I FINANCIAL BEHAVIOUR OF COMPANIES AND HOUSEHOLDS AND THEIR RISKS

COMPANIES[1]

Corporate business situation

Confidence

The **economic confidence indicator** calculated by the Estonian Institute of Economic Research indicated the persistence of a highly favourable situation also during the first months of 2007. In 2006, economic growth posted a record level in Estonia's history. The consumer confidence as well as the confidence indicators of construction, trading and manufacturing companies reached their historically highest levels (see Figure 1). The confidence of manufacturing companies improved as rapidly at the end of 2007 as the year before. The rise in the confidence of trading companies slightly slowed down and the indicators of construction companies remained somewhat more modest than a year ago.

The confidence of **manufacturing companies** improved during the first months of 2007 primarily owing to good expectations with regard to export orders (see Figure 2). The growth of production and sales also maintained the year-ago level as a result of strong domestic demand. In light of the high demand on the one hand, and the shortage of labour and raw materials on the other, the price growth in manufacturing accelerated to 7.5% in March 2007.

At the beginning of 2007, the **construction market's expectations towards the general economic situation** remained a bit more modest than a year ago. While in the first half of 2006 GDP growth was boosted mainly by construction and real estate development, in the second half of the year the growth decelerated precisely in these areas. Although demand in the construction market is still high, resource shortages do not promote

Figure 1. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

[1] In this chapter, "companies" refer to non-financial companies.

Figure 2. Demand for the production of manufacturing companies and confidence indicator

Source: Estonian Institute of Economic Research

growth but instead prolong the working period covered with concluded contracts.

Similarly to manufacturing, also the construction sector suffered from the shortage of labour and raw materials and the resulting faster growth of production costs. The construction price index reflecting the changes in production costs rose to 13.5% in the fourth quarter of 2006 and to 15.6% in the first quarter of 2007.

New companies and bankruptcies

The pace of establishing **new companies** started to abate in the second half of 2006. In 2006, 22% more companies were founded than in the previous year, whereas during the first four months of 2007 the number of companies established grew only by 6% (see Figure 3). Most of the new companies are real estate and construction firms. During the first four months of 2007, the share of real estate companies among all newly established companies even reached 40% (24% on average in 2006). Excluding these, the number of new companies has dropped by over 25% within the first four months of 2007. Fewer companies were established mainly in wholesale and retail trade, but also in agriculture, fishery and manufacturing.

Along with the declining number of new companies the number of **bankruptcies** started rising in the second half of 2006, exceeding the year-ago figure by 20%. From January to April 2007, 67 more companies went bankrupt, which is 50% more than during the same period the year before. 30% of the bankrupt companies were operating in the trade sector and slightly over 20% in manufacturing. The share of the latter among bankrupt companies has increased.

Corporate investment and economic indicators

The growth rate of corporate turnover remained slightly lower in 2006 compared to 2005. Nevertheless, the growth in total profits and in the value added reached the highest levels in recent years, amounting to 36% and 27%, respectively. Consequently, **profitability** increased (see Table 1).

An opposite trend could be noted in case of manufacturing companies: the growth of turnover accel-

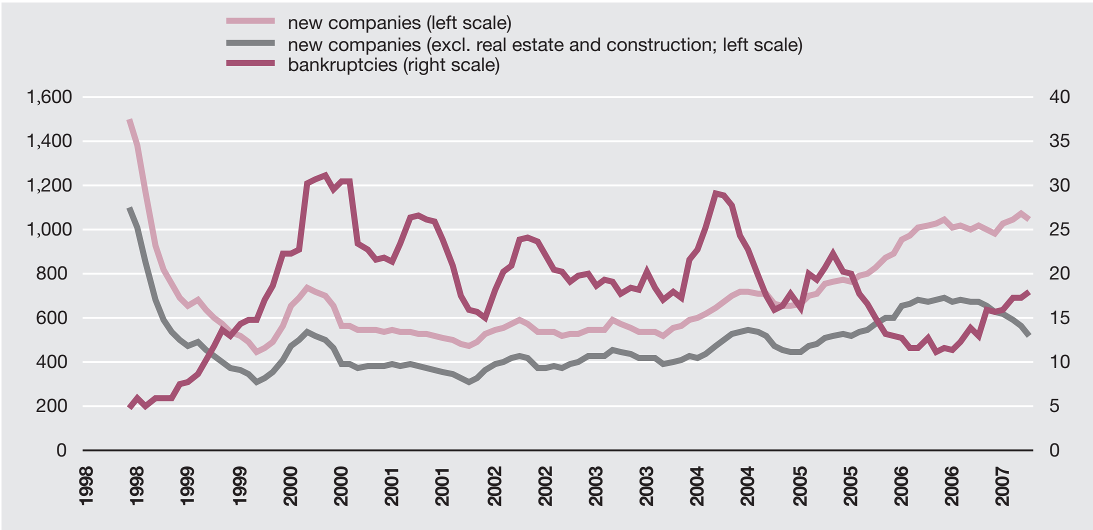

Figure 3. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-months moving average)

Source: Estonian Enterprises Register

Table 1. Corporate indicators (%)

	All fields of activity			Manufacturing		
	2004	2005	2006	2004	2005	2006
Growth of net sales	13.7	20.3	19.5	13.8	15.3	17.3
Growth of total costs	14.8	19.4	18.1	15.1	14.3	17.8
Growth of total profit	0.1	32.8	35.9	0.6	27.0	12.3
Growth of value added	7.2	22.6	27.4	7.1	17.2	15.6
Total profit to net sales*	6.8	7.6	8.6	8.0	8.8	8.4

Source: Statistics Estonia

erated and that of profit slowed down. Though market conditions were favourable, the rapid growth of costs started to undermine profitability. Although total profitability declined slightly, the level achieved may still be considered good.

Investment growth was especially robust in 2006, having increased by 36% year-on-year (see Figure 4). The rapid growth continued in 2007 and a correction is expected no sooner than next year. Investment in fishing, agricultural, real estate, renting and business companies grew the most. The issue of investment structure raised in earlier forecasts, according to which the share of investment in machinery and equipment should start rising, has not found confirmation yet. On the whole, in 2006 the share of real estate investment in total corporate investment increased to over 60%, even reaching two thirds in the last quarter of the year. Investments were mainly channelled to the construction and renovation of buildings and facilities.

Corporate financial position and saving

In 2006, corporate financial liabilities increased more than financial assets. The negative volume of **net financial assets** rose by 29.6 billion kroons up to 232.4 billion (see Figure 5). However, as financial liabilities increased less than GDP, then

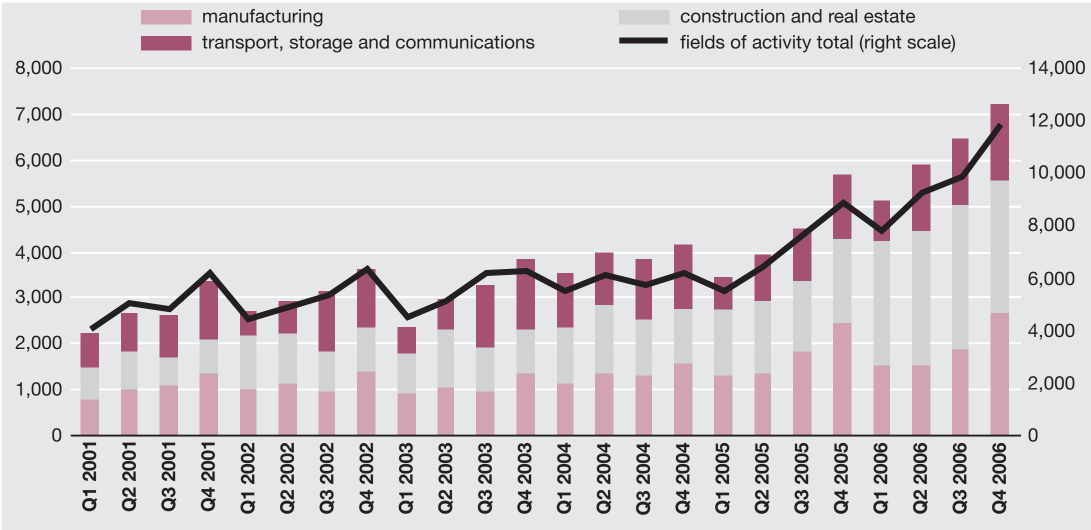

Figure 4. Corporate fixed investment (EEK m)

