

# The Real Economy and Financial Markets in Austria

## Nonfinancial Corporations High Investment Demand in 2003

While real GDP growth was weak at 0.7% in 2003, real investment demand rose by 4.6% in this period. To a large extent, this was attributable to a catching-up effect, i.e. demand for replacement investment accelerated in the wake of declining investment growth rates in 2001 and 2002. Moreover, temporary tax incentives – subsidies on investment that exceeded the average investment level of the previous three years – and public infrastructure spending had a stimulating effect. Overall, the amount of investment that could be financed from internal cash flow was maintained at 2002 levels. The manufacturing industry, for instance, reached a cash flow ratio of 11.0% in 2003 according to preliminary estimates by WIFO, the Austrian Institute of Economic Research.

Any assessment of how investment demand may develop in 2004 is complicated by numerous uncertainties.

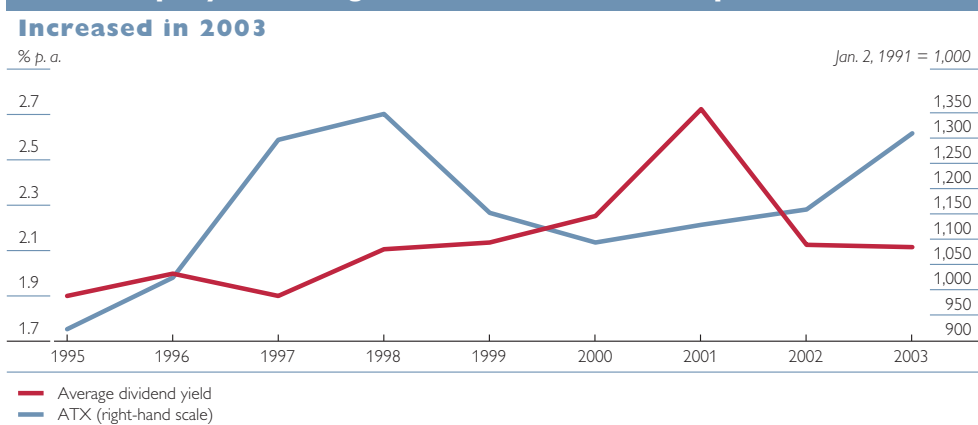
The recovery of the European economy remained weak, and the appreciation of the euro against the U.S. dollar as well as price increases for major commodities dampen businesses' propensity to invest. The latest WIFO Investment Survey indicates that the manufacturing industry, the key production sector, has been cutting investment expenditure. The OeNB economic outlook of June 2004 expects real investment growth to come to 3.3% in 2004.

## Need for External Financing Increased

In 2003 the volume of external corporate financing rose to EUR 18.2 billion, from EUR 10.0 billion in 2002. The higher share of equity financing reflects valuation gains that stem from the rise in market capitalization in 2003.<sup>30</sup> With the average dividend yield hitting 2.12% in 2003, the lowest level since 1998, it became more attractive for companies to raise risk capital.

Chart 15

### Cost of Equity Financing Decreased as Market Capitalization Increased in 2003



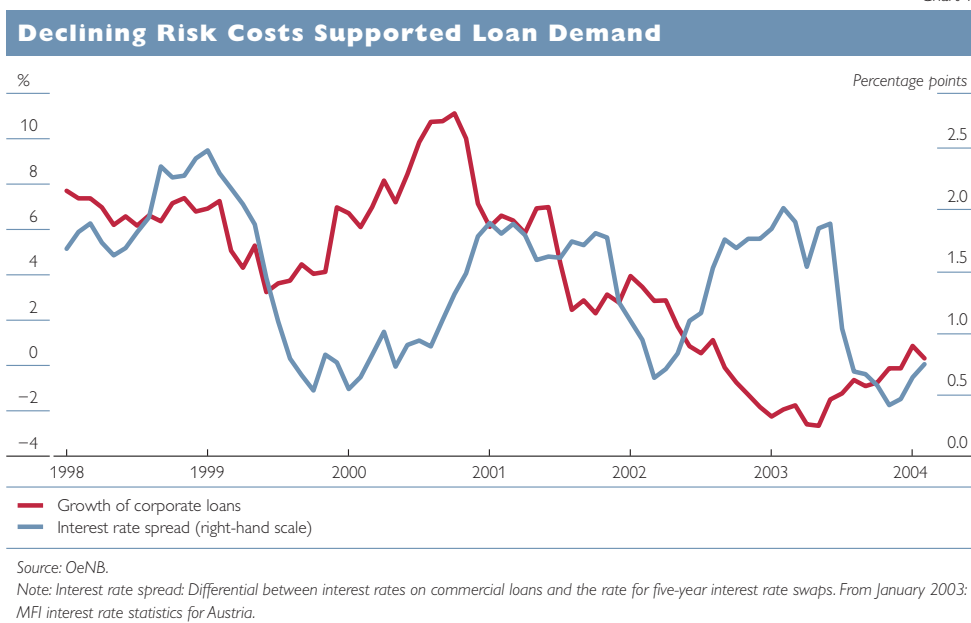
Source: Wiener Börse AG.

