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Research Report on Austria

13th of February, 2015

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Introduction

The Austrian economy is mainly supported by strong macroeconomic fundamentals, such as acceptable and steady levels of inflation, low unemployment, high GDP per capita and consistent Current Account surpluses. Despite government debt being substantial, especially due to the restructuring of part of the banking system, it is still at bearable levels and the share of short-term debt is small. Additionally, the increasingly flat yield curve on sovereign bonds reflects very low refinancing costs. Even though the estimated deficit for 2014 is relatively narrow, it is projected to be higher than that expected by the authorities at the beginning of that year due to the aforementioned restructuring plan of the banking system. At the same time, expenditures in certain economic sectors, as well as labor taxes, are still too elevated, however, further fiscal reform is expected to address this issue. The financial sector is characterized by a healthy domestic banking system and slightly underdeveloped financial markets. Nonetheless, attention must be focused on the high dependence of the banking industry on the economies of Central and Easter Europe (CEE).

Strong macroeconomic fundamentals built the base for a strong economy. Austria's solid economy is underpinned by stable and robust macroeconomic indicators. First of all, the level of prices, measured by the Harmonized Index of Consumer Prices (HICP), has remained stable over the past six years and the deflationary pressure, which is a concern in the European Union (EU), has not been as pronounced in Austria (see graph 1). Furthermore, the current estimated level of HICP (1,5 - 1,7%), is very close to the European Central Bank (ECB) target (see graph 2). Unemployment rates, however slightly increasing, have been low and stable with the figure forecasted by the European Commission (EC) for 2014 set to be 5,3%. Finally, a GDP per capita in PPP[1] terms of 45 400 USD, one of the highest in the EU, along with an inequality adjusted HDI[2] of 0,81, support the potential for consumption and highlight the high standard of living in the country.

Main Economic Indicators of Austria

Macro indicators	2012	2013	2014*
Gross pub. debt, bill EUR	228,5	233,3	257,9
Nominal GDP, bill EUR	307,0	313,3	314,5
Real GDP growth, %	0,9	0,3	0,4
Gross gov. debt/GDP,%	74,4	74,5	82,0
Deficit (surplus)/GDP,%	-2,6	-1,5	-2,9
Inflation rate,%	2,4	2,0	1,7
Curr. Account balance/GDP,%	2,4	2,7	3,0

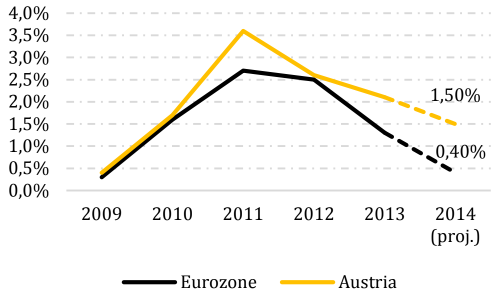
Development indicators	2014
Inequality adj. HDI	0,81
GDP per capita (Thou. of USD)	45,4

Default indicator	As of 13.02.2015
5-Year CDS spread (Bp)	22
10Y Gov Bond Yield, %	0,42

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg, Austria Statistics, EC
* Assessment of RAEX (Europe) based on current data provided by Austrian Statistics, Austrian National Bank, IMF and EC.

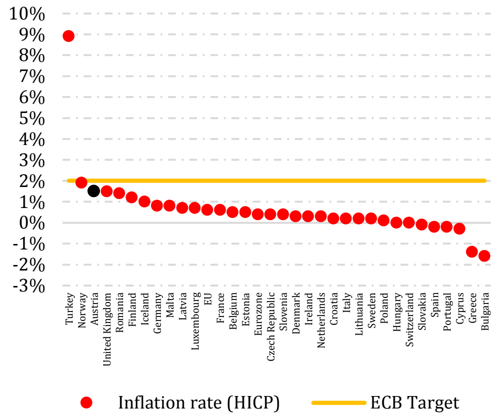
[1] Purchasing Power Parity.
[2] Human Development Index.

