FOR AGENDA

SM/03/367

October 31, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Austria—Staff Report for the 2003 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2003 Article IV consultation with Austria, which is tentatively scheduled for discussion on **Monday, November 24, 2003**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Austria indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Demekas (ext. 36755) and Mr. Tzanninis (ext. 34114) in EU1.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Monday, November 10, 2003; and to the European Commission and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

AUSTRIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Austria

Approved by Ajai Chopra and M. T. Hadjimichael

October 30, 2003

Consultation discussions were held in Vienna during August 28–September 9, 2003. The mission comprised Messrs. Demekas (head), Tzanninis, and Ms. Krajnyák (all EU1). The mission met the Deputy Federal Chancellor and Minister of Social Affairs; the Ministers of Finance and of Economic Affairs and Labor; the Deputy Governor of the Austrian National Bank (OeNB); members of the parliamentary budget committee; officials of the federal government, the OeNB, and the Financial Market Authority; the federation of trade unions; the federation of Austrian industry; and representatives from the banking sector, the academic community, and the main economic research institutes. Mr. Prader, Alternate Executive Director for Austria, participated in the meetings.

The mission presented its preliminary conclusions at a joint press conference with the Deputy Governor of the OeNB. The authorities released the mission's concluding statement and intend to publish this report.

The elections of November 2002 returned to power the coalition between the People's Party and the Freedom Party that had been in government since 2000. As a result, the broad economic policy priorities of the authorities have remained largely unchanged.

Austria has accepted the obligations of Article VIII (Appendix I) and subscribes to the Special Data Dissemination Standard. Data provision is adequate for surveillance (Appendix II). Data in this report reflect information received until October 16, 2003. More recent data may be obtained directly from the following sources:

Austrian Institute of Economic Research (WIFO) .... http://www.wifo.ac.at
Austrian National Bank .... http://www.oenb.co.at
Federal Ministry of Finance .... http://www.bmf.gv.at
Institute of Advanced Studies (IHS) .... http://www.ihs.ac.at
Statistics Austria .... http://www.oestat.gv.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/applications/web

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Background

Although Austria is in its third year of sluggish growth, it has weathered the global slowdown better than its major EU partners and the short-term outlook, though subdued, is improving. Inflation and unemployment remain among the lowest in the EU. In a major shift from the policies of the 1990s, the government has adopted an ambitious supply-side reform program, with the goal to reduce the tax burden, contain fiscal pressures from population ageing, and raise Austria's potential growth rate. A wave of deregulation and privatizations during the last three years, a major pension package this year, and tax reforms planned for 2004-05 are significant steps in this direction.

Key issues

- **Short-term outlook**. Several factors suggest that the slowdown may have run its course and the staff expects growth of real GDP to recover slowly from 0.9 percent in 2003 to 1½ percent in 2004 and accelerate further in 2005. The inflation outlook is benign.

- **Fiscal policy**. Staff supports the tax reform plans for 2004-05 and the objective of reducing further the tax burden over the medium term, and recommends that future measures be designed to simplify the system and lower the burden on factors of production. However, the authorities' expenditure reduction plans lack specificity and the cuts envisaged for 2004-05 do not compensate for the revenue losses from tax reform (although the intention is to cover the ground later on). This may raise questions about the credibility of medium-term commitments. For tax reform to succeed, the necessary expenditure cuts should be set out in a comprehensive, multi-year expenditure framework, with specific quantitative targets and the measures to achieve them. Designing and implementing such a framework may take time, notably because it requires re-negotiating the financial arrangements between various levels of government in order better to align spending authority with taxing responsibility. Staff thus advises the authorities to consider phasing in the 2005 tax reform more gradually.

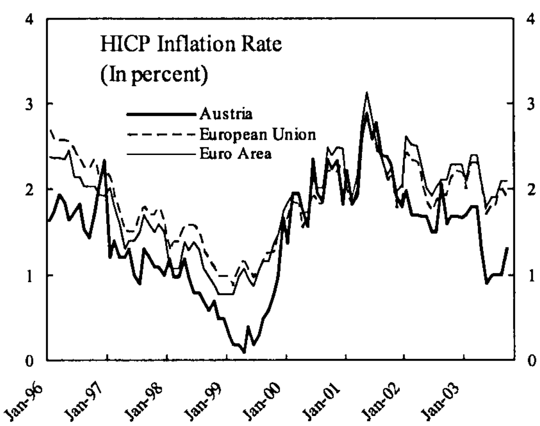
- **Pension reform**. The recent reform makes an important contribution toward long-term fiscal sustainability, but there is still unfinished business in this area. The 10 percent cap on benefit losses needs to be revisited in order to minimize its undesirable effects, while providing a cushion especially for low-income pensioners. The priority now is to harmonize the various public pension schemes and to reform disability pensions, with a view primarily to reducing inequities and distortions.

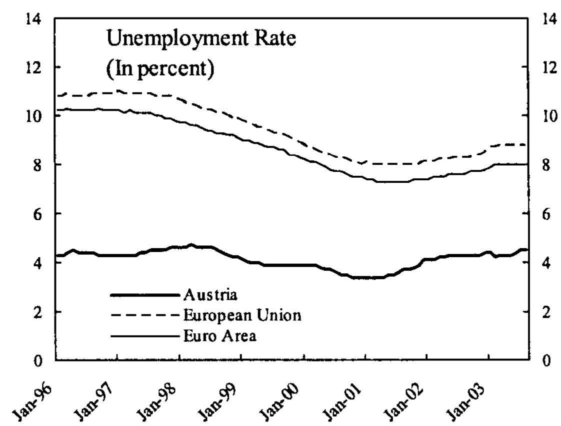
- **Financial sector issues**. The financial system has fared reasonably well during the slowdown, and appears to be sound and well supervised. Although foreign currency loans to households are unlikely to jeopardize the stability of the financial sector, closer supervisory scrutiny is warranted.

- **Structural policies**. Progress since 2000 has been significant. Deregulation and privatization will boost competitiveness and yield increasing benefits in the long run. It is important now to complete this agenda and design policies to raise labor force participation, especially among the elderly.

I. Background

1. **The Austrian economy performed well during the 1990s but long-term problems were left unaddressed.** Growth averaged 2½ percent, above the EU average, and inflation and unemployment rates compared even more favorably. But complacency and a tradition of consensus in public policy-making, while instrumental in maintaining social peace and wage moderation, resulted in fiscal policy drift (except for a spurt of adjustment during 1996–97 to meet the Maastricht criteria) and rising public debt. There was little effort to address structural fiscal issues—such as the growing burden of ageing population or the proliferation of various social transfers—and large segments of the economy remained under the control of the state.





2. **At the turn of the decade, there was a major policy shift toward fiscal consolidation and liberalization.** The center-right coalition that emerged in 2000 set the goal of balancing the budget over the cycle, produced the first (small) fiscal surplus in over 30 years, privatized some public enterprises, and launched a wave of deregulation. Following the renewal of the mandate of the coalition in November 2002, the new government reaffirmed its pledge to balance the budget over the cycle, privatize the remaining public companies, continue with deregulation, and reduce the tax burden to 40 percent of GDP by 2010. The first tax cuts are set for 2004, followed by larger cuts in 2005. The government also passed a major pension reform package in June 2003 against fierce opposition.

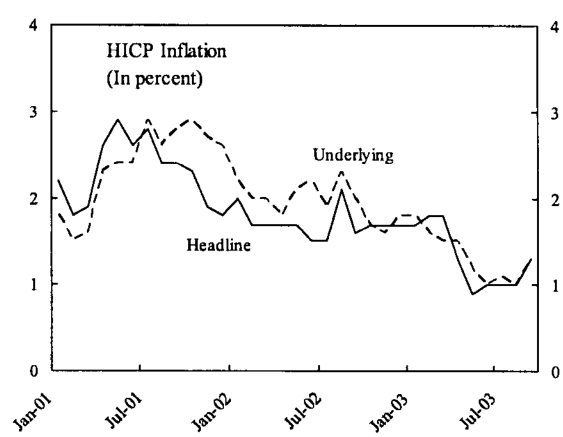
3. **This shift in strategy was broadly in line with previous IMF recommendations.** Directors welcomed the policy shift in 2000 and supported the government's overall strategy. At the conclusion of the last Article IV consultation on August 7, 2002, Directors commended the authorities' sound macroeconomic and structural policies and urged them to strengthen the focus on long-term challenges, notably population ageing.

4. **This year's consultation discussions took place against the background of a weak economy.** Although Austria has weathered the global slowdown better than its major EU partners, the economy has entered its third year of sluggish growth. Growth slowed from

1.4 percent in 2002 to 0.7 percent (year-on-year) in the first half of 2003 (Table 1 and Figure 1). The cyclical weakness during the past three years reflected mainly a sharp fall in investment, mostly in machinery and equipment. Through the end of last year, this fall was offset by buoyant exports, including to Central and Eastern European Countries (CEECs), where Austrian businesses have expanded successfully during the last decade. Data for the first half of 2003 suggest that, although investment may have started recovering from its two-year slump, the continuing weakness in partner countries—notably Germany—has started to affect Austrian exports.

5. **The slowdown has created considerable slack in the economy and helped turn the external current account into a surplus.** Given a potential growth rate estimated at just over 2 percent, the output gap widened further in 2003, in line with trends in the rest of the euro area (Figure 2). The slowdown also affected the labor market, where employment declined in 2002 and the early part of 2003, particularly in the manufacturing sector. The unemployment rate has nonetheless remained low, edging up only slightly during this period to 4½ percent in September. The external trade and current accounts registered surpluses for the first time in well over a decade as imports were dampened by the cycle but export growth remained positive, despite some deceleration in early 2003. The underlying competitiveness position is strong: Austria's diversified export base has sheltered the economy from the effects of the recent appreciation of the euro and the REER remains historically low (Figure 3). As a result, export market shares have grown (Figure 4).

6. **Inflation remains among the lowest in the euro zone.** Harmonized inflation decelerated during 2002–03 to 1.3 percent (year-on-year) in September. The deceleration was more pronounced for underlying inflation, which had been, on average, ¼ of a percentage point higher than headline inflation during 2002, but has matched harmonized inflation in recent months. Weak domestic demand, a stronger euro, and wage moderation were the main contributing factors.



7. **The budget target was relaxed but fiscal policy was mildly contractionary in 2002** (Figure 2). In the face of the prolonged slowdown, the government revised its original "zero-deficit" budget target to allow the operation of automatic stabilizers, and furthermore announced two small fiscal stimulus packages (totaling 0.3 percent of GDP) in mid-year. However, better-than-expected nontax revenues, expenditure savings by regional and local governments, and some shifting of fiscal operations outside the budgets of subnational governments cushioned the effect of the cycle on the general government deficit, which totaled 0.4 percent of GDP for the year (Table 2). The impact of the stimulus packages on the fiscal balance will be registered largely in 2003.

8. **Monetary policy loosening in the euro area has provided stimulus.** A series of interest rate cuts by the ECB during 2002–03 offset the effects of a modest real effective appreciation and maintained accommodative monetary conditions in Austria (Figures 2 & 3). The downward trend of real interest rates provided opportunities to business to expand bond financing, substituting to some extent for lower bank credit.

II. Report on the Discussions

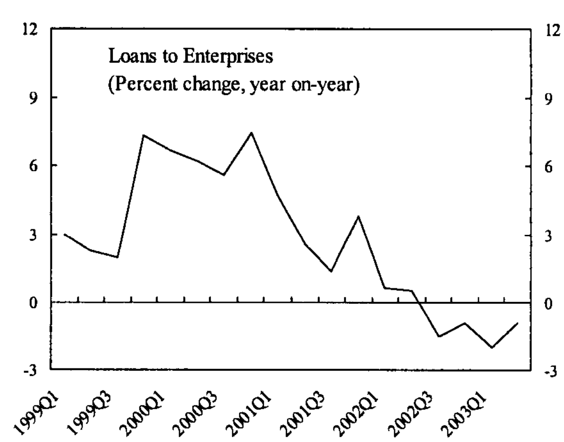
9. **The main topics of this year's consultation discussions were the authorities' medium- and long-term policy initiatives, notably tax and pension reform.** Although the current cyclical weakness creates political headwinds—including within the coalition—the government maintains its focus on a medium-term program of broad structural reform, with the ultimate goal to preserve Austria's competitiveness and raise its potential growth rate. It has started turning this program into reality with major pension and tax reforms. Discussions thus focused on how to complete these reforms, while, at the same time, maintaining an appropriate policy stance over the coming years. Discussions also covered financial sector and structural issues.

A. Short-Term Outlook

10. **A number of factors suggest that the slowdown may have run its course** (Figure 4):

- **Retail sales** have been gaining strength since mid-2002.
- **Construction investment** has staged a recovery in 2003 after two years of decline.
- Labor market conditions are stabilizing, with **employment** recently showing the first signs of growth after a period of retrenchment.
- **Competitiveness** has remained strong and export market shares have continued to grow.

11. **The shift to a neutral fiscal policy stance and the lagged effects of accommodative monetary conditions are also expected to help the recovery.** The budget for 2003–04 (paragraphs 15–16) implies a broadly neutral policy stance (see Table 2) and the authorities thought that monetary conditions in the euro area were appropriate and would not restrain the recovery. As regards the recent fall in credit to enterprises, staff and the authorities agreed



that, on the basis of available indicators, it appeared to be a reflection of weak investment demand and there was no concern that credit conditions might impede the recovery. The authorities noted that the shift to tighter credit standards by banks—especially vis-à-vis small- and medium-sized enterprises—in anticipation of the Basle II standards had largely been completed and that credit conditions for households continued to be easy.

12. **Staff expects growth to recover slowly and remain below potential through 2004.** Staff projects real GDP growth of 0.9 percent in 2003. This implies a very gradual recovery in the second half of 2003, led by a slowly improving external environment and strengthening investment. Growth would gather pace in 2004 but, at an average of 1½ percent, still lag behind potential, and reach 2½ percent in 2005 (Table 3).

