

The sound of success

Also in this section

Remember, remember

What did you do during the war? Page 3

Sleeping with the enemy

Austria's way of resolving political conflicts. Page 4

Ungrateful Europeans

Austrians don't love the EU, but nor will they leave it. Page 5

Mustn't grumble

The economy is having an excellent run and business is booming. Can it last? Page 7

A very superior rustbelt

Who says heavy industry has had its day? Page 8

Be happy, stay happy

What Austria needs to do to keep its luck coming. Page 9

Acknowledgments

The author is grateful to the many people who helped with this report. In addition to those mentioned in the text, particular thanks go to Wolfgang Bachmayer, Peter Berger, Erhard Busek, Josef Christl, Peter Filzmayer, Gilbert Frizberg, Michael Landesmann, Werner Lanthaler, Christoph Leitl, Paul Luif, Gabriele Matzner-Holzer, Werner Muhm, Anton Pelinka, Claus Raidl, Hans Rauscher, Bernd Schilcher, René Siegl, Michael Steiner, Erich Streissler, Emmerich Tólos, Andreas Unterberger, Franz Voves, several of the experts at the WIFO economic research institute, and Gregor Woschnagg.

A country briefing on Austria is at

www.economist.com/austria

A list of sources is at

www.economist.com/specialreports

An audio interview with the author is at

www.economist.com/audio



Austria has had some lucky breaks and has used them with brio, says Barbara Beck. But what should it do for an encore?

HEISS umfehdet, wild umstritten
Liegst dem Erdteil du inmitten,
Einem starken Herzen gleich
(Hotly fought over, fiercely contested,
You lie at the centre of the continent,
Like a strong heart).

The words of the second verse of Austria's post-war national anthem, set to music that may or may not be by Mozart, at first seemed to miss the point. They were written in 1947 by an Austrian poet, Paula von Preradovic, because the old anthem had been pinched by the Germans. They would have been right for the pre-1918 Habsburg empire, but the world had just been divided by the iron curtain, leaving little Austria squeezed up against the Western side of the border with the communist East. It was at the centre of nowhere.

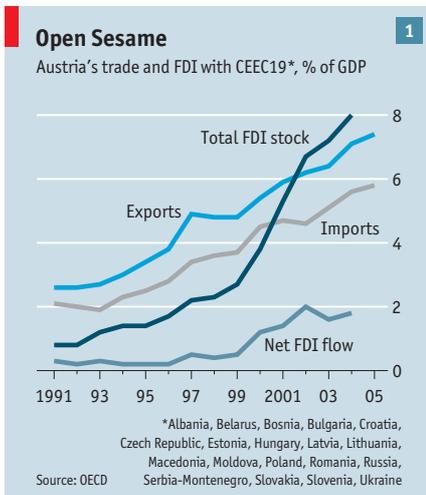
The anthem's prophecy took 40 years to come true, but it now seems spot on. The end of the cold war in 1989 and the recent entry of many of Austria's eastern and southern neighbours into the European Union have put the country back at the heart of the continent. That has proved an excellent place to be.

Austria has benefited more from Europe's opening to the east than any of the other older EU members, in several ways. First, its trade with central and eastern Europe (CEE) has soared over the past decade and a half, helping to reduce its trade deficit to manageable proportions. Second, and more important, Austria's stock of direct investment in central and eastern Europe zoomed from next to nothing in the

early 1990s to nearly €19 billion (\$28 billion) in 2004, equivalent to 8% of Austria's GDP (see chart 1, next page).

The kind of business Austria is doing in the region has also changed. Whereas a decade ago much of its investment was concentrated on manufacturing, now the biggest chunk goes on financial intermediation, property and services, suggesting that Austrian firms are doing lots of new kinds of business there. Austrian banks, in particular, are spreading their wings to the east (of which more later).

All this has meant higher growth and employment in Austria itself than would otherwise have been possible. In a paper published last year, Fritz Breuss of Austria's WIFO economic research institute attempted to quantify the effects on the Austrian economy of the eastern opening, together with those of Austria's EU entry in 1995, EU economic and monetary union in 1999 and the entry of ten new EU members in 2004. Some of the effects overlap, but in broad terms Mr Breuss reckons that in the past decade and a half the opening to the east has boosted Austria's real GDP by around 3.5%; that over the past ten years Austria's accession to the EU and its membership of the euro zone have added an extra 4.5%; and that over the next ten years the 2004 EU enlargement will yield a further 2%. The future gains may turn out to be bigger, because the new EU members are growing faster than the older ones. Further boosts might come from Bulgaria and Romania, which joined at the beginning of ▶▶



▶ this year, and perhaps from other Balkan countries if and when they get in.

Why has Austria been so much more successful in the region than other west European countries? It helped to be next door, even though after nearly half a century of separation the transport links across the old East-West borders were in a sorry state. It also made a difference that Germany, a natural competitor, was preoccupied with its own unification. Austrians reckon that “not being Germany” helped because their big neighbour can seem overbearing to smaller countries (including, sometimes, to Austria).

But probably the biggest part of the explanation lies in Austria's own extraordinary history. For most of the past millennium it was a much bigger and more powerful country than it is now, as well as a more multilingual and multicultural one. Vienna still has the feel of an imperial capital, much grander than seems appropriate for a country with a mere 8m people. It is impossible to understand Austria today without knowing something of its past.

During 640 years of Habsburg rule, from 1278 to 1918, the country waxed and waned as its borders shifted back and forth across Europe. There were plenty of battles, but also acquisitions by other means: some Habsburgs married well. The famous saying “*Bella gerant alii, tu, felix Austria, nube* (let others wage war; you, fortunate Austria, marry)” referred to the marital habits of the 15th-century Holy Roman Emperor Maximilian I and his family.

In 1867 the emperor of Austria also became king of Hungary, in a dual monarchy known as “k.u.k.” (*kaiserlich und königlich*, or imperial and royal). In his book “*The Man Without Qualities*”, Robert Musil, an

early-20th-century Austrian writer, satirised the country as “Kakanien”, a place stuck in a time warp, redolent of bureaucracy and twirly moustaches. Mention of Kakanien still makes Austrians smile.

