

## Austria's Financial System Has Further Improved Its Resilience to Crises

### **Global Economic Recovery Weakened Slightly**

The global economy, which had grown strongly in 2004, expanded at a slightly slower pace in the first few months of 2005. Growth was mainly driven by the United States, China and the emerging economies in Eastern Asia, whereas the Japanese and the euro area economies grew at a slower pace. While maintaining a positive growth differential with the euro area, Central and Eastern European countries (CEECs) also posted partly even considerably lower growth rates at the beginning of 2005.

### **International Financial Markets Develop Favorably**

Despite fairly vigorous economic activity, long-term yields in the international bond markets remained unusually low until spring 2005. At the same time, corporate bond spreads remained also very low compared with government bonds of similar maturity. While on the one hand reflecting the<sup>1</sup> favorable corporate profit situation, on the other hand this development showed that institutional investors continued to tolerate high risks and intensified their quest for yields in light of the low nominal interest rate levels.

The favorable profit outlook for companies has also contributed significantly to the stock price increases in the euro area equity markets until spring 2005. In 2004 and in the first quarter of 2005, the uptrend of the Austrian Traded Index ATX continued to exceed the development of the major international stock indices.

The performance of Austrian investors' portfolios benefited from the generally favorable environment of the financial markets. This held true for both institutional investors (such as insurance companies or investment funds) and households, which managed to compensate for a large part of the valuation losses in the financial assets they had suffered due to plunging stock prices between 2000 and 2002.

Mirroring these developments, downward risks prevailed in the financial markets in the spring of 2005. U.S. external imbalances continued to be high, which involved the risk of abrupt currency shifts and might, in turn, lead to a noticeable hike in long-term interest rates especially in the U.S.A. High oil prices constituted another important risk factor.

### **Profitability of Central and Eastern European Banking Sector Improves Further**

In 2004, Central and Eastern European banks again posted high average returns on equity. The big Austrian banking groups continued to expand their business in CEE, and the profits earned in this region again represented a large portion of the Austrian banking groups' operating results. This contribution to income is in part attributable to the high valuation of the major CEE currencies as a result of the current international environment and the largely favorable fundamentals. Hence, potential currency valuation changes pose a certain risk for subsidiaries' future contributions to Austrian banks' operating results.

<sup>1</sup> In early May, however, the corporate bonds of General Motors and Ford - two of the most important issuers on the U.S. bond market - were downgraded to junk bond status.

### **Financial Position of Austrian Companies and Households Strengthened**

The Austrian economy was not entirely immune to the decline in euro area growth. In 2004, companies were still able to raise their profits and therefore to rely on internal sources of finance for their investments. They used a wide range of financing instruments for external funding, with bank loans posting positive growth rates for the first time in two years. In recent quarters, the corporate sector's overall resilience to shocks generally strengthened as a result of improved balance sheet structures, higher profits and the fact that financing conditions continue to be favorable.

The assessment of the household sector's financial situation, by contrast, produces more complex results: In 2004, households' financial assets of households showed the highest growth rate since the introduction of financial account statistics, while their total debt rose further. In this context, the growth of assets and loans appears to have been distributed unevenly across individual households. Unlike in other euro area countries, the real estate market in Austria has not overheated so far.

### **Austrian Banks' Risk Profile Improved**

The Austrian banking sector's risk profile improved in 2004. The higher profitability in domestic business is attributable to a significant increase in in-

come from participating interests and in fee-based income as well as to a lower need for risk provisions. The capital ratio is still high, and stress tests also confirmed the banking sector's resilience to shocks. All in all, Austria's banking system does not show any signs of particular fragility.

However, the Austrian banking sector still has to cope with its traditional weaknesses: The cost burden remained comparatively high, even though the cost/income ratio declined. As a result of fierce competition, interest income is low by international standards, with banks' interest margins declining even further in 2004. Even though margins are small, interest income still constitutes a reliable income component for Austrian banks. At present, the sound profitability of Austrian banking subsidiaries in the CEECs contributes significantly to the increased risk-bearing capacity of Austria's banking sector but drives up the dependency on future developments in these markets.

The growing share of foreign currency loans in total domestic lending needs to be constantly monitored. Even if we consider that the reported loan volumes represent an upper limit as creditors pay separately into repayment vehicles to save for loan repayment, the volume of foreign currency loans in the euro area remains high. In a development that has doubtlessly fostered stability, however, Swiss franc-denominated loans have almost completely replaced Japanese yen-denominated financing.