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Austria: 2012 Article IV Consultation—Staff Report; Informational Annex; Statement by the Staff Representative; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Austria

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Austria, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 2, 2012, with the officials of Austria on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 2, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- The Informational Annex, completed on 8/2/12
- The Statement by the Staff Representative
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 27, 2012 discussion of the staff report that concluded the Article IV consultation.
- The Statement by the Alternate Executive Director for Austria

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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AUSTRIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

July 31, 2012

KEY ISSUES

Context: Austria has relatively strong macroeconomic fundamentals and limited economic slack, but deep ties with the rest of the euro area and the legacy of an overly ambitious eastward financial sector expansion are creating substantial challenges.

Growth outlook and risks: After a strong 2011, a weak external environment is slowing down growth, though buoyant wages should support private consumption. A switch to a more domestic demand-led growth would help reduce imbalances within the euro area. The main risks stem from a further intensification of the crisis in the euro area and its ramifications to Central, Eastern and Southeastern Europe (CESEE).

Fiscal Policy: The new medium-term structural consolidation path strikes an appropriate balance between fiscal discipline and the cyclical needs of the economy, but needs to be locked in by accelerated reforms to contain aging cost. In addition, there are sizeable contingent liabilities from medium-sized bank restructuring.

Financial sector: Recovery in some CESEE credit markets is slower than expected. NPLs are still rising and profitability is subdued, but large banks have strengthened their capital and liquidity positions. Plans to restructure medium-sized banks that received public support need revamping to allow more efficient disposals.

Structural issues: Labor market participation could be increased by reducing the burden on labor from taxes and social security contributions and smoothing high tax wedges. The budgetary impact could be offset by spending cuts or increases in less distortionary taxes, such as real estate, excise, or environmental taxes.

Approved By
Rodrigo Valdés and
Tam Bayoumi

Discussions took place in Vienna from June 22 to July 2. The staff team comprised Ms. Detragiache (head), and Messrs. Steinlein, Vandenbussche (all EUR), and Klyuev (RES). Mr. Prader (OED) participated in the discussions. The mission met with Governor Nowotny, Labor Minister Hundstorfer, State Secretary for Finance Schieder, other senior officials, parliamentarians, and social partners, banking sector, and think tank representatives.

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INTRODUCTION

1. **Austria has relatively strong macroeconomic fundamentals, but deep ties with the rest of the euro area and the legacy of an overly ambitious eastward financial sector expansion are creating substantial challenges**. With intensified market scrutiny of sovereign and bank creditworthiness in late 2011 and a sovereign rating downgrade in early 2012, the authorities reacted. They introduced a fiscal rule and strengthened medium-term consolidation plans; and, in the banking sector, they increased capital requirements and stepped up the monitoring of the funding sources of large banking groups' subsidiaries. This policy response and the ECB's LTROs brought relief, but the subsequent partial nationalization of the fourth-largest bank was a reminder of the challenges ahead.

2. **Policies need to preserve market confidence, increase resilience against future adverse external spillovers, and boost potential growth.** As in other euro area countries, fiscal policy must balance the need to safeguard confidence in the sovereign with the risk of an excessive pro-cyclical fiscal tightening. In the financial sector, regulation and supervision need to be strengthened without causing a disruptive decline in credit supply (including in CESEE), while the fiscal costs of restructuring intervened banks must be contained. To boost potential growth, the large tax wedges that discourage labor supply and demand need to come down, but without adding to the fiscal deficit.

RECENT ECONOMIC DEVELOPMENTS, OUTLOOK, AND RISKS

Background

3. **Growth was strong in 2011, supported by buoyant employment, and the economy has limited slack.** For the year as a whole, growth amounted to 2.7 percent, mainly driven by strong investment (Figure 1). The last half of the year was flat, but the first quarter of 2012 saw a recovery, with broad-based growth of 0.3 percent q-o-q. Employment grew strongly, and unemployment reached a post-2009 low of 4.2 percent in 2011, the lowest rate in the euro area. Wage growth lagged inflation and stood at 2.7 percent in 2011.

4. **Inflation has fallen rapidly from its 2011 high, but wages are rising.** At 3.6 percent in 2011, inflation reached its highest level in decades as excise tax increases and a stronger pass-through of commodity price hikes opened a gap to Germany and the rest of the euro area. In the first half of 2012, these effects subsided and the discrepancy narrowed, and inflation stood at 2.2 percent in June. On the other hand, negotiated wage growth has accelerated to above 3 percent, reflecting the backward-looking wage setting mechanism but also, possibly, tight labor market conditions. Housing prices accelerated in the first quarter of 2012, but after a long period of stagnation (except for a few "hot spots" such as Vienna).

5. **The current account surplus is shrinking, reflecting in part cyclical factors**. After peaking in 2008 at 5 percent of GDP, the current account has narrowed, reaching 1.9 percent of GDP in 2011. Staff calculations indicate that cyclical factors, namely a smaller output gap than trading partners

and less favorable terms of trade than the norm, lowered the CA surplus by 1.2 percentage points of GDP. Imports were boosted by high energy prices, while exports as a share of GDP remained below their 2008 record (Figure 2). Consistent with regional rebalancing, the bulk of the decline in the trade balance in 2011 was against the rest of the euro area. The real and nominal exchange rates were broadly stable in 2011. Unit labor cost growth accelerated, but in line with that in Austria's trading partners, while the global export market share continued its trend decline. Outward FDI and cross-border lending gathered steam, but some of Austrian portfolio investment abroad was withdrawn, even as foreigners resumed portfolio investment in Austria. Capital flows into CESEE remain depressed, with only timid signs of improvement, in part related to Austrian banks' support to their subsidiaries.

6. **The fiscal position has improved but public debt is still rising**. In 2011, the deficit fell to 2.6 percent of GDP, but this improvement is likely to be partly reversed to some 3 percent of GDP in 2012, on the back of slowing growth and significantly higher support to troubled medium-sized banks (Figure 3). General government gross debt stood at 72 percent of GDP, up from a pre-crisis level of 60 percent of GDP.

7. **Banks' profitability in 2011 suffered from the continued deterioration of loan quality in several CESEE countries and losses on securities portfolios.**[1] With consolidated assets of 380 percent of GDP, the banking sector is large relative to the economy, reflecting the strong presence of Austrian banks in the CESEE region. In the face of funding pressures in European markets in the second half of 2011, Austrian banks increased their reliance on central bank funding and cut their external positions (Figure 4). These cuts focused on markets other than Austria and the CESEE, most notably the euro area periphery – though exposure to Italy remains significant. The return on assets fell sharply during 2011, including because of losses from the Greek PSI. With the recovery in CESEE sluggish, large write-downs on goodwill for past acquisitions and continued provisioning on the growing stock of NPLs were necessary. In addition, Hungary's scheme to help borrowers indebted in foreign currency caused sizable losses for Austrian banks.

Staff's view

8. **Economic growth is set for a gradual recovery in late 2012 and throughout 2013.** Even with a projected slowdown around mid-year, some ¾ percent annual growth for 2012 should still be in the offing. A continued growth revival thereafter, mainly on the back of domestic demand, would point to 1¾ percent growth in 2013. On the other hand, protracted uncertainty about prospects in the euro area will continue to cloud the landscape and preclude a more robust recovery. Annual average inflation will be close to 2 percent in 2012 and remain around that level thereafter.

9. **Austria's external balance is on the strong side relative to economic fundamentals, but is expected to decline in line with regional re-equilibration**. Although the real effective exchange rate is close to a level consistent with fundamentals, the current account, at 1.9 percent of GDP in 2011, is somewhat stronger than predicted by standard models, with the divergence reflecting

[1] Further information on the banking sector is provided in Annex I.

factors other than policy distortions.[2] One of these factors, wage moderation, may now be coming to an end, with real wage growth accelerating this year and expected to remain around ¾ percent in the medium term. Accordingly, the current account surplus is projected to continue its recent downward trend in the medium term as growth becomes more driven by domestic demand, consistent with rebalancing within the euro area.

10. **Risks stem mainly from a further intensification of the euro area crisis and could lead to a negative feedback loop between banking and sovereign risk.** An escalation of financial instability in the euro area would spill over to Austria through trade and financial linkages.[3] Renewed and protracted stress in wholesale funding markets for euro area banks, if not addressed by offsetting policy measures, could impact Austrian banks by increasing their funding costs and, ultimately, forcing them to contract their asset portfolio. The government may have to step in with additional financial support in the form of capital injections or guarantees, thereby worsening the sovereign fiscal position. Higher sovereign spreads, in turn, would push up bank funding costs, exacerbating deleveraging.

11. **Spillovers via CESEE might further aggravate such a downside scenario**. Growth in CESEE would weaken because of trade and financial linkages with the euro area, with adverse repercussions on the quality of the Austrian banks' loan portfolios, already burdened by the legacy of the 2008/2009 crisis. On the other hand, the floor on the Swiss franc/euro rate would limit adverse balance sheet effects for holders of Swiss franc-denominated mortgages in Austria and CESEE, thus short-circuiting a potential channel of contagion.

12. **Severe spillovers could be expected in an extreme scenario in which Italy was strongly affected by contagion**. This would reflect the close trade links, direct banking sector exposure (some 5 percent of GDP), and the fact that the second largest banking group in Austria is a subsidiary of an Italian bank.

The authorities' view

13. **The authorities broadly concurred with the staff's projections and assessment of the main risks.** The June forecast of the Austrian Central Bank (OeNB) deviates only marginally from the staff's baseline scenario in 2012 and 2013 (and is a bit more sanguine in 2014). Differences are also marginal to the projections of the Austrian economic research institute IHS, while the WIFO institute foresees growth in 2012 and 2013 at only 0.6 and 1.3 percent. Furthermore, there was broad agreement that the most prominent risk for the outlook stems from an intensification of the euro area crisis.

[2] CGER models suggest that the real effective exchange rate is undervalued 1, 3 or 8 percent according to the equilibrium real exchange rate, macroeconomic balance, and external sustainability approaches, respectively. The new External Balance Assessment (EBA) methodology indicates a two percent real exchange rate undervaluation and a current account gap (the difference between the cyclically-adjusted current account balance and the value implied by fundamentals and desired policies) of about 3 percent of GDP (but a zero policy gap).

[3] Risks are summarized in the Risk Assessment Matrix (Box 1).

14. **The authorities agreed that the external position was strong but did not necessarily foresee a further weakening in the short run.** They acknowledged that adjustment in the euro area would require higher–than–average inflation in surplus countries, and would not oppose such a development in Austria. They also noted that private sector wages are formed through collective negotiations with no government interference, and emphasized the importance of non-price factors (such as a first-mover advantage in CESEE) in explaining Austria's success in export markets.

Box 1. Risk Assessment Matrix[4]

(Scale—high, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized
Strong intensification of euro area crisis	**Medium** Re-intensified financial instability in euro area, triggered by events in periphery, leading to a sharp euro depreciation and higher sovereign and bank risk spreads**,** pressures on wholesale bank funding markets, and capital flow reversals in CESEE.	**High** Spillovers would work through trade and financial linkages directly (including from Italy) and via CESEE. Multiple feedback loops would unfold, including between Austrian sovereign and bank credit worthiness/funding cost. Euro depreciation, however, would stimulate growth, while the peg on the CHF/EUR rate would prevent adverse balance sheet effects from the high share of CHF-denominated loans.
Fiscal adjustment off-track	**Medium** Additional bank support outlays not offset by other spending cuts/revenue increases. Yield of newly introduced taxes in 2012/13 lower than expected and no substitute measures; no agreement on unspecified measures in consolidation package (e.g. subsidies, health care); substantial non-compliance at subnational level with domestic stability pact.	**High** Fiscal discipline might be in doubt, causing sovereign and bank bond spreads to climb rapidly. Foreign investors might no longer roll over exposures (though long average maturity of sovereign debt would help). Austrian banks may step in and support sovereign debt, but would have to reduce other exposures, with likely negative feedback loops. Higher funding costs would also threaten the banks' ability/willingness to fund some CESEE operations.
Adverse developments in individual CESEE countries	**Medium** Destabilizing policies in a number of CESEE countries to which Austrian banks are significantly exposed.	**Medium** Spillovers would work through trade and financial linkages, notably the loan portfolio of Austrian banks. Potential confidence effects may hurt Austrian sovereign creditworthiness with feedback on bank ratings and funding cost.

[4] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

Global GDP growth slowdown	**Medium** Slowing demand from emerging Asia and the U.S.	**Medium** Direct effects through lower export demand (in particular from Germany and CESEE) and deterioration of loan portfolio of Austrian banks in CESEE.
Sharp increase in oil prices	**Low** Geo-political risks could lead to a sharp increase of oil prices.	**Medium** Higher energy prices would increase inflation and could depress demand (both domestic and external).

POLICY DISCUSSIONS

The discussions focused on fiscal, financial sector, and structural policies to increase the economy's resilience against euro area shocks, contain adverse spillovers, manage legacy problems in the financial sector, and increase potential GDP growth through better labor utilization.

A. Implementing and Anchoring Structural Fiscal Consolidation

Background

15. **The authorities' consolidation plans envisage a balanced budget by 2016.** The government's current medium-term fiscal framework was strengthened in March 2012 and targets a balanced budget for general government by 2016 (Box 2). Net of capital transfers to banks, this would amount to an average annual adjustment of almost ½ percent of GDP in structural terms. Additional bank restructuring costs may push up the debt level, but even in this case the strict implementation of the new adjustment path and adherence to the new fiscal rule framework should ultimately put debt back on a downward trajectory.

16. **However, a significant part of the consolidation plan is subject to high yield uncertainty or not yet underpinned by specific measures.** The main measures in 2012 (anticipated taxation of corporate pensions) and 2013 (tax treaty with Switzerland) have high yield uncertainty, while in 2014-16 measures underlying almost a quarter of the consolidation still need to be implemented, are unspecified, or depend on the cooperation of subnational governments (financial transaction tax, subsidy and health care reform, and expenditure consolidation by states and municipalities). Not yet implemented or unspecified measures are not reflected in the staff's baseline scenario.[5]

[5] If the authorities' plans are fully implemented, their fiscal targets would be achieved under staff's baseline macroeconomic scenario.

Staff Baseline and Authorities' Adjustment Scenario
(Percent of GDP unless indicated otherwise)

	2011	2012	2013	2014	2015	2016
Staff Baseline Scenario						
Headline balance	-2.6	-3.0	-1.8	-1.5	-1.1	-0.8
Structural balance	-2.0	-1.6	-1.3	-1.2	-0.9	-0.8
Debt	72.3	74.6	74.3	73.6	72.4	71.3
Output gap	-0.8	-1.5	-1.2	-0.8	-0.4	-0.2
Real GDP (percentage change)	2.7	0.8	1.8	1.8	1.8	1.7
Authorities' Adjustment Scenario						
Headline balance	-2.6	-3.0	-2.1	-1.5	-0.6	0.0
Structural balance	-2.4	-2.1	-1.7	-1.3	-0.7	-0.4
Debt	72.2	74.7	75.3	74.6	72.8	70.6
Output gap	0.0	-0.9	-1.0	-0.4	0.3	0.7
Real GDP (percentage change)	3.1	0.4	1.4	2.0	2.2	2.1

Sources: Austrian Stability Program 2011–16; and IMF staff projections.

17. **In addition, further fiscal costs from restructuring medium-sized banks are likely and aging-related fiscal pressures will emerge in the longer run.** In 2008–11, the government injected € 7½ billion (2½ percent of GDP) into banks, one third of which were or became capital transfers. This year has so far witnessed € 2.3 billion in bank support, mainly capital transfers. This year has so far witnessed an additional € 2.3 billion in bank support, mainly capital transfers. In addition, crisis-related federal government guarantees stood at € 17.2 billion at the end of 2011, with a guarantee of similar magnitude by a state to one of the nationalized banks. Against this background, medium-sized banks with significant public ownership will likely cause further fiscal needs.[6] In addition, there are fiscal pressures from an aging population: the European Commission projects the increase in Austria's aging-related expenditure at some 4½ percent of GDP between 2015 and 2050 from already one of the highest levels in the EU.[7]

18. **Improvements in the fiscal governance framework have advanced but not on all fronts.** At end-2011, parliament adopted a federal "debt brake" rule limiting the federal structural deficit (including social security) to 0.35 percent of GDP from 2017 onwards. Furthermore, in May 2012 a revamped domestic stability pact was approved that extends the "debt brake" to sub-national governments and restricts their overall structural deficit to 0.1 percent of GDP, also starting in 2017. However, these fiscal rules have not been enshrined in the constitution, as a sufficient parliamentary majority could not be mustered. In addition, not much progress has been made in the discussions on a reform of intra-governmental financial arrangements (Annex II).

[6] There are also contingent liabilities in non-financial public enterprises, as described in the 2011 IMF Staff Report.

[7] European Commission and Economic Policy Committee (2012), "The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060)", Brussels.

