

Austria's Real Economy: Supported by the Low Interest Rate Environment

Corporate Debt Picks Up Slightly Austrian Economy Slows Down

After unexpectedly strong growth at the beginning of 2012, Austria's economy has lost considerable momentum in recent months. The European financial and debt crisis has brought down Austrian exports and industrial production. Foreign trade has been dampened by the recession in important European export markets and thus no longer provides a growth impetus, which in turn has put a strain on domestic production. In the face of increasing uncertainty about future sales prospects, enterprises reduced or postponed their investment plans. This concerned in particular fixed investments which decreased slightly in the first half of 2012, while the growth of construction investment remained positive. Leading indicators signal that the economy lost further momentum in the second half of the year.

Investment demand was supported by corporate profits, even though the surge in corporate profitability which could be observed in 2011 abated somewhat in the first half of 2012. Corporate earnings were sustained by brisk economic activity at the beginning of the year and by falling commodity prices. Wage developments, however, did not support corporate profitability in the first half of 2012. In the second quarter, gross operating surplus was up 8.3% year on year. In addition, the nonoperational component of corporate profitability was boosted by the low interest rate level. While, in nominal terms, gross operating surplus already caught up with pre-crisis levels in 2011, the gross profit ratio (i.e. gross operating surplus in relation to gross value added of the corporate sector) has

yet failed to reach its pre-crisis highs and even fell slightly in the first half of 2012 to 41.4%. However, this level was still markedly higher than the comparative level in the euro area.

Economic growth loses momentum

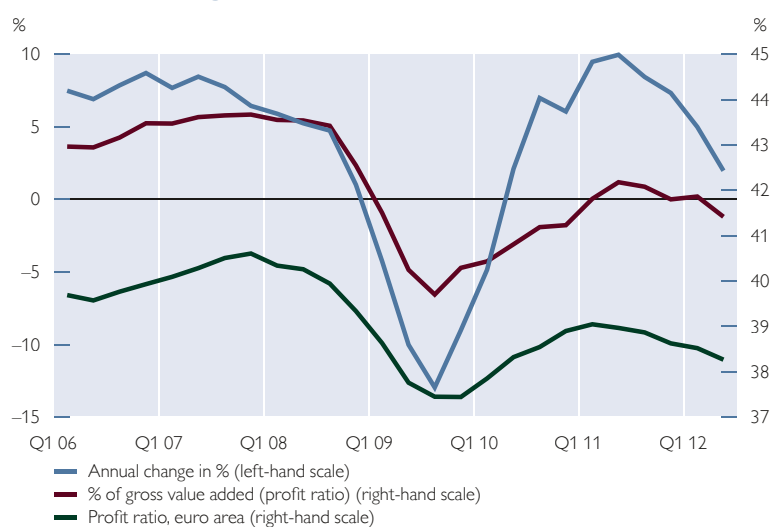
Corporate Sector Further Reduces External Financing

According to the financial accounts, the volume of external financing amounted to EUR 9.6 billion¹ in the first half of 2012, which was about one-third below the comparable 2011 figure. On the one hand, this decrease may reflect an increasing amount of internal financing owing to the still growing profits; on the other hand, it may be attributable to lower financing needs due to declining investment. The reduction in external financing was driven by a decrease in equity financing. Debt financing was almost 50% higher than in the first half of 2011 and accounted for almost 90% of the external financing volume (compared

Profit growth slows down

Chart 7

Gross Operating Surplus of Nonfinancial Corporations



Source: Statistics Austria.

¹ Adjusted for foreign-controlled holdings in special purpose entities.

to roughly 40% in the first half of 2011).

Bank Loans Gain Importance in Corporate Financing

Bank lending gains momentum

Lending by domestic banks accounted for around 20% of nonfinancial corporations' external financing in the first half of 2012, more than twice the comparable 2011 figure, which means that the growth of bank loans to the corporate sector in Austria has accelerated during 2012. According to the MFI balance sheet statistics, the annual rate of change in Austrian bank lending (adjusted for reclassifications, valuation changes and exchange rate effects) reached 2.7% in nominal terms in September 2012; deflated with the GDP deflator,² the growth rate amounted to 0.8% in the third quarter of 2012.³ The largest contribution to loan growth came from lending at longer maturities (more than five years), which continued to record stable growth in Austria, whereas the growth of loans with a maturity of less than one year declined. Thus, the Austrian corporate sector could avoid the slowdown witnessed in the euro area as a whole, where the nominal growth rate turned negative in the first half of 2012.

