Economic Recovery in the Euro Area and in Austria in a Dynamic Global Economic Environment

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The world economic recovery is continuing at a slightly more subdued pace. In the U.S.A., weaker consumer spending contributed to a slowdown in growth momentum. At the end of June 2004, the Federal Reserve abandoned its low interest rate policy and has since increased base rates by 50 basis points. In Asia, Japan's economy is back on the road to recovery and China's and Southeast Asia's high growth rates are by and large still on course.

Economic recovery in the euro area continued, albeit with marked divergences between countries. Growth is currently being fueled by external demand, in particular. The latest increase in crude oil prices triggered a rise in inflation. The ECB's projections paint a relatively upbeat picture of anticipated GDP growth. Although the outlook for price stability has deteriorated in the current climate of higher crude prices, in the medium term the price stability target will most probably be met.

In Central and Eastern Europe, the economy continues to grow at a more dynamic pace than in the former EU-15. The new EU Member States countries are now endeavoring to implement the next step of integration – the introduction of the euro.

1 Slowdown in Robust World Economic Growth

1.1 U.S.A.: Fed Ends Low Interest Rate Period at the End of June

Whereas U.S. economic growth in the first quarter of 2004 accelerated to 4.5% (annualized on the previous quarter), it slowed to 2.8% in the second quarter. In particular, weaker consumer spending (+1.6%, compared with +4.1% in the previous quarter), primarily attributable to the steep rise in energy prices and to reduced automotive sales, and a sharp deterioration in net exports contributed to this decline in growth. By contrast, private real estate investment and a sharp increase in corporate investment made a key contribution to growth. The rise in public expenditure slowed down.

Although growth in the second quarter of 2004 should not necessarily be interpreted as entailing a trend reversal, it could signify temporary sluggishness. The latest data are contradictory: since mid-2003 the Purchasing Managers' index compiled by the Institute for Supply Management ISM has outperformed its 10-year average and has been well in excess of the 50% mark, signaling growing goods production. However, the index in August slipped from 62% to 59%: order intake and output were equally responsible. Recent data for industrial output and private residential construction were fairly positive. By contrast, the U.S. index of leading indicators suggests only moderate real GDP growth. According to the Conference Board, the index deteriorated in July for the second successive month, falling 0.3% to 116 points (sharpest decline since February 2003). However, it is too early to say that the index's uptrend (which has persisted since March 2003) has now ended. The forecasts widely assume real GDP growth of about 4.5% in 2004, which is likely to weaken to some 3.75% in 2005 (e.g. OECD and Consensus Forecasts). The upturn in the U.S. labor market slowed in June and July. Although the jobless rate in July dipped from 5.6% to 5.5%, job growth in both months was well below expectations. Productivity growth in the second quarter decelerated by 2.9% on the previous quarter (+3.7%) and unit labor costs advanced by 1.9%.

Consumer price gains in July 2004 slowed to 3% year on year. At 1.8% year on year, the rise in the core rate over the same period was smaller than in June (1.9%).

At the end of June, the Federal Reserve abandoned its low interest rate policy of maintaining the Fed

funds rate at 1% and increased it by 25 basis points for the first time in four years. Further hikes by 25 basis points each followed in August and September, taking the rate to 1.75%. It is the Fed's declared intention to increase base rates gradually.

One of the biggest risks currently for U.S. economic growth is the potential persistence of high energy prices, which could act to squeeze growth in the second half of the year. Another risk factor would be a renewed surge in core inflation, which could prompt the Federal Reserve to hike interest rates more sharply than originally planned, leading to a further curb on rate-sensitive spending. Similarly, an unexpectedly steep rise in interest rates could rein in consumption and investment sharply, since private households are currently relatively deep in debt and the saving ratio is low. In addition, the high current account and budget deficits (of almost 5% and approximately 4.5% of GDP in 2004, respectively) represent risks in the medium and long term.

1.2 World Economic Growth Driven by Asia and the U.S.A.

For the last nine quarters in a row, Japan's economy has been on the road to recovery, although growth lost considerable momentum in the second quarter of 2004. Real GDP grew by 0.4% compared with the previous quarter. Thanks to demand from Asia (especially China), exports performed robustly, albeit with some signs of weakness. By contrast, corporate investment – a key engine for growth – was unexpectedly poor. Although the relative weakness of domestic demand cloud the overall picture somewhat, private consumption could prove positive in the next quarter and could keep the recovery on course.

Improved consumer sentiment is currently supported by a brighter labor market. Since early 2003 the jobless rate has fallen from 5.5% to 4.6% in mid-2004. In general, an increasingly broadly based recovery is expected this year. The Bank of Japan (BoJ) is standing by its almost zero interest rate policy. For 2004, both the BoJ and the IMF count on prices to fall, which would underpin hopes of finally beating deflation in the near future. Looking at fiscal policy, continued high budgetary deficits and total debt levels are a problem. However, plans to consolidate public sector budgets should be seen in a positive light.

Despite high oil prices, economic recovery in Asia (excluding Japan) has also continued in 2004, thanks to stronger exports and more animated domestic demand. In China, the government corrected its growth forecast for 2004 down to 7%, signaling a more balanced economic growth target. Nonetheless, data for the first six months of 2004 indicate continued high levels of growth and rising inflation. Despite a decline in bank lending, demand for investment continued to strengthen. Whereas inflows of short-term foreign capital to Asia (excluding Japan) are scant, since early 2001 foreign currency reserves have almost doubled. In the second quarter of 2004, however, hardly any foreign exchange reserves (China's excepted) were boosted any longer in a bid to prevent further risks (arising from this surplus liquidity) for prices and the economy. Economic recovery should be used to expedite financial market reforms that are currently dragging in certain countries.

