

Euro Area Growth Broad-Based in Early 2006

Lower Rate of Inflation

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The global economy continued to look robust at end-2006. In the U.S.A. private consumption increased, notwithstanding the protracted housing slowdown, and the services sector continued to grow at a dynamic pace. In view of the still buoyant economy, a cut in U.S. interest rates does not appear imminent. In Japan, the economic recovery persisted, leading the Bank of Japan to raise interest rates in February 2007 – for the first time since ending six years of zero interest rates in July 2006. In China and Southeast Asia, the rapid pace of growth continued to accelerate.

In the euro area, real GDP growth accelerated in the fourth quarter of 2006 and is, moreover, increasingly being driven by domestic demand. The latest forecasts indicate above-potential GDP growth in 2007. Furthermore, the labor market developed favorably, with both the actual and structural unemployment rate down by a significant margin. Since September 2006, the rate of inflation has been below the 2% mark owing to, among other factors, the fall in crude oil prices and the hitherto weak pass-through of the increase in Germany's VAT rate to consumer prices. In this climate the short-term prospects for price stability have improved as well.

The economies of the new EU Member States continued to outperform the euro area economies in the second and third quarter of 2006. This was primarily attributable to soaring domestic demand. Inflation rates visibly declined in most countries on the back of falling oil prices in the second half of 2006.

The Austrian economy will expand at a dynamic pace also in the first half of 2007. For both the first and second quarter of 2007, the current OeNB economic indicator forecasts real GDP growth of 0.7% on a seasonally-adjusted and quarterly basis. The Austrian economy will thus continue to grow at the rate it expanded in 2006. For 2007 as a whole, therefore, growth of 3% (or just above this figure) looks feasible from a current perspective.

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1 Continued Growth of the World Economy

1.1 U.S.A.: Moderate Economic Growth in the Fourth Quarter of 2006

In the fourth quarter of 2006, the U.S. economy showed moderate real GDP growth of 2.2% on an annualized basis after having slowed down visibly already in the previous two quarters. The cooling has so far largely reflected a housing slowdown, although the slowdown in inventory investment and in corporate investment also dampened output growth in the fourth quarter of 2006. However, consumer spending increased

by 4.2% on a quarterly basis and thus remained relatively robust in the fourth quarter of 2006, thanks to the favorable labor market situation, steep wage increases and relatively low oil prices. At 3.4%, real GDP growth in 2006 as a whole outperformed the long-term trend of some 3%. Productivity growth, while increasing sharply to 3% in the fourth quarter of 2006, only reached 2.1% on an annual basis, thus remaining below the figure for 2005 (2.3%).

In mid-February 2007, the Federal Reserve issued an optimistic statement on growth and the trend in inflation. In its opinion, the U.S.

Cutoff date for data:
March 9, 2007.

economy is expanding at a solid pace. Consequently, the Federal Reserve once more did not signal an early cut in interest rates, after having increased key interest rates 17 times in succession from mid-2004 to mid-2006 by 25 basis points each time to 5.25%.

The Federal Reserve statement was relativized somewhat by a recent release of data for January 2007. The number of new housing starts, for instance, was markedly down. In addition, U.S. consumer prices advanced at a stronger year-on-year rate (2.1%) in January 2007 than expected (December 2006: 2.5%). The increase in the core rate amounted to 2.7%. For 2007 as a whole, the Federal Reserve predicts that core inflation will decelerate to between 2.0% and 2.25% (2008: between 1.75% and 2.0%).

In January 2007, the Conference Board index of leading indicators firmed slightly compared with the previous month. This means that the index is continuing its slight uptrend of the past few months, signaling a modest acceleration of economic momentum in the second half of 2007. The Federal Reserve predicts real GDP growth of 2.5% to 3.0% in 2007 and 2.75% to 3.0% in 2008. According to the OECD's fall 2006 economic outlook, real GDP growth will be 2.4% in 2007.

The unemployment rate, which has been falling since mid-2003, reached a low of 4.5% toward end-2006 only to rise slightly to 4.6% in January 2007. Nonfarm enterprises created 111,000 new jobs in January on a seasonally-adjusted basis (2006 average: 187,000 per month). Employment grew in both the services and construction sector while manufacturing continued to shed jobs. Nonetheless, the labor force partici-

pation rate was 0.3 percentage point higher in January 2007 than 12 months earlier.

The risks to the U.S. economy remain its imbalances, which are its high current account deficit as well as consumers' high levels of debt and their low propensity to save. In addition, higher mortgage rates since mid-2004 are checking the take-up of additional mortgage loans and are thus contributing to a cooling of the housing market, which could dampen private consumption.

1.2 Japan: Renewed Hike in Interest Rates in View of Stable Growth Prospects

At 1.2%, Japan's real GDP grew for the eighth time in a row on a quarterly basis in the fourth quarter of 2006. GDP growth was driven by rebounding consumer spending, investment and exports, which accounted for a half, a third and a sixth of the total, respectively. However, since employees have so far hardly derived any benefit from high corporate profits, the adequate sustainability of consumer spending is not assured.

The Bank of Japan (BoJ) continues to assess the state of the Japanese economy as it did in October 2006. The central bank expects the Japanese economy to expand by 2.4% in the current fiscal year ending on March 31, 2007 (fiscal year 2007/08: 2.1%). In the calendar year 2006, the Japanese economy grew by 2.2% in real terms, i.e. for the seventh year in succession. In the OECD's fall 2006 economic outlook, Japan's GDP growth is set to be 2.0% in 2007. Although very healthy corporate profitability and buoyant export markets will continue to fuel Japan's growth, the latter depends on support from household spending. The

consumer price index (CPI) excluding fresh food, which is of key importance for monetary policy, remained unchanged on an annualized basis in January 2007 (full-year 2006: +0.1%). Since enterprises are starting to pass on their high energy costs to consumers and fiscal consolidation measures will necessitate an increase in VAT, consumer prices are likely to continue rising in future. For 2007, the OECD predicts an inflation rate of 0.3%.

