

Good Financial Position of the Real Economy Sectors

Risk Situation of Enterprises Stable

Corporate Investment Gained Momentum

In the first half of 2006, cyclical developments in Austria were dynamic. While growth had mainly relied on exports in the past years, domestic demand picked up in 2006 as well. Enterprises had already intensified their investment activities in the second half of 2005. Current leading indicators, such as the WIFO Investment Survey, point to a further marked revival in the first half of 2006. In the light of rather low capacity utilization, replacement investments and streamlining measures are probably the main motives behind a vast majority of these investment projects.

In addition to capital investments, enterprises have recently also increased

their financial assets to a significant extent. In 2005, financial investment exceeded EUR 12 billion and was thus 2½ times higher than the comparable figure of the previous year. These investments also included a series of strategic equity investments in Austrian and foreign enterprises (see box “Enterprises’ Financial Assets on the Rise”).

Internal Financing Potential Remains High

The profit situation of Austrian enterprises continued to be favorable in 2005. Unit labor costs developed moderately, and low nominal interest rates helped keep financing costs down. The development of the profit margin⁵ and the gross operating surplus⁶ appear to point to a further increase in profits in 2005.

Enterprises’ Financial Assets on the Rise

Does the continuous increase in Austrian enterprises’ financial assets, which was only briefly interrupted in 2004, indicate that Austrian businesses – like enterprises in other countries – tend to invest more in financial assets instead of real capital? We will briefly look into this question using financial accounts data.

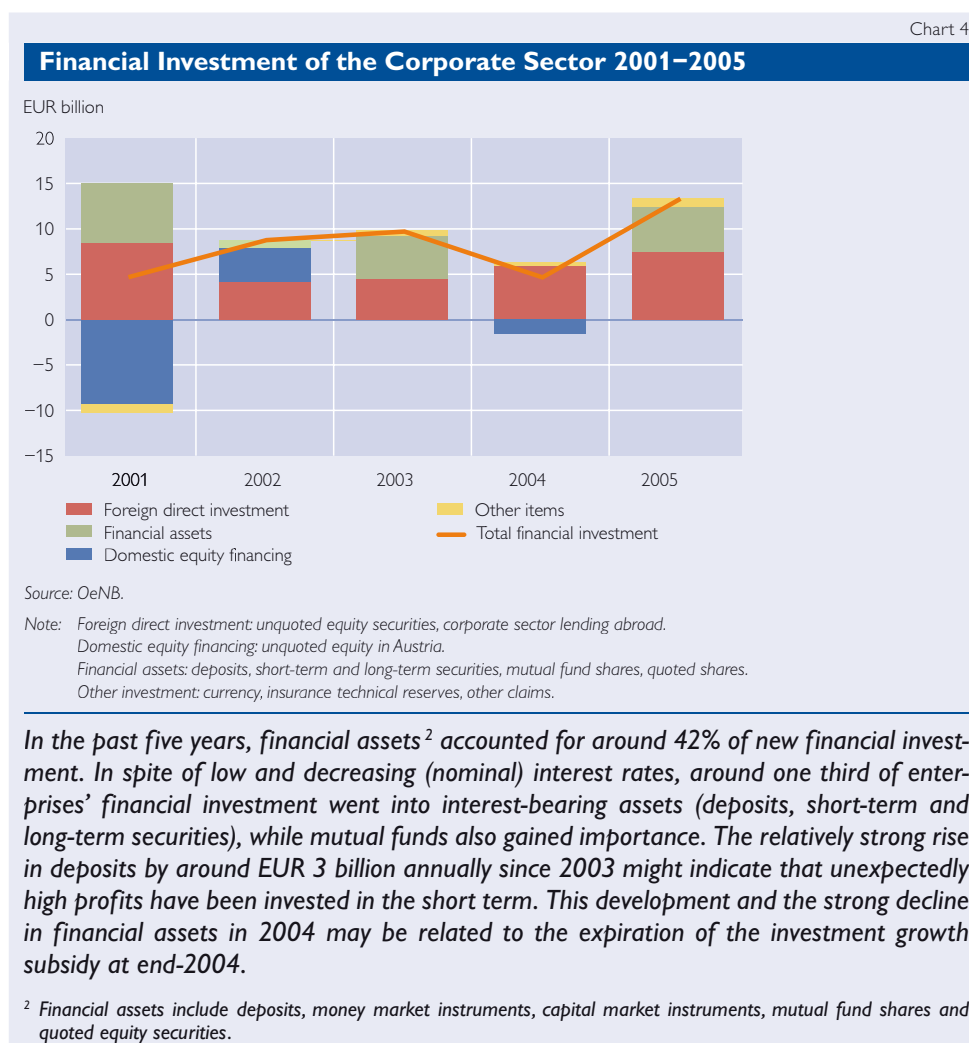
First of all, one must bear in mind that in the financial accounts, financial investment also includes several positions that do not constitute financial assets in a narrower sense. On the one hand, they record the comprehensive foreign direct investment (FDI) of the corporate sector. If, in a first approximation, we sum up unquoted equity and loans¹ granted to foreign borrowers by Austrian companies, we see that they account for almost three quarters of financial investments in the period from 2001 to 2005. On the other hand, the position “financial investments” includes strategic holdings in Austrian enterprises, which declined between 2001 and 2003 and have changed little ever since.

¹ To a considerable extent, these loans are intragroup loans that have a close economic link to equity capital transactions.

⁵ The profit margin is the ratio of the deflator of gross value added to unit labor costs.

⁶ The gross operating surplus is the surplus created by corporate operations after the remuneration of the production factor labor. It can be determined by deducting the compensation of employees and taxes on production (less subsidies) from GDP, and is the national accounts’ equivalent of gross operating income. The gross operating surplus is an approximation variable for measuring absolute profits.

