PRESS RELEASE JULY 31, 2020

# DBRS Morningstar Confirms Republic of Austria at AAA, Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (DBRS Morningstar) confirmed the Republic of Austria's Long-Term Foreign and Local Currency – Issuer Ratings at AAA. At the same time, DBRS Morningstar confirmed the Republic of Austria's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (high). The trend on all ratings remains Stable.

KEY RATING CONSIDERATIONS

The confirmation of the Stable trend reflects DBRS Morningstar's view that Austria's improvements in public finances over the last few years have left the country with enough room to mitigate the impact of the Coronavirus Disease (COVID-19) outbreak on its economy. The government's response to the pandemic has been significant and public debt is expected to rise above the peak registered in 2015 of 84.9% of GDP from the 70.4% recorded in 2019. A gradual recovery is expected to lead to a resumption in the government's prudent fiscal strategy. While a considerable degree of uncertainty remains on the economic outlook, government support is providing relief to the economy and this mitigates the risk of long-lasting implication on growth. According to the latest European Commission forecast (EC, Summer 2020), Austria's gross domestic product (GDP) is expected to drop by 7% in 2020, less than the Euro Area's expected 8.7% contraction, before rebounding by 5.5% in 2021.

The ratings are underpinned by Austria's prosperous, diversified, and stable economy, reflecting a real GDP per capita that is about 27% higher than the European Union (EU) average, as well as the country's solid and credible institutions. Moreover, Austria's historical track record of conservative fiscal policy bodes well for a post-pandemic improvement in public finances in the medium term. This, along with moderate private sector debt, offsets some vulnerabilities stemming from the banking sector which will likely face a deterioration in credit quality going forward and the costs associated with an ageing population.

RATING DRIVERS

One or a combination of the following factors could lead to a downgrade: (1) Austria fails to achieve a gradual improvement in public finances over the medium term; or (2) there is a prolonged deterioration in macroeconomic prospects, placing the public debt ratio on an even more rapid upward trajectory.

RATING RATIONALE

Substantial Government Support Provides Relief but At a Cost of a Record Deficit

After two years of budgetary surplus, the comprehensive fiscal support package announced by the Austrian government to mitigate the negative effects of the COVID-19 pandemic on its economy will translate into a record deficit this year. Nevertheless, Austria's fiscal position is expected to continue to benefit from prudent government budgetary policy demonstrated by a good track record.

The government has put in place a series of measures to sustain the economy and to support households and SMEs, including guarantees, short-time work arrangements, tax breaks, debt moratoria, as well as higher expenditures in the healthcare sector. The latest policy initiatives announced in mid-June comprise investment incentives, an extension of the fixed-cost subsidy to refund firms incurring shortfalls related to COVID-19, and a reduction in the lowest income tax rate to 20% from 25%, retroactively effective since 1 January 2020. The whole support envelope is sizable and accounts for around 13% of GDP. It will provide relief to the economy, but along with the fall in revenues mainly because of the sharp recession, it will result in a large deficit this year. Recent initiatives are not incorporated in the latest government deficit projection of 8.0% of GDP 2020 presented in April 2020 but in DBRS Morningstar's view, depending on the take up rate of some measures and the pace of the recovery, fiscal deterioration will be likely larger in 2020. As the economy rebounds, the deficit is expected to improve significantly in 2021 and possibly fall to below 3% of GDP in 2022. However, the considerable degree of uncertainty about the recovery might put pressure on the government to implement further support initiatives or to delay the phasing out of coronavirus-related measures to sustain the demand. These factors cloud Austria's fiscal outlook and could delay the pace of improvement in the fiscal trajectory. This has led DBRS Morningstar to a negative qualitative assessment of the "Fiscal Management and Policy" building block.

Austria's additional fiscal vulnerabilities relate more to the long-term because of the rising cost of pension-related and long-term healthcare spending. In particular, according to the 2018 Ageing Report, Austria's pensions spending is among the highest in Europe, and it is expected to increase more than the EU average, reducing fiscal space in the future. Latest projections from the Austrian Institute of Economic Research (Österreichisches Institut für Wirtschaftsforschung, WIFO) prior the outbreak, pointed to a deterioration of 1.6 percentage points in pensions costs to 15.1% of GDP between 2020 and 2040. Similarly, long-term health care could increase by 1.0 percentage points to 2.6% of GDP by 2040 from 1.6% in 2020.

