July 2005
IMF Country Report No. 05/248

Austria: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Austria

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005Article IV consultation with Austria, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 2, 2005, 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 June 28, 2005. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 20, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Austria.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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AUSTRIA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Austria

Approved by Michael Deppler and Martin Fetherston

June 28, 2005

Consultation discussions were held in Vienna during April 21–May 2, 2005. The mission comprised Messrs. Hilbers (head), Tzanninis, Lundback, and Epstein (all EUR). Mr. Prader, Alternate Executive Director for Austria, attended the meetings. The mission met the Ministers of Finance and Social Security, Generations and Consumer Protection; the Governor of the Austrian National Bank (OeNB); the Chief Executive Officers of the Financial Market Authority (FMA); the chairman and members of the parliamentary budget committee; senior officials of the federal government, the OeNB, and the FMA; and representatives of the private sector, economic research institutes, employers' organizations, and the federation of trade unions.

The authorities released the mission's concluding statement and intend to publish this report.

Since 2000, the government has been supported by a coalition between the People's Party and the Freedom Party. In April 2005, a majority of the members of Parliament of the Freedom Party created a new party—the Alliance for the Future of Austria—while continuing their support for the government. The next parliamentary elections are scheduled to take place by November 2006.

Austria has accepted the obligations of Article VIII (Appendix I) and subscribes to the Special Data Dissemination Standard, and data provision is adequate for surveillance (Appendix II). Data in this report reflect information received by June 15, 2005. 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.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

Austria's economy continues to perform relatively well. Growth of real GDP accelerated to 2.2 percent in 2004 supported by strong exports, inflation remains fairly low, and the unemployment rate, while high by Austrian standards, is one of the lowest in the EU. Moreover, company profitability increased and stock prices went up sharply. Much of this favorable performance can be traced to sound economic policies, the diversification of the Austrian economy into the Central and Eastern European countries (CEECs), and a social partnership that has delivered wage moderation, thereby maintaining a strong competitiveness position.

Key issues

- **Short-term outlook**. Staff expects economic growth to slow down to 1.9 percent in 2005 and to reach 2.2 percent in 2006, and inflation to remain low and stable over this period. There are uncertainties related to the behavior of consumption and external developments, and downside risks to this outlook warrant close monitoring.

- **Fiscal policy**. There will be a widening of the deficit in 2005–06 resulting from tax reform preceding compensating expenditure measures. This does not raise sustainability concerns, as long as it is limited and temporary. There is broad political support in Austria for the government's objective to balance the budget over the cycle, but unless the authorities identify the areas where further expenditure savings can be implemented and proceed expeditiously to mobilize the necessary consensus, the feasibility of returning to budget balance in 2008 will be compromised.

- **Structural policies**. Progress in this area has been impressive in recent years, but there is no room for complacency. Additional tasks remain, including with regard to the further liberalization of labor, product, and services markets. Pension reform is well under way, and next steps will be to also include the regional governments in the harmonization effort and to ensure proper use of the disability pension system.

- **Financial sector issues**. Follow-up to last year's FSAP has been satisfactory and the financial sector had a good year, but the authorities need to remain vigilant, including with regard to foreign exchange lending and the banks' rapidly expanding activities abroad.

I. Introduction

1. **A policy shift since 2000 has oriented Austria's economic policies toward fiscal consolidation and liberalization.** The coalition government in power since 2000 set the objectives to balance the budget over the cycle, reduce the tax burden to 40 percent of GDP by 2010, contain fiscal pressures from population aging, and increase Austria's growth potential. Concrete steps so far include a small fiscal surplus in 2001 and a marked reduction in the size of government during 2000–04; a major pension reform in 2003 and harmonization of the main pension systems effective 2005; privatization and deregulation in product and labor markets over the past five years; and tax reform in 2004–05. These steps and the underlying objectives have been supported by the Fund (Box 1).

Box 1. Key Fund Policy Recommendations and Implementation

During Article IV consultations in recent years, the Executive Board commended the authorities for their success in balancing the budget, reducing taxes, containing public spending and launching an effective structural reform process.[1] Overall, policy implementation has been consistent with Fund policy advice.

Fiscal policy. Directors endorsed the authorities' medium-term macroeconomic policy objectives of sustaining a balanced budget over the cycle, further reducing the tax burden, and pursuing structural reforms to increase Austria's growth potential. During the 2004 consultation, a number of Directors encouraged the authorities to strive to bring the deficit in 2005–06 as close as possible to the target of a cyclically adjusted balance. The authorities noted that temporarily higher deficits result from expenditure measures lagging tax measures, and that they plan a return to a balanced budget in 2008.

Financial system. The FSAP found the financial system to be generally sound, well supervised, and resilient to shocks. The authorities were advised to maintain their proactive approach to supervision with a view to enabling and supporting further restructuring and consolidation in the financial sector, and in particular to closely monitor risk exposures of Austrian banks in Central and Eastern Europe. Supervision has been strengthened further in the meantime, and developments in CEECs are closely monitored, including through collaboration with local supervisors.

Structural policies. Directors praised the authorities for their achievements on the structural front and encouraged them to follow through with their reform agenda. Top priority was to be given to the harmonization of the public and private pension schemes, which came about to a large extent earlier this year. Further harmonization to also include civil servants at the regional and local levels in the system has proven more difficult. In other areas, including disability pensions, deregulation, the liberalization of services, and privatization there has been significant progress as well, although further work is needed toward the full implementation of the recommendations.

[1] See 2004 Public Information Notice at http://www.imf.org/external/np/sec/pn/2004/pn0481.htm.

2. **There are reasons to be relatively optimistic about the Austrian economy.** The recovery took firm hold in 2004 and although some slowdown in growth is expected in 2005, Austria has not seen signs of weaknesses recently witnessed by some other EU countries. Growth averaged 1¾ percent during 2000–04, comparable to the euro zone average, and inflation and unemployment rates compared favorably (Table 1; Figure 1). Competitiveness has remained strong, with Austrian exports gaining market shares in recent years, and several economic reforms have already been implemented. As a result, Austrians enjoy high standards of living, ranking fourth in the EU and twelfth in the world in terms of per capita GDP. The key challenges

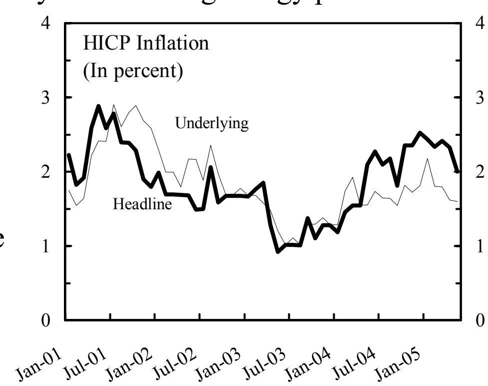
facing the Austrian authorities are to adhere to the agreed path of fiscal consolidation while avoiding potential reform fatigue.

II. Recent Developments

3. **Economic activity gathered speed in 2004, supported mostly by strong export performance.** Growth of real GDP rose to 2.2 percent in 2004 from 0.8 percent in 2003 (Figure 2). Consumption growth was modest, in view of small gains in employment and nominal wage growth barely matching inflation. Investment demand continued to expand, benefiting from the improved prospects for exports and the extension of tax incentives through end-2004. The export boom that began in early 2004 (exports of goods surged over 12 percent in real terms in 2004) lost some momentum in the last quarter of the year, but still made a considerable contribution to growth. Consequently, the output gap has begun to narrow.

4. **Austria's competitiveness remained strong, despite the appreciated euro.** Nominal wage increases averaged 2 percent, while industrial productivity rose 5½ percent in 2004. As a result, relative unit labor costs declined and Austria's REER rose only modestly during the past 12 months (1½ percent in ULC terms). Austria enjoys a large competitiveness advantage built since the 1990s on the back of sustained wage moderation. In addition, the successful expansion of Austrian business into the CEECs—and recently into Southeastern Europe and EU-15—has boosted demand for Austrian exports. Export market shares showed strong gains in past years, although recently there has been a decline with regard to EU trading partners (Figure 3).

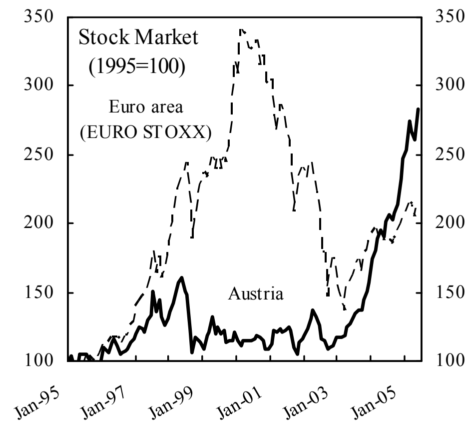
5. **Inflation was contained and unemployment continued to be among the lowest in the euro zone.** Harmonized inflation accelerated during the course of 2004 to 2.0 percent (period average), and the 12-month inflation was 2.0 percent in May 2005. Rising energy prices and hikes in energy taxes, as well as increases in rents, were the main contributing factors. Underlying inflation has risen at a more tempered pace, reflecting one-off government measures as well as rising housing-related costs. Improved prospects for the economy helped employment stage a recovery in 2004. Moreover, vacancies have been rising, signaling a turnaround in the labor market. Nevertheless, the unemployment rate has remained stable at about 4½ percent for over a year (a record high for Austria), reflecting growing labor supply due to immigration and an increase in participation by older cohorts.



6. **The fiscal policy stance became more accommodative in 2004**. Concerned about a faltering recovery, the authorities took discretionary fiscal measures after the passage of the 2004 budget, namely a fiscal package announced in late 2003 with measures aimed primarily at supporting R&D and investment, and the front-loading in 2004 of some of the tax measures initially planned for 2005. In the event, the budgetary cost of these measures was larger than planned. Against an initial budget deficit target of 0.7 percent of GDP, the additional measures—plus higher spending on pensions of civil servants due to a surge of early retirements in view of pension reform—contributed to a widening of the general government deficit to 1.2 percent of

GDP in 2004 and a fiscal impulse of nearly ½ percent of GDP (Table 2). Monetary conditions have remained accommodative throughout this period with real interest rate declines compensating for the impact of real appreciation.

7. **Financial conditions improved during 2004.** Company profitability rebounded, and the Vienna stock exchange—which had escaped the dotcom boom and bust—staged an impressive rally in 2004 (up more than 50 percent for the year), fueled in part by the growing interest in Austrian firms' operations in the CEECs. Companies took advantage of the rally by issuing equity to cover most of their external financing needs in 2004. In addition, they benefited from the downward trend in real interest rates.



III. Report on the Discussions

8. **Discussions focused on the short-term outlook and the government's policy objectives, with a particular emphasis on fiscal, structural, and financial sector policies.** With the budgets for 2005 and 2006 adopted by the parliament in November 2004 and April 2005 respectively, a key discussion issue in the fiscal area was the tension between the pursuit of further tax reform and the government's commitment to a balanced budget over the cycle. In the structural field, although the major part of the government's reform agenda has been accomplished, there are significant unfinished tasks. In addition, discussions covered the financial sector, based on the findings and recommendations of the 2004 FSAP.

A. Short-Term Outlook

9. **Growth is expected to weaken somewhat in 2005–06.** Staff projects growth to average 1.9 percent in 2005 and 2.2 percent in 2006 (Table 3). This envisages a gradual shift in the sources of growth from external to domestic demand. A strong competitiveness position, coupled with robust underlying growth in productivity, and the fiscal stimulus to personal incomes and investment provided by the measures in the 2005–06 budgets will provide ongoing support to economic activity. Specifically:

- **Private consumption** is expected to strengthen, supported by further employment gains.
- **Investment** growth is expected to remain robust, helped by good prospects for exports, increased corporate earnings and favorable financing conditions, and capacity utilization that currently exceeds long-run averages.
- **Export growth** is expected to slow due to a softening of external demand. With **imports** growing strongly on the back of strengthening domestic demand, the external sector is expected to make virtually no contribution to growth in 2005–06.

