

Austria—2006 Article IV Consultation, Preliminary Conclusions of the IMF Mission

December 11, 2006

Strong outlook for Austria's economy

- 1. Situated at the heart of Europe, Austria benefits from access to diverse markets, both mature and emerging.** Growth has been consistently above the euro area average in recent years, and the external position has been strong. Key factors in the country's economic success have been: a consistent focus on macroeconomic stability; a range of structural reforms; a social partnership facilitating wage moderation; and an orientation towards rapidly growing countries in Central, Eastern, and Southeastern Europe (CESE).
- 2. The economy gathered speed in 2004-05, and growth is now projected to exceed 3 percent in 2006, with some slowdown in 2007.** Growth so far in 2006 has been broad based with continued strong exports, private consumption growth, and a clear pick-up in investment. GDP growth in 2006 would be the highest since 2000 and the output gap would be almost closed. Growth is expected to come down to a rate somewhat above 2½ percent in 2007 on the heels of lower demand from trading partners. Inflation is forecast to remain comfortably below 2 percent in 2007. These forecasts are in line with those made public by the OeNB earlier today.
- 3. Unemployment is relatively low and has been declining.** At 4.7 percent in November, the unemployment rate is low compared to the euro area. As economic activity picked up in recent years, employment growth has accelerated strongly and put unemployment on a downward trend, but the pace of reduction is more limited than the growth in employment due to an increase in the labor force. Unemployment is forecast to come down slightly in 2007.
- 4. Continued wage moderation will be essential to maintain Austria's competitiveness.** Wages have been increasing modestly, despite higher labor demand, and unit labor costs have been contained. Recent agreements between social partners for 2007 show a continuation of this trend. The mission welcomes this development given that the margins in international trade are small and significant wage increases would quickly erode Austria's healthy external position.

Need for continued fiscal responsibility

- 5. It is important to remain focused on the fiscal bottom-line in the coalition discussions.** The strong economy is expected to result in a reduction of the deficit to 1.2 percent of GDP in 2006. The further outlook will depend on the outcome of the coalition discussions. According to estimates, the measures included in the various election programs that are currently being discussed could add 1-2 percent of GDP to the annual deficits in the next four years. In recent weeks, the mission witnessed a tendency to agree on or raise public expectations about significant increases in expenditures without a clear identification of the financial aspects. In this context, we welcome the functioning of a coalition financing working group that will assess the budgetary implications of the various proposals in order to allow a necessary prioritization of the various proposals.
- 6. It is optimistic to assume that the fiscal picture will return to balance by itself.** Looking forward, a "no policies" baseline scenario has been agreed upon by the two parties as the basis for budgetary projections in the context of the coalition discussions. This scenario shows an increase in the deficit to about 1½ percent of GDP in 2007 and 2008. The mission is skeptical about the projected subsequent decline in 2009-10, which hangs on relatively optimistic assumptions for fiscal developments in these years.
- 7. We feel strongly that fiscal responsibility and continued consolidation should remain key objectives of the Austrian government:**
 - First, further fiscal consolidation is necessary **to ensure long-term fiscal sustainability** in an environment of an aging population, which—as elsewhere in Europe—will lead to rising pension and health and old age care expenditures, even with the current pension reform underway.
 - Second, to be credible, the objective of **fiscal balance over the cycle** implies surpluses under strong economic conditions. The Austrian economy has been one of the strongest and fastest growing economies in the euro area. On the basis of its strong performance and the official target of balance over the cycle—confirmed by the key political parties in recent weeks—one would expect surpluses, which underscores the need for further consolidation.

- Third, **the best period to implement structural fiscal adjustments is during an economic upturn.** Thus, now is the time to take a critical look at the efficiency of the expenditure side. This is the more relevant with monetary policy being determined on a euro-area wide basis, which leaves fiscal policy as Austria's main macroeconomic stabilization tool.

- Fourth, Austria has built its recent economic fortunes on a **reputation of fiscal responsibility.** This is of particular relevance for a small, open economy that is heavily dependent on foreign trade and investment.

8. **To avoid a deterioration in its public finances, Austria should stick to the path outlined in the November 2005 Stability Program.** Specifically, the new government's objectives should continue to be a balanced budget over the cycle. Given the current health of the economy, a return to balance by 2008 remains feasible. This would require an adjustment of about ½ percent of GDP for both 2007 and 2008. As taxes in Austria are generally still at a high level, the adjustment should come mainly from the expenditure side. Setting clear spending priorities and identifying durable expenditure measures targeting the least productive areas of government spending will therefore be necessary. To this end, broad based budgeting reforms should be implemented, as described in the Stability Program, including the adoption of a formal medium-term budgetary framework that sets explicit medium-term expenditure targets consistent with the fiscal objectives.

