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April 4, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Austria - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Austria, which is tentatively scheduled for discussion on Friday, April 25, 1986.

Mr. Szapary (ext. 8866) or Mr. Mayer (ext. 8863) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

AUSTRIA

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the 1986 Article IV Consultation with Austria

Approved by Brian Rose and J.T. Boorman

April 4, 1986

I. Introduction

The 1986 Article IV consultation discussions were held in Vienna during February 21-March 3, 1986. The staff team consisted of Messrs. Szapary, Reitmaier, Mayer, Fontana (all EUR) and Mrs. Maragh-Borough (Secretary, TRE). Discussions were held with Mr. Vranitzky, Minister of Finance; Mr. Lacina, Minister of Transport and Public Enterprises; Mr. Koren, President of the Austrian National Bank; and other senior officials. Mr. Schneider, Alternate Executive Director, attended the discussions as an observer. Austria has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Recent Developments and Policies

The economic performance of Austria compares favorably to that of most European countries. For more than a decade, Austria has succeeded in achieving relatively rapid economic growth, combined with a high degree of price stability, low unemployment, and a satisfactory external position. Economic policies have been instrumental in achieving these successes. The mainstays of these policies have been the so-called "social partnership" and the "hard currency policy." The former, through consensus between labor unions, employers, and the government has been fundamental in moderating cost pressures, while the latter, which has established a strong link between the Austrian schilling and the deutsche mark, has provided a stable financial environment in which the social partnership could be successfully operated. Over the medium term, the hard currency policy requires convergence in fundamental economic conditions and policies between Austria and Germany.

1. Recent developments in the real economy

Austria came out of the last recession at about the same time as Germany (Chart 1), with the notable difference that Austria adopted a stimulative fiscal stance in 1982-83 to help pull the country out of the recession. The expansionary measures included income tax cuts and employment support programs. While this enabled Austria to record a somewhat higher economic growth than Germany in 1982-83, it saddled the country with a large fiscal deficit which, as discussed below, the authorities now find difficult to control.

In 1985, Austria's real GDP growth increased to 3 percent (from 2 percent in 1984), with net exports and domestic demand each contributing about 1 1/2 percentage points to growth (Tables 1 and 2). The strong contribution of the foreign balance reflected a sharp pickup in exports accompanied by some slowing of imports. 1/ Private consumption, which contracted in 1984 when real wages declined as a result of a surge in inflation, rebounded sharply in 1985 as inflation decelerated and real wages increased. Gross fixed investment, especially in machinery and equipment, also strengthened, registering, at 4 1/2 percent, the highest rate of growth since 1977. After declining in the early 1980s, profitability in industry began to increase in 1984, exceeding historical average levels by the end of 1985; at the same time, capacity utilization increased significantly. According to the authorities, while rationalization has remained the predominant investment motive, capacity expansion has played an increasingly important role since 1984.

Although the rate of unemployment doubled from as low as about 2 percent in the 1970s and early 1980s to 4 3/4 percent in 1985, it remains low compared with that in other European countries. To a large extent, this has been the result of the creation of new jobs in a rapidly expanding services sector, but it also reflects slow adjustment of the Austrian manufacturing sector to environmental changes. Following the first round of oil price increases, there was considerable labor hoarding in the nationalized industries, which started to be corrected only in the early 1980s. Since then, there has been labor shedding by nationalized industries, but excess labor continues to burden a large number of them. Despite the acceleration in economic growth, the rate of unemployment continued to edge upwards in 1985, reflecting the continued adjustment in nationalized industries and an increase in the female participation rate, a phenomenon observed also elsewhere in Europe.

During 1982-83, the inflation differential (measured by the CPI) vis-à-vis Germany was virtually zero, with inflation falling in both countries (Chart 2). In 1984, a differential of 3 percentage points (annual average) emerged against Austria, as the rate of inflation continued to decline in Germany while it increased to 5 1/2 percent in Austria, owing largely to an increase in the value added tax by 2 percentage points. In 1985, inflation slowed in Austria to about 3 percent, and the differential vis-à-vis Germany narrowed to about 1 percentage point by the end of the year, but widened again somewhat in

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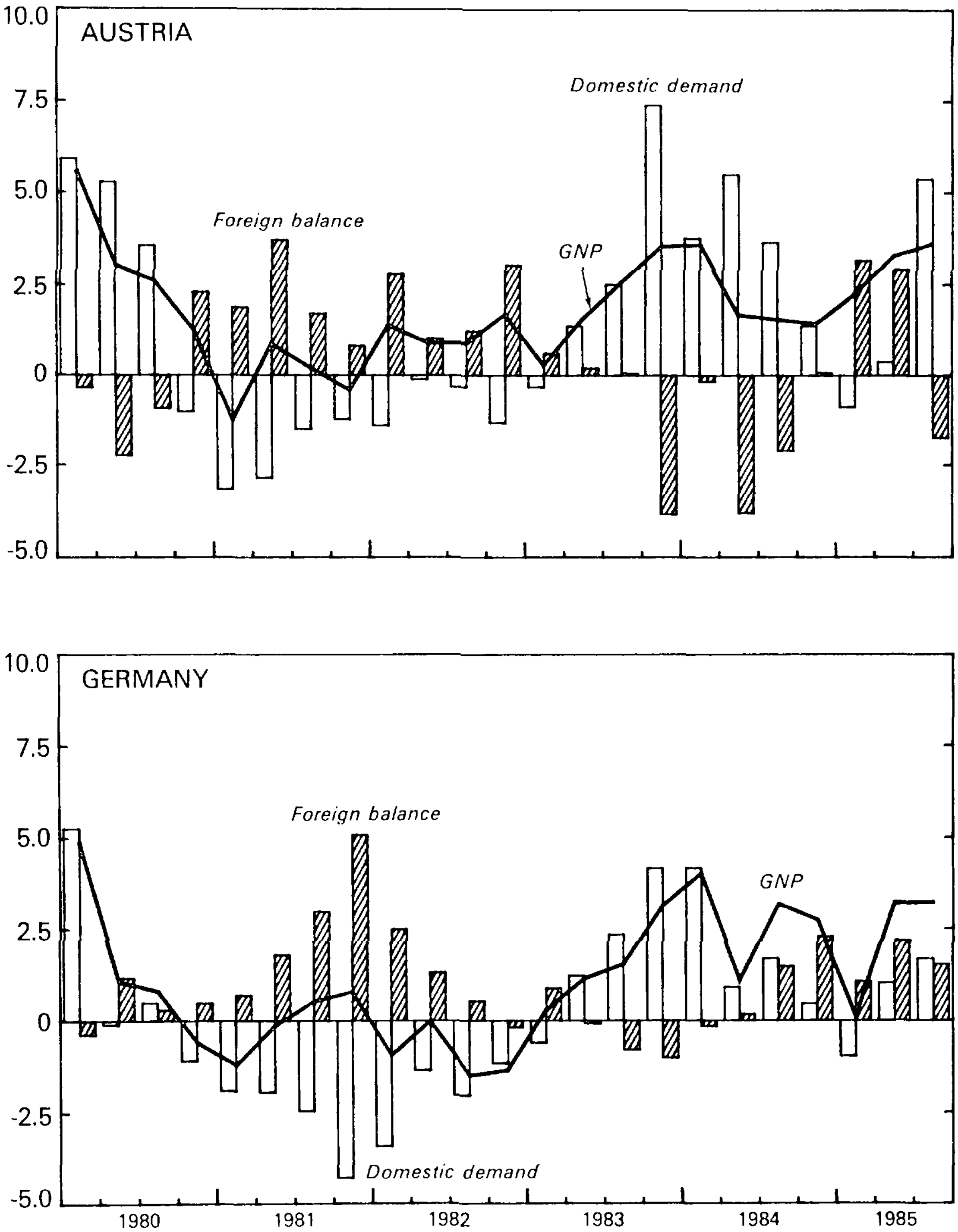
1/ Part of the turnaround in the net foreign balance was due to the re-export of energy products imported in 1984 under transit trade.

