September 29, 2010
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 10/83-2

12:25 p.m., August 30, 2010

2. Austria - 2010 Article IV Consultation

Documents: SM/10/209 and Correction 1, and Supplement 1, and Supplement 1, Correction 1

Staff: Waysand, EUR; Roaf, SPR

Length: 35 minutes

Executive Board Attendance

J. Lipsky, Acting Chair

Executive Directors	**Alternate Executive Directors**
	M. Majoro (AE)
	T. Kudiwu (AF), Temporary
	D. Vogel (AG)
	W. Chetwin (AU), Temporary
	J. Prader (BE)
	J. Jaramillo (BR)
	Y. Luo (CC)
	C. Balsa (CE), Temporary
	P. McGoldrick (CO), Temporary
A. Fayolle (FF)	
	S. von Stenglin (GR)
	M. Patra (IN), Temporary
	D. Marchettini (IT), Temporary
	M. Nomura (JA), Temporary
	M. Daïri (MD)
	W. Abdelati (MI), Temporary
	T. Manchev (NE), Temporary
P. Callesen (NO)	
	M. Atamanchuk (RU), Temporary
A. Alazzaz (SA)	
	A. Chua (ST)
	K. Zajdel-Kurowska (SZ)
	W. Lindquist (UA), Temporary
	R. Elder (UK), Temporary

J. Lin, Acting Secretary
P. Walker, Assistant

Also Present
European Central Bank: W. Coussens. European Department: V. Herzberg, J. Kahkonen, E. Steinlein, C. Waysand. Monetary and Capital Markets Department: N. Rawlings. Secretary's Department: L. Bonato, M. Yslas. Strategy, Policy, and Review Department: S. Chen, J. Roaf. Senior Advisors to Executive Directors: K. Korhonen (NO), J. Poulain (FF), H. Teferra (AE). Advisors to Executive Directors: M. Maia (BR), H. Yung (CC), I. Chowdhury (SZ), H. Do (ST), P. Garcia-Martinez (GR), A. Hagan (MD), R. Hills (UK), K. Ismail (MI), Y. Shinagawa (JA).

2. AUSTRIA—2010 ARTICLE IV CONSULTATION

The staff representative from the European Department (Ms. Waysand) submitted the following statement:

> This statement provides information that has become available since the staff report (SM/10/209) was circulated to the Executive Board on July 30, 2010. The information does not alter the thrust of the staff appraisal.
>
> Supported by a strong contribution of net exports, Austria's economic growth picked up as expected in the second quarter. Following a flat outturn in the first quarter, real GDP rose by 0.9 percent q-o-q in Q2. Exports accelerated, while gross fixed capital formation continued to contract. Conditions in the labor market further improved over the summer, with the harmonized seasonally-adjusted unemployment rate falling to 3.9 percent in June and vacancies in July up by one third compared with a year ago. Inflation declined to 1.7 percent y-o-y in July from 1.8 percent in June.
>
> CEBS stress tests indicated that participating Austrian banks were able to maintain a tier 1 capital ratio well above 6 percent in the stressed scenarios. The results, published in July, were consistent with earlier national tests run by the Austrian central bank.
>
> In light of the broad agreement reached in July 2010 by the Group of Governors and Heads of Supervision of the Basel Committee, while Austrian banks will still need to strengthen their capital positions compared with previous (Basel II) requirements, the increase will be more limited than what was implied by the December 2009 proposals. In particular, the committee will allow some partial recognition of minority interests in core capital. The Governors and Heads of Supervision are expected to finalize the calibration and transition arrangements in September.
>
> Reported non-performing loans (NPL) of Austrian banks have continued to rise. Erste Bank and Bank Austria reported an increase in their NPL ratios from 6.6 percent and 3.5 percent at the end of 2009 to 7.3 percent and 4.1 percent respectively at the end of June 2010.
>
> A Memorandum of Understanding on financial supervision is being concluded with Russia.

Mr. Prader submitted the following statement:

The Austrian authorities appreciate the consultations with the Fund and commend the staff for the high quality of the staff report. They broadly concur with the staff's assessment of Austria's economic situation and its general recommendations on economic, fiscal and financial policies.

The staff report shows that the worst of the past recession is over and all macroeconomic indicators, including on employment and unemployment, are improving. The main challenge is to consolidate the fiscal position without hampering the growth potential, whilst maintaining the social balance. We also note the Fund's interest in the Austrian financial system and its engagement in CESEE.

Short-Term and Medium-Term Outlook

Most recent data show that Austria, which suffered from a severe decline of exports last year, is now benefiting from the resumption of international trade. This has brought capacity utilization in manufacturing back close to average, which gives confidence that investment activity could also turn around towards the end of the year. Private consumption showed continued moderate growth throughout the crisis, not least thanks to substantial fiscal stimulus measures. The short-term outlook for the remainder of the year is positive, as tourism could also gain market shares. Notably, also some CESEE countries benefit from the current improvement of economic activity, while some others are still in the stage of adjustment, as rightly stated in the staff report.

The staff report points at factors which might lower GDP-growth in the medium to long-term. While not giving rise to major concerns or questions about the growth model of Austria, these factors will be monitored and taken into account, when formulating the medium-term economic and fiscal strategies.

Fiscal Policy

At 3.5 percent and 4.7 percent of GDP in 2009 and 2010, the general government deficit reflects the biggest stimulus package ever and the operation of automatic stabilizers. Even if the absolute level of the deficit has remained below the euro area average thanks to the relatively good performance before the crisis, the government is firmly committed to embark on a decisive consolidation path. In line with the staff report and European procedures, fiscal consolidation will start in 2011. Current plans provide for a fiscal deficit of 2.3 percent of GDP in 2014, thus well below the staff's medium-term macroeconomic framework. With the new budget framework law in place at the federal level, expenditure ceilings for the years to 2014 have already been set by Parliament. The spending ministries are currently developing instruments to cope with the ceilings, which will be implemented with the 2011 federal budget, scheduled for adoption by the end of the year. The authorities could agree with the staff that consolidation should focus more on the expenditure side, but other factors necessitate also measures to raise revenues.

Financial Sector

In 2009, market confidence in Austrian banks was restored, owing to public financial support and a more favorable environment created by stepped up central bank liquidity operations as well as EU/IMF programs in CESEE. At year-end 2009, the banking sector reported a recovery in bottom-line profitability despite higher risk costs, and capitalization levels continued to improve on the back of capital increases and deleveraging. The new Basel requirements will, however, make a further strengthening of Austrian banks' capital position necessary.

As evidenced by the latest OeNB stress tests, the Austrian banking sector has shown resilience to risk. The results of the CEBS stress testing exercise confirmed this assessment for the major banks, even though Austrian banks were subjected to a more severe CESEE scenario than their competitors. Furthermore, the disclosure of sovereign portfolios revealed only a comparatively low direct exposure of Austrian banks to Euro area countries that have come under market scrutiny.

As of today, it is noteworthy that irrespective of market turbulences, Austrian banks have lived up to their commitment as long-term investors in CESEE. The responsible role played by foreign banks in CESEE should also be considered in the discussion on the introduction of banking taxes in the region—disproportionately high tax levels will certainly not be helpful for its recovery process and its banking systems. Austrian banks were among the most active banks in the European Bank Coordination Initiative and continue their cooperation under the auspices of the EBRD in the "Vienna Initiative Plus." In this respect, Austria has taken a prominent role to contribute to the solution of the FX lending issue in CESEE by agreeing with banks on a set of guidelines to curb the most risky forms of foreign currency lending in CESEE. A level playing field—to be achieved via the "Vienna Initiative Plus"—will be essential for the long-term success of these measures. In the domestic market, the Austrian authorities, in 2010, imposed a de facto ban on foreign currency loans to un-hedged private households in Austria, after a string of softer measures proved to be insufficient.

We agree on the importance of keeping the financial sector support package in place for the time being and of closely monitoring the withdrawal of monetary stimulus measures, as the banking sector still faces a challenging environment. This concerns inter alia the refinancing of maturing bonds, the unfolding of credit risks in Austria as well as in CESEE, the sustainability of current operating profitability levels and the challenges arising from regulatory changes.

Mr. Stein and Mr. von Stenglin submitted the following statement:

We thank staff for their solid report and Mr. Prader for his informative buff statement. The Austrian economic outlook has shown signs of improvement but vulnerabilities regarding external economic developments and financial sector risks remain. Against this backdrop, the main key policy challenges are the need to undertake the required fiscal consolidation, to closely monitor risks to financial stability, and to raise potential output through structural reforms to help dealing with the effects of ageing on economic growth and fiscal balances.

Fiscal Policy

We appreciate the authorities' commitment to embark on a decisive consolidation path. We concur with staff that consolidation needs to start as planned in 2011 in order to put the public debt ratio on a declining path. The approved new medium-term expenditure ceilings are a step in the right direction. We encourage the authorities to present an appropriately ambitious budget for 2011, including the concrete measures that would underpin the necessary consolidation. In this context, it would also be advisable that any unforeseen budget over-performance should be used to accelerate the reduction of gross public debt. Moreover, the credibility of fiscal consolidation could be boosted by an early specification of how the authorities intend to reach their medium-term deficit objective, so that Austria can meet its obligations under the Stability and Growth Pact to bring the deficit below 3 percent by 2013. We also concur with staff that fiscal consolidation should indeed focus on the expenditure side, although other factors necessitate also measures to raise revenues.

Regarding the fiscal framework, we welcome the efforts to strengthen the internal fiscal rule. In his respect, we would like to stress that coordinating the fiscal adjustment among the different layers of government and strengthening the Austrian Stability Pact would be crucial for the success of the consolidation strategy.

Financial Stability

We concur with staff that the overall situation of the financial sector has improved. Recent stress tests confirmed that banks are generally adequately capitalized to withstand shocks, but considerable heterogeneity among individual banks calls for vigilance. We commend the decisive authorities' response to stress in the financial sector that helped to recapitalize banks and guarantee parts of their liabilities and assets. The financial sector has also benefited from internationally coordinated support packages for several CESSEE countries and from increased liquidity support by the ECB. We also welcome that banks have broadly maintained their exposure in the CESEE region in the context of the European Bank Coordination Initiative (the "Vienna Initiative").

However, we concur with staff that vulnerabilities remain, in particular regarding the weak capital positions of some banks and their strong dependence on wholesale and market funding, rising non-performing loans, and uncertainties regarding the sustainability of some bank' earnings performance if funding costs or the need for provisioning increases. Therefore, continuing close monitoring of individual banks' situation and appropriate action to reinforce capital buffers are necessary. Moreover, the Austrian banks would be significantly affected by the proposed Basel requirements and, as pointed out by Mr. Prader in his buff statement, the new capital and liquidity requirements will make a further strengthening of Austrian banks' capital position necessary, although they would also pave the way for a safer financial system going forward. The financial sector support package needs to remain in place, even though the authorities should consider gradual exit of support measures to limit distortions.

We fully support ongoing efforts to discourage foreign currency lending in Austria and in CESEE countries, which according to staff have decreased only marginally abroad. However, we concur with staff that reducing the share of foreign exchange-denominated loans in the CESEE region, while providing continued financing to the region remains a key challenge.