Austria's history reached its nadir in the first half of the 20th century. The treaty of St Germain after the first world war reduced it from a cosmopolitan empire of 50m to a small, German-speaking republic of 6.5m. The shock was immense, and was soon to be amplified by the Great Depression. The resulting political turmoil led to the catastrophic *Anschluss* (absorption into Germany), which wiped Austria off the map and turned it into a German province, the *Ostmark* (see box, next page).

After the second world war, having regained its sovereignty under its 1955 state treaty with the Allies, Austria became more reconciled to its reduced role in the world. Although its links with its former empire had been weakened during the Nazi period—and became even more tenuous during the cold war—it continued to take a special interest in its eastern and southern neighbours and thought of itself as a mediator between East and West.

The people on the other side of the border remain close cousins. Vienna's telephone book is full of names that hail from farther south and east, and many Austrian citizens still speak the languages that go with the names. It is said that half of them have relatives in the countries of the old Habsburg empire. They share the same culture and find it easy to do business together. They work just as hard as the Germans or the Swiss, but they are also more relaxed and less prickly.

Count your blessings

For the moment, the main difference between Austria and its neighbours to the south and east is that it is vastly richer. In fact, as the fourth-richest country in the EU measured by GDP per person at purchasing-power parity, it is better off than most of its western neighbours too. In recent years it has been growing faster than many of them, and it is set to maintain that lead for the next few years.

Twenty-first-century Austria seems comfortable in its skin. It has come to terms with being small and is beginning to see the advantages. Within the EU it may not carry the clout of a Germany or a France, but there are plenty of other small members with which it can make common cause. Its neutrality, forced on it after the second world war, has proved not only convenient but sufficiently flexible to suit

changing circumstances. It generally gets on well with its western neighbours. Even an old argument over South Tyrol, a German-speaking province that was handed to Italy after the first world war, has been resolved. Relations with its eastern neighbours are not only mostly cordial but have also proved highly profitable.

A predominantly Catholic country, Austria wears its faith lightly. When the pope came to visit in September, the crowds were welcoming but not ecstatic. Some commentators described him as “cool”. Austria's stance on social issues is relatively liberal: abortion and homosexuality were legalised in the 1970s, though gay marriage has yet to arrive. The country is proud of the fact that it recognised Islam as an official religion back in 1912.

Austria's system of proportional representation, which tends to produce coalition governments and often grand coalitions, may lack the cut and thrust of a first-past-the-post system, but it appears to reflect the wishes of its people. Its tradition of “social partnership” between employers and employees may seem opaque, but it has ensured a long period of social peace and moderate pay settlements. Its welfare state, though not as lavish as those of the Nordic countries, keeps its citizens fairly ▶▶





comfortable in adversity and allows many to achieve their ambition of “retiring well” (on 90% of previous net income for the average earner). The once excellent education system is showing signs of wear and tear, but remains good in parts.

Trains, trams and buses generally run on time. The country’s beautiful scenery of mountains, lakes and forests, looked after by an environmentally conscious people, offers a high quality of outdoor life, as well as bringing in lots of well-heeled tourists. And Austrians have no need to worry about nuclear mishaps on

their soil: the only nuclear power plant, at Zwentendorf, was mothballed nearly 30 years ago. (Unfortunately neighbouring countries such as the Czech Republic have failed to take similar precautions.)

Indoor life benefits from generous state spending on culture, not just on Mozart and the Johann Strausses but experimental stuff as well. On a more quotidian level, Austrians are among Europe’s most avid newspaper readers (though some of the mass-circulation press is unedifying).

Does all this make Austria an “island of the blessed”? Coined in 1971 by an ear-

lier pope, Paul VI, this has become a slightly ironic-catchphrase for everything that is good about the country: affluence, social justice, a harmonious society. Those blessings remain, but, as this special report will argue, Austrians should not take them for granted. In an era of globalisation there is no such thing as an island: a subprime crisis in America or a commodity boom set off by China will reverberate in the most remote Alpine valley, and new competitors pop up from nowhere. Austria needs to keep working at its luck. That is something its politicians should bear in mind. ■

Remember, remember

What did you do during the war?

NOT all of Austria’s history was glorious. The birth in 1918 of the post-Habsburg, downsized, monoglot Austria of the First Republic inspired little enthusiasm among its people, and its democracy soon proved fragile. In 1933 Engelbert Dollfuss, chancellor of a right-of-centre government, dissolved parliament. The following year the army put down Social Democratic protests in a brief but bloody civil war. Soon afterwards Dollfuss was assassinated during an abortive putsch by Austrian Nazis. In March 1938 German troops moved into Austria unopposed, Hitler staged a triumphant return to the country of his birth, and in the subsequent referendum an inconceivable 99% of the population voted for *Anschluss* to Germany. Virulent anti-Semitism became *de rigueur*, and many Jews who had not managed to emigrate were sent off to the concentration camps.

Were the Austrians willing partners in all this or was their hand forced? The four Allies’ Moscow Declaration of 1943 described Austria as the first victim of Hitler’s policy of aggression and promised to reinstate it as a free and independent country. After 1945 Austria eagerly seized on the “victim” formula, which was retained in its 1955 state treaty to re-establish its sovereignty. Immediately after the war many Nazis were purged and some sentenced to death, but an amnesty was granted in 1948. By then the cold war had become the dominant political reality and the Nazi period was beginning to recede into the background.

It was recalled to mind by the “Waldheim affair” in 1986. Kurt Waldheim was a former Austrian foreign minister who served as secretary-general of the United Nations in 1972-82. When four years later he ran for the Austrian presidency, journalists started digging and discovered that his recently published autobiography gave a highly misleading account of his wartime service with the *Wehrmacht*. The Austrians elected him president anyway, but during his six years in office he did not receive a single state invitation from a Western government. Subsequent inquiries produced no evidence that Waldheim had actually taken part in any war crimes, but cast doubt on his claim that he had not known what was going on. His death earlier this year, aged 88, revived uncomfortable memories.

