Global Economic Downturn Persists

Crisis in Financial and Real Estate Markets Dampens Growth

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The global economic downturn is persisting. In the U.S.A., tax rebates provided only a temporary stimulus to the economy. As the U.S. real estate crisis continues, it triggered the takeover of mortgage finance corporations Fannie Mae and Freddie Mac by their regulator in early September 2008. The crisis of the U.S. real estate and financial sectors, which has gathered momentum lately, sustained high commodity prices and the deterioration in the labor market are all badly damaging consumer confidence. As a reaction to the most recent aggravation of the financial crisis, the U.S. government announced its plan to establish a well-endowed stabilization fund.

As to the euro area, economic growth slowed unexpectedly sharply in the second quarter of 2008. Real GDP contracted by 0.2% quarter on quarter. Particularly, gross fixed capital formation made a negative contribution to growth, but also consumer restraint depressed economic performance. The ECB's current projections assume only a gradual improvement in the economy.

In August 2008, HICP inflation in the euro area was 3.8%, down from its probable peak of 4.0% in the summer months. This trend reversal is attributable to the latest fall in commodity prices – the main inflation driver in recent months. In addition, as the commodity price upsurge commenced in fall 2007, more favorable basis effects will now have an immediate impact. Accordingly, the ECB's inflation projections for 2009 range between 2.3% and 2.9%.

Austria's economy cannot decouple itself from the global economic slowdown as it heavily depends on exports. Furthermore, significant stimuli from private consumption, which is usually the key pillar of economic activity in the mature phase of the economic cycle, are currently not in evidence. A high saving propensity and steep inflation are both equally responsible for this development. According to the OeNB economic indicator's results, the OeNB projects the Austrian economy to nearly stagnate in the second half of 2008.

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1 Global Economic Downturn Persists

1.1 U.S.A.: Tax Rebates Provide Only Temporary Stimulus to the Economy; U.S. Government's Bailout Package Worth up to USD 700 Billion

In the U.S.A., annualized real GDP growth accelerated by a vigorous 3.3% in the second quarter of 2008 after having risen by 0.9% in the first quarter of 2008 and shrunk by 0.2% in the fourth quarter of 2007. Growth in the second quarter of 2008 was led primarily by net exports and higher consumer spending, which is largely attributable to the distribution of tax rebate checks. A rigorous rundown in inventories and flagging residential construction investment made a seriously negative contribution to growth.

The latest U.S. economic indicators signal a significant slowdown of economic activity in the second half of 2008 and in 2009, with downside risks having markedly risen recently. In July 2008, U.S. leading indicators (Conference Board) clearly deteriorated having fallen in eight of the past 12 months. In August 2008, industrial production was down sharply, and capacity utilization shrank to its lowest level since

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October 2004. In July 2008, private construction expenditure fell to its lowest level since March 2001 – the official start of the previous recession. In August 2008, the labor market situation visibly deteriorated as the jobless rate rose to 6.1% and nonfarm payroll jobs were cut by 84,000. After major increases in May and minor growth in June, retail sales were down slightly both in July and August 2008. The reason for the favorable development in May and June 2008 was probably the payment of tax rebates. Since consumers have evidently already spent most of these tax rebate checks, their uncertainty stemming from deteriorated labor market conditions, still fairly high energy prices, real estate sector difficulties and the financial turmoil fallout will become more clearly apparent in the next few months.

Yet, there are also some positive signs. In August 2008, consumer confidence (Conference Board) improved for the second month in a row, primarily owing to the sharp fall in fuel prices. Over the long term, however, this value is still very low. In the second quarter of 2008, employee productivity grew by a robust 4.3% (annualized) after having advanced by only 2.6% in the first quarter of the year. Productivity growth has therefore been much stronger than in previous periods of economic downturn.

In early September 2008, the OECD revised its U.S. growth forecast for 2008 up to 1.8%, while the equivalent IMF projection is 1.3%, and the Federal Reserve's ranges from 1.0% to 1.6%. For 2009, the IMF and the OECD predict real GDP growth to slow to 0.7% and 1.1% respectively. This would be the lowest growth rate since 2001. As these forecasts do not yet reflect the latest developments, further downward revisions are likely.

In August 2008, U.S. consumer prices rose by 5.4% year on year, which was somewhat less steep than in July (+5.6%). In August 2008, the CPI dropped by 0.1% month on month for the first time since October 2006, which was mainly attributable to the fall in energy prices. Core inflation climbed by a relatively modest 2.5%. The Federal Reserve predicts core inflation to range from 2.2% to 2.4% in 2008.