In view of stable economic growth in the fourth quarter of 2006, the BoJ decided on February 21, 2007, to raise key interest rates by 25 basis points to 0.5%. In addition, the BoJ bases its rationale for this decision on a “forward-looking monetary policy” with a horizon of one to two years. The increase in overnight rates can also be seen as a warning signal regarding the recent surge in carry trades, which are based on raising funds in low-yield currencies for the purposes of investing profitably in high-yield currencies. In the past few months, carry trades have become a crucial driving force behind exchange rate fluctuations. However, since the interest rate gap continues to remain wide relative to major currency areas and the BoJ has not announced any further interest rate hikes for the near future, these arbitrage transactions will not lose their appeal for the time being. This is reflected in the renewed weakness of the Japanese yen.

1.3 Asia: Robust Economy, China Further Tightens Monetary Policy

Real GDP growth accelerated in a number of countries in non-Japan Asia (NJA: India, Malaysia, the Philippines, South Korea, Taiwan and Thailand). Both the domestic economy and the external sector contin-

ued to be important pillars of growth even though external demand was weaker in part (especially in the Special Administration Region of Hong Kong). Although Indonesia’s economy was hit by exceptional factors (floods, earthquake) in the fourth quarter of 2006, it grew by 5.5% in real terms over the year as a whole. In NJA, countries still enjoy a favorable economic outlook, with the main risk considered to be a stronger U.S. economic downturn.

Furthermore, China’s GDP growth continued to soar to 10.7%, driven by dynamic growth in gross fixed capital formation and exports. Continued growth in the trade balance surplus as well as direct investment inflows mean that China now leads the world in terms of currency reserves. Since bank lending and money supply growth have also increased at a faster than average pace, China’s central bank raised key interest rates twice in 2006 and repeatedly lifted the minimum reserve rate for deposits, most recently in January and February 2007. In addition, it instructed commercial banks to restrict lending, and it absorbed liquidity by issuing bonds.

2 Euro Area: Good GDP Growth, Inflation Remains Below 2%

2.1 GDP Growth Beats Expectations

In the last quarter of 2006, the euro area economy picked up marked momentum. Real GDP grew by 0.9% on the previous quarter and by as much as 3.3% on the fourth quarter of 2005, showing the usual signs of firming. While initially the cyclical upturn was primarily export-led, domestic demand has since started to support economic growth as well. In the fourth quarter of 2006, household

consumption contributed 0.3 percentage point to GDP growth. Gross fixed capital formation, which was fueled by high capacity utilization, made an equally high contribution to GDP growth. According to a European Commission survey, capacity utilization has exceeded its historical average of 81.8% since early 2006 (first quarter of 2007: 84.4%). Net exports registered strong growth rates, particularly in export-oriented countries such as Germany and Italy. All in all, average real GDP growth stood at 2.6% in 2006 as a whole.

In the fourth quarter of 2006, growth accelerated especially strongly in Italy and France. In Germany, too, economic growth gathered momentum at the end of the year. The acceleration in growth is primarily attributable to buoyant net exports. By contrast, domestic demand grew at only a moderate pace and was even more sluggish than in the third quarter of 2006. This is not in line with expectations of consumers rushing to beat the VAT increase from 16% to 19% effective from 2007 onward. Al-

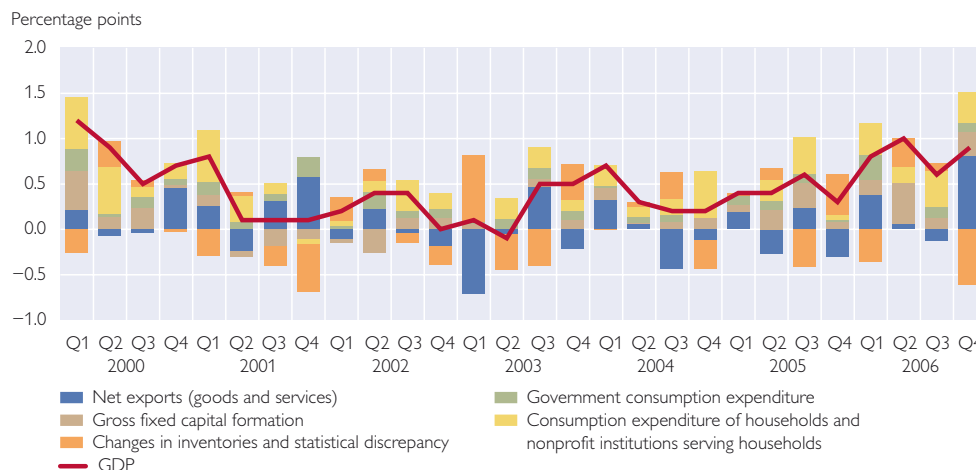
though car manufacturers and furniture makers benefited from robust demand, continued modest income trends clearly curtailed further demand. Furthermore, many retailers announced credibly that they intended to refrain from passing through the bulk of the VAT increase to consumers. In addition, domestic demand was dampened by the fact that the dynamic demand for export goods was met primarily by an inventory rundown.

