

## Framework Conditions for the Austrian Financial System Remain Favorable

### **Strong Economic Activity in the Industrialized Countries**

The economies of the industrialized countries continued to expand at a robust pace in early 2007, with the exception of the U.S., where the real estate sector as well as certain industrial subsectors, in particular, showed signs of cooling off. In the euro area, by contrast, economic growth – which has been increasingly driven by domestic demand – remained dynamic. In the particularly volatile crude oil market, prices rebounded in the months after January 2007, following a period of decline.

In 2006, the economies of Central, Eastern and Southeastern Europe (CESEE), which are becoming more and more important for Austrian enterprises and banks, expanded at growth rates that surpassed those observed in the euro area. Several countries in the region built up substantial external imbalances, but were able to finance them by direct investments in most cases. Next to robust economic activity, most countries recorded high – sometimes even rising – credit growth rates, with foreign currency loans remaining widely popular with customers.

### **Rising Interest Rates in International Financial Markets**

Cyclical dynamics together with the ECB's interest rate hikes contributed to an uptrend in short- and long-term interest rates in the euro area. Term premia remained low by historical comparison, but continued to be positive (contrary to those in the U.S.). Risk premia on corporate bonds relative to government bonds of similar

maturity remained historically low, with risk premia on bonds in CESEE even recording a decline.

The favorable economic developments also supported prices at international stock exchanges, which – aside from short periods of falling stock prices and higher volatility – have recorded further gains since the fall of 2006. In this environment, the Austrian Traded Index (ATX) also continued its upward trend in the first few months of 2007.

### **Capital Markets Gain Importance for Domestic Enterprises and Households**

Developments in the Austrian economy remained highly dynamic. Corporate profits continued to augment in 2006, which not only improved enterprises' internal financing potential but – together with higher external equity financing – also strengthened the corporate sector's capital position further. In the second half of 2006, external corporate financing mainly took place on the capital market, although (euro-denominated) bank loans also began to pick up again.

Capital market instruments not only played a dominant role in corporate financing, but also in household investments. In total, stocks, bonds and mutual funds accounted for significantly more than one quarter of households' financial assets at the end of 2006. While direct investment in stocks and bonds predominantly concentrated on Austrian or euro area issuers, stocks and bonds issued outside the euro area play a clearly more important role in indirect investment via mutual funds. The share of mutual funds in financial investment declined

in 2006, however, while structured products attracted more investors.

At the same time, rising interest rates and lending volumes drove up the interest payment burden of nonfinancial enterprises and households. Unlike enterprises, households have not substantially reduced their foreign currency borrowing so far, which means that household financing continues to be subject to significant currency risks.

### **Austrian Banks' Risk Capacity Remains High**

In 2006, profits generated by Austrian banks continued to rise. Their increase was largely attributable to the results Austrian banking groups recorded in Central and Eastern Europe (CEE) and which accounted for 38,7% of overall results in 2006. Hence, business in CEE has become even more important for Austrian banks, in particular as profit growth in Austria slowed down in 2006 after a period of robust growth in 2005 and 2004. The main reasons behind domestic developments were the further narrowing of the interest margin as well as rising staff costs, which reflect an expansion of staff resources (not least in connection with the expansion of activities in CEE). The (unconsolidated) cost-to-income ra-

tio, which had reached a historic low in the previous year, went slightly up again.

Given the favorable economic environment, banks have been arriving at increasingly positive assessments of credit risk. Even if banks lately recorded a slight decline in foreign currency loans (in particular to enterprises), these loans continue to be of major importance and thus constitute a significant source of risk. Moreover, Austrian credit institutions' foreign currency lending is not only restricted to domestic borrowers; rather, Austrian banks (or their subsidiaries) have granted considerable volumes of foreign currency loans to borrowers in CEE.

Overall, Austrian banks' risk-bearing capacity continues to be high and their capital ratio remains adequate. Moreover, stress tests show that the Austrian banking system's resilience to shocks is satisfactory.

Although the favorable macroeconomic environment supported the performance of insurance companies and mutual funds, their growth dynamics has slowed down against previous years. Given the increasing demand for personal pension plans and the favorable economic environment, the overall outlook remains positive.