By the end of Waldheim’s presidency Austria had become readier to face the past. In 1991 Franz Vranitzky, a long-serving Social Democratic chancellor, acknowledged in a speech in parliament that his country bore some of the responsibility for the second world war and offered an apology.

By the time Austria joined the EU in 1995, the wartime past had more or less faded from memory. But the other EU governments feared a resurgence of right-wing extremism in 1999 when the far-right Freedom Party, led by Jörg Haider, bagged nearly 27% of the vote in an election and entered a coalition with the centre-right Austrian People’s Party. For over six months they ostracised Austria before

conceding that there was no legal basis for the boycott and resuming normal business. The Freedom Party lost much of its support at the following election and subsequently split.

A way of saying sorry

In 1995 the Austrian government marked the 50th anniversary of the birth of the Second Republic by setting up a national fund for Austrian victims of the Nazi regime. The sums offered, though not large, were an acknowledgment of the wrong that had been done. The fund has received over 32,000 applications and paid out €150m. Two other funds offer, respectively, reparation for loss of tenancy rights and of property. Hannah Lessing, the national fund’s general secretary, has no personal memories of the period, but her father escaped just in time and her grandmother died in Auschwitz. Of about 200,000 Jews who lived in Austria in the 1930s, more than half emigrated ahead of the *Anschluss* and 65,000 perished. The total in Austria now is only about 10,000.

Ms Lessing says that present-day Austrians are no more racist than other people and that the number of neo-Nazis is tiny. (Holocaust denial is a crime, as it is in Germany.) But she feels there is a danger that the lessons of the past may be forgotten. A good thing, then, that since 1988 teaching about the Holocaust has been obligatory at Austrian schools, and that all schoolchildren must visit the former concentration camp at Mauthausen.

Sleeping with the enemy

Austria's way of resolving political conflicts

THEY call it a “consensus democracy” or “democracy by negotiation”, and it is tailor-made for their particular needs. When Austria's Second Republic was born after the second world war, the country was desperate to prevent a recurrence of the deep political divisions that, in 1934, had led to a bloody civil war. Thanks to that fear of adversarial politics, 11 of Austria's 20 post-war governments have been “grand coalitions” of the two big parties—the centre-right Austrian People's Party (“Blacks”) and the centre-left Social Democratic Party (“Reds”).

After a break starting in 2000, during which the Blacks controversially governed in coalition with the far-right Freedom Party (“Blues”), the most recent election in October 2006 produced yet another grand coalition (see chart 2) after the Social Democrats, led by Alfred Gusenbauer, unexpectedly finished slightly ahead of the People's Party. Mr Gusenbauer, a 47-year-old career politician, duly bagged the job of chancellor he had always wanted, but had to cede a number of other key posts—including finance, economy and foreign affairs—to the People's Party. Some supporters accused him of failing to carry out election promises, such as cancelling Austria's order for Eurofighter planes and rescinding recently introduced university tuition fees, but he had little choice.

So far this has proved an ill-tempered match, with constant bickering between the partners. Even so, they are likely to stick together for the whole of the current electoral term, which ends in 2010. Neither wants to be responsible for breaking up the coalition, for fear of something worse.

Coalitions are rarely easy. The previous government, headed by the People's Party's Wolfgang Schüssel, faced a different set of problems. In the 1999 election the Blues, led by the controversial Jörg Haider, enjoyed a triumph after a xenophobic campaign, capturing nearly 27% of the vote, almost the same as the Blacks. The People's Party eventually formed a coalition with Mr Haider's outfit, provoking huge protests at home and a cold shoulder for Austria from other EU countries for a few months (see previous article). Mr Haider went back to his home in Carinthia, a deeply conservative region where he is now state premier.

The Black-Blue coalition fell apart after only a couple of years, but was reinstated after a snap election in 2002 at which Mr Schüssel's strategy was vindicated. His party's share of the vote rose steeply whereas that of the Freedom Party plummeted. In 2005 the Blues weakened themselves further by splitting into a mainstream wing and a more extreme fringe. They now seem consigned to minor-party status (unlike in Switzerland, where in last month's elections the right-wing Swiss People's Party won 29% of the vote).

As the newly dominant partner in Austria's coalition, the People's Party was left free to introduce a number of overdue reforms, including a reorganisation of the state pension scheme, a shake-up of the universities and a cut in the corporate-tax rate from 34% to 25%. Most polls ahead of last year's election suggested that it would be rewarded with a bigger share of the vote. But many Austrians felt that the Schüssel government was “socially cold”, ie, too free-market-oriented, and voted Social Democrat instead—so the country ended up with yet another grand coalition.

Something for everyone

The fact is that most Austrians are perfectly happy with that. They are used to a system in which power and jobs are shared out to reflect a wide range of opinion. For most of the post-war period an important element of Austrian politics has been the *Proporz*, a form of “jobs for the boys” in which posts and contracts in the public sector and state-owned industry were divvied up



Gusenbauer got what he wanted

among supporters of the two big parties. That meant they had to work closely together, but were also able to keep an eye on each other. In a small country, everybody knows everybody else anyway, but belonging to a party was often a great help in advancing one's career, which explains why party membership in Austria, at 15% of the adult population, is among the highest in the West. The *Proporz* now seems to be somewhat in retreat, not least because most state industries have been privatised so there are fewer jobs to be handed out; but it has far from disappeared.

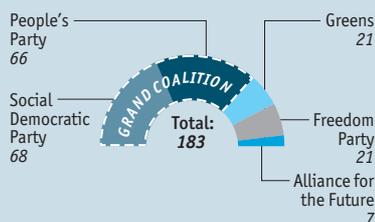
The same sort of thing happens in the nine states in Austria's federal system. Most of them give all parties of any size the right to take part in the state government, with posts handed out in proportion to their share of the vote. This makes it hard to form governments, but at least nobody can complain about having been left out.