Unemployment in the euro area continued to decline sharply thanks to robust economic growth. The unemployment rate gradually fell from a record high in mid-2004 (8.9%) to 7.4% in January 2007, reaching its lowest level in more than a decade. However, this decline is not only cyclically induced. The structural reforms of the past few years also reduced the structural unemployment rate. As a result, GDP growth is currently associated with considerably higher employment effects than a few years ago. In the second and third quarter of 2006, employment growth

Chart 1

Growth Contribution of Real GDP Components in the Euro Area

Quarter-on-quarter changes



Source: Eurostat.

on a quarterly basis stood at 0.4%, a level not seen since 2000. The European Commission's employment expectations in industry and the services sector suggest that the trend in employment will be dynamic in the months to come.

2.2 Forecasts Indicate Continued Growth

In coming quarters, the conditions required for the economy to continue developing favorably will prevail. Even the hitherto expected deceleration of GDP growth in the first quarter of 2007 will prove to be more moderate from a current perspective, as German consumers did not rush to beat the VAT increase, which would have sharply depressed consumer demand in the following quarters. Although some industrial sentiment indicators have slipped slightly since early 2007, they remain well above their historical averages, thus still signaling above-potential growth. There

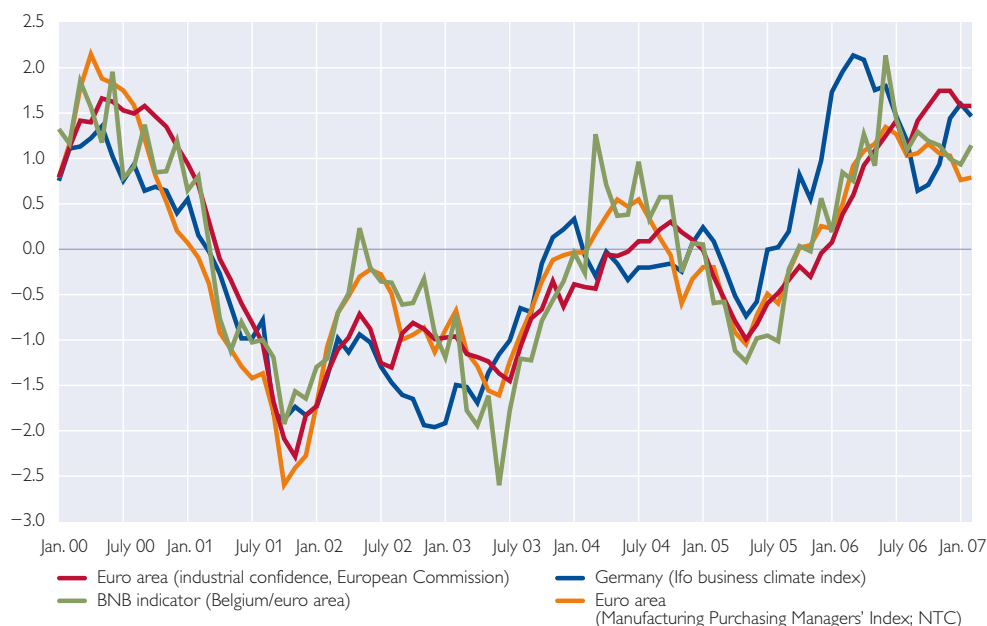
are without exception positive signs for private consumption, which is being fueled by the improved labor market situation and the favorable inflation expectations. For instance, a survey conducted by the European Commission shows that consumer confidence is in a stable uptrend. As a result, domestic demand should remain the mainstay of the economy.

The European Commission endorses this assessment. According to its euro area GDP growth projection, growth for the first quarter of 2007 will be between 0.4% and 0.8% and, for the second quarter of 2007, between 0.5% and 0.9%. In its interim update for the fall 2006 economic outlook, the European Commission revised upward its growth expectations for 2007 as a whole by 0.3 percentage point to 2.4%. It expects the growth differentials between Europe's largest economies to converge and deems the forecasting risks to be balanced.

Chart 2

Business Climate Indicators

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



Source: European Commission, Ifo, NTC, BNB, OeNB calculations.

In addition, the ECB released upbeat staff projections in March 2007. ECB staff experts expect GDP growth to range between 2.1% and 2.9% in 2007 and between 1.9% and 2.9% in 2008, with both external and domestic demand likely to fuel the economy.

2.3 Euro Area Inflation Remains below 2% in Early 2007 thanks to Unexpectedly Weak VAT Effects in Germany

It was assumed as late as fall 2006 that a good chunk of Germany's VAT reform would be passed onto consumers in the form of higher prices. As a result some forecasts saw inflation in the euro area rise by as much as 0.4 percentage point. However, the first few months of 2007 showed that this effect was more modest. Clearly, fierce competition counteracted a full pass-through to consumers, as healthy profitability allowed enterprises to absorb the effect.