10. **The authorities and mission agreed that downside risks to the short-term outlook warrant close monitoring.** Domestic demand has yet to take off decisively in this recovery, and the baseline outlook hinges on a rebound in private consumption. Indeed, while various indicators have been improving, consumer confidence continues to lag (Figure 4). Uncertainty associated with the pension reforms has contributed to higher savings rates, which could keep a lid on faster consumption growth in the near term. Additionally, the authorities noted that Austria is not isolated from the recent deceleration in output growth seen globally. They pointed out that downside risks primarily include concerns about the strength of activity in the euro area—particularly Germany, which remains an issue not just directly for Austria but through its effects on activity in Europe in general. Finally, higher oil prices[1] and a large, disorderly appreciation of the euro could weaken the prospects for exports and discourage investment.

11. **Consumer price inflation is expected to average 2 percent in 2005.** Inflation persisted at about 2¼ percent in early 2005 and the staff expects it to moderate somewhat toward the end of the year as the base effect of higher oil prices and government measures dissipates. Two factors support this outlook: the still considerable slack in the labor market; and wage settlements in 2004 (governing wage growth in 2005) that suggest moderate wage developments ahead. There are no signs yet of second-round inflation effects from higher oil prices, and the risk of higher oil prices feeding into wage increases is low. The authorities noted that the recent rise in inflation was caused inter alia by last year's increase in rents, the impact of which can be expected to run out by this summer.

12. **Austria's economic outlook is affected by its changing international economic and financial relationships.** The mission discussed the implications of the growing economic and financial links between Austria and the CEECs and Southeastern Europe. These links have helped diversify the economy and, recently, cushion it from relatively less favorable developments in Western Europe in general, and Germany in particular (Box 2).

B. Fiscal Policy

13. **The fiscal deficit will widen in 2005–06 because of tax reform, but there was agreement that this does not threaten macroeconomic stability if it is temporary.** The widening of the deficit by an average of 0.7 percentage point of GDP in nominal terms during these years—the worsening is about 1 percent of GDP in structural terms—is the result of a reduction in the tax burden by more than 1 percentage point of GDP on average per year that is largely but not fully offset by expenditure cuts (Table 2). Staff would have preferred more ambitious deficit targets in 2005–06, but recognized that expenditure cuts require broad consensus, including in the Austrian case among key subnational authorities, and thus take longer to design and implement.

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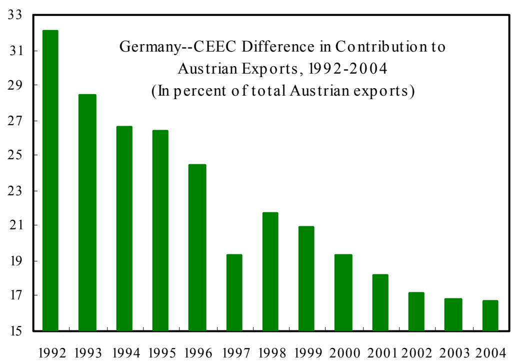
[1] To date, the overall impact of rising oil prices appears moderate, explained by the relatively low oil intensity of production and consumption in Austria.

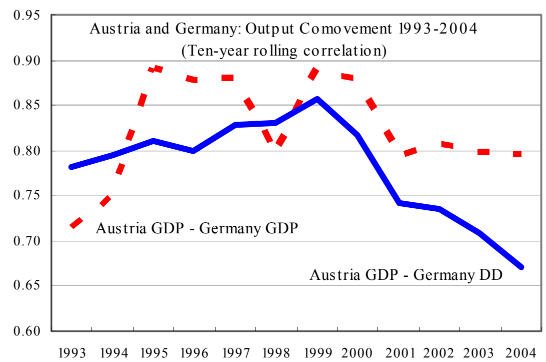
Box 2. Austrian Growth and the Linkages to Germany and the CEECs

Austria has benefited for many years from access to diverse markets among mature European economies. In particular, Austria's strong economic ties to Germany have helped sustain a relatively stable growth path and provide a buffer against external shocks. There are signs, however, that the economy is diversifying away from Germany, and toward the faster growth economies of CEECs.[1]

Two key findings from an accompanied selected issues paper on this subject:

- Germany remains Austria's largest trading partner, but its relative importance for Austrian exports has weakened. In 1992, Germany accounted for 40 percent of Austria's exports; CEECs contributed 8 percent. By 2004 Germany's share dropped to 32 percent, while CEECs' share doubled to 16 percent.
- German and Austrian business cycles are no longer as synchronized as they once were, particularly with respect to the correlation between Austria's real GDP and German domestic demand growth rates.





[1] The group of CEECs included here are: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia, representing the bulk of Austria's trade and investment links with the region.

14. **The mission reiterated its support for the government's objectives to balance the budget over the cycle and lower the tax burden further.** Consistent with this, the latest Stability Program has set out an ambitious consolidation goal for 2007–08, aiming for an adjustment of about 1¾ percent of GDP in both nominal and structural terms. Further modest tax cuts are envisaged for 2007–08 that would allow the government to meet its target of a 40 percent of GDP tax burden as early as 2008, two years ahead of schedule. The mission welcomed the broad political acceptance of the policy of a balanced budget over the cycle. It noted that, while the fiscal policy priorities within a balanced-budget objective may differ across the political spectrum, the general recognition that such a policy is good for Austria is commendable.

Austrian Stability Program: General Government Accounts 1/

	2004	2005	2006	2007	2008
	(In percent of GDP)				
Receipts	48.7	47.5	46.2	46.0	45.8
of which: tax burden	*42.7*	*41.6*	*40.5*	*40.3*	*40.0*
Expenditures	50.0	49.5	48.0	46.7	45.8
Overall fiscal balance, EDP definition 2/	-1.3	-1.9	-1.7	-0.8	0.0
General government debt ratio	64.2	63.6	63.1	61.6	59.1

1/ Official projections, November 2004. These may differ from Table 2, which incorporates the latest estimate for 2004 as well as the 2005-06 budgets.
2/ Maastricht Excessive Deficit Procedure (EDP) definition, which differs from ESA95.

15. **The mission noted, however, that the policies to achieve these objectives in 2007–08 are not well defined.** The identified areas at the federal government level—chiefly further reform of public administration—are insufficient to deliver the required expenditure savings. As for the subnational governments, the initiatives under way aimed at generating sustainable savings—notably reform of public administration and the health sector—are expected to help them achieve the agreed targets of the Austrian Stability Pact, but not contribute to a further improvement of the general government balance.

16. **Unless the government identifies the areas where expenditure savings can be implemented and proceeds expeditiously to mobilize the necessary consensus, the prospects for returning to budget balance in 2008 will diminish.** In view of the 2006 elections, it is conceivable that the budget for 2007 will become law only within calendar-year 2007, which will make it difficult to achieve the ambitious general government deficit target for that year set out in the Stability Program. Designing expenditure measures that are both durable and target the least productive areas of government spending is therefore an urgent priority, and further tax cuts should be conditional upon the identification of such measures. The authorities, however, were not in a position to outline concrete expenditure measures at this stage, noting the upcoming elections in 2006.

17. **Limited progress has been made in redressing federal-provincial fiscal relations and increasing the contribution of subnational governments to the fiscal reform effort.** The mission noted that the new revenue-sharing arrangement between federal and local governments (*Finanzausgleich)* and the Austria Convention (*Oesterreich-Konvent)* had the potential to increase efficiency, streamline the functions of various levels of government, generate savings, and improve the incentive structure by realigning spending responsibilities and revenue-raising powers (Box 3). However, neither seized the opportunity to address the efficiency of subnational governments. The mission expressed the hope that the required broad political consensus will emerge to provide impetus to what seems to be a stalled constitutional reform process, as Austria needs a modern, efficient framework guiding relations between the various layers of government.

18. **The mission emphasized that there is considerable scope for rationalizing expenditures in a number of areas.** This includes the size of public administration, especially at the subnational level. The *Finanzausgleich* included measures in the health sector, but there is still room for savings. The authorities underscored the importance of keeping the health system accessible to all. They agreed, however, that it possible to improve the efficiency of the health sector through rationalization of services—including through cooperation of subnational governments—without materially affecting the quality of services. In addition, staff recommended that the authorities reexamine the size and role of subsidies. The housing subsidy amounting to about 1 percent of GDP is particularly costly and not well targeted. Staff reiterated that, moreover, more frequent means-testing of social transfers would be desirable.

Box 3. The Intergovernmental Fiscal System in Austria

There are three key levels of government in Austria: federal, provincial, and municipal. Government finances are characterized by intergovernmental coordination and dispute-settling mechanisms. The framework for expenditure responsibilities and taxing powers is laid out in the constitution. As in most federations, the bulk of tax revenues is collected at the federal level while spending is more decentralized. Consequently, vertical equalization transfers take place. There is concentration of decision-making at the federal level, with subnational governments being largely responsible for the administration of programs.

The framework for coordinating public finances between the three levels of government comprises the:

- **Revenue-sharing agreement (*Finanzausgleich*)**. Given the need for equalization transfers, a formal coordination and agreement is necessary to ensure financing of all subnational governments. Federal revenues are distributed among subnational governments based mainly on the size of their population, with some adjustments made in favor of larger municipalities and provinces with per capita revenue below the national average. The agreement becomes federal law, the Fiscal Equalization Law (*Finanzausgleichgesetz*). A new *Finanzausgleich* covering 2005–08 was agreed in late 2004.

- **Austrian Stability Pact**. In line with the EMU Stability and Growth Pact, Austria established an internal pact that allocates to subnational governments a budget-surplus target. The pact (which becomes law after ratification by the federal and provincial parliaments) envisages the application of sanctions for fiscal underperformance. In the latest Austrian Stability Pact for 2005–08, subnational governments agreed to raise their aggregate fiscal surplus from ½ percent of GDP in 2005 to ¾ percent of GDP by 2008, the level set in the previous *Finanzausgleich*.

Intergovernmental coordination is a strength of the system. However, there is scope to provide better incentives for efficient fiscal management. Rationalizing intergovernmental fiscal relations would require steps that realign spending and financing responsibility, strengthen accountability, streamline the functions of various levels of government, and generate savings. The *Austria Convention* (set up by the federal parliament to submit a proposal for reform of the constitution) had the potential to revamp intergovernmental fiscal relations. However, it appears that the fiscal aspects of the proposed constitutional changes are not much different from the current system.

19. **The mission was encouraged by the progress made in designing a medium-term expenditure framework.** Early legislative approval will be important to enable the framework to become operational by 2007. The authorities emphasized that this framework will help improve the transparency and operation of fiscal policy, strengthen the budgetary process, and achieve medium-term fiscal goals (Box 4).

Box 4. Medium-Term Expenditure Framework

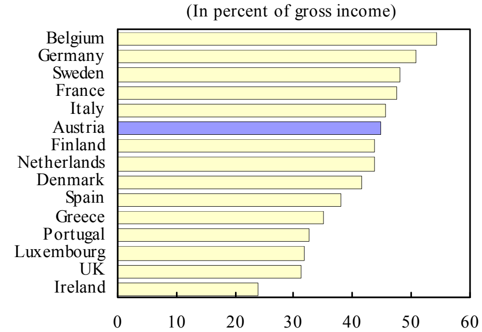
The Ministry of Finance is preparing a comprehensive reform of the federal government fiscal budgeting and accounting system, which has three main components: (i) the introduction of a Medium-Term Expenditure Framework (MTEF); (ii) more target-based budgeting; and (iii) improved accounting and information systems.

There appears to be broad basic political support for an MTEF and the intention is to have a law passed so that it can take effect in 2007. The MTEF would include the following elements:

- The MTEF would cover four years, to be revised and updated annually on a rolling basis with binding expenditure ceilings.
- Ceilings on cyclical expenditures would be guided by the prevailing economic conditions, and ceilings on other expenditures would be set in nominal terms.
- The MTEF is intended to be an instrument for setting strategic expenditure priorities and expenditure ceilings would be broken down by broad categories. Subsequently, the expenditures on broad categories would be allocated among ministries, being binding only for the next annual budget.
- The MTEF would only cover the federal government, although budgetary targets for provinces and municipalities are set in the Austrian Stability Pact.

