (January 1, 2007) by some 35% to almost USD 80 (July 20, 2007) and, since early September, has been just under USD 80 following a brief rally (USD 66.8 on August 22, 2007). The dissipating base effect of prices of the core component energy and the increase in petroleum tax as of July 2007 are continuing to reinforce the rise in the price of crude oil. Price increases of the core component food are primarily attributable to higher bread and milk product prices. In August 2007, inflation retreated to 1.7%, i.e. to the euro area level.

4.3 Recovery in the Labor Market Slows Down

The Austrian labor market is continuing to develop very favorably on the back of economic expansion even though trends are becoming sluggish in some areas. Registered unemployment declined from 295,300 in January 2007 to 191,200 in August 2007. This corresponds to a 4.8% drop year on year in August 2007 and signifies a slight slowdown in momentum on July 2007 (–5.7%) (chart 5). The number of the long-term unemployed has fallen particularly sharply on account of the buoyant Austrian economy (–23.5%). In August 2007, the problem groups of the young unemployed (–5.6%) and those aged 50+ (–2.4%) registered a slight fall in numbers. In March 2007, employment growth peaked and has since been slackening marginally. In August 2007, it stood at 1.4% (see chart 5). At 4.3%, the jobless rate (Eurostat) has remained consistently low from May to August 2007.

Although the number of vacancies reported is continuing to rise steeply (August 2007: +14%), growth momentum has been slowing since December 2006. The number of job seekers per position, i.e. the ratio of the number of those reported unemployed to the number of vacancies reported, is continuing to decline, thereby also reflecting Austria's currently favorable labor market environment (August 2007: –16.5% year on year). However, this figure, too, peaked in December 2006.

A trend reversal is evident from the number of persons in training. Whereas this figure registered positive double-digit growth in 2006, since March 2007 it has suffered negative growth. In other words, fewer people are taking up training compared with a year ago. In August 2007, a mere 34,025 persons were undergoing training. The same goes for the number of young persons seeking apprenticeship positions, which – as was largely the case in 2006 – is characterized by declining growth (chart 5).