INTERNATIONAL MONETARY FUND

Austria: Staff Concluding Statement of the 2016 Article IV Mission

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A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Austria is stable and prosperous. Nevertheless, it can still improve its economic performance to ensure a continuing rise in incomes and employment within a stable macroeconomic environment. To this end, a comprehensive package of structural and fiscal reforms can raise low GDP growth and ensure the steady decline of public debt in the long term. Financial system stability needs to be maintained in a challenging environment.

1. **Austria's recovery has strengthened.** In 2016, we project growth at 1.4 percent, an improvement over the average growth of 0.6 percent in 2012-15. Growth has been broad based, driven by private consumption supported by income tax reductions, a recovery in investment, and higher public consumption due to spending on refugees. At 1.4 percent y/y in October, inflation remains low, but is above the Euro Area average (0.5 percent). Employment growth has picked up in 2016, catching up with the rising labor supply driven by migration and higher labor force participation. As a result, unemployment has stabilized recently, although it remains elevated relative to historical levels.

2. **The near-term outlook is similar to developments in 2016, but in the medium term growth would subside without reforms.** In 2017, we project growth to slow only marginally to 1.3 percent, as the 2016 fiscal stimulus tapers off. Current momentum in private investment and employment, supported by the ECB's continuing accommodative policy stance, as well as strengthening demand in main partner countries, should underpin growth around that level. In the medium term, the closing output gap and the necessary gradual fiscal consolidation should see growth revert to its potential rate, which we estimate at just above 1 percent in the absence

of growth-enhancing reforms. With the output gap eventually turning positive, inflation should run somewhat above 2 percent in the medium term.

3. **The external position is strong and broadly in line with fundamentals.** Exports, especially of services, have held up well so far—the current account surplus is expected to rise to close to 2½ percent of GDP in 2016, and the international investment position has strengthened further. Over the medium term, we project the current account surplus to gradually decline to about 2 percent of GDP, broadly in line with the average over 2012–15, as the composition of economic growth shifts more toward domestic demand, and higher import prices and the slight overvaluation of the real effective exchange rate are felt.

4. **The financial sector is stable but credit dynamics are mixed.** Austria's banking system as a whole is well capitalized, but large banks' capital buffers remain low compared to peers, although this gap has been reduced recently. To meet their capital targets, banks rely on divesting non-core assets abroad and capitalizing profits. Bank profits increased in 2015/16, largely due to lower risk provisioning as the quality of their portfolios improved, as well as higher profits in a few Central and Eastern European markets. However, operational costs are being cut only slowly. While Austrian firms' demand for business credit remains subdued—notwithstanding low interest rates—borrowing by households (largely mortgages) has picked up against a background of rising house prices. Nevertheless, financial stability risks seem contained, as by 2016:Q2 the median loan-to-value ratio for mortgage loans was about 65 percent and the household debt-to-income ratio about 90 percent, which is significantly below the Euro Area average. The settlement with HETA creditors paves the way for a closure on the legacy of the global financial crisis.[1]

5. **Risks to the outlook are mainly external, with limited likely impact overall.** Increasingly inward-oriented economic policies by some trading partners, structurally weak growth in advanced economies, a slowdown in emerging markets, or an increase in risk premia embedded in global interest rates could all weaken the economic and financial outlook. However, the impact would likely be limited, as the European Single Market, the destination of 70 percent of Austria's exports, continues to provide a stable framework. Moreover, declining bank exposure to risks in Central and Eastern Europe, as subsidiaries are being divested, is reducing vulnerabilities.

6. **Notwithstanding this overall robust background, a number of challenges need to be addressed:**

- *Growth remains low.* With potential GDP growth rate at just above 1 percent, limited mainly by low productivity growth, a sustained reduction in unemployment and a continuing rise in living standards would be difficult to achieve.

[1] HETA is the wind-down unit for the former Hypo Alpe Adria bank.

- *Long-term fiscal sustainability needs to be ensured.* We project that the fiscal structural balance will turn to a deficit of some ¾ percent of GDP in 2016 as a result of the tax reform. Fiscal policy plans envisage a gradual reduction of the structural deficit to ½ percent of GDP, Austria's medium-term objective (MTO), by 2020. This, as well as the positive effects of the HETA deal and other bank restructurings, would lower public debt to some 71 percent of GDP by 2022. In the longer run, however, the ageing population will gradually increase demands on the public sector. Without additional measures, demography-related spending pressures would drive up expenditure by some 3 percentage points of GDP, widen the budget deficit accordingly, and push public debt above 100 percent of GDP by 2060.
- *The financial system should be strengthened further, recent improvements notwithstanding.* To sustain the high confidence in Austria's financial system, large banks need to close the capital gap relative to peers. However, slow credit demand, high costs, and declining interest margins hamper a sustained increase in profits in the home market, while in Central and Eastern European markets higher profits are accompanied by higher economic, political, and regulatory risks. This makes it challenging for banks to raise capital. Rising house prices warrant attention, though risks to the financial sector are limited at this point.

