CONCLUDING STATEMENT

Austria: Concluding Statement of the 2024 Article IV Mission

EMBARGO UNTIL MARCH 1, 3 PM (CET)

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.

Vienna, Austria – March 1, 2024: *An International Monetary Fund (IMF) mission, led by Kevin Fletcher and comprising Adil Mohommad, Magali Pinat, and Mengxue Wang, visited Austria during February 16-March 1, 2024, to conduct discussions on the 2024 Article IV consultation. At the end of the visit, the mission issued the following statement:*

Nimble policy has helped mitigate the effects of major adverse shocks in recent years (the pandemic, the energy price shock, and the rise in interest rates to contain subsequent inflation), but they have inevitably weighed on growth. Looking forward, growth is expected to gradually strengthen during 2024-25 while inflation declines to near its target. This baseline forecast is, however, subject to important risks. Policies should focus on maintaining macroeconomic and financial stability while containing risks and preparing the ground for strong, sustainable growth. This requires (i) undertaking well-designed fiscal adjustment measures to support disinflation, rebuild buffers, and offset rising spending pressures from aging, climate change, and other needs; (ii) conserving bank profits to bolster buffers against risks, maintaining prudent macroprudential policy settings, and closing financial-sector data gaps; and (iii) advancing structural reforms to boost labor supply, increase housing supply, accelerate the green transition, and strengthen economic resilience and productivity.

Recent economic developments and outlook

Nimble policy responses have helped mitigate major shocks in recent years. Growth rebounded strongly from the pandemic thanks in large part to strong policy support, with output quickly rising back above pre-pandemic levels. In response to the energy price shock, the authorities made use of available fiscal room to cushion the impact of higher energy prices while maintaining price signals that incentivized households and firms to conserve energy. Such conservation efforts, together with similar measures in other major European economies and steps to secure access to additional gas supplies, greatly mitigated the shock's impact.

Nevertheless, high energy prices and tighter financial conditions have lowered growth. The economy began to weaken in mid-2022 and contracted by 0.8 percent in 2023, as high energy prices reduced output in energy-intensive industries and as elevated inflation and rising interest rates weighed on private consumption and residential investment.

Growth is expected to gradually recover going forward. The economy is expected to expand by around ½ percent in 2024 as rising real wages support higher consumption. Growth is projected to build further momentum during 2025-26, reaching near 1½ percent as the effects of monetary tightening fade and support a recovery in investment. Further out, growth is projected to fall to around 1 percent as demographic headwinds from population aging weigh on labor supply and potential growth.

Labor markets have remained strong despite weaker growth. The employment rate hit a record-high in mid-2023, and the unemployment rate remains moderate. Labor market tightness is also seen in job vacancy rates that remain above pre-pandemic levels and in strong nominal wage growth, which exceeded the euro-area average in 2023. Labor market tightness is expected to ease somewhat in the near term amid widening slack in the economy, with initial signs of this trend visible in a modest uptick in the unemployment rate in the second half of 2023.

Headline inflation is expected to fall gradually to near the target by mid-2025. Declining energy prices have helped reduce headline inflation to 4.3 percent in January from double digits a year ago. However, core inflation remains elevated (5.4 percent) due to sticky services inflation and lags in the transmission of lower energy input prices to core inflation. Sticky services inflation in turn reflects rapid nominal wage growth and the post-pandemic rebound in the global demand for services, especially tourism. Nonetheless, continued pass-through of lower energy input prices to core inflation and a modest widening in economic slack are expected to help reduce inflation to near its two percent target by mid-2025.

This baseline outlook is, however, subject to important risks in both directions. Upside risks include a stronger-than-anticipated boost from external demand. Key downside risks include intensified Red Sea trade disruptions and further shocks to global commodity markets, especially gas. While Austria currently maintains high levels of gas storage, continued dependence on Russian gas nonetheless exposes industries and consumers to renewed supply disruptions. Domestic risks include an abrupt correction in housing and commercial real estate markets, which would adversely affect financial sector and household balance sheets and dampen growth. If inflation were to become entrenched above the euro-area average, this could also damage Austria’s competitiveness over time.