CHART 1

AUSTRIA AND GERMANY

CONTRIBUTIONS TO GROWTH[1]



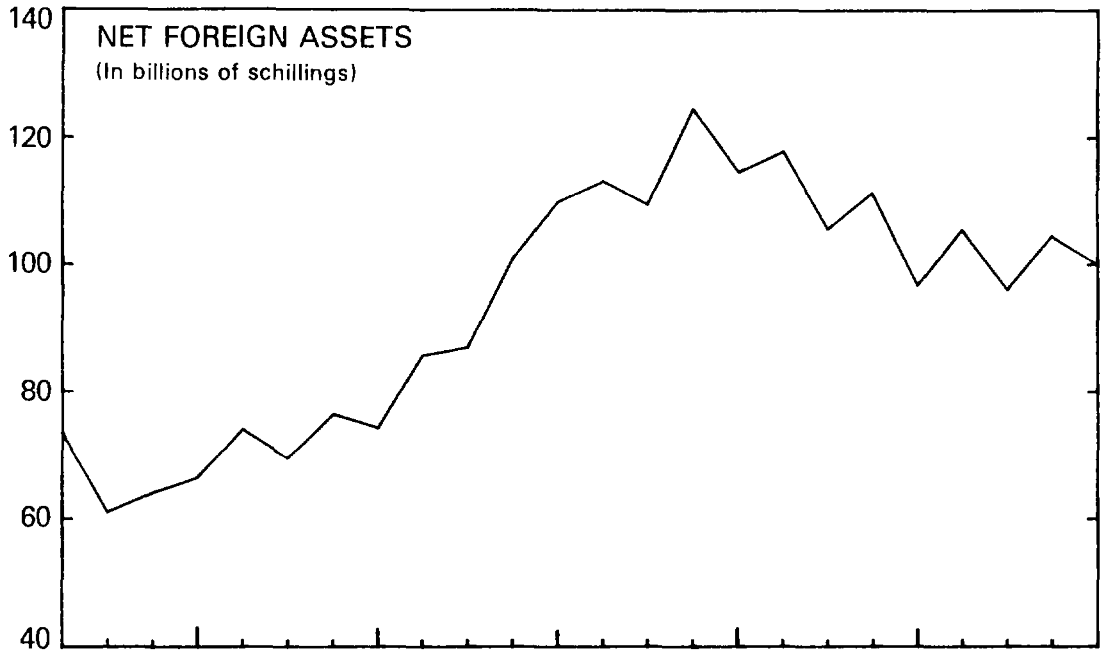
Source: IMF, *Data Fund.*

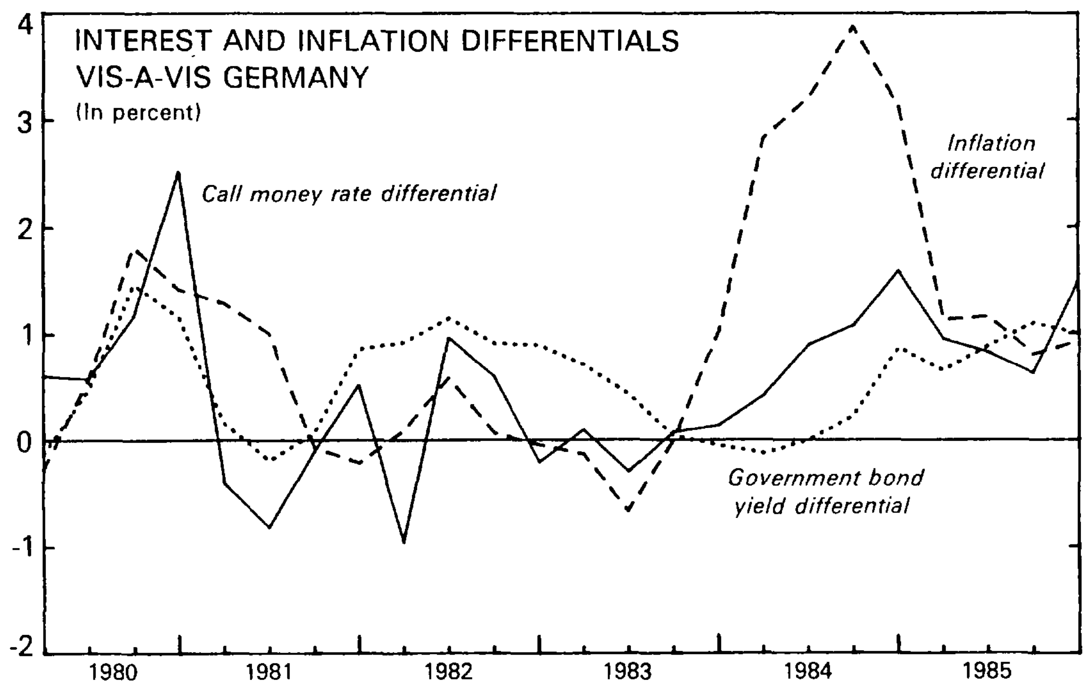
[1]GNP changes in percent; domestic demand and foreign balance: contributions to growth in percentage points.

CHART 2

AUSTRIA

KEY VARIABLES OF THE HARD CURRENCY POLICY





Source: IMF, *Data Fund.*

the beginning of 1986. Following their broadly parallel movements during the early 1980s, unit labor costs in manufacturing declined somewhat more in Austria than in Germany during 1983 and the first three quarters of 1984 (Chart 3). Since then, however, the increase was faster in Austria due to higher wage increases as the wage round of the autumn of 1984 included compensation for the price surge brought about largely by the increase in the value added tax.

2. Fiscal policy

Until the beginning of the 1980s, Austria's federal government budget deficit declined gradually, from an average of 4 1/2 percent of GDP in 1975-76 to 2 1/2 percent in 1981 (Chart 4 and Table 3). The stimulative fiscal policy stance in 1982-83 resulted in a widening of the deficit to almost 5 1/2 percent of GDP. Concern about the rapid increase in public debt and debt servicing prompted the authorities to adopt a fiscal consolidation package in 1984, which relied heavily on the increase in the value added tax and adjustments in tariffs for public services. As a result, the deficit narrowed to 4.4 percent of GDP in 1984. In 1985, the consolidation effort faltered and the deficit in relation to GDP remained at the previous year's level. Despite measures to reform the pension system, the expenditure/GDP ratio increased, owing in part to higher interest payments and transfers, including, in particular, transfers under agricultural price support schemes. As a consequence of these deficits, federal government debt rose to close to 40 percent of GDP by 1985 and interest payments on this debt to almost 20 percent of federal tax revenue.

3. Monetary and exchange rate policies

Monetary policy in Austria is circumscribed by the hard currency strategy. With the schilling/deutsche mark exchange rate kept practically stable 1/ and capital movements virtually free of restrictions, any disequilibria in the domestic financial markets can be quickly eliminated through changes in net foreign assets. The money supply thus becomes largely endogenous, with the relationship between domestic and German interest rates determining the composition of money growth in terms of its domestic and foreign components. In 1985, the growth of M1 slowed while that of broad money accelerated due to a strong growth of time and savings deposits. The authorities attribute this to increased use of new financial instruments--and therefore lower demand for cash--and greater interest rate sensitivity of the public.