20. **The authorities emphasized that the tax reform agenda is not yet completed.** The mission agreed and noted that recent measures have mainly targeted taxes on profits and capital. These measures will enable Austria to attract business as well as boost employment, investment, and growth in the medium term and beyond. However, little has been done to reduce the burden on labor, which remains high by international standards. Moreover, tax allowances and preferential tax treatments run counter to the need to widen the tax base. The mission noted that tax reform should aim not only at lowering the tax burden, but also at simplifying the system, increasing its transparency, and minimizing distortions, and was pleased to see that these are areas the authorities consider addressing in future tax reforms. It emphasized that further tax cuts should coincide with corresponding expenditure measures.

Tax Wedge, 2004 1/
(In percent of gross income)



Source: OECD.
1/ All taxes on labor (single workers earning the average income of a production worker), including employers' social security contributions.

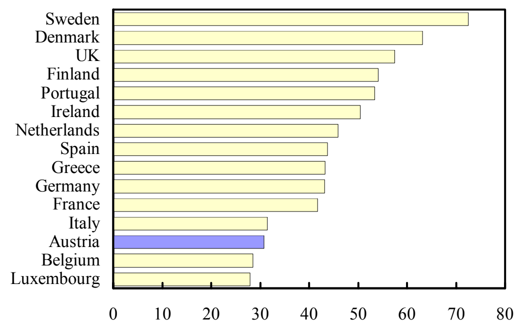
C. Structural Policies

21. **The authorities saw additional structural reforms as key to a further strengthening of growth and reduction in unemployment.** The mission agreed that, although progress had been impressive, further liberalization and deregulation of labor, product and services markets as well as an enhanced focus on education will contribute to raising the underlying growth potential

of the economy. It also noted that these reforms would need to be mutually reinforcing to maximize the impact on growth, which in any event would take some time to materialize.

22. **Key tasks remain in a number of areas.** The Austrian labor market is relatively flexible, but labor force participation of older workers remains among the lowest in the EU. Pension reform is expected to help raise participation rates, but the government needs to do more in the area of labor market policy to facilitate the integration of older workers. The deregulation of product markets is well advanced, but services (including free professions) remain heavily regulated. More flexible shop-opening hours have been legislated, but the authorities noted that implementation by provinces has stalled. The authorities welcomed discussions among social partners to institute more flexible work hours, which could lead to lower overtime costs. The authorities were advised to continue cutting red tape further, strengthening the role of the Federal Competition Authority, and to proceed with their remaining privatization plans, taking advantage of the favorable conditions in equity markets. The authorities emphasized the importance of bringing public and private R&D spending to internationally agreed levels in order to strengthen the growth potential of the economy.

Labor Force Participation Rates for Ages 55-64, 2003 1/
(In percent)



Source: OECD.
1/ Data for France and Luxembourg are for 2002.

23. **The recent harmonization of pension schemes has been a major step in reducing inequities (Box 5).** In addition, the harmonization will generate savings in the long run, and will help labor mobility by facilitating transferability of pension claims. This, as well as the 2003 pension reform, is a major accomplishment, which has significantly improved long-term fiscal sustainability by ensuring substantial reductions in projected pension expenditures (Appendix III). Even though population aging will put pressure on the pension system and drive up costs for health and other care, the reforms have helped Austria be better prepared than many other advanced economies to face the demographic challenges of the future. However, staff noted that the lowering of the cap on pension benefit losses surrenders some of the long-term savings achieved with the 2003 reform. The authorities pointed to equity considerations—those retiring now should not be treated much differently than earlier retirees—and also noted that the fiscal loss is limited to a period during which the pension system is not expected to face large demographic pressures.

24. **The mission argued that the next order of business on the pension front should include the completion of the harmonization and safeguards for the proper use of disability pension schemes.** The authorities noted that pensions of most civil servants at the subnational level remain outside the unified pension system, and agreed to the need to include them in the new framework. Further harmonization would be an issue of equity, while it would also generate additional savings. Its achievement will require the provinces and municipalities to work toward a solution that would bring these groups within the unified system. Despite the ongoing rationalization of disability pensions, the number of new claimants remains high, and it will be

important for the government to continue its efforts to ensure that access is restricted only to those who need these pensions.

Box 5. Pension Harmonization

Effective January 1, 2005, most groups of workers were included in a unified pension system, with equal contributions and benefits guided by the provisions of the general social security law (ASVG) as amended in 2003 (see IMF Country Report No. 03/372, Annex).

- Harmonization applies to those currently **50 years or younger**.
- The unified system is guided by the same **fundamental principles** that guide the ASVG, notably: (i) 45 years of contributions; (ii) a gradual rise in the retirement age to 65 by 2017; and (iii) benefits amounting to 80 percent of lifetime earnings.
- **Special provisions** apply. A lower age (60 years) of retirement applies to persons doing hard physical labor. Contribution rates for farmers and the self-employed will be lower, with the federal government covering the difference.
- **Pension increases** will be based on changes in the cost of living.
- The 10 percent **cap on benefit losses** under the reform of the ASVG in 2003 has been reduced to 5 percent, to rise by 0.25 percentage point annually until it reaches 10 percent in 2024.

D. Financial Sector Issues

25. **Following a favorable assessment by the Financial Sector Assessment Program (FSAP) last year, the performance of the financial system has strengthened further (Table 4).** The financial system continues to be generally sound and resilient to potential adverse shocks. The private sector pointed to the continued low margins in banking in Austria, which creates incentives for the banks to expand abroad. Capital ratios are adequate and bank profitability has improved owing largely to rapidly expanding activities in the CEECs. Moreover, cost-cutting efforts on the domestic front have continued, albeit slowly. The staff co mended the authorities for taking measures in the areas identified by the FSAP, including with regard to supervision and regulation (expanded on-site inspections, additional supervisory guidelines and minimum standards), insurance (improved stress testing) and AML/CFT (new guidelines), and encouraged them to make further progress. The authorities expressed interest in an FSAP update, preferably in 2007.

Austria: Banking Sector Soundness and Profitability, 2000-04

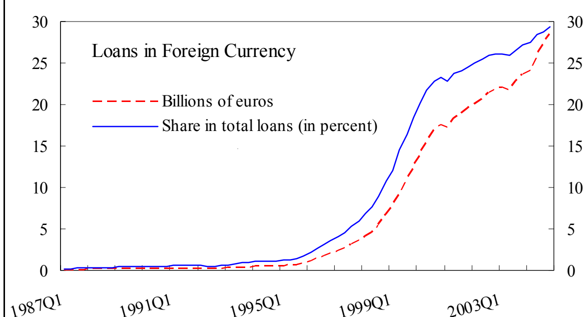
	2000	2001	2002	2003	2004
Net interest income (in percent of total assets)	1.2	1.2	1.2	1.2	1.1
Operating profit (before tax, in percent of total assets)	0.8	0.8	0.7	0.7	0.7
Cost/income ratio (in percent)	66.6	67.4	69.3	68.2	67.2
Loan-loss provisions (in percent of bank claims)	2.9	3.1	3.3	3.3	3.3
Capital adequacy ratio (in percent)	13.3	13.7	13.3	14.5	14.7
Return on equity (in percent)	9.4	9.8	5.4	6.3	9.3
Total assets (billions of euros)	562.7	587.7	573.3	605.1	652.8

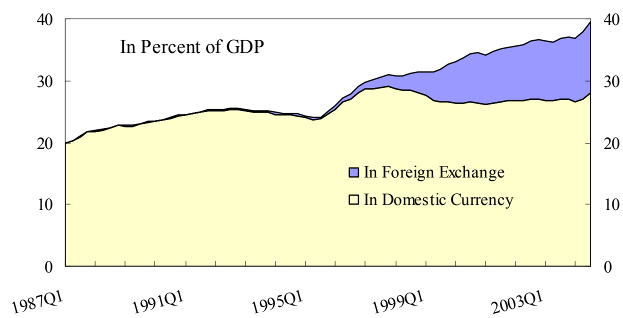
Source: OeNB.

26. **The continuing growth of foreign currency loans to households remains an area of concern in the financial system.** These loans—mainly in Swiss francs—are a source of vulnerability, both for the borrowers as well as, more indirectly, the lenders (Box 6). The authorities agreed, but emphasized the limited legal and regulatory opportunities that are open to them to intervene. The staff supported the public information campaign launched by the OeNB as well as the measures the FMA has taken to improve risk management of banks. It urged the authorities to continue informing consumers about the risks involved, address consumer protection aspects, and monitor developments very closely.

Box 6. What Explains the Surge of Foreign Currency Loans to Austrian Households?

Foreign currency loans to Austrian households entered a phase of explosive growth around 1995. Even though their growth has moderated since 2001, foreign currency loans still account for about half the growth of total credit to households. By end-March 2005, about 30 percent of outstanding loans to households were in foreign currency. The spread of these loans reflects currency substitution and has not led to a lending boom. Nearly all these loans are in Swiss francs and, to a lesser extent, Japanese yen. The popularity of foreign currency loans among households is a uniquely Austrian phenomenon in the euro zone, which has raised questions about the driving forces and heightened concerns about risks.





A staff study circulated as a selected issues paper, suggests the following:

- The rapid spread of foreign currency loans among Austrian households cannot be fully explained by economic determinants and seems to reflect elements of herd behavior.
- Supply factors have also played a role in the growth of foreign currency loans. Banks have been promoting these loans, including because of their potential to raise fee income.
- Foreign currency loans expose parties involved to a host of risks. Key risks include exchange and interest rate risk for the borrowers and, as a result, potential credit risk for the lenders.
- Policy measures addressing the demand and supply of these loans have so far not had a significant impact on either the levels or growth rates of these loans.

27. **Supervision is being strengthened further and adapted to the changes in financial markets.** Recent developments in asset markets are being monitored closely, and the staff encouraged the financial sector authorities to remain vigilant. The expansion in the CEECs, while beneficial overall, has brought new risks, including with regard to lending in foreign exchange. The FMA has developed further its strategy to improve the supervision of Austrian financial

institutions in the region. Furthermore, EU enlargement has enhanced cooperation of supervisors with the new member states. Amendments of the Banking Act and the Financial Market Authority Act adopted recently by parliament clarified that the state, not the supervisors, could be held liable for the performance of the supervisors' duties, but no state liability would arise from the activities of external auditors unless they performed examinations following a specific request by the FMA. However, the supervisors felt the amendments had not gone far enough to address their concerns; they would have preferred the amendments regarding the external auditors to have been enacted as constitutional law and the potential liability of supervisors in the performance of their supervisory duties to have been limited further.

IV. Staff Appraisal

28. **Austria's economy is performing relatively well, reflecting continued structural reforms and sound macroeconomic policies.** Growth of real GDP has gathered speed in 2004 on the back of strong exports, inflation has been moderate, and unemployment—although high by Austrian standards—has been one of the lowest in the EU. Productivity has outpaced wage growth and, as a result, relative unit labor costs have declined. Company profitability rebounded and the Vienna stock exchange staged an impressive rally. Much of this favorable performance can be traced to balanced economic policies and a social partnership that has delivered wage moderation, thereby maintaining a strong competitiveness position.

29. **In particular, a strong track record of policy implementation has placed Austria ahead of its peers.** A policy shift since 2000 has oriented Austria's economic policies toward fiscal consolidation and liberalization. The main objectives have been to balance the budget over the cycle, reduce the tax burden, and increase Austria's growth potential. Notable achievements so far include a marked reduction in the size of government; major pension reform and harmonization of the main pension systems; privatization and deregulation in product and labor markets; and tax reform in 2004–05.

30. **Austria has also profited from its sustained focus on the East.** It is likely among the EU-15 countries that have benefited most from the transition in Eastern Europe and the subsequent entry into the EU of 10 new member states. Austria's early focus on building economic and financial relationships with CEECs, including through the banking, the industry, and the transport sectors, is now bearing fruit; it has increased its exposure to a relatively fast-growing area in Europe, while it has reduced its dependence on traditional trade partners, in particular Germany. This diversification of the economy is likely to have positive effects for both growth and macro stability in the period ahead.

31. **The short-term growth outlook is relatively favorable, although the pace of expansion is likely to be more gradual.** Robust underlying growth in productivity and the fiscal stimulus in the 2005–06 budgets will provide ongoing support to economic activity. However, domestic demand has yet to take off decisively. In addition, higher oil prices and concerns about the strength of activity in the euro area—despite an increasing orientation toward Central and Eastern Europe—could weigh on short-term prospects.

