

Financial Position of Real Economy Sectors Strengthened

Companies Show Higher Resilience to Crises

Lively Investment in 2004

After a weak fourth quarter of 2004, the Austrian economy picked up again at the beginning of 2005, although it did feel the dampening effect of declining euro area growth. In 2004, exports, along with investments, were the main forces carrying the economy in Austria; investments in particular had reaccelerated since the third quarter of 2004 owing to a rise in capacity utilization and the related necessity to make capacity-boosting investments.² In addition, the strong investment growth in 2004 appears to have been caused essentially by a frontloading of investment prompted by the investment allowance, whose termination will most likely reduce investment activity in the course of 2005. Business survey data collected in the course of the WIFO Economic Survey also indicated a slight

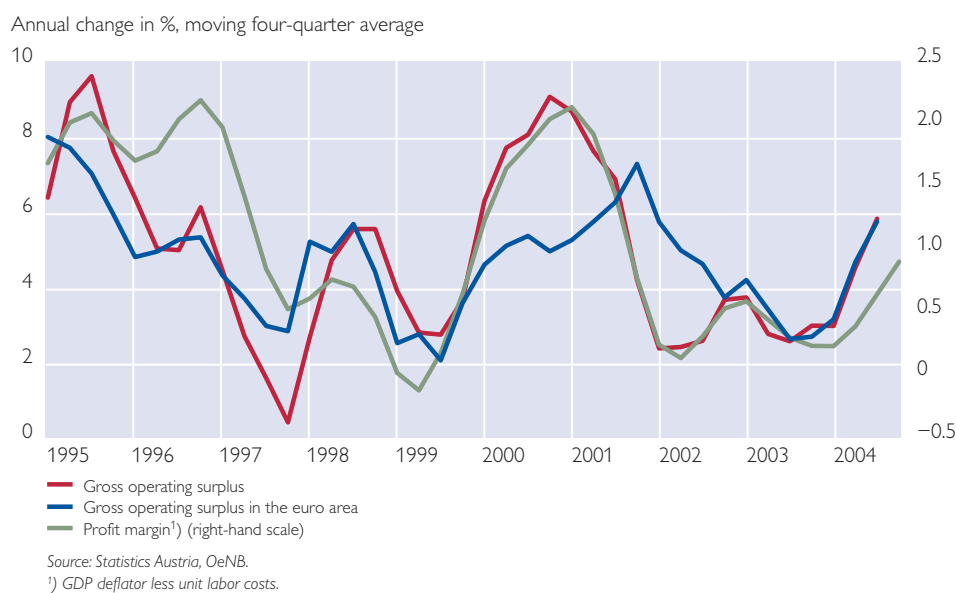
slowdown of the economic recovery, given that in spring 2005 fewer businesses said they were planning to expand their production than in autumn 2004.

Increase in Companies' Internal Financing Potential

In the second half of 2004, the corporate sector's demand for external financing did not rise to the same extent as investment, as companies were able to raise a considerable part of the required funds through internal financing. Based on the favorable development of unit labor costs, the profit situation of Austrian companies improved steadily in the course of 2004, even though climbing commodity prices made production more expensive, which resulted in lower earnings. In addition, low interest rates reduced companies' financing costs.

Chart 5

Indicators for Profitability Performance in the Corporate Sector



² Although base effects slowed down the annual growth rate in the fourth quarter of 2004, gross fixed capital formation, in seasonally adjusted terms, continued to expand fast until the end of 2004.

The development of the profit margin³ and the gross operating surplus⁴, which both showed an uptrend in the course of 2004, may serve as an indicator for companies' improved profit situation (see chart 5).

Bank Loans' Contribution to Corporate Financing Back on the Rise

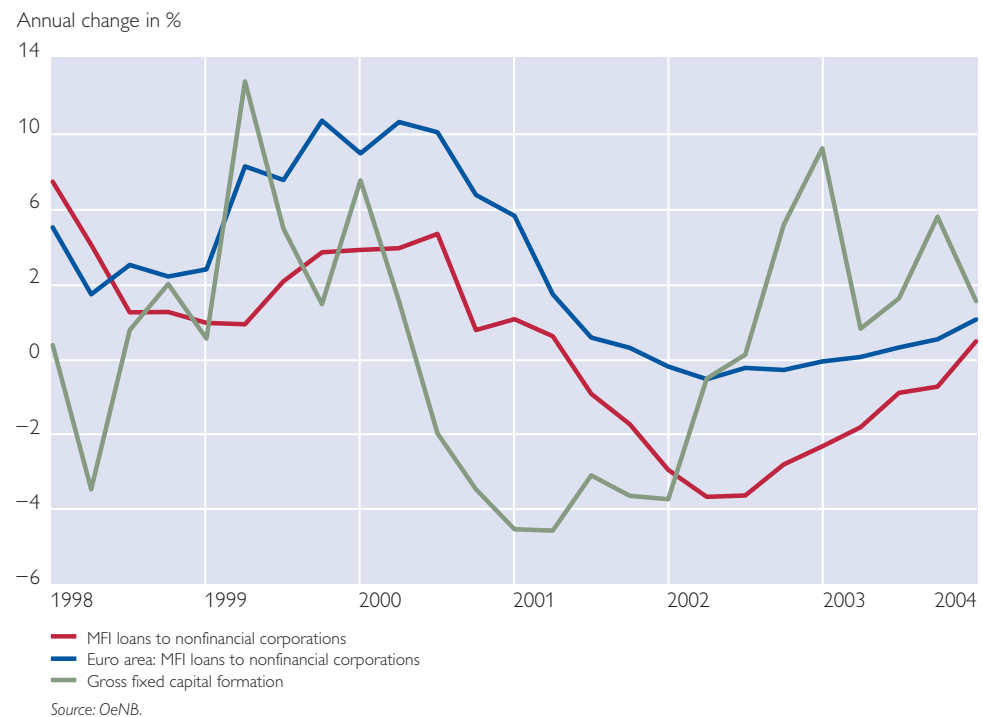
External financing advanced at a slower pace than investment spending given the corporate sector's favorable operating performance; moreover, the structure of external investment also changed in the second half of 2004.

