

## Financing Conditions for the Real Sector Deteriorate Marginally

### Corporate Finance Perspectives Cloud over Slightly

#### Investment Activity Quickens

Austrian business activity picked up appreciably in 2006, supported by increasingly animated investment and solid export growth. Investment in plant and equipment was stimulated, above all, by external impulses and reinforced by a rise in capacity utilization.

In parallel to real investment, financial investment gathered momentum in the first six months of 2006, climbing by more than 40% to EUR 12.4 billion. Almost half of all new investment was in securities (bonds and quoted stock), which grew three times as much as in the first half of 2005. As in the previous years, deposits continued to mount, increasing at about the same fast rate as in the first half of 2005, whereas Austrian enterprises' direct investment in companies abroad in the first half of

2006 was lower than the comparable 2005 value according to balance of payments statistics.

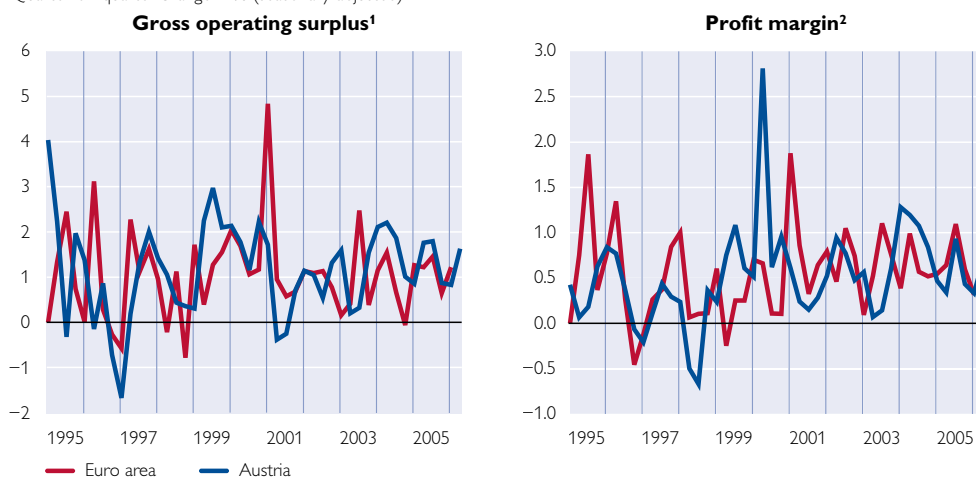
The development of insolvencies mirrored the brighter economic prospects: They sank by 6.4% in the first three quarters of 2006 against the same period of 2005. Both newly opened insolvency proceedings and the number of no asset cases declined. While default liabilities advanced by 3.1% in nominal terms, their share in overall corporate financial liabilities (according to the financial accounts) continued to decrease in line with the downtrend of the past few years; this share stood at 0.7% in the third quarter of 2006.

Overall, the corporate risk perspective deteriorated marginally in the first half of 2006. The rise in interest rates has increased the interest payment burden on companies. Moreover, financing conditions at the Vienna stock exchange (Wiener Börse

Chart 4

### Indicators of Profitability Performance in the Corporate Sector

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



Source: Eurostat.

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

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

AG) worsened when stock prices plummeted in May 2006, thus ending a three-year bullish trend. The end of price increases on the stock exchange also contributed to the (at least) temporary halt to the rise in the capital ratio<sup>1</sup> in the second quarter of 2006, which occurred despite ongoing high equity funding (above all through the stock market). Also, companies' debt ratio augmented slightly in the second quarter of 2006, after having diminished in recent years both as a share of the gross operating surplus and as a share of GDP. By contrast, companies' risk-bearing capacity was bolstered by the pronounced reduction in foreign currency risk in the past few years and by the continued rise in corporate profits.

#### **Internal Financing Potential Remains High on the Back of Sustained Growth in Profits**

Corporate profits made great headway in the past few years and remained high, as in the whole euro area. The development of the profit margin<sup>2</sup> and of the gross operating surplus<sup>3</sup> signal further gains in profits in the first half of 2006. Unit labor costs developed moderately, and still historically low nominal interest rates helped keep financing costs down.

#### **Financing Conditions Deteriorate Marginally**

While financing conditions for Austrian companies remained good in the first three quarters of 2006, they were not quite as favorable as in 2005, both for borrowing funds and for issuing equity capital.

As a consequence of the market setback in the second quarter of 2006, stock prices on the Vienna bourse could not keep up with the pace of profits, resulting in a slight worsening of conditions for procuring corporate finance on the stock exchange. This marginal deterioration is reflected both in the decline of the price-to-earnings ratio and in the widening of the difference between the earnings yield<sup>4</sup> and the government bond yield, whose development may be seen as an indicator of the stock market risk premium.