Chart 4



External Financing Strongly Relies on Equity

Even though – thanks to their high profits – Austrian enterprises were able to finance their business activities largely from their own income, their demand for external financing went up in the face of strengthening investment and equity financing. In 2005, total external financing of the Austrian corporate sector grew by more than 40% against the previous year, reaching EUR 17.5 billion.

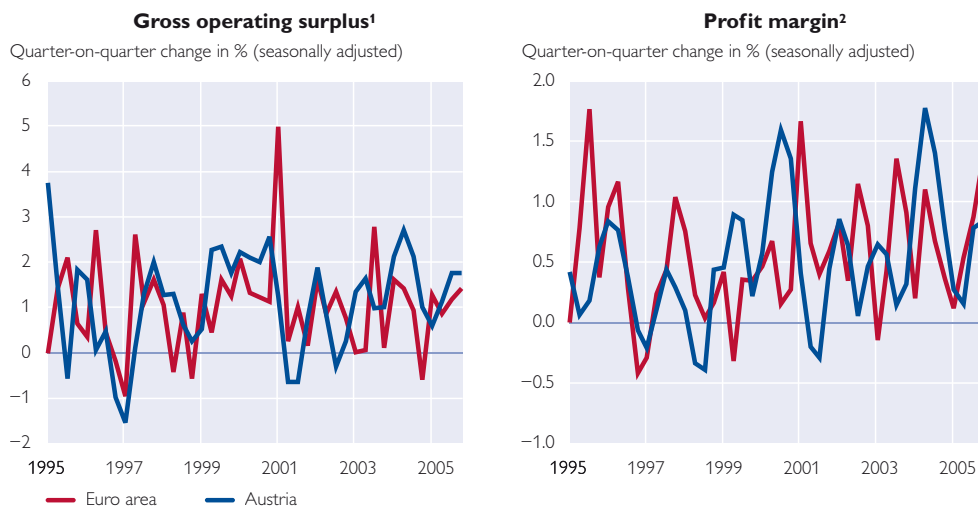
Around one third of external financing stemmed from equity instruments, and approximately one quarter each from bonds and bank loans.

The percentage of capital market instruments (bonds and shares) in external financing doubled to 37% in 2005.

Shares issued at Wiener Börse AG between October 2005 and March 2006 totaled around EUR 1.1 billion. Even if there were only few new issues by Austrian nonfinancial corporations, the number of capital increases was considerable. A major part of the latter was attributable to real estate companies. In the last quarter of 2005 and the first quarter of 2006, the robust issuance activity as well as continued strong price increases drove up the market capital-

Chart 5

Indicators of Profitability Performance in the Corporate Sector



Source: Eurostat.

¹ Including mixed income of the self-employed.

² GDP deflator less unit labor costs.

ization of nonfinancial corporations listed at Wiener Börse AG by more than EUR 10 billion to just below EUR 70 billion, which corresponds to around 28% of GDP.⁷

In 2005, bonds again made a major contribution to the funding of the corporate sector as a whole, with the picture being shaped by a few large-scale issues. According to the OeNB's securities issues statistics, the outstanding volume of bonds issued by nonfinancial corporations went up by 23% against the previous year. In many cases, the motivation for issuing bonds was to benefit from the currently relatively low interest rate level over a longer period of time.

Moreover, several issues also served to finance mergers and acquisitions.

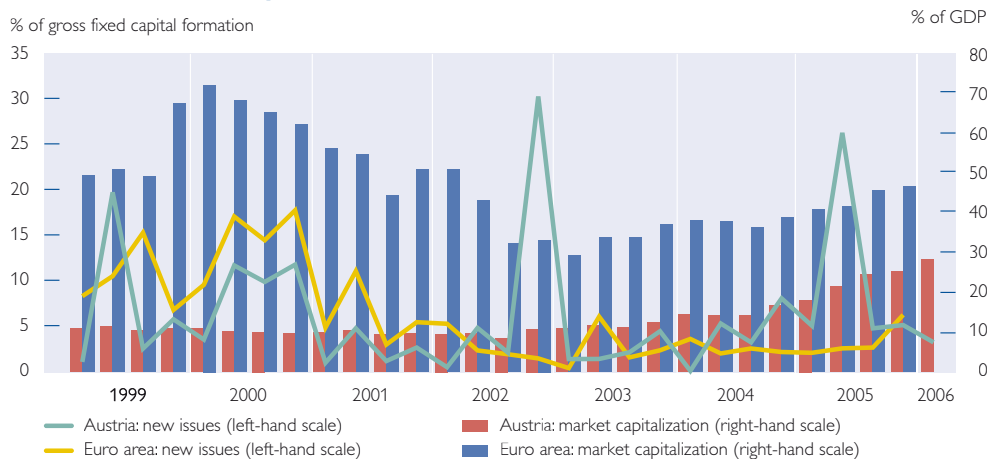
The annual growth rate of bank loans granted to the corporate sector has been above 3% since December 2005 and reached 3.6% in March 2006.⁸ Until recently, the dynamism in this segment lagged behind that observed in the euro area. According to the Austrian results of the Euro-system bank lending survey, in recent quarters enterprises increasingly took out loans to fund mergers and acquisitions or to restructure companies. Further important motives for borrowing funds were the funding of fixed capital formation as well as the need to finance inventories and work-

⁷ The market capitalization of all stocks listed on Wiener Börse AG (including financial corporations) came to more than 49% of GDP at end-March 2006.

