

# Reports

# Government and Central Bank Support Measures Make an Impact

## **Growth Prospects Look Up**

In the aftermath of the first global recession in decades, the economic situation stabilized owing not least to decisive monetary and fiscal policy action. The abatement of the crisis in the real economy is also reflected in the international financial markets, where investors' risk aversion has decreased sharply. For instance, money market as well as government and corporate bond risk premiums have now receded from their highs by a large margin. However, sustained support for an economic policy-induced end to the recession via private consumer and investor demand is a key factor of uncertainty for future growth prospects.

In addition, most Central, Eastern and Southeastern European (CESEE) economies are showing initial signs of stabilization. At the same time, significant differences still exist within the region: While Poland has not entered recession at all, other CESEE countries have to overcome sharp falls in GDP. In particular, the coordinated approach of the IMF, the EU and international financial institutions in concert with international commercial banks active in the region under the European Bank Coordination Initiative have proved to be a stabilizing factor for both the financial markets and the real economies of these countries and contributed to the responsible behavior of all parties involved. Nonetheless, owing to global, regional and country-specific factors, the current outlook remains subject to considerable uncertainty.

## **Financing Conditions Still Difficult**

Even though the Austrian economy succeeded in returning to positive growth in the second half of 2009, the impact of the crisis on company balance

sheets became increasingly visible. For instance, corporate profits fell by 12% in the second quarter of 2009, reducing the corporate sector's debt serviceability in view of unchanging levels of debt. External financing also contracted significantly. While bond financing resumed significant momentum in 2009 both at home and abroad, lending growth slackened and, following the slump in 2008, equity financing did not recover. The decline in corporate financing volumes is likely to have had both demand and supply-side causes. Corporate financing conditions have, however, recently improved thanks to lower interest rates, economic policy support and smaller risk premiums.

In view of the price losses in the capital market since the start of the crisis, households' financial investment has been marked by safe investment vehicles and, in particular, by deposits. After the financial turmoil revealed the risk potential of foreign currency loans in the form of both valuation losses of repayment vehicle products and currency fluctuations, the foreign currency loan portfolio of Austrian households has slimmed substantially since end-2008 although its levels still remain high at around EUR 36 billion. In the face of a depressed labor market, the household sector's income risk, in particular, has come to the fore as debt levels remain overall steady, even though a survey conducted by the OeNB shows that the volume of debt is concentrated in higher income households.

## **Loan Defaults Continue to Mount Despite Austrian Banks Benefiting from Improved Climate**

At an international level, fall 2009 saw a – to some extent – marked improve-

ment in Austrian banks' profitability on the back of increased trading and commission income. Increased income generation from capital market business suggests however that the recovery is likely to remain subject to considerable volatility.

In Austria too a positive trend is evident – also driven by an improved trading result and robust interest income. In the third quarter of 2009, unconsolidated operating income grew by some 14.1% to EUR 4.9 billion. However, this steep rise is also attributable to the relatively weak result in 2008. Net interest income rose by 9.2% year on year. Trading activities also made a positive contribution to income. Fee-based business, a growth driver over the last few years, deteriorated however by 16.2% year on year.

All in all, favorable operating profitability has hitherto offset the – to some extent – steep increase in loan loss provisions both in Austria and abroad. The fact that the slump in growth is only reflected in banks' books with a time lag means however that a considerable portion of loan loss

provisions is still outstanding. A further steep rise in the loan loss provision ratio of subsidiary banks in CESEE, which steadily climbed since its low of 2.7% in the third quarter of 2008 to 4% in the second quarter of 2009, and in Austria, where it rose to 2.6% in the third quarter of 2009, represents one of the main risks to the Austrian banking sector. The continued high share of foreign currency loans in the CESEE portfolio of Austrian banks further heightens this risk.

Regularly performed stress tests confirm however that Austrian banks overall have sufficient risk-bearing capacity, although the need to further strengthen capital adequacy in the medium term has become obvious, owing not least to the international debate on the quality of the composition and the level of banks' own funds.

The Austrian insurance industry also benefited from the capital market recovery, albeit premium income grew at a modest pace in view of the economic climate. Likewise, the demand for Austrian mutual funds stabilized after having shrunk significantly.