

# Real Economy's Risk Position Remains Below Precrisis Level

## Volume of Corporate Sector's External Financing Low

### Economic Activity Slows Down

After Austria's economy had expanded vigorously in the first half of 2011 as a result of the global economic recovery, the upturn came to a halt at mid-year. Among the reasons for slowing growth are loss of confidence caused by the sovereign debt crisis, weakening economic stimulation from abroad, sluggish domestic activity and expiring cyclical growth drivers.

Compared with the intensity of the slump recorded during the global economic and financial crisis, the rebound of investment activity during the economic upswing turned out to be relatively modest. The low investment level suggests that the majority of investments did not aim to expand capacities but rather replace existing production facilities. Planned investments were delayed yet again, as the external environment had weakened and the sovereign debt crisis had strongly increased uncertainty among companies. Pros-

pects for building construction had brightened somewhat in the first half of 2011 but suffered a downturn afterward, with residential and nonresidential construction being equally affected.

Corporate profits, which declined substantially during the economic downturn of 2008 and 2009 – a fact which constituted a major shock absorber – have been rising again for almost two years. Since the second half of 2010, the gross operating surplus – in real terms – has once again been above precrisis levels (in the second quarter of 2011, it was above precrisis levels in nominal terms as well), even if corporate profit growth slowed down again to 2.8% in the second quarter. The gross profit ratio, which expresses the gross operating surplus in relation to gross value added, has also been on the rise again since 2010 but has yet failed to reach its precrisis highs. A similar trend can be observed for profit margins (i.e. the margin between the selling prices charged by companies and the manufacturing costs they incur

Economic upturn comes to an end

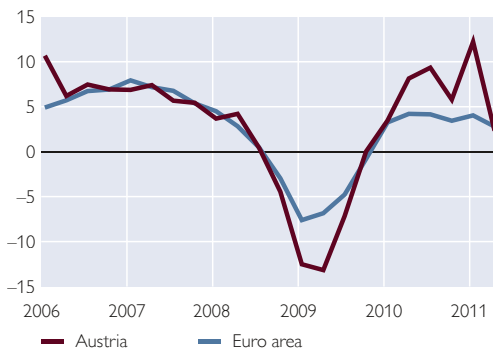
Profits on the rise again

Chart 15

## Macroeconomic Profit Indicators

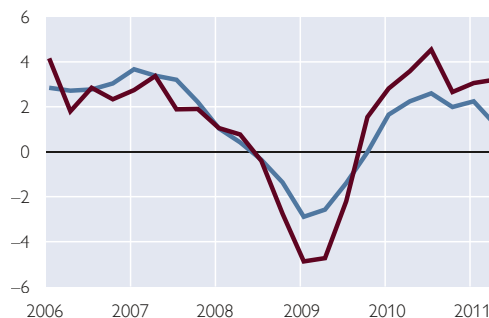
### Gross Operating Surplus<sup>1</sup>

Annual change in %



### Profit Margin<sup>2</sup>

Annual change in %



Source: Eurostat.

<sup>1</sup> Including mixed income of the self-employed.

<sup>2</sup> GDP deflator less unit labor costs.

and, consequently, a proxy for the mark-up at the macro-level).<sup>1</sup> Both indicators show that corporate profits in Austria were slightly more volatile than in the euro area: While falling more strongly at the peak of the crisis, they went up faster afterward. Until the first half of 2011, this growth reflected a continuous rise in sales, while at the same time the strain on corporate costs was relieved as wage increases were only moderate. Moreover, the nonoperational component of the corporate profits was boosted by the fact that the interest rate level continued to be relatively low.

#### External Financing Has Dropped Further

Equity financing going up

As options to resort to internal sources of finance improved, companies required lower volumes of external financing. According to financial accounts data, the volume of external financing came to EUR 7.7 billion<sup>2</sup> in the first half of 2011, which is nearly one-third below the comparable 2010 figure and corresponds to just one-quarter of the 2007 figure. In the first half of 2011, corporate financing increasingly relied on equity instruments, which contributed more than 40% to external financing, up from less than 20% in the first six months of 2010.

Stable financing conditions

#### Bank Lending Recovers Slowly

Moderate bank lending growth

Bank loans continued to contribute relatively little to the growth of overall external financing in the first half of

2011, even though their share rose to approximately one-eighth (first half of 2010: 4%).<sup>3</sup> Bank loans extended to the corporate sector have moderately gone up for about one year. According to the MFI balance sheet statistics, the annual rate of change in Austrian bank lending (adjusted for reclassifications, valuation changes and exchange rate effects) stood at 2.2% in September 2011, which more or less corresponds to the euro area growth rate.<sup>4</sup> Lending at longer maturities (more than five years), in particular, recorded stable growth rates and for the first time in two years, short-term loans (less than five years) had stopped contracting by August 2011.

The slight rise in lending appears to be attributable to both supply- and demand-side factors. The results of the Eurosystem's Bank Lending Survey (BLS) for Austria indicate that banks' credit standards for corporate clients had been stable over a two-year period until they were tightened somewhat in the third quarter of 2011 when bank's own financing conditions deteriorated slightly. At the same time, moderately growing investments caused a rise in corporate loan demand. However, the BLS registered a marginal decline in corporate loan demand in the third quarter of 2011, when economic growth slowed down again.