The U.S. real estate crisis continues to rage. House prices, which have fallen nationwide by an average of 16% in the previous 12 months, are still sliding. This trend is likely to persist until the high and still expanding inventory of unsold houses is run down, which is unlikely to occur before the end of 2009. The growing number of foreclosures also contributes to this trend. In early September 2008, the Federal Housing Finance Agency (FHFA) – regulator of Fannie Mae and Freddie Mac, the two most important U.S. real estate finance corporations – noted that, in view of their inadequate capital resources, the latter could no longer fulfill their statutory mandate of providing liquidity to the mortgage market. Fannie Mae and Freddie Mac's problems derive from their growing number of loan losses, amounting to a total of just under USD 15 billion in the previous 12 months. To prevent the financial crisis from further escalating, the FHFA placed both corporations under conservatorship, which means that the regulator will assume control for an unlimited period of time. Their management was replaced, and the U.S. Treasury injected capital (ceiling: USD 100 billion) in the form of senior preferred stocks into the corporations. Furthermore, the U.S. Treasury will repurchase mortgage-backed securities (MBS) in the market in a bid to bolster their price. The prime objective of state intervention for Fannie Mae and Freddie Mac is to restore confidence in these two corporations, which together hold almost 50% of all U.S. mortgages. This measure is also designed to improve the image of the U.S. market in the eyes of foreign investors, as the latter – particularly from China, Japan, Luxembourg and Belgium – own a significant share of Fannie Mae and Freddie Mac bonds. State intervention is also meant to limit a further increase in private insolvencies and to prevent a potential collapse of private consumption, which is key to the U.S. economy. Although the costs of this "rescue package" to be picked up by the taxpayer are as yet unforeseeable, they will depend on the future economic performance of these two institutions.

In September 2008, another blue chip joined the list of private investment banks hit by the financial crisis. In the second week of September, Lehman Brothers, the fourth-largest U.S. investment bank, reported an unexpectedly high quarterly loss of USD 3.9 billion. On September 15, 2008, the bank was forced to file for bankruptcy, as negotiations between senior Wall Street bankers and the U.S. government to rescue the bank had broken down. To prevent a chain reaction and a further destabilization of the financial system, the Federal Reserve, the ECB and other central banks injected liquidity into the financial markets. Since leading financial houses are very closely interlinked, a default by a single major bank also increases the risk of a spillover to other banks. Likewise, the risk of a further economic downturn in the U.S.A. is also increased. So as to prevent the threatening negative synergy effects generated by financial turmoil and economic downturn, the U.S. government has drafted an emergency plan to combat the financial crisis. According to this plan, the U.S. government is to purchase bad mortgages and illiquid securities up to a value of USD 700 billion from banks (including foreign banks operating in the U.S.A.). Yet this plan still needs to pass the U.S. Congress.

In the wake of the financial crisis, the Federal Reserve, between September 2007 and April 2008, cut its key interest rate seven times by a total of 325 basis points to 2% (April 30, 2008). The federal funds target rate has since remained unchanged. In its statement following the latest Federal Open Market Committee (FOMC) meeting held on September 16, 2008, the Federal Reserve expressed its unease about a more severe economic slowdown somewhat more strongly than it voiced its concern about high inflation. The next FOMC meeting will take place on October 28–29, 2008.

1.2 Japan: Growth Slumps in the Second Quarter of 2008, Further Slowdown Expected

After a relatively strong first quarter in 2008, Japan's real GDP growth contracted by 0.7% against the previous period in the second quarter of 2008 – the largest slump in seven years. Growth was depressed by weak external demand, in particular. Above all, automotive and steel exports to the U.S.A. and Europe fell dramatically. In addition, private consumption declined for the first time in two years. Rising living costs and a weak labor market depressed consumer sentiment. Still, Japan's economy is now likely to be better prepared for a downturn than it was in 2001. Corporate profits have so far dropped less sharply. As a countervailing measure, the Japanese government, for the first time in six years, is preparing an economic stimulus package worth EUR 70 billion.

Owing to more sluggish global demand, the economy is expected to slow in 2008. The IMF and the OECD downgraded their growth forecasts to 1.0% and 1.2% respectively. The Bank of Japan (BoJ) cut its forecast to 1.2% for the financial year 2008 (April 2008 to March 2009). Despite a favorable profit situation, the BoJ's quarterly survey revealed a significant deterioration in Japanese corporate sentiment. The diffusion index, which reflects the business climate, worsened in all categories although large manufacturers were the worst hit.

After a fairly long-lasting period of deflation, rising wages and higher import prices for commodities started to push up consumer prices from October 2007 onward. In July 2008, the rise in the CPI and core inflation came to 2.3% and 0.2% year on year respectively. As a result, the CPI breached the upper limit of the BoJ's definition of price stability for the very first time. However, recently falling commodity prices should dampen future inflation. The BoJ expects the CPI to advance by 1.8% in the current fiscal year.

Key interest rates were last raised by 25 basis points to 0.5% in February 2007. Although the interest rate gap between Japan and the world's leading currency areas has since narrowed to some extent, it still remains wide. The BoJ announced it would not further raise interest rates in the near future.

1.3 Asia's Economy Still Robust despite Downturn; Rising Consumer Prices

Despite sluggish global demand, Asia's emerging economies continued to expand at a high level in the first half of 2008. Buoyant demand within the region and from other emerging economies contributed to robust export growth. The IMF, however, anticipates a modest slowdown to 7.7% in 2008 (2007: 9.3%), with China and India remaining the driving forces of growth.

In China, real GDP growth amounted to 10.4% year on year in the first half of 2008. Whereas export momentum slowed somewhat on the back of more sluggish global demand and a modest appreciation of the Chinese yuan against the U.S. dollar (until mid-July 2008 whereafter it has since remained stable), both investment and consumption have continued to soar. The price freeze in respect of administered prices and declining food prices dampened the rise in consumer prices (August 2008: 4.9% year on year). In India too, economic momentum continued at a somewhat slower pace, although consumer prices reached a 16-year high in August 2008.