2 Euro Area: Modest Recovery Continues

2.1 GDP Growth Largely Bolstered by Exports

Eurostat's initial forecast for real GDP growth in the euro area in the second quarter of 2004 indicates that the economy is continuing to grow at a stable pace: real GDP rose by 0.5% quarter on quarter (first quarter of 2004: 0.6%) and by 2.0% year on year (fourth quarter of 2003: 1.3%). By countries, Finland registered the highest growth (1%) on the previous quarter, followed by France and Belgium with 0.8% each. In Greece and the Netherlands, however, real GDP slipped by 0.6% and 0.2%, respectively. In addition, the subcomponents reflect marked differences between countries. For instance, German GDP growth in the second quarter was driven almost entirely by net exports whereas growth momentum in France was determined primarily by domestic demand.

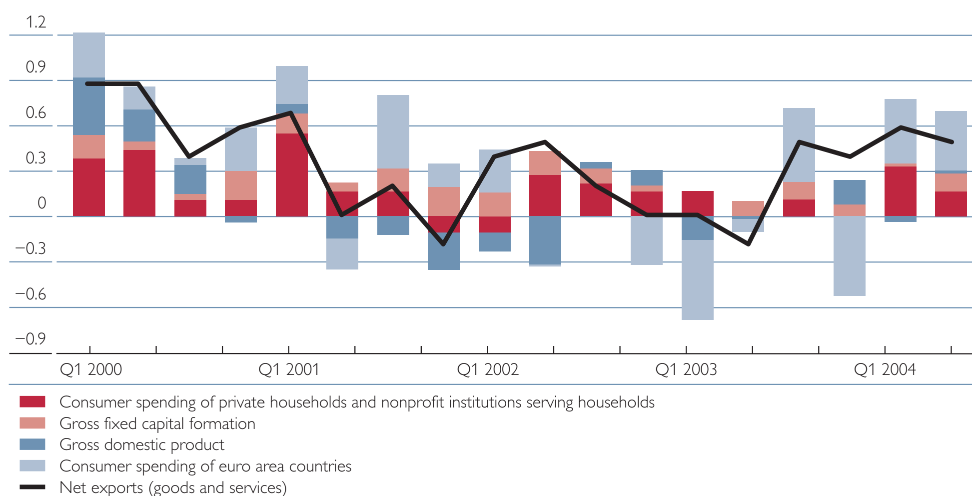
Trends in gross fixed capital formation continue to look volatile. After rising by 0.8% in the fourth quarter of 2003 (compared with the previous quarter), this component contracted by 0.2% in the first quarter of 2004. For the second quarter of 2004, growth came to 0.1%. However, it should be noted that the contraction in the first quarter of 2004 was primarily the result of a steep decline in construction investment in Germany, which continued to fall sharply in the second quarter of 2004 as well. In the remaining countries of the euro area, by contrast, investment expanded.

After posting extremely low quarterly growth rates since early 2001, stronger private household consumption growth resumed in the first (+0.6%) and second (+0.3%) quarters of 2004. Tax cuts in some euro area countries are likely to have contributed to this development, boosting disposable income more sharply. However, leading indicators for consumption suggest that uncertainty still prevails. According to the European Commission, consumer confidence

Chart 1

Quarterly Contribution to Growth from Real GDP Components in the Euro Area

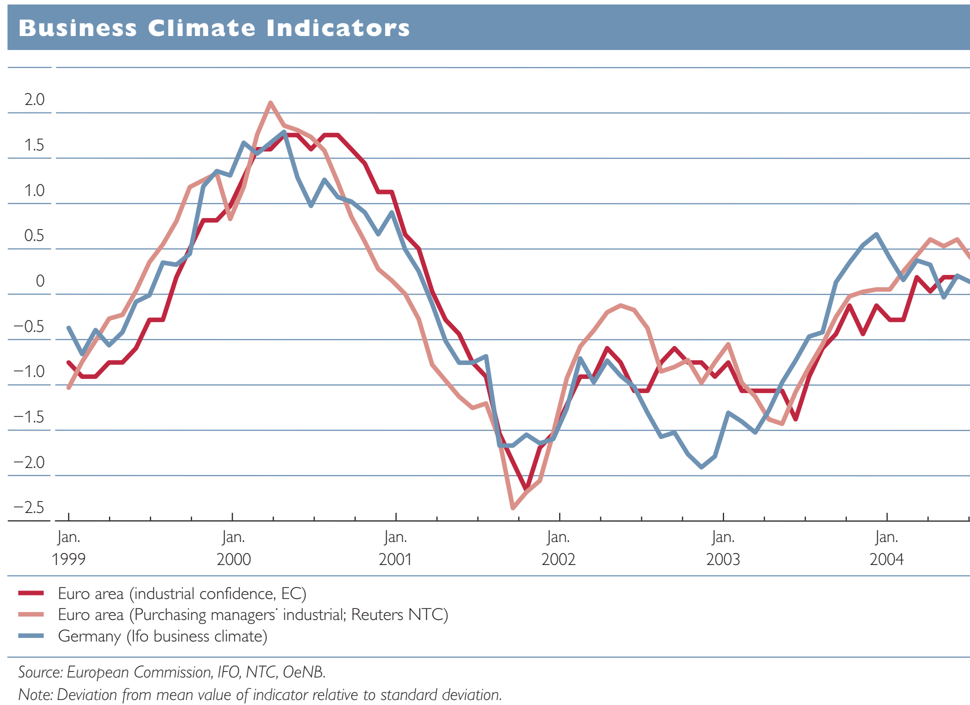
Percentage points



Source: Eurostat.

