11 March 2019

Public Finance

Republic of Austria
Rating Report

Credit strengths

- Wealthy, diversified and internationally competitive economy
- Favourable public debt profile
- Low private sector debt

Credit weaknesses

- Ageing society increases healthcare and pension liabilities and curbs medium-term growth potential
- Limited reforms to federal fiscal structures and (labour) taxation

Rating rationale and Outlook:

The AAA rating is supported by Austria's euro area membership, its wealthy, diversified and internationally competitive economy, robust economic growth rates, ongoing fiscal consolidation, favourable public debt profile, low private sector debt levels and improvements in the banking sector, including exposures to Central and Eastern European countries. Austria's ageing society poses medium-to-long-term public expenditure and growth challenges. Limited reforms to the overly complex federal fiscal structure, which results in weak incentives to contain costs at the subnational level, as well as Austria's labour-unfriendly taxation system pose further challenges. The Stable Outlook reflects Scope's view that the risks Austria faces remain manageable given the economy's inherent credit strengths, despite the cyclical slowdown.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Austria	Peer comparison: Average	Peer comparison: Finland
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	2		1
Final rating	AAA		AA+

AAA | AA | A | BBB | BB | B | CCC | CC | C

Source: Scope Ratings GmbH

Note: The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with one selected country chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Reversal of fiscal consolidation
- Fading commitment to and implementation of structural reforms
- Re-emergence of banking sector risk

Ratings and Outlook

Foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Lead analyst

Alvise Lennkh, CFA
+49 69 6677389-85
a.lennkh@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Domestic economic risk

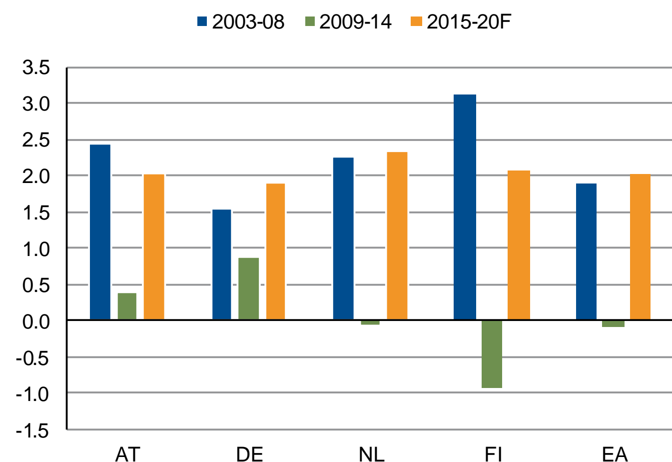
Growth potential of the economy

Robust albeit declining growth prospects, in line with euro area

Following strong expansion, the Austrian economy has reached a mature phase in the cycle. Real GDP growth is projected to have reached 2.7% in 2018, driven by robust domestic demand due to a rise in private consumption on the back of favourable labour market developments. There has been strong and sustained employment growth since 2010, the unemployment rate has been below 5% since February 2018 and wages are increasing. GDP growth is also driven by solid investment linked to high capacity utilisation in the business sector, and a strong export performance despite less dynamic growth in international markets. For the 2015-20F period, we expect the Austrian economy to grow at an average of 2% annually, in line with its peers.

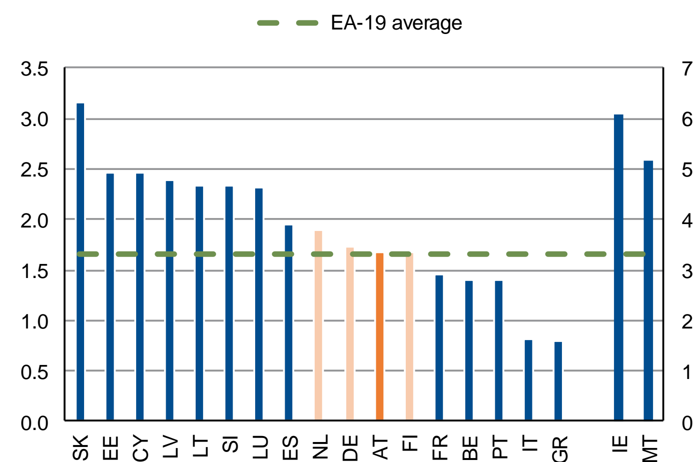
As the cycle matures, we expect private consumption to remain stable, supported by increases in disposable income also due to the tax relief provided by the new 'Family Bonus Plus' programme. At the same time, we expect the contribution to growth from investment, which has been very strong over the past few years, and net exports to decrease gradually. As a result, we expect GDP growth to slow down to around 1.5% for the 2019-21 period in line with the weakening global economy, and the growth rates of Finland (1.5%) and Germany (1.6%) but below those of the Netherlands (2.3%).

Figure 2: Real GDP growth
%



Source: Haver, EC, Scope Ratings

Figure 3: Potential GDP growth (2018-20F, average)
%



Source: Haver, EC, Scope Ratings; NB. IE and MT on RHS.

Labour participation and multifactor productivity need to be raised going forward

While the short-to-medium-term growth outlook is robust, with potential growth estimates at around 1.8% (IMF) and 2.0% (European Commission, (EC)) in line with peers and the euro area average, Austria's long-term economic growth prospects face two key challenges. First, Austria's labour participation rate remains comparatively low, particularly for women, the low-skilled and the elderly[1]. Although it has increased since the early 2000s from a level below 70%, Austria's labour participation rate remains comparatively low at around 74%, below Germany (83%), the Netherlands (82%) and Finland (77%).

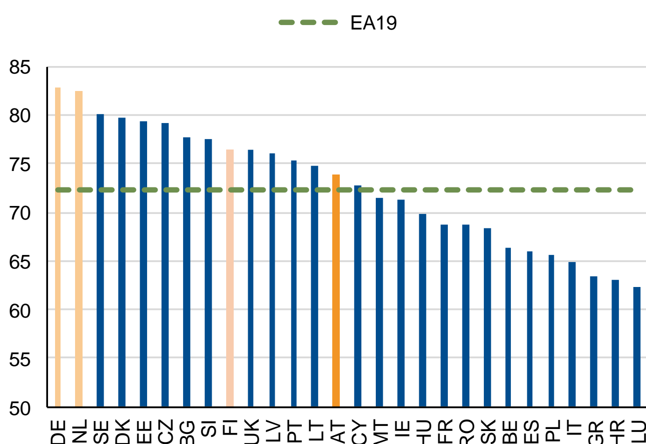
[1] As of Q3 2018, the participation rate for those educated to lower secondary level and aged 20-64 stood at 55%, compared to participations rates of 77% for those educated to post-secondary level and 88% for those at tertiary level. With the exception of highly educated women aged 15-24, the female participation rate is markedly lower than for men for all age cohorts and education levels. Finally, the participation rate of Austrians aged 55-65 is lower than those aged 25-54 by 27 pp for people educated to lower secondary level, 34 pp for people educated to post-secondary level and 17 pp for the highly educated.

ICT adoption, the labour market and business dynamism identified as areas for improvement

Second, we note that since 2008, multifactor productivity as measured by the OECD, has remained flat in Austria, below Germany but in line with the Netherlands, whereas Finland's multifactor growth, which declined sharply during the euro area crisis, has picked up over the past three years. The need for Austria to enhance its productivity is also reflected in its comparatively low score on the World Economic Forum's Global Competitiveness Index, in which it is ranked 22 out of 140 countries, behind regional peers Germany (3), the Netherlands (6) and Finland (11)[2].

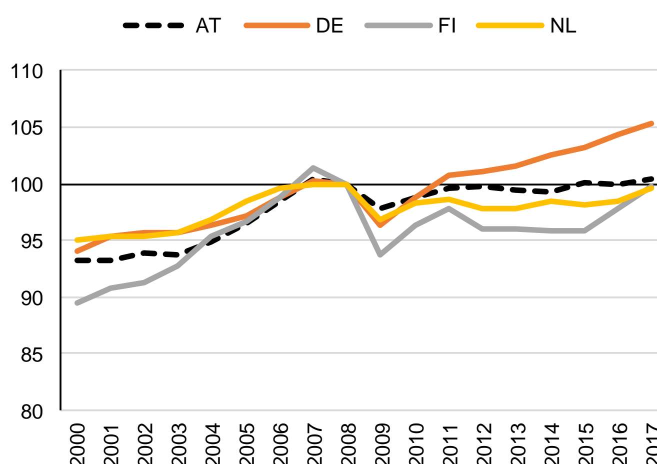
Going forward, raising Austria's growth potential will hinge on further increasing the participation rate, particularly for women, the low-skilled and the elderly, as well as enhancing the country's multifactor productivity. In this context, while the steady increase in expenditure on research and development to above 3% of GDP is positive, it will be important to strengthen science-business links, support knowledge-intensive sectors, scale-up innovative businesses, provide later stage funding options and address skills shortages to overcome the stagnation in total factor productivity.