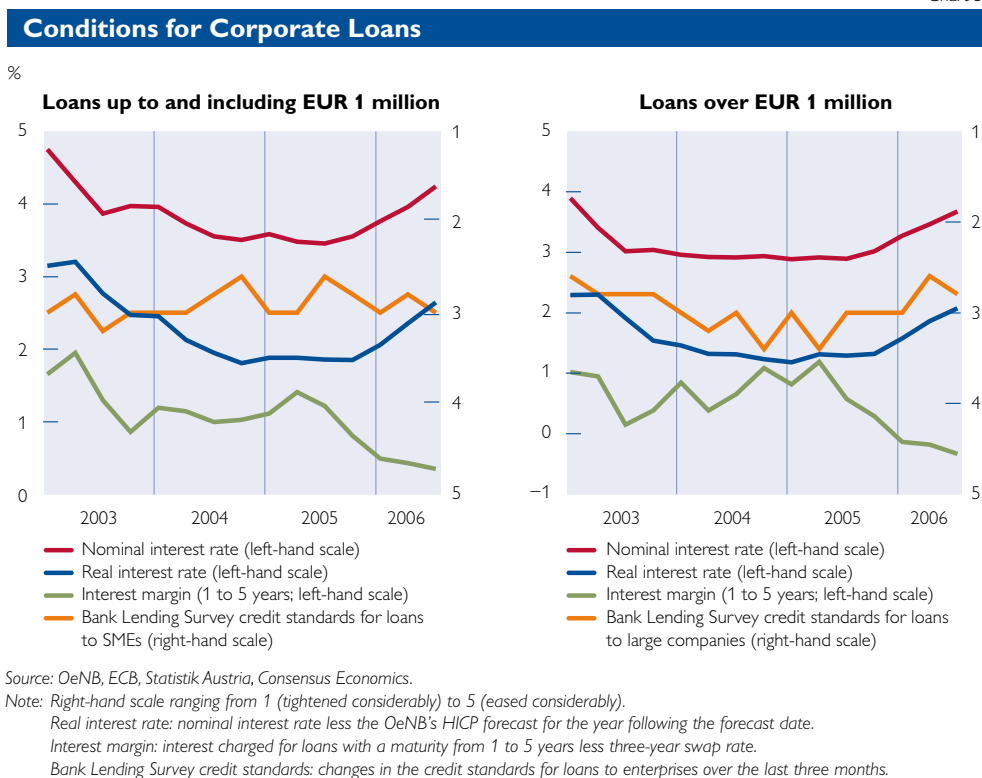
The conditions for borrowing by way of loans also deteriorated in the first three quarters of 2006. The development of the nominal and real interest rates for corporate loans reflects the rise in monetary policy rates since December 2005 (see chart 5). Nevertheless, the interest rate level in Austria remained very low both historically and when compared with that in the euro area.

<sup>1</sup> Strictly speaking, the ratio of shares and other equity to total liabilities. The financial accounts statistics do not cover the claims of equity investors on nonfinancial assets and thus underestimate the absolute level of equity.

<sup>2</sup> The profit margin is the ratio of the deflator of gross value added to unit labor costs.

<sup>3</sup> The gross operating surplus is the surplus created by business activity, after the compensation of the production factor labor. It is calculated from GDP less compensation of employees and less taxes on production (excluding subsidies) and is thus the SNA (System of National Accounts) equivalent of gross operating income. The gross operating surplus constitutes a proxy for measuring absolute profits.

<sup>4</sup> The earnings yield is the inverse of the price-to-earnings ratio.



A comparison of banks' retail interest rates and interest rates for largely risk-free financial assets provides an indicator of the average risk premium contained in banks' interest rates.<sup>5</sup> The difference between interest rates for corporate loans and swap rates of comparable maturities shows that the risk premium for loans up to EUR 1 million decreased further in the first three quarters of 2006; the premium for larger-volume loans remained very low. Most likely, these low premiums are a consequence of the ongoing improvement of economic conditions.

This finding largely coincides with the Austrian results of the Eurosystem bank lending survey, according to which lending conditions were

tightened overall in the first three quarters of 2006. This development hit large companies more than small and medium-sized enterprises (SMEs). At the same time, banks increasingly took risk aspects into account in their conditions for corporate credits: While they reduced the interest margins for lending to borrowers with average credit ratings in the first three quarters of 2006, they raised them for riskier loans.

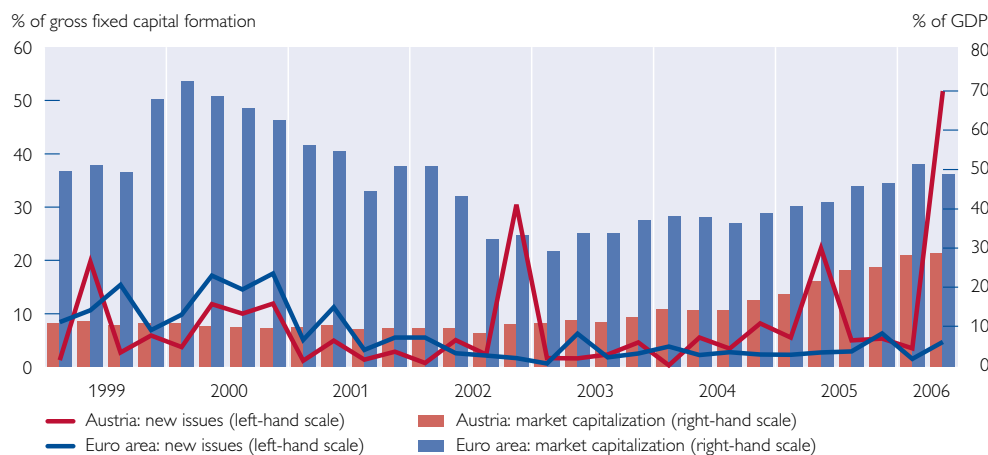
### Capital Market Developments Informs External Financing Structure

Although high profits enabled Austrian companies to finance their activities largely from their own income, their external financing re-

<sup>5</sup> The interest margin reflects not only the credit risk, but also the specific competitive situation of the Austrian loan market, which, while not influencing risk adjustment as such, does have an impact on the volume of risk adjustment.

Chart 6

### New Issues<sup>1</sup> and Market Capitalization of Quoted Shares of Nonfinancial Corporations



Source: ECB, OeNB.

<sup>1</sup> Capital increases and new listings.

quirements surged by about 40% to EUR 14 billion in the wake of more animated investment activity and increased financial investment in the first half of 2006.

About 53% of external corporate financing was in the form of equity. As in 2005, the share of capital market finance exceeded that of funds provided by banks: the percentage of capital market instruments (bonds and quoted shares) in external financing practically doubled to 60%.