Source: Statistics Estonia

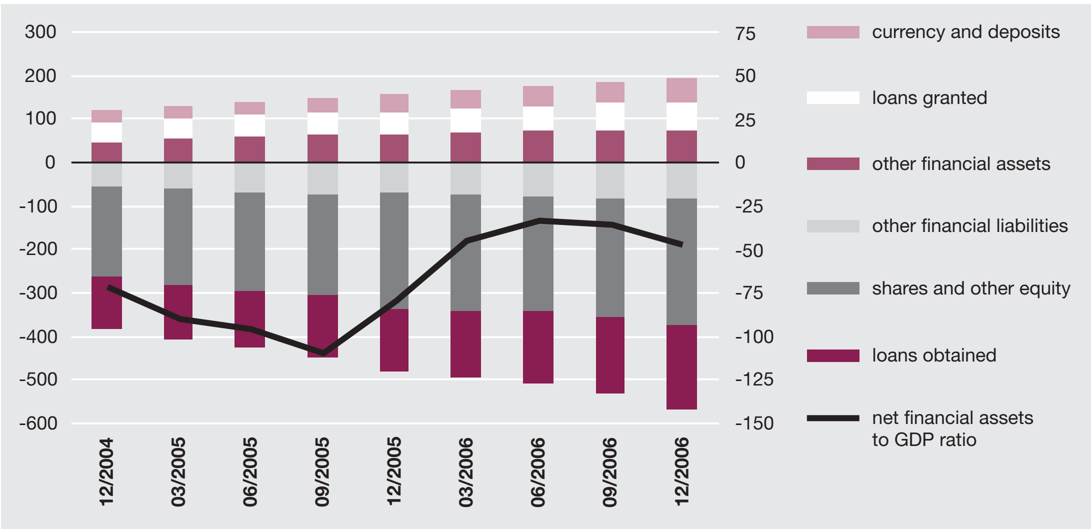

Figure 5. Corporate financial assets and liabilities (EEK bn; left scale) and net financial assets (% of GDP; right scale)

the negative net financial position decreased by 4 percentage points to 114% of GDP in 2006, i.e. to the level seen at the end of the first quarter of 2004.

The greatest share (slightly over 40%) of corporate **financial assets** consists of shares and other equity, which increased rapidly also in 2006 although not as fast as in 2005. The stock market correction in the second quarter of 2006 and the lower growth in the value of stocks compared to 2005 played an important part in this. In contrast, the volume of loans granted by the corporate sector increased considerably faster than in 2005. Their contribution reached 25% of the growth in total financial assets in 2006.

The year-on-year growth of **domestic corporate deposits** dropped since the fourth quarter of 2006 below 30%. This was mainly caused by the base effect deriving from the previous year's rapid deposit growth – actually, the monthly growth remained quite strong (see Figure 6). At end-March 2007, the share of time deposits in total deposits accounted for 30% like a year before. The volume of overnight deposits started increasing rapidly at the beginning of 2006 but subsided by the beginning of 2007.

Although the growth rate of **financial liabilities** remained slightly slower year-on-year (17% and 26%, respectively), the growth rate of corporate loans exceeded the previous year's indicator considerably (30% and 21%, respectively). The smaller growth of shares and other equity issued by companies compared to 2005 was partly caused by the impacts of the stock market correction in the second quarter of 2006 and a slower rise in the value of shares.

The strong growth of corporate loans and the modest increase in shares and other equity issued have caused a steep rise in financial leverage of the corporate sector. This is illustrated by a higher **debt-to-equity ratio**, which rose by 9 percentage points, year-on-year, to 67% by the end of 2006 (see Figure 7).

Corporate debt

As the investment demand continues to be strong, the corporate sector's demand for external funds remains high. In the second half of 2006, the **growth rate of corporate debt** started soaring again, after having slowed down at the beginning of the year, and reached 31% by the end of the year (see Figure 8). The corporate debt growth is primarily shaped by borrowing from domestic banks and leasing companies. By the year-end, the growth rate of lending from domestic banks and leasing companies totalled 47%. The share of foreign debt liabilities declined even further, reaching a quarter of the total debt at the end of 2006 (a third of the total debt the year before).

Although data on the external debt for the beginning of 2007 are not available yet, the growth rate of corporate loans issued by resident banks and leasing companies reached 47% also in the first quarter of 2007, like it did in the fourth quarter of 2006. Based on that, the total debt growth rate presumably remained at a level comparable with the end of 2006 also at the beginning of 2007.

As the growth of corporate debt picked up further, the level of **indebtedness** rose to 71% of GDP by the end of 2006, having grown by 7 percentage points within a year. Thus, the indebtedness of Estonian companies exceeded Finland's indicator for 2005 (68%) and also the aggregate euro area indicator for 2006 (69%).

In 2006, both domestic and foreign creditors increasingly financed real estate and construction companies who received almost 60% of the total external funds (43% a year ago; see Figure 9). As regards other sectors, transport, storage and communications companies received more funds than earlier, i.e. 11% of the external funds of the corporate sector in 2006 (2% in 2005). The financing of these fields of activity increased primarily owing to