Figure 4: Employment participation
%, 2018-20F average



Source: Haver, European Commission

Figure 5: Multifactor productivity
2008 = 100



Source: OECD, Scope Ratings GmbH

Economic policy framework

Comprehensive euro area reforms and accommodative monetary policy appropriate

Economic growth has also benefited from an effective economic policy framework. Austria, along with all euro area member states, has profited from the overhaul of the euro area architecture, which now provides a greater degree of resilience to crises as and when these emerge. While further progress is needed to deepen the Economic and Monetary Union – notably the completion of the Banking and Capital Markets Unions – the establishment of the European Stability Mechanism as the conditional lender of last resort for sovereigns, together with the European Central Bank's unconventional and accommodative monetary policy programmes, has been appropriate for the euro area and thus Austria as a comparatively small and very open economy.

We note that despite Austria's robust economic growth, the ECB's expansionary monetary policy stance[3] has led to a significant decline in financing rates for all sectors of

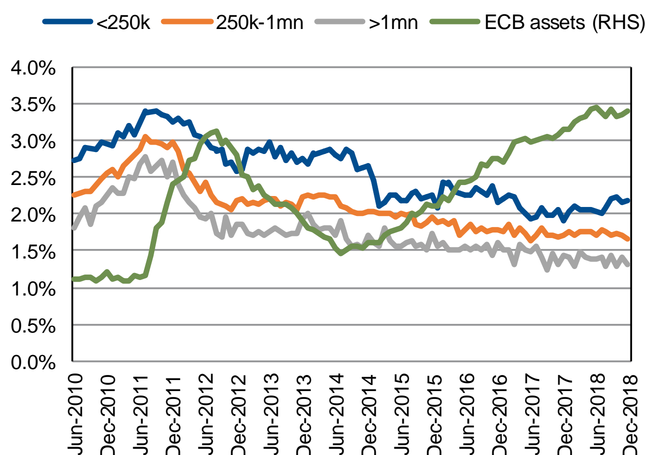
[2] Specifically, the report highlights Austria's relative shortcomings (rank out of 140 countries in brackets) with regard to: i) information and communications technology adoption (46), particularly fibre internet subscriptions (70); ii) the labour market (26), specifically, the flexibility of wage determination (139) internal labour mobility (126) and the labour tax rate (127); and iii) business dynamism (26), as evidenced by the time it takes to start a business (103) and attitudes toward entrepreneurial risk (91). Similarly, the European Commission notes that regulatory barriers in Austria's business service sector are still among the highest in the EU. In key business services, such as legal, patent agent, architectural and engineering services, Austrian regulation is one of the most restrictive in the EU.
[3] The ECB's accommodative monetary stance is determined by: i) the low level of interest rates and the expectation that they will remain low over a prolonged period; ii) the large volume of the securities portfolio acquired over the three years during which the asset purchase programme has been in place; and iii) the commitment to reinvest securities as they mature for so long as may be necessary.

the economy. Borrowing rates for non-financial corporates (NFCs) have dropped between 100 and 150 bp depending on the size and maturity of loans. Financing rates have fallen without increasing inflationary pressures, except for the rise in asset prices, particularly on the housing market in urban areas.

Inflationary pressures curtailed by subdued nominal wage and unit labour costs

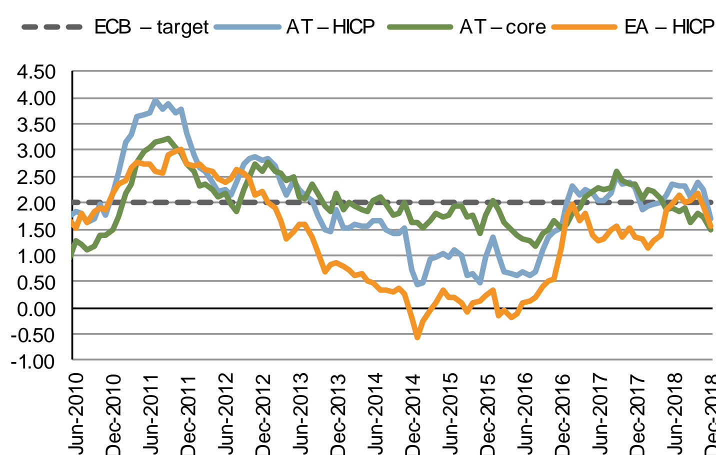
While headline inflation rose above 2% in 2018, the price level is converging towards core inflation of around 1.9% (reflecting the expected drop in oil prices), markedly above euro area core inflation and in line with the ECB's target of close to but below 2%. This development can be partly explained by modest real unit labour costs, which have remained stable since 2010, despite real wage increases over the past few years. According to the Austrian national bank (OeNB), nominal wages are set to increase by 4.0% in 2019 (2.1% in real terms) and 3.6% in 2020 (1.7% in real terms) with upside risks due to skills shortages. However, despite expected wage increases, and a positive output gap, inflationary pressures are likely to remain moderate over the coming years, due to the inflation-dampening effect of the expected decrease in commodity prices and the cyclical slowdown, and thus in line with the ECB's 2% target.

Figure 6: NFC borrowing rates and ECB's assets (RHS)
% of GDP (RHS)



Source: Haver, ECB

Figure 7: Harmonised index of consumer prices
%



Source: Haver, ECB, Eurostat

Macroeconomic stability and sustainability

Strong employment growth and low unemployment rate

Labour market conditions have been improving markedly over the past few years with employment increasing every year since 2010 from around 3.3m to above 3.7m in 2018, driven by higher participation rates and immigration. The unemployment rate has fallen from its peak of 6.3% in June 2016 to 4.% as of December 2018, the ninth lowest in the EU, in line with Germany (3.3%), the Netherlands (3.6%) and below Finland (6.7%). Nevertheless, the IMF points to several challenges regarding the labour market, including the integration of accepted low-skilled asylum seekers and the need to reduce language barriers, as a potential reduction of efforts to integrate immigrants could diminish their contribution to the economy and increase welfare spending. In addition, the IMF points to the benefits of strengthening education to prepare workers for jobs that demand higher – though not necessarily only academic – skills[4].

Low income but high wealth inequality

Austrian living standards are high and income inequality and poverty relatively low, reflecting a considerable redistribution of income. However, we see risks to macroeconomic sustainability from: i) an aging population, which may impact employment and

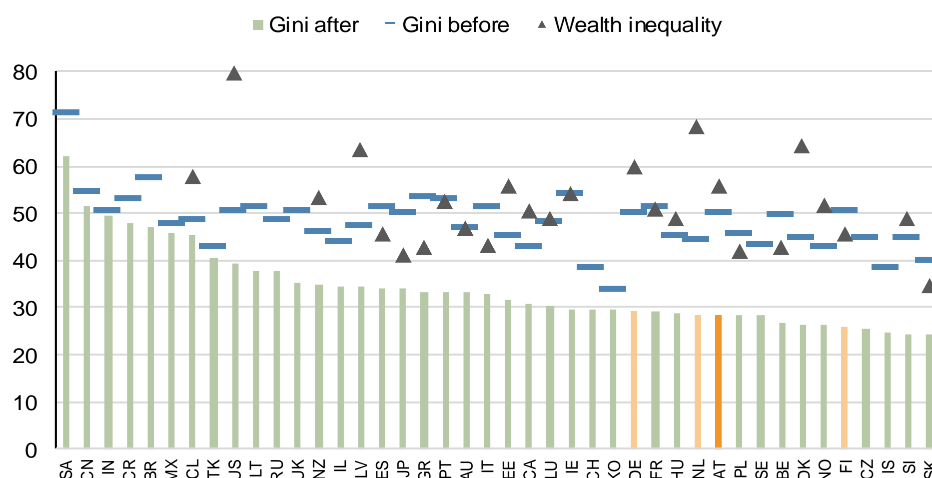
[4] The IMF notes that the increase up to the age of 18 of compulsory schooling or training and the training guarantee for people under 25 are likely to make a positive contribution while the government's decision to discontinue targeted support for the long-term unemployed over 50 years of age is likely to have an adverse impact.

thus GDP growth amongst other factors; and ii) high and permanent wealth inequality. Similar to other advanced economies, Austria's population is ageing with a steady increase in the population of those aged 65 or above, which will increase age-related expenditure and lower potential growth, reducing the government's fiscal space.

Scope also notes Austria's high wealth inequality. In 2017, the share of total net wealth held by the top 10% of households stood at 56.4%. According to the OeNB, this reflects the well-developed welfare state[5] and the role social housing plays in Austria, with about 12% of all households living in homes owned by the state, another 17% in cooperative housing subsidised by the state, and finally, a substantial number of the 18% that rent on the 'free market' benefiting from rents regulated by the state.