Chart 2

Business Climate Indicators



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

has been stagnating since February 2004. In July, it stood at –14 points, or still somewhat below its long-term average of –12 points. The reasons for this are twofold: first, the labor market scenario remains unfavorable and, second, discussions about reforming healthcare and pensions systems are fueling uncertainty and dampening consumer demand.

After a paltry rise of 0.1% in the first quarter of 2004, public sector consumption grew by a stronger 0.6% in the second quarter. In particular, high budget deficits in Europe are likely to have contributed to low growth in the first quarter of 2004. The latest data available indicate that seven euro area countries will exceed the 3% deficit ceiling in 2004. To counter this development, some of these countries are curtailing public sector consumption.

The growth momentum of exports – interrupted in the fourth quarter of 2003 – continued. However, imports also kept surging. As in the first quarter of 2004, the contribution of net exports to growth was 0.4% in the second quarter. The sizeable contribution of net exports to growth is due to growth differentials between the euro area and its trading partners. The leading indicators for economic growth have painted a relatively fickle picture in the last few months. Since early or mid-July, they have all signaled an uptrend, which has now leveled off in the last few months or, in some cases, even reversed gradually. This could suggest that the economic recovery has yet to stabilize properly.

2.2 Industrial Output Positive, Labor Market Scenario Remains Tight

Since mid-2003 the growth rates of seasonally adjusted industrial output in the euro area have been on a steady, albeit extremely volatile, uptrend. At 2.7%, year-on-year growth in June 2004 was lower than in May. Compared with the previous month, industrial output in June declined by 0.4%,

having climbed four times in a row since February. In view of the data series' wildly fluctuating performance, a trend reversal cannot be inferred from the latest development.

At 9.0%, the seasonally adjusted jobless rate remained stable from April to July 2004. The tight labor market scenario can also be seen in the steadily falling share of public sector jobs (since early 2001) as a percentage of the total working population in the euro area. Since the second quarter of 2002, employment has been growing very little. In the first quarter of 2004, the increase in service sector employment just managed to offset the job cutbacks seen in other sectors. In the same period, labor productivity rose by 1.1% after more or less stagnating in previous quarters.

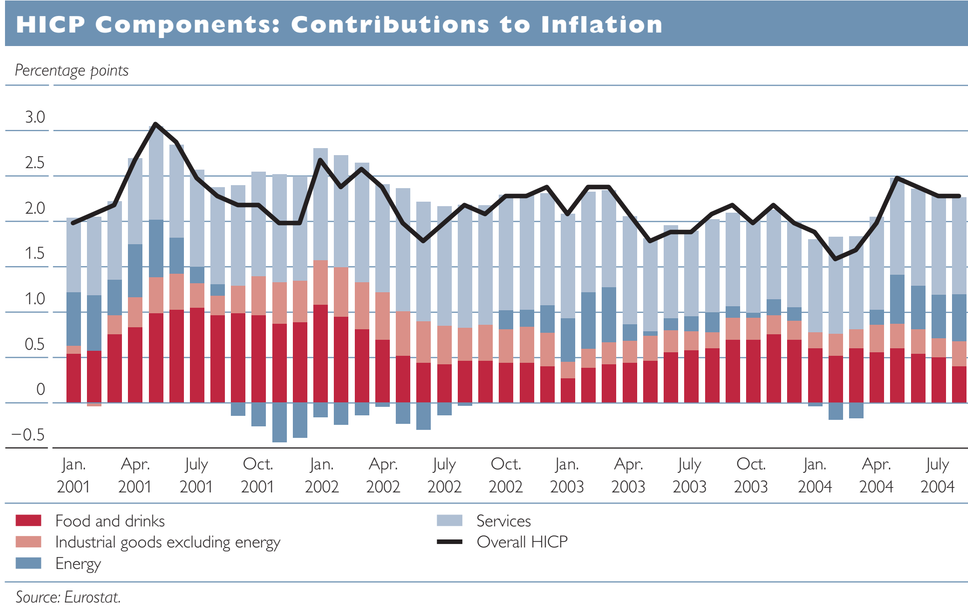
2.3 Energy Prices Are Fueling Inflation Again

In the middle of August 2004, nominal crude oil prices reached levels not seen since oil prices were first recorded. In August 2004 a barrel of crude (Brent) exceeded the previous year's level by 44%. Despite these record prices, the situation still defies comparison with the 1970s and 1980s, as real oil prices were significantly higher at that time and price rises were considerably steeper, with oil prices tripling in short order. For the euro area, the increase in oil prices – primarily quoted in U.S. dollars – was dampened on the whole by the development of the euro's exchange rate against the U.S. dollar. Thus the rise in oil prices quoted in euro in August 2004 was only 30% higher on a year-on-year basis.

The increase in oil prices can be attributed to the global economic recovery and, in particular, to dynamic demand from fast-growing countries such as China and India. These factors also led to a steep rise in price of other commodities, particularly metals. The increase in crude oil prices was also attributable, above all, to geopolitical uncertainties and concerns about output losses in key oil producing countries, which have a direct impact on prices, especially since the short-term production ca-

Chart 3

HICP Components: Contributions to Inflation



Source: Eurostat.

pacity has almost been exhausted. Against this backdrop, the oil futures markets are not anticipating prices to drop markedly over the coming months.

In May 2004 the increase in crude oil prices triggered a jump in the HICP inflation rate from 2.0% to 2.5%. In the months since, the contribution of energy prices to inflation has been 0.5 percentage point. The fact that the inflation rate dropped back down to 2.3% in July is due above all to the decline in the price growth of unprocessed foods. Inflation remained at 2.3% in August.