The Unprecedented Shock Interrupts the Improvement in the Debt Trajectory but Debt Affordability Remains Strong

After years of a steady improvement in the debt trajectory, the unprecedented crisis related to the pandemic will result in a stark rise in the public debt ratio this year. The shock will interrupt the downward trend that had seen Austria reducing its public debt by around 15 percentage points in almost five years, not far from its 2007 level. This was achieved thanks to conservative fiscal policy accompanied by efforts to wind down nationalised banks. In DBRS Morningstar's view, the sharp recession and large fiscal package could bring the public debt-to-GDP ratio to surpass the previous peak of 84.9% recorded in 2015, from 70.4% registered last year. However, provided that this shock remains temporary, once the recovery is firmly underway, the government's prudent fiscal strategy mitigates the risk of a further deterioration in the debt trend.

Austria's liquidity position is very sound. Around 79% of total outstanding government bonds are now trading at negative yields and total interest costs on the federal debt is expected to stabilize at 1.1% of GDP this year, despite the sharp contraction in the level of GDP. However, total federal interest costs of EUR 4.0 billion in 2020, remain on a downward trend and a further reduction is expected going forward. Moreover, Austria's average debt maturity profile is sound at around ten years, as is its debt structure, with about 90% of total outstanding bonds at fixed rates. This reduces rollover risk, mitigating the potential effect of abrupt interest rate increases. All these factors contributed DBRS Morningstar's positive qualitative assessment of the "Debt and Liquidity" building block.

The Recovery in Trade and in Tourism Will be Key for the Rebound

The Austrian economy was affected relatively mildly by the COVID-19 outbreak and the government was among the first to relax lockdown measures in mid-April. DBRS Morningstar expects that a gradual recovery in both Eurozone supply chains and tourism should help the rebound in activity. Government measures have provided relief but the increase in the unemployment rate along with a high degree of uncertainty over the evolution of the pandemic might result in more cautious consumption and investment patterns. However, DBRS Morningstar is of the view that the government support to an already diversified and productive economy, provides a degree of resilience against the risk of the pandemic potentially causing long-lasting damage to growth.

Physical distancing measures, already implemented in mid-March, contained the spread of the virus but led to a freeze in economic activity, which contracted by 2.6% in Q1 2020. Several sectors have been under strain including transport, accommodation, retail trade, and arts and entertainment, causing 1.4 million people to apply for short-time work during the peak in April. Preliminary estimate from WIFO point to a severe GDP contraction of 10.7% quarter-on-quarter in Q2 but a trough seems to have been reached in April and the number of beneficiaries from the short-time labour programme has declined to 1.1 million people as of mid-June. Nonetheless, a gradual rebound in the rest of the year will not prevent GDP from contracting by 7% in 2020 before a recovery of 5.5% next year, according to the EC. DBRS Morningstar anticipates an uneven recovery among sectors, with those primarily affected by physical distancing measures seeing the most adverse impact. Both the tourist sector and retail trade will likely weigh on the labour market, with the unemployment rate expected to increase from 7.4% registered in 2019 (national definition) to 9.7% according to the latest WIFO projections.

Risks to the economic outlook in the short-term are tilted to the downside, largely related to the risks of a new significant surge in infections both in Austria and in key trading partners. By contrast, in the medium-term, economic prospects remain in part constrained by restrictive regulation in the services markets, low labour participation among women and foreign nationals and the high tax wedge which constrains potential GDP.

Austria's external position is sound and hinges on a competitive service sector as well as a diversified manufacturing base, well integrated in EU value chains. The track record of current account surpluses along with a positive net international investment position (NIIP) support the country's ratings. However, the disruption in global value chains is taking a toll on Austria's export-oriented economy this year. The high reliance on large export partners, including Germany and to lesser extent the United States, will weigh on the country's export performance in 2020 and lower demand is also projected from Central, Eastern, and South European (CESEE) countries.

Moreover, the flow of tourism, which contributes largely to the surplus in services (2.6% of GDP in 2019), has been affected by the initial travel ban and physical distancing measures. With the borders reopening, tourist flows are expected to go back to normal only gradually, and the current account surplus will likely narrow. The EC forecasts a drop to 1.3% this year from 2.6% of GDP in 2019 before strengthening again to 2.0% in 2021. By contrast, the latest data on NIIP point to a further improvement in Austria's position to 15.3% of GDP in Q1 2020 from 9.6% in Q4 2019, because of an increase in net direct investment only partially offset by the widening in the negative portfolio position.

High Capital Ratios Mitigate Risks for Banks Stemming From The Deterioration in Loan Quality Because of Coronavirus

The economic and financial fallout of the pandemic will likely weigh on Austria's banking system, which, nevertheless, benefits from an elevated level of capitalisation and a currently low level of nonperforming loans (NPLs). Moreover, government support to the real economy is expected to ease the impact of the COVID-19 on the banking system. Past improvements in loan quality are expected to be interrupted by the deterioration in the economic environment in Austria. From 2012 to 2019, NPL ratios declined from 4.7% to 1.7% and from 13.9% to 2.4% in Austria and CESEE countries, respectively. As the consequences of the crisis unfold and the government support measures are phased out, the Austrian banking system's loan quality portfolio will likely deteriorate.