Figure 8: Income and wealth inequality

Gini coefficient before and after taxes and transfers; share of wealth owned by top 10%



Source: OECD, Scope Ratings

Public finance risk

Fiscal policy framework

Comprehensive fiscal framework at EU and euro area level

As a European Union member, Austria is part of the EU's fiscal policy framework centred around the 1997 Stability and Growth Pact (SGP) which was modified via the 2005 reforms, the 2011 Six Pack (five regulations and one directive), and the 2013 Two Pack (two regulations), as well as the Treaty on Stability, Coordination, and Governance of 2012 (with the relevant articles referred to as the Fiscal Compact)[6].

Fiscal framework at the national level in need of reforms

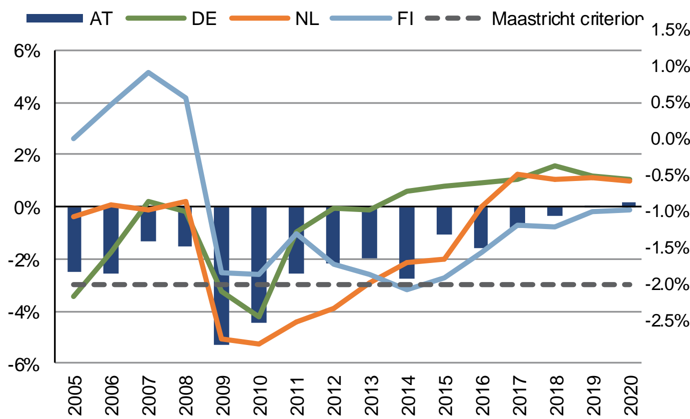
In addition to the European context, Austria has its own federal fiscal framework, which still suffers from a strong misalignment between spending powers and revenue-raising responsibilities across the different levels of government[7]. The fiscal framework is particularly complex and gives subnational governments weak incentives to contain costs as their spending powers are disproportionately higher than their revenues from autonomous taxes. In 2016 (the year with the latest available figures), subnational

[5] State pensions, health and other state-organised insurance systems substitute private wealth.
[6] The 1997 SGP included three EU-wide rules: ceilings of 3 % of GDP for the overall fiscal deficit and 60 % of GDP for public debt (corrective arm), and a requirement for medium-term budget positions to be "close to balance or in surplus" (preventive arm). The 2005 reform of the SGP aimed at enhancing the economic rationale underlying the rules and improving their flexibility by introducing country-specific medium-term objectives set in structural terms. The Six Pack reform in 2011 was designed to improve enforcement by adding an expenditure benchmark to the preventive arm and making the debt criterion in the corrective arm operational. The Fiscal Compact and Two Pack reforms of 2012 and 2013 reinforced monitoring and surveillance in the euro area and called for the anchoring of EU rules at the national level. In 2015, revised guidance on the implementation of the SGP increased its flexibility to encourage investment and structural reforms, and account for the economic cycle.
[7] EC, Austria, Country Report, February 2019

governments raised revenues amounting to 2% of GDP from their own taxes, while their overall expenditure amounted to 17.7% of GDP[8].

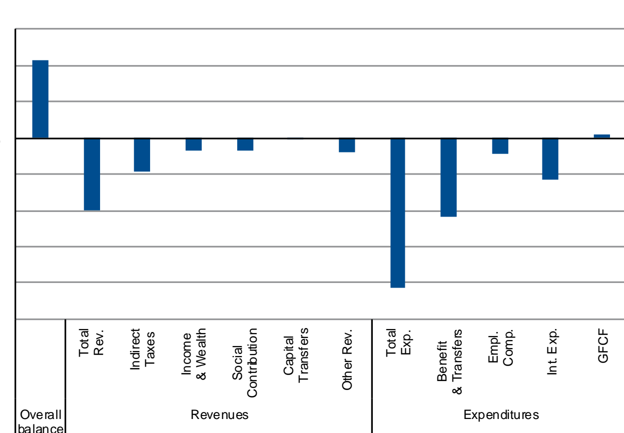
The 2017 Financial Equalisation Law, which regulates the financial agreements between the different levels of government up to 2021, has done little to address this issue. The federal government has presented a legislative package including spending reviews, more task-oriented financing, benchmark systems, a reform of subnational competencies and discussions on increasing tax autonomy at the subnational level as well as reducing the rights of mutual approval. However, the Austrian Fiscal Council notes that many work packages and reforms are behind schedule or on hold[9].

Figure 9: Overall fiscal balances
% of GDP



Source: Haver, AMECO

Figure 10: Change in Austria's budget balance
% of GDP, diff. between avg. 2018-20F vs avg. 2015-17



Source: Haver, EC

These developments, or indeed the lack thereof, highlight the complexity of the matter and the need for a comprehensive process to change federal structures and fiscal relationships. The Austrian Fiscal Council notes that the reform of the system needs to raise allocative efficiency, bundle responsibilities for revenues, spending and tasks, increase transparency, reduce mixed financing and simplify the system of transfers.

Successive budget surpluses expected for 2019-20

Against this institutional background, and based on its sound economic structure, good tax compliance and a high overall level of taxation[10], the general government has steadily improved its public finances over the past few years, reducing the budget deficit from above 5% in 2009 to a balance in 2018. We observe that this improvement has largely been driven by very good cyclical conditions and a further decrease in debt servicing costs, which more than offset the slight loosening of fiscal policy in 2018[11], which is expected to continue in 2019[12].

We therefore expect the budget balance to improve slightly in 2019 and remain positive in 2020 and 2021 also given that a comprehensive reform of personal and corporate income tax is announced for 2020 only. As a result of budget surpluses and the continued

[8] OECD Fiscal Decentralisation Database
[9] For example, the preparation of a reform of federal structures based on the results of the Austrian Convention (Österreichkonvent).
[10] Despite the 2016 tax reform, the burden on labour remains high and is set to increase as tax brackets are not indexed to inflation.
[11] On the expenditure side, expansionary effects have resulted from increasing labour market subsidies (even though the new government suspended several measures), raising the number of federal government employees, abolishing public long-term care providers' recourse to patients' assets and decoupling long-term unemployment benefits from partners' incomes. These effects have been reinforced by revenue-side measures: contributions to the family burden equalisation fund have been lowered from 4.1% to 3.9%, and unemployment insurance contributions have been reduced for low-income earners. Moreover, the VAT rate on hotel overnight stays, which had been raised to 13% in April 2016, was cut back to 10%.
[12] The key revenue-side measure is the introduction of higher tax relief for families with children (Familienbonus Plus), which will depress wage tax revenues in 2019 and income tax revenues in 2020. Moreover, the rate for contributions to the accident insurance scheme, which used to be 1.3%, will be lowered to 1.2%. On the expenditure side, spending decreases (related to the phasing out of previous temporary spending increases and cuts to child benefits for children living abroad) will be offset by spending increases (higher research subsidies).

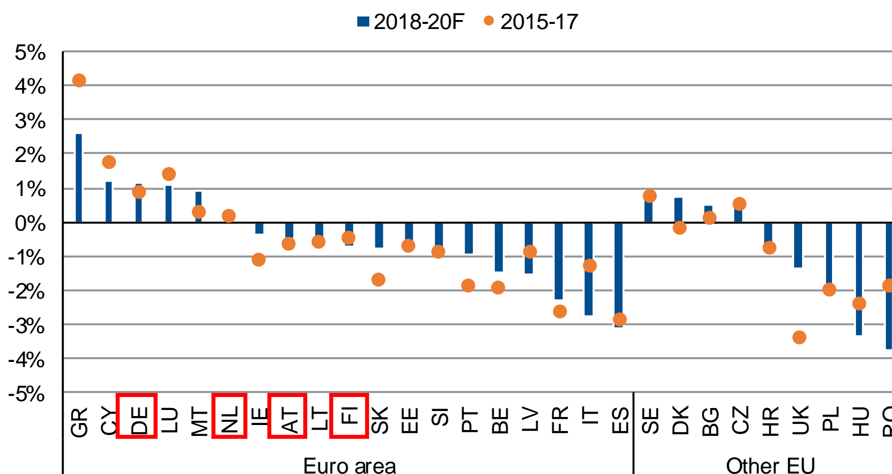
reduction of the debt held by public wind-down vehicles, we expect the debt-to-GDP ratio to drop to around 65.5% by 2021, i.e. return to pre-crisis levels, from a peak of 84.8% in 2015.

Some structural adjustment

We note that while most of the adjustment has been cyclical, benefiting from the improving labour market conditions, resulting in lower benefits and reduced interest expenditure, Austria's structural balance will remain below the -0.5% of GDP deficit in the coming years which is in compliance with EU fiscal rules.