The Austrian National Bank followed the decline in international interest rates over most of 1985. In May 1985, the National Bank began to make use of short-term open market operations as an alternative to discount and lombard operations for commercial bank financing, in order to gain more flexibility in influencing the money market rate. The

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1/ Since 1980, the exchange rate of the schilling has been maintained between S 7.0 and S 7.1 per deutsche mark.

interest rate on the open market operations was gradually lowered to 4 3/4 percent by September and has been kept at this level since then. The discount rate was reduced from 4 1/2 percent to 4 percent in August following a similar move by the Bundesbank, while the lombard rate was maintained at 5 1/2 percent throughout 1985.

Until the third quarter of 1983, there was little lasting divergence between Austrian and German short-term interest rates (Chart 2), while long-term rates showed a positive, though declining, differential in favor of Austria. During 1984, a considerable positive differential in favor of Austria emerged, first in short-term rates and then, to a lesser extent, also in long-term rates. These increases in the interest rate differentials can be traced in part to the introduction of a tax on interest income, 1/ but they probably also reflect some perception of exchange risk linked to the emergence of a significant inflation differential. During the first three quarters of 1985, as Austrian short-term interest rates declined, the differential vis-à-vis Germany narrowed. However, toward the end of the year, the authorities had to allow a sharp increase in interest rates to halt a decline in reserves (see below).

Between 1980 and the first quarter of 1985, the trade-weighted effective exchange rate for the schilling appreciated by 2 1/2 percent in nominal terms, but it depreciated by 6 percent in real terms (based on unit labor costs) (Chart 3). Since then, the schilling has been appreciating in both nominal and real terms; between the first and fourth quarters of 1985, the appreciation was 3 1/2 percent in nominal and 4 1/2 percent in real effective terms. 2/ During the first two months of 1986, the schilling appreciated by another 1 percent in nominal effective terms.

4. Balance of payments developments

Until the early 1980s, Austria's external current account had been in deficit. After recording a relatively large surplus (1 percent of GDP) in 1982, Austria's external current account has remained in approximate balance in recent years (Table 4). A large part of the deficits recorded until 1981 was financed by short-term capital inflows, with long-term official borrowing contributing importantly in some years. Austria's total gross long-term external debt is equivalent to about 28 percent of GDP; including short-term debt, the ratio is approximately 60 percent.

1/ In January 1984, Austria introduced a 7 1/2 percent tax on interest income which was reduced to 5 percent a year later. This tax is withheld at source.

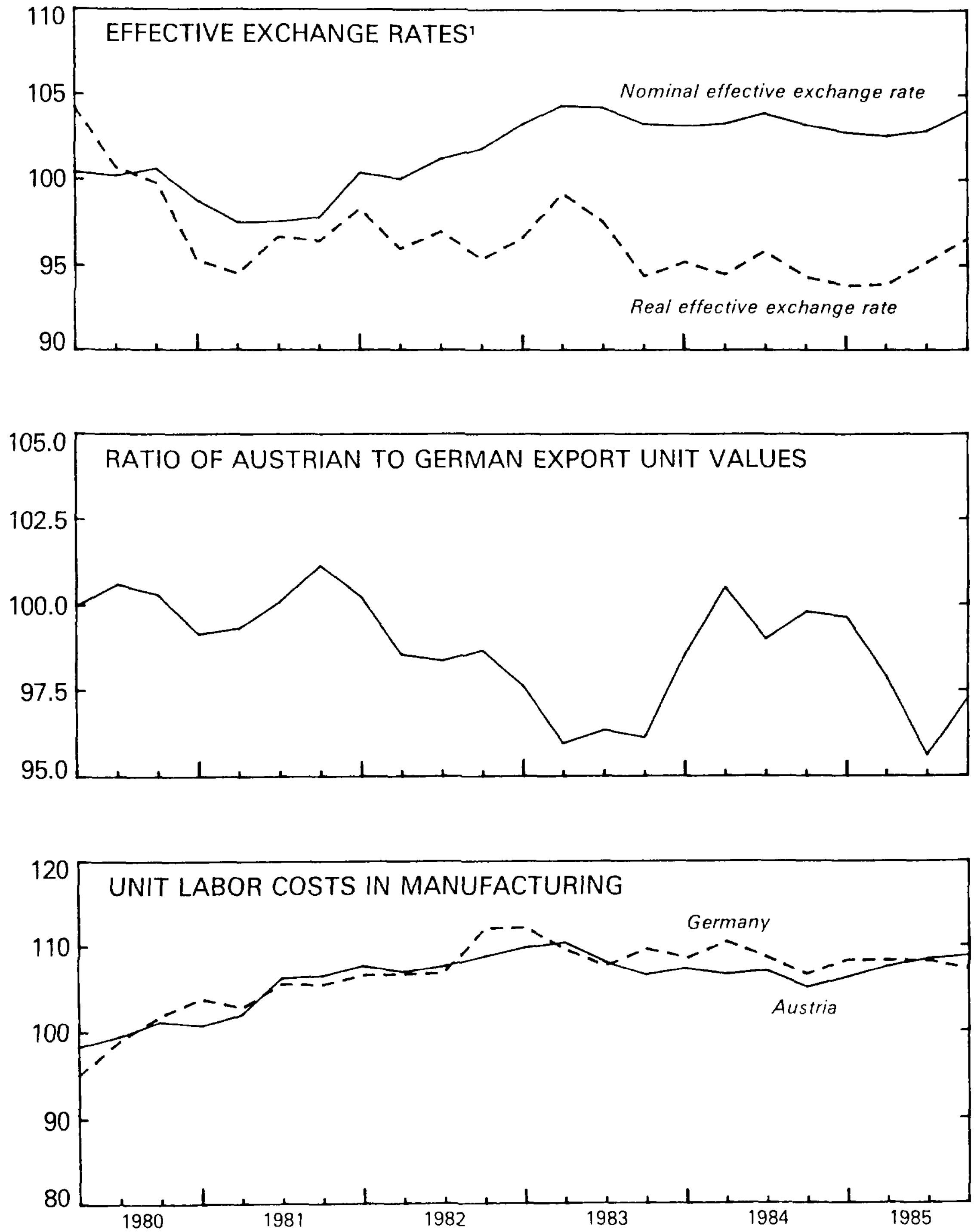
2/ The MERM gives a greater weight to the U.S. dollar than the bilateral trade-weighted basket. Accordingly, on a MERM basis, the schilling depreciated during the first period and appreciated more during the recent period.

CHART 3

AUSTRIA

KEY EXTERNAL INDICATORS

(1980 = 100)



Source: *Data Fund*

[1] Trade weighted, 17 partner countries.

Provisional data for 1985 indicate a current account deficit of S 2 billion but the authorities estimate that, after correction for the initial underrecording of certain services receipts, final figures would show a small surplus of about S 1 billion (0.1 percent of GDP). A significant development in 1985 was that the underlying trade balance (excluding transit trade) did not deteriorate, even though Austria's relative cyclical position would have normally implied such a deterioration. The authorities attributed this to increased import substitution and, more importantly, to a shift in the structure of exports toward finished goods which allowed Austria to take advantage of the most dynamic segments of export markets in Europe and the United States.