Box 2. Austria: The Authorities Consolidation Program 2012–16

In May 2012, the federal coalition government agreed on a broad array of measures to strengthen medium–term fiscal consolidation. The package is reflected in the medium-term fiscal framework 2013-2016, and entailed numerous legislative changes, including amendments to the 2012 budget. The authorities estimate the impact of these measures, defined as difference to no-policy-change revenue and expenditure of the same year, as follows:

The Authorities' Consolidation Package 2012
(In million euro, unless indicated otherwise)

	2012	2013	2014	2015	2016	*Total*
(1) Revenue increases 1/	1,198	2,270	2,157	2,268	2,597	10,490
(in percent of authorities' GDP projections)	*0.4*	*0.7*	*0.7*	*0.7*	*0.7*	
of which:						
Social contributions		227	289	350	429	1,295
Capital gains tax (real estate sales)	10	350	450	500	750	2,060
Financial transaction tax			500	500	500	1,500
Tax treaty w/ Switzerland		1,000	50	50	50	1,150
Anticipation of pension taxation	900	-75	-75	-75	-75	600
Tax increase for high incomes		110	110	110	110	440
(2) Expenditure reductions 1/	503	1,719	3,426	5,211	6,517	17,376
(in percent of authorities' GDP projections)	*0.2*	*0.5*	*1.0*	*1.5*	*1.8*	
of which:						
Public administration: wages 2013/14		206	253	311	311	1,081
other	55	185	283	461	479	1,463
Pensions: moderate pension increases 2013/14		400	720	720	720	2,560
other pension expenditure 2/		255	438	951	1,304	2,948
Subsidy reform				500	500	1,000
Health care reform (social insurance)	60	144	256	392	520	1,372
Expenditure consolidation states and municipalities	55	-68	595	791	1,279	2,652
(1)+(2): Sum of revenue and expenditure measures	1,701	3,989	5,583	7,479	9,114	27,866
(in percent of authorities' GDP projections)	*0.6*	*1.3*	*1.7*	*2.2*	*2.6*	

Source: Strategiebericht zum Bundesfinanzrahmengesetz 2013-2016; staff calculations and estimates.
1/ cumulative against authorities' baseline.
2/ further pension-related measures are included under "social contributions" above.

Almost 2/3 of the measures are taken on the expenditure side. There is a clear focus on the pension area, with more than a third of the estimated impact stemming from a limitation of pension increases below inflation in 2013/14. The measures underlying the envisaged cuts in subsidies and health care expenditure and the consolidation contributions by states and municipalities are back-loaded and still unspecified.

On the revenue side, the tax treaty with Switzerland, the anticipated taxation of corporate pensions, a capital gains tax on real estate sales, and a tax increase for high-income earners should fall on wealthier households and thus have very small multipliers.

As regards social contributions, several measures harmonize pension systems of different occupational groups and raise ceilings on contribution bases, while the exemption for older workers from unemployment insurance contributions has been lifted.

Staff's view

19. **The envisaged medium-term structural consolidation path strikes a good balance between fiscal prudence and growth considerations.** In structural terms, net of capital transfers to banks, the authorities' plans for 2013-16 would amount to an average annual adjustment of almost ½ percent of GDP, broadly in line with staff's recommendation in the 2011 Art IV consultation.

Provided that the new fiscal rules are adhered to and the consolidation is locked in after the authorities' planning horizon, this path should ultimately put debt on a downward trajectory even in case it is pushed up by additional bank restructuring cost. From a growth perspective, in the years when the economy is expected to be weaker (2012 and 2013), roughly half of the consolidation measures fall on wealthier households and are thus likely to have only rather modest effects on consumption. In case cyclical conditions deteriorate more than expected, it would be desirable to let automatic stabilizers work, though adverse effects on the credibility of the fiscal rules would have to be taken into account.[8] On the other hand, any relaxation of the envisaged consolidation path in structural terms could only be justifiably considered in case of a deep recession, as may arise from the realization of tail risks, such as a strong intensification of the euro area crisis. In this case, measures would need to be strictly temporary and targeted.

20. **Hence, the authorities should strictly implement the planned consolidation in structural terms, but also take further measures to anchor sustainability in the longer run.** The planned savings in health care, subsidies, and by states and municipalities should be rapidly underpinned by specific measures. Moreover, contingency plans would need to be designed to offset potential underperformance of consolidation measures or cope with the likely required additional bank support. Concerning the latter, the offsets should be calibrated to ensure that bringing the debt-to-GDP ratio back to its pre-crisis level of about 60 percent of GDP by the end of the decade remains achievable. Also, given rising aging cost pressures and long implementation lags for related measures, additional pension reforms should be legislated soon. This would prevent the deficit from expanding again after 2016 – a precondition for complying with the new fiscal rules and keeping the debt-to-GDP ratio down.

21. **While the introduction of a system of fiscal rules for general government is commendable, more progress is needed in fiscal governance reform**. Following earlier budget reforms, including a medium-term fiscal planning framework, the new fiscal rules are a further major step towards better fiscal governance, although anchoring them in the constitution would have provided a stronger commitment. Moreover, as emphasized in past consultations, incentives for rule compliance at subnational level would be strengthened if intra-governmental financial arrangements were streamlined, provided a stronger nexus between spending decisions and financing responsibilities, and granted meaningful tax autonomy to states. In connection with the negotiation of the next vintage of the financial equalization law, which expires in 2014, such reforms should be implemented**.**

The authorities' view

22. **The authorities assured that the envisaged consolidation path would be fully implemented.** They were confident in their budgetary projections and noted that the macroeconomic outlook was now somewhat better than the one used in the budget. Accordingly, for 2012 the issue of

[8] For the transition years 2012-16, the deficit targets in the domestic stability pact are formulated in terms of the headline rather than the structural deficit (Annex II).

automatic stabilizers to offset a downturn was likely to be moot. For later years, the authorities saw as a priority the need to ensure the credibility of the new fiscal rules. Furthermore, the authorities were skeptical about stimulus measures in case of a deeper crisis, pointing to the limited fiscal multipliers in a small open economy and the difficulty of finding suitable measures in light of the 2008–09 experience.

23. **Further reforms of fiscal federalism would be difficult in the short run.** The authorities assured that subnational governments would contribute their share to the consolidation effort, given the revamped domestic stability pact. On fiscal federalism, while optimistic that the next vintage of the fiscal equalization law would be ready in time, the authorities had low expectations as to the feasibility of deeper reforms. In this respect, they pointed, in particular, to the reluctance of states to accept any significant tax autonomy.

B. Managing Financial Sector Risks from Euro Area, CESEE, and Swiss Franc Exposures while Accelerating Medium-Size Bank Restructuring

Background

24. **Large banks met the June 2012 capital requirements set by the European Banking Authority (EBA).** The two large Austrian-owned banks subject to the requirement used a mix of genuine build-up of risk-bearing capacity (retained earnings, conversion of non-EBA-eligible liabilities into common equity, improved collateralization), and other measures such as risk-weighted assets optimization, reclassification of assets, and changes in accounting options. Compared to their European peers, large Austrian banks' capital adequacy remains on the low side, but their leverage is below the median. In addition, state capital injections received in 2009 still need to be repaid.

25. **The Austrian supervisory authorities introduced a set of macroprudential guidelines to strengthen the resilience of the banking sector**. The measures, introduced in March 2012, apply to the three largest Austria-based banks, all of which have large foreign operations (Box 3). They include early implementation of the Basel III capital requirements, a capital surcharge, the design of recovery and resolution plans, and close monitoring of subsidiaries' local stable financing for new lending. The latter is expected to limit the growth of Austrian banking sector's foreign exposures, as well as help reduce future funding and credit risk in subsidiaries, thereby fostering financial stability in host countries. As to the likely short-term impact of the guidance, banks cited strong local deposit growth and lackluster credit demand in CESEE as factors curbing cross-border funding needs in subsidiaries.

Box 3: Austrian Authorities' Supervisory Guidance on the Strengthening of the Sustainability of the Business Models of Large Internationally Active Austrian Banks

On March 14th, 2012, the Austrian supervisors issued new supervisory guidance for the largest three Austria-based banks after consultations with CESEE supervisors; the goal is to improve the sustainability of these banks' foreign operations (particularly those in CESEE) and secure financial stability both in Austria and in host countries. The guidance consists of three pillars:

- **Higher capital buffers.** Basel III capital rules have to be fully implemented by January 1st, 2013 without transitional provisions (though private and government participation capital issued under the Austrian bank support act will initially be included in the Core Tier I capital base), as well as a Core Tier I capital surcharge of up to 3 percentage points from January 1st, 2016. The rules governing the exact amount of this surcharge remain to be determined.

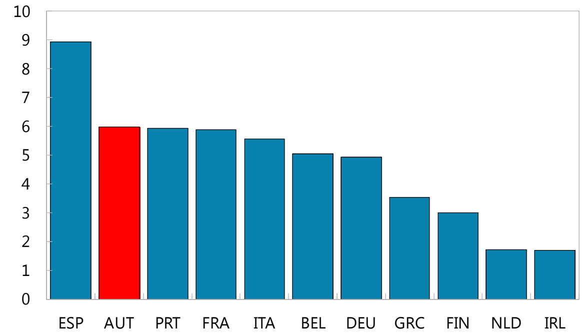
- **Promotion of stable local funding of subsidiaries.** Supervisors will monitor the funding of subsidiaries to encourage more reliance on local funding. The latter will be measured by the Loan-to-Local-Stable-Funding-Ratio (LLSFR), defined as loans to non-banks divided by local stable funding (i.e., deposits from non-banks + supranational funding + capital from third parties + total outstanding volume of debt securities with original maturities of one year or more issued by the subsidiary to investors outside their consolidated group). The "LLSFR flow ratio" is defined using the year-on-year changes in the numerator and the denominator of the LLSFR. Subsidiaries with a stock-LLSFR above 110 percent shall achieve a sustainable flow-LLSFR so as to reduce their LLSFR over time to below 110 percent, unless home and host supervisors agree that (i) there are no impediments to liquidity transfers between parent and subsidiary and there would not be any in a stress situation either; and (ii) a burden sharing agreement is in place between the supervisory and fiscal authorities of the countries concerned. In any case, the Austrian supervisors will place a particular focus on subsidiaries with a current LLSFR exceeding 110 percent. In addition, parent banks are expected to price intragroup liquidity transfers taking into account adequate risk, in line with the relevant EBA guidelines.

- **Recovery and resolution plans**. Parent banks must have these plans submitted by end-2012.

26. **A number of medium-sized banks continue to need government support.** Earlier this year, the government semi-nationalized the fourth largest bank after delays in the implementation of its restructuring plan contributed to large losses. Another bank, nationalized in 2009, still struggles to make a profit, needs to improve its capital adequacy, and so far has not found buyers for its units earmarked for sale. A bad bank created from another nationalized institution made large losses following the Greek PSI, has large residual exposures to the EA periphery, and a large negative gap between the book value and the market value of its portfolio. Losses on Greek bonds also erased one third of the capital of the associated good bank. While nationalized banks have generally reduced their balance sheet size though disposals, the process has been slow, and valuations of some of the remaining assets remain uncertain.

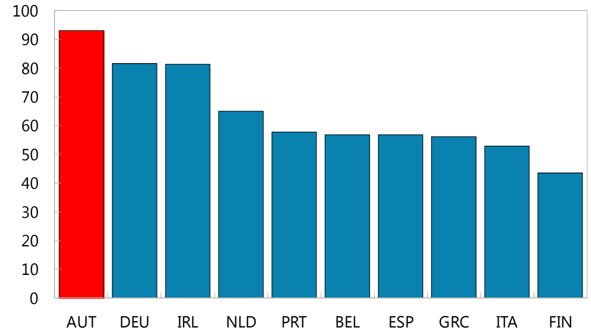
27. **The domestic banking sector shows signs of overcapacity.** While the number of banks (head offices) has been on a declining trend in the past few quarters, it remains very large (824 at end-2011). The number of branches has increased by 6 percent during 2011, and branch and bank employee density are high in international comparison.[9] In addition, the profitability of domestic banking activities has been consistently low, so that banks have relied on their foreign operations to try to achieve their return on equity targets.[10]

Selected Euro Area Countries: Bank Branches per 10000 Inhabitants, 2011 1/



1/ Population data for 2010
Sources: ECB; World Bank; and IMF staff calculations.

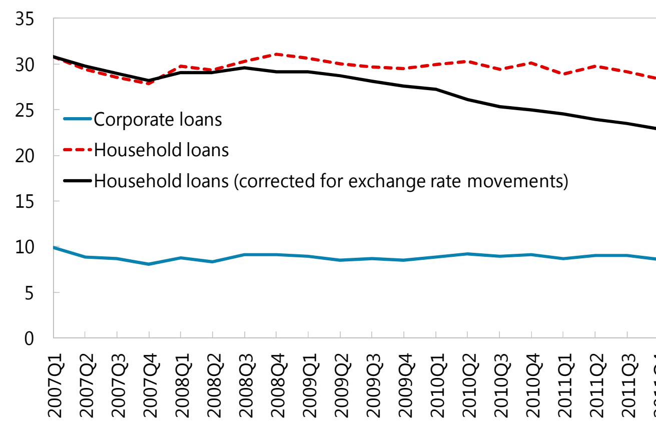
Selected Euro Area Countries: Number of Bank Employees per 10000 Inhabitants, 2011 1/



1/ Population data for 2010
Sources: ECB; World Bank; and IMF staff calculations.

28. **The large stock of Swiss franc-denominated loans in Austria is a vulnerability.** Following strong supervisory measures and adverse exchange rate movements, the flow of foreign currency loans has been negligible for the last three years. However, at end-2011 28.4 percent of credit to households was still denominated in foreign currency (mostly the Swiss franc). Among these loans, 75 percent of loans to households and 18 percent loans to businesses are associated with repayment vehicles (RPVs), i.e. principal repayments are invested in securities or life insurance products. A recent survey shows a funding gap in RPVs

Share of Foreign Currency Loans
(In percent of total loans)



Sources: OeNB; and IMF staff calculations.

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[9] The peer comparison group includes countries such as Belgium, Ireland, the Netherlands and Spain, which have a banking sector of a similar or larger size relative to GDP compared to Austria's. The relatively large number of bank employee density cannot be attributed to Austria being a regional financial center because large international Austrian banks have a retail focus and the vast majority of their staff is employed by subsidiaries abroad.

[10] Likely impediments to a rationalization of banking sector capacity in the past include a variety of factors, such as the ability to generate profits through foreign expansion in the years of the CESEE boom, the historical importance of the cooperative sector, collective labor agreements making layoffs difficult, and a lack of bank resolution tools.

of around EUR 4 billion for Swiss-franc-denominated RPV-loans, or 19 percent of the outstanding volume, mostly reflecting the appreciation of the Swiss franc.

Staff's view

29. **Intensive monitoring of the banking system is warranted in light of the fragile European market situation.** Staff emphasized the importance of contingency planning for the downside scenario of an escalating euro-area crisis. While the banking system's liquidity situation appeared comfortable in the aggregate as a result of the build-up of liquid assets and eligible collateral as well as efforts to increase the maturity of foreign currency funding and recent ECB actions, pockets of vulnerabilities could re-emerge quickly, which may require policy intervention. In the context of crisis preparedness for cross-border financial groups, cooperation with host supervisors is also key.

30. **Staff welcomed the new macroprudential guidelines for large Austrian banks and encouraged the involvement of supervisory colleges in their implementation.** Staff had emphasized the need to build up strong capital buffers against future risks, especially in the too-big-too-fail institutions, during last year's Article IV consultation. Early implementation of the new Basel III capital requirements and capital surcharges on systemic banks will increase the capacity of these institutions to absorb unexpected losses. The requirement to draft recovery and resolution plans is a potentially important crisis management tool. Lastly, close monitoring of the funding structure of foreign subsidiaries to encourage reliance on local funding for new lending should help reduce structural vulnerabilities. Staff analysis suggests that the LLSFR is an important and appropriate monitoring tool, and that the enforcement of a threshold of 110 should not be mechanistic (see Box 4 and forthcoming Selected Issues Paper "Funding of Austrian Banks' Subsidiaries and Associated Risks"). In addition, any corrective measures should be discussed in the context of supervisory colleges, especially in light of the present concerns about possible disruptive deleveraging. Finally, the mission warned about the risk of circumvention through cross-border lending by the parent bank.

Box 4. Funding of Austrian Banks' Subsidiaries and Associated Risks

Evidence for CESEE banks suggests that the loan-to-local-stable-funding ratio (LLSFR) is an appropriate tool to monitor credit risk. In a sample of CESEE banks, including many foreign bank subsidiaries, a measure of credit risk (the change in banks' loan-loss provisions) in the two years following the Lehman Brothers bankruptcy (2008–10) is positively and significantly associated with the banks' loan-to-deposit ratio (LDR) at the end of 2008, even after controlling for aggregate factors and individual bank loan growth. The LDR is a close proxy for the LLSFR, the ratio monitored by the Austrian supervisors, which cannot be computed based on publicly available data. This suggests that the use of the LLSFR as a vulnerability indicator related to credit risk in a supervisory context is warranted.

At the same time, the data caution against the mechanistic implementation of any specific threshold for supervisory action. The dispersion in the change in asset quality after the shock of end-2008 is large for any particular level of the LDR, suggesting that significant credit risk can also build up in banks with a low LDR. Furthermore, the jump in the average deterioration in asset quality seems to take place at a somewhat higher level than the LLSFR threshold of 110 percent in the Austrian supervisors' guidelines. Thus, while a conservative threshold of 110 will clearly reduce Austrian banking groups' funding and liquidity risk, from the point of view of curbing credit risk a less conservative threshold may be acceptable.