Figure 11: Structural balance

% of GDP



Source: Haver, AMECO, Scope Ratings

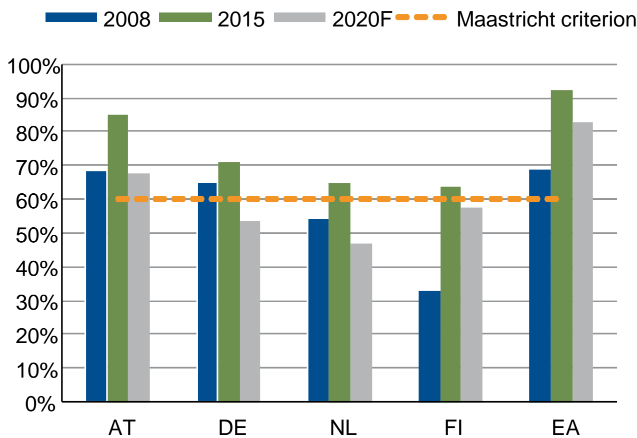
Elevated pension and healthcare liabilities

Nevertheless, despite this positive fiscal adjustment, spending on healthcare and old-age pensions will increase markedly over the coming years in line with peers, reducing the government's fiscal space. Current pension expenditure is comparatively high and is expected to rise further as life expectancy increases while the statutory retirement age remains fixed[13]. According to the latest EC ageing report, Austria's pension spending is set to increase from around 13.8% of GDP to around 14.9% in 2040, above Finland (13.9%), Germany (12.0%) and the Netherlands (8.5%).

The main driver of Austria's high healthcare expenditure is its oversized hospital sector, which is the result of a fragmented financial and organisational structure. While efficiency gains can be made, in the absence of reforms, the European Commission estimates that healthcare spending will increase from around 7% to 7.8% in the coming decade, which is below the level for Germany (8.0%) but higher than spending in the Netherlands (7.0%) and Finland (6.8%). Based on these projections, Austria's total healthcare and pension-related expenditure will be 22.7% of GDP in 2040, above the euro area average (21.0%), and that of Finland (20.7%), Germany (20.0%) and the Netherlands (15.5%).

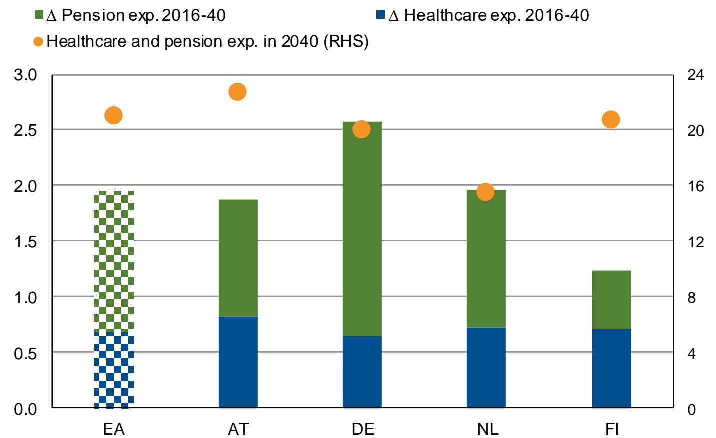
[13] Closing the gap between the effective and statutory retirement ages would reduce public spending, but the potential savings are lower than for measures affecting the statutory retirement age. EC, 2018.

Figure 12: Debt levels
% of GDP



Source: Haver, EC

Figure 13: Pension and healthcare liabilities
% of GDP



Source: EC Ageing Report 2018, Scope Ratings.

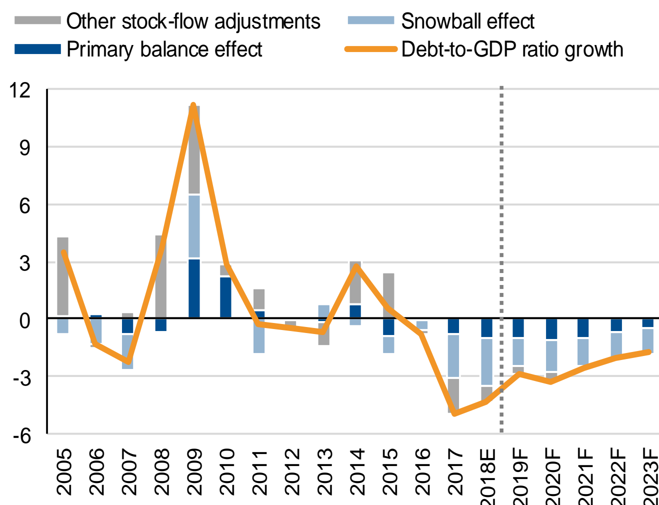
Debt sustainability

Adequate debt dynamics, even in stressed scenario

Our public debt sustainability analysis, based on IMF forecasts and a combination of growth, interest-rate and primary-balance shocks, confirms that slower growth and primary balances remain the key risks to Austria's debt sustainability. The results reflect Austria's positive debt dynamics, with expected primary surpluses and moderate, albeit slowing growth rates going forward.

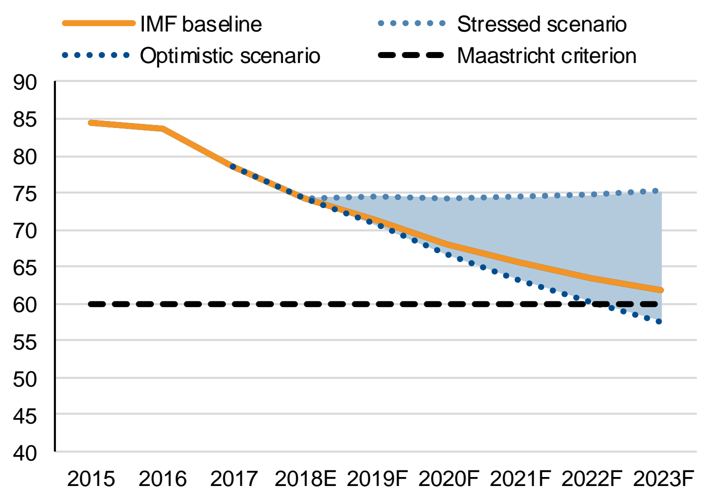
Our baseline scenario is for the debt-to-GDP ratio to fall to slightly above 60% by 2023. A more adverse scenario, assuming a combined 1.0 percentage point shock for each year over the forecast horizon to real GDP growth (lower), interest payments (higher) and the primary balance (lower), would keep the debt-to-GDP level stable at around 75%. This would still be below the peak reached in 2015 of 84.8%, but markedly above the debt levels of peers, which the European Commission estimates at 54% for Germany, 47% for the Netherlands and 58% for Finland by 2020. These estimates confirm the need for Austria to maintain robust growth rates and sustain a solid level of primary surpluses over a multi-year period in order to approach the Maastricht criterion of 60%.

Figure 14: Contribution to gov. debt changes, % of GDP



Source: IMF, Scope Ratings GmbH. NB Other includes stock-flow adjustments.

Figure 15: Government debt, % of GDP



Source: Scope Ratings GmbH

Scenario	Time period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2014-2018	1.8	0.4	0.2	74.2
IMF baseline	2019-2023	1.6	0.8	-0.5	61.7
Optimistic scenario		2.1	1.3	-0.7	57.6
Stressed scenario		0.6	-0.2	0.7	75.3

Source: IMF, Scope Ratings GmbH

Significantly declined government guarantees

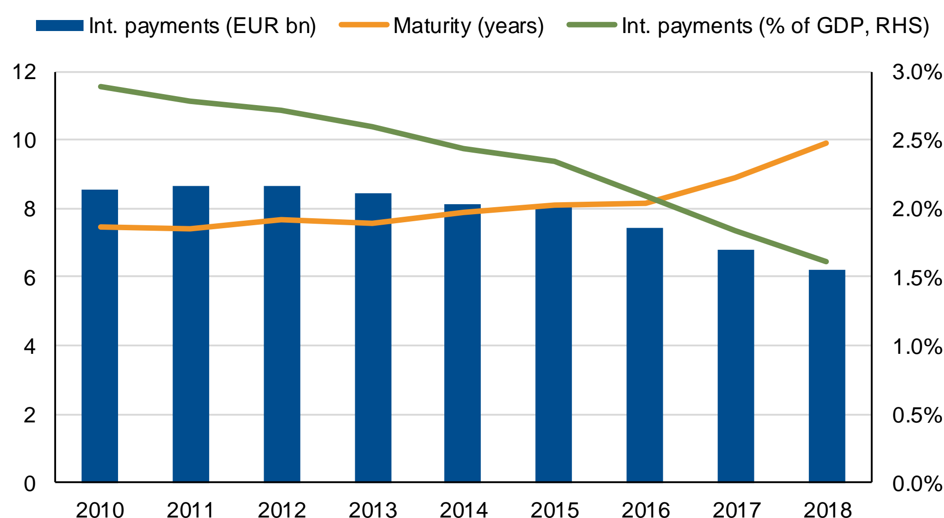
Finally, we also consider Austria's potential contingent liabilities stemming from government guarantees, public-private partnerships and the liabilities of government-controlled entities. We view positively the decline in Austria's government guarantees from a peak of around 53% of GDP in 2010 to 15.8% in 2017. Still, after Finland (32.0%), Austria's government guarantees are the second highest among EU member states, above those of Germany (13.3%) and the Netherlands (3.6%). Liabilities from public-private partnerships of 0.1% of GDP are not a concern while the liabilities from government-controlled entities of around 26% of GDP (data for 2016 on a non-consolidated basis) are markedly below those of Finland (42%), Germany and the Netherlands, both at around 100% of GDP.