In several Asian emerging economies, tighter financing conditions as a result of the financial crisis, monetary policy tightening and deteriorating consumer and corporate confidence are dampening domestic demand. In addition, weak GDP growth in their traditional U.S. and Western European export markets is darkening future growth prospects. Many countries are currently trying to curb the effects of higher inflation by subsidizing energy prices and intervening in foreign exchange markets to strengthen their national currency.

2 Euro Area: Short-Term Outlook Darkens

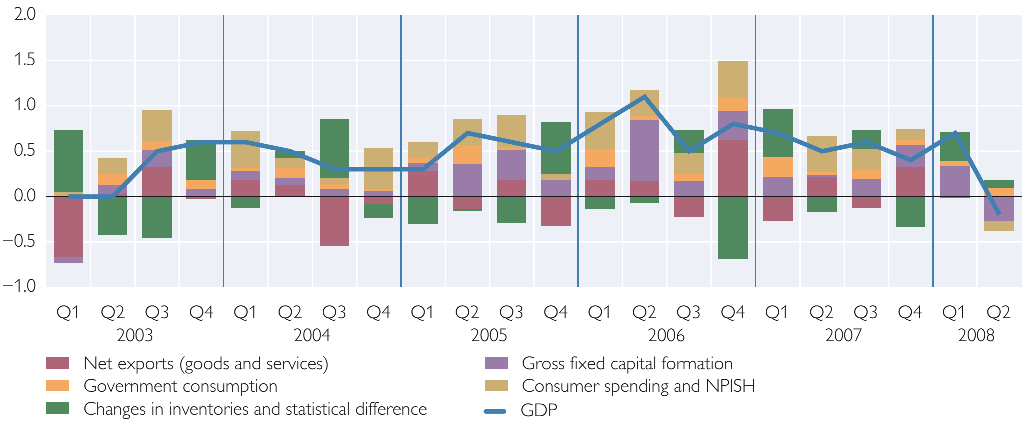
2.1 Economic Downturn More Severe than Expected

In the euro area, real GDP in the second quarter of 2008 shrank by 0.2% quarter on quarter. After the dynamic growth generated by special factors in the first quarter of 2008 (+0.7%), a growth correction was to be expected. For in-

Chart 1

Contribution to Real GDP Growth in the Euro Area

Quarterly changes in percentage points



Source: Eurostat.

stance, the mild winter had stimulated construction activity, thereby boosting gross fixed capital formation. However, the extent of the moderation has come as a surprise and the economic downturn seems to be deeper and more prolonged than previously anticipated. Compared with the second quarter of 2007, real GDP increased by 1.4% in the euro area.

The correction in the second quarter of 2008 was particularly pronounced when it came to gross fixed capital formation, which contributed negatively to growth for the first time in more than five years. Weak investment activity is also partly explained by the shrinking utilization of existing production facilities. According to a European Commission survey, industrial capacity utilization peaked in the second quarter of 2007 whereafter it has been in decline. In the third quarter of 2008, it is expected to decrease by almost 1 percentage point to 82.9%, making dynamic investment activity less likely. Yet, capacity utilization still remains high in historical terms.

Dynamic commodity price growth in recent quarters led to a loss of households' purchasing power and in turn to heightened consumer restraint. As a result, private consumption made a negative contribution to growth in the second quarter of 2008. Of GDP components, only government consumption stimulated the economy.

A breakdown by economic sector shows that only business-related and financial services, as well as other services, made positive contributions to growth. No other sector provided any positive impetus in the second quarter of 2008. In Germany, France and Italy, the economic contraction was more pronounced than in the euro area average while Spain still registered positive GDP growth.

2.2 Leading Indicators Dip below Long-Term Average

There are hardly any signs of a rapid improvement in the economic climate. Instead, most leading indicators of economic growth signal stagnation. Indicators reflecting the current situation and expectations about the near future have both deteriorated.

The European Commission's Economic Sentiment Indicator (ESI) registered a further drop in August 2008. The ESI's retail and industrial confidence components accounted for this deterioration while its services and construction components staged a modest recovery. Since July 2008, the ESI has trended below its historical average. Key national indicators such as the Ifo Business Climate Index have recently also continued to slide. In August 2008, the Industrial Purchasing Managers' Index signaled continued sluggish growth in both industry and services. Like the second quarter of 2008, the third quarter is therefore also likely to be lackluster.

The European Commission's survey of consumer confidence – a component of the ESI – has steadily worsened since mid-2007. Household expectations about both the general performance of the economy and their own financial situation suffered severely. Merely in August 2008, consumer confidence staged a modest recovery. This somber appraisal of the situation has translated into marked consumer restraint. Households answered the question about their current propensity to consume and about their willingness to make major purchases in the near future as cautiously as never before since the creation of this indicator.

The pessimism underlying consumer sentiment is backed by an unfavorable development in real income, which is related to two factors. First, nominal income has declined more rapidly. Second, the labor market outlook has darkened, thus dampening income expectations. In April 2008, seasonally adjusted unemployment rose by 0.1 percentage points to 7.3% for the first time in three years and has since remained at this level. Large regional differences lie at the root of this phenomenon. In Spain, the jobless rate climbed by almost 3 percentage points within a single year. In Italy too, more people registered as unemployed, whereas in Germany and France the unemployment rate is still falling. The European Commission's survey on employment expectations indicates a further deterioration of the labor market situation across all economic sectors. Households' fear of unemployment has mounted significantly. Consumer demand cannot therefore be expected to provide much impetus for GDP growth in the third quarter of 2008.

