Inflationary Pressures Worldwide despite Downturn in Growth

Dampened Growth also Expected in the Euro Area

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The international environment is increasingly being dominated by a cooling global economy. In the U.S.A., the real estate and financial crisis has spilled over to the real economy. Growth in consumer demand has declined, and the deterioration in the labor market suggests a deepening of this trend. In addition, the leading indicators point to a marked downturn in growth, and major Austrian and international organizations recently downgraded their GDP forecasts for the U.S.A.

In the euro area, the economy likewise weakened somewhat in the fourth quarter of 2007. Despite the increased euro exchange rate, net exports made the largest contribution to GDP growth. Domestic demand was driven by gross fixed capital formation while consumer spending was down for the first time since 2001. The latest macroeconomic projections by ECB staff experts anticipate a slowdown in the euro area's GDP growth for 2008.

In February 2008, euro area inflation (based on the HICP) reached 3.3%, a record high since the euro area was created. This rise is primarily attributable to the increase in energy and food prices. The increase in the euro exchange rate occurring in the same period mitigated the inflationary pressures to some extent. The projections for inflation in 2008 were further upgraded.

Despite the international financial crisis and its dampening effects worldwide, the Austrian economy looks surprisingly healthy. The OeNB economic indicator of March 2008 signals only a modest downturn in GDP growth for the first half of 2008.

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1 Rising Inflationary Pressures Worldwide

1.1 U.S.A.: Marked Downturn in Growth with Higher Inflation

In the U.S.A., after very dynamic economic growth in the third quarter of 2007, annualized real GDP growth markedly slowed to 0.6% in the fourth quarter of 2007. Whereas weaker residential construction investment and inventory rundown contributed negatively to growth, the previous two key pillars of economic activity – consumer spending and net exports – grew at a slower pace. This reflects the impact of the real estate and credit crisis. At 2.2%, growth in 2007 as a whole was the weakest since 2002.

Marked dampened growth is expected to continue in 2008. The latest U.S. economic indicators also point in this direction, e.g. the sharp deterioration in consumer confidence and falling employment. Both the IMF and the U.S. Fed recently downgraded their growth forecasts for 2008.

Inflationary pressures, which have been mounting since fall 2007, only marginally eased recently. In February 2008, consumer prices advanced by 4.0% year on year. Core inflation, which fell to 2.3% in February 2008, continued to exceed the U.S. Fed's comfort zone. For 2008 as a whole, the U.S. central bank expects a downturn-induced decline in consumer price growth ranging between 2.1% and 2.4%.

The U.S. labor market situation also visibly deteriorated in recent months. For instance, for the first time since June 2003 the number of

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nonagricultural jobs fell for two successive months in January and February 2008. Given a sharp decline in the number of employed persons, the cutback in jobs has, so far, not affected the unemployment rate, which recently stood at 4.8%.

The U.S. real estate market continues to witness high levels of excess supply. Just as with the sale of existing houses, new house sales have been shrinking in the last two and a half years. In addition, house prices are continuing to fall. The resulting negative wealth effects and the credit squeeze are also affecting households. Following generous injections of capital into the U.S. banking sector, the crisis began to spread to other financial institutions (particularly specialized insurers and hedge funds). In mid-March 2008, JP Morgan acquired the investment bank Bear Stears, which was threatened by insolvency. The U.S. Fed supported this transaction by injecting liquidity of USD 30 billion. Credit card companies' write-off requirements are also on the rise.

Following the downslide in equity prices, the U.S. Fed convened an extraordinary meeting on January 22, 2008 and cut the Federal Funds target rate by 75 basis points. At its regular Federal Open Market Committee (FOMC) meeting, it made a further cut of 50 basis points to 3.0%. On March 18, 2008, the U.S. central bank reduced its target rate by a further 75 basis points in view of the continued turmoil on international financial and real estate markets. Since September 2007, the U.S. Fed has successively lowered its key interest rate five times by a total of 225 basis points. These rate cuts have not had the expected impact on the credit markets, however. Banks remain very cautious owing to losses and writedowns of more than USD 190 billion so far as a result of the subprime crisis and looming total loan losses of USD 400 to 600 billion. On March 11, 2008, the ECB, in conjunction with the Bank of Canada, the Bank of England, the U.S. Fed and the Swiss National Bank, announced new measures to mitigate the liquidity strains in the money markets and credit markets.

Current U.S. fiscal policy is also endeavoring to counter a potential recession by means of an economic recovery package, which was approved by President Bush on February 13, 2008 (total volume: more than 1% of GDP) and which comprises, in particular, tax relief measures and investment incentives.