Market access and funding sources

Significantly lengthened debt maturity

Austria's market access is solid, and its funding sources diversified geographically and in terms of instruments[14]. The current favourable financing environment, together with Austria's status as a safe haven and successive debt reduction, have resulted in interest payments falling from around 2.9% of GDP in 2010 to 1.6% of GDP in 2018, or from EUR 8.6bn to EUR 6.2bn. At the same time, the Austrian debt agency's funding strategy is prudent, with a funding profile of around 95% at a fixed rate, less than 15% of short-term debt and no foreign currency risk. The average life of debt outstanding was extended between 2010 and 2018 from around 7 years to 10 years, above the average debt maturities of Germany (6 years), the Netherlands (7 years) and Finland (6 years).

Figure 16: Cost and maturity of outstanding debt
EUR bn; years; % of GDP



Source: EC, OeNB, ECB, Scope Ratings

[14] Government bonds RAGB, debt issuance programme (DIP 144A), EMTN programme (Euro Medium Term Notes), Australian Dollar MTN programme – 'Kangaroo Programme', online retail savings product (bundesschatz.at), loans and Schuldschein format, Austrian Treasury Bills (ATB Programme). Austrian debt agency.

ECB's purchases shift investor base

Non-resident holdings of Austrian government debt are comparatively high, at around 80% based on IMF data, in line with Finland (80%) but above Germany and the Netherlands (both around 50%), reflecting the size of the Austrian capital markets. However, over 80% of debt-holders are in the euro area. Finally, as a result of the ECB's public-sector purchase programme, which halted its net purchases as of January 2019 but continues to reinvest the principal payments from maturing PSPP securities, the Eurosystem holds around EUR 50bn or 25% of Austria's total debt stock.

External economic risk

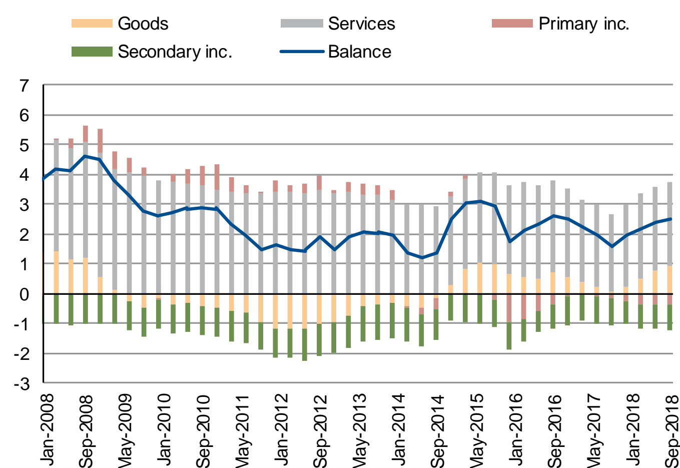
Current account vulnerabilities

Internationally competitive economy and successive current account surpluses

Austria has constantly recorded current account surpluses since 2002. As of Q3 2018, the current account surplus stood at around 0.9% of GDP. This positive result is driven mostly by a plus in the balance of goods and services which reflects the Austrian economy's (price) competitiveness. The real effective exchange rate (deflated by unit labour costs for the total economy) has hardly changed over the past ten years. In fact, since 2010 the real effective exchange rate has depreciated slightly, in line with Germany and other highly-rated euro area peers. Given the stable level of price competitiveness, Austrian exporters have benefited greatly from the pickup in global trade over the past few years. We note that more than half of Austria's goods exports are destined for the euro area, led by Germany with a share of 30% of Austria's total goods export, followed by the United States (6.7%), Italy (6.1%) and Switzerland (4.4%).

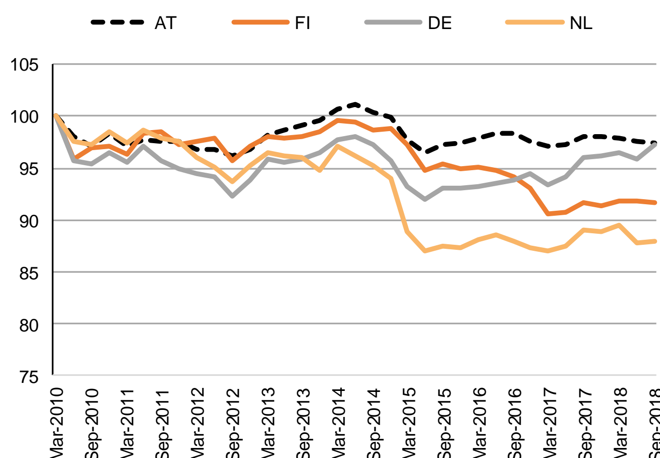
Consequently, the protectionist tendencies of the United States could indirectly affect the outlook for Austria's export-oriented economy, particularly if European cars are hit. The OeNB notes that Austria is part of the central European value chain in the automotive sector, and estimates that almost 0.4% of Austria's employment is entirely devoted to the production of cars for the United States.

Figure 17: Sustained current account surpluses
% of GDP



Source: Haver, OeNB, Scope

Figure 18: Unit labour cost-deflated real effective exchange rate
2010 = 100



Scope: Haver, ECB, Scope

External debt sustainability

From external debtor to creditor

Due to its sustained current account surpluses since 2002, Austria has steadily improved its net international investment position (NIIP), which turned positive in 2013. As of Q3 2018 the NIIP stood at around 5.4% of GDP (approx. EUR 21bn), slightly above Finland (-1.6%) but well below Germany (59.5%) and the Netherlands (65.4%).

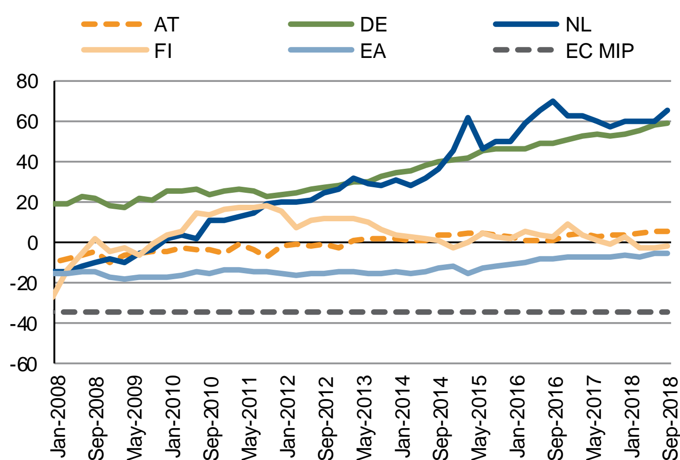
Declining external debt due to deleveraging of financial sector

While the NIIP level is key for external sustainability, and a credit strength for Austria, vulnerabilities embedded in the balance sheet – related to its size, composition and structure – also matter when assessing external vulnerabilities[15]. In this context, we note that the size of gross external liabilities has fallen significantly, driven by the banking sector's deleveraging of around 60 pp of GDP between Q1 2010 and Q3 2018. As of Q3 2018, Austria's total external debt was around 151% of GDP, in line with Germany (145%), but below Finland (190%) and the Netherlands (534.2%).

As a result, the government and central bank's share of total external debt has increased from around 35% to nearly 50% while financial institutions have, in the context of the deleveraging process, reduced their share of Austria's total external debt from 48% to around 28% over the same period. The share of portfolio debt securities in Austria's foreign liabilities, whose non-contingent nature may complicate the absorption of shocks, has remained stable at around 43%. The share of direct investments has increased slightly to around 30% in Q3 2018, indicating a minor improvement in the debt-equity mix of Austria's external balance sheet.

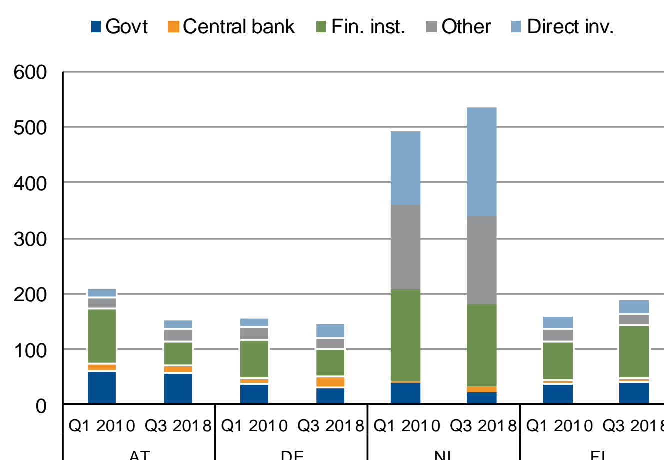
Finally, the NIIP burden – as measured by the investment income balance for direct, portfolio and other investments – turned positive for the first time in 2018, reflecting an overall decline in liabilities and yields, particularly for portfolio debt. While we are mindful that the net payments associated with Austria's external position could increase if euro area interest rates were to normalise, the expected gradual normalisation of the ECB's monetary policy along with the structural improvements in Austria's external balance sheet mitigate these risks.