Austrians are good at striking compromises. Hannes Androsch, a former vice-chancellor turned businessman, explains that in Germany the word *grundsätzlich* (in principle) means “no”; in Austria it means “yes”. Disagreements are resolved by sitting round a table and talking until everybody has got a bit of what he wants.

The same idea is enshrined in Austria's post-war system of “social partnership”, a mechanism through which government, employers and employees co-operate over

Too big to fail

Seats in the National Council



Source: Austrian parliament



pay and economic policy. It is seen almost as a second arm of government. The main bodies involved are chambers of commerce and workers' chambers, both of which have compulsory membership and elected representatives. Trade unions also play a part but have lost clout in recent years, and have been damaged by a corruption scandal over BAWAG, a bank they used to own but had to sell.

Corporatism may be out of fashion elsewhere, but in Austria it seems to deliver results. Strikes are extremely rare, pay settlements tend to be reasonable and unit labour costs are forever dropping. Growth is higher and unemployment lower than in comparable countries. Industrialists cite the system as a source of competitive advantage; labour representatives see it as a way of achieving social justice. For all that its demise is being regularly predicted, there seems to be plenty of life left in it.

Isn't this all a bit too cosy? The consensus model may not be corrupt (in fact, Austria comes off well in international com-

parisons of corruption), but it is certainly not transparent. People who are not ready or able to work through the entrenched institutions lose out. And because it takes time to get everyone to agree, change is necessarily slow, perhaps too slow. Besides, many of the rules that govern business are no longer made in Vienna but in Brussels or farther afield, so there is a limit to what can be decided behind Austria's closed doors.

And those grand coalitions? Austrian voters may not mind them, but many politicians long for a system that produces clearer majorities. Germany next door, with a different system of proportional representation, has mostly avoided grand coalitions until recently and seems uncomfortable with the present one. Austria has produced a constant stream of proposals to reform its voting system, but the smaller parties tend to resist them. The latest idea is for a *minderheitsfreundliches Mehrheitswahlrecht*, a first-past-the-post system that takes account of the interests

of minorities. But it is hard to believe that anything will come of it: too many people have too much to lose.

Agreement has been reached, though, on a few other, less radical changes to the political system. Starting with the next election in 2010, the standard term of government will increase from four to five years; postal voting will become available to everyone; and the active voting age will come down from 18 to a surprising 16.

That may be a slight help to the Greens, who in the 2006 election garnered over 11% of the poll, a little more than the Freedom Party. Their voters are predominantly middle-class, prosperous, environmentally concerned—and younger than supporters of other parties. The Greens' boss, Alexander Van der Bellen, a mild-mannered economics professor, thinks there is a chance that his party could enter the government after the next election, as a potential coalition partner for either of the big parties. That would be a novel feature in the Austrian political landscape. ■

Ungrateful Europeans

Austrians don't love the EU, but nor will they leave it

THE sign on the door reads "Ministry for European and International Affairs". When Ursula Plassnik became its boss three years ago, it was called "Ministry for Foreign Affairs". She changed the name because she thought it sounded as though foreign policy was something quite separate from the domestic variety. "We are part and parcel of Europe and the world," she says. "We should feel ownership as stakeholders, not onlookers."

Austria has been a member of the European Union for less than 13 years and has suffered a few hiccups since it joined, but is now comfortably settled in. In May 2005 its parliament approved the original version of the new EU constitution with just one dissenting vote (only to see it ditched by the French and Dutch referendums shortly afterwards). Getting approval for the scaled-down treaty revision agreed on at the EU summit last month should be easy: Austria's politicians know that membership has been good for the country.

Yet for decades it seemed inconceivable that Austria would ever join the European club. Under its 1955 state treaty, it had to promise to abstain from any direct or indi-

rect political or economic union with Germany. West Germany was a member of what in 1957 became the European Economic Community, so Austria could not be. It had to look for other ways of getting access to Europe's huge market without the political obligations of EEC membership. In 1960 it became a founder member of the European Free Trade Association (EFTA), along with Britain, Denmark, Norway, Portugal, Sweden and Switzerland.

Some of the original EFTA members subsequently joined the grander club, which left EFTA looking rather naked. When in 1986 the European Community decided to push for a single internal market to promote the free movement of people, goods, services and capital, the remaining EFTA countries set up the European Economic Area in the hope of sharing some of the benefits. The agreement eventually took effect in 1994, but by then Austria was about to move on. The political changes on the other side of the iron curtain had made it possible to start thinking about membership of the EC itself (although the Russians were still not keen on the idea).

Austria, for its part, had become keener because it badly needed the economic boost it thought entry would provide. Its nationalised industries were in crisis and growth was sagging. It put in an application in 1989, got the terms of entry approved by a two-thirds majority in a referendum in 1994 and joined at the start of 1995, together with Finland and Sweden. As one of the richer members, it also qualified to join the new club-within-a-club launched in 1999, Europe's Economic and Monetary Union—though it struggled to cut its public spending to meet the Maastricht criteria for entry. In 2002 it swapped its schillings for euro notes and coins.

Rich rewards

The benefits to Austria of EU membership are hard to quantify precisely, but according to various educated guesses they are substantial. The study by Fritz Breuss mentioned earlier suggests that over the past ten years membership brought extra GDP growth totalling about 4.5%. Another study, by Franz Nauschnigg of the Austrian Society for European Policy, compared Austria with Switzerland—neigh- ▶▶

►bouring countries with similar economies, one inside the EU, the other outside—and found that GDP growth in Austria between 1990 and 2006 was 28% higher than in its Alpine neighbour. Not all of the difference can be explained by EU entry—Austria had a lot of catching up to do—but there is little doubt that growth would have been slower outside the club.

And there is more to come. The lifting of the iron curtain and, more recently, the arrival in the EU of new members in central and eastern Europe have provided Austrian businesses with a remarkable opportunity on their doorstep which they have eagerly seized. Austrian firms, particularly banks and other financial-service providers, have piled into the region to take advantage of these new markets (see next article). Foreign companies too are increasingly using Vienna as a base for their operations in the new member states.