31. **Restructuring of intervened mid-sized banks should be accelerated and take into account excess capacity in Austria.** The recent experience with medium-sized banks where the government had to take a significant ownership stake has shown the cost of delaying the disposal of legacy and non-core assets. While most intervened banks have reduced their balance sheet size, the restructuring process has been slow. Introducing more flexible structures to facilitate the efficient disposal of assets would help contain final fiscal costs. In addition, the exit strategy from government ownership following balance sheet clean-up should take into account the fact that the Austrian market is overbanked.

32. **Putting in place a new early intervention and bank resolution framework should be a priority.** Stronger intervention tools would give the Austrian supervisors a stronger mandate to impose early and forceful corrective measures, while a new resolution regime – including revamped deposit insurance – would provide more flexibility in dealing with insolvent institutions. Early legislation on the matter consistent with FSB recommendations and the June 2012 EC proposal would be desirable.

33. **Banks' capital allocation against the risks related to foreign currency loans with repayment vehicles in Austria should be conservative.** While these loans are currently performing well, the sizable funding gap in repayment vehicles indicates that problems may arise when loans mature. To guard against this risk, a review of parameters used in banks' internal risk models is warranted to make sure that banks are well prepared for persistent funding gaps.

The authorities' view

34. **The authorities indicated that, although there had been no sign of significant stress so far, they had stepped up their monitoring of banking sector liquidity, including intra-group exposures.** Banks have been encouraged to pay particular attention to their funding and liquidity profiles, in particular in foreign currency, and have increased their pool of ECB-eligible collateral. In addition, the authorities conduct regular macroeconomic stress tests. A cross-border stability group formed last year with several CESEE countries was expected to hold its first crisis simulation exercise in early July, and would be an opportunity to discuss burden-sharing issues for the first time.

35. **Any supervisory action related to the new guidelines on the funding model of subsidiaries would be the outcome of a process in the context of supervisory colleges.** The monitoring of trends in the "sustainability" of subsidiaries' loan book growth started in 2012Q1, a first full assessment will take place at year-end based on year-on-year data, and deeper consultations with host supervisors would then take place about the appropriate course of action in case of deviations from the guidelines. The authorities were aware of the risk of circumvention through cross-border lending but viewed it as small and relatively easy to monitor.

36. **The authorities were open to a review of the strategy for the disposal of legacy assets in banks with significant state ownership, and agreed that there was scope for a reduction in overbanking in the Austrian market.** They agreed that delays in restructuring were often costly, but argued that all institutional structures aimed at winding down portfolios had their pros and cons. On

overbanking in Austria, they shared staff's view that greater cost efficiency would be welcome as it would improve capital generation capacity. They foresaw that the gradual implementation of Basel III standards would foster consolidation of small institutions, while EC state aid rules would likely force intervened banks to downsize their domestic operations.

37. **Adopting a new framework for early intervention and bank resolution is a priority.** The authorities reported that a concept paper for new domestic legislation based on principles consistent with the European Commission's June 2012 proposal had been prepared and discussed by interested parties in mid-June. They were also considering a reform of the Austrian deposit insurance framework that would include the move to an ex ante funding mechanism. The Austrian parliament adopted a motion in early July asking the government to look into these issues.

38. **Austrian supervisors plan to strengthen the risk management of Swiss franc loans to unhedged borrowers in Austria through the publication of more detailed guidelines and the supervisory process, in line with ESRB recommendations issued last year.** The Austrian guidelines issued in 2003 and 2010 will be reviewed and updated by the end of the year in particular with respect to internal risk pricing and capital allocation. The authorities are considering taking supervisory measures through Basel II's second pillar in the course of next year. The authorities also noted that banks can build up capital buffers gradually as the first large vintage of Swiss franc mortgages will mature only in 2017. Finally, they pointed out that households who borrowed in foreign currency had higher average income, a factor limiting downside risk.

C. Increasing Growth by Improving Incentives to Work

Background

39. **Labor force participation by some groups is low in international comparison**. While female and youth employment rates are high and the percentage of long-term unemployed is low, the employment rate of older workers is much lower than in most OECD countries (Annex III). The average effective retirement age is at around 59 years for men and 57 years for women, well below the statutory age. The unemployment rate is high among unskilled workers, and a considerable share of workers, especially women, is employed part-time.

40. **Incentives for early retirement remain despite several steps to reduce them**. Access to the early retirement scheme for long-term contributors has been limited, and further tightening is envisaged for 2014, but other paths to early retirement exist, including through disability or occupational pensions. Rehabilitation efforts for disabled workers have recently been enhanced and eligibility criteria tightened, but the range of alternative occupations against which disability is assessed remains relatively narrow. The penalty for the regular early retirement scheme was raised in the mid-2000s to 4.2 percent per year and is slated for a further rise to 5.1 percent in 2017, still

somewhat below most estimates of the actuarially neutral adjustment.[11] The statutory retirement age for women is 60 years—5 years less than for men, a rare disparity for advanced economies.

41. **Austria has some of the highest tax wedges among advanced economies, so that for some individuals work does not pay.** High social security contributions and the interaction of tax and benefit systems contribute to the wedges. Tax wedges for both primary and secondary earners are among the highest in the OECD, the latter reflecting the sole-earner tax credit among other things. At the same time, a combination of relatively high sectoral minimum wages and social security contribution may be pricing low-skilled workers out of the market. These wedges likely explain the low employment rate among the low-skilled and the prevalence of part-time work.

Staff's view

42. **Further action to increase employment of older workers is desirable.** While there has been commendable progress in several areas, the disability regime remains relatively liberal and robust implementation of the rehabilitation and reintegration efforts is key to achieve the desired progress. As the retirement scheme for long-term contributors is made less attractive, it is important to ensure that alternative avenues into early retirement do not see a spike in usage. The planned increase in the early retirement penalty for standard pensions is welcome, but it would still remain below the actuarially neutral value. At the same time, there is clear scope for accelerating the timetable for unifying female and male statutory retirement ages and for tying both to life expectancy. To increase the willingness of employers to hire older workers, a review of age-based wage premiums in collective labor contracts would be important.

43. **The burden on labor resulting from high taxes and social security contributions should be reduced to increase labor supply and potential growth.** A budget-neutral reduction in social security contributions, particularly for low-skilled workers, and a redesign of taxes and benefits to smooth high and uneven marginal effective tax rates would be beneficial to labor force participation. The budgetary impact could be offset by spending reductions or increases in less distorting forms of taxation, such as environmental, excise, or real estate taxes. The latter is especially low in international comparison and could also be used to strengthen the tax autonomy of subnational governments. Model simulations (see Annex III) show that reducing labor taxes by one percentage point of GDP in a budget-neutral manner can increase output in the long run by as much as ¾ percent.

The authorities' view

44. **The authorities stressed that measures taken in recent years will increase labor supply and saw a reduction in the burden on labor as desirable.** With respect to older workers, their focus has been on bringing the effective retirement age closer to the statutory age rather than increasing the latter, and they expect a substantial increase in labor force participation of older workers as a result of actions already taken or planned. They also noted steps to increase availability of daycare,

[11] The 2011 *OECD Survey* of Austria cites an estimate of 6 percent by Austrian experts and 7.5 percent by the OECD.

which should stimulate female labor supply. The government and the social partners recognize that labor taxation and tax wedges are high and share a desire to reduce them in a budget-neutral way, but agreement is still lacking on how to pay for the cuts.

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45. **The ongoing rebalancing of GDP growth toward domestic demand is welcome**. Real wage growth is picking up, facilitating a shift in demand toward private consumption and resulting in a decline in Austria's current account surplus. The continuation of these developments would contribute to restoring macroeconomic equilibrium within the monetary union.

46. **The new consolidation path strikes a good balance between fiscal prudence and growth considerations and should be fully implemented in structural terms.** The planned average annual structural adjustment would foster the credibility of the new fiscal rules and should eventually put debt on a downward path. The envisaged adjustment is also relatively growth-friendly. Its full implementation needs to be ensured by rapidly identifying specific measures in health care, subsidies, and at the subnational level. To the same end, contingency plans need to be designed in case some consolidation steps do not generate the projected yield or new outlays emerge, with the possibility of further bank restructuring costs an area of particular concern.

47. **To anchor debt reduction and sustainability in the medium and long term, further expenditure reforms will be necessary.** Even if a structural deficit close to balance is reached by 2016 as envisaged, aging-cost pressures will tend to push it up again and hamper further debt reduction. To contain these pressures, the authorities should soon adopt additional reforms, given the long implementation lags of such policies in particular in the pension area. The other main areas to tackle remain health care spending as well as subsidies.

48. **While the recent introduction of a system of fiscal rules is commendable, more progress is needed in fiscal governance reform.** Incentives for compliance with fiscal rules at the subnational level would be strengthened by streamlining intra-governmental financial arrangements, establishing a stronger nexus between spending decisions and financing responsibilities, and granting meaningful tax autonomy to states. These reforms should take place in connection with the renewal of the fiscal equalization law.

49. **Intensive monitoring of systemic banks, including through regular stress tests, is warranted in light of the fragile European market situation.** The recent increase in capital ratios in large banks is the result of genuine build-up of risk-bearing capacity, one-off accounting changes, and risk-weighted asset optimization. However, the continuing need to provision against non-performing loans keeps hampering profitability, thus reducing internal capital generation capacity. Swiss franc loans to unhedged borrowers in Austria are also a source of risk, which the authorities are rightly planning to address through additional supervisory measures.

50. **The mission welcomes the new macroprudential guidelines for large Austrian banks**. Early implementation of the new Basel III capital requirements and capital surcharges on systemic banks will increase the capacity of these institutions to absorb unexpected losses. The requirement to draft recovery and resolution plans is a potentially important crisis management tool. Lastly, close monitoring of the funding structure of foreign subsidiaries to encourage reliance on local funding for new lending should help reduce structural vulnerabilities. Appropriately, the monitoring will take place in close cooperation with host country supervisors

51. **The authorities should develop a strategy for a more efficient disposal of legacy assets in banks with substantial government ownership with the goal of minimizing final fiscal costs**. The recent experience with medium-sized banks has shown the cost of delaying the disposal of legacy and non-core assets. A revised strategy should provide for more rapid and flexible balance sheet clean up. The exit strategy from government ownership should take into account the need to reduce overbanking in the Austrian market.

52. **Putting in place a new early intervention and bank resolution framework should be a priority.** Stronger intervention tools would give the Austrian supervisors a better basis – and clearer responsibility – to impose early and forceful corrective measures. The authorities have started consultations on the design of a new national framework based on principles consistent with the European Commission's June 2012 proposal. We encourage rapid progress on this front and reliance on international best practice should there be further delays in the EU legislative process.

53. **Substantial steps have been taken to increase the employment of older workers, and further action is desirable**. Robust implementation is essential for maximizing the impact of measures already taken. In addition, the authorities and the social partners should continue on the road of reform. Specifically, there is clear scope for accelerating the timetable for unifying female and male statutory retirement ages and tying both to life expectancy. Further efforts to improve the employability of older workers (including reducing age-based wage premiums) would also be welcome.

54. **Taxation of labor should be reduced in a budget-neutral way to foster labor supply and increase potential growth**. A reduction in social security contributions would lower the tax burden on labor; there is also a case for smoothing marginal effective tax rates to improve incentives to get employment or move from part-time to full-time work. The fiscal impact could be offset by spending reductions or increases in less distortionary forms of taxation, such as environmental, excise, or real estate taxes. The latter is especially low in international comparison, and its increase could also strengthen the tax autonomy of subnational governments.

55. **It is recommended that the next Article IV consultation with Austria be held on the usual 12-month cycle.**

Table 1. Austria: Selected Data, 2007–13

Total area	83,850 square kilometers
Total population (2011)	8.4 million
GDP per capita (2011)	US$ 49,818 (35,868 Euro)

	2007	2008	2009	2010	2011	2012	2013
						Projections	
	(change in percent unless indicated otherwise)						
Demand and supply							
GDP	3.7	1.4	-3.8	2.1	2.7	0.8	1.8
Total domestic demand	2.5	0.7	-2.0	1.8	2.5	0.9	1.9
Consumption	1.2	1.6	0.9	1.3	0.5	0.8	1.2
Gross fixed capital formation	3.6	0.7	-7.8	0.8	7.3	1.5	3.2
Net exports (growth contribution in pp)	1.4	0.8	-2.3	0.4	0.4	0.0	0.1
Exports of goods and nonfactor services	8.9	1.4	-15.6	8.7	7.2	2.0	4.0
Imports of goods and nonfactor services	7.1	0.0	-13.3	8.8	7.2	2.1	4.3
Output gap (percent of potential GDP)	3.7	3.3	-2.3	-2.0	-0.8	-1.5	-1.2
Employment and unemployment							
Employment	1.9	1.3	-1.5	0.6	1.8	0.6	0.6
Unemployment rate (in percent)							
Registered (national definition)	6.2	5.8	7.2	6.9	6.7	6.8	6.8
Standardized (Eurostat)	4.4	3.8	4.8	4.4	4.2	4.3	4.3
Prices							
Consumer price index (period average)	2.2	3.2	0.4	1.7	3.6	2.3	1.9
General government finances (percent of GDP)							
Revenue	47.6	48.3	48.5	48.1	48.0	48.6	48.7
Expenditure	48.6	49.3	52.6	52.6	50.6	51.6	50.5
Balance (EDP-definition)	-0.9	-0.9	-4.1	-4.5	-2.6	-3.0	-1.8
Structural Balance	-2.6	-2.4	-3.0	-3.0	-2.0	-1.6	-1.3
Gross debt (end of period)	60.2	63.8	69.2	71.8	72.3	74.6	74.3
Balance of payments							
Trade balance (goods) (in billion euro)	1.3	-0.6	-2.4	-3.2	-7.0	-8.1	-8.5
Current account (in billion euro)	9.6	13.8	7.5	8.6	5.9	5.2	5.3
(In percent of GDP)	3.5	4.9	2.7	3.0	1.9	1.7	1.7

Sources: Austrian authorities; Datastream; and IMF staff estimates and projections.

Table 2. Austria: Medium-Term Macroeconomic Framework, 2007–17

(In percent of GDP unless indicated otherwise)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
						Projections					
National accounts											
GDP (growth in percent)	3.7	1.4	-3.8	2.1	2.7	0.8	1.8	1.8	1.8	1.7	1.6
Total domestic demand	2.5	0.7	-2.0	1.8	2.5	0.9	1.9	1.9	1.9	1.8	1.7
Consumption	1.2	1.6	0.9	1.3	0.5	0.8	1.2	1.4	1.4	1.4	1.4
of which: Private consumption	0.9	0.7	1.1	1.7	0.7	0.9	1.3	1.4	1.4	1.4	1.4
Gross fixed capital formation	3.6	0.7	-7.8	0.8	7.3	1.5	3.2	3.2	3.1	2.9	2.7
Exports of goods and nonfactor services	8.9	1.4	-15.6	8.7	7.2	2.0	4.0	4.5	4.6	4.5	4.5
Imports of goods and nonfactor services	7.1	0.0	-13.3	8.8	7.2	2.1	4.3	4.8	4.9	4.9	4.9
Growth contributions (percentage points)											
Final domestic demand	1.6	1.2	-1.0	1.1	1.8	0.9	1.5	1.7	1.6	1.6	1.6
Net exports	1.4	0.8	-2.3	0.4	0.4	0.0	0.1	0.1	0.0	0.0	0.0
Inventories and statistical discrepancies	0.7	-0.6	-0.5	0.5	0.5	-0.1	0.2	0.1	0.1	0.1	0.0
Prices and unemployment											
CPI inflation (pa; annual percent change)	2.2	3.2	0.4	1.7	3.6	2.3	1.9	1.9	1.9	1.9	1.9
Unemployment rate (percent)	4.4	3.8	4.8	4.4	4.2	4.3	4.3	4.2	4.1	4.0	4.0
Current account balance	3.5	4.9	2.7	3.0	1.9	1.7	1.7	1.6	1.5	1.4	1.2
Goods and services balance	4.5	4.8	3.7	3.5	2.3	2.2	2.2	2.1	2.0	1.9	1.7
General government accounts											
Revenue	47.6	48.3	48.5	48.1	48.0	48.6	48.7	48.5	48.5	48.5	48.5
Expenditure	48.6	49.3	52.6	52.6	50.6	51.6	50.5	50.0	49.5	49.3	49.3
Balance	-1.0	-1.0	-4.1	-4.5	-2.6	-3.0	-1.8	-1.5	-1.1	-0.8	-0.8
Gross debt	60.2	63.8	69.2	71.8	72.3	74.6	74.3	73.6	72.4	71.3	69.8
Structural balance	-2.6	-2.4	-3.0	-3.0	-2.0	-1.6	-1.3	-1.2	-0.9	-0.8	-0.8
Memorandum items:											
Overall balance (EDP-definition)	-0.9	-0.9	-4.1	-4.5	-2.6	-3.0	-1.8	-1.5	-1.1	-0.8	-0.8
Gross national saving	26.6	27.7	23.8	24.6	25.2	25.1	25.6	25.9	26.1	26.2	26.2
Gross domestic investment	23.1	22.8	21.0	21.6	23.2	23.4	23.9	24.2	24.6	24.8	25.0
Potential output (growth in percent)	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.5	1.5	1.5	1.5
Output gap (in percent of potential output)	3.7	3.3	-2.3	-2.0	-0.8	-1.5	-1.2	-0.8	-0.4	-0.2	0.0
GDP (current prices, in billion euro)	274.0	282.7	276.2	286.4	300.7	308.5	319.8	331.4	343.5	355.4	367.4

Sources: Austrian authorities; and IMF staff estimates and projections.

