

The Real Economy and Financial Markets in Austria

Nonfinancial Corporations Weak Economy Depresses Potential for Self-Financing

In 2002, companies operated in a sluggish economic environment, which had a negative impact on their profitability. The economy grew by just 1.0% in real terms in 2002, only slightly more than in 2001 at 0.7%.

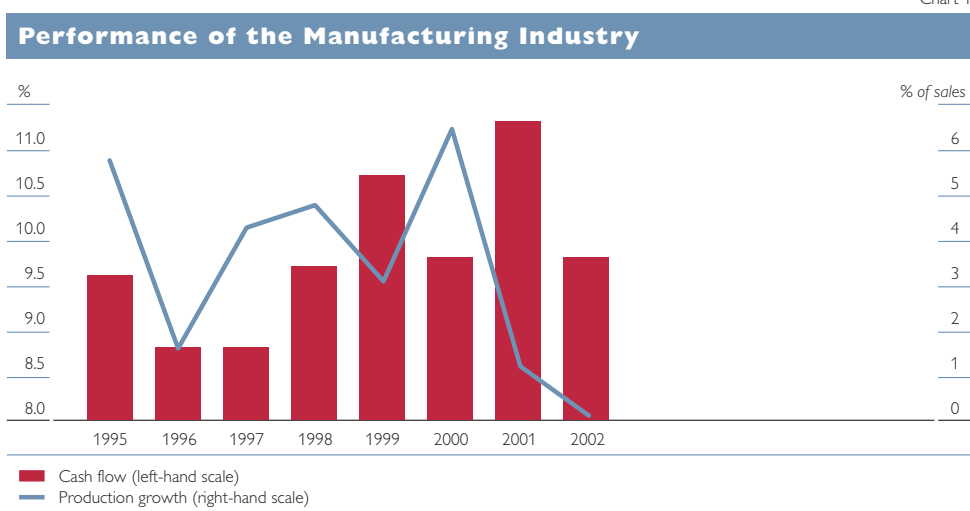
In lockstep with the cyclical slump, key operating expenses also became less of a liquidity burden on enterprises. In addition, the low level of interest rates helped ease the constraints on profitability. Companies were able to refinance liabilities assumed during an earlier period in which interest rates were higher. Also, short-term and adjustable rate loans reduced interest expenditure. The cost of labor also rose only marginally on account of slow economic growth. The real wage increases for payroll employment lagged labor productivity in 2002, which helped profit margins improve.

Currently, energy represents a major uncertainty factor on the cost

side. The appreciation of the euro in the first months of 2003 partly offset the hike in oil prices, but a long-term rise in the price of oil would affect firms' profit outlook and thus their financial position.

As no data for the earnings of the aggregate corporate sector are available, the profit development in the manufacturing sector, which contributes most to value added across the entire economy, will serve as an example. Output merely edged up in 2002, rising 0.1% in real terms. Hence growth fell substantially short of comparable values recorded in the previous years. The cash flow ratio probably also reflects this output development, albeit with a one-year lag (see chart 19). According to estimates by the Austrian Institute of Economic Research (WIFO),¹ manufacturing cash flow amounted to 9.8% of sales in 2002 compared to 11.3% in 2001, a level attained despite the slowdown of the economy.

Chart 19



Source: WIFO.

¹ See Peneder M. and M. Pfaffermayr. 2003. *Mäßige Ertragsentwicklung im Jahr 2002. Cash-Flow und Eigenkapital der österreichischen Sachgütererzeugung*. In: *WIFO-Monatsberichte 3*. Vienna: Austrian Institute of Economic Research.

Table 7

Development of Nonfinancial Corporations' Equity and Debt Finance					
	1995	2001	1995	2001	Growth since 1995
	EUR billion		Share in %		%
Equity	26.6	62.3	17.4	24.1	134.0
Domestic investors	13.3	27.5	8.7	10.7	107.3
Foreign investors	13.3	34.8	8.7	13.5	160.4
Debt finance	126.4	195.9	82.6	75.9	55.0
Bonds	7.7	18.6	5.0	7.2	141.4
Loans	112.5	171.5	73.5	66.4	52.5
Other liabilities	6.2	5.8	4.1	2.2	- 6.5
Total capital	153.0	258.2	100.0	100.0	68.7

Source: OeNB (financial accounts).

This markedly reduced companies' ability to finance investment from their sales revenue. With enterprises' self-financing capacity diminishing, additions to equity from profit is likely to have been on the decline, but no data have become available yet to confirm this assumption.

Equity Financing Gains Importance

Companies succeeded in partly countering lower self-financing capacity by external finance in the form of equity. While funds raised on the Vienna stock exchange by capital increases against cash deposits widened to EUR 1.2 billion from 2001 to 2002, only one domestic company was in fact newly listed on Wiener Börse AG.