Falling lending rates

Banks tighten credit standards

This increase in lending in Austria took place despite the fact that, according to the Austrian results of the euro area bank lending survey (BLS), credit standards for corporate loans had been slightly tightened by Austrian banks since mid-2011. This tightening affected large firms more strongly than small and medium-sized enterprises (SMEs). Costs related to banks' capital

positions and heightened risk concerns reflecting the economic slowdown affected banks' lending policies. At the same time, the banks surveyed in the BLS noted a slight decline in corporate loan demand, again primarily relating to large companies. On the one hand, this can be explained by somewhat lower funding requirements for fixed investment; on the other hand, companies still relied on internal sources of finance to a considerable extent, as they had sizeable amounts of cash to finance their activities (in September 2012, bank deposits were up 6.6% year on year).

Apparently, in the current phase, tighter credit standards have not materialized primarily in loan volumes but in tighter terms and conditions. Stronger risk discrimination by banks found its expression not only in higher margins on riskier loans, but also in rising collateral requirements as well as more (or stricter) loan covenants. Given banks' stricter loan policies toward large firms, these were faced with a stronger tightening than SMEs.

The net tightening of banks' lending terms and conditions partly offset the easing effect of interest rate cuts. In response to the three ECB interest rate cuts of November and December 2011 and July 2012 (by 0.25 percentage points each) and the associated decline in money market rates, corporate lending rates fell by 101 basis points between December 2011 and September 2012. While interest rates fell for all loan sizes and maturities, this decrease was slightly more pronounced for larger loans (with a volume of more than EUR 1 million) and for short-term loans.

² Based on the GDP deflator for the second quarter of 2012, as the deflator for the third quarter was unavailable at the cutoff date.

³ At the cutoff date, financial accounts data were available up to the second quarter of 2012. Therefore, the figures on growth contributions presented here refer to the first half of 2012. More recent developments of financing flows are discussed based on data from the MFI balance sheet statistics and the securities issues statistics.

On top of loans by domestic banks (EUR 1.8 billion), Austrian enterprises took out EUR 0.9 billion from foreign banks in the first half of 2012, which corresponds to an annual growth rate of 15.7% in the second quarter of 2012. Taken together, Austrian and foreign bank lending accounted for about 29% of corporate external financing in the first half of 2012.

Bonds Contribute Considerably to Corporate Financing

In the first half of 2012, bond issues of EUR 3.6 billion accounted for more than one-third of Austrian companies' financing, which was well above the average of the previous years. In the first two quarters of 2012, net new bond issuance exceeded the total volume of new bank lending by one-third (thus reaching a volume twice that of loans from domestic banks) and remained strong in the further course of the year. At an annual growth rate of 11.8% (according to securities issues statistics), the expansion rate of corporate bonds in September 2012 markedly exceeded that of other financing instruments. From a funding perspective, this disintermediation may be viewed as a reduction of the corporate sector's dependence on one specific source of finance. This development would also be in line with the findings of the BLS that larger firms – to which market financing is primarily limited – were faced with tighter lending policies in 2012 than SMEs. However, a considerable portion of new bonds were issued by corporations that are majority-owned by the public sector. In the first half of 2012, these corporations' share in gross new issues amounted to some 55%, a percentage that roughly equals

the average of the past five years. The share of variable rate bonds declined slightly in 2012, falling from 13.8% at the end of 2011 to 12.1% in September 2012, while the share of bonds issued in foreign currency remained flat at roughly 10%.

Bond yields, like bank lending rates, contracted in 2012, but their decline was much more pronounced than that of lending rates. After a marked increase in yields for lower-rated bonds caused by investors' lower risk appetite in the second half of 2011, the yields on BBB-rated bonds dropped by 329 basis points in the first ten months of 2012, reaching 4.01% in October 2012.⁴ Over the same period, the yields on AAA-rated corporate bonds declined by 150 basis points, so that the yield spread between BBB issues and top-rated euro-denominated corporate bonds narrowed from 394 to 215 basis points, the lowest value recorded since July 2011. Bond yields were more than 4 percentage points below the peak values observed at the height of the financial market turmoil in the fall of 2008.

Low Recourse to Trade Credit

A noteworthy share in firms' funding sources is accounted for by trade credit, which represented more than 5% of outstanding financial liabilities at mid-2012. In the first half of 2012, while recovering from the reduction in the second half of 2011, the net volume of trade credit by domestic companies decreased by about 60% compared to the first half of 2011, vigorous sales at that time notwithstanding. As a key element of firms' working capital, trade credit closely depends on economic activity, of course; it is also possible, however, that – like short-term bank loans –

Bonds account for one-third of external financing

Trade credit declines

⁴ Euro area figures are used here, as no time series is available for yields on Austrian corporate bonds.

