August 2000
IMF Staff Country Report No. 00/95

AUSTRIA: Staff Report for the 2000 Article IV Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Austria, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 23, 2000,** with the officials of Austria on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 18, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement **of August 3, 2000**, updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the August 3, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Austria.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published--both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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AUSTRIA

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation with Austria

Approved by C. M. Watson and G. Russell Kincaid

July 18, 2000

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I. Summary and Key Issues

1. At the conclusion of the 1999 Article IV consultation on June 9, 1999, Executive Directors commended Austria's remarkable inflation, growth, and labor market performance in recent years, noting that these achievements owed much to the successful implementation of the 1996-97 fiscal consolidation package and the cumulative effect of incremental structural reforms implemented with the active engagement of the social partners. Directors noted, however, that further fiscal consolidation—through a durable reduction in the still high expenditure-to-GDP ratio—and greater flexibility of product and labor markets were needed so as not to jeopardize these achievements.

2. In line with these recommendations, the 2000 Article IV consultation discussions in Vienna, which were held during May 15-23, 2000,[1] focused on the appropriate pace and extent of fiscal consolidation and continued structural reform.

- The authorities responded positively to the staff's call for more ambitious **fiscal targets** than embodied in the updated Stability Program. They broadly agreed with the structural fiscal adjustment suggested (1½ percentage points of GDP, or about half the size of the 1996-97 consolidation program), but preferred a more gradual reduction of the overall deficit than suggested by the staff. Subsequently, however, they revised their fiscal target to overall balance by 2003 at the latest and amended the coalition agreement accordingly.

- For the implementation of the 2000 budget, the staff urged saving any **revenue windfalls** from faster economic growth and from the sale of mobile phone licenses.

- On **expenditure cuts** suggested by the staff, the authorities acknowledged the importance of reducing general government wages and employment, housing subsidies, and spending on pensions and health care, but they were less receptive to the suggestion to cut family benefits and curtail agricultural subsidies. The staff warned that expenditure cuts in the above areas would need to increase if additional spending on research and development, agriculture, and the military is undertaken as envisaged in the coalition agreement.

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[1] The mission—comprising Messrs. Flickenschild (head), Gagales, Hviding, Ms. Krajnyák (all EU1), and Mr. Young (FAD)—met with the Ministers of Finance and Economic Affairs and Labor; the Governor of the Oesterreichische Nationalbank (OeNB); the chairmen of the federal debt commission and the parliamentary budget committee; the leader of the federation of trade unions; the president of Statistics Austria; and representatives from the lower levels of government, the chamber of industry, the banking sector, the academic community, and the main economic research institutes. Mr. Prader, Alternate Executive Director for Austria, participated in the meetings. On Austria's relations with the Fund, see Appendix II.

- The staff welcomed the authorities' initiative to accelerate **privatization** of, inter alia, the postal savings bank, the telecommunications operator, and the tobacco company, and encouraged the authorities to proceed with the complete divestiture of all remaining government holdings of commercial enterprises.

3. The discussions took place against the backdrop of **political sanctions** imposed by the other EU countries in reaction to the inclusion in the new ÖVP-led coalition of the Freedom Party (FPÖ). The economic effects of the EU sanctions were, however, considered minor, and the **economic outlook** was seen as bright. Indeed, the authorities agreed with the staff that their own projections were a bit pessimistic in view of the rapid recovery in export markets, the strong competitive position, and the high levels of business and consumer confidence. Despite the rapid drop in the unemployment rate, inflationary risks were not considered to be imminent, given the remaining slack in the economy, continued wage moderation, and the effects of product market deregulation.

II. Economic Developments and Prospects

A. Recent Economic Developments

4. **As elsewhere in Europe, after a dip in the first half of 1999, an export-led recovery took hold in the second half and gained strength and breadth in 2000** (Figures 1 and 2). Benefiting from the strong links with the rapidly growing central and eastern European countries in transition (CEECs) and a significant improvement in external competitiveness, Austria's growth performance has matched the euro-area average in recent years despite past sluggishness in its most important trading partners (Germany, Italy, and Switzerland; Table 1).

- **Exports** rallied in the second half of 1999 and the first quarter of 2000, helped by a strong winter tourist season and much improved external competitiveness: since 1995, the unit labor cost based real effective exchange rate has depreciated by almost 20 percent (Figure 3). In 1999, goods exports to Italy and the United States grew very fast, while exports to Germany stagnated.

- **Investment** in machinery and equipment has benefited from the improved export climate and lower interest rates; construction is suffering, however, as tax incentives for renovations expired at end-1999 and several large public sector contracts were completed.

- **Consumption**, which had remained resilient throughout the downturn, has been boosted by the cut in income tax rates from January 1, 2000 and by wage and employment growth. Purchases of durable goods, such as cars, have been buoyant.

- After several years of stagnation, **employment** growth picked up toward the end of 1999, reflecting mainly a sharp increase in service sector jobs, mostly of a part-time nature: in May 2000, the standardized unemployment rate fell to 3.3 percent, the third lowest in the euro area, compared with 3.7 percent in 1999 (Figures 4 and 5). About a third of this reduction, however, can be ascribed to active labor market programs.

- The sharp increase in oil prices pushed up headline HICP **inflation** to 1.6 percent year on year in May, but excluding energy components, inflation remains moderate (at about 1 percent; Figure 6). Both headline and underlying inflation remain about ¼ percentage point below the euro-area average, most likely reflecting relatively larger price effects from deregulation in Austria than in countries which started the deregulation earlier.[2]

- Despite the strong export performance, the **current account** deficit widened from 2.3 percent of GDP in 1998 to 2.8 percent in 1999 (Figure 7).[3] The deterioration stemmed mainly from an increasingly negative investment income balance as revaluation effects and past current account deficits caused the net international investment position to worsen by 4 percentage points to an estimated -24 percent of GDP.

Table 1. Growth, Inflation and Unemployment in Austria and the Euro Area

(In percent)

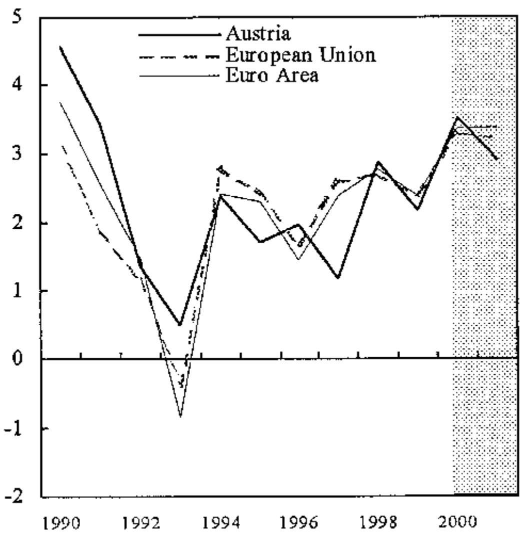
	1990-1999	1999	2000
GDP growth			
Austria	1.9	2.2	3.5
Euro Area	1.9	2.3	3.2
Inflation			
Austria	2.0	0.5	1.9
Euro Area	2.7	1.2	1.7
Unemployment			
Austria	4.0	3.7	3.5
Euro Area	10.5	10.1	9.4

Source: World Economic Outlook, IMF.

[2] Austria's energy and telecom prices were until recently among the highest in the EU.

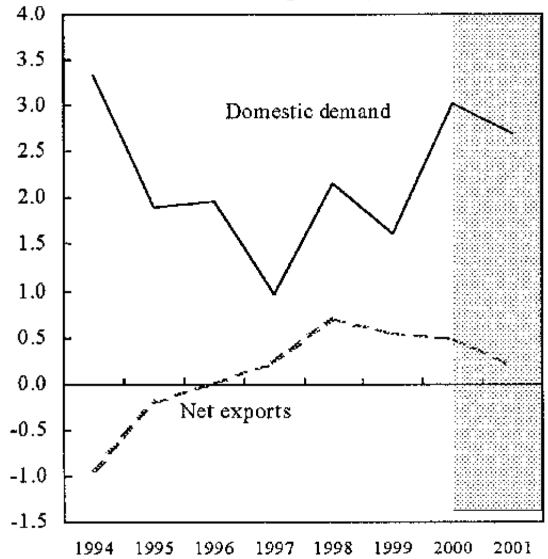
[3] The underlying current account deficit (adjusted for cyclical effects, lagged effects of exchange rate changes, and special factors such as oil price changes and other external shocks) is estimated at around 1.8 percent of GDP in 1999, see Appendix I of the accompanying Selected Issues paper.

Figure 1. GDP Growth
(In percent)



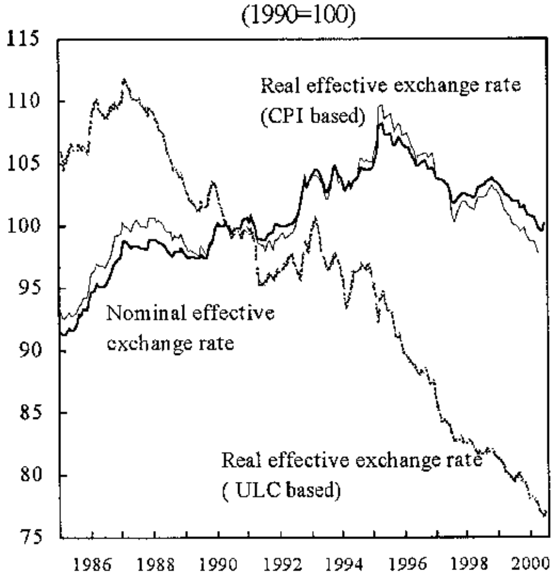
Source: IMF, World Economic Outlook.

Figure 2. Contribution of Demand Components to Real GDP Growth
(In percent)



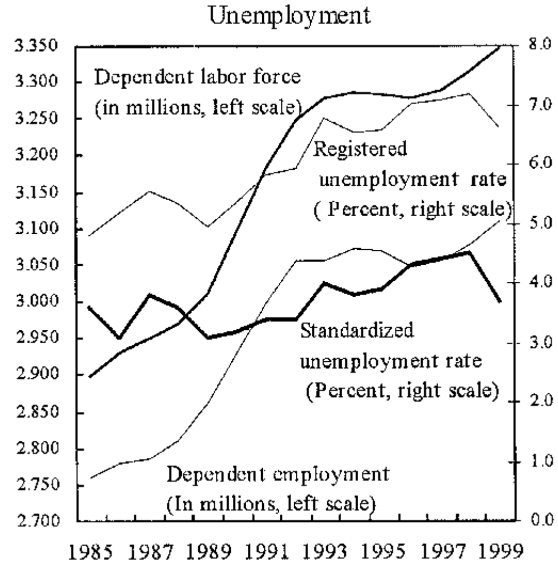
Source: IMF, World Economic Outlook.