2.3 Inflation Peaks in the Summer

HICP inflation peaked in the summer. In August 2008, it declined by 0.2 percentage points to 3.8%, against the previous two months (June and July 2008: 4.0%).

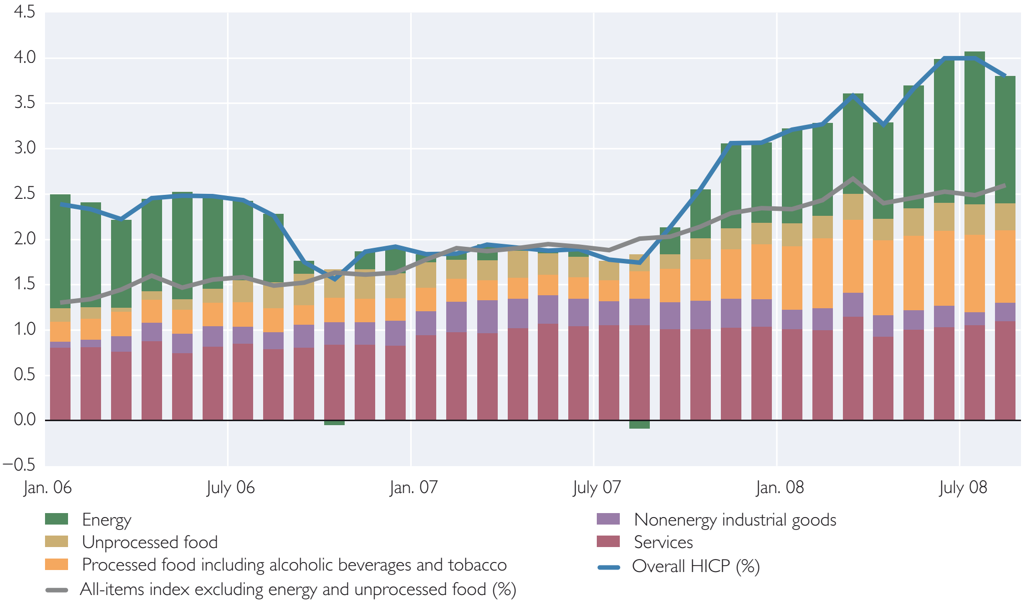
The turnaround in inflation is attributable primarily to the development of commodity prices and, in particular, crude oil prices. Since its record high of USD 145 per barrel, the price of a barrel Brent crude has fallen by 40% from mid-July to mid-September 2008. Even for food, beverages and tobacco the time of rocketing prices is over for the time being. As for cereal and oil seed prices, they have been falling since spring and summer 2008 respectively. For these volatile price components, however, even a price stabilization would see their contribution to inflation increasingly diminish over the coming months, as their dynamic upsurge had commenced in fall 2007, which means that more favorable basis effects will now unfold.

Even so, a large share of euro area inflation is still explained by energy and food prices. In August 2008, these two components accounted for two-thirds of inflation. Furthermore, lag effects can be expected in both cases. For instance, the prices of other energy

Chart 2

HICP Components

Percentage points, monthly data



Source: Eurostat.

sources (especially gas) track crude oil prices only with a time lag and, even in the case of food, increased cost pressures are only gradually passed onto consumers.

In August 2008, core inflation, which explicitly excludes the most volatile components of inflation namely energy and unprocessed food, stood at 2.6%. Prices for processed food and services prices are responsible for this unusually high level of core inflation, which indirectly also reflects the developments of the volatile price components of energy and food. For instance, prices for transport services and travel as well as café and restaurant prices rose particularly rapidly. Thanks to the appreciation of the euro and to international competition, however, high cost pressures along the value chain have so far not fed through to price increases for nonenergy industrial goods. The prices of these goods rose by a mere 0.5% year on year.

The euro exchange rate depreciated against the U.S. dollar by more than 10% between its record high of 1.599 USD/EUR on July 15, 2008, and mid-September 2008. Key factors behind this exchange rate movement are likely to be concerns about growth prospects in the euro area and a related narrowing of the interest rate gap between the euro area and the U.S.A., as well as the easing in the commodity markets. In June and July 2008 when Japan's economic outlook deteriorated, the euro initially appreciated against the Japanese yen. When, in early August 2008, the euro area economy also began to sputter and a reversal of carry trades commenced, the euro softened markedly relative to the Japanese yen. The euro depreciated in effective terms by 5% between mid-July and mid-September 2008.

2.4 Sharp Downward Correction of GDP Forecasts, Further Downward Revisions Expected

The ECB's projections of early September 2008 assume a slow improvement in the economy. Lower oil prices will have a positive impact on disposable income and thus gradually bring consumer restraint to an end. Emerging markets' sustained dynamic demand will also stimulate the economy. The ECB expects annual average real GDP growth to range between 1.1% and 1.7% in 2008, and to stabilize between 0.6% and 1.8% in 2009. Compared with the projections of June 2008, the outlook for both 2008 and 2009 has deteriorated. Uncertainty remains particularly high regarding these projections, as further energy and food price shocks as well as financial turmoil cannot be ruled out.