Figure 19: Net international investment position
% of GDP



Source: Haver, Eurostat, Scope

Figure 20: External debt composition
% of GDP



Source: Haver, national central banks, Eurostat

Vulnerability to short-term external shocks

Low external vulnerability but exposed to shifts in global trade

Austria's positive NIIP mitigates the sovereign's exposure to shocks or sudden shifts in market sentiment. In addition, we believe that the strengthened euro area architecture and the ECB's expansionary monetary policy stance further reduce Austria's risk to external shocks. However, as a small, open economy, we are mindful that, along with its euro area peers, Austria's economy is exposed to the rise of global protectionism and a possible 'hard' Brexit, particularly via import tolls and repercussions on global demand with a potential disruption of supply chains.

[15] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op198.en.pdf?dd48dc2fe1941f6f88e9c75eb4becc18

Financial stability risk

Financial sector performance

Better-capitalised banking sector with improving asset quality

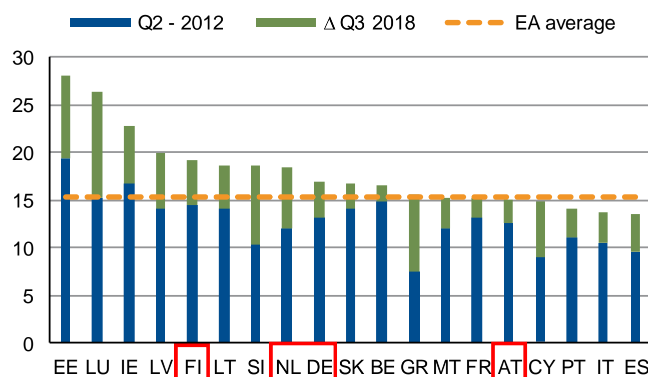
Austria's financial stability has strengthened in recent years, underpinned by an improved economic environment and enhanced supervisory measures. Capitalisation levels for Austrian banks have risen, with the consolidated common equity tier-1 (CET1) ratio at 14.8% in Q3 2018, in line with the European average[16].

Austrian banks' credit quality has strengthened, with the non-performing loan ratio dropping to 3.1% in 2018 from above 6% in 2014. This improvement is particularly notable in Central Eastern and South-Eastern Europe (CESEE) where the NPL ratio has continued to decline, reaching 3.9% as of mid-2018, down from 2014 levels of 11.8%. The coverage rate of NPLs decreased to 51% in the first half of 2018 but remains well above the European average of 46%. However, we note that the quality of consumer loans has weakened and that the potential for further asset quality improvements is expected to moderate[17].

HETA continues winding down its assets

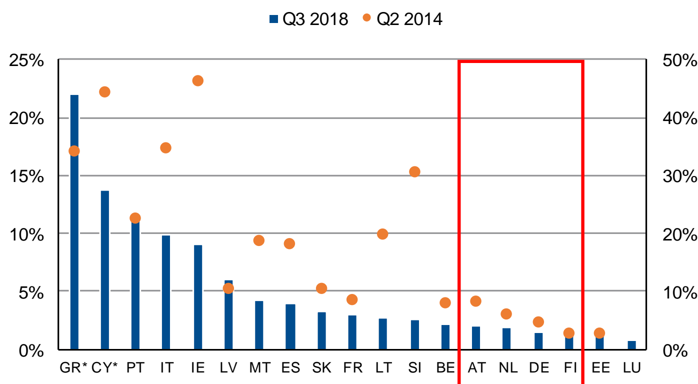
HETA, Austria's wind-down vehicle for Hypo Alpe Adria, continues to make progress in winding down its assets. In June 2018, HETA's expected wind-down rate for the year was 91%. The bad bank expects to reduce net loans by roughly 68% in 2019 and should finalise the wind-down process in 2020. Nevertheless, pending court proceedings, constraints due to banking secrecy and data protection as well as risks linked to legal and tax issues could still curb the portfolio wind-down[18].

Figure 21: Banking sector capitalisation
Regulatory tier one capital to risk-weighted assets, %



Source: Haver, IMF, Scope Ratings

Figure 22: Banking sector asset quality
Non-performing loans to total gross loans, %



Source: Haver, IMF, Scope Ratings

Rising bank profitability also driven by lower provisions

Despite the persisting pressures induced by the low interest rate environment, Austrian banks recorded strong profits in the first half of 2018, buoyed by historically low risk provisions. Consolidated net profits for the first half of 2018 amounted to EUR 3.6bn, a 7% increase compared to Q2 2017. Growth in interest income picked up for the first time since 2015 but operational expenses also rose, leading to a cost-to-income ratio of about 66%, in line with the euro area average[19]. In Q3 2018, Austrian banks' return on equity stood at 6.9% compared to returns on equity recorded by banks in Germany of 3.3%, 4.7% in Finland and 6.6% in the Netherlands. Despite these overall improvements, the OeNB highlights the need for banks to streamline business models to improve cost efficiency and safeguard the financial sector.

[16] Oesterreichische Nationalbank, Facts on Austria and its Banks, October 2018
[17] Oesterreichische Nationalbank, Financial Stability Report, November 2018
[18] Heta Asset Resolution, company presentation, June 2018
[19] https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html

Reduction of vulnerabilities linked to shift within CESEE exposure

The Austrian banking sector continues to have extensive financial relations with CESEE countries. High levels of CESEE exposure constitute a potential vulnerability[20] and Austria's exposure to the region remains high, with claims on CESEE accounting for two thirds of the Austrian banking sector's foreign claims in 2018. However, we note that Austrian banks also benefit from their activities in the region with net results contributing over 44% of total profitability. In addition, the IMF points to the financial sector's divestment strategy and the shift in Bank of Austria's CESEE exposure to its Italian parent bank, Unicredit, as contributing to a reduction in the country's financial vulnerabilities[21].

The asset quality of all loans granted in CESEE continues to improve as Austrian banking subsidiaries have become more concentrated in EU countries. Over three quarters of total CESEE assets are now in the Czech Republic, Slovakia, Romania, Hungary and Croatia, while exposure to more economically volatile countries such as Russia and Ukraine has decreased. In this context, based on European Banking Authority data, Erste Bank and Raiffeisen have increased their share of total domestic exposures together with those to the Czech Republic, Slovakia, Romania, Hungary and Croatia from 62% of all exposures in 2011 to 79% in 2018.

Financial sector oversight and governance

Strong supervisory and regulatory frameworks

Austria's macroprudential framework has the Financial Market Stability Board (FMSB) as the central macroprudential decision-making body while the Financial Market Authority (FMA) has the authority to implement measures to contain systemic risk. The OeNB oversees the analysis of financial market developments and informs the FMSB of findings relevant for maintaining financial stability and reducing systemic risk. Austrian macroprudential supervisors also cooperate with the ECB and the European Systemic Risk Board in considering the cross-border consequences of their decisions and measures[22]. The ECB has been responsible for the integrated supervision of banks in the euro area under the Single Supervisory Mechanism and the Austrian authorities actively contribute to the ongoing work under the Single Supervisory Mechanism[23].

Recent macroprudential strengthening

Regulatory and supervisory frameworks were strengthened in 2017 when the authorities updated their supervisory guidance and established a legal basis for using macroprudential tools. Current macroprudential instruments include (but are not limited to): the countercyclical buffer, the buffer for systematically important financial institutions, the systemic risk buffer and risk weights.

The systemic risk buffer has been applied to a total of 13 banks since the beginning of 2018. Furthermore, in July 2018, oversight and financial supervision were enhanced further when the FMSB presented recommendations to the FMA, emphasising the importance of systemic risk buffers and advising that the buffer for other systematically important financial institutions be applied to seven Austrian banks[24].

