

# Financial Crisis Hits the Real Economy

## Financial Crisis Impairs Corporate Sector Financing Conditions

### Marked Economic Downturn in Austria

In the first half of 2009, the impact of the international economic crisis on Austria's economy gathered momentum. Real GDP went down in the first quarter of 2009 and is likely to decline in the second quarter as well. As the year progresses, the tax reform and economic stimulus packages should dampen the economic slump.

The gloomy economic outlook also dampened capital formation. New orders in manufacturing in Austria were on the decline since fall 2008, capacity utilization shrank and investment dropped sharply.

Finally, the growth rate of corporate profits also weakened considerably. In the fourth quarter of 2008, the gross operating surplus (including mixed income of the self-employed) had still been 4.6% above the same value of the previous year.

### External Financing Share Decreases

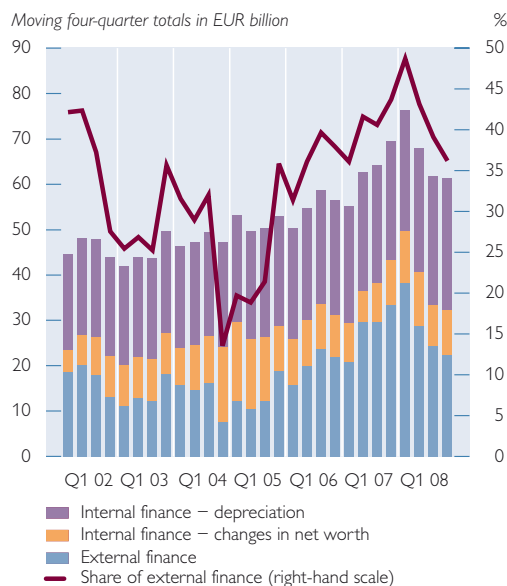
In 2008, external financing contracted by roughly one-third to EUR 22.4 billion compared to 2007, whereas internal financing in the corporate sector rose by 8% to EUR 39 billion. The share of external financing in corporate finance, which had risen from less than 20% in the first quarter of 2005 to just under 50% in the first quarter of 2008, fell back to 36% in 2008.

### Financial Crisis Causes Equity Financing to Grind to a Halt

The decline in external financing is traceable mainly to the drop in capital raised on the stock exchange. Financing via the stock exchange came to a standstill as a result of the crisis. No

Chart 17

## Internal and External Corporate Finance



Source: OeNB.

significant listings have been made on Wiener Börse since mid-2008. New issues came to 0.4% of outstanding amounts in the first quarter of 2009.

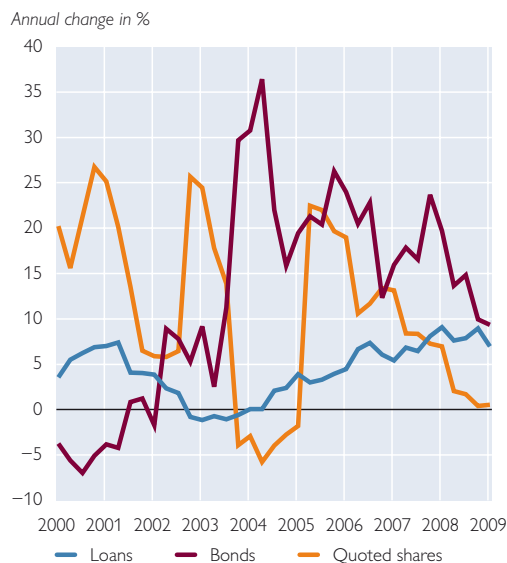
In addition to investors' more pronounced risk aversion, these figures stem from the sharp fall in equity prices and the resulting marked deterioration of the conditions for raising capital on the stock exchange. By November 2008, the earnings yield – the inverse of the price-to-earnings ratio – expanded to 17%, up from 6.5% recorded in mid-2007 when the financial turmoil began. Afterwards, tensions eased again, bringing the earnings yield back down to 11.1% at the end of April 2009.

In the second half of 2008, corporations raised approximately 29% of their external financing in the form of equity (including over-the-counter equities) – noticeably less than in the preceding years (average for 2003 through 2007: 48%). The proportion of shares in total liabilities contracted from 52% to 44% in 2008, a develop-

ment due to both the reduced amount of capital raised and to the lower market value of quoted shares.