In its interim forecast of early September 2008, the European Commission sharply downgraded its GDP growth expectations for 2008 by 0.4 percentage points to 1.3%, as all the downside risks cited in its spring forecast – worsening financial and real estate turmoil as well as commodity price upsurge – have occurred and have been depressing both corporate and consumer confidence.

As the latest aggravation of the financial crisis has occurred after the production of the current projections and forecasts, neither as yet reflect the possibly ensuing further dampening effects on the overall economic growth. Consequently, the next projections and forecasts are likely to show further downward revisions.

Even if commodity prices may have peaked for the time being and more favorable basis effects will have an impact from fall 2008, inflation will ease only gradually. According to the ECB, HICP inflation will range between 3.4% and 3.6% in 2008, and between 2.3% and 2.9% in 2009. For both 2008 and 2009, this signifies a marked upward revision. Upside risks will arise not only from further price shocks but also from stronger second-round effects from previous shocks.

3 CESEE Countries Still Growing Faster than Euro Area

3.1 Robust GDP Growth in the First Half of 2008

In the first quarter of 2008, the EU Member States of Central, Eastern and Southeastern Europe (CESEE) – Bulgaria, Poland, Romania, Slovakia, Slovenia, the Czech Republic and Hungary – registered average real GDP growth of 5.9% year on year, thus growing much faster than the euro area as a whole (+2.1%). Initial figures released show that economic momentum seems to have held up in the second quarter of 2008 as well, although growth appears to be slowing down in Slovakia (albeit from an extremely high level) and the Czech Republic. By contrast, the economic performance of Romania, Bulgaria and Hungary picked up in the first half of 2008. In Poland – the region's largest economy – GDP growth remained at around 6% year on year, thus making a substantial contribution to growth in the region as a whole.

In the first quarter of 2008, key growth stimuli came from domestic demand. In early 2008, consumer spending further increased almost across the entire region. Somewhat more sluggish growth visible in the Czech Republic is probably attributable to higher inflation as well as to fiscal measures adopted in early 2008. In Romania, already dynamic private consumption growth continued to accelerate, amounting to more than 15% year on year in the first quarter of 2008

Table 1

Economic Growth in CESEE EU Member States

	2006	2007	Q3 07	Q4 07	Q1 08	Q2 08[1]
	Real GDP growth rate (annual change in %)					
Bulgaria	6.5	5.9	4.9	6.9	7.0	. .
Poland	6.2	6.5	6.4	6.1	6.3	6.0
Romania	7.9	6.0	5.7	6.6	8.2	9.3
Slovakia	8.5	10.4	9.4	14.3	8.7	7.6
Slovenia	5.7	6.1	6.4	4.7	5.4	5.5
Czech Republic	6.8	6.6	6.4	6.6	5.2	4.5
Hungary	3.9	1.3	0.9	0.8	1.7	2.2

Source: Eurostat.

[1] *Initial figures released.*

(2007: +11%). Besides, it is not expected to slacken in the second quarter of 2008. In Romania, as in other countries of the region, private consumption was fueled by both expansive lending growth and rising real wages. For instance, Bulgaria and Romania registered real household lending growth of more than 30% and nearly 70% year on year respectively. With real growth rates of more than 10%, wages in the two newest EU Member States also rose dynamically. A similar trend could also be observed in most of the other countries under review.

In the first quarter of 2008, gross fixed capital formation grew in Bulgaria, Poland and Slovenia by 15% and in Romania by as much as 33% (year on year respectively). However, its momentum was not as high as in 2007 and in Slovenia it remained almost constant. In the Czech Republic, Slovakia and Hungary, by contrast, gross fixed capital formation grew at a considerably slower pace in the first three months of 2008 than in 2007 (+2.0%, +2.4% and –5.4%, year on year respectively).

In the first quarter of 2008, dampened demand in the euro area, the region's main trading partner, did not yet translate into a generally deteriorated export growth. Compared with full year 2007, export growth in the first quarter of 2008 increased or remained almost unchanged in most countries of the region. Only Slovakia and Slovenia registered a significant decline in export growth, which was in both cases also reflected in a negative contribution to growth by net exports.

Overall, the risks for the CESEE region as a whole have considerably increased in the wake of global financial turmoil. The key risk factors include the slowdown in euro area growth, tighter financing conditions owing to higher risk aversion, and a generally worse investment climate. In the Baltic countries, particularly Estonia and Latvia, real GDP growth slowed significantly in early 2008. This deceleration had been widely expected owing to accumulated internal and external imbalances (high current account deficit, inflationary pressures, overheated real estate markets, rapid wage growth, lending boom).

3.2 Sustained Price Pressure and Exchange Rate Fluctuation Determine Monetary Policy

Despite a slightly easing inflation in most countries of the region in August 2008, global inflationary pressures are still clearly apparent. They are mainly

Table 2

Price Developments in Selected CESEE EU Member States

	2006	2007	Apr. 08	May 08	June 08	July 08	Aug. 08
	Annual rate of change in the HICP (%)						
Bulgaria	7.4	7.6	13.4	14.0	14.7	14.4	11.8
Poland	1.3	2.6	4.3	4.3	4.3	4.5	4.4
Romania	6.6	4.9	8.7	8.5	8.7	9.1	8.1
Slovakia	4.3	1.9	3.7	4.0	4.3	4.4	4.4
Slovenia	2.5	3.8	6.2	6.2	6.8	6.9	6.0
Czech Republic	2.1	3.0	6.7	6.8	6.6	6.8	6.2
Hungary	4.0	7.9	6.8	6.9	6.6	7.0	6.4

Source: Eurostat.

the result of rising food and energy prices, which explained on average some two-thirds of the measured inflation. In addition to these global factors, changes in both indirect taxes and administered prices, as well as increasingly tight labor markets and rising unit labor costs also induced these pricing pressures.