The share of bank loans in external financing has increased considerably since mid-2004. After a decrease in borrowing in 2003, bank liabilities have shown a positive annual growth rate since mid-2004, which averaged 3.1% in the fourth quarter.⁵ Thus, credit growth in Austria remained below that of the euro area as a whole and it developed less dynamically over in 2003 and 2004 than investment spending of nonfinancial corporations.

However, there are no signs that the slow growth in lending was attributable to a reduction in credit supply.

Chart 6

MFI Loans to Companies and Corporate Investment



³ The profit margin is defined here as the relation of the gross valued added deflator to unit labor costs.

⁴ The gross operating surplus is the surplus created by corporate operations after the remuneration of labor as a production factor. It can be determined by deducting the compensation of employees and taxes on production (less subsidies) from GDP, and it is the national accounts' equivalent of gross operating income. The gross operating surplus is an approximation variable for measuring absolute profits.

⁵ Changes in the classification of the "nonfinancial corporations" and "households" sectors by a number of reporting entities resulted in a break in the relevant time series for the June 2004 reporting date. According to the available data, the resulting error amounted to EUR 2 billion for loans to households (excluding freelance professionals and nonprofit institutions serving households) in June 2004. The growth rates of loans to corporations and to households (excluding freelance professionals and nonprofit institutions serving households) have been adjusted as of the second half of 2004.

The Austrian results of the bank lending survey (BLS) for the euro area show that in recent quarters, banks only made minor changes on their credit standards. At the same time, the surveyed bank managers stated that corporate sector loan demand decreased owing to improved internal financing. The major factors affecting corporate borrowing were mergers and acquisitions, corporate restructuring and, more recently, investment financing.

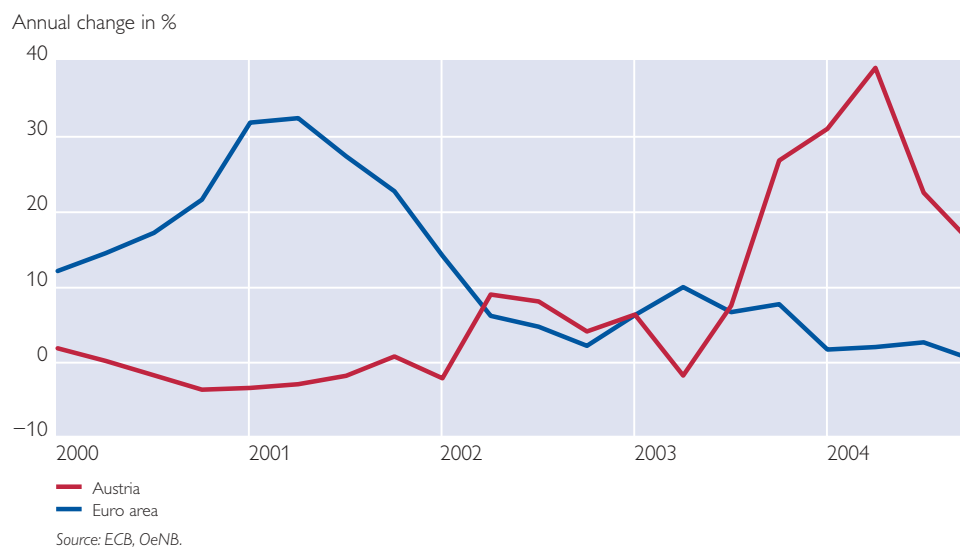
The structure of loans continued to shift toward longer maturities owing to a flattening of the yield curve and low nominal interest rates. This decline in the relative share of short-term debt in total debt may be partly attributable to the fact that the rise in acquisitions of durable capital goods drove up long-term corporate financing needs rather than the demand for short-term working capital loans. Liquidity risk tended to decrease owing to the declining share of short-term loans; since short-term assets went up at the same time, the overall corporate liqui-

dity position rose sharply in the course of 2004.

In the second half of 2004, bonds continued to play an important role in corporate finance, contributing about one quarter to the external financing of Austrian companies. Issuance statistics show that bond issues by nonfinancial corporations increased by 16% in this period year on year, while the growth rate of corporate bonds in the euro area as a whole reached its lowest value since the introduction of Economic and Monetary Union (EMU), coming to 1.6%. In contrast to the euro area, where some 15% of corporate bonds had maturities of less than one year at the end of 2004, Austrian companies did in fact not issue any short-term bonds. As bonds have longer maturities than loans and as they are usually payable at maturity, stronger bond issuance tends to reduce the liquidity burden of the corporate sector. At the same time, bonds allow issuing companies to profit from the current, relatively low interest rate

Chart 7

Outstanding Volume of Corporate Bonds



level over a longer period of time and thus to reduce interest rate risk.

Recently, raising funds on the stock exchange has become more and more important. Even though there was only one new listing on the Vienna stock exchange (Wiener Börse AG) in 2004, funds raised by nonfinancial corporations developed in a dynamical manner. Overall, raising funds on the stock exchange contributed just under 6% to the financing of gross fixed capital formation, thus showing a clear uptrend in the course of the year (see chart 8), and accounted for some 15% of external financing. In the second half of 2004, Wiener Börse AG accounted for more than 8% (in terms of volume) of capital increases and new listings of listed shares of euro area nonfinancial corporations (after 3.2% in the first half of 2004). Even though a rise in