The risks to this economic outlook are primarily in the continuing and intensifying turmoil in the financial markets as well as in the spreading of this crisis to other segments such as credit cards, car credit or credit default swaps (financial instruments used by banks and investors to hedge risks).

1.2 Japan: Growth Spurt in the Fourth Quarter of 2007

In Japan, despite the global financial crisis, real GDP growth in the fourth quarter of 2007 accelerated to 0.9% on a quarterly basis (third quarter: +0.3%). Robust gross fixed capital formation and continued high levels of exports – the latter thanks to brisk demand from East Asia and the EU – are fueling growth. Private domestic building activity, by contrast, continued to wane owing to more stringent building regulations. Once again, exports were the main engine of growth in 2007 as a whole while the positive contribution from private consumption was smaller than in 2006. As a result, GDP growth slowed slightly to 2.1%.

In general, economic momentum in Japan is expected to weaken in 2008. The IMF and OECD downgraded their growth forecasts to 1.5% and 1.6%, respectively. Weaker global levels of demand, lags in wage increases and a hesitant recovery in the domestic construction industry were cited as justification for these downgrades. In addition, corporate profits have been falling since their peak of mid-2007 owing to higher input prices. The Japanese government anticipates real GDP growth of 2.0% for the coming fiscal year (April 2008 to March 2009).

While sustained downward wage pressures are dampening consumer price growth, increased import prices for commodities are beginning to stoke inflation. In January 2008, for instance, the CPI rose by 0.7% year on year, i.e. to the same level as in the previous month. At 0.8%, the corresponding rate of change in core inflation (excluding fresh food) remained unchanged. This is its steepest rise since March 1998.

Key interest rates were last raised by 25 basis points to 0.5% in February 2007. The Bank of Japan (BoJ) bases its rationale for this decision on a "forward-looking monetary policy" with a horizon of one to two years. The interest rate gap relative to major currency areas remains wide, and the BoJ has not announced further rate hikes for the near future. The exchange rate of the Japanese yen has been firming against the U.S. dollar since mid-2007 and markedly so since early 2008. Fears of a possible U.S. economic downturn and the unwinding of carry trades were cited as reasons for this development. Against the euro, however, the Japanese yen remained within a relatively narrow margin of fluctuation.

1.3 Asia Continues to Boom; China Wrestles with Overheating and Rising Cost of Living

The major emerging Asian economies (excluding Japan) enjoyed continued robust GDP growth. According to the IMF, real GDP growth in the region was 9.6% in 2007 but is expected to fall to 8.6% in 2008. China and India remain the engines of growth in Asia.

In 2007, real GDP growth in China further accelerated to 11.4% despite measures to cool its overheated economy. Tighter credit and monetary policies should now curb high levels of investment demand. In addition, the policy of a moderate gradual appreciation of the renminbiyuan relative to the U.S. dollar was eased to some extent in 2007, permitting somewhat more discernible appreciation. Despite a halt in the rise of administered prices, consumer price growth continued to accelerate in February 2008 to 8.7% year on year. This was owing to mounting food prices, in particular. In addition, inflationary pressures in most other Asian countries are still strong owing to high food and commodity prices. India saw continued economic momentum albeit at a slightly slower pace. Asia's overall bright economic prospects are underpinned by both domestic demand and robust growth of exports between Asian countries, as well as with Europe and the Gulf states.

2 Euro Area: Continued Steep Inflation in Energy and Food

2.1 Slowdown in GDP Growth in the Fourth Quarter of 2007

In the fourth quarter of 2007, real GDP growth rose by 0.4% quarter on quarter on a seasonally adjusted basis. This means that growth momentum slowed in the second half of 2007. Compared with the fourth quarter of 2006, GDP growth stood at 2.2% (third quarter of 2007: 2.6%). As a result, GDP growth of 2.6% was posted for 2007 as a whole. Of individual euro area countries, the Netherlands (1.2%) and Finland (0.9%) achieved the highest GDP growth on a quarterly basis. Of the large euro area countries, Spain posted an above-average performance (0.8%).

Compared with the previous quarter, net exports accounted for the largest contribution to GDP. While exports advanced a further 0.5%, imports slipped by 0.4%, thus causing the contribution of net exports to reach 0.4 percentage points in the fourth quarter, their highest level for 2007 as a whole. Both exports and imports suffered a decline in growth in the second half of 2007. Since the U.S.A. are the second most important recipient of euro area exports after the U.K., a further slowdown of the U.S. economy would reduce the contribution of net exports to GDP growth in the coming quarters. As for euro area imports, China replaced the U.K. as the EU's biggest trading partner in 2007.