Until the third quarter of 2011, financing costs had eased the burden on loan financing. Although interest rates for corporate loans rose to 2.69% by

<sup>1</sup> As national accounts data for the individual economic sectors are published on an annual basis only, quarterly corporate profit figures for the corporate sector are not available.

<sup>2</sup> Adjusted for foreign-controlled holdings in special purpose entities (SPEs).

<sup>3</sup> At the cut-off date, financial accounts data were available through the second quarter of 2011, which means that growth contribution data presented here refer to the first half of 2011. More recent developments of financing flows are illustrated using data from the MFI balance sheet statistics and securities issues statistics.

<sup>4</sup> For more information on the current developments of bank loans to the corporate sector, see the OeNB's lending report (Kreditbericht, available in German only at [www.oenb.at](http://www.oenb.at)).

September 2011, thus gaining around ½ percentage point against their April 2010 low, they were still 3 percentage points below their October 2008 levels (i.e. immediately after the Lehman bankruptcy). As indicated by the BLS, the noninterest components of loan conditions, which had been tightened during the crisis, have remained mostly unchanged since mid-2010.

Box 1

### Corporate Lending: An Econometric Analysis

*Like in most other euro area countries, net new lending has weakened significantly in Austria as a result of the financial and economic crisis. The number of loans extended to Austrian nonfinancial corporations actually contracted for the most part of 2010. Given this development and the high share of bank loans in corporate financing, the analysis of corporate loans has gained significance for economic policymaking. In this context, a particularly crucial question is whether there is a credit crunch, i.e. banks' credit supply is lower than what was to be expected in view of the current macroeconomic environment.*

*In addition to the descriptive statistical analyses as presented e.g. in the OeNB's lending report (Kreditbericht), there are other approaches to examining bank lending developments and their determinants. These include, for example, conducting surveys of banks and companies regarding credit supply and credit demand or analyzing banks' and borrowers' balance sheet data. Furthermore, lending trends can be analyzed by applying econometric methods on the basis of macroeconomic data. The first preliminary results of an error correction model of bank lending to Austrian nonfinancial corporations are presented below.*

*The survey considers real quarterly data (i.e. adjusted for price changes) from the first quarter of 1988 through the first quarter of 2011, focusing on lending to nonfinancial corporations (outstanding amounts). Moreover, the model takes into account the three-month interest rate, which should help approximate borrowing costs fairly reliably because of the high share of variable-rate loans in total loans, gross fixed capital formation as an approximation variable for credit demand and gross operating surplus as a measure of internal financing capacities as well as of companies' credit quality. Our analysis did not reveal any evidence that other benchmarks used in the relevant literature, e.g. banks' equity or the number of corporate insolvencies, increased the model's explanatory power.*

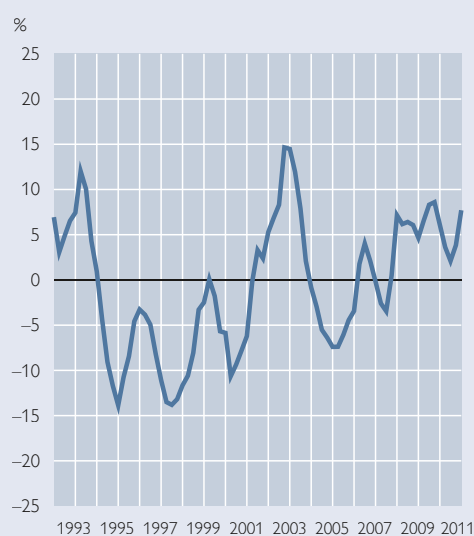
*The following discussion focuses on the long-term connection between the considered variables, which may be interpreted as an equilibrium relationship and may shed light on the question of whether lending development is in line with macroeconomic fundamental data. We find that investment exerts a major influence on lending: A 1% increase in investment, for instance, will cause the volume of credit outstanding to rise by 1.6% in the long run. This considerable influence does not come as a surprise, as companies borrow primarily for investment purposes. An interest rate hike of one percentage point will diminish the volume of credit outstanding by 8%. If the gross operating surplus increases by 1%, the credit volume will go down by 0.8%. This means that the decline in demand resulting from improved internal financing capacities is more pronounced than any potential supply effects due to improved creditworthiness. The drop in borrowing resulting from an increase in gross operating surplus appears plausible because such an increase improves the ability for internal financing and – according to pecking order theory – companies prefer internal financing by means of retained earnings to external financing by loans.*

*In periods in which loans deviate particularly clearly from the equilibrium relationship assumed in the model, other factors exert an especially strong influence on loans. The chart below shows corporate loans' deviation from their equilibrium stock in percent. For the period since the outbreak of the financial and economic crisis in mid-2007, the chart neither shows a trend of excessive lending (i.e. a marked positive deviation) nor a long-term shortage in lending (i.e. a marked negative deviation).*

*The fact that the model results show a slight loan overhang for this period was predominantly attributable to real loans decreasing less sharply than real investment. This develop-*

ment could be related to the fact that since the onset of the crisis companies have primarily focused on making replacement investments, which are subject to less uncertainty and for which, probably, more collateral is available, which makes it easier to finance them via loans. At the same time, this result can be interpreted as evidence for a functioning house bank principle, according to which banks – in the case of long-term customer relationships – smooth their lending over the business cycle and, therefore, will be less hard-pressed to restrict lending in the event of a downturn. A similar development was observed in other periods of declining investment (1992 to 1993 and 2001 to 2002). Moreover, gross fixed capital formation does not fully capture companies' credit demand. Austrian outward direct investment, for example,

#### Real Bank Lending to Companies – Deviation from Equilibrium Level



Source: OeNB, authors' calculations.