Since March 2004, core inflation (increase in HICP excluding energy and unprocessed foods) has hovered around 2.1%, or 0.2 percentage point above the rates posted since mid-2003. There are two contributing factors: first, tobacco and narcotics prices, which currently enjoy inflation rates of 14% as a result of tax increases on tobacco in several countries, and second, the implications of the health reforms in Germany and the Netherlands, which are reflected in the prices for healthcare services and in pharmaceutical products. Excluding all these factors, core inflation is likely to just exceed 1.5%.

2.4 Lending Growth Continues in the Euro Area

The growth of loans to the private sector in the euro area has steadily accelerated since March 2004 (July: 6.2%). In addition, public-sector lending is continuing to grow dynamically. This means the trend (visible since early 2003) of a gradual upturn in lending is continuing. More animated lending growth, moreover, is primarily attributable to increased lending for residential construction. By contrast, consumer loans and loans to nonfinancial corporations are growing only sluggishly. The reason for the rise in home loans is likely to be the low level of long-term interest rates.

Since its low in May 2004, growth in money supply M3 has picked up to some extent (July: 5.5%). In the period May to July 2004, the three-month average of growth rates was 5.2%. In addition, a shifting of portfolios into longer-term and higher-risk investment vehicles should be under way. This may be concluded from the ongoing tepid growth in other short-term deposits and in marketable financing instruments. Demand deposits recently notched up higher growth rates. The powerful expansion rates of cash and demand deposits moreover point to healthy demand for extremely liquid funds, due, in particular, to the current low level of interest rates.

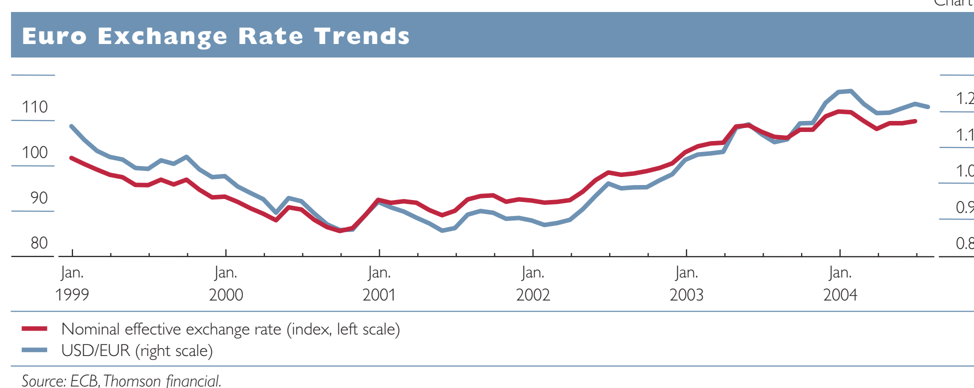
2.5 The Euro Exchange Rate Fluctuates between 1.20 and 1.24 per U.S. Dollar

Since attaining a high of USD/EUR 1.29 on February 17, 2004, the USD/EUR exchange rate has failed to reach comparable peaks. Since the end of May, the exchange rate has ranged between USD/EUR 1.20 to USD/EUR 1.24. This narrow band has seen fairly pronounced fluctuations, for which fresh U.S. economic data (particularly, the unexpectedly high U.S. current account deficit) were also to blame. In addition to these data, short-term speculative buying and selling were also responsible. Whereas the EUR/USD exchange rate between May and July 2004 rose by an average of 5.3% compared with the same three-month period in 2003, the increase in the nominal effective euro exchange rate was only 1.2% during the same period.

Long-term interest rates in the euro area recently fell and stood at 4.2% at the end of August, or close to their level at the start of the year. This means the steep rise from March to May did not continue. The interest rate gap (favoring the U.S. dollar) which opened up during this period has narrowed again dramatically. For the most part, the decline in long-term interest rates should be attributable to higher oil prices, which have led to a heightened demand for bonds because of gloomier growth prospects and greater uncertainty. At the same time, long-term inflationary expectations determined from surveys have barely changed. Likewise, geopolitical uncertainties, which make investing in safe segments attractive, act to support the bond markets.

Chart 4

Euro Exchange Rate Trends



Source: ECB, Thomson financial.

Since the start of this year, market prices have moved sideways, albeit in a slight downtrend. They were hit by interest rate hikes (both implemented and expected), higher oil prices and geopolitical uncertainties. These factors are likely to have overshadowed company news, which has been upbeat on the whole.

2.6 Increasing Optimism for Economic Growth

The European Commission's short-term economic forecast anticipates quarterly growth rates of 0.3% to 0.7% for the last two quarters of 2004, respectively. The outlook for the coming months therefore remains cautious. Positive driving forces such as the robust growth of the external economic environment and favorable financing conditions are currently being checked by the delayed effects of euro appreciation and the rise in oil prices.

The ECB has for the first time publicly released its economic experts' half-yearly (summer and winter) projections. These projections should be seen as supplementing those prepared in the intervening quarters in collaboration with the economists at both the ECB and the national central banks of the Eurosystem. The projections are published in the form of ranges so as to account for uncertainty to which every forecast is exposed.

Compared with the Eurosystem's projections prepared in June, the ECB's projections released in early September paint a somewhat more upbeat picture of predicted GDP growth. Accordingly, real GDP should grow by 1.6% to 2.2% in 2004 and by 1.8% to 2.8% in 2005. Robust export growth should increasingly feed through to domestic demand and should boost the momentum of investment and consumption growth.

The jobless rate should start to fall in 2005. In an environment of increased oil prices, however, predicted price trends are somewhat higher than they were in the June projections. For 2004, ECB experts now anticipate an increase in the HICP within a range of 2.1% to 2.3%, with energy prices making a significant contribution to inflation. In 2005 moderate domestic cost pressures and limited increases in import prices (owing to delayed euro appreciation effects) should offer a more favorable environment for price stability. The expectation of both modest wage growth and dynamic productivity growth will act to support prices. The inflation rate could therefore range between 1.3% and 2.3% in 2005.