⁸ MFI balance sheet statistics data. Analyzing loans to enterprises and households has become more complicated owing to a change in the balance sheet statistics that requires the reporting of gross instead of net risk provisions as of June 2005. Since then, Austrian MFIs have reported their entire risk exposure inclusive of risk provisions. The figures quoted here are based on an estimation using the monthly balance sheet report. See Alois Klein, 2006. EZB-MONSTAT – die Auswirkungen der meldetechnischen Umstellungen im Bereich der Kreditpositionen zum Berichtstermin Juni 2005 auf bestimmte Kreditaggregate. In: Statistiken – Daten & Analysen Q1/06. OeNB. 13–15.

Chart 6

New Issues¹ and Market Capitalization of Quoted Shares of Nonfinancial Corporations



Source: ECB, OeNB.

¹ Capital increases and new listings.

ing capital. Bond issues, however, reduced enterprises' demand for bank loans.

Financing Conditions Remain Favorable

The conditions for external financing have remained positive for Austrian companies, both for borrowing funds and for issuing equity capital.

After the interest rate charged on loans to enterprises had continued to decrease slightly until the fall of 2005, it went up moderately after the rise in key interest rates of December 2005 and March 2006 (see Chart 8). The interest rate level in Austria remained very low both historically and when compared with the euro area. In real terms, lending rates declined throughout 2005, as inflation rates were expected to go up.

A comparison of banks' retail interest rates and interest rates for largely risk-free financial assets provides an indicator of the average risk

premium contained in banks' interest rates.⁹ The difference between interest rates for corporate loans and swap rates of comparable maturities shows that the risk premium has continuously decreased since the second half of 2005. This might reflect an improvement in the economic outlook over the past months.

By and large, this result matches the findings of the bank lending survey, according to which banks have slightly tightened lending conditions for SMEs since the third quarter of 2005, while keeping them stable for big enterprises. Risk factors play an increasing role in laying down the conditions of corporate lending. While banks reduced the interest margins for lending to borrowers with average credit ratings for four consecutive quarters, they raised them for riskier loans in most cases.

Financing conditions on the stock exchange remained favorable as well in the first months of 2006. Follow-

⁹ In addition to the credit risk, the interest margin also reflects the specific competitive situation of the Austrian loan market which, while not influencing risk adjustment as such, does have an impact on its volume.

ing a 53% rise in stock prices in 2005, the ATX further increased by 16% in the first quarter of 2006. Given the price gains, the price/earnings ratio went up (despite the positive profitability performance of the enterprises listed at Wiener Börse AG) until the third quarter of 2005, followed by a

slight decline. In a longer-term comparison, the price/earnings ratio was still relatively high and constantly remained above the reference value for the entire euro area. This means that, on average, equity financing was less expensive in Austria than in the euro area.

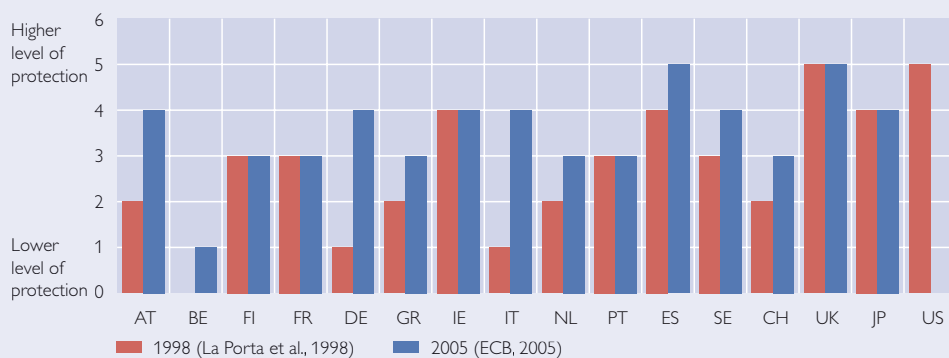
Corporate Governance in Austria Improved

A typical characteristic of corporations is the separation of ownership and management. Corporate governance refers to the rules that define the rights and responsibilities of supervisory board, managing board and shareholders. Thus, corporate governance can play a significant role in securing financial market stability and financing enterprises via the capital market, which is one of the reasons why major initiatives to improve the rules of corporate governance have been launched at the EU level.

One aspect of improved corporate governance is the stronger protection of minority shareholders. The chart below shows an index based on a paper by La Porta et al. (1998)¹ that measures the level of minority shareholder protection. For 2005, the ECB (2005) updated this indicator using the OECD Corporate Governance and Company Law Database (see also Fritzer, 2006).²

Chart 7

Minority Shareholder Protection



Source: See footnotes 1 and 2.

Note: This index is based on the sum of quantified data for the following variables: (1) proxy by mail allowed at the general meeting (1 = yes; 0 = no); (2) shares not blocked before general meeting (1 = yes; 0 = no); (3) cumulative voting or proportional representation (1 = yes; 0 = no); (4) oppressed minorities mechanism to counteract management decisions (1 = yes; 0 = no); (5) preemptive rights to purchase new issues of stock (1 = yes; 0 = no); (6) percentage of share capital to call an extraordinary shareholder meeting (1 = the minimum percentage is less than 20%; 0 = all other options). The index scale ranges from 0 to 6, with lower values indicating fewer rights for small shareholders.

The 2005 update for the United States is not available yet. The underlying data were originally published by the OECD. This reproduction, however, does not necessarily reflect the official views of the governments of the respective Member States.

¹ La Porta, R., F. López-de-Silanes, A. Shleifer and R. Vishny. 1998. Law and Finance. In: *Journal of Political Economy* 106(6). 1113–1155.

² ECB. 2005. Assessing the Performance of Financial Systems. In: *ECB Monthly Bulletin*. October. 75–89.
Fritzer, F. 2006. The Financial System and the Institutional Environment as Determinants of Economic Performance: Austria in Comparison. In: *Monetary Policy & the Economy Q1/06*. OeNB. 136–158.