Chart 18

### Key Elements of External Corporate Finance



### Bond Financing Continues to Expand

So far, corporate debt financing has weakened less than corporate equity financing. Bond financing continued to increase, albeit with less momentum. The annual growth rate of corporate bonds according to the OeNB's securities issues statistics ran to 9.3% in March 2009 and has remained above the rate for the euro area. Enterprises in the quasi-public sector accounted for the lion's share of bonds issued.

The financial crisis has caused the terms and conditions for bond issues to worsen substantially. In fall 2008, corporate bond yields on the euro bond market rose markedly in the wake of heightened uncertainty and higher risk aversion and later stabilized at a high level. Yields went up above all for higher-risk bonds, and in April 2009, yields on BBB-rated bonds came in at about 8.5%.

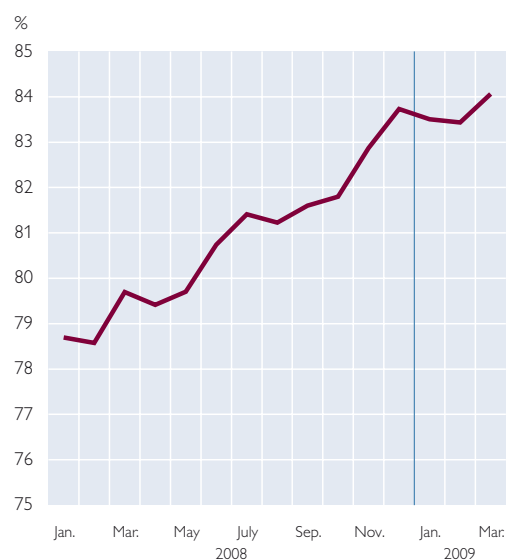
### Bank Lending Has Been Augmenting

Bank loans gained importance among corporate external financing options in 2008, accounting for 73% of external finance in the fourth quarter of 2008 and recording an annual growth rate of 7% in March 2009. For the first time since Stage Three of Economic and Monetary Union began in 1999, the growth rate of banks' lending to enterprises was higher in Austria than in the euro area as a whole, where bank lending growth diminished far more. However, in the first three months of 2009, bank lending growth weakened to EUR 0.6 billion from EUR 2.3 billion in the fourth quarter of 2008.

Bank lending growth partly offset the near-paralysis of capital market financing. Moreover, it is conceivable that companies resorted to bank loans to meet their higher liquidity needs, a conclusion that is corroborated by the circumstance that the rate of increase in enterprises' bank deposits plummeted from fall 2008 onward.

Chart 19

### Credit Line Utilization as Captured by the Central Credit Register



Possibly, the current bank lending expansion partly reflects past borrowing decisions of companies and their stepped-up access to credit lines that were extended some time ago. Data are available only for major loans of above EUR 350,000 and show that companies' usage of available credit lines increased more than banks' extension of new credit lines. As a result, the ratio of utilization of credit lines and the extension of new credit lines advanced continuously throughout the year 2008 from about 79% to just under 84%. In the first quarter of 2009, utilization of credit lines continued to edge upward (chart 19).

Since November 2008, interest on loans has decreased considerably as a result of the massive key interest rate

cuts by the ECB. In March 2009, interest on new loans of up to EUR 1 million to nonfinancial corporations came to 3.4%, on loans of over EUR 1 million to 2.8%, some 2½ percentage points below the October 2008 level in both cases.

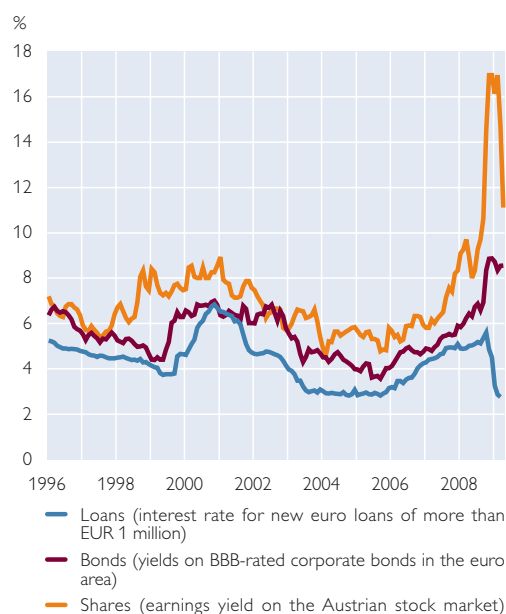
While banks may have cut interest rates on loans, they also tightened lending standards. According to the Austrian results of the euro area bank lending survey, the financial crisis has been hampering refinancing conditions and lending policies, especially in the corporate customer segment, for almost two years. Moreover, the worsening of the economic outlook and more selective credit ratings have contributed to a restrictive lending policy. Since the third quarter of 2007, credit standards for corporate clients have become continuously more restrictive, and conditions and terms – interest margins as well as collateral requirements, the size and maturity of loans granted, the covenants as well as noninterest rate charges – have been tightened.