An especially large portion of funds was raised in the form of quoted shares in the first half of 2006. New issues on Wiener Börse AG came to about EUR 7.5 billion, with new listings accounting for some EUR 2.5 billion of this amount; the privatization of the Austrian postal service – Post AG – represented the highest volume among the new listings. Moreover, the stock exchange han-

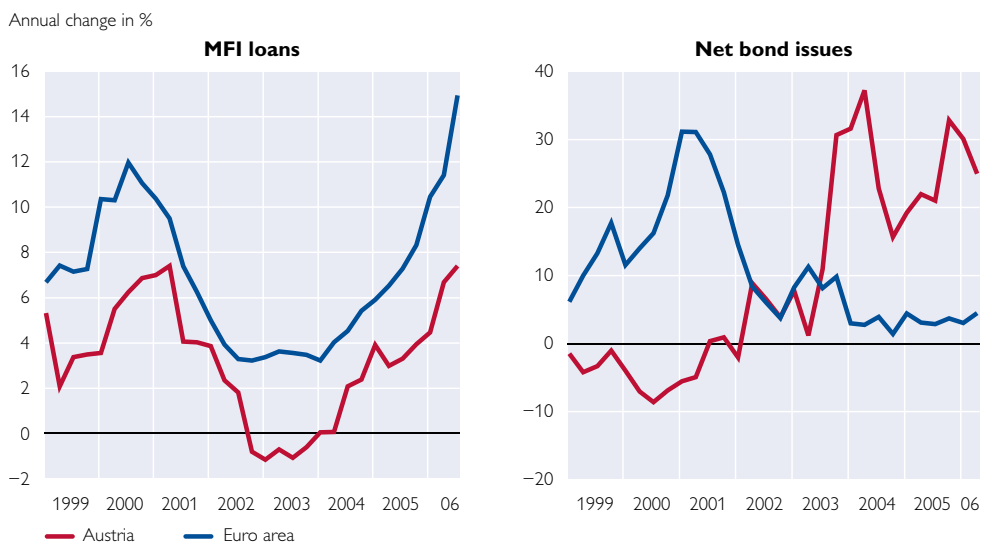
dled numerous capital increases, many of them of real estate companies. On the whole, service companies launched most of the issues on the Vienna bourse.

Thanks to the high issuing volumes, the market capitalization of the nonfinancial corporations listed on the Vienna stock exchange advanced by more than EUR 10 billion to EUR 71 billion in the first half of 2006 – an amount corresponding to some 28% of GDP.<sup>6</sup> By contrast, the drop in stock prices in May 2006 acted as a damper on the rise in market capitalization on Wiener Börse AG, which had been fueled by stock price gains in the preceding years.

Among debt components, bond-based financing remained highly dynamic in the first half of 2006. According to the OeNB's securities issues statistics, the outstanding volume of corporate bonds went up by

<sup>6</sup> The market capitalization of all stocks listed on Wiener Börse AG (including financial corporations) came to more than 48% of GDP at mid-2006.

**Corporate Debt Financing**



Source: ECB.  
Note: Percentage change against the previous year on the basis of changes in transactions, i.e. adjusted for reclassifications, revaluations, exchange rate and other nontransaction changes.

more than 20% against the previous year, once again far more than the euro area equivalent.<sup>7</sup>

Bank lending to the corporate sector accelerated in tandem with the rise in investment; its annual growth rate came to 7.4% in the third quarter.<sup>8</sup> Until recently, however, growth in this segment has lagged behind that observed in the euro area. All new loans to companies were denominated in euro; enterprises reduced their outstanding foreign currency loans by 2.2% year on year in August 2006.

According to the Austrian results of the Eurosystem bank lending survey, in the first three quarters of 2006, enterprises took out loans mainly to fund mergers and acquisitions or to finance corporate restructuring. Moreover, a key motive for

borrowing was to fund fixed capital formation. Bond issues, however, reduced enterprises' demand for bank loans.

As in previous years, in the first half of 2006, the financing of loans by foreign parent companies accounted for a substantial share of the corporate sector's external finance.

**Rise in the Capital Ratio as Shown in the Financial Accounts Slows**

Even though the end of the rise in stock prices on the Vienna stock exchange did not affect funding by means of stock issues until mid-2006, it probably did have an impact on companies' capital ratio as shown by financial accounts data. The rise in corporate capital ratios in recent years resulted not only from external equity financing, but also from the de-

<sup>7</sup> By analogy to the ECB method, the outstanding volume of bonds is calculated as the percentage change against the previous year on the basis of changes in transactions, i.e. adjusted for reclassifications, revaluations, exchange rate and other nontransaction changes.

<sup>8</sup> Bank lending to the corporate sector is also calculated using the ECB method.

velopment of stock prices. As international conventions prescribe that equity raised on the stock exchange be valued at current market values in the financial accounts, the Austrian capital ratio, which had been comparatively low for a long period, had been largely attributable to the low valuation of stock prices on Wiener Börse AG. When the Austrian Traded Index ATX caught up in the course of the last years, the Austrian capital ratio moved closer in line with the European average: While the Austrian capital ratio was still 24 percentage points below the European average in 2000, the gap narrowed to just under 13 percentage points in 2005. The end of the bullish trend on the stock market halted this development, and the capital ratio sank slightly in the second quarter of 2006. However, it should be noted that this decline stemmed exclusively from the calculation method and, considering the volatility of stock prices, is not necessarily indicative of an enduring development.

### Interest Expenses Rise

Despite the dynamic growth of lending to the corporate sector (which was related above all to the rising significance of equity in the financing structure), the sector's exposure to interest rate risk has declined perceptibly in recent years.<sup>9</sup> The share of bonds and loans in total corporate sector liabilities contracted from 62% to 54.6% between 2002 and 2005 (see chart 8, right panel).

How rapidly regular interest payments reflect interest rate changes depends not just on the amount of liabilities on which interest is paid, but also on the fixation periods of the amounts outstanding. As bond-based financing has become more widespread, so have longer-term interest rate fixations, given that bonds usually have fixed rates. Most bank loans are at variable rates, even those with longer maturities. In the first half of 2006, the structure of loans shifted slightly in favor of longer fixation periods. The share of loans at floating rates or up to 1 year initial rate fixation periods in new business dipped in recent months, but at about 90% remained very high in a euro area comparison.