III. Short-Term Prospects

Prospects for 1986 are heavily influenced in Austria as elsewhere by the sharp decline in oil prices and the fall of the U.S. dollar, both of which will improve Austria's terms of trade, contributing to a decline in inflation and boosting consumption. On the assumption of an average oil price of $15 per barrel and current exchange rates, real GDP is expected to grow by 3 percent, the same rate as in 1985 but with the growth stemming entirely from domestic demand. Real export growth is expected to slow considerably because of a weakening of import demand in the United States, oil producing countries, and Eastern Europe, which will be only partly offset by a strengthening of demand in Western Europe. Nevertheless, and despite an increase in the growth of real imports and some weakening of net tourist receipts, the external current account is forecast to show a surplus of about S 12 billion 1/ (US$0.7 billion or 0.8 percent of GDP) due to an improvement in the terms of trade estimated at 4 percent.

Inflation, as measured by consumer prices, is projected to decline to about 1 1/2 percent. The Austrian representatives observed that the pass-through to consumers of the lower international oil prices was expected to be somewhat slower in Austria than elsewhere because of the oligopolistic market structure existing in the energy sector. Hence, the short-term effect of the oil price decline on prices and consumption could be smaller in Austria than in other industrial countries. On the other hand, the delayed pass-through would provide some price dampening effect in 1987. The rate of unemployment is projected to remain unchanged at about 4 3/4 percent.

IV. Policy Issues

The hard currency strategy has served Austria well and Executive Directors have consistently endorsed this strategy, although on occasion questions have been raised about its sustainability. Over the years,

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1/ Each dollar decline in the price of oil per barrel reduces Austria's net oil import bill by somewhat over S 1 billion on an annual basis.

this policy has faced various challenges but, as the record shows, Austria has been able to overcome them. In many ways, the policy has acted as a catalyst for adjustment, prompting the authorities to undertake whatever corrective measures were needed to maintain this policy. During the discussions, the authorities forcefully reiterated their commitment to the hard currency policy. Against the backdrop of relatively favorable recent developments and immediate prospects, the discussions with the authorities focussed on the challenges the policy is likely to face during the years ahead.

1. Public sector policies

A new challenge stems from Austria's relatively large fiscal deficits. In the long run, the successful pursuit of the hard currency policy critically depends on convergence in the fundamentals between Austria and Germany, including convergence in fiscal performance. Since 1981, a significant divergence has emerged in fiscal policies: while the deficits have narrowed in Germany, they have generally widened, with the notable exception of 1984, in Austria (Chart 4). 1/ Unless domestic saving is increased substantially, 2/ the large fiscal deficits will eventually weaken the external position, undermining public confidence in the sustainability of the hard currency policy and raising the question whether Austria will be able to maintain that policy without pushing interest rates up to undesirably high levels. Since 1983 the differential in nominal interest rates vis-à-vis Germany has increased significantly and this can be traced in large part to the effect of fiscal policies. Indeed, the acceleration of inflation and the resulting emergence of a considerable interest rate differential in 1984 was to a large extent the indirect consequence of the expansionary fiscal policy of 1982-83, since the value added tax was raised in 1984 primarily with a view to bringing the fiscal deficit under control.

The authorities agreed that the maintenance of the hard currency policy implied convergence in fiscal policies over the medium term. They said that their medium-term objective was to reduce the fiscal

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1/ The divergence is apparent at both the federal and general government levels, although in Austria the general government deficits have been consistently lower than those of the federal government as the local authorities have been running surpluses, which have been mostly used for lending for local development. The focus on the federal deficit is, however, appropriate, since changes in the general government deficits are dominated by federal government operations and, as in other federal systems, the local authorities, while constituting a relatively large share of the general government, cannot be considered as agents of fiscal policy to the same extent as the federal government.

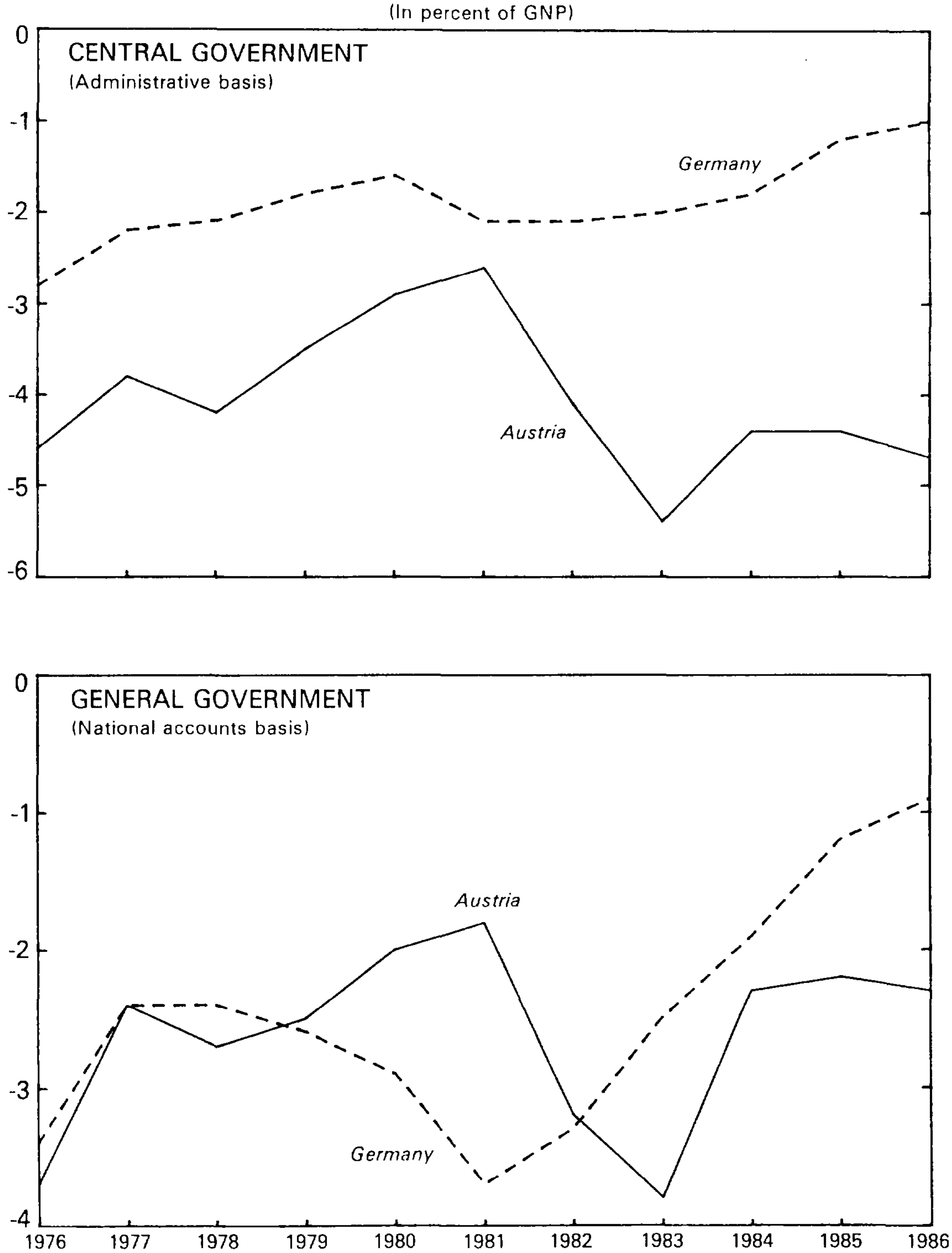
2/ The saving-investment balance has been less favorable in Austria than in Germany. During the period 1974-85, domestic private savings as a ratio to personal disposable income averaged about 10 percent in Austria and 14 percent in Germany; the private savings/investment ratio averaged 24 percent and 43 percent, respectively.