The generally visible appreciation of most of these countries' currencies was attributable primarily to sustained robust GDP growth with strong export activity (especially in the Czech Republic) and to expected interest rates increases owing to accelerated inflation. As to Hungary, a gradual improvement in macroeconomic fundamentals was another factor.

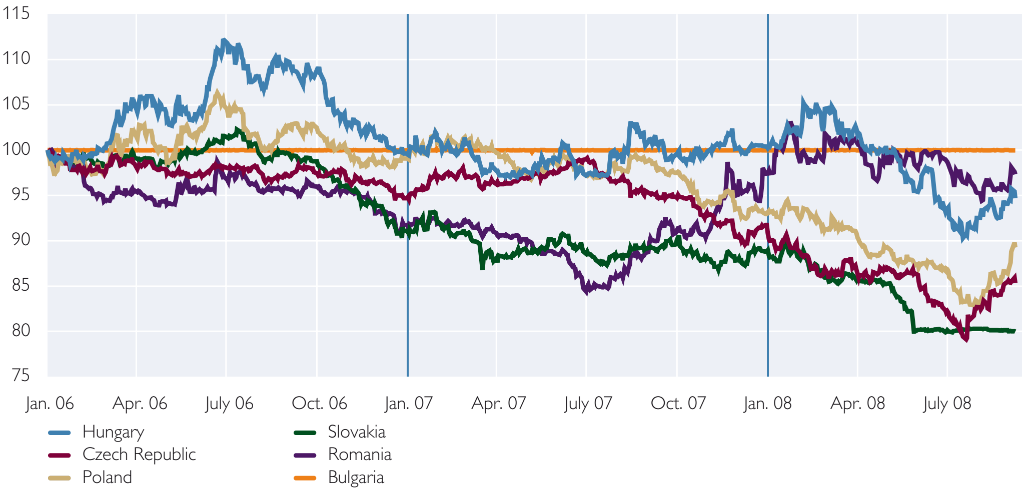
In view of the monetary climate outlined, many central banks in the region reacted with key interest rate changes. Poland, Hungary and Romania continued with tightening their monetary policy. For instance, Poland raised its key interest rate in two moves from

Chart 3

Exchange Rate Development: Local Currency Against the Euro

(Upward trend signifies nominal depreciation)

January 1, 2006 = 100



Source: Thomson Financial.

5.5% to 6.0%. This decision was based on the fact that Poland had missed its inflation target of 2.5% +/–1 percentage point (measured against the CPI) by a wide margin. In Hungary, interest rates were raised by 100 basis points to 8.5% in three stages. The reason for this decision was the high risk of a sustained breach of Hungary's inflation target of 3% (measured against the CPI). The National Bank of Romania cited quite similar reasons for its four interest rate hikes from 9% to 10.25%. Here too, the country's current inflation trend makes it look unlikely that the inflation target of 3.8% +/–1 percentage point (measured against the CPI) will be reached in December 2008.

By shaving 25 basis points off its key interest rate to 3.5% on August 7, 2008 (after having raised it by 25 basis points in March 2008), the Czech National Bank acted contrary to the regional trend. The reason for this move was primarily the Czech koruna's strong appreciation, which might dampen economic growth. In the Czech Republic inflation is currently also well above the inflation target of 3% (measured against the CPI). The Czech National Bank, however, considers high inflation to be only a temporary phenomenon, for which it holds responsible first and foremost the increase in indirect taxes and administered prices arising from the fiscal consolidation package adopted in early 2008.

3.3 Slovakia to Become the 16th Member of the Euro Area

In its convergence report of May 7, 2008, the European Commission proposed the adoption of the euro in Slovakia on January 1, 2009, as the country now fulfills all required convergence criteria. At the Ecofin Council meeting held on July 8, 2008, the convergence rate of the Slovak koruna for accession to the euro area was fixed at SKK 30.1260 per euro. This value corresponds to the central parity of the Slovak koruna in the exchange rate mechanism II after the latter was increased by 17.6% on May 28, 2008 following strong appreciation pressure. In the course of this realignment, the Slovak government issued a comprehensive economic policy statement, which comprises, above all, structural fiscal adjustment measures.

3.4 Growing Wage Pressures Resulting from Dynamic Labor Market Developments

In recent quarters, the region under review stood out in terms of its particularly dynamic labor market developments. In many countries, sharply falling unemployment rates and robust employment growth resulted in tight labor markets. This development is essentially attributable to the healthy economic performance of CESEE countries and the migration of their labor to western EU countries. Unemployment in Bulgaria, Poland and the Czech Republic fell particularly sharply. Above all, the lack of skilled labor worsened. Among other factors, this situation led to accelerated wage growth with unweighted average wage growth amounting to more than 13% year on year in the first quarter of 2008 (2007: +10.9%). This dynamic wage growth was only partly offset by higher productivity, which translated into some steep increases in unit labor costs.