### Deterioration of Creditworthiness

Increasing use of debt financing raised the ratio of companies' debt to their gross operating surplus from 187% in the first quarter of 2007 to 205% in the fourth quarter of 2008. Debt in relation to GDP also rose from 77% in the first quarter of 2007 to 84% in the fourth quarter of 2008. However, Austrian company debt is still far lower than the euro area average, and it started to expand later than in the euro area, where the increase already began in 2005.

Chart 20

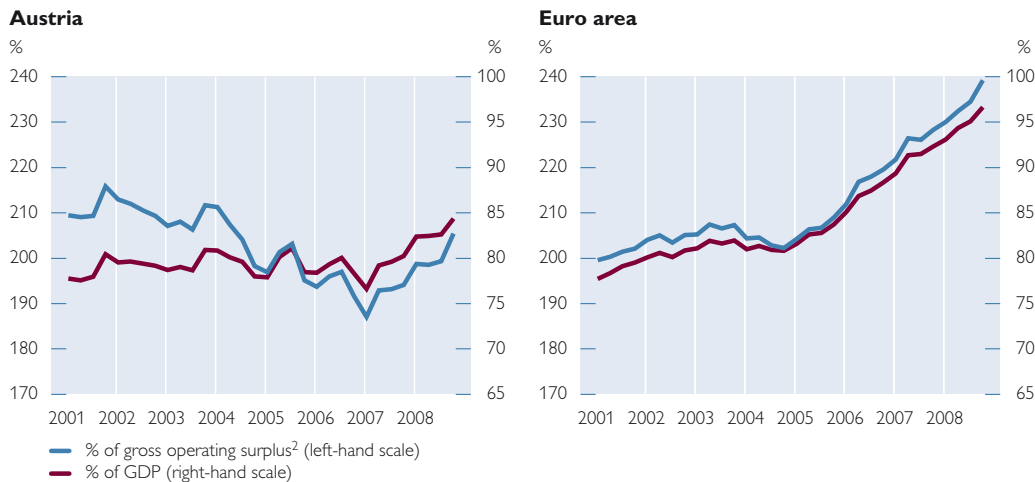
### Corporate Financing Conditions



Source: OeNB, Thomson Reuters, Wiener Börse AG.

Chart 21

### Corporate Sector Debt<sup>1</sup>



Source: ECB, OeNB.

<sup>1</sup> Short-term and long-term loans, short-term and long-term debt securities.

<sup>2</sup> Including mixed income of the self-employed.

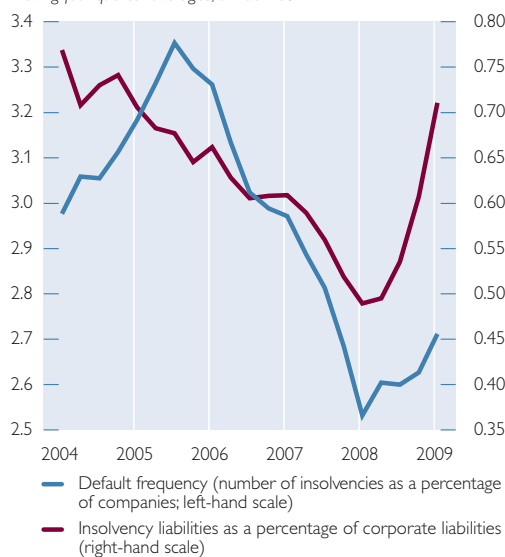
Insolvency statistics clearly signal the deterioration of corporate credit-worthiness. Insolvency numbers and liabilities have been going up since the second quarter of 2008. An analysis of the Austrian credit monitoring agency Kreditschutzverband von 1870 shows

that in 2008 the bulk of insolvencies still resulted from bankrupt companies' internal problems. But a noticeably larger number of insolvencies than in previous years was triggered mainly by external causes, such as changed market conditions, insolvencies of customers or delivery failures of suppliers. Their share went up from 10% to 16%. The share of insolvencies traceable to a shortfall of capital was of the same order and remained unchanged in 2008.