Table 3. Austria: Balance of Payments, 2007–17

(In percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Projections						
Current account	3.5	4.9	2.7	3.0	1.9	1.7	1.7	1.6	1.5	1.4	1.2
Trade	4.5	4.8	3.7	3.5	2.3	2.2	2.2	2.1	2.0	1.9	1.7
Exports	57.8	58.3	49.3	53.3	56.3	57.2	58.2	59.4	60.7	62.0	63.6
Imports	53.2	53.5	45.6	49.8	53.9	55.0	56.0	57.3	58.6	60.2	61.9
Goods	0.5	-0.2	-0.9	-1.1	-2.3	-2.6	-2.7	-2.8	-2.9	-3.2	-3.4
Exports	43.3	43.0	35.1	38.9	41.5	41.9	42.6	43.5	44.5	45.5	46.6
Imports	42.9	43.2	36.0	40.0	43.8	44.6	45.3	46.3	47.4	48.6	50.0
Nonfactor services	4.1	5.0	4.6	4.6	4.7	4.8	4.8	4.9	5.0	5.0	5.1
Exports	14.5	15.3	14.2	14.4	14.8	15.3	15.6	15.9	16.2	16.6	17.0
Imports	10.4	10.3	9.6	9.8	10.1	10.5	10.7	11.0	11.2	11.5	11.9
Balance on factor income	-0.6	0.6	-0.4	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Credit	11.4	10.7	9.0	9.7	9.8	9.7	9.7	9.7	9.7	9.7	9.7
Debit	12.0	10.1	9.4	9.4	9.5	9.5	9.5	9.5	9.5	9.5	9.5
Current transfers, net	-0.4	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Capital and financial accounts	-4.1	-5.3	-3.6	-0.6	-2.4	-1.7	-1.7	-1.6	-1.5	-1.4	-1.2
Capital account, net	0.1	0.0	0.0	0.0	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
FDI, net	-2.0	-5.4	0.0	-1.1	-4.4	-4.3	-4.2	-4.1	-4.0	-4.0	-4.0
Portfolio investment, net	8.3	9.4	-2.5	-2.4	4.9	5.4	5.9	5.9	5.9	5.9	5.9
Financial derivatives	-0.3	0.1	0.2	-0.1	0.3	0.2	0.1	0.1	0.1	0.1	0.1
Other	-9.5	-9.5	-2.1	3.2	-2.8	-2.8	-3.3	-3.4	-3.4	-3.2	-3.0
Reserve assets	-0.7	0.2	0.9	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.6	0.4	0.9	-2.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Austrian National Bank; WIFO; and IMF staff projections.

Table 4. Austria: General Government Operations, 2007–17

(In percent of GDP, unless indicated otherwise)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Projections				
Revenue	47.6	48.3	48.5	48.1	48.0	48.6	48.7	48.5	48.5	48.5	48.5
Taxes	27.3	28.1	27.4	27.2	27.3	27.8	28.0	27.9	28.0	28.1	28.1
Indirect taxes	13.9	14.1	14.6	14.5	14.3	14.4	14.4	14.2	14.1	14.0	14.0
Direct taxes	13.3	14.0	12.7	12.7	13.0	13.4	13.6	13.7	13.9	14.1	14.1
Social contributions	15.7	15.9	16.5	16.3	16.2	16.3	16.3	16.3	16.3	16.3	16.3
Other current revenue	4.7	4.4	4.6	4.7	4.5	4.5	4.4	4.3	4.2	4.1	4.1
Expense	48.7	49.4	52.7	52.7	50.6	51.6	50.5	50.0	49.5	49.3	49.3
Compensation of employees	9.0	9.2	9.8	9.7	9.4	9.5	9.3	9.2	9.2	9.1	9.1
Goods and services	4.2	4.5	4.7	4.5	4.3	4.3	4.2	4.1	4.0	4.0	4.0
Interest	2.9	2.7	2.8	2.6	2.6	2.7	2.7	2.7	2.6	2.6	2.5
Subsidies	3.3	3.5	3.6	3.5	3.6	3.6	3.7	3.7	3.6	3.6	3.6
Social benefits	23.2	23.6	25.4	25.3	24.6	25.0	24.8	24.7	24.5	24.5	24.5
Other expense	6.1	6.0	6.4	7.0	6.1	6.6	5.9	5.6	5.6	5.4	5.4
Net operating balance	-1.1	-1.1	-4.2	-4.6	-2.6	-3.0	-1.8	-1.5	-1.1	-0.8	-0.8
Net acquisition of non-financial assets	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending / Net borrowing	-1.0	-1.0	-4.1	-4.5	-2.6	-3.0	-1.8	-1.5	-1.1	-0.8	-0.8
Memorandum item:											
Primary balance	1.9	1.7	-1.3	-1.8	0.0	-0.4	0.9	1.1	1.6	1.7	1.7
Structural balance	-2.6	-2.4	-3.0	-3.0	-2.0	-1.6	-1.3	-1.2	-0.9	-0.8	-0.8
Change in structural balance	0.1	0.3	-0.6	0.0	1.0	0.4	0.3	0.1	0.3	0.1	-0.1
Public debt	60.2	63.8	69.2	71.8	72.3	74.6	74.3	73.6	72.4	71.3	69.8

Sources: Austrian authorities and IMF staff projections.

Table 5. Austria: Financial Soundness Indicators for the Banking Sector, 2008–11

(Percent)

	2008	2009	2010	2011
Capital adequacy				
Regulatory capital to risk-weighted assets 1/	12.9	15.0	15.4	15.8
Regulatory Tier I capital to risk-weighted assets 1/	9.3	11.1	11.7	12.0
Capital to assets (percent) 2/	6.3	7.0	7.5	7.2
Large exposures to capital 2/	67.6	55.5	64.8	62.9
Nonperforming loans net of loan-loss provisions to capital 2/	8.6	6.3	8.2	8.0
Asset quality				
Nonperforming loans to total gross loans 2/	1.9	2.3	2.8	2.7
Sectoral distribution of loans to total loans 3/				
Residents	67.4	68.7	70.0	70.0
Deposit-takers	28.1	27.7	25.2	25.4
Central bank	1.0	1.4	1.4	2.0
Other financial corporations	3.2	3.2	3.2	2.9
General government	3.1	3.4	3.8	4.0
Nonfinancial corporations	16.6	16.9	18.4	18.1
Other domestic sectors	15.4	16.2	18.1	17.7
Nonresidents	32.6	31.3	30.0	30.0
Geographical distribution of loans to total loans 2,3/				
Domestic economy	67.4	68.7	70.0	70.0
Advanced economies, excluding China	12.1	15.4	13.7	14.5
Emerging market and developing countries, including China	20.5	15.9	16.3	15.6
Africa	0.1	0.1	0.1	0.1
of which: Sub-Sahara Africa	0.0	0.1	0.1	0.1
Central and Eastern Europe	16.3	13.0	13.2	12.6
Commonwealth of Independent States and Mongolia	3.2	2.0	2.1	2.0
Developing Asia, including China	0.2	0.4	0.4	0.4
Middle East	0.4	0.4	0.4	0.3
Western Hemisphere	0.3	0.1	0.1	0.1
Earnings and profitability 1/				
Return on assets	0.1	0.1	0.5	0.1
Return on equity	2.6	1.5	7.9	1.4
Net interest income to gross income	64.6	69.7	67.4	63.3
Noninterest expenses as a percentage of gross income	90.4	86.0	83.0	87.4
Liquidity 2/				
Liquid assets to total assets	26.8	26.1	23.5	25.4
Liquid assets to short-term liabilities	69.7	76.2	68.0	71.6
Net open position in foreign exchange to capital	1.6	0.6	0.3	0.1
Other FSIs 2/				
Gross asset position in derivatives as a percentage of tier 1 capital	n.a.	n.a.	n.a.	n.a.
Gross liability position in derivatives as a percentage of tier 1 capital	n.a.	n.a.	n.a.	n.a.
Trading income as a percentage of gross income	-4.0	2.8	3.4	1.7
Personnel expenses as a percentage of noninterest expenses	50.6	51.4	50.3	51.2
Spread between reference lending and deposit rates (basis points)	232.0	191.0	197.0	208.0
Spread between highest and lowest interbank rates (basis points)	n.a.	n.a.	n.a.	n.a.
Foreign currency-denominated loans to total loans	25.6	22.4	22.1	21.4
Foreign currency-denominated liabilities to total liabilities	19.4	14.4	11.3	12.0
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.

Sources: OeNB; and fsi.imf.org.
1/ Domestically controlled, cross-border and cross sector consolidation basis
2/ Domestic consolidation basis
3/ Total loans include loans to financial institutions

Table 6. Authorities' Response to Past IMF Policy Recommendations

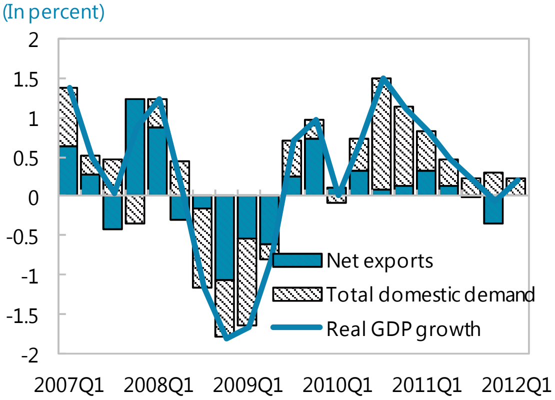
(Scale—fully consistent, broadly consistent, or marginally consistent)

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal policy I Implement consolidation measures of at least ½ percent of GDP annually, mainly through expenditure rationalization in three areas: pensions, health care and subsidies.	**Broadly consistent** New medium-term fiscal framework envisages average annual structural adjustment of almost ½ percent of GDP. Focus on pension area, but more needs to be done. Health care and subsidy measures still need to be specified.
Fiscal policy II Strengthen Domestic Stability Pact.	**Broadly consistent** Comprehensive new fiscal rule framework, including revamped Domestic Stability Pact.
Fiscal policy III Streamline intergovernmental fiscal relations and create stronger nexus between spending and financing responsibilities at the subnational level.	**Marginally consistent** No substantial progress.
Financial sector policy I Take macroprudential measures to address risks posed by systemically important banks.	**Broadly consistent** New macroprudential guidelines for internationally active banks have been issued. EBA capital exercise also leading to stronger capital for systemically important banks.
Financial sector policy II Strengthen early intervention powers for bank supervisors and revisit the institutional framework for bank supervision and regulation, including with respect to macro-prudential policy.	**Marginally consistent** Consultations have begun on a reform of early intervention and bank resolution. No plans yet for other reforms.
Structural reforms Increase labor market participation of low-skilled, older and female workers and strengthen human capital formation through reforms of the education system.	**Broadly consistent** Pension reforms to rein in early retirement have been strengthened but more needs to be done. Tax wedges and major education reforms still to be addressed.

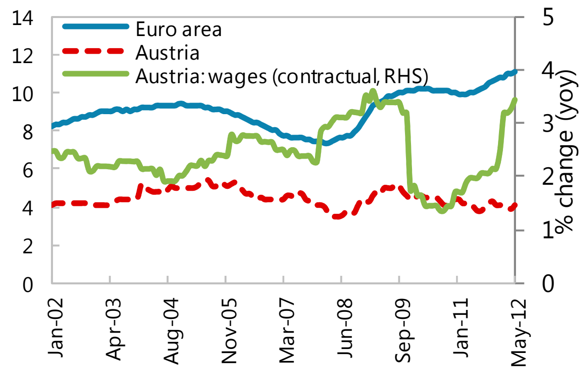
Figure 1. Austria: Recent Economic Developments

Macroeconomic conditions are relatively healthy.

Real GDP Growth and Growth Contributions
(In percent)

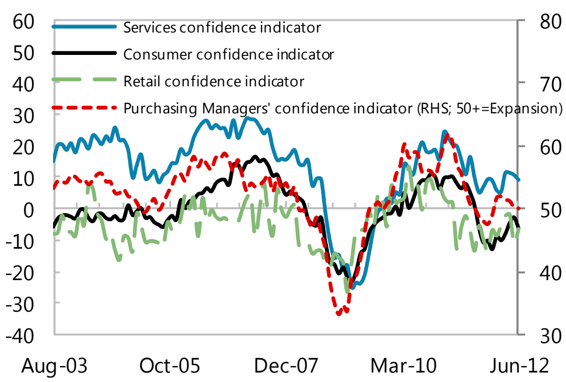


Harmonized Unemployment Rate
(In percent)

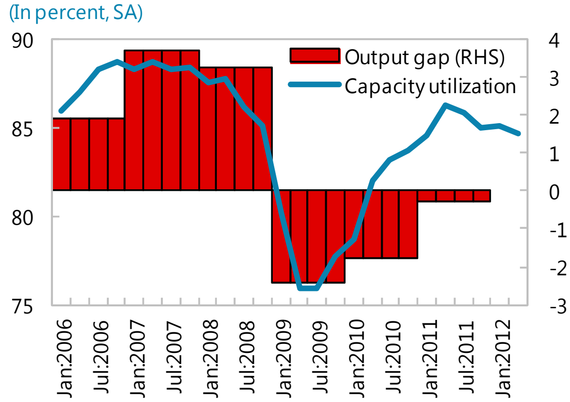


Indicators point to a modest upswing.

Confidence Indicators and PMI

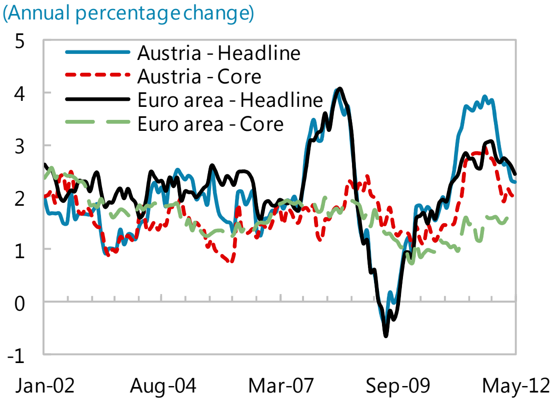


Capacity Utilization
(In percent, SA)



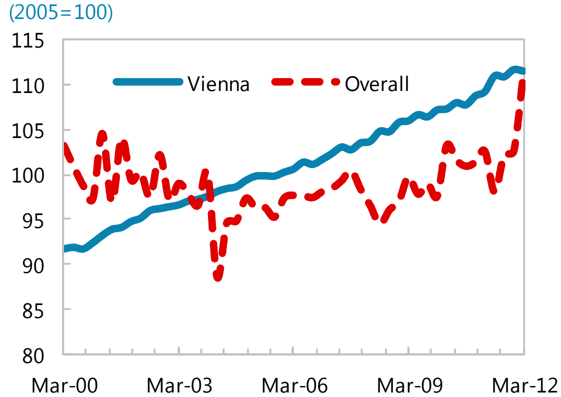
Inflation is falling...

Harmonized CPI
(Annual percentage change)



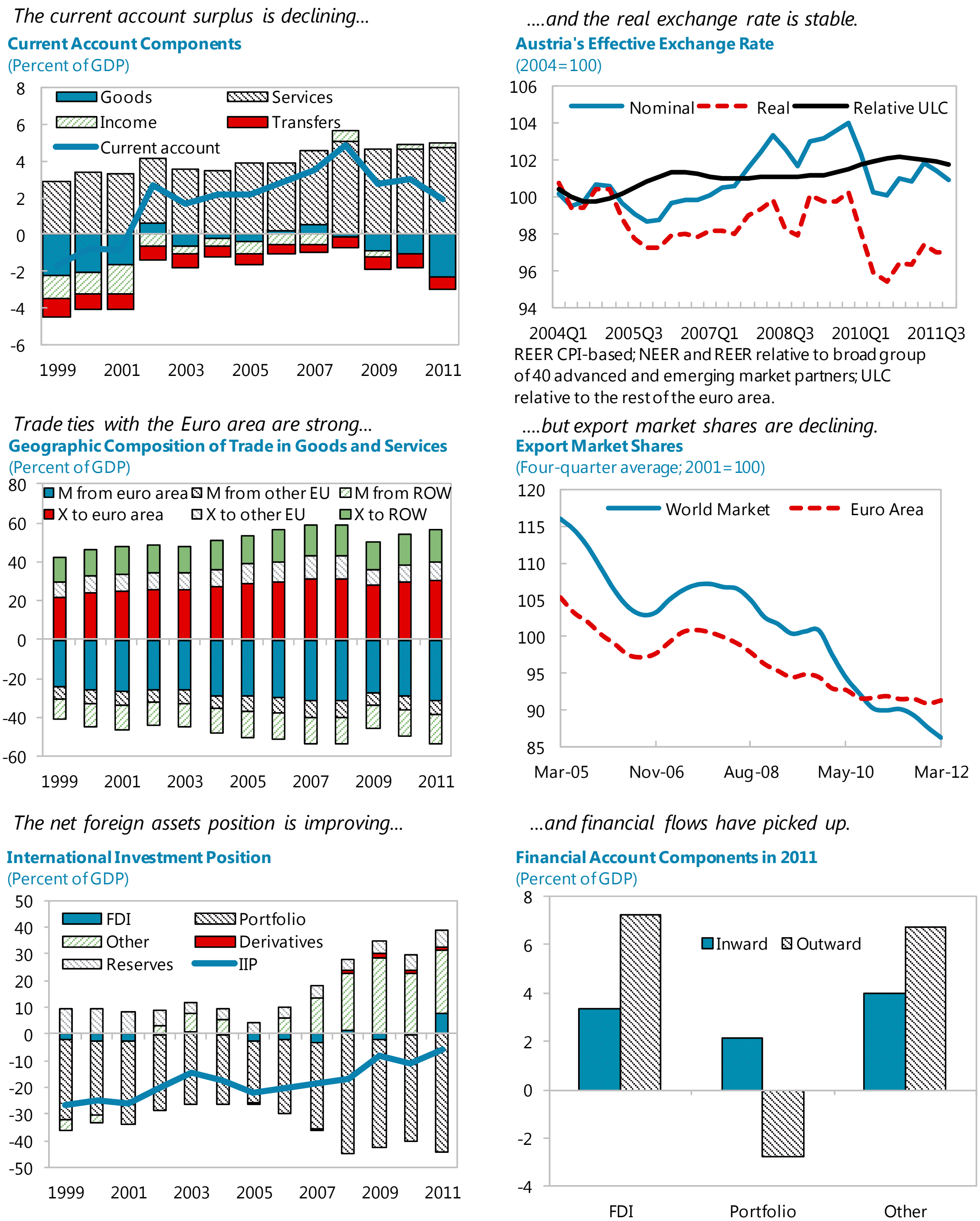
...but house prices are picking up.

