

# Difficult Environment for Austria's Financial System

## **Financial Turmoil Does Not Spare Growth Prospects**

In the course of 2008, sustained financial turmoil worldwide led to a downward revision of the economic outlook for both industrialized countries and emerging market economies (EMEs).

Also the growth outlook for the economies of Central, Eastern and Southeastern Europe (CESEE) has deteriorated, although projections mostly continue to clearly exceed those for the euro area. In some countries, however, the overheating of the economy until mid-2008 meant that major external imbalances persisted, or even increased. These imbalances and, in some countries, also the relatively large share of domestic foreign currency loans have contributed to a further increase in both interest rate and exchange rate risks, which have already partly materialized. In addition, the risk premiums on government bonds show significant increases for these countries whereas other Central European countries were hit by these developments to a lesser extent.

As a result of the turbulence in financial markets, a number of countries including Austria have put together packages to strengthen both the liquidity and capital base of their banking sectors. In many countries, moreover, the guarantee on savings was increased. Central banks worldwide have also reacted to the very tight liquidity situation in the money markets. Risk indicators in the equity, bond and interbank markets have remained at a high level, however.

## **Financing Conditions Deteriorate, Equity Financing Dries Up**

Having passed the economic peak in 2007, the Austrian economy's growth

outlook worsened again in the course of the reporting year. While Austrian enterprises' profit situation in the first half of 2008 remained healthy, the initial impact of events in the financial markets was already reflected in the half-yearly data for companies' external financing. For instance, financing via quoted shares almost dried up, and growth in bond-based financing slowed from a high level. Although financing conditions deteriorated, credit growth continued to remain buoyant until August 2008. In addition to a further negative impact on enterprises' external financing potential, the marked deterioration in the capital market environment and in growth prospects in the second half of 2008 will, however, lead to a reduction in their financing potential via earnings.

Furthermore, the risk position of Austrian households was shaped by events in the world financial markets. These events left their mark especially in the form of valuation losses on capital market products, which are particularly relevant to funded pension provision and foreign currency loans. In view of unusually high volatilities in the stock markets, the first half of 2008 saw a shift in financial assets from capital market instruments – in particular, mutual fund shares – to deposits. Just as in the corporate sector, events in fall 2008 can be expected to produce a further reinforcement of this effect. In addition, considerable exchange rate risks still exist on the financing front. Both the increased volatility of the Swiss franc against the euro and the valuation losses on repayment vehicle products have led to the materialization of the risk potential of foreign currency loans. The role foreign currency loans still play in Austria (and also in some CESEE

countries) is an additional source of risk.

### **Indirect Effects of Financial Turmoil Also Hit Austrian Banks**

Whereas the Austrian financial sector was relatively mildly hit by the direct effects of the turmoil stemming from the U.S. subprime market, it cannot escape the impact of the international financial crisis. Although Austria's banking sector continues to boast a healthy profit situation in historical terms, its profits are down for the first time after years of growth. The half-yearly results showed that the decline was primarily attributable to negative trading income and some sharp falls in fee income – a key growth driver to date.

Especially thanks to still very healthy CESEE business in the first half of 2008, Austrian banks avoided the more noticeable deterioration in profitability and efficiency suffered by international banks. In view of still significant external imbalances in some countries, however, the further increase in the importance of CESEE business rep-

resents also a risk for the future profitability of banks active in this region.

Owing to the perceptible worsening of the economic environment since mid-2008, which is not yet reflected in the data available, trading activities and fee-based business can be expected to suffer a further blow, while loan loss provisions will rise. Since the latter are at historical lows in both Austria and CESEE, a longer-lasting decline in the banking sector's profitability should be assumed.

Unlike many international banks, however, Austrian credit institutions have been in a position to cushion the pile of blows so far with their current earnings. Austrian banks also benefit from their business model as retail banks. The steep growth in deposits is strengthening Austrian banks' liquidity positions, mirroring depositors' confidence in their banks' risk-bearing capacity.

The Austrian insurance sector was also hit by extraordinarily high volatility in international capital markets. Furthermore, demand for Austrian mutual funds has cooled significantly.