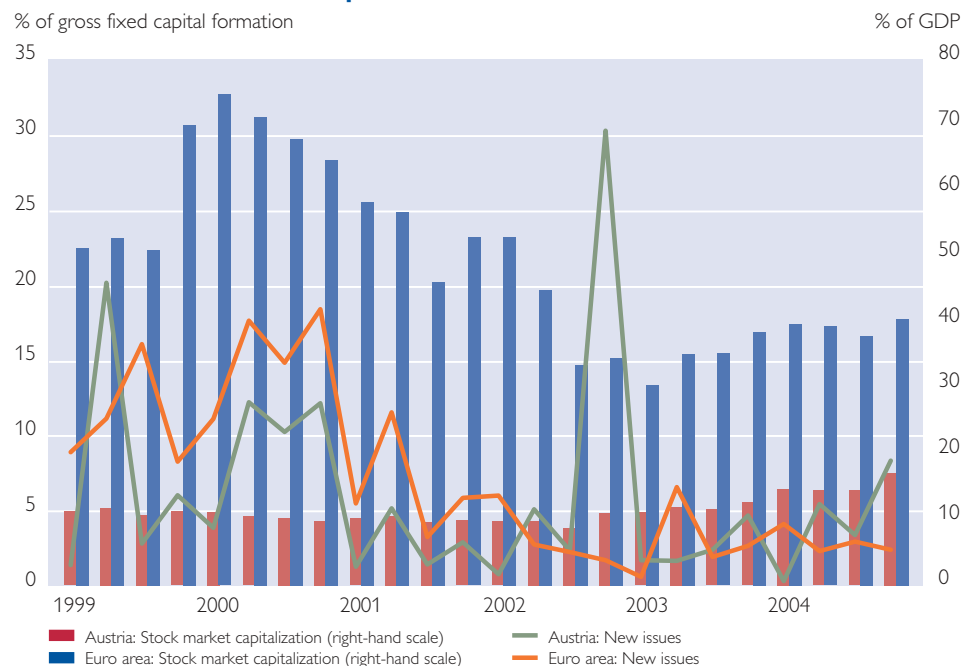
stock prices at Wiener Börse drove up the market value of issued shares by EUR 12 billion in the fourth quarter of 2004 alone, corporate sector financing through stock market listings remained below the high values registered in 1999 and 2000.

The stock market capitalization of nonfinancial corporations listed on Wiener Börse has augmented from EUR 32 billion to EUR 39 billion since mid-2004 and lately came to some 17% of GDP.⁶ This corresponds to almost half the total euro area average, which stood at 40% at the end of 2004.

Moreover, off-market equity financing went up, so that the overall share of equities in corporate sector liabilities increased considerably in 2004. On the whole, Austrian companies have thus broadened their financing base. On the one hand, they were able

Chart 8

Capital Increases, New Listings and the Market Capitalization of Listed Shares of Nonfinancial Corporations



Source: OeNB, ECB.

⁶ At the end of 2004, the market capitalization of all stocks (including those of financial corporations) listed on Wiener Börse AG amounted to almost 28% of GDP.

to increasingly rely on internal financing given their favorable profitability situation, and on the other hand they made use of a broader variety of external financing instruments.

Financing Costs Remain Low

The conditions for external financing continue to be favorable for Austrian companies both for borrowing funds and for issuing equity capital.

The slight downtrend of interest rates for corporate loans observed in the first half of 2004 did not continue in the second half of the year. However, the interest rate level remained low both over time as well as vis-à-vis the euro area.⁷ In real terms, the lending

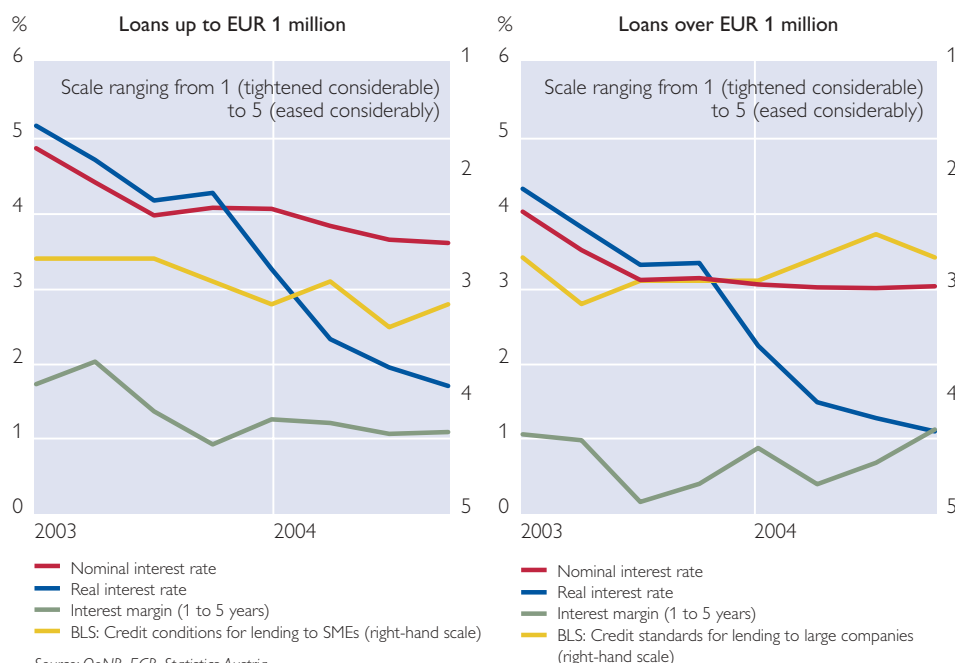
rate (interest on corporate loans less inflation⁸) was dropping throughout 2004.

A comparison of retail interest rates and those on largely risk-free assets may provide information on the risk costs contained in bank interest rates. The interest rate differential between corporate interest rates and swap rates with corresponding maturities shows that risk premiums for large financing volumes increased only slightly, while they remained practically unchanged for loans up to EUR 1 million.

This assessment of largely unchanged credit standards corresponds to the most recent bank lending survey

Chart 9

Conditions for Corporate Loans



⁷ Data of the harmonized ECB interest rate statistics have only been provided since the January 2003 reporting date.

⁸ Deflator for gross fixed capital formation.

results. After slightly loosening their credit standards in the fourth quarter of 2004, banks did not change the basic stance of their corporate lending policy in the first quarter of 2005. However, conditions for corporate lending were tightened in some areas. Above all, banks expanded the margins on riskier corporate loans in the last two quarters, while the margins on loans to borrowers with an average credit standing remained constant.