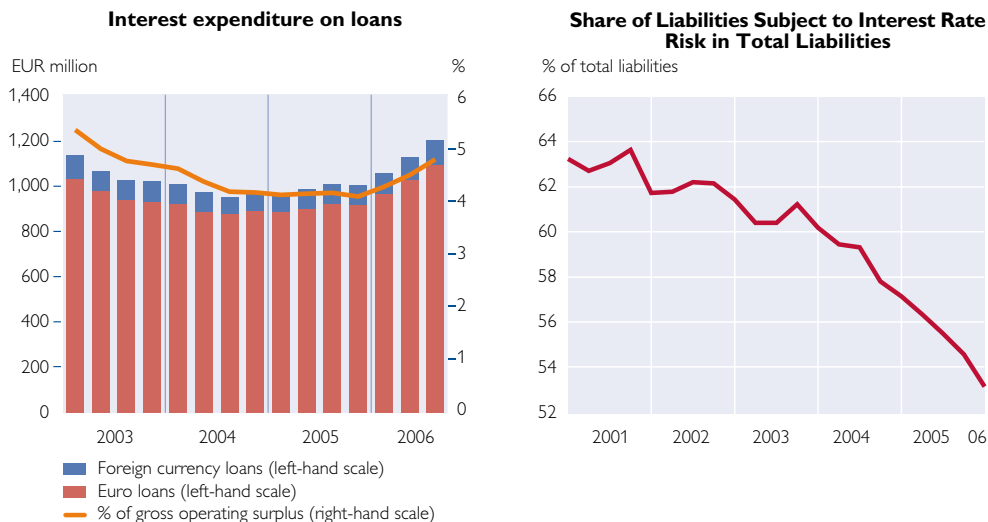
The corporate sector's interest expenditure is likely to rise slightly in 2006, both because enterprises took out more loans and because interest rates have increased. We multiplied the volume of loans outstanding by the relevant interest rates to obtain an estimate of the cost burden of interest payments on enterprises. To calculate interest on loans, we used the interest rates recorded in the interest rate statistics.<sup>10</sup>

This method only takes into account interest payments, but not non-interest rate charges (such charges are especially relevant in the case of foreign currency loans). Interest expenditure already edged up in nominal terms in 2005; in 2006, it also rose in relation to corporate profits (the gross operating surplus), though it still re-

<sup>9</sup> This aggregated perspective does not take into account the corporate sector's use of hedging instruments (and the possible risks associated with such instruments).

<sup>10</sup> The interest rates for new business (both corporate and household) were used to determine interest on foreign currency loans, as the interest rate statistics do not contain any data on outstanding amounts of foreign currency loans. As the lion's share of foreign currency loans is at variable rates, which are adjusted periodically, the inaccuracy of this method is not likely to be very large.

**Interest Rate Risk in the Corporate Sector**



Source: OeNB, Thomson Financial.

Note: Interest expenditure on euro loans: euro loans to nonfinancial corporations according to MFI balance sheet statistics multiplied by the corresponding interest rates on outstanding amounts according to the ECB interest rate statistics. Interest expenditure on foreign currency loans: foreign currency loans to nonfinancial corporations according to MFI balance sheet statistics multiplied by the corresponding interest rates on U.S. dollar, Japanese yen and Swiss franc loans to households and nonfinancial corporations according to the ECB interest rate statistics. Liabilities subject to interest rate risk: loans and bonds.

mained markedly below the 2003 values. Considering that the calculation is an approximation, these figures are surrounded with uncertainty. Nevertheless, they do indicate that higher interest expenditures are beginning to negatively affect the risk-bearing capacity of the corporate sector, even though the share of items on which companies pay interest in their financing structure is declining.

**Push to Reduce Foreign Currency Loan Exposure**

Companies have reduced their exchange rate risk substantially in recent years. The share of foreign currency loans in the corporate portfolio came to just 11.6% at the end of September 2006, down 6 percentage points from three years earlier. Moreover, the share of foreign currency-denominated corporate bonds has fallen markedly in recent years. This trend has helped keep exchange rate effects on foreign currency loans

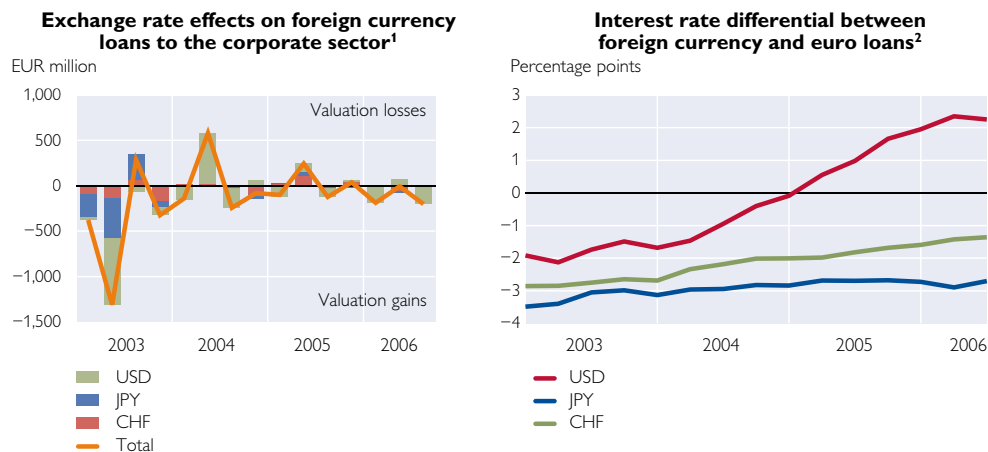
fairly small in the past few quarters (see chart 9, left panel). It should be noted that these exchange rate effects are purely unrealized rather than realized losses or gains.