7. **In the mission's view, a comprehensive, consistent, and coordinated policy package would address the challenges outlined above.** Increasing potential output would boost employment and living standards and ease the fiscal burden of demographic change. A reform package combining structural reforms with deficit-neutral fiscal measures could permanently boost potential GDP by some 3 percent over the medium term. Efficiency gains in public spending would create fiscal space for further growth-supporting policies and ensure the continued decline of public debt. Maintaining financial stability is a key component of a stable overall macroeconomic environment. Specifically:

- *Structural reforms.* Austria performs well in many structural policy indicators. However, there is scope for lowering barriers to entrepreneurship (regulations that hinder entry and competition in professional services and other heavily regulated professions, as well as regulations that impose a high administrative burden on companies, including start-ups) and barriers to investment in the network sectors. In this regard, the start-up promotion package announced earlier this year and increased support for R&D in 2016 are steps in the right direction.
- *Public investment.* While Austria's infrastructure is of high quality, investment is low: in 2015, gross budget investment (including capital transfers) stood at only 3.7 percent of GDP, resulting in net investment below ½ percent of GDP. Moreover, Austria has fallen back in the World Economic Forum's ranking of infrastructure quality. An increase in public investment focusing on infrastructure bottlenecks,

offset by efficiency-improving savings in government consumption (see below) would raise the productivity of private sector investment and thus potential output.

- *Shifting the tax mix.* Despite recent tax relief, Austria's high taxation of labor (including social security contributions) is still a drag on employment creation. A revenue-neutral shift of taxation further away from labor and toward property, pollution, and consumption would help raise employment and output. If low-income households are adversely affected by such a tax shift, they should be protected through the social assistance system.
- *Raising labor force participation (LFP) by the elderly and women.* While low LFP and part-time work may very well reflect individual and societal preferences, they strain social security systems, due to both lower contributions and higher demand for basic income support from pensioners with too low accumulated pension rights. LFP among the elderly is already on the rise and is likely to rise further in the long term as already legislated reforms to raise the pension age for women gradually take effect after 2024. However, bringing forward this increase, further tightening early retirement options, and indexing the pension age to life expectancy would generate further and faster savings. Measures to make full-time work more attractive for women (including through an extension of kindergarten and school hours where needed) should also help. The planned introduction of incentives to work beyond the official pension age would help as well, as will ongoing efforts to integrate accepted asylum seekers into the labor market. In this latter regard, the authorities' efforts to provide language training and develop a system to identify and recognize asylum seekers' skills are well placed.
- *Ensuring fiscal sustainability.* The authorities' envisaged path toward a structural fiscal balance target of -0.5 percent of GDP by 2020 is appropriate in view of the need to reduce public debt. While this plan is achievable, exercising continuing fiscal restraint over several years in spending on compensation of employees and goods and services would require strong political will. However, maintaining this target in the long run to keep reducing debt toward 60 percent of GDP would require additional policy measures to counteract the impact of population ageing on spending. Specifically, significant savings in the health and (to a lesser extent) education sectors without compromising quality, as well as in subsidies, should be feasible. Moreover, pension system measures (see above) could reduce demography-related spending pressures. Combined, the expenditure savings in these areas could amount to 2½-3 percent of GDP, which would allow both reducing debt below 60 percent of GDP over the long term and financing additional growth-enhancing policies. Some of the expenditure reforms would require adjustments of fiscal relations between federal, state, and municipal governments with the aim of improving the incentives for Austrian states and municipalities to enhance the efficiency of public service delivery. The recent framework agreement between the federal government and the states is a

first step in this regard, but needs to be followed up by detailed action plans and efficiency targets set in line with best domestic and international practice. As these reforms take time for their full effects to unfold, the authorities should use the current window before ageing-related spending pressures rise significantly to carry them out.

- *Raising banks' capital.* The phasing in of a systemic risk buffer for bank capital of up to 2 percent over 2016-19 remains appropriate. The authorities will need to stand firm in enforcing capital strengthening along the envisaged path, using the full range of tools available to them. This would bolster financial stability and place the banking system in a better position to finance private sector investment should credit demand recover with reforms that lead to faster potential growth.
- *Strengthening macroprudential tools.* While real estate-related risks to the financial sector are currently limited, the draft law giving the Financial Market Authority expanded responsibilities for the development and application of real estate-specific macroprudential tools—as recommended by the Financial Market Stability Board—should be passed as soon as possible to allow the authorities to stay ahead of the curve. This is all the more important since the design, development, and application of macroprudential tools is typically a time-consuming process, and implementation often needs to be phased. Measures to stimulate the supply response to the increased demand for housing in the major cities should also be implemented, such as reviewing the zoning regulations and other restrictions on construction.
- *Improving the AML/CFT framework.*[2] To preserve Austria's position as a financial center, the authorities will need to strengthen the AML/CFT framework in line with the recommendations of the 2016 Financial Action Task Force (FATF) Mutual Evaluation Report. The report recommended enhancing the effectiveness of AML/CFT supervision, improving investigation and prosecution of money laundering, and strengthening the use of financial intelligence. The mission welcomes the action plan adopted by the authorities to this end and encourages its rapid implementation.

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We would like to thank all our counterparts in the government, the OeNB, and the private sector for the excellent organization and exceptional warmth of the welcome that we were accorded during our visit to Austria.

[2] AML/CFT stands for Anti-Money Laundering/Combatting Financing of Terrorism. The Financial Action Task Force is an intergovernmental body tasked with setting standards and promoting effective implementation of measures for combatting money laundering, financing of terrorism, and other related issues.