INTERNATIONAL MONETARY FUND

AUSTRIA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Austria

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July 1, 2004

Consultation discussions were held in Vienna during April 29–May 11, 2004. The mission comprised Messrs. Demekas (head), Mehrez, Tzanninis, Ms. García-Escribano (all EUR), and Mr. Ouanes (MFD). Mr. Prader, Alternate Executive Director for Austria, attended the meetings. The mission met the Ministers of Finance, Economic Affairs and Labor, and Social Affairs; the Governor of the Austrian National Bank (OeNB); the President of the Federal Parliament and members of the parliamentary budget committee; officials of the federal government, the OeNB, and the Financial Market Authority (FMA); and representatives of the private sector, economic research institutes, and the trade unions.

The mission presented its conclusions at a joint press conference with senior officials from the OeNB and the FMA. The authorities released the mission's concluding statement and intend to publish this report.

A Financial System Stability Assessment (FSSA) report has been prepared as part of the Financial Sector Assessment Program (FSAP) and is circulated under separate cover. The findings of the FSAP were discussed with the authorities during the Article IV consultation mission and are summarized in this report.

The coalition government between the People's Party and the Freedom Party has been in power since 2000. The next parliamentary elections are to take place by November 2006.

Austria has accepted the obligations of Article VIII (Appendix I) and subscribes to the Special Data Dissemination Standard. Data provision is adequate for surveillance (Appendix II). Data in this report reflect information received by June 16, 2004. More recent data may be obtained directly from the following sources:

Austrian Institute of Economic Research (WIFO) .... http://www.wifo.ac.at
Austrian National Bank .... http://www.oenb.co.at
Federal Ministry of Finance .... http://www.bmf.gv.at
Institute of Advanced Studies (IHS) .... http://www.ihs.ac.at
Statistics Austria .... http://www.statistik.at
Eurostat .... http://www.europa.eu.int/comm/eurostat
Information and documentation on Austrian economic
Statistics may also be found at the Special Data
Dissemination Standard website of the IMF .... http://dsbb.imf.org

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Executive Summary

Background

The Austrian economy has continued to perform relatively well. Growth of real GDP averaged 1 percent during 2001-03, unemployment is among the lowest in the EU, and competitiveness remains strong. Also, a gradual recovery is underway and short-term economic prospects are positive, although risks remain. In a major shift from the policies of the 1990s, the authorities have adopted an ambitious strategy aiming at balancing the budget over the cycle, reducing the tax burden to 40 percent of GDP by 2010, containing fiscal pressures from population ageing, and increasing Austria's growth potential. Concrete achievements so far include the first (small) fiscal surplus in over 30 years in 2001, followed by three years of structural budget balance; a major pension reform in 2003; a wave of privatizations and deregulation in product and labor markets; and tax reforms in 2004-05.

Key issues

- **Short-term outlook**. Staff expects growth to rise to 1.6 percent in 2004 and 2.4 percent in 2005, and inflation to remain low and stable over this period. There are uncertainties related to the behavior of consumption, but risks to this outlook are balanced.

- **Fiscal policy**. The tax reform of 2005 will contribute to a temporary widening of the fiscal deficit in 2005-06 because the planned expenditure savings will come on stream gradually. The authorities envisaged a return to budget balance in 2008, when the next wave of tax reform is expected to be launched. This temporary widening of the deficit does not raise concerns about fiscal sustainability. However, staff cautioned that the deviation from the policy of structural balance—especially before an election year—might raise questions about the government's medium-term intentions. Also, unless the widening is limited and reversed quickly, the next wave of tax reform may not be feasible. In the short-run, staff recommended securing the savings already planned in order to contain the deficit in 2005-06, and ensuring that regional governments contribute to this effort. In the medium term, achieving the necessary expenditure cuts required re-thinking the role of the state and introducing a comprehensive medium-term expenditure framework.

- **Financial sector issues**. The recent FSAP found the Austrian financial system to be generally sound, well supervised, and resilient to shocks. There is a high degree of compliance with international standards. Looking ahead, there are areas of potential risk stemming primarily from the exposure of Austrian banks in central and eastern European countries and to foreign currency loans to households, and scope for strengthening supervision and reviewing the current deposit insurance system over the medium term.

Structural policies. Progress with the authorities' ambitious reform program has been impressive, but there is unfinished business. Completing the remaining agenda should be the main policy objective in the period ahead. The immediate priority should be to harmonize the various public pension systems—a key commitment of the government.

I. INTRODUCTION

1. **Despite a solid growth performance, the 1990s were characterized by policy drift**. Annual growth averaged 2½ percent, above the EU average, but, except for a spurt of adjustment during 1996-97, persistent fiscal deficits resulted in a rising public debt-to-GDP ratio. In addition, policies shied from tackling longer-term structural problems: growing population-ageing pressures were left unattended, labor force participation of the older age cohorts was one of the lowest in Europe, the state retained a pervasive role in the economy, and productivity growth in services, in particular, was lackluster.

2. **In a major policy shift, the coalition government in power since 2000 consolidated Austria's public finances and embarked on an ambitious reform agenda**. Its objectives are to balance the budget over the cycle, reduce the tax burden to 40 percent of GDP by 2010, and increase Austria's growth potential. It made significant steps in this direction with the first (small) fiscal surplus in over 30 years in 2001; a major pension reform in 2003; a wave of privatizations and deregulation in product and labor markets over the past four years; and tax reforms in 2004 and 2005. The successful fiscal consolidation effort, in particular, set Austria apart from its EU partners (Box 1).

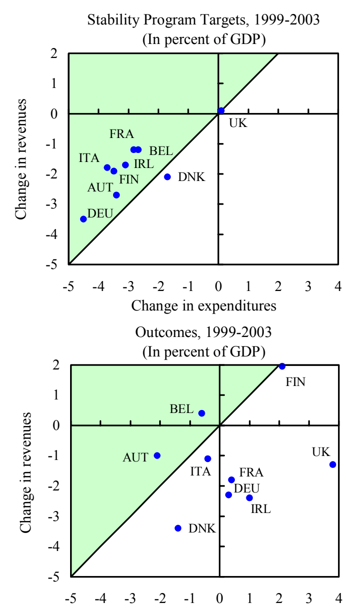
Box 1: Austria Stands Out

Most EU countries set ambitious fiscal targets in the late 1990s...

Following the fiscal consolidation effort during 1996-99, most EU countries set ambitious medium-term goals in their 1999 Stability Programs to reduce the tax burden (vertical axis) and cut expenditures (horizontal axis) while, at the same time, delivering a further improvement in the general government balance (shaded area). Austria made similar plans, targeting a ¾ percentage point improvement in the general government balance.

...but only Austria managed to achieve them.

In the event, largely as a result of the global slump, fiscal balances worsened in all but two EU countries. In many cases, the worsening went beyond the operation of automatic stabilizers. However, only Austria managed to reduce the tax burden ***and*** cut the deficit by 2003. And even though Austria's tax and expenditure reductions were smaller than initially planned, the deficit reduction was broadly on target.



Sources: OeNB; and IMF staff calculations.

3. **This policy shift was broadly in line with previous IMF advice**. Echoing earlier recommendations, at the conclusion of the last Article IV consultation on November 24, 2003, Directors endorsed the authorities' policy strategy since the turn of the decade but stressed that their ambitious tax reform plans should not jeopardize macroeconomic stability.

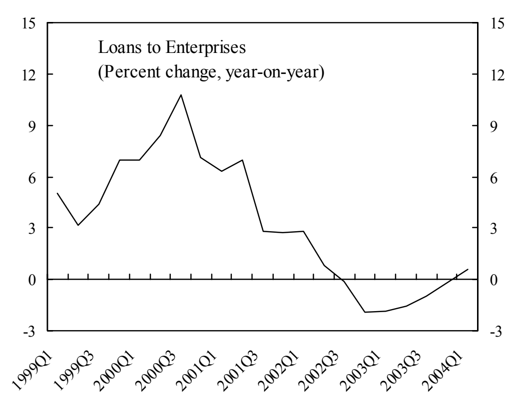
II. Recent Developments

4. **Austria has weathered the global slowdown relatively well** (Figure 1). Growth performance was broadly in line with the average of the EU but better than Austria's major EU partners, notably Germany. Real GDP grew 1 percent per year during 2001-03 buoyed by strong exports during most of the period. Growth decelerated to ¾ percent in 2003 and the current account remained broadly balanced (Table 1). Unemployment rose by almost 1 percentage point but, at 4½ percent in mid-2004, remains well below the EU average, as in the past. Broader measures of labor market slack, notably the employment ratio, have also shown only a modest deterioration during this slowdown, and the average duration of unemployment actually fell to 101 days in 2003.

5. **Austria's competitiveness and export performance remained strong despite the appreciated euro**. Austria's REER rose modestly during the past twelve months (¾ percent and 1½ percent in ULC and CPI terms, respectively). Austria enjoys a large competitiveness margin built during the 1990s on the back of sustained wage moderation. In addition, the successful expansion of Austrian business into Central & Eastern European countries (CEECs) has boosted demand for Austrian exports. As a result, although real export growth slowed in 2003 (dipping briefly into negative territory in Q2), export market shares remained largely intact (Figure 2). Moreover, a change in the direction of exports is underway: as Austria starts gradually to lose its first-mover advantage in the new EU members, it is gaining market share in Southeastern Europe.

6. **The slack in the economy and a stronger euro have kept inflation pressures low**. Inflation (headline and underlying) averaged 1¼ percent in 2003, among the lowest in the euro zone, and its acceleration to 2.1 percent in May 2004 reflects the impact of higher energy prices. Wage growth (2¼ percent in 2003) was in line with productivity developments, and collective agreements for 2004 suggest continued moderate growth.

7. **The macroeconomic policy stance was neutral in 2003**. At 1.4 percent of GDP, the general government deficit was on target, implying a broadly neutral fiscal stance (Table 2). Higher-than-planned spending on unemployment and family benefits owing to the weaker economy was offset by lower interest payments. Monetary conditions were also neutral as lower interest rates offset the impact of the stronger euro. Bank credit to enterprises has rebounded, after contracting in 2003 reflecting weak investment demand, a restructuring of balance sheets in favor of equity financing and, to a lesser extent, tighter lending practices by banks in anticipation of the Basel II standards. Increasing reliance on foreign—including company-to-company—financing suggests that bank credit understates the true availability of enterprise financing in Austria.