In the euro area (including Slovenia), the inflation rate of the Harmonized Index of Consumer Prices

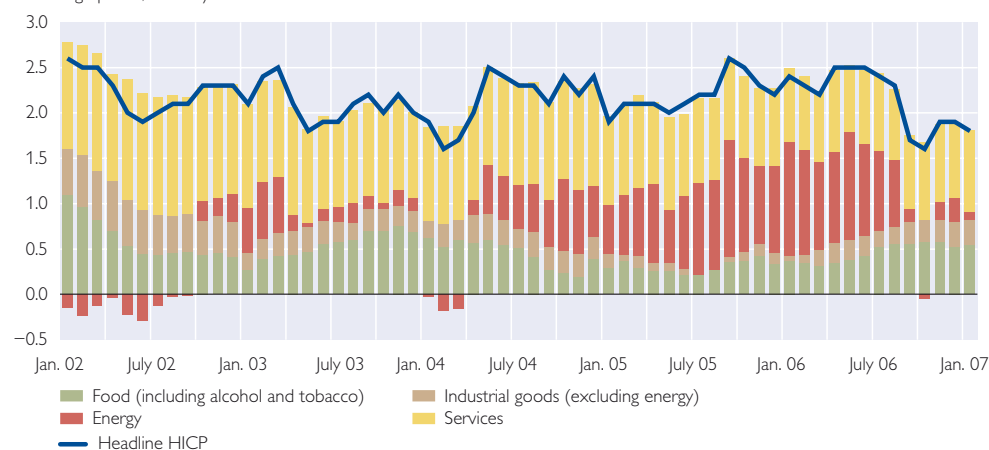
(HICP) fell to 1.8% in January 2007. The HICP flash estimate for February 2007 was also 1.8%. Since September 2006, inflation has therefore been below the 2% mark. This is attributable primarily to the fall in crude oil prices. The contribution of energy goods to inflation has been minimal or even negative in the last few months. Unprocessed food prices, which registered the highest growth rates in four years in fall 2006 as a result of the hot dry summer, recently rose at a slower pace, due to the mild winter among other things.

In the second half of 2006, core inflation (excluding energy and unprocessed food) steadied, ranging from 1.5% to 1.6%. In January 2007, however, core inflation then climbed to 1.8%. This might imply certain risks for the future. For instance, although the inflation rate for industrial goods (excluding energy) remains low thanks to fierce international competition, it has steadily risen from 0% in mid-2005 to almost 1%. As for services, several exceptional factors (telecoms, administered

Chart 3

HICP Components: Contributions to Inflation

Percentage points, monthly data



Source: Eurostat.

prices) have dampened price increases since mid-2004. These downward pressures on inflation should now become less important.

The complexity of the development of prices is also noted by the European Commission. Although it markedly revised downward its interim inflation outlook to 1.8% in view of weak inflation effects in Germany and moderate oil prices, it sees risks in upward pressures on producer prices and a possible lack of wage restraint. Wages have so far risen at a moderate pace, however. In the third quarter of 2006, unit labor cost growth stabilized at 0.8%. As a result, no significant second-round effects generated by oil prices are identifiable.

According to ECB staff projections released in March 2007, the HICP inflation rate will range between 1.5% and 2.1% in 2007 and between 1.4% and 2.6% in 2008. Whereas lower oil prices have improved the inflation outlook, the Governing Council of the ECB is vigilant vis-à-vis the future wage trend, particularly, in view of predicted higher GDP growth.

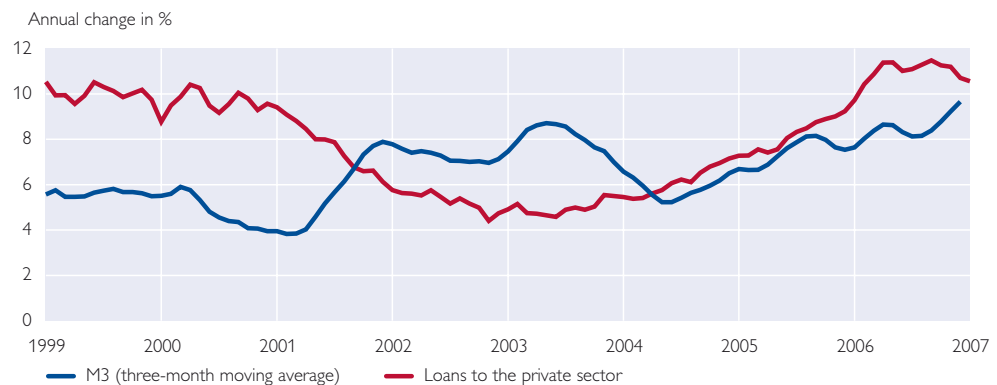
2.4 Historical Highs for Money Supply and Lending Growth

Money supply growth has been steadily accelerating since mid-2004. In the period from November 2006 to January 2007, the three-month average of annual money supply growth M3 was 9.7%, attaining a new high. This trend reflects, above all, accelerating growth in short-term deposits. Clearly, the increased rates for maturities of up to two years raise the appeal of investing in short-term assets. Falling, albeit continued high growth of M1 is due to still relatively low interest rates in the euro area.

However, lending growth recently slowed down following historical highs. Growth in private sector loans, which are of particular significance given their sheer volume, fell to their lowest level in almost a year. The reasons for the nonetheless continued high growth in lending lie in the historically low level of both short- and long-term interest rates as well as in the dynamic growth in housing purchases. The surge in M&A activities in the euro area is likely to have contributed to the rapid expansion of corporate borrowing.

Chart 4

M3 and Loan Developments in the Euro Area



Source: ECB.

2.5 Further Hike in Key Interest Rates by 25 Basis Points

On March 8, 2007, the Governing Council of the ECB endorsed a further increase in key interest rates by 25 basis points to 3.75%. This means that key rates have been raised by a total of 175 basis points since December 2005. This rate hike was justified on the basis of the favorable economic climate and the potential risks for price stability.

The markets largely anticipated this increase, which had already been factored into the three-month inter-bank rates prior to the Governing Council's decision. The yield curve has become steeper since early 2007, with the interest rates for ten-year euro bonds rising more rapidly than the three-month rates. Even though the yield curve exhibits a normal trend, the margin between interest rates at the long and short end remains historically low.

