Austria: Staff Concluding Statement of the 2022 Article IV Mission

FOR IMMEDIATE RELEASE

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- June 13, 2022:

The Austrian economy was one of the most affected in the EU by the COVID pandemic, but it has rebounded well. The war in Ukraine has been another economic shock and—while current growth forecasts remain favorable—has caused downside risks to rise considerably. Austria has fiscal space and should use it to build resilience to energy shocks, diversify energy sources, and accelerate investment in the green transition. Policies to cushion vulnerable households and firms from inflation and high energy prices are appropriate, but they should be temporary, targeted, and should not distort energy price signals. The eco-social tax reform is a positive step and should be implemented quickly. The financial sector remains healthy and profitable, but risks have risen from the war in Ukraine and continued housing price inflation, and prudential measures should be taken to address these risks. Efforts should be stepped up to integrate refugees (including recently arrived Ukrainians) and immigrants into the labor force, and to address skills and regional job mismatches. Action to boost digitalization and increase labor force participation among older workers would aid in enhancing Austria's growth potential.

Economic outlook

Austria was one of the EU countries more affected economically by the COVID pandemic, but it has rebounded robustly. The large share of tourism in Austrian GDP accounted in part for the steeper contraction and for a somewhat slower initial recovery. However, in recent quarters, growth has been strong. Real GDP surpassed its pre-COVID level in 2021Q4, notwithstanding a partial lockdown due to the Omicron outbreak. Government policies to respond to the pandemic and cushion its economic impact were largely appropriate and effective in supporting households and firms.

The war in Ukraine constitutes another shock to the economy and has caused downside risks to rise considerably. Strong growth in the services sector and buoyant private consumption in 2022Q1 gave Austria's recovery a boost and led IMF staff to revise upward our assessment of growth for this year. However, the war and associated sanctions have dampened the outlook for European trading partners and Austria's high dependence on

Russian gas leaves it vulnerable to the fallout from the war. Growth is now projected to slow to about 4 percent in 2022, from 4.8 percent in 2021, and moderate further in 2023 as sanctions are assumed to remain in place.

Inflation has accelerated sharply. Price hikes were driven initially by significant supply chain bottlenecks in the wake of an unexpectedly strong recovery in world demand. The war has further aggravated price pressures—mainly through a sharp increase in energy prices—and recent severe lockdowns in China may extend the supply chain shortages. Nevertheless, IMF staff expect 12-month inflation to peak in the coming months and gradually decline in the second half of the year. For the entire year, we project inflation to average around 7 percent.

Uncertainty around the outlook is very high with risks firmly tilted to the downside. A potential escalation of the war in Ukraine could further depress the European outlook and impair consumer and business confidence. An abrupt stoppage in natural gas supplies could have major adverse effects on households and on production. Continued supply chain disruptions and further increases in energy and commodity prices could lead to higher and more persistent inflation and weigh on growth. The evolution of the pandemic remains a risk due to possible new highly contagious and/or lethal variants. A housing price correction could adversely affect balance sheets of households and the financial sector. On the upside, a quick solution to the war would boost growth. Swift adjustment to phase out energy imports from Russia could accelerate the green transition and strengthen economic resilience.

Economic policies to build resilience and accelerate the green transition

Economic policies should aim at cushioning the impact of war, building resilience, and boosting growth*. Key policy priorities include: (i) providing targeted, temporary, and non-distortive relief measures to vulnerable households and affected firms; (ii) building resilience to energy shocks through investment in energy storage and transport facilities from alternative sources; (iii) accelerating the green transition through timely implementation of the eco-social tax reform and additional climate-friendly measures; and (iv) assisting refugees and helping them integrate quickly into the Austrian labor market*.