<sup>30</sup> Market capitalization reflects the development of the ATX (Austrian Traded Index), which is currently composed of 20 corporations operating in the production and service industries and in the field of banking and insurance. Using stock price developments as an indicator of the capital position of the economy as a whole presupposes that the equity of unlisted corporations is valued at market prices.

Loan interest rates dropped for both new business and outstanding amounts in 2003.<sup>31</sup> At the same time, the higher share of equity in firms' capital structure enhanced the value of equity available to back loans and thus firms' creditworthiness, which also fed through to risk premiums.<sup>32</sup>

The spread between interest rates on corporate loans and the rate for five-year interest rate swaps<sup>33</sup> has narrowed significantly from the middle of 2003 after having widened continually from mid-2002. In early 2004, risk costs rose again somewhat.

Chart 16



On balance, falling capital costs enabled businesses to stabilize their liquidity conditions against the background of moderate profit growth. This gave firms more financial room for maneuver amid the overall weak growth in 2003. At the same time, the changes in capital costs in 2003 show that financial markets have become more optimistic about corporate profitability and indebtedness as well as about the general economic outlook.

### More Capital Raised Abroad

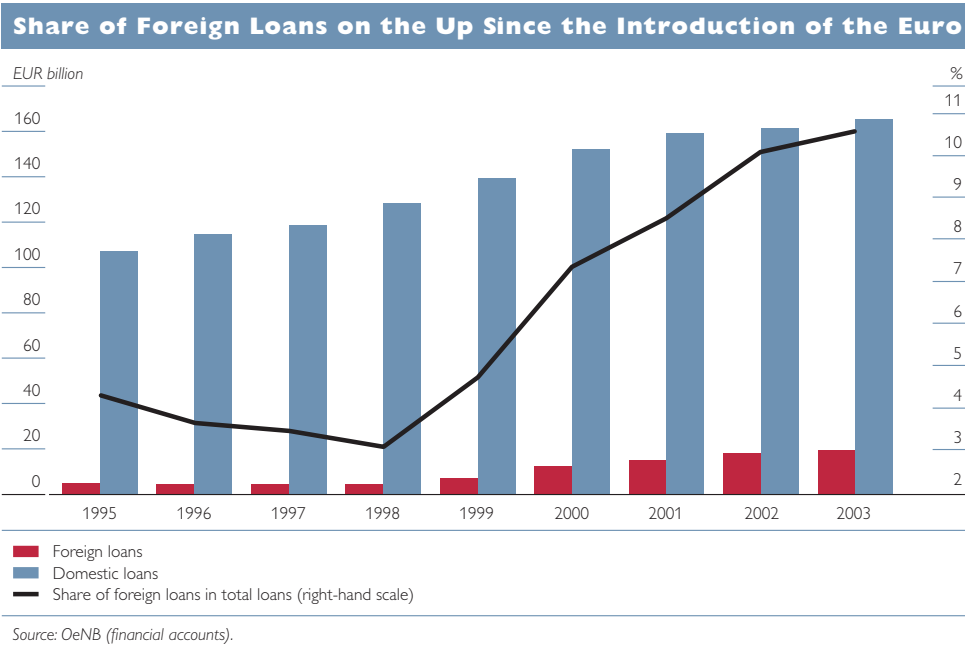
Notwithstanding the favorable financing conditions, businesses' propensity to borrow has not risen significantly. To some extent, the low borrowing levels also reflect banks' more cautious lending policies, as evident from recent results of the Bank Lending Survey for Austria. Annual loan growth was even negative in 2003. At the beginning of 2004, lending to businesses inched up again somewhat, however. This stagnation in bank lend-

<sup>31</sup> In addition, bond yields were at a low level in 2003 (see the section on corporate bond developments).

<sup>32</sup> The appreciation of the euro against major debt currencies also contributed to the improvement of corporate balance sheets. Valuation gains caused the foreign currency liabilities of nonfinancial corporations to drop by EUR 1.4 billion in 2003.

<sup>33</sup> The rate for interest rate swaps between banks includes only small credit risk premiums. Consequently, the gap between interest rates for corporate loans and swap rates is an indicator of the risk that banks incur when extending a loan to companies.

Chart 17



ing is without parallel in a long-term comparison.<sup>34</sup>

Since the introduction of the euro, nonfinancial corporations have increasingly raised funds abroad. Between 1999 and 2003 the share of foreign loans in total loans to businesses increased from 4.8% to 10.5%. To some extent, this is attributable to the growth of intercompany loans amid the surge in foreign direct investment. Such loans do not qualify as loan financing proper, but as liabilities of the domestic subsidiary to the foreign parent company. The implication of such financial relations for financial stability in Austria is that they cause the debt risk to be transferred, to some extent, from the domestic economy to foreign economies.<sup>35</sup>