In Austria, the protection of minority shareholders³ has significantly improved since the end of the 1990s (in chart 7, higher values represent more rights for minority shareholders). Based on this indicator, Austria is now among the euro area countries with the strongest protection of minority shareholders. Only the voting options for shareholders at the general meeting (e.g. no electronic voting) and the voting right of minority shareholders (no cumulative voting in the election of CEOs) do not correspond to the highest possible standards.

In recent years, the Austrian stock market has become more important for corporate funding – a trend which is also due to the improved protection of minority shareholders. In country comparisons, several studies have found a strong positive correlation between the protection of small shareholders (as measured by this index) and stock market liquidity.⁴

However, the index does not measure all aspects that play a role in capital market developments. The revised Austrian Code of Corporate Governance, which became effective at the beginning of 2006, comprises 81 rules, of which more than 30 were modified. The Code now includes enhanced disclosure requirements vis-à-vis shareholders (e.g. disclosure of information on the technical qualification of candidates for the supervisory board; disclosure of the remuneration scheme in the annual report in addition to the disclosure of the full remuneration of the managing board) and rules strengthening the independence of the supervisory board (e.g. members of the supervisory board must not be members of the managing board of the enterprise or its subsidiaries; the chairperson of the supervisory board must not be a previous CEO of the enterprise). Moreover, the competences and responsibilities of the managing board were defined more clearly (e.g., as a rule, members of the managing board must not be members of the supervisory board of other enterprises).

Like in many other countries, the Code of Corporate Governance is conceived as “soft law” in Austria and therefore, largely relies on voluntary compliance.⁵ Thus, Austrian enterprises listed on the prime market of Wiener Börse AG are obliged to disclose whether they comply with the Austrian Code of Corporate Governance and, if not, provide an explanation.

The revised Code of Corporate Governance has the potential to make (listed) enterprises more transparent for investors and might thus also raise the attractiveness of Wiener Börse AG. However, as the Code is designed as “soft law,” its effectiveness largely depends on the voluntary compliance of enterprises.

³ There is no harmonized definition of minority shareholders. Often this term denotes shareholders that hold less than 10% of voting rights.

⁴ La Porta, R., F. López-de-Silanes, A. Shleifer and R. Vishny. 1997. Legal Determinants of External Finance. In: *Journal of Finance* 52(3). 1131–1150. This paper is a classic insofar as it provides empirical proof of the positive correlation between shareholder protection and financial market liquidity.

⁵ The Austrian Code of Corporate Governance comprises three categories of rules: (1) Legal requirements (L): These rules are based on mandatory legislation, but only apply to Austrian and listed corporations. For enterprises not listed at the Vienna stock exchange, these rules are to be interpreted as C rules (see (2)). (2) Comply or explain rules (C): These rules must be followed; if not, any deviation must be explained stating the reasons. (3) Recommendations (R): These rules are pure recommendations.

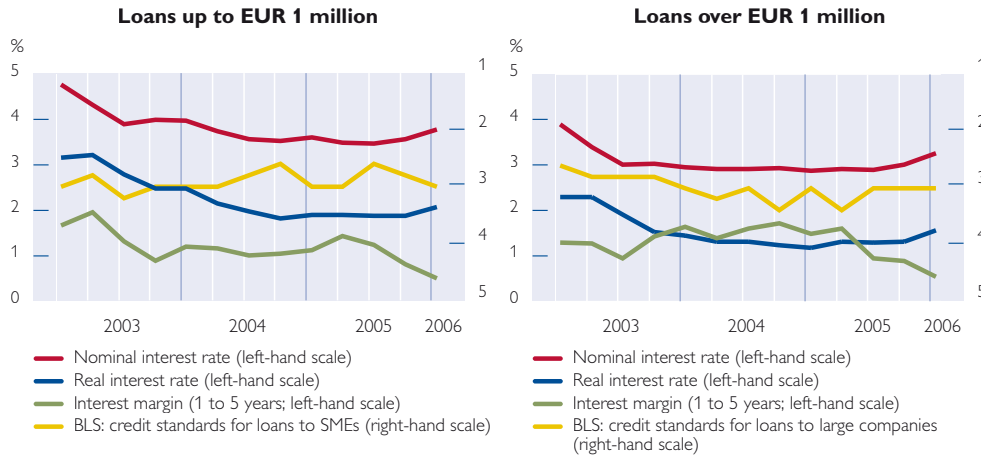
A similar picture emerges from the spread between the earnings yield¹⁰ and the government bond yield, whose development can be interpreted as an indicator of the stock market risk premium. The yield

spread slightly narrowed in the second half of 2005 and, as the conditions for equity financing took a slightly more favorable course than the general interest rate level, it widened slightly in the first quarter of 2006.

¹⁰ The earnings yield is the inverse of the price/earnings ratio.

Chart 8

Conditions for Corporate Loans



Source: OeNB, ECB, Statistics Austria, Consensus Economics.

Note: Scale ranging from 1 (tightened considerably) to 5 (eased considerably).