Note: The chart shows the moving four-quarter average.

which is largely financed through loans, is not included in investment statistics. The significant reduction of direct investment observed during the past few years is therefore likely to be another factor that contributed to the loan overhang shown in the chart. By contrast, the extraordinarily strong interest rate cuts with which the ECB responded to the crisis have caused the equilibrium loan level to rise and, consequently, facilitated an approximation of the actual volume of credit outstanding to the equilibrium level as lending contracted. During the crisis period, the gross operating surplus had only a minor influence on loan overhang developments.

It should be noted, however, that any possible instabilities of the model – especially in the context of the financial crisis – could impair the results. For an assessment of the credit market situation, the results presented here must not be viewed independently but may serve to complement the results of other analyses.

#### Bonds account for sizeable portion of corporate financing

#### Sustained Expansion in Bond Financing

At 31%, bond issues accounted for an above-average portion of Austrian companies' financing in the first half of 2011. Corporate bond issues have gained some momentum throughout 2011, and securities issues statistics show that despite a slight decline in September, corporate bond issues recently posted an annual growth rate of 6.7%, which means that their expansion rate still markedly exceeded that of other financing instruments. In line with the downward movement in interest rate levels, the share of variable rate bonds, which had been in decline since fall 2008, had dropped to 12.7% by September 2011. Likewise, the

proportion of foreign bond issues saw a continuous decrease as of mid-2010 and was slightly below 10% in September 2011.

Until recently, bond yields remained at low levels, thus mirroring the development of lending rates. As of mid-2011, however, yields for lower-rated bonds clearly reflected investors' reduced risk appetite. While, at 3.32%, yields on AAA-rated bonds were nearly half a percentage point below mid-year levels in October 2011, yields on BBB-rated bonds came to 6.07% at the same time, which is approximately one percentage point higher than at mid-year.<sup>5</sup> In the second half of 2011, the yield spread

<sup>5</sup> Euro area figures are used here, as no times series is available for yields on Austrian corporate bonds.

between BBB issues and top-rated euro-denominated corporate bonds widened from 127 to 275 basis points. Such a high figure had last been recorded in June 2009. Nonetheless, bond yields were still significantly lower (between 2.3 and 3.3 percentage points, depending on their rating class) than the peak levels recorded at the height of the financial market turmoil in the fall of 2008.

**Slight Recovery in Equity Financing**

Financing via the stock exchange, which the crisis had severely constrained for a long time, picked up at the end of 2010 and continued its moderate upward momentum in the first half of 2011. In

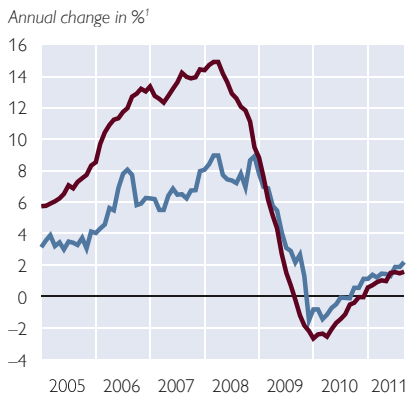
this period, quoted stocks accounted for a little over 10% of nonfinancial corporations' external financing volume. In the first eight months of 2011, the level of corporate funds raised via the stock exchange was, at EUR 4 billion, almost four times as high as in the same period of the previous year. However, almost all companies that raised (additional) capital via the stock market had already been listed on the stock exchange; there has only been one new listing on the Vienna Stock Exchange (in April 2011) since the onset of the crisis. In line with falling stock prices – the ATX plunged 30% in the third quarter of 2011 – financing via the