### More Bankruptcies despite Declining Debt/Equity Ratio and Lower Interest Expenditure

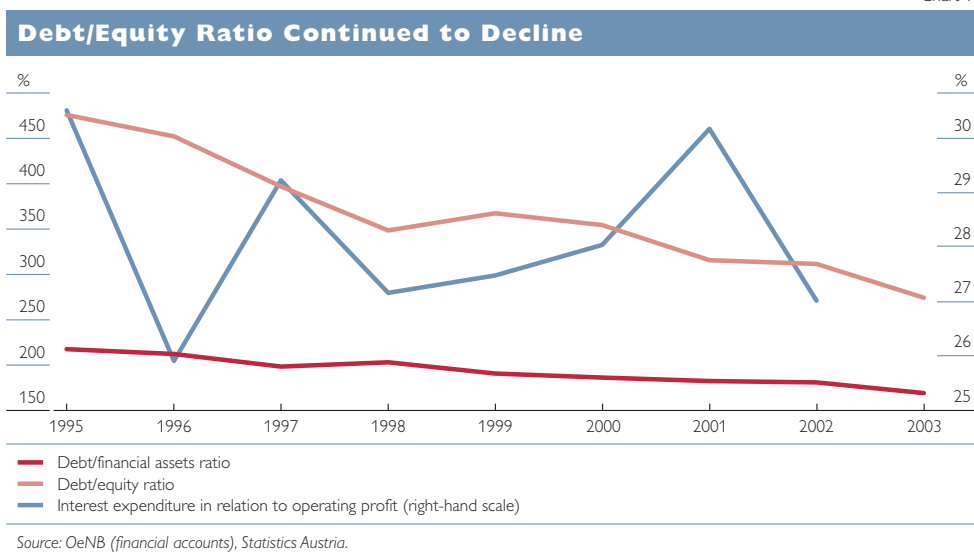
Financing conditions have improved for businesses in recent months. In addition to the low level of interest rates, the declining debt/equity ratio has caused interest expenditure to drop.

In the first quarter of 2004, the number of bankruptcies jumped nonetheless by 15.4% against the same quarter of 2003, according to preliminary estimates by the credit information company Kreditschutzverband. Compared with 2003, when bankruptcies rose by 6.9%, this is a significant worsening. The volume of default liabilities reached approximately EUR 420 million in the first three months of 2004, which corre-

<sup>34</sup> Only the temporary stagnation in bank lending to businesses in the second half of 1983 comes close to these developments. At the time, annual growth rates did not turn negative, however, as happened between September 2002 and December 2003.

<sup>35</sup> Note that disturbances may spread more rapidly today within the international financial system because of the high degree of integration that has been achieved. Austrian companies with bad credit ratings that default on foreign loans may affect thus financial stability in Austria if their foreign creditors have financial relations with Austria.

Chart 18



sponds to an increase by 9.2% compared with the corresponding quarter of 2003.

### Households

#### Income Outlook Remained Subdued

According to the OeNB's economic outlook of June, the disposable income of households is projected to grow 1.0% in real terms in 2004, only slightly faster than in 2003. The outlook for income growth has not improved in recent months. Employment is expected to inch up a mere

0.2% in 2004, while the jobless rate (Eurostat definition) stands to worsen from 4.4% to 4.5%. Against this background, consumer demand remains slack. The OeNB projects consumer demand to grow by 1.4% in real terms, more or less as fast as in 2003.

#### Debt Dynamics Weakened

Household debt grew by 2.8% year on year in 2003, well below the corresponding rate of 2002 (4.5%). At EUR 6.6 billion, interest payments on debt tied up 5% of disposable in-

Chart 19

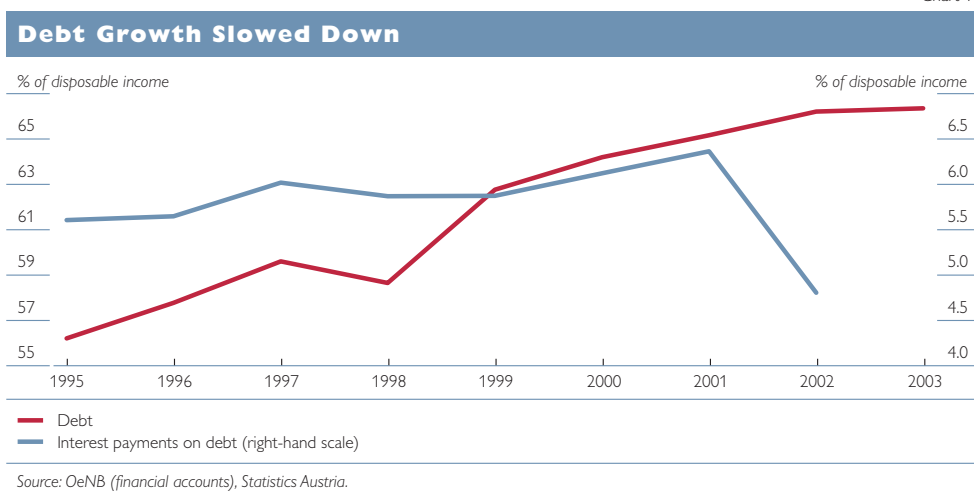
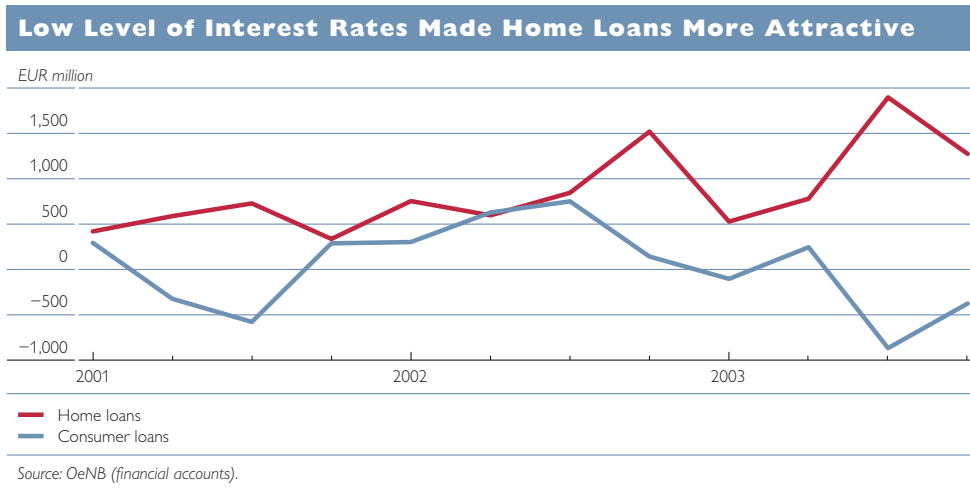