Real Property Prices
(2005=100)



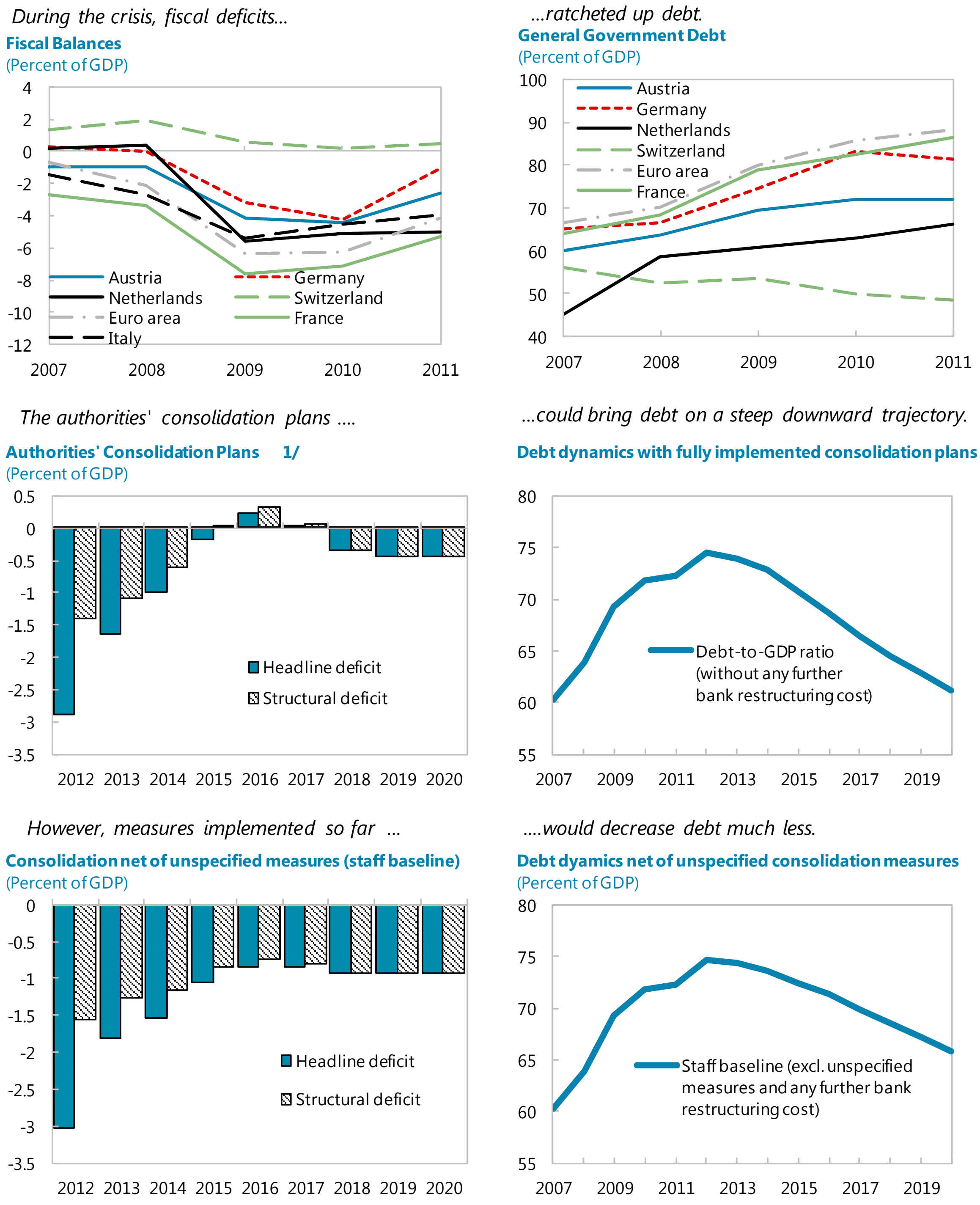
Sources: Austrian authorities; IHS; WIFO; ECB; Haver; WEO; REO; and other IMF staff calculations.

Figure 2. Austria: External Sector



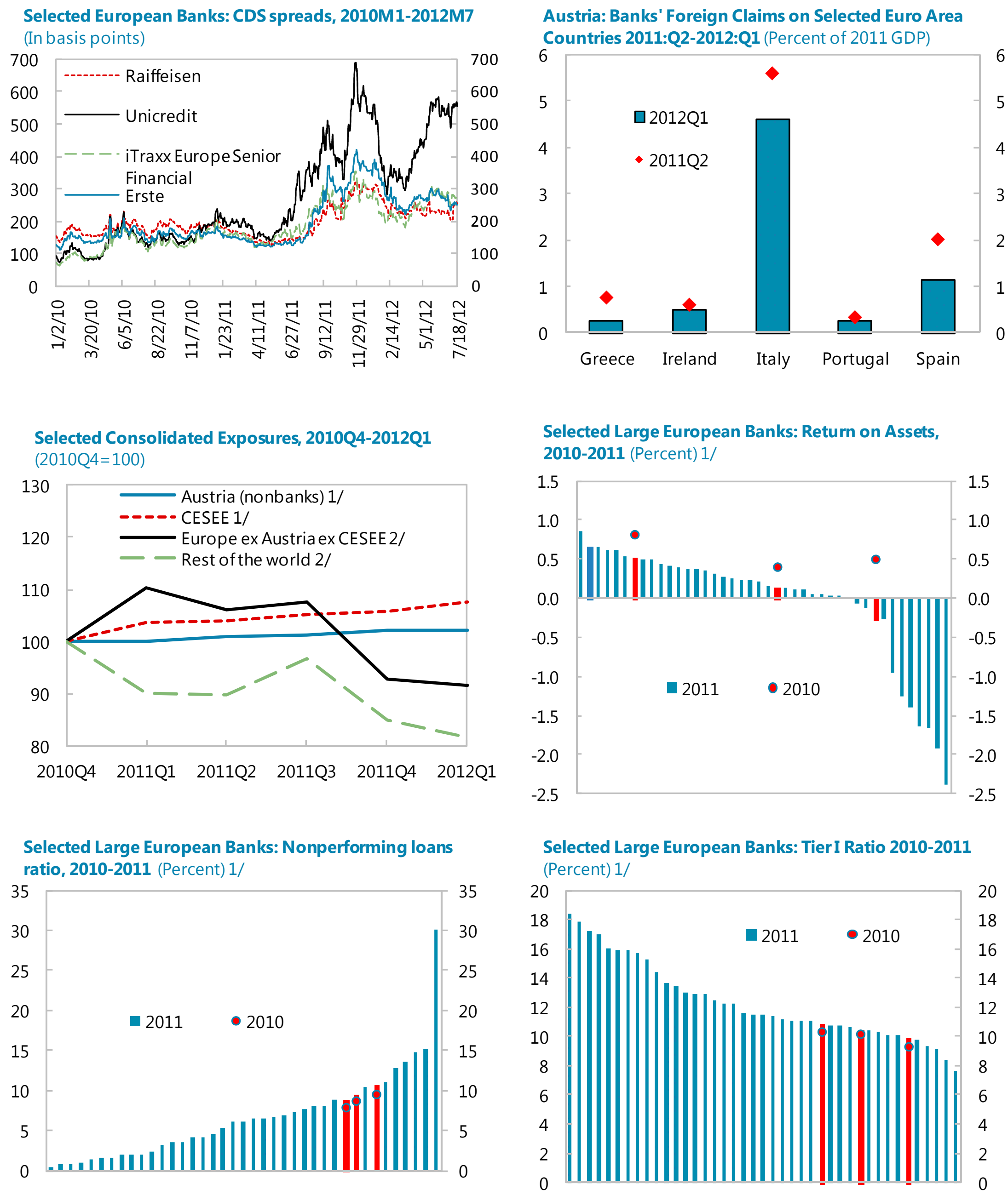
Sources: Austrian National Bank; Eurostat; ECB; Haver; DOTS; WEO; and IMF staff calculations.

Figure 3. Austria: Fiscal Developments and Outlook



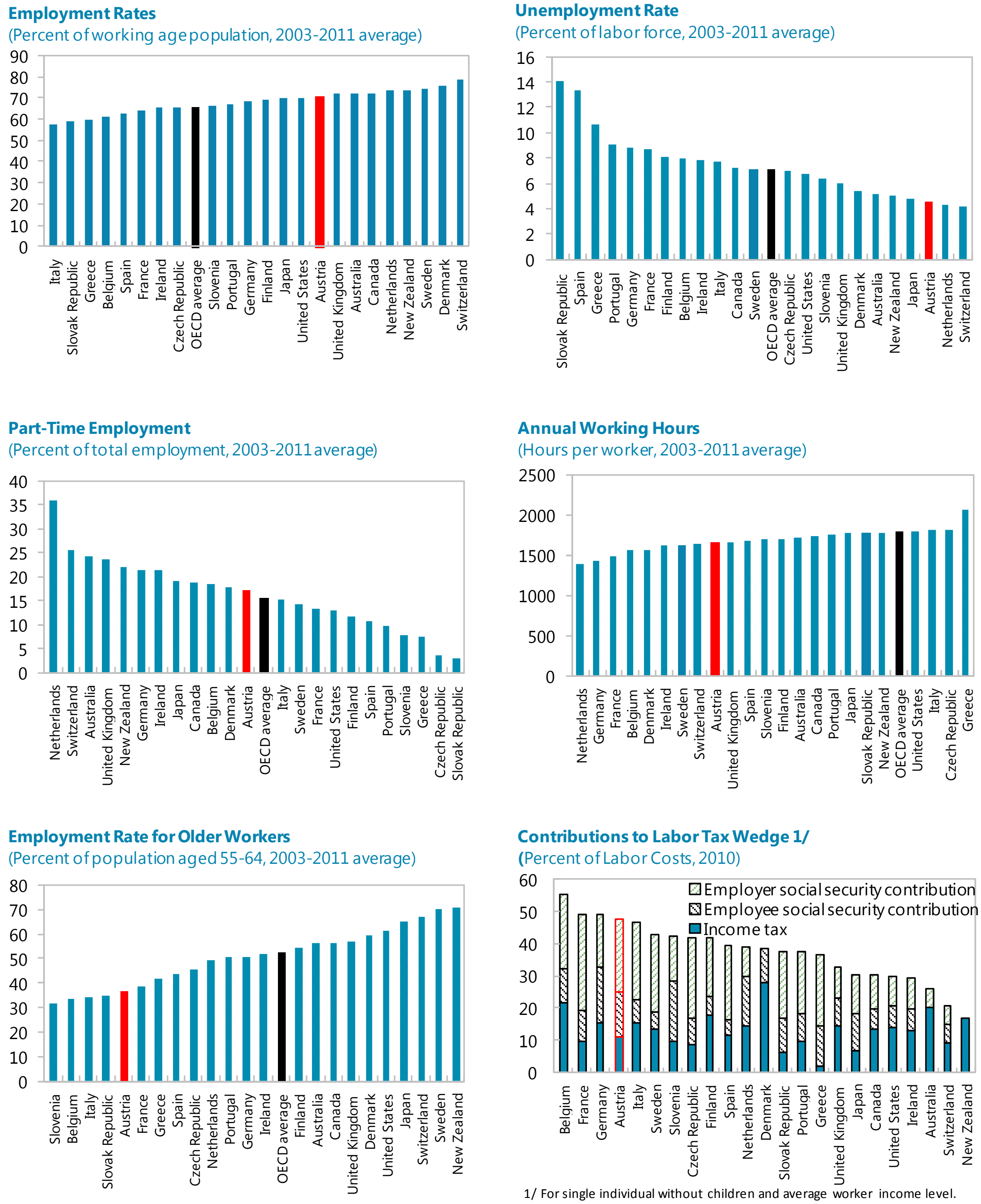
Sources: Austrian authorities; WEO; and IMF staff calculations and projections.
1/ assumes the staff baseline macroeconomic scenario; full implementation of expenditure and tax measures in the medium-term fiscal framework 2012-16; and, afterwards, a gradual return to the structural deficit of 0.45 percent of GDP allowed under the new fiscal rules.

Figure 4. Austria: Banking Sector, 2011



Sources: OeNB; Bloomberg; SNL Financial; BIS consolidated banking statistics; and IMF staff calculations.
1/ Series includes foreign-owned banks and is adjusted for currency movements and provisions.
2/ Series does not include foreign owned banks, is based on exposures expressed in euros, and is not adjusted for currency movements or provisions.
3/ Austrian banks are shown in red and non-Austrian banks are shown in blue. The set of "large European banks" includes 2 Belgian banks, 1 Danish bank, 5 French banks, 5 German banks, 5 Italian banks, 2 Dutch banks, 1 Norwegian bank, 5 Spanish banks, 4 Swedish banks, 2 Swiss banks, and 5 British banks.

Figure 5. Austria: Labor Market Indicators in Comparative Perspective



Sources: OECD and IMF staff calculations.

Annex I. Financial Sector Performance and Vulnerabilities[1]

Aggregate balance sheet structure and profitability

1. The Austrian banking sector's total consolidated banking sector assets have been stable since 2008Q1. They amounted to EUR 1.17 trillion at end-2011, or 380 percent of GDP. The share of fully consolidated subsidiaries – which are mostly located in Central, Eastern, and South-Eastern Europe (CESEE) – was also stable at 23.2 percent. The structure of aggregated assets and liabilities remained characteristic of a banking system dominated by classic commercial banking activities (Table A1). The loan-to-deposit ratio remained close to 128 percent[2], as both loans and deposits grew by 3-4 percent year-on-year.

Table A1. Austria: Selected Components of Banking System's Balance Sheet, 2010-2011
(In percent of total consolidated assets)

	2010	2011
Assets		
Cash and cash balances with central banks	2.1	2.9
Loans and advances (including to banks)	70.5	69.8
Securities	15.9	16.9
Liabilities		
Liabilities to non-banks	44.0	44.5
Liabilities to credit institutions	18.3	17.8
Securities	20.8	19.8

Sources: OeNB; and IMF staff calculations

2. Overall profitability slumped, with the aggregate ROA declining from 0.46 percent in 2010 to 0.11 percent in 2011, as goodwill write-offs in CESEE (most notably in Hungary, Romania and Ukraine because of a deteriorated outlook), losses on sovereign bond portfolios (including through the Greek PSI), new provisioning charges for asset impairment, and losses associated with a Hungarian government-sponsored scheme that caps the exchange rate for repayments on foreign currency mortgages took their toll. Yet the share of operating profits emanating from CESEE subsidiaries jumped to 66 percent, as the interest margin in Austria remained low at a level slightly above 1 percent, about 0.5 percentage points below that of the Euro Area (EA) average.

Capital adequacy

3. In spite of this deteriorating performance and the implementation of the stricter Basel 2.5 capital requirements at end-2011, the Tier I ratio improved in the banking system as a whole (to 10.3 percent) and in the three large internationally active banks (see table below) even if it remained slightly below the average of European peers. The two Austrian-owned banks subject to the end-

[1] Prepared by Jérôme Vandenbussche

[2] This loan-to-deposit ratio refers to banking groups covering 80 percent of the system's total consolidated assets."

June 2012 EBA capital exercise met these requirements. They filled the capital gap that existed at the start of the exercise in the fall of 2011 by running down or selling some capital-intensive businesses, taking some capital clean-up measures (including through an update of collateral appraisals), moving from local to international accounting standards in some countries, retaining earnings, and buying back or converting some non-EBA-eligible capital into common equity.

4. The Austrian macroprudential guidance introduced this year (Box 2) should require little extra capital in the baseline scenario, in particular because grandfathering provisions in the new forthcoming EU capital regulation will make private and state participation capital eligible as Core Tier I.[3] Nevertheless, the largest banking group has announced that it would likely change its institutional structure and deconsolidate part of its Austrian activities should the treatment of minority interests in the forthcoming European Union' Capital Requirements Directive (CRD IV) be too penalizing in terms of eligible capital.