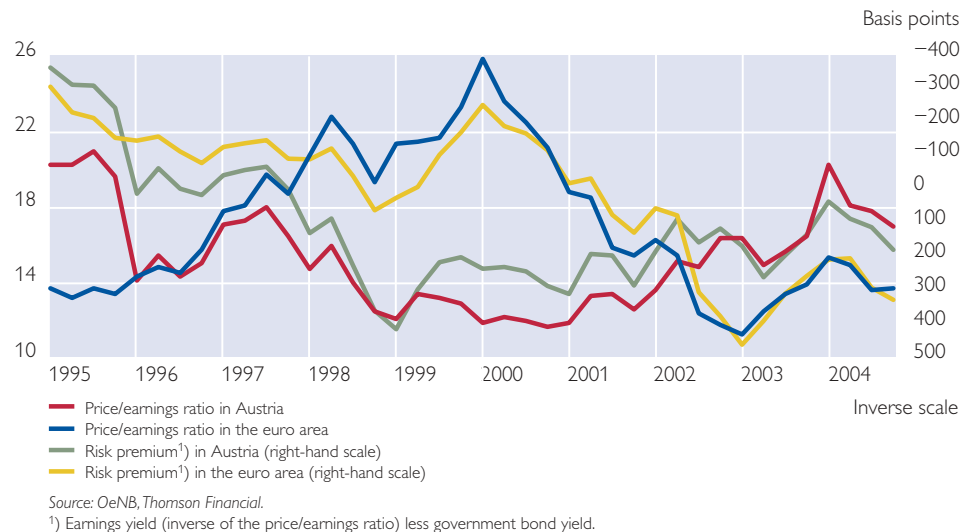
Financing conditions on the stock market have also been favorable so far. ATX performance in 2004 and in the first quarter of 2005 considerably exceeded that of important international stock indices. The price/earnings ratio has trended downward since the sec-

ond quarter of 2004, as higher stock prices coupled with an increase in corporate profits. This implies that equity financing on the stock exchange has become slightly more expensive; nevertheless, the price/earnings ratio has remained above the comparative value for the euro area as a whole.

The situation is similar for the spread between earnings yields⁹ and government bond yields whose movements over time can be seen as an indicator for the stock market risk premium. The slight increase in the yield spread in 2004 shows that the conditions for equity financing on the stock market developed somewhat less favorably than the general level of interest rates (see chart 10).

Chart 10

Financing Conditions on the Stock Market



Debt Ratio of the Corporate Sector Declines

Given the relatively moderate borrowing activity, corporate sector liabilities – relative to GDP and corporate earnings – went down slightly in the previous year (see chart 11).

The favorable earnings situation and the corporate sectors' improved capital position, however, only had a lagged effect on insolvencies. The number of insolvency proceedings dropped slightly in the first quarter of 2005, whereas no-asset cases went up by

⁹ The earnings yield is the inverse of the price/earnings ratio.

25% year on year. Expressed as a percentage of the total number of companies, the overall insolvency ratio came to 0.7%. The volume of default liabilities, which in the fourth quarter of

2004 had been one-eighth above the comparable value of the previous year, decreased by more than 20% in the first quarter of 2005.

Chart 11

Corporate Debt¹⁾



Summary

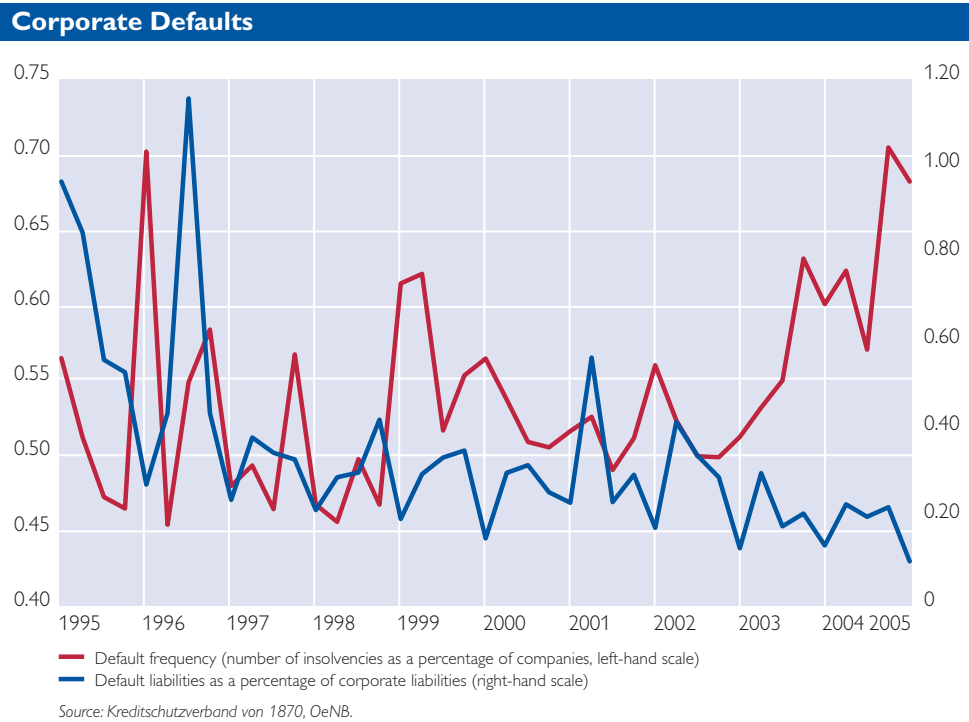
The improved financial position and the still favorable financing conditions in the financial markets suggest that the corporate sector's resilience to crises has increased over the last few quarters.

The rise in profits and equity capital has improved both the balance sheet structure and the corporate sector's credit rating. Higher profits allowed companies to increasingly rely on internal financing; moreover, they made use of a wide range of (external) financing instruments. In this respect, bank loans became more important again in companies' financing decisions in the second half of 2004.

