Increasing Capital Market Orientation of the Real Economy Sectors

Financial Position of Nonfinancial Corporations Improved

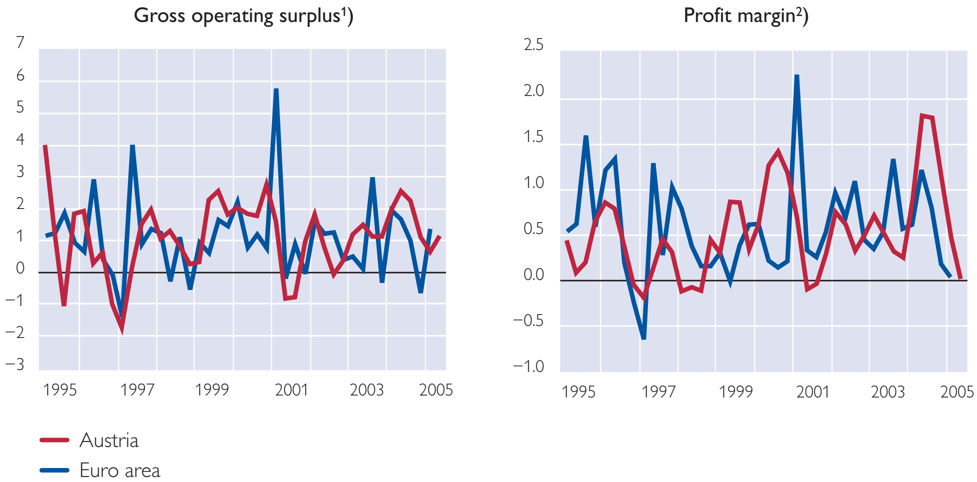
Reduced Investment in Plant and Equipment

Around the turn of the year 2004/05, the Austrian economy lost momentum, as both exports and domestic demand slowed down. Despite a favorable profitability performance, the corporate sector's investment declined in real terms, which was attributable – at least in part – to the expiration of the investment growth subsidy as at end-2004 (a fact that is likely to have induced in particular the manufacturing sector to frontload investment). Moreover, uncertainties about business cycle developments and sales prospects may also have contributed to dampening investment, and the rather low degree of capacity utilization in the Austrian industrial sector did not provide any incentives to step up investment in real capital, either.

Chart 4

Indicators of Profitability Performance in the Corporate Sector

Quarter-on-quarter change in % (seasonally adjusted)



Source: Eurostat.
[1]) Including mixed income of the self-employed.
[2]) GDP deflator less unit labor costs.

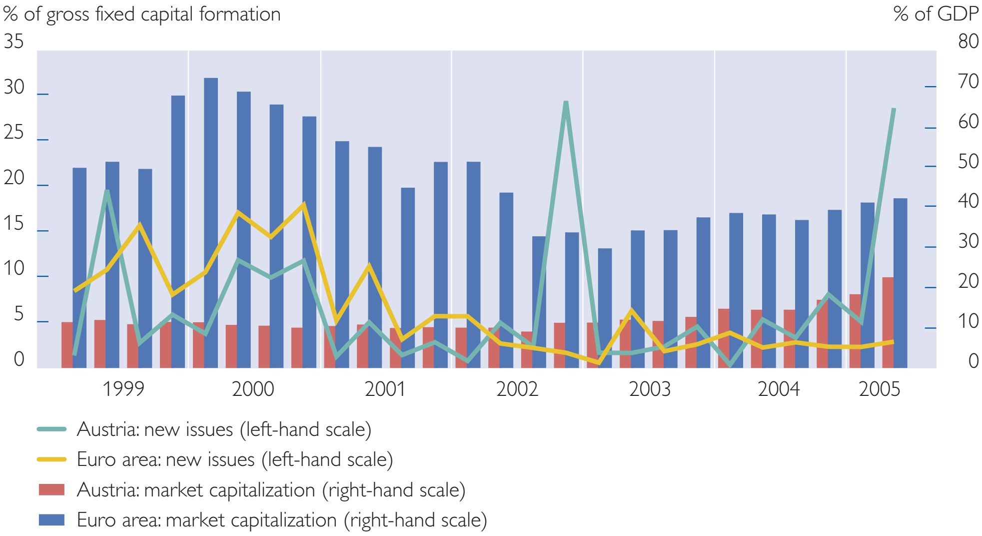
Nonfinancial corporations, by contrast, considerably expanded their financial assets in recent months. In the first half of 2005, financial investment came to just below EUR 9 billion, more than twice the comparable figure of the previous year. This figure includes a number of strategic equity investments both in Austria and abroad.

Internal Financing Potential Remains High

In the course of 2005 so far, Austrian enterprises have mostly been able to use income to finance investment spending. Following strong increases in the previous year, profits continued to develop well, even if rising commodity prices drove up production costs and thus reduced income dynamics. As in the previous year, labor costs trended downward in real terms; moreover, the low level of nominal interest rates helped keep down financing costs and thus relieved the financial burden on enterprises.

Chart 5

New Issues1) and Market Capitalization of Quoted Shares of Nonfinancial Corporations



Source: OeNB, ECB.

1) Capital increases and new listings. Adjusted for the issue of around EUR 5.5 billion by Raiffeisen International Bank-Holding AG, which – like all financial holding companies – is classified by Statistics Austria as a nonfinancial corporation.

The development of the profit margin[4] and of the gross operating surplus[5] appear to indicate a continuing positive profit situation of nonfinancial corporations, which have, since the beginning of 2005, recorded further rises in profit, albeit at a clearly weaker rate.

External Financing Strongly Driven by Equity

External financing of the Austrian corporate sector went up by more than 50% to close to EUR 9 billion in the 12 months up to mid-2005. The growth of bank loans remained subdued, while corporate borrowing on the capital market expanded at a very dynamic pace.