Figure 3. Effective Exchange Rates
(1990=100)



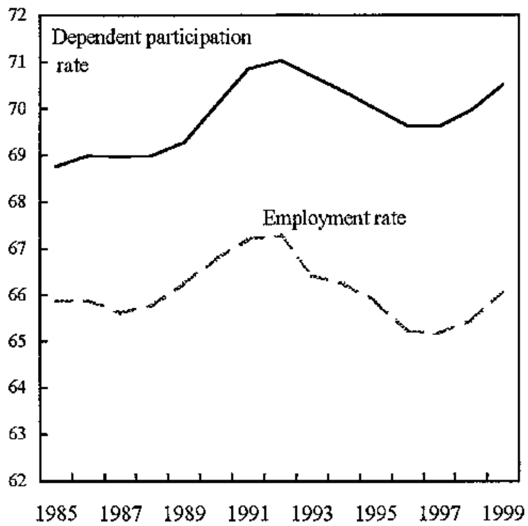
Source: IMF, International Financial Statistics.

Figure 4. Employment and Unemployment



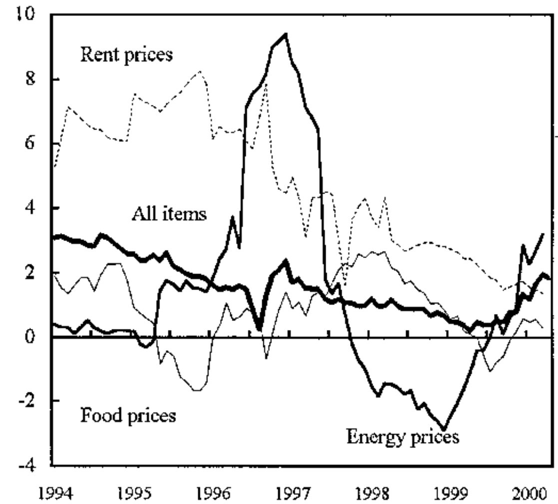
Source: IMF, World Economic Outlook.

Figure 5. Dependent Participation and Employment Rates 1/



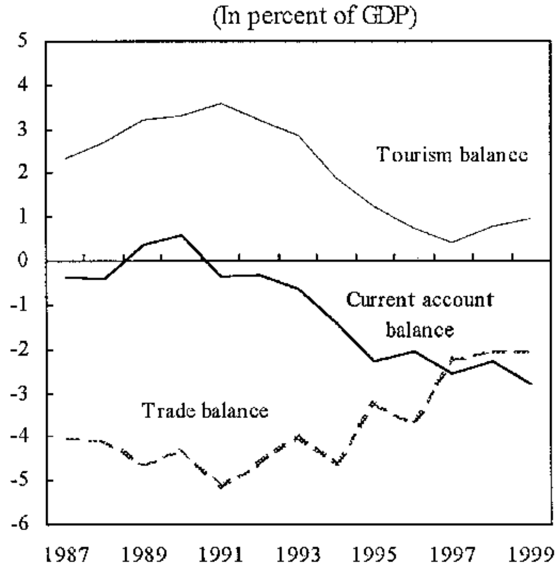
Source: IMF, World Economic Outlook.
1/ In percent of dependent labor force.

Figure 6. Consumer Prices
(Percent change)



Source: OECD, Main Economic Indicators.

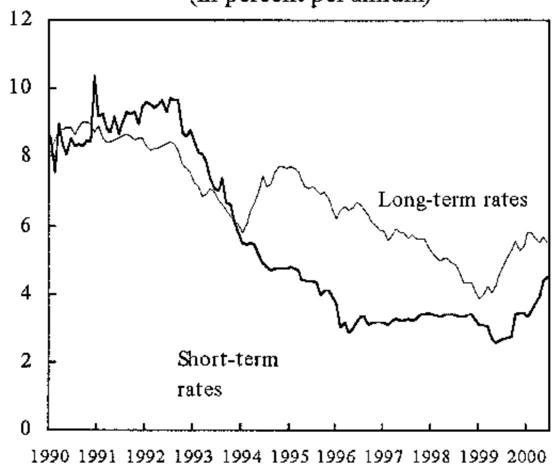
Figure 7. External Balances
(In percent of GDP)



Source: IMF, International Financial Statistics.

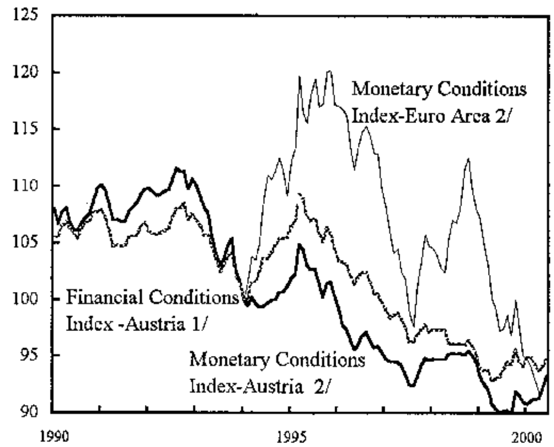
5. **Reflecting the euro's weakness, monetary conditions eased during 1999 and tightened only marginally in early 2000**. Despite a cumulative increase in the European Central Bank's (ECB's) repo rate of 1¾ percentage points since November 1999 (from 2.5 percent to 4.25 percent), monetary conditions remain expansionary as the euro's weakness more than compensates for the interest rate increases (Figures 8 and 9).

Figure 8. Interest Rates
(In percent per annum)



Source: IMF, International Finance Statistics; and WEFA database.

Figure 9. Monetary and Financial Conditions Index, 1994=100



Source: IMF, International Finance Statistics.
1/ Weighted average of real short-term interest rate (weight: 0.25), real long-term interest rate (0.50) and real effective exchange rate (0.25).
2/ Weighted average of real short-term interest rates and real effective exchange rate (weights: 3 and 1, respectively).

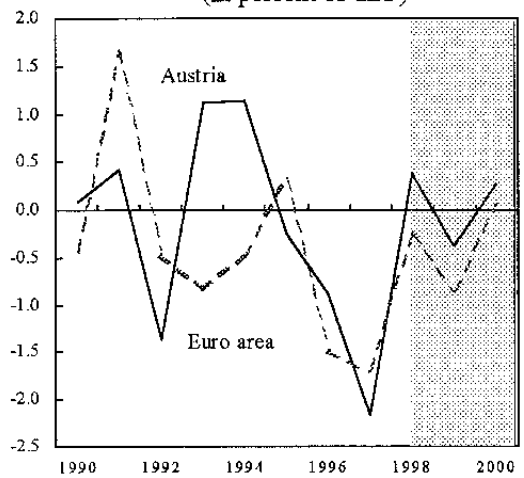
6. **During the last 2½ years, fiscal policy has been on hold.** After a major consolidation effort in 1996-97 amounting to about 3 percent of GDP, no further structural or "underlying" improvement has been achieved in the general government finances. The surplus on the primary underlying balance—the general government deficit net of interest payments, cyclical effects, subsidized lending, and one-off measures[4]—was roughly unchanged during 1998-99,[5] and is expected to fall slightly in 2000. Thus, the overall fiscal impulse has been

[4] Such as the sale of real estate and mobile phone licenses.

[5] The deterioration in the 1998 balance (following the expiration of some temporary measures included in the 1996-97 consolidation package) was about equal to the improvement in 1999.

broadly neutral since 1997 (Figure 10). Moreover, even after the reduction in income tax schedules introduced in January 2000, the revenue ratio has remained constant at about 52 percent of GDP, while the expenditure ratio, at 53¾ percent of GDP, is the highest in the euro area, according to staff estimates.

Figure 10. Fiscal Impulse
(In percent of GDP)



Source: IMF, staff estimates.
1/ Change in structural primary balance; In the case of Austria adjusted for sale of mobile phone licenses and real estate and net subsidized lending.

B. Outlook

7. **Benefiting from a significantly improved international environment, expansionary monetary conditions, and a broadly neutral fiscal stance, economic growth is projected at 3.5 percent in 2000.**[6] This outlook is confirmed by recent business and consumer surveys and the most recent data on manufacturing orders, tourist overnight stays, goods exports, and industrial production, all of which show double-digit annual growth rates. The expansion is broad-based, with total domestic demand and private consumption moving in line with potential output growth (2½-2¾ percent); the net export contribution should remain at about ½ percentage point of GDP in 2000 and decline gradually thereafter.[7] Consequently, real GDP growth would slow to 3 percent in 2001-02.

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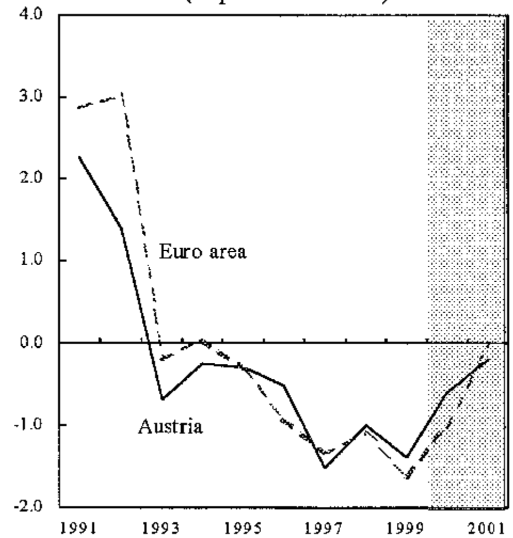
[6] The staff's projection exceeds the July consensus forecast of 3.1 percent.

[7] A sharp appreciation of the euro against the US dollar would have limited direct effects on Austrian exports, because a relatively small share of total export markets is dollar related.

(continued...)

8. **Despite strong growth, there is no imminent danger of a substantial pickup in inflation.** While underlying inflation is expected to advance to 1½ percent during the next two years, a mid-year hike in indirect taxes is expected to push headline inflation temporarily beyond the 2 percent threshold.[8] There is some risk that this may adversely affect the fall round of wage negotiations. However, with an output gap estimated by the staff to be about 1 percent of potential GDP, the Austrian economy still has some free capacity, and continued deregulation is expected to put some restraint on retail price increases (Figure 11). Moreover, recent wage settlements have been restrained and domestic asset prices remain low.

Figure 11. Output Gap
(In percent of GDP)



Source: IMF, World Economic Outlook.

9. **The forecast risks are broadly balanced**: while continued boom conditions in the United States could present surprises on the upside, the main downside risks are a sharp equity-market-induced slowdown in the United States and any sharp increase in interest rates. By contrast, the risks arising from sanctions imposed by the other EU governments or from a decline in domestic asset prices would seem to be minor.[9]

III. Policy Discussions

10. **The discussions took place in a fundamentally changed political environment**: after half a century of consensus politics dominated by social democrats (SPÖ) and conservatives (ÖVP), the new coalition government—which was sworn in on February 4, 2000—had triggered strong reactions from Austria's EU partners and, given its more right-wing orientation, there were doubts about the future of the social partnership. In its coalition agreement, the new government had expressed a desire to introduce more business-friendly

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Indirect effects through the slowdown in the euro area are, however, likely to be more important.