The share of loans denominated in Japanese yen has sunk considerably below the share of U.S. dollar-denominated financing, implying that the respective exchange rate risk incurred increasingly corresponds to a real transaction. This decline in foreign currency lending was probably influenced measurably by the narrowing differential of interest rates on foreign currency and on euro loans (see chart 9, right panel).

**Corporate Risk Perspective Worsens Slightly**

The corporate sector's risk position was quite positive at mid-2006: After expanding robustly in recent years, the capital ratio exceeded the values of the previous years, and the debt ratio was below the highs it had posted

Chart 9

**Foreign Exchange Risk in the Corporate Sector**

Source: OeNB.

<sup>1</sup> Exchange rate change multiplied by the loan volume (average of the current and previous month).<sup>2</sup> Interest rate statistics data on new business: Interest rate for loans to households and nonfinancial corporations in U.S. dollars, Japanese yen and Swiss francs minus interest rate for euro loans to nonfinancial corporations.

in the past years. The increased equity ratio and the greater reliance on bond financing have reduced the relative dependence of corporate finance on interest rate developments. Companies have also cut their foreign currency risk exposure substantially. The (until recently) unbroken rise in profits and the positive economic outlook have also given no indication of a sudden slump in profits.

However, in the first half of 2006, signs of a marginal worsening in companies' risk-bearing capacity arose: Financial market developments had underpinned the corporate sector's financial position in recent years, but no longer did so in 2006. Although financing conditions are still favorable by historical standards, they have been impaired somewhat by higher interest rates and the downturn in stock prices on the Vienna stock exchange. At the same time, the end of the sharp rise in stock prices has halted the catching-up process of the

capital ratio at least temporarily. The corporate debt ratio augmented marginally in the second quarter of 2006. The high share of variable rate loans in corporate borrowing has, however, caused companies' financing costs to go up recently. To sum it up, the corporate sector's risk position deteriorated slightly in the first half of 2006.

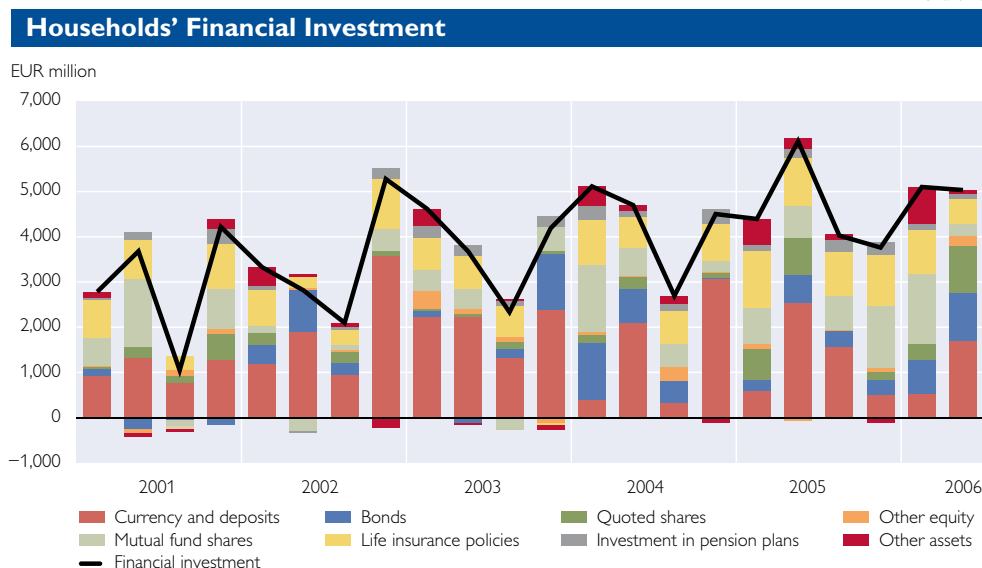
**Households' Financing Situation Deteriorates Slightly****Employment Climbs, Real Wages Merely Edge Up**

A look at developments on the labor market shows a powerful rise in employment,<sup>11</sup> which – together with a greater number of persons in training programs – resulted in a decline in unemployment figures. Unlike in the last few years, real incomes are also expected to advance in 2006. The saving ratio has been on the rise since 2001. It came to 9% in 2005 and is anticipated to augment further in

<sup>11</sup> Both full and part time employment.



Chart 10



Source: OeNB.

2006. The number of private bankruptcy cases in the first three quarters of 2006 was 16% higher than in the same period of 2005; at the same time, the amount of bankruptcy liabilities enlarged by only 5.2%.

### Long-Term Securities Account for Half of All Financial Investment

In the first half of 2006, stocks, bonds and mutual fund shares accounted for almost half of households' total financial investment. By category, financial investment differed markedly in the first and second quarters of 2006. As enterprises raised substantial capital on the Vienna stock exchange (Wiener Börse AG) in the second quarter, household direct investment in stocks listed on the stock exchange was very high.

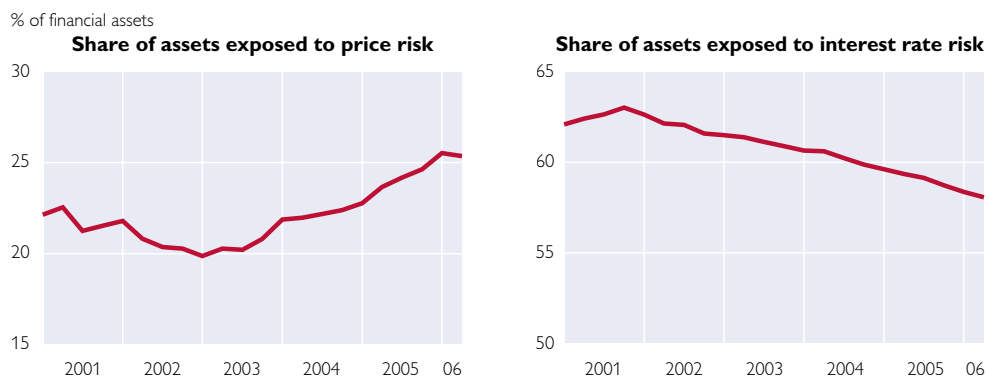
Households' financial investment is subject to interest rate risk (deposits, bonds and mutual fund shares<sup>12</sup>) and price risks (quoted stocks, bonds and mutual fund shares). The growth of the share of household financial assets subject to price risk since 2003 reflects Austrian households' greater investment in marketable instruments. In the past five years, quoted stocks have made especially large gains among household financial assets exposed to price risk. Therefore, the share of assets in this category whose price risk results from stock price changes (quoted stocks, mutual fund shares<sup>13</sup>) expanded more than the share of assets subject to price risk on account of interest rate changes (bonds).<sup>14</sup>