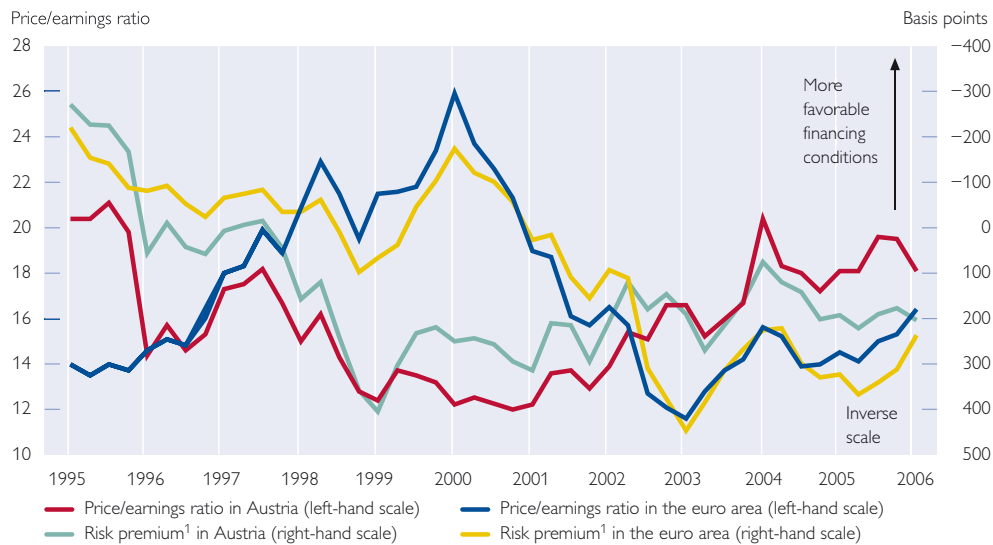
Real interest rate: Nominal interest rate less the OeNB's HICP forecast for the year following the forecast date.

Interest margin: Interest rate charged for loans with a maturity from 1 to 5 years less three-year swap rate.

BLS credit standards: Changes in the credit standards for loans to enterprises over the last three months.

Chart 9

Financing Conditions on the Stock Market



Source: Thomson Financial, OeNB.

¹ Earnings yield (inverse of the price/earnings ratio) less government bond yield.

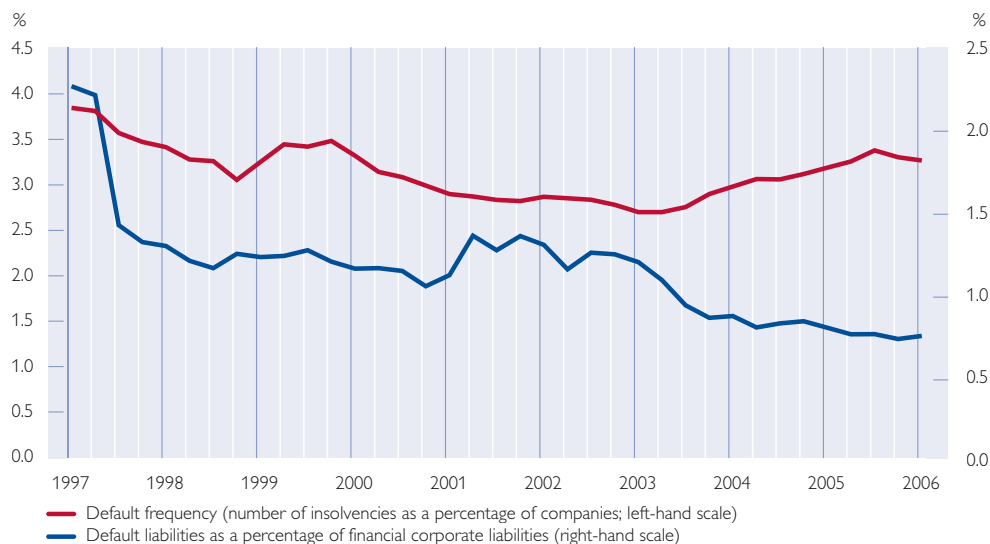
Default Liabilities Decreased

Default liabilities went down by 4.5% in 2005; in the first quarter of 2006 they were around 30% lower than in the same period of the previous year. This was not least due to the fact that there have been fewer large-scale insolvencies recently. Chart 10 shows

that, already for several years now, there has been a downward trend in the share of default liabilities in overall corporate financial liabilities (according to the financial accounts). In the fourth quarter of 2005, this share reached a low of 0.73%.

Corporate Defaults

Four-quarter moving averages, annualized



Source: KSV, OeNB.

Default frequency, by contrast, has been on the rise over the last two years. In the first quarter of 2006, the number of newly opened insolvency proceedings went up by 6.1%, while the number of no asset cases increased by 5.7%. Altogether, the insolvency rate — in relation to the total number of enterprises — came to 3.3% (annualized) in the first quarter of 2006. As insolvencies usually constitute a lagging economic indicator, this increase reflects the weak economic development of the past years.

Financial Position of Enterprises Remains Sound

In broad terms, the assessment of the financial position of the corporate sector has not changed since the publication of the Financial Stability Report 10 (December 2005). Although corporate liabilities showed a relatively strong increase in 2005, the corporate sector's net financial position considerably improved against the previous year because financial investments grew significantly over the same period. Moreover, enterprises' potential for internal financing remained high given their continued favorable income situation. Together with higher external equity financing, this led to a further increase in the capital position of the corporate sector.¹¹

¹¹ This rise was not only caused by new borrowing, but rather the strong increases in stock prices on Wiener Börse AG, the Vienna stock exchange, which drove up the value of holdings and thereby corporate liabilities by EUR 21 billion in 2005.

Financing conditions remained favorable for enterprises. Borrowing went up again so that the interest burden on enterprises slightly increased in absolute terms in 2005, but this rise was clearly below the growth in profits. As long as profitability stays this high, enterprises should continue to have a high debt repayment capacity and be able to afford an increase in interest payments should interest rates rise and/or borrowing increase in the future. If profitability decreased, this would not only reduce the funds available for repaying loans, but also lead to an increase in the corporate sector's interest costs owing to banks' stronger risk orientation in the definition of lending conditions.

In 2005, however, the corporate sector could further reduce its interest rate risk by increasingly resorting to equity and longer-term types of financing.

Strong Growth in Households' Net Financial Assets

Subdued Development of Private Consumption

While HICP inflation was significantly less dynamic during the first months of 2006, it amounted to 2.1% in 2005. This weakened households' purchasing power so that private spending did not gain any momentum despite tax reliefs provided by the second stage of the latest tax reforms. In real terms, the growth rate of consumption was only 1.4%. The considerable wage increases agreed in the latest round of wage settlements should gradually lead to strengthened

consumer confidence and a slight upturn in private consumption (provided that oil prices do not accelerate further).