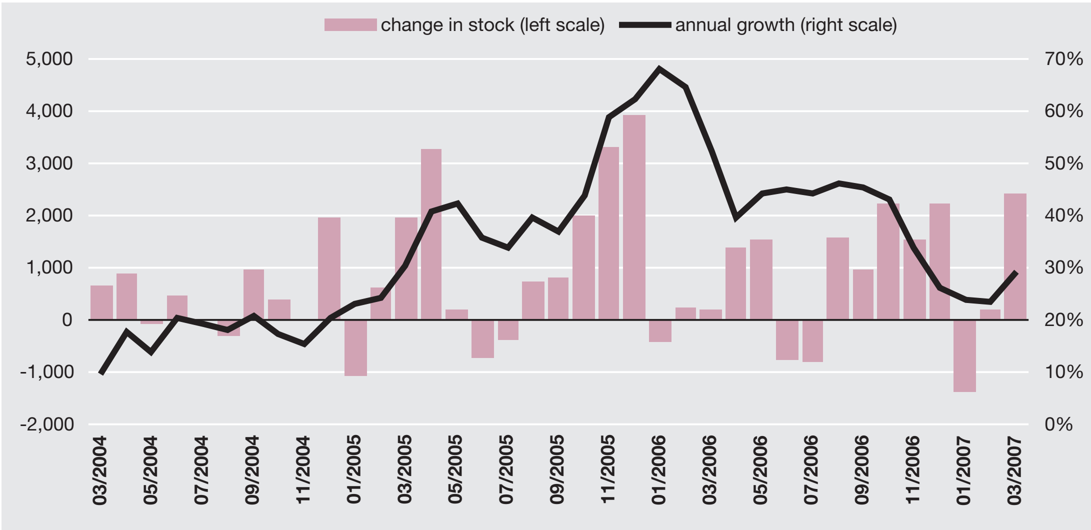

Figure 6. Growth dynamics of non-financial corporations' deposits

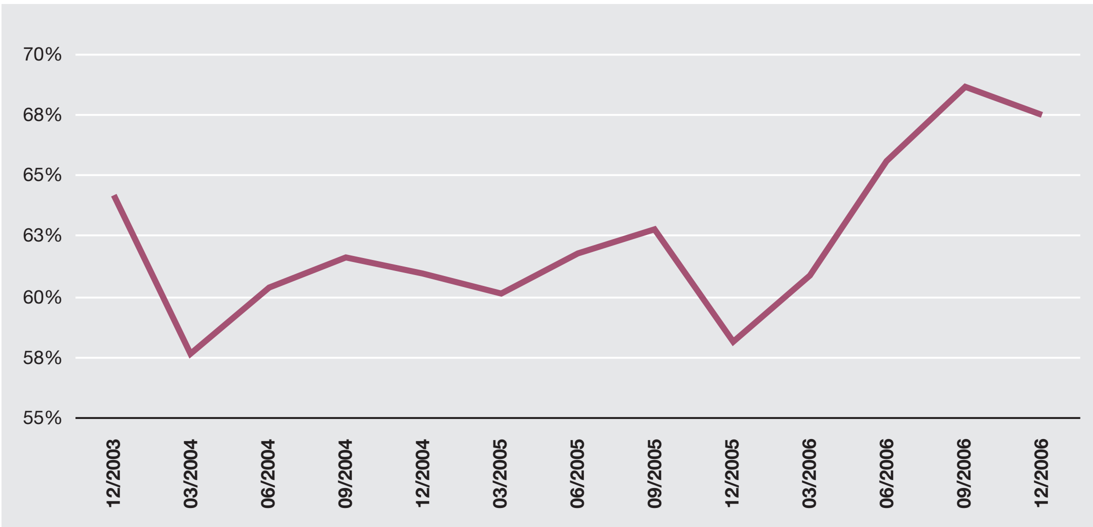

Figure 7. Corporate debt-to-equity ratio (%)

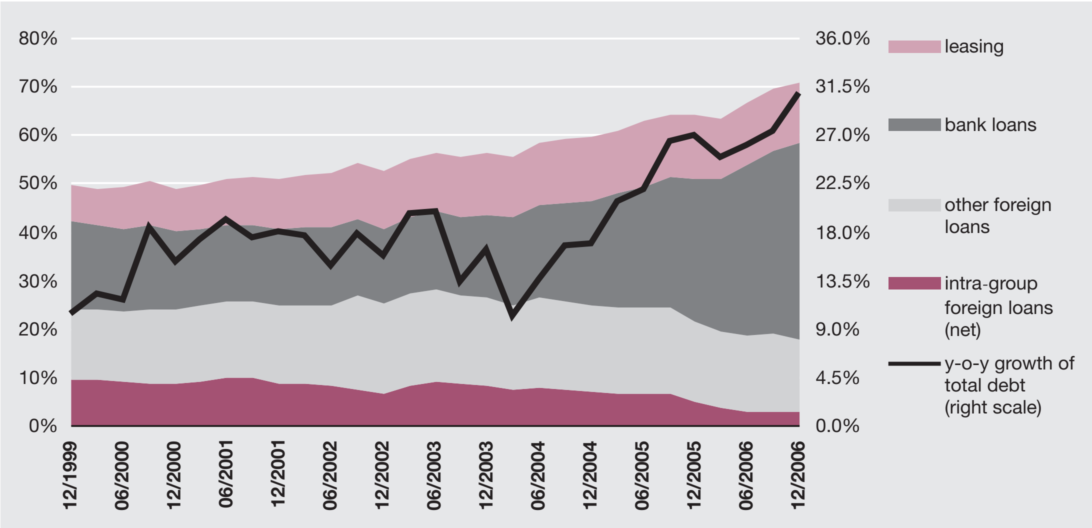

Figure 8. Corporate debt (% of GDP)

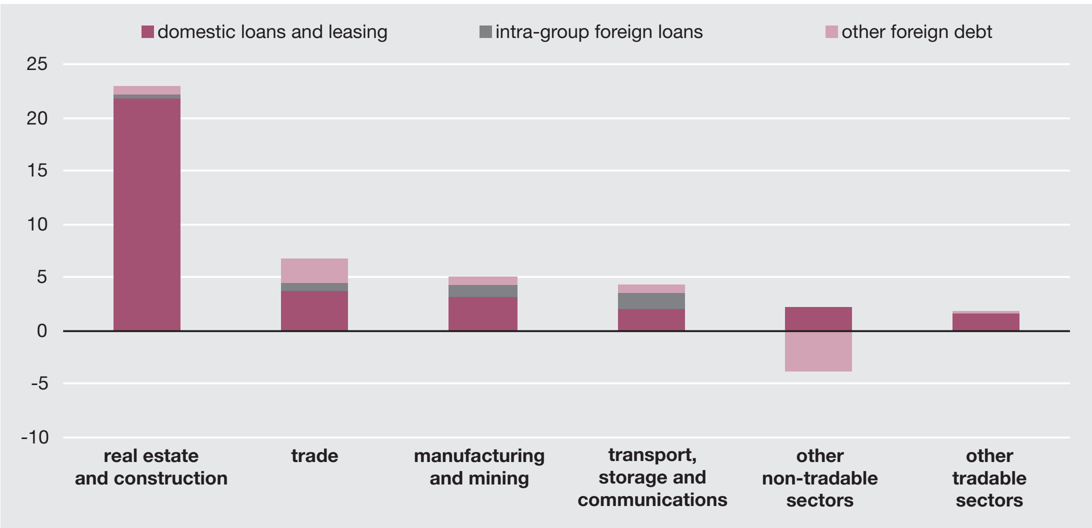

Figure 9. Corporate net borrowing in 2006 (EEK bn)

a decrease in the share of other non-tradable sectors as well as trade and manufacturing.

Real estate financing by domestic banks

Loans granted by domestic banks were again mostly used for acquiring real estate. At the end of March 2007, 60% (53.7 bn kroons) of funds taken from domestic banks was channelled into financing real estate (58% at the end of September 2006). The debt liabilities of real estate companies comprised 57% of this (56% in September 2006).

In other sectors (excluding real estate companies), borrowing to acquire real estate again increased faster than other loans (year-on-year growth reached 63% and 46%, respectively, at the end of March 2007). The total volume of real estate loans is 36 billion kroons, i.e. 44% of the debt liabilities of other companies (excluding real estate companies). Trade and construction firms and other business services companies were especially eager to borrow for real estate purposes from April 2006 to March 2007 (see Figure 10).

The **average interest rates on long-term corporate loans** have increased considerably as a result of higher key interest rates, reaching 5.7% in March 2007 (see Figure 11). The average interest margin, however, has not risen. Although banks have announced the application of stricter credit standards for real estate developers, statistics do not confirm this. The average interest margin on loans issued to real estate companies has not risen and is lower than the corporate average.

HOUSEHOLDS

Economic situation of households

Confidence and household budget surveys

According to the consumer survey compiled by the Estonian Institute of Economic Research, **household confidence** remained strong during the first months of 2007, though it no longer exceeded that much the estimates expressed a year earlier (see Figure 12). In 2006, the strengthening confidence of private consumers brought about higher con-

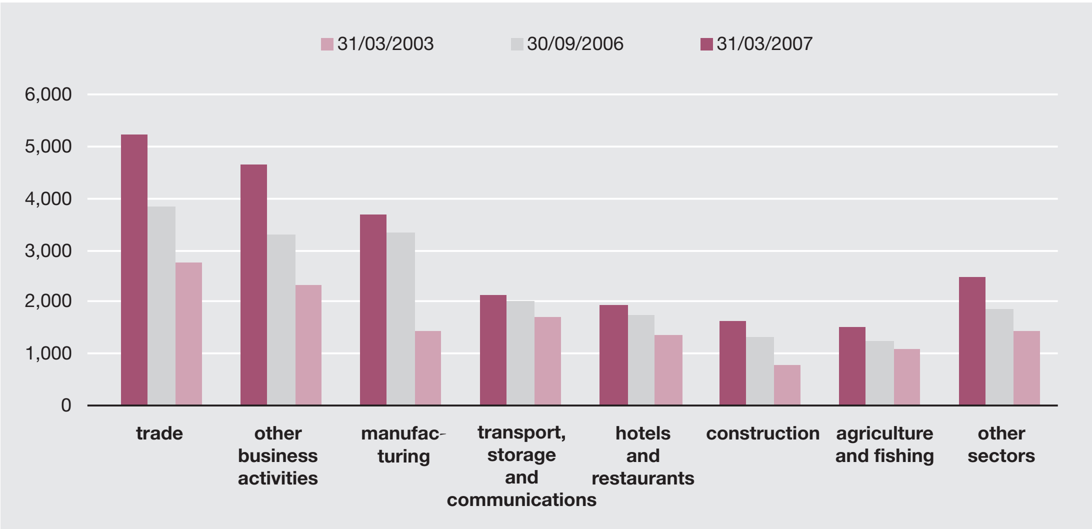

Figure 10. Bank loans taken by companies for acquiring real estate (EEK m)