Capital increases in the first half of 2011

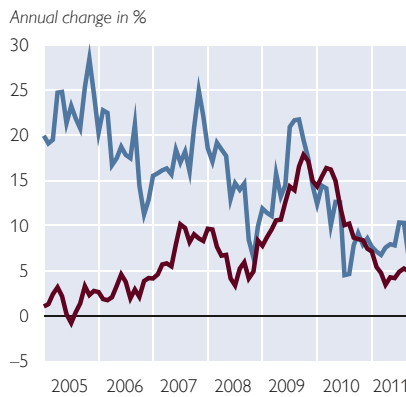
Chart 16

**Volumes of and Conditions for Key Elements of Nonfinancial Corporations' Financing**

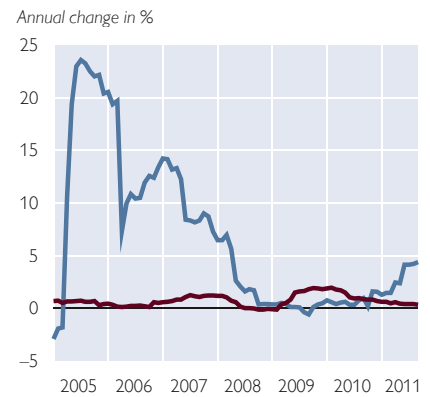
**Loans: Volumes**



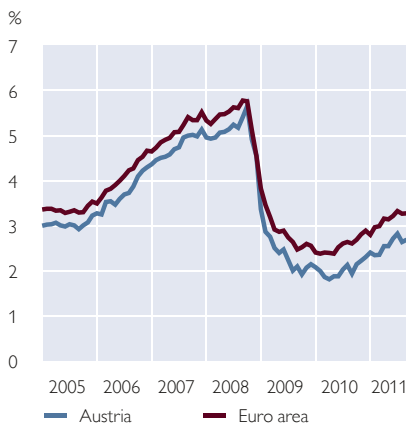
**Bonds: Volumes**



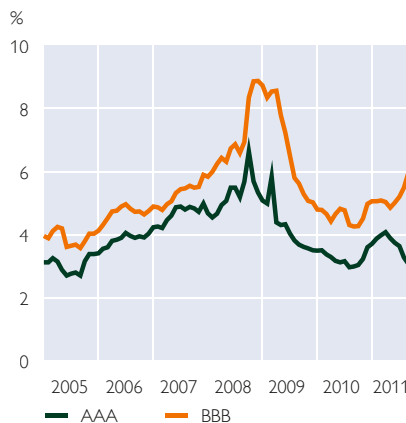
**Quoted Stocks: Volumes**



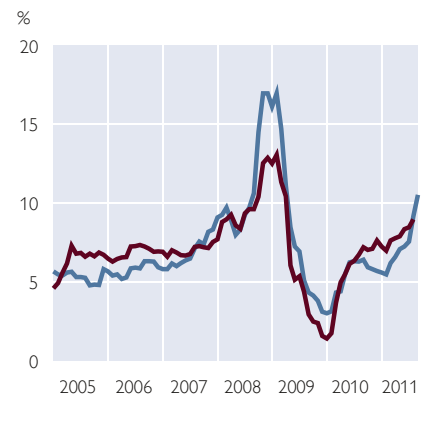
**Loans: Interest Rate**



**Bonds: Yields**



**Quoted Stocks: Earnings Yield**



Source: OeNB, ECB, Thomson Reuters, Wiener Börse AG.

<sup>1</sup> Adjusted for reclassifications, valuation changes and exchange rate effects.

stock market slowed down dramatically in the second half of the year.

Measured in terms of earnings yields (i.e. the inverse of the price-to-earnings ratio), the cost of raising capital on the Austrian stock market has increased considerably since mid-year as a result of sharply falling prices. From June through October 2011, the earnings yield increased from 7.2% to 10.9%, but still remained clearly below the highs of almost 17% recorded during the crisis at end-2008.

At EUR 2,4 billion, over-the-counter equities accounted for close to one-third of external financing in the first six months of 2011. In total, corporations obtained 43% of their external financing in the form of equity in 2010. Relative to its total liabilities, the corporate sector's equity position (i.e. the proportion of stocks in total liabilities and shareholders' equity) held virtually steady at nearly 43% in the first half of the year.

### Still no Noticeable Improvement of Risk Indicators

The financial position of the corporate sector, which in some cases had deteriorated sharply in 2010 as a result of the crisis, has stabilized or even improved slightly over the course of 2011, but some key creditworthiness indicators were still well below precrisis level. Corporate debt (in terms of total of loans and bonds) saw a decline in growth to 5.2% in the first half of 2011. As corporate earnings recovered further at the same time, the ratio of corporate debt to profits fell slightly in the first half of 2011, which suggests elevated debt servicing capacity. At 270% of the gross operating surplus, however, the debt ratio of the Austrian corporate sector was still considerably

higher than before the outbreak of the crisis and also higher than in the entire euro area. The debt-to-equity ratio of Austrian companies was also higher than in the euro area, which gives evidence of the great significance of debt financing in Austria. In the first half of 2011, the debt-to-equity ratio remained relatively stable.

In the past two years, the subdued pace of borrowing, coupled with low interest rates, kept interest expenses down, which relieved the burden on (aggregate) corporate sector costs.<sup>6</sup>

However, interest expenses have risen somewhat since the middle of 2010, largely owing to a slight rise in interest rates. But even though the corporate sector's debt-to-equity ratio had remained stable throughout the crisis and its exposure to interest rate risk had not climbed overall, rising interest rates might create a noticeable burden for highly indebted companies.

This aspect is all the more relevant since the Austrian corporate sector exhibits an above-average share of variable loans, making it substantially vulnerable to interest rate risk. Austrian companies have a share of foreign currency loans that is almost twice as high as that of companies in the euro area. This figure has been stable over the past few years and is significantly lower than the comparable figure for the household sector.

The relatively low expansion of debt financing and the low interest rate level, which make debt servicing easier for more highly indebted companies, are probably among the reasons why the number of corporate insolvencies has risen relatively little during the crisis compared to the intensity of the economic slump and has even declined

Variable rate loans  
cause interest rate  
risk

Corporate equity  
position unchanged

Debt servicing  
capacity still below  
precrisis level

Number of  
insolvencies down

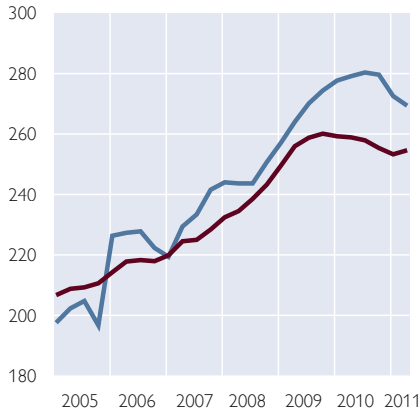
<sup>6</sup> This does not apply to companies that have not taken out bank loans.