The increase of the saving rate which went hand in hand with subdued consumption resulted in a clear improvement in households' net financial positions (financial investments minus new borrowing). In the second half of 2005, their financial investments totaled EUR 7.8 billion and, hence, were twice as high as new borrowing.

The next section discusses the development of households' liabilities, followed by a presentation of their financial assets and, finally, conclusions.

Favorable Financing Conditions for Home Loans

The downward trend in (ex ante) real interest rates¹² for home loans and consumer loans observed in the past years came to a halt in early 2006 (see chart 11). Real interest rates for home loans remained more or less stable, while those for consumer loans increased slightly. The results of the bank lending survey indicate that, since the beginning of 2005, developments have not been uniform for home loans and consumer loans. While the survey's findings point to unchanged conditions for home loans, the terms for consumer loans were tightened in the first three quarters of 2005. The survey results for the first quarter of 2006, however, suggest that loan conditions have been relaxed again. Banks' interest margin¹³ for

¹² The ex ante real interest rate (nominal interest rate minus HICP forecast) was calculated on the basis of the OeNB's inflation forecast.

¹³ The correct reference rates for loans with a maturity of 1 to 5 years are interest rate swaps with the same maturity. Like the ECB, we chose the three-year euro interest rate swap rate for data reasons.

Chart 11

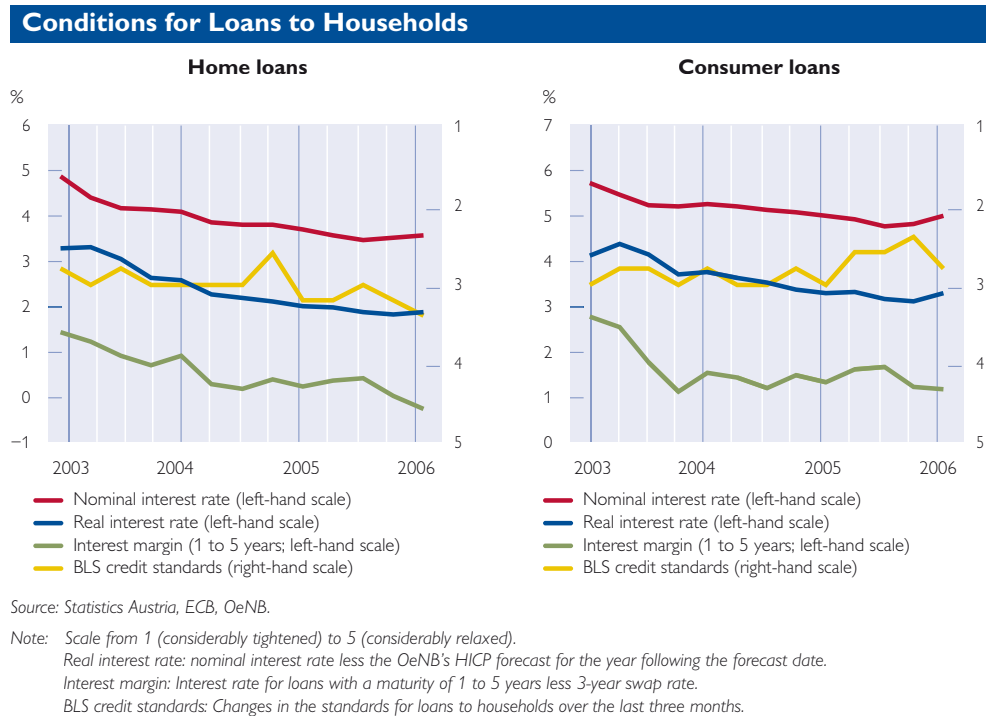
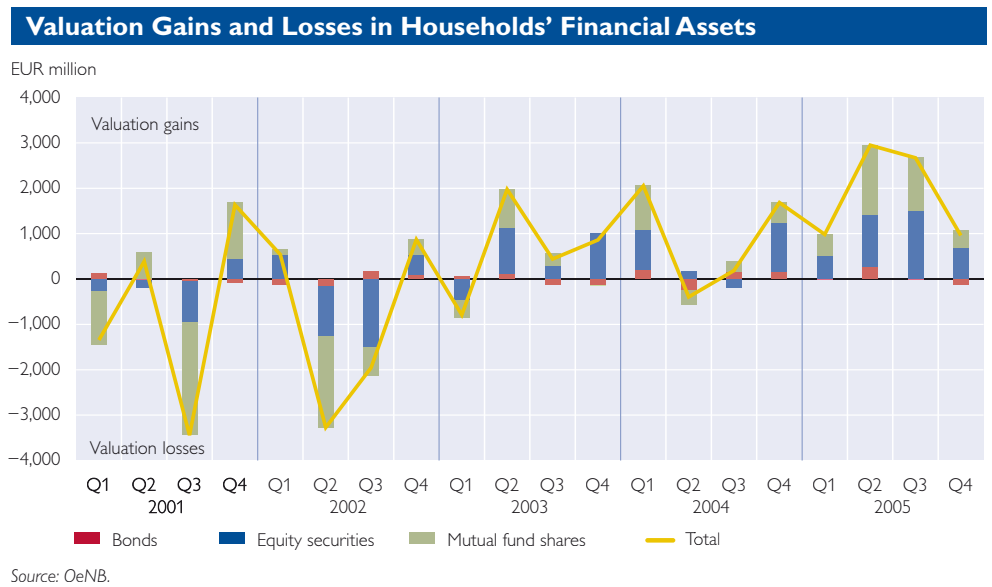


Chart 12



medium-term home and consumer loans showed a rather flat development in 2005. This tendency continued for consumer loans in early 2006, while the interest margin slightly narrowed for home loans. All in all, and especially in a long-term comparison, financing conditions for home loans may be considered favorable, while

loan standards have been slightly tightened for consumer loans.