Chart 22

### Development of Corporate Insolvencies

Moving four-quarter averages, annualized



Source: Kreditschutzverband von 1870, OeNB.

### Conclusion: Crisis Seizes Corporate Finance

The financial crisis is impairing Austrian corporate financing. Since the onset of the crisis, companies have had to resort increasingly to borrowing to offset the decline in corporate profits and external equity financing. Consequently, the share of bank lending, which had clearly lost significance in the years leading up to the financial crisis, augmented substantially. Banks have, of course, tightened their lending standards and have been factoring their

clients' risk-bearing capacity and economic prospects more strongly into lending decisions, but in the aggregate, lending to the corporate sector has expanded up to now. The downside is that more borrowing from banks has swelled companies' debt: After rising for years, equity ratios dropped in 2008. Austrian companies have a greater latitude for taking out new debt than euro area companies on average, but primarily debt-based corporate finance carries considerable long-term risk, despite the fact that current low interest rates dampen the cost involved in borrowing.

### Substantial Price Losses Hit Households' Financial Assets

#### Uncertain Business Environment

The economic downturn in the first quarter of 2009 caused conditions in

the Austrian labor market to deteriorate, weakening disposable incomes and dampening consumer spending growth, which came to just 0.9% year on year in 2008. The high household saving rate, which advanced from 11.6% in 2007 to 12.4% in 2008, is evidence of high uncertainty and a lack of household confidence in the economic outlook.

### Lending to the Household Sector Weakens

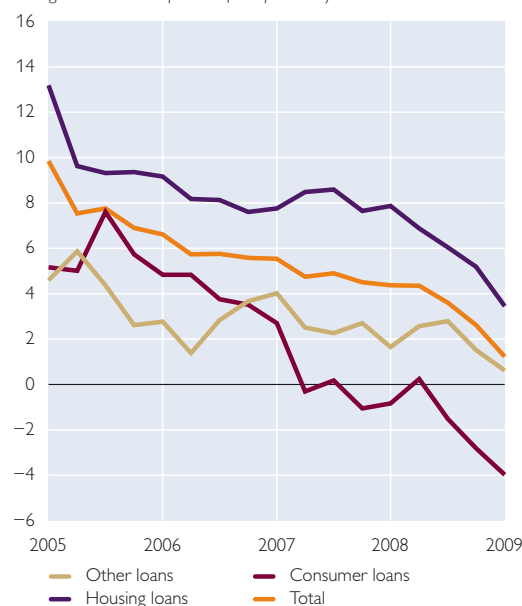
Declining by EUR 0.8 billion in the first quarter of 2009, the growth of lending to households has slumped. This corresponds to a 3.2 percentage point reduction in credit growth against the same quarter of 2008 – credit growth had come to 4.4% in the first quarter of 2008 compared to 1.2% in the first quarter of 2009.

Chart 23

### Lending Growth and Real Estate Prices

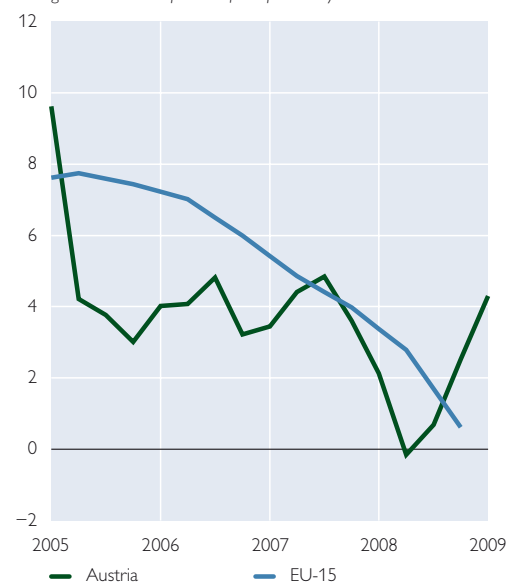
#### Growth of Lending to the Household Sector

Change on the same quarter of the previous year in %



#### Growth Rate of the Real Estate Price Index<sup>1</sup>

Change on the same quarter of the previous year in %



Source: ECB, OeNB, Statistics Austria, Vienna University of Technology.