III. Report on the Discussions

8. **Discussions focused on the government's outstanding policy objectives**. The political cost of last year's pension reform notwithstanding, the government's economic policy priorities remain unchanged. Discussions explored ways to realize the remaining objectives while safeguarding the past achievements of fiscal policy over the coming years.

- Although the major part of the government's reform agenda is already accomplished, there are **significant unfinished tasks**. Most importantly, harmonization of the various public pension schemes—a key commitment of the government—is still pending; and tax reform will have to go beyond the measures in 2004-05 in order to lower the tax burden to 40 percent of GDP by 2010.

- There is **tension between the pursuit of tax reform and the government's commitment to a balanced budget over the cycle**, as shown by the envisaged widening of the deficit in 2005-06. To return to balance by 2008, as planned by the government, and indeed to implement further tax reform by 2010, extensive expenditure restructuring is necessary at all levels of government.

9. **Discussions also covered the financial sector** based on the findings and recommendations of the recent FSAP.

A. Short-Term Outlook

10. **There are some signs that the economy is picking up steam**. Fixed investment rebounded in the second half of last year after a three-year slump, buoyed partly by tax incentives introduced in September 2002, and industrial production has been gathering pace (Figures 3 & 4). Other indicators, however, are mixed: employment showed steady gains during 2003 but took a turn for the worse in early 2004; private consumption growth came to a halt in Q4 2003, also mirrored in slowing retail sales; and consumer and business confidence indicators remain tentative.

11. **The slump in private consumption in late 2003 is a puzzle**. The behavior of private savings and consumption in Austria has historically been dominated by consumption smoothing. In 2003, however, private savings rose despite a drop in the growth rate. If confirmed (quarterly data are subject to significant revisions), this increase may reflect a shift toward precautionary savings behavior reflecting the 2003 pension reform and increased uncertainty about the recovery.

12. **Nonetheless, there are reasons to be optimistic about the short-term outlook**:

    - **Competitiveness** remains strong and the inroads made into new markets offer opportunities for continued export growth.

- A **healthy financial system** at home and the **de-leveraging of corporate balance sheets** bode well for the financing of investment.

- The **tax cuts** planned for 2005, as well as the extension of tax incentives through end-2004, will provide stimulus.

13. **Authorities and staff broadly agreed on the assessment of economic prospects and risks**. Staff projects growth to pick up to 1.6 percent in 2004,[1] gradually accelerating above potential in the second half, and average 2.4 percent in 2005. This forecast is broadly in line with those of the OeNB, the leading research institutes, and the May consensus forecast. The main sources of growth in 2004 would be investment and exports, though the pace of investment would moderate following considerable frontloading during 2003 in response to the tax incentives. But with high—by Austrian standards—unemployment and moderating wage growth, consumption is expected to recover only slowly in 2004. In 2005, consumption will start making a larger contribution and exports are projected to rise further. However, as imports gather momentum on the back of strengthening domestic demand, the external sector is expected to make virtually no contribution to growth in 2004-05. Inflation is projected to remain around 1¾ percent during 2004-05 as the still substantial slack in the economy and wage moderation in 2004 broadly balance the impact of higher oil prices.

14. **There is considerable uncertainty around the baseline outlook, but risks are evenly balanced**. With a strong competitiveness position, Austrian exports are poised to benefit from a positive surprise in external demand. But the recovery will not gain traction until private consumption starts growing again. The uncertain outlook for household consumption and savings thus increases the margin of error around staff's current forecast. In addition, risks associated with the external environment—including oil prices—cast a shadow on the short-term prospects for Austria: despite recent favorable data, the recovery underway in the euro area remains on shaky ground as long as the much-anticipated recovery in Germany is not firmly established; and persistent global imbalances might cause a further, disorderly appreciation of the euro that could hurt exports.

B. Fiscal Policy and Tax Reform

15. **The authorities targeted an appropriately neutral fiscal stance in 2004**. They expected the general government deficit to narrow to 1.2 percent of GDP in 2004, consistent with a broad structural balance, but 0.4 percent of GDP above budget plans. This difference mainly reflects the operation of automatic stabilizers; much of the impact of discretionary measures—most notably the fiscal package announced in October 2003 with measures aimed primarily at supporting R&D and investment—would be offset by additional expenditure

[1] This includes a one-off calendar adjustment of 0.1 percentage point. In comparison, the calendar adjustment in Germany is estimated at 0.6 percentage point.

savings. More importantly, the budget includes the first round of tax reform (IMF Country Report No. 03/372), whose net budgetary impact will be virtually nil this year. Staff endorsed the plans for 2004 and agreed with the authorities that automatic stabilizers should be allowed full play.

16. **The authorities considered the tax reform planned for 2005 to be a critical step in their efforts to enhance Austria's attractiveness as a business location and promote investment and growth** (Box 2). They also saw it as the first major step toward their longer-term objective to reduce the tax burden. The emphasis on reducing corporate taxes was meant to make the most of the higher visibility of this tax, compared with taxes on labor, and was also in tune with trends in neighboring countries: the authorities estimated that the planned measures would reduce the effective corporate tax rate to 21-22 percent, a level comparable to that in the new EU members. The total net revenue loss from tax reform was estimated at 1 percent of GDP. Staff noted that, while little had been done to reduce the burden on labor, the priority given to the corporate tax was understandable given the mobility of capital and the reality of corporate taxation in the expanded EU.

Box 2. Tax Reform in 2005

- **Corporate tax** will be lowered through a reduction in the tax rate from 34 to 25 percent and a relaxation of rules on the taxation of groups of companies, allowing a group headquartered in Austria to offset local profits with losses elsewhere. In addition, the tax base will be widened by eliminating the tax-free transfer of realized hidden reserves of corporations and the interest deduction on the increase of own capital, and additional incentives will be provided for spending on R&D.

- The brackets of the **personal income tax** will be reduced from four to three and the tax-exempt personal income threshold raised from € 14,500 to € 15,770. The general tax credit will be built into the tax schedule to make the marginal tax rates more transparent. The top marginal rate will remain at 50 percent. Tax credits for sole earners and single parents will increase effective 2004.

- Some **taxes with small yield** will be abolished (tax on sparkling wine) or reduced (tax on beer).

17. **The authorities have ambitious expenditure plans to offset the impact of tax reform but, with the bulk of savings coming on stream later, they anticipate temporary structural deficits in 2005-06**. The November 2003 Stability Program envisaged a range of expenditure measures (presented in IMF Country Report No. 03/372): health spending is to be reduced through hikes in certain contributions and co-payments; staff in public administration is to be reduced by 10,000 by 2006 and operating expenses to be lowered by 3 percent at the federal level; and education spending at the regions is to be controlled through increasing the student-teacher ratio. These measures, in addition to the cyclical strengthening and the impact of the 2003 pension reform, were expected to offset the impact of the tax cuts by 2007 and return the general government budget to broad balance by 2008. But the deficit was projected to increase temporarily to 1¾ percent of GDP in 2005 and 1½ percent of GDP in 2006 as a result of the lack of synchronicity between tax and

expenditure cuts. Given the short-term outlook, this would represent a procyclical relaxation of fiscal policy in these two years.

18. **Staff questioned the planned temporary widening of the deficit in 2005-06**. A temporary deficit of this size would not threaten macroeconomic stability or fiscal sustainability in Austria (Table 3), even in conjunction with various adverse macroeconomic shocks (Appendix III). However, staff noted that this deviation from the policy of balanced budget over the cycle, especially before an election year, might raise questions about the government's medium-term intentions. In addition, staff noted that even these deficit targets for 2005-06 were subject to risks, since they assumed full implementation of the planned expenditure measures, some of which—notably in health and education—depended to a considerable extent on regional governments. Without these measures, the deficit could reach 2 percent of GDP in 2005 and 2006.

19. **The authorities were cognizant of the risks but defended their approach**. As they argued last year, tax and expenditure cuts could not be synchronized fully because expenditure measures had to be implemented by all levels of government, required consensus and coordination, and could not be expedited. A good part of the planned savings depended on regional governments, with whom negotiations on a new revenue sharing agreement (*Finanzausgleich*) and internal stability pact were ongoing. In the authorities' view, the long-term benefits of tax reform outweighed the costs of a temporary hike in the deficit. While they acknowledged the risks inherent in their plans, they pointed out that Austria had already managed once to reduce taxes while cutting the deficit, and would do it again.

20. **Both sides agreed that, unless the widening of the deficit was limited and reversed as quickly as possible, further tax reform after 2005 would not be feasible**.

- **In the short run**, this required securing the savings already planned—namely in public administration, health spending and other transfers—to contain the deficit in 2005-06. It also meant that the *Finanzausgleich* that would be concluded this year should ensure a significant contribution to this effort by subnational governments.

- **In the medium term**, success in containing expenditure required a re-thinking of the role of the state. The ongoing work of the *Austria Convention* (Box 3) presented an excellent opportunity to improve efficiency and generate savings at all levels of government. Moreover, the staff reiterated the recommendation to introduce a comprehensive medium-term expenditure framework, with multi-year targets broken down by major program. Work on such a framework had indeed progressed since last year: a draft linking the objective of a balanced budget over the cycle with overall spending ceilings by program and by ministry had been prepared. However, it was not clear that it could be implemented under the existing legal framework, which envisaged only annual budgets submitted to parliament.

Box 3. Austria Convention

The federal parliament set up in May 2003 a body of experts (*Austria Convention*) to submit proposals for reform of the federal constitution so that the state can fulfill its tasks in a cost-effective, transparent, and citizen-friendly way.

The *Convention* is expected to submit by end-2004 proposals covering a range of issues, including the goals and tasks of the federal state; division of responsibilities between the federal government, provincial governments, and municipalities; and the structure of public administration.

21. **There was agreement about the direction of future tax reform**. The authorities saw the main benefit of tax reform in terms of a higher growth potential. Having lowered the tax burden on capital with the reforms of 2004-05, they intended next to reduce the burden on labor, which was relatively high. Staff endorsed these plans, which were supported by the results of its own empirical study showing that (i) reducing government size benefits growth, and (ii) cuts in direct taxes have a higher effect on growth than cuts in indirect taxes (Box 4). The authorities welcomed the findings, which they considered supportive of their case for tax reform.