Following the turmoil in mid-2006, stock markets rallied quickly, attaining new highs in mid-February 2007. Contributory factors were healthy profitability and lower oil prices, as well as robust demand for stocks fueled by M&A activities. The Dow Jones EURO STOXX rose by some 20% in 2006, posting a historically high increase. At end-February 2007, however, stock markets were subjected to sharp price corrections and substantially increased volatility. This is likely to reflect increased risk aversion as well as jitters on the part of investors vis-à-vis the future trend of the U.S. economy.

The strong euro trend in the foreign exchange markets continued initially in fall 2006. This was due to, among other factors, the narrowing of the negative interest rate differential between the euro and the U.S.

dollar. The EUR/USD exchange rate appreciated to some extent in early 2007. Early 2007 also saw pound sterling firm relative to the euro. By contrast, the Swiss franc and the Japanese yen softened, which may be attributable to an ample currency supply of Swiss francs and Japanese yen fueled by carry trades. At end-February 2007, the euro outperformed its average in 2006 by some 2% in effective nominal terms.

3 Economic Growth in Central and Eastern Europe (CEE)

3.1 Strong Economic Momentum in the New EU Member States

In the first half of 2006, average real GDP growth in Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia fell just short of 6% year on year whereas, in the third quarter of 2006, came to just above 6% compared with the same period a year ago. This means that CEE countries continued to enjoy accelerating growth – evident as early as 2005 – in 2006. Preliminary data on GDP growth in the fourth quarter of 2006 suggest the continuation of this trend. This region's economic momentum is attributable primarily to Poland and Romania. In Poland – the region's largest economy in GDP terms – growth accelerated from 3.5% in 2005 as a whole to 5.8% in the third quarter of 2006. In Romania – the third largest economy of the EU's Eastern and Southeastern European Member States – GDP growth doubled compared with 2005 as a whole. In addition, Bulgaria and the Slovak Republic registered higher than average growth. At almost 10% in the third quarter of 2006, Slovakia reported the highest growth in real terms since

Table 1

Real GDP Growth in Selected Eastern European Economies						
Annual change in %						
	2005	2006	Q1 06	Q2 06	Q3 06	Q4 06
Bulgaria	5.5	..	5.6	6.6	6.7	..
Czech Republic	6.1	..	6.4	6.0	5.8	..
Hungary	4.2	..	4.9	3.8	3.8	..
Poland	3.5	5.9	5.2	5.5	5.8	7.0
Romania	4.1	..	6.9	7.8	8.3	..
Slovak Republic	6.0	8.2	6.7	6.7	9.8	9.5
Slovenia	4.0	..	5.1	4.8	5.6	..
Croatia	4.3	..	6.0	3.6	4.7	..

Source: Eurostat, national statistical offices.

the founding of the Republic in 1993. In Hungary, however, GDP growth was more sluggish than in the other countries of the region. In Croatia, the economy gained momentum in the third quarter of 2006 after a muted second quarter.

In almost all the countries of this region reviewed here, growth was largely driven by domestic demand. Both private consumption and corporate investment soared. Household spending was fueled primarily by an improved labor market situation. Growing employment, falling jobless rates and increasing real wages strengthened consumer confidence. Furthermore, lending growth, which was robust in some countries, boosted consumption.

High levels of macroeconomic demand, coupled with favorable financing conditions, good capacity utilization and satisfactory profit performance generated strong investment growth. This development was particularly marked in Poland, Slovenia and the new EU Member States in Southeastern Europe. In all the aforementioned economies, investment activity registered double-digit growth rates in the third quarter of 2006. In Poland, this amounted to almost 20%. Above all, Bulgaria and

Romania continued to benefit from high FDI inflows.

This general picture of growth fueled by domestic demand is shattered only by Hungary, where private consumption has been stagnating since early 2006. Both public consumption and investment expenditure registered negative growth in the second and third quarter of 2006. This was due to a comprehensive budget consolidation package necessitated by a very high budget deficit (2006: 10.1% of GDP). Growth generated in Hungary is almost entirely attributable to net exports. This is based on the continued robust growth in exports. By contrast, the weak domestic economy is currently dampening the growth in imports.

In the other CEE countries, net exports relative to GDP growth were hardly of any consequence in the third quarter of 2006 and were for the most part slightly negative. In Bulgaria and Romania, the trend in high and accelerating import growth continued, as a result of which net exports were deep in the red despite quite robust export growth. Both countries saw considerable improvement in their economic outlooks in connection with their accession to the EU and their dynamic GDP

growth. In anticipation of rising income, Bulgarian and Romanian households have been stepping up consumption, which has in turn caused lending to the private sector to soar. Strong consumer activity is reflected in both countries' high and growing current account deficits as well. By the third quarter of 2006, both Bulgaria and Romania had accumulated a current account deficit of some 11% of GDP, i.e. about 3 percentage points higher than in the comparable period in 2005. In both cases, this development can be attributed to a strong trade deficit. In the third quarter of 2006, the average current account deficit of the five CEE countries stood at 3.2% of GDP. At 8.9% of GDP, the Slovak Republic posted a considerably higher deficit. This country's deficit can be attributed in equal parts to its trade balance and to a deficit on its income account.

Croatia's GDP growth was also fueled by a buoyant domestic economy, in particular. Investment activity, followed by private consumption, made the biggest contribution to growth. The external sector's contribution to growth was slightly negative.