Fiscal policy

The authorities should seek opportunities to overperform on the fiscal deficit target for 2024. The 2024 budget plans to keep the fiscal deficit broadly unchanged from 2023, with higher interest costs, higher expenses related to adjustments for high past inflation, and increased spending on defense and pensions offsetting the phasing-out of some energy-price relief measures. More near-term fiscal adjustment would ideally be desirable to better support disinflation and rebuild fiscal buffers. The authorities are therefore encouraged to save any

revenue overperformance and avoid adopting new deficit-creating measures during the year. Remaining energy-price relief measures should also be phased out as early as possible now that wholesale gas prices have fallen back to more normal levels. Fiscal policy should also remain agile and adjust as conditions warrant, including by easing (accelerating) adjustment if growth and inflation surprise sharply on the downside (upside).

Steady fiscal consolidation remains important over the medium term. Austria has some fiscal space partly attributable to effective debt management, with relatively long average maturities and low overall risk of sovereign stress. However, rising structural fiscal costs (related to aging, defense spending, and needed investment in the green transition and digitalization) could push public expenditure up by 3-4 percent of GDP by 2030. Absent offsetting measures, this would cause fiscal deficits and the debt-to-GDP ratio to rise significantly over time. Substantial fiscal adjustment measures are thus needed to offset fiscal pressure from rising spending needs and to put the public-debt ratio on a clear downward path. Options for such measures include reducing subsidies and tax expenditures, especially environmentally harmful ones; updating property tax valuations (the last comprehensive update of property values based on actual market prices was in 1973); and pension reforms, among other options. With such measures, the authorities should aim to bring down the structural primary balance close to zero by 2028, with structural adjustment of about 0.3 percent of GDP per year during 2025-28. In the longer run, such a balance would stabilize debt below the Stability and Growth Pact target of 60 percent of GDP while also providing a modest cushion against adverse shocks.

Financial sector policies

The financial system has been stable, liquid, and profitable. Banks had record-high profits over the past two years on rising interest margins, with returns above the average for other European banking systems. Overall, the banking sector's CET1 capital ratio stood at 16.6 percent in mid-2023, comparable to the EU median, though the average ratio for the largest Austrian banks remained somewhat below the typical level of EU comparators. Liquidity appears ample, with the liquidity-coverage ratio at 168 percent. Pension and insurance companies also appear liquid and well capitalized.

Banks should use high profits to strengthen capital buffers and improve protection against adverse shocks. The recent increase in bank profits is likely to be partly temporary, as higher deposit rates will weigh on net interest margins, which are expected to have reached their peak, and as further credit losses may materialize on exposures to commercial real estate (CRE) and other vulnerable sectors. Supervisors should thus continue to encourage banks to be conservative in capital distributions. Banks should use the current high profits to build up protection against adverse shocks, including by further strengthening capital buffers and insuring against cybersecurity risks by boosting investment in security technology. In this context, the implementation of higher capital requirements (O-SII and systemic risk buffers) in 2022 for individual banks is welcome. The current setting of the countercyclical capital buffer at zero is also appropriate given the negative credit gap, but this buffer could be increased once the credit cycle turns and shifts into expansionary territory.

Prudent lending standards for residential real estate should be maintained. To guard against macro-financial risks associated with excessive mortgage debt, the authorities prudently adopted limits on loan-to-value ratios and debt-service-to-income ratios in 2022. These measures should be maintained despite the recent interest-rate-driven downturn in housing markets, as the prudential limits are needed as a permanent, structural measure and are not especially tight in international comparison. Indeed, the limits are quite flexible due to substantial exemptions and hence are not economically binding at the moment for many banks. Even if looser limits were to substantially increase mortgage credit, this could actually undermine housing affordability by causing house prices to spike. Efforts to improve affordability should focus instead on boosting housing supply by easing disincentives and regulatory constraints on new construction (e.g., slow permitting procedures), including by reviewing land-use and rental regulation and increasing taxes on vacant land zoned for residential housing.