Chart 17

## Risk Indicators for Nonfinancial Corporations

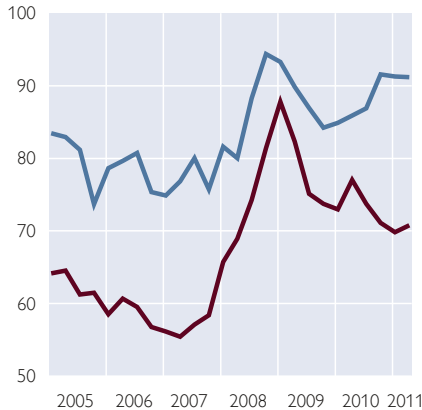
### Debt

% of gross operating surplus



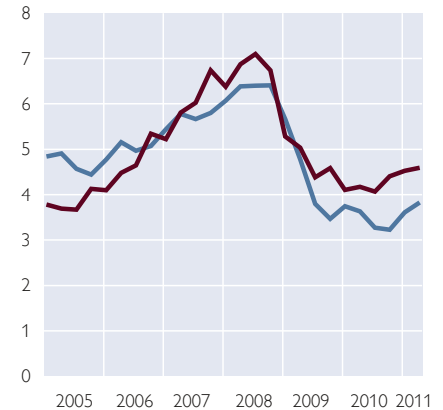
### Debt-Equity-Ratio

%



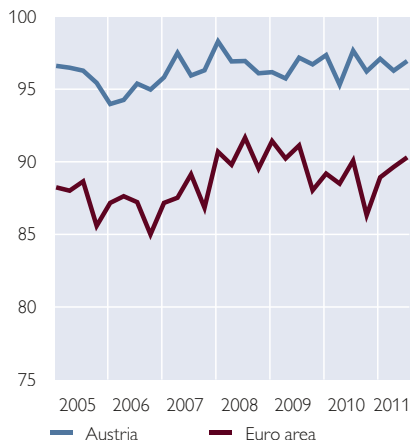
### Interest Expense

% of gross operating surplus



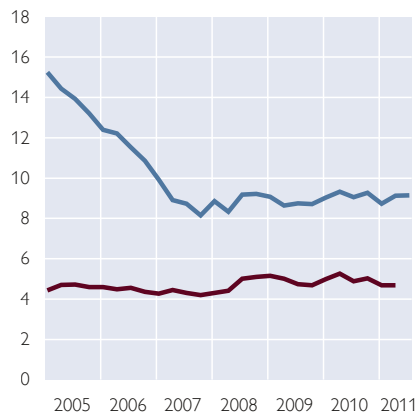
### Variable Rate Loans

% of total new lending



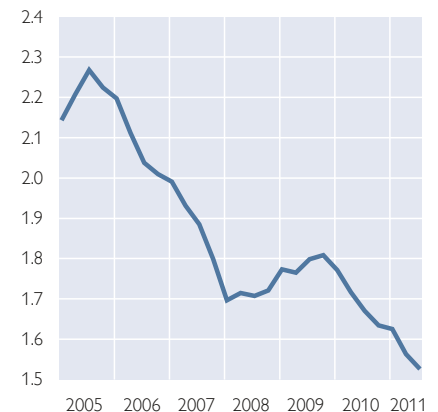
### Foreign Currency Loans

% of total assets



### Insolvencies

Number of insolvencies in % of companies



Source: OeNB, ECB, Eurostat, KSV 1870.

since mid-2010. Based on the total of the past four quarters to rule out seasonal fluctuations, the number of insolvencies in the third quarter of 2011 was 6.8% below the 2010 figure; it also dropped in relation to the number of companies.

### No Improvement in Households' Risk Situation

#### Sluggish Growth in Income and Consumption

While public sector consolidation measures and rising inflation in the first

three quarters of 2011 placed a burden on households' disposable income, favorable labor market conditions provided a positive stimulus to the income situation. Overall, development of real household income in 2011 remained subdued. Against this backdrop, consumer spending increased only slightly, but still by a higher margin than income, sending the saving ratio further down. By the second quarter of 2011, households' saving ratio had been contracting for two years and went down to 7.2% (average of the past four quarters).

Reduced propensity to save

Investments in life insurance have a stabilizing effect

Bank deposits' share in financial investment contracts sharply

Considerable unrealized valuation losses

Capital market investment slows down

### Financial Investment Still Low

In step with the reduced saving ratio, households'<sup>7</sup> financial investment continued to be sluggish in the first half of 2011 and, at EUR 5.6 billion, was 2.6% higher than in 2010, but 47% below the peak recorded in the first half of 2007 before the crisis took hold.