CHART 4

AUSTRIA

FISCAL BALANCES IN AUSTRIA AND GERMANY

(In percent of GNP)



Sources: National authorities; and IMF staff projections.

deficit of the federal government to about 2 1/2 percent of GDP. The immediate goal, which was achieved in 1985, was to stabilize the deficit and this would be followed by a succession of steps toward the medium-term consolidation target. However, since parliamentary elections were scheduled for April 1987, any major new initiative would have to wait until 1987. The 1986 budget did not include any major revenue or expenditure measures although there were tough prebudget negotiations with ministries to keep spending down. The budget foresees a slight widening of the deficit/GDP ratio to 4.7 percent (from 4.4 percent in 1985), but the authorities thought that the actual budget outcome would be better as they had given strict instructions to keep expenditures other than legal commitments below budget estimates by a margin of 3-5 percent; at the maximum this could apply to 25-30 percent of total outlays. In this regard, the staff team noted that past experience in trying to keep expenditures below budget allocations had not been encouraging.

The dynamics of the Austrian federal budget are such that if no deficit-reduction measures are taken, the deficit goes on widening, as revenue has a tendency to grow more slowly and expenditure more rapidly than GDP. The low buoyancy of the tax system is mainly due to numerous tax exemptions, tax avoidance owing partly to high marginal tax rates, and the weak performance of many nationalized industries which has weakened the potential tax base. A reduction of income tax exemptions coupled with a reduction in marginal tax rates on personal income could help increase the buoyancy of the tax system. Clearly, however, the deficit reduction effort will need to concentrate on expenditures.

The authorities are fully aware that the focus of the consolidation effort will have to be on expenditures, especially since there is public pressure for a personal income tax cut in 1987 to adjust for fiscal drag since the last adjustment in 1982-83. They explained that the expenditure reduction efforts would be concentrated on the railways, agriculture, and "global" subsidies, i.e., those which were associated with a very broad list of criteria and which therefore were not very well targeted. The pension system would also be reviewed; the measures introduced in 1985 had offered the opportunity to seek longer term solutions without undue time pressure. The search for a solution centered on ways to rationalize the system without widespread cuts in benefits and to improve the balance between public and private pension schemes.

The nationalized industries represent a growing burden to the federal government through direct transfers and off-budget guarantees. Direct transfers to the ÖIAG (Österreichische Industrieverwaltungs-AG) group, the holding company of the nationalized industries, are budgeted to absorb 1 1/2 percent of federal government tax revenue in 1986, up from 1/2 percent in 1984. In addition, newly extended credit guarantees to the same group averaged about 4 percent of tax revenue in 1984-85. The issue of nationalized industries was hightened recently by the financial troubles of Voest-Alpine A.G., the most important nationalized company and also the country's largest industrial conglomerate. The needed capital infusion to reconstitute the financial position of Voest-Alpine has been estimated at S 15-20 billion, although the final amount has not yet been agreed. The capital is planned to be raised by the ÖIAG over three years and the government stands ready to pay both the amortization and the interest charges on the loans. There will be no effect on the 1986 budget, but starting in 1987, there will be additional expenditures for many years to come. The staff estimates that for 1987-89, the additional outlays might amount to the equivalent of almost 1 percent of federal tax revenue per year.

The authorities have stressed that the Voest-Alpine difficulties have given new impetus to their efforts to streamline management in the nationalized industries. They have also publicly stated that this was the last time that a nationalized company was to be rescued and reiterated the deadlines by which companies which had not become profitable would be closed down. The deadlines varied between end-1986 or end-1988 depending on the type of businesses of the nationalized industries. Although they did not intend to apply this rule mechanically, the authorities thought it important to establish goals and thus to break the perception that there would always be subsidies from the government to keep operations going. Privatization was not actively considered; with the renewed emphasis on profitability, management rather than ownership was regarded by the authorities as the primary problem. Besides, unless the nationalized industries were restructured and strengthened, the government would not be able to sell them at a fair price. The authorities also emphasized the climate of uncertainty that would be created for employees of the nationalized industries by privatization (the nationalized industries account for about 18 percent of total industrial employment).

2. Monetary and external policies

In 1985, there was a substantial outflow of short-term capital as banks, in response to the narrowing of the interest rate differential and a weakening of credit demand in the first part of 1985, proceeded to reduce their open short-term liability positions in deutsche mark. At the same time, there was a continued, albeit reduced, outflow of private long-term capital mostly into U.S. dollar denominated assets despite the greater exchange risks involved. The authorities explained this phenomenon by a desire for portfolio diversification coupled with the interest rate illusion associated with the uncovered interest differential favoring dollar assets; the psychological impact of the tax on interest income; and an aggressive marketing by banks which earn high commissions on such foreign investments.

In the course of 1985, these short- and long-term capital outflows contributed to a significant decline in international reserves. 1/ To stem the outflow of reserves, the National Bank allowed interest rates to rise toward the end of the year by not raising the limits on its discount and open market financing facilities which had by then been exhausted as a result of the growing recourse by the Government to the domestic banking system to finance its deficit. The resulting sharp rise in the short-term interest rate differential vis-à-vis Germany, which reached 2.7 percentage points in December, induced banks to bring in capital by taking up large short-term open positions in deutsche mark. 2/ However, this resulted in a worrisome maturity mismatch of the banks' foreign assets and liabilities. Moreover, it also created a potential problem for reserve management for the National Bank in case the banks decided suddenly to reduce their open deutsche mark positions. To address these problems, in January 1986, the National Bank concluded a gentlemen's agreement with commercial banks with the aim of phasing down the open deutsche mark positions in the course of 1986. To compensate for the related short-term capital outflows, the Government and the Austrian Kontrollbank, which is the official export credit agency, are expected to increase their external borrowings. The authorities explained that these external borrowings should be undertaken in such a way as to preserve a smooth development in international reserves, the stability of which was regarded as important for pursuing the hard currency policy.

The staff commented that the increase in interest rates at the end of 1985 was, at least in part, related to the need to finance the budget deficit. While increased external borrowing by the Government could, in the short run, relieve pressure on domestic interest rates, the availability of external borrowing should not lead to a postponement of fiscal adjustment. Currently Austria's net external debt service ratio, at about 8 percent, was low, but this ratio would rise substantially if Austria returned to a position of external current account deficits similar to that of the 1970s. According to staff projections (Table 5), such a situation would arise if, assuming no fiscal adjustment in Austria, oil prices in nominal terms gradually returned to their 1985 levels by the early 1990s. Austria's balance of payments remains vulnerable also because of weaknesses in its export structure and its relatively heavy dependence on low-income tourism.

One major weakness of Austria's export structure has been that exports have been concentrated in labor-intensive consumer and basic goods, areas where world demand and prices have been growing relatively

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1/ Due to the depreciation of the U.S. dollar, the decline in reserves in 1985 also reflects relatively large valuation changes.

2/ In January 1986, the differential narrowed to 2 percentage points. In March 1986, the Austrian National Bank did not follow the cut in the German discount rate. The authorities announced that this was to demonstrate their determination to maintain the hard currency policy.

slowly and where Austria has been facing increased competition from newly industrialized countries. This has been evidenced, inter alia, by less favorable developments in export prices of industrial products in Austria than, for example, in Germany, over recent years (Chart 3). So far this has not led to a weakening of Austria's external position, since the country has benefited in recent years from buoyant external demand and a depreciation of the schilling in real terms. With the appreciation of the schilling since early 1985 and a weakening of external demand, the balance of payments position might deteriorate after 1986, once the oil price decline has had its full effect. Since Austria's external position is not as strong as that of Germany, it is less well placed to absorb an appreciation of its currency. In this connection, the staff expressed some concern about the more rapid rise in unit labor costs in Austria than in Germany in 1985 and possibly also in 1986 since the autumn 1985 wage round resulted in wage increases of 5-6 percent in Austria.