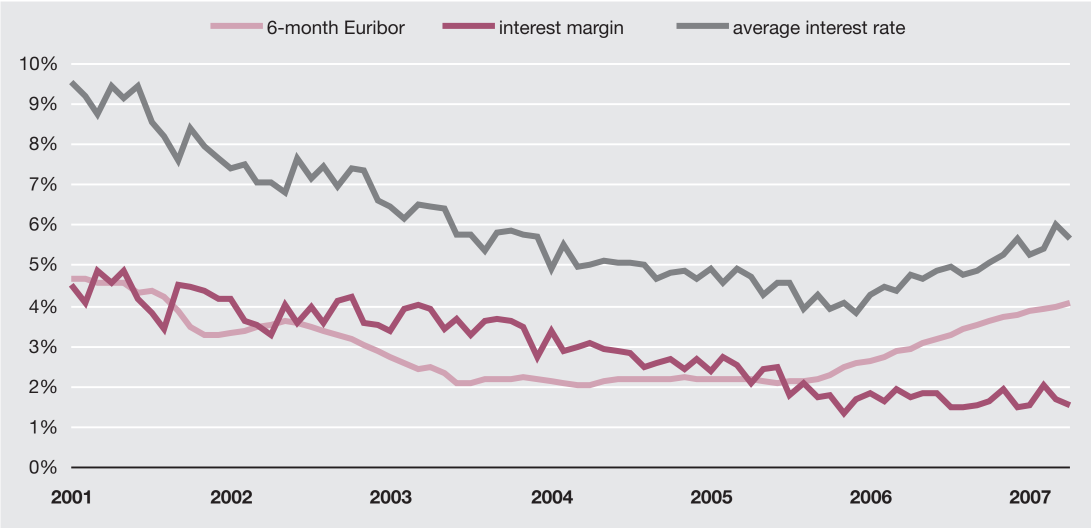

Figure 11. Average interest rate, key interest rate and average interest margin on long-term corporate loans (%)

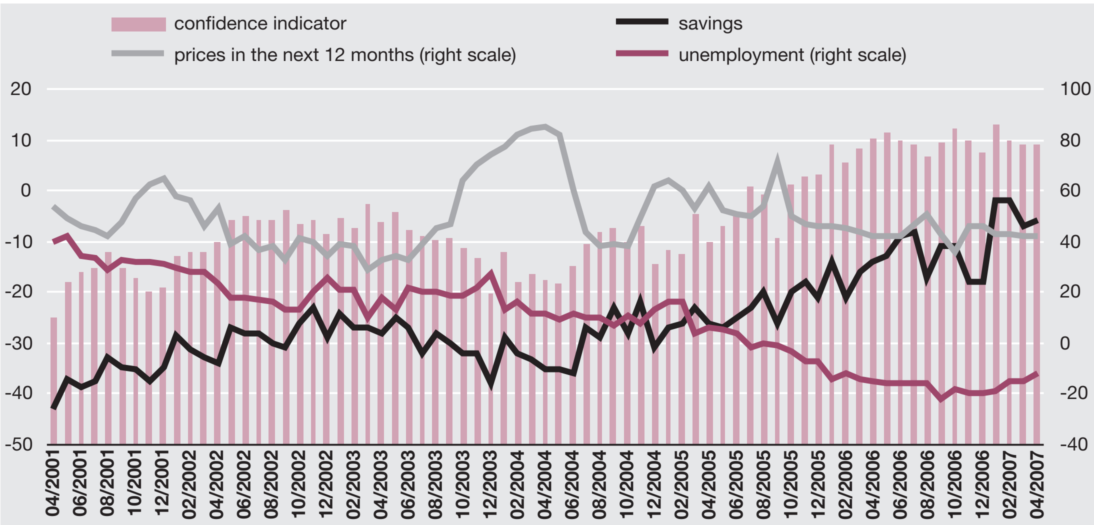

Figure 12. Consumer confidence indicators

Source: Estonian Institute of Economic Research sumption growth. The expectations of this year's first months indicate the persistence of growth. Consumers' expectations of their ability to save increased even further. In light of rapid wage growth it can be concluded that private consumers have not changed their saving habits significantly. The concerns of unemployment have stopped to decrease which is in line with the slowdown in the number of the registered unemployed.

Although consumer price inflation picked up in the first quarter of 2007, this has not affected households' future expectations. The inflation expectations for the next twelve months are still lower than one year ago.

Labour market

Rapid economic growth in 2006 influenced the labour market situation significantly: unemployment decreased, employment increased and wage growth accelerated (see Figure 13). Last year, the number of the employed rose by 6.4%. More jobs than on average were created in the services sector, whereas in manufacturing the number of jobs decreased. Compared to 2005, the **unemployment** rate dropped from 7.9% to 5.9%. Furthermore, the number of the long-term unemployed decreased substantially. Over two thirds of the employment growth can be attributed to the return of the former inactive to the labour market, which is why also the labour market participation rate increased considerably last year.

Wages

The number of the employed stabilised in the second half of 2006, since the labour supply is relatively limited despite the high demand. As a result, wage growth has gained speed as expected (see Figure 14). In 2006, incomes in general grew very fast: **average wages** rose by 16.2%, net wages by 17.3% and the average pension by 18.2%. Moreover, this created over-optimistic expectations and wage demands even increased: in the fourth quarter of 2006, the growth of average gross monthly wages reached 18%. Considering the 4.5% inflation, the real wage growth reached its all-time high – 13%.

Structure of expenditures

According to Statistics Estonia, in 2006 the average expenditure per household member amounted to 3,712 kroons and net income to 4,343 kroons. Compared to 2005, expenditures increased by 16% and incomes by 25%. Within a year, the share of spending on food in the expenditures of household members decreased, whereas expenditures on transportation, leisure and healthcare increased. The share of unavoidable costs decreased from 42% last year to 40% of total expenses.

The income growth was brought about by higher employment and also the rise of wages and pensions. The growth rate of expenses was inhibited by bigger loan repayments compared to 2005.

Financial position and savings

In 2006, the volume of loans granted to households increased much faster than savings, which is why the **net financial position** of households deteriorated considerably. Within the year it dropped by 8 percentage points to 12% of GDP (see Figure 15). Based on the developments in borrowing and depositing during the first quarter of 2007 it may be presumed that the positive net financial position decreased also at the beginning of 2007, although at a slower rate than in the second half of 2006. Households' stock of loans and leasing increased by 7.4 billion and deposits by 3.0 billion kroons in the first quarter of 2007.

Households prefer more liquid **financial assets** and hold a larger share of their financial assets in deposits than they used to before. The deposit growth rate remained at the level of 30% and even higher both in 2006 and at the beginning of 2007 (see Figure 16). The growth of time deposits recovered in mid-2006 after slowing down for a while and accelerated even further at the beginning of 2007. Growth was mainly boosted by short-term deposits with maturities of up to one month, their volume reaching