New Debt Incurred Primarily for Housing Investments

In 2005, bank loans to households achieved a growth rate corresponding to the level of the previous years. The annual growth rate was 7.0% in

March 2006. Expansion has slightly decelerated in the past 12 months. The main purpose of borrowing remains home financing. With an annual growth rate of 8.8%, home loans have seen a dynamic development. By contrast, consumer loans registered a noticeable slowdown and, in March 2006, were only 3.8% above the reference value of the previous year. This could be related to

slightly more restrictive credit standards for consumption purposes.

The demand for foreign currency loans remained high. At the end of 2005, foreign currency borrowing reached a share of 31% in total loans. In the past year, the Swiss franc essentially dominated the expansion of foreign currency borrowing, whereas loans denominated in Japanese yen continued to decrease.

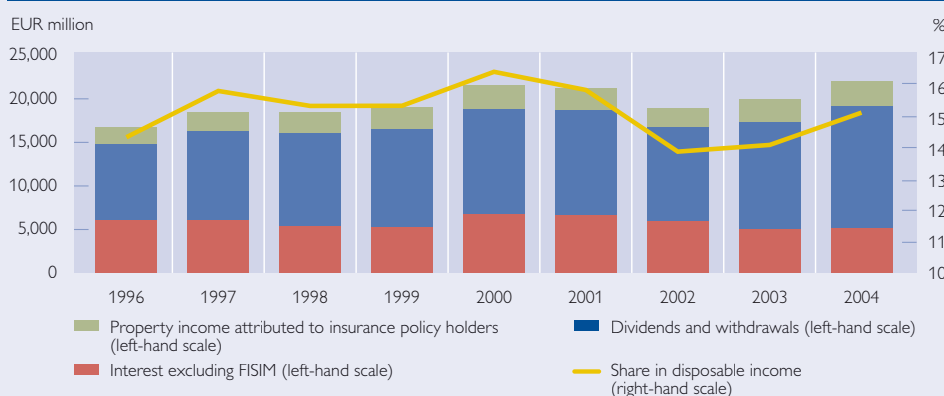
Households' Investment Income Rises

In macroeconomic terms, financial assets are an important part of disposable income. In the past years, a considerable share of households' real income growth came from the development of (gross) investment incomes. It should be noted, however, that financial assets and, as a result, investment incomes are distributed unevenly.²

The most significant elements of investment incomes are dividends and withdrawals from companies (i.e. the part of corporate profits distributed to or withdrawn by the owners). Their share in total investment income rose from 52% in 1996 to almost two-thirds in 2005; in 2003 and 2004, dividends and withdrawals accounted for the entire growth of investment income. The interpretation of this indicator, however, is made rather difficult by the fact that, because of data problems, it has to be calculated as a residual value.

Chart 13

Household's Investment Income



The second most important position is interest income. Its share in the investment income of households decreased from 37% in 1996 to 23% in 2005. This weak development mainly reflected the decline of interest levels in the past years, which was only partly offset by the – relatively low – increase in households' interest-bearing financial assets.

¹ Here, households not only include individuals and groups of individuals in their capacity as consumers, but also sole proprietorships and partnerships (without legal personality) as well as private nonprofit organizations, such as private foundations.

² See Beer, C., P. Mooslechner, M. Schürz and K. Wagner. 2006. *Austrian Households' Financial Wealth: An Analysis Based on Microeconomic Data*. In: *Monetary Policy & the Economy Q2/06*. OeNB (forthcoming).

The third type of investment income is property income attributed to insurance policy holders. Its share in total investment income was more or less constant throughout the entire period under review, ranging from 11% to 13%. It should be noted, however, that this is a purely hypothetical value which reflects the investment performance of insurance companies and pension funds.

In this analysis, the development of stock prices on Wiener Börse AG has no influence on investment incomes because valuation gains arising from securities do not form part of investment income. They are not transactions, but changes in the value of financial assets.

In the past years, investment incomes showed a relatively high correlation to the related financial investments. This is particularly true for investments in interest-bearing financial assets, which to a large extent were fuelled by interest income as, for example, credited interest on deposits remained on accounts and only a relatively small share was used for consumption. On account of declining interest rates and the dwindling importance of interest-bearing assets in financial investment, however, this correlation has been less pronounced recently. A relatively stable link could also be discerned between income from insurance yields and property income attributed to insurance policy holders. By contrast, there was a considerable gap between dividends and withdrawals on the one hand and equity investment on the other. To a large extent, this can probably be attributed to the fact that a major part of shareholdings represent no pure financial investments for households and that corporate profits are primarily re-invested in the form of retentions, i.e. they are not distributed at all.

High Investments in Insurance Products

According to the financial accounts, financial investments by households amounted to EUR 7.8 billion in the second half of 2005. In this period, the demand for mutual fund shares and insurance products was particularly strong, accounting for more than half of financial investments. Households increased their claims on mutual funds by EUR 2.1 billion and their claims on insurance companies and pension funds by a total of EUR 2.5 billion. By contrast, direct investments in listed shares and bonds were considerably lower (second half of 2005: EUR 0.8 billion).

High Valuation Gains from Capital Market Investments

Because of the good performance of capital markets, investments in equity securities and mutual fund shares yielded high valuation gains for households. In the second half of

2005, the valuation gains reached EUR 3.8 billion for mutual fund shares and stocks, while bonds recorded a negative performance (–EUR 111 million).