The structure of corporate financing has shifted toward longer-term forms of borrowing. The higher proportion of equity financing and the increased recourse to bonds as well as the tendency toward longer-maturity bank loans have contributed to this development. This means that while the corporate sector is now exposed to a lower liquidity risk, it cannot take full advantage of the lower financing costs caused by low interest rates.

All in all, the corporate sector has improved its robustness to shocks. At the same time, the increased use of capital market instruments has spread corporate risk, which was covered primarily by the banking sector in the past,

Chart 12



more broadly across the financial markets.

However, some risks still remain: Even though corporate profits were very high in 2004, economic growth forecasts are cautious, which means that companies' internal financing potential might decrease. Moreover, the cost savings caused by the currently low level of interest rates for corporate lending might partly be reversed if interest rates go up markedly. However, many companies have lately reduced their vulnerability to interest rate changes by raising funds through the issuance of bonds and shares.

Households' Financial Investment and Debt on the Rise

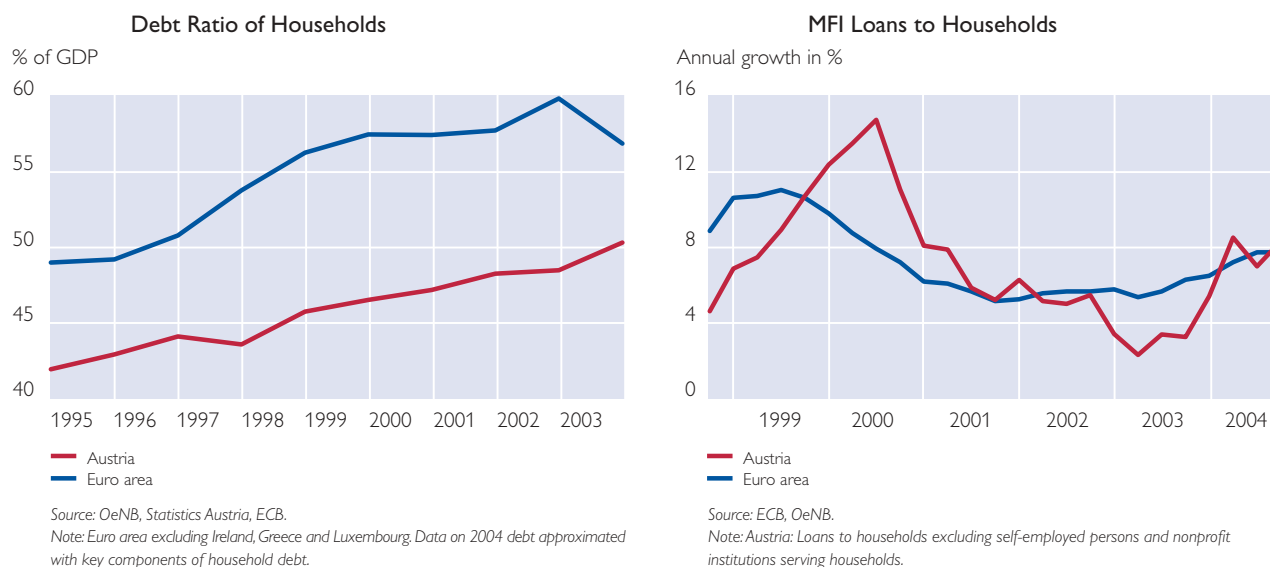
Only Slight Income Growth in 2004

In 2004, household income improved only marginally. Disposable income went up by 1.7% in real terms, at the

same rate as in 2003. Despite the subdued increase in income, households began to spend more for private consumption. Going up by 1.5% in real terms, private consumption growth more than doubled compared to 2003, which implies that a substantial proportion of income growth was spent for consumption. At the same time the saving ratio climbed from 8.9% to 9.3%. According to the OeNB's economic outlook for Austria, household income should augment in 2005. Disposable income is expected to increase by 2.0% in real terms owing to positive effects of the tax reform and the sustained rise in employment. The saving ratio should come to 9.7%. The uptrend in the saving ratio in recent years is partly ascribable to redistributions of employees' net personal incomes, which have a low saving ratio, to the profits of self-employed persons.¹⁰ In households' financial

¹⁰ See WIFO Forecast April 2005.

Indicators for Households' Debt



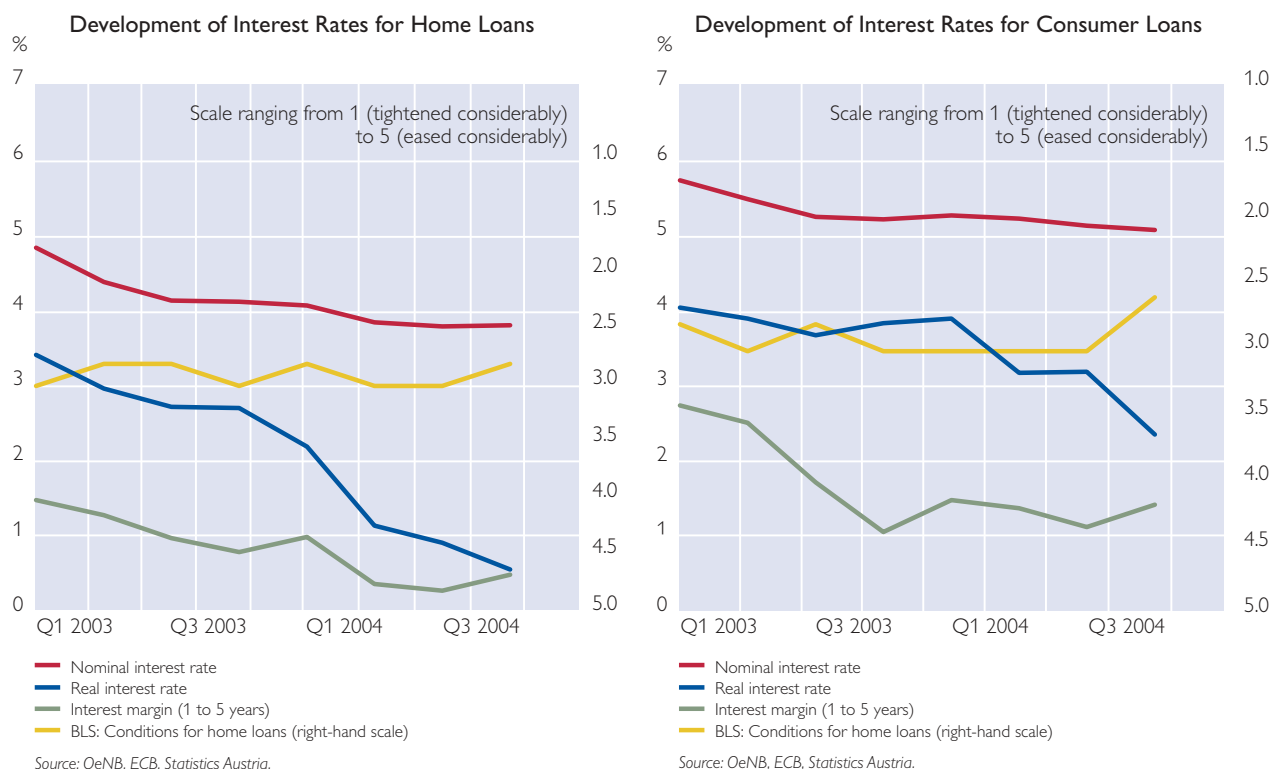
flows, this development is reflected in the strong recent rise in financial assets, which is accompanied by high debt.