We welcome the strengthening of the financial sector supervision and regulation. We also encourage the authorities to continue to work on an appropriate bank resolution framework which could help to limit distortions in the financial sector.

Structural Policies

We concur with staff that potential growth should be supported by structural reforms. In particular, the low labor force participation rate of older workers and the high unemployment of migrant workers pose a challenge to the Austrian labor market. Recent pension reforms have strengthened incentives to work longer but further reforms raising the effective retirement age would be advisable.

Mr. Virmani and Mr. Patra submitted the following statement:

We thank staff for a well-written report and Mr. Prader for his comprehensive buff statement. The global crisis was primarily transmitted to the Austrian economy through the trade channel, producing in 2009 its deepest recession in decades. Analogously, it is the rapid upswing in world trade that is paving the way for a moderate recovery in 2010 that should strengthen in the following years when domestic demand firms up and takes over as the growth driver. The authorities are to be commended for their timely and sizable response in the form of discretionary fiscal measures, including labor and credit market support, on top of allowing the free operation of automatic stabilizers. Developments in Europe—euro area as well as in emerging economies of central, eastern and south eastern Europe—present the most significant risks to a gradually improving outlook.

Macroeconomic Outlook

We note that the authorities are somewhat more optimistic than staff on the outlook for 2011 and beyond, with recent upward revisions being driven mainly by the recovery in world trade. Yet, available indicators suggest that the growth of Austria's exports remains moderate relative to previous recovery episodes, reflecting the still uncertain demand conditions in major trading partners. Fixed investment continues to contract and the outlook is weak in comparison with historical averages. On the other hand, it is private consumption that is responsible for stabilizing the economy, held up by tax cuts and transfer payments. What is the likely impact of the planned phasing out of stimulus measures from 2011 onwards? Given labor market conditions, what are the risks to the outlook for growth on account of fiscal consolidation?

Employment conditions remain difficult, especially in the manufacturing sector. What is the outlook for employment growth as short-term working schemes and training programs are phased out? Furthermore, there was a visible deceleration of labor supply in 2009 and demographic developments may likely affect labor supply adversely over the medium-term. Is the influx of foreign workers from new EU members with the easing of restrictions in 2011 expected to compensate? On the other hand, the resulting reduction of real wages may further dampen employment prospects. The staff's comments are welcome.

Fiscal Policy

We agree with staff that in view of country-specific conditions, fiscal consolidation will have to be primarily expenditure-based. However, we seek staff's views on the possibility of additional revenue shortfalls due to the 2009 tax reform and the extension of access to the special early retirement scheme overburdening the consolidation effort. We are also interested in any details of the revenue measures which are expected to constitute 40 percent of the deficit reduction. We agree that it is important to reinforce fiscal discipline at all levels of government. How can enforcement mechanisms be strengthened under the internal stability pact?

Financial Sector

We note that deleveraging in the Austrian banking sector has led to a large reduction in international claims. Does this presage a change in the business model with a preference for domestic assets, thus favoring the smaller local banks? In view of the persistent need to make provisions for credit risks, what are the implications for credit supply and credit costs, and, in turn, on the real economy? While some bank resolution methods such as mergers are not explicitly recognized, are they excluded under the extant legal framework? We commend the authorities on the improvements being made in the regulatory and supervisory framework and capacity, especially in the context of cross-border operations, and wish them well in their efforts to return to pre-crisis growth and strength.

Mr. Assimaidou submitted the following statement:

We thank staff for a well-written report, and Mr. Prader for his insightful buff statement.

The Austrian authorities are to be commended for the strong policy measures implemented to counter the downturn of 2009, including the fiscal stimulus and financial sector support packages, which helped improve confidence in the economy. As a result, the Austrian economy is now recovering from recession, driven by the revival in export demand. Inflation has continued to remain low and in line with the average for the euro area. Also noteworthy are the facts that the authorities have succeeded to contain the rise in unemployment, Austria's fiscal position remains solid compared to most of its Euro area peers, and the current account balance remains in surplus. The improved confidence in the financial sector is also well taken.

Looking ahead, it is heartening to note that Austria is well-posted to benefit from the revival in trade in 2010 and 2011, and that tourism is also expected to improve. However, since the outlook is expected to remain fragile, particularly in view of the uncertainties surrounding the international environment and financial markets, the authorities are encouraged to monitor closely economic developments in the euro area and the Central, Eastern, and South Eastern European (CESEE) countries, in order to ensure that the economic recovery is sustained. In Box 1 and Annex1 of the main report, staff has provided interesting information on "boom-bust" in CESEE and implications for Austria. We welcome staff's good description of the overview of economic linkages between CESEE and Austria. We hope that the authorities can draw some important lessons from the staff's findings and stand ready to take appropriate actions if and when needed to ensure that their economy remains strong and stable. Can staff elaborate on what the best lines of defense can be for Austria, should renewed tensions occur in CESEE?

Over the medium term, among factors that might keep growth below pre-crisis levels, we note in particular the ongoing weakness in investment and the aging population. In this regard, it is reassuring to note from Mr. Prader's statement that the authorities will monitor these factors when formulating their medium-term economic and fiscal strategies.

In the fiscal sector, as long as the recovery remains fragile, we agree that the withdrawal of the fiscal stimulus should be gradual. Moreover, with a debt-to-GDP ratio expected to increase to 70 percent in 2010 against 59 percent in 2007, we concur with the view that this trend should be reversed. In this vein, we welcome the authorities' planned consolidation path aimed at bringing the government deficit below 3 percent of GDP by 2013, starting in 2011, so as to put debt back on a downward and sustainable trend. However, a careful preparation of measures to achieve the fiscal consolidation remains paramount. Furthermore, as the overall tax burden and taxation of labor are already at the highest levels and provide little scope for tax increases in Austria, we see merit in a well-designed expenditure-based consolidation, with participation at all government levels, which could minimize the effects on growth and enhance sustainability. In this connection, the authorities' intention to introduce a performance-based budgeting by 2013 is a move in the right direction to ensure budgetary discipline. It is unfortunate to note from Box 4 of the report that the current federal framework continues to suffer from a number of shortcomings, including with the Internal Stability Pact, while there seems to be room for improvement in information exchange and coordination among partners. We would like to encourage the authorities to spare no efforts to improve the efficiency of the fiscal federalism.

Regarding the financial sector, we note that banks' capitalization has continued to improve, spurred by capital increases and deleveraging, and liquidity positions have strengthened. Moreover, the banking sector registered a slight recovery in profitability in 2009 and non-performing loans remained at low level. Despite these encouraging developments, it seems also that important challenges remain, as evidenced by the issue of sustainability of banks' earnings performance in case of a deterioration of the international environment, as well as the possibility of seeing banks' profitability be dented by anticipated bank levies. Moreover, we concur with the view that providing continued financing to the CESEE, while reducing the share of foreign loans will remain a key challenge. We, therefore, encourage the authorities to monitor closely the situation of the banks and ensure that proper measures are taken, in order to enhance the resilience of the financial sector. We also find appropriate the extension of the current financial sector-support package, and the need to further strengthen supervisory, and we welcome Austria's action plan to remedy strategic deficiencies previously identified by the Financial Action Task Force (FATF).

With these remarks, we wish the Austrian authorities every success in their future endeavors.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

Austria's strong performance prior to the crisis helped it weather global turbulences which negatively impacted trade, investment, and credit conditions. The crisis highlighted vulnerabilities that need to be addressed in order to preserve Austria's economic strength. These vulnerabilities include a rising public debt level and financial exposure to distressed European countries. Debt levels rose to finance the fiscal response and support the financial sector. In addition, potential growth has decreased to a lower path, although the output decline is less severe than in some other European countries. While growth is expected to pick up with the recovery in global trade, fiscal consolidation, as well as continued strengthening of financial sector resilience and structural measures to bolster potential growth will be important as the staff rightly emphasize.

Gross government debt rose to 70 percent of GDP in 2010 and is projected to rise to 75 percent of GDP by 2013 even with the planned deficit reduction from 2011 onwards. The permanent tax cuts that were introduced in 2008 helped support demand, but we concur with staff's advice to avoid across the board tax increases given the already high level of tax to GDP. We welcome the authorities' medium-term expenditure framework, which can be further strengthened with spending controls at the sub-national level and ceilings on issuance of local government debt and guarantees. To control expenditure growth without harming growth, staff suggests increased efficiency of social spending and better targeted benefits. However, the staff report only mentions savings from public health insurance companies amounting to 0.2 percent of GDP. Could staff elaborate on the potential yield from efficiency savings and on other viable sources of expenditure savings?

Extension of the financial support measures until end 2010 is appropriate, but careful consideration should be given to the design of exit policies. Despite the overall resilience and improved position of the financial sector, dependence on wholesale and market funding is a source of vulnerability and capital positions need to be further strengthened in some instances. Closer monitoring, including through stress testing, would help facilitate prompt action as needed. A stronger intervention and resolution framework is also needed to ensure early actions. For banks with large exposures to countries in central, eastern, and southern Europe, careful attention is needed to balance the need to maintain exposure levels with the need to enforce tighter lending standards particularly with the aim of reducing the share of foreign exchange lending. Coordination with partner country supervisors would be helpful in this regard and we take positive note of the efforts to curb the most risky forms of foreign currency lending as noted in Mr. Prader's helpful buff statement.

I take note of the authorities' concerns that new Basel requirements will be overly demanding on banks and of the high sensitivity of banks to the definition of Tier 1 capital. It would be helpful to know if there have been any updates on the results of the study on the quantitative impact of the Basel proposal on banks. It will be important to balance the need to strengthen capital and liquidity positions with the goal of preserving the recovery, particularly given the issues facing banks, namely rising nonperforming loans, high share of funding bonds that will mature in the next few years, rising funding costs, and anticipated bank levies.

To support potential growth, further consideration should be given to stepping up competition in the services sector, including by following through on the recommendations of the EU Services Directive. Better utilization of labor resources is also a priority and in this regard we welcome the introduction of free pre-school education for 5-year olds as a way to improve employment conditions for women. Growth, as well as fiscal sustainability, would be enhanced by increasing the effective retirement age and eliminating those special measures that are undermining the effectiveness of the 2003 pension reforms. We would welcome staff comment on the merits and possible scope of reducing the high effective labor tax on the low-skilled workers.

With these comments, we wish the authorities success in addressing the current challenges.

Mr. Bakker and Mr. Manchev submitted the following statement:

We thank staff for the focused report and appreciate their analysis on the implications for Austria of the "boom-bust" cycle in Central, Eastern and South Eastern European (CESEE) Countries. We broadly agree with the staff appraisal and we associate ourselves with the statement by Mr. Stein and Mr. von Stenglin.

Austria is expected to recover from its worst recession in decades and we commend the authorities for their prompt and adequate response to the recent crisis. We share the staff appraisal for a modest recovery of the Austrian economy in 2010 and 2011, but the risks surrounding this outlook should not be underestimated given the strong dependence on exports, the increasing concerns over a "double-dip" recession in some of the important trading partners, and the lower than envisaged effects from the recent increase in R&D investments.