32. **Following a strong implementation record over the past five years, the credibility and success of Austria's fiscal policies now face a critical test.** In past years, the authorities

have been successful in reducing the size of government while maintaining limited deficits. Lately, the focus has shifted to tax reform. Reducing the tax burden is appropriate as it will increase Austria's attractiveness as a business location. However, as a result, larger deficits will emerge in 2005–06. The objective is to erase these deficits by 2008 as spending cuts required to return to a budget balance are to come on stream gradually. The credibility of this strategy hinges on identifying the necessary expenditure reductions. Unless the government succeeds in reversing the widening of the deficit as planned, plans for further tax reform would not be feasible.

33. **In this context, the accommodative fiscal program for 2005–06 should, in the current cyclical conditions, be seen as the maximum acceptable.** The widening of the deficit resulting from tax reforms in 2005–06 does not raise sustainability concerns as long as it is limited and temporary. It will be essential for the authorities to resist any temptation to spend unanticipated windfalls—especially if the economy turns out to be stronger than anticipated—or to introduce additional spending packages.

34. **Looking further forward, there is a need to design and set in motion now the expenditure cuts that would enable the next government to return to a budget balance by 2008.** The medium-term objective to balance the budget over the cycle is appropriate, but policies to achieve this are so far not well defined. Unless the government identifies the areas where expenditure savings can be implemented and proceeds expeditiously to mobilize the necessary consensus, the feasibility of reaching the budget targets in 2007–08 will be compromised. In this connection, there is scope for rationalizing public administration—especially at the subnational level—the health sector, and various subsidies. Progress made in designing a medium-term expenditure framework is therefore welcome, and it will be important for the framework to become operational by 2007 and contribute to meeting the fiscal objectives. The failure to agree on substantial changes in the federal-provincial relations, however, was a setback to fiscal reform and it is hoped that the necessary political consensus is reached to modernize this relationship in the future.

35. **The pace of structural reforms in Austria has been impressive, including in comparison to its European peers, but there is no room for complacency.** The government should maintain the momentum and take advantage of the current conditions to complete the outstanding reform agenda in order to tap the dynamism of the private sector and help unleash the full growth potential of the Austrian economy. This includes further measures to deregulate the services market, liberalization of shop-opening hours by local governments, and a more flexible work hours regime. In this connection, the government's emphasis on public and private R&D spending in the context of the Lisbon Agenda is well placed.

36. **Due to substantial pension reform in recent years, Austria is relatively well prepared to face demographic challenges.** Pension reform and harmonization have been major steps in reducing inequities and achieving fiscal savings, although the recent lowering of the cap on pension benefit losses surrenders some of the gains. Follow-up measures should include bringing the pensions of civil servants at the subnational level under the unified pension system, and close monitoring of the disability scheme to ensure that access is restricted to those who qualify for this pension and that the system is not used as a safety valve for pension reform as has happened in some other countries.

37. **2004 was a good year for Austria's financial sector, but developments in financial markets in Austria and abroad require close monitoring.** The authorities implemented a variety of measures recommended during last year's FSAP exercise. However, there remains an imbalance between developments in Austria's home market, where margins are tight and further consolidation can be expected, and the abundant growth abroad, in particular in the CEECs. At home, the continuing growth of foreign currency loans to households remains an area of concern, and all relevant authorities should continue informing the public about the risks involved, including in the context of consumer protection. Abroad, the supervisory authorities should remain vigilant with regard to risks associated with the rapidly expanding activities of Austrian financial institutions in Eastern and, more recently, Southeastern Europe. This includes, but is not limited to, the rapid growth of lending to the private sector, including in foreign currency. Close cooperation and exchange of information with local supervisors, as already set in motion, are strongly recommended.

38. **Staff welcomes Austria's official development assistance reaching about 0.4 percent of GNP in 2006** and encourages them to raise it further toward the U.N. target of 0.7 percent of GNP.

39. **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 (2004)	8.1 million
GDP per capita (2004)	US$ 36,142 (€ 29,018)

	2000	2001	2002	2003	2004	2005 Proj.
	(Percentage changes at 1995 prices)					
Demand and supply						
GDP	3.4	0.7	1.2	0.8	2.2	1.9
Total domestic demand	3.1	-0.2	-0.7	2.3	0.7	1.9
Consumption	3.0	0.4	0.2	0.6	1.4	1.5
Gross investment	3.7	-2.7	-4.2	6.7	1.7	2.7
Foreign balance 1/	0.3	0.9	1.9	-1.5	1.4	0.2
Exports of goods and nonfactor services	10.5	6.8	3.8	1.4	8.9	5.4
Imports of goods and nonfactor services	10.1	5.0	-0.2	4.8	6.4	5.4
	(Percentage changes; period averages)					
Employment and unemployment						
Labor force 2/	0.0	0.7	0.4	0.4	0.8	1.0
Employment 3/	0.9	0.4	-0.5	0.2	0.7	1.1
Employment rate (in percent) 3/	63.3	63.2	62.5	62.2	62.5	62.7
Unemployment rate (in percent)						
Registered 4/	5.3	5.5	6.2	6.3	6.4	6.3
Standardized 4/	3.7	3.6	4.2	4.3	4.5	4.6 5/
Prices and incomes						
GDP deflator	1.8	1.7	1.3	1.6	1.9	1.8
Consumer price index	2.0	2.3	1.7	1.3	2.0	2.0 6/
Unit labor costs (manufacturing)	1.2	1.6	-0.7	0.3	0.6	0.7
	(Percent of GDP)					
General government finances 7/						
Revenue	49.8	51.0	50.2	49.5	49.4	47.9
Expenditure	51.4	50.9	50.6	50.8	50.6	49.9
Balance	-1.6	0.1	-0.4	-1.3	-1.2	-2.0
Gross debt (end of period)	65.8	66.1	65.7	64.5	63.6	63.5
	(Billions of euros)					
Balance of payments						
Trade balance	-3.0	-1.4	3.8	1.0	3.4	2.5
Current account	-5.4	-4.1	0.7	-1.2	1.4	0.3
(In percent of GDP)	-2.5	-1.9	0.3	-0.5	0.6	0.1
	(Percent; period average)					
Interest rates						
Three-month interbank rate	4.4	4.3	3.3	2.3	2.1	2.1 8/
10-year government bond	5.6	5.1	5.0	4.1	4.1	3.2 8/
	(Levels; period average)					
Exchange rates						
Euro per US $	1.09	1.12	1.06	0.89	0.81	0.77 8/
Nominal effective exchange rate (2000=100)	100.0	100.2	101.0	104.1	105.2	104.2 9/
Real effective exchange rate (1990=100)						
ULC based	100.0	99.3	100.2	103.4	104.6	105.6 6/
CPI based	100.4	101.4	102.5	104.7	106.0	107.7 9/

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/ April.
6/ May.
7/ 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).
8/ June 15
9/ March.

Table 2. Austria: General Government Accounts, 2001-08 1/

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	51.0	50.2	49.5	49.4	47.9	47.2	45.8	45.7
of which: Tax 2/	*44.8*	*43.7*	*43.3*	*43.2*	*41.8*	*41.0*	*40.3*	*40.0*
Expenditure	50.9	50.6	50.8	50.6	49.9	49.1	46.7	45.8
Overall balance (ESA 95 basis)	**0.1**	**-0.4**	**-1.3**	**-1.2**	**-2.0**	**-1.8**	**-0.9**	**-0.1**
Federal government	-0.7	-1.1	-2.0	-1.6	-2.5	-2.3	-1.6	-0.9
Other levels	0.8	0.6	0.7	0.4	0.5	0.5	0.7	0.8
minus one-off measures								
Net sale of real estate 3/	0.0	0.0	0.1	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	-0.1	0.2	0.7	0.5	0.4	0.3	0.2	0.1
Structural balance (ESA 95 basis)	**-0.6**	**-0.2**	**-0.2**	**-0.7**	**-1.6**	**-1.6**	**-0.7**	**0.0**
Fiscal impulse 6/	**-2.7**	**-0.4**	**0.0**	**0.5**	**0.9**	**0.0**	**-0.9**	**-0.7**
Primary structural balance (ESA 95 basis) 7/	**2.1**	**2.2**	**2.0**	**1.4**	**0.5**	**0.5**	**1.4**	**2.0**
Public debt	66.1	65.7	64.5	63.6	63.5	62.9	61.4	59.2
Memorandum items:								
Output gap 8/	0.3	-0.5	-1.5	-1.1	-1.0	-0.7	-0.4	-0.3
Overall fiscal balance, EDP definition 9/	0.3	-0.2	-1.1	-1.1	-1.9	-1.7	-0.8	0.0

Sources: Federal Ministry of Finance; Austrian Stability Program (2004-08); and IMF staff estimates and projections.

1/ For 2004, authorities' estimated outturn. For 2005-06, projections are based on the budgets for these years. Projections for 2007-08 are based on the Austrian Stability Program (2004-08).

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 Framework, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
	(Percentage changes at 1995 prices)							
National accounts								
GDP	0.8	2.2	1.9	2.2	2.1	2.1	2.2	2.2
Domestic demand	2.3	0.7	1.9	2.0	1.6	1.7	1.8	1.9
Final consumption	0.6	1.4	1.5	1.7	1.4	1.4	1.7	1.7
of which: Private consumption	0.6	1.5	1.8	2.1	1.8	1.8	2.1	2.2
Gross investment	6.7	1.7	2.7	3.1	2.4	2.4	2.1	2.2
Exports of goods and nonfactor services	1.4	8.9	5.4	5.6	5.4	5.3	5.3	5.3
Imports of goods and nonfactor services	4.8	6.4	5.4	5.6	4.8	4.7	4.8	4.9
	(Percentage change)							
Prices and unemployment								
CPI inflation	1.3	2.0	2.0	1.8	1.7	1.7	1.7	1.7
GDP deflator	1.6	1.9	1.8	1.8	1.8	1.8	1.7	1.7
Unemployment rate (in percent)	4.3	4.5	4.5	4.2	4.0	4.0	3.9	3.8
	(Percent of GDP)							
External accounts								
Current account balance	-0.5	0.6	0.1	0.0	0.3	0.6	0.5	0.4
Goods and services balance	1.1	2.1	1.3	1.3	1.6	1.8	1.8	1.7
General government accounts 1/ 2/								
Revenue	49.5	49.4	47.9	47.2	45.8	45.7	45.7	45.7
Expenditure	50.8	50.6	49.9	49.1	46.7	45.8	45.8	45.8
Balance	-1.3	-1.2	-2.0	-1.8	-0.9	-0.1	-0.1	-0.1
Gross debt	64.5	63.6	63.5	62.9	61.4	59.2	57.1	55.0
Memorandum items:								
Gross national saving (percent of GDP)	21.4	22.3	22.5	22.6	23.1	23.6	23.8	24.0
Gross domestic investment (percent of GDP)	21.9	21.7	22.4	22.6	22.8	23.0	23.3	23.7
Output gap (percent of potential GDP)	-1.5	-1.1	-1.0	-0.7	-0.4	-0.3	-0.1	0.0
Potential GDP growth	1.9	1.8	1.8	1.9	1.9	2.0	2.1	2.2

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' estimated outturn. Projections for 2005-06 are based on the budgets for these years. Projections for 2007-08 are based on the Austrian Stability Program (2004-08). For 2009-10, projections assume unchanged overall and structural balances from those in 2008.