3 Economic Growth in Central and Eastern Europe: Bulgaria, Croatia and Romania in Focus

3.1 Private Consumption Growth Nears Long-Term Trend Level

In the first quarter of 2004, economic growth in the new Member States of the European Union in Central Europe (Poland, Slovenia, Slovakia, the Czech Republic and Hungary) ranged from a low of 3.1% year on year in the Czech Republic to a high of 6.9% year on year in Poland. In the same period, growth levels of the current accession countries[1] (Bulgaria, Croatia and Romania) also lay within this range. In full-year 2003, by contrast, economic growth in all the new Central European Member States was slower than in the current accession countries.

Table 1

Real GDP Growth in Eastern Europe

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	annual change in %						
Poland	4.0	4.0	1.0	1.4	3.8	4.7	6.9
Slovenia	5.6	3.9	2.7	3.4	2.3	2.5	3.7
Slovakia	1.5	2.0	3.8	4.4	4.2	4.7	5.5
Czech Republic	0.5	3.2	2.6	1.5	3.1	3.3	3.1
Hungary	4.2	5.2	3.8	3.5	2.9	3.6	4.2
Bulgaria	2.4	5.4	4.1	4.9	4.3	4.9	5.3
Croatia	–0.9	2.9	4.4	5.2	4.3	3.3	4.2
Romania	–1.2	2.1	5.7	5.0	4.9	4.6	6.1

Source: Eurostat, national statistical office, wiiw.

Looking at growth dynamics from the demand side, the new EU Member States interestingly enough show a pattern that may be broadly characterized by the following common features.

First, compared with previous periods, *private consumption growth* in the first quarter of 2004 adjusted toward the long-term trend level. This means the Czech Republic and Hungary saw a downward correction from quite a high growth level, partly as a result of fiscal consolidation measures. In Poland and Slovenia, private consumption growth accelerated from comparatively low levels, while in Slovakia it resumed at a moderate pace after last year's contraction.

[1] *In view of the European Council's unconditional decision of June 2004 to enter into accession negotiations with Croatia, in this contribution the term "accession country" refers not only to Bulgaria and Romania, but also to Croatia, regardless of the fact that accession negotiations have not yet been formally opened.*

Second, compared with previous periods, the first quarter of 2004 saw growth of *gross fixed capital formation* accelerate or resume (in countries like Poland and Slovakia, which had suffered from investment contraction). This said, the level of investment growth is still comparatively low in Poland and Slovakia. In general, demand for capital goods was supported by the dynamic trend in exports and by improved profitability in industry due to the decrease in unit labor costs or to their rise at a lower rate than producer prices.

Third, taking private consumption and fixed capital formation trends together, the contribution of total domestic demand to GDP growth increased in all countries with the exception of Hungary, where the investment take-off did not fully offset the slowdown in consumption.

Fourth, *real export growth* accelerated in almost all countries under review, except in Poland and Slovakia, where very powerful growth lost some speed. Fifth, the combination of high (or higher) export growth and the sizeable weight of exports as a percentage of total real GDP (ranging from 63% in Slovenia to 93% in the Czech Republic) meant that the contribution of exports to GDP growth was greater than that of total domestic demand. The only exception in this respect was Poland with an export weight of a mere 32%, which reflects the fact that Poland is the largest economy among these countries.

However, not all features of the economic growth of the new EU Member States in the first quarter of 2004 are common features: *import growth* and the contribution of *net exports* to GDP growth developed along quite different lines. In the Czech Republic and in Slovenia, both higher domestic demand and higher export growth pushed up import growth to such an extent that the contribution of net exports to growth remained negative. In both countries, however, the deterioration of real net exports was not reflected in the balance of payments, which even improved and posted a modest surplus. Driven by higher export growth, Hungary's import growth also accelerated. The contribution of net exports to growth was close to zero. Despite stronger domestic demand, lower export growth in Poland and Slovakia dampened import growth, as a result of which the contribution of net exports remained positive. Moreover, this development was reflected in an improved balance of payments.

Turning to the current accession countries, Bulgaria reveals a growth pattern that is, at first glance, similar to that of the Czech Republic. In both countries, the corrective slowdown in consumption growth was more than offset by investment growth and the resulting increase in domestic demand fueling higher import growth and leading to a deterioration in net exports. However, this development was far more pronounced in Bulgaria, with booming investment demand (on the back of improved corporate profitability and a steep rise in loan demand) and a highly negative contribution to growth by net exports, which was reflected in a further deterioration of the goods and services balance. In Croatia and Romania, by contrast, the momentum of economic growth differed significantly from the common features outlined above for the new EU Member States in Central Europe. In Romania, domestic demand did not advance, as the deceleration in gross fixed capital formation growth more than offset the further rise in consumption growth. At

the same time, export growth declined. This combination of weaker (or constant) domestic demand and lower export growth dampened import growth. However, this slowdown was not enough to keep net exports from deteriorating further, which was reflected in the further worsening of the goods and services balance. In the first quarter of 2004 the Croatian economy continued to grow strongly. Although gross fixed capital formation advanced at a far slower pace than in the previous year, its contribution to GDP growth was similarly high to that of private consumption. By contrast, net exports made a negative contribution to growth of approximately one percentage point.

3.2 Heterogeneous Price Trends

Price trends have been quite heterogeneous in the Central and Eastern European countries under review. Among the new Member States in Central Europe, inflation rates (as measured by year-on-year changes of consumer prices in the second quarter of 2004) ranged from 2.5% in the Czech Republic to 8.0% in Slovakia. Among the current accession countries, inflation rates (in the first quarter of 2004) ranged from 1.9% in Croatia to 6.4% in Bulgaria and 13.6% in Romania.