Equity financing almost at a standstill

trade credit may have been substituted by longer-term financing. What is more, it is possible that due to its relatively informal character and at the same time relatively high cost, increased recourse to trade finance might be correlated with financial distress and/or hampered access to other forms of finance. Thus, the low usage of trade credit may also be an indication that although bank credit standards were tightened this year, their increased

restrictiveness did not drive firms into alternative sources of finance.

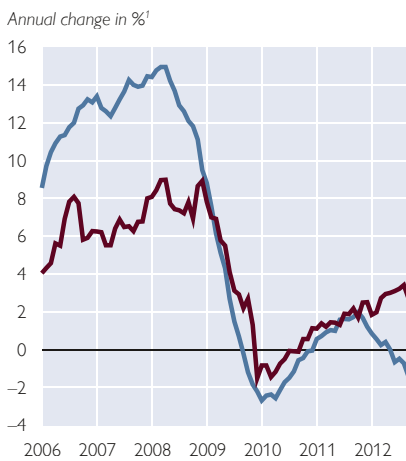
Equity Financing Still Affected by the Crisis

Equity financing continued to be hampered by the crisis in the first half of 2012, with quoted stocks accounting for just 0.3% of external financing for nonfinancial corporations. There were no new listings in the first three quarters of 2012 and only a few capital

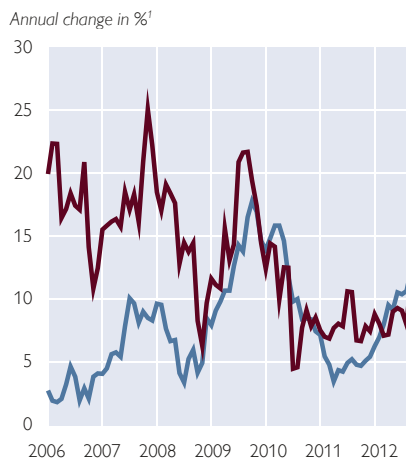
Chart 8

Key Elements of Nonfinancial Corporations' Financing: Volumes and Conditions

Loans: Volumes



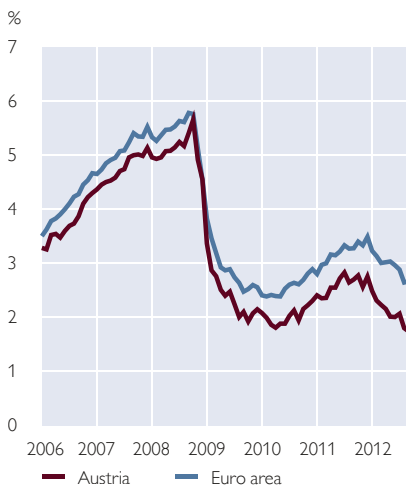
Bonds: Volumes



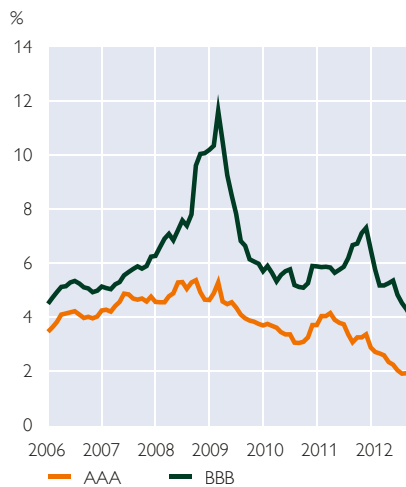
Quoted Stocks: Volumes



Loans: Interest Rates



Bonds: Yields



Quoted Stocks: Earnings Yields



Source: OeNB, ECB, Thomson Reuters, Wiener Börse AG.

¹ Adjusted for reclassifications, valuation changes and exchange rate effects.

increases. Therefore, the amount of capital raised on the stock exchange amounted to less than EUR 0.1 billion and, taking a few small delistings into account, net issuance was virtually nil in the first three quarters of 2012. The earnings yield (i.e. the inverse of the price-to-earnings ratio) of the ATX, which can be used as an indicator of the cost of raising capital on the Austrian stock market, dropped from 11.6 in December 2011 to 7.5 in October 2012.

