Research Report on Austria

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Introduction

The Austrian economy is still characterized by solid macroeconomic fundamentals and a resilient domestic financial system despite having a sluggish performance in 2014. During 2014 and in the beginning of 2015 some macroeconomic indicators, such as GDP growth, unemployment, government debt and international trade, showed slightly negative dynamics and the banking system's exposure to CEE countries became more critical. However, Austria still enjoys low levels of inflation and unemployment, as well as acceptable amounts of short-term debt, a narrow fiscal balance and a high GDP per capita. These indicators support the generally positive condition of the national economy. In contrast, government debt continues to grow mainly due to the government support of "bad banks" in the country. Furthermore, the banking sector shows domestic strength, while its exposure to the CEE economies is a risk that must not be overlooked. Finally, new fiscal reforms, such as the new tax laws, will support consumption growth and reduce participation in the growing shadow economy.

Main Economic Indicators of Austria

Macro indicators	2012	2013	2014
Gross pub. debt, bill EUR	259	262	278
Nominal GDP, bill EUR	317	323	329
Real GDP growth, %	0,9	0,2	0,4
Gross gov. debt/GDP,%	81,7	81,2	84,4
Deficit (surplus)/GDP,%	-2,3	-1,5	-2,4
Inflation rate,%	2,9	2,0	1,5
Curr. Account balance/GDP,%	2,3	1,0	1,8

Development indicators	2014
Inequality adj. HDI	0,82
GDP per capita (Thou. of USD)	46,4

Default indicator	07.08.2015
5-Year CDS spread (Bp)	28
10Y Gov Bond Yield, %	0,91

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg, Austria Statistics, EC

Gross government debt continues to increase amid continuous support to troubled Austrian banks, nonetheless, the structure of debt is solid. Preliminary data for 2014 presented in our previous report[1] showed an estimated government debt to GDP ratio of 82%, however, the actual figure was 2 p.p. higher (84,4% of GDP) and, according to estimates by the European Commission, it is projected to grow further in the following years. The hike on debt figures has been mainly caused by the government support to troubled banks, affected during the financial crisis, which have needed regular capital injections such as KA Finanz and Heta. In fact, a recent ruling form an Austrian federal court has, for now, prevented the government to "bail-in" junior bond-holders. In 2014 the authorities approved a law to eliminate guarantees from the government to bond-holders of certain banks. As a result of the federal court ruling the gap of more than 7 billion EUR from Heta still remains uncovered, while the government has already provided 5,5 billion EUR in capital to this "bad bank". Recapitalization of the banking sector has contributed to a

[1] Refer to previous research report to see these programs: Research Report on Austria from 13th of February 2015 (http://raexpert.eu/reports/Research_report_Austria_13.02.2015.pdf)

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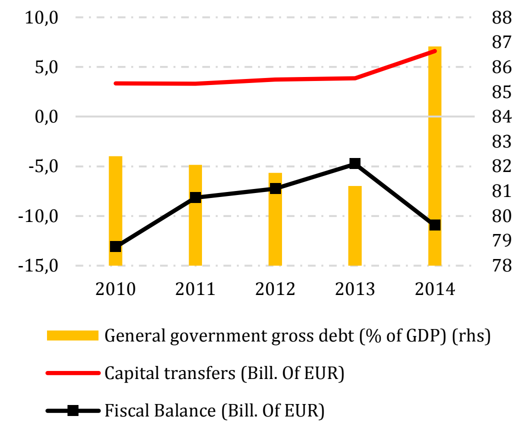
Graph 1: Effect of capital transfers on the fiscal balance and government debt