Box 4. Staff Research on Tax Reform, Government Size, and Growth

While many studies, as well as the experience of several countries, confirm that reducing the fiscal deficit through expenditure consolidation benefits growth, the literature examining the economic impact of reducing both taxes and spending simultaneously is not extensive. An empirical study by the staff, based on the experience of 18 OECD countries and circulated as a **Selected Issues paper**, suggests the following:

- Reducing government size (both revenues and expenditures) by 5 percentage points of GDP in high-tax economies would increase the long-term growth rate by about ¼ of a percentage point per year.
- This impact could be even higher if tax reductions focus on direct, rather than indirect taxes, because the former are more distortionary.
- Lowering corporate taxes has a positive impact on private investment.

C. Financial Sector Issues

22. **The authorities welcomed the findings of the FSAP and broadly agreed with the key recommendations**.[2] The mission concluded that the Austrian financial system was generally sound, well supervised, and resilient to shocks, and had a high level of compliance with international standards in banking, insurance, securities, and anti-money laundering (Box 5). Also, indicators of financial vulnerabilities were at comfortable levels (Table 4).

[2] See the accompanying Financial System Stability Assessment for details.

Box 5. FSAP Main Findings

The Austrian financial system is generally sound, resilient to shocks, and dominated by banks. The insurance sector is well developed, but securities markets play a minor role in financing enterprises. The banking sector consists of about 900 banks with total assets of about 270 percent of GDP at end-2003. It is profitable and well-capitalized and, in recent years, has seen major restructuring and consolidation: only four of the largest ten banks in 1990 still exist and government ownership has been reduced drastically. The sector has also seen a successful expansion in the CEECs, and the large banks have made major strides in adopting best practices in risk management. These features helped the system weather the recent slowdown relatively well.

Austria enjoys a high standard of financial supervision, based on strong institutions and a modern legal framework. The consolidation of supervision in the new Financial Market Authority (FMA) in 2002 was smooth; cooperation among the FMA, OeNB, and Ministry of Finance is good; and the FMA's capacity to discharge its mandate is being built quickly and effectively.

Looking forward, the FSAP identified the following medium-term challenges and areas of potential risk.

- The successful **expansion in the CEECs** has helped boost the performance of banks, offsetting chronically low profitability in the home market. But growing exposure to local clients there implies new risks and requires continued monitoring and vigilance.
- Despite progress in recent years, bank and branch density in Austria remains high by international standards, creating room for **further restructuring and consolidation**. Banks should avoid complacency arising from high profitability in the CEECs and persevere in their efforts to improve their cost structure.
- The **growth in foreign currency lending**, particularly to households that do not have a foreign currency hedge, is a source of concern. The authorities should continue educating customers about the risks and helping banks—particularly the smaller ones—improve their risk management.
- The **sectoral deposit insurance system** has worked well and incorporates multiple lines of defense. But the restructuring underway in the banking industry argues in favor of taking a fresh look at the system to reduce the likelihood of recourse to public funds.
- **Financial supervision** should be strengthened further. While ongoing reforms and EU directives in the pipeline will address most of the remaining gaps, the authorities need to resolve outstanding legal issues, in particular the public liability of supervisors, so that the latter can carry out their mandate effectively.

23. **All agreed that Austrian banks' exposure in the CEECs required continued vigilance, though risks appeared manageable**. The ongoing shift from relatively risk-free assets (government securities) that still dominate the balance sheets of Austrian banks in the CEECs to loans to local customers called for increased vigilance. To this end, the supervisory authorities were in close contact with the banks to sensitize them to the risks of doing business in the CEECs, as well as with local supervisors. In addition to the existing four Memoranda of Understanding (MoUs) with CEECs, two MoUs were to be concluded soon and more were in the pipeline. Finally, the FMA and OeNB were planning to intensify on-site inspections abroad.

24. **In the authorities' view, the relatively low domestic profitability of Austrian banks was not a symptom of inefficiencies but the result of special factors**. Although the overall return on assets was healthy, reflecting the profitability of operations in CEECs, the

cost-income ratio was among the highest in Europe (though still lower than Germany). The authorities attributed this mainly to Austrian banks' conservative provisioning, better service, and the historical legacy of a sector dominated by cooperative banks. They nonetheless agreed that the prospects of closer cross-border financial integration and intensified competition at the European level necessitated ongoing cost-cutting efforts. Such adjustment was already underway in commercial banks, including by closing branches, had indeed been a factor behind the recent improvement of domestic profitability, and was expected to continue.

25. **In most other areas, the authorities had already begun to address issues identified by the FSAP**:

- **Supervision was adapting quickly to changes in financial markets**. The supervisors had intensified on-site inspections of **banks**, had issued regulations in response to recommendations by the FSAP, and planned to issue more. On the **insurance** side, in sharp contrast to no on-site inspections a few years ago, inspections planned for this year alone would cover about half the sector. In the area of **securities** supervision, three new directives would, among other things, give the FMA new instruments to fight insider trading. Also, two guidelines were issued to strengthen the **AML/CFT** framework.

- **Governance was being strengthened further**. While pointing to an already high level of compliance with the Code of Corporate Governance in the banking sector, the authorities outlined plans to introduce by end-2004 standards for internal audits, the auditing profession, and the number of company boards on which a person can serve.

- **Risks stemming from lending in foreign currency were being addressed**. The proactive stance by supervisors and banks had contributed to a shift away from the more volatile Japanese yen to Swiss franc loans. Furthermore, the FMA had issued two minimum standards to improve banks' risk management; conducted a bank survey and put under closer prudential supervision those banks found to have weak risk management; and drafted amendments to the Consumer Protection Act and the Banking Act requiring full disclosure of risks to consumers.

26. **Changes to the deposit insurance system were not an immediate priority**. The authorities pointed out that the multiple lines of defense in the sectoral deposit insurance scheme had worked well so far and had not prevented entry of foreign banks and consolidation. Even though there was room for improvement, changes would require the full support of banks and thus take time to implement.

D. Structural Policies and Other Issues

27. **The authorities aimed to complete pension reform with the full harmonization of the public pension systems**. The 2003 pension reform had already yielded small budgetary savings that would increase over time (IMF Country Report No. 03/372, Annex). Moreover,

the decision to let the 10 percent cap on benefit losses expire in 2032 had removed some of the uncertainty concerning the long-term impact of the reform. The authorities planned to harmonize the public pension systems by the end of this year, with the main objective of reducing inequities and distortions; generating additional savings was secondary, to be achieved only in the long run. However, the authorities faced an uphill battle in building consensus in key areas. Staff noted that harmonization would ensure fairness between future pensioners and have positive effects on the labor market by enhancing mobility and removing the distortions generated by the different contribution rates and benefit levels across schemes. Staff also noted that, despite the ongoing rationalization of disability pensions, the number of new claimants remained high.

28. **The authorities intended to maintain the momentum of structural reform**. This was a key component of the government's economic strategy, and one where very significant progress had been made since 2000 (Box 6), placing Austria among the top EU members in terms of implementing the Lisbon Agenda.

29. **The full impact of these reforms on productivity and growth would only be felt in the medium term, but some encouraging signs were already evident**. Labor force participation of older workers—among the lowest in Europe—rose marginally in 2002-03. Despite the weak economy, business start-ups jumped over 12 percent in 2003, and R&D spending actually rose. Partly as a result of plans to cut corporate taxes, there had been a sharp rise in interest by foreign business in moving operations to Austria. Also, the liberalization of the electricity sector in 2001 has resulted in lower prices for consumers.

30. **The government planned to continue the push for deregulation**. In the near term, the proposed amendment to the Cartel and Competition Laws would bring Austria fully in line with EU law. Over the medium term, the government's priorities would center on further deregulation of product markets and services and further reductions in red tape. Given the chronically low productivity growth in Austria's services sector, staff expressed its support of this agenda, and urged the authorities to speed up the opening of sheltered sectors to competition.

31. **Austria has been a strong supporter of multilateral trade liberalization within its EU membership, and in favor of preferential treatment of poorer countries**. The authorities reiterated their support for the removal of access barriers for non-agricultural products, and noted that their concerns about trade in agricultural products (such as ensuring environmental protection and food safety) were fully taken into account in the EU negotiating positions in the WTO. Concerning the Doha round, the authorities viewed the outcome of the Cancún Ministerial Conference as a setback, and remained committed to the objectives of the Doha Development Agenda. While strongly in favor of a rules-based international trade system, the authorities supported special and differential treatment of developing countries. As regards CAP reform, they expected only a small macroeconomic or budgetary impact.

Box 6. Main Structural Reforms Since 2000

Privatization: The government sold stakes in ten enterprises, leaving just two enterprises with majority government stake and five with minority government stakes in the government holding company (ÖIAG). The ÖIAG is to be dissolved after the completion of privatization.

Competition: Recent reforms have brought Austrian competition law closer to international best practice: an independent Federal Competition Authority was created under the new legal framework for competition that came into force in 2002; the Cartel Law was strengthened in 2002 by establishing a federal cartel attorney and reinforcing the range of sanctions; and draft amendments to the Cartel and Competition Laws designed to bring the national competition law fully in line with EU law are under deliberation.

Retail, distribution, and trades: Regulations governing the services sector have been eased somewhat. Entry restrictions on a number of trades were also eased in 2002. The amendment to the Shop Opening Hours Act, enacted in July 2003, entitles retailers to open their shops for 66 hours a week (as was the case under the old regulation), but within a more extended time frame. The amendment also sets the maximum shop opening hours at 72, but implementation has been left to the regional governments.

Network industries: The electricity (2001) and gas sectors (2002) were liberalized ahead of EU deadlines.

Research and development: The government set the goal to raise R&D spending to 2.5 percent of GDP by 2006 and 3 percent of GDP by 2010; granted tax incentives for R&D; set up a national R&D foundation; and, will provide funds to raise the ratio of public/private spending on R&D to one half.

Labor market: The law restricting placement by private employment agencies was abolished in 2001; a new severance pay scheme came into force in 2003, extending entitlements and requiring employers to contribute to employee provident funds; permits for seasonal workers and rules for the employment of foreign nationals were eased; the 2003 and 2004 budgets included measures to reduce nonwage labor costs, reform part time employment and the incentive/disincentive system with a view to increasing older workers' participation and employment rates. Pending changes to the unemployment benefit system included the introduction of unemployment insurance on a voluntary basis for the self-employed and limiting conditions under which benefit recipients can reject job offers.