The development of other equity (unquoted stocks and other equity instruments) was also subdued in the first half of 2012 after having accounted for only roughly 10% (or close to EUR 1.0 billion) of external financing in 2011. In the first six months of 2012, corporations similarly obtained only little more than 10% of their external financing in the form of equity. Relative to the corporate sector's total liabilities, its equity position (i.e. the proportion of stocks in total liabilities) decreased from 42.8% to 42.3% in 2011.

Companies' Debt Servicing Capacity Deteriorates Slightly

The annual growth rate of corporate debt (in terms of total loans and bonds), which had slowed in 2011, started to rebound in the first half of 2012 and stood at 4.4% at mid-year. This increase was mainly attributable to long-term financing instruments, while short-term financing receded in the first half of 2012. Although this figure was still well below the long-term average, together with the slowdown in earnings growth, this acceleration reduced the sustainability of corporate debt somewhat. The ratio of corporate debt to gross operating surplus rose by 7 percentage points to 490%, which was still considerably higher than in the pre-crisis years. The ratio recorded by

Austria was, however, lower than in the euro area as a whole. Reflecting increasing debt growth and subdued equity financing, the debt-to-equity ratio rose somewhat in the first half of 2012 and reached 121% in June 2012. Contrary to the debt-to-income ratio, the debt-to-equity ratio is considerably higher in Austria than in the euro area, which highlights the importance of debt financing in Austria.

Firms' ability to service their debt continued to be supported by the low interest rates. In the first three quarters of 2012 interest expenses even declined in relation to gross operating surplus. However, even though corporate sector debt – and thus the sector's exposure to interest rate risk – has increased only moderately during the crisis, a rise in interest rates could create a noticeable burden for highly indebted companies. This aspect is especially relevant in the light of the above-average share of variable rate loans in Austria. Compared with their euro area peers, Austrian companies currently have markedly lower interest expenses, but their exposure to interest rate risk is considerably higher. Moreover, companies that face refinancing risks may also be more vulnerable to a tightening of bank lending standards. The level of corporate leverage, which is still high by historical standards, continues to imply considerable vulnerabilities to upward pressures on the terms and conditions of financing – be they price or non-price terms of loan contracts. The share of foreign currency loans in total corporate loans is currently almost twice as high in Austria as in the euro area, but has declined by roughly 2 percentage points in the course of 2012. There is, however, no evidence that banks have limited lending more than they usually would in an economic downturn,

Variable rate loans imply interest rate risk

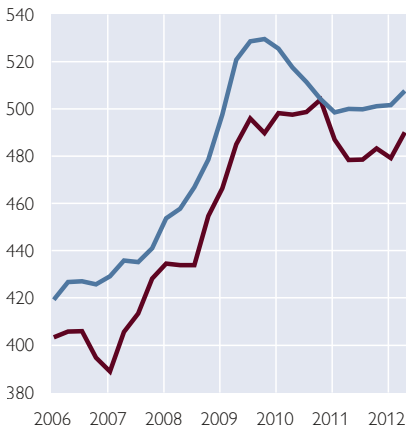
Corporate equity position slightly decreases