[8] The increase in indirect taxes and fees on tobacco and electricity consumption is expected to add ½ percent to the HCIP in June 2000.

[9] The authorities reported that only a few international conferences had been canceled and that merchandise exports did not lend themselves to consumer boycotts due to the paucity of internationally recognized brand names. Share prices and share ownership among households were low in Austria and the housing market suffered from excess supply.

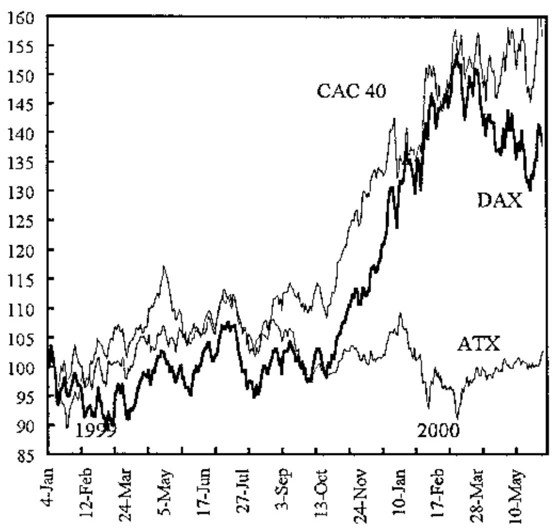
policies, including a reduction in nonwage labor costs and the complete privatization of government stakes in commercial enterprises. With regard to fiscal consolidation, the coalition agreement followed the previous Stability Program, already judged to be "insufficiently ambitious" by the OECD, the IMF, and the OeNB. This criticism, now directed at the new government, was reinforced by the EU Council shortly before the mission's arrival in Vienna.

11. **Against this background, the discussions focused on the scope for greater fiscal consolidation**; monetary and exchange rate policies were discussed only to the extent that they had implications for the appropriate stance of fiscal and structural policies. Financial prudential issues were also accorded a prominent place in the discussions.

A. Macroeconomic Policy Mix

12. **The authorities viewed monetary conditions as appropriately supportive of the economic recovery in Austria**. They considered the recovery to be healthy and did not see any signs of near-term overheating. Asset prices were not particularly inflated—unlike other European bourses, the Vienna stock exchange had remained flat since the start of 1999 (Figure 12), and the housing market was suffering from excess supply. Recent employment growth had largely occurred in the highly flexible service sector, while job shedding continuing in manufacturing and other traditional industries. Money and credit growth was also below the euro-area average, and the underlying inflation rate was expected to remain comfortably below the 2 percent level for the remainder of the year.

Figure 12. Equity Market Indices
(January 3, 1999=100)



Source: Bloomberg.

13. **Despite the relatively supportive monetary stance, the authorities did not see any urgent need for fiscal tightening for conjunctural reasons**. Notwithstanding the targeted reduction in the overall deficit in 2000, the current fiscal stance was considered to be mildly supportive as the stimulative effect of higher disposable household income (due to the reduction in income tax schedules) would about offset any restrictive effects from the hike in indirect taxes. The mission argued that monetary conditions had been easing through most of the 1990s and should by now be viewed as expansionary. For this reason, the mission considered that the current mildly stimulative fiscal stance was not appropriate.

14. **The authorities judged that—given the time constraint under which it was prepared—the 2000 budget was the best that could be achieved under the**

circumstances:[10] efforts to meet the objective under the revised Stability Program had been made more difficult by the need to find compensatory measures for a pre-election tax and family support package—equivalent to a little more than 1 percent of GDP—that had been adopted by the previous government. As it was difficult to design durable reform measures rapidly, the 2000 budget included one-off measures equal to 0.3 percent of GDP (the sale of one additional mobile phone license and the transfer of property to a separate institution), increases in indirect taxes (on energy, tobacco, and car insurance), and an across-the-board cut in discretionary spending. For the purposes of achieving the Stability Program's deficit target (see Box 1), the authorities were also counting on a surplus of 0.5 percent of GDP by the extrabudgetary funds and the lower levels of government.[11]

15. **Despite the recent upward revision in growth projections, the authorities saw some risks that the targeted 2000 budget deficit might be exceeded:** in particular, if lower levels of government would not provide a ½ percent surplus as envisioned by the federal government; the social security funds might experience a smaller than projected aggregate surplus (owing mainly to a larger than expected deficit in the health fund and the only partial compensation of the municipalities for the cancellation of the alcoholic beverage tax). While agreeing with this conclusion, the mission estimated that the "growth dividend" tax revenues would be sufficiently large to offset any shortfall in the lower levels' surplus. Attaining the deficit target of 1.7 percent for the general government in 2000 would, however, require that the central government save its tax windfall in order to narrow its own deficit further. Any additional windfall, such as higher than expected revenues from the sale of additional mobile phone licenses, should be used to further reduce the deficit.

B. Medium-Term Fiscal Plans

16. **For 2001, the authorities were focusing on crafting a budget consistent with the desired consolidation path over the remaining term of the present government (2001-03).** Although not formally a part of a multi-year budget, the achievement of a sound 2001 outturn was considered an important step toward attaining their medium-term objectives, and a three-year federal government fiscal plan would be prepared shortly. In addition, the renegotiation of fiscal relations between the federal government and the other levels of government—renewed every four to five years—was seen as an important element in the effort to improve the foundations of general government finances in the next five years.

[10] The budget passed parliament on May 18, 2000, barely 3½ months after the government was sworn in.

[11] This corresponds to a surplus of about 0.1 percent of GDP for lower levels' administrative budgets; 0.4 percent of GDP corresponds to net subsidized lending for housing purposes, which in the administrative accounts is classified as expenditure.

17. **The medium-term fiscal targets were established in the framework of the EU coordination of fiscal policies:** the updated Stability Program, finalized in March 2000, stipulates a reduction in the general government deficit to 1.5 percent of GDP in 2001, followed by further small annual reductions of 0.1 percent of GDP, to reach 1.3 percent of GDP in 2003 (Box 1 and Table 2).

- **Government consumption** was to be cut by gradually reducing staffing levels—at an annual rate of 2 percent—through attrition in the federal government, and discretionary spending would be allowed to recuperate only a small portion of the across-the-board cut imposed in 2000 (Table 3).

- **Pension expenditure** would be reduced by raising gradually the early retirement age by 1½ years; increasing the per-year discount for early retirement from 2 percentage points to 3 percentage points; and abolishing early retirement in the case of disability. The aim was to cap federal transfers to the public pension funds at 2.3 percent of GDP during 2000-03, thereby achieving savings of about ½ percentage point of GDP by 2003.

- At the same time, however, the already generous **family benefits** would be raised and extended to cover all women, regardless of whether they had worked or not, and **nonwage labor costs** would be reduced. **One-off measures** amounting to 0.3 percent of GDP were included to offset the deficit-increasing effect of these measures (sale of mobile phone licenses and real estate).

Table 2. Austria: Adjustment Measures in the Stability Program (March 2000) 1/

(In percent of GDP)

	2000	2001	2002	2003
Revenue	0.55	0.46	0.30	0.30
Motor vehicle insurance tax	0.13	0.17	0.17	0.17
Tobacco duty	0.02	0.04	0.04	0.04
Electricity tax	0.08	0.14	0.10	0.10
Nonwage labor costs	-0.00	-0.17	-0.28	-0.27
Sale of assets and licenses	0.32	0.28	0.27	0.26
Expenditure	-0.41	-0.61	-0.68	-0.85
Staff compensation	-0.05	-0.18	-0.28	-0.34
Discretionary spending	-0.36	-0.28	-0.27	-0.26
Family assistance	0.00	0.02	0.20	0.23
Pensions	-0.00	-0.17	-0.33	-0.48
Other measures	0.14	0.08	0.08	0.08
Total	1.09	1.15	1.06	1.22

Sources: Austrian Stability Program; and staff estimates.

1/ The effects of the pre-election tax reductions and family measures are not included in this table (amounting to a little more than 1 percent of GDP).

Table 3. Austria: General Government Wages and Employment

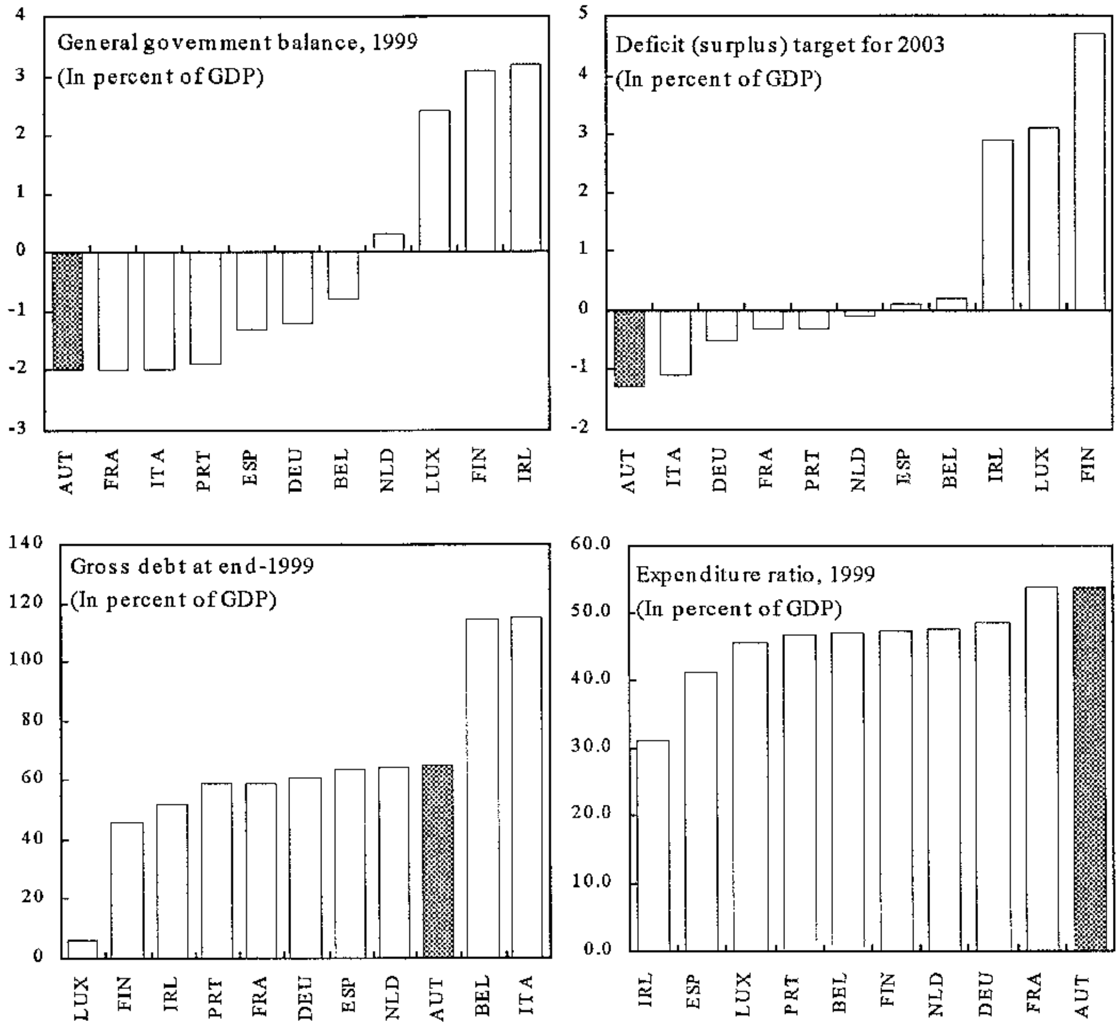
	1995	1999
Wage bill (in percent of GDP)		
Austria	12.8	11.5
Rest of euro-area 1/	11.1	10.8
Employment (in percent of total employment)		
Austria	16.6	16.2
Rest of euro-area 1/	17.3	16.5

Sources: OECD Economic Outlook Database.
1/ Excludes Austria.