Table 4. Austria: Indicators of Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005		Date
External indicators								
Exports (annual percentage change, in U.S. dollars)	0.4	4.1	8.8	21.6	20.7	13.3	1/	Projection
Imports (annual percentage change, in U.S. dollars)	-0.3	2.3	5.3	23.7	18.7	14.9	1/	Projection
Terms of trade (annual percentage change)	1.4	0.8	0.6	0.1	1.1	1.9	1/	Projection
Current account balance	-2.5	-1.9	0.3	-0.5	0.6	0.1	1/	Projection
Capital and financial account balance	2.2	1.7	-1.5	0.3	-0.6	...		
Of which : Inward portfolio investment (net, debt securities)	13.6	10.9	8.1	8.3	8.7	...		
Inward portfolio investment (net, equity)	1.8	-2.3	1.3	0.9	2.3	...		
Inward foreign direct investment (net)	4.6	3.1	0.2	2.9	1.7	...		
Other investment liabilities (net, positive=inward)	7.1	1.1	-3.1	4.4	8.6	...		
Official reserves (in billions of U.S. dollars)	14.3	12.5	9.7	8.5	7.9	7.3		May-05
Official reserves in months of imports	1.8	1.5	1.1	0.8	0.6	0.5		May-05
Foreign assets of the financial sector (in billions of U.S. dollars) 2/	88.7	91.6	108.4	140.0	173.2	173.7		Apr-05
Exchange rate against U.S. dollar (period average)	1.09	1.12	1.06	0.89	0.81	0.77		Jun 15
Public sector								
General government balance 3/	-1.6	0.1	-0.4	-1.3	-1.2	-2.0	1/	Projection
Structural balance 4/	-3.3	-0.6	-0.2	-0.2	-0.7	-1.6	1/	Projection
General government debt 3/	65.8	66.1	65.7	64.5	63.6	63.5	1/	Projection
Financial sector								
Growth rate of credit to the private sector 5/	6.8	3.5	1.2	2.0	5.3	6.0		May-05
Growth rate of credit to households (annual average)	11.6	6.7	6.1	4.2	8.5	...		
Stock market index (level; end of period) 6/	107.3	114.0	115.0	154.5	243.1	294.8		Jun 15
Price-earnings ratio 7/	18.8	15.3	18.2	15.2	16.1	16.0		Jun 15
Foreign exchange loans 8/	36.9	37.4	46.5	55.5	65.1	...		
Foreign exchange loans, share in total loans (in percent) 8/	17.5	18.2	18.8	22.1	24.7	...		
Net interest income (in percent of total assets)	1.2	1.2	1.2	1.2	1.1	...		
Operating profit (before tax, in percent of total assets)	0.8	0.8	0.7	0.7	0.7	...		
Cost/income ratio (in percent)	66.6	67.4	69.3	68.2	67.2	...		
Loan-loss provisions (in percent of bank claims)	2.9	3.1	3.3	3.3	3.3	...		
Nonperforming loans (median; in percent of total loans)	2.4	2.3	2.3	2.2	...	...		
Capital adequacy ratio (in percent)	13.3	13.7	13.3	14.5	14.7	...		
Return on equity (in percent)	9.4	9.8	5.4	6.3	9.3	...		

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

1/ IMF staff projections.

2/ Outside the Euro area. Austria's Contribution to the Consolidated Balance Sheet of Euro Area MFIs

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

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

5/ Credit to the non-government sector (euro area).

6/ ATX index (1991=100).

7/ Price-earnings ratio for ATX.

8/ Loans to domestic nonbanks.

Table 5. Austria: General Government Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 9/**
General government debt 1/	65.8	66.1	65.7	64.5	63.6			**63.5**	**62.9**	**61.4**	**59.2**	**57.1**	**55.0**	**0.5**
o/w foreign-currency denominated	9.1	8.8	8.8	8.7	8.5			8.5	8.5	8.2	7.9	7.7	7.4	
Change in general government debt	-0.7	0.3	-0.4	-1.3	-0.9			-0.1	-0.6	-1.5	-2.2	-2.1	-2.1	
Identified debt-creating flows (4+7+12)	-0.9	-1.2	-2.7	-1.7	-2.0			-0.5	-0.5	-1.5	-2.2	-2.2	-2.1	
Primary deficit	-2.0	-3.7	-3.0	-1.8	-1.8			-1.0	-1.2	-2.1	-2.8	-2.7	-2.6	
Revenue and grants	49.8	51.0	50.2	49.5	49.4			47.9	47.2	45.8	45.7	45.7	45.7	
Primary (noninterest) expenditure	47.7	47.3	47.2	47.7	47.6			46.9	46.1	43.7	42.9	43.0	43.1	
Automatic debt dynamics 2/	1.2	2.5	0.3	0.1	-0.2			0.5	0.7	0.6	0.5	0.5	0.5	
Contribution from interest rate/growth differential 3/	0.4	2.0	1.8	1.6	0.5			0.7	0.6	0.6	0.5	0.5	0.5	
Of which contribution from real interest rate	2.5	2.5	2.5	2.1	1.8			1.9	1.9	1.9	1.8	1.8	1.7	
Of which contribution from real GDP growth	-2.1	-0.5	-0.8	-0.5	-1.4			-1.2	-1.3	-1.3	-1.3	-1.3	-1.2	
Contribution from exchange rate depreciation 4/	0.8	0.5	-1.4	-1.5	-0.6			-0.2	0.1	0.0	0.0	0.0	0.0	
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	
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	
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	
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	
Residual, including asset changes (2-3)	0.2	1.5	2.3	0.5	1.1			0.4	-0.1	0.0	0.0	0.1	0.0	
General government debt-to-revenue ratio 1/	132.2	129.7	131.0	130.3	128.9			132.5	133.2	134.1	129.6	125.0	120.4	
Gross financing need 5/	16.8	14.1	16.2	16.2	15.7			16.3	16.1	14.9	13.7	13.2	12.7	
in billions of U.S. dollars	32.6	27.2	33.7	41.4	45.9			51.0	51.3	49.6	47.5	47.6	47.8	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.4	0.7	1.2	0.8	2.2	2.1	1.1	1.9	2.2	2.1	2.1	2.2	2.2	2.1
Average nominal interest rate on public debt (in percent) 6/	5.8	5.6	5.2	4.9	4.9	5.7	0.7	4.9	4.9	5.0	4.9	4.9	4.9	4.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	3.9	3.9	3.3	3.0	4.5	1.0	3.1	3.1	3.2	3.1	3.2	3.2	3.2
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.4	-5.3	19.0	20.4	7.8	1.1	11.2	2.7	-1.4	0.1	0.1	0.1	0.1	0.3
Inflation rate (GDP deflator, in percent)	1.8	1.7	1.3	1.6	1.9	1.2	0.7	1.8	1.8	1.8	1.8	1.7	1.7	1.8
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.6	-0.3	1.0	1.8	1.9	1.2	1.8	0.4	0.4	-3.1	0.3	2.5	2.5	0.5
Primary deficit	-2.0	-3.7	-3.0	-1.8	-1.8	-1.6	1.2	-1.0	-1.2	-2.1	-2.8	-2.7	-2.6	-2.1
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 9/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 7/								**63.4**	**63.3**	**63.1**	**62.9**	**62.7**	**62.5**	**1.4**
A2. No policy change (constant primary balance) in 2006-10								**63.5**	**63.0**	**62.6**	**62.1**	**61.7**	**61.2**	**0.5**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2006 and 2007								**63.4**	**64.9**	**65.5**	**63.3**	**61.2**	**59.1**	**0.5**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007								**63.4**	**65.3**	**67.1**	**66.8**	**66.6**	**66.4**	**0.6**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007								**63.4**	**65.0**	**66.5**	**64.3**	**62.2**	**60.1**	**0.5**
B4. Combination of B1-B3 using one standard deviation shocks								**63.4**	**65.9**	**68.3**	**66.1**	**64.0**	**62.0**	**0.5**
B5. One time 30 percent real depreciation in 2006 8/								**63.4**	**66.8**	**65.3**	**63.1**	**61.0**	**59.0**	**0.5**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**63.4**	**72.9**	**71.5**	**69.4**	**67.3**	**65.3**	**0.6**

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 $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = 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 $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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.

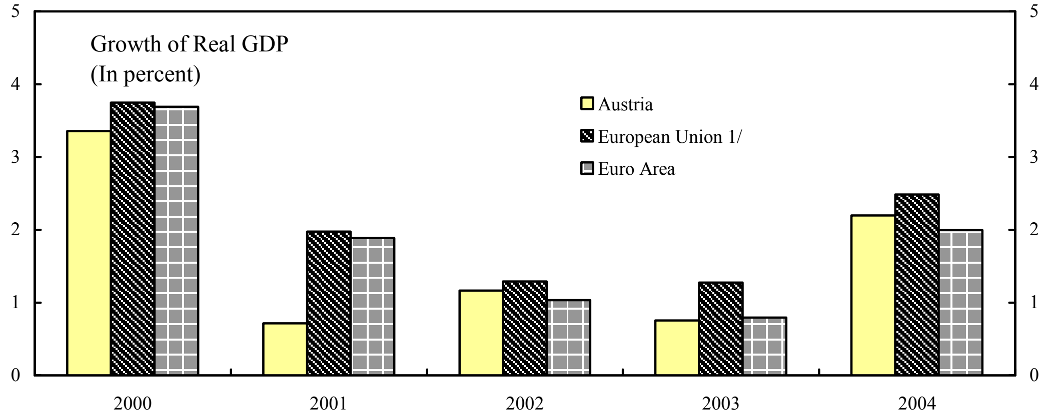
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

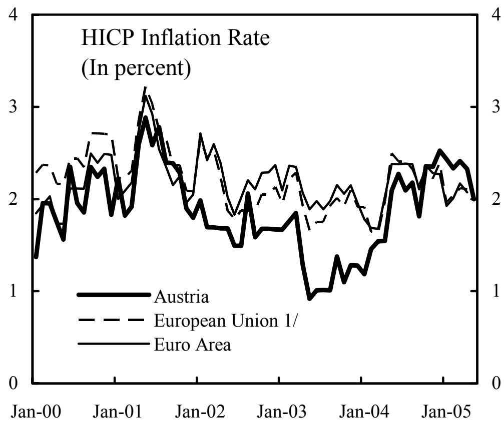
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

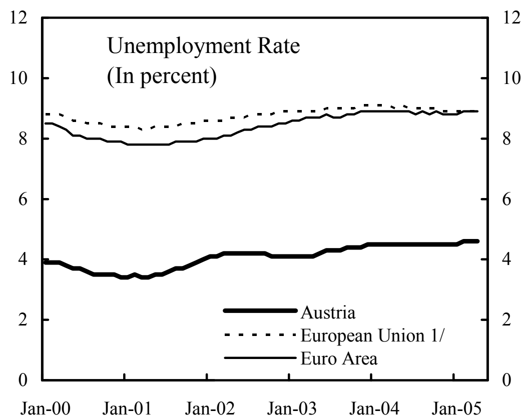
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Macroeconomic Aggregates in Austria and the European Union

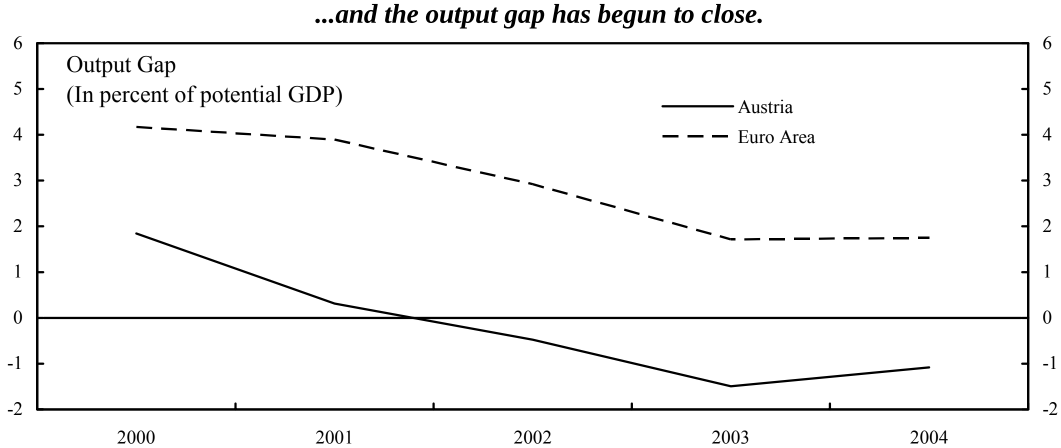
The Austrian economy has performed better than its euro-area partners in recent years...