The fiscal deficit has fallen sharply and the public debt-to-GDP ratio is expected to decline rapidly, leaving Austria with fiscal space which can be used to support the economy. While deficits were high in 2020 and 2021 to respond to COVID and its economic effects, IMF staff expect the 2022 deficit to fall to around 2.5 percent of GDP due mainly to the unwinding of temporary pandemic support and strong economic growth. Under current policies, the deficit would decline to around ½ percent of GDP in the medium-term, and the debt-to-GDP ratio would fall below 70 percent of GDP. IMF staff believe that Austria could undertake a slightly slower fiscal consolidation path without jeopardizing its fiscal stability, using the additional resources for building resilience against energy shocks and increasing green investment and productivity enhancing reforms.

The government has taken measures to address inflation concerns and the immediate effects of the war in Ukraine, totaling around 1 percent of GDP. Many of these are appropriately targeted to more vulnerable households and firms and are temporary in nature. However, some actions, such as a temporary cut in the tax rate on household energy, are costly, less targeted, and could undermine green transition efforts by distorting price signals. IMF staff recommends that any additional support should allow full pass-through of international prices to consumers while providing more targeted and temporary transfers.

An immediate policy focus to ensure energy security is crucial to address Austria's vulnerability to Russian gas disruptions. Despite having a high share of renewable electricity, about 20 percent of final energy consumption is dependent on natural gas of which about 80 percent is Russian. In the event of a gas shutoff from Russia, existing studies estimate an output loss of about 1-3 percent of GDP over one to two years, depending on the degree of gas substitutability and the extent of the shortfall. These losses could be larger if there are bottlenecks to fuel switching within key gas-dependent sectors that are also critically integrated into supply-chains. A further spike in energy and related prices could depress demand even more. IMF staff welcome the government's contingency planning, focused on building gas reserves in the short-term through the establishment of a strategic gas reserve. While boosting storage may help withstand a shock in the very near term, we encourage the authorities to simultaneously start actions for more sustainable medium-term solutions. These would ideally combine steps to encourage conservation (including financial incentives, such as a bonus-malus system), incentives to prepare for fuel switching in electricity production, and strategies to diversify gas supplies in coordination with EU partners. Concurrently, the government should accelerate measures to increase domestic green energy production and speed the transition away from fossil fuels in both production and consumption via public investments and cooperation with—and incentives for—the private sector.

Staff welcome the planned introduction of the eco-social carbon tax to help achieve Austria's emissions reduction target and aid the energy transition. While this package alone will not be sufficient to reach Austria's long-term goal of carbon neutrality, it constitutes an important step in that direction. The carbon tax covers emissions in the transportation and building sector, currently outside of the current EU-ETS scheme and accounting for about 40 percent of nation-wide emissions. The scheme was designed to be revenue neutral in the medium-term and provides for transfers to households to compensate for higher energy prices. It also includes a price stability mechanism to help shield consumers from excessive energy inflation in any given year. IMF staff support the protection of vulnerable households who may be adversely affected by the carbon tax, but advise against increasing broad-based compensation over and above the medium-term neutrality objective, which would be poorly targeted, distortive, and erode fiscal space. Staff encourage the government to implement the eco-social reform as quickly as possible, as any delay will hinder climate and energy transition objectives. In the future, when the fixed price scheme is phased out to a market-based one, staff encourage the authorities to plan against an abrupt transition and ensure that the market price does not fall below the terminal fixed price of €55 per ton.

Staff welcome further personal income cuts in the second and third-income brackets as envisaged in the eco-social tax reform. However, the labor tax wedge will continue to rise over time due to bracket creep, and accelerate in a higher inflation environment. Therefore, we support the authorities' plan to index the personal income tax brackets to inflation.