Debt Continues to Rise

The debt ratio of Austrian households increased further in 2004. Liabilities came to around one half of GDP; at 57%, however, they were below the euro area reference value (see chart 13). In a comparison of euro area countries, Austria (along with Italy and Finland) ranks in the lower range in terms of household debt.

According to financial account data, households took out loans to the amount of EUR 7.7 billion. This corresponds to an annual growth of 7.0%. Home loans (EUR 5.0 billion) accounted for the bulk of borrowings while consumer credits amounted to EUR 1.3 billion. In general, the rise in debt is somewhat problematic within the current macroeconomic framework. Given the currently rather moderate income growth, consumer loans, above all, are becoming riskier as no collateral is provided should the debtor turn insolvent (contrary to home loans, where real estate can be used as collateral).

Conditions for Loans to Households



Note: Real interest rate: Nominal interest rate less changes in the deflator for construction investment and consumer spending. Interest margin: Interest rate for loans with a maturity from 1 to 5 years less three-year swap rate. BLS credit standards: Changes in the credit standards for lending to households over the last three months.

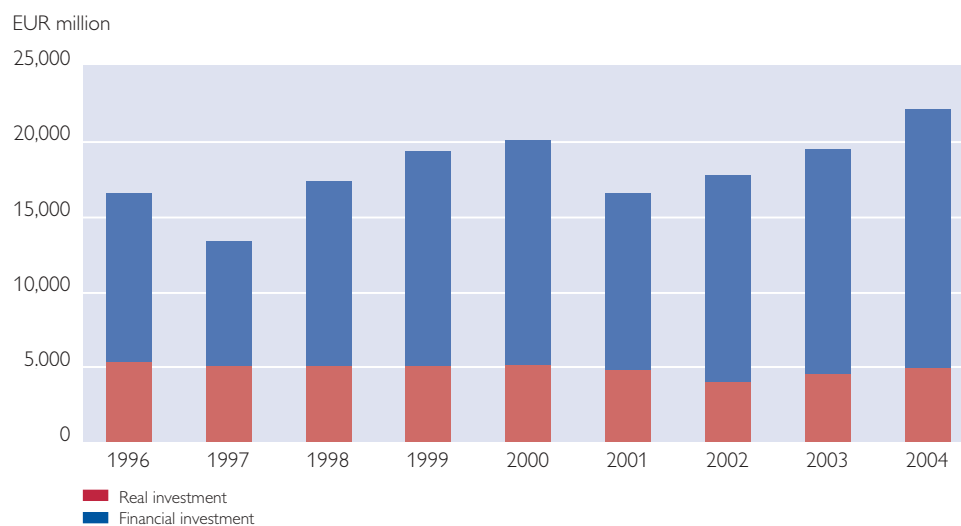
Further Improvement of Financing Conditions in the Second Half of 2004

In the second half of 2004, financing conditions for housing and consumer loans improved further. Interest rates for new housing loans decreased by 60 basis points to 0.49% in real terms, while real interest rates for consumer credits went down from 3.22% to 2.41%. In the second half of 2004, banks' interest margins expanded slightly for mid-term consumer and housing loans, which might indicate that the banking sector expects loans to become riskier. The results of the

bank lending survey also indicate a slight tightening of credit standards for the fourth quarter of 2004 (see chart 14). In general, the low interest rate level contributes substantially to reducing the burden on private borrowers. At the same time, however, the favorable interest rates entail certain risks. Households might not sufficiently take into account the future financial burden that might arise from higher interest rates, which would result in a deterioration of credit quality.¹¹

¹¹ Variable interest rates dominate the credit market in Austria. It is not possible, however, to break down the respective types of loans - at fixed or variable interest rates - and assign them to the individual economic sectors.

Chart 15

Households' Real and Financial Investment

Source: Statistics Austria, OeNB.

Note: Real investment according to national accounts. Values estimated for 2004.

Continued Acceleration of Wealth Accumulation in 2004

Households continued to step up wealth accumulation substantially in 2004. In total, households' real and financial investment appears to have expanded by EUR 21.9 billion (see chart 15).¹²

In real investment considerable funds seem to have flown into new housing.¹³ Indicators for this assumption are the strong demand for housing loans on the one hand and an uptrend in prices for new apartments observable since mid-2004 on the other.