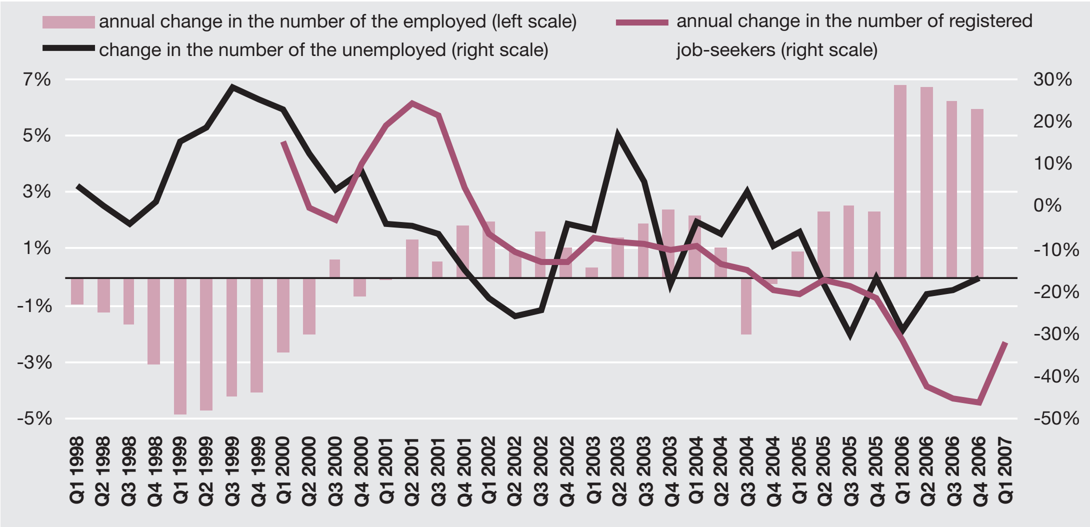

Figure 13. Annual change in the number of the employed, the unemployed and registered job-seekers

Source: Statistics Estonia

Figure 14. Average annual wage growth

Source: Statistics Estonia

Figure 15. Household financial assets and liabilities (EEK bn and % of GDP)

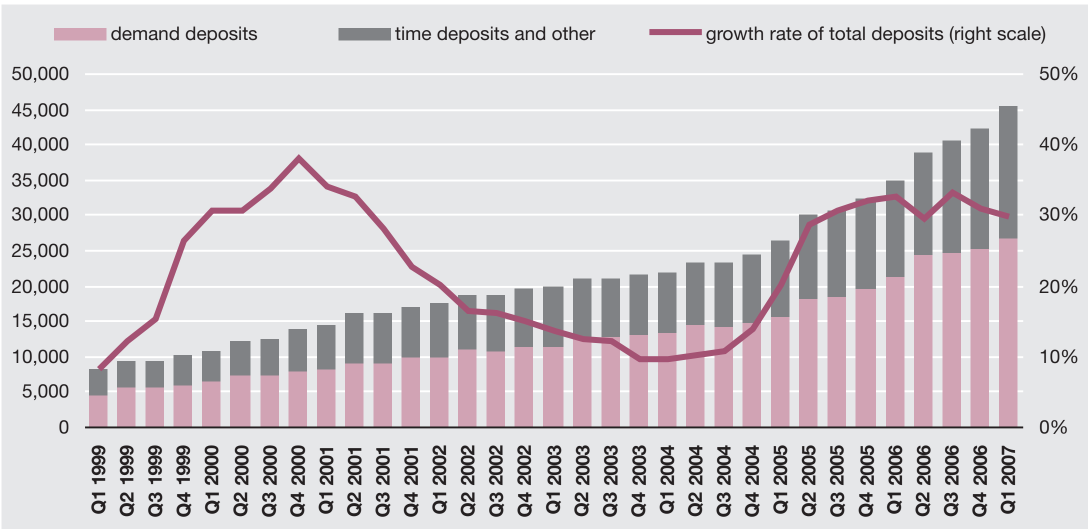

Figure 16. Household deposits in domestic banks (EEK m) and deposit growth

3.0 billion kroons at the end of March 2007 (year-on-year growth 81%; see Figure 17). Overnight deposits also kept soaring and their volume amounted to 1.9 billion kroons at the end of March 2007 (year-on-year growth 138%). The rapid growth of other deposits probably stemmed from the so-called investment deposits, their return rates being bound to the stock market yield. The volume of other deposits has tripled within the year, reaching 2.6 billion kroons in March 2007.

The stable growth of **pension savings** among financial assets continues. At end-2006, the volume of pension assets stood at 8.3 billion kroons, comprising approximately 7% of households' financial assets and 4% of GDP. At the end of 2006, households owned approximately 6.7 billion kroons worth of **shares listed on the stock exchange and investment fund units**, i.e. about 6% of financial assets and 3% of GDP.

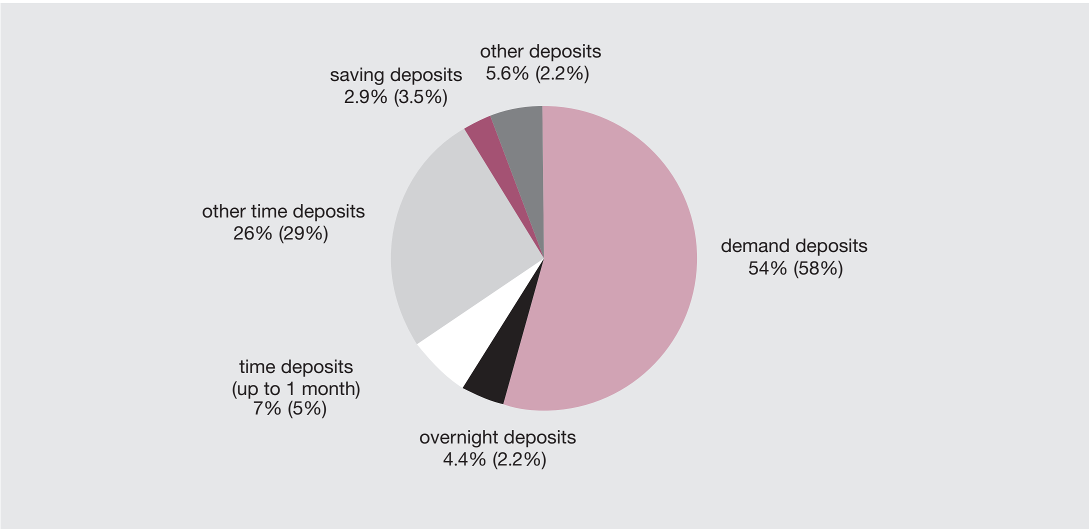

Figure 17. Structure of household deposits as at 31 March 2007 (in brackets as at 31 March 2006)

MICROECONOMIC PATTERNS OF HOUSEHOLD SAVING BEHAVIOUR

In the three previous years people saved relatively little, whereas in 2005 saving gained much popularity. The savings ratio calculated in relation to household disposable income doubled within the year, reaching 8% by the end of 2005. Though the total volume of savings has been increasing recently, it is still much smaller than in advanced economies. Although this may be largely explained by differences in the level of financial deepening between countries, several fascinating country-specific patterns emerge when analysing consumption expenditure and income at the level of households.

The analysis[2] based on the data of the annual Household Budget Survey conducted by Statistics Estonia confirmed that saving behaviour can be explained by several indicators describing the household and its wealth. Although the survey's data does not directly enable to assess the value and dynamics of household assets (both financial and non-financial, i.e. real estate), it is nonetheless possible to analyse the impact of the various features of households on saving. The best possibility to assess saving behaviour is to view the difference between income and consumption expenditure. The savings ratio construed on the basis of that is the main ratio used to analyse the financial behaviour of households at the microeconomic level.

1. **Incomes**. Analysis results confirmed the existence of a positive relation between the savings and the regular income of a family (see Figure 18). Savings are positively influenced also by seasonal incomes such as bonuses. This is entirely in accordance with the theory of intertemporal smoothing of consumption. The bigger the initial savings ratio, the smaller the effect on the savings ratio is[3]. At the same time, it should be kept in mind that in case of wealthier households, the same savings money-wise comprise a significantly smaller share of disposable income compared to households with lower disposable income.
2. **Real estate**. The effect of owning real estate as one of the wealth components on saving behaviour is almost non-existent. From the one hand, this may be caused by rapid changes in the real estate market during the monitored period, as their impacts on consumption and saving appear slowly (the abrupt price rise in 2005 is not reflected in households' savings ratios yet). Besides, in Estonia there are much more real estate owners than households who rent housing[4]. This, in turn, means that the growth of housing wealth might not affect the saving behaviour primarily because real estate is used purposefully (as a residence) and changes in its value are not used for increasing income for speculative purposes.
3. **Durable goods**. Durable goods may also be considered signs of wealth in transition and advanced economies and thus, they may be regarded as an additional factor for explaining saving behaviour. In Estonia, the existence of durable goods decreases the savings ratio of households: if a family

[2] D. Kulikov, A. Paabut, K. Staehr. "A Microeconomic Analysis of Household Saving in Estonia: Income, Wealth and Financial Exposure", Working Paper of Eesti Pank, forthcoming.
[3] The savings ratio is the share of savings in disposable income.
[4] According to the data of the Household Budget Survey, approximately 86% of the Estonian residents live in a housing that belongs to a family member.