Table A2. Austria: Large- and Medium-sized Banks' Selected FSIs
(In percent)

	Core Tier I ratio 1/		ROA		NPL ratio		Provisions/NPLs 2/	
	2010	2011	2010	2011	2010	2011	2010	2011
Large banks								
Bank 1	9.2	9.4	0.5	-0.3	7.6	8.5	60	61
Bank 2	10.0	10.6	0.4	0.1	9.1	10.1	48	48
Bank 3	8.5	9.1	0.8	0.5	8.9	8.6	66	68
Medium-sized banks:								
Bank 4	8.3	7.6	0.0	-2.3	13.3	13.5	38	37
Bank 5	7.2	7.8	0.3	0.3	3.2	3.8	59	45
Bank 6	5.8	5.4	-2.7	0.2	24.7	30.7	36	34

Sources: OeNB; SNL Financial; and IMF staff calculations.
1/ Core Tier I capital is defined as Tier I capital minus hybrid capital; Basel 2.5 risk-weights are used for both years.
2/ The ratio's numerator is total loan loss provisions, except for bank 2 and bank 5 for which it is loan loss provisions for NPLs only.

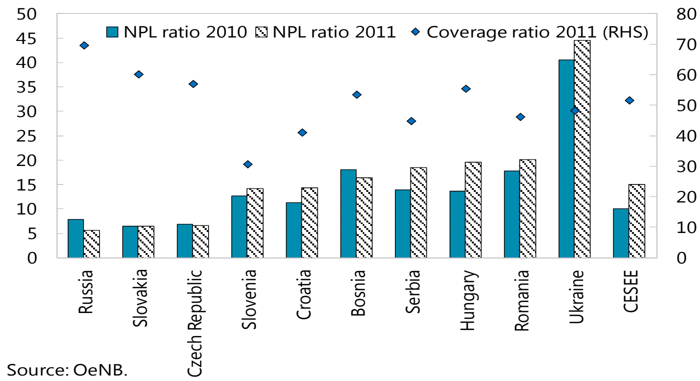
5. Among medium-sized banks, one bank which was nationalized in 2009 reported a turnaround in 2011 after large losses on CESEE exposures in 2010 but remains weakly capitalized. A restructuring plan is under examination by the European Commission while the bank is looking for buyers for parts of the business and is examining strategic options for its large wind-down portfolio. Another troubled medium-sized bank that already relied heavily on government capital support had to be semi-nationalized in early 2012 as it lost 50 percent of its equity after its restructuring plans were delayed and the value of some of its assets had to be written down. This bank is systemic as it serves as a central institution for a large group of smaller Austrian banks that are its main private shareholders. Following the latest round of government support, these shareholders agreed to make their association with the central institution stronger and more formal, a transformation which is expected to create a more robust banking group.

[3] Participation capital is non-voting, but fully loss-absorbing.

Asset composition and quality

6. At the time of the June 2011 Article IV mission, Austrian banks expected their NPL ratios in CESEE subsidiaries to peak in mid-2011. Yet the stock of NPLs kept increasing throughout the year and the aggregate NPL ratio reached 15 percent in 2011Q4 as the growth outlook in CESEE deteriorated with the intensification of the Euro Area sovereign crisis and the sharp slowdown in Western Europe. Austrian banks anticipate that asset quality will deteriorate further in several CESEE countries during the remainder of 2012. Low coverage ratios (provisions/NPLs) in some subsidiaries suggest that some banks may need to continue adding to their provisions even as NPL growth turns negative. As emphasized in the 2011 Article IV Staff Report, the quality of some CESEE loan books remains subject to a non-negligible degree of uncertainty because of the possibility of evergreening and difficulties in valuing collateral.

Banks' CESEE Subsidiaries' NPL Ratio and Coverage Ratio



Source: OeNB.
Note: Some individual country data are omitted due to confidentiality agreements.

7. The amount of foreign currency loans in CESEE subsidiaries declined for households, but increased significantly for corporations, in particular in Romania and Russia. In total, the share of FX loans in CESEE declined by 1 percentage point to 47.5 percent in exchange-rate-adjusted terms in 2011.

8. NPLs on exposures booked in Austria remain low, but the large share of Swiss franc-denominated loans to unhedged borrowers in a context of Swiss franc strength is a persistent cause for concern. At end-2012Q1, foreign-currency loans (FCLs) to Austrian non-banks amounted to EUR 56 bn (18.7 percent of GDP), of which EUR 38 billion were attributable to households, EUR 12 billion to nonfinancial corporations, and EUR 3billion to the public sector. FCLs to households represented almost 30 percent of loans to that category, consisted mostly of mortgages (73 percent) and were mostly denominated in Swiss francs. Adverse exchange rate developments over the past four years have made these loans more risky. Furthermore, since most of them are linked to repayment vehicles (RPV) and have bullet maturity, the full impact of the Swiss franc appreciation will be felt only when sizable loan vintages mature starting in 2017. Following strong supervisory measures—but also unfavorable exchange rate movements acting as a deterrent—the stock of household foreign-currency loans (adjusted for exchange rate movements) is now on a declining trend.

9. A survey performed by the OeNB in June 2011 showed a funding gap for CHF-denominated RPV loans to households of EUR 4bn (or 19 percent of the amount due at maturity). The increase of loan loss provisioning ratios on CHF loans has been muted so far. This is partly attributable to loan conversions into EUR-denominated loans, and to the fact that the rise in installment amounts due to

the CHF appreciation has been compensated by a decrease in interest rate levels since the initiation of the loans.

10. Exposures of Austrian-owned banks to peripheral Euro Area countries with high risk premia remain modest in comparison with other large and medium-sized European countries. They amounted to 6.4 percent of GDP at end-2012Q1 and were concentrated in Italy, which is Austria's second largest trading partner. Exposures to Italy of the second largest Austrian banking group – which is Italian-owned – are relatively more significant.

Funding and liquidity

11. The Austrian banking sector's liquidity situation appears comfortable in the aggregate, with the net financing gap being very largely covered by the cumulated counterbalancing capacity at various horizons. The banks' liquidity position has become more conservative in recent months, which reflects in part their increased reliance on Euro system operations through the two 3-year LTROs (in December 2011 and February 2012). Their total allotted volume at end-May 2012 represented 1.3 percent of the EA-wide allotted volume. According to an OeNB survey, banks' motives for participating in the LTROs were (i) increasing their liquidity buffer in a context of high funding markets uncertainty; (ii) substituting more expensive funding sources; and (iii) funding their lending activities. Austrian banks also improved their net position on the unsecured interbank market, while they shifted their issuances from unsecured funding towards covered bonds.

12. Regarding foreign-currency liquidity, the US dollar position is well covered by the USD/EUR swap arrangement between the ECB and the US Federal Reserve. The unbalanced CHF positions are the legacy of fast growth of Swiss franc lending combined with short-term funding via FX-swaps during the last decade. Pressured by the Austrian authorities, banks have made efforts to lengthen their funding tenors in the EUR/CHF swap market, diversify counterparties and funding instruments, obtain direct or indirect access to the Swiss National Bank's tender operations, and post sufficient collateral to withstand a funding shock in the FX-swap market.

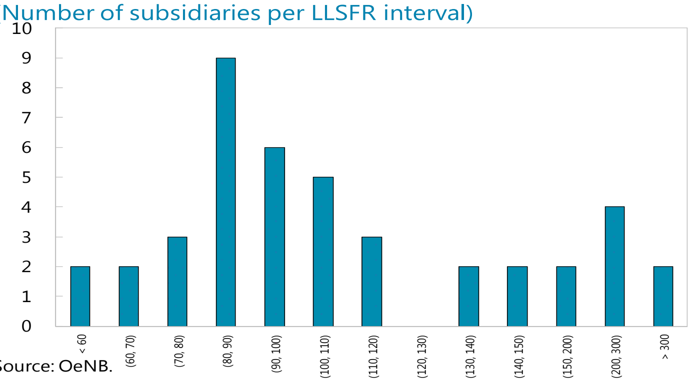
Intra-group funding and deleveraging in CESEE

13. Intra-group liquidity transfers to CESEE subsidiaries declined by about EUR 7 billion from their peak of EUR 48 billion at end-June 2011 to their end-2012Q1 level. Because banks were able to attract local deposits for a similar amount, the size of the loan portfolio remained stable over the same period of time. Thus there was no reduction in credit supplied by subsidiaries operating in the region in the aggregate. Exposure reductions in recent quarters were concentrated on Hungary and largely driven by the foreign currency loan early redemption scheme.

14. The Austrian supervisor introduced a new monitoring tool, the Loan-to-Local-Stable-Funding-Ratio (LLSFR) as part of its guidelines to improve the sustainability of the three large Austrian banks' growth model in the CESEE region (see Box 3 in the SR and Selected Issues Paper). The first LLSFR-monitoring exercise based on end-2012Q1 data showed that 15 subsidiaries out of 42 had a stock-LLSFR above the 110 threshold defined in the guidance (see Figure A2). These 15

subsidiaries together represented 22 percent of total assets in subsidiaries. The sustainability of the flow-LLSFR will be determined based on year-on-year data and a follow-up to assess the situation of any subsidiary above the threshold would take place in the context of the relevant supervisory college early next year.

Distribution of Austrian Banks' Subsidiaries' Loan-to-Local-Stable-Funding-Ratio, 2012Q1
(Number of subsidiaries per LLSFR interval)



Source: OeNB.

Stress testing

15. The OeNB regularly performs stress tests to assess the resilience of the banking system. Liquidity indicators are monitored and stress-tested frequently using data from a weekly forward-looking liquidity reporting system introduced in late 2008. Macroeconomic stress tests are performed twice a year for the entire consolidated Austrian banking system. The adverse scenario of the latest test simulated the impact of a very severe recession together with that of several risk factor add-ons, such as haircuts on sovereign holdings of EA program countries, frontloaded implementation of Basel III risk-weights, greater distribution of profits, and a small shock to the cost of funding. Over the projection horizon (2011Q4-2013Q4), the Core Tier I ratio of the banking system would fall from 9.9 percent to 8.5 percent without the add-ons, and would remain significantly above the new phased-in Basel III minimum of 4.5 percent with the add-ons. Each of the three largest banks would remain above the 7 percent full implementation Basel III minimum.

Annex II. The New Fiscal Rule Framework[1]

1. Austria has made substantial advances in fiscal governance in recent years. In addition to a medium-term expenditure framework at the federal level that is operational since 2009 and other budget reforms, more recently a system of numerical fiscal rules has been introduced. To this end, the federal budget law was amended with a simple parliamentary majority in December 2011; and a revamped Domestic Stability Pact was agreed between federal government, states, and municipalities in May 2012. Although the government has a continued preference for anchoring the new rules in Austria's constitution, this has so far not been possible as none of the three opposition parties has been willing to contribute to the necessary qualified constitutional majority.

2. The central component of the new fiscal rules is a limit on the general government structural deficit of 0.45 percent of GDP as of 2017, split into 0.35 percent of GDP for the federal level (including social security) and a total of 0.10 percent of GDP for all states and municipalities. These limits are combined with an "error correction mechanism": deviations between actual and prescribed structural balances will be accumulated in compensation accounts; if the (negative) balance in the accounts exceeds 1.25 percent of GDP for the federal level or 0.367 percent of GDP for states and municipalities, a correction has to be initiated. This takes the economic cycle into account, i.e., if there is a negative output gap, a correction is only required as long as the gap narrows.

3. In the transition period from the current fiscal situation to the requirements of the new framework (2012-16), the domestic stability pact determines the fiscal targets in terms of headline rather than structural deficits. This could lead to pro-cyclicality if growth turns out less favorably than projected. The targets in the Domestic Stability Pact are set as follows:

Domestic Austrian Stability Pact: Targets
(Headline deficit limits in percent of GDP)

	2012	2013	2014	2015	2016
Federal level	2.47	1.75	1.29	0.58	0.19
Subnational level	0.54	0.44	0.29	0.14	-0.01
plus (implicit): social security	-0.01	-0.05	-0.07	-0.11	-0.15
Total for General Government	3.00	2.14	1.51	0.61	0.03

Sources: Austrian Stability Pact 2012; Austrian Stability Program 2013-16.

4. The system of rules also incorporates explicitly the stipulations at EU level on expenditure growth limits, debt reduction, and exemptions. The latter include a "severe cyclical downturn" exception. Furthermore, the rules oblige all levels of government to introduce limits on guarantees, which are, however, not quantified in the pact.

[1] Prepared by Siegfried Steinlein.

5. The rules are supported by a sanctioning mechanism: If the Austrian Statistical Agency identifies a violation of the rules, the Court of Auditors follows up with a report to a body consisting of two federal, two state, and two municipal representatives. This body will ask the non-complying entity for remedial actions within two months. If such actions are not taken, the body can impose a financial sanction in the amount of 15 percent of the (highest) deviation from any of the stipulated targets by unanimous voting. Peers of the affected party at the same government level are not allowed to vote. A sanctioned entity has the right to appeal to a second instance (an "arbitration court"). The latter will have three members, one of which will be appointed by the appealing entity. According to the authorities, the arbitration court will decide only on whether to overturn the sanction of the first instance and will need unanimity for doing so.

6. Although concluded without expiration date in principle, the Domestic Stability Pact will become void if there is no successor agreement to the current arrangements on intra-governmental fiscal relations ("fiscal equalization law") that end in 2014 (but could be extended to 2016). As pointed out in previous staff reports (SR 2010 and 2011), these relations are highly complex, and characterized by frequent task overlaps and a pervasive disconnect between spending decisions and financing responsibilities, which is also reflected in the fact that there is basically no tax autonomy at the state level.

7. Experience in neighboring Switzerland shows that, although often difficult from a political economy perspective, reforms of federalist fiscal relations are not impossible to implement (see 2012 staff report on Switzerland). Switzerland streamlined both the task distribution across government levels and its fiscal equalization mechanism in 2008. The number of areas for which the Swiss Confederation and Cantons have joint responsibilities was almost cut in half, and a clearer division of labor was introduced for the remaining joint tasks. In a similar vein, fiscal equalization was rationalized to two mechanisms that are transparently based on resource potential and needs of each of the Swiss Cantons. Furthermore, in Switzerland, a considerable degree of tax autonomy creates a strong nexus between spending decisions and financing responsibility and enhances fiscal discipline at the subnational level, while a no-bail-out presumption for cantons and municipalities is inherent.

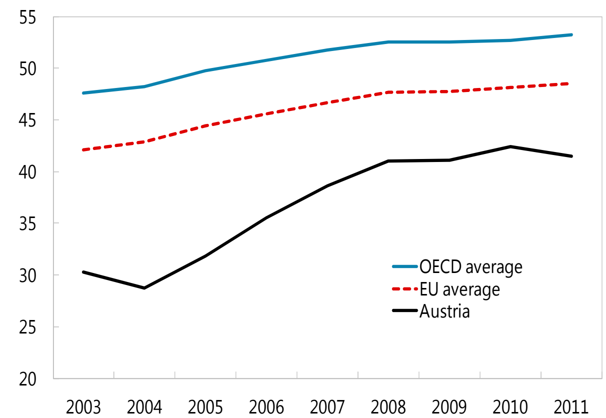
Annex III. Boosting Potential Growth by Expanding Labor Supply[1]

Situation in the labor market

1. While Austria generally has favorable labor market outcomes relative to other advanced countries, there is scope for increasing labor supply. Austria stands out in international comparison as having one of the lowest unemployment rates in the EU and the OECD. The percentage of long-term unemployed is also relatively small. The relative performance is not quite as strong in terms of the participation rate, which is only somewhat above the OECD median and average. Nonetheless, all in all Austria boasts a relatively high employment rate, although the share of part-time workers is fairly high, particularly among women.

2. Certain population groups are less involved in the labor market than their peers in Austria or in other countries. These groups include older workers, unskilled workers, and lower-income women with family responsibilities.

Employment Rate of Older Workers
(Percent of Population Aged 55-64)



Source: OECD; and IMF staff calculations.

- *The employment rate of older workers is much lower than in most OECD countries*. It should be noted, however, that the elderly employment rate has increased considerably over the last few years—from 28.8 percent in 2004 to (still relatively low) 41.5 percent in 2011. The average effective retirement age during the 2004–09 period was 58.9 years for males and 57.5 years for females—both the second lowest ages in the OECD.

- *Unemployment rates of low-skilled workers are high*. Low-skilled workers are concentrated in certain groups, such as older workers, immigrants, women, and workers on non-standard contracts. It should be noted that the share of the low-skilled in the working-age population is diminishing.

- *Even though the female employment rate is in the top half of the OECD, women are relatively more often working part time and finding it less attractive to work when they have small children.*

Reasons for selected problems

3. An examination of the tax/benefit system suggests that the system plays a role in discouraging labor effort. Generous pension benefits and easy avenues to early retirement make work unattractive to older workers. High tax wedges curtail the financial benefit from entering

[1] Prepared by Vladimir Klyuev.

employment from inactivity, especially for low-wage earners. The tax treatment of secondary wage earners and child care costs also discourage participation.