<sup>12</sup> In the case of mutual fund shares, only fixed-income (bond-based) funds should be taken into account; however, the financial accounts statistics do not distinguish between different types of mutual funds.

<sup>13</sup> This calculation should only take into account equity funds. The mutual fund statistics show that Austrian mutual fund assets covering about 95% of the assets that Austrian households invest in mutual funds break down into bonds (54%), mutual fund shares (23%) and stocks (16%).

<sup>14</sup> As structured products are gaining ground, it will become harder to distinguish between individual components in the future.

Chart 11

**Risk Exposure of Household Investment**

Source: OeNB.

Note: Assets exposed to price risk: debt securities, quoted shares and mutual fund shares.

Assets exposed to interest rate risk: deposits and mutual fund shares. Only bond funds should be taken into account in the case of mutual fund shares, but no separate data are available.

While the share of assets subject to price risk has risen, the share of assets subject to interest rate risk has steadily diminished in recent years. For the purpose of this analysis, only the direct effects of an interest rate change are taken into account, not the indirect impact e.g. on stock price developments. 85% of the assets subject to interest rate risk are deposits; they account for nearly half of all household financial assets. Clearly, the household sector's relative risk exposure has shifted from interest rate risk to price risk. Hence, capital market developments now have a greater impact on the valuation of household financial assets.

**Capital Market Valuation Losses in the Second Quarter of 2006**

With stock prices sliding, households' stock investments suffered valuation losses in the second quarter of 2006, following valuation gains in the first quarter. Bond prices declined in the wake of interest rate hikes, resulting in valuation losses of bond investments in the first half of 2006. Developments on the stock and bond markets had repercussions on mutual

funds, which consequently faced valuation losses in the first half of 2006. Overall, households chalked up valuation gains on their capital market investments in the first half of 2006, but these gains fell short of the profits made in 2004 and 2005. When the ATX recovered in autumn 2006, households enjoyed valuation gains once again. In any case, the drop in prices in the second quarter clearly demonstrated the risks involved in investing in capital markets.

**Financial Assets Highly Intermediated**

Households may bear the entire valuation risk of their assets or let other sectors (e.g. intermediaries) bear (part of) it. Some 65% of household financial assets are highly intermediated (deposits and life insurance policies), 15% to a medium degree (mutual fund shares and investment in pension fund plans), and about 20% to a low degree (direct investment in capital markets, shares and other equity). As a case in point, mutual fund shares represent about 45% of all capital market securities – stocks, bonds and mutual fund shares – in Austrian

Chart 12

**Valuation Gains and Losses in Household Financial Assets**



Source: OeNB.

Note: Value for 2006 calculated as net changes adjusted for transactions.

households' portfolios. Unlike private investors, mutual funds are equipped to operate on the basis of professional risk management principles. Typically, mutual funds' investment is more diversified than that of households, which invest directly. Therefore, mutual funds are able to reduce the risk arising from price changes of individual stocks. Consequently, households may reduce the risk involved in investment on capital markets by investing in mutual fund shares. Additionally, households do not assume the full risk of investment in life insurance policies (15% of household financial investment) either, as this investment comes with minimum capital guarantees.

Assessments of the risk aspect of investment in life insurance policies and in pension plans must take into account these assets' long-term investment horizon. The assets invested in these two instruments cannot be withdrawn at short notice, or only at a cost; therefore, households cannot use them to cover expenses, e.g. in the case of income losses. The share

of assets invested in pension plans rose from 1.6% at the end of 1995 to 3.6% at the end of the first half of 2006, that invested in life insurance policies increased from 11% to 15%.

**Weak Credit Growth**

The growth of credit to Austrian households in the first nine months of 2006 fell short of the year-earlier value. In September 2006, the annual rise in monetary financial institutions' (MFI) lending to households came to 6.1%, adjusted for nontransactional changes. Consumer loan growth declined more than home loan growth. Austrian households' new debt consisted mainly of housing loans, which accounted for 55% of new loans and about half of households' liabilities.

Credit growth is much higher in the euro area as a whole than in Austria, and the decrease in credit growth started much later in the euro area. Housing price developments and structural changes on credit markets in some euro area countries may be implicated in the difference in credit

developments between Austria and the euro area.

Housing loans are generally secured by real estate. Real estate price growth has accelerated since mid-2005 (annual growth of the price for owner-occupied housing in the second quarter of 2006: 6.8%). In the preceding years, however, real estate prices tended to grow at a slower rate than in the euro area. Consequently, no significant valuation losses of real estate or problems for housing loans resulting from valuation losses are on the horizon.