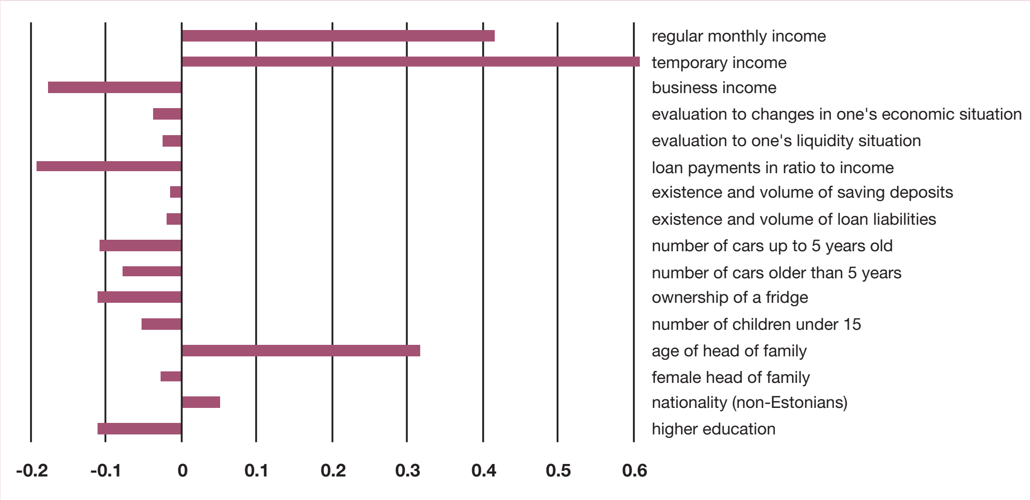

Figure 18. Factors influencing the savings ratio significantly (estimates for parameters during 2002–2005)

Source: D. Kulikov, A. Paabut, K. Staehr "A Microeconomic Analysis of Household Saving in Estonia: Income, Wealth and Financial Exposure", Eesti Pank Working Paper, forthcoming

owns a car, a refrigerator or a dishwasher, the savings are considerably smaller than in households without such durable goods. Higher consumption of goods accompanying the ownership of a car, for instance, (fuel, repair costs, etc.) might also have a say here. Such a result leads to the conclusion that several households are saving in order to purchase durable goods common in advanced economies. These families may be experiencing liquidity constraints or the financial system does not have consumer credit products suitable for them.

4. **Existing financial assets and liabilities**. Initially, indicators describing the financial assets and liabilities of households led to contradictory results. The data revealed that the existence of deposits and other financial assets affects saving adversely, which complies with the theory of intertemporal consumption smoothing. However, it also became apparent that existing loan and leasing liabilities affect savings negatively. This means that if households have access to various loan products, they can obtain loans for increasing consumption on account of future incomes and thus smooth their consumption over time.
5. **Loan servicing**. The amount of loan repayments (incl. interest payments) affects household savings adversely: the greater they are, the smaller the savings ratio. This means that savings decrease along with the increase in household indebtedness. This, in turn, means that the growth of loan repayments entails an increase in the sum of consumption expenditure. Although it might seem illogical at first glance, this indicator can also be used to describe the creditworthiness of households (for instance, this enables households to receive incomes when purchasing additional real estate, etc.).
6. **Age**. The fact that older and younger households save more than middle-aged families

contradicts the life-cycle theory, according to which middle-aged households with the highest incomes should save the most. At the same time, this result may describe differences in the saving behaviour of different generations, as the same result has also been reached in surveys on other transition economies (e.g. New Zealand, Russia). In Estonia, the savings ratio is the lowest in households where the head of the family is 29 years old. The savings ratio of older households (the head of the household being 65 years old) is nearly 8.3 percentage points higher. The great savings ratio of the older generation may be explained by the precautionary motive as well as thrifty consumption habits. Young people's interest in saving may primarily be explained by the desire to purchase their own home (the loan down payment motive).

7. **Other features**. Other characteristics such as the number of adults and children in the household, or the nationality, education and gender of the head of the household also play an important role in the development of the savings ratio. Similarly to surveys conducted in advanced economies, surveys on Estonia indicate that households with a female household head generally save less. As regards nationality, the savings ratio of non-Estonians is higher. The number of children in a household also affects the ability to save: the more children in the family, the less there are available resources for saving. The household head's higher education entails a lower savings ratio.

It may be concluded that indicators related to income and wealth play the most important role in describing the savings behaviour of Estonian households. The analysis carried out based on the data of the Estonian Household Budget Survey, however, does not allow to describe the trends of total household savings. It is also impossible to explain changes in total savings over time. However, it is possible to monitor the household savings ratio based on different characteristics within a unit of time.

Household debt and loan-servicing capability

Level and growth of debt

The **year-on-year growth of households' loans and leasing** started to decelerate after reaching the record level of 62.4% in March 2006. By the end of March 2007, it reached 55.6% (see Figure 19). Loan growth is mainly slowing down owing to the subdued growth of household loans; the growth rate of consumer credit does not display any clear signs of deceleration.

The annual **growth of household indebtedness** has remained brisk, but has not accelerated compared to autumn 2006. Year-on-year, indebtedness grew by 10 percentage points to 43% of GDP and by 19 percentage points to 79% of disposable income (see Figure 20). From among other Nordic and Baltic countries, the Estonian financial deepening, which stood at 10 percentage points, was exceeded only by Latvia where household indebtedness grew by 12 percentage points (see Figure 21).

Housing loans

The year-on-year growth of housing loans decelerated from the record level of 64.9% in March 2006 to 55% by March 2007. At the end of March 2007, the stock of housing loans amounted to 71.2 billion kroons. Although the increase in housing loans has slowed down, the number of new borrowers has not decreased much, given the **number of housing loan contracts**. With the first four months of 2007, as many more (12%) new housing loan contracts were concluded year-on-year as in the fourth quarter of 2006.

Meanwhile, since the beginning of 2007 (and especially in April) new contracts have been concluded mainly for smaller loans, i.e. loans amounting up to half a million kroons. Considering real estate prices, these are probably loans for renovating rather than purchasing housing (see Figure 22). This is also