No wonder Austrian business is all in favour of the EU. But a slick advertising campaign launched by seven large companies to sell the club to the man in the street (“Schau über den Tellerrand”—look beyond the edge of the plate) fell on deaf ears. Public opinion in Austria is more Eurosceptic than in any other EU country except semi-detached Britain. In the most recent Eurobarometer opinion poll in spring this year, only 36% of Austrians saw their country’s EU membership as a good thing and 25% thought it was a downright bad thing. Opinion on whether their country had benefited from membership was almost evenly split, with 44% saying it had and 43% it had not. The antis complain that Austria is too small to make much of an impression on the EU, which they see as being run by and for the benefit of the biggest members. And whether pro or anti, Austrians are still cross about that EU boycott in 2000 over the inclusion of Mr

Haider’s party in their government.

Austrian Europhiles insist that although their countrymen may not love the EU, they would not dream of leaving it. A long-running poll that puts the choice in simple terms—should Austria remain in the EU or pull out again?—has fairly consistently produced a two-thirds majority in favour of staying in—much the same proportion that voted “yes” to entry in the 1994 referendum.

A closer analysis of how opinions divide shows that the level of support for EU membership tends to reflect people’s economic interests. Well-educated and highly qualified Austrians are in favour because they see lots of business opportunities in the new member countries and welcome foreign workers in Austria to ease labour shortages. Those near the bottom of the social scale are against because they worry that foreign workers will take their jobs.

Austria likes to think of itself as a place that opens its doors to outsiders. It took in more than a million ethnic Germans from central and eastern Europe in 1945-50, as well as hundreds of thousands of refugees from Hungary and Czechoslovakia after the troubles there in 1956 and 1968 respectively. More recently it has accepted many asylum-seekers from flashpoints around the world.

But although foreign nationals now make up nearly 10% of its population (see chart 3), not counting illegal immigrants who by definition are hard to quantify, its treatment of foreigners has sometimes been less than generous. Unlike some other EU countries it has offered few voting rights to resident foreigners, and it did not give unrestricted access to workers from the central and eastern European countries that joined in 2004. Skilled people from those countries will now be admitted from next year, but only to ease an acute shortage in Austria. The unskilled may have to wait until the EU’s deadline of 2011, when all restrictions must go.

What about further enlargement? “My agenda is the Balkans,” says Ms Plassnik. “One day Belgrade and Pristina will be members of the EU.” She considers the resolution of Kosovo’s status “a maturity test for European foreign policy”. And farther south-east still? Turkey now realises that it has to change if it wants to join the EU, she says. She does not exclude the possibility that it might become a member one day, but “a tailor-made EU-Turkish relationship might be an alternative.” Most Austrians are bitterly opposed to Turkish entry. The memory of the Otto-



Promoting the EU by the plateful

mans’ siege of Vienna in 1683 lingers on.

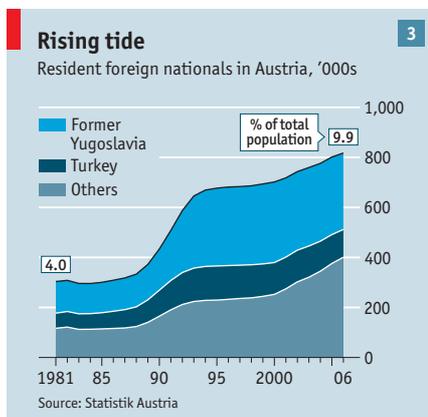
A more recent episode of Austria’s past also reverberates in the present. When Austria signed its 1955 state treaty, it had to agree, at Russia’s request, to become permanently neutral. That suited the Austrians too. It did not stop them from aligning themselves with the West, but it ruled out joining NATO. At about 0.8% of GDP, Austria spends quite a modest amount on defence, and compulsory military service for its young men is now a mere six months. Neutrality is supported by more than 70% of the population and has become part of modern Austria’s identity as a small, peaceful and prosperous country.

Carry on in neutral

Critics say that Austria has elevated neutrality to a creed, claiming that it will keep the country out of harm’s way but all the while free-riding on NATO’s tanks. Many Austrians had even become convinced that their country’s neutral status would protect them from the threat of terrorism—until in September several Austrian Muslims were arrested in Vienna on suspicion of hatching a terrorist plot.

What is clear is that the meaning of neutrality has changed since the end of the East-West conflict. Although NATO membership is still taboo, Austria does take part in the organisation’s “Partnership for Peace” programme and allows NATO peacekeeping forces to use its airspace. It also takes part in UN peacekeeping missions. More importantly, it has signed up to the EU’s joint defence policy, which will involve a sizeable European force.

To jettison its neutrality, Austria would have to find a two-thirds majority in its parliament and do a fair bit of explaining abroad. Redefining it goes a long way at a much lower political cost. ■



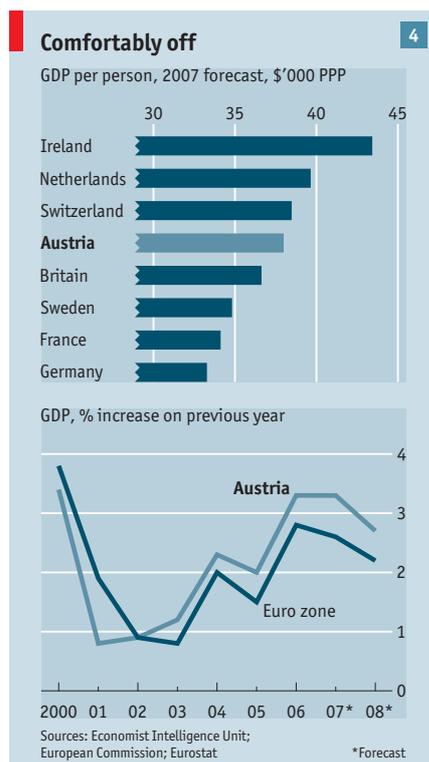
Mustn't grumble

The economy is having an excellent run and business is booming. Can it last?