Almost half of the rise was attributable to equity instruments, and around half of these, in turn, consisted of stocks issued at Wiener Börse AG. Even if Austrian nonfinancial corporations launched only few new issues in 2005, the number of capital increases was considerable. Around EUR 4 billion were raised this way according to the OeNB's securities issues statistics, which means that equity issuance at Wiener Börse AG contributed considerably to corporate sector financing. In the first half of 2005, the robust issuance activity as well as continued strong price increases drove up the total market capitalization of nonfinancial corporations listed on Wiener Börse AG from EUR 39 billion to EUR 59 billion, which corresponds to around 24% of GDP[6] and already constitutes more than half of the corre-

4 *The profit margin is the ratio of the GDP deflator to unit labor costs.*

5 *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.*

6 *The market capitalization of all stocks listed on Wiener Börse AG (including financial corporations) came to just under 38% of GDP in mid-2005.*

sponding euro area average (see chart 5).

The lively development of foreign direct investment in Austrian enterprises contributed substantially to the inflow of funds in the form of shares. All in all (i.e. including portfolio investment) more than two-thirds of new equity over this period stemmed from cross-border transactions.

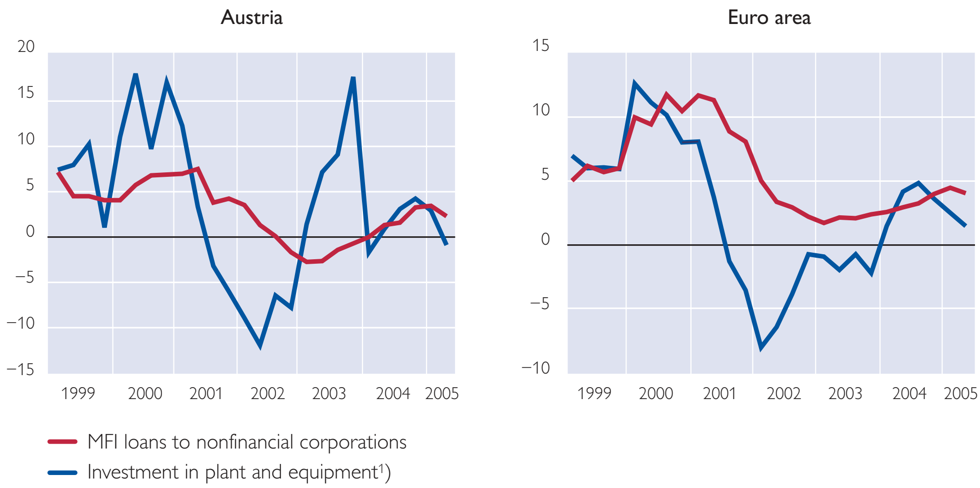
Amongst the debt components, bond-based financing played a more important role in the first half of 2005. According to the OeNB's securities issues statistics, the outstanding volume of bonds issued by nonfinancial corporations went up by 20.8% against the previous year. Given the very low (nominal) yield level and the flattening of the yield curve, a number of enterprises appear to have made provisions to profit from the low interest rates in the long run. Moreover, some issues served to fund mergers and acquisitions.

After bank lending to the corporate sector had trended downward in 2003 and in the first quarter of 2004, it went up by 2.1% in the second quarter of 2005 compared to the previous year[7]. This means that while credit expansion in Austria still remained below that of the euro area as a whole, for the first time in two years it surpassed the growth rate of investment in plant and equipment as investment was weak in the first half of 2005.

Chart 6

MFI Loans to Companies and Corporate Investment

Annual change in %



Source: OeNB, Eurostat, WIFO.

[1]) Whole economy. The quarterly national accounts do not contain any data on individual economic sectors.

In the first half of 2005, the term structure of loans continued to shift toward longer maturities, prompting liquidity risk to trend downward; as short-term assets went up at the same time, corporate liquidity on the whole increased markedly. At clearly more than 90%, the share of variable and short-term fixed interest-bearing loans in new business remained very

[7] *MFI Balance sheet report data. Analyzing loans to enterprises and households has become more complicated owing to a change in the balance sheet report 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.*

high, also when compared with that in the euro area. The share of foreign currency in lending to enterprises declined in the first half of 2005.

Financing Conditions Remain Favorable

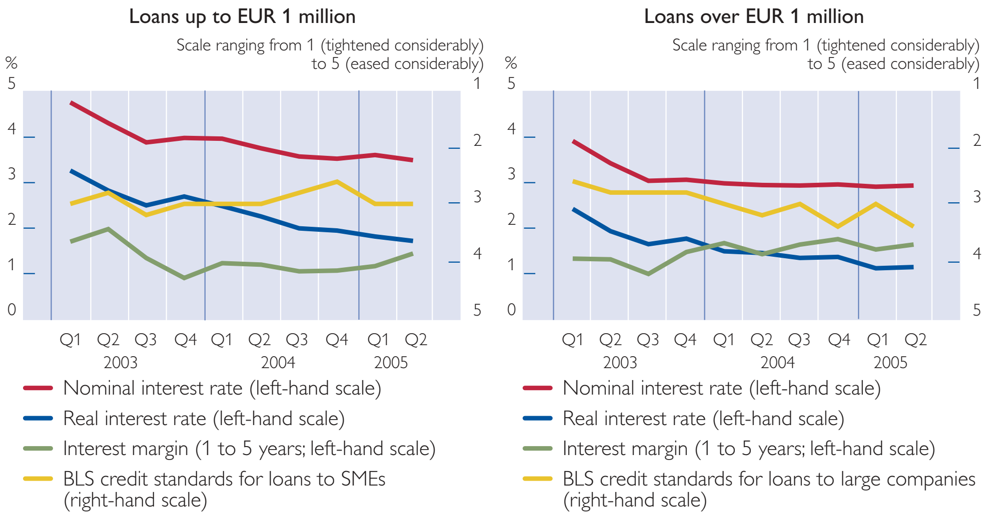
The conditions for external financing have stayed favorable for Austrian companies, both for borrowing funds and for issuing equity capital.