4. The low employment rate for the elderly reflects fairly generous pension benefits and relatively easy paths into early retirement or disability pension. Both gross and net replacement rates for average earners are among the highest across advanced economies. The statutory retirement age for women is 60 years—five years younger than for man and than what is typical for both males and females in the OECD. The penalty for early retirement, which was raised from 3 percent to 4.2 percent in 2004, is still below actuarially neutral adjustment. Moreover, as described in more detail in the 2011 Staff Report, several avenues facilitate early retirement. The most prominent among them are the lax disability regime and the *Hacklerregelung* scheme, which allows long-term contributors to the public pension system to retire considerably earlier than the statutory age and permits purchasing contribution years under certain conditions. Criteria for drawing a disability pension are relatively lax, with a disproportionately large number of Austrians qualifying for one. In 2010, only 28 percent of new pensioners took "standard" retirement, while 41 percent benefited from an early retirement scheme and 31 percent were granted a disability pension.

5. In recent years substantial steps have been taken to discourage early retirement. The price for purchasing contribution years under the Hacklerregelung has been raised significantly, and starting with 2014 such *ex post* purchases of secondary and tertiary education years will no longer be counted as eligibility-creating contribution months. Moreover, in the same year the eligibility for early retirement under that scheme will be raised by 2 years to 57 for women and 62 for men, largely eliminating its advantages relative to the standard corridor pension. The early retirement penalty under the corridor pension will be raised in 2017.[2] Disability criteria have been tightened, with stricter evaluation (expanding beyond fitness only for the previous occupation) and mandatory rehabilitation before filing for a pension. These are important steps in the right direction and the impact of these reforms can be expected to build over several years, although a number of alternative avenues into early retirement remain open, and on the whole the incentives for older workers to stay in the labor force still appear lower than in most advanced economies.

6. The average tax wedge on labor is one of the highest in the OECD, primarily because of high social security contributions paid by both the employer and the employee. Austria is one of few advanced economies that have bucked the general trend toward reducing tax wedges. Importantly, while low-income workers do not pay income taxes, they are still subject to social security contributions.[3] Given relatively generous unemployment benefits and social assistance, the monetary gain from taking up employment is low, or even negative, for many people with low earning potential. The tax wedge on secondary earners is one of the highest in the OECD, partly because of sole-earner tax credits, which are lost if a spouse takes up more than marginal employment. Studies show that the labor supply of low-skilled, older workers, married women and

[2] The early retirement penalty under *Hacklerregelung* will remain at 4.2 percent.

[3] Except for those at the very bottom of the wage distribution.

single mothers is particularly sensitive to after-tax earnings.[4] On the demand side, the combination of high minimum wages in many sectors and high employer contributions to social security may price low-skilled workers out of jobs.

Possible solutions

Restrict avenues into early retirement and raise statutory retirement age

7. Eligibility criteria for disability pensions could be tightened further—including a stricter obligation to look for jobs in alternative occupations. This would complement enhanced rehabilitation efforts and the recent initiatives to improve workplace suitability for older employees.

8. Reforms to reduce the access to and the generosity of various early retirement schemes could continue. The *Hacklerregelung* scheme, which does not have a clear justification on economic or equity grounds, should be allowed to expire. The rationale and eligibility criteria for other avenues into early retirement, including for workers with particularly heavy working conditions during part of their work history and for subsidized old-age part-time working arrangements with a possibility of front-loading, should be reevaluated. The use of these alternatives may increase once *Hacklerregelung* becomes less accessible. The early retirement penalty (and the late retirement premium) under the corridor pension system will remain below the actuarially neutral value even after an increase planned for 2017.

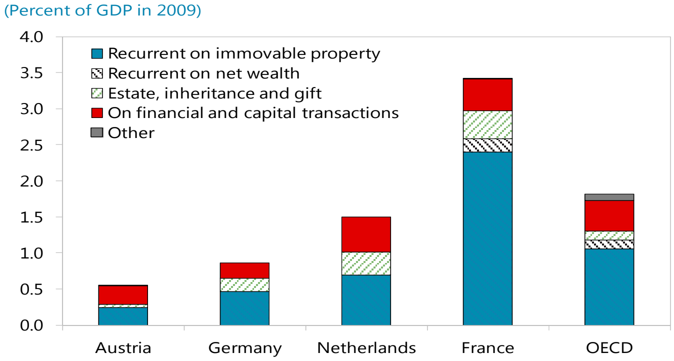
9. The statutory retirement age for women could be equalized with that of men much sooner than envisaged by current law. Historical reasons for differentiation no longer apply in a modern society, and such a gap is rare among advanced countries. Moreover, it would be advisable to link the statutory retirement age to longevity.

10. At the same time, obstacles to employment of older workers could be eliminated. In particular, the practice of stipulating higher wages for older employees in collective bargaining agreements creates a disincentive for firms to hire them.

Reduce labor tax wedges, particularly for the low-skilled

11. Taxation could be rebalanced away from labor taxes toward less distortionary revenue sources. The most direct way to reduce the labor tax wedge is to lower payroll taxes. Room for such cuts exists. Compared to other

Property Taxes in Selected Economies
(Percent of GDP in 2009)



Sources: OECD; and IMF staff calculations.

[4] See estimates in Appendix 4 of *Fiscal Policy and Employment in Advanced and Emerging Economies*, forthcoming IMF Board Paper, and references therein.

advanced economies, Austria relies heavily on taxing labor and less on taxing consumption and capital.[5] Property taxes are particularly low, reflecting both low rates and low valuations. Some of the excises, particularly on alcohol, are also rather low. Environmental taxes are fairly low as well, although not out of line with the rest of the OECD. One could consider increasing the VAT, which is one of the least distortionary sources of revenues—although one should note that Austria's VAT is fairly efficient, with relatively little revenue (compared to other EU countries) lost to reduced rates or evasion. Expenditure cuts could also be used for compensation and, specifically, over time one could also consider lowering pension benefits commensurately with the reduction in contributions, given the relatively high pension replacement rate in Austria.

12. Lower payroll taxes would stimulate labor force participation and raise potential GDP. According to OECD analysis,[6] the employment rate in Austria could be raised by 2.4 percent within 10 years following a reduction of the average labor tax wedge to the level observed in the six OECD economies with the highest employment rate. A simulation using the IMF's GIMF model (see the next subsection) shows that a one percent of GDP reduction in labor taxes offset by a cut in government transfers would raise real GDP by three quarters of a percent over the long run.

13. Reducing social security costs for low-skilled workers would be particularly effective. According to a joint study by the OECD and the Institute for Advanced Studies, halving employer social security contributions for workers in the bottom quintile of wage distribution (with the budgetary impact offset by spending cuts) would increase low-skilled employment by about 1 percent and GDP by about a quarter percent.[7] Increasing the in-work benefit for low-income workers is a complementary option for lowering welfare walls. The interaction of the tax and benefit systems creates a very uneven distribution of marginal tax rates, which spike to the neighborhood of 100 percent in some situation, and effort should be made to smooth those rates.

Simulation of budget-neutral tax reform

14. The Fund's Global Integrated Monetary and Fiscal Model (GIMF) was applied to analyze the impact of a budget-neutral tax reform on the Austrian economy. GIMF is a micro-founded, non-Ricardian, multi-country, dynamic general equilibrium model developed at the IMF and used extensively for policy analysis.[8] The model features optimizing consumers, a realistic trade and production structure, and a variety of fiscal instruments, making it well-suited for exploring the effects of changes in fiscal policy.

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[5] See Chapter 1 of the 2011 *OECD Survey of Austria* as well as the 2012 edition of *Taxation Trends in the European Union* for a detail discussion of Austria's tax structure.

[6] Bouis R. and R. Duval, 2011, "Raising Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond," *Economics Department Working Papers*, No. 835.

[7] *OECD Survey of Austria* 2009.

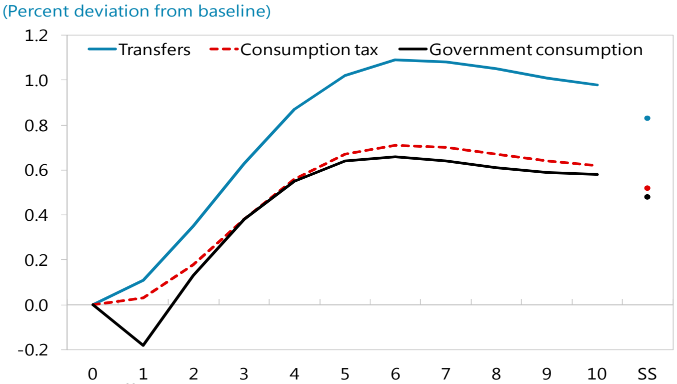
[8] A comprehensive overview of the model can be found in IMF Working Paper 10/34, "The Global Integrated Monetary and Fiscal Model (GIMF) – Theoretical Structure."

15. In the experiment, the labor tax is reduced permanently by one percent of GDP, and government transfers are lowered by the equivalent amount. The reduction in the labor tax corresponds approximately to a cut in the rate of social security contributions by 3 percentage points.

16. This reform would have a substantial, permanent impact on output (Figure A1). Lower payroll taxes stimulate investment and work effort. As a result, real GDP increases relative to the baseline of unchanged policy, with potential output higher by 0.8 percent in the steady state. With time, private consumption also increases above the baseline. The trade and current account balances improve marginally, mostly thanks to stronger exports.

17. Alternative ways of paying for labor tax reduction would bring somewhat smaller, but still considerable benefits. Property taxes are quite low in Austria. They are one of the least distortive sources of revenue,[9] and relying on a property tax increase in place of a transfer cut to finance a reduction in labor taxes would likely not change the results materially. If instead government consumption is cut or the consumption tax is raised, the long-term impact of a labor tax reduction declines by about a third to a still substantial number of about 0.5 percent of GDP.

Impact of Labor Tax Cut on Real GDP with Different Financing Options 1/
(Percent deviation from baseline)

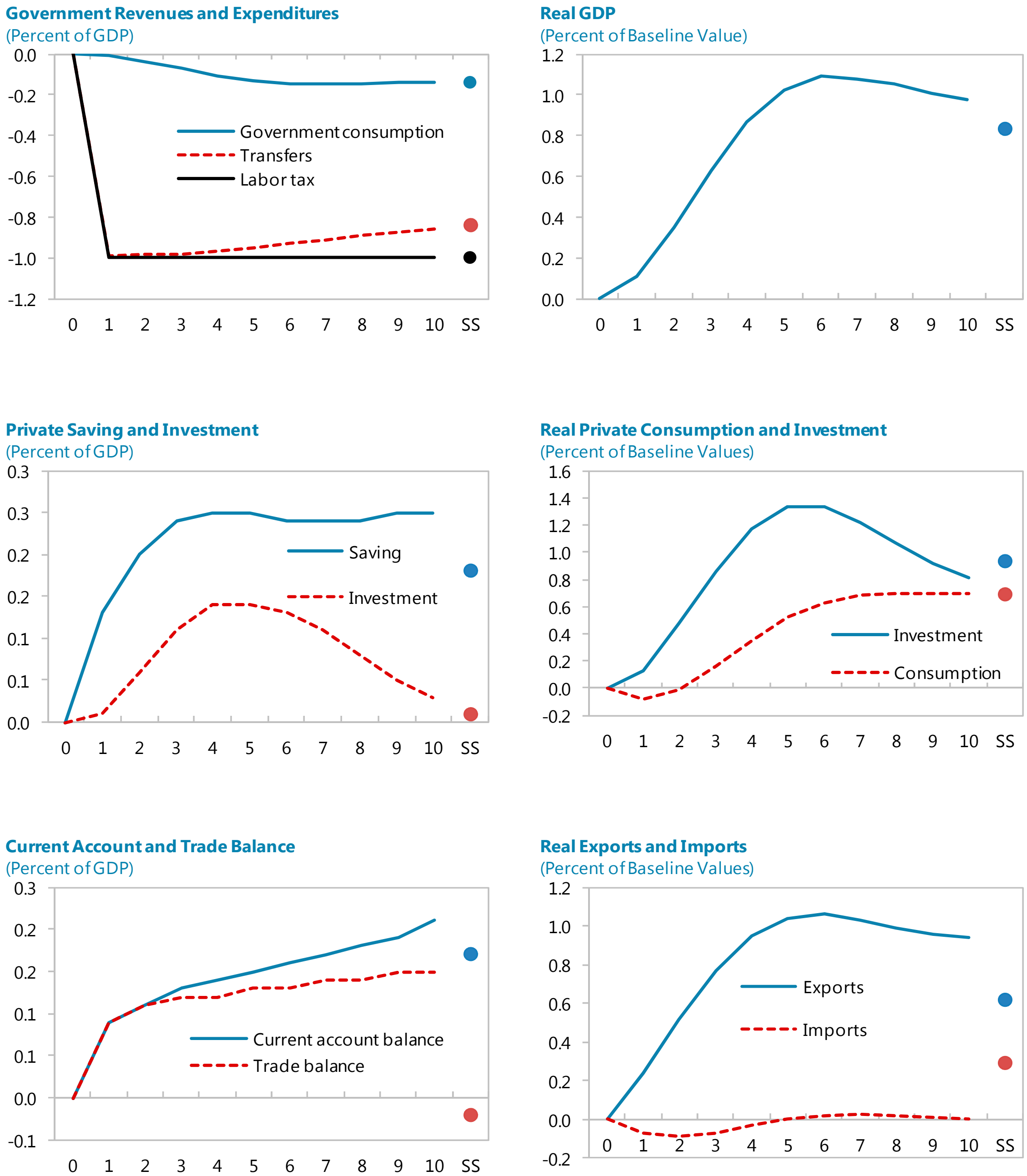


Source: IMF staff calculations.
1/ SS = Steady State

[9] For evidence see, for example, J. Arnold, 2008, “Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries,” *Economics Department Working Papers*, No. 643.

Figure A1. Austria: Fiscal Reform Impact 1/

Deviations from Baseline



Source: IMF staff simulations.
1/ SS = Steady State

INTERNATIONAL MONETARY FUND

AUSTRIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 31, 2012

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2012)

Mission: Consultation discussions were held in Vienna from June 22 to July 2, 2012. The authorities released the mission's concluding statement, which is available at: http://www.imf.org/external/np/ms/2012/070212.htm

Staff team: Ms. Detragiache (head), Messrs. Steinlein and Vandenbussche (all EUR) and Mr. Klyuev (RES). Mr. Prader, Alternate Executive Director for Austria, attended the meetings.

Country interlocutors: Central Bank Governor Nowotny, Minister of Labor Hundstorfer, State Secretary for Finance Schieder, members of Parliament, and representatives of the social partners, the financial sector, and economic research institutes.

Fund relations: Austria is on a 12-month consultation cycle. The last consultations were held June 3-14, 2011 and the staff report is available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=25222.0

FATF: The Fund published its report on Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism in November 2009. The report is available at: http://www.imf.org/external/pubs/ft/scr/2009/cr09299.pdf
Based on its action plan and commitments, the FATF plenary removed Austria from the specific review list in June 2010. Significant progress has been made to remedy several deficiencies but some remain. Austria has been encouraged by the FATF Secretariat to provide its third follow-up report in February 2013.

I. **Membership Status:** Joined: August 27, 1948; Article VIII, as from August 1, 1962

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	2,113.90	100.00
Fund holdings of currency	1,443.64	68.29
Reserve position in Fund	670.29	31.71
Lending to the Fund:		
New Arrangements to Borrow	365.20	

III. **SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	1,736.31	100.00
Holdings	1,630.24	93.89

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund:**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	**2013**	**2014**	**2015**	**2016**
Principal	--	--	--	--	--
Charges/Interest	0.07	0.15	0.15	0.15	0.15
Total	0.07	0.15	0.15	0.15	0.15

VII. **Implementation of HIPC Initiative:** Not Applicable

VIII. **Exchange System:**

As of January 1, 1999, the currency of Austria is the euro, which floats freely and independently against other currencies. Austria's exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exception of restrictions notified to the Fund in accordance with decision No.144-(52/51) resulting from UN Security Council Resolutions and EU Council Regulations.

STATISTICAL ISSUES

1. **Macroeconomic statistics are adequate for surveillance.** Austria subscribed to the Fund's Special Data Dissemination Standard (SDDS) in 1996, and its metadata are available on the Fund's electronic Dissemination Standards Bulletin Board. Austria is availing itself of the SDDS flexibility option on the timeliness of the industrial production index and the merchandise trade data.

2. **The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB.** The arrangement provides an efficient transmission of monetary statistics to the IMF and for publication in the IFS and IFS Supplement.

Austria: Table of Common Indicators
(as of July 30, 2012)

	Date of latest observation	Date received	Frequency of data	Frequency of reporting	Frequency of publication
Exchange rates	07/29/12	07/30/12	Daily	Daily	Daily
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 2012	07/20/12	Monthly	Monthly	Monthly
Reserve/Base Money	June 2012	07/30/12	Monthly	Monthly	Monthly
Broad Money	June 2012	07/30/12	Monthly	Monthly	Monthly
Central Bank Balance Sheet	June 2012	07/15/12	Monthly	Monthly	Monthly
Consolidated Balance Sheet of the Banking System	June 2012	07/30/12	Monthly	Monthly	Monthly
Interest Rates[2]	07/29/12	07/30/12	Daily	Daily	Daily
Consumer Price Index	June 2012	07/14/12	Monthly	Monthly	Monthly
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2012:Q1	06/30/12	Quarterly	Quarterly	Quarterly
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	June 2012	07/30/12	Monthly	Monthly	Monthly
Stocks of Central Government and Central Government-Guaranteed Debt	June 2012	07/30/12	Monthly	Monthly	Monthly
External Current Account Balance	2012:Q1	06/30/12	Quarterly	Quarterly	Quarterly
Exports and Imports of Goods and Services	2012:Q1	06/30/12	Quarterly	Quarterly	Quarterly
GDP/GNP	2012:Q1	06/11/12	Quarterly	Quarterly	Quarterly
Gross External Debt[5]	2012:Q1	06/30/12	Quarterly	Quarterly	Quarterly
International Investment Position	2012:Q1	06/30/12	Quarterly	Quarterly	Quarterly

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

Statement by the IMF Staff Representative on Austria
August 27, 2012

1. **This statement provides information that has become available since the Staff Report (SM/12/207) was circulated to the Executive Board on August 2, 2012**. The information does not alter the thrust of the staff appraisal.