Business environment: The Industrial Code was liberalized and procedures for the establishment of industrial plants were shortened in 2001. Steps to promote private entrepreneurship included cuts in red tape, reduction of the administrative burden on establishing new business, tax concessions for start-ups, funds to strengthen equity capital for small and medium enterprises, and training in entrepreneurial skills.

IV. Staff Appraisal

32. **A strategic policy shift since 2000 has made Austria a showcase for reforms**. In a relatively short period of time, Austria has strengthened its public finances; implemented a bold pension reform that strengthened significantly the long-term sustainability of the system; began to reduce the tax burden; unified financial sector supervision; modernized the legal and institutional framework of competition policy; and took measures to make the labor market more flexible, stimulate R&D, and encourage entrepreneurship.

33. **The near-term economic prospects are positive although uncertainties remain**. The improving global outlook coupled with Austria's strong competitiveness, as well as the rebound in domestic investment, provide a sound basis for the recovery. But the pace will depend on the behavior of consumption, whose prospects are uncertain.

34. **The challenge ahead is to complete the unfinished reform agenda**. To manage the fiscal implications of recent and future reforms, especially of the tax system, while maintaining a balanced budget over the cycle, the government will need to show the same perseverance it has shown in implementing its far-reaching structural reform agenda since 2000.

35. **The government's tax reform plans, whose first major round comes next year, are appropriate**. The reform in 2005 will reduce further the tax burden, make Austria more attractive as a business location, and boost investment and growth in the long run. Still more needs to be done in the medium term to achieve the government's objective to lower the tax burden to 40 percent of GDP by 2010. The emphasis in the next round of reform should be to lower the tax burden on labor, which is among the highest in developed countries.

36. **But the success of this and future tax reforms hinges on implementing lasting expenditure cuts**. The planned tax reform implies a widening of the deficit in 2005-06, possibly up to 2 percent of GDP, meant to be temporary as savings accelerate over time. The difference in the timing of tax and expenditure measures is understandable. A temporary deficit of this magnitude would not endanger macroeconomic stability or fiscal sustainability, but would nonetheless represent a substantial deviation from the government program targets, raising questions about the government's medium-term intentions. More importantly, unless this widening of the deficit is reversed, further tax reform after 2005 will not be feasible.

37. **Putting the budget on the path to structural balance will require additional efforts by all levels of government**. In the short term, the focus should be on implementing the planned expenditure measures and ensuring that subnational levels of government contribute to the fiscal effort in order to contain the increase in the deficit in 2005-06. In the medium term, restoring a structural budget balance and reducing the tax burden further would require substantial, durable savings that cannot be generated without a re-thinking of the role of the state. The *Austria Convention* provides an excellent opportunity for streamlining relations between the various levels of government, aligning spending authority with taxing responsibility, redefining the essential functions of the government in a modern market economy, and improving efficiency in the delivery of public services.

38. **Success of the expenditure reduction measures would also require a comprehensive medium-term expenditure framework**. The Stability Program should be supplemented by a multi-year framework, with annual targets broken down by major program. Such a framework would illustrate tradeoffs, enhance transparency, facilitate policy choices, and strengthen credibility. The advancement of work in this area since last year is

welcome; now the authorities should carry this agenda forward to the cabinet and, eventually, parliament.

39. **The financial system is generally sound, well supervised, and resilient to shocks**. The banking system is profitable, bank capital ratios are comfortably above prudential minima, and stress tests confirm the resilience of the system. Austria enjoys a high standard of financial supervision and a high degree of observance of international standards in banking, insurance, securities, and anti-money laundering. The authorities are commended for taking prompt action in areas identified by the FSAP.

40. **Looking forward, there are medium-term challenges and areas of potential risk in the financial system**. The successful expansion in the CEECs has raised the exposure to risks and requires continued vigilance. Despite progress in recent years, there is still scope for further restructuring and consolidation in the banking sector. The extent of foreign currency lending, particularly to households, is a source of concern. The recent measures to make banks and households more aware of risks are welcome, and the authorities are urged to continue their proactive approach. The sectoral deposit insurance system has worked well, but the restructuring underway in the banking industry would require reexamining the system in the medium term. Financial supervision should be strengthened further, and the outstanding legal issues be resolved so that supervisors can carry out their mandate effectively.

41. **The government is encouraged to complete its structural reform agenda**. Progress so far has been substantive, but key tasks remain. Harmonizing the various pension systems should be the highest priority: delivering on this major commitment would underscore the government's credibility and cement the gains from last year's pension reform. The ongoing rationalization of disability pensions should be continued, focusing on targeting them to those truly unable to work. There is considerable scope for efficiency gains and budgetary savings in the health sector. The authorities are encouraged to continue their efforts to raise labor force participation of older workers; reduce red tape further; liberalize services; and privatize the remaining state holdings in the government holding company.

42. Staff welcomes the authorities' commitment to raise **official development assistance** to 0.33 percent of GNP by 2006 and encourages them to raise it further toward the U.N. target of 0.7 percent of GNP.

43. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Austria: Basic Data

Total area	83,850 square kilometers
Total population (2003)	8.07 million
GDP per capita (2003)	US$ 31,377

	1999	2000	2001	2002	2003	2004 Proj.
	(Percentage changes at 1995 prices)					
Demand and supply						
GDP	2.7	3.4	0.8	1.4	0.7	1.6
Total domestic demand	2.9	2.6	-0.2	0.0	1.8	1.7
Consumption	2.6	2.4	0.7	0.6	1.1	1.1
Gross investment	4.5	3.3	-2.5	-3.3	4.6	3.5
Foreign balance 1/	-0.2	0.8	0.9	1.4	-1.0	-0.1
Exports of goods and nonfactor services	8.5	13.4	7.5	3.7	1.0	4.3
Imports of goods and nonfactor services	9.0	11.6	5.9	1.2	3.0	4.7
	(Percentage changes; period averages)					
Employment and unemployment						
Labor force 2/	0.5	0.0	0.7	1.1	1.1	0.8
Employment 3/	1.2	1.0	0.4	-0.5	0.2	0.7
Employment rate (in percent) 3/	62.3	62.5	62.5	62.0	61.9	...
Unemployment rate (in percent)						
Registered 4/	6.0	5.3	5.5	6.2	6.2	6.3 5/
Standardized 4/	4.0	3.7	3.6	4.3	4.4	4.4 5/
Prices and incomes						
GDP deflator	0.7	1.4	2.1	1.4	2.0	1.5
Consumer price index	0.5	2.0	2.3	1.7	1.3	2.1 5/
Unit labor costs (manufacturing)	-1.3	1.2	1.5	0.9	0.8	0.9
	(Percent of GDP)					
General government finances 6/						
Revenue	51.6	50.6	51.7	50.9	49.7	49.3
Expenditure	54.0	52.3	51.6	51.3	51.2	50.5
Balance	-2.4	-1.7	0.1	-0.4	-1.4	-1.2
Gross debt (end of period)	67.5	67.0	67.1	66.6	64.9	64.2
	(Billions of euros)					
Balance of payments						
Trade balance	-3.4	-3.0	-1.4	3.7	1.7	1.3
Current account	-6.3	-5.4	-4.1	0.7	-2.1	-2.3
(In percent of GDP)	-3.2	-2.6	-1.9	0.3	-0.9	-1.0
	(Percent; end of period)					
Interest rates and credit						
Domestic credit to nonbanks (year-on-year percent change)	5.3	6.8	3.5	1.2	1.8	3.1 7/
Credit to enterprises (year-on-year percent change)	6.5	7.1	2.7	-1.9	-0.2	1.6 7/
Credit to households (year-on-year percent change)	10.8	9.6	6.0	6.9	3.3	5.2 7/
Three-month interbank rate	3.0	4.4	4.3	3.3	2.3	2.1 8/
10-year government bond	4.7	5.6	5.1	5.0	4.1	4.5 8/
	(Levels; period average)					
Exchange rates						
Euro per US $	0.94	1.09	1.12	1.06	0.89	0.83 8/
Nominal effective exchange rate (1990=100)	102.1	99.9	100.2	100.6	102.6	103.0 5/
Real effective exchange rate (1990=100)						
ULC based	80.3	78.7	78.5	79.0	80.7	81.2 5/
CPI based	100.4	97.7	98.5	99.6	101.9	102.9 7/

Sources: Data provided by the Austrian authorities; and IMF staff estimates and projections.

1/ Change in percent of previous year's GDP.
2/ Dependent labor force (does not include self-employed).
3/ Excluding self-employed and employees on parental leave and military service.
4/ In percent of total labor force. The standardized rate is survey-based, according to EU standards.
5/ May.
6/ On ESA95 basis. The Maastricht Excessive Deficit Procedure (EDP) definition—used by the Austrian authorities—differs from this due to the inclusion of revenues from swaps (see Table 2).
7/ April.
8/ June 16.

Table 2. Austria: General Government Accounts, 2000-06 1/

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006
Revenue	50.6	51.7	50.9	49.7	49.3	48.4	47.8
of which: Tax 2/	*43.5*	*45.4*	*44.2*	*43.2*	*42.8*	*42.3*	*42.1*
Expenditure	52.3	51.6	51.3	51.2	50.5	50.2	49.9
Overall balance (ESA 95 basis)	**-1.7**	**0.1**	**-0.4**	**-1.4**	**-1.2**	**-1.8**	**-2.0**
Federal government	-1.8	-0.7	-1.1	-1.9	-1.7	...	...
Other levels	0.1	0.8	0.7	0.5	0.5	...	...
minus one-off measures							
Net sale of real estate 3/	0.4	0.0	0.0	0.0	0.0	0.0	0.0
One-off revenues 4/	--	0.5	--	-0.2	--	--	--
One-off expenditures 5/	--	--	--	-0.3	--	--	--
plus							
Cyclical adjustment	-0.8	-0.2	0.2	0.7	0.8	0.5	0.3
Structural balance (ESA 95 basis)	**-3.3**	**-0.6**	**-0.3**	**-0.2**	**-0.4**	**-1.3**	**-1.7**
Fiscal impulse 6/	**0.5**	**-2.7**	**-0.3**	**-0.1**	**0.2**	**0.9**	**0.5**
Primary structural balance (ESA 95 basis) 7/	**-0.5**	**2.2**	**2.3**	**2.2**	**1.9**	**1.1**	**0.7**
Public debt	67.0	67.1	66.6	64.9	64.2	63.6	63.1
Memorandum items:							
Output gap 8/	1.8	0.3	-0.4	-1.5	-1.8	-1.2	-0.6
Overall fiscal balance, EDP definition 9/	-1.5	0.3	-0.2	-1.3	-1.0	-1.7	-1.8

Sources: Federal Ministry of Finance; Austrian Stability Program (2003-07); and IMF staff estimates and projections.