In Hungary, Poland and in the Czech Republic, annual inflation rose in the first and second quarters of 2004, relative to average annual inflation in the comparable period a year ago. In addition to higher energy prices, this was primarily due to hikes in indirect taxes (related to EU accession) and to increased food prices, which were also partly accession-related.

By contrast, inflation decreased in Slovakia, where relatively low core inflation (below 3.0%) dragged down headline inflation, which was distorted by hikes in administered prices and by tax changes. Inflation also declined in Slovenia on the back of lower unit labor cost increases, attributable to the gradual deindexation of the economy. Although inflation in Romania was lowered steadily in recent quarters, in Bulgaria it rose steeply this year as a result of tax changes, a strong expansion in lending and rising food prices (owing to last year's drought).

Table 2

Inflation in Eastern Europe:

Annual Change in the Consumer Price Index (HICP)

	2000	2001	2002	2003	Q4 2003	Q1 2004	Q2 2004
	annual change in %						
Poland	10.1	5.3	1.9	0.7	1.4	1.8	3.4
Slovenia	8.9	8.6	7.5	5.7	5.0	3.7	3.8
Slovakia	12.2	7.2	3.5	8.5	9.4	8.2	8.0
Czech Republic	3.9	4.5	1.4	–0.1	0.8	2.0	2.5
Hungary	10.0	9.1	5.2	4.7	5.4	6.8	7.4
Bulgaria	10.3	7.4	5.8	2.3	4.7	6.4	6.7
Croatia[1]	6.4	5.0	1.7	1.8	1.8	1.9	×
Romania[1]	45.7	34.5	22.5	15.3	14.8	13.6	×

Source: Eurostat, national statistical office, wiiw.
[1] CPI.

3.3 Some Improved Rating Assessments for Sovereign Long-Term Foreign Currency Debt

Among the countries under review, Slovenia has the highest rating awarded by Moody's and Standard & Poor's for sovereign long-term foreign currency debt. Whereas for the last ten months Moody's did not make any changes to its ratings of the countries under review, Standard & Poor's has upgraded the ratings of several countries (Bulgaria, Slovenia and Slovakia) in 2004. These upgrades reflect the improved economic scenario as well as a more prudent fiscal policy and, in the case of Bulgaria, the prospect of EU membership in 2007.

Table 3

Ratings for Sovereign Long-Term Foreign Currency Debt[1]

Currency	Moody's			Standard & Poor's		
	Previous rating	Latest change	Current rating	Previous rating	letzte Änderung	Current rating
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA–
SKK	Baa3	12.11.02	A3	BBB	02.03.04	BBB+
CZK	Baa1	12.11.02	A1	A	05.11.98	A–
HUF	A3	12.11.02	A1	BBB+	19.12.00	A–
BGN	B1	05.06.03	Ba2	BB+	24.06.04	BBB–
HRK		01.27.97	Baa3		01.17.97	BBB–
ROL	B2	17.06.02	Ba3	BB–	17.09.03	BB

Source: Bloomberg.
[1] *After the cutoff date fot this analysis, Standard & Poor's raised Romania's foreign currency rating from BB to BB+.*

Economic Forecasts for Central and Eastern European Countries

The OeNB establishes bi-annual forecasts of the economic development in the Czech Republic, Hungary and Poland as well as in Russia. These three new EU countries account for more than three quarters of the total GDP of all new Member States and, hence, are representative for this part of the European Union.[2]

When euro area growth was decelerating sharply during recent years, private consumption was the major pillar of growth in the three new EU countries under study, which implies that their GDP growth rates outperformed that of the euro area, partly even considerably. The current economic recovery in the euro area will stimulate export growth in the Czech Republic and in Hungary, in addition to the growth contribution by private consumption. In Poland, the current upswing in the euro area will maintain export growth at the high level of 2003 (when it was supported by the strong corrective depreciation of the zloty in 2002–03), despite the re-appreciation of the zloty. Correspondingly, according to the present forecast, GDP growth will accelerate in the Czech Republic, Hungary and Poland in 2004 and 2005 and remain at a high level in 2006.

It can be assumed that integration into the single market will further stimulate both exports and imports, even though the short-term (one- to two-year) economic effects of EU accession are nearly impossible to quantify precisely ex-ante. Exports will be supported further by decreases in nominal unit wage costs in industry. Gross fixed capital formation will be stronger, too, as a result of export demand, direct EU accession effects, higher profitability in industry and a cut in corporate income tax rates. The high (or higher) contribution of exports and investment to GDP growth as well as – in Poland – higher

[2] *These forecasts, which are established together with the Suomen Pankki, the central bank of Finland, in particular with respect to Russia, are based on preliminary global growth projections and technical assumptions concerning the oil price and the euro/U.S. dollar exchange rate which are prepared by the ECB for the Eurosystem at the start of the process of the Broad Macroeconomic Projection Exercise. These underlying assumptions are pivotal to the forecasts presented here, as these three new EU countries have a strong export orientation towards the euro area, and Russia is one of the major global oil producing countries.*

private consumption growth will lead to an increase in import growth, adding to the direct impact of EU accession on imports.

This year, private consumption will grow at a lower rate than in the previous year in the Czech Republic and, in particular, in Hungary, where it grew at an especially high pace in 2003. Among other things, hikes in indirect tax rates are dampening private consumption. This is also one of the reasons why the acceleration of private consumption growth (from a relatively lower level) will be fairly limited in Poland.