Despite the overall recent improvement and registered slight recovery in profitability, the vulnerability of the Austrian banking sector remains high to any prospective tension in CESEE countries or emerging from unhedged domestic borrowers. We share the staff's view on the necessity of higher capital and liquidity requirements on banks in light of the recent crisis. Hence, we concur with staff that the authorities' efforts to implement and enforce tighter foreign exchange-lending standards and to reduce these exposures are very welcome. Austrian authorities should carefully monitor the development of financial and macroeconomic conditions when planning and proceeding with the implementation of future new regulation for the banking sector or withdrawing from the already implemented measures. We also emphasize that such measures will be more effective, if the authorities take into account the key role of Austrian banks for the stability of the financing to the CESEE region.

The government support to the banking sector and the role played by the automatic stabilizers has significantly weakened Austria's fiscal position, although, deficit and debt levels remain lower than in a number of advanced countries. The long-term sustainability of the public finances should be ensured by a judiciously timed and credible fiscal consolidation and structural reforms. The proposed annual adjustment in the structural deficit of at least 0.5 percent of GDP per year as prescribed by the Stability and Growth Pact is warranted given the pace of debt accumulation. We concur with staff that there is a need to more clearly identify the structural reforms underpinning the expenditure reductions of the current plans. The policies could be redirected toward an increase of labor participation of older workers, tackling the high unemployment among less skilled workers and promoting full-time female participation. We encourage staff to further comment on this issue.

Mr. Shimoda and Mr. Nomura submitted the following statement:

We would like to thank the staff for the well-written paper and Mr. Prader for his informative and candid statement. As we broadly agree with the thrust of the staff appraisal, we would like to limit our comments on the following points:

Fiscal Policy

The staff argues that one of the key areas for expenditure-based fiscal consolidation should be rationalization of the domestic inter-governmental fiscal relationship by disentangling allocation of responsibilities and better aligning taxing with spending. We strongly support the staff recommendation, and would like to encourage the authorities to make utmost effort to proceed with the staff recommendation.

Generally speaking, with regard to countries where the size of vertical fiscal coordination—transfer of revenues from federal level to state and municipal level government—is relatively large, compared with horizontal level coordination, it is no wonder state and municipal level governments tend to rely more on, and request more for, transfers from federal government than making their own efforts to close their own budgetary gap, including the efforts of building consensus among residents in individual state or municipality to increase state or local tax.

One way to expel such moral hazard and rationalize domestic inter-governmental fiscal relationship could be to develop or improve a sense of ownership in state and municipal level governments in their own fiscal management by abolishing any institutionalized vertical fiscal coordination system yet, at the same time, transferring corresponding revenue sources from federal government to state and local governments. This could be achieved by clearly defining the division of labor and the allocation of revenue sources among all levels of government, and eliminating any shared responsibilities or shared revenues. Allowing bankruptcy of state and municipal governments, with clear prohibition upon federal government from providing any financial assistance, should also be considered. In the long run, these measures would also be useful for building a sense of responsible democracy.

We would like to know whether the staff has any intention of sending these policy recommendations to countries with high level of vertical fiscal coordination. The staff's comment is welcome.

Financial Sector Issues

Given the remaining vulnerabilities with regard to the banking sector and the lingering concern over the outlook for CESEE, we agree with the authorities' view on the need to keep the financial sector support package in place for the time being.

Having said that, it seems equally important to assess its implications on the fiscal outlook of Austria, so that the authorities can communicate to the market that associated risks to the Austrian fiscal outlook are limited. This public announcement would contribute to preventing speculative investors from fabricating suspicions over Austrian sovereign debt risks.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Itam submitted the following statement:

We thank staff for the comprehensive and well-written paper, and Mr. Prader for his helpful buff statement.

Austria, which suffered from a severe decline of exports during the crisis, is now benefiting from the recovery of international trade. It is encouraging that the worst of the recession is over and all macroeconomic indicators, including on unemployment, are improving. In view of the openness of the economy and the close trade and financial ties to central, eastern and south eastern Europe (CESEE), that have been severely affected by the crisis, it is not surprising that the downturn was felt through both the trade and the financial channels. The legacy of the crisis left Austria with a large fiscal deficit and mounting public debt; a financial sector weakened by the bursting of credit bubbles in some CESEE countries; and lower potential growth hampered by ongoing weak investment, and an aging population. Despite the sign that the economy is improving, the question remains how sustainable the recovery will be in light of the ongoing weak investment and fading government stimulus measures.

Fiscal Consolidation

The challenge facing Austria is to consolidate the fiscal position without hampering the growth potential, whilst maintaining a social balance. Preparing a credible fiscal consolidation path to be implemented, as well as maintaining financial stability is necessary to restore confidence and avoid a prolonged period of slow growth. To this end, we welcome the authorities' concurrence with these priorities, as conveyed by Mr. Prader in his buff statement.

Furthermore, we note that the discretionary fiscal measures implemented to cushioning the impact of the crisis, consisting mostly of personal income tax, are largely permanent. While welcoming the planned performance-based budgeting, we join staff in calling for early agreement on identifying credible fiscal consolidation measures, including measures that are aimed at structural fiscal consolidation over the medium term to support potential growth.

Additionally, addressing the long-term sustainability of public finances with a credible path of fiscal consolidation based principally on expenditure restraint will be crucial. Given Austria's relatively high tax rates in major categories, we concur with staff that most of the needed fiscal adjustment should be through expenditure reductions, although we see room for a significant increase in property taxes that would support municipalities' finances. We are encouraged by the approval of the new medium-term expenditure ceilings by parliament, and commend the authorities for pursing their fiscal structural reform effort. However, to ensure that expenditure ceilings are consistent with long-term sustainability, they need to be sufficiently ambitious, including by explicitly taking into account long-term aging cost and increasing the efficiency of the federal fiscal system. In addition, the current framework needs to be strengthened and introduction of ceilings to local governments' debt and guarantees issuance will be crucial to ensure participation of sub-national levels in the consolidation process. The staff's comment on the status of contribution of sub-national levels in the consolidation process is welcome.

Financial Sector Support

Given vulnerabilities in the financial sector owing to the economy's strong economic links with CESEE countries, we encourage the authorities to remain highly vigilant to the potential transmission channels of external shocks and to maintain their proactive stance in securing adequate risk buffers. In the event of market pressures in the region, readiness for prompt implementation of capital injections is desirable in the context of a possible rise in non-performing loans beyond the levels estimated in stress tests. As staff indicates, we are encouraged by the authorities' commitment to providing additional support, if necessary. In this connection, an early shaping of a clear and credible strategy for fiscal consolidation would also help in containing the sovereign bond yields and the CDS spreads against the concerns about the Austrian financial sector.

The banks' strategy of maintaining their presence in CESEE will undoubtedly have positive spillovers for regional economic activity and stability, provided the risks are well-managed. In this connection, we welcome the authorities' commitment to maintain close collaboration between home and host authorities, as well as adequate contingency planning. We believe, however, that a worsening of the situation in the CESEE region would require a coordinated international intervention. The responsible domestic policies in Austria alone cannot guarantee a successful exit from the crisis and, in this respect, underscores the importance of the authorities' engagement in international initiatives on cross-border banking issues in Eastern Europe.

With these remarks, we wish the authorities success in their future reform endeavors.

Mr. Jaramillo and Ms. Maia submitted the following statement:

We thank staff for a concise and well-written report and Mr. Prader for his buff statement.

Austria's response to the crisis helped buffer impacts on the population, particularly by protecting consumption. The crisis brought to the forefront the high degree exposure of Austrian Banks in CESEE countries, which was addressed by a large banking stabilization scheme. However the outlook remains uncertain: domestic adjustment policies are essential for medium term stability, but recovery will depend to a large extent on a very volatile external environment.

Fiscal Policy

Mr. Prader mentions in his buff that the worst of the recession is over. It may be, but we would venture that considerable downside risks remain. Consequently we agree that it would be premature to remove the stimulus this year. If the outlook continues to improve, a reversal of some of the emergency measures would be useful steps towards regaining fiscal sustainability. But to achieve the latter, further efforts will be necessary. Although a medium-term budgetary framework was introduced, the expenditure ceilings seem to be not sufficient to ensure sustainability. Delays in further action could require stronger measures later on and could impact the credibility of the consolidation effort.

The 60/40 split between expenditure and revenue measures to work towards fiscal consolidation is a commendable step. Nevertheless, the burden of the consolidation effort falls on the central government. We agree with staff's suggestion that expenditure ceilings should also be adopted at the local level. In fact without a better burden-sharing between the different levels of the government, fiscal consolidation will become much more difficult.

The 2011-14 financial framework already approved by Parliament will require significant cuts in expenditure, and the staff report usefully highlights some areas where, based on comparisons with other European countries, there appears to be room for reductions, including much publicized subsidies to national bank and the national railroad employees, and very generous disability incentives and early retirement schemes. Finally, with average government salaries well above average private sector remunerations, moderation of wage increase in the public sector could provide significant savings, as wages make up almost $^1\!/_5$ of total government expenditure.

Financial Sector

Banks' vulnerabilities are high relative to other EU countries. Thus, close monitoring, and measures to shield the banking system from contagion and mitigate systemic risks in case of unfavorable developments in CESEE countries, appear warranted. Furthermore, close collaboration between home and host authorities will be essential to improve risk management and contingency planning for Austrian banks operating in this group of countries. In this connection, we welcome the role played by Austrian banks in the European Bank Coordination Initiative, and the authorities' commitment to further enhance the regulatory and supervisory approach. Also, we support the authorities' timely decision to ban foreign currency loans to un-hedged private households.

We do take note of the results of the recent stress tests undertaken by the OeNB, indicating sufficient banking system buffers to withstand a severely negative CESEE scenario. But, given level of non-performing loans there, we would urge continued strengthening of bank capital based on frequent stress test exercises, even if this seems overcautious.

Structural Issues

We would have liked to see more discussion in the report on structural reform issues. In this area, the main challenges are addressing the rather early effective retirement age, and the implementation of the pension reform. Incentives to encourage more homogeneous labor market participation across the different segments of the population would be useful. In particular, the fact that about one third of the work force has entered disability benefits at the average age of 51 turns on a flashing red light.

Mr. Sadun and Ms. Marchettini submitted the following statement:

We thank the staff for the informative report and Mr. Prader for the helpful context provided in his buff statement.

After experiencing years of sustained growth, Austria's economic activity contracted markedly in the first half of 2009, hit by a combination of trade and financial shocks, and a related sharp contraction of investment. A modest export-led recovery is now underway, though the near-term outlook is clouded by significant downside risks, mainly related to the external economic and financial uncertainties. Looking ahead, Austria's medium-term potential growth is expected to decline, as a result of population ageing and deleveraging in some CESEE countries. The authorities should reckon with these challenges through a mix of decisive fiscal measures and structural reforms, aimed at easing labor market segmentation and increasing competitiveness.

We share the views expressed by Mr. Stein and Mr. von Stenglin, and we limit our comments to a few topics.