In the fourth quarter of 2007, private consumption fell for the first time since 2001 on a quarterly basis, thereby making a negative contribution to GDP growth. In the same period, government consumption also declined for the first time in eight years on a quarterly basis. Inflation in the last few months of 2007 also dampened consumer demand. Consumer confidence surveyed by the European Commission steadily deteriorated during the second half of 2007. Both general GDP growth expectations and those relating to the financial situation of households have worsened considerably.

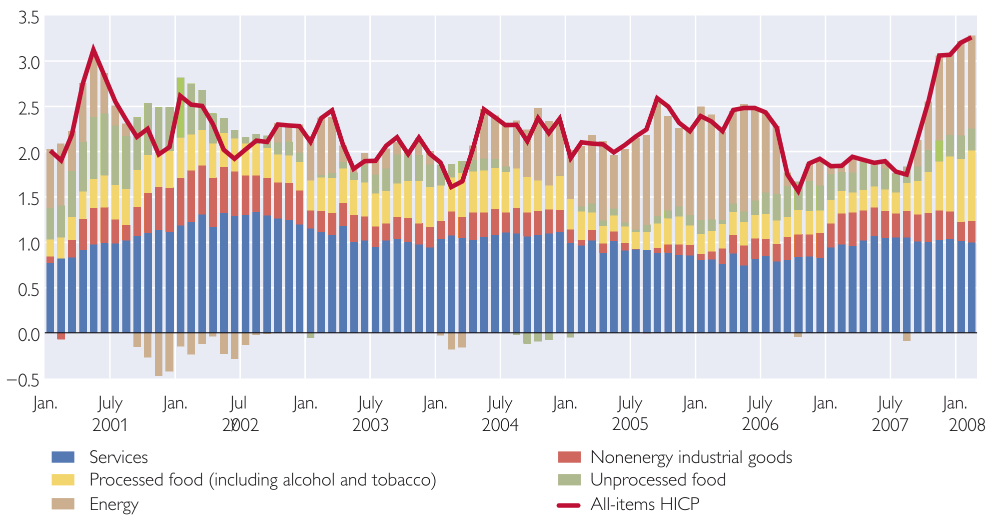
In the fourth quarter of 2007, gross fixed capital investment expanded by 0.8% against the third quarter, contributing 0.2 percentage points to GDP growth as a whole. Moreover, the contribution made by investment to GDP growth was thus smaller than in the third quarter of 2007. Investment growth, which is becoming more sluggish, is partly explicable by existing production facilities' lower levels of capacity utilization. According to a survey conducted by the European Commission, industrial capacity utilization peaked in the second quarter of 2007 and has since been on the wane. Although capacity utilization levels should have fallen slightly also in the first quarter of 2008, they still remain historically high.

A sectoral breakdown of activity shows that GDP growth was fueled primarily by business-related and financial services. Other services and goods production also made positive contributions albeit to a smaller extent. Other sectors, in contrast, failed to provide growth momentum in the fourth quarter of 2007. Even trade, which grew in the first three quarters of 2007, stagnated.

The labor market situation continued to ease in recent months. In January 2008, the euro area's seasonally-adjusted unemployment rate fell to 7.1%. This improvement was pri-

Chart 1

HICP Components: Contributions to Inflation



Source: Eurostat.

marily attributable to developments in Germany and France. The last time the French unemployment rate was as low as it currently is was in August 1983. In the fourth quarter of 2007, the number of employed in the euro area grew by 0.2% on a quarterly basis. On an annual basis, however, it rose by 1.7%. The European Commission's survey on employment expectations in the service and industrial sectors showed a continued deterioration in February 2008. As for households, the fear of joblessness continued to strengthen. Employment growth is therefore likely to have been more sluggish in the first quarter of 2008. Currently available data show that the favorable labor market situation has still not fed through to higher wage increases for the employed. In the third quarter of 2007, employee remunerations grew by 2%, which was roughly equivalent to the average in recent years.

2.2 Inflation in Early 2008 at its Highest Level since the Creation of the Euro Area

In February 2008, HICP inflation continued to rise and stood at 3.3%. This is its highest annual growth rate since 1999. In particular, sustained upward pressures on food and energy prices were responsible for the high inflation rate in February 2008. By contrast, the contributions to inflation from services remained constant and those from industrial goods excluding energy were smaller than in the previous year, as in January 2008. Although exchange rates are dampening the inflation of imported consumer goods, the producer prices of domestic consumer goods – in particular, those of food – are still subject to inflationary pressures.