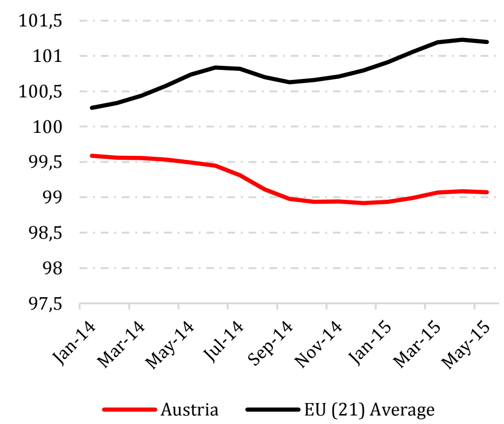


Source: RAEX (Europe) calculations based on data from IMF and Statistics Austria

widening of the fiscal deficit (see graph 1). Nevertheless, the structure of the Austrian debt is well balanced with short-term debt representing a low 5,5% of GDP and the yield on the 10Y government bond remains at 0,91%.

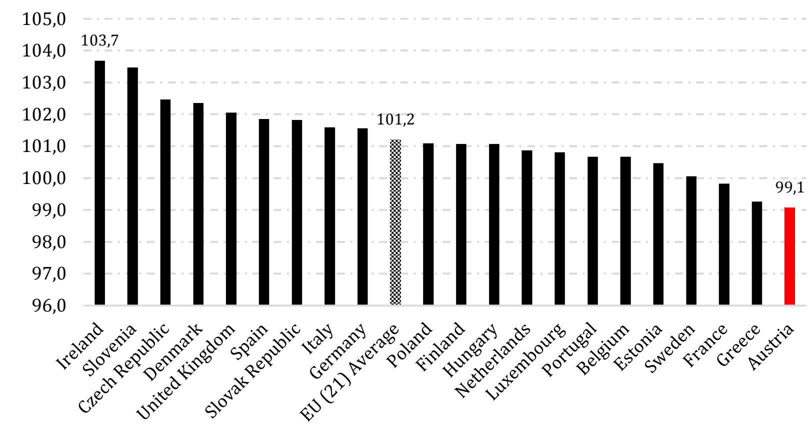
Low GDP growth, but other macroeconomic indicators remain strong. Real GDP growth has been weak since 2012 at an average of 0,48%. Growth in 2014 was as low as 0,4%. The 2015 prospects are slightly better due to a pickup in consumption. However, most of the consumption growth can be attributed to public rather than private spending. Private consumption slightly increased by 0,1% (as compared to the previous quarter) in early 2015 despite negligible real disposable income growth. Consumption levels and stable inflation were mainly supported by a declining savings rate. The sustained increase in prices has been larger than in the EU, although in a downward trend. However, inflation has remained steady in 2Q 2015 reflecting stalled private consumption and a combination of cheaper oil and higher prices for services. Even with the recovery of the European economy, consumer confidence in Austria has remained lower than in other EU countries since early 2014 (see graphs 2 and 3).

Graph 2: Consumer confidence index dynamics



Source: RAEX (Europe) calculations based on data from OECD

Graph 3: Consumer confidence index among EU members (May 2015)



Source: RAEX (Europe) calculations based on data from OECD

The unemployment rate is one of the lowest in the EU, but has grown marginally due to a growing supply of labour driven by immigration and retired people entering the job market due the new pension law.

The exposure of the banking system to CEE economies and declining private credit levels are a growing concern. As mentioned in the February report of this Agency, the Austrian banks have substantial

