

Austria's Financial System Faces Difficult Conditions

Turmoil on International Financial Markets Persists

The international financial market turbulence caused by the U.S. mortgage crisis in summer 2007 continued in the first half of 2008. Uncertainty about the distribution of resulting valuation losses across the international financial system generated a loss of trust among banks and led to liquidity strains on the interbank market. At the same time, risks were generally reassessed, and at the beginning of 2008, international stock markets saw a further, markedly sharper downward price adjustment.

In response to the difficulties in the financial markets and the slowdown of economic activity, the Federal Reserve reduced its key interest rate by a total of 3¼ percentage points to 2% between September 2007 and April 2008 while the ECB kept its key interest rate stable at 4%. Furthermore, leading central banks including the ECB, the Federal Reserve and the Bank of England tried to ease financial market tensions by adopting a number of measures to influence liquidity conditions, but those measures have not had a lasting effect so far. On the whole, the gap between money market interest rates and key interest rates has widened visibly since the onset of the turmoil as a result of continued uncertainty. The changed risk perception in bond markets has also significantly increased risk premia on corporate bonds of less-than-prime issuers. For top-rated companies the risk spread has risen substantially in the U.S.A., but not so in the euro area.

Financial market disruptions constitute an increasing risk for the international economy. In view of declining investment in real estate, more stringent credit conditions and rising unem-

ployment rates, economic growth prospects for the U.S.A. have worsened distinctly. As to the euro area, short-term indicators also point to a slowdown in economic growth, albeit to a lesser extent. At the same time, rising energy and food prices have visibly accelerated inflation in recent months.

The emerging economies in Central, Eastern and Southeastern Europe (CESEE) have been affected by the turmoil to a lesser extent so far and recorded robust growth in the second half of 2007. While almost all countries of the region continue to rely on external funding, they do so to largely varying degrees. Financing conditions in international financial markets have, however, come to increasingly reflect risk aspects and in turn particularly countries with high current account deficits and a heavy reliance on loans for funding have become more vulnerable to a sudden unwinding of such imbalances.

Higher Financial Costs for Businesses and Households

While the Austrian economy has remained fairly robust in the first half of 2008 despite the international financial turmoil, its growth prospects have deteriorated noticeably. The corporate sector managed to further improve its internal financing capacity in 2007 thanks to persistently healthy profits. Regarding external finance, the tensions in financial markets made it more difficult for businesses to raise capital particularly in equity markets, whereas no slowdown was registered in bank lending. Loan conditions have, however, started to reflect underlying risks more strongly in recent quarters.

Moreover, financial market turbulence led to higher financing costs for the real economy sectors both for equity and debt financing. Given their high share of variable rate loans, both businesses and households thus faced a swift increase in their interest burden.

In the past year, growth of households' new debt slowed down. Although the foreign currency share in outstanding loans declined by 3 percentage points to 28%, the financing side of households is still characterized by high exchange rate risks.

At the same time, household investment in stocks and mutual fund shares suffered substantial valuation losses in the second half of 2007, which have also affected the performance of stock-based saving instruments and repayment instruments for repaying bullet loans. It has to be mentioned though that households investing in long-term debt securities dispose of above-average incomes and assets and thus predominantly of a high risk-bearing capacity.

Financial Market Turmoil Affects Austrian Banks Only Indirectly

The direct impact of financial market turbulence on Austrian banks has been comparatively limited. By the end of 2007, Austrian banks had to write off EUR 1.1 billion invested in related structured products, which is a relatively small amount compared with other countries. This can largely be explained by the fact that their foreign business activities focus mainly on CESEE. Moreover, Austrian banks' "originate and hold" strategy and the relatively high significance of customer

deposits have been particularly effective in this respect.

Yet, Austrian banks were affected by the turmoil indirectly: Refinancing on the interbank market became more difficult for them, and they incurred transaction losses caused by fluctuations in value on capital markets.

Despite these difficult conditions, the Austrian banking sector developed favorably in 2007. The ongoing dynamic activities of Austrian banks in CESEE contributed substantially to this development. In 2007, Austrian banks' CESEE business already accounted for 26% of total assets and 43% of consolidated profits before taxes. Especially the banks' subsidiaries in non-EU countries have been growing at a dynamic pace.

Austrian banks have been able to step up their lending and income not only abroad but also at home. In 2007, fee-based services and commissions advanced operating profits by 14.5% and the (unconsolidated) cost-to-income ratio improved markedly from 65% to 62%.

Given the uncertainty regarding further repercussions of financial market turmoil, there is still the risk that banks might perform less well in future as a result of declining fee and commission income and increasing value adjustments.

Overall, Austrian banks' risk-bearing capacity remains high. Both stable capital ratios and stress tests confirm the Austrian banking sector's good shock resilience. This ties in with a favorable report by the IMF on Austria's financial sector under the 2007 FSAP update.