

Austria's Financial System Continues to Perform Well in a Difficult Environment

Financial Market Turmoil Marginally Dampens Growth Prospects

On the whole, growth in both the industrialized and the emerging market economies was robust in the first three quarters of 2007, despite persistently high oil prices. While the U.S. subprime mortgage market crisis is likely to act as a damper on growth in the fourth quarter, especially in the U.S.A., economic activity is forecast to remain positive in 2008, with protracted turmoil in the financial markets representing the main downside risk. Most Central, Eastern and Southeastern European (CESEE) countries posted substantially higher growth than euro area countries in the first half of 2007 in an ongoing surge of economic catching-up supported by a rise in domestic lending that outpaced deposit growth by a good measure in some countries. However, existing economic imbalances were reinforced in some countries, further aggravating interest rate and exchange rate risk.

Responding to the financial market turbulences, major central banks injected liquidity into the money market at several instances, which helped calm markets. Both swap spreads and risk premia on corporate bonds increased until the turmoil in the markets peaked mid-August, but sank again afterwards. However, by October 2007, only the risk spreads on corporate bonds had declined to below the level predating the crisis. This drop reflected companies' good profit performance. After prices on global stock markets had plummeted at the height of the turbulence, they remained volatile in the following months. The CESEE foreign exchange

markets succeeded in stabilizing again, with the Romanian leu representing an exception.

Real Economy Sectors' Risk Position Remains Good in the Face of Worsening Financing Conditions

Austria experienced a boom in 2007, which is likely to have climaxed judging by the overall European trend. Austrian companies continued to chalk up expanding profits despite the euro's strength and expensive oil. While these bigger profits increased enterprises' internal financing capacity, also the volume of external financing in the capital market and in the form of loans from banks augmented in the first half of 2007. At the same time, higher interest rate levels and higher earnings yields on the Vienna stock exchange worsened equity and debt financing conditions for the Austrian corporate sector. However, good profits ensured that on the whole, the corporate risk position remained favorable, even though the sector's financial assets are becoming exposed to increasingly greater stock price risks and even though external economic conditions are unlikely to underpin corporate risk positions as strongly as in the past.

Households' risk position also remains positive, although rising interest rates have an important impact on this sector, too. The large share of variable rate loans has become a burden on the sector's financial liabilities. Austria's labor market continues to benefit from the favorable economic environment, which in turn has helped improve households' debt-servicing capacity. Although the share

of foreign currency loans declined in the first half of 2007, financial liabilities continue to attract sizeable exchange rate risks. Moreover, the share of assets that are subject to valuation risks due to stock price changes has been rising gradually. It may be expected, though, that most of the households exposed to these market risks are high-income or high-asset households in a position to absorb negative developments linked to these risks.

Ongoing Dynamic Development of the Austrian Banking Sector

The Austrian financial sector also performed very well in 2007 despite the turbulent framework conditions. In particular, the banking sector posted further growth. Both assets and profits augmented, above all because Austrian banks' business in CESEE countries remained dynamic. Austrian banks' CESEE business has already grown to account for 25% of total assets and 42% of consolidated profits before taxes. Additionally, on the basis of the annual result for 2006, Austrian banks made further gains in domestic transactions, in particular in fee-based income. The expected consolidated return on assets of the Austrian banking sector totaled 0.72% for the end of June 2007. The consolidated cost-to-income ratio

amounted to 59%, marking an improvement by nearly 3 percentage points. Austrian banks were hit comparably little by the U.S. real estate crisis, partly because of their strong focus on doing business in CESEE.

The interest margin on domestic activities narrowed further to less than 1% most recently. In the current favorable economic environment, banks continue to assess credit risk positively. Given historically low interest margins, a shift in the credit cycle could well have a negative impact on the profitability of banks' domestic business, however.

Although the declining trend of domestic foreign currency lending has gained a solid foothold, foreign currency loans remain important in Austria as well as some CESEE countries and thus remain a nonnegligible source of risk.

Overall, Austrian banks' risk-bearing capacity remains high. Capital ratios and the results of stress tests that show the banking sector's resilience to shocks has improved from end-2006 confirm this assessment.

Whereas the insurance sector performed well against the backdrop of the positive development of the economy, demand for Austrian investment funds cooled off, which may be partly attributable to heightened interest in structured products.