The interest rate charged on loans to enterprises edged down further in the first half of 2005 and was very low both historically and when compared with the euro area. In real terms, lending rates sank perceptibly in the first half of 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 risk premium contained in banks' interest rates. It shows that interest margins (interest rate charged for loans to enterprises less swap rate) have hardly changed throughout 2005.

This result matches the findings of the Bank Lending Survey (BLS), according to which banks eased lending conditions in corporate banking in the second and third quarters of 2005. Above all, banks have reduced the interest margins for lending to borrowers of average creditworthiness, while they tightened a number of other conditions applicable to the approval of corporate loans, in particular loan fees.

Chart 7

Conditions for Corporate Loans



Source: OeNB, Statistik Austria, Consensus Economics.

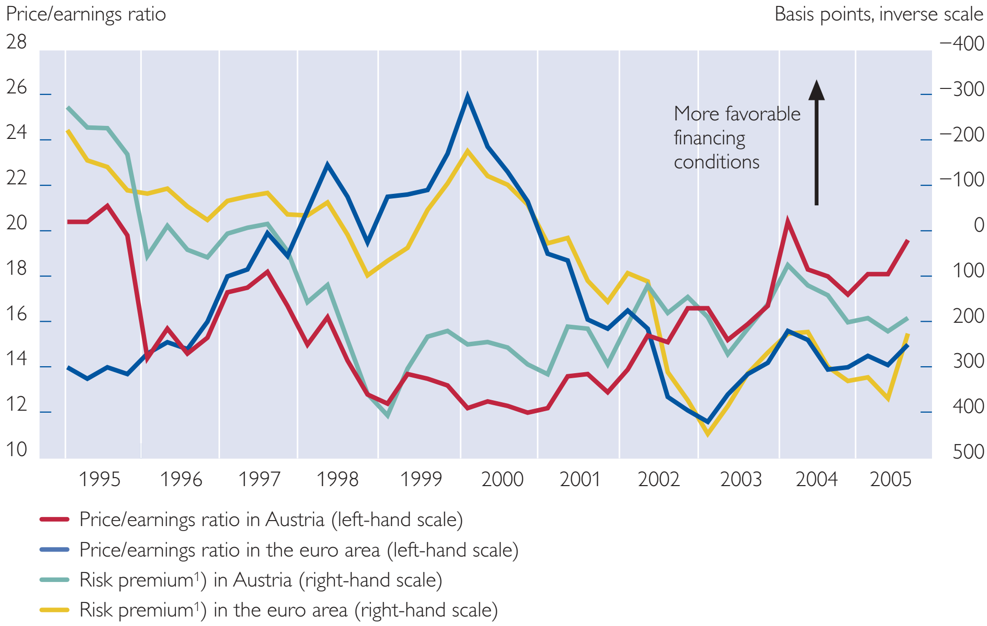
Note: Real interest rate: Nominal interest rate less the Consensus Economics consumer price index forecast for the year following the forecast date. Interest margin: Interest rate charged for loans with a maturity from one to five years less three-year swap rate. BLS credit standards: Changes in the credit standards for loans to enterprises over the last three months.

Financing conditions on the stock exchange remained favorable as well. In the first three quarters of 2005, ATX performance went up by 41% and thus continued to exceed that of major international stock indices. This means that the price/earnings ratio went up slightly despite the positive profitability performance of enterprises listed at Wiener Börse AG, which implies that equity financing at Wiener Börse AG has become slightly cheaper. The price/earnings ratio at Wiener Börse AG surpassed the comparable ratio for the euro area as a whole.

A similar picture emerges from the spread between the earnings yield[8] and the government bond yield, whose development over time can be interpreted as an indicator of the stock market risk premium. The yield spread went up only slightly in 2005, as the conditions for equity financing developed slightly less favorably than the general interest rate level.

Chart 8

Financing Conditions on the Stock Market



Source: OeNB, Thomson Financial.

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

Debt-Servicing Capacity Improved

Given the relatively low degree of borrowing, corporate sector debt relative to GDP and to corporate earnings hardly increased, while financial investments went up considerably at the same time (see above). This is why in the first half of 2005, net borrowing of the corporate sector was zero for the first time.[9]

[8] *The earnings yield is the inverse of the price/earnings ratio.*

[9] *The increase of net financial liabilities is essentially attributable to the fact that stock price developments caused equity capital levels to rise.*

Chart 9

Net Borrowing and Net Financial Assets of the Corporate Sector

Source: OeNB.
[1]) Balance of financial assets over financial liabilities.

In the first three quarters of 2005, default liabilities went down by 6% against the comparable period of the previous year. In the 12 months up to September 2005, default liabilities accounted for 0.76% of corporate sector liabilities and thus remained largely unchanged vis-á-vis previous periods (see chart 10). The default frequency, by contrast, has been on the rise over the last two years. In the first three quarters of 2005, the number of insolvency proceedings went up by 7.5% against the comparable period of 2004, while the number of no asset cases increased by 28% over the same period. Altogether, the insolvency rate in relation to the total number of enterprises came to 2.8% (annualized) in the third quarter of 2005. The higher number of insolvencies may in part be linked to the increase in the number of startups over the past few years: According to the Kreditschutzverband von 1870 (KSV), more than half of the insolvent enterprises had been in operation for less than ten years at the time they went bankrupt.