Debt ratio rises

Risk Indicators for Nonfinancial Corporations

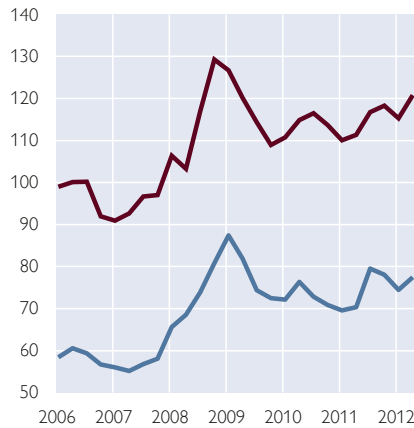
Debt

% of gross operating surplus



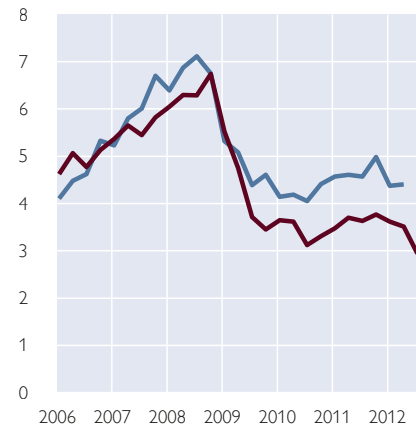
Debt-to-Equity Ratio

%



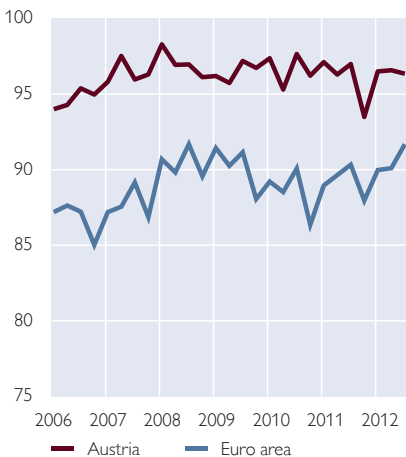
Interest Expense

% of gross operating surplus



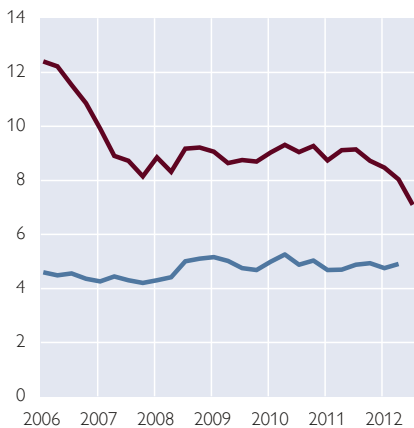
Variable Rate Loans

% of total new lending



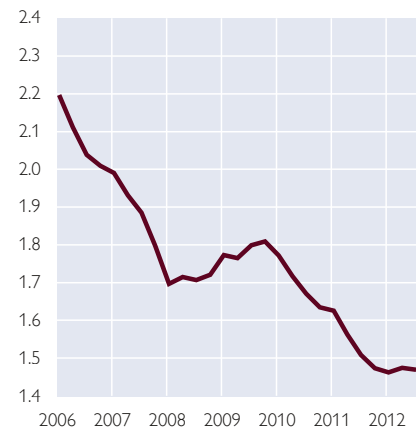
Foreign Currency Loans

% of total loans



Insolvencies

Number of insolvencies in % of companies



Source: OeNB, ECB, Eurostat, KSV 1870.

Number of insolvencies still low

implying that the risk of a possible recovery being hampered by a lack of bank funding is not to be considered large at this point.

The number of corporate insolvencies, which had increased relatively little since the onset of the crisis and declined since mid-2010, remained low in the first three quarters of 2012. Based on the total of the preceding four quarters (to adjust for seasonality) the number of insolvencies recorded in the third quarter of 2012 was 0.9% lower

than the 2011 figure; it also dropped markedly in relation to the number of existing companies. On the one hand, this development can be ascribed to the so far rather slow rise in debt financing and the low interest rate level (which makes debt servicing easier even for highly indebted companies). On the other hand, the favorable economic developments in 2011 may have contributed to the decrease in insolvencies in 2012, given that insolvencies usually lag cyclical movements.

Foreign Currency Loans to Households Decrease Markedly

Rebound in Real Income Growth

Household disposable income grew in real terms in the first half of 2012, profiting from relatively high wage settlements and lively employment growth. However, inflation, negative wage drift as a result of the increase in part-time jobs, as well as shifts to jobs in the low-wage sectors put a drag on household real incomes. Even if the saving rate increased somewhat in the first half of 2012, it was still low by historical standards. For one thing, the low interest rate environment may have reduced the attractiveness of saving, and for another, the economic crisis particularly affected property income, i.e. that portion of disposable income that is probably much more likely to be saved than labor income.

Household Financial Investment Still Below Pre-Crisis Levels

After strong reductions in the first six months of each 2010 and 2011, household⁵ financial investment rebounded slightly in the first half of 2012 and, at EUR 6.3 billion, was 13.8% higher than in the corresponding period of 2011, although it was still almost 40% below the pre-crisis peak value recorded in 2007.

At EUR 3.9 billion, deposits accounted for almost two-thirds of financial investment in the first half of 2012, thus almost doubling the corresponding 2011 figure. The largest inflows were recorded for overnight and short-term deposits, whereas the volume of long-term deposits declined in 2012. Broken down by types of deposits, demand deposits accounted for more than 70% of new deposits, whereas time and savings deposits contributed just 12%

and 16%, respectively (even though their share in total outstanding deposits amounts to almost three-quarters). This ongoing shift in the maturity structure suggests that households have a high preference for liquidity, and may also be connected to low opportunity cost due to low interest rates.

In light of lingering uncertainty in the financial markets and considerable valuation losses in 2011, Austrian households have reduced their holdings of capital market assets since mid-2011. After a net disinvestment of EUR 0.7 billion in the second half of 2011, there was another slight outflow in the first half of 2012. Mutual fund shares and debt securities dropped in net terms by less than EUR 0.1 billion each, while investment in quoted stocks rose marginally (EUR 0.02 billion).