After decreasing by 1.5% year on year in the first half of 2004, residential property prices remained unchanged

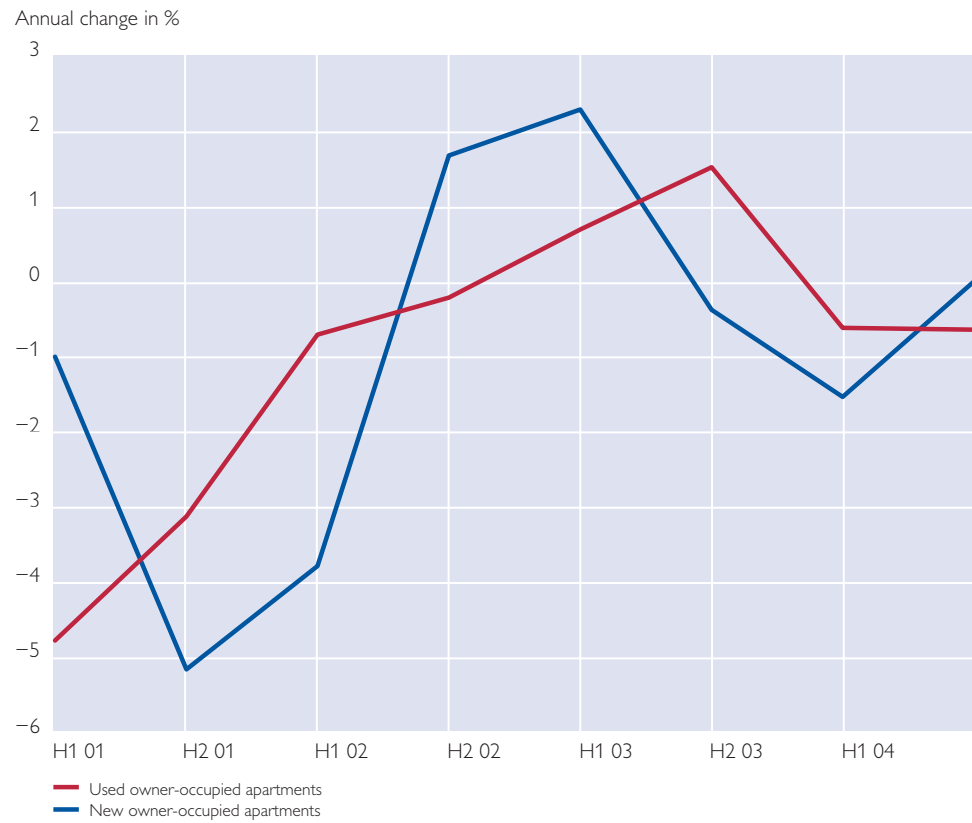
at the end of 2004. These price developments might be a result of lower excess supply. Thus, residential property prices continue to remain below the long-term average. The prices for used owner-occupied apartments dropped only slightly by 0.6% in 2004 (see chart 16).

Financial investment came to EUR 17.2 billion in 2004. The preference for liquid assets declined slightly against previous years. After having accounted for more than half of financial investment in 2002 and 2003, currency and deposits amounted to EUR 6 billion in the reporting year, i.e. around one third of financial investment. This indicates a trend toward normalization in

¹² This is a first estimate. Statistics Austria will release data on households' real investment for 2004 in December 2005. Real investment is estimated via households' saving and net lending/net borrowing in the capital account.

¹³ Around half of households' real investment was housing-related investment. Investment by self-employed persons, who are statistically classified under the "households" sector, also contributed considerably to real investment.

Real Estate Prices in Austria



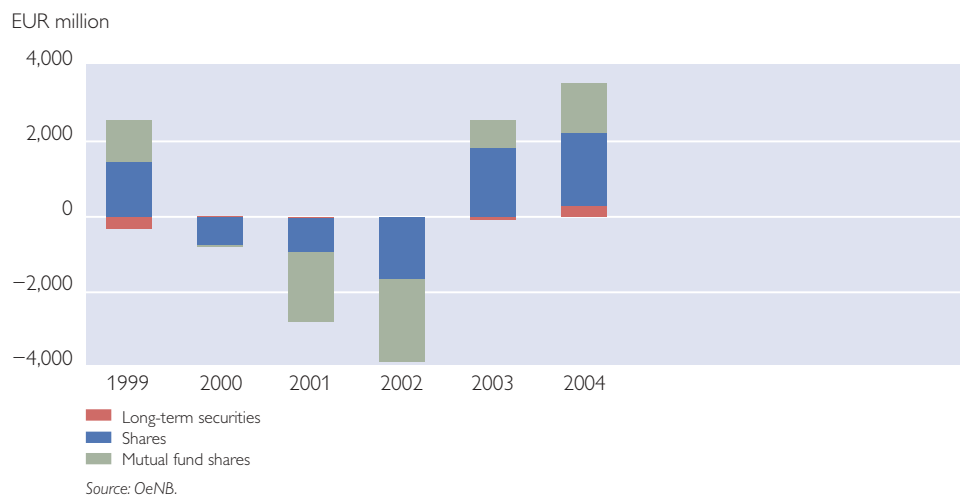
holding cash. The demand for insurance products went up. The volume of life insurance reserves and the investment in pension funds expanded by EUR 4.8 billion. After interest in mutual fund shares had slowed down in previous years, mutual fund shares picked up again in 2004, with investment amounting to EUR 2.9 billion. The high volumes invested in insurance products and mutual funds in particular in recent quarters are attributable on the one hand to the increase in households' private pension savings and on the other to the demand for foreign currency loans.¹⁴

Financial investment was supported by the price development on the national and international securities markets (see chart 17). Amounting to EUR 3.5 billion, price gains accounted for some 17% of the overall growth of financial assets. More than half of the valuation changes was attributable to price gains of EUR 1.9 billion in shares, while positive price changes for mutual fund shares came to EUR 1.3 billion. In combination with price gains of EUR 2.6 billion in 2003, households were thus able to largely compensate their capital losses they incurred between 2000 and 2002. According

¹⁴ Life insurance reserves along with mutual funds act as repayment instruments for foreign currency loans. Households' continuously rising demand for foreign currency loans thus entails positive effects on financial investment through life insurance reserves and mutual fund shares.