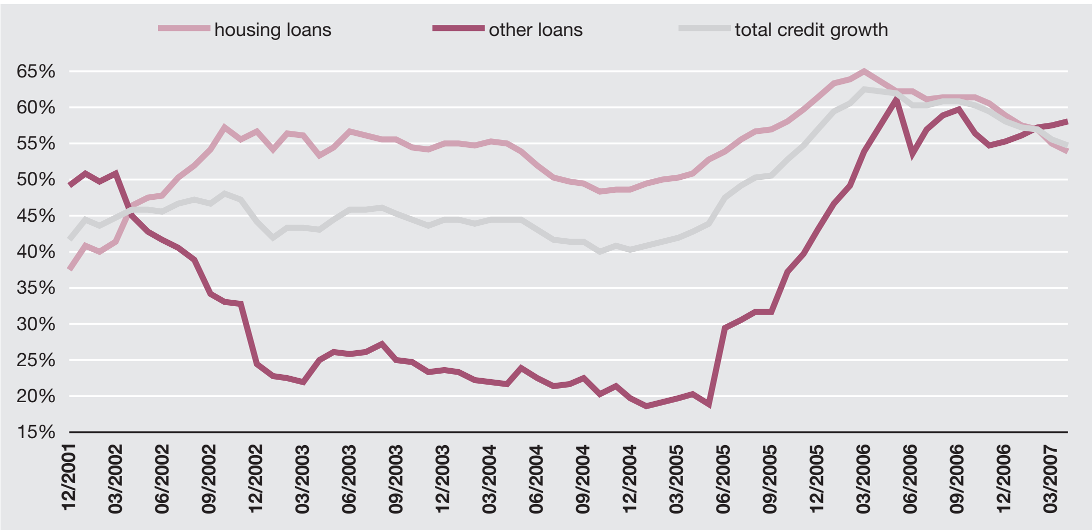

Figure 19. Annual growth of domestic credit to the household sector

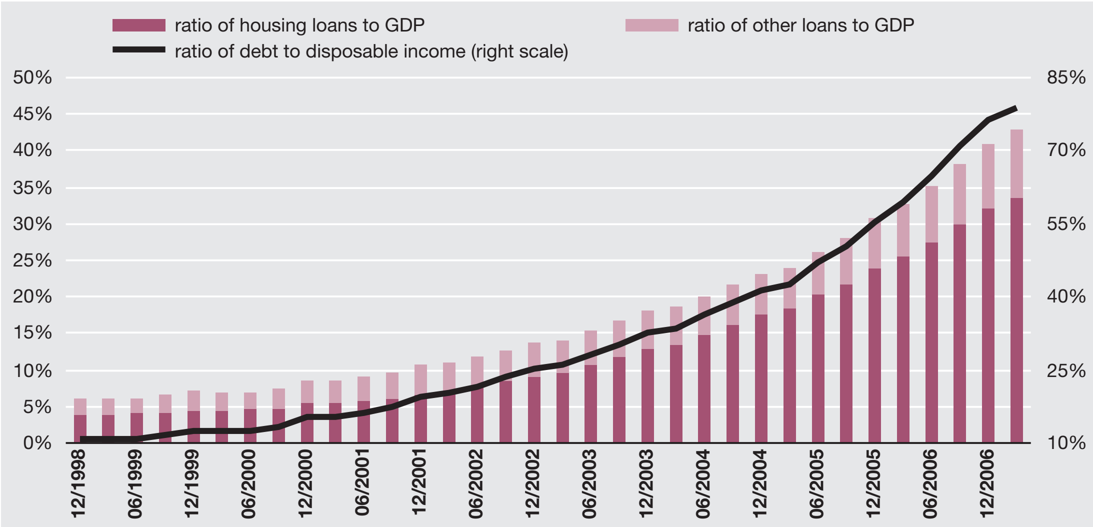

Figure 20. Household indebtedness

Figure 21. Ratio of household indebtedness to GDP (left scale) and annual growth rate (pp; right scale) in Nordic and Baltic countries

Source: national central banks

Figure 22. Structure of housing loans granted by loan amount (%)

supported by the fact that the number of housing transactions is declining. Thus, it is possible that some borrowers had a housing loan already before and there are actually less new housing loan customers than new contracts.

In addition to an increase in the interbank interest rates, the rise in the **average interest rates on housing loans** was shaped by the growing average interest margin. The average interest rate in March 2007 (5.0%) stood almost 2 percentage points higher than the lowest rate seen in April 2005 (3.1%; see Figure 23).

While in autumn 2006 the average interest margin on housing loans kept declining because of the tight competition of banks although interbank loan interest rates were on the rise, in November 2006 the average margin started to increase. In March 2007, it exceeded the level of October 2006 by 17 basis points. This was probably caused by the increasing share of borrowers with higher credit risk.

The application of longer loan maturities has expanded the number of potential borrowers in an environment of high real estate prices and growing loan servicing costs. In 2006, the average **housing loan maturity** continued to extend, but the share of loans with maturities of over 25 years among housing loan contracts concluded in the first quarter of 2007 has not risen (see Figure 24). While in the fourth quarter of 2006, 61% of loans were granted with maturities over 25 years, in the first quarter of 2007 their share remained 1.5 percentage points lower (a similar development also characterises April indicators).

Housing loan developments are also influenced by the decreased activity on the **housing market**. In the third quarter of 2006, the number of real estate transactions with residential buildings and dwellings started to shrink compared with the same period of 2005. In the first quarter of 2007, the number of transactions remained 8% smaller than the year before (see Figure 25). Also the year-on-year growth of housing prices has been slowing down considerably since the second half of 2006. The year-on-year price growth of a two-room Tallinn apartment in satisfactory condition decelerated to 6% in the first quarter of 2007 and compared to the fourth quarter of 2006,