As in the preceding years, investment in life insurance and pension funds had a stabilizing effect on financial investment in the first half of 2012, though with net investment of EUR 0.9 billion it fell by roughly one-quarter in year-on-year terms. Thus, they accounted for around 15% of total financial investment in the first half of 2012. Inflows into these instruments were, for a large part, not the result of current investment decisions, but – given the long maturities and commitment periods – reflected past decisions. Demand for funded pension instruments is a key factor in this context. Moreover, life insurance policies are often used as repayment vehicles for foreign currency bullet loans.

After the substantial (unrealized) valuation losses in their securities portfolios in 2011, Austrian households registered small valuation gains in the first half of 2012. At EUR 1.3 billion, these were equivalent to 1.4% of their

Saving ratio remains low

Capital market investment negative

Investment in life insurance has stabilizing effect

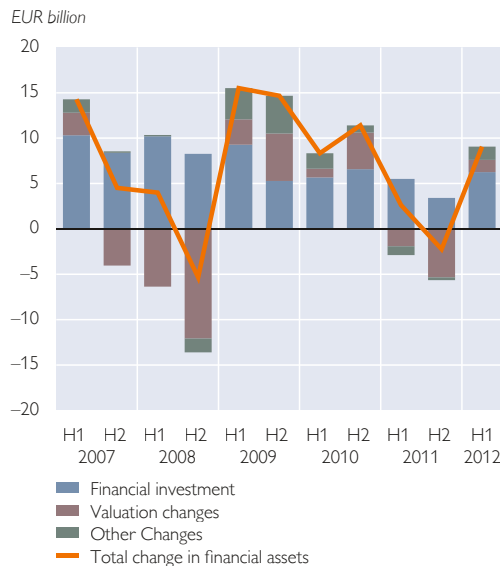
Strong recourse to short-term deposits

Considerable unrealized valuation gains

⁵ Nonprofit institutions serving households are not included here.

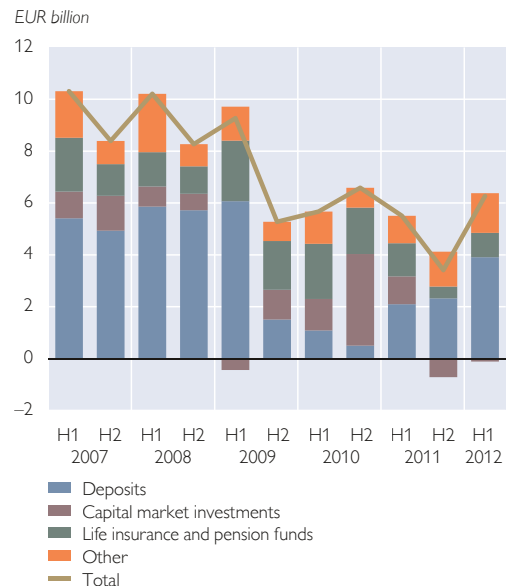
Changes in Households' Financial Assets

Determinants of Changes in Financial Assets



Source: OeNB.

Components of Financial Investment



Foreign currency loans decline further

securities holdings. Quoted stocks, debt securities and mutual fund shares in the portfolios of Austrian households all registered roughly equal (unrealized) valuation gains. Taking financial investment, valuation gains and other changes together, financial assets rose by EUR 9.1 billion in the first half of 2012.

Lending Growth Subdued but Supported by Housing Loans

Growth of bank lending to households was subdued in 2012. From the second half of 2011 onward, annual growth rates receded continually and in August 2012 bank loans to households (adjusted for reclassifications, valuation changes and exchange rate effects) increased by a mere 0.3%. In September 2012, a slight rebound was registered when the annual growth rate increased to 0.8%.

A breakdown by currencies shows that euro-denominated loans continued to expand unabatedly (September 2012:

6.6%), while foreign currency loans were reduced markedly; in September 2012, they had fallen by 13.3% year on year. This considerable reduction highlights the effectiveness of the Austrian Financial Market Authority's minimum standards for granting and managing foreign currency loans, which aim at substantially limiting new foreign currency lending to households.

Broken down by purpose, the slowdown in loan growth was mainly driven by a decline in consumer loans (-1.8% against the previous year) and other loans (-2.5%). Housing loans still grew at 2.9% year on year, although their expansion rate also decreased in the course of 2012. While the favorable financing conditions probably still supported the growth of housing loans, and though households needed more funding to purchase real estate as housing prices have been on the rise in Austria (+15.7% year on year in Vienna and +10.1% in Austria excluding Vienna in the third quarter of 2012), other housing

market indicators pointed to a downturn in credit demand. Although there are no current data on newly completed housing projects available, the falling number of residential building permits (–8.7% year on year in the first half of 2012) suggests a reduction in construction activity. According to results of the BLS, both banks' credit standards and households' demand for housing loans have been broadly stable in 2012 so far.

