FOR AGENDA

SM/83/268

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December 30, 1983

To: *Members of the Executive Board*

From: The Acting Secretary

Subject: Austria - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Austria, which has been tentatively scheduled for discussion on Wednesday, January 25, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hermann, ext. 74370 or Ms. Christensen, ext. 75663.

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INTERNATIONAL MONETARY FUND

AUSTRIA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with Austria

Approved by L. A. Whittome and Subimal Mookerjee

December 29, 1983

I. Introduction

Article IV consultation discussions were held with the Austrian authorities in Vienna during the period October 21 to November 2, 1983. The staff team comprised D. Ripley (Head of Mission), B. V. Christensen, W. Hermann, and P. Nyberg with M. Wallace as secretary (all EUR). Mr. Schneider, Alternate Executive Director, attended the discussions as an observer. Austria has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Background

In recent years the performance of the Austrian economy has been favorable by international comparison. Real GDP has been stable or has risen modestly, and the rate of inflation has decelerated markedly (Chart 1). Most notably, the current account balance, which had been in deficit since 1969 and had acted as a constraint on domestic policies, has been in surplus since 1982. The improvement in the external balance took place, notwithstanding a rapid rise in the fiscal deficit, and a relatively strong cyclical position in 1982. Despite the increase in fiscal support over the last two years, unemployment had risen to more than 5 percent at the end of 1983. Nevertheless, this rise does not seem to have impaired the cooperative relationship between the trade unions, employers, and the Government, which is widely known as the social partnership.

Real GDP is expected to grow by 1 percent in 1983, or at the same rate as in 1982. The stimulus for growth comes primarily from private consumption, which is expected to rise by almost 3 percent against 1 percent in 1982. This reflects an increase in real disposable incomes of a similar magnitude, facilitated by a sharp deceleration in the rate of inflation and by a second round of tax reductions, but also purchases in anticipation of the increase in the value added tax in January, 1984.

Despite the introduction of two fiscal programs in 1982, which focused on promoting private investment, investment activity remained sluggish in 1983. For the year as a whole, real gross fixed investment is expected to decline by 2 percent with construction decreasing by 1 percent and investment in machinery and equipment by 3 percent. Industrial investment, however, which fell by 16 percent in 1982, is expected to decline by a further 7 percent to levels last registered in the early 1970s. The foreign balance is expected to make a negative contribution to growth of 1 percent: the growth of real exports of goods and services has slackened with the weakening of foreign markets, while imports have been bolstered by the rise in private consumption.

The rate of unemployment is expected to increase by 1 percentage point to 4 1/2 percent in 1983 on average (Chart 2). The recent strong increase in unemployment, which contrasts with developments after the first oil shock may be attributed to a smaller outflow of foreign workers; slower growth of employment opportunities in the services sector; and most importantly, the protracted nature of the current recession, which has led industries to shed labor to a larger extent than before. This applies, in particular, to the nationalized industries, which reduced employment by nearly 10 percent between 1980 and 1983.

During the last decade, there has been a clear drop in profits and in the self-financing ratio of industrial enterprises. Aggregate industrial profits were expected to again decline in 1983. To be sure, this was not a problem specific to Austria, and it was difficult to measure whether the compression of profits has been greater in Austria than abroad. It was agreed, however, that the financial problems were particularly severe in the nationalized industries, which are concentrated in the production of iron, steel, and other basic goods.

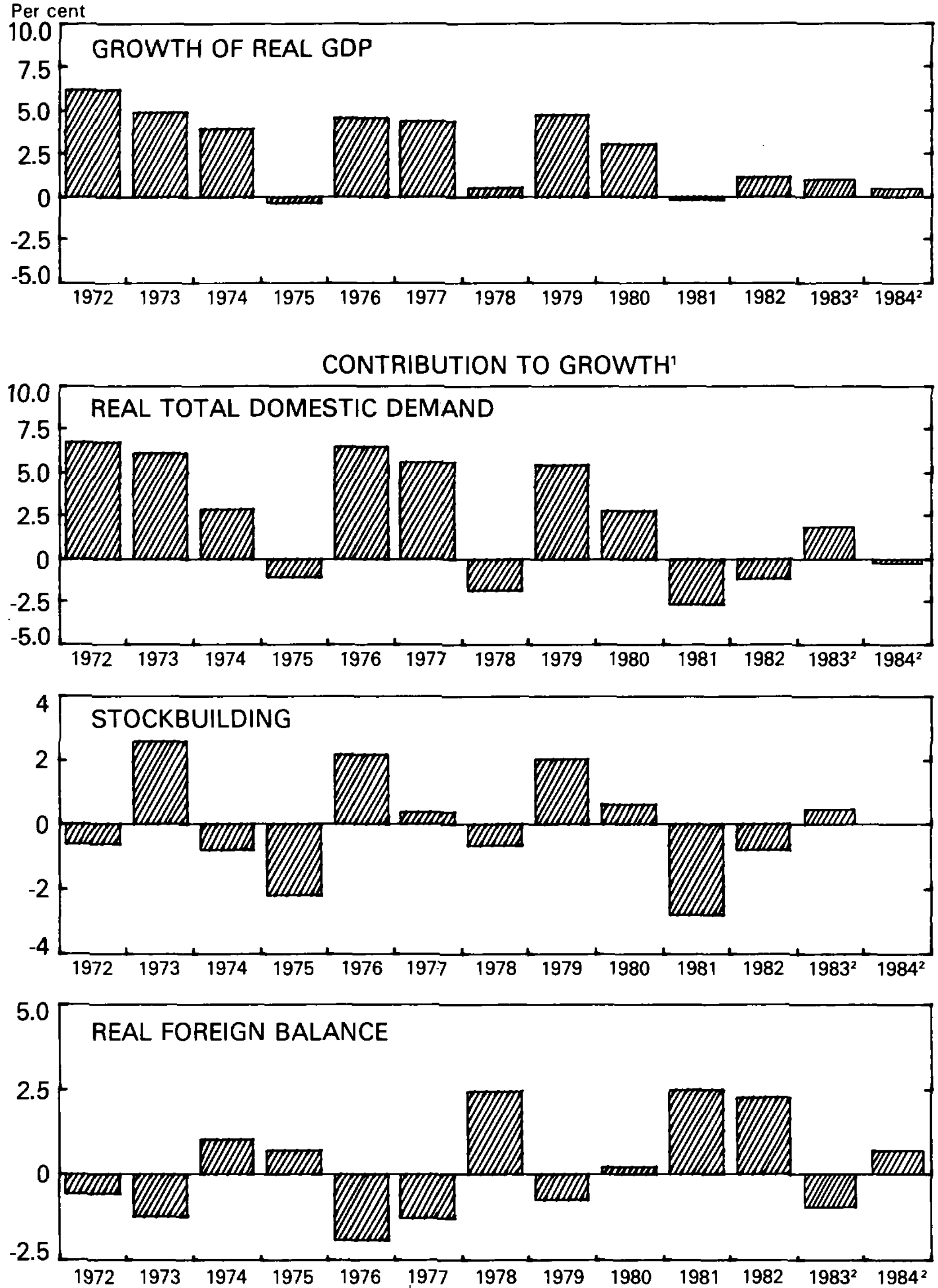
The increase in consumer prices decelerated from 6 3/4 percent in 1981 to 5 1/2 percent in 1982 (Chart 3). In October 1983, consumer prices stood 3 1/2 percent above the level a year earlier. While external factors pushed prices upward in 1980 and 1981, they also contributed to the deceleration in 1982 and 1983, as import unit values rose by only 1/4 percent in 1982 and are expected to decline by 2 percent in 1983. The development in unit labor costs, reflecting, in large part, wage moderation, has also contributed to the deceleration in the rate of inflation: the rise in unit labor costs decreased from 6 percent in 1981 to 3 percent in 1982 and a projected 1 percent in 1983.

The current account, which showed a deficit of 2 percent of GDP in 1981, swung into a surplus of 1 percent in 1982; a similar surplus is expected for 1983 (Chart 4). Most of the improvement has been in the trade balance, with a marked strengthening in unclassified exports of