Core inflation (all-items index excluding energy and unprocessed food) also rose in February 2008 (2.4%). The momentum of core inflation is mainly attributable to the sharply rising inflation in processed food. After the prices for each of these goods had climbed by some 2% year on year in the first six months of 2007, from July 2007 this rate rose on average by 0.7 percentage points from one month to the next, reaching a new annual high of 6.4% in February 2008.

The increase in oil prices also made a significant contribution to inflation in the euro area. At the end of February 2008, the price of North Sea Brent crude exceeded the USD 100 per barrel mark for the first time in its history. On March 14, 2008, it reached a new record high of USD 108 only to fall by 8% in the days thereafter to March 24, 2008. Although this signifies an increase in USD-denominated oil prices of some 67% on an annual basis, the simultaneous strengthening of the EUR/USD exchange rate meant that euro-denominated oil prices rose a mere 43% over the same period. In February 2008, shocks in the financial markets, which were accompanied by fears of recession, induced a temporary drop in the price of oil.

On March 18, 2008, the EUR/USD exchange rate achieved a fresh record high of 1.57, having climbed 6% since early 2008 alone. In this case too, the exchange rate softened in the second half of March, standing at 1.54 on March 24. Since the start of the financial turmoil in August 2007, the EUR/USD exchange rate has risen by some 12%. The euro strongly firmed against the U.S. dollar as early as the second half of 2007. This appreciation was motivated primarily by the expected widening of the interest rate gap between the euro area and the U.S.A. From November 2007 to February 2008, the EUR/USD exchange rate had a relatively high margin of fluctuation ranging from 1.44 to 1.49. The EUR/USD exchange rate has risen steadily from early March 2008. Positive economic signals in the euro area and negative ones in the U.S.A. are likely to have contributed to this development. The euro's effective exchange rate has also strengthened. In addition to the USD/EUR exchange rate, the GBP/EUR exchange rate has also softened. Since August 2007, it has depreciated by some 10%.

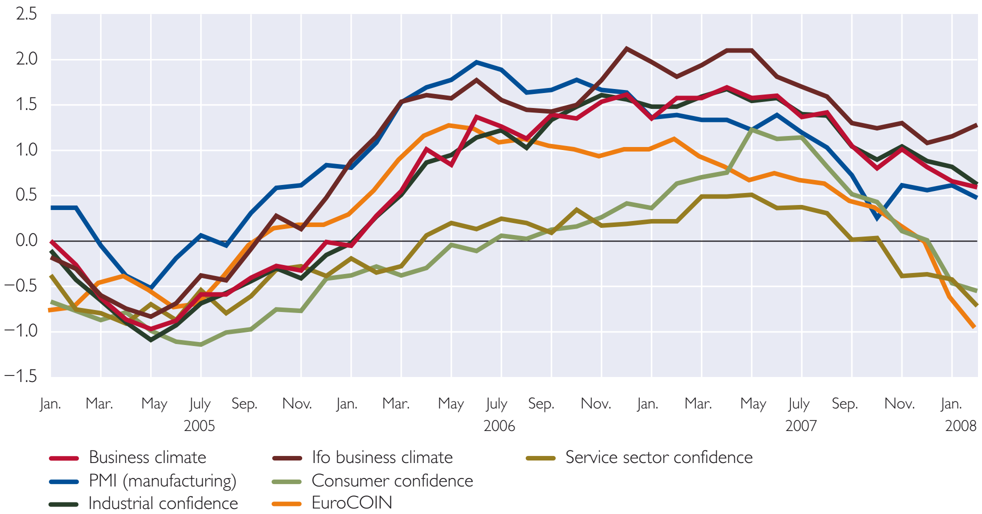
2.3 Leading Indicators Signal More Sluggish Growth

Although indicators for short-term economic trends currently signal a slowdown in the euro area's GDP growth, individual country indicators (e.g. the Ifo Business Climate Index for Germany) recently rallied. The European Commission's economic sentiment indicator further deteriorated in February 2008 and now exactly matches its historical average. The services confidence indicator fell particularly sharply, and the industry and construction components registered declines. In particular, consumer expectations for the next 12 months have worsened, with confidence stagnating on the whole. However, the financial services indicator rallied strongly, making up for much of its decline in the second half of 2007.

The Ifo Business Climate Index for the German manufacturing industry advanced for the second time in a row in February 2008. This time the rise was exclusively attributable to the improved assessment of the current situation. Business expectations continued to deteriorate slightly. Although Germany's manufacturing industry is in good health on the whole, expectations continue to indicate economic distress.