13. **This short-term growth outlook is subject to considerable uncertainty, but risks are probably tilted to the upside.** While the international environment appears to be improving and there are indications that activity in Austria has bottomed out, it is hard to forecast the timing and speed of the recovery, particularly in investment. Reflecting these uncertainties, at the time of the discussions, the 2004 growth forecasts of the OeNB and leading research institutes ranged between 1.2 and 2.1 percent. The staff forecast is on the conservative side. Even though a delay in global recovery could weaken the prospects for exports—an engine of growth in recent years—and discourage investment, upside risks dominate. A better international environment combined with Austria's strong competitive position and export market diversification would improve business sentiment rapidly, as would the rebound in stock markets and the lagged effects of the monetary stimulus. Indeed, preliminary national accounts data for the second quarter of 2003 released after the consultation discussion suggest that the incipient recovery in investment may be stronger than initially estimated.

14. **The factors that led to the fall in inflation are waning.** Staff expects inflation to average 1¼ percent in 2003 and 2004 as the effects of lower oil and food prices dissipate, the euro exchange rate stabilizes, demand gathers steam, and the prospects for deflation in Germany—Austria's largest source of imports—are becoming increasingly remote.

B. Fiscal Policy

15. **The two-year budget for 2003-04 is aimed at maintaining the broad structural balance reached in 2002.** This is consistent with Austria's commitments under the EU's Stability and Growth Pact. For 2003, the budget envisages revenues to fall by just under ½ percent of GDP due to the cycle and expenditures to rise by ¾ percent of GDP relative to 2002, resulting in a general government deficit of 1½ percent. The rise in spending reflects cyclical factors and some discretionary outlays (mainly increases in family benefits, deferred relief for the 2002 floods, and the carryover from the 2002 stimulus packages), which are partly offset by targeted cuts in public administration. For 2004, the budget targets a reduction of the general government deficit to just under 1 percent of GDP through continuing expenditure cuts. The budget for 2004 also incorporates the first round of tax reform (Box 1),

but its revenue impact in that year is to be almost entirely offset by increases in environmental taxes.

Box 1. Tax Reform Plans

The **long-term goal** is to reduce the tax burden from 44½ percent of GDP in 2002 to 40 percent by 2010, and simplify the structure and enhance the transparency of the system.

The **first two phases** of tax reform involve the following:

- In **2004**, the budget incorporates an increase in the tax-exempt personal income threshold by about 65 percent to € 14,500; a halving of the tax on retained profits of partnerships and sole proprietors (currently ranging from 0 to 50 percent); and a cut of the tax on companies' incidental wage costs by 3 to 10 percentage points.

- Plans for **2005** include an overhaul of the personal income tax, aiming at a general reduction and a flatter progression of tax rates; a reduction of the corporate income tax rate by at least 3 percentage points from the current 34 percent; and cuts in nonwage labor costs.

The **budgetary impact** in 2004 will be virtually nil, as the thrust of the tax cuts will be felt later and hikes in fuel taxes offset the remaining effect. The government estimates the net impact in 2005 (with details still to be worked out) at 1¼ percent of GDP.

16. **The staff endorsed the budget plans for 2003–04**. The "zero-deficit" policy implemented in 2001 was successful in balancing the budget for the first time in over three decades and setting the stage for medium-term fiscal consolidation. The staff had also supported the original "zero-deficit" budget for 2002 even though it was procyclical, in order to bolster the credibility of the new policy and on the expectation of a milder slowdown. But in view of the deeper-than-expected slump, sticking to a zero headline deficit in 2002—and *a fortiori* in 2003—would have meant an excessive and unwarranted withdrawal of stimulus. Therefore, the mid-2002 shift to a policy of structural balance, which is consistent with the authorities' Stability Program (see below), strikes the right balance between cyclical and medium-term considerations. Should risks to the outlook materialize, the authorities indicated—and the staff agreed—that fiscal stabilizers should be allowed full play.

17. **Fiscal policy over the medium term is oriented toward maintaining a balanced budget over the cycle and reducing the tax burden to 40 percent of GDP by 2010**. The latter (implying a reduction in the tax burden of 4½ percentage points of GDP) is an important part of the government's supply-side strategy to reduce the role of the state, liberalize the economy, and promote private entrepreneurship and innovation. The measures legislated for 2004 and planned for 2005 were the first significant steps in this direction. The latest (March 2003) updated Stability Program (Box 2) incorporates these measures into the government's medium-term plans.

Box 2. Austria's Updated Stability Program (2003–07)

The updated Program of March 2003 reaffirms the goal set in previous programs to **balance the budget over the cycle**. A major new element is the implementation of **tax reform** in 2004 and 2005, in line with the ultimate objective of lowering the tax burden to 40 percent of GDP by 2010. Because the planned expenditure reductions do not offset the tax cuts fully, the **overall and structural deficits are projected to widen in 2005** before they resume their downward trend. The debt ratio would continue to decline steadily to just under 60 percent of GDP by 2007.

Austrian Stability Program: General Government Accounts 1/

	2003	2004	2005	2006	2007
	(In percent of GDP)				
Receipts	51.2	50.8	49.5	49.4	49.4
of which: tax burden	*44.3*	*44.0*	*43.0*	*42.9*	*42.9*
Expenditures	52.4	51.6	51.0	50.5	49.8
Overall fiscal balance, EDP definition 2/	-1.3	-0.8	-1.5	-1.1	-0.4
General government debt ratio	67.0	65.1	63.8	62.1	59.7

1/ Official projections, March 2003.
2/ Maastricht Excessive Deficit Procedure (EDP) definition, which differs from ESA95.

18. **On the expenditure side, the authorities have ambitious plans in a number of areas.** The authorities are aware that expenditure savings of the size required to cover the revenue loss from tax reform could not be achieved by untargeted, across-the-board cuts. They are thus targeting savings in a number of key expenditure categories and have started taking measures in several of these.

- **Health spending** is to be reduced through hikes in certain contributions, co-payments, and deductibles, and increases in the share of generic drugs.

- In **public administration**, the government plans a reduction of staff by 10,000 (some 5 percent of the total) by end-2006 mainly through attrition and a 3 percent reduction of operating expenses at the federal level.

- **Education spending** at the provincial (Länder) level is to be controlled through an increase in the student/teacher ratio.

- The recent **pension reform** (see following Section) will not only bolster the long-term sustainability of the system but also generate savings of about ¼ percent of GDP already in 2006.

19. **Furthermore, the authorities pointed to initiatives still in gestation that could result in significant additional savings in the future.** These were the *Austria Convention*, a broad forum of experts and representatives of the social partners with the mandate to re-think the role of the state in the economy; and the negotiation of a new financial arrangement (*Finanzausgleich*) between the federal, provincial, and municipal governments, which would re-define and try to balance the tax and spending responsibilities of the various levels of

government (the current *Finanzausgleich* expires in 2004). These initiatives would help contain spending over the medium and long term, but it was too early to predict the precise size and timing of their effects.

20. **The staff supported the objective of reducing the tax burden over the medium term, as well as the specific tax reform plans for 2004–05, emphasizing that they should be designed to promote sustainable growth.** Austria's relatively high tax burden would increasingly act as a brake on growth, especially in the context of an expanding EU, where tax rates are generally on a downward trend. To promote the authorities' supply-side objectives, tax reform should aim at easing the burden on factors of production. The intention to focus the first two rounds of tax reductions primarily on personal and corporate income taxes was thus appropriate, as it would strengthen incentives to work and encourage entrepreneurship. The staff supported the authorities' intention to gear future reforms—which must be significant in order to reach the objective of a 40 percent tax burden by 2010—toward simplifying the complex direct tax system,[1] and urged them to minimize distortions in the tax treatment of various assets.

21. **However, the staff noted that, although the government's broad expenditure priorities were appropriate, their plans lacked specificity and the cuts envisaged in the updated Stability Program did not match the revenue losses from tax reform.** The staff supported the government's emphasis on permanent, high-quality measures. It pointed out, however, that the lack of specificity regarding their quantitative impact and time horizon, as well as the uncertainties surrounding the savings that are supposed to be generated by subnational governments, weakened the authorities' medium-term strategy. The previous Stability Program for 2001–05, which did not incorporate tax reform, aimed at achieving a small surplus in 2004 and maintaining it thereafter over the cycle, while the updated Program projects deficits through 2007. Moreover, because the planned expenditure adjustment in 2004–05 does not fully offset the impact of the first two rounds of tax cuts, there would be a temporary jump in the deficit in 2005 by about ¾ percent of GDP. Against this background, the staff questioned the postponement of the medium-term balanced budget objective—a question also raised by the European Commission—and expressed concern about the temporary increase in the deficit in 2005 which, under current projections, would be procyclical.

22. **The authorities did not share the staff's concern about the difference in the timing of revenue and expenditure cuts.** They argued that tax reform would generate long-term economic benefits that would outweigh the costs of a temporary hike in the deficit in one

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[1] Personal income tax and social security schedules are encumbered by various deductions and tax credits, special treatment accorded to some forms of income (such as Christmas and leave bonuses), and exemptions for various social benefits.

year. They pointed out that, while tax reform was under the control of the federal government, the necessary expenditure measures had to be implemented by all levels of government and required consensus and common action, and could thus not be expedited. They also pointed out that, despite the temporary increase in the deficit in 2005, the debt-to-GDP ratio is expected to decline steadily throughout the period covered by the updated Program. They thus felt it was unnecessary, indeed futile, to try to synchronize precisely revenue and expenditure cuts in each year. Instead, they argued that their fiscal strategy should be judged not merely by its impact on the deficit but by the quality and the long-term economic effects of the planned tax and expenditure measures.

23. **A comprehensive medium-term expenditure policy framework would enhance credibility and facilitate strategic policy choices**. The staff agreed that a one-off procyclical jump in the deficit would be a price worth paying for early tax reform, especially as it did not raise any long-term sustainability issues (Appendix III). But in the absence of detailed and firm expenditure plans, this increase in the deficit in 2005—a pre-election year—might raise questions about the credibility of the medium-term commitments in the Stability Program. A comprehensive multi-year expenditure framework, with annual targets broken down by major program, and accompanied by a set of specific policies to achieve them would illustrate policy tradeoffs, help reconcile conflicting objectives, and enhance transparency and credibility. It would be especially helpful in rationalizing subsidies and social transfers, where the scope for savings is considerable. Work on such a framework, drawing on the experience of other countries, had begun at the Ministry of Finance last year. However, the November 2002 elections had interrupted this work and the design was still at an early stage.

24. **In the absence of such a framework, the staff proposed phasing in gradually some of the tax cuts planned for 2005**. Designing an appropriate medium-term expenditure framework would take time, especially given the need first to conclude negotiations on a new *Finanzausgleich*. Staff thus considered that legislating the tax reform measures planned for 2005 in the context of the 2005 budget but delaying the effective date for some of them to later years might be a good second-best solution: it would confirm the government's commitment to tax reform and, at the same time, preserve the integrity of the medium-term fiscal program.

C. Pension Reform

25. **The recent pension reform makes a key contribution toward long-term fiscal sustainability by lowering expected pension spending considerably**. The reform introduces parametric changes to the existing pay-as-you-go system to strengthen the link between lifetime contributions and benefits; set benefits at a more realistic level; and create incentives for longer working life by making the choice between working and retiring actuarially fairer. Measures were also taken to encourage the creation of a private pension pillar and a special "hardship fund" was created to support low-income pensioners. In a last-minute political compromise, which was not part of the government's original proposal, total benefit losses from the reform were capped at 10 percent (for a detailed presentation of the pension reform

and a quantitative staff assessment see Annex). The combination of these measures is projected to generate savings of about 1½ percentage point of GDP annually in the long run, eliminating more than one third of the projected increase in the pension system's deficit. Moreover, the reform will help raise labor force participation of older cohorts, thus lowering the fiscal burden of the pension system even further, though its impact in this area is more uncertain. Due to demographic trends, the profile of pension spending still shows a hump in 2030–35, but the reform dampens considerably its path over time (to a peak of about 16 percent of GDP from 14½ percent today) and makes fiscal pressures more manageable.

26. **The staff strongly supported this reform, but pointed to a number of undesirable effects introduced by the 10 percent cap on benefit losses.** *First*, the cap severs the notional link between contributions and benefits, one of the major guiding principles of this reform: once the cap becomes binding, benefits would be determined essentially by the old formula reduced by 10 percent, regardless of the new parameters. *Second*, because the cap has no expiration date although it will clearly become obsolete with time, it introduces uncertainty about the long-term impact of the reform. And *third*, because the cap is applied to all pensioners, it reduces savings in the long run without providing support to those who need it most. The staff thus argued that this cap be revisited with a view to minimizing its undesirable effects while, at the same time, providing a cushion especially for low-income pensioners.

27. **Staff and authorities agreed that the priority should now be to harmonize the various public pension schemes and to reform disability pensions.** The pension fund for private sector employees covers about three-quarters of the insured population. But other funds—notably that for civil servants—have different provisions and, in some cases, more generous benefits. The authorities intend to harmonize the various schemes, with a view primarily to reducing inequities and distortions. Generating additional savings would be a secondary objective, to be achieved only in the long run. In addition, the authorities intend to rationalize disability pensions, whose generous provisions and lax enforcement risk turning them into an early retirement vehicle. The authorities pointed out that harmonization is a complicated issue, both technically and politically, and for this reason they intend to phase in the measures slowly.

D. Financial Sector Issues

28. **In the authorities' assessment, the financial system is fundamentally sound and well supervised.** The latest available data (June 2003) suggest that bank profitability remained solid throughout the slowdown and capital ratios are more than adequate (Table 4). The insurance sector has also fared reasonably well. High profits from banking and insurance business in CEECs helped mitigate the impact on profitability of rising client bankruptcies, losses in equity markets, and insurance claims related to the 2002 floods. The risk from the exposure of Austrian banks in CEECs was manageable: loan exposure was limited and assets were mostly invested in government securities. Furthermore, cross-border supervision had been strengthened, with three Memoranda of Understanding already signed with supervisors in CEECs and five more at various stages of negotiation. The authorities expressed satisfaction

with the functioning of the Financial Market Authority (FMA), created in 2002 (for details see SM/02/211). A state-of-the-art legal framework, experienced staff, and financial and operational independence enable the FMA, in cooperation with the OeNB and foreign supervisors, to safeguard the soundness of the Austrian financial sector at a time of increasing complexity and cross-border expansion.