Austrian Enterprises Highly Resilient to Crises

In the first half of 2005, financing conditions in the financial markets continued to be favorable for Austrian enterprises. The ongoing favorable profit situation strengthened the potential for internal financing; moreover, enterprises had a broad range of (external) financing instruments at their disposal. Thus, the weak investment activity of the corporate sector cannot be attributed to financial restrictions.

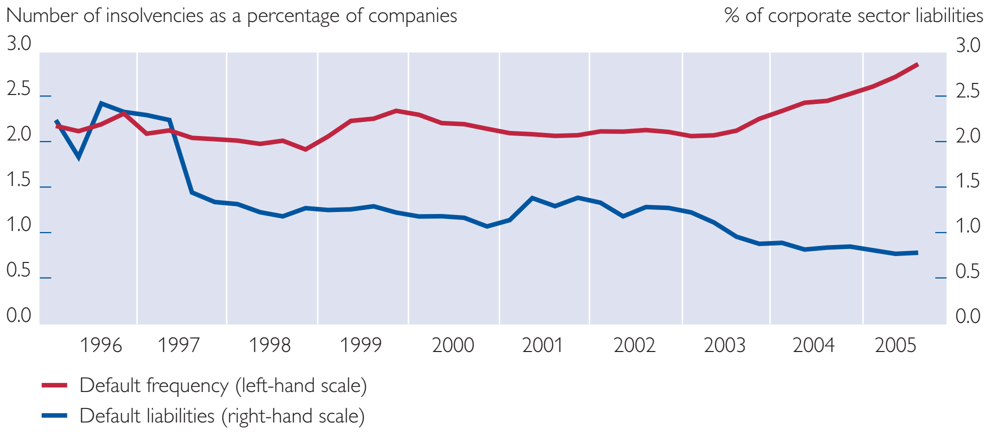
At the same time, high profits and increases in equity capital improved both the financial position and crisis resilience of Austrian enterprises. However, to the same extent by which rising profits and the low level of (nominal) interest rates have boosted the financial position, a reversion of this development could reduce companies' currently high crisis resilience.

Thus, the further development of enterprises' internal financing potential, which has recently been very high given the currently favorable profit situation, is subject to uncertainty, as perspectives for cyclical developments

Chart 10

Corporate Defaults

Four-quarter moving averages, annualized



Source: KSV, OeNB.

are subdued. Another risk factor in this context is the price of crude oil. A continued high level, or a further rise, of prices would not only weigh on the cost side of enterprises, but – in the longer term – also on the demand side. So far, the currently low level of lending rates has benefited companies; should interest rates go up again, this trend might be at least partly reversed, even if many enterprises have recently reduced their dependence on interest rate changes by raising funds via issuing bonds and equities. The majority of bank loans – also those with longer maturities – has a floating rate, however.

Finally, the increased use of capital market instruments has spread entrepreneurial risk (and the interest rate risk for typically fixed-rate corporate bonds) more broadly across financial markets.

Households' Financial Investment on the Rise

In the first half of 2005, the high inflation rate noticeably eroded households' purchasing power. Hence, consumer spending did not gain momentum despite tax reliefs provided by the second stage of the latest tax reform. Households' real consumption expenditures grew by 0.2% in the first quarter of 2005 and by 0.1% in the second quarter of 2005 (quarter on quarter, seasonally adjusted). Considering the high oil prices and low consumer confidence, the short-term outlook for consumer spending is not very bright.

Households' financial investment rose by EUR 11.5 billion in the first half of 2005, thus displaying significantly stronger growth than in the same period of 2004 (EUR 9.7 billion).

The household sector's debt ratio increased, as well, with new debt coming to EUR 3.9 billion in the first half of 2005, slightly up from EUR 3.8 billion in the same period of 2004.

By mid-2005, Austrian households' net financial assets totaled EUR 221.8 billion or 154% of disposable income.[10]

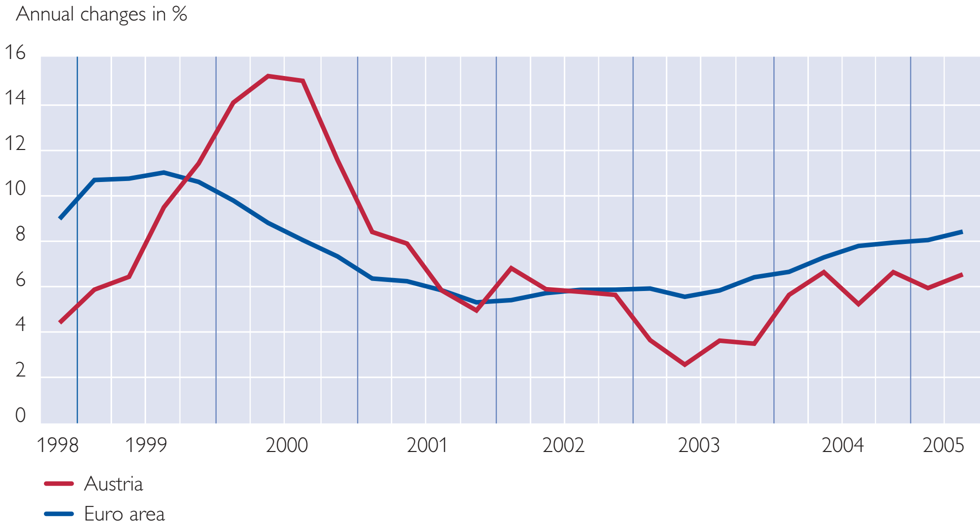
[10] *This relation refers to Austrian households' disposable income in nominal terms in the full year 2004, as it is only computed on an annual basis.*

Households' Debt Increased

Austrian households' debt amounted to 50.7% of GDP in 2004. Despite increasing by 2.3 percentage points against 2003, household debt in Austria is still well below the figures observed in other euro area countries. In the Netherlands, for instance, household debt came to more than 100% of GDP in 2004. In the first two quarters of 2005, household debt in Austria continued to grow. According to the financial accounts, new debt came to EUR 3.9 billion in the first half of 2005, slightly up from EUR 3.8 billion in the same period of 2004.