More generally, the economic environment expected for the next couple of years will provide a window of opportunity for fiscal consolidation measures. However, the upcoming elections (2005 in Poland, 2006 in Hungary and in the Czech Republic) might work against such measures. The moderate decline in GDP growth forecast for 2006 in Poland rests on the assumption of major fiscal consolidation steps taking place after the elections.

The risks to this forecast for the three new EU countries are, firstly, considerably weaker euro area growth and, secondly, strong monetary policy reactions by these countries' central banks to prevent second-round effects of the recent inflation pick-up, which so far has been primarily supply side driven (e.g. energy prices, food prices, hikes in indirect tax rates related to EU accession). This could weaken gross fixed capital formation growth in particular. Partly linked to this risk is the risk of an accelerated currency appreciation, which would weaken the price competitiveness of exports and enhance import growth. In this respect, however, the U.S. dollar/euro exchange rate also plays a role that should not be underestimated, in particular in the case of Poland.

Table 4

Three New EU Member Countries and Russia

Real GDP forecast of September 2004

	2001	2002	2003	2004[1]	2005[1]	2006[1]
	Year-on-year change at constant prices, %					
Poland	1.0	1.4	3.8	5.8	5.4	4.1
Czech Republic	2.6	1.5	3.1	3.8	3.9	3.9
Hungary	3.8	3.5	2.9	3.6	3.7	3.8
Russia	5.1	4.7	7.3	6.9	5.9	4.8

Source: Eurostat, OeNB, Bank of Finland.
[1] Forecast value.

In Russia, high economic growth will continue in 2004, driven by high energy and other raw material prices. However, the high growth rates are attributable also to prudent monetary and fiscal policies, the structural reforms implemented in recent years, political stability and, generally, economic actors' increased optimism. Assuming that the oil price will decrease moderately from the current high levels and that the ruble will further appreciate in real terms, the forecast for Russia sees robust, but moderately declining GDP growth for 2004 to 2006.

Economic growth should be supported by all demand components throughout the forecast period. Private consumption growth should remain healthy, benefiting from wage increases, hikes in pensions and higher profits. While fiscal policy – supported by higher oil prices – has been designed to be more restrictive this year, a decrease in the fiscal surplus is planned for 2005. Gross fixed capital formation growth rates will continue to be high, albeit on the basis of a low starting level. Only slowly declining inflation and continuous nominal upward pressure on the exchange rate will imply a further real appreciation of the ruble. Thus, in addition to increased import demand resulting from strong economic growth, increasingly fierce cost-triggered import competition will take place. While this may also accelerate restructuring at the corporate level, it will probably lead to a decrease in net exports initially.

One of the major risk factors to this forecast is the oil price. It will continue to be a major risk factor for growth, as the dependence of the Russian economy on the extraction and export of energy has risen further recently. Irrespective of the price development, capacity constraints (e.g. with respect to oil pipelines) may imply declining net exports. A further risk factor would be an excessively quick real appreciation of the ruble. This would have negative effects on the competitiveness of industrial exports,

as the gain in competitiveness resulting from the sharp depreciation during the severe financial crisis of 1998 has already been eroded nearly completely. The dragging on or even escalation of the Yukos affair could increase the uncertainty regarding the authorities' respect for property rights and cloud the investment climate. Finally, the turbulences in the summer of 2004 have demonstrated the fragility of the banking sector.

4 Austria: Boom in Exports Remains Mainstay of Economic Recovery

In the first half of 2004, Austria's economic performance was driven by robust growth in exports. The forecast for growth in the second half of the year is also optimistic. For both the third and fourth quarters of 2004, the OeNB economic indicator predicts real GDP growth of 0.5% quarter-on-quarter. For the year 2004, this means a growth rate of 1.7%.

The first half of 2004 brought a significant change in the breakdown of GDP growth. Whereas growth in 2003 was driven by domestic demand (in particular, extremely dynamic investment), exports were the mainstay of the economy in the first half of 2004.

Table 5

Breakdown of Real GDP Growth in Austria

	2003	2004Q1	2004Q2	2003	2004Q1	2004Q2
	Annual change (annual figures) and quarterly change (quarterly figures), %			*Contribution to GDP growth in percentage points*		
GDP	0,7	0,4	0,9	0,7	0,4	0,9
Private consumption	1,4	0,3	0,5	0,8	0,1	0,3
Public sector consumption	1,1	–0,1	–0,1	0,2	0,0	0,0
Gross capital formation	5,8	–0,5	–0,8	1,3	–0,1	–0,2
Exports	1,9	0,6	5,8	×	×	×
Imports	5,0	–0,7	4,0	×	×	×
Net exports	×	×	×	–1,6	0,8	1,1
Statistical discrepancy	×	×	×	0,0	–0,4	–0,3

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

In the second quarter of 2004, real exports of goods and services grew by an annualized 25% on a quarterly basis. Although growth rates such as these cannot be expected in the quarters to come, exports in 2004 will clearly be the mainspring of the economic expansion. In the first half of 2004, imports grew on the back of export growth, in particular. In the second half of the year, import growth should be driven more strongly by domestic demand.

In 2003, the rise in GDP was largely fueled by investment. After two years of decline, investment activity picked up sharply in early 2003. This can be primarily attributed to the need for replacement investment. Total investment contracted slightly from a high level in the first half of 2004. However, this dip also reflects the fact that economic recovery has still not stabilized completely. The boom in exports should, however, also be reflected in investment during the rest of 2004.

Results of the OeNB Economic Indicator of September 2004:

Continued Robust Growth in the Second Half of 2004[3]

The OeNB economic indicator forecasts continued robust economic growth in Austria in the second half of 2004. For both the third and fourth quarters of 2004, it predicts real GDP growth in Austria of 0.5% on a seasonally-adjusted quarterly basis. On a year-on-year basis, this means growth will quicken to 2.1% and 2.3%, respectively. For full-year 2004, growth thus comes to 1.7%. Compared with the OeNB's spring outlook, this means a revision of +0.2 percentage points. Growth will be fueled primarily by dynamic exports. During the second half of 2004, however, domestic demand should also make a greater contribution to growth.