CHART 1

AUSTRIA

CONTRIBUTIONS TO GROWTH

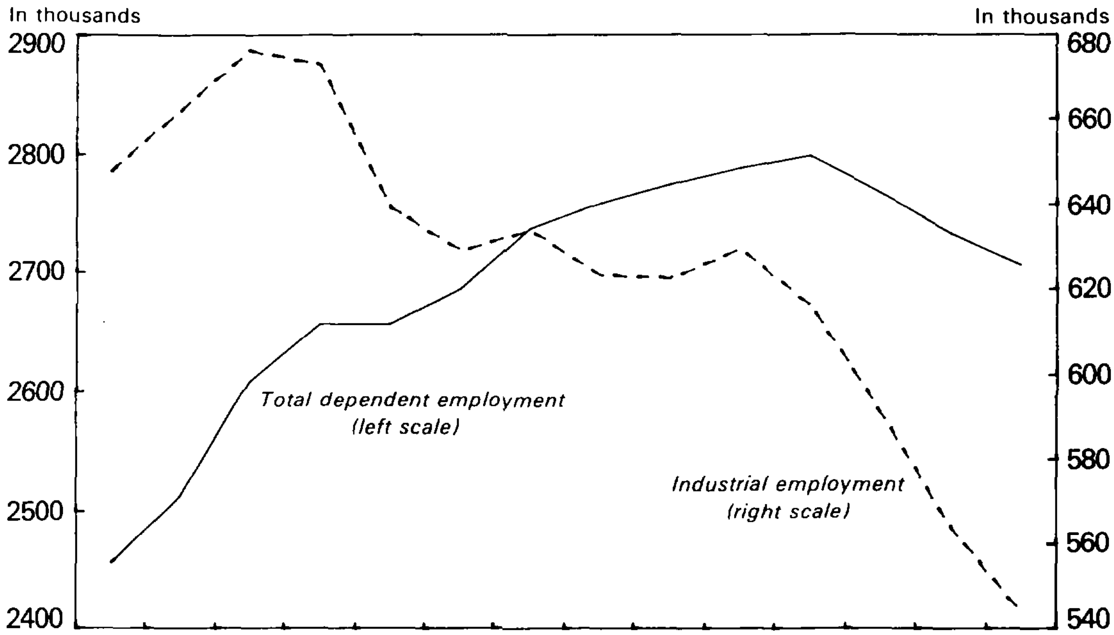


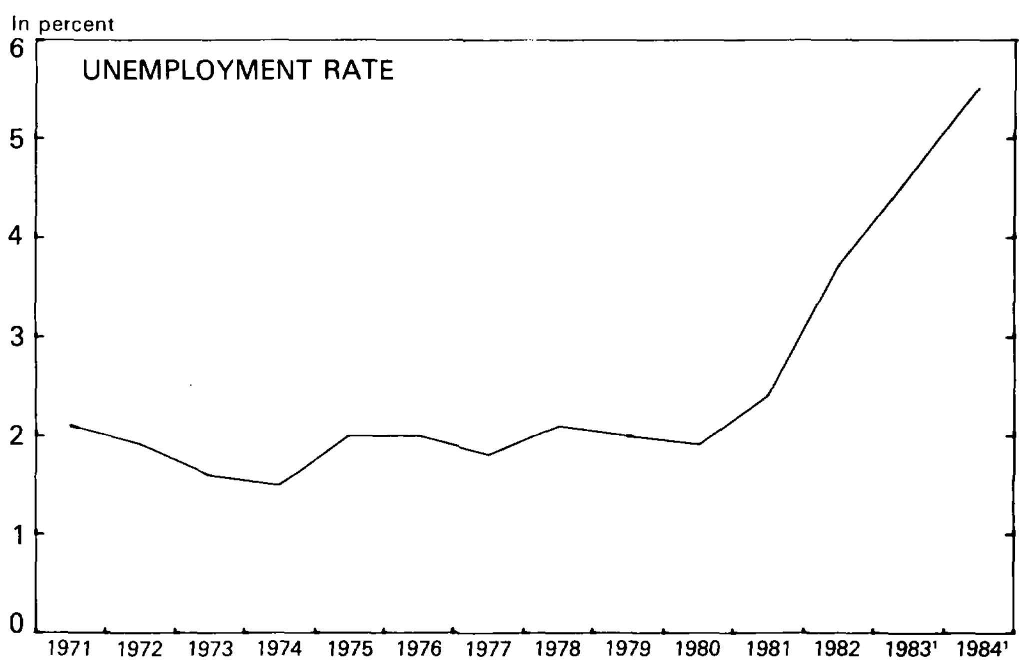
Source: Austrian Institute for Economic Research, *Monatsberichte*.
[1]Changes in per cent of previous year's GDP.
[2]Forecast by the Austrian Institute for Economic Research, September 1983.

CHART 2

AUSTRIA

LABOR MARKET INDICATORS





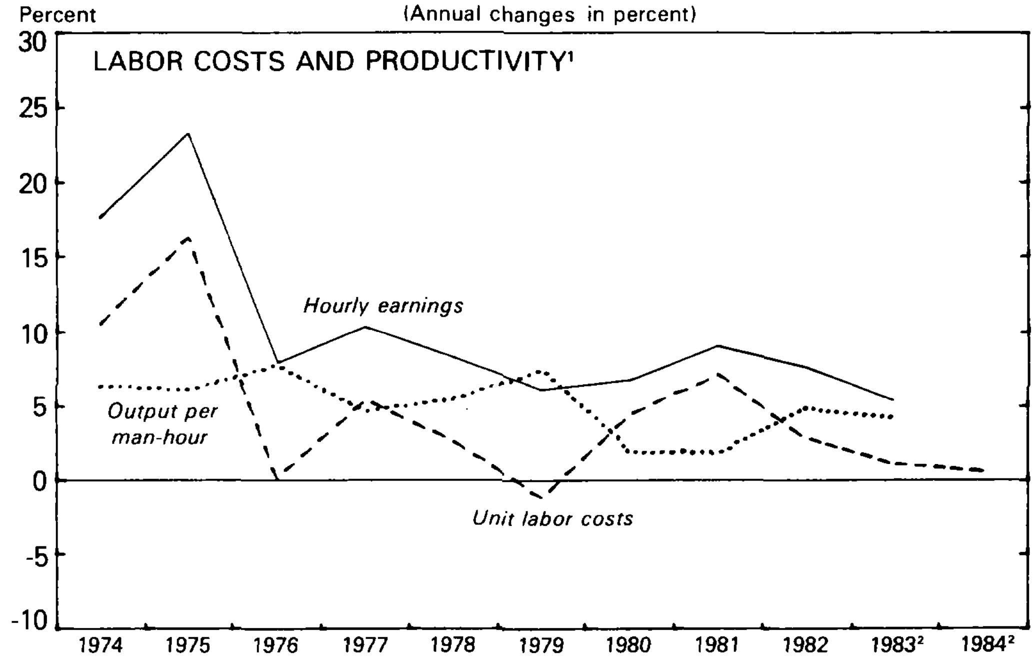
Source: Austrian Institute for Economic Research, *Monatsberichte.*
[1]Forecast by the Austrian Institute for Economic Research, September 1983.

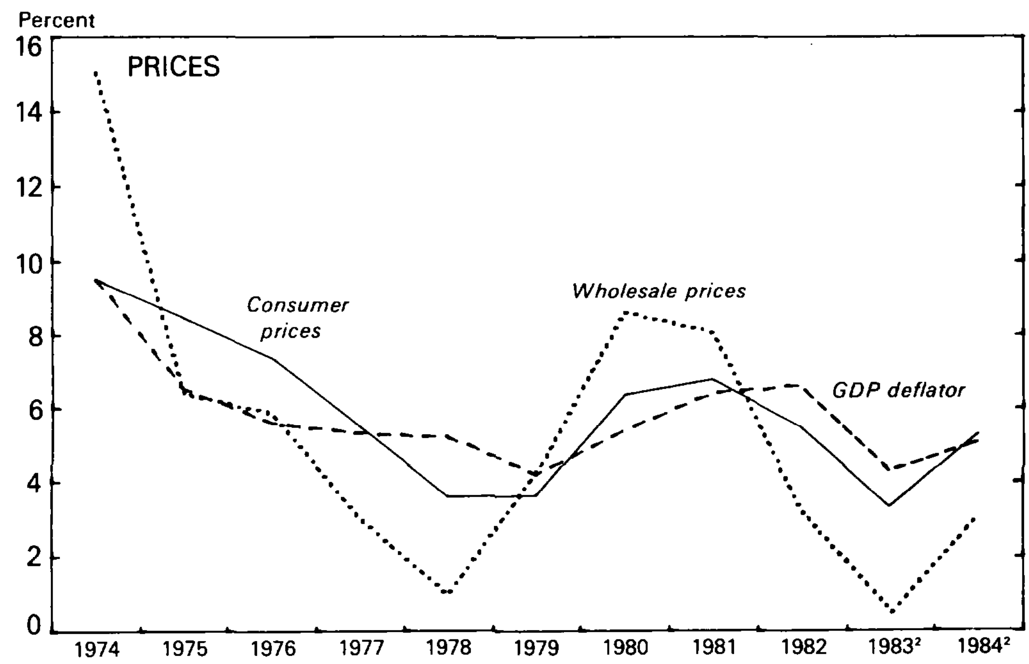
CHART 3

AUSTRIA

COSTS AND PRICES

(Annual changes in percent)





Sources: IMF, *International Financial Statistics*, and Data Fund; and forecast for 1983 by the Austrian Institute for Economic Research, September 1983.

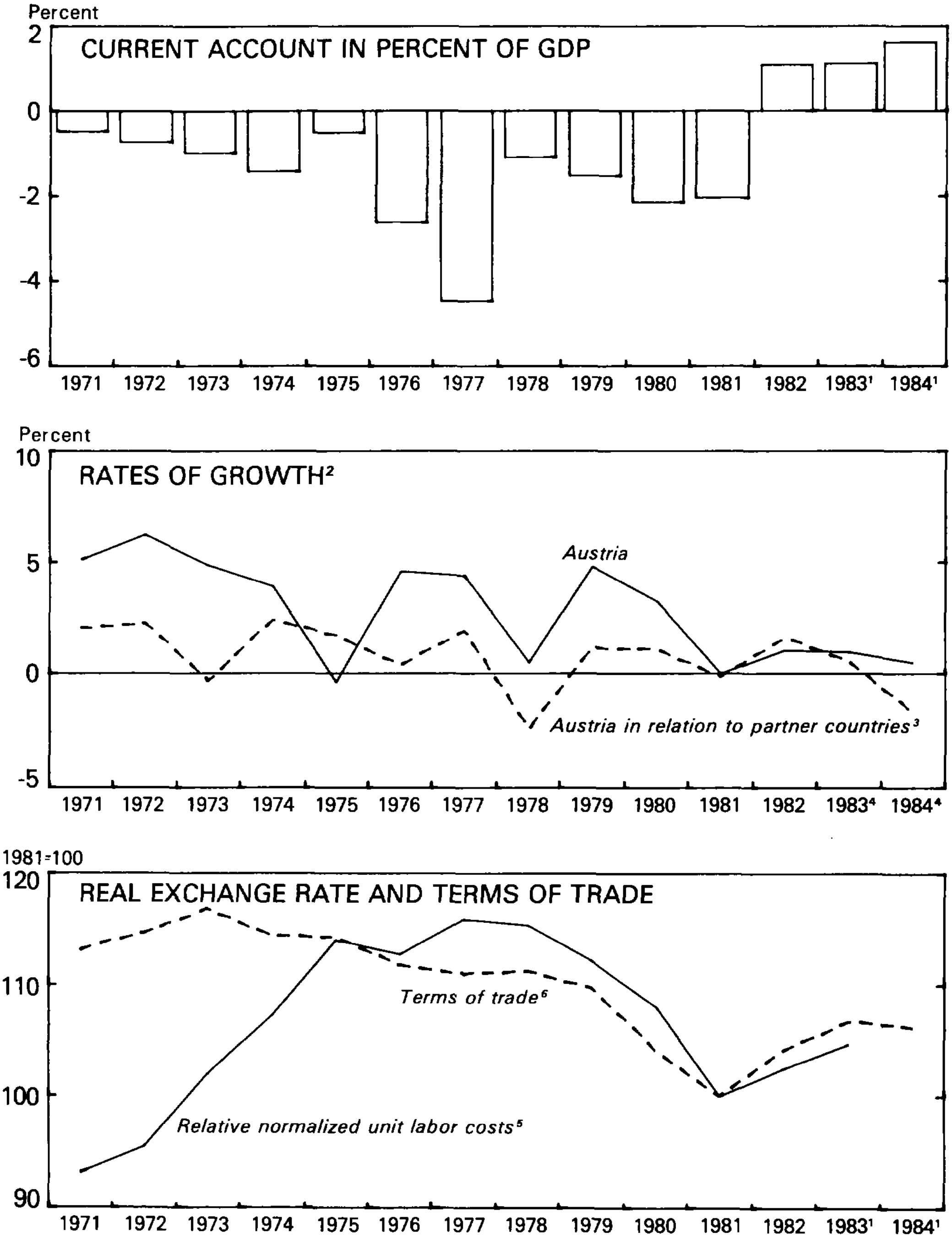
[1]Manufacturing sector.