AUSTRIANS love to complain, but when it comes to their economy even they admit that they are currently grumbling at a high level. After years of catching up with their wealthy European neighbours, they seem to have arrived: leaving aside a handful of countries like Switzerland, Norway and the newly rich Ireland, Austria is up there with the best of them (and, gratifyingly, slightly ahead of Germany). For most of the past ten years average GDP growth, at 2.3% a year, has been faster than the EU's. Last year's solid 3.3% could be matched this year, though next year things are likely to slow down a bit (see chart 4).

Not only is Austria rich and getting richer, but its wealth is reasonably well spread. According to the OECD, the Gini coefficient of income distribution in 2000 was about 25, roughly on a par with Scandinavia, against an OECD average of 31 (the higher, the less equal). Some of Austria's nine federal states are better off than others, with Vienna getting most of the cream, but the differences are not vast. And Europe's opening to the east has helped border regions that previously found themselves, as one banker puts it, "at the end of the world".

Inflation, at 1.4%, and unemployment, at 4.2%, are both enviably low by European standards. The budget deficit, at 1% this year (on the Maastricht definition), is already modest and will continue to fall, thanks to relatively buoyant tax revenues. Pay settlements are generally reasonable, helped by the system of "social partnership". In three of the past five years, including 2007, net real incomes from employment have barely budged even though the economy has been growing steadily, yet workers are not mounting the barricades (though nor are they throwing their money around). Austria's schilling was pegged to the Deutschmark for many years, keeping producers on their toes, and since 1999 membership of the euro zone has had a similar effect. As a result of all this, unit labour costs in manufacturing in euro terms in the ten years to 2005 fell by an astonishing 38%. Over the same period Germany managed only a 7% drop. (In services, however, Austria's productivity record is much less impressive.)



Being small, Austria has traditionally been an open, export-oriented country, and in the past few decades it has become the very model of internationalisation. Unlike Switzerland, it has no really big multinational companies and only a few well-known international brands (such as Swarovski, an upmarket maker of crystal jewellery and trinkets, and Red Bull, a fashionable energy drink). Its strength lies in its small and medium-sized companies, many of them family-owned, that make highly specialised, top-quality products and export them all over the world.

In the economic globalisation index produced by the Swiss Institute for Business-Cycle Research (KOF), which measures the free flow of goods, capital and services across countries, Austria moved up from 29th (out of 97 countries) in 1970 to 7th (out of 109) in 2004, well above the average for the EU 15 and the OECD countries. The downside of this openness is that Austria depends heavily on the econ-

omic health of its trade partners. Germany alone takes 32% of its exports, so the economic chill there a few years ago had a knock-on effect in Austria—which has made the recent German recovery all the more welcome.

A golden opportunity

But the favourite new playground of Austria's export-oriented firms is central and eastern Europe. Thanks to their cultural and historic links with the region, Austrian businesses were able to establish themselves quickly in the new markets, securing a "first-mover" advantage that may prove quite durable. Many of the countries in the region are small, but for Austria's small firms the extra business they bring represents a big net addition. And most of them (except Slovenia and the Czech Republic, which are already relatively rich) still have many years of catching up ahead of them, so both their economies as a whole and some of the markets within them are likely to grow much faster than their west European equivalents.

Some of the most lucrative markets have opened up in financial services. According to an analysis by Austria's central bank, foreign firms have secured around 70% of the banking market in the region, and two of the top three international banking groups that operate there are Austrian. The market leader is Milan-based UniCredit, which also has an Austrian component (Bank Austria). Number two is Erste Bank, Austria's biggest bank. It was later than some of its rivals to arrive in the region (in 2000), but has since snapped up ten banks and accumulated a total of about 16m customers there. Its biggest transaction to date was the purchase in 2005 of a 62% stake in Banca Comerciala Romana, Romania's largest bank, with 2.8m customers.

Erste's boss, Andreas Treichl, says there are still acquisitions to be made and plenty of new business to be developed: for example, customers in the region have been so busy borrowing that they have barely started to think about saving and investing. He reckons it will take 20 or 25 years for these countries to catch up, but that some of them could eventually overtake older ▶▶



► EU members such as Portugal and Greece. In the meantime they will be growing a lot faster than the rest of Europe—and as they grow, Austria will benefit.

Raiffeisen International, the quoted arm of Raiffeisen Zentralbank, has an only slightly smaller balance sheet than Erste in the region, and it is growing even faster. Walter Rothensteiner, the group's director-general, tried to buy market share in the region as quickly as possible, starting in 2000. The bank now has 13m customers there, against just 1.7m in Austria. People in these new markets have literally been queuing up to open accounts, he says, so they can take out loans for cars and other consumer goods.

Raiffeisen started off by setting up new

banks from scratch, wary of taking over existing ones for fear of finding skeletons in their cupboards; but it is now also buying up existing banks. Mr Rothensteiner does not think there is much left to take over, which will help to keep out other foreign banks. Austria's historical and family connections in the region also count for a lot, and Vienna's accessibility is good for keeping vital personal contacts going. Most importantly, he says, Austrians understand their eastern neighbours' easy-going mentality. He notes that Swiss banks have kept out of the region.

For the moment the bonanza shows no sign of slowing. According to Raiffeisen's research arm, the combined balance sheet of the banking sector in central and east-

ern Europe last year grew by 28%, to €1.1 trillion. By the end of 2011 it is expected to reach €2.5 trillion, and by 2016 it could double again. The biggest growth will be in retail banking. Total retail credit in central and eastern Europe last year averaged less than 18% of GDP, against about 54% in the euro zone, so the potential is vast. The market is also extremely profitable. According to Austria's central bank, in 2005 the subsidiaries of Austria's banks in central and eastern Europe made up 16% of their consolidated balance-sheet total, but about 35% of their profits. Austrian bankers say they need to charge a bigger risk premium in these markets. They may also be making hay while the sun shines.

Nor is it just Austrian bankers who are ►►

A very superior rustbelt

THE happiest day in his life, says Wolfgang Eder, was August 31st 2005. That was when the state of Austria sold its last remaining share in Voestalpine, the steel company of which he is boss. Until the mid-1980s the company had been entirely state-owned, but when the government decided to privatise some of the country's nationalised industries, Voestalpine, with a turnover of about €2 billion, seemed almost too far gone to bother with. From 1985 onwards the firm was extensively restructured, McKinsey was called in twice and more than two-thirds of the 90,000 staff lost their jobs.