Chart 2

Business Climate Indicators for the Euro Area



Source: European Commission, NTC, ifo, FTD, CEPR, Eurostat, OeNB.
Note: Deviation from the mean value of the indicator relative to the standard deviation.

In January 2008, the deterioration since mid-2007 in industrial confidence surveyed by the European Commission continued and has now undershot its low of 2007. This recent decline was attributable to the deterioration in business expectations. In February 2008, the Purchasing Managers' Index fell to 52.8. Although the index still indicates a rise in euro area industrial production, it falls well short of its average level of 2007. Both the purchasing and selling prices of the survey's respondents advanced in February 2008. The European Commission's business climate indicator continued to fall in February 2008, reaching a record low since March 2006. The indicator is nevertheless still at a relatively high level, thus signaling further, albeit less vigorous, industrial production growth. The decline was triggered primarily by poorer output expectations.

2.4 Forecasts Predict Dampening of Both GDP Growth and Inflation

The latest macroeconomic projections by ECB staff experts of March 2008 assume that real GDP growth in the euro area will be somewhat lower in 2008 than in 2007. As before, the euro area's economic fundamentals do not show any major imbalances. Although investment growth will be dampened by the cooling global economy, in view of the high capacity utilization levels and sustained growth in profitability it is likely to continue contributing to GDP growth. At the same time, employment and the labor force participation rate soared on the back of the improved economic situation and wage restraint. Although private consumption growth is currently being dampened by higher commodity prices, it is likely to continue to contribute to GDP growth in tandem with employment growth.

According to the latest projections, annual real GDP growth will range between 1.3% and 2.1% in 2008 and between 1.3% and 2.3% in 2009. Compared with the predictions made by Eurosystem experts in December 2007, the ranges projected for real GDP growth in 2008 and 2009 were corrected downward. This is attributable to more sluggish global demand, stronger pricing pressures from commodity prices and more unfavorable financing conditions. Available forecasts by international organizations largely confirm these prospects.

According to the projections of March 2008, HICP inflation will range between 2.6% and 3.2% in 2008 and between 1.5% and 2.7% in 2009. Compared with the predictions made by Eurosystem experts in December 2007, the projected ranges for inflation shifted up primarily owing to future steep food and energy price rises. As far as the domestic economy is concerned, wages in 2008 – particularly, in the public sector – are likely to climb more steeply than of late. In addition, profits will grow at a slower pace owing to the economic downturn. Risks to inflation are currently pointing to the upside over the forecasting horizon and include, in particular, future oil and agricultural product price rises, which could continue their steep uptrend of the past few months. Besides, there is the possibility that wage increases could be higher than currently expected owing to high capacity utilization and the favorable labor market situation.

3 GDP Growth in Central, Eastern and Southeastern Europe (CESEE)

3.1 Continued Strong Momentum in CESEE Member States

The economies of the CESEE Member States under review (Bulgaria, Poland, Romania, the Slovak Republic, Slovenia, the Czech Republic and Hungary) continued to grow robustly in the second half of 2007. At 6.1%, real GDP growth was extremely dynamic in the fourth quarter on a weighted average basis, accelerating by 0.4 percentage points compared with the third quarter of 2007. Growth benefited, above all, from favorable trends in Poland, which accounts for about 42% of the region's economic performance. In addition, the Slovak Republic, which was one of the world's fastest expanding economies in the fourth quarter of 2007, registered higher-than-average GDP growth of 14.3%. Hungary, where extensive budget consolidation mea-

Table 1

GDP Growth in Selected CESEE Member States

Annual change in real GDP growth in %

	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Bulgaria	6.1	. .	6.2	6.6	4.5	. .
Poland	6.2	6.5	7.2	6.4	6.4	6.1
Romania	7.7	6.0	6.1	5.7	5.7	6.6
Slovak Republic	8.5	10.3	8.3	9.3	9.4	14.3
Slovenia	5.7	6.1	7.2	6.0	6.4	4.7
Czech Republic	6.4	6.5	6.5	6.5	6.3	6.6
Hungary	3.9	1.3	2.7	1.2	0.9	0.8

Source: Eurostat.

sures have been dampening growth since mid-2006 already, posted considerably lower-than-average GDP growth. Another growth-dampening factor in the country was the impact of crop failure, which also hit Bulgaria and Romania.