[2]Based on forecast by the Austrian Institute for Economic Research, September 1983.

CHART 4

AUSTRIA

MAJOR DETERMINANTS OF THE BALANCE ON CURRENT ACCOUNT



Sources: Austrian National Bank, *Mitteilungen;* and Austrian Institute for Economic Research, *Monatsberichte;* and IMF, *International Financial Statistics,* and IMF staff calculations.

[1]Based on forecast by the Austrian Institute for Economic Research, September 1983.

[2]Real GNP/GDP.

[3]Austrian growth rate less partner country growth rates weighted by Austrian export shares for one year previously.

[4]Forecast by the Austrian Institute for Economic Research, September 1983, and Fund staff forecasts.

[5]Corrected for exchange rate changes. The figure for 1983 is estimated on the basis of unit labor costs during the first two quarters and exchange rates during the first three quarters of the year.

[6]Based on unit values.

goods and services and in transit trade. 1/ The Austrian authorities noted that the strengthening of the trade balance was indicative, in part, of the adjustment of domestic production to demand and of the competitiveness of Austrian products; they emphasized the rising importance of exports of specialized components, and exports of turnkey projects, accompanied by service exports, but also of increased import substitution. However, it was difficult to quantify the relative importance of structural and more transitory factors that had strengthened the current account. Staff calculations show that the improvement in the terms of trade could account for as much as two thirds of the decline in the trade deficit from 1981 to 1983. Though Austrian exports had gained marked shares, nonetheless the authorities agreed that there had recently been an increase in exports under guarantees, and a strong growth in exports to countries facing difficult external financial situations. Real energy imports were 12 percent lower in 1982 than in 1981, and in the first half of 1983 stood some 8 percent below a year earlier; this decline reflected cyclical factors, conservation, and also destocking.

After depreciating by about 8 1/4 percent in nominal effective terms in 1981, on average, the schilling has appreciated slowly but fairly continuously until March, 1983; by September 1983 it stood some 1 1/2 percent above its average 1981 level (Chart 5). The movement in real effective terms has been similar. In 1982, the average schilling/deutsche mark rate stood at S 7.03, and the authorities noted that the maximum spread between middle rates during the course of the year was 0.7 percent; the rate for the first ten months of 1983 had also averaged S 7.03, with a maximum spread of 0.5 percent.

III. The Stance of Policies

1. Monetary, exchange rate, and other external policies

Monetary policy in Austria is guided by exchange rate objectives, namely, the maintenance of a close relationship between the schilling and other currencies with a relatively stable domestic purchasing power; operationally, this implies a strong relationship between the schilling and the deutsche mark. The "hard currency" policy resulting from this linkage is seen by the authorities as an integral part of the social partnership, whose objectives include the maintenance of a high level of employment under conditions of price stability. It is thought to have led to moderation in wage claims and price developments by assuring that

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1/ Unclassified exports of goods and services were thought to be associated, in large part, with services connected with exports of investment goods and projects, which in earlier years had mostly moved in the same direction as errors and omissions. By contrast, "errors and omissions" registered a large deficit (S 11 billion) during the first eight months of 1983, while unclassified goods and services showed a surplus of S 21 billion. There was no explanation for the different movement of the two items.

undue growth in the domestic variables would not be accommodated by exchange rate adjustments. The constancy in the pursuit of monetary policy, focusing on stabilizing the short-term interest differential between Austria and Germany, and of exchange rate policy, has given rise to firm expectations about these relationships, facilitating the pursuit of these policies.

a. Monetary policy

In recent years the room for maneuver of monetary policy has become increasingly circumscribed by the international integration of capital markets and the close relationship sought with the deutsche mark. The authorities continue to focus on the movement of the differential between the Austrian and German call money rates (Chart 5). The differential that can be sustained without giving rise to capital movements or exchange rate pressure was said to have declined from some 1/2 percent to about 1/4 percent, reflecting both market developments and changes in reserve requirements.

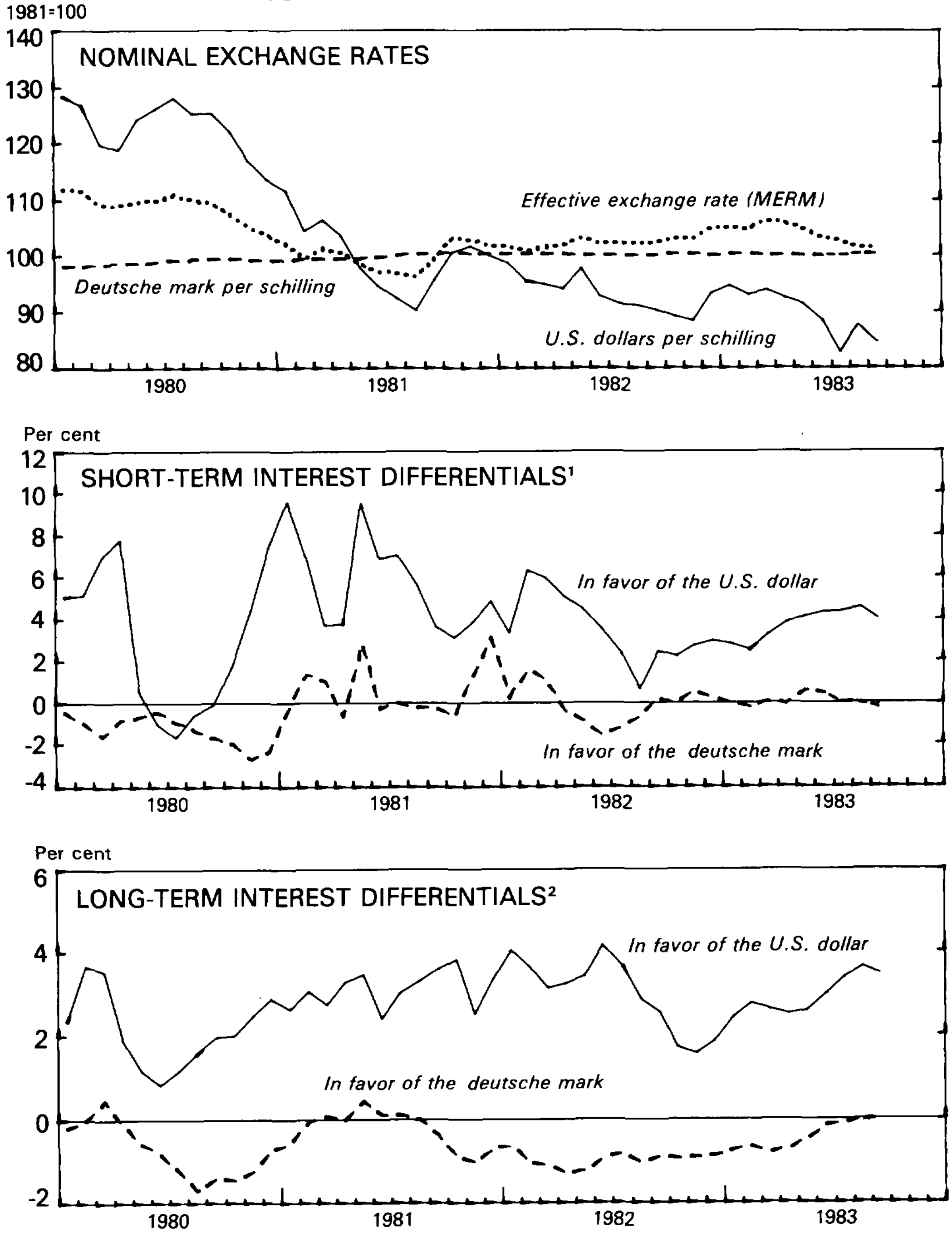
In the past it was explained that the short-term management of liquidity was made more difficult by large net foreign borrowings of the Government and other autonomous borrowers such as the official export financing agency; these flows are now much smaller because borrowing has been shifted to the domestic market in view of the ample domestic liquidity and the current account surplus. In September 1982 the scope for short-term open market operations was increased by raising the volume of such paper that could be purchased by the National Bank from S 3 1/2 billion to S 15 1/2 billion; this change signaled the intention of the authorities to shift from reliance on foreign exchange swaps to open market operations to guide short-term liquidity developments. Thus far in 1983, the monetary authorities have refrained from swap operations, while open market operations have been small.