Chart 20



come in 2002, the lowest value since 1995. For 2003, national accounts data have not yet become available, but the downward trend is expected to have continued. As is evident from the MFI interest rate statistics for loans to Austrian households, both interest rates on new business and on outstanding amounts declined. This implies that the drain on incomes from debt servicing continued to decrease significantly and that households were able to set aside more money against potential income losses.

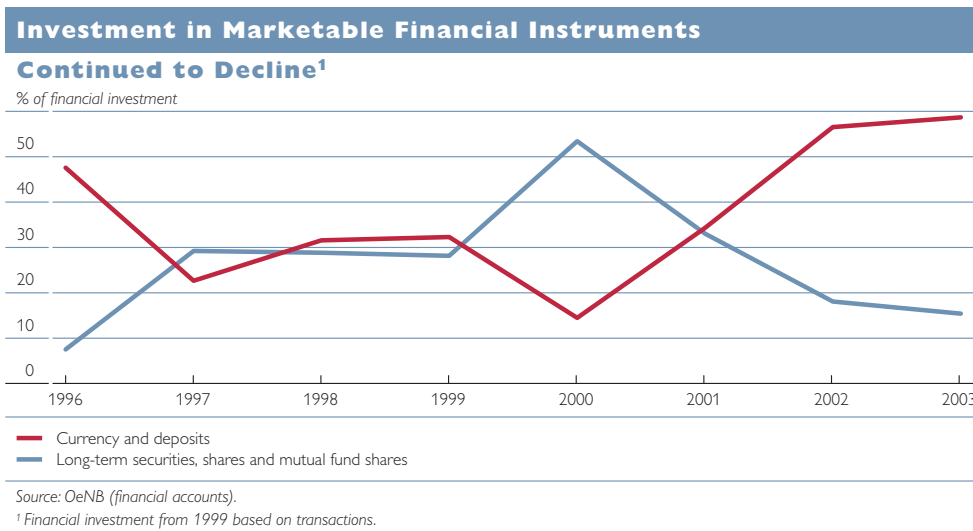
Debt growth was essentially fueled by demand for home loans, which grew by EUR 4.5 billion in 2003, while consumer loan transactions resulted in net redemptions of EUR 1.2 billion. The decrease in outstanding consumer loans reflects households' moderate propensity to spend. At the same time, the low level of interest rates provides an incentive to frontload expensive purchases with long-term financing horizons – a

financing behavior that is not without risk given the present uncertain income outlook. After all, debtors who have borrowed heavily may face financial constraints should they suddenly suffer income losses.

#### **Demand for Liquidity Dominated Financial Investment**

At EUR 8.0 billion, cash holdings and deposits accounted for the bulk of financial assets that households accumulated in 2003. This development can be attributed to the uncertain economic outlook and the low opportunity costs of holding money. Following price setbacks in national and international financial markets from 2000 to 2002, households have been continually investing less in market-oriented financial instruments, such as long-term securities, shares and mutual fund shares. While in 2000, this category attracted more than half of all financial investment (53.5%), this share was down to 16.2% in 2003.