In June this year Voestalpine reported revenues for the financial year 2006-07 of €7.05 billion, 13% up on the previous year. Profits, at €765m, were 45% up and the shares, at €56.34, had reached an all-time high (since briefly topped). The firm was also poised to take over Böhler-Uddeholm, a successful special-steel company, thus boosting its turnover by 45% (and saving Böhler-Uddeholm from the attentions of a British private-equity fund). For an outfit that 20 years ago was teetering on the brink of bankruptcy, that was quite a turnaround. How was it done?

What made the difference, says Mr Eder, was the absence of politics and the ability to run the company on commercial criteria. In the bad old state-owned days politicians told it what to produce

and the top management was picked under the *Proporz* system. In the early 1980s, the Social Democratic government of Bruno Kreisky thought it was far better for the firm to lose money than to lose jobs, so no one was sacked.

These days staff numbers are down to about 25,000, not counting Böhler-Uddeholm, but the people of Linz, where the company is based, still see it as an excellent employer. Voest has an employee share-ownership scheme in which over 10% of its shares are tucked away (and which also serves as a handy poison pill to discourage potential bidders). Linz itself is a lot greener and less polluted than it used to be, and is due to become European City of Culture in 2009.

Brain, not brawn

In the Linz steel plant, clean as a whistle and done up in a colour scheme recommended by a *feng shui* expert, there is hardly anybody to be seen. The few workers on duty keep an eye on progress from glassed-in observation posts above the shop floor, watching multiple computer screens. Voestalpine does not make commodity steel but occupies various high-end niches: top-quality steel, railway systems, steel sections and sophisticated automotive products, mostly made to order. With Böhler-Uddeholm, a market leader in very fancy special steels, it has

Who says heavy industry has had its day?

now acquired a further niche player.

Like other Austrian firms, Voestalpine has been doing a lot of business in central and eastern Europe since the iron curtain was lifted. It is the only big maker of high-end steel products within a 500km radius of Linz and has become the biggest supplier in these new markets. Demand in the region for cars and other consumer goods is soaring, but the company has no plans to produce any steel there. Mr Eder thinks buying communist-era steelworks could have entailed huge legacy problems, and he has plenty of capacity in Linz to supply whatever is needed. Wages next door may be only a quarter of what they are in Austria, but he reckons his workers are worth the money, and his unit labour costs are still dropping. As long as industry concentrates on the quality end of the market, he argues, it has a good future in Austria.

Manufacturing accounts for 19% of value added in Austria's economy, which makes it more of an "industrial" country than, say, Britain or America (both at 13%). That is all to the good, say many of the country's big bosses. According to Veit Sorger, president of the Federation of Austrian Industry, "one in two Austrian jobs, directly or indirectly, depends on industry." He foresees a "new industrial era" in which success will come from lots of R&D and constant innovation.

▶ chasing opportunities in central and eastern Europe. Boris Nemsic, the boss of Telekom Austria, the incumbent telecoms company, is scouring neighbouring countries for mobile-phone acquisitions. Austria, he points out, has the lowest mobile-phone prices in Europe and its market is saturated, so any growth has to come from abroad. By targeting smaller neighbours to the south-east and east, Mr Nemsic's firm, which went public in 2000, has expanded its market from 8m potential customers in Austria (including babies and centenarians) to 44m. The actual number of subscribers is currently 11m and rising: Telekom Austria has recently bought MDC, a mobile-phone group in Belarus, and is still

looking for further acquisitions.

Moreover, a number of foreign companies are now using Austria as a base for their operations in central and eastern Europe. Brigitte Ederer, CEO of Siemens Austria, the country's leading technology and infrastructure company, explains that as a rule the German company's foreign operations are controlled from its headquarters in Munich. But in the mid-1990s the German bosses decided that it was too difficult to keep an eye on the company's fragmented activities in the region from there, so they transferred overall responsibility for eight of the countries to the subsidiary in Vienna, closer to the action and better suited to what Ms Ederer describes as the

"small-scale grind" of this business.

Not all Austrian efforts to do business in the region have gone without a hitch. Earlier this year OMV, a big Austrian energy company, increased its stake in Mol, Hungary's national energy champion, and subsequently launched an informal takeover bid to create Europe's fourth-biggest refinery group after Total, ExxonMobil and Royal Dutch Shell. But Mol rejected the offer, backed by the Hungarian government, which has since passed a law to make it harder for foreign firms to take over "strategic" companies. The European Commission is threatening legal action against the Hungarians' protectionism. OMV is keeping its fingers crossed. ■

Be happy, stay happy

What Austria needs to do to keep its luck coming

IT WAS an Austrian economist, Joseph Schumpeter, who in his 1942 book "Capitalism, Socialism and Democracy" introduced the concept of "creative destruction": that old ways of doing things are constantly being swept away to make way for new ones. Austria saw a great deal of destruction in the first half of the 20th century and had to reinvent itself after the second world war. In the six decades since then it has succeeded beyond expectation, thanks in large measure to its own efforts but also helped by favourable external factors: a prolonged period of peace in Europe (except in the Balkans), an ever-expanding European Union, the collapse of communism and growing prosperity in the world.

Austria's economy underwent a measure of creative destruction in the 1980s when many of the country's nationalised industries were privatised and restructured. As this special report has argued, the overall effect was positive, and the increased emphasis on markets and competition since then has done the economy nothing but good.

The opening up of new markets in central and eastern Europe from the 1990s brought a further bout of change that has proved almost wholly beneficial for Austria. Its businesses, many of them small and nimble, were quick to seize these new opportunities and profited handsomely, as did the economy as a whole.

Austria's (relatively late) entry into the EU also brought some upheavals, but by

and large the country has done well out of membership. Even so, ordinary Austrians, unlike the business elites, have little affection for the club and remain worried about letting in too many workers from the new member countries.