Chart 11

MFI Loans to Households



Source: ECB, OeNB.
Note: Loans to Austrian households less freelance professionals and nonprofit organizations serving households.

New Debt Incurred Primarily for Housing Investments

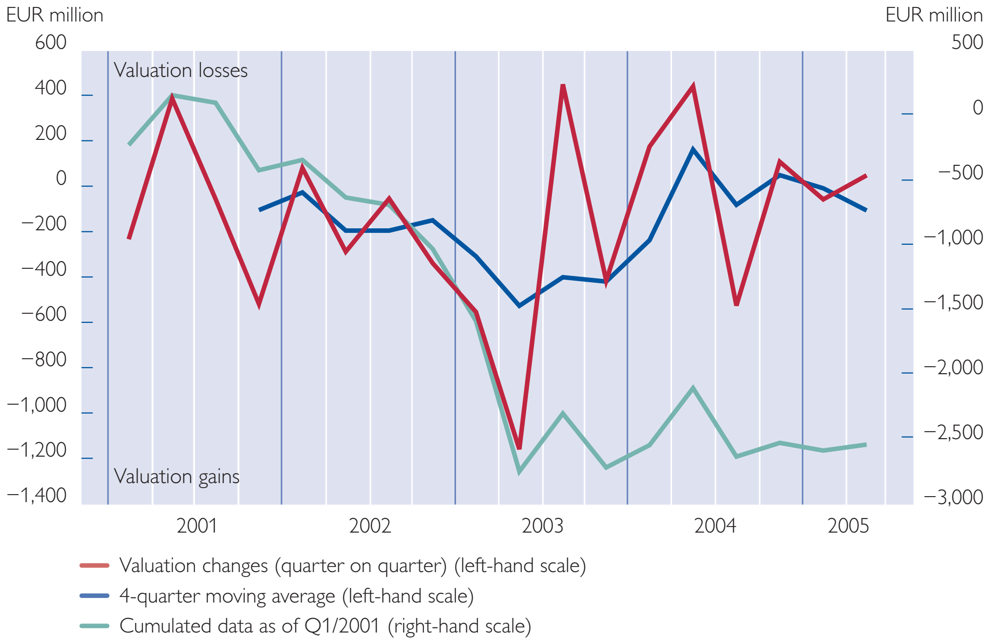
Home loans declined from EUR 2.3 billion in the first half of 2004 to EUR 2.0 billion in the first half of 2005, but they still accounted for the largest share of households' new debt in this period according to the financial accounts. By comparison, consumer loans posted particularly strong growth. While coming to merely around EUR 0.5 billion in the first half of 2004, consumer loans increased to EUR 1.3 billion in the first half of 2005 (of which EUR 1.0 billion were taken out in the second quarter of 2005).

According to the ECB's monetary statistics, the annual growth rate of lending by monetary financial institutions (MFIs) to households amounted to 6.5% in the second quarter of 2005, which is still well below the long-term average (see chart 11) and also moderate compared with other euro area countries.

According to the ECB's monetary statistics, the annual growth rate of lending by monetary financial institutions (MFIs) to households amounted

Chart 12

Exchange Rate Effects of Households' Foreign Currency Loans



Source: OeNB.

to 6.5%[11] in the second quarter of 2005, which is still well below the long-term average (see chart 11) and also moderate compared with other euro area countries.

In the first half of 2005, new foreign currency loans totaled EUR 2.0 billion according to the financial accounts, with loans denominated in Swiss francs accounting for the largest share. In the first two quarters of 2005, the valuation changes of foreign currency loans resulting from exchange rate effects were only small. Since the beginning of 2001, however, households have profited from considerable cumulated (mainly unrealized) valuation gains of foreign currency loans (see chart 12).

The large volume of foreign currency loans to households naturally also entails the risk of unfavorable exchange rate developments.

With regard to maturity structure, a trend toward short-term liabilities can be observed. Short-term loans grew by EUR 1.2 billion in the first half of 2005, which is well above the average of the past years and, according to the national accounts, also above the combined growth of short-term loans over the past four years.

Financing Conditions for Households Remained Favorable

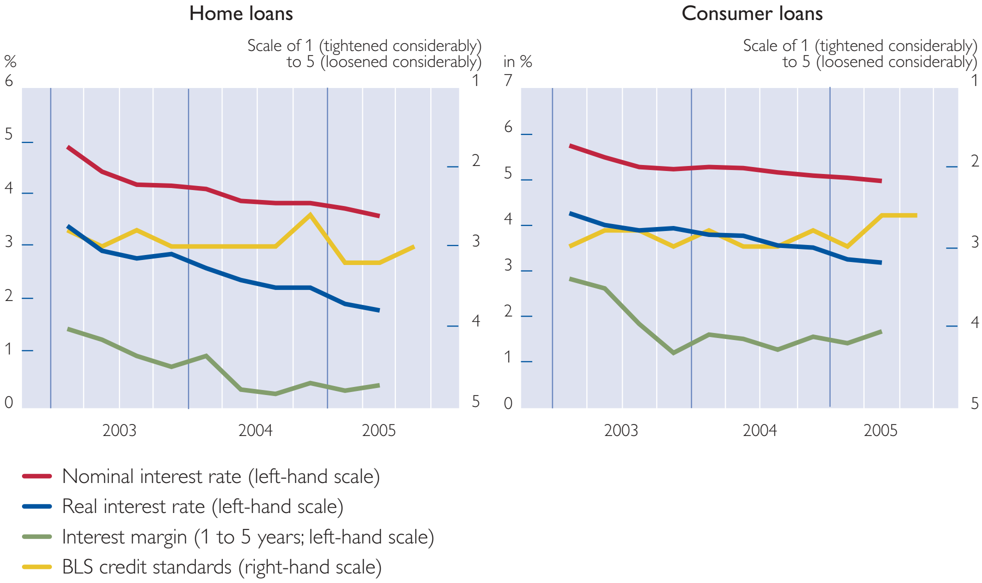
Real interest rates for home loans and consumer loans declined considerably in 2004 (see chart 13). (Ex ante) real interest rates continued to decline in early 2005.[12] The Bank Lending Survey indicates that the terms and conditions of consumer loans and home loans