<sup>1</sup> In nominal terms. For Austria, population-weighted average of Vienna and the rest of Austria (in line with the ECB method).

<sup>1</sup> In the following, the terms households and household sector will be used synonymously.

A breakdown of lending to households by loan type shows that lending weakened above all in the consumer loan category, where the March 2009 figure was 4.0% below the comparable year-earlier value (see chart 23, left-hand panel). The results of the OeNB's bank lending survey (a quarterly survey on bank lending in the euro area) in the most recent quarters suggest that the deterioration of consumer confidence was instrumental in dampening demand for consumer credit. The annualized growth rate of housing loans also diminished to 3.4% in the first quarter of 2009, bringing it some 4.5 percentage points below its year-earlier level. Nevertheless, this decline was far less pronounced than in a number of other euro area countries that are more severely hit by the weakening of their housing markets than Austrian, as a comparison of real estate price indexes shows (see chart 23, right-hand panel).

Moreover, until the end of 2008, the demand for housing and consumer credit was dampened by the long-term rise in interest rates on loans. Lending rates have been on the decline since

November 2008, though, with Austrian MFIs charging clearly lower interest rates on housing loans to Austrian households than on consumer credit.

In addition, the results of the bank lending survey indicate that credit standards for consumer and housing loans were tightened slightly in the first quarter of 2009 in view of banks' high refinancing costs and the gloomy economic outlook.

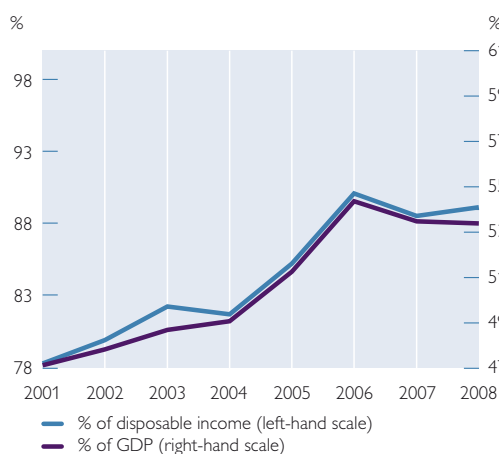
The share of foreign currency loans in total lending to households fell by half a percentage point to 30.3% in the first quarter of 2009. Swiss franc-denominated loans still accounted for the majority of such loans (94%), and Japanese yen-denominated loans for just 5%. As the Swiss franc continued to strengthen against the euro, (unrealized) revaluation losses on foreign Swiss franc-denominated loans came to 1.8% of the volume of foreign currency loans.

Performance risk represents a further risk for households' debt-servicing capacity. In the first quarter of 2009, roughly 74% of all loans to households were based on a repayment vehicle. A

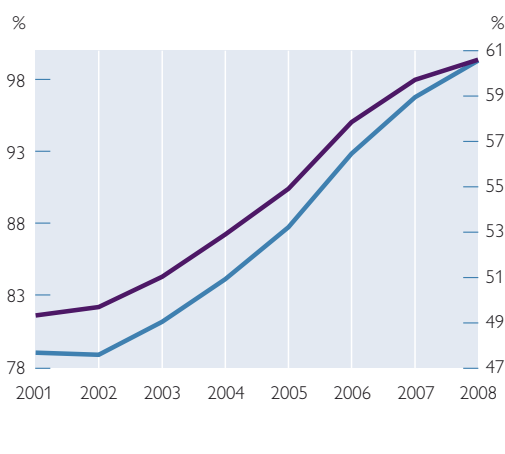
Chart 24

## Household Debt

### Austria



### Euro area



Source: ECB, OeNB.

current survey (see box 3 “Survey on the Risks of Loans Linked to Repayment Vehicles” in the section “The Financial Crisis Takes Its Toll on the Austrian Financial System”) shows that there is a gap in the coverage of repayment vehicle-based lending to households that could result in an additional financial burden to households.

### **Stabilization of Household Debt**

With the growth rate of lending to households easing continuously, the debt ratio of this borrower category has remained stable in spite of the slower increase in disposable incomes. At the end of 2008, the household debt ratio came to around 89% of disposable income or roughly 53% of GDP (see chart 24). Thus, Austrian household debt is moderate by comparison to the euro area average of 99% of disposable income or 61% of GDP.