The easing of monetary conditions in Germany from mid-1981 made possible a similar development in Austria. Domestic long-term interest rates declined in nominal terms but tended to stay relatively high in real terms due to the deceleration in inflation (Chart 6). It was thought that the real return on financial assets provided an attractive alternative to investments in fixed capital. The Austrian authorities, however, have pointed further to the fact that investments in Austria are protected, to a considerable extent, from the development of market interest rates because 40 percent of all credits are granted at preferential terms. In March 1983, the official discount rate was reduced from 4 3/4 to 3 3/4 percent, and the lombard rate from 5 1/4 to 4 1/4 percent (Chart 7). With the rise in the German lombard rate in September, the Austrian lombard rate was raised to 4 3/4 percent. During the first half of 1983 short-term interest rates declined by more than 1 percentage point, to some 4 1/2 percent but have subsequently firmed to 5 1/2 percent; long-term rates have fluctuated around 8 1/4 percent.

CHART 5

AUSTRIA

NOMINAL EXCHANGE RATE AND INTEREST RATE DEVELOPMENTS



Sources: IMF, *International Financial Statistics;* and Morgan Guaranty Trust, *World Financial Markets.*

[1] Call money rates less the Austrian call money rate.

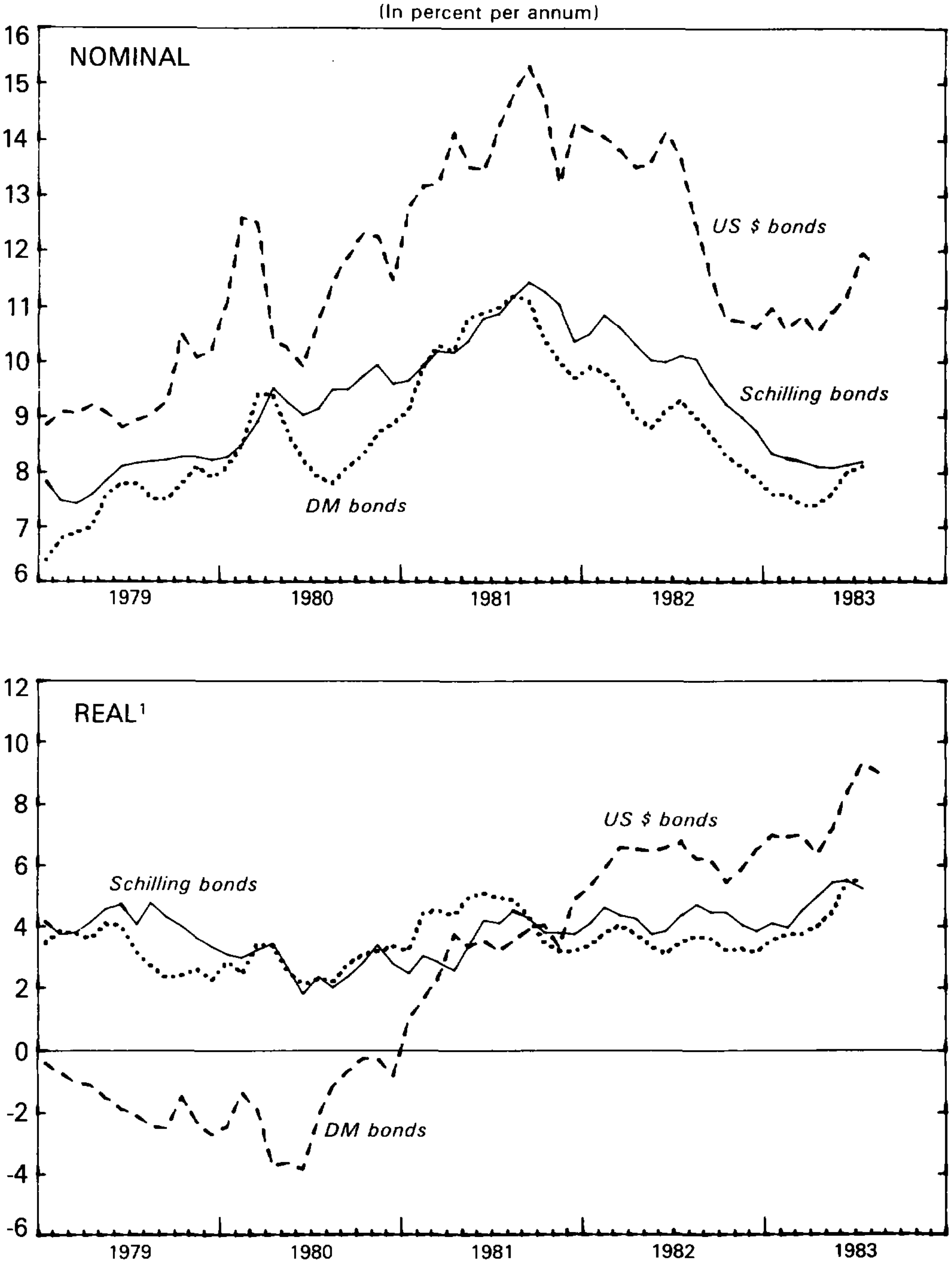
[2] Government bond yields less the Austrian government bond yield.

CHART 6

AUSTRIA

INTERNATIONAL COMPARISON OF GOVERNMENT BOND YIELDS

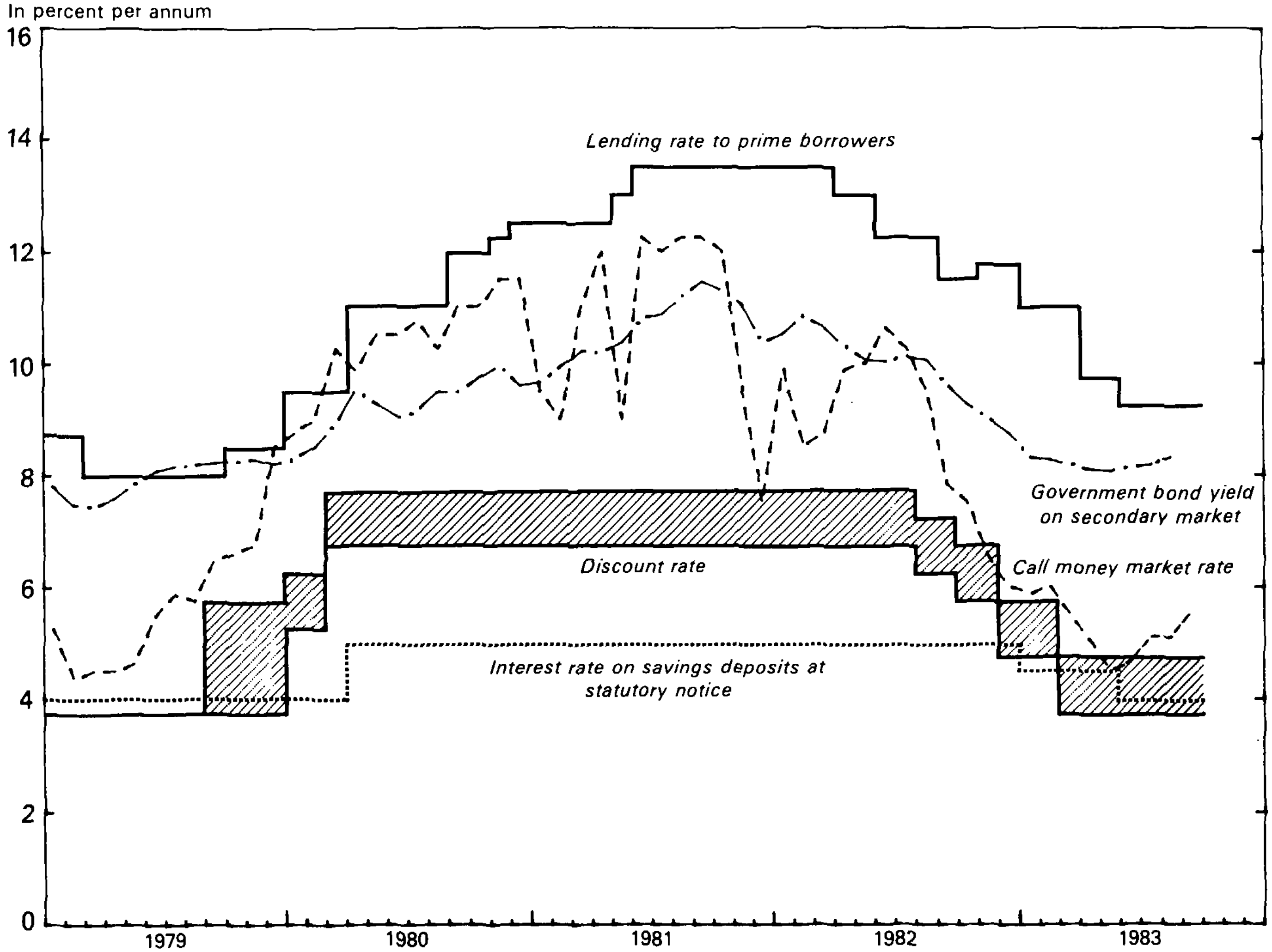
(In percent per annum)



Sources: Austrian National Bank, *Mitteilungen;* Deutsche Bundesbank, *Monthly Report;* and Morgan Guaranty Trust, *World Financial Markets.*

[1]Deflated by the rate of change of consumer prices.

CHART 7
AUSTRIA
INTEREST RATES



Sources: Austrian National Bank, *Mitteilungen;* OECD, *Financial Statistics;* and Morgan Guaranty Trust, *World Financial Markets.*
Note: Shaded area represents surcharge levied on borrowing in excess of 70 per cent of quota.