The authorities did not think that the appreciation of the schilling against the dollar would have a significant effect on total exports. Austria's exports to the United States were relatively small (less than 5 percent), while in third markets outside Western Europe, Austria was mostly engaged in exports where the competition came essentially from European and Japanese firms. If there were a revaluation of the deutsche mark as a result of a realignment within the European Monetary System (EMS), the schilling would follow the deutsche mark. The authorities did not think that a realignment within the EMS would alter Austria's relative competitive position, since such realignments were seen by them as compensating for past accumulated inflation differentials. Regarding the more rapid rise in unit labor costs in Austria than in Germany in 1985, the authorities noted that it had only offset the relative decline in unit labor costs in 1984.

The authorities pointed out that the volume of exports grew by 11 percent in 1985 which implied significant gains in market shares, and that 80 percent of the growth stemmed from the exports of finished goods. For the first time, exports of manufactured goods covered virtually 100 percent of the imports of manufactured goods, while a few years ago this ratio had been substantially lower. The authorities attached some importance to this development since in their view it indicated that the efforts to restructure industrial production were beginning to show results. These developments were partly the result of foreign investment (e.g., German investment in the production of cars and car engines), but Austrian firms had also become more innovative and there had been a clear improvement in marketing efforts. Nevertheless, the authorities emphasized that Austria's structure of industrial production was still concentrated on basic and semifinished goods (e.g., steel, basic chemicals, aluminum), sectors where the nationalized industries were predominant, making resource reallocation in these industries necessary. However, efforts to abandon traditional activities had proved very difficult, partly due to regional considerations.

Tourism is another area which has been undergoing a structural change in recent years. Developments in this sector are of importance since net receipts from tourism have covered most of Austria's deficit on trade. Traditionally, Austria has catered to the lower end of the tourist market, particularly in summer tourism, where price elasticities are fairly high and where Austria has been losing competitiveness to lower income countries in the Mediterranean area. This has been reflected in a continuous decline in overnight stays since 1982. 1/ On the other hand, demand for higher quality tourism, including city and winter tourism, has increased. The authorities regard the shift toward higher-spending tourism as desirable as it is expected to increase the long-run earning potential of the tourism sector and make it less vulnerable to cyclical developments. In the short- to medium-term, however, the structural change is likely to have some adverse impact on the balance of payments and will also entail hardship in regions which have mostly catered to low-income summer tourists.

3. Banking regulation

Over the years, there has been a gradual erosion in the profitability and capital base of certain banking institutions. Therefore, in 1984, the authorities initiated a gentlemen's agreement between banks to curb "ruinous" competition and began to draft a new banking law which is expected to come into force in January 1987. The new law is aimed at increasing minimum capital standards for banks; it also sets limits on the open foreign exchange positions of banks and contains limitations on a bank's exposure to a single debtor. The banks' provisioning for country risk is not directly regulated in the new banking law. However, the authorities expect that the strengthening of the banks' capital base and profitability would put the banks in a position to raise their own provisions.

4. Trade policy and development assistance

The authorities consider a new round of GATT negotiations essential for curbing the protectionist tendencies that have afflicted the international trade system in recent years. They stated that Austria had applied the provisions of the Multi Fibre Arrangement (MFA) in a liberal way. However, Austria would not be in a position to renounce a renewal of MFA. Austrian official development assistance (ODA), which amounted to the equivalent of 0.28 percent of GNP in 1984, increased to 0.34 percent of GNP in 1985. This compares to an average of 0.36 percent of GNP in 1984 by members of the Development Assistance Committee.

1/ The decline in net real wages in Germany, a major customer country in tourism, over the period 1982-84 has probably contributed to this development.

IV. Staff Appraisal

Over the past decade, macroeconomic developments in Austria have generally been favorable by international comparison and the authorities should be commended for their achievements. 1985 was another good year for Austria. Growth accelerated and was higher than in most European countries, while inflation declined and the differential vis-à-vis Germany narrowed. The external current account improved and there appears to have been a welcome shift in exports toward finished goods, a trend which, if continued, would signal that the efforts to restructure the economy have started to bear fruit. The prospects for 1986 are for a continuation of relatively rapid economic growth, a further slowing of inflation, and a further improvement in the external current account as a result of an expected increase in the terms of trade.

Fundamental to Austria's economic successes has been the hard currency strategy which has served as a cornerstone of the social consensus between government, management, and labor, and the authorities remain strongly committed to this strategy. The hard currency policy has served Austria well and the staff continues to support it. However, the staff would also like to emphasize the policy changes required to successfully maintain it.

In the staff's view, the main challenge during the years ahead lies in the area of fiscal policy. Fiscal consolidation in Austria has been less successful than in Germany, raising the question of whether the hard currency policy can be maintained without pushing up interest rates to unwanted levels. Since 1983, there has been on the whole a significant widening of the interest rate differential vis-à-vis Germany which can be traced largely to fiscal developments. The authorities themselves attribute the higher interest rates in Austria in part to the divergence in fiscal policy. The staff notes the intention of the authorities to increase foreign borrowing by the government. While this may reverse, in the short term, the increase in interest rates that took place at the end of 1985, recourse to higher external borrowing does not constitute in the long run a viable alternative to fiscal consolidation. Indeed, delaying the needed fiscal adjustment might increase its eventual cost and perhaps also reduce the ability of the authorities to do so in an orderly fashion, should there be for instance a marked deterioration in the external environment.

The 1986 budget foresees a slight increase in the deficit/GDP ratio, but the authorities have stated that the actual outturn was likely to be better as they had given strict instructions to keep discretionary expenditures below budget estimates. The staff welcomes this step and urges the authorities to implement it effectively. A feature of the Austrian federal budget is that revenue has a tendency to grow more slowly and expenditure more rapidly than GDP. Thus, unless specific measures are taken, the deficit will widen. The authorities are considering a number of measures to improve the buoyancy of the tax system, including a pruning of tax exemptions. Such measures would be welcome. Clearly, however, the deficit reduction effort needs to focus on expenditures in the basic deficit sectors, especially railways, agriculture, pensions, and the nationalized industries, with their associated subsidies and transfers.

The nationalized industries have been a growing burden on the budget and the recent losses of the most important nationalized company will add significantly to this burden during the years ahead. The staff welcomes the authorities' recent efforts toward strengthening management structures. It also supports the stated policy of the authorities that in the future loss-making enterprises will not be rescued by the Government. In this area, however, the ultimate test will be whether the authorities will be prepared to permit the closing down of nonviable enterprises.

The question of nationalized industries is also closely linked to the problem of structural adjustment in production and exports. The recent shift in exports toward finished goods is an encouraging development, but Austria's economy continues to rely heavily on basic and semifinished goods, sectors where the nationalized industries play a dominant role. Thus, there is a need to promote a reallocation of resources within the nationalized industries. The renewed emphasis on profitability in these industries should help such a resource shift.

Developments in unit labor costs in Austria have, by and large, paralleled those in Germany in recent years. In 1985, unit labor costs rose faster in Austria, offsetting a relative decline that took place the year before. Since the autumn 1985 wage round in Austria preceded the recent oil price decline and therefore reflected the then prevailing higher inflationary expectations, the unit labor cost increase in Austria might turn out to be significantly higher in 1986 than in Germany where the wage negotiations are in the spring. Should this happen, moderation in wage increases would be necessary in the autumn of 1986 to avoid a deterioration in relative external competitiveness.