3.2 Pricing Pressures Ease toward End-2006

In the second half of 2006, a reduction in inflation was evident in most countries of this region. In December, inflation ranged from 1.4 % in Poland to 6.6% in Hungary. First and foremost, this downtrend in inflation was due to the fall in crude oil prices. Whereas energy was on average responsible for almost 50% of inflation measured in the first three quarters of 2006, this share fell to only around 25% in the fourth quarter of 2006. Hungary, where energy's contribution to inflation indeed rose slightly on the back of higher gas prices, represents the outlier of this general trend. In Hungary, as in Bulgaria, the trend in inflation was marked primarily by the prices of processed food (including alcohol and tobacco). In both cases, this is attributable above all to the increase in indirect taxes.

In Romania, the inflation rate tumbled to below 5% at end-2006. In addition to the decreasing contribution of the energy component, this disinflation process can be attributed primarily to the development in unprocessed food prices. After 2005, which was marked by weather-induced catastrophes and floods, agri-

Table 2

Price Development in Selected Eastern European Economies

Annual change in HICP (%)

	2005	2006	July 06	Aug. 06	Sep. 06	Oct. 06	Nov. 06	Dec. 06
Bulgaria	5.0	7.3	7.6	6.8	5.6	5.7	6.1	6.5
Czech Republic	1.6	2.1	2.4	2.6	2.2	0.8	1.0	1.5
Hungary	3.5	4.0	3.2	4.7	5.9	6.3	6.4	6.6
Poland	2.2	1.3	1.4	1.7	1.4	1.1	1.3	1.4
Romania	9.1	6.6	6.2	6.1	5.5	4.8	4.7	4.9
Slovak Republic	2.8	4.3	5.0	5.0	4.5	3.1	3.7	3.7
Slovenia	2.5	2.5	1.9	3.1	2.5	1.5	2.4	3.0
Croatia ¹	3.4	3.2	3.4	3.4	2.8	2.1	2.5	2.0

Source: Eurostat, national statistical offices.

¹ CPI.

cultural production made a strong recovery in the course of 2006. Since September 2006, unprocessed food prices have exerted a dampening effect on inflation after having contributed 1.7 percentage points to inflation early that year. In Poland, more gradually rising processed food prices and falling industrial goods prices favored the trend in inflation.

In December 2006, core inflation rates (overall inflation adjusted for energy and unprocessed food) ranged from 1.1% in Poland to 8.8% in Bulgaria. Compared with early 2006, all the countries of this region (excluding Romania) witnessed a rise in this measure of inflation. This pressure on prices was triggered primarily by high growth momentum and stronger wage growth owing to capacity constraints in the labor markets.

3.3 Easing in Most Labor Markets

In the course of 2006, the labor market situation improved in all the countries of this region reviewed here thanks to the still dynamic economy. Successful structural reforms, high FDI inflows in expanding sectors and, to a certain extent, migration to other EU Member States contributed to a decline in unemployment rates. Labor market conditions improved above all in Poland and the Slovak Republic, the two countries within the EU with the highest rates of unemployment. In Poland, unemployment was reduced from 16.3% in the first quarter of 2006 to 13.2% in the third quarter of 2006. In the Slovak Republic, it was reduced from 15.0% to 12.9% over the same period. In both countries, employment growth accelerated to some 4% in the third quarter of 2006. A decline in long-term unemployment is also evident in most countries of this region.

3.4 Enlargement of the Euro Area

Slovenia was the first country from the EU enlargement round of May 2004 to introduce the euro as legal tender on January 1, 2007. The decision to do so was taken on July 11, 2006, by the Ecofin Council after the ECB and the European Commission had positively assessed Slovenia's convergence in their respective convergence reports. One of the key challenges facing the introduction of the euro in Slovenia was the avoidance of unjustified price increases. According to the Slovenian statistical office, in the direct run-up to the introduction of the euro (i.e. in December 2006), some goods and services categories (e.g. cafés and restaurants, furniture, cosmetic articles, textiles, personal services) were subjected to unusually high price increases, which might partly be associated with the introduction of the euro. In January 2007, however, inflation in fact registered an overall decline.

Both Malta and Cyprus intend to introduce the euro in 2008 and thus applied to the European Commission for a convergence test in February 2007. Their respective convergence reports will probably be presented in May.

4 Austria: OeNB Economic Indicator Signals Continued High Levels of Growth in the First Half of 2007

4.1 Peak of Economic Recovery Appears Attained

Fueled by exports and investment, Austria's GDP growth came to 3.4% on a seasonally adjusted basis in 2006 (nonseasonally adjusted: 3.2%). Austria benefited, in particular, from extremely buoyant demand in its export markets, which rose by just under 10% in real terms, compared

with 2005. Whereas U.S. output growth slowed slightly in the course of 2006, the economies of Austria's key trading partners, Germany and Italy, made a strong recovery. The national accounts show export growth to have reached 8.3% (table 3) but are likely to underestimate the expansion due to changes made to the compilation method for trade in services.¹ The high export momentum is reflected primarily in the performance of the goods balance compiled by Statistics Austria. In 2006, exports rose by 12.7% in nominal terms, attaining for the first time a value in excess of EUR 100 billion. Despite rising energy prices, the goods balance improved by more than EUR 1.6 billion and, with a deficit of only EUR 150 million, can be described as being almost balanced. On the strength of favorable external conditions, it looks quite likely that the goods balance will be back in the black in 2007. In particular, the strong advance in exports to new EU Member States Bulgaria and Romania was noticeable in

terms of the regional breakdown. In the services sector, the mild winter may negatively affect the services balance for the first quarter of 2007, given that overnight stays fell by 3.6% due to poor snow cover in January.