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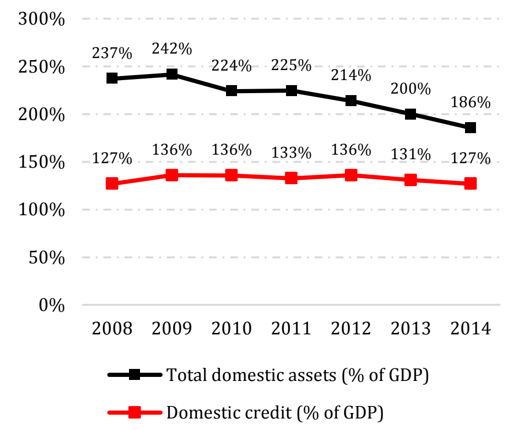
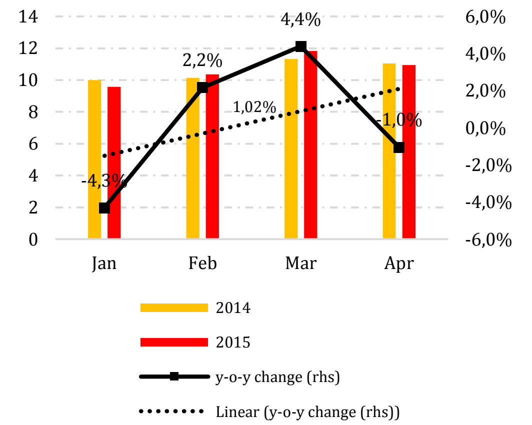
Graph 4: Private debt dynamics



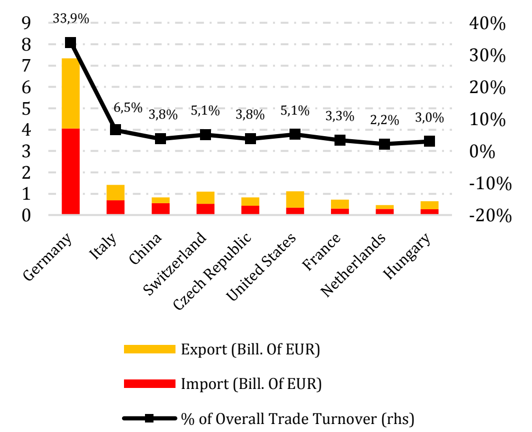
Source: RAEX (Europe) calculations based on data from IMF

Graph 5: Total exports from Austria (Bill. Of EUR)



Source: RAEX (Europe) calculations based on data from Statistics Austria

Graph 6: Austria's major trade partners



Source: RAEX (Europe) calculations based on data from Statistics Austria

exposure to the CEE markets. The exposure presents high risks due to the unfavorable economic conditions in the CEE region. Austrian banks, as well as other foreign banks, have issued mortgages denominated in CHF in CEE countries for several years due to the low interest rates policy of the Swiss Central Bank. The exposure of Austrian banks to loans issued to Romanian, Polish, Croatian and Hungarian households increased substantially by 2014. The Swiss Central Bank's decision to abandon the CHF peg to the EUR led to a sharp worsening of the Austrian banks' assets. Additionally, unrest in Ukraine and economic sanctions against Russia resulted in further losses for the Austrian banking sector. Moreover, domestic demand for debt has been stagnating since 2009 (see graph 4).

Austria's trade position continues to be balanced and tightly connected to the German economy. Exports have increased by 1,02% year on year in 1Q 2015 as compared to the same period in 2014; the hike was especially marked during February and March (see graph 5). The recovery of the EU economies and a weaker EUR have driven exports, mainly of services which account for more than 50% of the value-added of total exports. Exposure to the German economy remains high. Germany accounted for 34% of total foreign trade turnover followed by Italy with a share of 6,5% in April 2015 (see graph 6).

The new tax reform should boost consumption and reduce participation in the shadow economy while maintaining a stable fiscal balance. Labour taxes in Austria are one of the highest in the EU and lead to a growing participation in the shadow economy. This has prompted the government to introduce a new tax reform expected to ease the tax weight on low-earners. As a result, the marginal effective income tax rates would be better distributed among the different earning brackets. This should support private consumption and limit activity in the shadow economy, while maintaining a steady fiscal balance. However, the tax wedge in Austria remains one of the highest in the EU.

Conclusion

The general stance of the Austrian economy is solid despite negative trends of some indicators in 2014. The fiscal framework established by the government, along with the new tax law, should support and revive economic growth. Supported by strong macroeconomic indicators, which are normalizing once again in 2015, the Austrian economy should resume growth in the medium term. Problems of Austria's troubled banks and the overall exposure of the banking system to the CEE economies are major risks for this country.

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