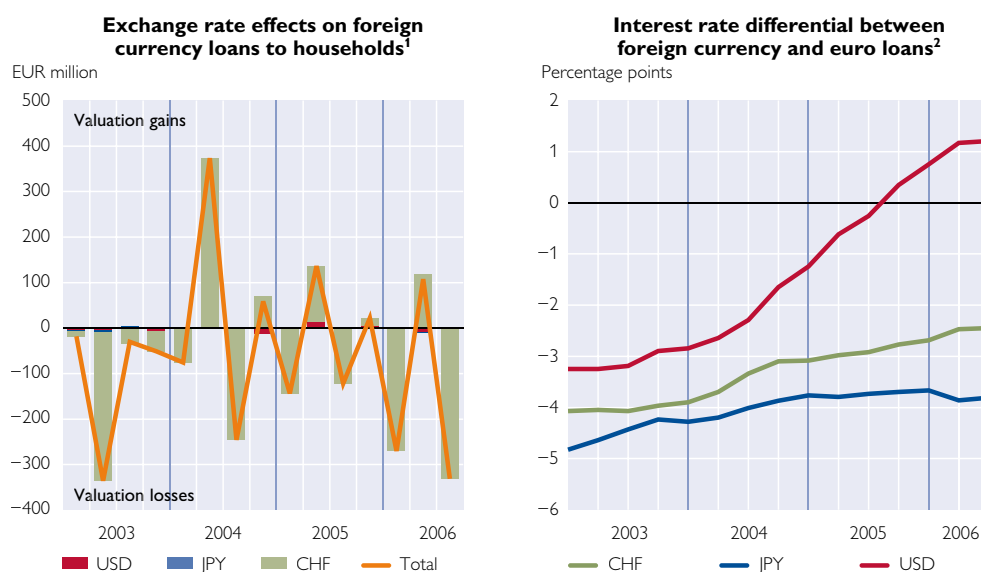
### Foreign Currency Loans Remain an Important Source of Finance

The share of foreign currency lending in the total volume of loans outstanding edged up again slightly in the first half of 2006 and came to about 32%. By currency, Swiss franc-denominated loans have expanded to account for

over 96% of foreign currency loans; all other currencies have come to play a negligible role. In terms of currencies' exchange rate volatility record, the Swiss franc showed less fluctuation in the past than the Japanese yen or the U.S. dollar. However, in the second quarter of 2006, movements of the Swiss franc exchange rate resulted in valuation losses of Swiss franc-denominated loans. But overall, foreign currency loans posted valuation gains in the first nine months of 2006. The interest rate differential between Swiss franc-denominated and euro-denominated credit has been contracting steadily since 2004. Interest rate increases in Switzerland have increased the interest rate burden on foreign currency loans. As foreign currency loans are bullet loans with variable interest rates, interest rate hikes impact fairly rapidly on the entire initial lending volume.

Chart 13

### Foreign Exchange Risk in the Household Sector



Source: ECB, OeNB.

<sup>1</sup> Exchange rate change multiplied by the loan volume (average of the current and previous month).

<sup>2</sup> ECB MFI balance sheet statistics data: Interest rate for loans to households and nonfinancial corporations in USD, JPY and CHF minus interest rate for euro loans to households.

### Credit Standards Deteriorate Slightly

Standards on loans to households worsened somewhat in the first three quarters of 2006. The interest rate increases in the euro area have already had a noticeable effect on consumer lending, causing both nominal and real interest rates to rise. By contrast, interest rates on housing loans have gone up only a bit. In new business, the effective rate of interest on consumer loans was 87 basis points higher at the end of the third quarter of 2006 than one year earlier; the rise came to 67 basis points for housing loans. Overall, lending rates are still to be considered low.

According to the bank lending survey results, the standards for housing loans and consumer loans also differed. Standards for housing loans

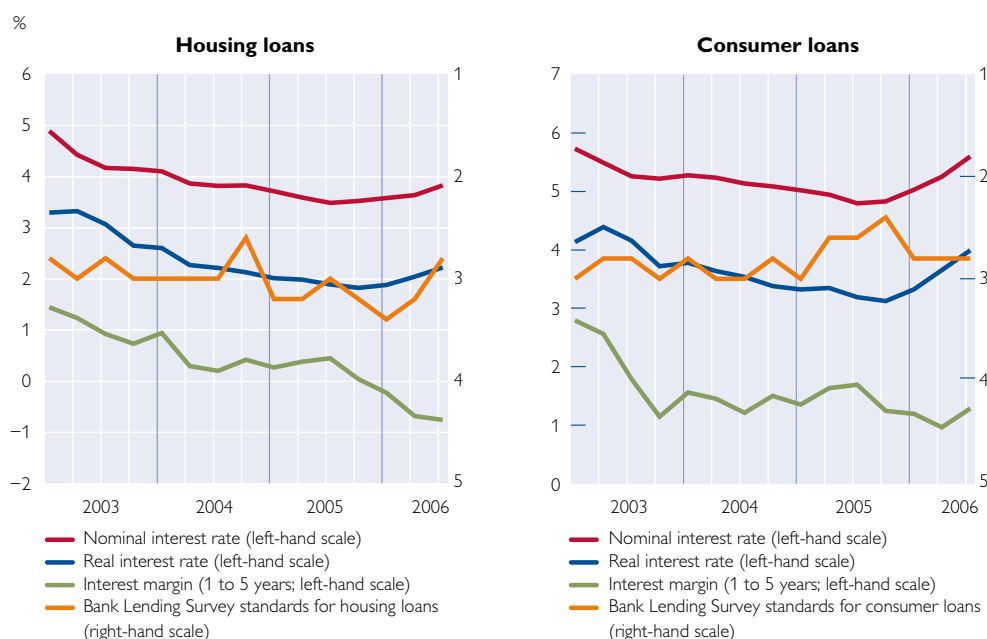
were eased further in the first half of 2006 and tightened marginally only in the third quarter of 2006, whereas standards for consumer loans were tightened successively from 2005 onward.

### Interest Rate Burden Rises

The rise in interest rates along with higher debt increased households' interest expenditure on personal loans. As variable rate loans represent a fairly large share of household credits, higher interest rates translate relatively quickly into higher interest expenditure by households. The share of variable rate loans in new housing loans stood at roughly 50% and at over 90% for new consumer and other loans to households. Foreign currency loans are strictly at variable rates.