1/ For 2004, authorities' budget and IMF staff's GDP projections. For 2005-06, projections reflect the Stability Program's expenditure and deficit objectives adjusted for estimated deviations from spending and tax plans based on information provided by the authorities.
2/ Tax revenue plus social security contributions (excluding imputed contributions).
3/ Transactions considered as negative expenditure by Eurostat.
4/ Adjustment for estimated: (i) windfall gains from accelerated income payments in 2001; and (ii) revenue loss from discontinuing in 2003 the withholding of refundable VAT on imports from EU countries.
5/ Adjustment for: (i) the 2002 flood relief that spilled over into 2003 and was not covered by EU transfers; and (ii) a one-time pension increase in 2003 that was not incorporated in the base for future pension adjustments.
6/ Negative of the change in the structural balance.
7/ Structural balance less net interest payments.
8/ In percent of potential GDP.
9/ The Maastricht Excessive Deficit Procedure (EDP) definition is used by the Austrian authorities. The difference from ESA95 is due to the inclusion of revenues from swaps.

Table 3. Austria: Staff's Medium-Term Macroeconomic Scenarios, 2002-09

	2002	2003	2004	2005	2006	2007	2008	2009
Scenario I: Unchanged Policies	(Percentage changes at 1995 prices)							
GDP	1.4	0.7	1.6	2.4	2.5	2.6	2.4	2.3
Domestic demand	0.0	1.8	1.7	2.5	2.7	2.9	2.4	2.0
Final consumption	0.6	1.1	1.1	1.9	2.1	2.4	2.2	1.9
of which: Private consumption	0.8	1.3	1.3	2.3	2.5	2.9	2.6	2.3
Gross investment	-3.3	4.6	3.5	4.2	4.6	4.4	2.9	2.2
Exports of goods and nonfactor services	3.7	1.0	4.3	5.4	5.8	6.1	5.8	5.7
Imports of goods and nonfactor services	1.2	3.0	4.7	5.7	6.3	6.7	6.0	5.3
CPI inflation (percentage change)	1.7	1.3	1.7	1.6	1.5	1.6	1.7	1.8
	(Percent of GDP)							
General government accounts 1/ 2/								
Revenue	50.9	49.7	49.3	48.4	47.8	47.8	47.8	47.8
Expenditure	51.3	51.2	50.5	50.2	49.9	49.6	49.5	49.5
Balance	-0.4	-1.4	-1.2	-1.8	-2.0	-1.8	-1.7	-1.7
Debt	66.6	64.9	64.2	63.6	63.1	62.2	61.4	60.7
External current account balance	0.3	-0.9	-1.0	-1.1	-1.2	-1.5	-1.6	-1.5
Scenario II: Stability Program	(Percentage changes at 1995 prices)							
GDP	1.4	0.7	1.6	2.4	2.4	2.2	2.3	2.3
Domestic demand	0.0	1.8	1.7	2.5	2.7	1.9	2.0	2.0
Final consumption	0.6	1.1	1.1	1.9	2.0	1.5	1.8	1.9
of which: Private consumption	0.8	1.3	1.3	2.3	2.5	2.0	2.2	2.3
Gross investment	-3.3	4.6	3.5	4.2	4.6	2.9	2.5	2.2
Exports of goods and nonfactor services	3.7	1.0	4.3	5.4	5.8	5.8	5.8	5.7
Imports of goods and nonfactor services	1.2	3.0	4.7	5.7	6.3	5.4	5.4	5.3
CPI inflation (percentage change)	1.7	1.3	1.7	1.6	1.5	1.5	1.6	1.7
	(Percent of GDP)							
General government accounts 1/ 3/								
Revenue	50.9	49.7	49.3	48.4	47.8	47.8	47.8	47.8
Expenditure	51.3	51.2	50.5	50.2	49.3	48.4	48.0	48.0
Balance	-0.4	-1.4	-1.2	-1.8	-1.4	-0.6	-0.1	-0.1
Debt	66.6	64.9	64.2	63.6	62.6	60.8	58.6	56.5
External current account balance	0.3	-0.9	-1.0	-1.1	-1.2	-1.2	-1.2	-1.1

Sources: Data provided by the Austrian authorities; IMF, International Financial Statistics; and IMF staff estimates and projections.

1/ On ESA95 basis. The Maastricht Excessive Deficit Procedure (EDP) definition differs from this due to the inclusion of revenues from swaps.

2/ For 2004, authorities' budget and IMF staff's GDP projections. For 2005-06, projections reflect the Stability Program's expenditure and deficit objectives adjusted for estimated deviations from spending and tax plans based on information provided by the authorities. Projections for 2007-09 assume unchanged structural balance from 2006.

3/ For 2004, authorities' budget and IMF staff's GDP projections. For 2005-06, projections reflect the Stability Program's expenditure and deficit objectives adjusted for updated IMF staff projections of yields of spending and tax measures based on information provided by the authorities. Projections for 2007 reflect the Stability Program's expenditure and deficit objectives. Projections for 2008 assume a further improvement in the structural and overall balances based on expenditure measures. For 2009, projections assume unchanged overall and structural balances from the previous year.

Table 4. Austria: Indicators of Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	Date
External indicators							
Exports (annual percentage change, in U.S. dollars)	3.9	0.4	4.1	8.6	22.0	15.2 1/	Projection
Imports (annual percentage change, in U.S. dollars)	4.4	-0.3	2.3	4.8	24.5	15.7 1/	Projection
Terms of trade (annual percentage change)	-0.6	2.2	-0.9	-1.5	-0.6	1.4 1/	Projection
Current account balance	-3.2	-2.6	-1.9	0.3	-0.9	-1.0 1/	Projection
Capital and financial account balance	3.5	2.3	1.8	-1.8	13.4	...	
Of which : Inward portfolio investment (net, debt securities)	11.5	13.8	11.0	8.2	8.4	...	
Inward portfolio investment (net, equity)	1.0	1.9	-2.3	0.9	1.0	...	
Inward foreign direct investment (net)	1.4	4.6	3.1	0.7	2.7	...	
Other investment liabilities (net, positive=inward)	9.4	7.1	1.1	-3.6	4.8	...	
Official reserves (in billions of U.S. dollars)	15.1	14.3	12.5	9.7	8.5	7.9	May
Foreign assets of the financial sector (in billions of U.S. dollars)	140.0	145.4	139.9	146.2	218.9	205.9	April
Foreign liabilities of the financial sector (in billions of U.S. dollars)	156.9	161.0	154.9	174.6	225.2	210.7	April
Official reserves in months of imports	1.9	1.8	1.5	1.1	0.8	…	
Exchange rate against U.S. dollar (period average)	0.94	1.09	1.12	1.06	0.89	0.83	16-Jun
Public sector							
General government balance 2/	-2.4	-1.7	0.1	-0.4	-1.4	-1.2 1/	Projection
Structural balance 3/	-2.8	-3.3	-0.6	-0.3	-0.2	-0.4 1/	Projection
General government debt 2/	67.5	67.0	67.1	66.6	64.9	64.2 1/	Projection
Federal government guarantees	28.7	27.7	29.0	25.4	…	…	
Financial sector							
Growth rate of credit to the private sector 4/ 5/	5.3	6.8	3.5	1.2	1.8	3.1	April
Stock market index (level; end of period) 6/	119.8	107.3	114.0	115.0	154.5	191.4	16-Jun
Price-earnings ratio 7/	16.6	18.8	15.3	18.2	15.2	16.7	16-Jun
Foreign exchange loans 5/	16.8	19.1	19.9	20.3	19.6	19.9	April
Foreign exchange loans, share in total loans (in percent) 5/	15.7	17.5	18.2	18.8	18.4	19.1	April
Deposits in foreign exchange 5/	1.6	1.6	1.3	1.1	1.1	1.3	April
Deposits in foreign exchange, share in total deposits (in percent) 5/	1.8	1.9	1.4	1.3	1.3	1.4	April
Return on assets (in percent)	0.3	0.4	0.5	0.3	0.4	…	
Return on equity (in percent)	6.9	9.4	9.8	5.4	7.2	…	
Risk-based capital asset ratio, total	13.1	13.3	13.7	13.3	14.4	14.0	April
Risk-based capital asset ratio, core capital	9.4	9.1	9.5	9.1	9.9	9.6	April

Sources: OeNB; Federal Ministry of Finance; Bloomberg; Datastream; IMF, International Financial Statistics; and IMF staff estimates and projections.

1/ IMF staff projections.

2/ European System of Accounts, 1995 (ESA95).

3/ General government deficit according to ESA95 adjusted for cyclical effects and one-off measures (e.g., asset sales).

4/ Excluding financial institutions and non-residents.

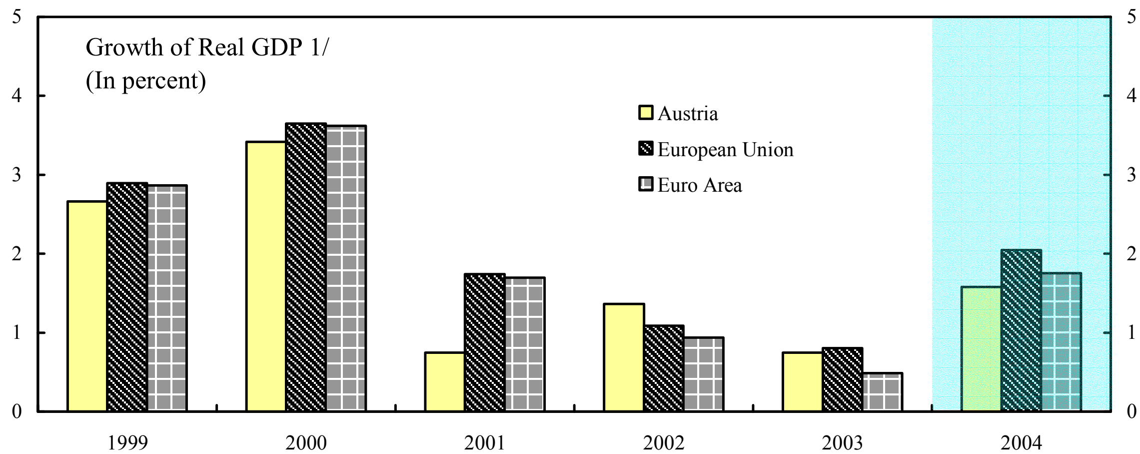
5/ Domestic nonbanks.