[11] *Owing to a change in the balance sheet report – which requires reporting gross instead of net risk provisions as of June 2005 – this figure is only preliminary.*

[12] *The ex ante real interest rate (nominal interest rate less CPI forecast) was calculated on the basis of Consensus Forecast CPI data for Austria. Consensus Forecasts are arithmetic averages of several forecasting institutions' projections.*

Chart 13

Conditions for Loans to Households



Source: OeNB, ECB, Statistics Austria, Consensus Economics.
Note: Real interest rate: nominal interest rate less the Consensus Forecasts' Consumer Price Index forecast for the year following the forecast date. Interest margin: Interest rate for loans with a maturity of 1 to 5 years less 3-year swap rate. BLS credit standards: changes in the standards applicable to the approval of loans over the last three months.

were slightly tightened in the second and third quarter of 2005. In the first two quarters of 2005, banks' interest margins[13] for medium-term home loans and consumer loans remained relatively stable, which suggests that banks' risk perception has not increased. All in all, and especially from a long-term perspective, households' financing conditions may be considered favorable.

Number of Private Bankruptcies Continued to Rise

Around 4,800 private bankruptcy filings were submitted in the first three quarters of 2005. The rising number of private bankruptcies caused default liabilities to increase to EUR 564 million (see chart 14).

The tendency to finance consumption through debt is one of the main reasons for overindebtedness; this view is also substantiated by the dynamic development of consumer loans in the first half of 2005. In the first three quarters of 2005, the number of no asset cases also increased against the same period of 2004.

Real Estate Price Developments Remained Subdued

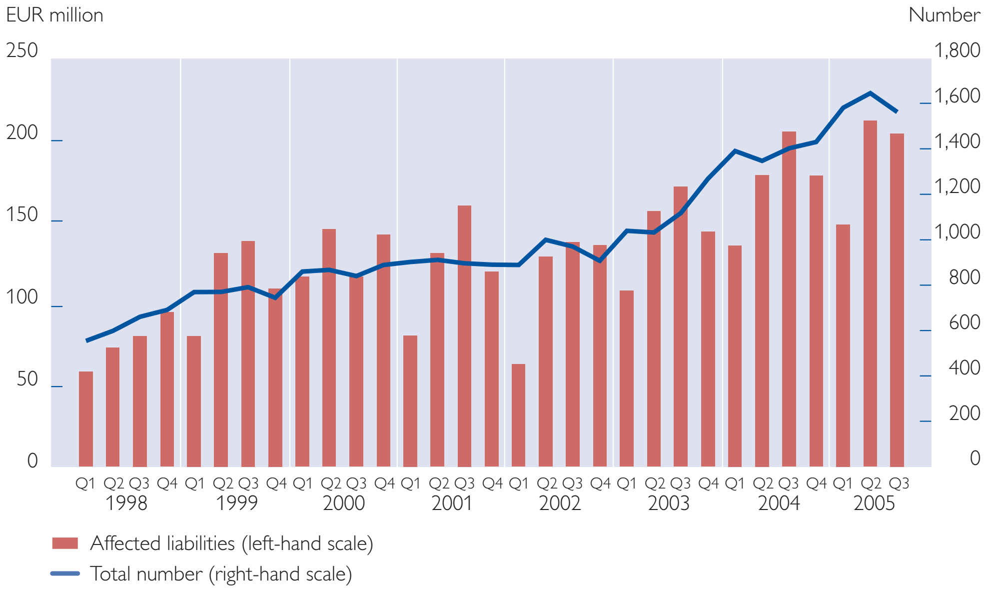
The development of the real estate price index has been very moderate in recent years. Between the beginning of 2000 and mid-2005, prices for new apartments in Austria grew by 8.3%,[14] which is below the euro area average.[15]

The ratio of real estate prices to rent prices is another indicator for "ad-

[13] *In order to make interest margins comparable it is necessary to use a market reference rate for instruments with similar maturities. Like the ECB, we chose the three-year euro interest rate swap rate for data reasons.*
[14] *In fall 2005, the index of price developments in the Austrian real estate market was for the first time calculated on a quarterly basis. The data have been calculated backward to 2000; therefore, it is currently not possible to compare older data.*
[15] *See, for instance, ECB. 2005. Financing Condition in the Euro Area. ECB Occasional Paper Series 37. October.*

Chart 14

Development of Debt Regulation Proceedings



Source: KSV.

equate" real estate price developments – when real estate prices rise significantly faster than rent prices over a prolonged period, we may conclude that they deviate from their fundamental value. As this ratio remained broadly unchanged between 2000 and mid-2005,[16] real estate prices are currently not being overvalued.

Insurance Products Posted Above-Average Growth

Households' financial investment rose by EUR 11.5 billion in the first half of 2005. The demand for insurance products was particularly pronounced. According to the national accounts, the private sector's claims on insurance companies and pension funds increased by a total of EUR 4.1 billion in the first half of 2005, against EUR 2.7 billion in the first half of 2004; of this, claims arising from life insurances accounted for EUR 3.0 billion, against EUR 1.9 billion in the first half of 2004 (see chart 15).