The monetary aggregates have grown rapidly in Austria in 1983--well in excess of the rates of growth experienced in Germany (Chart 8). A number of special factors were said to have given rise to a rapid expansion of currency in circulation, including, inter alia, the hoarding of bank notes abroad and discussions about the introduction of a withholding tax on interest income. The rapid growth of the monetary aggregates was of lesser concern to the Austrian authorities than to monetary authorities in some other countries, insofar as there was no official target rate of growth so that inflationary expectations were not immediately bolstered by a prospect of overshooting. Liquidity growth was not thought to give rise to any inflationary danger at present due to the slack in the economy and subdued inflationary expectations; however, continued divergence between the growth of the monetary aggregates in Austria and Germany was not felt by the authorities to be consistent with price and exchange rate objectives.

b. Exchange rate policy

The close relationship between the deutsche mark and the schilling found support throughout the economy. In addition to the benefits it provided in terms of domestic wage moderation and price stability, which facilitate investment decisions, it was noted that foreign exchange transaction costs were also reduced in that forward cover was not found essential for deutsche mark transactions. During EMS realignments, the schilling/deutsche mark rate had not come under pressure, nor had such pressure been apparent at the time of the coordinated intervention in August 1983. (At that time the National Bank sold dollars against deutsche mark for the first time.) The National Bank had intervened constantly at the daily fixing to clear the markets, but the amounts had been small. The main intervention currencies continued to be the deutsche mark and the dollar.

c. Other external policies

The Austrian economy is heavily dependent on trade since its domestic market is small; partly for historical reasons its production potential in many sectors greatly exceeds the absorptive potential of the domestic market. Increased integration with the EC has facilitated a strong increase in exports to this area, but efforts have also been made to diversify the geographical distribution of exports by increasing sales to the OPEC countries and to other third world countries. Trade with the state trading countries has traditionally been of substantial importance and is conducted under long-term agreements. Much of this trade and also trade with developing countries involves countertrade, and Austrian trading companies exist to facilitate these transactions. There had been no recent intensification of protectionist measures in Austria.

The rapid growth of exports under guarantee was noted by the staff; the authorities confirmed that in 1982 about 40 percent of merchandise exports were covered against political and commercial risk by official guarantees; these were particularly important for the exports of the nationalized industries. The availability of guarantees was decided on a case-by-case basis, and the cost of guarantees was invariant across transactions.

Austria's medium-term plan for development assistance stresses the need to satisfy basic needs. Priority is given to the LLDCs and it is the intention of the authorities to double the share of Austrian official development aid going to these countries by 1987. In 1981 the authorities had already attained their medium-term target of raising the ratio of ODA in total GNP to at least the average of the OECD countries, and for 1983/84 a figure of some 1/2 percent is in prospect. By 1990 it is expected that the ratio will rise to 0.7 percent. A large share of ODA takes the form of export credits at subsidized interest rates.

2. Fiscal policy

Fiscal policy is designed with a view to furthering growth and employment both in the short and medium term. In 1978, when the budget deficit reached a temporary peak of 4 1/2 percent of GDP, it was felt that a structural deficit had emerged and that a revival of activity would be insufficient to restore the budget deficit to an acceptable level (Chart 9). A medium-term target of 2 1/2 percent of GDP for the federal budget was established at that time. The upswing in activity in 1979/80, coupled with consolidation measures on the revenue side, reduced the deficit in 1981 to the targeted level.

With the rise in unemployment from mid-1981 and the weakness of activity, the working of automatic stabilizers increased the deficit, while additional employment support measures, particularly in construction, were introduced. Thus, in 1982 the budget deficit of the Federal Government exceeded the targeted outturn by 1 1/2 percentage points to reach some 4 percent of GDP; for 1983 the deficit was projected at 4 percent of GDP, but the outturn seems likely to reach the equivalent of 6 percent of GDP.

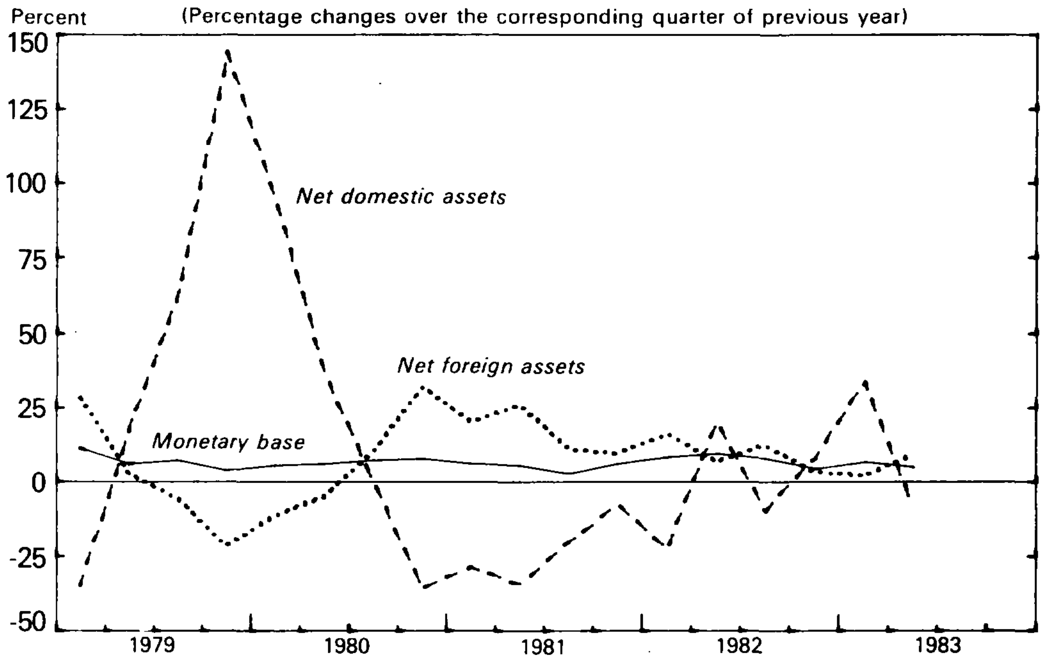
At the time of its adoption in the fall of 1982, the 1983 budget was known to be based on optimistic assumptions as to growth and employment, and the net deficit of the Federal Government was then projected to be stabilized in nominal terms, at just under S 50 billion. Deficit reducing measures were much smaller than in earlier budgets and focused on shifts in savings within the social security system that reduced the need for federal transfers and a tax measure designed to reduce tax evasion retroactively but which, in the event, did not give rise to revenues. The major expansionary measures contained in the 1983 budget included a second agreed round of reductions in personal income taxes and the continued financing of two employment support programs introduced in 1982. In view of the weakening in economic activity, the stabilization tranche of the contingency budget amounting to S 3 1/2 billion was also activated early in 1983. The authorities estimated that the overshooting of the deficit was mainly attributed to cyclical factors that had been more pronounced than had been foreseen.

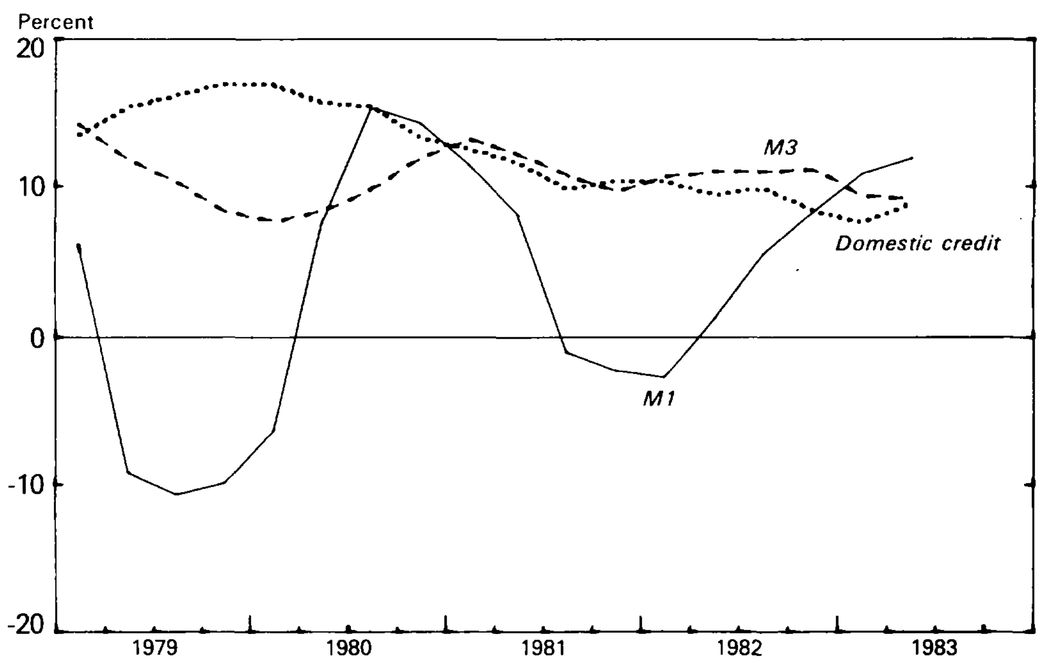
CHART 8

AUSTRIA

MONETARY AGGREGATES

(Percentage changes over the corresponding quarter of previous year)