18. **The mission considered the authorities' updated Stability Program to be insufficiently ambitious:** (i) currently as much as 3½ percent of GDP was absorbed by interest payments on the still high public debt; (ii) a larger margin was needed to allow discretionary fiscal action to reinforce the play of the automatic stabilizers in the event of adverse Austro-specific shocks; (iii) additional spending restraint was needed to create some headroom to face the mounting spending pressures from the adverse long-term demographic trends; and (iv) a stronger fiscal position would produce additional dividends in the form of lower financing costs for the entire economy. Comparison with other euro-area countries also suggested a more ambitious approach: under the revised Stability Program Austria's fiscal deficit, already the largest among euro area countries in 1999, would remain the largest in 2003, and its expenditure-to-GDP ratio was the highest in the euro area at a time when the other countries were already striving to reduce their spending further to make room for tax reductions (Figures 13 and 14).

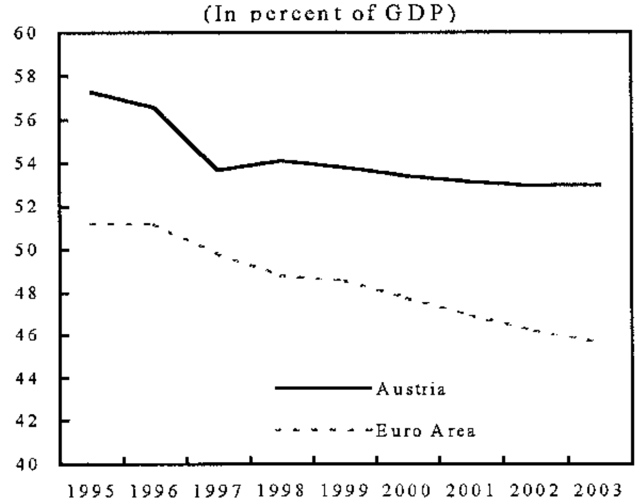
19. **The mission therefore presented an alternative adjustment program aimed at achieving structural balance by 2003** (Box 1). At 1½ percent of GDP, the recommended expenditure-based consolidation effort was just half of the structural adjustment achieved by the 1996-97 consolidation program. While acknowledging that the choice between expenditure priorities was a political one, the mission pointed to six areas where sufficient cuts could be made to achieve the targeted consolidation: family benefits, housing subsidies, pensions, health expenditures, agriculture, and staffing levels, especially in education. There should be ample room to cut public expenditure: housing subsidies had fulfilled their role in overcoming the postwar housing shortage and failed to reach their intended beneficiaries; family benefits were highly generous; and student-teacher ratios were very low, particularly in primary and secondary education (Table 4). To avoid across-the-board cuts and determine cutbacks on a rational basis, the staff suggested that the government should subject its spending programs to a number of public policy tests to determine whether they: (i) continued to be in the public interest; (ii) should be delivered by the government or devolved to the private sector; (iii) should be delivered by the central, provincial or local governments; (iv) could be redesigned to improve efficiency; and (v) were affordable, given fiscal constraints.

Figure13. Euro Area: Fiscal Balances (Actual and Targeted), Public Debt, and Expenditure Ratios.



Source: IMF, World Economic Outlook

Figure 14. Austria and Euro Area:
General Government Expenditure
(In percent of GDP)



Source: IMF, World Economic Outlook.

Box 1. The Stability Program and the Staff's Consolidation Scenario

(In percent of GDP)

	1999	2000	2001	2002	2003
	I. Authorities' Stability Program (March 2000)				
Revenue	51.7	51.1	50.2	49.5	49.1
Expenditure	53.7	52.7	51.6	50.9	50.4
Overall fiscal balance (ESA 95)	-2.0	-1.7	-1.5	-1.4	-1.3
Federal government	-2.4	-2.2	-2.0	-1.9	-1.8
Other	0.4	0.5	0.5	0.5	0.5
Gross public debt	64.9	64.1	62.7	61.9	61.2
Net subsidized lending (housing)	0.4	0.4	0.4	0.4	0.4
Net asset and license sale	0.1	0.3	0.4	0.3	0.3
GDP (growth rate)	2.2	2.8	2.8	2.5	1.9
	II. Staff's Alternative Adjustment Scenario (May 2000)				
Revenue	51.7	51.6	51.6	51.5	51.2
Expenditure	53.7	53.3	52.0	51.4	50.9
Overall fiscal balance (ESA 95)	-2.0	-1.7	-0.4	0.1	0.3
Gross public debt	64.9	63.7	61.5	59.1	56.8
Net subsidized lending (housing)	0.4	0.4	0.2	0.0	0.0
Net asset and license sale	0.1	0.3	0.4	0.3	0.3
GDP (growth rate)	2.2	3.5	3.0	2.9	2.5
Staff estimates: 1/					
Stability program:					
Cyclically-adjusted balance	-1.2	-1.3	-1.2	-1.4	-1.3
Underlying balance 2/	-1.7	-2.0	-2.0	-2.1	-1.9
Adjustment scenario:					
Cyclically-adjusted balance	-1.2	-1.3	-0.3	0.1	0.3
Underlying balance2/	-1.7	-2.0	-0.9	-0.2	0.0

Source: Data provided by the authorities; and staff calculations.
1/ In percent of potential output.
2/ Adjusted for cyclical effects, one-off items, and net subsidized lending.

The Stability Program includes deficit-reducing measures amounting to 1¼ percent of GDP (see Table 2), of which more than ¼ percent of GDP are temporary (asset and license sales).1/ The Stability Program is based on less optimistic economic projections than the staff's adjustment program. Conservative estimates on the value of the third generation mobile phone licenses were applied to both the Stability Program and the staff's alternative adjustment scenario. Based on recent experience, the staff scenario assumes a higher income elasticity of revenues and therefore allows for a higher expenditure ratio for a given fiscal balance objective. In accordance with the experience under the 1996–97 consolidation program, the staff's scenario does not assume any significant negative impact on economic growth.

The staff's alternative adjustment scenario seeks to establish underlying balance by 2003, adjusted for one-off measures and subsidized lending. The scenario implies a total fiscal adjustment amounting to 1½ percent of GDP and could be achieved by: (i) a real freeze in government consumption (saving: ¾ percent of GDP); (ii) a 50 percent cut in housing subsidies (saving: ½ percent of GDP); and (iii) reductions in pensions and family benefits (saving: ¼ percent of GDP).

1/ This more than compensates for the tax reductions and family measures introduced in 1999 (with effect from 2000), amounting to a little more than 1 percent of GDP.

Table 4. Austria: Ratio of Students to Teachers, 1996

	Primary education	Secondary education	University
Austria	12.7	8.9	14.5
France	19.5	13.3	17.1
Germany	20.9	15.0	12.5
Italy	11.2	10.2	25.7
EU 1/	16.8	14.4	19.4
OECD 2/	17.9	14.5	17.1

Source: OECD, Education Indicators at a Glance.
1/ Unweighted average. Excluding Belgium and Luxembourg.
2/ GDP weighted average.

20. **The mission noted that further pension reform was needed to ensure long-term fiscal sustainability.** Staff projections indicate that under current entitlement rules (i.e., assuming full implementation of the 1997 pension reform except for the discount for increased longevity), total pension expenditure under all pension systems would increase by at least 4½ percentage points of GDP by 2030. If revenue was not to be raised concurrently (e.g., by raising contribution rates), attempts to maintain overall fiscal balance would lead to a severe compression of primary current expenditure that would only be eased somewhat by a decline in interest expenditure as a consequence of a declining debt ratio. Clearly, such a compression was intolerable, and the demographically induced financial deterioration of the pension system had to be addressed by further reform, mainly on the entitlement side. The staff acknowledged that the government's planned measures (see paragraph 17) were a step in the right direction, but stressed that more would be required. Subsequent reforms should focus on: removing the incentives for early retirement that remain after the planned increase in the "penalty" discount; introducing increases in the statutory retirement age beyond what is currently planned and accelerating the timetable for the planned equalization for both genders; adjusting pensions for increased longevity; indexing pensions to inflation rather than wages; and harmonizing the separate pension systems on the basis of the least generous one. Greater reliance on mandatory and voluntary fully funded contribution-based schemes should also be considered.

21. Shortly after the mission, the Minister of Finance announced his intention to tighten the fiscal targets (relative to the Stability Program) and to aim for overall balance on the general government's fiscal accounts by no later than 2003.[12] No details

[12] On July 3, 2000, the coalition agreement was amended to take account of the new target. Moreover, at the authorities' request, a mission of experts from the Fiscal Affairs Department

(continued...)

were yet available, however, on whether this target would be achieved through increased taxation, one-off measures, or lasting expenditure reduction. The uncertainty is compounded by the coalition government's announced intention to (i) raise the economy-wide expenditure on research and development; (ii) acquire new military equipment; and (iii) improve the conditions for farmers. These measures would add as much as 1 percent of GDP to the deficit unless additional offsetting measures are taken.[13]

22. **The renegotiation of the fiscal relations between the federal and other levels of government was considered of central importance to the success of the medium-term consolidation program.** Under the terms of the current revenue-sharing agreement, close to 40 percent of tax revenue is transferred to the Länder and municipalities, either as pre-defined shares of federal taxes or as earmarked transfers, to finance costly and ill-targeted housing subsidies and the increasingly expensive primary education system. One suggested reform of the system would be to transfer some of the authority to tax to the Länder and municipalities, thereby raising their budgetary responsibilities and establishing a better balance between their tasks and their own resources. The authorities expected to finalize the new agreement, which would need to improve the incentives to economize on resources, by the end of 2000. The mission agreed with these plans, which would sharply reduce the need for intergovernmental transfers (currently some 10 percent of GDP, including tax revenue transferred to the lower levels of government as part of the revenue sharing agreement). In its view, it would be better to extend the present agreement by one year than to rush into an agreement that would leave the problems with the current system unaddressed.