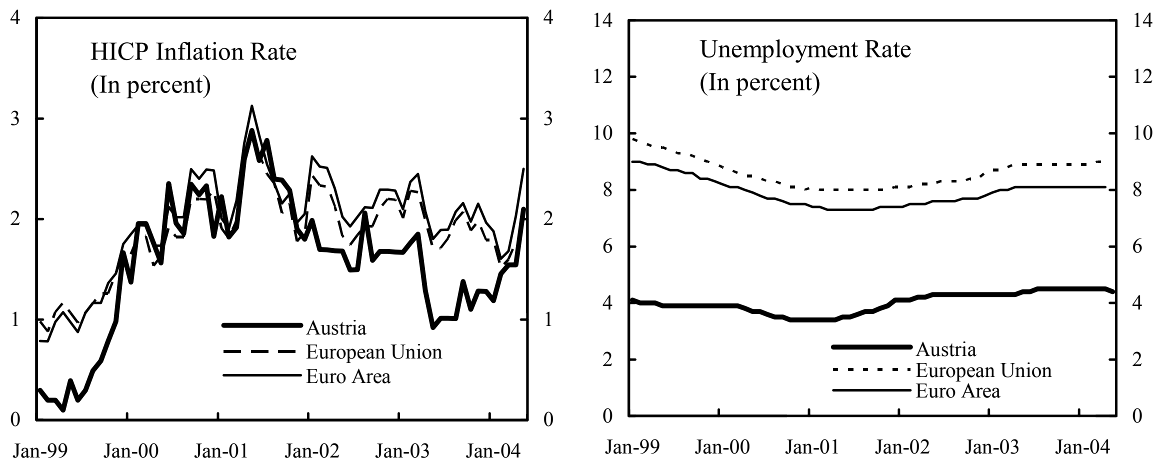
6/ ATX index (1991=100).

7/ Price-earnings ratio for ATX.

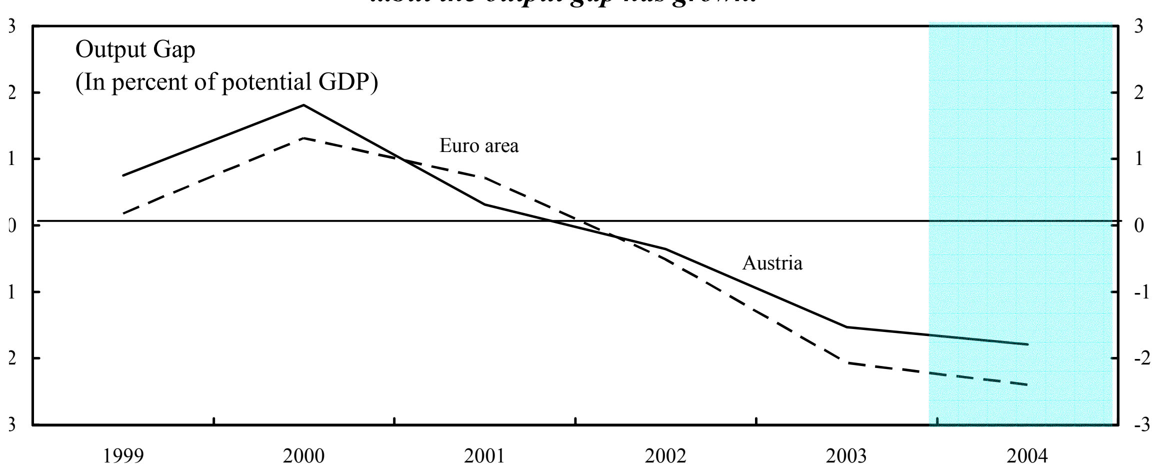
Figure 1. Macroeconomic Aggregates in Austria and the European Union

Austria has weathered the recent slowdown better than its euro area partners...



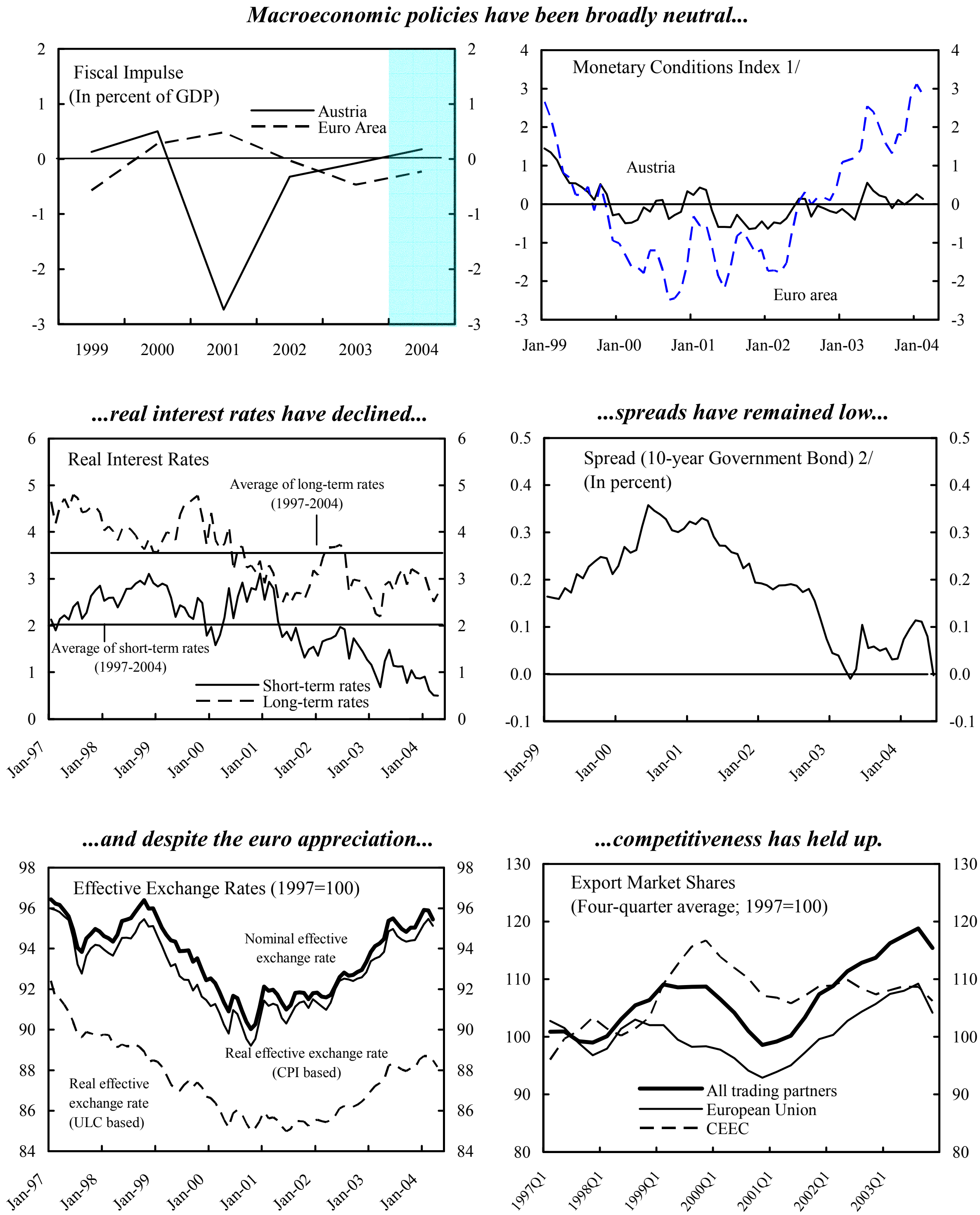


...but the output gap has grown.



Sources: IMF, World Economic Outlook; and Eurostat.
1/ IMF staff projections for 2004.

Figure 2. Austria: Policy Stance



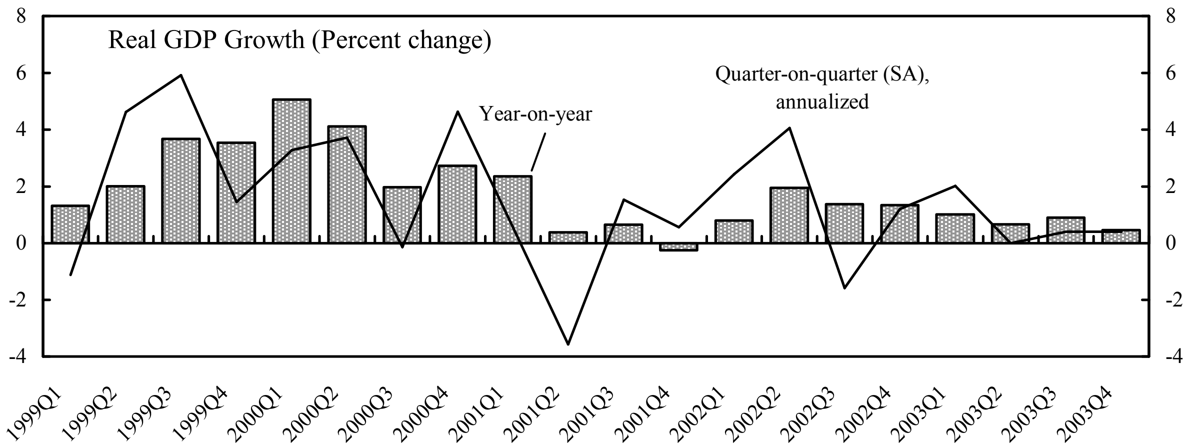
Sources: IMF, World Economic Outlook; IMF, Direction of Trade Statistics; IMF, International Financial Statistics; WIFO Institute; Eurostat; and IMF staff calculations.

1/ Normalized weighted average of deviation of real short-term interest rates and the real effective exchange rate from their average 1999-2004 levels (weights: for Austria 0.71 and 0.29, and for Euro area 0.75 and 0.25, respectively).