The authorities are about to introduce a new banking law aimed at strengthening the profitability and capital base of banks. This has been a matter of concern for some time and the staff supports the intended measures. The staff notes, however, that the low profitability and weak capital base of banks might well be the result of a tendency to protect institutions which might otherwise not be fully competitive. It is hoped that with the introduction of the new law, which provides for increased capital base, free competition will be restored in the banking system.

The staff welcomes the progress made in increasing Austria's official development assistance in 1985 which brought the level of Austrian ODA closer to that of the other OECD members.

In summary, the Austrian economy continues to perform well. As in the past, policies will need to be continuously adjusted to the requirements of the hard currency strategy. At present, a perhaps unduly large burden of maintaining this strategy falls on monetary policy; there has to be support from the fiscal side, and, over time, from a more efficient allocation of resources in the economy. This is all the more important since, with the performance of many European countries, and in particular that of Germany, improving, the environment for pursuing the hard currency policy has become more challenging. On the other hand, the improved environmental conditions brought about by the decline in international oil prices should facilitate the adjustment effort.

It is recommended that the next Article IV consultation with Austria be held on the standard 12-month cycle.

Table 1. Austria: Main Economic Indicators

	1982	1983	1984	1985	1986 2/
			(Percent change)		
Demand and supply 1/ (real terms)					
Total domestic demand	-0.8	3.0	3.6	1.6	3.5
Foreign balance 3/	2.0	-0.8	-1.5	1.4	-0.4
GDP	1.2	2.1	2.0	3.0	3.0
Industrial production 4/	-0.7	1.1	5.7	4.5	3.5
Unemployment rate (in percent of dependent labor force)	3.7	4.5	4.5	4.8	4.8
Prices and incomes					
GDP deflator 1/	6.4	4.0	4.8	2.9	3.2
Consumer prices	5.4	3.3	5.6	3.2	1.5
Wholesale prices	3.1	0.6	3.8	2.6	1.3
Export unit values 1/	4.1	-0.1	3.2	3.5	1.2
Import unit values 1/	1.0	-1.0	3.9	5.0	-2.8
Real disposable income 1/ 5/	3.7	3.9	0.2	2.0	3.4
Savings ratio (in percent of disposable income) 1/	10.1	8.9	9.8	9.3	9.9
Monetary base	7.5	7.2	2.2	1.7	...
Money (M1)	3.1	12.0	4.0	2.2	...
Money plus quasi-money (M3)	11.0	8.6	3.9	6.8	...
Domestic credit	9.5	7.3	7.4	9.3	...
Call money rate (annual average, in percent)	8.8	5.4	6.5	6.2	...
			(In percent of GDP)		
Federal government finances 6/					
Revenue	26.4	26.2	26.7	27.3	26.8
Expenditure	30.6	31.7	31.2	31.7	31.5
Financial balance	-4.1	-5.4	-4.4	-4.4	-4.7
			(In billions of schillings)		
Balance of payments 1/					
Trade balance	-62.6	-70.8	-76.8	-65.2	-52.2
Tourism balance	49.2	42.3	48.5	44.7	43.0
Current account	12.2	4.0	-3.9	-2.0 7/	11.5
(In percent of GDP)	(1.1)	(0.3)	(-0.3)	(-0.1)	(0.8)
Official reserves and exchanges rates 8/					
Gross official reserves					
In billions of schillings	128.3	127.1	134.0	122.4	...
In billions of SDRs	7.0	6.3	6.2	6.5	...
Schillings per SDR	18.4	20.3	21.6	19.0	...
Schillings per U.S. dollar	16.7	19.3	22.0	17.3	...
Schillings per deutsche mark	7.0	7.1	7.0	7.0	...

Sources: Ministry of Finance; Austrian National Bank; Austrian Institute for Economic Research; and staff estimates.

1/ Data for 1985 provisional.
2/ IMF staff projections.
3/ Change as a percentage of previous year's GDP.
4/ Excluding electricity and gas.
5/ Personal disposable income deflated by the price index for private consumption.
6/ The figures for 1986 represent the budget estimates.
7/ Preliminary estimates before correction for the underrecording in the services account and for unclassified transactions.
8/ End of period.

Table 2. Austria: Real Aggregate Demand

	1982	1983	1984	1985 1/	1986 2/	1982	1983	1984	1985 1/	1986 2/
	(Percentage changes over same period of preceding year)					(Percentage point contributions to changes in GDP)				
Private consumption	1.4	5.4	-0.8	2.5	3.0	0.8	3.0	-0.4	1.4	1.7
Public consumption	2.3	2.2	0.9	1.5	2.2	0.4	0.4	0.2	0.3	0.4
Gross fixed investment	-6.9	-0.9	2.0	4.5	4.3	-1.7	-0.2	0.4	1.0	1.0
Construction	-6.9	0.6	-0.5	--	2.5	-0.8	0.1	-0.1	--	0.3
Machinery and equipment	-7.2	-2.7	4.6	9.0	6.0	-0.8	-0.3	0.4	0.9	0.6
Final domestic demand	-0.5	3.3	0.2	2.8	3.2	-0.5	3.2	0.2	2.7	3.0
Stockbuilding 3/ 4/	-0.3	-0.3	3.3	-1.1	0.4	-0.3	-0.3	3.3	-1.1	0.4
Total domestic demand	-0.8	3.0	3.6	1.6	3.5	-0.8	2.9	3.5	1.6	3.4
Exports of goods and services 5/	2.0	3.1	3.5	9.5	5.0	0.8	1.2	1.4	3.8	2.1
Imports of goods and services	-3.3	5.7	7.7	6.2	6.3	1.3	-2.0	-2.9	-2.4	-2.6
Foreign balance 3/	2.0	-0.8	-1.5	1.4	-0.4	2.0	-0.8	-1.5	1.4	-0.4
GDP/GNP 6/	1.2	2.1	2.0	3.0	3.0	1.2	2.1	2.0	3.0	3.0

Sources: Austrian Institute for Economic Research, Statistische Übersichten, and Monatsberichte; IMF Data Fund; and staff calculations.

1/ Preliminary.
2/ Staff projections.
3/ Change as a percentage of GDP one year earlier.
4/ Including statistical discrepancy.
5/ Including net transit balance.
6/ Growth in GDP and GNP are almost identical since net factor payments from abroad are relatively small.

Table 3. Austria: Federal Budget and Financing Transactions

(In billions of schillings)

	1983	1984	1985	1986 1/ Budget
Federal budget				
Revenue	316.7	344.9	372.8	388.9
Tax revenue, total	281.8	313.3	336.5	356.5
Of which:				
Personal income taxes	97.8	106.0	116.4	126.2
Corporate income and business taxes	19.1	20.9	23.1	24.1
Value added tax	102.6	117.6	121.9	129.0
Minus: Tax sharing transfers to other levels of government	-107.2	-120.1	-129.6	-138.2
Tax revenue, Federal share	174.5	193.1	206.9	218.3
Federal enterprises, receipts	58.0	62.6	66.1	72.5
Other revenue	84.2	89.2	99.8	98.1
Expenditure	382.2	402.3	432.8	457.3
Wages, salaries, and pensions	127.3	134.3	143.0	150.0
Gross investment	28.3	28.7	28.4	30.5
Transfers to social security system	43.7	44.5	46.0	50.1
Interest (including fees)	27.4	33.8	38.0	44.2
Other expenditure	155.5	161.0	177.4	182.5
Net deficit	65.6	57.4	60.0	68.4
(In percent of GDP)	(5.4)	(4.4)	(4.4)	(4.7)
Redemption of debt	25.5	32.8	31.7	38.1
Gross deficit	91.1	90.2	91.7	106.5
Financing transactions 2/				
Domestic borrowing	77.2	72.8	76.9	76.0
Domestic bond issues	40.4	23.0	32.7	36.0
Treasury certificates	10.1	9.1	3.0	--
Other long-term loans	26.7	40.7	41.2	40.0
Foreign borrowing	17.1	15.3	12.2	30.0

Sources: Ministry of Finance, Bundesfinanzgesetz 1986 and Bundesvoranschlag 1986; and data provided by the Austrian authorities.