Chart 14

### Standards for Household Loans



Source: ECB, OeNB.

Note: Right-hand scale ranging from 1 (tightened considerably) to 5 (eased considerably).

Real interest rate: Nominal interest rate less the OeNB's HICP forecast for the year following the forecast date.

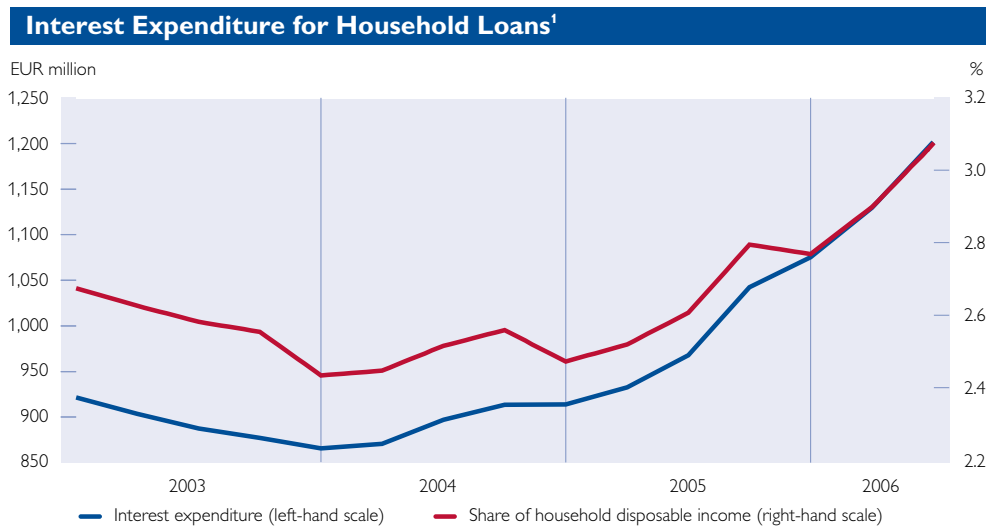
Interest margin: Interest charged for loans with a maturity of 1 to 5 years less three-year swap rate.

Bank Lending Survey credit standards: Changes in the credit standards for loans to households over the last three months.

Interest expenditure<sup>15</sup> has been on the rise since the beginning of 2004. The lift in interest rates since the third quarter of 2005 has accelerated the rise in interest expenditure. The share of household disposable income (according to national accounts)<sup>16</sup> spent to pay interest on loans averaged 3.1% in the third quarter of 2006. This value rose by 0.5 percentage point from the third quarter of 2005. Interest expenditure did not increase by much considering the size of the key interest rate increases in the euro area, a circumstance that may be explained by the fact that interest rates of loans outstanding, in particular of housing loans, were raised only marginally or have not been lifted yet. Therefore, most of the higher interest burden stemmed from

stepped-up interest expenditure on consumer loans (more consumer loans are at variable rates than housing loans) and on Swiss franc-denominated foreign currency loans (always at variable rates). However, when interpreting interest expenditure figures, it must be noted that the result is only an estimate of the cost burden of loans on households and that other factors are disregarded, e.g. non-interest related charges and subsidies, with the latter playing an important role especially for housing loans. Additionally, only interest payments, not payments of principal are considered. Finally, interest expenditure is determined by relation to the total disposable income of all households, including households that have not taken out a loan. A household survey conducted by the OeNB<sup>17</sup>

Chart 15



Source: OeNB.

<sup>1</sup> Volume of loans outstanding multiplied by the interest rate for loans outstanding according to the interest rate statistics (interest rate for new businesses in the case of foreign currency loans).

<sup>15</sup> Interest expenditure for household loans is calculated as the product of the volume of loans by maturity and purpose, and of the respective interest rate.

<sup>16</sup> Disposable income also covers the income of nonprofit institutions serving households. The calculations are based on provisional OeNB forecast values.

<sup>17</sup> Compare Beer, C., P. Mooslechner, M. Schürz and K. Wagner, 2006. Austrian Households' Financial Wealth: An Analysis Based on Microeconomic Data. In: Monetary Policy & the Economy Q2/06. OeNB. 94–110.

indicates that 40% of all households have taken out a loan. For these households, interest expenditure relative to income is correspondingly higher.

### **Household Financial Risk Increases**

While in 2005 households benefited from strong valuation gains on capital markets and very low interest rates on loans, capital market and interest rate developments in the first half of 2006 tended to have a negative effect on households' financial situation. These developments contrast with the surge in employment in the first half of 2006, which also resulted in lower jobless figures.

As the share of variable rate loans in households' portfolios is large, the household sector's financial liabilities are subject to sizeable interest rate risk; because they also contain a substantial share of foreign currency loans, they are subject to nonnegligible exchange rate risks and risks associated with the repayment vehicles as well.

In a euro area comparison, though, household debt is relatively low in Austria (2005: 54.2% of GDP). Household debt differs widely among euro area countries and averaged 63% of GDP in 2005.

Moreover, while interest rates on loans rose in the first half of 2006,

they nevertheless remained low in a long-term comparison. An assessment of the interest burden on households must also take into account that the household sector's total deposits exceed the total amount of outstanding loans. Hence, depending on the respective development of deposit and lending rates, in aggregate terms households' interest income could in fact rise more than their interest payments. From a financial stability perspective, though, the risks associated with higher interest payments outweigh the advantages of higher interest income.

In the second quarter of 2006, the valuation risk of households' investment on the capital markets materialized. When interpreting the financial stability aspect of valuation risk, one must not forget that most of the investment in long-term securities in the household sector is concentrated in the upper income and wealth deciles.<sup>18</sup> Thus, the holders of risky investment products are mostly households that should be in a position to absorb potential price losses. However, as saving for retirement by investing in capital markets has gained importance, developments in capital markets will play a greater role in assessing the financial stability of the household sector in the future.

<sup>18</sup> Compare Beer et al. 2006. *op. cit.*