Equity accounted for a rising share of total capital from the mid-1990s, augmenting from 18.1% to 24.7% in 2001 (see table 7). Foreign lenders have had a growing impact on Austrian companies' financial position through direct investment (inward FDI). According to the financial accounts, foreigners owned 13.5% of Austrian enterprises' total capital as against 8.7% six years earlier.

Since 1995 companies have more than doubled their capital base. This perceptibly improved the corporate sector's financial stability, which not only gave companies greater financial leverage in making investment decisions, but also improved their position in negotiating with lenders.

Chart 20

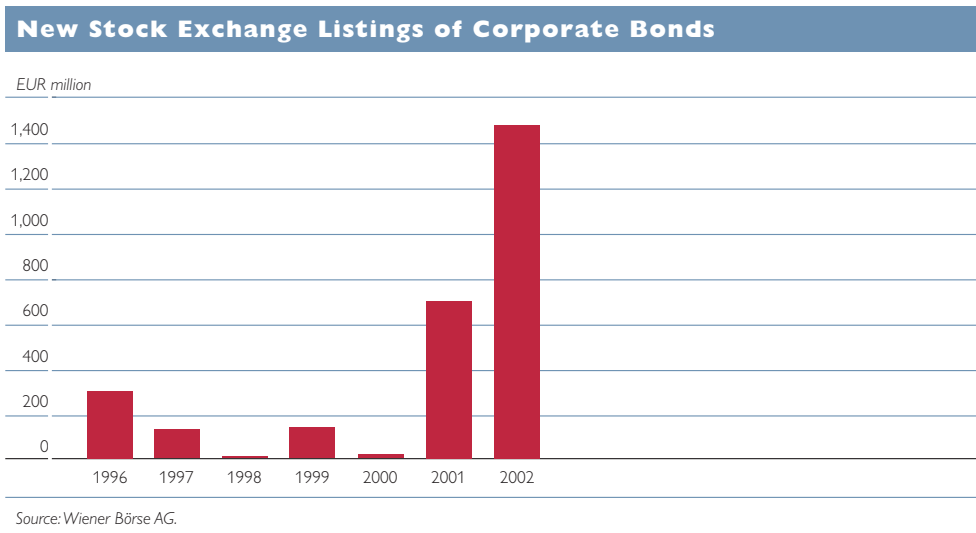
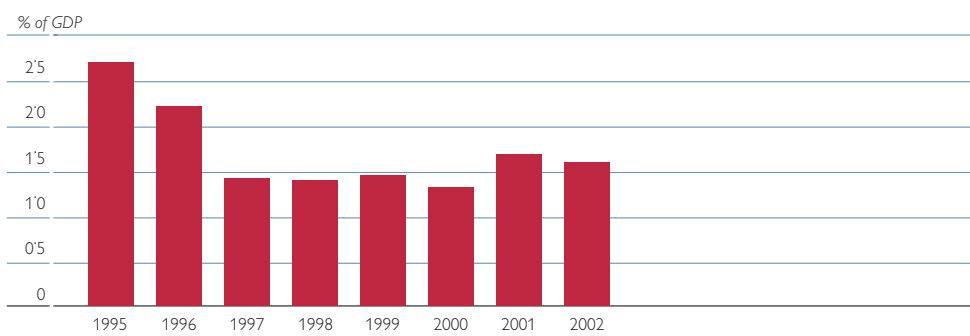


Chart 21

Default Liabilities

Source: Kreditschutzverband von 1870, Statistics Austria.

Greater Recourse to the Bond Market

Borrowers opted increasingly for bond financing rather than bank loans to finance debt. In the past year, some 25 enterprises issued bonds, partly in the form of private placements. Most, but not all, of these were large firms. The funds raised by means of bond issues doubled to over EUR 1.4 billion from 2001. Nevertheless, the volume remained small at 1.1% of loans outstanding.

Bond issues are the instrument of choice for companies that have either a high capital intensity or that plan large-scale – expensive – restructuring measures. In addition, this type of debt is repayable at maturity, keeping demands on companies' liquidity lower during the life of the bond than for a classical bank loan. This is important for companies above all during the current economic downturn. However, such a procedure does not rule out that the repayment of the bond at a later point in time may represent a burden on corporate financing debt in the future.

Are There Signs of a Credit Crunch?

Bank lending to the corporate sector was down by 1.8% in 2002 from the year before. One reason was that companies' financing needs shrank in

2002. The low capacity utilization accompanying demand weakness in Austria and abroad clearly reduced investment demand; companies slashed equipment spending by 8.9% in real terms in 2002. Expectations that sales would perform poorly in 2003, which the latest forecasts on aggregate economic growth in Austria confirmed, induced companies to hold back on expansion investment. Construction investment, one key input for the expansion of manufacturing capacities, dropped, which is a sign of companies' hesitancy to invest last year. Enterprises' concentration on replacement investment, which is mainly financed through write-offs, kept a lid on the demand for loans. Moreover, their debt financing of expansion and rationalization investment lost importance in the light of capacity underutilization and helped perceptibly dampen the dynamics of corporate debt.