Meanwhile, Austrians' traditional inferiority complex vis-à-vis Germany next door, with ten times as many people, has melted away as their economy has outperformed their big neighbour's. They have noted with quiet satisfaction that recently tens of thousands of workers from eastern Germany have arrived to work in Austria's

tourist industry: the traffic used to go the other way. (Less pleasingly, large numbers of German students have been flocking to Austrian universities to beat German admission quotas.)

So has Austria seen enough creative destruction for a while? Wilhelm Molterer, the finance minister (and head of the People's Party), gives a Schumpeterian answer: "New competitors come up all the time. What we need is permanent reform." He approvingly points to the reforms launched by the previous government, which had a relatively free hand because the then ruling coalition was dominated by his party. The current grand coalition, explains Mr Molterer (who is a hot tip to become the next chancellor), makes reforms rather more difficult.

There are plenty of things Austria needs to do if it wants to keep up its economic performance. Last year the WIFO economic research institute, at the invitation of the two sides of industry, produced a white paper in which it argued that continued high growth and full employment will depend on Austria advancing from the status of an upper-medium-tech country to an ultra-high-tech one. Over the past 15 years the country has already moved from a below-average position within the EU in its use of technology and innovation to nearer the top. Its spending on research and development (R&D) as a proportion of GDP has risen from 1.4% in 1993 to 2.4% last year. That is good, but not yet good ▶▶



In with the new, said Schumpeter

► enough. Karl Aiginger, WIFO's boss, argues that the only things Austria should be producing are those that sell on quality rather than price and require a measure of innovation and special skills to make. Anything else is a waste of time.

Nobody's perfect

But what does the country need to do to get to that happy position? Ask any Austrian academic, industrialist or politician, and he or she will come up with a shopping list that includes some of the following items:

- **Infrastructure.** Eighteen years after the fall of the iron curtain, the construction of road and rail networks is still lagging behind the expansion of business in central and eastern Europe. A motorway to Bratislava, Slovakia's capital, only 65km from Vienna, is still not quite ready. Austria's transport master plan also provides for improvements in the country's links to the south which will involve massive new tunnels through the Alps, but none of this will happen soon.

- **Public spending.** Austria's overall tax burden, at 43% of GDP, is three percentage points higher than the EU-15 average and seven percentage points higher than the OECD average. Corporation tax was cut to 25% a couple of years ago, but top personal-income tax rates are still widely seen as too high (though inheritance tax is about to be abolished). Another tax reform is planned for 2010, the year of the next election. Economic conservatives argue that currently buoyant tax revenues should be used to reduce the budget deficit rather than to cut taxes.

Everybody's favourite target for savings is excessive bureaucracy, which a federal structure makes particularly hard to tackle. The individual states depend on central government for almost all their revenue, so they have little incentive to cut out duplication and waste. The potential for savings is said to be large, but political sensitivities may prevent it from being realised.

- **Competition.** This is alive and well in export-oriented sectors, but services such as public utilities, transport, health services and some professions lag far behind. Austria's shop-opening hours are still among the most restrictive in Europe.

- **Labour market.** The labour-market participation rate among core full-time workers is high, but Austria has been less good at integrating groups such as women with young children and older workers, and far too many workers are able to retire early on grounds of disability.

- **Education.** This goes to the heart of what



Don't let the music stop

Austria has to do to remain competitive. Its spending on education as a share of GDP is above the European average, and the results used to be a source of pride. Its "dual" apprenticeship system, mixing formal learning and work experience, has been particularly successful. But the OECD's most recent PISA study on educational achievement shows Austria to be no more than middling in literacy and maths, and employers are complaining that would-be recruits cannot read and write properly.

Much of the debate currently revolves around secondary schools. The Social Democrats in the ruling coalition claim that selection for the different streams is taking place far too early and want to move it from age ten to 14. The most disadvantaged group is migrants' children, who often speak no German, get no help with learning it and therefore miss out on a decent education. Unemployment among young migrants is much higher than the national average, storing up economic and social trouble.

University education is also under review. Reforms brought in a few years ago have moved the system towards the EU's Bologna model, with short courses that can lead on to further qualifications. Modest fees have been introduced to reduce the 40% drop-out rate, but political courage did not stretch to bringing in entry restrictions based on performance at school, which explains why German students are now piling in. Only 18% of Austria's working population have higher educational qualifications, well below the OECD average of 25%, and the number of young people taking science courses is particularly low. That does not augur well for a country aiming for high-tech status.

The government is trying to push up spending on R&D and encourage innovation, but critics say its efforts are hampered by responsibility for innovation policy being shared among four different ministries. To promote top-level science, the government is currently setting up a new "Institute of Science and Technology Austria", modelled on American elite universities and offering only PhD programmes.

Ticking off all the items on the to-do list would take a lot more than one electoral term, particularly for a grand coalition. Some of them may not get done for a very long time. But at least the country is giving thought to what is needed if it wants to remain "felix Austria"; and attitudes are changing. Vienna's coffeehouses are as crowded as ever, and the cakes just as delicious, but perhaps people don't linger over them as long as they used to. Could those young Austrians on their ubiquitous mobile phones be ordering the collected works of Schumpeter? ■

Offer to readers

Reprints of this special report are available at a price of £3.50 plus postage and packing. A minimum order of five copies is required.

Corporate offer

Customisation options on corporate orders of 100 or more are available. Please contact us to discuss your requirements.

Send all orders to:

The Rights and Syndication Department
26 Red Lion Square
London WC1R 4HQ
Tel +44 (0)20 7576 8000
Fax +44 (0)20 7576 8492
e-mail: rights@economist.com

Please visit our website

www.economist.com/rights

for more information and to order special reports and reprints online

Future special reports

Countries and regions

America and the world February 2nd 2008

Business, finance, economics and ideas

Business in Japan December 1st 2007

Migration January 5th 2008

The ethical company January 19th 2008

Technology and government February 16th 2008

Asset management March 1st 2008

Previous special reports and a list of forthcoming ones can be found online

www.economist.com/specialreports