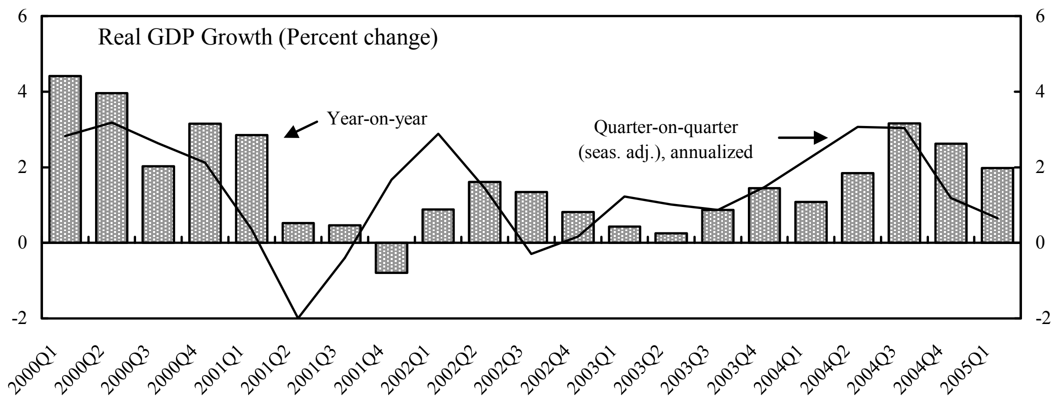
...and the output gap has begun to close.



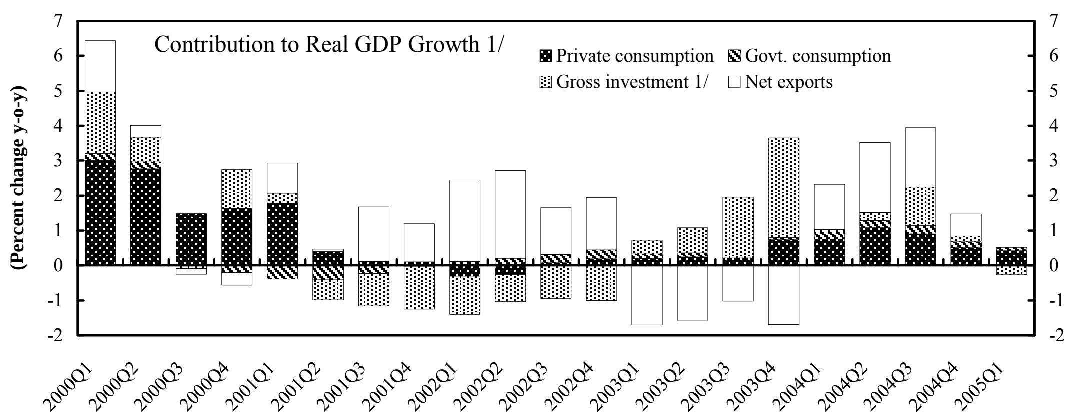
Sources: IMF, World Economic Outlook; and Eurostat.
1/ EU-25 for the entire period.

Figure 2. Austria: Gross Domestic Product

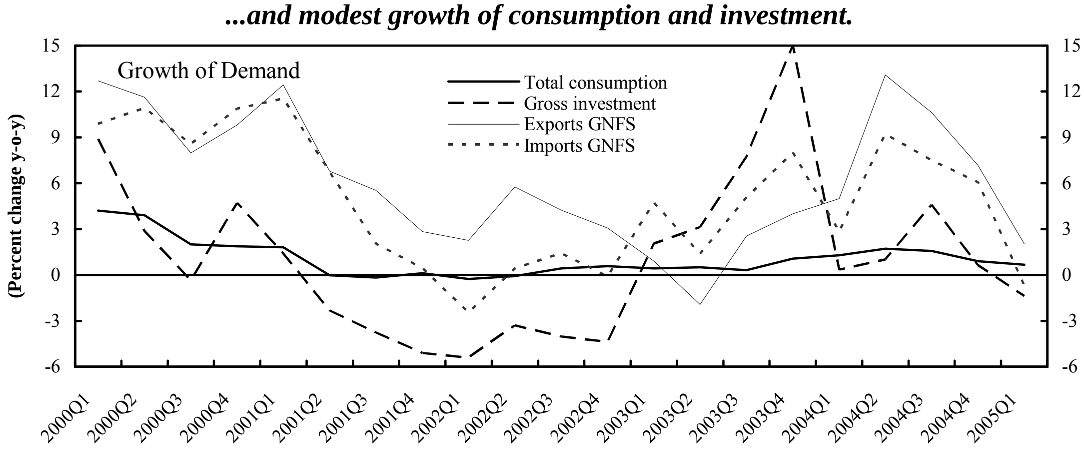
Growth of real GDP gathered speed in 2004...



...supported by the strong performance of the external sector...

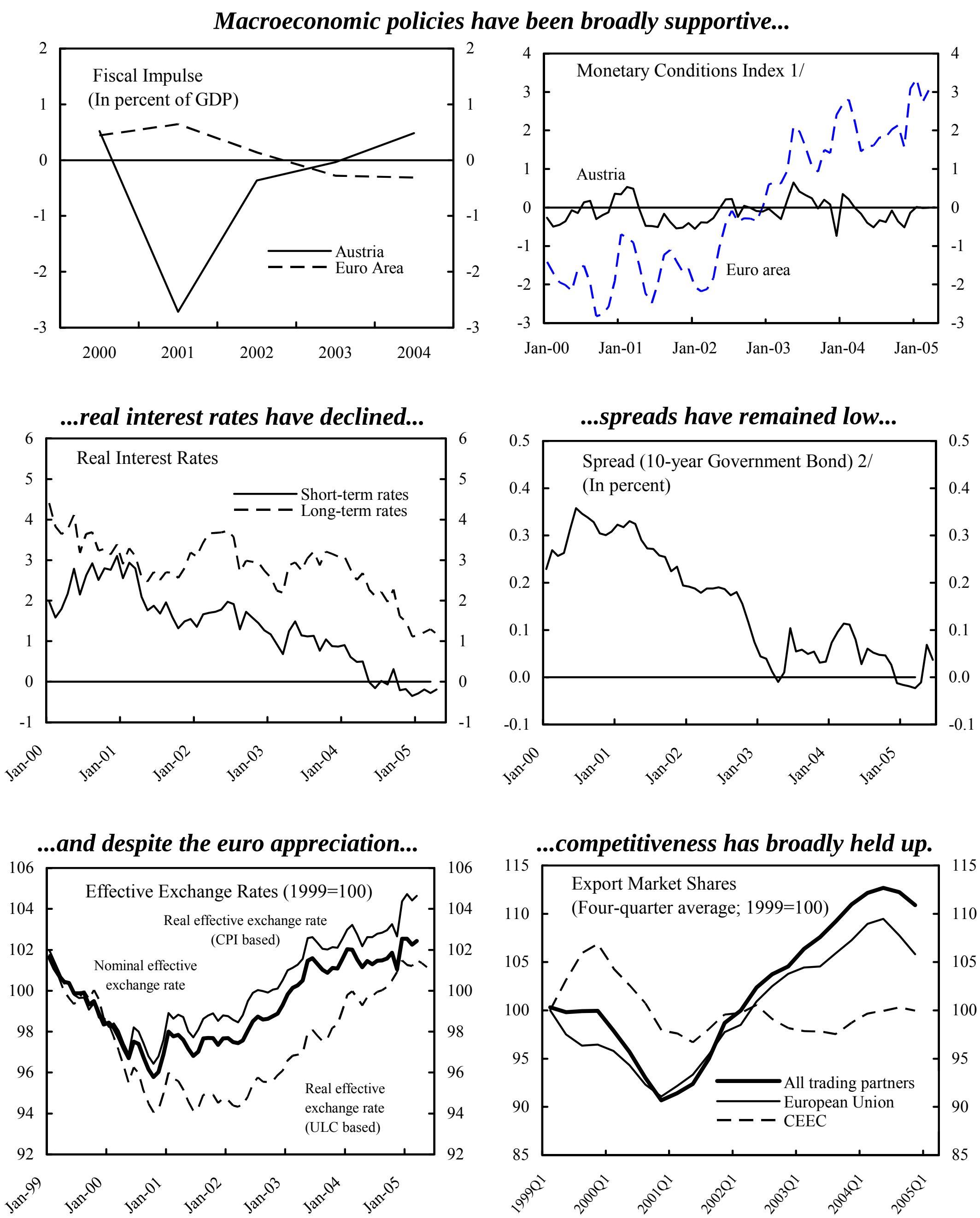


...and modest growth of consumption and investment.



Sources: Austrian Statistical Office; Eurostat; and IMF staff calculations.
1/ Excluding the statistical discrepancy.

Figure 3. Austria: Policy Stance

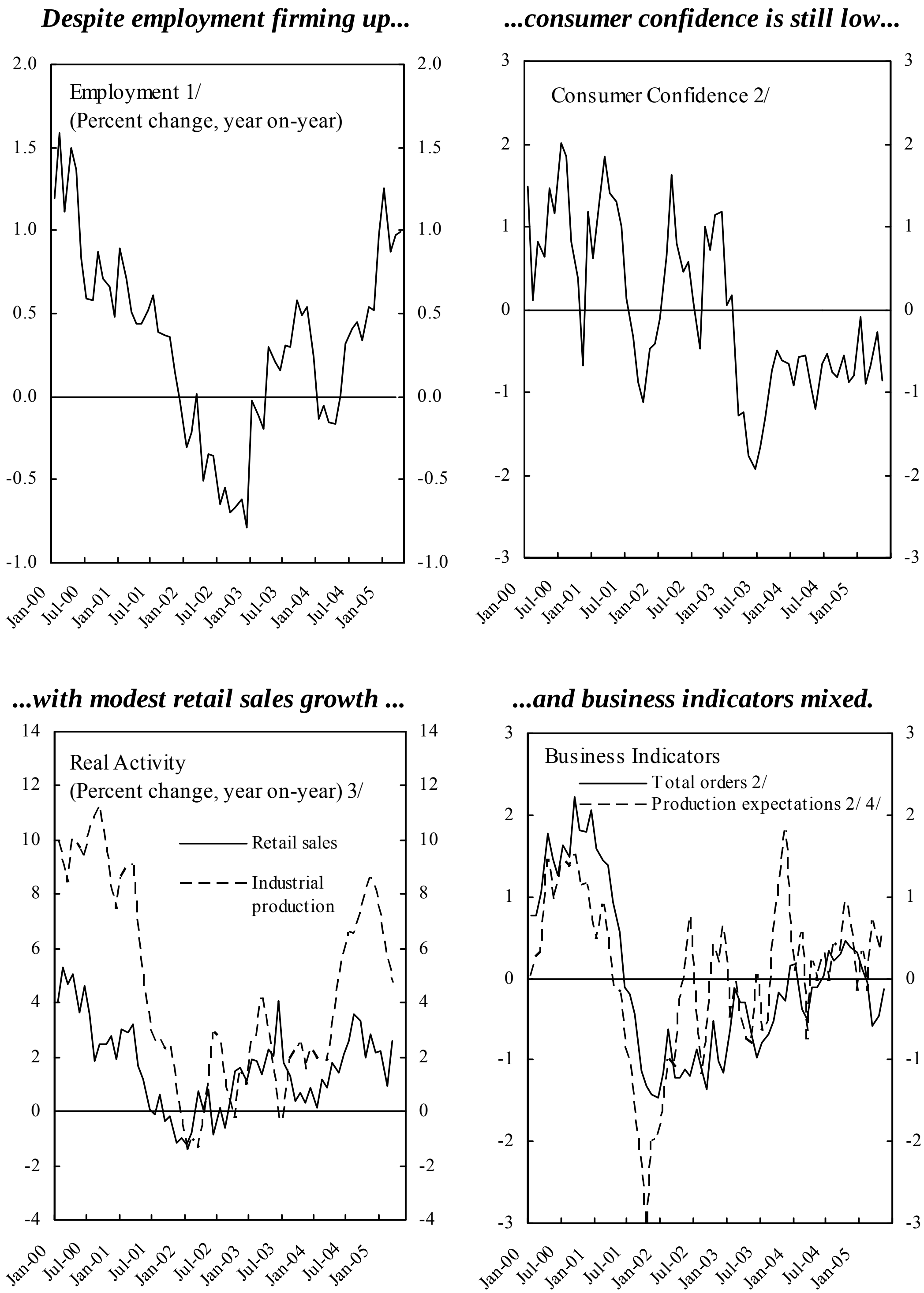


Sources: IMF, World Economic Outlook; IMF, Direction of Trade Statistics; IMF, International Financial Statistics; WIFO Institute; Eurostat; and IMF staff calculations.