Chart 21

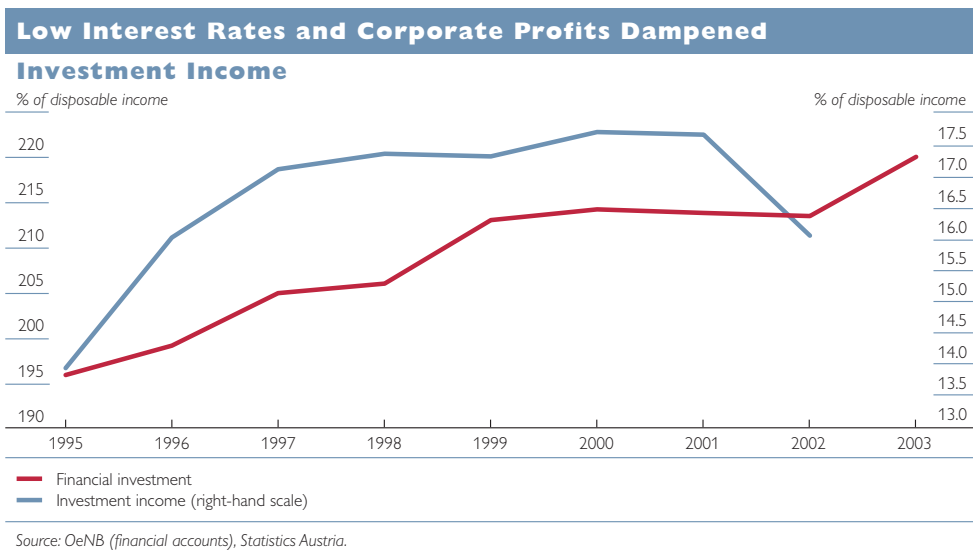


### Low Interest Rates and Corporate Profits Dampened Investment Income

In the second half of the 1990s, income<sup>36</sup> from financial investment grew at a significantly faster rate than disposable income. In 2002, though, the share of investment income in disposable income dropped markedly. High financial investment in low-return assets and weaker corporate earnings caused the share of investment income

in total disposable income to drop to 16.1% or EUR 21.6 billion. Data for 2003 have not yet become available. Yet, given investors' current preference for liquid financial instruments, low deposit interest rates and still subdued economic growth, it can be assumed that investment income was weak again in 2003 and will continue to be weak in the current year.

Chart 22



<sup>36</sup> Changes in assets that reflect valuation effects do not qualify as income.

### Pension Funds Cut Benefits

In 2003, approximately 3% of households' financial assets were claims on pension funds. While pension funds earned a nominal investment return of 6.9% p.a. on average between 1990 and 2003, the value of pension fund assets actually decreased in 2001 (-1.6%) and 2002 (-6.3%) owing to international capital market developments.<sup>37</sup>

In 2003, pension fund beneficiaries faced substantial benefit cuts. Almost half of the beneficiaries suffered cuts with losses reaching 8% on average. This reflects the high impact of international capital market developments on the benefits pension funds can actually pay out. Pension funds have already announced that there will be cuts also in 2004: 13,000 out of the 41,000 beneficiaries must expect to receive between 0.1% and 2% less than in 2003.<sup>38</sup>

While the roughly 41,000 pension fund beneficiaries account as yet for a small share of all old-age pensioners in Austria (December 2003: 1.1 million), the number of pension fund members (342,000 out of the approximately 3.2 million Austrians that were covered by the public pension scheme in 2003<sup>39</sup>) implies that potential benefit cuts by pension funds will have stronger macroeconomic implications in the future. In other words, in the future valuation changes in capital market assets may have quite an impact on the disposable income of households.

### Rising Market Prices Led to Valuation Gains in 2003

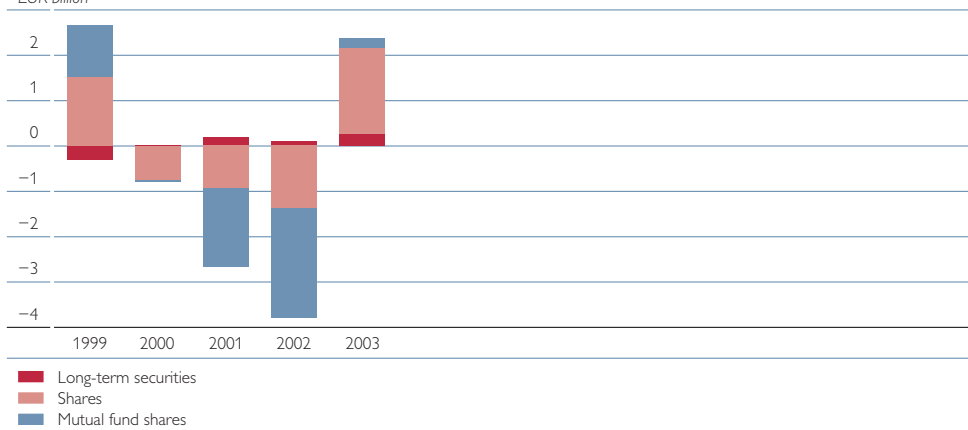
Along with income, the net worth of assets is also subject to an ever higher market risk. After households had suffered valuation losses in the amount of approximately EUR 7 billion between

Chart 23

#### Rising Market Prices Boosted Financial Assets by EUR 2.3 Billion

in 2003<sup>1</sup>

EUR billion



Source: OeNB (financial accounts).

<sup>1</sup> Partly estimated.

<sup>37</sup> In 2002 benefits contracted by EUR 379 million according to the Financial Market Authority.

<sup>38</sup> These cuts are not attributable to the capital losses of 2001 and 2002 alone; they also reflect the fact that a major occupational pension plan switched to a new discount rate.

<sup>39</sup> Source: Association of Austrian Social Security Institutions. 2004. *Die österreichische Sozialversicherung in Zahlen. 14<sup>th</sup> edition. Vienna.*

2000 and 2002 from investment in shares and mutual fund shares, market prices rebounded significantly in both national and international financial markets in 2003. All in all, valuation gains totaled EUR 2.3 billion, with shares accounting for the largest portion (EUR 1.8 billion).