In most CESEE Member States, GDP growth in the second half of 2007 was driven by domestic demand. Only Hungary saw a continued decline in domestic demand, which has been evident for some time. Private consumption benefited from the favorable development in the labor markets. Employment growth was dynamic in most countries of the region. Only Hungary suffered a slight decline. Unemployment fell in all countries under review here, and, in some, even reached historical record lows. In certain CESEE Member States, this led to a supply-side tightening in specific labor market segments, which has increasingly contributed to rising wages. Despite higher price pressures, real wages in recent months have grown significantly throughout this group of countries, and in Bulgaria and Romania by as much as more than 10%. In addition, lending, which is still rising rapidly, fueled private consumption, with Bulgaria and Romania leading regionally with growth rates of 36.4% and 68.2%, respectively (in real terms, on an annual basis).

In the second half of 2007, corporate investment accounted for the largest contribution to growth in Poland, Slovenia and the Czech Republic. In most of the other countries, this component grew strongly as well. In particular, continued robust industrial activity, which can be seen from high and, in some countries, from still growing capacity utilization and industrial production, had a positive effect. In addition, building activity growth was also very dynamic in Bulgaria and Romania. Although investment activity in Hungary recovered somewhat in the fourth quarter of 2007, it remained modest. However, it should be noted here that this poor performance stemmed less from the manufacturing industry than from a decline in construction investment and from generally low levels of government spending.

The external sector made an appreciable contribution to growth only in the Slovak Republic, in Hungary and in the Czech Republic. In the Slovak Republic, large volumes of production capacity were created in recent years in export-oriented industries, frequently financed via foreign direct investment (FDI). This development sharply boosted exports. In Hungary, a competitive industrial sector is boosting the external sector's contribution to growth in the face of falling domestic demand. In the Czech Republic, import activity lost significant momentum in the fourth quarter of 2007. In Bulgaria and Romania, net exports dampened GDP growth substantially. Extremely dynamic domestic demand in Bulgaria and Romania resulted in high levels of import growth. In addition, export activity lost steam in both these countries.

3.2 Rapidly Mounting Pricing Pressures as a Result of Both Global and Local Factors

In the second half of 2007 and in early 2008, inflation rose markedly in the CESEE Member States under review, ranging from 3.4% in the Slovak Republic to 12.2% in Bulgaria in February 2008. In the period from September 2007 to February 2008, the rise

Table 2

Price Developments in Selected CESEE Member States

Annual change of the HICP in %

	2006	2007	Sep. 07	Oct. 07	Nov. 07	Dec. 07	Jan. 08	Feb. 08
Bulgaria	7.4	7.6	11.0	10.6	11.4	11.6	11.7	12.2
Poland	1.3	2.6	2.7	3.1	3.7	4.2	4.4	4.6
Romania	6.6	4.9	6.1	6.9	6.8	6.7	7.3	8.0
Slovak Republic	4.3	1.9	1.7	2.4	2.3	2.5	3.2	3.4
Slovenia	2.5	3.8	3.6	5.1	5.7	5.7	6.4	6.4
Czech Republic	2.1	3.0	2.8	4.0	5.1	5.5	7.9	7.6
Hungary	4.0	7.9	6.4	6.9	7.2	7.4	7.4	6.7

Source: Eurostat.

in inflation in the Czech Republic and Slovenia was particularly steep. In the Czech Republic, this development was however largely attributable to especially high inflation since early 2008, which was influenced by the hike in the lowest VAT rate, the introduction of medical fees and price rises in housing, water, power, gas and other fuels in early 2008. In Slovenia, inflation momentum was strongly driven by food and, toward the end of 2007, by energy as well. Above all, after the end of dual pricing following the introduction of the euro (June 2007), seasonal products are likely to have been subject to inflation to a greater extent.

In general, price developments in the region were driven by both global and local factors. High global market prices for food and energy exerted particularly strong inflationary pressures owing to these product groups' high weighting in the consumer price index of the CESEE Member States under review. In addition, a number of countries (Hungary, Romania, Bulgaria) were hit by poor harvests, and Slovenia witnesses a low degree of competitive intensity in its retail sector, which facilitated a knock-on effect of the food price increases on consumers.

In most CESEE Member States, however, price developments were also influenced by local factors. These included high consumption growth (especially in Romania and Bulgaria), decreasingly negative or increasingly positive output gaps (especially in the Czech Republic, in Poland, Slovenia and the Slovak Republic), higher growth rates in unit wage costs, which were attributable to labor force shortages in some countries (especially in Bulgaria, Romania and Poland), changes in indirect taxes and administered prices (especially in the Czech Republic), sharp currency devaluation (in Romania) and procyclical fiscal policies in all the countries under review (except for Hungary).