Fiscal Policies and Consolidation

We agree with staff that starting fiscal consolidation by 2011 is of paramount importance. The deterioration of Austria's fiscal position during the crisis has been substantial. Furthermore, many stimulus measures were permanent, making future fiscal consolidation more difficult. In this respect, we appreciate the authorities' commitment to embark on a decisive consolidation path starting by 2011, although we believe, as other Directors, that the Government should be more precise in the identification of the concrete measures for achieving its ambitious deficit targets. The early specification of the consolidation strategy is key to make the plan credible and anchor investor expectations. As highlighted by staff, the consolidation path should be mainly expenditure based and should involve all levels of government. The adjustment efforts should focus on measures that enhance efficiency and have the least detrimental impact on economic activity.

The fiscal adjustment should be part of a medium-term consolidation plan. Though we recognize the preemptive steps already taken by the authorities to reform the pension system, further steps to upgrade Austria's social protection and increase the efficiency of the health care system would be beneficial. While these measures may provide only limited immediate savings, they could have a positive and sizeable effect on credibility in financial markets. Finally, the authorities should continue their efforts to reform the federal fiscal system and to enhance the fiscal relations among the different layers of government.

Financial Stability and Supervision

The banking sector has stabilized, but its financial situation remains vulnerable to potential spillovers from mature markets and emerging Europe. Massive public intervention, the EU-IMF programs in some CESEE countries, and the European Coordination ("Vienna") initiative contributed to stabilizing the banking system and reducing systemic risk. However, lingering uncertainty in global financial markets may weigh on asset quality and profitability, and may increase funding pressures on Austrian banks heavily reliant on wholesale funding to support their credit operations. Against this backdrop, we consider it appropriate to keep in place the financial sector support package for the time being.

Bank capitalization broadly increased but the quality of capital could improve. Despite improvements in banks' capital buffers, wide heterogeneity among banks remains. In this regard, the authorities are encouraged to take action to ensure the adequacy of bank capital, and to transpose into local regulation forthcoming EU directives and Basel Committee of Banking Supervision recommendations on the level and quality of capital.

Structural Reforms

Fiscal consolidation should be combined with structural measures aimed at supporting potential growth. The focus should be on enhancing the use of the labor force. In particular, training programs for low skilled and immigrant workers and measures to reduce the high gender gap would help to ease labor market segmentation and increase productivity. In the services sector, measures should be taken to ensure competition.

Mrs. Zajdel-Kurowska and Mr. Chowdhury submitted the following statement:

We thank staff for a comprehensive report and broadly concur with the staff's analyses and recommendations. While moderate signs of recovery have recently emerged, improving medium-term prospects remains challenging in view of still fragile domestic conditions and heightened uncertainty in the external environment. In the near term, further restoring health of the financial sector and a continuing accommodative fiscal stance are warranted in light of the still quite fragile prospects for economic recovery. These policies should be couched in a longer-run framework strengthening financial stability, ensuring fiscal sustainability, and renewing the momentum of structural reforms to boost potential output.

As a result of the ongoing budget relaxation and the financial sector assistance public debt has increased noticeably. The sizable weakening of the budgetary position calls for a strong and credible commitment to fiscal consolidation as the recovery firms. We support the authorities' intention to tighten fiscal policy starting in 2011, provided growth firms, with the eventual aim to reduce the deficit to below 3 percent of GDP. We welcome the clear identification of time-bound fiscal adjustment targets for 2011-14 and support the staff's call to early unveil the fiscal measures to achieve consolidation.

We agree with Messrs. Stein and von Stenglin on the importance to coordinate the fiscal adjustment among the different layers of government and strengthen the Austrian Stability Pact. A reform of fiscal federalism is important to contain fiscal risks stemming from lower levels of government and to successfully accomplish the consolidation strategy. We note with concern that some local governments have been issuing guarantees in excess of their financing abilities and wonder about the fiscal risks stemming from the existence of numerous extra-budgetary entities.

Fiscal consolidation should be accompanied by structural reforms to alleviate the adverse impacts of the crisis on potential output. Since the current crisis is likely to have long-lasting effects on potential output, the case for accelerating structural reforms is crucial to contain, particularly ageing related, expenditure. In this context, we agree with Messrs. Stein and von Stenglin that raising the effective retirement age would be advisable.

The authorities' interventions in the financial sector have been apt and helped to restore market confidence in Austrian banks. This being said, weaknesses remain, in particular regarding the capital position of some banks. As banks continue to face a still challenging credit and earnings outlook and in line with international efforts to strengthen capital requirements, efforts to strengthen banks' recapitalization would be welcome. Reinforcing capital buffers should include both an increase in the level and quality of capital. As banks would be strongly affected by the proposed Basel requirements, measures should be introduced in a forward looking way in order not to jeopardize the economic recovery.

The crisis has also exposed weaknesses in the bank resolution framework. We support the staff's call to design a specific bank resolution framework to increase the range of options for action for the authorities. Could staff elaborate on the work underway in Austria in this regard?

Mr. Talbot and Mr. Hills submitted the following statement:

We thank staff for a helpful paper, and Mr. Prader for his useful buff statement. We concur with the basic thrust of the staff paper's assessment that the key challenges faced by Austria are to restore fiscal sustainability, to support potential growth through structural reforms, and to strengthen financial stability—the latter particularly important, given Austrian banks' considerable exposures to CESEE countries. We associate ourselves with the comments of Mr. Stein and Mr. von Stenglin, and had a couple of additional comments and questions.

Macroeconomic Outlook and Structural Reforms

Like staff, we think that Austria is well placed to benefit from the pick-up in global trade. In 2011 and beyond, according to staff projections, around two-thirds of growth will be contributed by domestic demand. It is true that private consumption has been relatively resilient throughout the crisis, reflecting strong household balance sheets and low unemployment. But in order to achieve this level of medium-term growth, the authorities should adopt a policy framework aimed at strengthening the sources of domestic demand.

Structural reforms will be a key element of this. The staff's focus on improving the utilization of labor resources is particularly welcome. We would highlight in particular improving the employability of older workers, and reform of the educational system. Raising the number of science and engineering graduates would help Austria to translate its relatively high spending on R&D into a reorienting of the structure of the economy towards high-tech production.

Fiscal Policy

The government's plan to begin fiscal consolidation in 2011, with the intention of reducing the deficit to 3 percent of GDP by 2013, seems appropriate. We agree with staff that the medium-term focus of policy should be to ensure that debt moves onto a downward path. We would also tend to agree that there is somewhat more scope for an expenditure-based consolidation than the authorities currently envisage. At any rate, it will be particularly important to set out and then implement a detailed and credible set of medium-term measures, across all levels of government.

Financial Sector

The position of the banking sector in general has improved over the past year, but pockets of individual bank weakness remain, both in terms of capitalization and funding vulnerabilities. We therefore agree with staff that it is appropriate to keep the financial sector support package in place for the time being. We note that, in addition to raising additional capital, the banks have also responded by significantly deleveraging (by 13 percent of assets so far). How does staff judge that this deleveraging has affected the provision of credit to the real economy? Does staff expect that the new Basel requirements will cause banks to tighten credit standards?

On the regulatory structure, we strongly agree that a specific bank resolution framework is likely to be a helpful addition to the regulatory toolkit, and would also highlight the importance of enhanced early intervention powers for the supervisory authorities.

External Sector

Austria's economy and financial system are both highly internationally integrated, and so we agree that potential growth will be affected by reduced dynamism in some CESEE countries. However, there is considerable heterogeneity amongst countries in that region, and it would be useful to delve further into these distinctions, beyond the splitting out in Annex I of the "formerly booming" economies. In particular, staff points out that demand for Austrian exports, given the high import content, could be more dependent on the competitiveness of CESEE countries, and third-country demand, than on CESEE demand per se. To which countries and sectors does this high import content of exports particularly apply, and what magnitudes are involved? It would also be useful to examine trade links to Germany, to which Austria exports more than to all of the CESEE countries combined.

We agree with staff that there is a trade-off between reducing sources of vulnerability and maintaining essential funding flows to CESEE countries. We welcome the continued commitment of Austrian banks to maintain their exposures to Vienna Initiative economies. We tend to agree with staff that tighter foreign exchange lending standards are broadly appropriate, particularly for non-euro-denominated loans, although this should be applied flexibly across different countries as appropriate, in consultation with host supervisors, with greater consideration given to assessing lenders' robustness to exchange rate movements. What impact does staff expect that the Hungarian bank tax will have on the Austrian banks active in that country, both in terms of their profitability and future lending behavior?

Mr. Vogel and Mr. Hendrick submitted the following statement:

Austria is recovering from the global crisis thanks to the authorities' timely and effective contra-cyclical policies, but several risks and key challenges lie ahead. We agree with the staff assessment that Austria is well equipped to benefit from the pick-up in trade, but as in the case of other developed countries, it is also likely that in the medium-term growth potential will not return to pre-crisis levels, given the expected rebalancing in world demand. As Mr. Prader indicates in his helpful buff statement, the authorities' main challenge is to consolidate the fiscal position without hampering potential growth, and maintaining the social balance.

The needed economic stimulus to deal with the crisis led to a serious deterioration of the fiscal position and a substantial increase in public debt. Although we acknowledge that Austria's deficit and debt compares favorably with the average of the euro area, we agree with the staff on the need to identify early the measures to achieve the authorities' planned consolidation by 2014. We also see merit in the proposal to tilt the burden of the adjustment on the expenditure side, not only because this adjustment would be more sustainable in the medium term, but also given the already high overall tax-to-GDP ratios in Austria in relation to the European Union.

Improving the rules of the Fiscal Federalism and the Austrian Stability Pact could play a key role in containing expenditure. As clearly explained in Box 3 and 4 of the staff report, there is room for improvement in the composition and quality of public spending, while reducing the fiscal deficit. The fact that local governments spend almost one-third of general government outlays, but revenues come mainly from transfers from the central government, should not be a problem per se—on the condition that local governments spend wisely and they are held accountable. In developing countries, it is always argued that one of the main limitations for fiscal federalism is the institutional capacity at the sub-national level to effectively design and execute capital spending and to maintain an adequate control of current expenditure. We assume that this may not be an issue for Austria. Could the staff elaborate further on the underlying reasons why fiscal federalism is not working in Austria, and why the most recent pact has been "unsurprisingly" off track since 2009?

The Austrian economy is very sensitive, like other small open economies, to global developments and its main trading partners. In this regard, we take note that Germany and CESEE countries receive more than 50 percent of total exports which, in turn, represents about 50 percent of GDP. At the same time, it is systemically important to many CESEE countries through the financial channel, with foreign bank exposures near 140 percent of GDP. Box 1 provides details of the implication of the "boom-bust" in those countries for Austria, and the trade and financial linkages revealing a mutual dependence among these countries and the risks related to unexpected negative events in the recovery process for CESSE countries.

The financial sector has weathered the global crisis well but remaining risks call for further strengthening the financial stability framework. We welcome the positive outcome of the stress tests showing the resilience to risk by the Austrian banking sector. However, risks in the CESEE countries, forthcoming bank levies, and the implementation of the new Basel requirements will call for further strengthening banks' capital positions and still a sizable support from the central government until risks are manageable. We take positive note that Austrian banks have broadly maintained their exposure as agreed under the "Vienna Initiative." Although no validated quantitative estimates of the impact of Basel proposals are available, could the staff provide some notion of how much may be needed to boost capital and liquidity positions to a "safe level?"

With these comments, we wish Austria and its people every success in their future endeavors.