In addition, many corporates are likely to represent a risen credit risk considering the weakness of business activity. Insolvencies expanded by 2.0% in 2002; nevertheless, liabilities in fact diminished marginally even though economic growth decelerated noticeably. One important reason for insolvencies was inadequate capital cover, which became a critical ingre-

dient in insolvencies again last year. However, insufficient capital is not the sole factor implicated in insolvencies.

Thus it is not unlikely that companies exposed to a higher default risk face a restricted supply of loans. In any event, banks are likely at least to

boost the cost of lending to cover the growing risk of debtor default in an environment of economic weakness. Enterprises with low capital levels are likely to be hardest hit by this measure. However, there is no evidence of a general credit crunch for Austria.

What Financial Systems Contribute to Economic Growth

A complex interrelationship exists between the real economy and the financial system, and this interdependence represents a new challenge for economic policymakers. At an OeNB workshop held on January 27, 2003, academic and economic policy experts discussed which financial system is best suited to fostering economic growth, risk allocation and stability.¹) In a study, Franz Hahn used econometric methods to examine the links between financial market development and economic fluctuation in 22 OECD member countries from 1970 to 2000. The results indicate that capital market financing in the OECD countries tends to destabilize economic performance whereas funding via banks has a neutral effect. The public sector used to act a collective investment and risk association for the pay-as-you-go pension system; the risk is now being shifted more and more to households. Households have been investing more on financial markets – without a replacement for the erstwhile investment and risk association to allocate risk having been established yet. The participants of the workshop were nearly unanimously convinced that an orientation on shareholder value alone would impose problematic limitations on the functions of financial systems. The most recent scandals in the U.S. economy are evidence that up to now, no one has been able to define what the best financial system of all is.

Households

Weak Growth of Household Income and Consumption

The adverse economic conditions prevailing in 2002 took their toll also on household income. Real income grew by just 1.0%, which is below average. Among other things, the sluggish growth of income reflects the impact of the rise in the jobless rate to 6.9% from 6.1% in 2001 and the stagnation of employment.

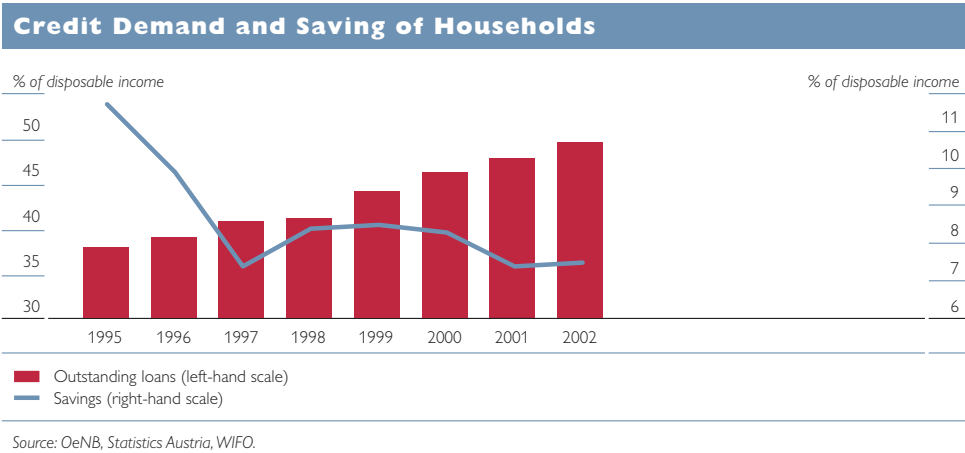
Households reacted to the deteriorating outlook for incomes by spending significantly less. Consumption expenditures rose by just 0.9% in 2002, compared with 1.5% in 2001. Purchases of consumer durables even declined by 0.2%, as households evidently postponed larger purchases in

the light of the unfavorable economic conditions. From a risk perspective this behavior is sensible as households thus avoided putting an extra strain on their budgets, which are already stretched by the weak growth of income and the uncertainty clouding the employment outlook.

Owing to lower consumer demand, the saving rate did not decrease any further in 2002 after having declined steadily since the mid-1990s. The decision of households to save more from current income under the prevailing tight economic conditions implies that they continue to be skeptic about the income outlook and are building up precautionary savings to tide them over any lean income times.

¹ The workshop contributions were published in the OeNB's Focus on Austria 1/2003.