After their contribution to financial investment had been extraordinarily low (3%) in the second half of 2010 in response to the announcement of a capital gains tax on securities, deposits again contributed more than one-third (EUR 1.9 billion) to financial investment in the first half of 2011. Their growth, however, remained slow at 1.0% – relative to financial assets one year ago. At the same time, new deposits changed in structure: The shift from time deposits to overnight deposits which had been recorded since 2009 came to a halt in mid-2011; since June 2011, deposits with agreed maturity actually increased again, especially time deposits, whereas savings deposits continued to fall. The modified maturity structure suggests that the strong preference for liquidity, which had shaped households' investment behavior in the previous years, may have exercised a somewhat less significant influence this year.

Moreover, in light of the sharp drop in stock prices, investor uncertainty appears to have grown again slightly. That is why, in the first half of 2011, capital market investment accounted for only some 20% of households' overall financial asset accumulation. Its growth rate slipped from 3.9% to 1.2%. Debt securities posted considerable growth in the first half of 2011, whereas mutual fund shares and quoted stocks were reduced

in net terms owing to the massive stock price losses.

As in the preceding years, investments in life insurance and pension funds had a stabilizing effect on financial investment. They accounted for around one-third of overall financial investment in the first half of 2011. A large proportion of capital inflows attributable to these investment instruments is not, however, the result of current investment decisions, but – given the extended maturities and commitment periods and the predominantly long-term objectives associated with these instruments – rather reflects decisions that were made earlier. A key underlying force in this context is the growing trend for funded pension instruments. Moreover, life insurance policies are frequently used as repayment vehicles for foreign currency bullet loans.

In mid-2011, the financial assets of Austrian households amounted to EUR 471 billion, up EUR 2.5 billion against end-2010. This means that financial asset growth was approximately EUR 3.1 billion lower than financial investment in the first half-year. To a great extent, this discrepancy reflects the considerable (unrealized) valuation losses in households' security portfolios, which reached nearly EUR 1.9 billion in the first half of 2011. In relative terms, quoted stocks were affected most strongly by price losses, accounting for 4.9% of the stock at end-2010, while in the case of mutual fund shares it was 2.8%. Debt securities also posted valuation losses. Another EUR 0.7 billion in valuation losses were recorded for investments in life insurance policies and pension funds.

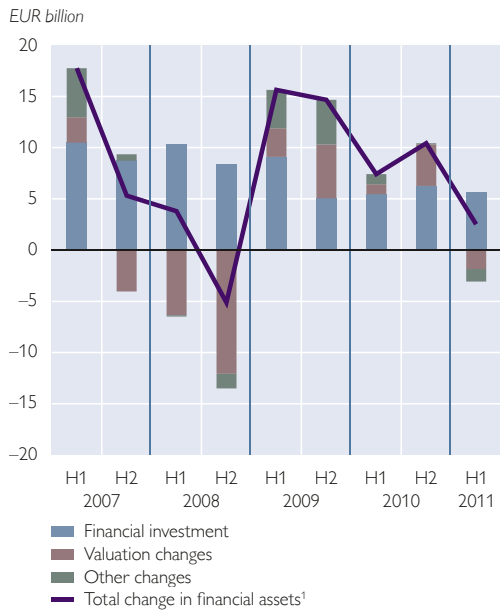
<sup>7</sup> Not including nonprofit institutions serving households.



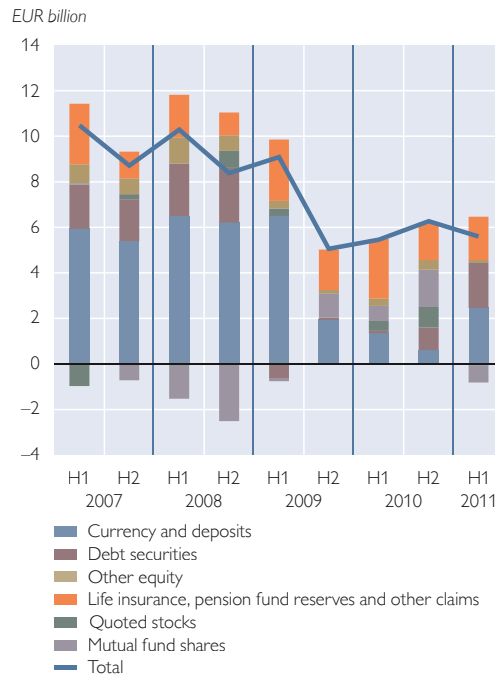
Chart 18

## Changes in Households' Financial Assets

### Determinants of Changes in Financial Assets



### Components of Households' Financial Investment



Source: OeNB.

<sup>1</sup> 2006: financial investment and valuation changes only.

### Subdued Lending Growth

According to Austria's financial accounts, bank loans accounted for slightly over 85% of households' financial liabilities in mid-2011. After bank lending to households had exhibited very moderate growth for two years, it accelerated slightly in 2011. In September 2011, the net increase (adjusted to account for reclassifications, valuation changes and exchange rate effects) in banks' loans to households came to 1.7%.

Examining loans in terms of currencies, we find that euro-denominated loans recorded strong gains (September 2011: 4.5%), whereas foreign currency loans fell sharply (-4.9%). The minimum standards on foreign currency lending issued by the Austrian Financial Market Authority led to a significant reduction in new foreign currency lending to households. Owing to the

strong appreciation of the Swiss franc against the euro, however, the foreign currency loan volume rose by EUR 1.2 billion (3.2%) year on year in September 2011 despite the above-mentioned decline in foreign currency loans.