To counter these developments, some central banks in the region raised their key interest rates. Since September 2007, the Czech central bank has hiked its key interest rate three times from 3% to 3.75%, its Polish counterpart four times from 4.5% to 5.5% and its Romanian equivalent three times from 7% to 9%. Particularly in the Czech Republic, the Slovak Republic and in Poland, monetary conditions were additionally tightened by an appreciation of the respective country's currency.

3.3 Impact of Financial Turmoil in the Region – Still Minimal

Robust domestic demand and adverse developments in the terms of trade contributed to the persistence and, in part, to the deepening of existing external imbalances in some CESEE Member States. Particularly in Bulgaria and Romania (both countries have especially high current account deficits), FDI coverage of the current account gap also narrowed and external debt continued to deepen. In addition, the structure of the external debt shifted toward short-term financing. In view of deteriorating international financing conditions, a heavy reliance on external capital flows to finance growth in some countries of this region represents a key risk factor.

So far, however, the capital markets of the CESEE Member States have been affected only to a relatively small extent by the latest turmoil in the international financial markets. In the region under review, the rise in bond market risk premia has been lower than in comparable emerging markets since October 2007. Similarly, equity market losses have so far been less marked than in other emerging markets, the euro area or the U.S.A. Of the region's currencies, only the new Romanian leu depreciated to a significant degree and for a protracted period. In general, the losses suffered by the countries under review were higher in countries with major economic imbalances (e.g. Bulgaria and Romania).

The continuation or intensification of the current global financial distortions could impact the region via several channels. The consensus view is that the direct impact on the CESEE Member States from a downturn in U.S. growth would be rather limited. Owing to the euro area's importance as a trading partner, a decline in euro area growth on the back of a cooling U.S. economy would, however, lead to a dampening of the region's exports and thus to a deterioration of its external positions. The transfer of risk via financial market linkages could play a comparatively more significant role and be reflected in higher financing costs and/or falling capital inflows. On the one hand, such a development may be triggered by a further decline in international investors' willingness to take risks vis-à-vis emerging markets. On the other, a restriction in foreign banks' lending to their subsidiaries in the region's often largely foreign dominated banking markets could have an impact as a channel of contagion. The concentration of a few international creditor nations (in particular, Austria, France, Germany and Italy) in the CESEE Member States increases this risk furthermore. The data on capital flows, of which some items are available up to the fourth quarter of 2007, do not indicate ebbing financial flows to the region, though. While the net capital inflows to some CESEE Member States are negative, this pattern basically reflects the accumulation of foreign assets by CESEE nationals.

4 Austria: Only Modest Economic Downturn in the First Half of 2008

4.1 Austrian Economy Grew by 3.3% in 2007

The Austrian economy looked in excellent health in 2007. Real GDP growth was 3.3% (seasonally and working day adjusted). Although the momentum of Austrian exports slowed during 2007 owing to the steadily rising external value of the euro and to the slackening global economy, exports performed relatively well in the fourth quarter of 2007. As a result of the sharp depreciation of the U.S. dollar against the euro, a further slowdown in export momentum can however be expected in the first half of 2008. This development is also signaled by the declining momentum of export orders. The performance of Austria's domestic economy varies greatly depending on both the sector and demand component. Although the momentum of goods production has eased, the manufacturing industry still enjoys above-average order book levels. The construction sector and tourism industry are currently performing very well. However, business-related services are suffering a sharp slowdown in growth. According to the EU business survey, companies expect their business activity to fall in the months ahead.

In 2007 as a whole, investment activity was even stronger than in 2006. Nonetheless, 2007 saw a sharp slowdown in growth, which appears set to continue in 2008. Despite healthy employment growth, private consumption did not pick up momentum during the economic boom of the last two years. Higher inflation – primarily owing to steep increases in energy and food prices – is also dampening real household income. Consumer demand is therefore not expected to gain momentum in the next few months.

Table 3

Results of the National Accounts (in Real Terms)

	2005	2006	2007	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07
	Annual change in % [1]			Quarterly change in % [1]							
GDP	2.3	3.1	3.3	0.7	0.8	0.8	0.8	0.9	0.8	0.7	0.6
Private consumption	2.3	2.0	1.5	0.6	0.5	0.4	0.3	0.3	0.5	0.5	0.3
Government consumption	1.6	2.0	2.6	0.5	0.5	0.4	0.4	0.4	0.4	2.0	1.2
Gross fixed capital formation	1.6	3.1	3.7	0.6	1.0	1.2	1.2	1.0	0.8	0.6	0.4
Exports	6.7	7.6	7.0	2.3	0.9	2.0	2.3	2.1	1.2	1.2	1.2
of which: goods	*7.2*	*8.0*	*7.6*	*2.6*	*0.5*	*2.2*	*2.8*	*2.2*	*1.2*	*1.2*	*1.3*
services	*5.4*	*6.4*	*7.0*	*1.5*	*1.6*	*1.6*	*1.7*	*1.7*	*1.8*	*1.8*	*1.6*
Imports	6.1	4.7	6.1	0.9	1.4	1.7	1.9	1.5	1.1	1.6	1.2
of which: goods	*6.5*	*5.8*	*6.4*	*1.3*	*1.5*	*1.6*	*1.9*	*1.8*	*1.1*	*1.6*	*1.1*
services	*2.3*	*5.2*	*4.4*	*1.4*	*1.7*	*1.4*	*0.8*	*0.6*	*1.0*	*1.7*	*1.8*