Protecting Resilience and Stability in the Financial Sector

The banking sector has weathered the pandemic well, but risks related to the Ukraine war warrant cautious monitoring of asset quality and enhanced supervision. Overall, banks have adequate capital and liquidity buffers, while earnings have been robust. There have been so far limited balance sheet and market spillovers from the war, mainly due to strong local liquidity management in Central, Eastern and South-Eastern European (CESEE) subsidiaries. Nonetheless, a prolonged war and spillovers to the CESEE countries could exacerbate market volatility, creating pressures on lending, while dimming profitability prospects. Still, to guard against headwinds from the geopolitical situation, the authorities could consider calibrating the parameters of existing systemic risk buffers (SyRB and O-SII) for banks that have pronounced exposures in Russia and CESEE countries. While the counter-cyclical capital buffer has been so-far maintained at the rate of 0 percent, the authorities should begin planning for future activation, dependent on the evolution of the macroeconomic outlook and credit growth (which is currently slightly beyond prudential thresholds).

Residential real estate prices have continued to rise strongly, with increasing signs of overvaluation on the OeNB's metric. Mortgage lending has risen considerably, with continuing deviations from the Financial Market Stability Board (FMSB) prudential guidelines.

For this reason, IMF staff strongly support the FMSB plan to make binding the upper limits for loan-to-value ratios, debt-service-to-income ratio, and loan maturities effective in the coming weeks. Once in place, the authorities should carefully monitor the effectiveness of these actions and stand ready to adjust as needed. Additional capital-based macroprudential measures, such as a sectoral systemic risk buffer calibrated to real-estate exposure, could also be considered if vulnerabilities persist. Risks stemming from commercial real estate also warrant close monitoring and collection of granular data. More broadly, although non-performing loans are low, loans with deteriorated credit quality ('Stage 2 exposures') merit continued monitoring.

The recent orderly liquidation of Sberbank Europe was a successful test of the Austrian deposit guarantee system (DGS) and of cooperation between Austrian and European banking authorities. All three Austrian DGS institutions provided resources for the liquidation in a timely fashion, and the mechanisms to protect depositors and dispose of the bank's assets allowed a smooth and effective resolution. IMF staff remain concerned about potential inefficiencies in this fragmented deposit insurance system, however. Staff welcome a working group established to strengthen the supervision of less significant institutions and recommend authorities implement the proposals of this group. Headcount increases for LSI supervision at OeNB and FMA are already underway.

Structural reforms to reduce scarring and ensure an equitable and resilient recovery

The labor market has performed better than expected in the recovery from the pandemic. Employment is now above pre-COVID levels and both the overall unemployment rate and the long-term unemployment rate are below their previous levels, reflecting the effectiveness of pandemic policies (such as the short time work scheme) and the strong recovery. Nevertheless, there is evidence of growing skills and regional mismatches in the labor market. To address these, IMF staff recommends policies to support the reallocation of workers and reduce these mismatches, such as re-skilling programs and relocation assistance. Measures to rapidly integrate refugees from Ukraine are a welcome step from both a humanitarian and economic perspective and can contribute to resolving labor shortages. More generally, efforts should be made to improve the labor market outcomes for all immigrants, by pursing policies such as combined language and work-oriented activity assistance and targeted wage subsidies to incentivize their hiring. As the employment and labor participation gaps of immigrants are especially pronounced for women, policies to provide more child-care could also reap benefits. Expanding labor market access to all asylum seekers and accreditation schemes for humanitarian migrants would further speed up integration efforts.

Accelerating the digital transition in areas where Austria lags EU peers, including digital connectivity, use of internet services, and integration of digital technology will help boost productivity and raise Austria's growth potential. Such spending could also contribute to the green transition, as greater digital access can increase work-from-home options and online banking and commerce, which could lower transport needs, lowering fossil fuel consumption and greenhouse gas emissions.

Long-term measures to increase labor force participation of older citizens and lower long-term spending pressures from population aging would be advisable. Austria's pension system is currently financially healthy, with past reforms helping to raise effective retirement ages and contain fiscal costs. However, Austria's effective retirement age and statutory retirement age are both still low by international standards, and labor force participation for those 55-64 remains below EU and OECD averages. Increased labor force participation by this population segment could help address labor and skills shortages while reducing future pension costs. In the longer term, further aging will generate increased pension and health care costs, while contributions will decline. Reforms to address this increasing liability would be appropriate in the coming years.

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