Categorized by purpose, consumer loans saw declines (-4.2% against the previous year), while gains were observed in housing loans (3.9%) and other loans (0.9%). According to the BLS, credit supply from banks had remained stable since mid-2010, which suggests that the current growth in lending appears to be fundamentally rooted in demand-side factors. In the housing loan segment, some indicators are signaling a rise in credit demand. Although no information is available on finished new construction projects, the rising number of residential building permits indicates a slight upturn in

Exchange rate-adjusted decline in foreign currency loans

residential building in the first half of 2011 (9.1% year on year). Concurrently, rising real estate prices are causing an upward shift in demand for funding requirements for the acquisition of real estate on the secondary market.

The framework conditions for household loans have changed only marginally over the course of 2011. Credit standards for both housing and consumer loans were tightened only to a very small extent during the financial crisis and have remained unchanged

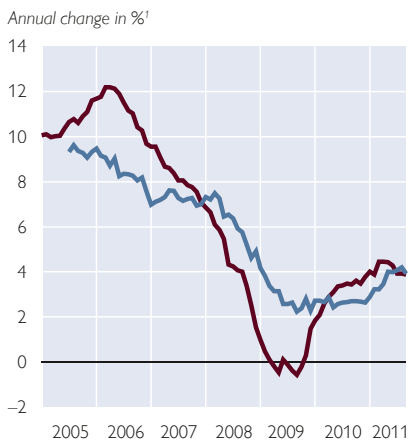
since the third quarter of 2010. Lending conditions continued to be favorable. Even though an increase was observed as a result of two key interest rate hikes in April and July 2011 as well as higher money market interest rates, the interest rate for new housing loans stood at 2.95% in September 2011, which is 0.24 percentage points above the end-2010 figure. Interest rates on consumer loans had started to go up already in 2010 and rose by another 14 basis points to 5.09% in the first nine months of 2011. Nonetheless,

Financing conditions remain favorable

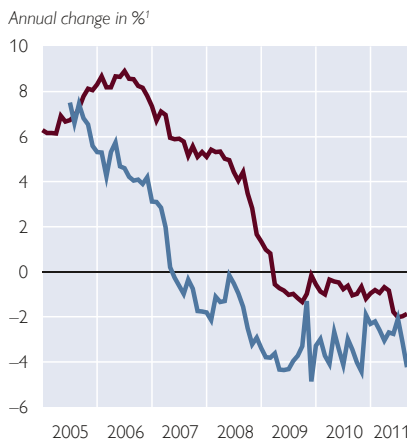
Chart 19

Volumes of and Conditions for MFI Loans to Households

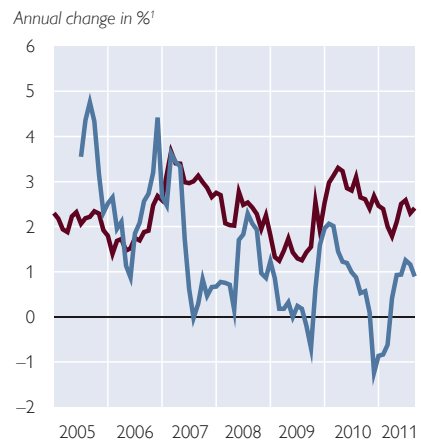
Housing Loans: Volumes



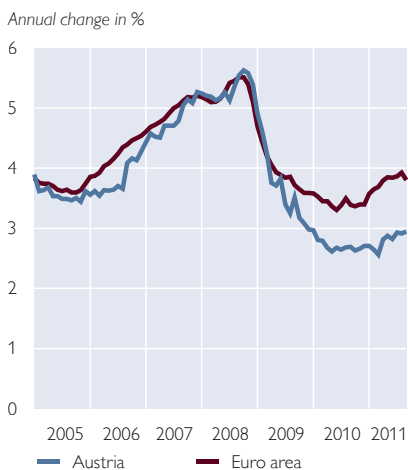
Consumer Loans: Volumes



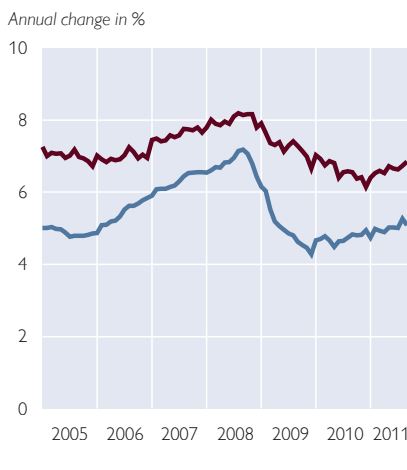
Other Loans: Volumes



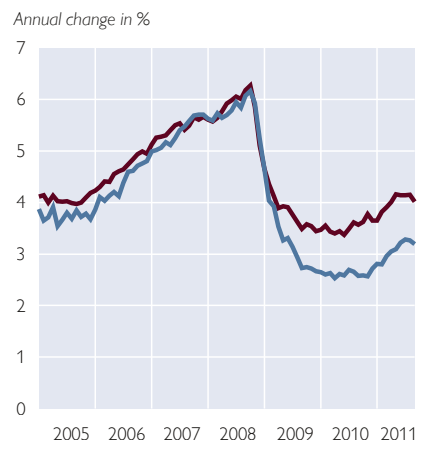
Housing Loans: Interest Rate



Consumer Loans: Interest Rate



Other Loans: Interest Rate



Source: OeNB, ECB.

