INTERNATIONAL MONETARY FUND

Embargo 15.30

Austria: Staff Concluding Statement of the 2015 Article IV Mission

December 14, 2015

Raising growth sustainably calls for a push on reforms, gradual but sustained fiscal consolidation focused on making expenditures efficient, fast resolution of pending banking issues and vigilant monitoring of banks' plans to increase their capital ratios, and rapid integration of immigrants.

1. **While Austria's post-crisis growth has been modest, the outlook suggests a moderate improvement.** Following a strong rebound after the 2009 crisis, growth stalled below 1 percent in 2012-14. As potential growth has dropped as well, largely reflecting a slowdown in total factor productivity (TFP), the negative but moderate output gap is expected to close in 2018. Sluggish demand and falling energy prices have brought headline inflation below 1 percent, although core inflation is higher, mitigating deflation risks. On the positive side, unemployment, although rising, has remained moderate at below 6 percent. Strengthening private consumption, investment, and exports are expected to raise growth to about 1½ percent in 2016.

2. **The financial and external positions have improved.** Bank leverage has declined and the dependence on wholesale funding remains low. The current account surplus exceeds 2 percent of GDP thanks to sustained price competitiveness and robust tourism inflows, even at times of geopolitical tensions. The net international position has moved into positive territory.

3. However, significant headwinds remain and new challenges are emerging:

- Austrians are living longer, a favorable social outcome. This, however, means that age-related health and long-term care costs are on the rise, putting strong pressures on public finances. The old-age dependency ratio is set to rise sharply as well, implying higher pension spending given Austria's generous pension system. These factors would push further the already high public debt (86 percent of GDP).
- A surge of asylum seekers is putting pressure on public spending. In 2015, asylum applications are expected to reach 80,000-90,000, equivalent to about 1 percent of Austria's population, followed by a similar number in 2016. Staff project net fiscal costs to reach 0.1 percent of GDP in 2015 and 0.3 percent in 2016.
- While Austrian banks have strengthened their balance sheets, the sector remains large, concentrated, and highly interconnected. Moreover, capitalization of major banking groups remains below peers, and profitability is low. While the restructuring and resolution of the banks that had to be nationalized during the crisis have progressed significantly, their legacy wind-down units still need to dispose of assets.

4. **The authorities have responded with policy steps in the right direction.** These include moves to cut the hefty taxation on labor, reduce the incentives for early retirement, and cap health spending. Moreover, the authorities have moved to rationalize the division of responsibilities on health and education and increase transparency of spending at all levels of government to avoid duplication. While still in early stages, measures to integrate refugees are timely and well-targeted.

5. We see three policy priorities going forward:

- Calibrate the fiscal stance to strike a balance between supporting activity while it's still weak and rebuilding fiscal buffers, mainly through expenditure reforms;
- Sustain the efforts to integrate immigrants into the Austrian economy, and advance structural reforms to raise potential growth and improve the fiscal accounts;
- Resolve remaining crisis legacies in the banking sector, and further strengthen financial sector resilience.

Fiscal policies for stability and sustained growth

6. **In the short run, a broadly neutral fiscal stance, as envisaged in the 2016 budget, is appropriate until the output gap closes.** Keeping to these plans, however, is subject to significant risks related to (i) the ability to fully finance the ambitious 2016 personal income tax reform and (ii) uncertainties about the costs associated with the refugee crisis. While recent revenue buoyancy will help, it is likely that additional measures will be needed to reach the targeted deficit.

7. **In the medium term, high public debt and looming ageing costs call for further fiscal consolidation.** We recommend moving gradually to a structural surplus of ½ percent of GDP in 2018-2020 once the output gap has closed, and keeping this surplus until the debt-to-GDP ratio reaches 60 percent of GDP. This would regain space for countercyclical fiscal policy and the absorption of tail risks, improve Austria's structural budget position ahead of rising ageing costs, and allow faster return of AAA credit rating and sustained lower borrowing costs in the long run.

8. **We thus see a case for broad reform-based cuts in large expenditure areas where Austria spends more than peers without achieving better outcomes.** Gradual cuts would not impact growth significantly, while helping meet the 2016-2020 structural targets. We estimate the overall savings that can be generated through expenditure reforms at about 4 percentage points of GDP by 2020. Specifically:

- In healthcare, the effort to shift care away from hospitals toward outpatient services should be stepped up, and inputs (e.g. number of beds and doctors per 1000 residents) should be aligned with peers to contain cost inefficiencies;
- Education spending per student should also be reduced to that of peers, retaining some savings to improve educational outcomes, especially in secondary education.
- Savings in subsidies to both enterprises and households could be enhanced by introducing more transparency and better targeting at all levels of government.
- In the pension system, raising incentives to work longer and further improving the system of disability retirement to prevent abuse could deliver further savings. Moreover, anchoring the statutory retirement age to longevity gains, as is now best practice in the EU, would reduce pension spending by 1 percentage point of GDP in the long run. In addition, starting the planned increase in women's pension age sooner than 2024 would reduce income inequality and support labor supply.