Graph 1: Dynamics of Inflation rates (HICP) in Austria and the Eurozone



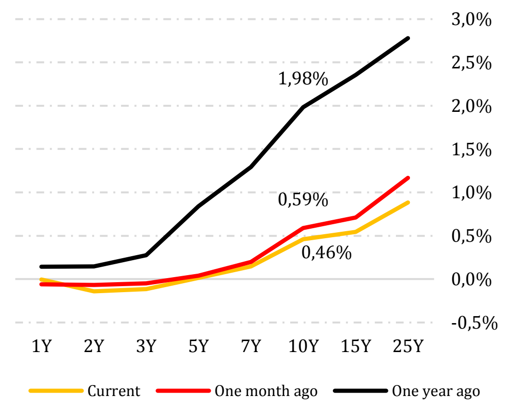
Source: RAEX (Europe) calculations based on data from Eurostat

Graph 2: Inflation rates (HICP) in the EU (2014*)



Source: RAEX (Europe) calculations based on data from Eurostat
*Provisional for the Eurozone and Austria

Graph 3: Yields on Austrian sovereign debt (as of 13.02.2015)



Source: RAEX (Europe) calculations based on data from the National Bank of Austria

High gross government debt, however bearable, with a marginal share of short-term debt and low financing costs. According to several sources, including the EC, the projected amount of government debt of Austria for 2014 will be above 80% of GDP, higher than most of the top rated economies. Most importantly, this increase is due to the restructuring of part of the banking system[3], which was severely affected during the 2008 global financial crisis. Despite this, the proportion of short-term debt to GDP is merely 3,74%. Besides, the fiscal policy, which will be discussed later on, will help to curb additional increases in debt levels. Another factor that offsets the large debt levels is the low yield on sovereign bonds (0,42% on the 10Y bond). As can be observed in graph 3 the yield curve on Austrian debt has flattened substantially from one year ago, thus, making financing less costly.

Balanced external position fueled by services exports combined with significant exposure to the German economy. Austria is also well settled regarding the external position. First of all, the country has no debt obligations denominated in foreign currency, which represents an advantage if exchange rate shocks were to occur. What is more, the Current Account balance is estimated to have a surplus of 3% of GDP in 2014 and has been positive since 2001. The consistent positive balances have been mainly driven by services exports such as, engineering, R&D, information technology and tourism, among others. In fact, The latest 2Y QE programme of the ECB is expected to push this further. Nevertheless, potential risks may arise if a slump in German economic growth would occur. Austria is tightly connected to Germany, where the share of total imports from this country is 40% and the proportion of total exports to Germany is 30%.

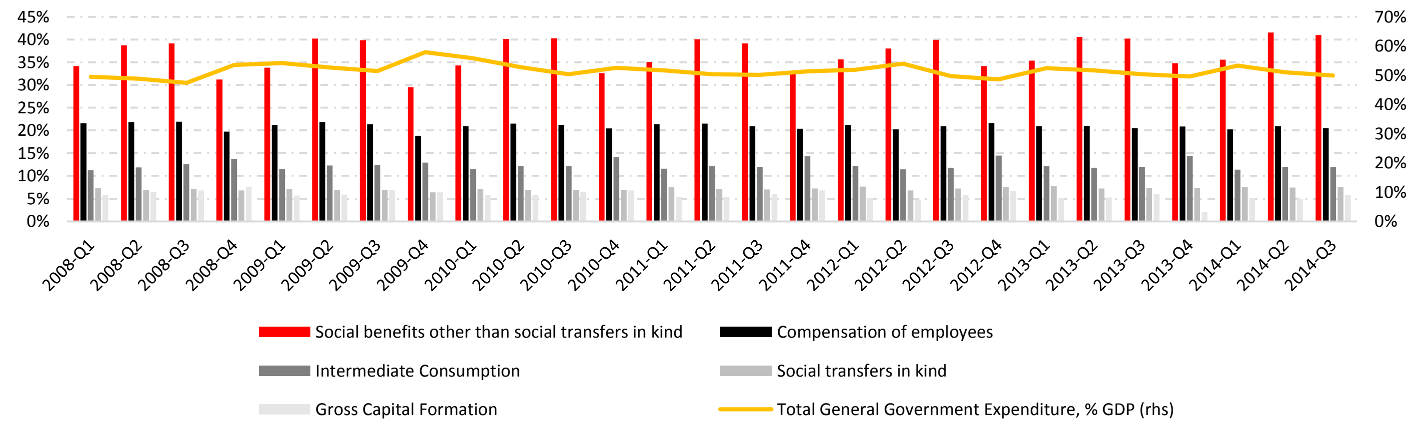
Fiscal deficit, however wider than expected in 2014, remains below the 3% SGP[4] target, though expenditures and lower income taxes will contribute to fiscal consolidation. The latest fiscal deficit projection from the EC for 2014 is 2,9%, still under the 3% threshold established in the SGP. Despite this, the figure is slightly higher than the initial projection from the Austrian authorities mainly due to the restructuring plan of the Hypo Group Alpe Adria Bank, which was nationalized after the 2008 global financial crisis. Apart from this, expenditure levels for pensions, subsidies, and health care have been and remain high (around 40% of total expenditure) as shown in graph 4. In order to approach this issue, the

[3] Hypo Group Alpe Adria Bank is one of the Banks which was nationalized by the government after the crisis in 2009 in order to prevent a bank collapse. Due to recent capital shortages, the government will provide around 2 billion EUR. Additionally, the recapitalization of ÖVAG bank is also part of the restructuring plan.