C. Product and Labor Market Policies

23. The functioning of product and labor markets in Austria is tightly linked to the evolution of the social partnership system. In this respect, **the authorities noted that they shared the view of previous postwar governments that the social partnership had contributed importantly to the success of the Austrian economy** (Box 2). The authorities appreciated the gains from the close cooperation among the different parties in the labor and product markets and hoped to be able to continue to benefit from the low level of conflict, which had characterized labor relations in the postwar period. The successful operation of the social partnership was seen as an important factor behind the Austrian economy's ability to achieve, consistently over many years, above-average productivity growth and wage moderation in relation to its trading partners. Although there were some complaints about recent attempts to bypass the social partners, both the federation of trade unions and the

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is visiting Austria during July 18-August 2, 2000 to discuss pension reform and the system of intergovernmental fiscal relations.

[13] The cost of achieving these objectives was not included in the updated Stability Program of March 2000.

chamber of industry—two key institutions of the social partnership—as well as the authorities expressed support for a continuation of regular close consultation of the social partners and their involvement in the early stages of the legislative process.

Box 2. The Austrian Social Partnership

The Austrian social partnership system is composed of a network of formal and informal consultations between the government, the three main chambers (of industry, labor, and agriculture), the trade union federation, and the federation of industrialists. In contrast to most other countries, membership in the chambers, which are mainly financed by member fees, is compulsory and rights to comment on draft legislation are legally enshrined. Although the chamber system was introduced during the Habsburg Monarchy (1848), the main features of the social partnership system were established shortly after the Second World War to prevent the reappearance of costly social and industrial strife, which had ravaged the economy during the interwar years.

24. **At the same time, the authorities were determined to accelerate structural reform, even if that were to entail some cost to social harmony.** The new government's privatization program and its pension reform proposals had led to an increasingly confrontational climate, although the disruptions had so far been minor. The authorities' structural reform program followed the lines of the 1999 National Action Plan for Employment. Although the targets of 100,000 new jobs and a harmonized unemployment rate of 3.5 percent had been achieved two years ahead of schedule, further efforts were needed to fulfill the Plan's other objectives.

- Improvements in the **employability** of the long-term unemployed, older workers, and women were to be achieved through intensified active labor market programs (ALMPs), targeted at particularly vulnerable groups. In the context of the tightening of early retirement rules, there was a special need to bolster the employability of older workers. (The nonemployment rate among older workers is high compared to other OECD countries; see Box 3).

- **Economic growth** would be stimulated from the supply side by increasing expenditure (either by the private sector through tax incentives or directly through public spending) on research and development (R&D);[14] reducing nonwage labor costs; simplifying

[14] In 1997, the OECD average was 2.2 percent of GDP; in the United States as much as 2.8 percent of GDP was spent on R&D. The authorities were aiming at raising total (private and public) spending on R&D from its current level of 1.6 percent of GDP to 2.5 percent of GDP by 2005.

Box 3. Austria's Labor Market Performance in a European Context

Austria stands out among EU member countries as having maintained over the past thirty years one of the lowest unemployment rates; low youth and low-skilled unemployment; below average long-term unemployment; and the second highest employment rate (measured in full-time equivalents). Several factors have contributed to this commendable performance despite massive restructuring, which has reduced employment in manufacturing by more than 25 percent since 1980:

- The **social partnership** system which, by involving actively special interest groups in the formulation and implementation of macroeconomic, incomes, and social policies, has made it possible to internalize policy externalities and promote the longer-term interest of the country as a whole. The social partners have facilitated wage moderation (necessitated by the peg to the DM since 1981); have allowed (unlike in Germany) some wage differentiation across sectors/enterprises in line with specific productivity and demand conditions (thus preserving competitiveness) despite the high degree of centralization of the wage bargaining process; and have enabled extensive industrial restructuring in an environment of social peace.

- The system of **apprenticeship training**, which—despite the need for periodic modernization (as in Germany)—smoothes the transition from school to work and obviates pressure from high contractual wages, thus contributing to the low youth unemployment.

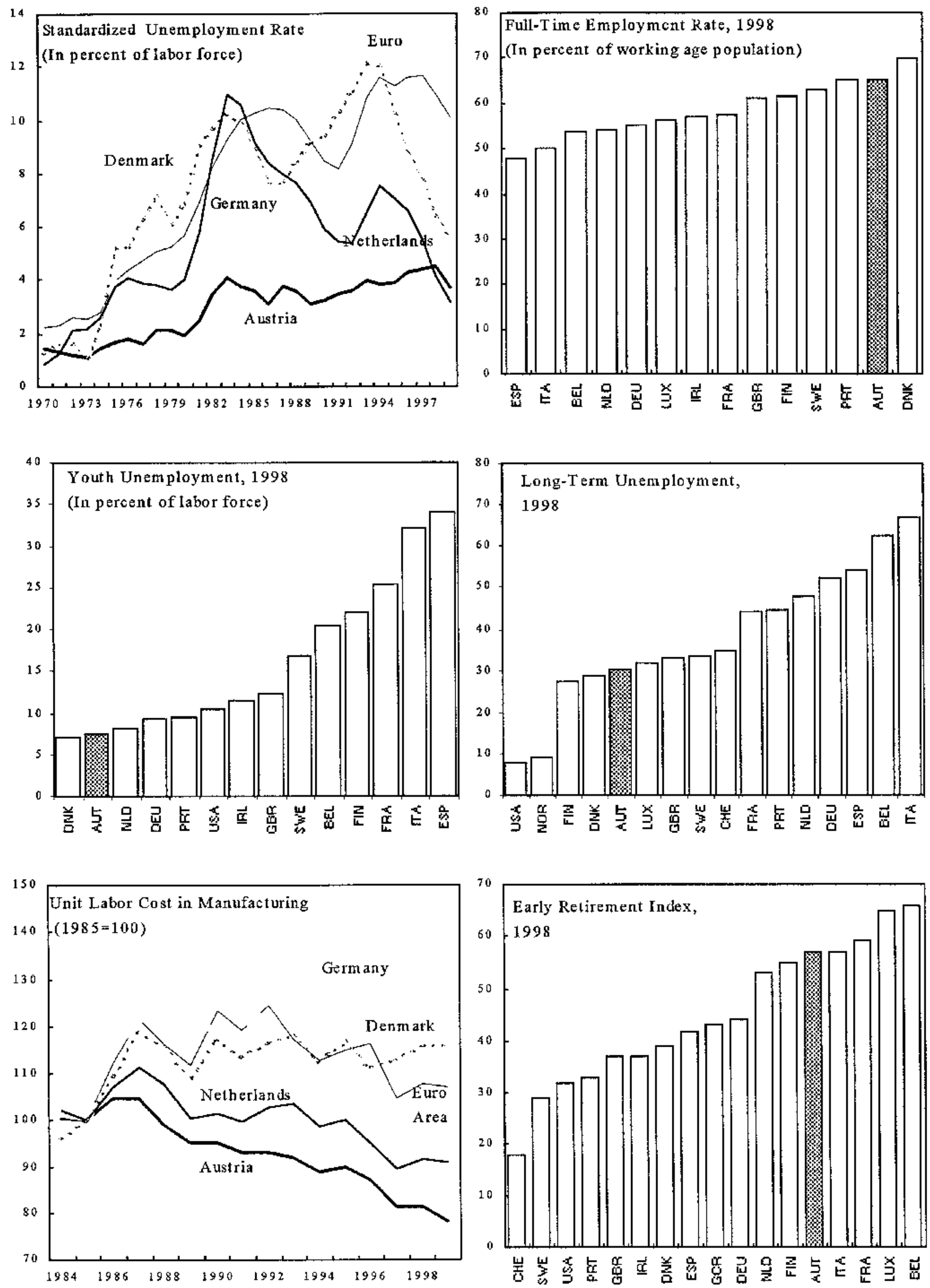
- Although they have obvious drawbacks, **early retirement** incentives (as in most other EU countries) and the expansion of **public sector employment** (unlike in most other EU countries) have played a major role in mitigating the rise in unemployment until the mid-1990s. The average age of early retirement declined from 61 in 1970 to 57½ in 1998, and non-employment among the pre-retirement population exceeds the EU average (but is lower than in Belgium or France). Moreover, the share of the public sector in total employment has been rising, whereas in other EU countries it has been either constant or declining.

- **Active labor market policies (ALMPs)** have risen to prominence since the mid-1990s, with a clear emphasis on employability and entrepreneurship, and innovative programs like job coaching, training, and contestable unemployment placement services. However, public expenditure on ALMPs remains among the lowest in the EU (0.4 percent of GDP).

The labor market has not been without tensions: unemployment has ratcheted up and the recent decline has been less pronounced than in the EU at large (which, however, occurred from a much higher level). Long-term unemployment has risen and (in the absence of measures) its incidence is likely to increase as a larger part of the labor force will reach pre-retirement age. Most new jobs are part-time whereas demand is mostly for full-time jobs. Economic insecurity is perceived as rising due to intensifying competition (intra-EU and international) and the erosion of the welfare system and structures that used to shelter the population in the past (early retirement, public employment, counter-cyclical fiscal policy, and immigration restrictions). The main challenges for labor market policy are to preserve the beneficial features of the social partnership in an era of increasing political confrontation, strengthen labor market adaptability and flexibility (employment protection remains well above the EU average and regional labor mobility is low), and improve the business environment and growth prospects.1/

1/ Austria's labor market performance is reviewed in the accompanying Selected Issues paper.

Box3. Figure 1: Labor Market Performance



Source: OECD.

administration, particularly by the introduction of a time-bound one-stop approval for investment projects (*Anlagenrecht*); liberalizing of the Trade Law and deregulating professional services; accelerating the deregulation of the electricity and gas sectors; reform of the competition authority to improve its effectiveness;[15] and privatizing remaining government holdings in commercial enterprises.

25. **The authorities were encouraged by the positive experience with deregulation in the telecommunications and electricity sectors.** Deregulation of the telecommunications sector had led to price reductions of 30-40 percent and a booming supply of new services, and electricity prices for large users had been reduced by up to 20 percent. While initially lagging behind the other EU countries, these results had encouraged the authorities to plan full liberalization of the electricity sector—including free choice of supplier for households and small businesses—by October 2001, well ahead of the EU deadline. The gas sector would be fully liberalized one year later.

26. The privatization plans are somewhat less bold than initially announced by the government. **Although it has expressed its intention to proceed with complete privatization, the government has established a list of companies, including the telecom operator, the tobacco company, and the postal savings bank,** which will be sold first (Box 4); not included yet were the remaining (minority) state holdings in the steel, engineering and petrochemical industries. The procedure and timing of the planned privatizations were to be determined by ÖIAG, the state industrial holding company.

Box 4. The Privatization Program

The origin of the state industrial holdings in Austria dates back to the immediate post-World War II period, when the largest industrial companies and banks and all public utilities were nationalized.