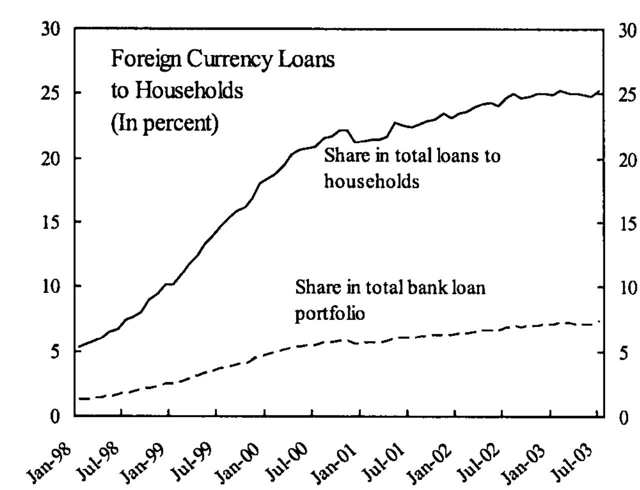
Austria: Banking Sector Soundness and Profitability

	1999	2000	2001	2002	June 2003
Net interest income (in percent of total assets)	1.2	1.2	1.2	1.2	1.2
Operating profit (before tax, in percent of total assets)	0.7	0.8	0.8	0.7	0.7
Cost/income ratio (in percent)	70.6	66.6	67.4	69.3	68.4
Loan-loss provisions (in percent of bank claims)	3.0	2.9	3.1	3.3	3.5
Capital adequacy ratio (in percent)	13.1	13.3	13.7	13.3	13.9
Return on equity (in percent)	6.9	9.4	9.8	5.4	6.3

Source: OeNB.

29. **Preparations for the forthcoming Financial Sector Assessment Program are well advanced.** The FSAP, whose conclusions and recommendations are to be discussed during the 2004 Article IV consultation, will provide an opportunity to assess financial sector soundness and effectiveness of supervision in greater depth. The authorities have set up a inter-agency coordinating group to prepare the FSAP and act as the counterpart of the missions in October and December 2003.

30. **Staff expressed concern about the rise of foreign currency loans to households.** Austrian banks account for over one-third of Swiss franc and Japanese yen loans in the euro area. These loans have been growing for some time spurred by lower interest rates and now account for most of new credit to households.[2] Banks are largely hedged against exchange rate risk, but the concentration of collateral in real estate and the uneven regional distribution might expose some of the smaller regional banks to losses should adverse exchange or interest rate developments lead to higher default rates on these loans. Supervisory concerns are mitigated by the historically low default rates on household debt and by benign real estate



[2] A typical foreign currency loan to a household is used for house purchase; has a variable rate; involves repayment of principal at maturity; and requires households to establish redemption savings accounts with the lending bank, with regular contributions to build assets over time to cover the principal repayment. These accounts also serve as additional collateral, and can be in a different currency than the loan.

price trends (real estate prices fell through most of the 1990s, and although there has been some growth since mid-2001, the increase has been modest). But the staff wondered whether risk management practices in smaller banks, in particular, were adequate for handling this risk.

31. **The authorities shared the staff's concern and were taking measures.** While these loans are unlikely to jeopardize the stability of the financial sector, the FMA and OeNB have intensified the monitoring of highly exposed banks and started a public information campaign. In addition, they are considering a range of options to raise banks' and customers' awareness of the risks involved and improve risk management practices. These include issuing guidelines dealing with internal reporting and auditing, stress testing, and risk management.

32. **Austria is now in full compliance with all 28 Financial Action Task Force (FATF) recommendations against money laundering that require specific action.** In July 2002, legislation discontinuing anonymous passbook accounts came into effect, closing the last outstanding discrepancy between Austrian practice and the FATF recommendations. Austria is also in full compliance with six of the seven special recommendations on terrorist financing and in partial compliance with the recommendation dealing with money/value transfer systems, awaiting EU regulatory proposals in this area. The process of implementing the OECD's anti-bribery initiatives has stalled, as draft legislation dealing with the responsibility of legal entities has not mustered the necessary support.

E. Structural Policies

33. **The government intends to complete its ambitious structural agenda, building on the considerable progress achieved since 2000** (Box 3). The remaining six enterprises in which the government holds a large stake (including Telekom Austria) are slated for privatization during this legislature, and the government stake in one company (steel group Voestalpine AG) was sold in September. The government holding company (ÖIAG) is to be dissolved after the completion of privatization, signaling the end of government ownership of enterprises. Further deregulation plans target the railways.

34. **The government places great emphasis on promoting private entrepreneurship and making Austria an attractive business location.** It has cut red tape and reduced the administrative burden on establishing new business, making it possible to set up a new company in one day; and has introduced tax exemptions to newly founded companies. The government also considered instituting more flexible work hours, but this proposal encountered strong opposition. The Austrian labor market performs well, as suggested by low unemployment, aggregate wage moderation, and strong evidence of cross-sector wage flexibility (SM/00/179). Recent changes to the severance pay system will contribute to greater flexibility. Staff and authorities agreed that further measures should focus on increasing labor force participation, particularly of older workers.

Box 3. Main Structural Reforms since 2000

Product markets: The liberalization of the electricity (2001) and gas sectors (2002) was completed ahead of EU deadlines. The Industrial Code was liberalized and procedures for the establishment of industrial plants were shortened in 2001. An independent Federal Competition Authority was established in 2002 to act as an investigative body that can file motions with the Cartel Court. The Cartel Law was reformed in 2002 through establishing a federal cartel attorney and reinforcing the range of sanctions.

Retail and distribution: More flexible shop opening hours were legislated in 2003 but implementation was left largely to the Länder.

Labor market: The law restricting placement by private employment agencies was abolished in 2001. The severance pay system was reformed in 2002 with a view to improving business competitiveness and enhancing labor market flexibility. Measures to upgrade training and reintegration were included in the 2003 budget and non-wage labor costs for older employees were reduced.

Privatization: The first phase was completed during the previous legislature with the sale of the government's stake in seven enterprises. The second phase began with the sale of Voestalpine AG in September 2003.

III. Staff Appraisal

35. **Austria has weathered the slump relatively well.** The economy has continued to grow, albeit at a slow pace, and the unemployment rate rose only slightly and remains one of the lowest in Europe. This resilience largely reflects the benefits of extensive trade and investment links with the economies of Central and Eastern Europe, where Austrian business expanded successfully during the last decade.

36. **The government's economic policy priorities and recent achievements are commendable.** Reducing the burden of the state, ensuring healthy public finances, liberalizing markets, and encouraging private entrepreneurship and investment will help competitiveness and growth in the long term. The government has taken some very significant steps to turn this strategy into reality, notably implementing a prudent fiscal policy, a major pension reform, and continued liberalization and structural reform. This has created a sound macroeconomic policy environment and allowed the authorities to concentrate on designing policies for the future.

37. **The challenge now is to keep the focus on the medium-term objectives and pursue them in a resolute and balanced way.** The policy priorities are right. The authorities should stay the course and, in particular, strike the right balance between tax and structural reforms that will enhance Austria's growth potential on one hand, and expenditure discipline that will maintain credibility and stability on the other.

38. **Tax reform will help improve the economy's long-term growth potential.** The tax burden on labor and profits dampens incentives to work and makes Austria less attractive as a business location. These disadvantages loom even larger in the context of an expanding EU. The plans for 2004–05 are appropriate. But Austria needs tax reform—not just tax cuts—

aiming not only at lowering the tax burden but also at simplifying the system and minimizing distortions in the treatment of various forms of assets. These should be the guiding principles of tax reform in 2005 and beyond.

39. **For tax reform to succeed, the necessary expenditure cuts should be set out in a comprehensive medium-term expenditure framework.** The Stability Program should be supplemented by a medium-term expenditure framework, with annual spending targets broken down by major program, and accompanied by a set of specific policies to achieve them. Such a framework would illustrate policy tradeoffs, help reconcile conflicting objectives, and enhance transparency and credibility.

40. **Medium-term expenditure savings should concentrate primarily on entitlements and subsidies.** As the authorities recognize, ongoing efforts to reduce staffing and operational outlays, while necessary, will not be sufficient to generate the savings necessary over the medium term. The solution should be sought in restructuring entitlements, where the pension and ongoing health system reforms will soon start having an impact. Rationalizing the multitude of subsidies and transfers, notably for housing and families, and targeting them to those truly in need would generate savings without compromising social objectives.

41. **Without a credible medium-term expenditure framework, tax reform might weaken fiscal discipline and undermine policy credibility.** Under current plans, the second phase of tax reform in 2005 is not accompanied by commensurate expenditure cuts and would thus lead to a sizeable increase in the deficit at a time when the economy is expected to be growing rapidly. Although the Stability Program targets expenditure reductions in 2006–07 that would return the deficit to a downward trend, these are not sufficiently specific. In the absence of a medium-term expenditure framework, the increase in the deficit in 2005, a pre-election year, might raise questions about the credibility of the medium-term commitments in the Stability Program. Designing and implementing such a framework might take time. In the meantime, the government should consider phasing in the 2005 tax reform more gradually: the entire package could be decided in the context of the next budget, but some of the measures could take effect in later years.

42. **Successful reform of inter-governmental fiscal relations is key to achieving the medium-term fiscal objectives.** This requires re-thinking the role and functions of the state and re-defining the fiscal relations between the federal, provincial, and local governments. The *Austria Convention* should result in concrete proposals for fundamental state reform and for improving efficiency. The negotiation of a new financial arrangement between the federal and subnational governments in 2004 will provide the opportunity to simplify the current system of inter-governmental fiscal relations, align spending authority with taxing responsibility at each level, and ensure that the burden of adjustment is equally distributed between them.

43. **The recent pension reform was a major step toward ensuring the long-term sustainability of the pension system.** The effective reduction in benefits to a more realistic level and the gradual elimination of early retirement will generate considerable savings. The

reform is also expected to raise labor force participation of older cohorts, thus lowering the fiscal burden of the pension system even further. The Austrian reform compares favorably with similar recent initiatives in other European countries.

44. **However, certain aspects of the reform should be reconsidered.** In particular, the 10 percent cap on benefit losses has a number of undesirable effects. It undermines the notional link between contributions and benefits and reduces savings in the long run. Some protection of individual pensioners from the brunt of the reform is necessary, both on grounds of inter-generational equity and for political reasons. But such protection should be focused on low-income pensioners and be phased out gradually in the long run.

45. **More importantly, pension reform is still an unfinished business.** To cement the gains from the recent reform, the government should deliver on its commitment to harmonize the various pension schemes, with a view to reducing inequities and distortions between schemes. The ongoing rationalization of disability pensions should aim at preventing its abuse and safeguarding its status as a last-resort benefit for those truly unable to work.

46. **The creation of the FMA has strengthened financial supervision but continued vigilance is required.** Experience with the new entity has been positive but the task of supervision will become more complex as cross-border financial integration is advancing. At the same time, home-grown problems, such as the growth of foreign currency loans to households, will continue to test the supervisors. These loans, though unlikely to jeopardize the stability of the financial sector, should come under closer scrutiny. The authorities should step up their efforts to make customers aware of the risks and ensure that banks are better protected through improved risk management.

47. **The government's structural reform agenda is appropriate.** The emphasis on deregulation and promotion of a favorable business environment will boost competitiveness and yield increasing benefits in the long run. Progress since 2000 has been significant. The emphasis should now be on completing this agenda and designing policies to raise labor force participation, especially among the elderly.

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

49. 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 (2002)	8.14 million
GDP per capita (2002)	US$ 25,075

	1998	1999	2000	2001	2002	2003 1/
	(Percentage changes at 1995 prices)					
Demand and supply						
GDP	3.9	2.7	3.4	0.8	1.4	0.9
Total domestic demand	2.9	2.9	2.6	-0.1	0.0	0.7
Consumption	2.7	2.6	2.4	0.7	0.6	0.9
Gross investment	4.6	3.8	2.7	-2.7	-1.9	-0.3
Foreign balance 2/	1.0	-0.2	0.8	0.9	1.4	0.2
Exports of goods and nonfactor services	8.1	8.5	13.4	7.6	3.7	1.1
Imports of goods and nonfactor services	5.7	9.0	11.6	5.9	1.3	0.8
	(Percentage changes; period averages)					
Employment and unemployment						
Labor force 3/	0.8	0.5	0.0	0.7	1.1	0.5
Employment 4/	1.0	1.2	1.0	0.4	-0.5	0.1
Unemployment rate (in percent)						
Registered 5/	6.5	6.0	5.3	5.5	6.2	6.4
Standardized 5/ 6/	4.5	3.9	3.6	3.6	4.1	4.5
Prices and incomes						
GDP deflator	0.5	0.7	1.4	2.0	1.4	1.2
Consumer price index 6/	0.8	0.5	2.0	2.3	1.7	1.3
Unit labor costs (manufacturing)	-1.2	-1.3	1.2	1.5	0.9	0.8
	(In percent of GDP)					
General government finances 7/						
Revenue	51.7	51.8	50.8	51.9	51.0	50.6
Expenditure	54.2	54.2	52.4	51.8	51.3	52.1
Balance	-2.5	-2.4	-1.6	0.1	-0.4	-1.5
Gross debt (end of period)	64.9	67.5	67.0	67.1	67.1	67.3
	(In billions of euros)					
Balance of payments						
Trade balance	-3.3	-3.4	-3.0	-1.5	3.5	3.3
Current account	-4.7	-6.3	-5.4	-4.7	1.6	0.4
(In percent of GDP)	-2.5	-3.2	-2.6	-2.2	0.7	0.2
	(Percent; end of period)					
Interest rates and credit						
Domestic credit to nonbanks (year-on-year percent change) 8/	5.2	5.3	6.8	3.5	1.1	1.2
Credit to enterprises (year-on-year percent change) 8/	7.3	6.5	7.1	2.7	-1.9	-0.7
Credit to households (year-on-year percent change) 8/	5.2	10.8	9.6	6.0	6.9	4.0
Three-month interbank rate 9/	3.6	3.0	4.4	4.3	3.3	2.1
10-year government bond 9/	4.7	4.7	5.6	5.1	5.0	4.4
	(Levels; period average)					
Exchange rates						
Euro per US $ 9/	...	0.94	1.08	1.12	1.06	0.86
Nominal effective exchange rate (1990=100) 6/	103.1	102.1	99.9	100.2	100.8	102.6
Real effective exchange rate (1990=100)						
ULC based 6/	81.9	80.3	78.8	78.5	79.0	80.7
CPI based 10/	102.3	100.4	97.7	98.5	99.6	102.4

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

1/ Staff projections unless otherwise indicated.
2/ Change in percent of previous year's GDP.
3/ Dependent labor force (does not include self-employed).
4/ Excluding self-employed, and employees on parental leave and military service.
5/ In percent of total labor force. The standardized rate is survey-based, according to EU standards.
6/ Data for 2003 are for September.
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/ Data for 2003 are for August.
9/ Data for 2003 are for October 16.
10/ Data for 2003 are for July.