Table 3

Selected Labor Market Indicators for CESEE EU Member States

		2006	2007	Q1 08	Q2 08
Bulgaria	Unemployment rate (%)	9.0	6.9	6.1	5.6
	Employment rate (%)	58.7	61.7	62.6	. .
	Wage development	6.2	16.2	19.3	. .
	Unit labor costs	4.1	14.4	16.8	. .
Poland	Unemployment rate (%)	13.9	9.6	7.7	7.5
	Employment rate (%)	54.5	57.0	58.0	. .
	Wage growth	1.7	8.1	13.9	. .
	Unit labor costs	−0.8	6.2	12.1	. .
Romania	Unemployment rate (%)	7.3	6.4	6.0	. .
	Employment rate (%)	58.8	58.8	57.7	. .
	Wage growth	19.3	22.1	23.7	. .
	Unit labor costs	13.0	15.2	15.4	. .
Slovakia	Unemployment rate (%)	13.4	11.2	10.4	10.4
	Employment rate (%)	59.4	60.7	61.3	. .
	Wage growth	6.2	8.1	11.6	. .
	Unit labor costs	1.8	0.3	5.5	. .
Slovenia	Unemployment rate (%)	7.5	7.4	7.6	7.6
	Employment rate (%)	57.3	57.3	56.1	. .
	Wage growth	6.9	6.5	8.5	. .
	Unit labor costs	2.4	2.6	6.2	. .
Czech Republic	Unemployment rate (%)	7.2	5.3	4.5	4.4
	Employment rate (%)	65.3	66.1	66.1	. .
	Wage growth	6.8	7.1	9.3	. .
	Unit labor costs	1.2	2.3	5.9	. .
Hungary	Unemployment rate (%)	7.5	7.4	7.6	7.6
	Employment rate (%)	57.3	57.3	56.1	. .
	Wage growth	8.6	8.4	7.4	. .
	Unit labor costs	5.2	6.7	3.8	. .

Source: Eurostat.

Note: Wage growth and unit labor costs both relate to the aggregate economy year on year.

4 Austria: Global Economic Gloom Increasingly Overshadows Austrian Economy

4.1 Period of Austrian Economic Expansion Comes to an End in the Second Quarter of 2008

According to the latest national accounts data, the Austrian economy in the second quarter of 2008 grew by 0.4% (in real terms, seasonally and working day-adjusted, on a quarterly basis), thereby corresponding to the growth outlook of the OeNB economic indicator. A similarly low growth rate was last seen just less than five years ago in the fourth quarter of 2003. In addition, real GDP growth for the first quarter of 2008 was revised down by 0.1 percentage points to +0.6%. Thus, the boom period of the Austrian economy, lasting from 2005 to 2007, has now come to an end.

The composition of growth has changed compared with the last few years and reflects the different external macroeconomic conditions. Owing to the visible cooling of the economies of Austria's key trading partners, Austrian exports (+0.5%) are no longer a driving force of growth. Although investment growth is also slowing down, it still looks fairly robust in comparative terms. In the next few months, however, Austrian enterprises are likely to scale down their investment activity significantly. Although private con-

Cutoff date for data: September 30, 2008 sumption growth remained very subdued at 0.3%, it is not expected to further deteriorate over the next few months. The negative effect of the gloomier economic outlook will be offset by the expected drop in inflation from the fourth quarter of 2008. Government consumption, by contrast, grew very vigorously thanks to a consignment of Eurofighters. Yet, this has not had an impact on GDP growth as imports rose simultaneously. The sluggish or low momentum of all demand components points to weak growth in the second half of 2008.

In addition to the national accounts, other "hard" indicators also support Austria's economic slowdown. For instance, industrial production (harmonized trend) in July 2008 shrank for the fourth time in a row (–0.1% seasonally and working-day adjusted, on a monthly basis). Retail sales growth slowed on the back of unexpectedly high inflation and the related weak rise in real household income. In the first half of 2008 as a whole, real retail sales were only 0.9% higher than in the previous year. In external trade, the cooling of the global economy was clearly apparent. Statistics Austria's goods balance showed a surplus of EUR 0.4 billion for the first seven months of 2008, i.e. EUR 0.5 billion less than in the same period a year ago. Whereas the deficit in trade with the EU was reduced slightly, the surplus in trade with non-EU countries was markedly smaller – not least because of high energy import costs. By contrast, tourism registered gratifying growth. In the first eight months of 2008, the number of overnight stays rose by 4.4%. Both winter and summer tourism witnessed growth, with the number of foreign visitors rising at a faster than average pace (+5.1%).

4.2 Sharp Deterioration in Confidence Indicators

A sharp deterioration in sentiment indicators signals a further slowdown in economic momentum. In September 2008, the European Commission's Economic Sentiment Indicator for Austria worsened slightly on the previous month – at 94.6 points it is significantly below its long-term average of 100. Similarly poor sentiment values were last measured in 2003. The Bank

Table 4

Austria's National Accounts Results (Real)