<sup>1</sup> Adjusted for reclassifications, changes in valuation and exchange rate effects.

they were still 2.6 percentage points (housing loans) and 2.1 percentage points (consumer loans) below precrisis level.

**Households' Currency and Interest Rate Risks**

In absolute numbers, the amount of household debt does not give rise to concern. Moderate borrowing and low interest rates allowed the absolute debt level to remain relatively stable during the crisis, and in mid-2011, it amounted to EUR 166 billion. According to the financial accounts, total household liabilities climbed 3.7% in the past twelve months. Households' debt burden

amounted to 97% of their net disposable income. Thus, the debt ratio continued to be lower than in the euro area as a whole, where the corresponding value was 107%.

Low interest levels and moderate borrowing caused households' interest expenses to remain low, even though they had increased slightly since mid-2010 following a rise in interest rates. In the third quarter of 2011, interest expenses averaged 2.5% of disposable income, slipping by approximately 1.5 percentage points compared to the onset of the crisis three years earlier. One of the factors that favored this drop was the rising proportion of variable inter-

The problem is not the amount of household debt but...

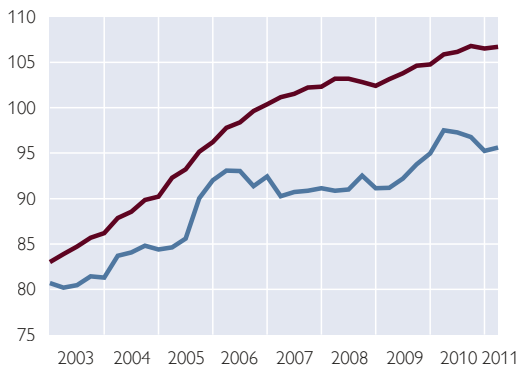
...the short rate fixation periods...

Chart 20

**Household Risk Indicators**

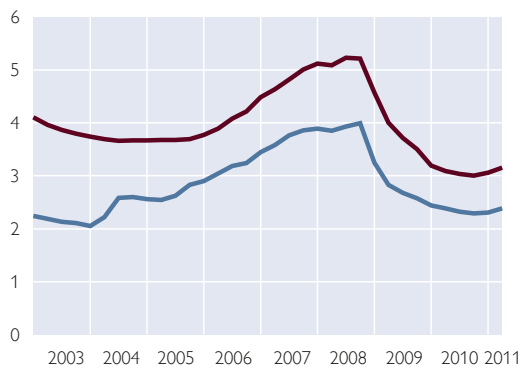
**Liabilities**

% of net disposable income



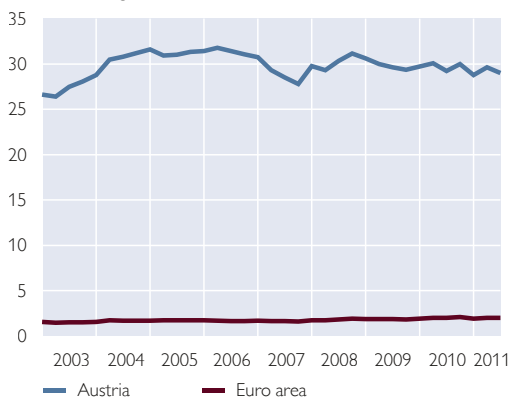
**Interest Expenditure**

% of net disposable income



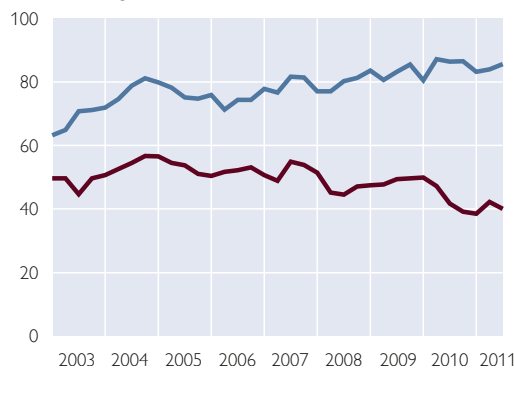
**Foreign Currency Loans**

% of total lending



**Variable Rate Loans**

% of new lending



Source: OeNB, Statistics Austria, ECB, Eurostat.

Euro area: interest expenditure for euro-denominated loans only.

...and the share of  
foreign currency  
loans

est loans. In the third quarter of 2011, 86% of new loans had an initial rate fixation period of up to one year. That share, which is particularly high by international comparison, contributed to the speed with which the ECB's interest rate reductions were transmitted to lending rates in Austria and to the fact that consumer interest rates are lower in Austria than in the euro area in general. However, it would have the opposite effect on interest expenses if interest rates were to climb again.

The sustained high proportion of foreign currency loans constitutes another

risk factor for households' financial positions. In the third quarter of 2011, as much as 29% of households' entire credit volume was still denominated in foreign currency. Although foreign currency loans have been reduced for more than two years on a net basis, their share in the total volume of outstanding loans went down only marginally owing to exchange rate developments in the past few years. Between September 2009 and September 2011, the Swiss franc appreciated against the euro by 26%, which clearly showed the risk potential of foreign currency debt.