Mr. Chua and Mr. Do submitted the following statement:

We are pleased to see that the Austrian economy has weathered the global crisis and that a gradual recovery is underway. The authorities have acted appropriately during the crisis to support domestic demand and shore up the financial sector. It is also notable that Austrian banks have acted responsibly and maintained their presence as long-term investors in the CESEE. This has contributed to the stabilization of the situation in the region.

Significant challenges remain for Austria in both the near- and medium-term.

First, the authorities need to implement a credible and well-targeted fiscal consolidation plan. We welcome the new budget framework law, which sets expenditure ceilings for the years to 2014. We agree with Mr. Prader that consolidation should focus more on the expenditure side, with some measures also on the revenue side.

Second, it would be important for Austria to undertake an ambitious and sustained program of structural reform to enhance potential growth. This should include reforms to the social security system, in a manner that is consistent with sound microeconomic principles and the societal values.

Third, vulnerabilities in the banking sector, in particular the capital positions of some banks and their dependence on wholesale funding, should be addressed. Further, like Messrs. Shimoda and Nomura, we believe that it would be important for the authorities to assess the impact of the financial sector support package on Austria's fiscal outlook. In the medium-term, we encourage the authorities to extend the resources available to the financial regulator so they will be in a position to strengthen the safety and soundness of the financial system going forward.

Finally, Mr. Prader has raised an important point in his statement that the introduction of banking taxes should be handled with care. We agree that it would be important that these taxes are designed in a way that preserves the ability of banks to support the recovery process and future growth in the region.

Mr. Legg and Mr. Chetwin submitted the following statement:

We thank staff for their papers and Mr. Prader for a concise and helpful buff statement.

Austria appears to be on its way out of the 2009 recession and is returning to growth, thanks in part to policy stimulus and financial sector support. Nonetheless, the staff points out that risks remain to the economic outlook, and also that there are structural challenges to the pursuit of growth in the medium-to-long term. We generally agree with staff's analysis and policy recommendations, including the three main policy challenges—fiscal consolidation, ensuring financial stability, and bolstering potential growth. We have only a few comments.

We agree that it is important to consolidate the fiscal position in the medium term, while noting that there is space to maintain fiscal support for the economy through 2010. The world has recently seen the importance of fiscal space to either provide direct support or to bolster confidence. The confidence effect could be important because of the relatively high rollover needs of some Austrian banks in coming years, and their exposure to some CESEE economies along with the risk of any further problems in those countries.

We encourage the identification of specific measures for fiscal consolidation, to enhance the credibility of the authorities' plans. We also support staff's suggestion that the focus should be more on the expenditure side given the potential to cut less effective spending and to reduce distortions caused by subsidies.

Indeed, the pension scheme and other labor market institutions, particularly when combined with the ageing population, pose risks both to economic efficiency and to the fiscal position. As Mr. Prader notes, the authorities clearly place high value on social balance. That objective is worthy in itself, but staff's analysis suggests that in some areas the mechanisms to achieve the balance could be better designed. Moreover, in the longer term a more-efficient economic structure might pay off socially by raising the economy's performance.

In particular, the structure of the public pension scheme appears to discourage labor supply in a country whose population is ageing. Other support affecting labor supply should similarly be reviewed to ensure that it achieves its goal while minimizing the distortion to economic decisions.

Finally, given the importance of the financial sector and its foreign operations, we were surprised to note that the Austrian authorities are unable to perform on-site inspections in some non-EU member states. Are they in fact receiving the necessary information from the local supervisors in those countries? Or is this a concern that needs to be addressed?

We wish the authorities well for the future.

Mr. Callesen and Mr. Korhonen submitted the following statement:

We thank staff for its focused report and Mr. Prader for his insightful buff statement. We associate ourselves broadly with the statement by Messrs. Stein and von Stenglin, and offer the following for emphasis.

Macroenvironment and Fiscal Policy

Significant integration of the Austrian economy with its neighboring countries has helped it to enjoy a healthy pace of growth for at least five years until the world crisis. We agree with staff assessment that the tight integration now bears risks both directly and via financial links. Nevertheless, there are some signs of revived export demand and the industrial production has increased 5.7 percent from 2009. The incipient growth should be supported by decisive action to reform economic structures. As in many other countries the main focus should be on increasing effective retirement age (especially by reversing the extension of the special early retirement scheme decided in 2008), efficiency in various government levels, and effectiveness of expenditure in the healthcare sector. Policy action to open basic infrastructure service provision, such as electricity and telecommunication, is long overdue according to the OECD. We wish that the authorities would see the potential benefits for growth in such measures.

The Austrian unemployment rate has remained at a low level despite the economic crisis. A high level of part-time female participation is one characteristic of the labor market. We would have appreciated more analysis on the labor market. Could staff comment more profoundly the backdrop of its resilience? A Low unemployment rate seems also to explain at least partially indications of Austrians being the least willing in the EU to move abroad to take up employment.

We believe that the authorities should use the opportunities offered by the crisis to implement reforms that will have long-term impacts. Sweeping changes that would improve coordination and reduce overlap between various government structures would be welcome. Since the administrative structures are likely to reflect a long-standing tradition, it might be advisable to test the receptiveness of the political climate under any sign sense of urgency. Likewise, extension of spending limits to Länder and local government levels should enable more immediate improvements in policy coordination if the more profound structural reforms require time.

Financial Sector

We take note that the banking sector's NPLs arise to 2.3 percent of their global portfolios, reaching to as much as 9.7 percent of the non-bank customer loans in CESEE. We are somewhat concerned that staff estimates that NPLs have not yet peaked. This will burden the banks' operating profitability and overshadow their capitalization, which has not yet reached totally comfortable levels. Nevertheless, we take note that the situation varies considerably between banks, and that the banks whose data was submitted to the EU-wide stress tests exceeded the regulatory minimum levels even under the stress scenarios applied.

We agree with staff that foreign exchange loans, especially to households, should remain a key focus of supervision and subject to heightened monitoring by banks' risk management functions.

Although recognizing that stressed CESEE portfolios are important in Austrian banks' balance sheets, we encourage the authorities to ensure that support measures—although for the moment appropriate—will not be held in place longer than necessary in order to allow a level playing field to return to the markets as soon as reasonably possible. We believe that direct support measures should gradually be replaced by further steps taken to strengthen supervisory cooperation with all CESEE counterparts.

At the end of 2007, twelve Austrian banks were operating 73 fully consolidated CESEE subsidiaries according to the OeNB. Effective supervision of such a myriad of entities is a huge challenge without proper supervisory cooperation. The shareholders of the largest Austrian banks were also principally foreign. Thus an effective design and operation of institution specific financial stability groups is a crucial element of Austrian financial stability. Progress in EU arrangements to strengthen bank-specific resolution frameworks should also be beneficial to Austria.

Finally, we wish to commend authorities for the steps that have allowed the recent removal of Austria from the special review list of FATF.

Mr. Alazzaz submitted the following statement:

I thank staff for a clear and concise report and Mr. Prader for his insightful buff statement. Despite entering the global economic and financial crisis from a position of strength and the implementation of measures to cushion the downturn, Austria's economy was hit hard by the crisis. Real GDP declined by 3.9 percent in 2009 mainly as a result of a sharp decline in exports. Economic recovery is underway helped by the pickup in global demand. However, the external environment remains subject to significant uncertainties, and real GDP growth is projected to be only in the order of 1.5 percent in each of 2010 and 2011. The main challenge facing the authorities in the period ahead lies in the pursuit of policies that would achieve fiscal consolidation without hampering growth prospects.

On the fiscal front, the general government deficit widened from an average of 0.5 percent of GDP during 2007-08 to 3.5 percent in 2009 and is projected to rise to 4.7 percent in 2010 as a result of the adoption of the stimulus packages and the operation of the automatic stabilizers. Accordingly, the debt to GDP ratio is set to rise from less than 60 percent in 2008 to slightly above 70 percent in 2010. Against this background, I welcome the firm commitment of the authorities to embark on a decisive fiscal consolidation path starting in 2011, with the aim of reducing the fiscal deficit to 2.3 percent of GDP in 2014. In this connection, it is encouraging that expenditure ceilings until 2014 have already been set by the Parliament. Nonetheless, as agreed by the authorities and staff, the envisaged expenditure reductions would need to be underpinned by structural measures to be sustainable.

In the financial area, public financial support, increased liquidity from ECB operations, as well as the improved economic situation created by EU/IMF-supported programs in some Central, Eastern and South Eastern European (CESEE) countries, helped reduce market pressures on Austrian banks and restore confidence. It is encouraging that the banking sector registered a recovery—albeit slight—in profitability in 2009, and that capitalization levels have continued to improve on the back of capital increases and deleveraging. Nevertheless, the new Basel requirements will make a further strengthening of the capital position of Austrian banks necessary. I note that Austrian banks have broadly maintained their exposures to European Bank Coordination Initiative economies, thus contributing to their stabilization. I commend the efforts by the authorities to implement and enforce tighter foreign exchange-lending standards in coordination with other supervisors.

With these remarks, I wish the authorities further success.

Mr. Guzmán and Ms. Balsa submitted the following statement:

We thank the staff for their focused report and Mr. Prader for his insightful buff statement.

Austria is a good example of the effects of spillovers. The main drivers of Austria's economic prosperity in the last decade are now the main drivers of uncertainty. As stated in the report, Austria took advantage of the opportunities arising from the development of CESEE economies, with empirical studies estimating that EU enlargement increased Austrian GDP growth by 0.4 percentage points each year. The global crisis and the consequent context of less dynamism in some neighboring countries are now the main uncertainties affecting potential growth and financial stability. In light of this, we welcome Austria's positive growth data in the second quarter, supported by a strong contribution of net exports, as stated in the statement update.

We welcome the analysis on inward spillovers included in the report, in particular in the annex on "boom-bust" in CESEE and implications for Austria. Nevertheless, the importance of outward spillovers is evident: foreign currency lending is discouraged while at the same time recommendations are made to avoid excessively undermining the financing of CESEE countries.

We can subscribe to Mr. Stein and Mr. von Stenglin's comments in their gray statement and take the opportunity to emphasize the following points.

We welcome the authorities' commitment to fiscal consolidation starting in 2011, as expressed in Mr. Prader's statement. The global crisis and the stimulus measures have hit public deficit and debt, and we note that the stimulus measures were mostly designed to be permanent, which complicates consolidation efforts. The authorities have plans for a consolidation path up to 2014, with annual structural reductions of about 0.5 percent of GDP. We concur with staff on the convenience of identifying measures to achieve consolidation, although a flexible approach can be appropriate within such an uncertain context. In this regard, we would appreciate more details on the structural measures referenced in the report to be included in the 2011 budget to support sustainable expenditure reductions. The staff's comments are welcome.

In the same vein, we appreciate the analysis on the Austrian Internal Stability Pact and its weaknesses, being aware of the relevance of the role to be played by regional and local governments in the fiscal consolidation efforts. Could the staff elaborate on the prospects for feasible improvements in this area?