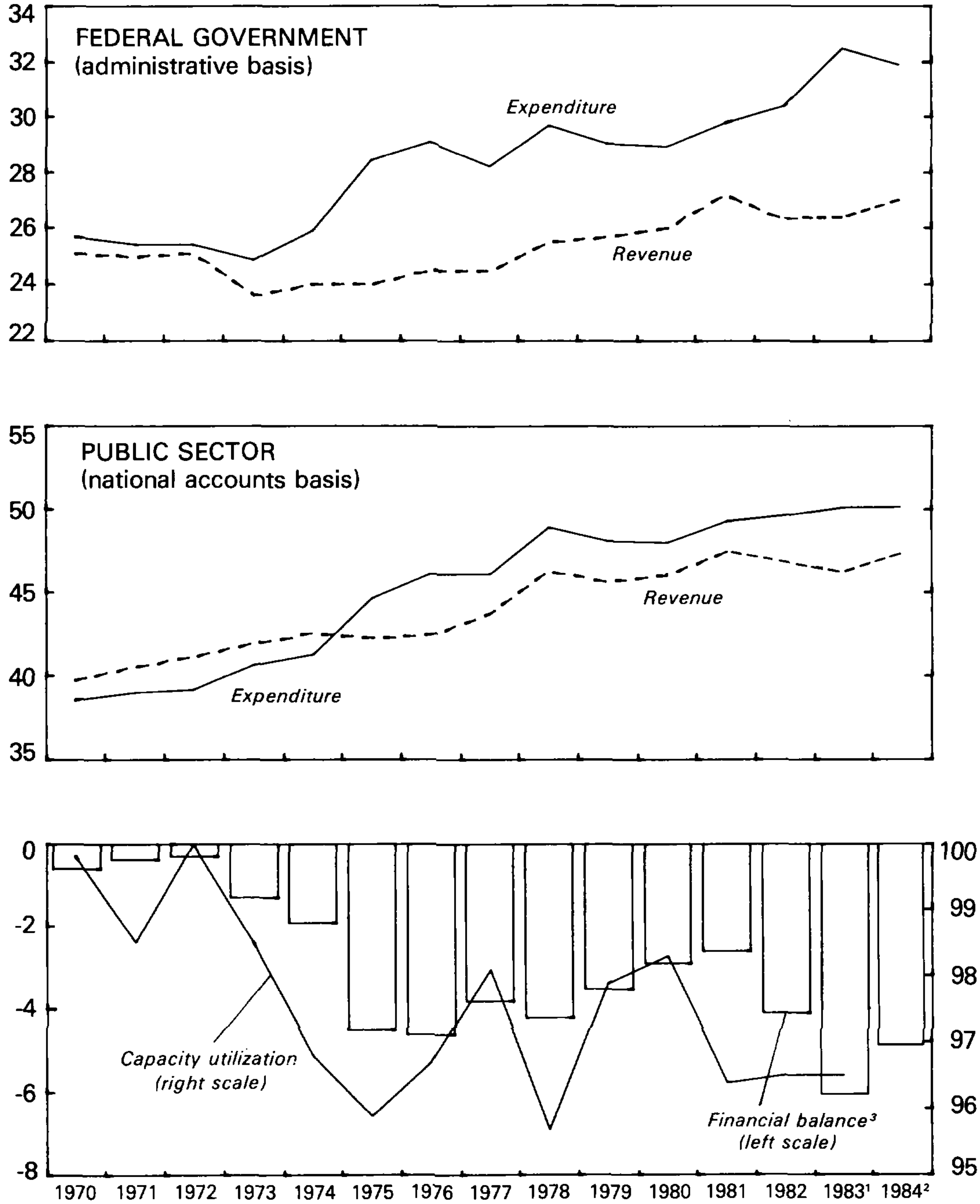
Sources: Austrian National Bank, *Mitteilungen;* and IMF, *International Financial Statistics.*

CHART 9

AUSTRIA

FINANCIAL TRANSACTIONS OF THE PUBLIC SECTOR

(In percent of GDP)



Sources: Austrian Institute for Economic Research, *Monatsberichte;* and Ministry of Finance, *Bundesfinanzgesetz.*

[1]Estimate.

[2]Budget.

[3]Federal government.

The proposed budget for 1984 is designed to reduce the deficit to 5 percent of GDP. To this end, the Government has again placed primary emphasis on raising revenues. The main measures foreseen are an increase in the value added tax by 2 percentage points effective January 1, 1984, and in certain tariffs, which together will directly give rise to an increase in the cost of living index of 1 3/4 percentage points; the introduction of a 7 1/2 percent withholding tax on interest income (most interest income is not taxed at present); and an increase in contribution rates for the unemployment scheme and for the pensions of civil servants. Expenditure savings are concentrated on cuts in housing subsidies and some social benefits, and reduced access to unemployment benefits. Negotiated wages of civil servants are budgeted to increase by 3 1/2 percent. All in all, expenditures (excluding amortization payments) are expected to rise by less than 4 percent, and revenues by 8 percent above the projected 1983 outturn.

The Austrian authorities explained that the 1984 budget was designed to minimize the adverse consequences for growth of a given cut in the budget deficit. Thus, the emphasis was given to revenue-raising measures, because they were thought to have a less depressing effect on activity than expenditure cuts. Even though in their view the federal deficit was not now excessive by general OECD standards, interest payments and certain other expenditure items were increasing more rapidly than revenues. A rising deficit would limit the scope for fiscal support in future, and corrective measures therefore had to be implemented. The current situation was well suited to a reduction in the deficit, since the upturn in activity abroad looked increasingly assured, and an incipient recovery in Austria could also be detected. Even though the Government was also reducing business taxes somewhat, the net effect of the budgetary measures on the profits position of enterprises would be small but negative because of the adverse consequences of the revenue raising measures.

The need for expenditure cuts, especially for the pension system, was widely recognized and precise proposals for reform would be discussed at midyear 1984 for incorporation in the 1985 budget; these reforms would probably affect new recipients of multiple pensions but increases in contribution rates were also likely to play a large role. It was the objective of the Government to first stabilize the deficit at some 5 percent of GDP and then to reduce it gradually.

On the revenue side, the prevalence of low and declining tax elasticities had long characterized developments in Austria. These stemmed not only from reductions in tax rates but also from the existence of specific excise taxes, the falling importance of customs revenues and the prevalence of tax deductions and tax exemptions; of particular note was the virtual absence of taxation on the thirteenth- and fourteenth-month salaries and preferential treatment accorded overtime pay. It was thus explained that some 30 percent of personal income was nearly exempted from taxation; whereas average tax rates for middle income workers amounted to some 10 percent; marginal rates for these workers were about 33 percent. Tax reform with a view to simplifying the personal income tax system had been under consideration for some time, but was difficult to implement. With the rise in the VAT, some 55 percent of tax revenues of the public sector would stem from indirect taxes. Among the industrial countries France relied proportionally more heavily on indirect taxes. The importance of indirect taxes in Austria was not thought to be a cause for concern, though reliance on such taxes should not be increased.

Though the Federal Government was continuously in deficit, the deficit of the general government was very much smaller (Chart 9). Nonetheless, the authorities noted that some of the provinces and municipalities faced financial difficulties, and the figures for the general government were thought to give a rather unreliable picture of fiscal activities. 1/

Total federal debt (excluding guaranteed debt) is estimated to exceed S 400 billion or 35 percent of GDP at the end of 1983 and debt servicing payments will amount to 17 percent of revenues (Chart 10). The share of foreign debt in total federal debt has fallen to 30 percent, as about 82 percent of the gross financing requirement in 1983 was taken up domestically--against 74 percent in 1982. The Government expects to further increase its reliance on domestic sources of credit.

The size of the public sector, as measured by the national accounts statistics, did not give rise to undue concern among the authorities, though it was agreed that the influence of the Government on economic decision-making might be rather widespread through the nationalized industries, firms controlled by the government-owned banks, the numerous government organizations to promote business activity, and the different channels for preferential finance. Some thought that simplification of the policy instruments might well increase efficiency. However, in the Austrian setting the coordination of policies of these various groups had not proved difficult since the number of persons involved in the different groups was small and the flow of information, though informal, was quite complete.

As noted, a large proportion of exports are covered by export guarantees against political and commercial risk. Outstanding guarantees to countries facing financial difficulties have increased particularly rapidly. The Government has also taken responsibility for credits raised by road financing companies, and a new road financing company was set up in the fall of 1982 in order to increase the scope for this borrowing. As discussed in section 3 below, financial support provided to the nationalized industries has also increased rapidly, particularly in the field of guaranteed credits; the ceilings for guaranteed principal and

