

# Austrian Financial System Benefits from Good Economic Conditions

## **Positive Economic Outlook – Global Imbalances Pose Ongoing Risks**

In the past quarters, the industrialized and emerging market economies have grown at a dynamic pace. Moreover, forecasts – above all for the euro area and Japan – are favorable. In the U.S.A., though, growth has lost some momentum at a high level. A disorderly correction of global imbalances remains the main risk to cyclical developments. Oil prices have eased recently, improving the outlook for inflation, but an inflation-related rise in interest rates could nevertheless weaken growth prospects. While spreads on emerging economies' foreign currency-denominated bonds have risen in recent months, they are still at historically low levels.

Most Central and Eastern European countries (CEECs) have been posting growth rates far exceeding those in the euro area and have seen a generally strong rise in (foreign currency) loans. Some of these countries, however, have large and growing external imbalances. At the end of September 2006, the exchange rates of most Central and Eastern European (CEE) currencies were unchanged or stronger against the euro than at end-March, whereas the yields spreads of national currency-denominated government bonds widened for the most part. A change in international investors' risk tolerance represents a source of risk especially for countries in need of high external funding.

## **Corporate Risk Perspective Worsens Slightly**

Against the background of favorable economic developments, Austrian corporate profits have risen further. The

marked expansion of investment activity reflects, among other things, investor confidence in future developments, reinforced also by favorable economic forecasts. Until recently, the corporate risk perspective was positive, though it deteriorated a bit in the first half of 2006. While falling prices on stock markets during the second quarter of 2006 and stepwise interest rate hikes have worsened corporate borrowing conditions slightly, they nevertheless remain favorable by historical standards. However, as variable rate loans represent a high proportion of corporate borrowing, companies' financing costs have gone up recently. Enterprises continue to procure a considerable amount of funding through capital markets – the issuing volumes of stocks and bonds alike continued to make substantial headway in the first half of 2006.

## **Risk to Households' Financial Position Intensifies**

Although real income growth remained subdued, Austrian households enlarged their financial assets. Stocks, bonds and mutual funds shares accounted for nearly half of the rise in household financial assets. However, following a steady rise in asset values for some time, households were for the first time in quite a while faced with valuation losses of the assets they had invested in capital markets. On the bright side, the latest interest rate increases had a positive impact also on households' interest income on bank deposits. Households remain keen on foreign currency loans – almost one-third of their outstanding loans is denominated in foreign currencies, mostly (97%) in Swiss francs. As the bulk of euro and foreign cur-

rency loans are at variable rates, households have been exposed to exchange rate and interest rate risks on their borrowings in addition to the price risk on their assets that was realized in the first half of 2006.

### **Austrian Banking Activity Posts Dynamic Growth**

The rise in Austrian banks' profits remained unbroken in 2006. In the first half of 2006, operating profit on a consolidated basis mounted by more than 19% compared to the first half of 2005, augmenting to EUR 4.5 billion. This steep rise is partly a sign of Austrian banks' growing dependence on their highly successful CEE business, which accounts for well over a third of the result in the observation period. Austrian banks' CEE business outside the EU-27 has not played a very important role until recently, but has gained significance in the wake of acquisitions and of the ongoing restructuring within Unicredit Group. Austrian banks' domestic activity has also exhibited clear signs of a lasting recovery. Partly buoyed by the healthy economic environment, fee-based income grew at a robust rate and demand for loans accelerated

noticeably. At 64.1%, the cost-to-income ratio stayed historically low, and the capital ratio remained favorable. Given these healthy profits and enduring high capital ratios, Austrian credit institutions' risk exposure improved further. Stress tests in the major risk categories confirm this assessment.

In parallel to the expansion of lending cited above, banks' interest margins contracted further, though, dropping to a new low of only 1.03%. Data for banks' new lending and deposit-taking business do not indicate any future improvements in margins. Given these tight margins, banks' profits may well be affected if the currently more favorable assessment of loan quality should be reversed. The continued sizeable share of foreign currency lending to domestic borrowers poses an additional risk, as does the proportion of foreign currency lending by Austrian banks in some of the CEECs, which is also increasing.

Like Austrian banks, Austrian insurance companies are doing well, also drawing on their CEE business success.