Chart 22



Loan Growth Exceeds Income Growth

Despite the weak economy, lending to households grew at a faster pace than disposable income. Loan growth in 2002, while less than half the peak rate registered in mid-2000, was as high as at the beginning of 1999 when the income situation had been much brighter.

Due to the high financing requirements for housing needs, the cost of servicing such loans accounts for a huge part of households' regular financial expenses.

The ability to finance real estate and housing purchases with debt is an important precondition for any real investment by households. In this respect it should be noted that, in relation to wages and salaries, the volume of mortgage loans has been increasing steadily since 1995. Households tend to finance their housing needs above all by borrowing from (domestic) banks as well as building and loan associations. In recent years, they have shown an increased preference for loans with long-term maturities. Consequently, the percentage of mortgage-backed loans with an agreed ma-

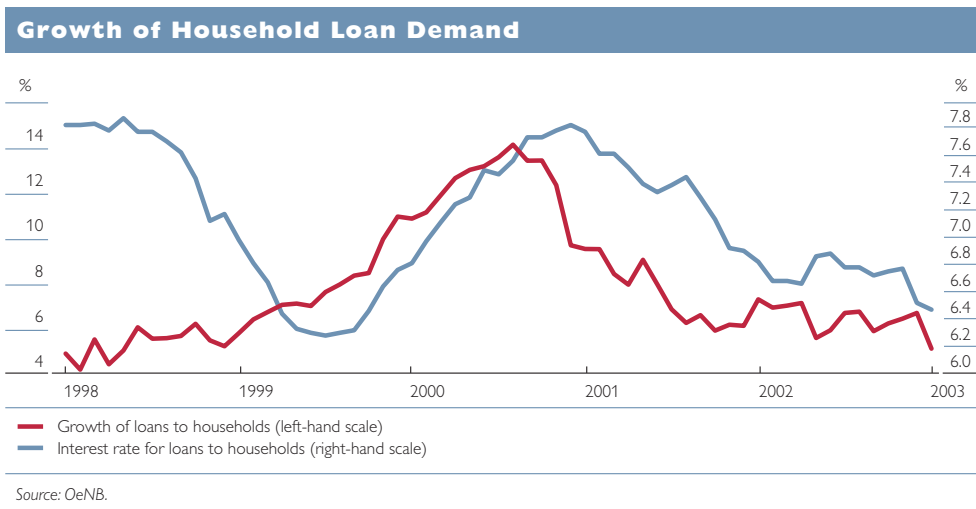
turity of more than five years climbed to 88% by December 2002. Borrowers rolling over short-term loans to medium-term and long-term loans as the yield curve flattened have benefited from lower current interest rate payments.

17.8% of all housing loans outstanding in 2002 were foreign currency-denominated. Hence, foreign currency debt of households and the underlying risks have continued to grow. The big appeal of foreign currency loans¹⁾ is that interest payments are much lower than on a comparable euro-denominated loan. However, the savings made on interest payments come at the price of exchange rate uncertainty, which may cause asset positions to worsen visibly when the euro depreciates against the loan currencies. A more cautious and forward-looking handling of this financing instrument by borrowers and lenders is called for in order to prevent, as much as possible, potential risks from becoming actual problems.

The number of private bankruptcy proceedings increased by 6.9% in 2002. The private bankruptcies filed

1 It should be noted that the interest rate advantage of foreign currency loans is reduced by any additional costs of borrowing.

Chart 23



in 2002 were characterized by low levels of overindebtedness, so that the debt volume declined somewhat from EUR 490 million to EUR 464 million.

Financial Investment is Boosted by Rising Property Income

Apart from borrowing, households built up savings on the order of approximately EUR 10 billion, which is visibly below the comparable figure of 1995, when EUR 12.8 billion were saved. Consequently, the overall

growth of financial investment was also lower in 2002, with property income increasing and thus raising financial investment.

On the one hand, the rise in financial investment caused by growing property income reflects the strong profit orientation that guided households' financial investment decisions in the past. On the other hand, households have been saving less from their labor income, but instead have been relying more heavily on income generated from investment in property.