Loan conditions remained favorable. Interest rates on short-term loans (up to one year) stood at 2.80% in Sep-

tember 2012, 0.73 percentage points below their October 2011 level, reflecting the key interest rate cuts of November and December 2011 and July 2012 as well as the associated decline in money market rates. Looking at data across the entire maturity bands, interest rates on new housing loans stood at 2.69% in September 2012, which was 0.34 percentage points lower than the value recorded in October 2011. Over the same period, interest rates on consumer loans dropped by 0.65 percentage points to 4.48%. As a result, interest rates were 2.9 percentage points

Financing conditions remain favorable

Chart 11

MFI Loans to Households: Volumes and Conditions

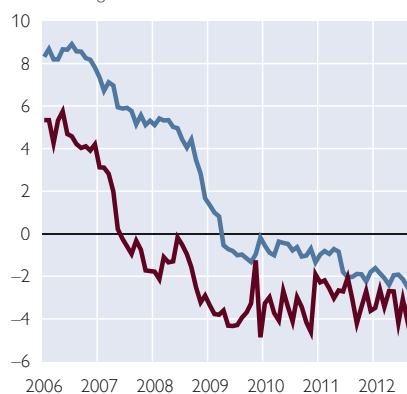
Housing Loans: Volumes

Annual change in %¹



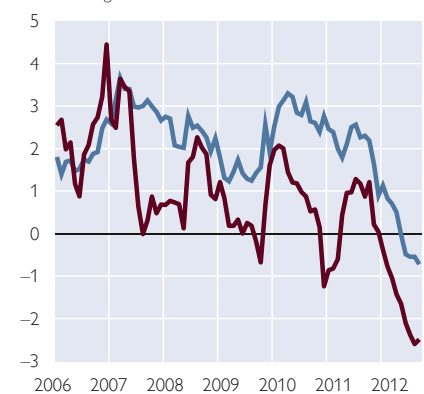
Consumer Loans: Volumes

Annual change in %¹



Other Loans: Volumes

Annual change in %¹



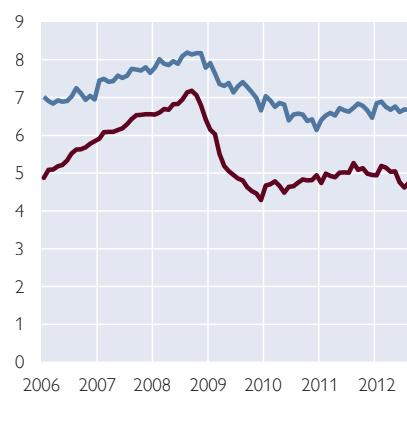
Housing Loans: Interest Rates

%



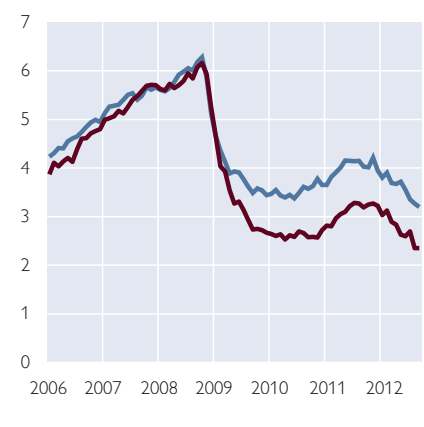
Consumer Loans: Interest Rates

%



Other Loans: Interest Rates

%



— Austria — Euro area

Source: OeNB, ECB.

¹ Adjusted for reclassifications, valuation changes and exchange rate effects.

(housing loans) and 2.7 percentage points (consumer loans) below their pre-crisis levels.

Households' Currency and Interest Rate Risks

Household debt increases moderately

By international comparison, the indebtedness of Austrian households is rather low and has remained relatively stable during the crisis due to moderate borrowing. According to the financial accounts, total household liabilities stood at EUR 167.7 billion at mid-2012,

up by a mere 1.1% in nominal terms from a year earlier. As a percentage of net disposable income, household debt amounted to 87.4% (–2.2 percentage points from end-2011). The debt ratio of Austrian households thus was again lower than in the euro area as a whole (106% in the first quarter of 2012).