The development of debt regulation proceedings, i.e. private bankruptcies, also reflected the stabilization of household debt: Whereas the number of private bankruptcies went up by 6% year on year in the first quarter of 2009, the volume of default liabilities expanded less than households’ total liabilities.

### **Interest Rate Risk Is Stable**

With interest rates on loans declining in recent months and as a result of stabilizing household debt in 2008, households’ debt servicing burden – interest payments as a percentage of net dispos-

able income – stagnated after having trended upward for some time. Thus, the interest rate burden remained at 3.9% in the fourth quarter of 2008, the same level as in the third quarter. The most recent developments have already shown a contraction of the household interest payment ratio and therefore a stabilization of their interest rate risk.

Austrian household debt is characterized by a certain degree of heterogeneity masked by the aggregated data. First, not all households indeed carry debt; consequently, the aggregated interest payment ratio is too low for those households that have taken out debt.

Second, the debt-servicing capacity also depends on individual household income. First calculations on the basis of an OeNB-commissioned survey on household real estate assets (OeNB Household Survey on Housing Wealth 2008)<sup>2</sup> signal that in 2007 the debt-servicing ratio (interest payments and principal repayments as a percentage of household net incomes) was above average for the lowest-income households and below average for the highest-income households.

Third, the impact of interest rate changes depends on the type of interest rate agreed for the respective loan. In Austria, the share of variable rate loans is traditionally very high (83.6% in the first quarter of 2009 compared with 47% in the euro area). Hence, market interest rates have a rapid impact on loan interest.

<sup>2</sup> See Fessler, P. et al. 2009. *Real Estate Wealth of Austrian Households (preliminary title)*. In: *Monetary Policy & the Economy Q2/09*. Vienna: OeNB, forthcoming.

Box 1

### Real Estate Financing by Austrian and Euro Area Private Households

Real estate debt accounts for the lion's share of household debt. In summer 2008, the OeNB conducted a survey on housing finance among the Austrian banks most heavily engaged in mortgage lending. A report on housing finance in the euro area provides additional information.<sup>1</sup> The main results of both the survey and the report are summarized below.

In the past decade, household debt for house purchase rose both in Austria and the euro area (from EUR 54 billion in 2001 to EUR 87.8 billion in 2007 in Austria). Several factors contributed to this rise: comparatively low interest rates, increasing disposable incomes and population growth figures, deregulation and liberalization trends that boosted the number of providers and widened the range of financial products. Given the low interest rates level, households' interest rate burden remained under control despite the rise in debt. The loan-to-value ratios (LTVs) rose, and households were given more flexible repayment terms, e.g. longer repayment periods than at the beginning of the 1990s. According to the housing finance survey, LTVs required by Austrian banks ranged from 70% to 96% in 2007, and the maximum duration of mortgage loans extended in 2007 came to 25 to 30 years.

The mortgage spread, i.e. the difference between interest on housing loans and banks' refinancing costs, has diminished in the course of time. This phenomenon may signal stepped-up competition. Moreover, in recent years, more securitization, improved financing conditions and a possible underestimation of risks may have contributed to looser credit standards (though much less so than in the U.S.A. or the U.K.).

The share of variable-rate credits ranged between 10% and 99% of total loans in the euro area in 2007. This huge range is likely to have resulted from different cultural, institutional (e.g. consumer protection considerations) and regulatory as well as fiscal factors (e.g. tax breaks for owner-occupied housing). In Austria, the majority of new loans carry variable interest rates – for new housing loans, the share of variable rate loans ranged from 52.8% to 68.5% in 2008.

In Austria, foreign currency lending plays a key role in housing finance. Foreign currency-denominated loans accounted for 39.2% of all Austrian housing loans in 2008.

<sup>1</sup> ECB. 2009. *Housing Finance in the Euro Area*. ECB Occasional Paper No. 101.

### Continued Large Revaluation Losses in Financial Assets

The transaction volume of household financial assets dropped in 2008 in the wake of rising uncertainty and gloomier economic prospects. In the fourth quarter of 2008, the transaction volume weakened to EUR 2.7 billion, which corresponds to a slowing of the rate of growth from 4.6% in the fourth quarter of 2007 to 4.1% in the fourth quarter of 2008 – a rate last seen in the second quarter of 2002 (see chart 25, left-hand panel).