1/ Normalized weighted average of deviation of real short-term interest rates and the real effective exchange rate from their average 2000-04 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 4. Austria: Recent Trends and Short-Term Outlook



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 2000-2004 mean.

3/ Three-month moving average.

4/ Twelve months ahead.

Austria: Fund Relations
(As of May 31, 2005)

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	1,345.80	71.88
Reserve position in Fund	526.50	28.12

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	179.05	100.00
Holdings	107.91	60.27

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				
	2005	2006	2007	2008	2009
Principal	--	--	--	--	--
Charges/Interest	0.91	1.78	1.78	1.79	1.78
Total	0.91	1.78	1.78	1.79	1.78

VII. **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.

VIII. **Article IV Consultation:**

Austria is on a 12-month consultation cycle. The last consultation was completed on August 2, 2004 (EBM/04/76).

IX. **Financial Sector Assessment Program (FSAP):**

Austria participated in the FSAP in 2004.

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 is taking an SDDS flexibility option for the timeliness of the industrial production index.

The timeliness of Austrian data could be improved, particularly with respect to data on industrial production, the (accrual based) current account, international investment position, and merchandise trade. Compared to Germany and France, for instance, the publication of these data lags by about one month.

The transition to compiling data in accordance the *European System of Accounts 1995 (ESA 1995)* has complicated the analysis of the 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 1995*, are not complete. Although data on expenditure by function has not been available since 1995, the authorities have resumed reporting the total outlays of general government according to major functional categories for 2000–2004, compiled in accordance with the methodology of *GFMS 2001*, for inclusion in the *Government Finance Statistics Yearbook*. Similarly, reporting of data on financing and debt data have been resumed for inclusion in the *Government Finance Statistics Yearbook*, although a breakdown between domestic and foreign debt according to residency is not reported.

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: Table of Common Indicators
(as of May 31, 2005)

	Date of latest observation	Date received	Frequency of data	Frequency of reporting	Frequency of publication
Exchange rates	5/31/05	5/31/05	Daily	Daily	Daily
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr. 2005	5/25/05	Monthly	Monthly	Monthly
Reserve/Base Money	Apr. 2005	5/16/05	Monthly	Monthly	Monthly
Broad Money	Apr. 2005	5/16/05	Monthly	Monthly	Monthly
Central Bank Balance Sheet	Apr. 2005	5/16/05	Monthly	Monthly	Monthly
Consolidated Balance Sheet of the Banking System	Apr. 2005	5/25/05	Monthly	Monthly	Monthly
Interest Rates[2]	5/31/05	5/31/05	Daily	Daily	Daily
Consumer Price Index	Apr. 2005	5/19/05	Monthly	Monthly	Monthly
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec. 2004	3/11/05	Annually	Annually	Annually
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar. 2005	5/15/05	Monthly	Monthly	Monthly
Stocks of Central Government and Central Government-Guaranteed Debt	Mar. 2005	5/15/05	Monthly	Monthly	Monthly
External Current Account Balance	Q1 2005	5/23/05	Monthly	Monthly	Monthly
Exports and Imports of Goods and Services	Q1 2005	5/23/05	Monthly	Monthly	Monthly
GDP/GNP	Q4 2004	3/10/05	Quarterly	Quarterly	Quarterly
Gross External Debt[5]	Q4 2004	3/30/05	Quarterly	Quarterly	Quarterly

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.

AUSTRIA: FISCAL SUSTAINABILITY ANALYSIS

This Appendix analyses medium-term (2005–10) general government debt sustainability and assesses the impact of aging on Austria's fiscal situation and public debt profile. The conclusion is that Austria's medium-term fiscal position appears resilient to different macroeconomic scenarios and shocks, and that the long-term outlook is manageable.

In recent years, Austria's general government debt has been broadly stable with a small decline of 2¼ percentage points since 2000 to 63½ percent of GDP at end-2004 (Table 5). This is in contrast to the developments in the 1990s when persistent fiscal deficits brought the level of debt up by almost 10 percentage points (from 56½ percent of GDP at end-1989 to 66½ percent at end-1999).

Looking forward, the baseline medium-term scenario results in a drop in public debt by about 8½ percentage points from end-2004 to 55 percent of GDP by end-2010, reflecting the planned return to balanced budgets by 2008. The scenario is based on government policies as communicated to the mission, and expressed in the 2005 and 2006 budgets, and the Austrian Stability Program for 2004–08. In keeping with the government's aim to run balanced budgets over the cycle, balanced budgets are assumed for 2009 and 2010.

Debt levels decline over the medium-term also in scenarios with looser fiscal policies or more pessimistic macroeconomic assumptions. If there was no adjustment (keeping the primary balance at its 2005 level), or if key macroeconomic and fiscal variables are set at their 10-year historical averages, debt levels would still not enter an upward path. The general government debt ratio is, moreover, resilient to various macroeconomic shocks, resulting only in temporary increases in debt levels. The exception is when real GDP growth is set at its historical average minus two standard deviations during 2006–07, which results in a virtually flat debt trajectory after the initial jump. However, this is a scenario where real GDP growth equals 0 in two consecutive years and budget expenditures are kept unchanged from the baseline scenario in nominal terms. It is not surprising or particularly worrying that, under such circumstances, a quick reversal to declining growth rates would require some fiscal policy response.

The long-term outlook could potentially be more difficult as population aging puts pressure on the pension system, and drives up costs for health and other care, but the recent pension reforms has significantly improved long-term fiscal sustainability. The reforms are expected to improve the projected expenditures by as much as 3 percentage points of GDP in the long term, limiting the increase in pension expenditures to about 1 percentage point from 2005 to the peak in 2035. Public health care and other public care costs are estimated by the Austrian government to increase by a little over 2 percentage points of GDP over the next 45 years.

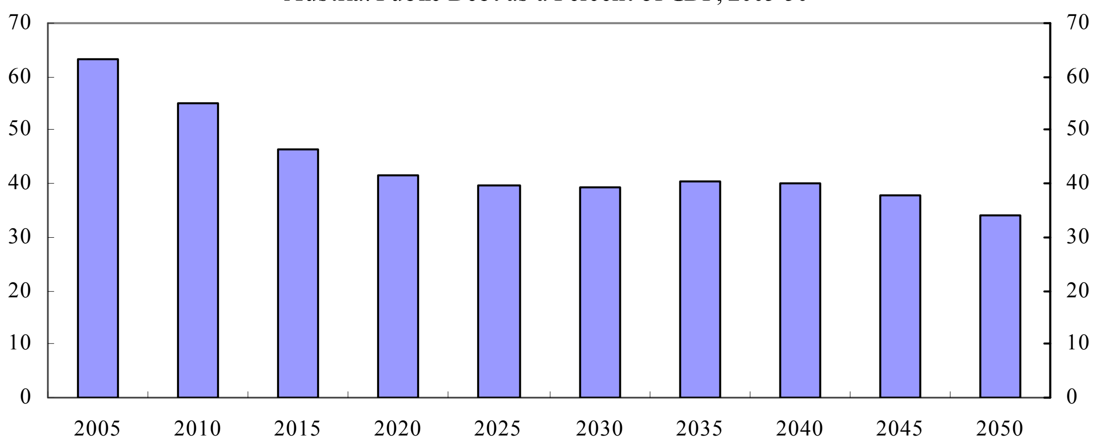
Long-Term Fiscal Sustainability Scenario

	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
	(Percent of GDP)									
Pension expenditures	14.2	14.2	14.2	14.6	14.8	14.9	15.1	14.5	14.1	13.6
Health and other care expenditures	5.8	6.1	6.3	6.6	6.8	7.1	7.3	7.6	7.8	7.9
Interest payments	3.1	2.7	2.6	2.3	2.1	2.0	2.0	2.0	1.9	1.8
Overall balance	-2.0	-0.1	-0.2	-0.5	-0.8	-1.1	-1.4	-1.2	-0.8	-0.4
	(Percent)									
Real GDP growth	1.9	2.2	2.0	1.6	1.5	1.4	1.6	1.7	1.8	1.6

Sources: Austrian Ministry of Finance; and staff estimates.

Even with these pressures on fiscal developments, Austria's fiscal policy appears to be on a sustainable path. Assuming that the medium-term fiscal plans, as described above, are followed through 2010, and that the balance of non-aging related expenditures and revenues remain unchanged thereafter, public debt will be on a broadly declining trend through 2050. This is encouraging in light of the high projected dependency ratio in Austria; by 2050 the Austrian population aged 65 and over as a share of the population aged 16–64 is projected to be 55 percent compared to an average of 49 percent in the EU-15.[1]

Austria: Public Debt as a Percent of GDP, 2005-50



Sources: Ministry of Finance; and staff estimates.

[1] OECD *Social Indicators*, 2005 edition.

Statement by Johann Prader, Alternate Executive Director for Austria
July 20, 2005

The Austrian authorities welcome the consultation with the Fund and commend the staff for the high quality of its staff report. They broadly agree with the staff's assessment of Austria's economic situation and its general recommendations on economic and financial policies. They welcome the Selected Issues study, which sheds light on the specific Austrian phenomenon of foreign exchange borrowing of households.

The staff report again highlights Austria's good economic performance relative to its European peers in terms of GDP-growth, unemployment, competitiveness and public finances.

Short-term outlook

The most recent data show that real GDP grew by 2.4 percent in 2004, revised upward from the 2.2 percent estimate quoted in the staff report.

In the first quarter of 2005, GDP growth was only 0.2 percent, but reached 2.1 percent year-on-year. The lagged effects of the appreciation of the Euro on exports, low investment due to the expiration of a temporary tax allowance and continued weak growth of private consumption were responsible for the outcome. On the positive side, dependent employment expanded at a rate of 1 percent in the first half of 2005. Further, the increase in both disposable income and after-tax profits as a result of the recent tax reform will gradually support private consumption and investment. Yet, signals of a strong upswing are currently absent. In view of high oil prices and the declining momentum of world trade, high growth is not very likely.

Fiscal policy

In 2003, the current fiscal policy strategy was adopted for the period until 2008. It aims at a balanced budget over the cycle and at reducing the tax burden to 40 percent by 2010. A major step to reduce the tax burden has been implemented in 2004/2005. In the short-run, tax cuts are not fully financed by expenditure cuts, resulting in a temporary deviation from a balanced budget (cyclically-adjusted) in the years 2004-2007.

Since then, fiscal policy has stayed broadly on track, but has been adjusted to a somewhat weaker economic environment. The latter prompted several actions, aimed at enhancing the supply-side of the economy and providing a growth stimulus. Over the period 2003-2005, the cumulative growth stimulus amounted to some 3/4 percentage points and helped to contain the still widening output-gap. The particularly strong fiscal impact contributed to the 2.4 percent GDP growth in 2004.

The 2005 budget is dominated by the tax reform aimed at reducing the tax burden of private households and further strengthening the growth potential of the economy. Recently, the economic research institutes revised downwards the GDP forecast for 2005 to around 1.9 percent. Yet, the authorities are confident to keep the overall budget balance at 1.9 percent of

GDP, owing to better than expected tax revenues so far in the year. The estimated deficit is still comfortably within the cyclical safety margin of the EU's Stability and Growth Pact (SGP).

Taking into consideration the moderate economic developments in 2005, the authorities see no danger in the pro-cyclicality of the tax reform, especially as the output gap will remain negative, at least until 2006. Previous investment incentives were phased out and reductions in public expenditure will be phased in. Thus, the tax reform will support the Austrian economy on its recovery to potential output, but will not lead to any overheating.