	2003	2004	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08
	Annual change (%)[1]					*Quarterly change (%)*[1]					
GDP	0.8	2.5	3.3	3.3	3.0	0.8	0.6	0.6	0.7	0.6	0.4
Private consumption	1.2	2.0	2.6	2.5	0.9	0.1	−0.1	0.3	0.4	0.2	0.3
Government consumption	1.0	1.1	1.5	2.2	1.9	0.0	−0.1	1.6	1.1	−1.8	2.5
Gross fixed capital formation	2.2	2.0	2.5	2.8	3.9	1.0	0.9	0.9	0.7	0.6	0.7
Exports	4.8	8.0	6.4	7.3	8.4	2.3	2.0	1.6	1.2	0.8	0.5
of which: goods	*2.8*	*10.6*	*7.2*	*7.0*	*8.6*	*2.4*	*1.6*	*1.2*	*1.2*	*1.0*	*0.4*
services	*3.2*	*5.0*	*7.7*	*6.3*	*6.8*	*1.8*	*1.9*	*1.8*	*1.6*	*1.2*	*1.0*
Imports	4.0	9.5	6.9	5.4	7.0	1.9	1.5	1.7	1.0	−0.2	1.4
of which: goods	*4.3*	*10.6*	*6.8*	*5.5*	*7.8*	*2.2*	*1.7*	*1.7*	*0.8*	*−0.2*	*1.7*
services	*2.7*	*6.1*	*7.0*	*4.6*	*4.4*	*1.0*	*1.2*	*1.2*	*0.9*	*0.6*	*0.5*

Source: Eurostat.

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

Box 1

Results of the OeNB Economic Indicator of October 2008[1]

As a result of the financial turmoil, the global economic outlook has recently continued to darken considerably. Austria's economy cannot decouple itself from this development as it heavily depends on exports. Furthermore, significant stimuli from private consumption, which is usually the key pillar of economic activity in the mature phase of the economic cycle, are currently not in evidence. A high saving propensity and steep inflation are both equally responsible for this development. The Austrian economy will therefore nearly stagnate in the second half of 2008. According to the OeNB economic indicator's results, the OeNB projects real GDP growth of 0.2% (seasonally and working day-adjusted, on a quarterly basis) in the third quarter of 2008. The fourth quarter of 2008 will most unlikely see the Austrian economy grow (+0.0%). For 2008 as a whole, Austria will nonetheless still register real GDP growth of close to 2% due to buoyant activity seen at the start of the year.

However, this outlook is exposed to extraordinarily high uncertainty. By international standards, the Austrian financial system is only to a small degree directly affected by the financial crisis – still, neither its extent nor its impact on the global economy and on Austria's key trading partners can be definitively estimated from a current perspective. In the current climate, it should be particularly highlighted that only developments occurring to end-September 2008 were included in the data used for calculating the OeNB indicator. The events of recent weeks are therefore still not reflected in these data. While this should hardly affect developments in the third quarter, the growth rate projected for the fourth quarter of 2008 should be interpreted rather as an upper limit in the event of no further aggravation of the financial crisis.

Table 5

Short-Term Outlook for Austria's Real GDP in the Third and Fourth Quarters of 2008 (Seasonally and Working Day-Adjusted)

2006				2007				2008			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Year-on-year quarterly change (%)											
3.5	3.3	3.2	3.3	3.3	3.2	2.9	2.7	2.5	2.2	**1.8**	**1.1**
Quarterly change (%)											
0.8	0.8	0.8	0.9	0.8	0.6	0.6	0.7	0.6	0.4	**0.2**	**0.0**
Annual change (%)											
3.3				3.0				1.9			

Source: Results of the OeNB economic indicator of October 2008, Eurostat.

[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 and the next quarters (in each case, on a quarterly basis, using seasonally-adjusted data). The forecast's values are based on the results of two economic models, an unobserved components model and a dynamic factor model. Further details on the models used can be found at www.oenb.at in the Monetary Policy and Economy/Outlooks section. The next publication is due in January 2009.*

Austria Purchasing Managers' Index fell sharply in August 2008. At 46.0 points – its lowest value since 2001 – the index signals a deepening of the recession in Austrian industry. The Ifo Business Climate Index for Germany, which is also known to be a good leading indicator for Austria, further deteriorated in September and now stands at only 92.9 points. Austrian enterprises continued to scale down their investment plans for 2008. Owing to the flat investment trend during recent years' economic boom, a sharp deceleration in investment growth similar to the period between 2001 and 2002 is, however, not to be expected from a current perspective.

4.3 Upcoming Trend Reversal in the Labor Market

In recent months, developments in the labor market have represented a ray of hope for the Austrian economy. In September 2008, the number of registered unemployed fell for the 31st month in succession. At 183,327 registered unemployed, jobless numbers were lower by 1,820 persons or by 1.5% compared with the preceding year. However, they did not fall to the same extent as in previous months. Furthermore, employment momentum has markedly slowed recently. Up by some 70,591 persons (+2.1% year on year), the number of payroll employees came to 3,467,791 persons at end-September 2008. As a result, the unemployment rate (Eurostat definition) was 3.3%. However, the labor market is also witnessing growing signs of a trend reversal. In September 2008, reported vacancies fell by 7.7% – a clear signal that the boom period of the last three years is now over.

4.4 Slight Drop in Inflation

In June 2008, inflation peaked at +4.0% (HICP). It has since dropped slightly, standing at 3.6% in August 2008. At 0.8 percentage points, fuel prices contributed most to inflation. In August 2008, food and nonalcoholic beverages accounted for a fifth of inflation. Communication expenditure, however, had a price-dampening effect. In the fourth quarter of 2008, basis effects arising from the rise in inflation since October 2007 will – for the first time – have a dampening effect on inflation. Inflation should therefore continue to fall over the next few months.