Structural reforms need to play a key role in the recovery of potential growth; this is more relevant from the stand point of lower growth prospects in some partners. A better use of labor resources is a priority, more so for certain population segments. Nevertheless, only a gradual pension reform introduced in 2003 to increase the effective retirement age is detailed in the report, while new problems have been generated by recent measures which have tended to lower participation rates. A deeper analysis would be welcome on the specific structural reforms which could be more relevant in the case of the Austrian economy.

In the financial arena, the Austrian banking sector seems to have shown resilience to the crisis, despite the weakening effects of credit bubbles in some partners. The main challenges are now supervision and regulation reforms at the national and international levels, including an adequate resolution framework; a close monitoring of individual institutions; and an appropriate exit strategy from public financial support.

We note the authorities are well aware of the need to strengthen banks' capital position in view of the expected new Basel requirements, although the wide heterogeneity among institutions has to be taken into account. Finally, we appreciate Mr. Prader's comments on the relevant role of Austrian banks in the Vienna Initiative.

With these remarks, we wish the authorities every success in dealing with the challenges ahead.

Mr. Rediker and Mr. Lindquist submitted the following statement:

The global crisis impacted Austria through several channels, including stresses in the European financial system, the fall in global trade, and extensive trade and financial links with Central, Eastern, and South Eastern Europe (CESEE). Growth has resumed, though the crisis has left Austria with several challenges to address. The growth outlook is likely to remain more tepid than pre-crisis, and the authorities will need to undertake a medium-term fiscal consolidation. The financial crisis and slump in parts of CESEE also exposed key financial sector vulnerabilities that the authorities are taking steps to address.

Growth Outlook and Structural Reforms

Austria benefited from CESEE's convergence process in recent years, but with the recovery in much of CESEE likely to be protracted, Austria's growth outlook will be somewhat dampened. The growth model is not in need of a major overhaul, but the current juncture does present an opportunity to tweak it to confront a less buoyant external environment and an aging population. We agree with the staff that while Austrian labor markets function comparatively well, there are still certain rigidities—including education achievement gaps and barriers that preclude higher labor participation for women—that, if addressed, would improve labor resource utilization. A strong implementation of the EU services directives will also help strengthen growth in the domestic services sector.

Fiscal Policy

Austria's fiscal stimulus provided an important boost for demand during the crisis, and we agree that stimulus should continue this year, as serious risks to the recovery still exist, and there are no near-term risks to fiscal sustainability. The authorities' plans to begin reducing the deficit in 2011, with a phased consolidation through 2014, are appropriate.

We encourage the authorities to coordinate their adjustment with their EU partners. The mix of consolidation measures should be as growth friendly as possible, and we appreciate the staff's efforts to identify areas where there may be room for more efficiency in expenditures. It is worth considering the staff's recommendation to adopt more binding expenditure ceilings at the sub-national level.

Financial Sector

European banking sector strains and the severe downturns in parts of CESEE had a large impact on the Austrian banking sector. The authorities' support measures have been successful at stabilizing the sector. While Austrian banks' capital positions were found to be robust enough to weather the downside scenarios in the recent CEBS stress tests, the authorities will still need to monitor capital positions closely. Non-performing loans, especially those in subsidiaries, have likely not yet peaked. In addition, new international capital regulations being negotiated may require a strengthening of capital bases. We appreciate Austrian banks' participation in the Vienna Initiative, as Mr. Prader highlights in his statement. The Vienna Initiative has been successful in maintaining foreign banks' exposures to subsidiaries in CESEE and has greatly contributed to financial stability in the region. Like Messrs. Talbot and Hills, we ask if the staff could comment on the possible impact of the Hungarian bank tax on Austrian banks.

The lengthy resolution process for Hypo Alpe Adria demonstrates the importance of implementing the FSAP recommendations to strengthen the bank resolution framework. We also welcome the authorities' efforts to further enhance cooperation between domestic supervisors.

Finally, one clear lesson of the crisis is the risks involved in foreign currency lending to unhedged borrowers. Reducing this type of lending in Austria has been a success, but reducing this practice in subsidiaries abroad remains a challenge. We encourage the IMF to work with partners such as the EBRD, EIB, and the Austrian authorities to reduce regional risks from foreign-currency dominated lending to CESEE. One possible strategy for this would be facilitating the development of the necessary infrastructure to strengthen domestic-currency bond markets in CESEE, which would provide banks with domestic-currency wholesale funding sources.

AML/CFT

We welcome Austria's AML/CFT reforms undertaken after its June 2009 Mutual Evaluation Report. We congratulate the Government of Austria on enacting a comprehensive legislative package in June 2010 to address many of the deficiencies identified by the FATF, in particular the criminalization of money laundering and terrorist financing, as well as significant reform of its national asset freezing mechanism.

Mr. Luo and Ms. Wang submitted the following statement:

We thank staff for the comprehensive and well-written paper, and Mr. Prader for his helpful buff statement. We concur with the thrust of staff appraisal and agree that ensuring fiscal sustainability and maintaining financial stability while boosting growth potential through structural reforms will be key to Austria’s economic future. We welcome the authorities’ determination, as mentioned in Mr. Prader’s buff statement, to consolidate the fiscal position while limiting its adverse impacts on economic recovery and maintaining social balance.

Fiscal Consolidation

The underlying fiscal position has deteriorated significantly, due to automatic stabilizers and a high fiscal stimulus in response to the crisis. Taking into account aging-related costs for social security, we see urgency of implementing a credible fiscal consolidation plan. To enhance the credibility of the fiscal consolidation, the government should begin fiscal consolidation in 2011 as promised so as to achieve the target deficit to 3 percent of GDP by 2013. The policy focus should be more on expenditure constraints.

We welcome the authorities’ new medium-term budgeting framework at both the federal and sub-national levels, but agree with staff’s view that the medium-term expenditure ceilings have to be sufficiently ambitious so as to ensure fiscal sustainability and credibility.

Financial Sector

We commend the authorities’ efforts in supporting financial sectors. As banks continue to face an uncertain economic environment and their exposure to some CESEE economies, vulnerabilities remain in terms of the capital positions of some banks and their reliance on wholesale funding. Therefore, policy support packages could only be withdrawn gradually when economic conditions stabilize. Additional capital buffers are strongly recommended. We welcome the continued commitment of Austrian banks to maintain their exposures to Vienna Initiative economies.

We concur with Mr. Prader that the banking levy should be handled with care and pay due regard to country specifics.

Structural Reforms

The Austrian pension system and labor market institutions have proved to be inconsistent with enhancing economic efficiency and preserving fiscal sustainability. The focus should be on encouraging labor participation. More incentives should be introduced to strengthen products and services sector competition.

With these remarks, we wish the authorities success in their future reform endeavors.

Mr. O'Sullivan and Mr. McGoldrick submitted the following statement:

We thank staff for their well-focused report and Mr Prader for his informative buff statement. We broadly agree with the staff's appraisal and merely comment for emphasis.

Given its openness and exposure to Central and South-Eastern European countries, it is remarkable how robust the Austrian economy has been during the course of the global crisis, vulnerabilities notwithstanding. The recession in Austria was not overly pronounced and the staff predicts a mild recovery, while employment levels remained high. To a large extent, this is due to the support measures put in place by the Government. Further, the current account remained in surplus throughout, though one might note that this is due to the strength of services sector earnings. Austria's exposure to Central and South-Eastern European economies is considerable, not just with regard to trade but, as the staff quite rightly focuses on, especially with regard to financial services.

Already high expenditure levels have increased further during the crisis and given the resultant deficit, while not extraordinarily large, could now be consolidated with greater ambition, especially once one considers potential liabilities in the financial sector. During the crisis, the authorities took decisive steps to support economic activity. While these helped maintain output and employment, these measures should be rolled back. Though the deficit is not exceptionally large and debt levels are manageable, contingent risks resulting from exposure to vulnerable markets imply that fiscal space may yet prove very valuable. Further, the authorities should also consider identifying specific measures that would deliver the consolidation needs. A fiscal rule could also prove useful and is consistent with Fund advice for other countries. Such an expenditure rule should not only address federal matters but also local governments, which, as Mrs. Zajdel-Kurowska and Mr. Chowdhury point out, lack federal accountability. What is more, we are somewhat surprised at the authorities' intentions to consolidate by raising revenues as well as reducing expenditure—expenditure levels are high and, hence, cutbacks should be the focus of any consolidation efforts. Complementary structural reforms could also deliver significant savings. Specifically, expenditure on social benefits and transfers is particularly large while participation rates are very low for those above fifty years of age. Could the staff comment on whether and how these features of the economy fit together and what the reasons underlying such a structural phenomenon are? We also note the sudden jump in unit labor costs in 2008 and wonder if these are merely related to temporary labor support programs aimed at avoiding crisis induced unemployment. Does the staff believe the ULC will adjust symmetrically once the crisis has passed?

The report aptly focuses on the exposure to Central and South-Eastern Europe, especially due to the strong financial linkages that have grown over the past decade. Overall, the financial system would appear to be fairly stable, though considerable heterogeneity appears to exist. The results of the stress tests, both those conducted at the domestic and the European level, are reassuring. Further, the authorities acted swiftly and decisively to contain any emerging risks. Nonetheless, vulnerabilities remain and are growing in some cases and individual banks' exposures could develop considerable concentration of risky exposure. Hence, we urge the authorities to remain vigilant and press ahead with pertinent financial reforms. Certainly, having a clear idea about cross-border responsibilities is useful for any interconnected financial system. Likewise, this crisis has shown the importance of developing contingency plans, which also would need to consider resolution frameworks.

Mr. Daïri and Ms. Hagan submitted the following statement:

We thank staff for their concise report and Mr. Prader for his insightful statement. Austria is recovering from the effects of the global economic and financial crisis, thanks to its sound fundamentals and the authorities' timely and appropriate response. Yet, the recovery remains fragile and the outlook is fraught with uncertainty, including from renewed tensions in some CESEE countries. We agree with the thrust of the staff appraisal.

Fiscal stimulus has been instrumental in dampening the effects of the global crisis. Given that the recovery is still fragile, we support continuation of the stimulus in 2010. We welcome the authorities' consolidation plan over 2011-14, which, appropriately, is mainly expenditure-based, even though there seems to be room for revenue increase notwithstanding the relatively high tax/GDP ratio. The staff analysis in Box 3 suggests scope for consolidation in social protection, economic affairs, health, and education as Austria's spending in these areas far exceed the EU averages. We welcome Mr. Prader's indication that the new budget framework law is already in place at the federal level, and that expenditure ceilings for 2011-14 have been set by Parliament. On the revenue side, the potential for raising tax revenue from the real-estate tax alone is worth exploring, and we would appreciate staff indication of the feasibility of such an increase.

We welcome the restoration of confidence in Austrian banks, thanks to public financial support, central bank liquidity operations, as well as EU/IMF programs in CESEE, as noted by Mr. Prader. That stress tests find Austria's financial sector resilient is also welcoming, and so is information that implementation of the new Basel requirements would further strengthen Austrian banks' capital position. Notwithstanding a slight increase in 2009, profitability of Austrian banks remains very low, underscoring the need for close supervision and continued financial sector support. The need for support, though, should be continuously evaluated to avoid untoward effects on the budget.