Continued close monitoring of CRE risks is warranted, and data gaps should be closed. Many CRE markets in Europe and the US are facing a significant downturn amid higher financing costs and post-pandemic structural changes in demand for working and retail spaces. Austrian CRE markets appear in some ways to be faring better, with office vacancy rates remaining low. Nonetheless, a large Austrian real estate company failed in recent months, and data gaps complicate a full assessment of broader risks from a macroprudential perspective. Austrian banks' CRE lending has also risen over time to 20 percent of total loans (using a broad CRE definition) as of Q3 2023, which stands out in EU comparison. The CRE exposure of pension and insurance companies also appears sizable. The authorities should thus continue to closely monitor these risks and advance ongoing efforts to close data gaps, including by producing and publishing data on CRE prices, rental returns, and debt-service coverage ratios.

Implementing key recommendations from IMF staff's 2020 Financial System Stability Assessment for Austria would further reduce risks. Notable outstanding recommendations in this regard include (i) measures to strengthen the statutory independence of financial supervision and regulation and (ii) revising bankruptcy and resolution legislation to facilitate fast and efficient resolution of troubled financial firms and the broader management of financial crises.

Structural reforms

Boosting labor supply will help address growth challenges from demographic headwinds. As in many European countries, Austria's working-age population is projected to shrink considerably over the medium term, reducing economic growth. To help offset this decline, Austria should reduce gaps in labor force participation. In particular, female employees work fewer hours per week on average compared to other European countries, reflecting high rates of part-time employment. This gap is especially large starting in childbearing years, reflecting the uneven supply of childcare facilities across Austria, among other factors. Recently adopted plans to increase fiscal support for such services are thus welcome but could be expanded with more ambitious targets. While this will entail initial fiscal costs, much of this is likely to be offset by higher fiscal revenue due to an expanded workforce. Continued efforts to close gender wage gaps would further strengthen incentives

for women to engage in full-time work. Another area is which Austria has relatively low labor-force participation rates is among older workers. While this gap is expected to narrow as the standard pension retirement age for women rises to equal that for men, the gap could be further reduced by additional pension reforms, such as linking the retirement age to increases in life expectancy. Efforts to enhance the integration of immigrants into the labor force are also welcome and should be further deepened to support Austria's medium-term growth prospects.

Additional measures are needed to secure the green transition. Austria has made significant strides in its green transition agenda, including with the implementation of a national carbon price and by expanding renewable energy generation. However, the current trajectory of emission reductions falls short of Austria's commitment to reduce emissions not covered by the EU emissions trading system by 48 percent relative to 2005 levels. Austria has also set a target of 100 percent electricity generation from renewable sources by 2030, which will require substantial new investment. In addition to committing the necessary resources to achieve this target, authorities should reduce delays in permitting to speed up green infrastructure investment, upgrade electricity grids, and address skill shortages in occupations that are critical for the green transition.

Austria should prepare for risks from geoeconomic fragmentation and strengthen economic competitiveness. At the EU level, Austria can support solutions that aim to reduce fragmentation and preserve the benefits of global integration and multilateralism. Austria can also bolster its resilience against geoeconomic fragmentation by identifying specific products exposed to fragmentation risk, stress-testing supply chains, and developing strategies to cope with potential disruptions. In this context, accelerating the green transition would strengthen energy security. Continued efforts to expand digitalization, including by implementing Austria's 2030 Broadband Strategy, will also help retain Austria's competitiveness and improve medium-term growth prospects.

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The mission thanks the authorities and our other counterparts for the constructive policy dialogue and productive collaboration.