

Editorial

The Impact of the Financial Crisis on the Real Economy in Austria – Analytical Challenges from Exceptional Factors

The financial crisis that had started to unfold in the summer of 2007 took on even greater urgency in the fourth quarter of 2008. After spreading from the U.S.A. to international financial markets, it spilled over to the global real economy. With some lag, the impact on economic activity is also being felt strongly in Austria. National and international forecasting institutions currently expect negative growth rates for Austria in 2009. One of the hallmarks of the prevailing situation is that developments are unusually fast-paced, making it difficult to keep track of them and capture the relevant data. The global integration of economic activity, which has increased strongly in the past decades, as well as the fact that financial market structures were the origin of the crisis are likely to be the reasons the crisis has proliferated so quickly. Overall, the unfolding of events in 2008 and 2009 seems to have been determined by a number of exceptional factors that have only little significance during “normal” business cycles.

This exceptional situation represents an enormous challenge to standard economic analysis and, in particular, real economic forecasting. Traditional macroeconomic forecasting models do not take account of such special factors, nor can they in fact do so in any meaningful or comprehensive fashion. After all, we are dealing with effects that occur only in certain rare situations. Hence, these special factors and their transmission channels to traditional macroeconomic aggregates must be analyzed separately. The findings of these analyses must then be duly considered in the forecasting process,

in a way complementary to standard models. To this end, the OeNB’s latest economic outlook for Austria of December 2008 (in this issue) includes a variety of special factors: increased risk premiums for corporate and consumer loans; an additional dampening of corporate investment caused e.g. by a credit crunch; effects on consumer spending triggered by diminished household wealth in the wake of asset price losses; foreign trade effects as a consequence of a deterioration of the international environment; and confidence effects reflected in a higher saving ratio and a marked deterioration of export expectations. This approach was chosen to ensure that the OeNB economic outlook takes account of some specific key factors influencing the economy in the current exceptional economic conditions.

In fact, numerous transmission channels that could be relevant for the analysis of the current exceptional economic environment are conceivable and are being discussed in the economic literature. Some of the most important of these factors are outlined below.

Equity and liquidity of financial institutions
A heightened need for writedowns, a deteriorated risk structure of bank assets and/or a change in financial markets’ risk perception make it necessary to increase capital requirements for financial institutions. Consequently, banks may restrict or even stop lending altogether (credit crunch). Preventing a credit crunch is one of the main motivations many governments had in mind when they included the provision of equity or equity-like funding in their

Ernest Gnan,
Peter Mooslechner

bank support plans. If lending restrictions cannot be fully averted, financing constraints for debt-financed demand components will result, which in turn have a negative impact on economic growth.

In the short term, such lending constraints may be due to liquidity bottlenecks that banks themselves experience under conditions that we have seen worldwide for several months: a frozen interbank money market, where banks no longer lend to each other or reduce interbank lending to a limited amount of unsecured short-term loans. To counteract a liquidity shortage-based credit crunch, central banks across the world have provided the banking system with generous liquidity facilities in recent months.

Corporate value and creditworthiness of borrowers

A further transmission channel capable of triggering a restriction of lending is a deterioration in the creditworthiness of borrowers. For one thing, (expected) corporate and household solvency takes a blow during a recession or an economic crisis, and for another, a more unfavorable outlook for sales and profits reduces corporate value. In the case of listed corporations, lower value also takes the form of lower stock market capitalization. Both effects prompt banks to exercise more caution in lending. This in turn can raise risk premiums for loans, making borrowing more expensive, but it may also induce banks to restrict the volume of loans.

Household consumption and household assets

Losses in household wealth – triggered by, e.g., falling stock or real estate prices – may affect consumption. Especially if these losses are expected to be permanent, they will diminish anticipated future disposable income or

prompt households that seek to hold a certain level of wealth to increase the saving ratio. And, much like in the case of the decline in corporate value described above, losses may reduce households' loan collateral and may thus raise the cost of borrowing or decrease its volume.

Confidence

Furthermore, an (expected) deterioration of the economic outlook may affect consumer and corporate confidence in various ways. The expectation that profits will decline may dampen the propensity to invest, and the fear of unemployment may induce consumers to save more. The massive slump on stock markets across the world in tandem with reports about the crisis may “indirectly” persuade even savers who have not suffered asset price losses to curtail spending.

This issue includes four studies designed to illustrate how such transmission channels may be taken into account in economic forecasting via specific analyses, even though they are not directly part of the model used. The main objective of these studies is to provide an analytical basis and a quantitative estimate of the factors causing these effects so that they may be considered in forecasting.

Waschiczek analyzes the statistical evidence of signs of a credit crunch in corporate lending in Austria. The Austrian results of the bank lending survey show that since the onset of the crisis in summer 2007, lending has suffered on the back of deteriorated refinancing conditions in the interbank market and has become more restrictive. Moreover, the credit standing of firms is expected to deteriorate in the near future owing to the economic downturn, which would also contri-

bute to a slowdown in lending. Consequently, the emergence of a credit crunch in Austria cannot be ruled out.

Jobst and Kwapil examine whether the financial market turbulence and the related greater difficulty and banks' risen refinancing costs in the money and capital markets have led to a change in the transmission mechanism of interest rates from the money market to customers. The authors find that – in contrast to conventional wisdom – interest rates on corporate and housing loans, with rate fixations of between one and five years, were lifted less than the historical evidence would have suggested. A possible explanation for this phenomenon is the prevalence of relationship banking in Austria, which protects banks' customers from excessive interest rate fluctuations. The study also reveals that banks distinguish clearly between groups of customers. Whereas banks pass interest rate changes on to some customers the same way as they ever have, they only partly pass on changes in market interest rates to corporate borrowers and customers with housing loans with a long-term rate fixation.

Fenz and Fessler find that Austrian households and self-employed persons have suffered valuation losses of some EUR 17 billion since the onset of the crisis in mid-2007. Simulation results

based on the OeNB macroeconomic model, however, show that the effects of these valuation losses on private consumption and GDP growth in Austria are not very marked at -0.3% and -0.1% , respectively over a five-year period. Moreover, they occur with a substantial time lag. However, in light of the far-reaching nature of the current crisis, it cannot be ruled out that consumer spending may be impaired more strongly through confidence effects.

Finally, *Summer* shows that while a rich literature on financial crises and its mechanisms has been produced in recent years, it has not been integrated into the mainstream of economic thinking yet. Doubtless, the current crisis has given more weight and attention to these efforts. Against this background, crisis analysis is bound to be a “growth sector” in economics.

To sum it up, these studies are intended to represent a first contribution to understanding the current crisis better, and in particular to explaining some of the mechanisms and effects specific to the current situation. While we are no doubt standing at the beginning of our efforts to understand the current crisis, we hope that these analyses can provide some contribution to coping better with it.