Table 6

Short-Term Outlook for Real GDP

for the Third and Fourth Quarters of 2004 (Seasonally Adjusted)

	2002				2003				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Quarterly change (annual rate) in %	0.5	2.1	1.3	1.5	1.4	0.1	0.6	0.8	0.7	1.8	2.1	2.3
Quarterly change in %	0.6	1.0	–0.2	0.0	0.5	–0.2	0.2	0.3	0.4	0.9	0.5	0.5
Annual change in %	1.3 (1.4)[1]				0.7 (0.7)[1]				1.7			

Source: OeNB results of the OeNB economic indicator of September 2004, Austrian Institute of Economic Research (WIFO).
[1] Based on nonseasonally-adjusted and nonworking day-adjusted data.

In view of continued modest employment and wage growth, private consumption is relatively stable. A further acceleration in growth in the second half of 2004 does not, however, look very likely. Public consumption growth is marked by ongoing consolidation efforts. In the first half of 2004, public consumption declined marginally. In the second half of the year, it is not expected to augment significantly either.

The outlook for 2005 will depend above all on how the world economic recovery continues to develop. Whether euro area countries – in particular, Germany – succeed in placing growth (driven primarily by exports in the first half of 2004) on a broader basis is crucial for Austria. Failing this, growth can be expected to lose momentum in Austria as well. Although oil prices are currently at a high level, this should not jeopardize economic recovery provided they do not rise further considerably. However, they may well have a certain dampening effect on cyclical developments.

4.1 Confidence Strengthens Further in Austria

Whereas euro area economic indicators are still trending unevenly, the economic climate in Austria has recently stabilized. Since spring 2003, the European Commission's economic sentiment indicator has been in uptrend except for a setback toward the end of 2003.

Confidence indicators provide a cautious gauge of the breakdown of GDP growth in the second half of

[3] *Since the first quarter of 2003, the OeNB economic indicator 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 state space model and a dynamic factor model. Further details on the models employed can be found at www.oenb.at in the Monetary Policy and Economics section. The next publication is scheduled for January 2005.*

2004. The order book for exports suggests that deliveries abroad will continue to perform positively although growth rates as high as those in the second quarter of 2004 will be difficult to repeat. In the quarterly business survey carried out by the Austrian Institute of Economic Research, WIFO, for the third quarter of 2004, capacity utilization was better than in the preceding survey. This can be interpreted as a sign of stepped-up investment. After surging in spring 2004, retail confidence fell back to its level at the start of the year, which makes a sharp uptick in consumption look rather unlikely.

4.2 Labor Market Starts To Improve

Employment growth is accelerating visibly, albeit at a low level. Although the unemployment rate is still high, the number of vacancies has been surging since March 2004, indicating a further improvement in the labor market and a decline in joblessness in the near future.

In 2004, employment statistics are particularly difficult to interpret for two reasons. First, the number of individuals drawing parental leave benefit continues to grow, underlining the importance of the distinction between registered employment and employment adjusted for persons on parental leave, in compulsory military training or registered in a training program of the Austrian Public Employment Service. Hence, the (economically relevant) adjusted employment figures are lower than registered employment figures. Second, AMS (Austrian Public Employment Service) training participants have been dropped from employment statistics since early 2004, which means that actual employment growth is distorted downward. In 2004, both these effects will roughly cancel each other out. Growth in registered employment (year on year, January to August 2004) of 0.3% is therefore equivalent to approximately the number of actually newly created jobs. In the first eight months of 2004, growth in registered employment accelerated from +0.1% in January to +0.6% in August. Aggregated employment growth conceals highly divergent sectoral trends. Whereas jobs are being lost in industry, they are being created in the tertiary sector.

4.3 Oil Price Increase Triggers Rise in Inflation

Price trends in 2004 have basically been determined by the increase in crude oil prices. Inflation has consequently risen in the course of the year. At 2.2%, the rate of increase in the Harmonized Index of Consumer Prices (HICP) reached its highest level to date this year in August 2004. In 2003 prices edged up by a mere 1.3%. Compared with 2003, the relevance of certain subcomponents for aggregate inflation has changed perceptibly in 2004. In addition to energy, services made the biggest contribution to inflation. Since early 2004, government measures (e.g. the increase in energy tax or the introduction of the toll on freight vehicles) have added to inflation.

4.4 2003 Current Account Based on Payment Flows Almost Balanced

Vigorous export growth in the first half of 2004 improved the balance of goods and services. At EUR 1.89 billion, the current account surplus (based on payment flows) in the first seven months of 2004 exceeded that of the comparable period of the previous year by EUR 0.28 billion. This is wholly attributable to a reduction in

the goods deficit. By contrast, the surplus on services (with its important subcategory of tourism) suffered only a minimal decline. Finally, higher net payments from investment income and transfers resulted in a current account deficit. The current account (based on payment flows) turned from a surplus of EUR 0.02 billion in the first seven months of 2003 into a deficit of EUR 0.67 billion in the comparable period of 2004. The improvement in the merchandise balance is also reflected in the foreign trade data compiled by Statistics Austria. The balance moved from a deficit of EUR 1.4 billion in the first six months of 2003 into a surplus of EUR 0.4 billion in 2004. The merchandise trade deficit continued to deepen with the "old" EU Member States while the surplus with the 10 new Member States remained more or less unchanged. By contrast, there was a marked improvement in the balance with non-EU countries (up by more than EUR 2 billion to EUR 2.6 billion).