Efforts to boost competition in service delivery should support Austria's growth agenda as should the country's low unit labor costs and unemployment rate compared with its European peers. However, the aging population is a major challenge, and particularly so with the trend of early retirement. Given the long run nature of retirement decisions, it would be preferable for Austria to make forceful changes in its pension policy such as increasing the age for receipt of initial pensions. This should be supported by efforts to decrease the high unemployment of foreign-borns who constitute fifteen percent of the labor force. Growth would be further boosted by structural reforms to improve public spending efficiency and revenue mobilization, as well as to strengthen the financial sector.

With these comments, we wish the Austrian authorities further success in their endeavors.

Mr. Ducrocq submitted the following statement:

We thank staff for an excellent report and broadly agree with the staff appraisal. We also thank Mr. Prader for his insightful buff statement. We share the views expressed by Mr. Stein and Mr. von Stenglin and wish to emphasize the following.

The authorities responded to the crisis with forceful fiscal and financial sector policies, which helped mitigate the recession. Trade and financial linkages, especially with CESEE countries, were the main channel through which the global crisis hit Austria and should continue to weigh on both the real and the financial sector: staff rightly notes that both potential growth and the financial sector are likely to be negatively impacted for some years by the lower growth prospects in CESEE countries. In the short term however, Austria should benefit for the stronger growth recorded by Germany, its main trading partner.

Like several other Directors, we note that unemployment has remained very low in spite of the recession, and we would welcome staff's elaboration on the reasons behind such resilience.

We welcome the authorities' commitment to initiate fiscal consolidation as soon as 2011 to bring the deficit back below 3 percent of GDP by 2013. Although Austria entered the crisis with a relatively healthy fiscal position, the recession has taken a heavy toll on public finances. With stimulus measures over the last two years being mostly permanent, the structural deficit has significantly widened. Together with pressures stemming from ageing-related expenditures, this calls for a prompt consolidation. The path chosen by the authorities is appropriate and we strongly encourage them to identify specific measures as early as possible to strengthen confidence and credibility. Given the relatively high ratio of expenditures to GDP, we tend to agree with staff that consolidation should mainly rely on expenditure measures. The staff deserves credit for identifying several areas where rationalization could lead to significant savings.

Growth-enhancing structural reforms, beyond raising potential growth, would also be instrumental in ensuring fiscal sustainability. In particular, policy actions raising the effective retirement age would be helpful in this regard.

The banking sector remains fragile and subject to risks stemming from its exposure to CESEE. We welcome the overall results of the stress tests for Austrian banks but note that their performance was below the EU average, with some banks having weaker capital positions. We therefore agree that public support mechanisms should remain in place beyond the end of the year, under the conditions set by the European Commission. In particular, the requirement to establish viability plans for banks using the remaining mechanism should be useful. Tighter access costs will also be instrumental in limiting distortions.

Given the importance of Austrian banks in CESEE countries, we take very positive note that they broadly maintained their exposure to countries under the EBCI. Reciprocally, host countries would be expected to coordinate with home countries when designing new taxes, in order to avoid multiple taxation. In this regard, we understand the authorities' concerns after the recent introduction of a financial tax in Hungary.

The representative from the European Central Bank (Mr. Coussens) submitted the following statement:

We thank staff for their candid report and Mr. Prader for his frank buff statement. Since we associate ourselves with the views expressed by Messrs. Stein and von Stenglin, the points below are for emphasis only.

We broadly share the IMF staff's macroeconomic outlook. In particular, we agree with the staff's assessment that the economic recovery will be mainly driven by a pick-up in trade, supported by a recent moderation in wage dynamics and normalization of unit labor cost developments. The latest numbers suggest that exports of goods and services could expand more strongly than foreseen in staff projections, implying some upward risks to growth.

We share the IMF staff's view that Austria needs to start fiscal consolidation in 2011, with a view to correcting the excessive deficit situation by 2013 (in line with the EDP recommendation) and attaining the medium-term budgetary objective of a balanced budget. Fiscal consolidation should indeed focus on the expenditure side. It is important that specific measures for 2011 and beyond are announced already at this stage in order to further underpin the government's commitment to fiscal consolidation, coupled with a reform of fiscal federal relations.

We fully concur with the staff's assessment that the low labor force participation rate of older workers and the high unemployment of migrant workers pose a challenge to the Austrian labor market. Structural reforms, raising the effective retirement age and strengthening the education system, are needed to support potential growth and contain the fiscal costs of ageing.

Although banks' capital positions have been strengthened both through equity injection and deleveraging, capital ratios are currently below those of peers and there is wide heterogeneity among institutions. The IMF report underlines that there are remaining weaknesses in a number of banks that suffered greatly from the crisis. The ECB strongly supports the recommendations set forth in the report that close monitoring of individual banks' situation and appropriate action to reinforce capital buffers are necessary. Moreover, we agree with staff that, in the context of (i) still relatively weak capital ratios, (ii) the proposed Basel reform package and (iii) the high share of bonds maturing in coming years, retaining the financial sector support package should give banks more time and flexibility to raise additional equity and to refinance their maturing market debt.

The IMF staff report also indicates that renewed tensions in some CESEE countries could bear on funding costs and the profitability of Austrian banks, with potential adverse implications for domestic credit supply. In this context, the ECB would like to point out that, despite a rather sharp fall in profits, banking sectors in most CESEE countries have remained profitable. Moreover, capital adequacy ratios of banking sectors have improved in almost the entire region. Thus, our assessment is that the potential implications of renewed tensions in some CESEE countries for credit supply in Austria are likely to be quite limited.

Foreign currency lending still represented about a quarter of Austrian banks' loan exposures at the end of 2009. This is especially the case for subsidiaries that are present in CESEE countries, while in Austria foreign exchange loans have started to decline. In this context, the ECB concurs with the IMF staff assessment that reducing the share of foreign exchange-denominated loans in the CESEE region, while providing continued financing to that region is a key challenge. We welcome the steps taken by the authorities in this regard.

According to the IMF staff report, the Austrian banks would be significantly affected by the proposed Basel requirements. In this regard, the ECB would like to emphasize that the new capital and liquidity requirements are aimed at strengthening the resilience of the financial system; therefore any foreseen challenges to meet the new requirements should be interpreted as a clear call for the banks and authorities to take further steps towards achieving this goal.

The staff representative from the European Department (Ms. Waysand), in response to questions and comments from Executive Directors, made the following statement:

As we already issued a statement to update the Board on recent developments, I will not dwell on this and will concentrate my intervention on answering the questions, grouping them into three broad categories: the macro outlook and structural questions; fiscal consolidation questions; and, financial sector issues.

On the macroeconomic outlook and structural issues, a lot of Directors asked questions about labor market issues. There were three types of questions: some on labor market resilience, some on short-term prospects, and finally questions about medium-term prospects and supply of labor. Let me address these three types of questions in turn.

First is the resilience issue. As shown in the latest April WEO, the reaction of unemployment to the recession in Austria has been pretty muted. This is explained to a large extent by a muted reaction of employment to the recession. This muted reaction of employment to the recession, especially when compared with previous recession, can be explained by a number of factors: according to a central bank study, a concentration of the shock on the manufacturing sector whereas other sectors were much less hit; an increased recourse to short-term working schemes; and the scrapping of extra work time. All these factors, together with increased recourse to training, limited the increase in unemployment.

Turning to short-term prospects, and consistent with what I just said, there is a labor overhang constituted of people in training and people in short-term schemes, and this could provide for a limited decrease in unemployment in the months to come as this workforce is being reabsorbed. The truth, and the good news, is that in fact a large part of this overhang has already been reduced. When one looks at figures, the number of people currently in training amounts to 1.8 percent of the workforce compared with an average of 1.5 absent a crisis. When one looks at short-term working schemes, they amounted to 57,000 at the peak in June last year and they are now down to 12,000. So, a large part of the people in these schemes has already been reabsorbed.

At the same time, we have evidence that the latest indicators are good with vacancies strongly picking up, 30 percent year-on-year, and a decrease in unemployment, which has been extremely substantial, from 5.1 percent at peak to 3.9 percent now. This decrease in unemployment has in fact surprised most analysts, including us, by its magnitude. We expect the future evolution of unemployment to be less favorable, with labor participation picking up.

In terms of employment prospects, we have a very prudent assumption of a growth rate of employment of around 0.3 percent every year, this year and next, consistent with the need for firms to regain productivity and consistent also with existing national forecasts.

Turning to unit labor costs on which a question was asked, the rise in unit labor costs in 2009 can be explained by the fact that wage agreements were made on the basis of a then very high inflation, and there was, as you know, a disinflation surprise which did not lead to adjustments in wage agreements unlike in other countries.

In a longer-run perspective, unit labor costs in Austria pretty much behaved like unit labor costs in its German neighbors. So, also consistent with the latest wage agreements which are in nominal terms of around 1-1.5 percent this year, we believe that unit labor costs will moderate over time, compensating the burst in 2009.

Finally, on medium-term labor prospects, there were questions on immigration and ways to boost internal labor supply. On immigration, while the past effect of immigration was high, the future effect of immigration will to a large extent depend on the relative situations in countries in the region and in Austria.

We expect a modest effect of the removal of the remaining immigration restrictions per se, and this is for two reasons. First, given the freedom of circulation in the EU, it was only the ability to work officially, which was restricted for some categories. Second, there were already many exemptions to the restrictions. In particular, skilled workers were already able to come and to legally work in the country.

So, overall we do not expect a big effect of the removal of remaining restrictions and we do not expect also a large effect on wages. We do not think that the effect on wages will undermine labor participation, as was asked by one of the Directors. However, as noted earlier, unit labor costs will have to moderate.

Turning to policy recommendations and ways to boost the internal labor force, as noted by several Directors, increasing labor participation in Austria is key to support potential growth. We pointed to a number of policies already in the report in Box 2. Let me elaborate a bit, as several questions were asked.

For older workers, we think that the priority is to raise the effective retirement age. That will be through fully implementing the 2003 pension reform, eliminating loopholes, namely the abuse of part-time pension and also the abuse of the long-term insured pension scheme. Also, invalidity criteria could be toughened.

On female participation, we think that the extension of full-day preschool and school options would go a long way toward facilitating female full participation and not part-time participation into the labor market.

For the low-skilled workers, reducing the tax wedge is an obvious option but will have to be reconciled with fiscal consolidation. Existing simulations conducted by the IHS in Austria and the OECD suggest that lowering social contributions on low-wage earners could have a substantial effect on employment. Halfing the contribution on earners of less than 1,350 euros per month would increase employment of low-skilled workers by around 1 percent and total employment by around 0.4 percent, with a 0.5 percent of GDP effect on the deficit and a smaller effect over time.

In short, we agree that an increase in the effective retirement age would be a major area for improvement while reducing social contributions would obviously call for compensatory measures.

Getting to the issue of uncertainties and the best line of defense should tensions occur in CESEE, I believe that the elements are in place. The financial rescue package is still in place, together with the European Bank Coordination Initiative. These two elements should be instrumental in supporting confidence in the banking sector should a new shock arise in CESEE, but this will be all the more credible as fiscal credibility is insured. In this respect, a credible and sustainable fiscal adjustment will be key.

