

Rating Object	Rating Information	
REPUBLIC OF AUSTRIA	Assigned Ratings/Outlook: AA+ /stable	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal:	29-07-2016 30-06-2017
	Rating Methodologies:	"Sovereign Ratings"

Rating Action

Neuss, 30 June 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "AA+" for the Republic of Austria. Creditreform Rating has also affirmed Austria's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA+". The outlook is stable.

Key Rating Drivers

1. Very strong institutional setup, prosperous and very well-diversified economy
2. Economic recovery is gaining momentum, medium-term outlook clouded by uncertainties pertaining to prospects for potential growth which is currently lifted by increasing labor supply
3. High level of general government debt balanced by high debt affordability; after having peaked in 2015, we expect debt-to-GDP ratio to follow a downward trajectory going forward
4. Looming contingent liabilities stemming from banking sector and uncertainties related to the prospective government work program weigh on fiscal sustainability
5. Strengthening international investment position on the back of sustained current account surpluses

Reasons for the Rating Decision

The Republic of Austria's very high creditworthiness is underpinned by its stable and prosperous economy. With GDP per capita posting at USD 48,005 (2016, PPP terms), Austria has one of the highest per capita incomes in the euro area. Moreover, the country's economy remains well-diversified and highly competitive. The Austrian economy has a strong industry base (Q4-16: 21.8% of GVA, EA-19: 19.7%) and a relatively low exposure to financial and insurance activities (4.1 vs. 4.5% of GVA). Meanwhile, Austria gained four places in the World Economic Forum's Global Competitiveness Index, ranking 19th out of 138 countries in 2016.

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In general, we believe that the Austrian economy benefits from euro area membership, which entails broader and deeper capital markets as well as advantages associated with the euro as a reserve currency.

Our assessment also reflects the country's very strong institutional framework. As indicated by the World Bank's World Governance Indicators, Austria continues to be characterized by an exceptionally high quality of contract enforcement and property rights, high government effectiveness and low levels of corruption. Although the sovereign may lag behind AAA peers such as Germany, Denmark or Sweden when it comes to the determined effort in addressing essential reform steps to overcome structural impediments to economic development, the government has undertaken or initiated reforms which we view as first important steps in some crucial areas (see below).

Thus, a wide-ranging tax reform took effect on 01 January 2016, which lowered taxes for low- and middle-income earners and implemented a partial repayment of social security contributions for individuals with incomes below the first tax bracket. Still, Austria exhibits one of the highest tax wedges among OECD countries. While the average OECD tax wedge for a single person with no children stood at 36.0%, Austrian earners face a tax wedge of 47.1%, though it has decreased somewhat as compared to 2015 (49.6%).

The tax relief has bolstered private households' disposable income, thus prompting a sharp increase in private consumption spending, which grew by 1.5% y-o-y as compared to an annual average of 0.3% in 2011-15, and a recovery in investment, displaying a y-o-y growth rate of 3.4% (2015: 0.7%). Also, public consumption growth stayed high at 1.9%, mainly due to strong refugee inflows. On the back of a significant strengthened domestic demand, real GDP growth leapt to 1.5% in 2016, having averaged at 1.0% in 2011-15. Net exports dragged on growth last year, as investment-driven imports increased twice as fast as exports.

In this year's first quarter, economic activity stepped up a gear as real GDP rose by 1.9% y-o-y (Q1-16: 1.4%). We expect real GDP to increase by an average 1.8% in 2017-18, supported by solid private consumption and vivid investment activity. We believe that private consumption will benefit from the favorable performance of the labor market, which is set to remain strong. Even though the annual unemployment rate slightly increased from 5.7 in 2015 to 6.0% in 2016, the seasonally adjusted monthly average has edged down to 5.5% (Apr-17) more recently and Austria continues to have one of the lowest unemployment rates in Europe (EA-19: 9.3%). It has to be noted that the increase was mainly driven by brisk labor supply which has risen significantly over the recent years – in 2016 employment posted at 76.2% of active population, up from 75.5% a year before. In particular, high levels of migration and an increasing share of elderly employed people have led to the rise in labor supply.