Chart 24

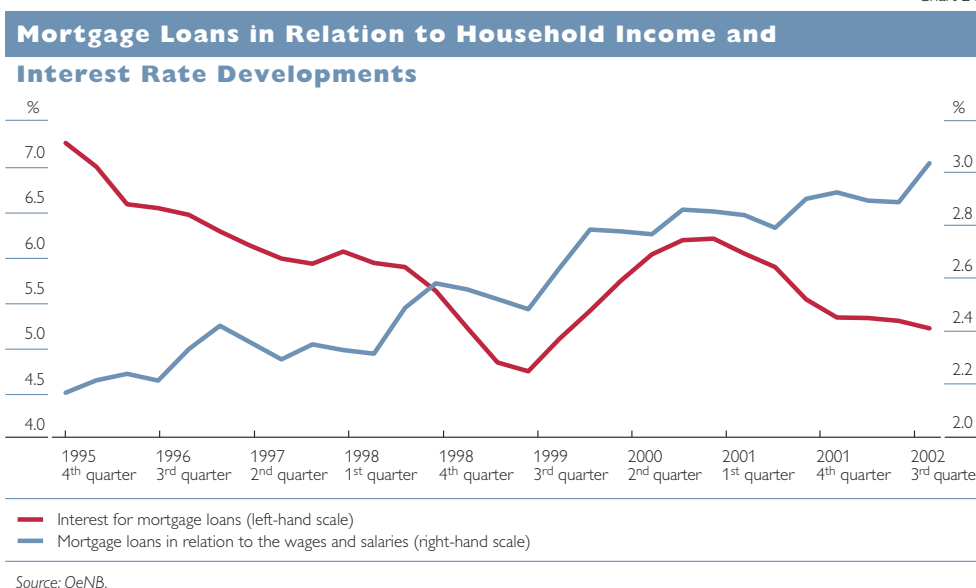


Table 8

Structure of Household's Disposable Income

	1995		2001		Growth since 1995 %
	EUR billion	Share in %	EUR billion	Share in %	
Mixed income	16.0	20.1	14.6	15.4	25.3
Property income	7.7	13.4	7.0	10.3	74.7
Compensation of employees	81.0	91.9	74.0	70.3	13.5
Social security benefits	4.7	5.3	4.3	4.1	12.9
Disposable Income	109.4	130.7	100.0	100.0	19.5

Source: Statistics Austria, OeNB calculations.

Since property income falls short of labor income as a source of savings, households needed to borrow as investment rose. At the same time, the procyclicality of saving increased, as under the continued weak economic conditions property income, which includes interest and dividends received on investments, is lower than in times of strong economic growth.

Financial Investment Heavily Affected by Price Losses

Households' investment decisions have been influenced considerably by the high price losses investors suffered in capital markets in recent years and the decreased availability of funds for investment.

For instance, following the negative overall performance of Austrian mutual funds and the ensuing valuation losses, mutual funds lost much of their appeal in 2002, after having been very much in demand with investors in recent years. In the first three quarters of 2002 the value of mutual fund assets held by private investors shrank by EUR 3.6 billion, with the losses even exceeding net new investment made in 2001 by about EUR 600 million.

At the same time, the high uncertainty in stock markets and the weakness of both the national and the international economy made bonds more

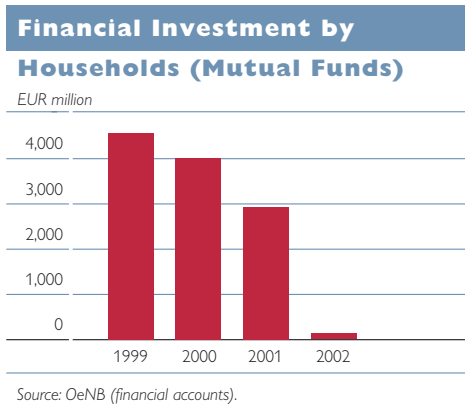
attractive for investors. Purchases of capital market instruments accounted for the bulk of financial investment in 2002. They totaled EUR 1.2 billion.

These asset reallocations motivated by price losses show that investors have been watching market developments and have responded adequately by choosing sound assets. As households have become more market-oriented in making investment decisions, they have, however, become more strongly exposed to price risks as well. As a result, households now face cyclical fluctuations with regard to both income and financial wealth. The valuation losses private investors suffered in 2002, according to preliminary calculations, were roughly as high as the combined price losses realized in 2000 and 2001, which totaled EUR 3.5 billion. This amount equals 2.6% of the disposable income of 2001.

At the same time, capital market developments are having a stronger impact on income, as the increasing additions to financial investment resulting from property income show.¹⁾ The fact that pension fund benefits are currently being cut is another case in point for the higher dependency on capital market developments. In Austria, pension funds continue to play a minor role in retirement provision and their cyclical decline in profitability is likely to have a limited effect on

1 The expansion of the second and the third pillar of pension provision should reinforce this trend.

Chart 25



households. However, individuals may be less inclined to take responsibility for saving for their own retirement and may become more uncertain about how future income replacement benefits are going to be funded considering that a period of poor pension fund performance is coinciding with a period of pension regime reforms.

To sum it up, in 2002 households were saving more from income than in previous years. At the same time, loan demand remained high despite the difficult economic situation. This

implies that households have been slightly more inclined again to build up own funds to finance investment spending. However, the propensity to rely on debt could increase the financial burden if incomes were to develop less favorably in the future, which would at the same time increase default probabilities.