Finally, a question was asked on countries and sectors where Austrian exports are used as input in the production process of their destination exports versus used in final consumption. While we do not have information on import content of CESEE countries' exports, we do have detailed information on the types of Austrian goods exported to different countries, which could give some sense of a possible answer.

As shown in the report, Austria exports a variety of goods to the region, but there is some diversity in the relative importance of various exports to various countries. I would just give an example and we can get back to the interested Directors bilaterally with more data. As a whole, 4 percent of Austrian exports are cars, but the share of cars in exports to Bulgaria is a bit higher than 9 percent while it is around 2 percent to Poland.

Turning to fiscal issues, we see risks to the scenario as broadly balanced, including risks to revenue for 2010 and the years after. We see the risks as depending primarily on macroeconomic developments in Austria and its major export markets.

Turning to the consolidation process, let me say that we do not have at this stage, and most likely will not have until December, a clear indication of precise measures which are being considered. Given the unknown nature of the consolidation measures, it is difficult to form an informed view of the impact of fiscal consolidation on growth and we concentrated our discussions on ways to minimize this impact. In particular, the degree of participation of sub-national government levels in the consolidation efforts is still unknown and subject to negotiations.

On the expenditure side, where we feel the efforts should predominantly be made, comparing spending levels in Austria with the Euro Area average gives a first rough benchmark for measuring the potential of savings. There is also a national study which gives estimates of saving potential. These estimates are extremely sizable: more than 1 percent of GDP for business subsidies, around 1 percent of GDP in the long run also for healthcare, a bit less for general public administration between 0.3 and 0.9.

However, the authorities have indicated doubts about the feasibility of all underlying measures, and obviously these estimates would have to be refined by comprehensive expenditure reviews. Also, and to answer a question, no revenue measures have been spelled out so far except for the tax on banks which has been announced by the Chancellor as yielding 500 million euros but is still undefined.

Given Austria's already high tax burden, staff recommended to be selective and to limit increases, if needed, to a few taxes that are currently low by international comparison and could bring additional benefits. Among these taxes, as the question was also asked, raising revenue from the real estate tax could be achieved by bringing the assessment basis closer to market value and it would bring the additional benefit of strengthening the revenue base of municipalities. However, there seems to be strong resistance against this move.

Turning to fiscal federalism, the reasons for the poor functioning of fiscal federalism lie both in improper incentives at sub-national levels and an insufficiently credible Internal Stability Pact. As a result, the headline nominal deficit targets have been missed consistently by the Länder already before the crisis. Between 2003 and 2007, on average, they were missed by half a percent of GDP. With the crisis, and as these are nominal targets, it is not surprising that both the central level and the sub-national levels missed their targets.

In this context, we agree that enforcement mechanisms within the Internal Stability Pact should be strengthened and that stronger reliance on own revenues at the local level could be helpful. However, we would not go as far as recommending a total abolition of vertical transfers and it is also unclear that allowing for bankruptcy of sub-national governments would be credible. We would rather recommended strict limits on sub-national government liabilities, including guarantees. These two recommendations are consistent with a recent Board paper of last year on the sound design of fiscal decentralization.

Turning to financial sector issues, deleveraging is mainly occurring in third markets and there is little evidence so far of supply constraints of credit in Austria. Looking ahead, it is likely that business models may change, both economic models as banks were sometimes very reliant on wholesale funding, and governance structures, which were not always matching the risks taken. It is, however, unclear that banks will favor their domestic markets as profits in recent years have been originating a lot from outside markets.

On the impact of future BIS requirements, as you know, reports have been issued by the BIS, but we do not have specific Austrian information and estimates. In particular, as the QIS was ongoing, we did not get information during the mission, nor after the mission. I am not able to answer the question on how much capital and liquidity would be enough, but I note that BIS report notes that the incremental net benefit from reducing the probability of banking crises is gradually declining and becomes negative after a certain range.

On the bank resolution framework, staff is unaware of work done at the Austrian level, but there is ongoing EU work on cross-border crisis management, including issues arising from early intervention and banking resolution.

Bank mergers are allowed in the Banking Act, but they are not seen as part of the possible procedures when terminating the receivership after a period of time.

On cross-border supervision, we are not able to conclude at this stage whether the authorities are actually receiving sufficient information. We note that MOUs seemed to be extremely important both for the authorities to conduct on-site inspections and also to allow the participation of supervisors in colleges. We encourage Austria to secure MOUs with all relevant countries, which would prove beneficial both for home and host supervisors.

On the Hungarian tax, foreign banks will be strongly affected by the tax introduced in 2010 by Hungary. For 2011, as details have not been specified, this may give banks incentives to shrink their activities or to rebook some of their activities to the parents' balances sheets, this not having much real impact but reducing transparency. Banks may also have an incentive to sell government bonds, although given their size, they are well aware that this could hurt them in return.

Finally, the introduction of the Hungarian tax complicates the introduction of an Austrian tax as some banks may be taxed twice, but this issue is not unique to Austria and staff has recommended coordination in this area.

Mr. Prader made the following concluding statement:

I thank Directors for their valuable comments, which I will faithfully convey to my authorities. I would also like to thank the mission team headed by Ms. Waysand for its excellent work. The discussions have benefited from the fact that Ms. Waysand is also the Mission Chief for Switzerland, which provided an interesting perspective in the sense of a comparison with a neighboring country with a very prudent fiscal policy and a major internationally-oriented banking system. Since she has answered most of the questions raised in the grays, I can be rather brief.

I am grateful that almost all colleagues emphasized the urgency of fiscal consolidation and support the government's efforts to submit a credible, sustainable, and politically feasible consolidation package. Still, there have been questions about the adjustment path.

First, like the staff, a number of colleagues took issue with the lack of information or precision on the planned consolidation measures. I should explain that, because of important, upcoming regional elections, the government has been careful not to reveal too much about the content of the planned budget package. Any premature discussion of the details will make it difficult to obtain agreement on the size and composition of the eventual measures.

Second, while some colleagues point to remaining considerable economic downside risks and question the urgency of fiscal adjustments, others, like Mr. O'Sullivan, raised the question of whether the speed of adjustment is not too slow and unambitious in view of the sharp rise in public debt and the sensitivity of Austria to developments in Eastern Europe and the financial markets.

Third, there is also the issue of the composition of the consolidation package. From an economic—i.e., efficiency—point of view, one may ask whether the planned 60:40 ratio of expenditure cuts to revenue increases is optimal if one takes into account that the ratio of revenues to GDP is already very high. Here, I can only refer to the well-known Austrian preference for social consensus, which sometimes represents a trade-off between efficiency and equality.

Fourth, the staff report and the Board rightfully put their finger on the inadequacy of the Internal Stability Pact and the need to reform fiscal federalism. Mr. Shimoda and Mr. Nomura made perceptive remarks about the moral hazard induced by a particular system of fiscal federalism that provides no incentive for sub-national levels to contain expenditures.

Unfortunately, a solution to this issue can only come from constitutional amendments requiring a two thirds majority, and additional reform steps, such as a law limiting the ability of lower levels of government to contract debt. Given the distribution of power between the lower levels of government and the central level, I am not optimistic that the lower levels of government will be prepared to renegotiate the Revenue Equalization Agreement between the federal government and the other levels.

Fifth, it is clear that the long-term sustainability of the public finances depends crucially on structural reforms in the health and pension sector. One important issue will be whether measures can be identified and agreed on that reverse the trend toward early retirement promoted by various social policies which turned out to be much more costly than originally estimated. Another one will be to contain the rapidly-rising health cost. It is estimated that, even without costly hospital construction programs of the Länder, the aging-related expenditure increases of healthcare amount to some 4 percent annually.

On the issue of financial stability, the crisis has made it possible for the supervisory authorities to implement a number of previously unpopular reforms, above all a ban on foreign exchange lending to private households. The authorities recognized that, despite the good profit results reported by almost all banks in the first half of this year, more needs to be done from the provision of a crisis resolution framework to the task of dealing with the restructuring of the Austrian banking system.

The Austrian banking system faces a difficult environment, from new capital requirements under Basel III, the upgrading of the European Deposit Insurance system, to the introduction of populist bank levies in Central and Eastern Europe. On the latter issue, Mr. Talbot and Mr. Rediker have inquired about the impact of the Hungarian bank tax on Austrian banks. Indeed, the Austrian authorities are concerned about its impact on Austrian banks, but they are even more concerned about its potential impact on the coordination of banks in Central and Eastern Europe and the economic and financial stability of the region if other countries in the region were to adopt similar taxes.

Finally, and nevertheless, I am not so sure that one can be certain that the eventual outcome of the long-standing debate on Austria's growth potential will be that Austria faces the prospect of declining growth rates. Despite everything that happened since the fall of 2008, so far all prophets of doom have been proven wrong by Austria's long-term growth performance.

The Acting Chair (Mr. Lipsky) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their timely policy response, which has helped mitigate the impact of the global crisis. They noted that, as an open and competitive economy, Austria is well placed to benefit from the recovery in world trade, although considerable risks remain to the growth outlook. Directors also observed that, while Austria's significant integration with other countries in central and south-eastern Europe has been beneficial, it has also exposed the economy to higher risks, notably in the financial sector. In this context, Directors encouraged the authorities to step up efforts to strengthen the fiscal position, improve the resilience of the financial system, and enhance medium-term growth prospects through structural reforms.

Directors welcomed the authorities' plan to embark on a decisive fiscal consolidation path beginning in 2011. They saw the planned pace of consolidation as broadly appropriate and encouraged the authorities to set out concrete commitments and measures early on. Directors noted, in particular, that well-designed measures, which focus mostly on expenditure and involve participation of all levels of government, could minimize the effects on growth and enhance fiscal sustainability. Given the already high overall tax burden, revenue measures should be well targeted. Directors also recommended strengthening the current fiscal framework ("internal stability pact") and introducing ceilings to local governments' debt and guarantees issuance.

Directors observed the improvement of the overall financial position of banks, but noted that more efforts are needed to enhance the resilience of the financial sector. In this context, they noted that, while care should be taken to avoid distortions, the extension of the current financial support package is appropriate. Directors also welcomed recent reforms to the supervisory framework and recommended that regulatory changes and all other measures under consideration be designed carefully. To strengthen supervision and intervention powers, Directors encouraged the authorities to consider a system mandating early remedial action and a proper resolution framework for financial institutions. They also advised the authorities to monitor closely the situation of individual banks in light of the results of stress tests and stand ready to take action as appropriate.

Directors welcomed the authorities' efforts to enforce tighter foreign-exchange lending standards in cooperation with other supervisors. They recognized, however, that reducing the share of foreign exchange loans, while providing continued financing to central and south-eastern Europe, will be challenging. Directors also welcomed the authorities' action plan designed to address FATF recommendations.

With medium-term potential growth expected to be lower compared with pre-crisis levels, Directors welcomed efforts to raise labor participation in some segments of the population (older, low-skilled, and foreign-born workers) and boost product market competition. In this regard, they saw scope to revisit special schemes and long transition periods in the implementation of the 2003 pension reform, which are undermining the necessary increase in the effective retirement age. They also encouraged measures to increase competition in the services sector, including through an effective transposition of the EU Services Directive.

It is expected that the next Article IV consultation with Austria will be held on the standard 12-month cycle.

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Secretary