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	51.9	51.0	50.6	50.2	49.3	49.2	49.2	49.2
of which: Tax 2/	*45.6*	*44.6*	*44.3*	*44.0*	*43.0*	*42.9*	*42.9*	*42.9*
Expenditure	51.8	51.3	52.1	51.2	51.0	50.5	49.8	49.3
Overall balance (ESA 95 basis)	**0.1**	**-0.4**	**-1.5**	**-1.0**	**-1.7**	**-1.3**	**-0.6**	**-0.1**
Federal government	-0.7	-1.0	-1.9	-1.7	-2.3	-2.0	-1.3	-0.9
Other levels	0.8	0.7	0.5	0.7	0.7	0.7	0.7	0.8
minus one-off measures								
Net sale of real estate 3/	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
One-off revenues 4/	0.5	--	-0.2	--	--	--	--	--
One-off expenditures 5/	--	--	-0.3	--	--	--	--	--
plus								
Cyclical adjustment	0.0	0.4	1.0	1.2	0.9	0.5	0.2	0.0
Structural balance (ESA 95 basis)	**-0.4**	**0.0**	**0.1**	**0.2**	**-0.8**	**-0.8**	**-0.4**	**-0.1**
Fiscal impulse 6/	**-2.7**	**-0.4**	**0.0**	**-0.1**	**1.0**	**0.0**	**-0.4**	**-0.2**
Primary structural balance (ESA 95 basis) 7/	**2.3**	**2.6**	**2.7**	**2.7**	**1.7**	**1.7**	**2.2**	**2.2**
Public debt	67.1	67.1	67.3	66.5	65.7	64.3	62.4	60.3
Memorandum items:								
Output gap 8/	0.0	-0.9	-2.1	-2.4	-1.8	-1.0	-0.4	0.0
Overall fiscal balance, EDP definition 9/	0.3	-0.2	-1.3	-0.8	-1.5	-1.1	-0.4	0.0

Sources: Austrian Statistical Office; Austrian Stability Program (2003-07); and IMF staff estimates and projections.

1/ For 2003, budget figures and IMF staff's GDP projections. For 2004, IMF staff's budget and GDP projections. For 2005-07, projections reflect the Stability Program's expenditure and deficit objectives. Projections for 2008 assume a further improvement in the structural and overall balances based on expenditure measures.

2/ Tax revenue plus social security contributions (excluding imputed contributions).

3/ Transactions considered as negative expenditure by Eurostat.

4/ Adjustment for: (i) estimated windfall gains from accelerated corporate income payments in 2001; and (ii) estimated 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 compensated with 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, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	(Percentage changes at 1995 prices)								
National accounts									
GDP	3.4	0.8	1.4	0.9	1.6	2.6	2.8	2.6	2.3
Domestic demand	2.6	-0.1	0.0	0.7	2.1	2.9	3.1	2.7	2.2
Final consumption	2.4	0.7	0.6	0.9	1.4	1.9	2.1	1.9	1.9
of which: Private consumption	3.3	1.5	0.7	1.1	1.7	2.4	2.6	2.4	2.3
Gross investment	2.7	-2.7	-1.9	-0.3	4.3	6.4	6.0	5.0	3.0
Exports of goods and nonfactor services	13.4	7.6	3.7	1.1	4.0	6.0	7.3	7.0	6.7
Imports of goods and nonfactor services	11.6	5.9	1.3	0.8	5.0	6.8	7.9	7.3	6.6
	(Percentage change)								
Prices and unemployment									
CPI inflation	2.0	2.3	1.7	1.3	1.2	1.2	1.3	1.4	1.5
GDP deflator	1.4	2.0	1.4	1.2	1.2	1.2	1.3	1.3	1.4
Unemployment rate (in percent)	3.6	3.6	4.1	4.4	4.4	4.1	4.0	3.9	3.8
	(Percent of GDP)								
External accounts									
Current account balance	-2.6	-2.2	0.7	0.2	-0.2	-0.6	-0.9	-1.1	-1.3
Capital account	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2
Financial account	2.5	2.2	-2.5	0.1	0.4	0.9	1.2	1.4	1.5
General government accounts 1/									
Revenue	50.8	51.9	51.0	50.6	50.2	49.3	49.2	49.2	49.2
Expenditure	52.4	51.8	51.3	52.1	51.2	51.0	50.5	49.8	49.3
Balance	-1.6	0.1	-0.4	-1.5	-1.0	-1.7	-1.3	-0.6	-0.1
Debt	67.0	67.1	67.1	67.3	66.5	65.7	64.3	62.4	60.3
Memorandum items:									
Gross national saving (percent of GDP)	22.7	22.2	24.3	22.4	22.5	22.8	23.4	23.9	24.1
Gross domestic investment (percent of GDP)	25.3	24.4	23.6	22.3	22.6	23.4	24.4	25.1	25.4
Output gap (percent of potential GDP)	1.4	0.0	-0.9	-2.1	-2.4	-1.8	-1.0	-0.4	0.0

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. See Table 2, footnote 1, for assumptions behind the projections.

Table 4. Austria: Indicators of Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	Date
External indicators							
Exports (annual percentage change, in U.S. dollars)	6.8	3.9	0.4	3.7	9.2	22.4 1/	Projection
Imports (annual percentage change, in U.S. dollars)	4.3	4.4	-0.3	2.5	4.0	22.4 1/	Projection
Terms of trade (annual percentage change)	0.2	-0.6	2.2	-0.9	-1.5	1.4 1/	Projection
Current account balance	-2.5	-3.2	-2.6	-2.2	0.7	0.2 1/	Projection
Capital and financial account balance 2/	2.6	3.5	2.3	1.9	-2.8	-5.4	Q1
Of which : Inward portfolio investment (net, debt securities) 2/	7.9	11.5	13.8	11.0	8.2	3.3	Q1
Inward portfolio investment (net, equity) 2/	0.5	1.0	1.9	-2.3	1.0	0.2	Q1
Inward foreign direct investment (net) 2/	2.1	1.4	4.6	3.1	0.7	0.5	Q1
Other investment liabilities (net, positive=inward) 2/	0.8	9.4	7.1	1.1	-3.6	4.7	Q1
Official reserves (in billions of U.S. dollars)	22.4	15.1	14.3	12.5	9.7	12.9	September
Foreign assets of the financial sector (in billions of U.S. dollars)	123.1	140.0	145.4	139.9	146.2	204.7	August
Foreign liabilities of the financial sector (in billions of U.S. dollars)	141.1	156.9	161.0	154.9	174.6	209.6	August
Official reserves in months of imports	2.9	1.9	1.8	1.5	1.1	...	
Exchange rate against U.S. dollar (period average)	...	0.94	1.08	1.12	1.06	0.86	16-Oct
Public sector							
General government balance 3/	-2.5	-2.4	-1.6	0.1	-0.4	-1.5 1/	Projection
Structural balance 4/	-2.6	-2.7	-3.1	-0.4	0.0	0.1 1/	Projection
General government debt 3/	64.9	67.5	67.0	67.1	67.1	67.3 1/	Projection
Federal government guarantees	28.1	28.7	27.7	29.0	25.4	...	
Financial sector							
Growth rate of credit to the private sector 5/ 6/	5.2	5.3	6.8	3.5	1.1	1.2	August
Stock market index (level; end of period) 7/	112.1	119.8	107.3	114.0	115.0	141.0	16-Oct
Price-earnings ratio 8/	18.5	16.6	18.8	15.3	18.2	16.0	16-Oct
Foreign exchange loans 6/	12.8	16.8	19.1	19.9	20.3	19.8	August
Foreign exchange loans, share in total loans (in percent) 6/	12.2	15.7	17.5	18.2	18.8	18.6	August
Deposits in foreign exchange 6/	5.6	1.6	1.6	1.3	1.1	1.2	August
Deposits in foreign exchange, share in total deposits (in percent) 6/	6.4	1.8	1.9	1.4	1.3	1.4	August
Risk-based capital asset ratio, total	13.5	13.1	13.3	13.7	13.3	14.4	August
Risk-based capital asset ratio, core capital	9.8	9.4	9.1	8.6	9.1	9.7	August

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

1/ Staff projections.

2/ Data for 2003 are in percent of projected annual GDP.

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).

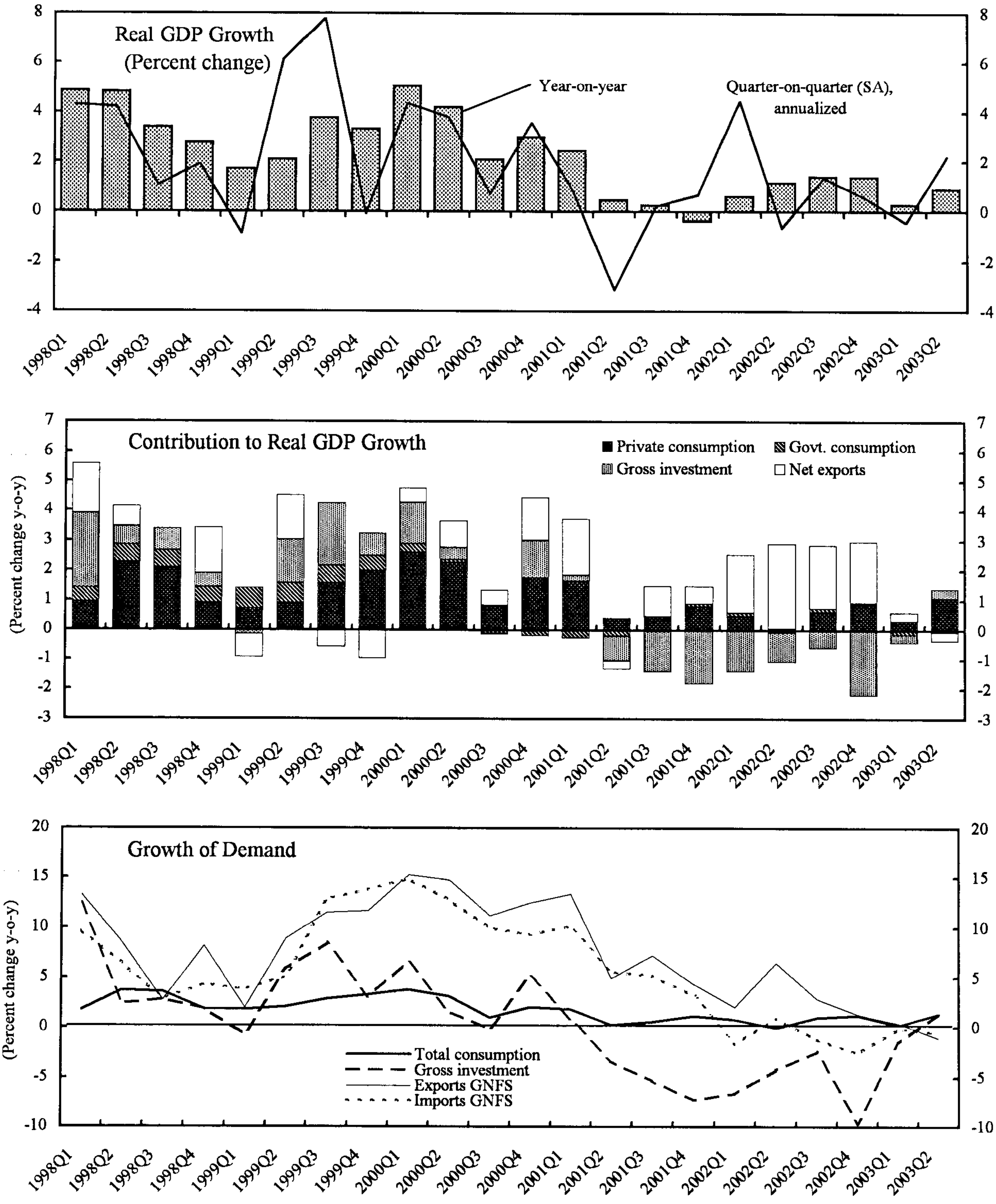
5/ Excluding financial institutions and non-residents.

6/ Domestic nonbanks.

7/ ATX index (1991=100).