Households sought to invest in safe investment vehicles, shifting large parts of their portfolio toward less risky assets: Their weaker financial investment

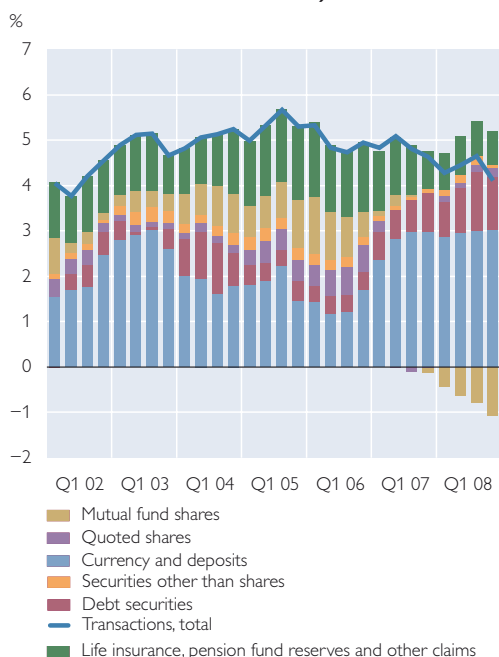
was due primarily to the negative growth contribution of mutual fund shares. The annual growth contribution of this investment category came to –1.1% in the fourth quarter of 2008, following –0.1% growth in the comparable quarter of the previous year (see chart 25). At 0.5% in the fourth quarter of 2008, the growth contribution of life insurance assets was also lower than the 0.7% recorded a year before. The reductions contrast with the increase in the growth contribution of deposits and bonds, with the expansion of bank deposit guarantees likely to have played an important part.

Additionally, massive price losses in the capital markets resulted in market

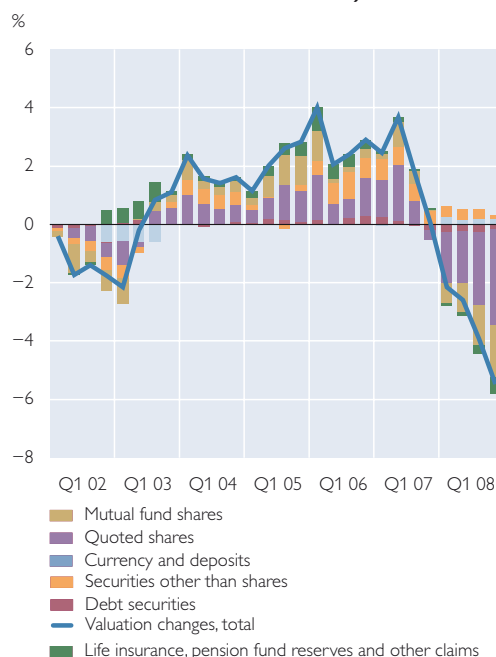


### Determinants of Change in Household Financial Assets

**Transactions<sup>1</sup> (including growth contributions of individual financial instruments)**



**Valuation changes<sup>2</sup> (including growth contributions of individual financial instruments<sup>2</sup>)**



Source: OeNB.

<sup>1</sup> As a percentage of total financial assets four quarters before.

<sup>2</sup> Calculated on the basis of securities data in the case of mutual fund shares, quoted shares and debt securities; calculated as the difference between stock changes and transactions for the remaining aggregates.

value losses of household financial assets also in the second half of 2008 (see chart 25, right-hand panel). These losses hit quoted shares especially hard: The negative valuation effects of this asset category caused overall household financial assets to shrink by 3.3% in the fourth quarter of 2008 against the same quarter of 2007. Measured in terms of households' 2007 year-end financial holdings, stock price losses affected 59% of households' portfolio of quoted shares. The growth contributions of mutual fund shares and life insurance as well as pension fund reserves were also negative in the fourth quarter of 2008, reducing financial assets by 0.6% and 0.2%, respectively, against the previous year. Plummeting stock market prices thus had an adverse effect on funded pension instruments.

### Conclusion: Household Sector Risks Have Increased

Financial sector-induced risks to the household sector have risen massively in the first half of 2009. High valuation losses in capital market investment had noticeable effects on the second and third pillars of pension provision and on the repayment vehicles for redeeming foreign currency loans. Conversely, sagging credit growth has stabilized debt, which, in tandem with the most recent cuts in interest rates, has reduced the interest rate burden on households. More unfavorable prospects for the labor market and for disposable income have increased the risk related to households' debt-servicing capacity, with the debt-servicing burden being proportionately higher for lower-income households in particular.