To be sure, the impact of the 2016 tax reform is likely to subside going forward and we expect that private household spending will be somewhat dented by rising HICP inflation, dragging on real disposable income. Fueled by rising energy prices and Austria's buoyant tourism sector, HICP inflation has picked up significantly, standing at 1.5% in May-17 – well above levels observed a year before (0.8%) – and the average EA-19 level of 1.0%.

Meanwhile, we forecast dynamic investment to remain in place. Business sentiment and new orders have seen further improvement and capacity utilization in the industry sector has increased to levels well above its long-term average, signaling an increasing need for expansion investment. Furthermore, investment activity should benefit from external demand which has got off to a good start this year (Jan-Mar 17: +10.3% y-o-y). Exports are likely to increase in view of improved prospects for global trade in 2017 and firming growth in the euro area and Germany in particular – the euro area and Germany account for 51.6% and 30.5% of Austria's exports (2016), respectively.

That said, we believe that medium-term prospects for the Austrian economy are subject to some uncertainty related to potential output going forward. Despite the recent improvement from an annual average potential growth of 0.9% (2010-15) to 1.4% in 2016, this was almost entirely driven by the increasing labor supply (see above), while investment as well as productivity were virtually flat over the recent years (AMECO data). Thus, between 2010 and 2016 the investment-to-GDP ratio ticked up slightly by 1.2 p.p. (with public investment: -0.3 p.p. GDP) and TFP fell by 0.2%.

Since last year, the government has announced several measures and reform plans to tackle structural weaknesses and obstacles for medium- to long-term growth. Initiatives include the de-bureaucratization and simplification of the Austrian Commerce Regulation Act (*Gewerbeordnung*), a package of measures to support start-ups (i.e. refunding of non-wage labor costs, lowering regulatory barriers for establishment of start-ups), the provision of financial support for infrastructure investment, as well as measures geared towards the enhancement of investment at the municipal level and expenditure on R&D.

On 30 January 2017 the government presented a work program (*Arbeitsprogramm der Bundesregierung 2017/2018*), summarizing the main policy proposals for the remainder of the SPÖ/ÖVP-coalition's legislative period. This comprehensive work program aims at strengthening growth and employment as well as improving competitiveness, while concurrently providing greater security to citizens. Key proposals include e.g. the gradual lowering of non-wage labor costs and a so-called employment bonus for creating new jobs, an inflation-indexation of lower tax brackets, limitation or reduction of (labor) migration, removing impediments to employment of older workers and de-regulation.

We believe that the measures outlined above generally point in the right direction and have the potential to foster growth and competitiveness. However, the government work program appears to be rather vague as regards a detailed quantification of the economic and fiscal impact of the proposed measures. It is noted that the cumulative costs of the program are estimated at around EUR 4bn and are supposed to be financed by expenditure savings, cuts, and redeployment, while EUR 1.2bn will be financed by growth and employment effects.

More importantly, the parliamentary coalition collapsed in May 2017 and an early general election will be held on 15 October 2017. Despite current efforts, we believe that a vigorous implementation of the authorities' ambitious reform package presented earlier this year can be called into doubt or is, at the least, uncertain. What is more, talk of nationalism or populism may resurface with the possibility of the far-right Freedom Party (FPÖ)

entering government. Recent polls see the center-right party ÖVP ahead of SPÖ and FPÖ, which are roughly at the same level.

Notwithstanding the potential fiscal risks implied by the work program and political uncertainty arising from the snap election, we expect that the Austrian government will maintain necessary fiscal adjustment and consolidation. Last year the headline fiscal balance deteriorated, mainly due to the 2016 tax reform, lower revenues from capital gains taxes, and refugee-related spending. Thus, the deficit widened from 1.1 to 1.6% of GDP in 2015-16. Owing to declining financing costs and vivid growth, general government debt levelled off and came in at 84.6% of GDP in 2016, after peaking at 85.5% of GDP a year before.