### Stock Market

In 2003 the Vienna stock exchange (Wiener Börse) attracted new listings totaling EUR 4.7 billion from twelve corporations. This corresponds to 9.2% of gross fixed capital formation in 2003, which is significantly above the average of the period 1993 to 2003 (3.1%).<sup>40</sup> However, the changes of ownership, in which the new listings resulted, were not necessarily effected with a view to raising cash for new investment. The biggest flotation in 2003 was the partial sale of Bank Austria Creditanstalt by the German Hypo Vereinsbank, totaling about EUR 4.2 billion. At the same time, 19

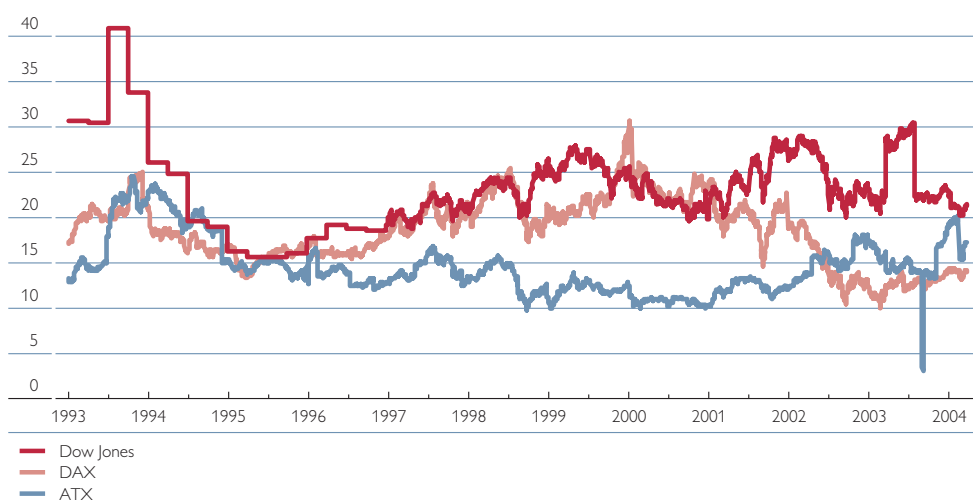
shares were delisted from the Vienna stock exchange.

By comparison, the number of rights issues made (i.e. issues of new shares for cash to existing shareholders) at the Wiener Börse in 2003 – twelve all in all – is a far more meaningful indicator of its financing role than the number of new issues. Rights issues were primarily made by a company developing entertainment software and three real estate corporations. On balance, EUR 449 million were raised through rights issues at the Wiener Börse in 2003, which equals about 0.9% of gross fixed capital formation (average for 1993 to 2003: 1.1%). The annual turnover (in EUR, double counting) rose by 52% to EUR 19.3 billion in 2003.

The ATX climbed by 34% in 2003, which is an average performance compared with the DAX (+37%), the Dow Jones (+25%) and a broad euro area index developed by Thomson Datastream (+42%).

Chart 24

### ATX Price/Earnings Ratio Finally Approaching Average Dow Jones and DAX Levels



Source: Thomson Datastream. Datastream provides only quarterly data for the Dow Jones up to 1997.

<sup>40</sup> Source: Wiener Börse. 2004. Jahresstatistik 2003.



Unlike the latter indices, which moved only slightly in the first quarter of 2004, the ATX has continued to increase since the beginning of the year.

The development of the price/earnings (P/E) ratio (see chart 24) until the first quarter of 2004 provides further evidence that the ATX did not join the rush of irrational exuberance (as diagnosed by Alan Greenspan) in the second half of the 1990s. Propelled by the points the ATX gained since early 2003, its P/E ratio is now fairly average in an international comparison. At a factor of 18, the P/E ratio is above the long-term average of the ATX (15.1 in the period from 1993 to 2003) and – while well below the averages the Dow Jones and the DAX achieved between 1997 and 2003 – approaching or catching up with the long-term average levels of these benchmarks.<sup>41</sup>

## Bond Market

### Corporate Bond Market Boomed

The financial accounts statistics show that the outstanding volume of corporate bonds jumped by EUR 4.4 billion net in the second half of 2003 alone (see chart 25). The full-year net issuance volume of corporate bonds even surpassed the net growth of corporate bank lending.

While issuance activity used to be dominated by energy utilities and quasi-public corporations, in recent years companies from other industries and, increasingly, smaller firms have also been issuing bonds. Typically, publicly issued corporate bonds had

a volume of EUR 70 million to EUR 250 million, while the volumes of privately issued bonds were much smaller.<sup>42</sup>

The issuance volumes of Austrian companies must also be seen in the light of the fact that a number of state-owned companies that used to heavily rely on the bond market have hardly issued any new bonds since 1998 because since then they have been able to borrow through the fiscal agency program, under which the federal government relends funds raised through government bonds. At the same time, bonds issued earlier by such companies came up for repayment, which further dampened the net increase in outstanding corporate bonds. Following a Eurostat decision in February 2003, bonds issued in order to finance state-owned companies must be included in the general government debt (Maastricht definition). As a result, the companies concerned are phasing out fiscal agency borrowing and have returned to the general bond market.