Real Estate: Housing Prices Rise

Real estate holdings account for a sizeable share of household assets, and financing home purchases is a key motive for taking out a loan. Property prices last boomed in Austria when the migration inflow surged unexpectedly following the opening up of Eastern Europe and when baby boomers started to buy real estate at the beginning of the 1990s. From 1993 onward, this price boom tapered off, and toward the end of the 1990s prices even declined. However, since mid-2001, prices have been on the rise again. In the latter half of 2002, housing prices climbed by 0.7%, which is still below the long-

Chart 26

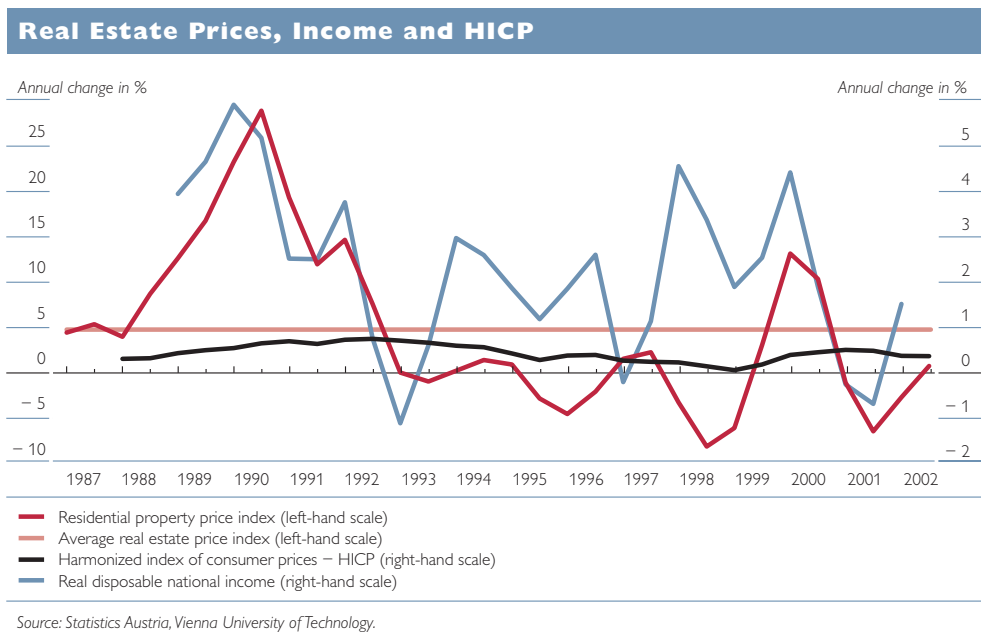
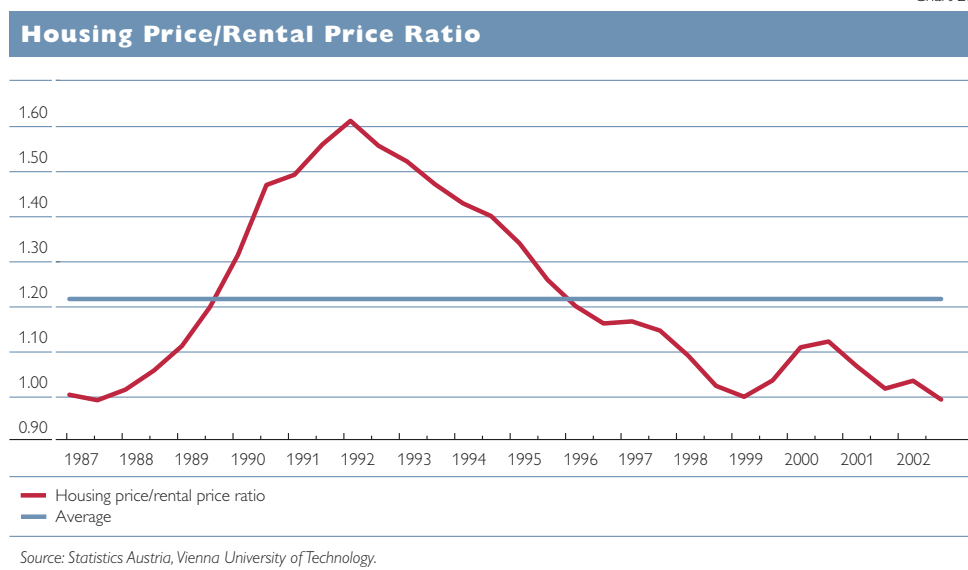


Chart 27



term average. The real disposable net income improved in the first half of 2002, but only by 1.4%.

Even though housing construction activity has been contracting for years, no price pressures have emanated from the demand for housing: The decline in building permits came to roughly 10% annually from 1998 to 2000 and slowed to about 3% in 2001, whereas the number of housing completions slumped by 14.7% in 2001. The marked 17.7% increase in building permits issued in the third quarter of 2002 implies that the market may have bottomed out.