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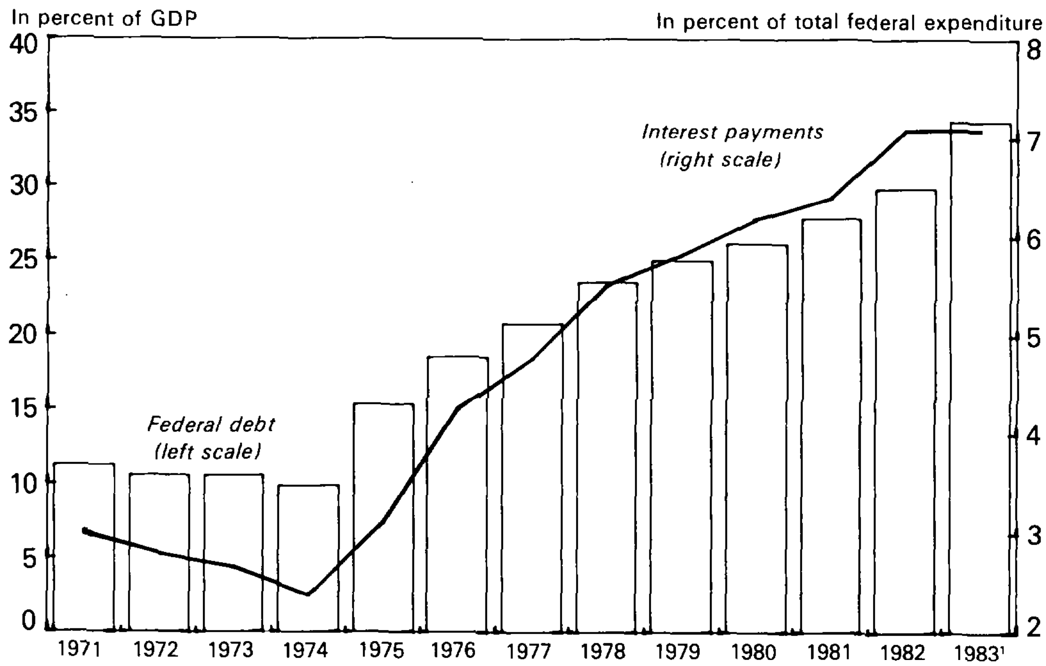
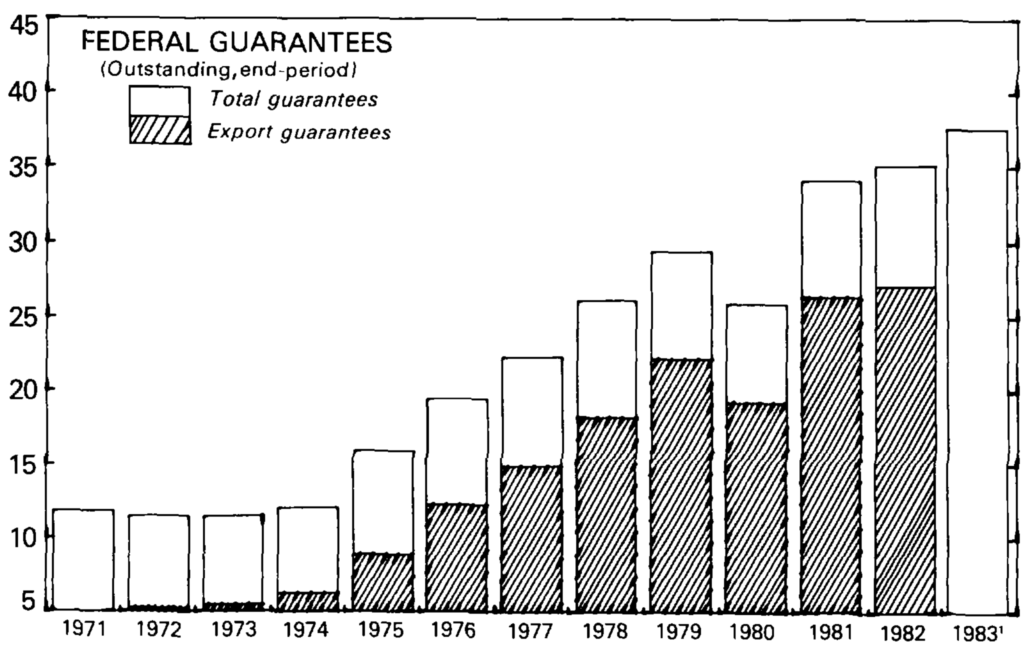
1/ One reason for the surplus on the accounts of the local authorities was the fact that earmarked taxes accruing to the Federal Government and transferred to the local authorities were booked as current receipts, but the on-lending for residential construction did not show up on a national accounts basis as outlays. Hence, growing surpluses had been registered in recent years.

CHART 10

AUSTRIA

FEDERAL GOVERNMENT DEBT AND GUARANTEES





Source: Ministry of Finance, *Bundesfinanzgesetz.*
[1] Estimate.

interest payments have each just been doubled to S 32 billion, and the Government has agreed to take over debt servicing obligations on a large share of this borrowing. Altogether, federal guarantees amounted to about S 400 billion at the end of 1982 and are likely to reach S 450 billion by the end of 1983 of which about three quarters are related to Austrian exports a further increase of S 50 billion is expected for 1984, bringing the total to 40 percent of GDP. It was noted that guarantees were also widely used in other countries to support activity and assist structurally weak sectors.

3. Structural policies

The Austrian authorities pursue an active industrial policy with the objective of supporting full employment both in the short and medium term; the pursuit of both objectives simultaneously may at times give rise to conflicts. Labor mobility is viewed by the Austrian authorities as fairly restricted, so that policy tends to focus not only on total employment opportunities, but also the geographical distribution of employment opportunities. Industrial policy is of necessity important to the authorities since the large nationalized banks have a controlling interest in private enterprises accounting for about 10 percent of industrial employment, whereas nationalized firms account for an additional 20 percent of industrial employment.

The instruments of industrial policy include direct support from the federal budget and credits at preferential rates from the National Bank. A number of organizations have been established, some quite recently, to take over shares in companies with financial difficulties but with prospects for viability; to promote venture or equity capital, partly through the expansion of tax deductions; to further the dissemination of technical information; and to further export marketing.

The OIAG, the holding company of the nationalized industries, has as its stated objective the elimination of losses in the production of finished goods in the nationalized industries outside iron and steel by 1986; capacity in the iron and steel sectors, and with it employment, are to be scaled back. Following the strategy set out by the OIAG, nationalized industries are being encouraged to develop new products with strong export potential, taking into account regional employment needs, since additional competition for existing domestic production is hard to justify. Most recently the Government has agreed to take on debt servicing obligations on borrowings by the OIAG in 1983-86 of S 16.6 billion--a figure that is admittedly close to the projected losses of the nationalized industries --to ease the financial situation of this sector and to further structural adjustment. Industries owned by the nationalized banks have also encountered financial problems. Hence, financial support was provided in 1982 to one of the nationalized banks, and further aid to firms owned by the nationalized banks is now under discussion.

Following the rationalization of energy prices, initiated in 1980, the chemicals industry has been at a disadvantage because of the high domestic price of energy and thought is being given by the Government to ways of reducing the cost of energy for this industry. However, given the difficulties encountered by the authorities in developing nuclear and additional conventional energy resources, supply constraints as well as pricing could cause difficulties.

With the increase in unemployment, the Government has stepped up its labor market policies consisting inter alia of increased training to be provided by the companies. The number of early retirees has also picked up to about 80,000 persons at end-1982 and an estimated 95,000 by end-1983. Over the last three years, the number of early retirees has increased by 35,000 corresponding to 1 1/4 percent of the labor force. The introduction of a 35 hour workweek did not appear to be in prospect.

IV. Prospects

The pickup in economic activity that became visible in the second half of 1983 is not expected by the authorities to accelerate in 1984 because of the tightening in fiscal policy. In September 1983, the Austrian Institute for Economic Research projected an increase in real GDP in 1984 of 1/2 percent with domestic demand making a small negative contribution to growth, and the foreign balance a positive contribution of 1/2-1 percent. The forecasts are based on the assumption of a growth of 3 percent in real GDP in the OECD countries and of 1 1/2 percent in Germany. The forecast, however, could turn out to be on the low side if the upswing abroad--and especially in Germany--were to be stronger than now projected.

Despite the projected increase in consumer prices of 5 1/2 percent, wages and salaries per employee are expected to increase by only slightly above 4 percent, with unit labor costs increasing by 1/2 percent. Thus trade unions are not expected to seek full compensation for the increase in the VAT. The first wage settlements concluded for 1984 have been modest at just over 3 percent for the metal industry and the textile industry, while the settlement for public sector employees is projected at 3 1/2 percent. With a 1 percent fall in employment, real disposable income could decrease by 1 1/2 percent. Assuming a decline in the savings ratio, real private consumption is expected to drop by 1 percent.

Gross fixed investment is expected to increase only slightly with construction remaining flat and investment in machinery and equipment increasing by about 1 1/2 percent. The decline foreseen in public construction is expected to be offset by a slight increase in private construction, partly promoted by fiscal incentives for the housing sector. Despite continued low capacity utilization and sluggish domestic demand, investment in machinery and equipment is expected to rise slightly due to some backlog demand for replacement investment as well as an improvement in the profit situation of small- and medium-sized enterprises and an improvement in activity abroad. Industrial investment, however, is expected to continue declining. In view of the stagnation in domestic demand, no pickup in stockbuilding is foreseen.

Merchandise exports are expected to grow by 3 1/2 percent or slightly above the foreign market growth projected at 3 percent. This estimate, however, could turn out to be on the cautious side, if the upswing abroad is strong. Services exports, however, may decline somewhat, as tourism revenue is affected by the increase in the VAT in Austria and by the lagged effect of depreciating currencies in competitor countries. With the leveling off of domestic demand, merchandise imports are expected to remain flat.

With no change in the terms of trade expected, the shift in the relative cyclical position of Austria will tend to strengthen the current account surplus to more than 1 1/2 percent of GDP (S 20 billion). The projection for the current account, however, is particularly uncertain since it depends heavily on a strong outturn for the balance on unclassified goods and services and on transit trade.

IV. Staff Appraisal

By international comparison, the performance of the Austrian economy in recent years is to be commended. The rate of inflation has decelerated markedly; the rise in unit labor costs has been dampened by wage moderation; and real GDP has remained stable or risen modestly since 1981. A supportive fiscal policy has been pursued over this period. Nonetheless, the Austrian current account swung into surplus in 1982, the first in almost 15 years, and has subsequently remained in substantial surplus. The strengthening in the current account contrasts with the experience after the first oil shock, when expansionary fiscal policies in Austria rapidly gave rise to a large external imbalance; it also contrasts with the more recent experience of other countries pursuing an expansionary fiscal policy.

It has been argued that the improvement of the current account reflects, at least in substantial part, the adaptation of the structure of production in Austria to domestic and international demand. The staff would concur with the view that there has been adjustment, but would warn that the importance of what may prove transitory factors should not be underestimated. Of the swing in the current account since 1981, one half may be attributed to the improvement in the terms of trade. Further, there has been a rapid increase in exports under guarantee, and exports to countries that have difficulty in obtaining foreign credits, so that the strength of real external demand may be somewhat overstated. Finally, Austria's cyclical position appears recently to be more depressed both relative to earlier downturns in activity in Austria and relative to the positions of partner countries.

Domestic developments in the industrial sector have been less satisfactory. Profits, as in most industrial countries, have fallen steadily and are now at a historic low. The difficulties faced by the nationalized industries--despite a relatively strong export performance--have given rise to a rapid increase in off-budget financial support.

Industrial investment is at levels last experienced in the 1970s. Thus, irrespective of the level of adjustment that has been achieved, there would appear to be a need for further efforts if the Austrian objectives of sustained growth and high employment are to be attained.