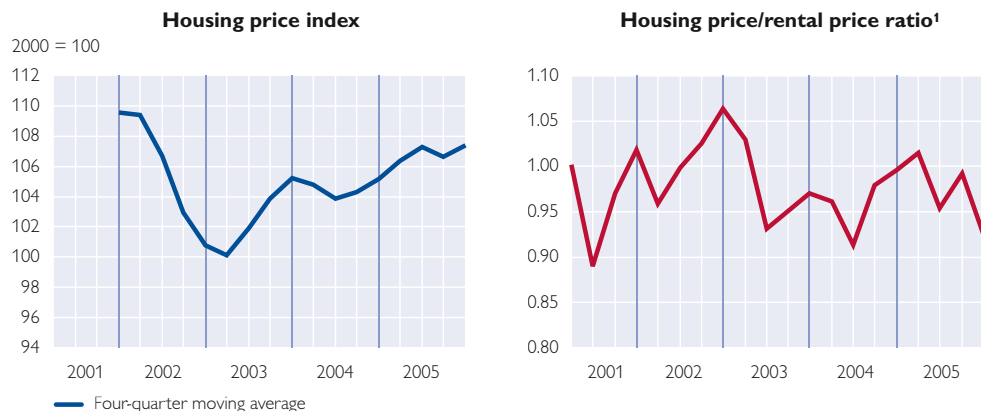
Both valuation gains and increased investments in capital market instruments resulted in an increase of the share of stocks, bonds, mutual fund shares and insurance products in households' overall financial assets, while the share of cash and deposits slightly decreased.

Real Estate Price Developments Subdued

In some euro area countries, real estate prices developed very dynamically. Spain has recorded two-digit growth rates for several years, while Austria as well as Germany are among those countries with rather subdued price developments in these markets. In 2005, prices for buying Austrian apartments showed a slight upward trend (see chart 14).

Chart 14

Indicators for Real Estate Prices

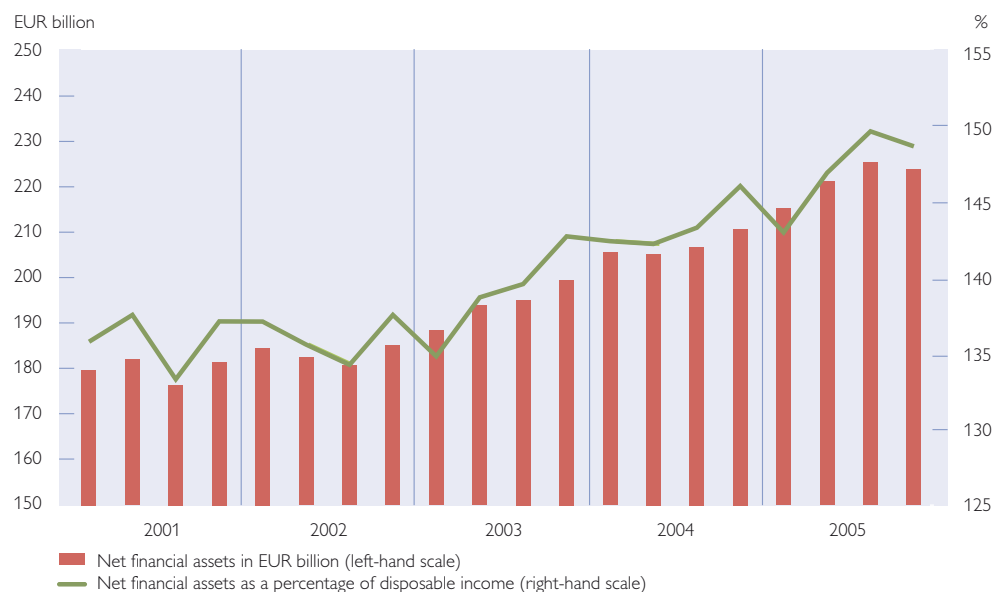


Source: Vienna University of Technology, AiB, OeNB.

¹ The housing price/rental price ratio is calculated by dividing the housing price index (new owner-occupied apartments) by the price index for rented apartments (2000 = 100).

Chart 15

Households' Net Financial Assets



Source: Statistics Austria, OeNB.

An indicator of an excessively high valuation of the real estate market is an increase in the housing price/rental price ratio. If housing prices rise significantly faster than rental prices – over a prolonged period –, they deviate from their fundamental

market value.¹⁴ However, as chart 14 shows, the housing price/rental price ratio does not display an upward trend in Austria so that there are no indications that the real estate market is overvalued.

¹⁴ See, for example, McCarthy, J. and R. W. Peach. 2004. Are Home Prices the Next 'Bubble'? In: Federal Reserve Bank of New York Economic Policy Review. 1–17.

Summary: Risk Exposure of Households Remains Stable

As financial investments of households clearly exceeded new debts and households additionally posted high valuation gains on capital market instruments in 2005, the net financial assets of the household sector increased to 149% of disposable income.

Strong investments on the capital market have resulted in high valuation gains, but are also accompanied by a moderate risk potential as evidenced by the valuation losses for bonds in the last quarter of 2005 (–EUR 111 million). If interest rates continue to increase, this development could accelerate.

Given the high share of variable-interest loans, loan costs are subject to significant interest rate risk. Moreover, Austrian households' financial liabilities involve certain foreign currency risks given the undiminished demand for loans denominated in foreign currencies.¹⁵ However, as the debt ratio of Austrian households is rather low in comparison with the euro area, this risk is probably limited.

As the risk factors indicated above were offset by the strong growth in the net financial assets, one can say that the risk exposure of households has remained broadly unchanged.

¹⁵ A major part of foreign currency loans is denominated in Swiss francs, a currency which has been largely stable against the euro in the past. In early 2006, however, the Swiss franc slightly appreciated against the euro.