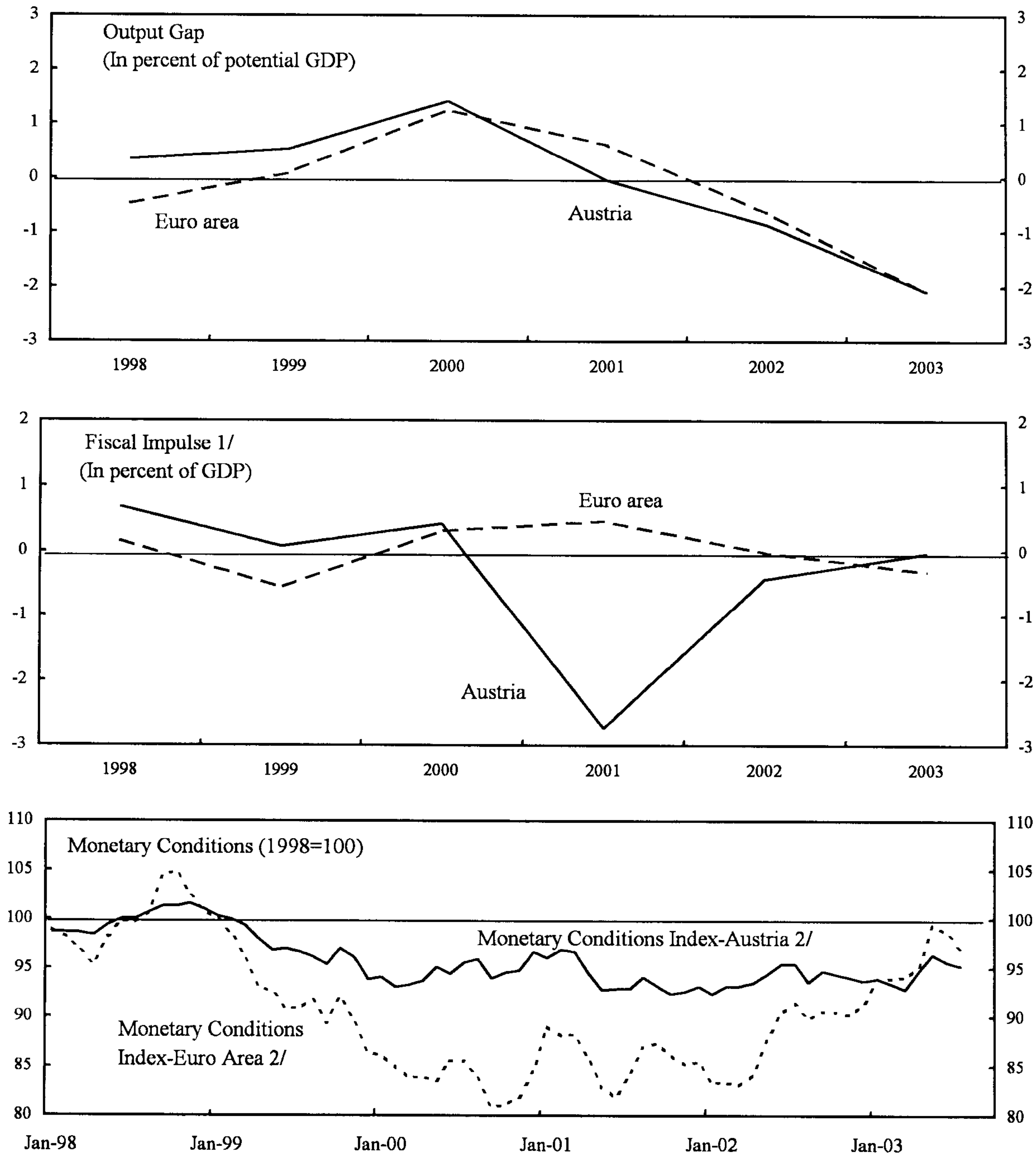
8/ Price-earnings ratio for ATX.

Figure 1. Austria: Developments in GDP, 1998-2003



Sources: Austrian Statistical Office; and IMF staff calculations.

Figure 2. Austria: Output Gap, Fiscal Impulse, and Monetary Conditions, 1998-2003

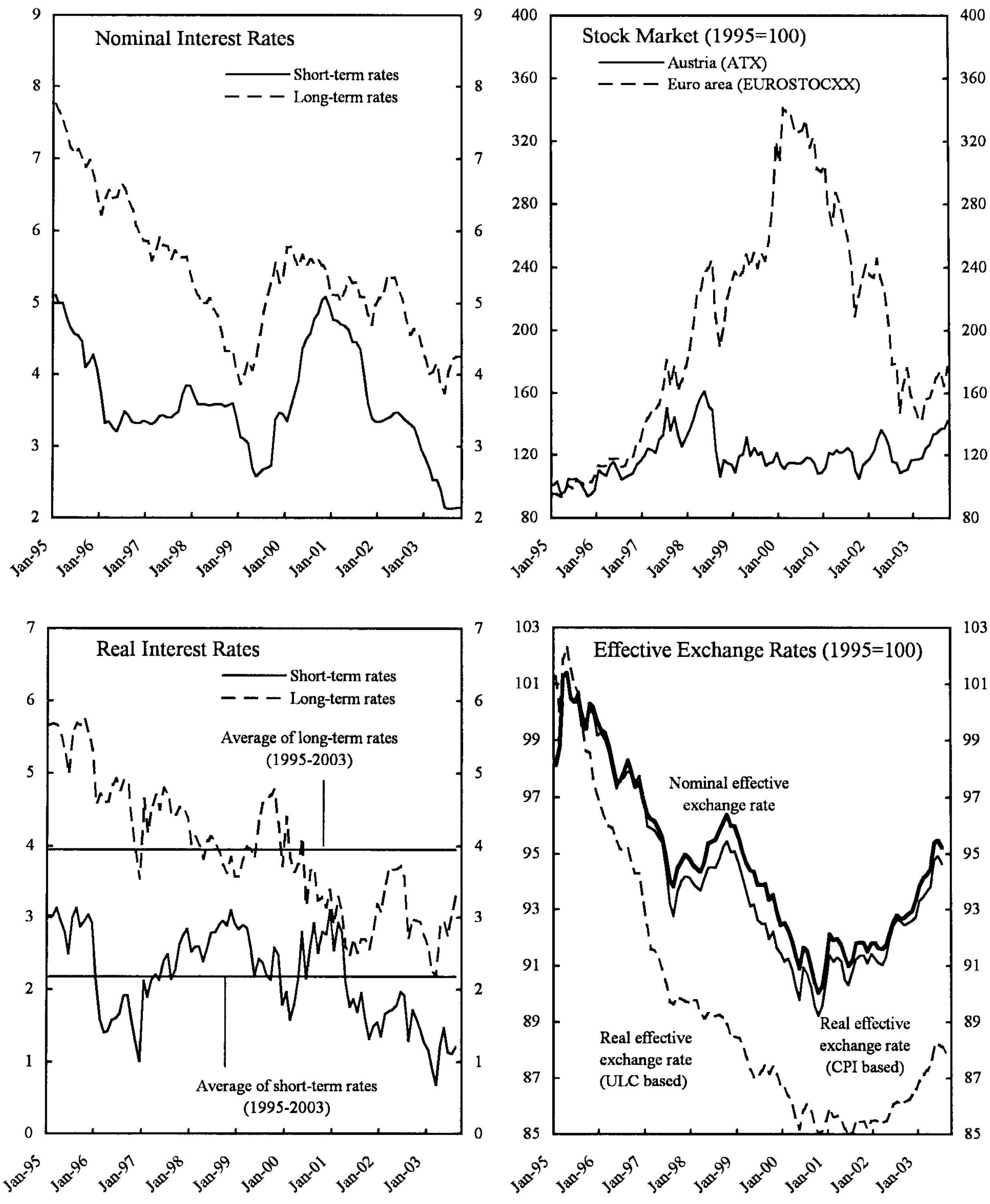


Sources: IMF, World Economic Outlook; International Finance Statistics; and IMF staff estimates and projections.

1/ For Austria, the fiscal impulse is defined as the change in the structural balance adjusted for one-off revenue and expenditure measures as well as the sale of mobile phone licenses and real estate.

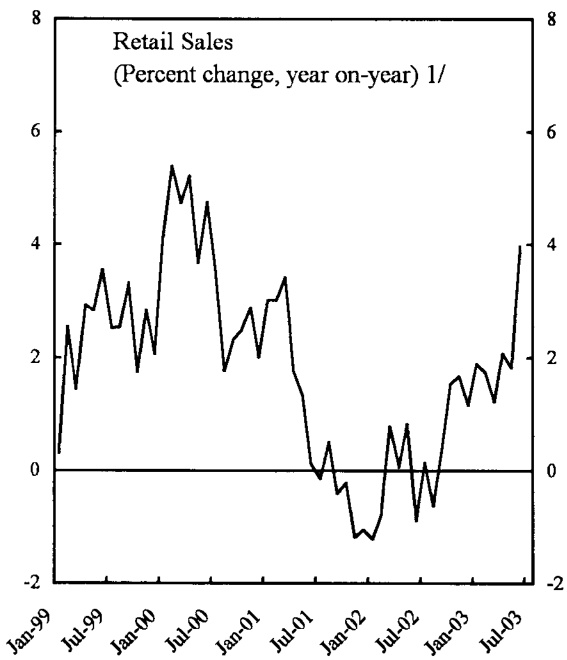
2/ Weighted average of real short-term interest rates and real effective exchange rate (weights: three quarters and one quarter, respectively).

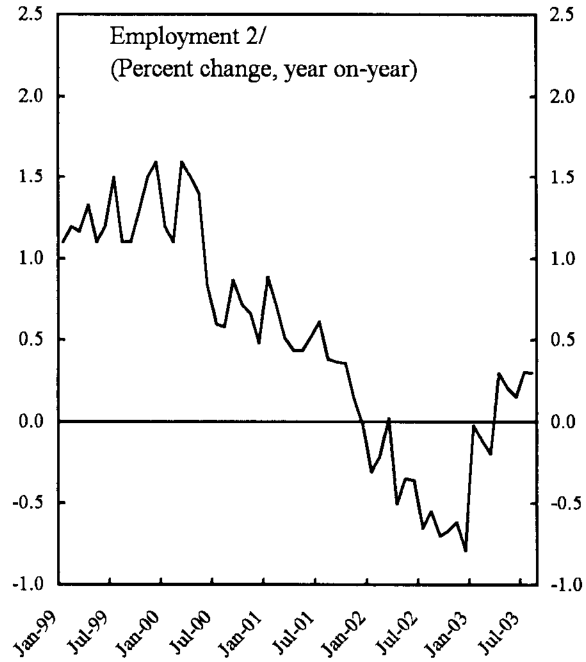
Figure 3. Austria: Financial Conditions, 1995-2003

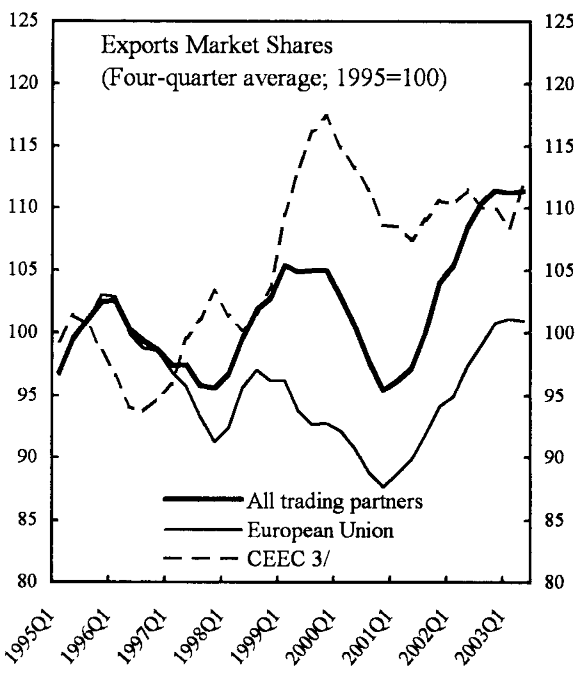


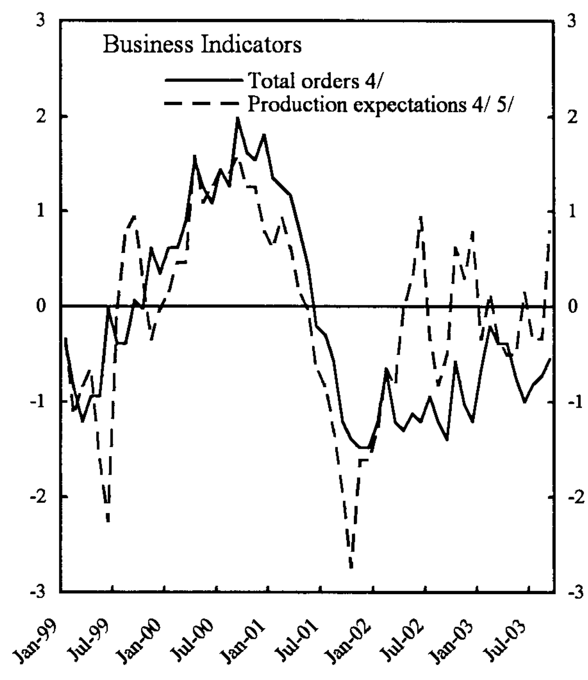
Sources: IMF, International Financial Statistics; WEFA database; Bloomberg; and IMF staff calculations.

Figure 4. Austria: Coincident and Leading Economic Indicators









Sources: Eurostat; IMF, Direction of Trade Statistics; WIFO Institute; and IMF staff calculations.

1/ Three-month moving average.

2/ Excluding self-employed, and employees on parental leave and military service.

3/ Central and Eastern European countries.

4/ Standardized: expressed in standard deviations from the 1998-2003 mean.

5/ Twelve months ahead.

EFFECTS OF THE 2003 PENSION REFORM

A. Summary and Staff Assessment

50. Like other developed economies, Austria will face considerable fiscal stress from population ageing. With the ratio of elderly to people of working age projected to more than double over the next 50 years, public spending on pensions, health care, and long-term care will increase significantly.[1] The 2003 pension reform's main objectives are to reduce this fiscal stress and increase the fairness of the pension system.

51. To achieve these objectives, the reform targets prolonging working life, reducing benefits, and tightening the link between contributions and benefits. The main measures—which are phased in gradually—include eliminating early retirement, slowing the accrual rate of pension benefits, and lengthening the assessment period. To limit individual benefit reductions, losses stemming from the reform were capped at 10 percent at a last-minute political compromise in parliament.