To reap these gains, a national strategy to reduce costs, fully coordinated at the national and subnational level, is essential. A key part of the strategy would be to benchmark spending targets to the best domestic and international practices. A concerted effort should also be made to avoid a duplication of services between the various levels of government and ensure their effective and efficient provision.

9. **These reforms would also make room for further reduction of the labor tax wedge.** In particular, the high social security contributions could be reduced more substantially beyond the modest cuts envisaged for 2017-18 to support demand for labor and help absorb the rising labor supply. Such cuts are desirable on their own right, even if expenditure is not reduced sufficiently, and could be financed, in a revenue-neutral way, by hikes in consumption, environment-friendly, and wealth taxes, which remain well below international averages.

Bold structural reforms and rapid integration of immigrants to raise the economy's potential.

10. **Raising productivity growth and labor force participation are needed to bolster potential growth.** As emphasized during previous consultations, policies to support enhanced IT penetration, improve access to finance for start-ups, and reduce administrative barriers for new business could be key levers to raise productivity by strengthening innovation and improving competition. Structural reforms to increase labor force participation—by lowering the burden of taxation, discouraging early retirement, improving the quality of education, and further expanding child care facilities—will reduce labor cost and build human capital. Moreover, measures to retain women, older workers, and people from migrant background in the labor force should be reinforced, countering the projected deterioration of the old-age dependency ratio.

11. **Successful integration based on early, intensive, and sustained policy response is key to reaping the benefits from immigration.** We estimate that the increased immigrant inflows over 2015-20 could lift potential GDP growth by ¼ of a percentage point by 2020 and reduce net pension and health spending by a similar amount. The authorities have rightly focused their policy efforts on providing language training as well as setting the frameworks for skill certification and targeted apprenticeship training. Speed of integration is essential to avoid attrition of skills and maintain work motivation. In this context, restrictions on asylum seekers to take up work while their applications are being processed should be eased and active labor market policies should be deployed to foster the employment of accepted refugees. Labor taxation should be further revisited to make work more financially attractive than receiving social benefits even at low wages. Providing affordable housing is crucial for attracting immigrants to areas with high labor demand.

Policies to resolve remaining crisis legacies in the banking sector and strengthen its resilience further

12. **The authorities have made significant progress in revamping the regulatory framework for the banking sector.** The implementation of key elements of the EU Banking Union is well advanced. This includes the SSM framework, the transposition of the Bank Recovery and Resolution Directive (BRRD), and the introduction of a pre-funded deposit guarantee scheme. On the macroprudential front, the Austrian Financial Market Stability Board is up and running and has proposed a systemic risk buffer, to be phased in during 2016-19. Other macroprudential measures have focused on stronger local funding of Austrian banks' subsidiaries abroad and reining in foreign-currency loans at home and abroad. Against this backdrop and given heightened risk and reduced profitability in some CESEE markets, large Austrian banks have been refocusing their business on core markets and activities, raising reliance on local funding of subsidiaries, and cutting operational costs.

13. **Nevertheless, further measures need to be taken.** Capital cushions of major banks, while improving, remain thin in comparison with peers, profitability is recovering only slowly, and the sector remains exposed to political and economic risks in CESEE as well as domestic Swiss franc loans. To address these challenges, the authorities should continuously assess the adequacy of bank capital requirements and stand ready to tighten them if risks intensify, including by modifying the size and phasing-in schedule of the systemic risk buffer. They should also swiftly press for alternative measures if banks' plans to raise capital ratios falter. In addition, the authorities should encourage banks to take proactive measures to mitigate risks related to Swiss franc mortgage loans, for instance by promoting loan conversion to euro-denominated mortgages with gradual amortization, loan reduction through early repayment, or higher contributions to existing repayment vehicles. Furthermore, macroprudential preparedness should be further strengthened by introducing instruments such as loan-to-value, debt-to-income, and debt-service-to-income limits for mortgage loans, possibly regionally differentiated.

14. **The resolution of failed banks has advanced, but certain options to resolve HETA raise difficult trade-offs.** The authorities have made substantial progress with the resolution of failed banks and the restructuring of the Volksbanken sector. The sale of Hypo Alpe Adria's SEE network has been completed, and the rest of the institution has been transformed into a wind-down unit ("HETA"). As regards the latter, the authorities need to judiciously balance the obvious benefits of a quick resolution with the reputational and financial risks associated with a retroactive change of contracts. For instance, the latter could call into question the credibility of guarantees issued by some subnational bodies and raise funding costs for some banks.

* * *

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