The relationship between housing prices and the equivalent rental values (i.e. the rent homeowners would pay or receive if they were renting the residences they own) is evident from the housing price/rental (p/r) value index, which is a kind of price/earnings

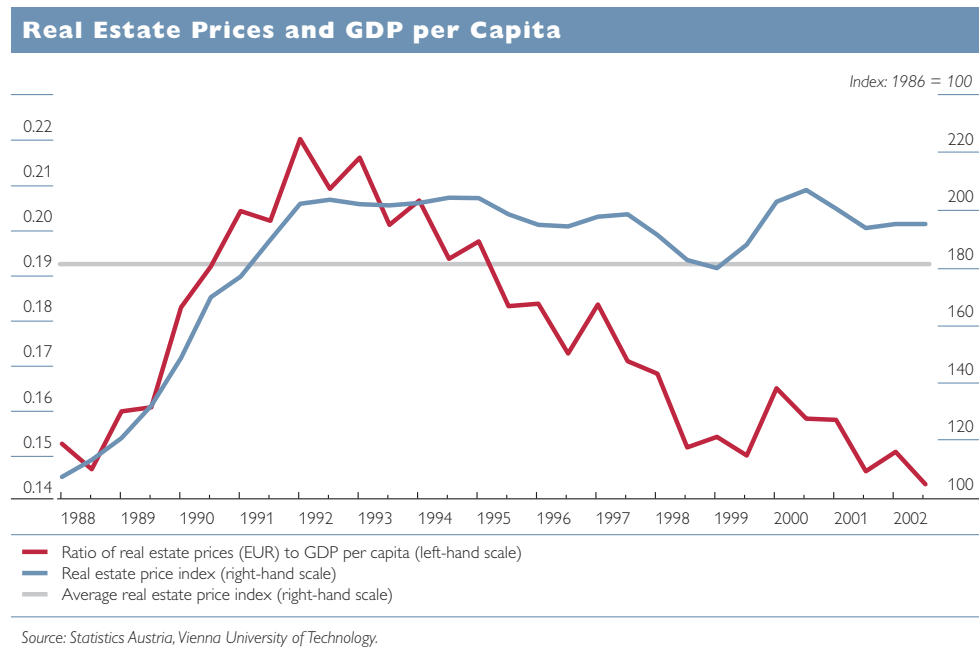
ratio for the housing market.¹⁾ This ratio clearly indicates a peak in housing prices in 1992. The decline of the ratio, incidentally, reflects less a decline in housing prices than a rise in imputed rental costs.²⁾

The ratio of housing prices to GDP per capita indicates whether such prices mirror the general path of economic developments.³⁾ While this ratio was still 15% above the long-term average in the first half of 1992, it has since dropped continually – with the exception of upward movements at the beginning of 1997 and of 2000 – to a value of around 26% below the long-term average.

To sum it up, developments in the housing market have not constituted an upward risk to price stability in Austria in recent years and there are no signs of a housing price bubble for the time being.

- 1 Leamer, E. E. 2002. *Bubble Trouble? Your Home has a P/E Ratio Too*. UCLA Anderson Forecast, June.
- 2 A high p/r value can be warranted in two situations: First, if other asset prices are also high, e.g. if stock profits and mortgage rates are low, and, second, in regions where housing demand surges and price increases are thus to be expected.
- 3 If this ratio remains constant over time or declines somewhat, this means that, provided all other macroeconomic determinants remain unchanged, the ability of individuals to finance housing purchases remains unchanged or decreases slightly.

Chart 28



Private Pensions in Austria and Their Role in the Capital Market

With the Austrian pension system based primarily on the first pillar, the public pay-as-you-go system, private pensions have typically played a minor role. Unsurprisingly, the fact that the public pension system is highly developed is being blamed in the economic policy debate not only for the rising problems of financing this regime as the population ages, but also, among other things, for the low degree of development of the Austrian capital market because saving for retirement through institutional channels (i.e. institutional investors such as insurance and pension funds) tends to generate little trading activity.

Against this background, the reforms of the private pension regime since the 1990s have also aimed at

contributing to the development of the Austrian capital market, above all by mobilizing accrued pension capital tied up in companies for investment with occupational pension institutions and by providing tax incentives for taking out personal pension plans launched by institutional investors.

New Severance Payment Scheme and Externally Managed Pension Funds

Under the 2002 reform of severance payments, existing severance claims may, and newly accruing severance claims (corresponding to 1.53% of wages) must, be transferred to dedicated severance funds.¹⁾ This regime is modeled on the transfer of internally funded corporate pension promises to externally managed pension funds. The conditions that apply to severance funds in general and the investment rules in particular are simi-

¹ While the new regime allows employees to opt for a lump-sum payment of their severance claims, which used to be the rule, it provides for tax incentives designed to prompt beneficiaries to roll over these assets into pension plans, i.e. to save for retirement through institutional channels.

lar to the rules governing pension funds. The permissible equity exposure of severance funds has been set at 40%.