Households' investment in quoted shares and mutual fund shares came to EUR 3.2 billion in the first half of 2005 (with quoted shares accounting for around one-half in terms of value). This is significantly above the level observed in the first half of 2004 (EUR 2.3 billion). Investment in long-term securities was somewhat less attractive in the first half of 2005: It came to EUR 884 million in the first half of 2005, down from EUR 2.0 billion in the same period of 2004.

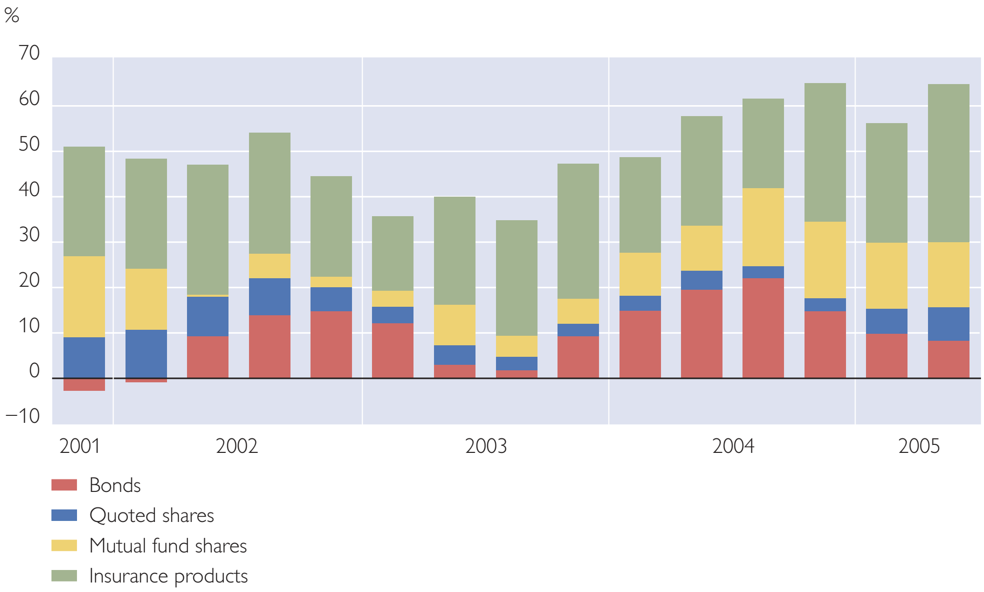
While households' bank assets (deposits and currency) increased by EUR 3.4 billion in the first half of 2005, i.e. more strongly than in the same period of 2004, they grew clearly less vigorously than capital market instruments.

[16] *Longer-term comparisons are currently not possible owing to non-comparable data before 2000.*

Chart 15

Share of Capital Market Instruments in Households' Financial Investments

Transactions; 4-quarter moving averages



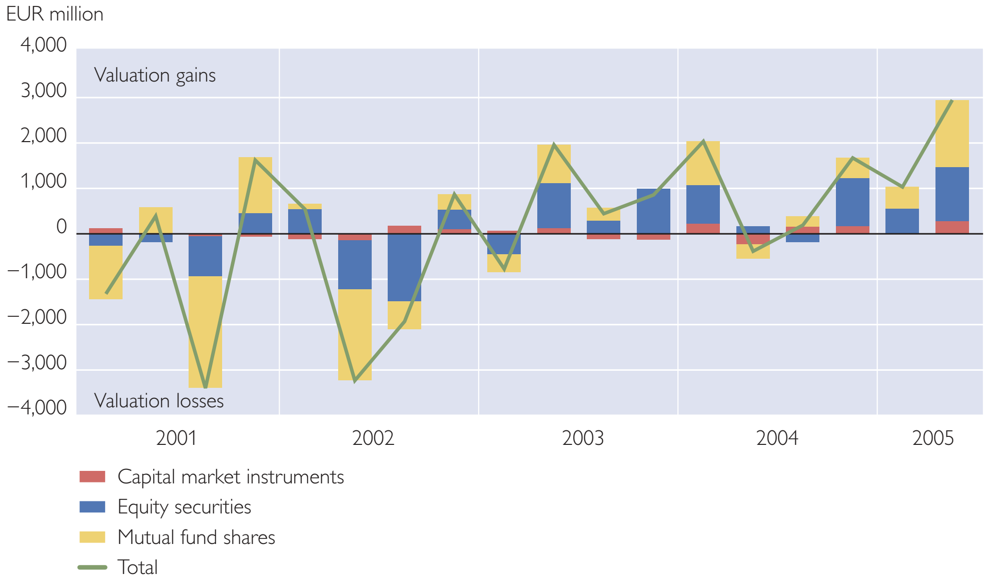
Source: OeNB.

Valuation Gains of Households' Financial Assets on the Rise

In the first half of 2005, the valuation gains of households' financial assets increased to EUR 4 billion (see chart 16), thus already topping the gains of the full year 2004 (EUR 3.5 billion). At EUR 3 billion, the valuation gains were especially pronounced in the second quarter of 2005. As the performance of the stock and bond markets has further improved since then, we may expect this trend to continue also in the third quarter of 2005. Equity securities and mutual fund shares accounted for the bulk of the valuation gains. While the valuation gains of mutual fund shares amounted to EUR 2 billion in the first half of 2005, those of quoted shares came to EUR 1.8 billion. Households' valuation gains over the past two years offset the unfavorable developments observed in 2001 and 2002.

Chart 16

Valuation Gains and Losses in Households' Financial Assets



Source: OeNB.