Monetary and exchange rate policy in and of themselves are seen to encourage economic efficiency and price stability by assuring decision makers that undue increases in wages and prices will affect demand. Thus the widespread support they receive would seem appropriate. It is to be noted further that though the real effective exchange rate over the last two years has appreciated, the change is not of major importance, and the Austrian authorities viewed both their current account and competitive position as comfortable. The marked stability of the deutsche mark/schilling rate has also fostered trade and is to be welcomed in that it reduces transaction costs. Although the recent rapid expansion of the monetary aggregates in Austria can be partly explained by temporary factors and is not thought to pose a problem at present for exchange rate or price stability, the staff agrees that the growth of these aggregates should be carefully monitored to ensure that such pressures do not emerge.

Substantial support for domestic demand has been provided through budgetary policy. In the event, the budget deficit rose by some 3 1/2 percent of GDP in the two years to 1983. In the absence of savings measures, the net borrowing requirement of the Federal Government in 1984 would have risen to 7 percent of GDP, a figure that is high not only by Austrian standards. The willingness of the authorities to take action to reduce this figure to 5 percent in 1984 is to be welcomed in view of the need to constrain the size of the public sector and to maintain the flexibility of fiscal policy in future.

The reduction in the deficit in 1984 is to be achieved primarily by tax increases that--though possibly less deflationary in the short-term than expenditure reductions--have an adverse effect on the business sector and on Austria's competitive position in tourism. Given the already very large share of government revenues in GDP, the staff would advise great caution in introducing further substantial rises in taxation in the near term and would suggest that greater efforts be made to control the deficit from the expenditure side. Federal expenditures will rise very rapidly in the coming years, particularly in the absence of reforms in the social security system, thus increasing the role of the Government in resource allocation. Total expenditures will be bolstered by rising debt servicing payments both for government and guaranteed credits. It is to be hoped that the Pension Reform Commission will be able to identify timely cuts of a sufficient magnitude rather than rely principally on increases in contribution rates and that support from the social partners will ensure the acceptance of such measures.

As regards an expansion of off-budget financing, particularly in the form of guaranteed credits, the final budgetary costs of such support are difficult to calculate and their economic implications need to be carefully monitored. Such support could prove counterproductive if it were to lessen incentives for efficiency, thus delaying the adjustment process; though financial support measures may usefully stabilize activity and employment in the short term, the possible trade-off between shorter- and longer-term employment opportunities should be borne in mind.

There has been a proliferation of government organizations designed to support the business sector. In addition, there are numerous channels for the allocation of preferential credits. As has been noted in the past, the flexibility of monetary policy has been impaired by selective credit schemes. It would appear that this system must give rise to inefficiencies in resource allocation. Similarly, the complex system of tax deductions causing differential taxation of income according to source involves economic costs that are difficult to quantify and has rightly long been viewed as an area that needs to be reformed.

In summary, the performance of the Austrian economy in the 1980s has been good. Austria has maintained a comparatively high level of employment although its economy is an open one and although a number of structurally weak sectors are of substantial importance. The strengthening of the external account attests to the competitiveness of Austrian goods, while efforts are being made to restore fiscal flexibility at an opportune moment. The staff would only caution lest the understandable desire to avoid short-term unemployment should lead to the pursuit of policies that might prolong the adjustment process. The staff would support the Austrian authorities in their intention to reduce future government deficits through expenditure control, rather than to offset such growth by revenue increases.

It is recommended that the next Article IV consultation with Austria be held on an 18-month cycle.

Fund Relations with Austria

(as of December 29, 1983)

Date of membership:	August 27, 1948
Status:	Article VIII
Quota:	SDR 775.6 million
Fund holdings of Austrian schillings:	SDR 168.1 million or 22 percent of quota
Austria's holdings of SDRs:	SDR 154.0 million or 86.0 percent of net cumulative allocation
Gold distribution:	231,072 fine troy ounces
Lending to the Fund:	Commitment under the supplementary financing facility SDR 50 million fully outstanding
Last Consultation:	The staff report for the 1982 Article IV consultation with Austria (SM/82/225) was discussed by the Executive Board on January 7, 1983 (EBM/83/7)
Exchange system:	The Austrian authorities aim at maintaining a close relationship between the schilling and other currencies with a stable purchasing power. In March 1973 the authorities adopted a policy of orienting the Austrian schilling toward the currencies participating in the European common margins arrangement, in particular the deutsche mark. After the establishment of the European Monetary System (EMS) on March 13, 1979, the Austrian authorities pursued a policy of maintaining a close relationship between the schilling and the currencies of the EMS. In practice, this has again implied a close link to the deutsche mark, which was confirmed in recent EMS realignments, when the Austrian schilling followed movements of the deutsche mark.

Basic Data

Area and population	1982
Total area	83,850 square kilometers
Total population	7,574,100
GDP per capita	US$8,831

	1982		1980	1981	1982	1983 1/	1984 1/
	In billions of schillings	In percent	(Volume changes; in percent)				
Demand and supply							
Private consumption	640.1	56.1	1.6	0.5	1.1	2.8	-1
Public consumption	212.7	18.6	2.3	1.8	2.0	2.0	1 1/2
Gross fixed investment	263.0	23.1	3.6	-1.7	-5.4	-2.0	3/4
Construction	139.7 2/	12.2	-0.7	-1.7	-5.9	-1.0	--
Machinery and equipment	110.1 2/	9.6	9.5	-1.7	-4.4	-3.0	1 1/2
Stockbuilding 3/	-0.8	-0.1	0.6	-2.8	-0.8	0.5	--
Total domestic demand	1,115.0	97.7	2.8	-2.6	-1.2	2.0	-1/4
Exports of goods and services	472.4	41.4	8.1	6.5	3.2	0.5	1 3/4
Imports of goods and services	446.3	39.1	7.3	0.2	-2.3	3.0	1/4
Foreign balance 3/	26.1	2.3	0.2	2.5	2.2	-1.0	3/4
GDP	1,141.1	100.0	3.0	-0.1	1.1	1.0	1/2
Industrial production 4/	306.0	...	3.0	-1.3	0.2	--	...
			(Annual averages; in thousands)				
Employment and unemployment							
Labor force			3,326	3,345	3,342	...	...
Employed foreign workers			175	172	156	...	...
Dependent employment			2,789	2,799	2,766	2,733	2,706
Unemployed			53	69	105	133	159
Unemployment rate (in percent of dependent labor force)			(1.9)	(2.4)	(3.7)	(4.6)	(5.5)
			(Changes in percent)				
Prices and incomes							
GDP deflator			5.4	6.3	6.6	4.3	5
Consumer prices			6.4	6.8	5.4	3.2	5 1/4
Wholesale prices			8.6	8.1	3.1	0.5	3
Export unit value			5.0	6.1	4.5	0.5	2
Import unit value			10.6	10.5	0.3	-2.0	2 1/2
Unit labor costs 5/			4.7	5.9	3.0	1.0	0.5
Real disposable income 6/			0.8	-1.1	3.2	3.0	...
Savings ratio (in percent of disposable income)			11.0	9.1	10.1	10.3	...

1/ Forecast by the Austrian Institute for Economic Research, September 1983.
2/ Excluding value added-tax.
3/ Changes as a percentage of previous year's GDP.
4/ Excluding mining, including small industry.
5/ Computation by the Austrian Institute for Economic Research.
6/ Corrected for changes in consumer prices.

	1980	1981	1982	1983 1/	1984 1/
	(Period averages; changes in percent)				
Monetary data					
Monetary base 2/	6.7	5.1	7.5	12.0	8.0
Money (M1)	7.4	3.7	3.1	13.5	6.0
Money plus quasi-money (M3)	9.5	11.4	11.0	...	...
Domestic credit	15.3	11.1	9.5	...	...
Call money rate (December average, in percent)	11.5	10.8	6.0	...	...
	(In billions of schillings)				
Federal Government finances 3/					
Revenue	259.0	287.8	300.9	317.0	341.9
(In percent of GDP)	(26.0)	(27.2)	(26.4)	(26.4)	(27.0)
Expenditure	288.3	315.3	347.6	390.0	404.0
(In percent of GDP)	(28.9)	(29.8)	(30.5)	(32.5)	(31.9)
Financial balance	-29.3	-27.5	-46.6	-73.0	-62.1
(In percent of GDP)	(-2.9)	(-2.6)	(-4.1)	(-6.1)	(-4.9)
Central Bank 2/					
Net foreign assets	85.9	94.2	97.4	99.9	...
Net domestic assets	28.9	27.9	29.3	31.5	...
Of which:					
Refinancing of banks	19.5	24.2	25.2	34.4	...
Open market transactions	10.9	11.1	12.3	12.1	...
Balance of payments 4/					
Trade balance	-87.5	-77.1	-62.6	-59.5	-53.2
Tourism balance	42.9	46.4	49.2	46.6	47.5
Unclassified goods and services	25.1	15.7	29.9	...	...
Current account	-21.4	-21.4	12.2	12.6	20.5
(In percent of GDP)	(-2.2)	(-2.0)	(1.1)	(1.1)	(1.6)
Official reserves and exchange rates 2/					
Gross official reserves					
In billions of schillings	112.4	123.7	128.3	127.5	
In billions of SDRs	6.4	6.7	7.0	6.5	
Schillings per SDR	17.6	18.5	18.4	19.6	
Schillings per U.S. dollar	13.8	15.9	16.7	18.6	
Schillings per deutsche mark	7.1	7.1	7.0	7.0	
Average effective rate, percentage change					
Nominal effective rate (MERM)	3.4	-8.3	2.4	2.0 5/	
Real effective rate (relative normalized unit labor costs)	-3.8	-7.4	2.5	3.6 6/	

1/ Forecast by the Austrian Institute for Economic Research, September, 1983.
2/ End of period unless stated otherwise; data for the Central Bank for 1983 are August figures and data for official reserves and exchange rates are September figures.
3/ The figures for 1983 are estimates and the figures for 1984 are the budget. Expenditures exclude debt redemption.
4/ The figures for 1983 and 1984 are based on the September 1983 forecasts by the Austrian Institute for Economic Research.
5/ January-September 1983; percentage change from corresponding months of 1982.
6/ Percentage change between first half of 1983 and first half of 1982.