Chart 17

Valuation Gains and Losses in the Financial Assets of Households



to surveys, however, only very few Austrian households hold stocks; this means that the related price risks are of minor importance for the overall household sector. For mutual fund

shares the situation is different: These are highest in demand in particular with households of average wealth, as their diversified portfolio keeps the investment risk reduced.

Methodological Questions on Financial Assets

of Austrian Households

The analysis of the financial position of households presented in the OeNB's Financial Stability Report essentially relies on financial accounts data. The financial accounts statistics provide details on the development of all economic sectors (households, nonfinancial corporations, general government) since 1998, but do not contain any information on important economic issues such as the personal distribution of assets. As a consequence, these macrostatistical data do not show whether the Austrians are accumulating more wealth; neither do they provide sufficient information on the average financial assets of Austrian households, as the financial assets of nonprofit institutions serving households (such as the church or the Austrian Trade Union Federation), of freelance professionals and of private foundations are assigned to the households sector in the financial accounts. Thus, a substantial increase in the financial assets of private foundations might conceal opposing developments at the household level.

Asset growth may be attributable to savings, inheritances or capital gains. Some of these factors rather depend on individual behavior (saving), while others are rather exposed to externalities (inheritances, capital gains). Altogether, they may cause financial assets to grow or decline.

The composition of households' portfolios is of particular interest for financial stability. It is important to know how profit- or risk-oriented investors are and how a rise in households' debt would be distributed across the individual subsectors. Another question is whether those households that are indebted are identical with those that have acquired assets. The macrostatistical data contained in the financial accounts do not suffice to answer these questions. In fact, finding an answer requires a solid microstatistical basis. Above all, given the great variety of factors that influence the accumulation of financial assets, compiling data at the micro level may be advisable. Micro-level data will also be indispensable when it comes to economic policy issues such as determining whether the Austrians are equipped to meet the challenges of private pension plans.

A number of central banks, such as Banca d'Italia, Banco de España and the Fed, conduct regular surveys on the financial wealth of households. Presently, the OeNB is also conducting a nationwide survey among households. The objective of this survey is to assess the composition of households' financial assets in order to identify characteristics of financial behavior and to examine the changes in asset distribution in recent years. The results of the current survey will be presented in one of the future issues of the Financial Stability Report.

Significant Rise in Private Bankruptcies

High household debt goes hand in hand with a rising number of private bankruptcies. The Kreditschutzverband von 1870 reports that the overall number of households' defaults rose by one quarter to 5,573 cases in 2004.¹⁵ In the first quarter of 2005, the number of private bankruptcies came to 1,582, which corresponds to an annual growth of 13.7%. In line with increasing excessive debt, default liabilities peaked at around EUR 700 million in 2004.

There was a significant rise in the number of no-asset cases, which aug-

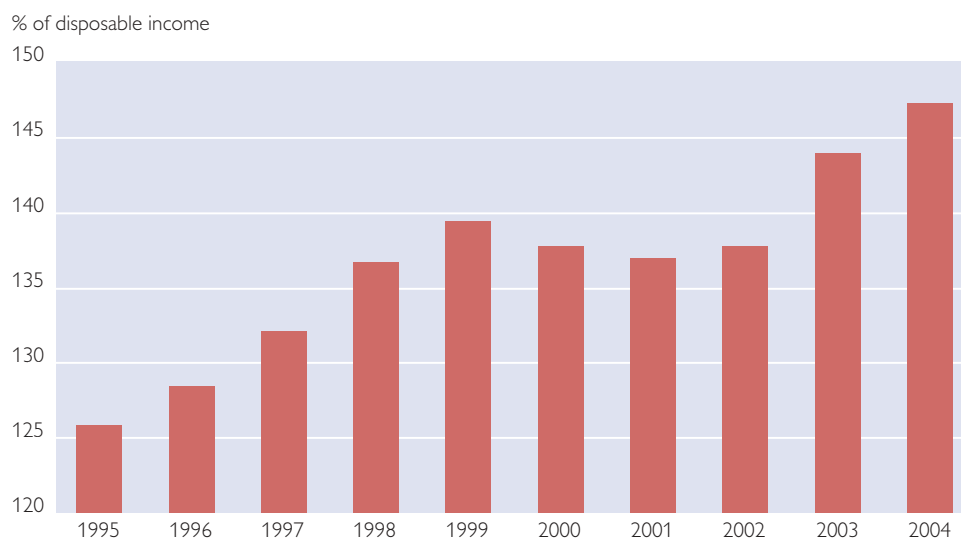
mented by around one third and reached 903 cases in 2004. In the first quarter of 2005, 304 bankruptcy filings were denied – a 40.1% increase year on year. In other words, the number of households unable to repay their debt is going up.

Financial Assets Increase Considerably while Credit Demand Accelerates

Estimates of households' financial situation vary. In 2004, financial asset growth and net financial assets reached the highest value since the introduction of financial accounts statistics in 1995 (see chart 18). This

Chart 18

Net Financial Assets of Households



¹⁵ According to the Kreditschutzverband, this increase is partly attributable to a change in the legal framework for private bankruptcies in 2002. The access criteria for private bankruptcy proceedings were loosened; while previously a discharge of residual debt had to be guaranteed, the new amendment only prescribes that procedural costs must be covered.

development strengthens the resilience to shocks.

In parallel, households' debt continues to increase. The fact that the incomes of employees and self-employed persons grow at very different speeds indicates that access to financial investment options has been highly disproportional in recent years – a fact which has contributed to a further concentration of assets in Austria. Both stabilizing consumption and investing in real estate thus depend on higher indebted-

ness, which generally means higher insolvency risks. Home loans, in particular, have been accelerating recently. Debt financing, which is high for real estate purchases, benefits from the low interest rate level which also helps reduce borrowing costs. In this context, it would be desirable, however, that households – in the long run – take into account possible future interest rate hikes that might excessively strain their budgets and thus drive up their default risk.