The first clear signs of inefficiencies in these industrial holdings appeared in the mid-1980s, when the nationalized industries posted large losses. After a period of recovery (partly as a result of a major reorganization), new troubles appeared in the early 1990s. These troubles triggered a partial privatization program: during 1993–97 the public sector's share in most of the industrial holdings was reduced to between one fourth and about three fourths of capital. Furthermore, the federal government sold its 70 percent stake in Creditanstalt, the country's second largest bank, to Bank Austria, the largest bank.

The sale of the remaining state holdings is scheduled to take place in two phases: the first phase includes the sale of the State Printing Press, the postal savings bank (PSK), Dorotheum (an auction house), Vienna Airport, Telekom Austria, and Austria Tabak; the second phase includes the privatization of VA-Stahl (steel), ÖMV (petroleum and petrochemical products), Austrian Airlines, ÖBB (the railways), and the Post. The second phase may include some provision to ensure a blocking minority in Austrian hands. The federal privatization program does not include the municipal savings banks (amounting to 9 percent of total bank assets), which are subject to significant municipal control.

The potential of the privatization program to reduce government debt is limited, however, as most of the proceeds will likely be used to repay the debt accumulated by, or off-loaded to, these companies (amounting to some 10 percent of GDP).

[15] The present authority suffered from its close relationship with the social partners, essentially blocking its ability to intervene in many cases.

27. **The authorities were positive about EU enlargement.** They noted that, in many respects, political developments lagged behind the economic integration process. Direct investment of Austrian firms in the CEECs was already substantial and the Austrian labor market was already significantly affected by labor flows—including informal employment—from the transition economies. Moreover, large-scale immigration was not likely to occur; earlier experience with the integration of Portugal and Greece into the EU showed that immigration was likely to be minor. Nonetheless, it was necessary to contemplate transition periods for the free movement of labor and trade in certain services. These transitional problems apart, the authorities were confident that strong historical links and comparative regional expertise meant that Austrian companies would significantly benefit from further integration of the CEECs into the EU market. They did stress, however, that it was not enough that the *acquis communautaire* was formally observed by the EU membership candidates if their practices did not fully comply with EU standards.

D. Bank Soundness and Prudential Supervision

28. **The supervisory authorities considered that the banking system was sound and that its profitability was good.**[16] With an average capital adequacy ratio of 13½ percent (9¼ percent representing core capital), the banking system was in their view well capitalized. According to revised aggregate data, Austrian banks' performance had improved during 1999 and their overall profitability was roughly in line with other European countries. In addition, the banks' risk management systems were considered commensurate with the risks assumed. Foreign exchange borrowing (amounting to some 18 percent of private sector bank loans in early 2000) was not a cause for great concern since 70 percent of the borrowing was in Swiss francs, a currency that tended to follow the euro closely.[17] Recent enhancements to cross-border supervision would also improve the consolidated supervision of foreign subsidiaries: a recent amendment to the Banking Law had opened the way for negotiating memoranda of understanding with supervisors in the CEECs and other non-EU countries that would allow on-site inspections by Austrian supervisors. The authorities did not share the staff's concern that Austrian banks' expansion in the CEECs entailed greater risks; in their view, the banks had proven able to benefit from new business opportunities without incurring excessive risks as the returns on those operations had been consistently high since the early 1990s.

29. **The authorities planned to revamp the system of financial supervision.** Building on an earlier reform proposal shelved shortly before the election, the authorities intended to draw on international best practice to improve the efficiency of the banking supervisory

[16] The challenges facing Austrian banks in the context of increased international financial integration are reviewed in the accompanying Selected Issues paper.

[17] Representatives of one large bank did, however, express concern about credit risk for banks with large foreign currency exposure to clients.

authority. Although they considered their supervisory practice to be largely in line with the Core Principles for Sound Banking Supervision,[18] the authorities agreed with the mission's view that the supervisor's operational independence could be strengthened through increased budgetary freedom (including the ability to pay higher salaries). The details of the reform were not yet ready; it had yet to be decided whether the new authority would remain with the Ministry of Finance, become a part of the OeNB, or be vested in a new institution. Against the background of the recent need for the OeNB to provide liquidity support to a small bank, the mission expressed concern about the current system's ability to deal with problem banks in an effective and consistent manner; the mission regretted that earlier attempts to amend the Banking Act with the aim to ease the requirements for early intervention had failed. Improved legal protection for supervisory staff could also enhance the supervisor's ability to respond rapidly and adequately to emerging problems.

IV. Staff Appraisal

30. **The Austrian economy shows many signs of good health:** economic growth is strong; inflation is in check; and the unemployment rate is the third lowest in the EU. Although some of this good performance can be ascribed to the favorable international environment, the combination of fiscal consolidation and structural reform pursued after EU entry in 1995 laid the foundation for these achievements. The authorities must, however, guard against being lulled into complacency by the current economic expansion: fiscal consolidation has stalled since 1998 and structural reform is still incomplete. These residual underlying weaknesses would quickly manifest themselves were the expansion to falter.

31. **The conjunction of a strong economic expansion and a new government offers ideal conditions for pressing ahead with further fiscal and structural reforms.** With one of the largest public sectors in the EU and the burden of social transfers, especially family benefits, rising, the government needs to undertake a fundamental overhaul of the role of the public sector. Against this background, it is encouraging that the government has decided to tighten the fiscal targets relative to its updated Stability Program to reach overall balance by 2003 at the latest.

32. **The planned fiscal consolidation should be achieved through durable expenditure reduction instead of tax increases or one-off measures.** The authorities should go even further and reduce spending sufficiently to create room for lowering nonwage labor costs. Plans to raise spending on family benefits, military equipment, and agricultural subsidies run counter to these objectives. Subjecting all federal spending programs to a public

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[18] Their assessment was that all but two of the 25 principles had been fully implemented, the exception being the principles on "connected lending" (there was no formal requirement that banks' lending to related companies or individuals needs to be extended on an arm's length basis) and the need for prior consent from foreign supervisors to grant a banking license to a foreign-owned subsidiary.

review ascertaining their utility and efficiency would likely result in a substantial reduction in the number of tasks assigned to the public sector and their increased decentralization.

33. **Front-loading fiscal adjustment would send a clear signal about the government's fiscal resolve and might have a confidence-building effect akin to the 1996-97 consolidation package.** Any overperformance on revenues in 2000 should be used to reduce the targeted deficit, and the 2001 budget should aim at narrowing the deficit substantially. Front-loading the consolidation process would also be appropriate both from a cyclical viewpoint and to offset expansionary monetary conditions; a postponement would risk ill-timed fiscal withdrawal.

34. **The authorities should ensure long-term fiscal sustainability by tackling up front the imbalances in the pension system.** To build consensus on further pension reform and facilitate agreement on specific measures, the government should commission regular actuarially based long-term projections for all pension systems. Such projections should be produced by an independent source and should encompass the civil servant pensions for all three levels of government.

35. **The present negotiations on the fiscal relationship between the different levels of government represent a golden opportunity to redefine the role of government at all three levels.** The authorities should aim for a thorough review of the intergovernmental fiscal relations and use this occasion to devise a more efficient and transparent system. The distribution of tasks between the three levels of government should be reassessed to establish a better balance between tasks and own financial resources, including the transfer of some power to tax to the lower levels of government and the abolition of revenue earmarking.

36. **Structural reform should focus on removing regulatory impediments to innovation and competition in the product and labor markets, rather than on increasing tax incentives and subsidization:**

- The government should sell its remaining holdings in commercial enterprises, even if that were to result in foreign ownership.
- The time-bound one-stop approval for investment projects should be legislated without further delay.
- An independent competition authority with full powers to initiate investigations and adjudicate cases without interference from the social partners or the government should be established.
- Access to the professions should be liberalized and regulations should be eased, for example, by switching from a list of permitted activities to a list of regulated activities.
- Labor market reform should focus on improving the employment conditions for older workers and increasing wage flexibility.

37. **The planned overhaul of banking supervision should strengthen its operational independence and effectiveness.** The banking supervisor should be given greater freedom to determine budgetary priorities, the legal instruments available to supervisors should be improved, and supervisors should be provided with adequate legal protection in the exercise of their duties. Although the Austrian banks' operations in the CEECs appear profitable and well managed, the risks involved in banking in these countries are high and supervisors should remain appropriately vigilant. In this light, agreements with CEEC supervisors to permit Austrian supervisors to conduct on-site examinations of Austrian banks operating in these countries would be welcome. Supervisors also need to remain vigilant to ensure that widespread bank lending in non-euro currencies is based on proper risk assessment.

38. Austria's official development assistance (ODA) is budgeted to decline from 0.25 percent of GNP in 1999 to 0.21 percent of GNP in 2000. Austria should strive to raise its ODA to the United Nations benchmark of 0.7 percent of GNP. It should use its influence in the EU to secure duty-free market access for the exports of the least developed countries and to liberalize world trade in agricultural products and services under the auspices of the WTO.

39. In accordance with the authorities' request, it is proposed to keep the Article IV consultation with Austria on the standard 12-month cycle.

Table A1. Austria: Basic Data

Total area	83,850 square kilometers
Total population	8.08 million
GDP per capita (1999)	US$ 24,695 1/

	1995	1996	1997	1998	1999 1/	2000 1/	2001 1/
	(Percentage changes at 1983 prices)						
Demand, supply and saving							
Private consumption 2/	2.9	3.2	0.1	1.5	2.4	2.7	2.8
Public consumption	3.1	1.3	-0.4	2.0	0.8	-0.1	0.0
Gross fixed investment	1.2	1.6	0.8	6.8	2.8	4.9	4.9
Construction	0.7	1.5	-1.6	4.1	1.2	1.0	1.5
Machinery and equipment	1.2	2.6	4.3	9.8	4.9	9.0	8.0
Inventory changes 3/	-0.6	-0.4	0.8	-0.7	-0.6	0.3	-0.1
Total domestic demand	1.9	2.0	1.0	2.2	1.6	3.0	2.7
Exports of goods and nonfactor services	6.5	6.0	10.1	8.7	4.7	8.0	7.5
Imports of goods and nonfactor services	7.0	5.9	9.4	6.9	3.5	7.0	7.0
Foreign balance 3/	-0.2	0.0	0.2	0.7	0.6	0.5	0.2
GDP	1.7	2.0	1.2	2.9	2.2	3.5	2.9
Real disposable income	2.6	1.0	-0.3	2.6	1.7	2.6	3.1
Personal saving ratio (in percent of disposable income)	9.8	7.8	7.4	8.3	7.5	7.5	7.8
	(Percent changes; period averages)						
Employment and unemployment							
Labor force 4/	-0.3	-0.2	0.3	0.7	0.9	0.9	0.6
Employment 4/	-0.4	-0.7	0.3	0.5	1.1	1.1	1.0
Unemployment rate (in percent)							
Registered 5/	5.9	6.3	6.4	6.5	6.0	6.1	5.7
Standardized 5/	3.9	4.3	4.4	4.5	3.7	3.5	3.5
Prices and incomes							
GDP deflator	2.3	1.3	1.6	0.6	0.6	1.5	1.7
Consumer price index	1.6	1.8	1.2	0.8	0.5	1.9	2.1
Unit labor costs (manufacturing)	-0.6	-1.0	-4.0	-0.7	-0.5	-1.8	-1.4

1/ Staff estimates and projections.
2/ Due to the adoption of EU conventions for national accounts statistics, public consumption increased by 1.5 percent in 1996 (abolition of VAT on health services) and fell about 4.75 percent in 1997 (reclassification of public hospitals).
3/ Change as percent of previous year's GDP.
4/ Dependent labor force (does not include self-employed).
5/ In percent of total labor force (dependent labor force plus self-employed). The standardized rate is survey based according to EU standards.