Given their analogous function and regime, severance funds are likely to have more or less the same effect on the capital market that pension funds have had: Pension fund assets tend to be invested mostly in mutual funds, which in turn invest only a fraction of their assets in Austrian shares. In fact, the underdevelopment of the Austrian capital market can largely be attributed to the lack of participation of Austrian institutional investors in trading at the Vienna stock exchange.¹⁾ Judging from the insignificant contribution pension funds have made to the development of the Austrian capital market so far despite the sizeable amount of assets they manage (about EUR 8 billion), severance funds are unlikely to stimulate capital market activity significantly.

Can The Third Pillar of the Pension System Boost Activity in the Austrian Capital Market?

The recent reform introducing a tax-advantaged personal pension scheme (the so-called *Zukunftsvorsorge* scheme) can be seen as an attempt to link individual retirement saving to the development of the Austrian capital market more efficiently than was possible with the various private pension options available earlier. State subsidies for individual retirement saving will henceforth be concentrated on a single scheme. The investment rules governing this scheme have been specifically tailored to boost the Austrian capital market: a minimum of 40% of assets under management must be

invested in shares of EEA countries whose stock market capitalization is below 30% of GDP.

However, concentrating the state subsidy for individual retirement saving with institutional investors on a product with a high share of domestic stocks may be fairly problematic from a financial and economic perspective. Irrespective of the development of the Austrian capital market, such a high share of domestic stocks obstructs a further international diversification within this asset class and thus an efficient risk diversification. Obstructing risk diversification is all the more problematic as especially from the portfolio perspective of the three-pillar model of the pension system, the exposure of the first pillar to domestic economy risks would call for an international diversification of the second-pillar and third-pillar schemes.

This built-in home bias of the newly introduced subsidized personal pension scheme exposes individual retirement saving through institutional channels to significant risks. It remains to be seen whether the use of these channels to develop the capital market can compensate for the ensuing risks and efficiency losses.

Of the assets accumulated under the *Zukunftsvorsorge* scheme, about EUR 300 million a year are likely to be invested in stocks over the medium term according to industry estimates. This corresponds to roughly 1% of the market capitalization of 2002 and to 1.65% of the average stock exchange turnover of the past 10 years. Given the traditionally low turnover rate on the Vienna stock exchange, the subsidized personal pension scheme

¹ See Waschiczek, W. and F. Fritzer. 2000. *Austrian Stock Market Survey and Outlook*. In: *Focus on Austria 4*. Vienna: Oesterreichische Nationalbank.

is unlikely to contribute significantly to the development of the capital market in the medium term. At the same time, it cannot be excluded that, as a result of the low liquidity, volatility may rise.

The built-in home bias of the subsidized personal pension scheme hardly appears to be suitable to compensate for the low participation of domestic institutional investors in the capital market up to now; at the

same time, the concentration of tax subsidies on this scheme may significantly increase the risk exposure of personal pensions. One channel through which this risk might spread to the systemic level is a general loss of confidence in retirement provision schemes, which might in turn affect key asset classes (such as domestic shares) in which the pension capital is invested.

Pension Reform, Risks and Financial Markets

The increasing prominence of financial market issues in the pension reform debate has put this issue on the radar screen of central banks, as is evidenced, for instance, by a conference organized by the Deutsche Bundesbank on "Aging, Financial Markets, and Monetary Policy" in 2001. More recently, on December 6, 2002, the OeNB held an international workshop on "Pension Finance Reform: From Public to Financial Economics."¹)

According to the introductory statement of Johann K. Brunner, University of Linz, the risks and benefits of switching to a funded system must be weighed carefully because the higher returns in funded systems do not guarantee a Pareto improvement: it is, after all, almost impossible to design the transition in tax and transfer systems without a generation or specific individuals being made worse off.

Among other things, the workshop focused on the role pension funds play in European financial markets. Philip Davis, Brunel University, London, showed that the financial market effects of the European Economic and Monetary Union and the effects of the growth of institutional investors, including pension funds, are mutually reinforcing and thus make a switch to funded pension regimes more appealing. At the same time, he noted that demographic aging constitutes a risk for financial stability in both unfunded and funded systems, because it introduces a cyclical component in financial markets, much like the lifecycle model of saving.

In his discussion of the paper presented by Philip Davis, Josef Zechner, University of Vienna, pointed out some other risks that are linked with strengthening the funded pillar of the pension system, in particular the remaining weaknesses in product design (no protection against inflation) and partially insufficient corporate governance mechanisms, which cannot be fully compensated by the existing regulatory framework.

1 The workshop contributions are published in *Focus on Austria* 2/2003.