52. Staff projections indicate that the reform represents a significant step towards restoring the sustainability of the public pay-as-you-go pension system, both relative to previous reforms in Austria and in international comparison. The reform measures would broadly stabilize pension spending over the next 10–15 years. Over the long run, pension spending could be reduced by about 1¼ – 1¾ of GDP annually, eliminating more than one third of the projected increase in the pension system's deficit. While most measures have desirable incentive effects, some aspects—in particular, the uniform 10 percent cap on benefits losses—appear to compromise some of the objectives.

53. The authorities' future reform agenda includes gradual but full harmonization of the various pay-as-you-go pension schemes, reform of the disability pension system, and the introduction of individual pension accounts. The latter would establish a notional defined-contribution system, directly linking lifetime contributions to the pension benefit level, which would strengthen the fairness of the pension system.

B. Main Measures of the 2003 Pension Reform

54. The following major changes were made to the ASVG (*Allgemeines Sozialversicherungsgesetz*), the largest scheme of the public pension system that covers about three quarters of workers and accounts for over 60 percent of total pension spending:

[1] Leif L. Eskesen (2002): "Population Ageing and Long-Term Fiscal Sustainability in Austria", IMF Working Paper WP/02/216.

- Early retirement is phased out during 2004–17 by raising the early retirement age to 65 (currently 61½ years for men and 56½ years for women) by 4 months per annum.[2]

- The bonus/malus in the case of late/early retirement is raised from 3 percent per year to 4.2 percent, with maximum gains/losses capped at 15 percent.

- The assessment base for pension benefits gradually shifts from the current best 15 contributory years (18 years in the case of early retirement) to the average of the last 40 contributory years. The measure is phased in by 2028.

- The accrual rate of benefits is reduced from 2 percent to 1.78 percent per contributory year. The measure is phased in by 2009.

- Eligible non-contributory periods include 36 months per child in the case of childcare, as well as periods devoted to home care (*Familienhospiz*).

- Longer contribution buy-in is possible for study periods (one year per school year and six months per semester, compared with the current eight and four months, respectively).

- The starting date for indexation of new pensions is delayed by one year.

- Special provisions apply to long-time workers (*Hacklerregelung*). Those with 45 years of service (40 years for women) can retire at age 60 (55 for women) until 2006, after which the retirement age increases by 1.5 years.[3]

55. Similar changes were introduced to the civil service pension scheme that covers 10 percent of workers and accounts for about one-third of pension spending, without, however, affecting the gap that in many cases exists between civil service and *ASVG* pension levels:

- The possibility of early retirement is eliminated by raising the early retirement age (currently 61½ years) while harmonizing the old-age retirement age for male and female civil servants at 65 years. The measure is phased in by 2018.

- The bonus/malus in the case of late/early retirement is raised from 3 percent per year to 4.2 percent.

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[2] The statutory old-age retirement age is to be unified gradually for men and women during 2019–34.

[3] The authorities estimate that this measure will affect about 5,000 workers.

- The assessment base for pension benefits gradually shifts from the last salary to the average of the last 40 contributory years. The measure is phased in by 2028.

- The accrual rate of benefits is reduced from 2 percent to 1.78 percent per contributory year.

- Social security contribution rates are raised by 1 percentage point.

56. Reform-related benefit losses are capped at 10 percent for those retiring starting in 2004, and a "hardship fund" has been established to compensate partially for losses of people with low pensions.

57. The reform is expected to lead to a higher effective retirement age both through eliminating early retirement and modifying incentives. Eliminating early retirement would contribute to a narrower gap between the actual and the statutory retirement age (in 1999, this gap was about five to six years). Slower accrual of pension benefits, with the maximum replacement rate reached after 45, instead of 40, contributory years and a slightly larger-than-actuarially-fair bonus/malus would provide financial incentives to stay longer at work.

58. The reform lowers benefits in two ways. First, reducing the accrual rate lowers the replacement rate unless retirement in postponed. Second, lengthening the assessment period leads to the inclusion of "weaker" contributory years, resulting in a lower benefit assessment base. As the lower accrual rate is phased in quickly but the longer assessment period more gradually, effects from the former are more important over the medium term.

59. In addition to its effects on the average benefit level, the longer assessment period, once it is fully phased in 2028, would de facto link lifetime contributions to individual benefits, increasing the transparency and the fairness of the pension system.

60. However, the 10 percent cap on benefit losses as currently designed (benefits under the new system cannot be more than 10 percent lower than what they would have been under the old system) offsets some of the reform measures' effects. The cap is likely to become binding for most people in the next few years. Assuming an individual retires t years after 2003, under the old system her benefits would be determined by the formula

$$B = 0.02 \times N \times \frac{1}{15} \sum_{i=1}^{15} \theta_i w_{t-i}$$

where B is the level of benefits, N is the number of contributory years, and the w_i are past wages (revalued with the appropriate revaluation factor θ_i).[4] Once the reduction in the accrual rate is phased in, i.e., from 2009, her benefits will be determined by:

$$B = 0.0178 \times N \times \frac{1}{15+t} \sum_{i=1}^{15+t} \theta_i w_{t-i}$$

The lower accrual rate by itself would reduce benefits by 11 percent; further reductions would follow from including lower-wage periods in the assessment base. Thus, the 10 percent cap will become binding for most new retirees by 2009. This will not only limit fiscal savings but also sever the newly-strengthened link between contributions and benefits. At the limit, the old pension system would be replicated at a 10 percent lower benefit level.

C. Long-Term Fiscal Effects

61. The 2003 reform is likely to lighten significantly the fiscal burden of ageing. Long-term staff projections indicate that although recent measures do not fully offset the consequences of population ageing and the pension system's deficit would still rise over the next decades, they eliminate over one third of the increase over the long run.

62. Although long-term projections are—on account of their sensitivity to underlying assumptions—subject to considerable uncertainty,[5] they indicate that the pension reform significantly improves the fiscal outlook over the long term. Assuming that the policy of fiscal prudence is maintained but the widening of the pension system's deficit is fully reflected in the general government deficit,[6] the reform would keep public debt within a manageable range over the next three decades.

Assumptions

63. The staff projections are based on the following assumptions:

- *Coverage of the projections*. The projections exclude the civil service pension scheme for two reasons. First, the dominant *ASVG* scheme was the focus of the reform effort.

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[4] For simplicity, it is assumed that (i) the individual is not retiring early; and (ii) her earnings profile is increasing over her working life so that the "best" contributory years are the last 15 years.

[5] See Eskesen (2002) for a discussion of the risks and uncertainties surrounding the estimated long-term fiscal effects of population ageing.

[6] That is, excluding the public pension sytem's deficit, the structural position of the general government remains unchanged from 2006 onward.

Second, although further changes are planned for the civil servants' scheme in the framework of full harmonization, details are not yet known.

- *Time frame.* The projections run through 2050 although, beginning in 2034, workers would be retiring under a new, fully harmonized system. Since detailed plans for harmonization are not yet in place, projections beyond 2034 can serve as a benchmark.

- *Demographics.* The staff projections are based on 2001 population projections by Statistik Austria that envisage average annual population growth of about 0.1 percent until 2035, and a similar rate small rate of decline afterwards.

- *Macroeconomic assumptions.* Labor productivity growth is assumed at 1¾ percent per annum, with inflation at 2 percent and the unemployment rate at 4 percent. Labor demand is assumed to be fully elastic, so that increases in participation rate translate into increases in employment.[7] Under the staff's baseline, these assumptions translate into GDP growth of about 1½–1¾ percent per annum.

- *Participation rates.* Assumptions regarding labor force participation follow the authorities' medium variant,[8] which envisages overall participation rising by some 8 percent in the 2000–50 period to 76 percent. This is at the high end among EU countries today but around the EU average projected for 2050.[9] Underlying the steep increase is rising female participation and strong growth in the older cohorts' participation. As younger female cohorts tend to have higher participation rates and many of the pension reform measures act on lengthening the working life, these assumptions are not unrealistic.

- *Time horizon for the 10 percent cap on benefit losses.* As the cap has no statutory expiration date, it is assumed to apply to all new retirees over the entire projection period.

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[7] This may be an optimistic assumption if the labor market has difficulty absorbing the larger number of workers.

[8] Part, P. and Hans Stefanits (2001): "Austria: Public Pension Projections 2000–2050", Ministry of Finance Working Paper 7/2001 (Vienna: Austrian Ministry of Finance).

[9] EU, Economic Policy Committee (2001): "Budgetary challenges posed by ageing populations: the impact on public spending on pensions, health and long-term care for the elderly, and possible indicators of the long-term sustainability of public finances" (Brussels).

Direct effects of the measures

64. The baseline projections, which already incorporate an increase over time of the older cohorts' participation rates toward the EU average, are assumed to capture most of the effects of the reform on financial incentives to postpone retirement. The reform scenario thus considers the cumulative direct effects of two measures: the elimination of early retirement and the reduction in benefits. The former will speed up the increase in the older cohorts' participation rate towards the EU average; the latter will reduce benefits by 10 percent compared with the baseline for new retirees.

65. Under the baseline, the deficit of the pension system without the civil service scheme is projected to increase by about 3½ percentage points of GDP till it peaks around 2035 (Figure 5).[10] Phasing out early retirement increases the participation of older workers over the next 15 years, leading to higher employment and lower pension spending. However, these effects dissipate over the long run as participation rates converge to the baseline. In contrast, lowering average benefits has permanent effects. Benefit losses of new retirees quickly reach 10 percent; savings from this source reach ½ percent of GDP in about 10 years and continue to rise as the pensioner population becomes dominated by benefit recipients who retired under the new system.

66. Taken together, these measures are projected to keep pension spending (excluding the civil service scheme) broadly stable over the next 10–15 years. Over the long run, they may shave off over 1¼ percent of GDP from spending (see table). In other words, about one third of the total projected increase in the public pension system's deficit (or about 40 percent of the increase if the civil service scheme is excluded) is eliminated. Assuming that the measures targeting the civil service scheme achieve similar results, total savings from the 2003 pension reform would amount to about 1½–1¾ percent of GDP.

Possible indirect effects

67. While the baseline participation rates were assumed in the previous simulations to capture most of the effects of financial incentives to retire later, the effects of the reform may in fact be larger. These additional behavioral effects on participation are hard to quantify. As an illustration, a 10 percent (or about 3½ percentage points) increase in the participation rate of the older cohorts is considered. This change raises employment and reduces pension spending over the long run beyond the direct effects of the reform measures (Figure 6). On account of higher employment, revenues of the pension system also increase. The resulting improvement in the deficit of the pension system is projected at about 0.2 percent of GDP, raising total savings from the reform to well over 1½ percent of GDP.

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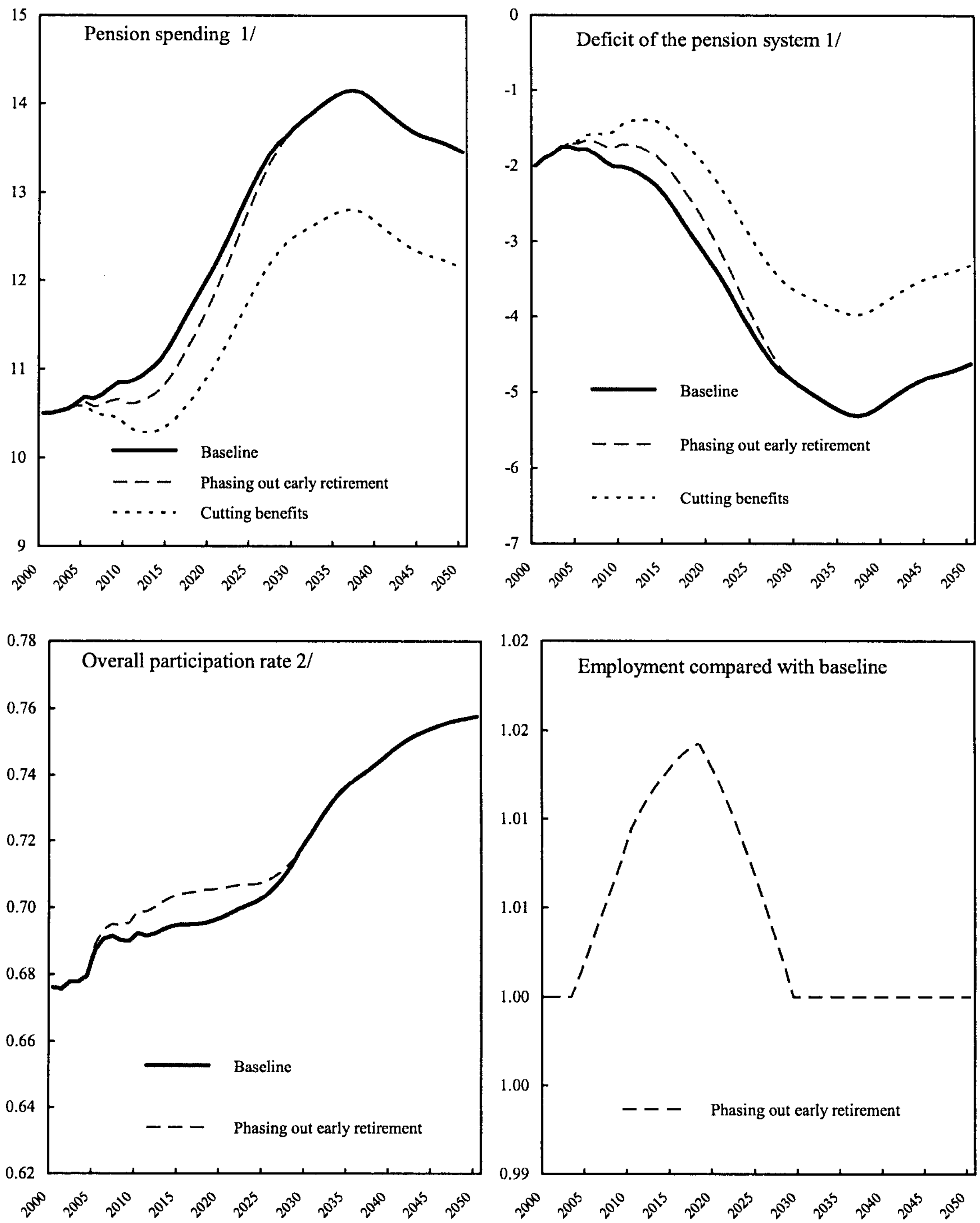
[10] Including the civil service scheme would bring the increase to about 4¼ percent of GDP.