In the first half of 2005, the share of deposits and currency in households' total financial assets declined whereas that of capital market instruments (quoted shares, bonds, mutual fund shares) and insurance products increased owing to valuation gains of, and increased investment in, capital market instruments.

Pension Provisioning as a Saving Motive – OeNB Survey Results for Vienna

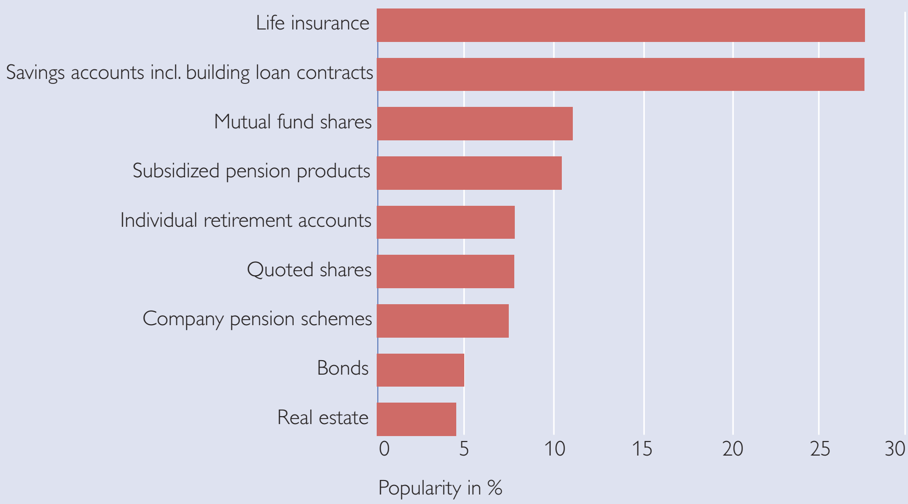
As a consequence of recent pension system reforms, Austrian households need to accumulate more financial assets to be able to maintain their normal standard of living also in old age. Such private pension provisions not only expand the volume of households' total investments but may also change their asset allocation. After all, at least 40% of contributions to subsidized pension provision products under the Austrian Tax Reform Act of 2002 ("prämienbegünstigte Zukunftsvorsorge") must be invested in quoted shares from EEA countries with a stock market capitalization of 30% of GDP or below. This may significantly alter the risk profile of household assets. Thus, pension system reforms may also impact on financial stability.

In order to supplement the data which banks report to the OeNB, the OeNB commissioned a survey among 1,026 households in Vienna and 1,530 households in other Austrian provinces in 2004. In addition to data on income and financial assets as well as demographic information, respondents were asked to specify their financial attitude and behavior and to detail the measures they had taken to provide for old age.[1] Understanding households' decisions in this field has become an important factor in monetary policy decisions and also helps explain private consumption developments.

[1] *The publication of detailed survey results is scheduled for end-2005.*

Preliminary results for Vienna indicate that about half of the survey respondents have invested in private pension provisions.[2] Life insurances and savings accounts (including building loan contracts) are the most common types of investment; about 10% of the Viennese population have opted for subsidized pension products (e.g. "prämienbegünstigte Zukunftsvorsorge"). For details, see the chart below on investments in private pension provisions made by the Viennese population. The decision to make pension provisions and the choice of specific investment vehicles are clearly influenced by socioeconomic factors. As a rule, persons living in high income and wealth household deciles are more likely to make provisions for old age. Furthermore, their portfolios usually contain a larger fraction of quoted shares, bonds and mutual fund shares than that of other population groups, i.e. comparably risky investment vehicles are primarily held by households that can afford losing money when stock prices fall. The evaluation of the survey results will provide a comprehensive economic analysis of households' asset allocation decisions and of their investment decisions in the context of private pension provisioning, taking account of households' socioeconomic standing.

Investments in Private Pension Provisions by the Viennese Population



Source: OeNB (own calculations based on a study by the opinion research institute Fessel-GFK).

[2] Respondents were asked to include all measures they had taken to top up their (future) state pension benefits. This is why private pension provisions include various types of investment in this context.

Investment in Capital Market Instruments Posted High Growth Rates

Households' financial investment rose by EUR 11.4 billion in the first half of 2005, thus displaying significantly stronger growth than in the same period of 2004 (EUR 9.7 billion). The household sector's debt increased, as well, but it was only slightly higher at EUR 3.9 billion than in the first half of 2004 (EUR 3.8 billion).

The strong growth of financial investment was mainly attributable to investment in capital market instruments and insurance products. The valuation gains of households' financial assets amounted to EUR 4 billion in the first half of 2005, with equity securities and mutual fund shares accounting for the bulk of valuation gains. In the first half of 2005, increased investment in capital market instruments and insurance products as well as the high valuation gains altered the structure of households' financial assets. While the share of currency and deposits in households' total financial assets decreased from 53.5% at end-2004 to 52.0% at end-June 2005, the share of capital market instruments and insurance products increased from 43.0% at end-2004 to 44.6% at end-June 2005. This shift in Austrian households' asset allocation is largely ascribable to higher investment in pension schemes. The household sector's increased investment in capital market instruments and insurance products led to significant valuation gains in the first two quarters of 2005, but it also increased potential risks.

Turning to households' financial liabilities, foreign currency loans (especially loans denominated in Swiss francs) continued to post vigorous growth in the first half of 2005. Foreign currency loans to the tune of EUR 2.0 billion accounted for more than 50% of new loans. This strong demand for foreign currency loans entails a considerable risk potential. Furthermore, the maturity structure of households' liabilities changed considerably in the first half of 2005, with short-term loans picking up markedly. This and the fact that the majority of new loans are variable rate loans are additional potential risk factors.

All in all, the indicators suggest that the Austrian households' financial position has become slightly more risky in the first half of 2005.