In 2006, external effects helped strongly revive investment activity. Gross fixed capital formation increased by 4.1% in real terms, with investment in construction as well as plant and equipment registering growth. Currently high levels of capacity utilization (85.1%) and the extremely positive results of the latest investment survey conducted by the Austrian Institute of Economic Research (WIFO) suggest undiminished investment momentum in 2007. While replacement investment is increasingly becoming less important as an engine for investment, favorable demand expectations and recently outstanding corporate profitability are becoming determinant factors.

By contrast, private consumption growth remained fairly subdued despite rising real wages and falling un-

Table 3

National Accounts Results (in real terms)

	2005	2006	Q1 06	Q2 06	Q3 06	Q4 06
	Annual change in % (seasonally and working day adjusted)		Quarterly change in % (seasonally and working day adjusted)			
GDP	+2.6	+3.4	+0.7	+0.9	+1.0	+0.8
Private consumption	+1.6	+1.8	+0.4	+0.4	+0.4	+0.3
Public consumption	+1.9	+0.9	+0.3	-0.0	+0.0	+0.2
Gross fixed capital formation	+1.3	+4.1	+1.2	+1.3	+1.3	+1.1
Exports	+6.9	+8.3	+2.6	+1.8	+1.8	+1.9
of which: goods	+6.4	+9.7	+2.7	+2.3	+2.0	+2.3
services	+6.7	+4.5	-0.4	+1.5	+1.4	+1.4
Imports	+6.1	+6.2	+2.3	+1.5	+1.1	+0.5
of which: goods	+7.0	+6.1	+1.7	+1.9	+1.2	+0.4
services	+2.8	+6.8	+3.4	+1.1	+1.3	+1.3

Source: WIFO (quarterly national accounts data).

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

employment rates during 2006 as a whole. In the fourth quarter of 2006, private consumption growth in fact slipped to 0.3% (in real terms, seasonally adjusted and on a quarterly basis) after having stood at 0.4% in each of the first three quarters of that year. The future development of private consumption will however be very crucial for the further develop-

ment of the economy. The OeNB's current short-term economic indicator (box 1) is based on the scenario of a gradual recovery in private consumption in the course of 2007. A faster and stronger than expected strengthening of private consumption would increasingly make growth self-sustaining and represents an upside risk for the short-term GDP outlook.

Box 1

OeNB Economic Indicator from March 2007: Growth Rate Remains High¹

The Austrian economy will expand at quite a dynamic pace in the first half of 2007. For both the first and second quarter of 2007, the current OeNB economic indicator forecasts real GDP growth of 0.7% (on a seasonally-adjusted and quarterly basis). This means that the Austrian economy will continue to grow at the rate it expanded in 2006. For 2007 as a whole, therefore, growth of 3% (or just above this figure) looks quite feasible from a current perspective.

Table 4

Short-Term Outlook for Austria's Real GDP in the First and Second Quarter of 2007 (seasonally and working day adjusted)

2005				2006				2007	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Quarterly year-on-year change (%)									
2.5	2.5	2.6	2.9	3.2	3.4	3.5	3.6	3.5	3.3
Change from previous quarter (%)									
0.4	0.7	0.9	0.8	0.7	0.9	1.0	0.8	0.7	0.7
Change from previous year (%)									
2.6				3.4				x	

Source: OeNB – Results of the OeNB indicator of March 2007, Eurostat.

In view of the buoyant demand for exports, well-filled order books and high levels of capacity utilization, vigorous export and investment activity will fuel the economy also in 2007. In the course of 2007, this momentum will carry over to private consumption, the growth of which has been fairly subdued in the past. Declining unemployment and a strong improvement in consumer sentiment indicate an acceleration in consumer spending – also stoked by the expected decline in inflation. In January 2007, inflation measured against the HICP came to 1.8%. Assuming stable crude oil prices, inflation in the next few months will tend to weaken as a result of base effects from past energy price increases and to strengthen real wage growth.

¹ Since the first quarter of 2003, the short-term indicator of the OeNB has been published four times a year. It forecasts real GDP growth for the current quarter and the next (in each case, on a quarterly basis, using seasonally adjusted data). The figures are based on the results of two econometric models, a stochastic state space model and a dynamic factor model. Further details on the models used can be found at www.oenb.at under the item "Forecasts" in the Monetary Policy and Economics section. The next publication is due in July 2007.

The risk of the current outlook is slightly to the upside. If consumer demand increases at an earlier stage and at a faster rate than assumed by the current OeNB economic indicator, even stronger GDP growth cannot be ruled out in the first half of 2007. Two exceptional factors increase the uncertainty of the outlook for the first half of 2007. First, the increase in VAT in Germany adversely affected GDP growth at the start of the year. However, the German economy and, above all, consumer confidence should now be so robust that the growth slowdown can be expected to have been a temporary dent. The impact on the Austrian economy is likely to be concentrated on the first half of 2007 and to dampen growth by no more than 0.1 percentage point. Second, the unusually mild winter has affected the economy particularly in the tourism and construction sectors, which both account for almost 10% of value added. However, the positive growth effects from additional construction activity are likely to more than offset the negative growth effects from tourism.