Macro-financial vulnerabilities and fragility

Low levels of private sector indebtedness

Private sector indebtedness is low and has remained unchanged over the past 15 years, currently standing at around 140% of GDP, in line with the euro area average, while credit growth remains positive. The debt of non-financial corporates (NFCs) has remained stable over the past ten years at around 90% of GDP. Lending to NFCs picked up slightly to around 8% on an annual basis in Q4 2018, with a large share of these loans bearing a

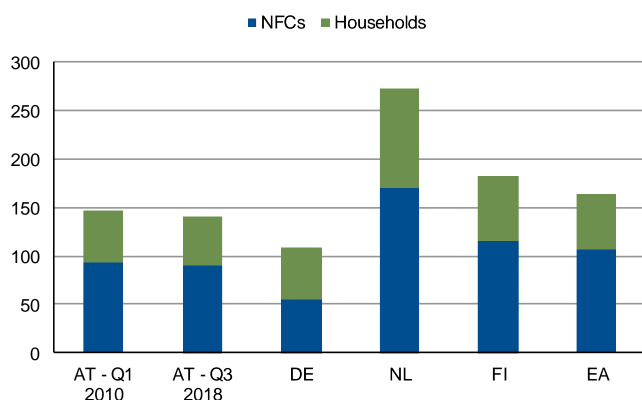
[20] In 2013, the IMF identified high NPL ratios and difficulties in assessing CESEE as a vulnerability for the banking sector. IMF, Austria : FSAP, September 2013
[21] IMF, Austria: 2018 Article IV Consultation, September 2018
[22] Financial Market Stability Board, The macroprudential policy strategy for Austria, December 2017
[23] Oesterreichische Nationalbank, Facts on Austria and its Banks, April 2018
[24] Oesterreichische Nationalbank, Financial Stability Report, November 2018

long maturity to finance fixed investments[25]. Similarly, the level of indebtedness of Austrian households remains stable and low at around 50% of GDP with more than two thirds of Austrian households without any debt. This reflects Austria's low share of owner-occupiers, estimated at around 46%, the second lowest share in the euro area, because households that i) cannot accumulate the necessary down payment through savings and ii) do not inherit the relevant assets, stay in rented apartments and houses, which are available and still relatively affordable.

Housing price increases not driven by credit and still in line with fundamentals

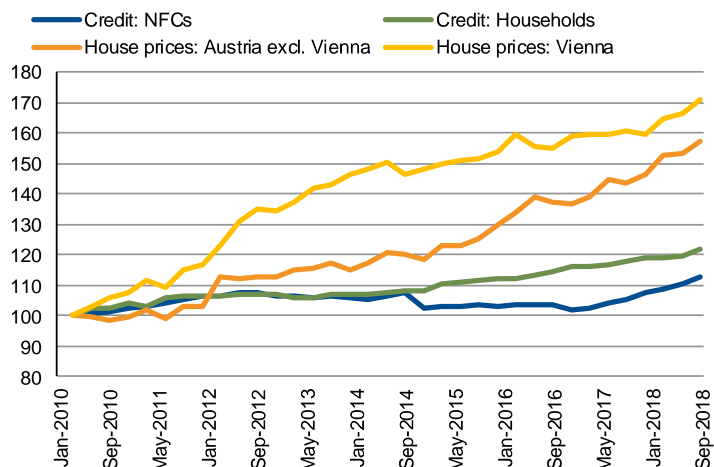
Residential property prices in Austria continued to rise in the first half of 2018, and prices have grown by around 5% per year every year since 2008. A significant disparity is observable in Austria, as residential property prices in Vienna remain 23% higher than those of the rest of the country. The OeNB notes that the increase in housing prices is largely attributable to fundamentals and considers that housing-related macro-financial risks are limited. In this context, the FMSB specified its definition of sustainable real estate financing in September 2018. We note that in the event of rising systemic risks, the FMA has the authority to mobilise instruments to reduce said risks[26].

Figure 23: Private-sector debt
% of GDP



Source: Haver, ECB, Scope Ratings

Figure 24: Housing prices and credit
Q1 2010 = 100



Source: Haver, ECB, Scope Ratings

Institutional and political risk

Perceived willingness to pay

Austria joined the European Union in 1995 and has fully adopted the EU's regulatory framework, providing an anchor for institutional stability and predictability. In our view, Austria is as likely as any EU peer to honour debt obligations in full and on time.

Recent events and policy decisions

Conservative populism mixed with modest economic orthodoxy

The Austrian government, a coalition between the conservative People's party and the far-right Freedom party, is led by Chancellor Sebastian Kurz and characterised by conservative populism – a synthesis of social conservatism and law enforcement with traditional loyalty to established European institutions and economic policies[27].

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[25] Oesterreichische Nationalbank, Facts on Austria and its Banks, October 2018
[26] Such instruments include caps on loan liabilities, interest payments and repayments; requirements regarding the maximum term of real estate financing arrangements; and a requirement for credit institutions to provide a timeframe within which a defined proportion of the total volume paid out to the borrower must be repaid at latest.
[27] https://foreignpolicy.com/2018/07/09/the-future-of-europe-for-better-or-worse-is-sebastian-kurz/

The government has notably shifted the country to the political right on social policies, taking an uncompromising stance on national security[28], subsuming migration and integration under that heading and linking these topics to welfare state measures[29]. However, on economic matters the government's policies focus mostly on the liberalisation, deregulation, and reform of the Austrian welfare system, along with reducing the country's relatively large public sector.

Greater state intervention expected

However, despite its market-friendly rhetoric, the government's conversion of ÖBIB (Österreichische Bundes- und Industriebeteiligungen GmbH) into ÖBAG (Österreichische Beteiligungs AG) reflects its desire for greater state interventions via a strong representation on the supervisory boards of the partially state-owned companies – including Post (53%), OMV (32%), Telekom Austria (28%), Casinos Austria (33%), Verbund (51%) and Bundesimmobiliengesellschaft (100%). It remains to be seen whether this change will indeed "contribute to the promotion of Austria as a business location and to promote growth and innovation" or, alternatively, reduce the private sector's dynamism given greater state control and intervention.

Key reforms on pensions, taxation and fiscal federalism still needed

Finally, Scope notes that the reforms introduced to tackle the key structural issues of the Austrian economy, notably its ageing society and the associated challenges, fiscal federalism and taxation are, to date, underwhelming. While the Family Bonus Plus programme[30] has become effective this year, a comprehensive reform of personal and corporate income tax is announced only for 2020. The next general election is scheduled for 2021, which gives this government enough time to implement is agenda.

Geopolitical risk

Austria's neutrality allows its government to portray itself as a bridge-builder between Western and non-Western countries while at the same time denying it a voice in the military and economic councils of the West/ NATO. While Austria's depleted military and police forces remain underfunded, Austria is not engaged in any bilateral wars, and is thus, in Scope's opinion, just as likely to be affected by geopolitical threats as its European partners.

Methodology

The methodology applicable for this rating and/or rating outlook, Public Finance Sovereign Ratings, is available at www.scoperatings.com.

Historical default rates of the entities rated by Scope Ratings can be viewed in Scope's rating performance report at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

[28] Chancellor Kurz declared securing and protecting Europe's external borders to be one of his top priorities under the official motto "A Europe that protects".
[29] For example, the coalition agreed to lower minimal social security for individuals with limited or no German skills. Moreover, parents who work in Austria will soon receive family allowances that are dependent on the living costs in their children's places of residence. The government has also reduced funding for integration measures.
[30] According to the government, around 950,000 families and approximately 1.6 million children will be relieved of a tax burden of up to EUR 1.5 billion, making the Family Bonus Plus the biggest family tax cut to date. At the same time, a child allowance of EUR 250 per child per year will be introduced for (low-earning) sole earners, single parents and carers.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, provides an indicative 'aa' ('aa') rating range for the Republic of Austria. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings.

For the Republic of Austria, the following relative credit strength has been identified: i) the economic policy framework; ii) macro-economic stability and sustainability; iii) debt sustainability; iv) market access and funding sources; v) current account vulnerability/resilience; vi) external debt sustainability; vii) resilience to short-term external shocks; and viii) financial imbalances and financial fragility. Relative credit weaknesses are signalled for: i) the fiscal policy framework. The combined relative credit strengths and weaknesses generate a two-notch adjustment and indicate a sovereign rating of AAA for the Republic of Austria. A rating committee has discussed and confirmed these results.

Rating overview	
CVS category rating range	aa
QS adjustment	AAA
Final rating	AAA

To calculate the rating score within the CVS, we use a minimum-maximum algorithm to determine a rating score for each of the 24 indicators. We calculate the minimum and maximum of each rating indicator and place each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower case.