The government is strongly committed to achieve a balanced budget by 2008. Austria will continue its reforms of public administration at the national and regional levels. The efficiency of general government is to be increased further. In 2004, the new fiscal revenue sharing scheme was agreed upon by the federal, regional and local governments. At the same time, the Austrian domestic stability pact was re-instated for the years until 2008. For the fiscal revenue sharing agreement in the period after 2008 it is planned to put special emphasis on the expenditure side. The federal and provincial levels have recently begun discussing the inclusion of civil servants at the sub-national levels into the harmonised pension system.

Taking into consideration the remarks made by Directors during last year's Board meeting, the Ministry of Finance has intensified and recently finalized a proposal for a medium-term expenditure framework. This proposal is due to be discussed in Parliament and a final decision should be expected this year. It would be implemented in 2007, as the federal budget for 2006 has already been approved by Parliament.

Other structural policies

In early July, Parliament adopted another set of policies to foster growth and employment. This package forms part of the Austrian National Action Plan to reach the targets of the EU-agreed Lisbon strategy. It includes efforts to increase the ratio of R&D expenditures to GDP from 2.35 percent in 2005 to 3 percent in 2010 by additional public spending and by broadening the income tax allowance of 25 percent to outsourced R&D and unincorporated companies. The housing savings-promotion scheme *("Bausparen*") will be extended to cover also credits for education and nursing.

Infrastructure investment will be speeded up and procedures for project approval streamlined. The package also includes measures against moonlighting and tax fraud. In addition, the labour market authority will dedicate a special premium to additional apprenticeships.

According to expert estimates, the total package will create some 20,000 new jobs (0.6 percent of the work force). The measures will not significantly affect the general government budget balance for 2005/2006.

Foreign exchange borrowing of households.

The Austrian authorities are well aware of the increase in foreign currency loans of households. They have time and again pursued campaigns to inform the public about the risks involved in such borrowing.

While one can certainly point to the potential risks of household indebtedness in foreign currency, the reasons for its popular appeal are obvious: some households saved substantial amounts by switching from yen to Swiss franc. Moreover, the Swiss franc is less volatile and less likely to appreciate further. In terms of the domestic market, borrowing in foreign currency has had a dampening effect on interest rates of loans, and on the interest rate spread, which both are now among the lowest in the Euro-area.

Linkages to Germany and Central and Eastern Europe

While the business cycle in Austria was for many years strongly linked to the business cycle in Germany, these close ties have weakened as a result of significant foreign direct investments in Central and Eastern Europe by Austrian Banks and manufacturing industries in recent years. This is welcome from a risk-diversification strategy point of view. The staff's paper hints at the possibility of a more volatile cycle in Austria. In our view, this scenario seems rather remote. More fundamentally, the staff’s study on the regional linkages of Austria supports a positive outlook for the Austrian economy.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/94
FOR IMMEDIATE RELEASE
July 22, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Austria

On July 20, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Austria.[1]

Background

Economic activity gathered speed in 2004, supported mostly by strong export performance. Growth of real GDP rose to 2.2 percent in 2004 from 0.8 percent in 2003. Consumption growth was modest, in view of small gains in employment and nominal wage growth barely matching inflation. Investment demand continued to expand, benefiting from the improved prospects for exports and the extension of tax incentives through end-2004. The export boom that began in early 2004 (exports of goods surged over 12 percent in real terms in 2004) lost momentum towards the end of the year, but still made a considerable contribution to growth.

Short-term prospects are relatively favorable. Economic growth is expected to slow down to slightly below 2 percent in 2005 with a slight increase projected for 2006, while inflation is estimated to remain low and stable over this period. There are uncertainties related to the behavior of consumption and external developments, however, and downside risks to this outlook warrant close monitoring.

[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.

The fiscal policy stance became more accommodative in 2004. Concerned about a faltering recovery, the authorities took discretionary fiscal measures after the passage of the 2004 budget, namely a fiscal package announced in late 2003 with measures aimed primarily at supporting Research & Development and investment, and the front-loading in 2004 of some of the tax measures initially planned for 2005. In the event, the budgetary cost of these measures was larger than planned. Against an initial budget deficit target of 0.7 percent of GDP, the additional measures—plus higher spending on pensions of civil servants due to a surge of early retirements in view of pension reform—contributed to a widening of the general government deficit to 1.2 percent of GDP in 2004 and a fiscal impulse of nearly ½ percent of GDP. There will be a temporary widening of the deficit in 2005-06 resulting from tax reform preceding compensating expenditure measures. The authorities plan for a gradual return to a balanced budget during 2007-2008, when expenditure measures come on stream.

Progress in the structural area has been impressive, and this has contributed to Austria's relatively favorable growth performance in the past period. In particular, pension reform is well advanced, including through the recent harmonization of pension schemes. Additional tasks remain regarding the need to also include pensions of civil servants at the subnational level in the unified system, as well as with regard to the further liberalization of labor, product and services markets.

Following a favorable assessment in the context of the Financial Sector Assessment Program last year, overall financial sector conditions improved further, including in terms of capital adequacy and profitability. Financial sector supervision has been strengthened and adapted to the changes in financial markets. The continuing growth of foreign currency loans to Austrian households, as well as the rapid expansion of the activities of Austrian financial institutions abroad remain areas of potential risk.

Executive Board Assessment

Executive Directors commended Austria's recent economic performance as among the best in the euro area, with GDP growth gaining strength on the back of strong exports, low inflation, and low unemployment. They noted that much of this favorable performance can be traced to sound economic policies, wide-ranging structural reforms, and a social partnership that, by delivering wage moderation, has helped maintain strong competitiveness. Directors supported the authorities' main objectives to balance the budget over the cycle, reduce the tax burden, and increase Austria's growth potential. Welcome achievements so far include a marked reduction in the size of government, major pension reform, privatization and deregulation in product and labor markets, and tax reform. Directors emphasized that identifying expenditure measures to return to a budget balance by 2008 will be key to ensuring the credibility and success of the authorities' strategy.

Directors observed that Austria's sustained focus on Eastern Europe has made it one of the EU-15 countries that have benefited most from the transition in that region and the subsequent entry into the EU of 10 new member states. In particular, they noted that Austria's early attention to building economic and financial relationships with Eastern Europe is now bearing fruit, and that the country can be expected to continue to benefit from this diversification of the economy.

Directors considered the short-term growth outlook to be relatively favorable, although the pace of expansion is likely to moderate. They expected robust growth in productivity, and the fiscal stimulus in the 2005–06 budgets to provide ongoing support to economic activity. At the same time, they acknowledged that domestic demand has yet to gain decisive traction, and that higher oil prices and concerns about the strength of activity in the euro area could weigh on short-term prospects.

Directors commended the authorities' success over the last few years in reducing the size of government and maintaining limited deficits. They noted that the recent shift in focus to tax reform and reducing the tax burden is appropriate as it will increase Austria's attractiveness as a business location. Directors observed that the tax reform will contribute to larger deficits in 2005–06 as offsetting spending cuts are to come on stream gradually. They agreed that this widening of the deficit does not raise sustainability concerns as long as it is limited and temporary, and stressed that it will be important for the authorities not to spend unanticipated windfalls or introduce additional spending packages.

Directors supported the authorities' objective to eliminate the fiscal deficits by 2008 and return to budget balance. They underscored the importance of designing and setting in motion now the expenditure cuts necessary to achieve this objective on time as envisaged. Unless the government identifies the areas where expenditure savings can be achieved and proceeds expeditiously to mobilize the necessary consensus, the feasibility of reaching the budget targets in 2007–08 will be compromised as will plans for further reducing the tax burden. Directors saw scope for rationalizing public administration—especially at the subnational level—the health sector, and various subsidies. They welcomed progress made in designing a medium-term expenditure framework that will enhance fiscal transparency and credibility, and encouraged the authorities to ensure that it becomes operational by 2007. Directors regretted the lack of agreement on substantial changes in federal-provincial relations. They expressed the hope that the necessary political consensus can be reached to modernize this relationship in the future, with a view to increasing efficiency, streamlining the functions of various levels of government, and realigning spending responsibilities and revenue-raising powers.

Directors commended the authorities on the impressive pace of structural reforms in Austria in comparison to European peers, but stressed that there is no room for complacency. They advised the government to complete the outstanding reform agenda taking advantage of the current favorable conditions. The priority should be on further measures to deregulate the services market, liberalization of shop-opening hours by local governments, and continued labor market reform, including a move towards more flexible work hours and further efforts to facilitate the integration of older workers. Directors supported the authorities' emphasis on raising research and development spending to international levels. Welcoming the reforms on competition policy, they advised that the role of the Federal Competition Authority be further strengthened.

Directors observed that substantial pension reform in recent years has put Austria in a better position to face demographic challenges. Pension reform and harmonization have been major steps in reducing inequities, enhancing labor mobility, and achieving fiscal savings. Directors stressed that follow-up measures should include bringing the pensions of civil servants at the subnational level under the unified pension system, and close monitoring of the disability scheme to ensure that access is restricted to those who qualify for this pension.

Directors welcomed the resilience of Austria's financial sector, but emphasized that developments in financial markets require continued close monitoring. They welcomed the authorities' implementation of a variety of measures recommended during last year's Financial Sector Assessment Program exercise. However, Directors noted that there remains a discrepancy between developments in Austria's home market, where margins are tight and further consolidation can be expected, and the strong growth abroad. Given the continuing growth of foreign currency loans to households, Directors underscored that all relevant authorities should continue informing the public about the risks involved, including in the context of consumer protection. They also urged the supervisory authorities to remain vigilant with regard to risks associated with the rapidly expanding activities of Austrian financial institutions in Eastern and, more recently, Southeastern Europe. In this context, they pointed to the rapid growth of lending to the private sector in these countries, including in foreign currency. They recommended close cooperation and exchange of information with local supervisors, as already set in motion.

Directors commended Austria's official development assistance reaching 0.4 percent of GNP in 2006, and encouraged the authorities to raise it further toward the U.N. target of 0.7 percent.

Austria: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
			(Change in percent, unless otherwise noted)		
Real economy					
Real GDP	0.7	1.2	0.8	2.2	1.9
Domestic demand	-0.2	-0.7	2.3	0.7	1.9
CPI (year average) 2/	2.3	1.7	1.3	2.0	2.0
Unemployment rate (in percent) 3/	3.6	4.2	4.3	4.5	4.6
Gross national saving (percent of GDP)	20.5	21.4	21.4	22.3	22.5
Gross domestic investment (percent of GDP)	22.4	21.0	21.9	21.7	22.4
			(In percent of GDP)		
Public finance					
Central government balance 4/	-0.7	-1.1	-2.0	-1.6	-2.5
General government balance 4/	0.1	-0.4	-1.3	-1.2	-2.0
General government balance (EDP basis)	0.3	-0.2	-1.1	-1.1	-1.9
General government debt	66.1	65.7	64.5	63.6	63.5
Interest rates 5/					
Three-month interbank rate	4.3	3.3	2.3	2.1	2.1
10-year government bond	5.1	5.0	4.1	4.1	3.2
			(In percent of GDP)		
Balance of payments (percent of GDP)					
Trade balance	-0.7	1.7	0.4	1.4	1.0
Current account	-1.9	0.3	-0.5	0.6	0.1
Fund position (as of May 31, 2005)					
Holdings of currency (percent of quota)					71.9
Holdings of SDRs (percent of allocation)					60.3
Quota (millions of SDRs)					1,872.3
Exchange rates					
Exchange rate regime			Member of euro area		
Euro per US dollar 5/	1.12	1.06	0.89	0.81	0.77
Nominal effective rate (2000=100) 6/	100.2	101.0	104.1	105.2	104.2
Real effective rate (1990=100) 2/ 7/	99.3	100.2	103.4	104.6	105.6

Sources: Austrian National Bank; Austrian Statistical Office; Federal Ministry of Finance; and IMF staff projections.

1/ IMF staff projections, unless otherwise indicated.

2/ The figure for 2005 refers to May.

3/ The figure for 2005 refers to April

4/ On ESA95 basis. The Maastricht Excessive Deficit Procedure (EDP) definition—used by the Austrian authorities and in EU multilateral surveillance—differs from this due to the inclusion of revenues from swaps.

5/ The figure for 2005 refers to June 15.

6/ The figure for 2005 refers to March.

7/ Based on relative normalized unit labor costs in manufacturing.