Finally, the higher issuance activity also reflects companies' intention to lock in the currently low volume of interest rates.<sup>43</sup> Unlike bank loans, which carry mostly variable interest rates, bond yields tend<sup>44</sup> to be fixed until maturity.

Bonds issued by Austrian companies are typically bought by foreign investors, who held roughly 70% of the outstanding volume at the end of 2003. Nearly one fifth of all corporate bonds outstanding in 2003 were held

<sup>41</sup> Averages of the period from 1993 to 2003: Dow Jones 22.6, DAX 18.0.

<sup>42</sup> Some bonds issues at the Wiener Börse in 2003, above all some of the larger issues, were in fact secondary listings (following a primary listing in Luxembourg).

<sup>43</sup> In addition to the decline in bond rates, the yield gap between corporate bonds and government bonds narrowed considerably in the euro area in 2003.

<sup>44</sup> Fixed-rate issues accounted for more than 98% of all bonds publicly issued at the Vienna stock exchange by Austrian companies from 2001 to 2003.

Chart 25

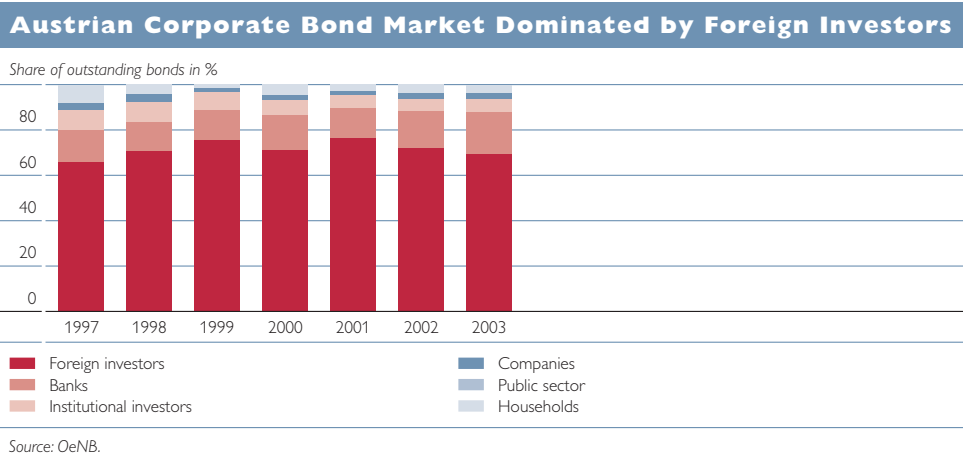


by banks; this share has slightly risen in recent years. By contrast, the shares of companies and households as well as domestic institutional investors in outstanding Austrian corporate bonds are very low.

The broadening of the range of investors should essentially reinforce the stability of corporate finance, as funding constraints that may be caused

by the withdrawal of individual banks can thus be avoided. In addition, bonds usually do not require collateral, which leaves borrowers more room for taking out loans. Finally, through the issuance of corporate bonds, credit risk is being spread beyond the banking system – and in the case of Austria, even beyond national borders.

Chart 26



### Demand for Housing Bonds Remained Strong

Housing bonds, which were launched in the Austrian market in 1993, provide a double tax advantage: The initial cost is income tax deductible, and interest coupons – which may be fixed or variable – are exempt from the first 4% of the annual investment income tax charge. Housing bonds are specifically earmarked for funding the construction and renovation of

homes (which tend to be backed by mortgages).

Until August 2001, six home loan banks operated in Austria; since September 2001 the number has been down to five. Between them, they had issued housing bonds in the order of EUR 6.2 billion by January 2004. This corresponds to a share of 3.3% in the total volume of bonds outstanding in Austria (thereof, more than EUR 1.5 billion were issued in 2003).