As part of the QS assessment, analysts conduct a comprehensive review of qualitative factors. This includes but is not limited to an economic scenario analysis, a review of debt sustainability, fiscal and financial performance and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The Republic of Austria has almost no foreign-currency-denominated public debt. Consequently, we see no reason to believe that Austria would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	35%
Real GDP growth	
Real GDP volatility	
GDP per capita	
Nominal GDP	
Inflation rate	
Unemployment rate	
Old-age dependency ratio	
Public finance risk	30%
Primary balance	
Interest payments	
Gross debt	
Gross financing needs	
External economic risk	15%
External debt	
Currency turnover/reserves	
Net international investment position (NIIP)	
Current account balance	
Institutional and political risk	10%
World Bank Worldwide Governance Indicators	
Financial risk	10%
Non-performing loans (NPLs)	
Tier 1 ratio	
Credit to GDP gap (bubble)	
Credit to GDP gap (imbalance)	
Indicative rating range	aa
QS adjustment	AAA
Final rating	**AAA**

QS

Maximum adjustment = 3 notches

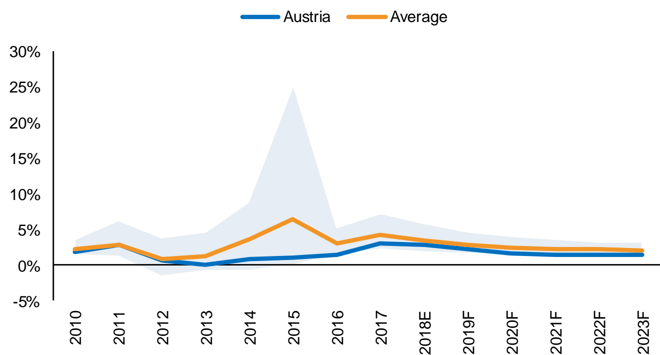
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	◉ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	◉ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	◉ Strong sustainability	○ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	◉ Very good access	○ Neutral	○ Poor access	○ Very weak access
Current account vulnerability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	◉ Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Banking sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Banking sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

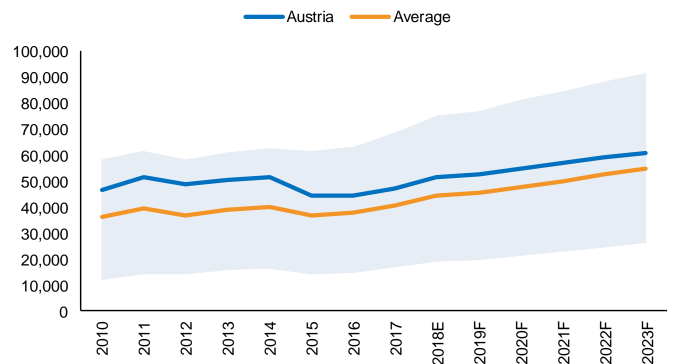
III. Appendix: Peer comparison

Figure 25: Real GDP growth



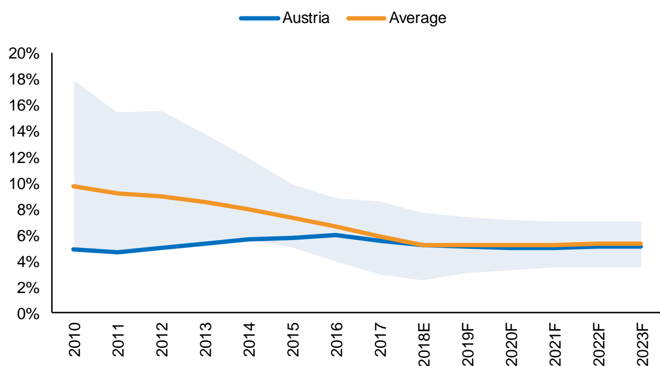
Source: IMF, calculations Scope Ratings GmbH

Figure 26: GDP per capita, USD



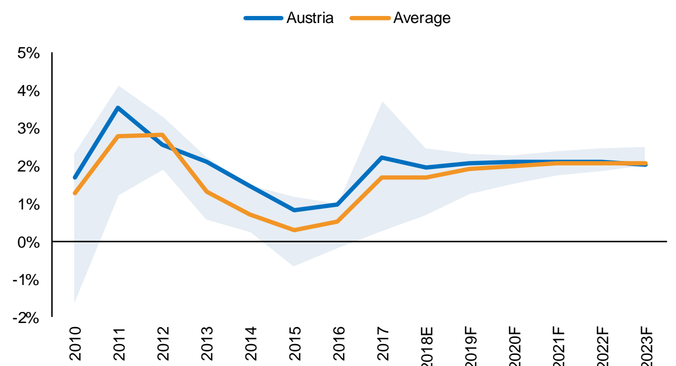
Source: IMF, calculations Scope Ratings GmbH

Figure 27: Unemployment rate, %



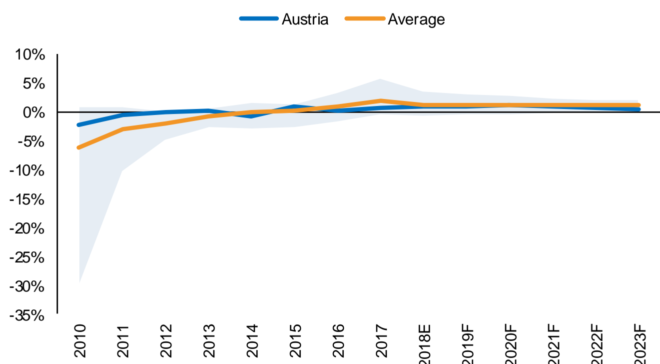
Source: IMF, calculations Scope Ratings GmbH

Figure 28: Headline inflation, %



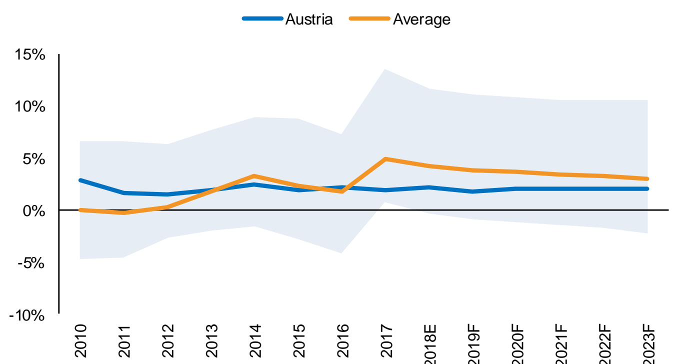
Source: IMF, calculations Scope Ratings GmbH

Figure 29: General government primary balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

Figure 30: Current account balance, % of GDP



Source: IMF, calculations Scope Ratings GmbH

IV. Appendix: Statistical tables

	2014	2015	2016	2017	2018E	2019F	2020F
Economic performance							
Nominal GDP (EUR bn)	333.1	344.3	356.2	369.9	386.1	401.3	416.9
Population ('000s)	8,544.0	8,630.0	8,740.0	8,815.0	8,885.0	8,950.0	9,012.0
GDP per capita PPP (USD)	48,787.5	49,883.0	50,521.5	52,397.8	-	-	-
GDP per capita (EUR)	38,982.4	39,920.3	40,423.9	41,931.9	43,597.0	44,839.9	46,263.3
Real GDP, % change	0.7	1.1	2.0	2.6	2.7	2.2	1.6
GDP growth volatility (10-year rolling SD)	2.2	2.1	2.0	1.9	2.0	1.0	1.0
CPI, % change	1.5	0.8	1.0	2.2	2.1	2.1	2.1
Unemployment rate (%)	5.6	5.7	6.0	5.5	4.9	4.8	4.8
Investment (% of GDP)	23.5	23.6	24.1	25.1	25.6	26.0	25.8
Gross national savings (% of GDP)	26.0	25.5	26.2	27.0	27.9	27.7	27.9
Public finances							
Net lending/borrowing (% of GDP)	-2.7	-1.0	-1.6	-0.8	0.0	0.1	0.1
Primary net lending/borrowing (% of GDP)	-0.7	0.9	0.1	1.0	1.3	1.1	1.1
Revenue (% of GDP)	49.6	49.9	49.0	48.3	48.2	48.2	48.2
Expenditure (% of GDP)	52.3	51.0	50.6	49.0	48.4	48.1	48.1
Net interest payments (% of GDP)	2.0	1.9	1.7	1.5	1.2	1.1	1.1
Net interest payments (% of revenue)	4.0	3.8	3.4	3.0	2.5	2.3	2.2
Gross debt (% of GDP)	84.0	84.8	83.0	78.3	74.2	71.3	68.1
Net debt (% of GDP)	59.2	58.2	57.6	56.0	51.0	48.9	46.5
Gross debt (% of revenue)	168.9	168.9	170.4	162.6	153.9	148.4	142.0
External vulnerability							
Gross external debt (% of GDP)	182.8	171.9	164.6	154.3	-	-	-
Net external debt (% of GDP)	20.0	19.3	20.7	18.2	-	-	-
Current-account balance (% of GDP)	2.5	1.7	2.5	2.0	2.2	1.8	1.7
Trade balance (% of GDP)	0.3	0.7	0.5	0.3	0.6	0.9	1.1
Net direct investment (% of GDP)	-0.6	1.5	0.5	0.0	-	-	-
Official forex reserves (EOP, EUR mn)	8,776.0	8,855.0	9,213.0	5,686.0	7,361.0	-	-
REER, % change	1.7	-2.1	1.7	1.0	2.1	-	-
Nominal exchange rate (AVG, USD/EUR)	1.3	1.1	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	3.5	3.4	2.7	2.4	-	-	-
Tier 1 ratio (%)	11.8	12.7	14.9	15.9	-	-	-
Private debt (% of GDP)	147.4	146.4	147.2	144.9	-	-	-
Credit-to-GDP gap (%)	-8.1	-8.9	-6.0	-9.0	-	-	-

Source: Source: IMF, European Commission, European Central Bank, Central Bank of Austria, Statistics Austria, World Bank, Haver Analytics, Scope Ratings GmbH

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Directors: Torsten Hinrichs and Guillaume Jolivet.