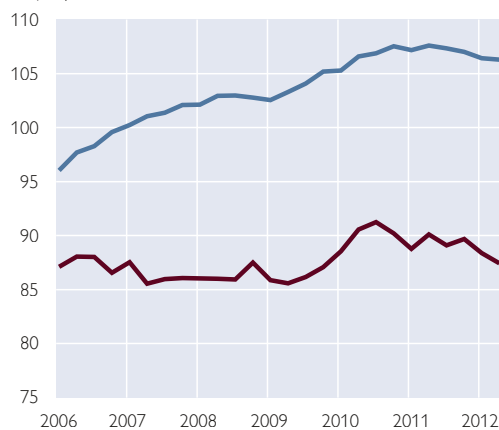
Owing to a combination of moderate debt levels and low interest rates, household interest expenses remained low and even declined somewhat further in the first two quarters of 2012 on

Chart 12

Household Risk Indicators

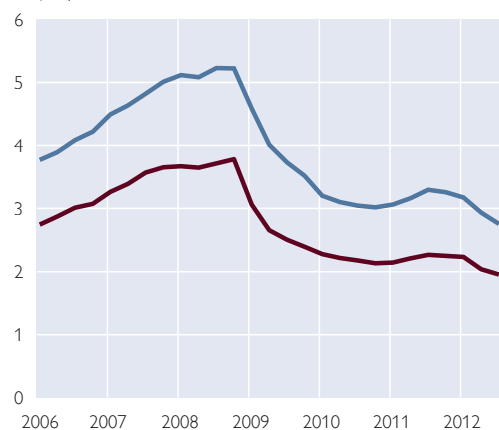
Liabilities

% of disposable income



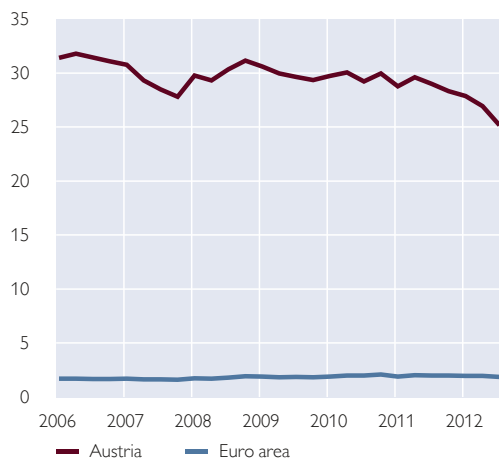
Interest Expense

% of disposable income



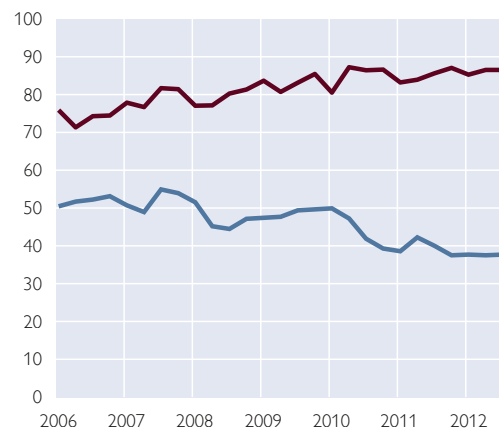
Foreign Currency Loans

% of total loans



Variable Rate Loans

% of total new loans



Source: OeNB, Statistics Austria, ECB, Eurostat.

Note: Figures for the euro area represent only the interest expense on euro-denominated loans.

the back of reduced interest rates for bank loans. As a percentage of disposable income, interest expenses amounted to 2.0% in the second quarter of 2012, which was around 1½ percentage points less than before the onset of the crisis. One factor that contributed to this decline was the high share of variable rate loans. In the third quarter of 2012, 86.5% of new loans were granted with an initial rate fixation period of up to one year, which is a very high share by international comparison. Therefore, when the ECB lowered its key interest rates during the crisis, lending rates in Austria were reduced at a faster rate than in the remaining euro area. In addition, retail rates have generally been

lower in Austria than in the euro area in recent years.

Another risk factor for the financial position of Austrian households is the still high share of foreign currency loans in total loans. In the second quarter of 2012, 24.9% of total loans to Austrian households were still denominated in foreign currency. While this ratio has fallen by roughly 46 percentage points since 2009, households are still exposed to substantial exchange rate risk, even though the Swiss franc has not appreciated further against the euro since September 2011, when the Swiss National Bank set a maximum exchange rate of CHF 1.20 to the euro.

Share of foreign
currency loans
declines

Interest expenses
decrease further