In DBRS Morningstar's view, Austrian banks' improvement in capitalisation has made the system more resilient in absorbing the increase in loan loss provision amid an environment of weak profitability, which however has been higher than in the EU over the last years. According to the Austrian Central bank (Oesterreichische Nationalbank, OeNB), while the debt-to-income ratio of Non-Financial Corporations (NFCs) remains well above the level in 2008, debt servicing capacity is supported by low interest rates. At the same time, household resilience is supported by a moderate debt level overall that has remained broadly stable as a share of net disposable income, at around 91%, over the last five years. Moreover, a relatively high net financial wealth estimated at about 127% of GDP as of Q1 2020 provides a buffer for households to absorb the economic shock.

Despite a significant reduction over the past years, Austrian banks remain exposed to a pocket of legacy risks including a large share of loans at variable rates, elevated reliance on the CESEE market with regard to profits and a high but declining FX mortgage loan portfolio. In Austria three-quarters of FX loans to households are bullet and linked to repayment vehicles and are sensitive to exchange rate movement as well as the performance of these vehicles. Moreover, although not credit-driven the house prices increased over the past decade present a risk of correction. Low interest rates and sustained immigration have contributed to Vienna's residential property prices being approximately 23% higher than their estimated fundamental values, according to the OeNB. These factors, including the likely deterioration in credit quality have led to a qualitative negative assessment in the " Monetary Policy and Financial Stability" building block.

The Government Response Bodes Well for Government Stability

The country benefits from its good track record of consensus-oriented policies, strong and credible institutions, and a prudent fiscal framework. Last September, national elections followed by months of negotiations saw the formation of an unprecedented government in Austria with the centre-right conservative ÖVP party and the Greens, the coalition's junior partner, agreeing on an agenda comprising tax reform, environmental sustainability initiatives, and increasing border controls. The untested government coalition, although supported by a slim majority, with the leadership of the prime minister Sebastian Kurz (ÖVP), has proven to be stable amid the current pandemic. The government has rapidly passed several measures to contain the spread of the virus and counteract the economic fallout of the pandemic. This has resulted in an improvement in opinion polls for the ÖVP.

ESG CONSIDERATIONS
A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework and its methodologies can be found at: https://www.dbrsmorningstar.com/research/357792.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments: https://www.dbrsmorningstar.com/research/364993/.

EURO AREA RISK CATEGORY: LOW

Notes:
All figures are in euros (EUR) unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments methodology (July 27, 2020) https://www.dbrsmorningstar.com/research/364527/global-methodology-for-rating-sovereign-governments

For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: https://www.dbrsmorningstar.com/research/357883.

The sources of information used for this rating include Statistik Austria, OeNB (Financial Stability report July 2020), OeBFA (Investor Presentation July 2020), Austrian Ministry of Finance (BMF) (Stability Programme, March 2020), 2018 Ageing report, Poll of Polls Politico, EC, EC (Summer forecast 2020, 2020 European Semester: Country Report -Austria, Assessment of the 2020 Stability Programme for Austria), ECB, WIFO, Eurostat, IMF, World Bank, UNDP, BIS, Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

This is an unsolicited rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES

With Access to Internal Documents: NO
With Access to Management: NO

DBRS Morningstar does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

Generally, the conditions that lead to the assignment of a Negative or Positive trend are resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are under regular surveillance.

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see:
http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

The sensitivity analysis of the relevant key rating assumptions can be found at: https://www.dbrsmorningstar.com/research/364992/.

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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

## Ratings

### Austria, Republic of

| Date Issued | Debt Rated | Action | Rating | Trend | Issued |
|---|---|---|---|---|---|
| 31-Jul-20 | Long-Term Foreign Currency - Issuer Rating | Confirmed | AAA | Stb | EU |

| Date Issued | Debt Rated | Action | Rating | Trend | Issued |
|---|---|---|---|---|---|
| 31-Jul-20 | Long-Term Local Currency - Issuer Rating | Confirmed | AAA | Stb | EU |
| 31-Jul-20 | Short-Term Foreign Currency - Issuer Rating | Confirmed | R-1 (high) | Stb | EU |
| 31-Jul-20 | Short-Term Local Currency - Issuer Rating | Confirmed | R-1 (high) | Stb | EU |



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