

## *Austrian Financial System in Good Shape*

### **Oil Price Heightens Business Cycle Risks – Yield Developments Pose an Additional Risk Factor**

Many industrialized countries and emerging market economies (EMEs) saw a robust upswing in the past quarters, whereas GDP growth in the euro area remained more subdued. Austria was no exception to the euro area trend. Exports and domestic demand have been on the decline since the beginning of 2005. Although economic prospects for the upcoming quarters remain positive, the high price of oil persists as one of the main sources of risk to economic growth. Oil price developments are also key for the future trend of inflation. While inflation in most industrialized countries already reflects the impact of more expensive oil, the appreciation of the currencies of some new Member States of the European Union (EU) has partly offset the risen price of oil.

Apart from the price of oil, developments of international short- and long-term interest rates and investors' risk tolerance represent a potential threat to the growth and financial stability of the emerging market economies of Central and Eastern Europe (CEE), as some of these countries' currencies have become quite strong and as risk premia on the (domestic and foreign currency-denominated) bonds of the EMEs are generally already quite low.

### **Corporate Financing Conditions Remain Favorable**

On the back of ongoing high profits and favorable financing conditions on both the capital and credit markets, the domestic corporate sector's financial position has improved. Capital market instruments again played quite

an important role for new corporate sector borrowing. The issuance of stocks and bonds posted a robust rise compared to a marginal increase in lending; this further ameliorated corporate balance sheets. Apart from the above-mentioned cyclical risks, a possible deterioration of financing conditions represents the main source of risk for the corporate sector.

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

Although, once again, real incomes merely edged up, Austrian households managed to enlarge their financial assets considerably. Valuation gains were partly responsible, as was households' recent preference for securities, mutual fund shares and insurance products for investment. The development of households' financial assets is clear evidence of the growing importance of private investment in pension schemes. At the same time, liabilities also continued to expand, albeit less substantially; the boom in foreign currency borrowing was unbroken. Both the number of bankrupt households and the volume of liabilities outstanding of bankrupt companies were on the rise again recently. Overall, these developments subject the household sector to increased risk. On the asset side, the sector is more heavily exposed to price risks, and on the liability side, it has to face growing currency risk because of foreign currency borrowing as well as increasing interest rate risk because the share of variable rate loans is high and rising in Austria.

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

On the back of the favorable market developments for the corporate sector, Austrian banks performed well, with

total assets expanding at a high rate. Banks' domestic business benefited from the above-mentioned intensified capital market orientation of the corporate sector and households' investment activity, which boosted fee-based income. This enabled Austrian banks to more than offset moderate credit demand. Austrian banks' cost/income ratio is better than it was in the entire period from 1995, and profit margins have regained their excellent levels of 2000 and 2001. However, high competition kept the domestic interest margin low. Austrian banks' business in CEE, which is characterized by strong credit growth and continued high profit margins, helped raise profitability most. Given these healthy profits and enduring high capital ratios as well as the noticeable drop in the ratio of specific loan loss provisions to claims on nonbanks, Austrian credit institutions' risk exposure improved further. Moreover, stress tests in the major risk categories testify to the reduction of the interest rate risk.

Austrian banks' success in CEE has resulted in their growing dependence

on the profitability of these markets for some time now. This makes it imperative for banks to put greater effort into their domestic business. In addition, this dependence renders it all the more important for banks to ensure that the quality of their rapidly growing loan portfolios in these markets remains sustainable and sound in the long term. As the experience of previous credit cycles shows, a moderate rise in credit risk costs is to be expected, now that credit growth has been recovering since 2003 following a period in which domestic lending was on the decline. Also, households' aforementioned greater risk exposure could affect the quality of domestic customers' portfolios. Additionally, banks' hedge fund investment risk must be carefully monitored in view of the higher risk inherent in this type of investment.

Like Austrian banks, Austrian insurance companies are doing well, also drawing on their CEE business success. Austrian pension funds' asset growth and their investment performance remained on track in 2005.