Figure 5. Austria: Direct Effects of the Pension Reform, Private Sector Pension Fund



Sources: Ministry of Finance; Ministry of Social Affairs; Statistik Austria; and IMF staff calculations.
1/ In percent of GDP.
2/ Ratio of labor market participants to working age population.

Austria: Projected Effects of the 2003 Pension Reform 1/
(In percent of GDP)

	2000	2005	2010	2015	2020	2025	2030	2035
Spending								
Baseline	10.5	10.7	10.9	11.2	12.1	13.1	13.7	14.1
Including direct effects of the reform:								
Early retirement 2/		10.6	10.6	10.9	11.8	12.9	13.7	14.1
Benefits 3/		10.6	10.4	10.4	11.0	11.9	12.5	12.8
Total savings		0.1	0.5	0.9	1.1	1.2	1.2	1.3
Including additional effects:								
Higher participation 4/		10.6	10.3	10.2	10.8	11.6	12.3	12.5
Savings with additional effects:		0.1	0.6	1.0	1.3	1.5	1.5	1.5
Deficit								
Baseline	-2.0	-1.8	-2.0	-2.4	-3.3	-4.2	-4.9	-5.3
Including direct effects of the reform:								
Early retirement 2/		-1.7	-1.7	-2.0	-2.9	-4.0	-4.9	-5.3
Benefits 3/		-1.7	-1.5	-1.5	-2.1	-3.0	-3.7	-3.9
Total savings		0.1	0.6	0.9	1.2	1.2	1.2	1.3
Including additional effects:								
Higher participation 4/		-1.6	-1.3	-1.3	-1.9	-2.7	-3.4	-3.7
Savings with additional effects:		0.2	0.7	1.1	1.4	1.5	1.5	1.6

Sources: Ministry of Finance; Ministry of Social Affairs; Statistik Austria; and IMF staff calculations.
1/ Excluding the civil servants' pension scheme.
2/ Phasing out early retirement during 2004-17.
3/ Combined effects of phasing out early retirement and a 10 percent cut in benefits phased in during 2004-09.
4/ 10 percent (about 3.5 percentage points) increase in the participation rate of the pre-retirement cohort.

An alternative breakdown of the effects

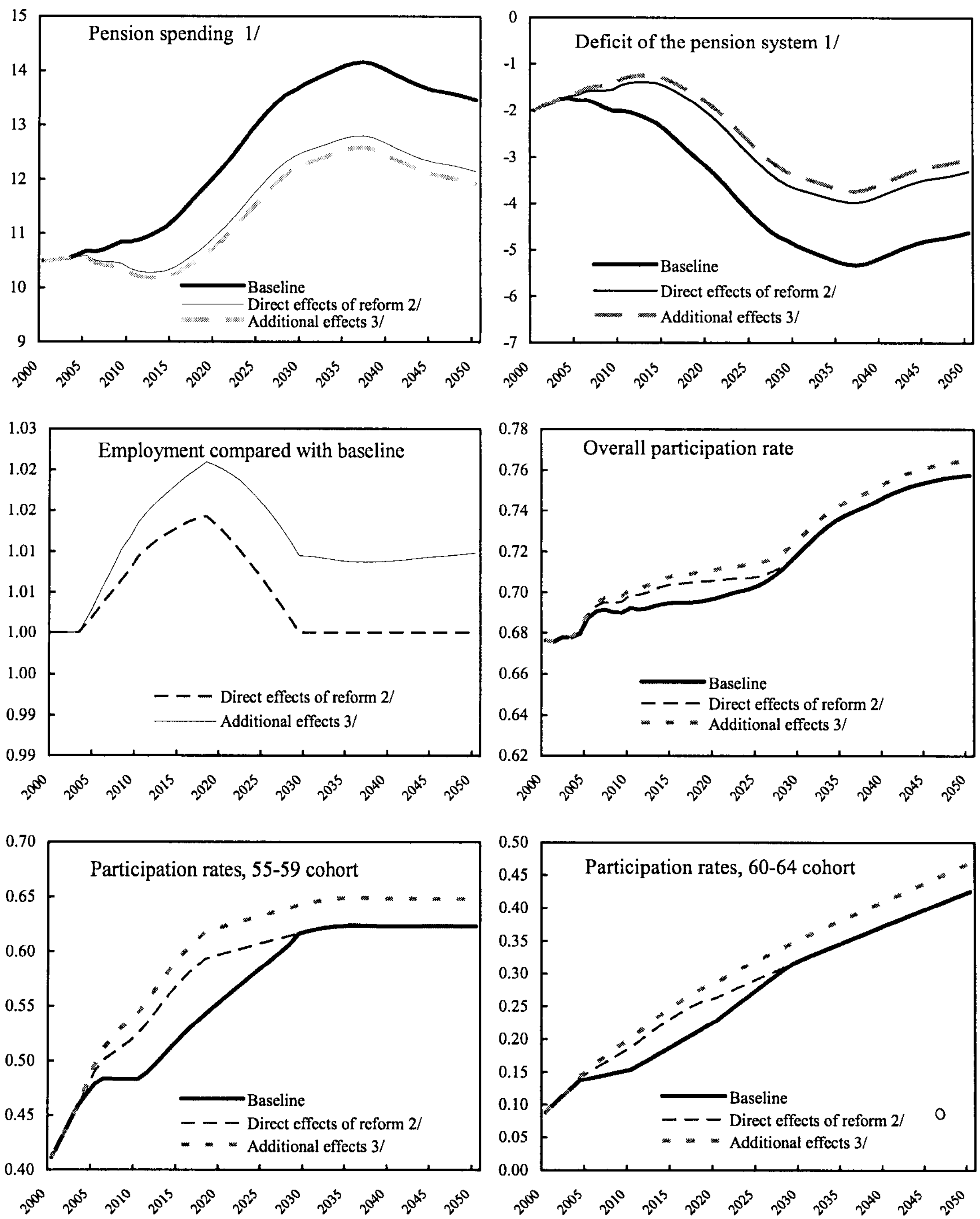
68. The projected increase in pension spending can be attributed to four effects:[11]

- More elderly people, or the ageing effect.
- Fewer workers, or the employment effect.
- Higher share of the elderly with pension entitlement, or the eligibility effect.
- Higher benefits-to-wage ratio, or the benefit effect.

[11] The breakdown corresponds to a loglinear approximation of the following formula:

$$\frac{Pension\ \ Spending}{GDP} = \underbrace{\left(\frac{Population \geq 55}{15 \leq Population \leq 64}\right)}_{1} * \underbrace{\left(\frac{15 \leq Population \leq 64}{Employment}\right)}_{2} * \underbrace{\left(\frac{Recipients}{Population \geq 55}\right)}_{3} * \underbrace{\left(\frac{Average\ \ Pension\ \ Benefit}{Average\ \ Productivity}\right)}_{4}$$

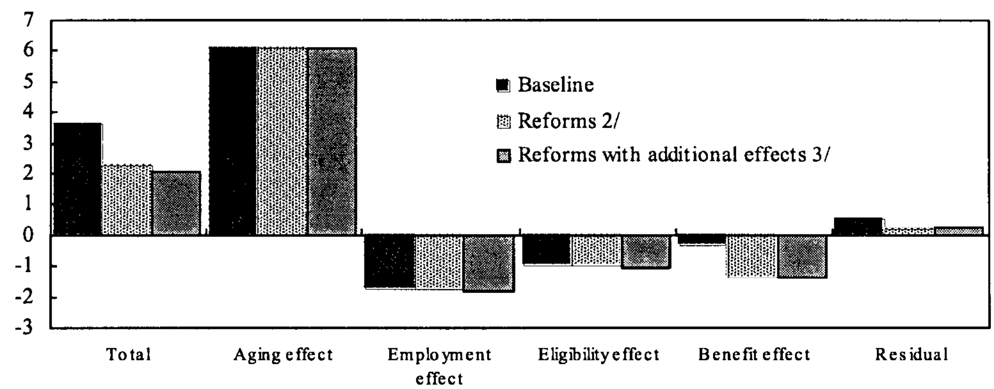
Figure 6. Austria: Direct and Additional Effects of the Pension Reform, Private Sector Pension Fund



Sources: Ministry of Finance; Ministry of Social Affairs; Statistik Austria; and IMF staff calculations.
1/ In percent of GDP.
2/ Includes effects of the elimination of early retirement and reductions in benefits.
3/ In addition to the direct effects of the reform, also includes a 10 percent (about 3.5 percentage points) increase in the participation rate of older workers.

69. Demographic developments by themselves—the ageing effect—would push up pension spending by over 6 percent of GDP by 2035. However, other developments mitigate this increase (see figure) to a different degree in the baseline and in the reform scenario. As participation rates of older cohorts rise strongly, the effects of higher employment and the lower share of pensioners partially offset the impact of ageing on pension spending. The pension reform accelerates the participation rate increase (via the elimination of early retirement) but leaves its long-run level unchanged; hence, the magnitude of the employment and eligibility effects is the same in the reform scenario and in the baseline. In contrast, the benefit effect dampens the increase in pension spending much more in the reform scenario than in baseline. If the reform's additional effects on participation are also considered, the employment and eligibility effects become relatively stronger than in the baseline. This breakdown illustrates that savings accrue mostly on account of the reform's impact on participation—mostly captured in the baseline—and on account of lower benefit levels.

Austria: Decomposing the Change in Projected Pension Spending, 2000-2035 1/



Source: IMF staff calculations.

1/ In percent of GDP, excluding the civil servants' pension scheme.

2/ Includes the projected direct effects of the reform.

3/ In addition to the direct effects of the reform, it includes the effects of a 10 percent (about 3.5 percentage points) increase in the participation rate of older cohorts.

D. The Austrian Pension Reform in European Perspective

70. Pension reform is high on the policy agenda in many EU countries. Reforms have recently been legislated in France, and proposals are currently being discussed in Germany and Italy. To tackle the future pension problem, the reform packages act on three broad fronts, albeit with a different emphasis: longer working life, lower benefits, or higher contributions. A combination of financial incentives (actuarially fair adjustments or a bonus/malus system in all cases; in Austria also a smaller accrual rate) and legislative changes (elimination of early retirement in Austria, raising the retirement age in Germany, lengthening the minimum contributory period required for early retirement in Italy) target lengthening working life. Benefit reductions are achieved via longer contribution periods (Austria, France; in Austria

also via a smaller accrual rate) or slower indexation (Germany, France). In addition, contribution rates for civil servants are to rise in Austria and France. The French and German packages also have a "feedback" element, in the form of a periodic evaluation of the pension system's sustainability and a built-in sustainability factor in the pension adjustment formula, respectively.

71. The long-term fiscal effects of the Austrian pension reform appear comparable in magnitude to the effects of the recent reform in France (which is estimated to save slightly less than 2 percent of GDP over the long run) and the targeted effects of the German reform proposal (about 1½ percent of GDP), and are greater than those expected from the Italian reform proposal.[12]

[12] However, excluding the effects of the 2003 reforms, the projected increase in Italian pension spending is smaller than elsewhere; see EU (2001).

Austria: Fund Relations
(As of August 31, 2003)

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	1,079.11	57.64
Reserve position in Fund	793.21	42.37

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	179.05	100.00
Holdings	132.56	74.04

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				
	2003	2004	2005	2006	2007
Principal	--	--	--	--	--
Charges/Interest	0.18	0.73	0.72	0.72	0.72
Total	0.18	0.73	0.72	0.72	0.72

VIII. **Exchange System:**

As of January 1, 1999, the currency of Austria is the euro. Austria's exchange system is free of restrictions on the making of payments and transfers for international transactions with the exception of restrictions notified to the Fund in accordance with decision No. 144-(52/51) resulting from UN Security Council Resolutions and EU Council regulations (e.g., restrictions in respect of the Taliban and certain persons in Iraq, Serbia and Montenegro, and Myanmar as well as terror organizations and their activists outside the European Union). Furthermore, national restrictions apply with respect to certain terror organizations and their activists within the EU, implementing decisions in the CFSP framework of the EU.

IX. **Article IV Consultation**

Austria is on a 12-month consultation cycle. The last consultation was completed on August 7, 2002 (EBM/02/86).

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 Austrian metadata are available on the Fund's electronic Dissemination Standards Bulletin Board (http://dsbb.imf.org). Austria has taken advantage of the SDDS flexibility options on the timeliness of the industrial production index and merchandise trade data.

The timeliness of Austrian data could be improved by bringing them up to "best practice" standards with regard to national accounts data, 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 the new *European System of Accounts 1995 (ESA 1995)* has complicated the analysis of Austrian national accounts and fiscal data. New national accounts data provide no information on household disposable income (only an economy-wide aggregate), barring the calculation of a household saving ratio. In addition, the reclassification of public hospitals in 1997 has introduced a break in the national account series on public and private consumption. Fiscal data from 1995, compiled in accordance with the *ESA 1995*, are not complete. From 1995, expenditure by function and financing and debt data have not yet been reported for inclusion in the *Government Finance Statistics Yearbook.*

There is a large difference between the data on goods trade recorded by the statistical office (Statistics Austria) and the payments data recorded by the Austrian National Bank. Data on accrual basis are only available with a long time lag. Data based on the *Balance of Payments Manual*, fifth edition *(BMP5)* are only available back to 1992.

Austria: Core Statistical Indicators 1/
As of October 16, 2003

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Central Government Balance 2/	GDP	Foreign Currency Central Gov't Debt
Date of Latest Observation	10/16/03	September 2003	September 2003	September 2003	August 2003	10/16/03	September 2003	August 2003	August 2003	August 2003	Q2 2003	September 2003
Date Received	10/16/03	10/14/03	10/14/03	10/14/03	9/25/03	10/16/03	10/16/03	10/16/03	10/16/03	9/18/03	9/23/03	10/6/03
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update	Reuters/ Bloomberg	OeNB	OeNB	OeNB	OeNB	Reuters/ Bloomberg	Statistics Austria	Statistics Austria	Statistics Austria	MoF	WIFO	MoF
Mode of Reporting	Electronic	Internet	Internet	Internet	Internet	Electronic	Internet	Internet	Internet	Internet	Email	Internet
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

OeNB = Austrian National Bank

WIFO = Austrian Institute of Economic Research

MoF = Federal Ministry of Finance

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

2/ Cash basis.