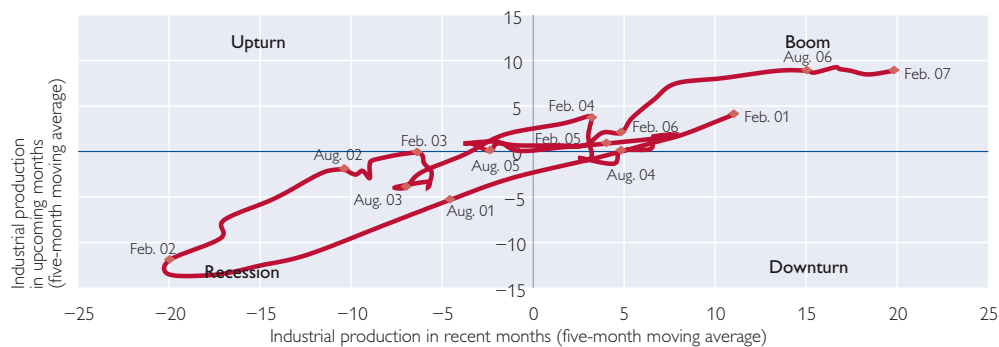
4.2 Confidence Indicators Signal Continued Economic Boom

The economic assessment indicator for Austria, which has been published by the European Commission since 1995, posted 123 points in February 2007, attaining its highest value ever measured. The strong improvement in consumer confidence is particularly good news, since it implies that the booming economy may have a knock-on effect on private consumption in 2007. These expectations are not reflected in the retail confidence indicator, which moved sideways – unlike the general trend of the last twelve months.

Industrials are currently very confident about the future. The assessment of industrial production in the past few months continued to improve, and expectations for the next few months are stagnating at a high level (chart 5). This is an indication that the peak of the industrial cycle has possibly been reached and that any further acceleration in growth should not be expected. From a current perspective, however, a turning point in the cycle is not identifiable. The assessment of both the domestic and foreign order book is favorable, which means that continued strong growth in industrial production

Chart 5

Assessment of Industrial Production in Recent and Upcoming Months¹



Source: European Commission.

¹ Both series were centered by their average of the period from February 2001 to February 2007.

should also be expected in the next few months. The outlook for the construction industry is also favorable. Both construction and civil engineering enterprises have well-filled order books, and the mild winter ensured additional growth impetus.

4.3 Inflation Remains Below 2% despite Economic Upturn

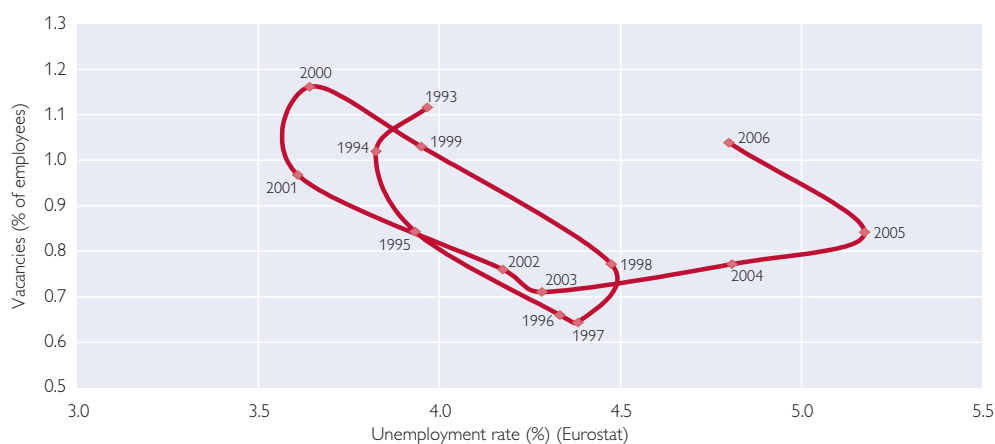
The inflation rate measured against the HICP has been climbing back since October 2006, reaching 1.8% in January 2007 (1.3%). The biggest surge in prices was seen in unprocessed food (+3.5%), processed food (+2.6%) and services (+2.5%) at the start of this year. In the energy sector, increases in electricity and gas prices contributed to the rise in inflation (+2.3%). However, the price development in industrial goods (excluding energy) had the opposite effect, dampening inflation (−0.1%). In January 2007, wage growth was 2.4%, falling slightly short of the annual average in 2006 (+2.7%). At +2.9%, wage growth in general government was stronger than other wage growth.

4.4 Employment Growth Beats Expectations

With a time lag, the surge in economic activity has now also filtered through to the labor market. Current employment growth – in February 2007, the number of employees increased by 2.4% – beats expectations. Similarly high growth was last witnessed in 1992. By contrast, employment growth persisted at below 1.5% even at the time of the economic boom in the late 1990s and in 2000. Employment growth is now so strong that, despite continued labor supply growth, unemployment is falling sharply. Since peaking in September 2005 (5.3%), the unemployment rate has fallen by almost 1 percentage point to 4.4% (Eurostat definition). In February 2007, 276,652 persons reported as being unemployed, i.e. around 35,000 fewer than in February 2006. In addition to the unbroken trend toward part-time work, temporary factors such as the mild winter are boosting the current momentum in the labor market. The number of unemployed fell by 15,000 in the construction industry alone. If

Chart 6

Beveridge Curve for Austria from 1993 to 2006



Source: Eurostat, Austrian Public Employment Service.

this trend in the construction industry had followed that of the remaining economy, the drop would have amounted to only somewhat more than 7,000 persons. The mild winter is therefore likely to explain around 50% of the reduction in unemployment within the construction industry.

In addition to temporary factors, there appear to have been signs of changes to structural conditions in the Austrian labor market. In the last

few years, for instance, the inverse correlation between reported vacancies and the unemployment rate, which is represented in the Beveridge curve, has shifted outward. This shift coincides with the introduction of various pension reforms. However, only time will tell whether this is a sign that Austrians should gear themselves up to a general rise in unemployment rates or whether this is just a temporary phenomenon.