1/ Projected financing transactions are not contained in the Federal budget documents and are highly tentative.

2/ Not including small variations in cash balances.

Table 4. Austria: Balance of Payments Developments

	1983	1984	1985 1/	1986 2/
	(In billions of schillings)			
Trade balance	-70.8	-76.8	-65.2	-52.2
Exports	277.1	314.5	354.3	386.2
Imports	348.3	392.1	431.1	443.4
Supplementary trade 3/	0.4	0.8	11.6	5.0
Services balance	40.4	48.4	44.6	43.0
Of which: Net travel	42.3	48.5	44.7	43.0
Unclassified goods and services	35.8	25.6	18.7	20.7
Net transfers	-1.5	-1.2	-0.1	--
Current account	4.0	-3.9	-2.0	11.5
(In percent of GDP)	(0.3)	(-0.3)	(-0.1)	(0.8)
Capital balance	-4.9	7.6	-13.3	...
Long-term capital	-24.1	-7.1	-4.1	...
Short-term capital	19.2	14.7	-9.2	...
Errors and omissions 4/	-0.5	2.6	4.4	...
Change in official reserves	-1.3	6.3	-10.8	...
	(Percentage changes)			
Rate of growth of:				
Real merchandise exports	4.1	9.6	10.7	5.2
Real merchandise imports	6.0	8.4	5.9	6.5
Terms of trade changes	0.9	-0.7	-1.4	4.1

Sources: Austrian National Bank, Zahlungsbilanz Österreichs; data provided by the Austrian authorities; and Fund staff calculations.

1/ Preliminary, before correction for underrecording in the services account and for unclassified transactions.

2/ Fund staff forecast.

3/ Including transit trade.

4/ Including valuation changes.

Table 5. Austria: Illustrative Debt Projection

(In percent)

	1985	1986	1987	1988	1989	1990	1991	1992
A. Baseline scenario 1/								
Current account/GDP	-0.1	0.8	0.4	0.3	0.2	0.1	-0.1	-0.2
Net debt/GDP 2/	8.4	6.3	5.2	4.3	3.7	3.3	3.3	3.6
Net debt service ratio 3/	7.5	3.1	3.3	3.2	2.9	3.7	3.9	4.6
Net interest payments ratio 4/	1.5	1.3	1.0	0.8	0.6	0.5	0.5	0.5
Net amortization ratio 5/	6.1	1.8	2.3	2.4	2.2	3.1	3.3	4.1
B. Alternative scenario 6/								
Current account/GDP	-0.1	0.8	0.2	-0.2	-0.6	-1.1	-1.6	-2.0
Net debt/GDP 2/	8.4	6.3	5.7	5.7	6.6	8.4	11.2	14.7
Net debt service ratio 3/	7.5	3.1	4.5	5.8	7.3	10.5	13.5	16.3
Net interest payments ratio 4/	1.5	1.3	1.0	1.0	1.0	1.2	1.6	2.1
Net amortization ratio 5/	6.1	1.8	3.4	4.9	6.3	9.3	11.9	14.2

Sources: Austrian National Bank, Mitteilungen; and Austrian Postal Savings Bank, Finanzschuldenbericht; and Fund staff calculations.

1/ Assumes an oil price of US$15 per barrel and constant export market shares throughout the projection period.

2/ Defined as net public and private nonbank medium- and long-term debt plus total net bank debt minus net foreign reserves (excluding gold) of the Austrian National Bank.

3/ In percent of exports of goods and nonfactor services.

4/ Calculated on net debt.

5/ On public debt and private nonbank debt. Amortization of existing public debt based on Finanzschuldenbericht, 1985. For new public debt, a five-year grace period is assumed; for private debt, amortization over eight years with no grace period is assumed.

6/ Assuming an annual increase of 12 1/2 percent in oil price in nominal terms starting in 1987, which would bring back the oil price at the end of the projection period to its 1985 nominal level.

Fund Relations with Austria

(As of end-February 1986)

I. Membership status

(a) Date of Membership: August 27, 1948.

(b) Status: Article VIII, as from August 1, 1962.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 775.6 million.

(b) Total Fund holdings of Austrian schillings: SDR 419.9 million. (54.1 percent of quota).

(c) Fund credit: none

(d) Reserve tranche SDR 355.7 million (45.9 percent of quota).

(e) Current operational budget: In the March-May operational budget, Austria is included for SDR 15.8 million on the transfer side and SDR 25.1 million on the receipt side.

(f) Lending to the Fund: Supplementary financing facility SDR 39.9 million.

III. Stand-by or extended arrangements and special facilities: None.

IV. SDR Department

(a) Net cumulative allocation: SDR 179.05 million.

(b) Holdings: SDR 160.47 million or 89.6 percent of net cumulative allocations.

(c) Current designation plan: Austria is in the December-February designation plan for SDR 7.3 million.

V. Administered Accounts

Austria has contributed SDR 1.18 million to the SFF Subsidy Account.

VI. Overdue Obligations to the Fund: None.

VII. Austria has not used Fund resources.

VIII. Exchange system:

The Austrian authorities aim at maintaining a close relationship between the schilling and other currencies with a stable purchasing power. In March 1973 the authorities adopted a policy of orienting the Austrian schilling toward the currencies participating in the European common margins arrangement, in particular the deutsche mark. After the establishment of the European Monetary System (EMS) on March 13, 1979, the Austrian authorities pursued a policy of maintaining a close relationship between the schilling and the currencies of the EMS. In practice, this has implied a close link to the deutsche mark.

IX. Last Article IV Consultation

Discussions for the 1985 Article IV Consultation were held in Vienna during the period February 8-21, 1985. The staff report (SM/85/114) was discussed by the Executive Board on May 22, 1985.

Austria - Statistical Issues

1. Outstanding Statistical Issues

Government finance

Annual and quarterly data provided for *IFS* cover budgetary and extrabudgetary operations of the central government in the GFS format but so far do not cover social security operations (which are covered in the annual data provided for the *GFS Yearbook*).

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Austria in the March 1986 issue of *IFS*. The data are based on reports sent to the Fund's Bureau of Statistics by the Oesterreichische Nationalbank which, during the past year, have been provided on a timely basis.

Status of IFS Data

		Latest Data in March 1986 IFS
Real Sector	- National Accounts	1984
	- Prices: WPI	December 1985
	CPI	December 1985
	- Production: Industrial	Q1 1985 1/
	- Employment: Total	October 1985
	- Earnings: Monthly	August 1985
Government Finance	- Deficit/Surplus	Q3 1985
	- Financing	Q3 1985
	- Debt	n.a. 2/
Monetary Accounts	- Monetary Authorities	December 1985
	- Deposit Money Banks	December 1985
	- Other Financial Institutions	Q3 1985
External Sector	- Merchandise Trade: Values	November 1985
	Unit Values	September 1985
	- Balance of Payments	November 1985
	- International Reserves	January 1986
	- Exchange Rates	January 1986

1/ Series provided by OECD; it is to be substituted by a corresponding series supplied by the country, which is more current.
2/ Data for 1983 are to be published in a forthcoming issue of *IFS*.