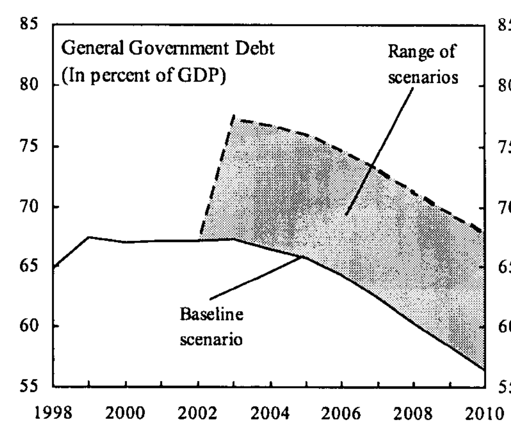
AUSTRIA: FISCAL SUSTAINABILITY ANALYSIS

72. This Appendix presents the baseline medium-term projections for general government debt, as well as the results of sensitivity tests based on shocks (expressed as temporary deviations from historical means) applied to the baseline scenario in 2003–04. The results are shown in Table 5.

73. **Austria's general government debt has been stable in recent years.** Reflecting the weak fiscal position in the 1990s, general government debt rose from 57 percent of GDP in 1990 to 67½ percent of GDP in 1999. The policy shift toward fiscal consolidation in 2000 contributed to small decline in the debt ratio by 2002.

74. **The staff's baseline scenario projects a decline in the general government debt ratio of about 7 percentage points to about 60 percent of GDP by 2008.** This scenario is predicated on the staff's macroeconomic forecast for the projection period; the authorities' Stability Program expenditure and deficit objectives for 2004–07; and the assumption of further small improvements in the structural and overall balances in 2008, in line with the authorities' objective to achieve and maintain a balanced budget over the cycle.

75. **The outlook for general government debt appears to be resilient to various macroeconomic shocks.** The general government debt ratio shows a sizeable, albeit temporary, increases under an "assumption of debt" scenario (scenario 7). However, even in scenario 7, after an initial peak the debt ratio would resume its decline once the impact of the shock fades. Although such a scenario that presumes major bank or other bailouts by the government is implausible in Austria, given the low degree of government ownership (especially in the banking sector, where it is practically non-existing), its implications are nonetheless manageable. This is even more the case in all other plausible scenarios.



76. **The only scenario in which the debt dynamics show a steady deterioration should be interpreted with considerable caution.** In scenario 1, it is assumed that the historical means of real GDP growth, real interest rate, and primary balance prevail over the projection period. In this case, the debt ratio rises modestly (by 3 percentage points of GDP) but steadily over the projection period without showing any signs of a downward trajectory. However, this result ignores the systemic policy shift that took place at the turn of the last decade, as well as Austria's commitments to the EU's Stability and Growth Pact. As a result of this policy shift, the average primary surplus in 2000–02 was 2 percentage points of GDP higher than the average over the 1993–2002 period used in the simulation.

Table 5. Austria: General Government Debt Sustainability Framework, 1998-2008

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						I. Baseline Medium-Term Projections					
1 General government debt 1/	64.9	67.5	67.0	67.1	67.1	**67.3**	**66.5**	**65.7**	**64.3**	**62.4**	**60.3**
of which: foreign-currency denominated	13.4	16.9	9.5	9.3	9.0	9.0	8.9	8.8	8.6	8.4	8.1
2 Change in general government debt	0.1	2.6	-0.5	0.2	0.0	0.1	-0.8	-0.8	-1.4	-1.9	-2.1
3 Identified debt-creating flows (4+7+12)	0.1	1.6	-0.7	-1.4	-2.9	-0.5	-0.8	-0.7	-1.3	-1.8	-2.0
4 Primary deficit	-1.4	-1.3	-2.2	-3.8	-3.2	-2.1	-2.5	-1.7	-2.2	-2.9	-3.2
5 Revenue and grants	51.7	51.8	50.8	51.9	51.0	50.6	50.2	49.3	49.2	49.2	49.2
6 Primary (noninterest) expenditure	50.3	50.4	48.6	48.1	47.8	48.5	47.7	47.6	47.1	46.3	46.0
7 Automatic debt dynamics 2/	1.5	3.0	1.5	2.4	0.3	1.7	1.7	1.0	0.9	1.1	1.1
8 Contribution from interest rate/growth differential 3/	1.1	1.6	0.7	1.9	1.8	2.3	1.7	0.9	0.8	1.0	1.1
9 Of which contribution from real interest rate	3.6	3.3	2.9	2.4	2.7	2.8	2.7	2.6	2.6	2.6	2.5
10 Of which contribution from real GDP growth	-2.4	-1.7	-2.2	-0.5	-0.9	-0.6	-1.0	-1.6	-1.8	-1.6	-1.4
11 Contribution from exchange rate depreciation 4/	0.4	1.4	0.8	0.5	-1.5	-0.6	0.0	0.1	0.1	0.1	0.1
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.0	1.0	0.2	1.6	2.9	0.6	0.0	-0.1	-0.1	-0.1	-0.1
General government debt-to-revenue ratio 1/	125.4	130.3	131.9	129.4	131.7	132.9	132.5	133.1	130.6	126.8	122.8
Gross financing need 5/	16.6	16.8	17.0	14.3	16.3	16.6	16.1	16.6	15.9	14.9	14.1
in billions of U.S. dollars	35.2	35.3	32.5	27.2	33.6	41.4	41.3	43.4	43.2	41.7	40.6
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	3.9	2.7	3.4	0.8	1.4	0.9	1.6	2.6	2.8	2.6	2.3
Average nominal interest rate on public debt (in percent) 6/	6.3	5.9	5.9	5.7	5.5	5.5	5.4	5.3	5.5	5.6	5.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.8	5.2	4.5	3.6	4.1	4.3	4.2	4.1	4.1	4.3	4.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.8	-7.8	-7.4	-5.3	19.0	6.7	-0.1	-1.1	-0.8	-0.7	-0.7
Inflation rate (GDP deflator, in percent)	0.5	0.7	1.4	2.0	1.4	1.2	1.2	1.2	1.3	1.3	1.4
Growth of real primary spending (deflated by GDP deflator, in percent)	4.4	2.9	-0.4	-0.3	0.7	2.3	-0.1	2.5	1.6	1.0	1.6
						II. Stress Tests for General Government Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2008					67.1	**67.6**	**68.0**	**68.5**	**69.0**	**69.5**	**70.0**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					67.1	**68.3**	**68.7**	**68.0**	**66.6**	**64.8**	**62.7**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					67.1	**68.0**	**68.4**	**67.6**	**66.2**	**64.2**	**62.1**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					67.1	**71.4**	**75.1**	**74.5**	**73.2**	**71.5**	**69.6**
5. Combination of 2-4 using one standard deviation shocks					67.1	**70.4**	**73.7**	**72.8**	**71.2**	**69.1**	**66.9**
6. One time 30 percent real depreciation in 2003 7/					67.1	**72.1**	**71.4**	**70.7**	**69.4**	**67.6**	**65.6**
7. 10 percent of GDP increase in other debt-creating flows in 2003					67.1	**77.3**	**76.7**	**76.1**	**74.9**	**73.2**	**71.3**
8. Impact on debt-to-GDP ratio if revenue-to-GDP rati o is at historical average minus two standard deviations in 2003-(					67.1	**67.5**	**66.5**	**65.7**	**64.4**	**62.5**	**60.4**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit (- = surplus)	-1.3	1.6	-2.4
Real GDP growth (in percent)	2.0	1.1	2.1
Nominal interest rate (in percent) 6/	6.3	0.7	5.4
Real interest rate (in percent)	4.7	0.6	4.2
Inflation rate (GDP deflator, in percent)	1.6	0.9	1.3
Revenue to GDP ratio	52.0	0.8	49.6

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 - p (1+g) - g + ae (1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - p (1+g) and the real growth contribution as -g.

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

5/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

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

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IMF Concludes 2003 Article IV Consultation with Austria

On [November 24, 2003], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Austria.[1]

Background

In a major shift from the policies of the 1990s, the government in power since 2000 has adopted an ambitious program of consolidation and supply-side reforms, with the goal to balance the budget over the cycle, reduce the tax burden, contain fiscal pressures from population aging, and raise Austria's potential growth rate. It made significant steps in this direction with the first (small) fiscal surplus in over 30 years in 2001, a wave of deregulation and privatizations during the last three years, a major pension package this year, and tax reforms planned for 2004–05.

Although Austria has entered its third year of sluggish growth, it has weathered the global slowdown better than its major EU partners. Real GDP growth was 1.4 percent in 2002 and is projected to slow to 0.9 percent this year. The cyclical weakness reflected mainly a sharp fall in investment through the end of last year, but this fall was partly offset by buoyant exports. Data for the first half of 2003 suggest that, even though investment may have started recovering from its two-year slump, the continuing weakness in partner countries has started to affect Austrian exports. During 2002–03, the unemployment rate has edged up only slightly to 4.5 percent and inflation decelerated to 1.3 percent by September, and both remain among the lowest in the EU.

[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. This PIN summarizes the views of the Executive Board as expressed during the [November 24, 2003] Executive Board discussion based on the staff report.

The short-term outlook is for growth of real GDP to recover slowly to 1.6 percent in 2004 and accelerate further to 2.6 percent in 2005. This outlook is subject to considerable uncertainty, but small improvements in the external outlook could accelerate significantly the incipient recovery in investment and lead to higher growth. Indeed, the international environment appears to be improving and there are indications that activity in Austria has bottomed out.

Fiscal policy remains anchored on the target to balance the budget over the cycle. The general government recorded a deficit of 0.4 percent of GDP in 2002, reflecting in large part the operation of the automatic stabilizers. The budget for 2003–04 is aimed at maintaining the broad structural balance reached in 2002, but mainly because of cyclical factors, the general government deficit is expected to be 1.5 percent of GDP in 2003 and 1 percent of GDP in 2004. Budget plans for 2004 include the first round of tax reform, but its revenue impact in that year is to be almost entirely offset by hikes in environmental taxes. More ambitious tax reform measures are planned for 2005, consistent with the government's goal to bring down the tax burden by about 4.5 percentage points of GDP by 2010. To make room for the tax cuts, the authorities plan to cut spending in a number of areas. But because the spending cuts in 2004–05 would not fully compensate for the revenue losses from tax reform (though the aim is to cover the ground in 2006–07), there would be a temporary increase in the deficit in 2005, which, given current projections, would be procyclical.

A major pension reform was adopted in 2003, which is expected to eliminate over one third (about 1.5 percentage points of GDP) of the projected increase in the pension system deficit in the long run. Moreover, the reform will help raise labor force participation of the elderly, thus lowering the fiscal burden of the pension system even further, though its impact in this area is more uncertain. Benefit losses from the reform were capped at 10 percent. On other structural areas, the government sold in September its stake in one of the remaining six enterprises in which it owns a large share; cut red tape and reduced the administrative burden on establishing new business; and expanded the scope for competition with measures targeting the product markets. Recent changes to the severance pay system will increase labor market flexibility.

The financial system has fared reasonably well during the slowdown, and supervision has strengthened with the establishment of the Financial Market Authority in 2002 and steps to improve cross-border supervision. However, foreign currency loans to households have continued to rise, and the supervisors have intensified the monitoring of highly exposed banks and started a public information campaign.

Executive Board Assessment

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

Austria: Selected Economic Indicators

	1999	2000	2001	2002	2003 1/
Real economy	Change in percent, unless otherwise noted				
GDP	2.7	3.4	0.8	1.4	0.9
Domestic demand	2.9	2.6	-0.1	0.0	0.7
CPI (year average) 2/	0.5	2.0	2.3	1.7	1.3
Unemployment rate (in percent) 2/	3.9	3.6	3.6	4.1	4.5
Gross national saving (percent of GDP)	22.7	22.7	22.2	24.3	22.4
Gross domestic investment (percent of GDP)	25.9	25.3	24.4	23.6	22.3
Public finance	In percent of GDP				
Central government balance 3/	-2.6	-1.8	-0.7	-1.0	-1.9
General government balance 3/	-2.4	-1.6	0.1	-0.4	-1.5
General government debt	67.5	67.0	67.1	67.1	67.3
Money and credit	End of year, percent change				
M3 4/	4.5	2.2	11.4	1.2	5.7
Domestic credit 4/	5.3	6.8	3.5	1.1	1.2
Interest rates	In percent				
Money market rate 5/	3.0	4.4	4.3	3.3	2.1
Government bond yield 5/	4.7	5.6	5.1	5.0	4.4
Balance of payments	In percent of GDP				
Trade balance	-1.7	-1.4	-0.7	1.6	1.5
Current account	-3.2	-2.6	-2.2	0.7	0.2
Fund position (as of August 31, 2003)					
Holdings of currency (in percent of quota)			57.6		
Holdings of SDRs (in percent of allocation)			74.0		
Quota (in millions of SDRs)			1,872.3		
Exchange rate					
Exchange rate regime			Member of euro area		
Euro per US dollar 5/	0.94	1.08	1.12	1.06	0.86
Nominal effective rate (1990=100) 2/	102.1	99.9	100.2	100.8	102.6
Real effective rate (1990=100) 2/ 6/	80.3	78.8	78.5	79.0	80.7

Sources: IMF, International Financial Statistics; Austrian National Bank; Austrian Statistical Office; and IMF staff projections.

1/ IMF staff projections, unless otherwise indicated.

2/ The figure for 2003 refers to September.

3/ 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.

4/ The figure for 2003 refers to August.

5/ The figure for 2003 refers to October 16, 2003.

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