Table A1. Austria: Basic Data (concluded)

	1995	1996	1997	1998	1999 1/	2000 1/	2001 1/
	(In percent of GDP)						
Public finances							
General government 2/							
Expenditure	57.3	56.6	54.0	54.1	53.7	53.4	53.1
Revenue	52.2	52.8	52.1	51.6	51.7	51.8	51.6
Overall balance	-5.1	-3.8	-1.9	-2.5	-2.0	-1.7	-1.5
Federal government	-4.7	-4.0	-2.7	-2.9	-2.4	-1.8	-1.6
Other levels of government	-0.4	0.2	0.8	0.5	0.4	0.1	0.1
Gross debt (end of period)							
Federal government	61.1	60.9	59.7	57.7	55.7	53.3	...
General government	68.4	68.3	63.9	63.5	64.9	63.7	62.7
Primary underlying balance 3/	-1.1	-0.2	1.9	1.5	1.9	1.6	1.3
	(In billions of schillings)						
Balance of payments							
Trade balance 4/	-76.8	-89.4	-56.6	-53.5	-55.0	-50.3	-31.7
Current account	-54.8	-50.8	-64.1	-59.7	-74.6	-56.0	-53.0
(In percent of GDP)	-2.3	-2.1	-2.5	-2.3	-2.8	-2.0	-1.8
	(Percent changes, end of period)						
Interest rates and credit							
Domestic credit to nonbanks	6.9	3.6	3.6	3.7	5.2	...	...
Three-month interbank rate							
(Level, in percent) 5/	4.6	3.4	3.5	3.5	3.0	4.5	...
10-year government bond							
(Level, in percent) 5/	7.1	6.3	5.7	4.7	4.7	5.6	...
	(Levels, period averages)						
Exchange rates							
Schillings per US$	10.08	10.59	12.20	12.38	...	...	...
Euro per US$ 5/	...	...	...	...	0.94	1.05	...
Nominal effective rate (1990=100) 6/	106.9	105.2	102.9	103.1	102.0	100.2	...
Real effective rate (1990=100)							
ULC based 6/	92.4	88.1	83.5	81.9	79.7	77.0	...
CPI based 7/	108.2	106.0	102.3	102.3	100.4	97.7	...

1/ Staff estimates and projections.
2/ On a national accounts basis.
3/ Structural balance adjusted for interest payments, asset sales, and subsidized lending.
4/ IMF (WEO) definition.
5/ For 2000, data refer to July 7, 2000.
6/ For 2000, data refer to June 2000.
7/ For 2000, data refer to April 2000.

Table A2. Austria: Indicators of Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000 Latest	2000 Date
Public sector					
General government balance 1/	-1.9	-2.5	-2.4	-1.7 2/	
Structural balance 3/	-2.0	-2.1	-2.0	-2.0 2/	
Public sector debt 1/	63.9	63.5	65.8	64.6 2/	
Extrabudgetary debt 4/	11.8	12.0	12.3	...	
Federal government guarantees	28.6	28.4	29.0	...	
Financial sector					
Growth rate of total credit	37.7	13.1	12.3	7.0	March
Growth rate of credit to the private sector 5/	9.3	5.0	3.7	3.5	March
Stock market index (level) 6/	487.0	464.3	493.3	481.6	April
Price-earnings ratio	15	13.7	12.5	19.5	June
Foreign exchange loans	8.8	12.8	16.9	17.9	March
Foreign exchange loans, share of total loans	8.3	12.2	16.5	18.3	March
Deposits in foreign exchange	6.3	5.6	1.6	1.7	March
Deposits in foreign exchange, share in total deposits	7.3	6.4	1.8	1.9	March
Risk-based capital asset ratio, total	12.9	14.3	13.9	13.7	March
Risk-based capital asset ratio, core capital	9.0	9.8	9.4	9.3	March

Sources: OeNB; Datastream; Bloomberg; Ministry of Finance; and staff estimates.
1/ European System of Accounts, 1995 (ESA 95).
2/ Staff projections.
3/ General government deficit according to ESA 95 adjusted for cyclical effects, one-off measures (e.g., asset sales), and net subsidized lending.
4/ Debt of government owned enterprises.
5/ Excluding financial institutions and foreigners.
6/ Price-earnings ratio for ATX.

Austria: Fund Relations
(As of June 30, 2000)

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

II. General Resources Account:	SDR Million	Percent Quota
Quota	1,872.30	100.0
Fund holdings of currency	1,299.68	69.4
Reserve position in Fund	572.56	30.6
Operational budget transfers (net)	-5.00	

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	179.05	100.0
Holdings	112.53	62.8

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

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Austria has not used Fund resources.**

VIII. **Exchange System:**

As of January 1, 1999, the currency of Austria is the euro. In cash transactions, however, the Austrian schilling remains legal tender until 2002, when euro notes and coins will be issued. Each euro is equivalent to AS 13.7603.

Austria's exchange system is free of restrictions on the making of payments and transfers for international transactions. However, Austria maintains exchange restrictions against Iraq pursuant to U.N. Security Council Resolution No. 661. These restrictions were notified to the Fund under Decision No. 144.

IX. **Last Article IV Consultation**

Discussions for the 1999 Article IV consultation were held in Vienna during March 12–24, 1999. The staff report (SM/99/108) was discussed by the Executive Board on June 9, 1999.

Austria: Statistical Issues

For the purpose of surveillance, the timeliness of Austrian data should be improved by bringing them up to "best practice" in Europe with regard to national accounts data, industrial production, the (accrual based) current account, and merchandise trade. Compared to Germany and France, for instance, the publication of these data lags by about one month.

The transition to the new European Standard of Accounts (1995) has complicated the analysis of Austrian national accounts. First, a break was created in the national account series as the new national accounts data (using the new standard) published in November 1999 included only revisions back to 1995. Second, the new national account data provide no data 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.

A large difference between the data on goods trade recorded by the statistical office (Statistics Austria) and the payments data recorded by the National Bank has given rise to significant problems in assessing the developments in the foreign trade balance and the current account in the recent years (data on accrual basis are only available with a long time lag). Data based on the fifth edition of the Balance of Payments Manual are only available back to 1992.

Austria has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and Austrian metadata are available on the Fund's electronic Dissemination Standards Bulletin Board. Austria has taken advantage of the flexibility options on the timeliness of the industrial production index, merchandise trade data, and the analytical accounts of the banking sector.

Austria: Core Statistical Indicators 1/
As of July 6, 2000

	Industrial Production	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Overall Government Balance 3/	GDP/GNP	External Debt
Date of Latest Observation	3/00	5/00	3/00	4/00	1999	00Q1	1998
Date Received	6/28/00	6/14/00	6/14/00	6/20/00	4/10/00	7/5/00	8/10/99
Frequency of Data	Monthly	Monthly	Monthly	Monthly	Annual	Quarterly	Annual
Frequency of Reporting	Monthly	Monthly	Monthly	Monthly	Annual	Quarterly	Annual
Source of Update	Statistics Austria	Statistics Austria	Statistics Austria	OeNB	MoF	WIFO	OeNB
Mode of Reporting	Internet	Internet	Internet	Fax	Internet	Internet	Internet
Confidentiality	None	None	None	None	None	None	None
Frequency of Publication	Monthly	Monthly	Monthly	Monthly	Annual	Annual	Annual

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.
3/ National accounts basis

Statement by the IMF Staff Representative
August 3, 2000

1. This statement provides information on economic and financial developments that has become available since the issuance of the staff report (SM/00/170, 7/18/00). The new information does not alter the thrust of the staff appraisal.

2. **Headline harmonized CPI inflation rose sharply by 0.8 of a percentage point in June**, reaching 2.4 percent year on year (at par with average inflation in the euro area) due to a hike in indirect taxes and fees (foreshadowed in the staff report), and unexpectedly higher energy prices. Excluding the effect of the latter, CPI inflation was 1.2 percent, up from 0.7 percent in May. The staff projects headline inflation to remain temporarily above 2 percent; as noted in the staff report, this may affect the upcoming wage negotiations.

3. **The budget plan for 2000-03 was revised in July** with a view to curtailing the general government deficit from 1.7 percent of GDP in 2000 to 1.3 percent in 2001 and to overall balance in 2002 and beyond. Compared with earlier plans to reduce the overall deficit to 1.3 percent of GDP only by 2003 (see Box 1 of staff report), this revision is close to the staff's recommendations for 2002-03, although the deficit for 2001 is still substantially larger than recommended in the staff report. While specific measures have yet to be articulated, the authorities' stated intention is to rely primarily on broad expenditure cuts, including reductions in public sector employment and transfers, and to use privatization revenue exclusively for public debt reduction and the financing of one-off expenditure.

4. In July, **the parliament passed the pension reform 2000,** which stipulates the gradual increase in the minimum retirement age by 18 months between October 2000 and end-2002 for both the private and public sectors; a higher penalty for early retirement; the abolition of early retirement due to reduced employability; and the rationalization of survivors' benefits. The reform, which is in line with the authorities' plans discussed with the mission, is expected to generate expenditure savings of ½ percent of GDP by 2003.

5. Agreement was reached by the two managements for the **takeover of Bank Austria** (the largest bank in Austria and a leading bank in Central and Eastern Europe) by Hypovereinsbank (HVB; Germany's second largest bank). This acquisition, which still needs to be ratified by shareholders, is likely to accelerate restructuring and intensify competition in the domestic banking sector.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/58
FOR IMMEDIATE RELEASE
August 8, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Austria

On August 3, 2000, the Executive Board concluded the 2000 Article IV consultation with Austria.[1]

Background

Barely dented by the global slump in late 1998 and early 1999, the Austrian economy has been growing at an annual rate in excess of 3 percent since mid-1999. The vigorous expansion is sustained by both external and internal factors: merchandise exports are benefiting from Austria's close links with the reforming central and eastern European countries and from the recovery in the EU; fiscal stimulus from tax cuts and increased social transfers as well as healthy employment gains are sustaining a rapid expansion in private consumption; and monetary conditions remain expansionary despite the recent increases in official interest rates. Inflation is low: although the increase in oil prices boosted headline consumer price inflation to 1.6 percent in May, underlying inflation remains at around 1 percent. An increase in indirect taxes in June is expected to push prices further up. Benefiting from rapid growth and intensified labor market programs, the unemployment rate has dropped to about 3½ percent of the labor force, the third lowest in the euro area.