Looking forward, we assume that the fiscal deficit should decrease to 1.1% of GDP and is set to narrow further in 2018-19. Austria's economic recovery and rising employment are likely to contribute to a gradually improving headline balance, as are the absence of further one-off payments for banks and declining interest payments. Moreover, the slowing refugee inflow should lead to lower expenditures. Applications for asylum halved (-52.7% y-o-y) in 2016 and stood 53.1% below last year's reading for the months January to May in 2017. The government expects an impact on the headline balance of approx. 0.47% of GDP (2016: 0.48% of GDP).

The sovereign is benefiting from very low interest rates in the euro area, as the average interest rate of debt issued in 2016 stood at a mere 0.3%, down from 0.5% in 2015. At the same time, interest expenditure declined from 4.74 to 4.24% of general government revenue in 2015-16. Hence, the high level of general government debt is balanced by the sovereign's high debt affordability. Furthermore, we view Austria's well-balanced debt distribution as credit positive, as the sovereign's debt portfolio achieved an average maturity of 8.8y in 2016 and as of 06-06-17 only 15.7% of total government bond volume outstanding is due in 2017-18. Also, Austria maintains a diversified and stable investor base.

We believe that general government debt will continue on a downward trajectory, buttressed by robust growth, the declining headline deficit and the sell-off of nationalized banks' assets. KA Finanz and immigon continued with the liquidation of their portfolios, reducing total assets by EUR 2.5bn and 1.4bn in 2016, respectively. Uncertainties related to the wind-down of HETA and the guarantee issued by Carinthia were largely eliminated in October 2016, as 98.7% of the creditors accepted the offer from KAF (*Kärntner Ausgleichszahlungs-Fonds*). As a result, the major share of funding (EUR 8.2bn) will come from the central government, leaving the state of Carinthia with a contribution of EUR 1.2bn. However, fiscal metrics are subject to large contingent liability risks. Although public guarantees fell as compared to 2015, they post at a still high 21.0% of GDP, of which 5.8 p.p. are linked to the financial sector (2015: 6.9% of GDP).

On the whole, we view fiscal risks stemming from the banking sector as limited and manageable. The loan-deposit ratio of Austria's banks decreased to 104.5% in Dec-16 (CESEE subsidiaries: 80%), down from 108.5% in Dec-15, and the NPL ratio fell further to a low 5.3% (Dec-15: 6.9%). Banks have also strengthened their capitalization and profitability, albeit facing ample room for improvement as compared to European peers –

displaying a CET1 ratio of 13.7% and a ROA of 0.5% (Dec-16). Concurrently, credit risk arising from the banks' CESEE exposure has to be monitored. The volume of foreign currency loans in CESEE countries is trending downwards. According to OeNB, it declined by 65% to EUR 33bn. Still, Austrian banks face a large foreign exposure concentrated in CESEE markets, with CESEE countries accounting for two thirds of banks' foreign claims. In addition, the volume of foreign currency loans in Austria dropped to EUR 25.1bn, having halved since 2011 (EUR 49.1bn), though private households still display a relatively high exposure to foreign currency loans (Dec-16: 13.7% of the total loan volume to households).

Rapidly rising house prices remain a concern, as Austria exhibits one of the most dynamic housing markets in Europe. Since mid-2015, house prices have picked up significantly, showing quarterly rates of more than 5%. However, household indebtedness is comparatively low, standing at 52.8% of GDP in Q4-16 (EA-19: 64.6%), according to Eurostat unconsolidated financial accounts data. And though trending upwards, the volume of outstanding mortgage loans has hovered in the range between 3.5 and 5.3% since Jan-16. What is more, the OeNB has emphasized that several aspects signal limited financial stability risk, i.e. the relatively low volume of loans for house purchase as compared to the euro area as a whole (Dec-16: 31.4 vs. 40.0% of GDP), conservative lending standards, and the low base level of house prices.