2. **Revised data shows somewhat stronger GDP growth in the first quarter of 2012, while preliminary data confirms the expected deceleration in the second quarter**. Together with their Q2 flash release, the Austrian authorities have revised their quarterly GDP series. Growth in 2012Q1 was revised upwards from 0.3 percent (qoq) to 0.5 percent (qoq). The Q2 flash estimate shows a deceleration to 0.2 percent (qoq), mainly due to a reduction of the external growth contribution to zero, but also somewhat weaker domestic consumption. Looking forward, the weak external environment suggests that the deceleration in economic activity will continue in the second half of the year and may even be stronger than originally envisaged. All in all, annual growth for this year is likely to be somewhat higher than the 0.8 percent in the staff report. However, growth prospects for 2013 may have worsened, given the overall external environment. The inflation reading in July was 2.1 percent (down from 2.2 percent in June).

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Austria

On August 27, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Austria.[1]

Background

Austria's growth performance was strong in 2011, supported by buoyant employment, and the economy has limited slack. For the year as a whole, growth amounted to 2.7 percent, mainly driven by investment. Employment grew strongly, and unemployment reached 4.2 percent in 2011, the lowest rate in the euro area.

At 3.6 percent in 2011, inflation reached its highest level in decades as excise tax increases and a stronger pass-through of commodity price hikes opened a gap to Germany and the rest of the euro area. In the first half of 2012, these effects subsided and the discrepancy narrowed, and inflation stood at 2.2 percent in June. On the other hand, negotiated wage growth has accelerated to above 3 percent, reflecting the backward-looking wage setting mechanism but also, possibly, tight labor market conditions.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

After peaking in 2008 at 5 percent of GDP, the current account has narrowed, reaching 1.9 percent of GDP in 2011. Imports were boosted by high energy prices, while exports as a share of GDP remained below their 2008 record. Consistent with regional rebalancing, the bulk of the decline in the trade balance in 2011 was against the rest of the euro area. The real and nominal exchange rates were broadly stable in 2011. Unit labor cost growth accelerated, but in line with that in Austria's trading partners, while the global export market share continued its trend decline. Outward FDI and cross-border lending gathered steam, but some of Austrian portfolio investment abroad was withdrawn, even as foreigners resumed portfolio investment in Austria. Capital flows into CESEE remain depressed, with only timid signs of improvement, in part related to Austrian banks' support to their subsidiaries.

The fiscal position has improved but public debt is still rising. In 2011, the deficit fell to 2.6 percent of GDP, but this improvement is likely to be partly reversed to some 3 percent of GDP in 2012, on the back of slowing growth and significantly higher support to troubled medium-sized banks. General government gross debt stood at 72 percent of GDP, up from a pre-crisis level of 60 percent of GDP.

Banks' profitability in 2011 suffered from the continued deterioration of loan quality in several CESEE countries and losses on securities portfolios. Faced with external funding pressures in the second half of 2011, Austrian banks increased their reliance on central bank funding and cut their external positions. These cuts focused on markets other than Austria and the CESEE, most notably the euro area periphery – though exposure to Italy remains significant. The return on assets fell sharply during 2011, including because of losses from the Greek PSI. With the recovery in CESEE sluggish, large write-downs on goodwill for past acquisitions and continued provisioning on the growing stock of NPLs were necessary. In addition, Hungary's scheme to help borrowers indebted in foreign currency caused sizable losses for Austrian banks.

Executive Board Assessment

Executive Directors commended the authorities for their strong economic performance and noted that wage growth and low unemployment continue to support domestic demand, contributing to a welcome rebalancing in growth. As a weaker external environment is now taking a toll on economic activity, Directors concurred that a further intensification of the euro area crisis represents the main risk to the economy. In this context, they agreed that policies should be focused on preserving market confidence, increasing resilience against adverse external spillovers, and boosting long-term growth.

Directors welcomed the adoption of a strong medium-term consolidation strategy, which strikes an appropriate balance between fiscal prudence and growth considerations. They agreed on the need to clearly identify measures that underlie the envisaged structural adjustment, and recommended that the authorities prepare contingency plans in case further support is needed for nationalized or partly nationalized medium-sized banks. In addition, noting the long implementation lags of related reforms, Directors encouraged additional steps to contain aging costs.

Directors welcomed the introduction of fiscal rules, which further strengthen the policy framework. They noted, however, that a comprehensive reform of fiscal federalism is needed to streamline intra-governmental financial arrangements and provide stronger incentives for rule compliance to sub-national governments.

Directors noted that the legacy of an overly ambitious eastward expansion continues to weigh on the banking sector. They welcomed the recent supervisory initiatives leading to an increase in the capital buffer of large banks and looked forward to the prompt definition of a strategy for a more efficient disposal of legacy assets in government-supported medium-sized banks. Directors welcomed the authorities' plans to strengthen early intervention and resolution tools in the banking system in line with international best practices.

Directors saw the new macroprudential guidelines as useful tools to improve financial stability. A capital surcharge, recovery and resolution plans, and greater reliance on local stable funding by foreign subsidiaries should bring about a more solid business model for large and internationally active Austrian banks. Directors also welcomed plans to monitor compliance with the guidelines in close cooperation with host supervisors.

Directors commended the authorities for the steps taken to foster labor market participation by older workers and looked forward to a rapid implementation of these measures. In addition, they encouraged the authorities to explore further reforms to strengthen work incentives, including the equalization of male and female retirement ages and the reduction of the tax burden on labor. Fiscal revenue losses from the latter reforms could be compensated by increasing less distortionary taxes.

Austria: Selected Economic Indicators, 2008–13

Total area	83,850 square kilometers						
Total population (2011)	8.4 million						
GDP per capita (2011)	US$ 49,818 (35,868 Euro)						
	2007	2008	2009	2010	2011	2012	2013
						Projections	
	(change in percent unless indicated otherwise)						
Demand and supply							
GDP	3.7	1.4	-3.8	2.1	2.7	0.8	1.8
Total domestic demand	2.5	0.7	-2.0	1.8	2.5	0.9	1.9
Consumption	1.2	1.6	0.9	1.3	0.5	0.8	1.2
Gross fixed capital formation	3.6	0.7	-7.8	0.8	7.3	1.5	3.2
Net exports (growth contribution in pp)	1.4	0.8	-2.3	0.4	0.4	0.0	0.1
Exports of goods and nonfactor services	8.9	1.4	-15.6	8.7	7.2	2.0	4.0
Imports of goods and nonfactor services	7.1	0.0	-13.3	8.8	7.2	2.1	4.3
Output gap (percent of potential GDP)	3.7	3.3	-2.3	-2.0	-0.8	-1.5	-1.2
Employment and unemployment							
Employment	1.9	1.3	-1.5	0.6	1.8	0.6	0.6
Unemployment rate (in percent)							
Registered (national definition)	6.2	5.8	7.2	6.9	6.7	6.8	6.8
Standardized (Eurostat)	4.4	3.8	4.8	4.4	4.2	4.3	4.3
Prices							
Consumer price index (period average)	2.2	3.2	0.4	1.7	3.6	2.3	1.9
General government finances (percent of GDP)							
Revenue	47.6	48.3	48.5	48.1	48.0	48.6	48.7
Expenditure	48.6	49.3	52.6	52.6	50.6	51.6	50.5
Balance (EDP-definition)	-0.9	-0.9	-4.1	-4.5	-2.6	-3.0	-1.8
Structural Balance	-2.6	-2.4	-3.0	-3.0	-2.0	-1.6	-1.3
Gross debt (end of period)	60.2	63.8	69.2	71.8	72.3	74.6	74.3
Balance of payments							
Trade balance (goods) (in billion euro)	1.3	-0.6	-2.4	-3.2	-7.0	-8.1	-8.5
Current account (in billion euro)	9.6	13.8	7.5	8.6	5.9	5.2	5.3
(In percent of GDP)	3.5	4.9	2.7	3.0	1.9	1.7	1.7

Sources: Austrian authorities; Datastream; and IMF staff estimates and projections.

Statement by Mr. Johann Prader, Alternate Executive Director for Austria
August 27, 2012

The Austrian authorities welcome the consultations with the Fund and thank staff for the high-quality report. They broadly agree with the assessment of Austria's economic and financial situation and the recommendations on economic and financial policies.

The staff report describes the robust development of the Austrian economy in 2011, with real GDP surpassing its pre-crisis level. So far, the economy has withstood the turmoil in the euro area fairly well, but a slowdown may be inevitable in the second half of 2012, given the deterioration of the external environment, also outside the euro area, and Austria's extensive trade and financial linkages. The fiscal position is relatively favorable in international comparison. Fiscal rules have been further improved recently, setting the stage for ambitious structural consolidation and a determined reduction of the debt burden. The Austrian authorities broadly agree with the staff's analysis of the challenges ahead as regards strengthening the long-term growth potential and improving the resilience of the banking sector.

Macroeconomic outlook

Staff rightly notes the strong fundamentals of the Austrian economy and resilience to shocks, which resulted in solid growth of 2.7% of GDP in 2011 despite the worsening of the external environment in the second half of the year. Output growth was supported by buoyant employment and investment activity, while consumption growth remained subdued due to relatively high inflation. Uncertainties over debt sustainability in the euro area periphery might have affected consumer confidence.

According to the latest available estimates, the first half of 2012 saw a moderate expansion of GDP, with growth rates of 0.5% in Q1 and 0.2% in Q2 (qoq). Employment growth continued well into 2012, even outperforming GDP growth in Q2 2012. However, a slowdown has set in and unemployment started to increase from past year's post-crisis low of 4.2%. The outlook for the remainder of the year has deteriorated over the past few weeks, as weaker-than-expected external conditions will weigh on export and investment activity. However, on the back of solid consumption growth, supported by lower inflation and high wage increases, the economy is expected to escape recession and the authorities' current estimate of a growth rate of 0.6% for 2012 as a whole should be feasible.

The authorities concur with staff that the main risks to the outlook are external and stem from a further intensification of the debt crisis in the euro area and possible spillovers to important trade and financial partners in CESEE. However, upward risks, in particular the possibility that uncertainty abates more quickly than currently expected, should also be taken into account. It is also noteworthy that Austrian sovereign bonds have been regarded as a safe haven, with spreads over German Bunds declining since the start of the year and long-term interest rates at historically low levels.

The staff report points out that Austria's long-term growth potential would benefit from reforms to strengthen work incentives. The authorities have undertaken important efforts in this direction as part of the consolidation package enacted in early 2012. Access to early retirement and invalidity pension has been tightened and the opportunity cost of withdrawing from the labor market before reaching the statutory retirement age has been raised. Funds for full-day child care and education have been increased with a view to encourage labor market participation of women and low-skilled workers. The authorities continue to monitor labor market developments very closely and give priority to structural issues in the formulation of medium-term economic and fiscal policies.

Fiscal policy

The government has put in place a "debt brake" similar to the German model, restricting the general government structural deficit to 0.45% of GDP from 2017. Its implementation was accompanied by a comprehensive consolidation package, aimed at reducing the structural deficit to 0.4% of GDP by 2016 and putting the debt ratio on a strictly downward path from 2013 onwards. The package was applied in addition to the measures already implemented in early 2011.

The baseline scenario in the staff report is very close to the authorities' projections in the Stability Program, thus underlining the overall credibility of the consolidation strategy. The report points out that the yield of some revenue measures in 2012 and 2013 is uncertain. However, Austria has a good track record of providing conservative and reliable revenue estimates and executing the budget strictly, so that risks to the consolidation targets are limited. Moreover, there are safety margins in the budget plans (e.g., interest expenditure in 2012 is likely to turn out lower than budgeted) and thus possible revenue shortfalls could be compensated. In the past, budgetary outcomes in Austria used to surprise on the upside rather than on the downside. As regards savings from 2014 onwards, the authorities remain fully committed to implement the necessary reforms in the areas of health care and subsidies as planned in cooperation with regional governments.

Budget execution at sub-national levels has benefited from the strengthening of the sanctioning mechanism in the Domestic Stability Pact in 2011, and will be reinforced this year by a complete overhaul, which extends the "debt brake" and the main elements of the reformed EU fiscal surveillance (debt and expenditure rules) to the state and local levels. It is noteworthy that the strengthening of the sanctioning mechanism seems to have had an immediate effect, with states overachieving deficit targets in the past year. Thus the risk of overspending at sub-national levels has been reduced significantly.

The staff report commends the consolidation package for striking a good balance between fiscal prudence and growth considerations, with structural reforms aimed at sustainable expenditure reduction at the center of the strategy. The authorities have put emphasis on a fair distribution of the burden without increasing mass taxes and with a view to future-oriented investment. Where taxes have been raised, emphasis has been put on broadening the tax base and on high-income groups, so as to avoid an increase in labor taxes that would counteract the efforts to increase work incentives.

Financial Sector

The Austrian banking sector is operating in a challenging international environment but managed to weather the renewed sovereign and banking sector stress in selected euro area countries relatively well so far. Over the past year, the liquidity management of Austrian banks has become increasingly conservative and the sector as a whole continues to exhibit below-average reliance on central bank funding compared to other euro area banks. Wholesale funding dependence is low in European comparison, and funding conditions for large Austrian banks with significant CESEE operations continue to be favorable. Nevertheless, as part of the euro area financial system, funding risks of Austrian financial institutions also remain contingent upon the broader international environment and in particular on current efforts to contain the crisis.

Recent foreign exposure developments by Austrian banks point at two diverging trends. On the one hand, banks gradually scaled back their comparatively low exposures to euro area countries with high risk premiums, partly related to the Greek PSI. On the other hand, the large and diversified foreign exposure to the CESEE region remained broadly stable in recent months and increased in many countries on an FX- and provisions-adjusted basis, as reflected in the staff report. The widespread deleveraging concerns that were raised in late 2011 have not materialized so far, and large Austrian banks continue to show a strong commitment to the region.

Despite the only modest deleveraging pressures, it is also important to recognize that the CESEE region has become, over the past three years, an increasingly heterogeneous market for banks to do business, both in terms of risks and potential returns. Signs of growing heterogeneity may not only be found in banking sector indicators such as credit risk or profitability, but also in policy choices, as illustrated by the unorthodox policy measures set by the Hungarian government in 2011, and macroeconomic conditions, as shown by the significant cross-country variation in current economic forecasts. From a prudential perspective, it is therefore obvious for CESEE banks to adapt to the increasingly heterogeneous operating environment and gradually rebalance their exposure to those segments that offer more favorable (and predictable) conditions than others. To the extent that exposure rebalancing is not associated with competitive pressures for other banks, it should be regarded as standard procedure in a market economy, and as something that prudential supervisors should expect from financial institutions managing their risks.

The Austrian authorities are closely monitoring the exposure development of Austrian banks to the CESEE region and are ready to set appropriate measures to prevent not only disruptive deleveraging but also the opposite situation, i.e. the build-up of additional risks that exceed their current risk-bearing capacity. Even though the large Austrian banks that participated in the EBA recapitalization exercise were able to meet the Core Tier 1 capital requirements as of end-June 2012, their capital position remains below average compared to international peers. Given the difficult market environment, a further strengthening of their risk-bearing capacity must be a priority before engaging in further growth. In addition, the authorities agree with the staff's view that further expansion in the CESEE region should be funded to a larger extent by local stable funding sources than in previous years, both from a credit risk and a funding risk perspective.

The set of macro-prudential guidelines known as the "Sustainability Package" and published by the Financial Market Authority (FMA) and the Oesterreichische Nationalbank (OeNB) in March 2012, was an important move in the direction of encouraging large Austrian banks to take further steps to permanently strengthen their capital base, further improve their liquidity situation and enhance the sustainability of their business model. In order to safeguard as far as possible the free movement of capital within the European Union, the Austrian authorities made clear that specific measures based on the guidelines will only be set after consulting with host authorities in the context of supervisory college cooperation. Given the large presence of Austrian banks in the region, improvements along the objectives of the "Sustainability Package" will not only benefit the affected banking groups, but ultimately financial stability in host countries as well.

Given the sluggish economic environment, credit risks continue to exert a significant drag on banks' overall profitability. NPL ratios in many parts of the CESEE region continued to increase during the second half of 2011, in particular in the foreign-currency loan segment. In Austria, the large stock of foreign currency loans and repayment vehicles loans poses a more medium-term challenge, assuming that the EUR-CHF exchange rate continues to stay at or above the floor set by the Swiss National Bank for the time being. The authorities concur with the staff's view that banks should be conservative in allocating capital to the associated risks. The existing guiding principles on foreign-currency lending in the domestic market are already in the process of being harmonized with the respective ESRB recommendations. From 2013 onwards, Pillar 2 measures may be applied to cover the risks arising from existing funding gaps in repayment vehicle loans.