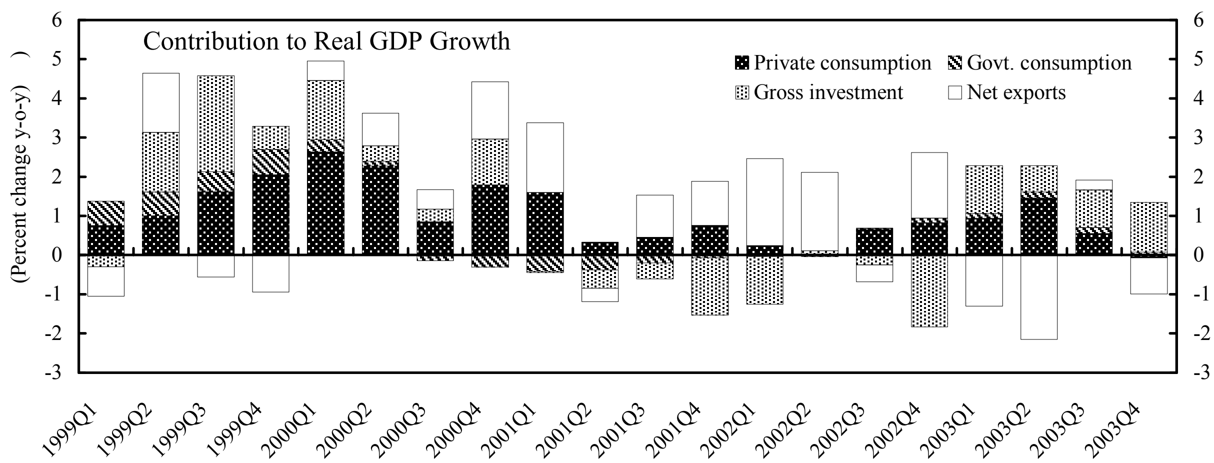
2/ Difference from 10-year German government bond yield.

Figure 3. Austria: Recent Trends and Short-Term Outlook 1

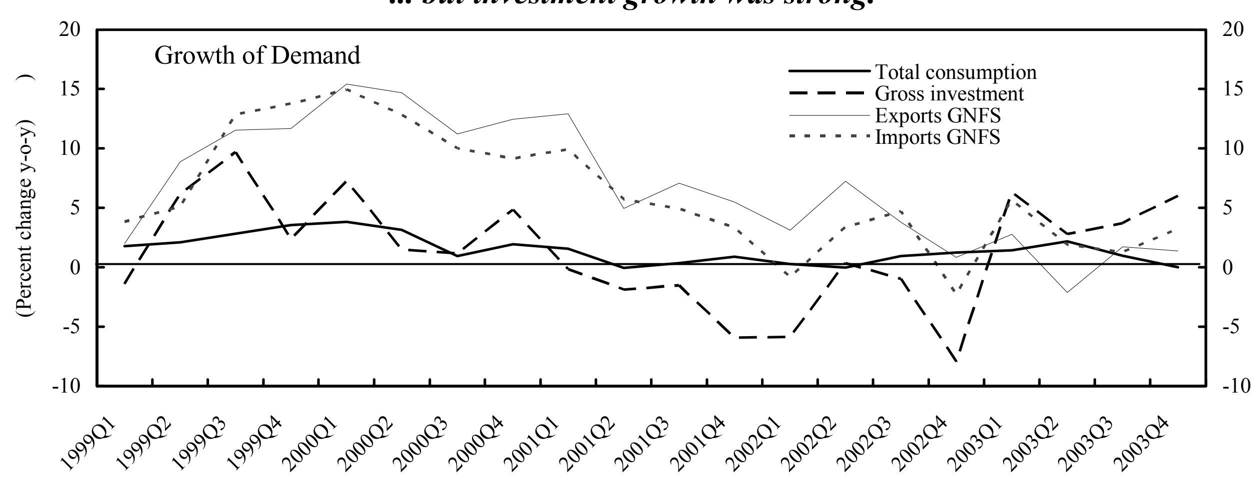
A modest but tentative recovery seems to be under way.



Consumption faltered in the fourth quarter...

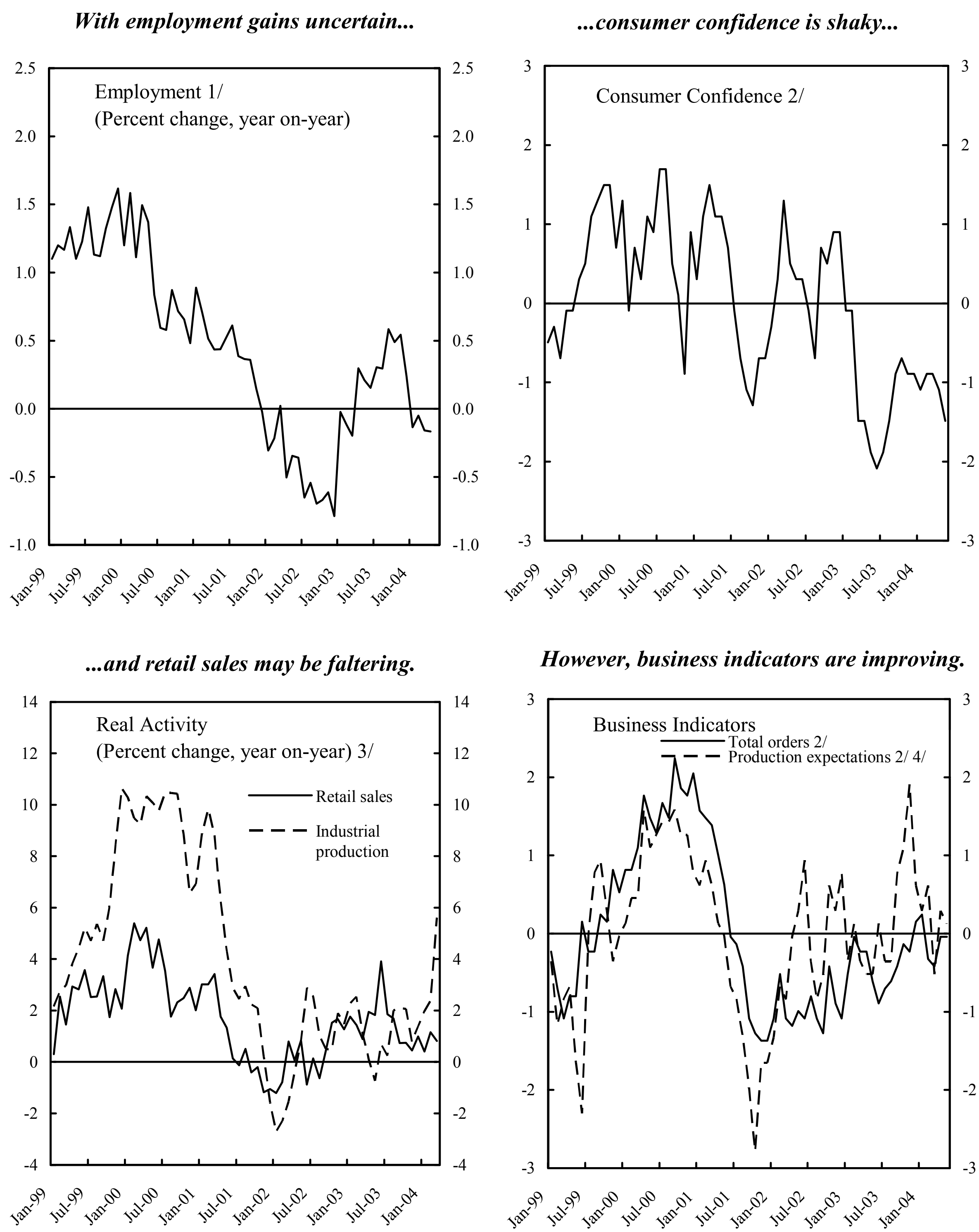


... but investment growth was strong.



Sources: Austrian Statistical Office; and IMF staff calculations.

Figure 4. Austria: Recent Trends and Short-Term Outlook 2



Sources: Eurostat; IMF, Direction of Trade Statistics; WIFO Institute; and IMF staff calculations.
1/ Excluding self-employed and employees on parental leave and military service.
2/ Standardized: expressed in standard deviations from the 1999-2004 mean.
3/ Three-month moving average.
4/ Twelve months ahead.

Austria: Fund Relations
(As of April 30, 2004)

I. **Membership Status:**
(a) Joined: August 27, 1948
(b) Status: Article VIII, as from August 1, 1962

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	1,872.30	100.00
Fund holdings of currency	1119.53	59.79
Reserve position in Fund	752.79	40.21

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	179.05	100.00
Holdings	118.81	66.35

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund:** None
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	--	--	--	--	--
Charges/Interest	0.75	0.99	0.99	0.99	0.99
Total	0.75	0.99	0.99	0.99	0.99

VIII. **Exchange System:**

As of January 1, 1999, the currency of Austria is the euro. Austria's exchange system is free of restrictions on the making of payments and transfers for international transactions with the exception of restrictions notified to the Fund (EBD/03/116, 12/17/03) in accordance with decision No. 144-(52/51) resulting from UN Security Council Resolutions and EU Council regulations. Furthermore, national restrictions apply with respect to certain terror organizations and their activists within the EU, implementing decisions in the CFSP framework of the EU.

IX. **Article IV Consultation**

Austria is on a 12-month consultation cycle. The last consultation was completed on November 24, 2003 (EBM/03/109).

X.	**Technical Assistance:**	7/19-8/4/2000	FAD	Evaluate current systems of public pensions and intergovernmental fiscal relations
XI.	**Resident Representatives:**			None
XII.	**Other**			None

Austria: Statistical Issues

Austrian statistics are adequate for surveillance. Austria has subscribed to the Fund's Special Data Dissemination Standard (SDDS) and its metadata are available on the Fund's electronic Dissemination Standards Bulletin Board (http://dsbb.imf.org/Applications/web/dsbbhome/). Austria has taken advantage of the SDDS flexibility options on the timeliness of the industrial production index and merchandise trade data.

The timeliness of some Austrian statistics could be improved, notably national accounts, industrial production, the (accrual based) current account, international investment position, and merchandise trade. Compared to Germany and France, for instance, the publication of these statistics lags by at least one month.

The transition to the new *European System of Accounts 1995 (ESA 95)* has complicated the analysis of Austrian national accounts and fiscal data. New national accounts data provide no information on household disposable income (only an economy-wide aggregate), barring the calculation of a household saving ratio. In addition, the reclassification of public hospitals in 1997 has introduced a break in the national account series on public and private consumption. Fiscal data from 1995, compiled in accordance with the *ESA 95*, are not complete. The government's stocks of assets, liabilities, and net worth have not yet been reported for inclusion in the *Government Finance Statistics Yearbook*.