Chart 27

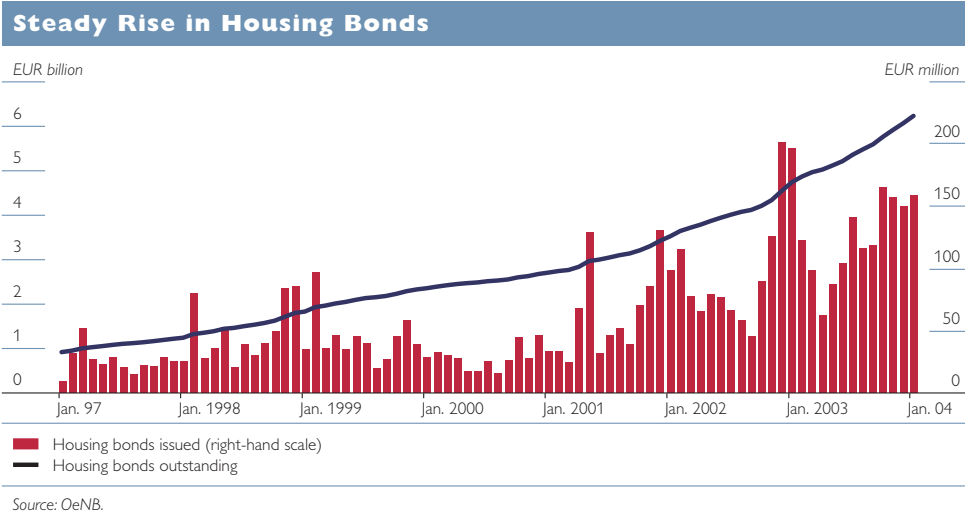
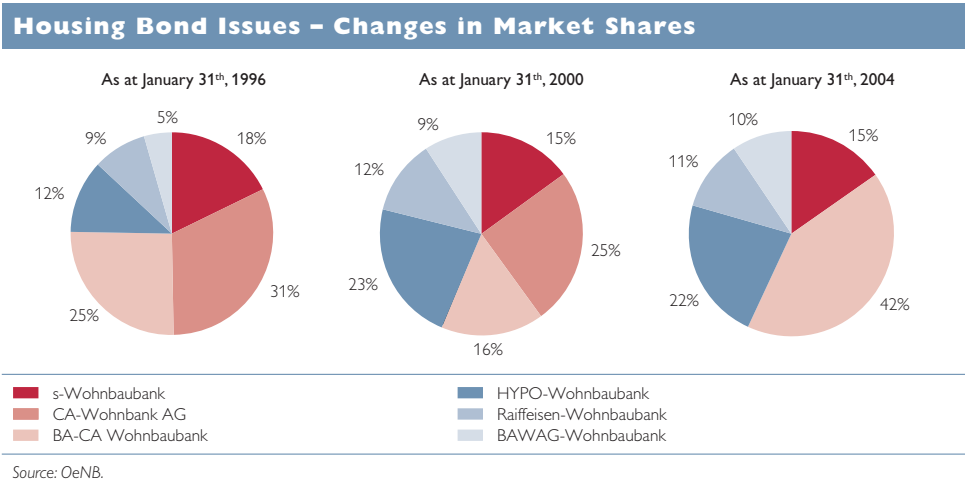


Chart 28



Based on market shares, BA-CA Wohnbaubank is the clear market leader, and Hypo-Wohnbaubank recorded the biggest growth rate in 2003 compared with 1996.

## Real Estate Market

### Range of Investment Products Widened with Open-End Real Estate Funds

The Austrian market was opened for open-end real estate funds on September 1, 2003. By mid-March 2004, four domestic real estate funds had issued instruments in the order of about EUR 500 million in this cate-

gory. So far, only a single foreign provider has entered the market, and banks have been the main channel (90%) through which the new product has been distributed.

### Tax Rules Distorted Competition Somewhat

Austrian real estate funds may invest only directly in property. In other words, buying real estate through a holding company, which is international practice, is not an option for Austrian funds. For tax purposes, 80% of unrealized revaluation gains

are treated as taxable income, while equalization payments for capital losses are not.<sup>45</sup> Moreover, domestic providers enjoy preferential tax treatment, which has sparked a debate: Distributions made by open-end real estate funds, be they foreign or domestic, are generally subject to an investment income tax of 25%. However, tax on income from foreign property is not treated as final in Austria. This means that whereas for domestic funds, double taxation agreements are taken into account at the time of distribution, investors in foreign funds may not claim such tax relief until they file their tax returns, which leaves them with a tax disadvantage and a higher administrative burden. One solution might be that banks voluntarily withhold investment income tax from the reinvested income of foreign funds.

#### **Austrian Closed-End Real Estate Funds Outperformed Foreign Funds**

To conclude, a few notes on the performance of other real estate investment instruments. Closed-end real estate investment schemes (often referred to as *closed-end real estate funds*<sup>46</sup>) may generally be expected to outperform open-end funds because the underlying risk is higher as

such funds typically invest into a single object. They provide a higher degree of transparency than open-end funds and offer a flexible product selection. Closed-end real estate funds tend to have a better performance, as they may invest only up to 95% of their assets.<sup>47</sup>

At EUR 3.68 billion invested in closed-end real estate funds, this category had a market share of 45.1% of the whole closed-end segment at the end of 2003. In an international comparison, Austria ranked third with EUR 353.6 million, which is a historic high (+187% year on year). This high share may be attributable to high tax credits; at the same time, foreign investors may have used the possibility to spread their portfolios more broadly.

The significance of *real estate shares* listed at the Vienna stock exchange is rising. At EUR 500 million invested at the end of 2003, real estate shares accounted for as much as 35% of the overall issuing volume.

In 2003, foreign investors were particularly keen on investing directly in property (EUR 0.8 billion, five times as much as in 2002). Austrian purchases of real estate abroad totaled EUR 0.3 billion.

<sup>45</sup> An amendment of this clause would prevent dichotomies such as funds suffering capital losses from the revaluation of assets but investors having to pay investment income tax on rental income.

<sup>46</sup> Unlike open-end funds, closed-end funds are typically set up for a fixed portfolio for which money is to be raised. The fund will stop issuing units once the required funding level has been reached. Open funds generally sell as many shares as investor demand requires.

<sup>47</sup> They must at all times be able to repurchase shares.