Growing Financial Market Volatility

Robust International Economy

Industrialized countries have so far proved to be fairly resilient to the increased price of crude oil. Although inflation rates increased on the back of rising oil prices, contagious effects on other goods and second-round effects in wage setting remained limited. In addition to a further surge in oil prices, above all, a disorderly correction of the high U.S. current account deficit and a significant rise in long-term bond yields could however dampen growth.

Yield Increases in International Financial Markets

Since September 2005, international bond markets have seen a rise in long-term interest rates, mirroring market players' expectations of economic recovery, but also fueled by recently emerging inflation and interest rate concerns especially in the U.S.A.

In addition, yield spreads on corporate bonds against government bonds of similar maturity widened slightly, although they were still low on a long-term basis. This reflected two factors: first, a favorable corporate profit situation, involving improved debt ratios with, at the same time, rather modest investment; second, institutional investors' continued high levels of willingness to assume credit risk ("the quest for yield") are also likely to have played a part.

Robust corporate profitability also fueled stock performance on international stock exchanges, superseding the effects of elevated oil prices. The Austrian Traded Index (ATX) continued to outperform leading international stock indices in the course of 2005 and in the first quarter of 2006 until stock prices started to tumble in mid-May 2006.

All in all, there was growing nervousness in the international financial markets in spring 2006, the visible sign of which was the liquidation of carry trades (in which investors borrowed in low interest rate countries and invested in higher-yielding bonds from countries like Hungary, Iceland or New Zealand) and increased volatility in the precious metal markets.

Sound Financial Position of Austrian Enterprises and Households

In 2005, financial market developments favorably influenced the performance of Austrian investors' portfolios. This held true for both institutional investors (such as insurance companies or mutual funds) and households. However, increased investment in capital market instruments and insurance products did not only generate high valuation gains for households but also enhanced their risk exposure.

In recent quarters, the Austrian economy gained momentum. As businesses continued to post growing profits, their internal financing potential was high over the reporting period. Along with the increase in equity raised externally, this has boosted the corporate sector's capital position. In 2005, the share of capital market instruments (bonds and stocks) as a percentage of external financing doubled.

Financing terms were favorable in the period under review. Provided profit growth continues to be positive, the debt-bearing capacity of enterprises should remain high, even if interest rates rise further. In addition, the corporate sector further reduced its interest rate risk in 2005 by enhancing the share of equity financing and increasingly making recourse to the bond market.

As regards the financing of households, the continued rise in foreign currency borrowing entails risks of which households should be made more aware of. In light of its considerably stronger net asset position, however, the household sector's financial situation has not deteriorated on the whole.

Austrian Banks Show Dynamic Profit Growth

Despite the latest problems at BAWAG P.S.K.[1] and Hypo Alpe-Adria Bank, the profitability of the Austrian banking system improved substantially in 2005. Contributing factors were not only the further expansion of international business but also enhanced profits on the domestic front, which were mostly attributable to income from participating interests as well as fees and commissions, whereas fierce competition kept the domestic interest margin low.

Yet again, the results of Austria's leading banking groups in Central and Eastern Europe (CEE) made a major contribution to the sector's improved profitability. In 2005, Austrian banks continued to expand their operations in this region. Business in CEE already accounts for 35% of the Austrian banking system's operating profit. Focusing their activities in particular on the new EU Member States, Austrian banks have reduced the risks arising from the institutional, legal and economic environment in these markets. At the same time, however, an even more dynamic performance by Austrian banks is visible in CEECs that have not joined the EU (yet). In these countries, though, expected higher returns of course also involve higher risk. Furthermore, the correction of external imbalances that have been building up in some CEECs both within and outside the EU may diminish banks' revenues.

As before, the capital adequacy levels of Austrian banks are high, and the results of stress tests confirm that the banking system is able to withstand shocks. In 2005, Austrian banks' credit risk decreased, whereas their market risk increased moderately.

From an overall perspective, the Austrian banking system is thus currently in good shape. External assessments of Austrian banks support this finding even if the ratings of some credit institutions have recently fluctuated under the influence of the latest developments. However, the valuation of Austria's major exchange-listed banks continued to rise sharply in 2005, reflecting investor confidence in their business model.

[1] *See also Box "BAWAG P.S.K. and Hypo Alpe-Adria: No Threat to Financial Stability."*