9. **Past staff work and studies by others have identified public administration, subsidies, and health as areas of potential efficiency gains.** There has been progress in streamlining public administration at the federal level, but efforts are lagging at the local levels. Reform of the health sector is at an early stage, and, also as pointed out by the OECD, duplication in the provision of health care remains significant. In the pension area, the general harmonization has thus far not reached the sub-national level, where benefits are among the more generous. Moreover, eligibility rules for disability pensions could be tightened to ensure that they do not provide a loophole for gaining access to early retirement. The targeting of subsidies could also be improved.

10. **Further streamlining of the functions of the various levels of government will be essential to expenditure control.** In the past, it has appeared difficult for the federal authorities to ensure local governments' contributions to the necessary reform efforts. Last year, the Austria Convent—established by the Parliament to prepare proposals for reform of the constitution—had the potential to revamp intergovernmental fiscal relations, but it could not achieve consensus on substantial improvements. The parties should use the opportunity of the coalition discussions to agree on a restart of this process with the objective to muster the necessary majority to ensure effective reform.

11. **Going forward, further tax cuts should be considered only after expenditure measures have been taken.** They should focus on reducing the burden on labor and simplifying the system, increasing its transparency, and minimizing distortions. The burden of taxation—in particular on labor—although coming down, remains high by international standards.

Managing financial sector expansion

12. **In recent years, the Austrian financial sector has been expanding rapidly, while overall showing strong results.** This development took place against the background of further declining domestic margins, and a slowly continuing domestic consolidation process. Domestic cost cutting, but above all the rapidly expanding activities in CESE have been responsible for increases in profits. Overall, the banking sector remains well-capitalized and resilient, with limited non-performing loans and adequate provisioning, and bank ratings for the major banks are in line with those of their peers. The authorities have undertaken stress tests, which indicate a satisfactory shock absorption capacity of the Austrian banking system, and have followed up on the recommendations stemming from the 2004 IMF Financial Sector Assessment Program (FSAP). The mission welcomes the authorities' interest in an FSAP update, provisionally planned for the second half of 2007.

13. **The rapidly expanding activities of the financial sector require close monitoring.** The expansion abroad in CESE has helped financial deepening in this region, but the risks involved have grown with the expansion of the activities. In particular, the rapid growth of foreign currency lending by Austrian banks, both in Austria and abroad, requires close monitoring in order to avoid foreign exchange risks for the customers to translate into credit risks for the banks. In Austria, the supervisors and banks have already taken useful steps to inform and educate consumers on the risks involved in borrowing in foreign exchange, but such efforts seem to be less advanced in CESE. In addition, and in preparation for the

implementation of Basel II, supervisors need to continue to ensure that the banks use appropriate and adequate risk management and measurement techniques.

14. More generally, close collaboration between the Austrian and the host supervisors in CESE is key to effective supervision of cross-border banking groups.

The enlargement of the EU has facilitated the cross-border supervisory cooperation with the new member states. The mission welcomes, in particular, the signing of Memoranda of Understanding (MoUs) between home and host supervisors regarding exchange of information and cross-border supervisory cooperation with these new member states. In addition, it will remain important to deepen cross-border supervisory cooperation with non-EU member states in which the Austrian financial sector has a significant market share, including the negotiation of MoUs. The mission further values the authorities' preparations for joint risk assessments with their foreign peers.

15. The mission welcomes the measures taken to further strengthen corporate governance in the banking sector. To avoid a repeat of recent problems at two Austrian banks, the authorities have proposed various actions, which have partly already been implemented. These actions, to be made possible by an increase in staffing, include: a higher frequency of on-site inspections, including follow-ups where necessary; intensified off-site examinations of systemically important banks; improvements of banks' corporate governance through enhanced fit-and-proper tests; and stricter requirements for external auditors. The mission recommends the forceful implementation of these actions.

Maintaining the pace of structural reforms

16. The mission encourages the authorities to take advantage of the current cyclical upturn to intensify structural reform efforts. Following considerable progress, the momentum of structural reforms seems to have slowed lately and could use a new impulse. In particular, further deregulation of the service sector is needed to foster entry and competition. More flexible shop opening hours have been legislated, but implementation by provinces has lagged. A large government stake in one enterprise (Austria Post) was sold earlier in the year, but the mandate of OIAG to carry out further privatizations expired at the end of October and should be renewed. The independent Federal Competition Authority is already having an impact, but its investigative powers and resources could be strengthened. Competition and network access in the electricity market could be further improved to help ensure a cost-effective and stable energy supply for Austria's economy.

17. Labor market regulation should encourage participation. The Austrian labor market is relatively flexible, but participation of younger and older workers remains low. More should be done to help raise participation rates, including strengthening the effectiveness of active labor market programs, particularly job search monitoring and sanctions. Financial incentives for returning to work could also be strengthened.