Source: WIFO.

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

Box 1

OeNB Economic Indicator of March 2008 Signals Only a Modest Downturn in Growth for the First Half of 2008[1]

Despite the international financial crisis and its globally dampening effects, the outlook for the Austrian economy in the first half of 2008 looks surprisingly favorable. As anticipated so far, although real GDP growth in 2008 as a whole will be markedly lower than in 2006 and 2007, a dramatic collapse of the Austrian economy does not currently look to be on the cards. On the basis of the available data – which however map only the developments occurring up to early 2008 – the OeNB economic indicator signals real GDP growth of 0.6% in the first quarter of 2008, followed by 0.5% in the second quarter (seasonally and working day adjusted, on a quarterly basis).

Table 4

Short-Term Real GDP Forecast for Austria for the First and Second Quarters of 2008 (Seasonally and Working Day-Adjusted)

2005				2006				2007				2008	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Quarterly year-on-year change in %													
2.3	2.2	2.2	2.7	3.2	3.1	3.0	3.3	3.4	3.4	3.3	3.0	2.8	2.4
Quarterly change in %													
0.3	0.9	0.9	0.6	0.7	0.8	0.8	0.8	0.9	0.8	0.7	0.6	0.6	0.5
Annual change in %													
2.3				3.1				3.3					

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

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

4.2 Labor Market in Excellent Health in Early 2008

Austria's labor market still looks in excellent health thanks to the booming economy in recent quarters. Moreover, temporary factors such as the favorable tourism season and the construction sector are boosting the demand for labor.

In February 2008, payroll employment numbers rose by 3.0% on an annual basis and the number of those reported unemployed fell by 11.9%. The jobless rate (Eurostat) declined to 4.2% in January 2008, reaching a record low since May 2003. The number of reported vacancies, the growth of which steadily declined in 2007, has increased sharply since early 2008. Despite the slackening economy, the labor market outlook for the next few months therefore remains bright.

4.3 Food and Energy Prices Continue to Fuel Inflation

At the start of 2008, inflation eased compared with its peak in December 2007 (+3.5%). In February 2008, the HICP rose by 3.1%. This increase was primarily attributable to the rise in prices for energy (+12.8%) and food including alcoholic drinks and tobacco (+8.9%). However, prices for industrial goods excluding energy (+2.1%) and services (+0.6%) advanced only slightly.

4.4 Sharply Increased Downward Risks for Output Growth

The downward risks to Austrian GDP growth outlined upon the release of the latest OeNB economic indicator in January 2008 have increased further owing to the developments of the last few weeks. The massive international financial distortions triggered by the U.S. real estate crisis are increasingly causing havoc, prompting international organizations to steadily downgrade their forecasts. Reviving the confidence of financial agents as soon as possible in order limit the impact of the financial crisis on economic growth, especially in the U.S.A., will be critical. In view of the given uncertainties, this is admittedly likely to take considerable time.

The extent of the spillover of the financial crisis to Europe also depends on whether and to what degree this crisis will induce investor and consumer restraint. Austria may benefit from the fact that the direct exposure of its domestic banking system to the U.S. real estate crisis is limited. Owing to its strong external trade links, however, Austria will nonetheless be hit by the weaker growth expectations worldwide. The price of oil, which has already exceeded the USD 100 mark, will increase the risks as well. Furthermore, although the sharp depreciation of the U.S. dollar is bolstering the U.S. economy, it represents an additional negative factor for the euro area.

Under the currently prevailing circumstances, it should be highlighted in particular that the OeNB economic indicator of March 2008 reflects developments only up to the beginning of 2008. The indicator therefore does not cover the developments of the last few weeks. While this situation should not greatly affect the projection for the first quarter of 2008, the growth rate forecast for the second quarter of 2008 should be interpreted as an upper limit in the event that the financial crisis is stabilized.