Fiscal policy has essentially been on hold, following a major consolidation effort in 1996-97 amounting to some 3 percent of GDP. The primary underlying surplus—the general government balance net of interest payments, cyclical effects, subsidized lending, and one-off measures—was roughly unchanged during 1998-99, and is expected to fall slightly in 2000. At about 53¾ percent of GDP, the expenditure-to-GDP ratio is the highest in the euro area. Last

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

year, public sector debt increased to nearly 65 percent of GDP, reflecting the appreciation of dollar and yen denominated debt.

Experience with deregulation in the telecommunications and electricity sectors has been encouraging: increased competition in these sectors has brought about substantial price reductions and a booming supply of new services. Moreover, greater emphasis on active labor market policies and innovative programs like job coaching and training have been instrumental in reducing unemployment. On the other hand, little progress has been made in reducing red tape, liberalizing access to professions, and rationalizing market regulation.

The new government, sworn in on February 4, 2000, has announced its intention to achieve fiscal balance by 2002, and to accelerate structural reform, including privatization.

The prospects for a sustained expansion are good. Strong external demand and continued economic liberalization should contribute to sustaining economic expansion at a rate of close to 3 percent per annum in 2001-02.

Executive Board Assessment

Executive Directors commended the authorities for the achievement of strong economic growth, subdued inflation, and low unemployment, which had been facilitated by cooperation with the social partners. Fiscal consolidation and structural reforms undertaken since EU membership in 1995 had also contributed importantly. Directors cautioned, however, that, with fiscal consolidation stalled since 1998 and structural reforms still incomplete, Austria's good economic performance could be jeopardized by an unexpected weakening in the external environment. They therefore stressed that the ongoing strong economic expansion offered ideal conditions for the new government to press ahead with the fiscal and structural reforms.

Directors welcomed the authorities' recent decision to accelerate and strengthen their consolidation effort. They viewed the objective of overall fiscal balance by 2002 as an important step in the right direction, and looked forward to the articulation of the authorities' supporting measures in the period ahead.

With strong economic growth and expansionary monetary conditions from an Austrian perspective, Directors judged that cyclical reasons would support a front-loaded approach to fiscal consolidation. They urged the authorities to use revenue windfalls from stronger growth and the sale of mobile phone licenses to accelerate the reduction of the deficit and lower public debt.

In view of the large size of the government sector, Directors recommended that fiscal consolidation be achieved through durable expenditure reduction rather than tax increases or one-off measures. They considered that expenditure cuts would need to be substantial enough to achieve a structural fiscal balance and to create room for measures to reduce nonwage labor costs.

Directors considered that long-term fiscal sustainability would require steps to shore up the pension finances against the consequences of population aging. In this regard, they welcomed the adoption of the 2000 pension reform law which represented a significant step in this direction. Directors noted that more adjustment was needed, however, which should focus on curbing entitlements, as higher contributions would weaken work and employment incentives, as well as external competitiveness.

Directors underscored the importance of a suitable agreement on the reordering of the financial relations between the three levels of government. Such an agreement should establish a better balance between tasks and own financial resources at each level, including the transfer of some power to tax to lower levels of government, and the phasing out of revenue earmarking.

Directors encouraged the authorities and the social partners to build on their past achievements by rapidly agreeing to measures to enhance the functioning of labor and product markets. Among the crucial measures in Directors' views were improvements in the employment conditions for older workers; increased wage flexibility; liberalization of access to the professions and an easing of regulations governing their exercise; adoption of a time-bound one-stop procedure for the approval of investment projects; and establishment of an independent competition agency. Directors also welcomed the authorities' intention to sell the government equity holdings in commercial enterprises. They encouraged the authorities to bring this process to a speedy conclusion.

Directors considered that rising competitive pressures in the financial sector required financial supervisors to remain appropriately vigilant, including with respect to Austrian banks' operations in Central and Eastern Europe and their lending to nonbank residents in non-euro currencies. The planned reform of banking supervision should be used to strengthen its operational independence and effectiveness.

For the purpose of surveillance, Directors viewed Austria's data provision as generally adequate, although the timeliness of some national accounts and external statistics could be improved. Directors encouraged the authorities to lift official development assistance toward the UN target and to use its standing in the EU to promote increased market access for the exports of the least developed countries.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Austria is also available.

Austria: Selected Economic Indicators

	1997	1998	1999	2000 1/	2001 1/
Real economy (change in percent)					
Real GDP	1.2	2.9	2.2	3.5	2.9
Domestic demand	1.0	2.2	1.6	3.0	2.7
CPI (year average)	1.2	0.8	0.5	1.9	2.1
Unemployment rate (in percent) 2/	4.4	4.5	3.7	3.5	3.5
Gross national saving (percent of GDP)	21.8	22.5	21.1	22.2	22.8
Gross domestic investment (percent of GDP)	24.4	24.8	23.9	24.2	24.6
Public finance (percent of GDP)					
Central government balance	-2.7	-2.9	-2.4	-1.8	-1.6
General government balance	-1.9	-2.5	-2.0	-1.7	-1.5
General government debt	63.9	63.5	64.9	63.7	62.7
Money and credit (end of year, percent change)					
Domestic credit	3.6	3.7	5.2	...	...
M3	1.2	6.4	4.7	...	...
Interest rates (in percent) 3/					
Three-month market rate	3.5	3.6	3.0	4.5	...
Government bond yield	5.7	4.7	4.7	5.6	...
Balance of payments (percent of GDP)					
Trade balance	-3.0	-2.6	-2.5	-2.3	-1.6
Current account	-2.5	-2.3	-2.8	-2.0	-1.8
Fund position (as of June 30, 2000)					
Holdings of currency (in percent of quota)			69.4		
Holdings of SDRs (in percent of allocation)			62.8		
Quota (in millions of SDRs)			1,872.3		
Exchange rate					
Exchange rate regime			Participant in euro zone		
Present rate (July 7, 2000)			US $0.9487 per euro		
Nominal effective rate (1990=100) 4/	102.9	103.1	102.0	100.2	...
Real effective rate (1990=100) 4/ 5/	83.5	81.9	79.7	77.0	...

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.

1/ IMF projections.
2/ In percent of labor force based on EU standards.
3/ Data for 2000 refer to July 7, 2000.
4/ Data for 2000 refer to June.
5/ Based on relative normalized unit labor cost in manufacturing.

Statement by Johann Prader, Alternate Executive Director for Austria
August 3, 2000

The authorities agree with the staff's assessment of Austria's economic situation and its growth and inflation prospects. They also agree with the general thrust of the Fund's recommendations, and consider that the staff report accurately reflects the sense of the policy discussions conducted during the mission's visit to Vienna in mid-May.

1. Some Major Changes in Economic Policy

Since the time of the mission, however, there have been significant changes in policies, especially fiscal policy. The government has speeded up the budget consolidation process in order to take advantage of the economy's present strength to put the public budgets on a sustainable path. The federal government's new four-year draft budget was sent to Parliament on July 17. This program revises the coalition's originally agreed deficit of 1.3 percent of GDP for 2003 (the end of the legislative term). The new commitment is that this year's general government deficit of 1.7 percent of GDP will be followed by a 1.3 percent deficit in 2001 and balanced budgets in 2002 and 2003.

Meeting these targets will put Austria solidly back among the mainstream EU countries in the one area--budget consolidation--where it has recently fallen behind. The new targets are consistent with the Fund staff's assessment, which in turn largely agrees with the EU Commission's appraisal of Austria's stability program at the beginning of May.

The government has already taken several steps to ensure that these more ambitious fiscal targets are reached. Measures which the staff paper describes as "planned" have already been approved by Parliament, such as the introduction of strong disincentives to early retirement: beginning in October this year, a gradual increase of 1.5 years in the minimum age for early retirement will begin; the pension reduction for early retirement was increased by 50 percent; early retirement due to reduced ability to work was abolished; and survivor benefits are to be reduced based on total income of the survivor. The harmonization of the differences in pension systems has been stepped up: specifically, the more generous scheme for civil servants will gradually be aligned with the system for the general public.

Since Austria's GDP share of public spending is one of the highest in the EU, the government's budget consolidation goals will primarily be pursued through spending reductions. A major reformation of the government sector will be accompanied by a reduction of the public sector's share in total employment. Over the legislative period, the public payroll will be reduced by 9,000 jobs (and an additional 4,000 in public enterprises). As the staff suggested, this will require reviews of all the tasks the government currently performs, to determine their necessity or utility and discover what level of government can best carry them out. Among other advantages, this should make it possible to identify overlaps whose elimination will make the government more effective and efficient.

The federal government is presently negotiating with the other levels of government about how to realign fiscal relations at the various levels for the next four years. The federal government hopes to persuade states and municipalities that they should also claim "ownership" of the consolidation and engage in efforts of their own in parallel with those of the federal government.

Other major elements of the consolidation program include reducing remaining subsidies, a stronger emphasis on investments in research and development (R&D), improved targeting of social transfers, reducing the interest costs of federal debt by using the proceeds of privatization and license sales for debt reduction; reducing the practice of earmarking for special funds; and making more money available for families, R&D, and innovation; and international benchmarking of market regulation.

The government is determined to bring Austria's budget performance back in line with that of its EU partners. It sees the present favorable economic situation as an opportunity that must not be squandered. Coordinating the consolidation efforts of the federal government, states, municipalities, and social security administration will make it possible to balance the budget by 2002. Budget consolidation and structural reform are the most important elements in the effort to prepare Austria's economy for the challenges of globalization and the New Economy. Austria's past performances have been among the most outstanding in Europe. Recent obstacles to change have been overcome by the present government. The newly agreed consolidation path is evidence of the government's willingness to accept the necessary changes and take the appropriate measures.

The government is likewise determined to accelerate the restructuring of the product and factor markets, so that the present favorable external environment can translate into sustainable high employment growth. The reformation of financial market supervision is a case in point. Faster, more comprehensive privatization and deregulation are major objectives for the new government. Privatization is being undertaken for its structural rather than its budgetary advantages. The goal is to better prepare the Austrian economy to meet the demands of globalization. Social consensus and cooperation with the social partners are still important, but must now defer to the need for speed in adapting to changes in the world economy.

2. A Positive Role for the IMF

The IMF's advice has played an important role in this consolidation effort. The Austrian authorities have sought special advice from the Fund concerning intergovernmental fiscal relations and pension reform. The aim is to make these issues transparent and promote their public discussion, and in this way preserve the momentum of fiscal and social reform. The Austrian authorities are confident that the broad international experience of the Fund staff will make valuable contributions to the restructuring of Austria's economy. I wish to convey my authorities' thanks for the IMF's swift response to Austria's request.