In the medium to long term, age-related expenditure is set to weigh on fiscal sustainability. In view of the rising share of elderly (65y+; 2013-60: 18.2 to 28.9%), pension and healthcare expenditure (2015: 14.8 and 8.0% of GDP), which are among the highest in Europe, are expected to rise. According to the Austrian Pension Commission, the reforms implemented so far, e.g. tighter pension eligibility criteria, have shown initial effects. Recently, the EU Commission has stressed that more has to be done to contain healthcare expenditure.

As regards the fiscal framework, fiscal competences remain fragmented and the framework can still be regarded as rather complex. Having said this, efforts to streamline the various layers of government are underway, as the Austrian government adopted the Fiscal Equalization Act, which e.g. intends to implement a revenue-/expenditure-sharing system and a system of benchmarks going forward.

We assess Austria's external position as sound and improving. Buttressed by a sustained current account surplus, the net international investment position has steadily strengthened, increasing from 2.9 to 5.2% of GDP in 2015-16, after standing at -12.9% of GDP in 2006. The current account is oscillating around 2% of GDP since 2011. Last year, the current account surplus narrowed somewhat from 1.9 to 1.7% of GDP, but held up well thanks to a strong balance of services (2.9% of GDP) underpinned by dynamic business services and tourism. Austria's external liabilities have continued on their downward path, falling from 171.4 to 159.4% of GDP in 2015-16. This is mainly due to deposit-takers having considerably down-sized their foreign liabilities over recent years (2016: 47.8% of GDP, 2007: 111.7%).

Rating Outlook and Sensitivity

Our Rating outlook on the long term sovereign rating of AA+ is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

Our AA+ rating could be lowered if we observed lower-than-expected medium-term growth or if the government failed to make progress in effectively implementing needed structural reforms. While the impact of Brexit on the Austrian economy is likely to be low, a slowdown in global trade, particularly in the euro area, may be detrimental to medium-term growth. In this vein, firming nationalist and protectionist policies in Europe may have a negative impact on economic activity in Austria. In addition, fiscal slippages could put pressure on the sovereign's ratings. Against this backdrop, the financial sector has to be vigilantly monitored, as resurfacing problems and further one-off costs could have negative repercussions on the general government's budget and the expected fiscal consolidation path. Also, we may consider a downgrade should the institutional framework in Austria be impaired.

Austria's credit rating could be raised if the Austrian economy expands at a higher-than-expected growth rate over the medium term. Against this background, faster progress in implementing structural reforms which put potential growth on a sustained upward path could be beneficial to our credit assessment. Additionally, significant progress in fiscal consolidation and a faster-than-projected wind-down of distressed banks could translate into an upgrade.

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Ratings*

Long-term sovereign rating	AA+ /stable
Foreign currency senior unsecured long-term debt	AA+ /stable
Local currency senior unsecured long-term debt	AA+ /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	2.8	0.7	0.1	0.6	1.0	1.5	1.9
GDP per capita (PPP, USD)	44,327	45,276	45,787	46,542	47,072	48,005	49,371
Inflation rate, y-o-y change	3.6	2.6	2.1	1.5	0.8	1.0	1.9
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.0	80.9	81.1	81.5	81.8	n.a.	n.a.
Fiscal balance/GDP	-2.6	-2.2	-1.4	-2.7	-1.1	-1.6	-1.1
Current account balance/GDP	1.6	1.5	2.0	2.4	1.9	1.7	n.a.
External debt/GDP	183.7	199.8	192.2	168.6	171.4	159.4	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of Creditreform Rating's "Sovereign Ratings" methodology. Creditreform Rating AG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating's rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

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