[4] The Stability and Growth Pact is a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies.

authorities have plans in place to reduce expenditure in these areas and, at the same time, to reduce substantially high labor taxes, which are propelling participation in the shadow economy.

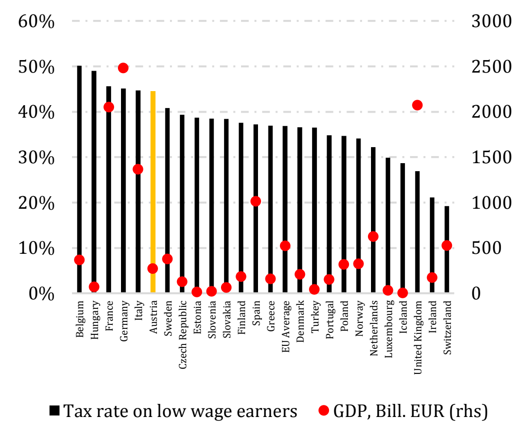
Graph 4: General government expenditure (% of total expenditure)



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

High taxes on low wage earners have contributed to drive the shadow economy. Even though Austria has one of the highest GDP per capita indicators in the EU, it also has one of the highest labor tax rates in the same economic area, especially for those who earn less. In fact, Austria's low earners tax rate is hand in hand with three of the biggest economies in the EU (Germany, France and Italy), (see graph 5). This issue has driven many Austrians to opt to participate in the shadow economy, a sector which is expected to increase 4,5% in 2015. Naturally, the bigger the shadow economy, the lesser the taxes the government will collect. Thus, as mentioned in the previous section, if the planned fiscal policy is executed as expected, further growth of the shadow economy could be avoided.

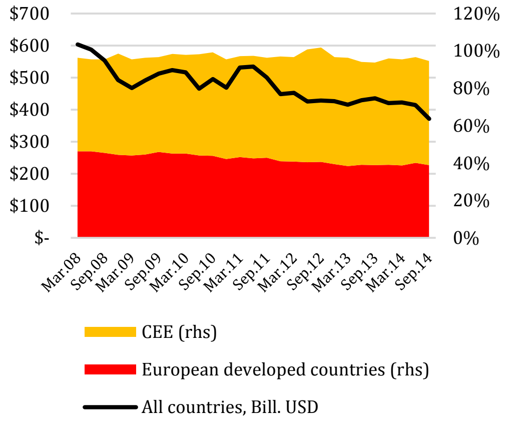
Graph 5: Tax rate on low wage earners in the EU (2013)



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

The financial sector has a strong domestic banking system, but externally exposed to the economies of CEE; additionally, slightly underdeveloped financial markets must also be addressed. The Austrian banks' capitalization, low rate of non-performing loans (NPLs) and moderate rates of private debt underpin the stable domestic banking system. However, the exposure of the Austrian banks in CEE present potential risks, especially due to the situation in Russia, Ukraine and unfavorable policy actions in Hungary. At the same time, the economic situation in many of the countries in CEE is volatile and riskier than in the Eurozone. Despite these potential risks and even though international exposure of Austrian banks has been reduced, their participation in CEE

Graph 6: Exposure of Austrian banks in CEE (% of Total)



Source: RAEX (Europe) calculations based on data from the Bank for International Settlements

economies has been slightly increasing over the last years (see graph 6). Regarding financial markets, underdevelopment is an obstacle, especially the availability of venture capital for starting companies and the lack financing opportunities for small and medium enterprises (SMEs).

Conclusion

We expect that the status quo of the Austrian Economy will not be harmed by short-term risks, however, there is a number of factors that must be closely monitored. Austria's general economic condition is very healthy. The country has a well-structured debt framework which includes low short-term debt, and cheap refinancing costs. These factors, along with the mid-term fiscal plan, which mainly includes reducing social expenditures, will help to mitigate the risk of further elevating government debt. Additionally, consistent positive Current Account balances, supported by the services industry, show a strong external position. Despite Austria being a developed high-skilled labor economy where most of their GDP is generated in the services industry, one of the issues resides on the low-skilled labor sector. High tax rates for the low earners might further encourage participation in the shadow economy and, thus, problems regarding fiscal policy execution may arise. The financial sector has two sides, on the one hand, the domestic banking system seems to be healthy and stable with moderate levels of indebtedness in the economy. On the other hand, increasing exposure of the banking industry in CEE, along with the current issues within that region, is something that could present a potential risk for the industry.