There is a large difference between the data on goods trade recorded by the statistical office (Statistics Austria) and the payments data recorded by the Austrian National Bank. Data on accrual basis are only available with a long time lag. Data based on the *Balance of Payments Manual*, fifth edition are only available back to 1992.

Austria: Core Statistical Indicators 1/
As of June 16, 2004

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Central Government Balance 2/	GDP	Foreign Currency Central Gov't Debt
Date of Latest Observation	6/16/04	May 2004	May 2004	May 2004	April 2004	6/16/04	May 2004	March 2004	March 2004	May 2004	Q4 2003	May 2004
Date Received	6/16/04	6/16/04	6/16/04	6/16/04	5/25/04	6/16/04	6/16/04	5/24/04	5/24/04	6/14/04	3/26/04	6/4/04
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update	Reuters/ Bloomberg	OeNB	OeNB	OeNB	OeNB	Reuters/ Bloomberg	Statistics Austria	Statistics Austria	Statistics Austria	MoF	WIFO	MoF
Mode of Reporting	Electronic	Internet	Internet	Internet	Internet	Electronic	Internet	Internet	Internet	Internet	Email	Internet
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

OeNB = Austrian National Bank
WIFO = Austrian Institute of Economic Research
MoF = Federal Ministry of Finance

1/ Austria is a member of the European Monetary Union. Exchange rates, foreign reserves, the central bank balance sheet, interest rates and other monetary indicators are published by the European Central Bank.
2/ Cash basis.

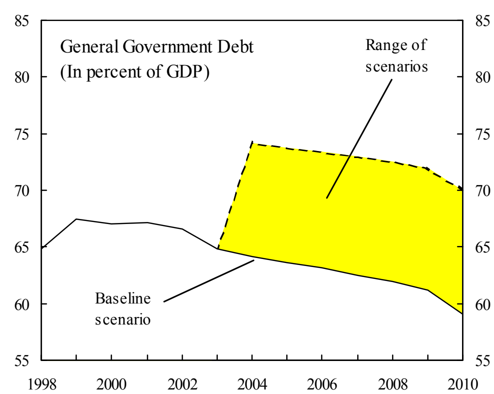
AUSTRIA: FISCAL SUSTAINABILITY ANALYSIS

1. This Appendix presents medium-term projections for general government debt, as well as the results of sensitivity tests based on shocks (expressed as temporary deviations from historical means) applied to the baseline scenario in 2004-05. The projections are based on an "unchanged policies" assumption (Scenario I in Table 3), which is more pessimistic than the government's Stability Program. The results are shown in Table 5.

2. **Austria's general government debt has been stable in recent years**. Reflecting the weak fiscal position in the 1990s, general government debt rose from 57 percent of GDP in 1990 to 67½ percent of GDP in 1999. The policy shift toward fiscal consolidation in 2000 contributed to small decline in the debt ratio by 2003.

3. **The staff's baseline scenario projects a decline in the general government debt ratio of about 4 percentage points to about 61 percent of GDP by 2009.** This scenario is predicated on the staff's macroeconomic forecast for the projection period; the authorities' budget projection for 2004; and the staff's fiscal projections for 2005-06. Projections for 2007-09 assume unchanged structural balance from 2006.

4. **The outlook for general government debt appears to be resilient to various macroeconomic shocks**. The general government debt ratio shows a sizeable, albeit temporary, increase under an "assumption of debt" scenario (scenario 7). However, even in scenario 7, after an initial peak the debt ratio would resume its decline once the impact of the shock fades. Although such a scenario that presumes major private sector bailouts by the government is implausible in Austria, its implications are nonetheless manageable. This is even more the case in all other plausible scenarios.



5. **The only scenario in which the debt dynamics do not show an improvement should be interpreted with considerable caution**. In scenario 1, it is assumed that the historical means of real GDP growth, real interest rate, and primary balance prevail over the projection period. In this case, the debt ratio rises marginally (by ½ percentage point of GDP) but steadily over the projection period without showing any signs of a downward trajectory. However, this result ignores the systemic policy shift that took place at the turn of the last decade, as well as Austria's commitments to the EU's Stability and Growth Pact. As a result of this policy shift, the average primary surplus in 2000-03 was 1 percentage point of GDP higher than the average over the six preceding years also used in the simulation.

6. **Over the longer term, pressures from population aging on the pension system would rise, but the 2003 pension reform made a key contribution toward the long-term sustainability of the system**. The reform is expected to eliminate over one-third (about 1½ percent of GDP annually) of the projected increase in pension spending in the long run. Accounting for the direct and indirect effects of the reform, the deficit of the pension system is projected to rise from about 1½ percent of GDP in 2005 to a peak of 3¾ percent of GDP around 2035, and decline thereafter as demographic dynamics improve (see IMF Country Report No. 03/372, Annex). While non-negligible, such deficits would not undermine fiscal sustainability as long as the government returns to its goal to balance the budget over the cycle, which would put the debt-to-GDP ratio on a robust downward trajectory.

Table 5. Austria: General Government Debt Sustainability Framework, 1999-2009

(In percent of GDP, unless otherwise indicated)

		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
							Projections					
							I. Baseline Medium-Term Projections					
1	General government debt 1/	67.5	67.0	67.1	66.6	64.9	**64.2**	**63.6**	**63.1**	**62.5**	**61.9**	**61.2**
	of which: foreign-currency denominated	16.9	9.5	9.3	8.9	8.7	8.6	8.5	8.5	8.4	8.3	8.2
2	Change in general government debt	2.7	-0.5	0.1	-0.6	-1.7	-0.7	-0.6	-0.4	-0.6	-0.6	-0.7
3	Identified debt-creating flows (4+7+12)	1.7	-0.7	-1.4	-2.8	-1.0	-1.6	-0.6	-0.4	-0.6	-0.6	-0.7
4	Primary deficit	-1.3	-2.2	-3.8	-3.1	-1.9	-2.0	-1.5	-1.3	-1.5	-1.5	-1.5
5	Revenue and grants	51.6	50.6	51.7	50.9	49.7	49.3	48.4	47.8	47.8	47.8	47.8
6	Primary (noninterest) expenditure	50.3	48.5	47.9	47.7	47.9	47.3	46.9	46.5	46.4	46.3	46.4
7	Automatic debt dynamics 2/	3.1	1.4	2.4	0.3	0.9	0.4	0.9	0.9	0.9	0.9	0.8
8	Contribution from interest rate/growth differential 3/	1.6	0.7	1.9	1.8	1.5	1.3	0.9	0.9	0.9	0.9	0.8
9	Of which contribution from real interest rate	3.3	2.9	2.3	2.7	2.0	2.3	2.4	2.4	2.3	2.3	2.2
10	Of which contribution from real GDP growth	-1.7	-2.2	-0.5	-0.9	-0.5	-1.0	-1.5	-1.5	-1.4	-1.4	-1.4
11	Contribution from exchange rate depreciation 4/	1.5	0.8	0.5	-1.5	-0.7	-0.9	0.0	0.0	0.0	0.0	0.0
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16	Residual, including asset changes (2-3)	0.9	0.2	1.6	2.3	-0.7	0.9	0.0	0.0	0.0	0.0	0.0
	General government debt-to-revenue ratio 1/	130.9	132.3	130.0	130.8	130.4	130.3	131.3	132.0	130.7	129.4	127.9
	Gross financing need 5/	16.8	17.1	14.3	16.4	16.4	16.0	16.4	16.4	16.0	15.6	15.4
	in billions of U.S. dollars	35.3	32.6	27.2	33.7	41.7	46.7	49.9	51.9	52.7	53.6	55.2
	Key Macroeconomic and Fiscal Assumptions											
	Real GDP growth (in percent)	2.7	3.4	0.8	1.4	0.7	1.6	2.4	2.5	2.4	2.3	2.3
	Average nominal interest rate on public debt (in percent) 6/	5.9	5.9	5.7	5.4	5.1	5.1	5.5	5.5	5.5	5.5	5.5
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.2	4.5	3.6	4.1	3.1	3.7	3.9	4.0	3.8	3.8	3.7
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.1	-7.4	-5.3	19.0	7.8	12.0	0.2	0.1	0.0	0.0	0.0
	Inflation rate (GDP deflator, in percent)	0.7	1.4	2.1	1.4	2.0	1.5	1.5	1.5	1.6	1.6	1.7
	Growth of real primary spending (deflated by GDP deflator, in percent)	3.0	-0.2	-0.5	1.1	1.0	0.3	1.5	1.7	2.1	2.2	2.4
							II. Stress Tests for General Government Debt Ratio					
	1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2009					64.9	**66.0**	**65.0**	**65.1**	**65.2**	**65.3**	**65.3**
	2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005					64.9	**65.7**	**65.1**	**64.7**	**64.1**	**63.5**	**62.9**
	3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005					64.9	**65.2**	**66.2**	**65.7**	**65.1**	**64.5**	**63.7**
	4. Primary balance is at historical average minus two standard deviations in 2004 and 2005					64.9	**67.8**	**70.4**	**70.1**	**69.6**	**69.1**	**68.5**
	5. Combination of 2-4 using one standard deviation shocks					64.9	**67.7**	**70.6**	**69.3**	**67.9**	**66.4**	**64.9**
	6. One time 30 percent real depreciation in 2004 7/					64.9	**69.2**	**68.7**	**68.3**	**67.8**	**67.2**	**66.6**
	7. 10 percent of GDP increase in other debt-creating flows in 2004					64.9	**74.2**	**73.7**	**73.4**	**73.0**	**72.5**	**71.9**
	8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05					64.9	**63.7**	**61.8**	**61.3**	**60.7**	**60.0**	**59.3**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2004-09
Primary deficit (- = surplus)	-1.4	1.5	-1.6
Real GDP growth (in percent)	2.1	1.1	2.2
Nominal interest rate (in percent) 6/	6.1	0.6	5.4
Real interest rate (in percent)	4.5	0.8	3.8
Inflation rate (GDP deflator, in percent)	1.5	0.7	1.6
Revenue to GDP ratio	51.5	0.9	48.2

1/ The general government comprises the federal government, provincial and local governments, and the various budgetary funds. Debt figures are in gross terms.
2/ Derived as [(r - p (1+g) - g + ae (1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - p (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae (1+r).
5/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).