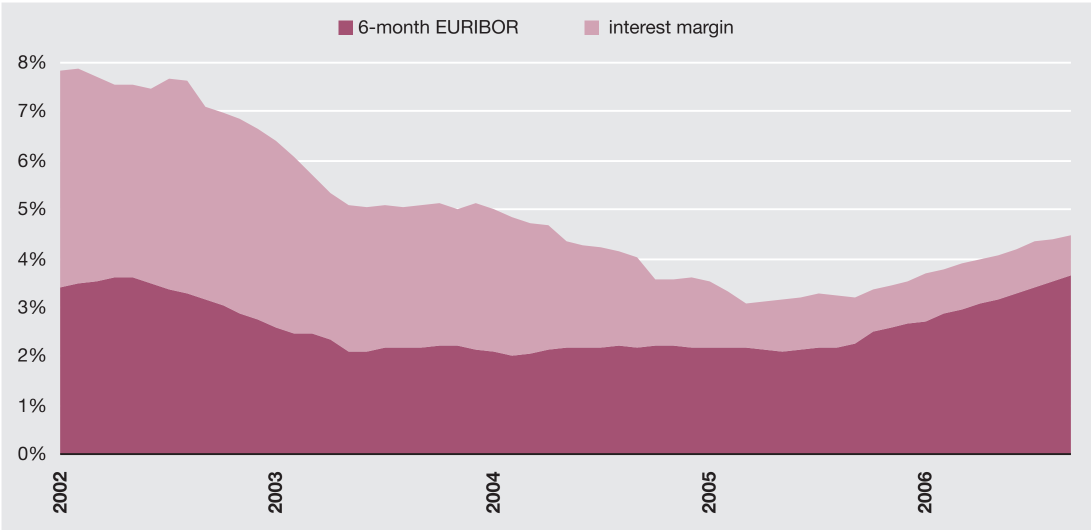

Figure 23. Dynamics of housing loan interest rates

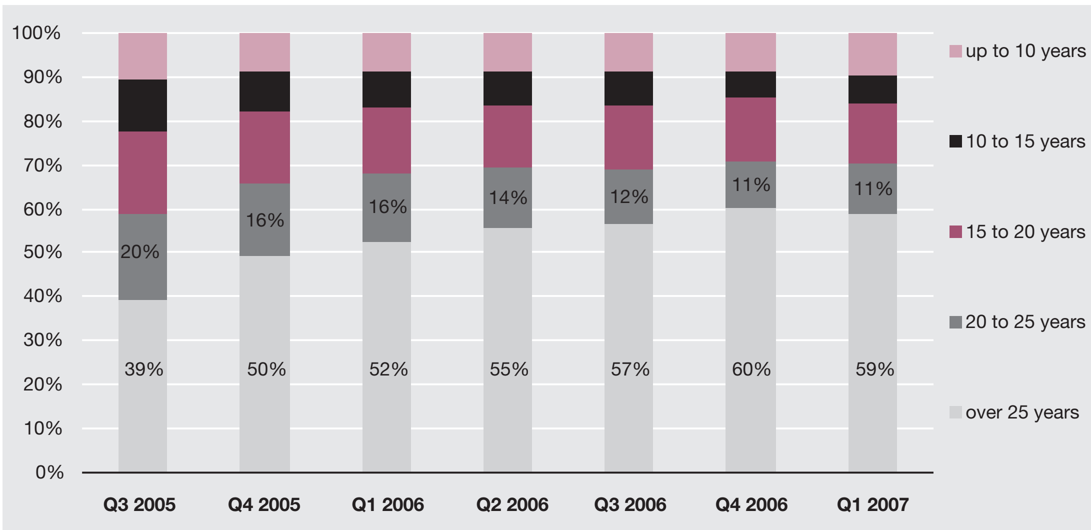

Figure 24. Maturity structure of new housing loans

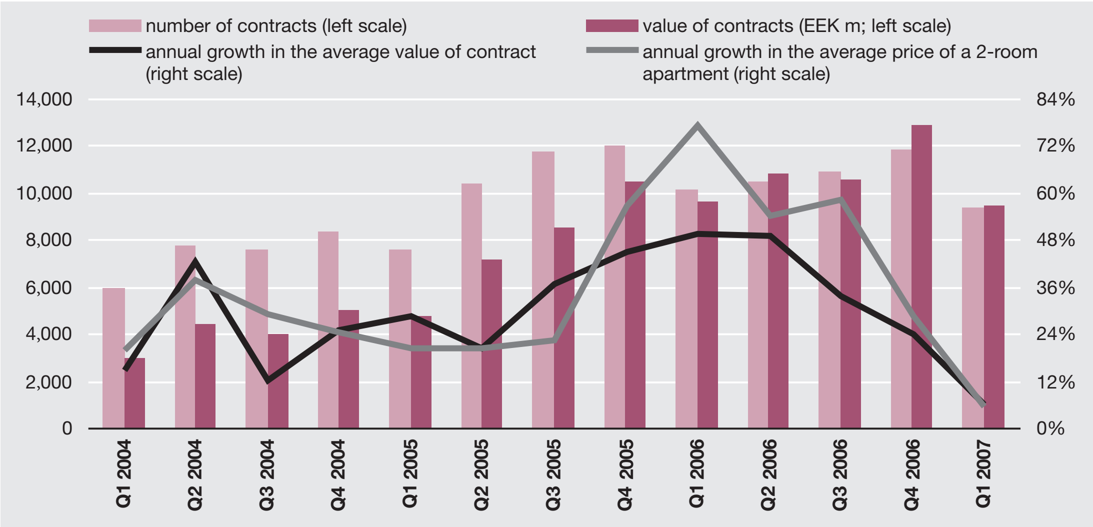

Figure 25. Notarised purchase-sale contracts with residential buildings and dwellings as real estate, average value of contract and annual growth in the average price of a 2-room apartment in satisfactory condition in Tallinn

Source: Statistics Estonia

the average price has dropped by 5%. As the apartment price growth has moderated and wage growth has picked up, the ratio of average apartment prices and average gross wages has not exceeded the level achieved at the beginning of 2006.

Consumer credit

Unlike housing loans, the year-on-year growth of **loans not directly related to the financing of housing** has not really slowed down. The annual growth rate of the respective loan and leasing stock stood at 58% at the end of March 2007, which is 2 percentage points lower than the high reached in September 2006. Compared to autumn 2006, the annual growth of car leasing has accelerated from 35% to 44%. Also the year-on-year growth of other loans picked up further at the beginning of 2007, amounting to 100% in March 2007 (see Figure 26). The year-on-year growth of study loans has remained low and steady and that of consumer credit obtained by credit card and without instalments decelerated from 105% in autumn 2006 to 85% in March 2007.

The volume of household **consumer credit** rose to 12.7 billion kroons by the end of March 2007, comprising an estimated 6.0% of GDP. Together with car leasing and study loans the stock of consumer credit stood at 20.1 billion kroons, i.e. 9.4% of GDP.

The **interest rates on consumer credit** generally move less in line with developments in key interest rates than the interest rates on housing loans (see Figure 27). The usage of real estate for collateralising consumer credit has become more popular, which has also helped to keep the average interest rate lower. At the end of March 2007, 77% of consumer credit without instalments and other loans was mortgage-backed (70% in March 2006). Thus, the volume of consumer credit collateralised by real estate has more than doubled within a year.

Households' loan-servicing capability and risks

Households' loan-servicing costs increased. By the end of March 2007, the **interest burden** of house-

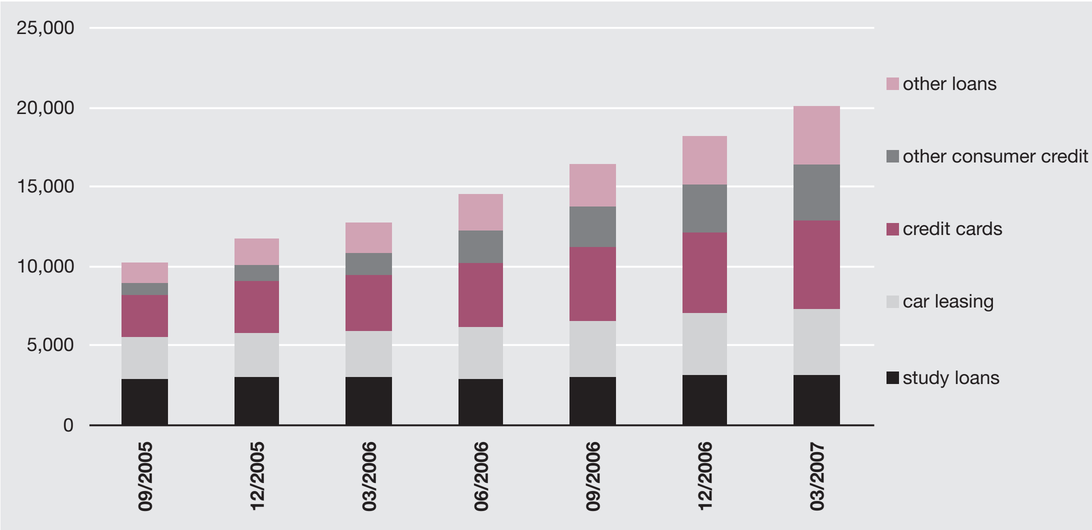

Figure 26. Stock (EEK m) and structure of non-housing household loans/leasing

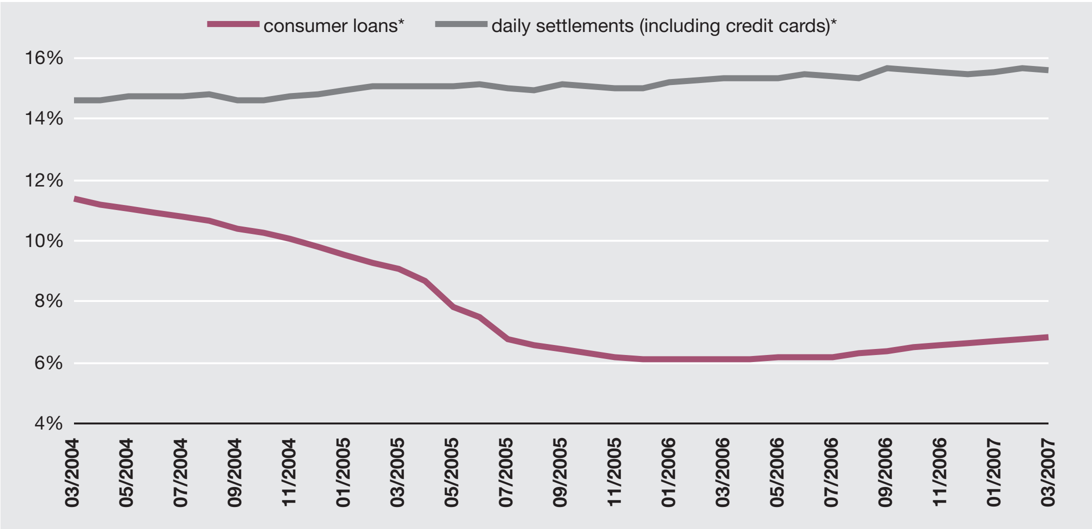

Figure 27. Consumer loan interest rates

* without the data of BIG

holds, i.e. the sum of loan and leasing interest rates in proportion to disposable income increased to 3.7% (see Figure 28).[5] The impact of higher interest rate on the interest burden is constantly growing and that of credit growth is declining. In the first quarter of 2007, the average interest rate rise accounted for about a half of the increase in interest costs.

The growing interest burden affects the ratio of loans with floating and fixed interest rates in the debt portfolio of households. Since December 2006, a more distinct trend towards **fixing interest rates** can be perceived. As a result, in March 2007 the share of fixed interest rate products rose to 9% of loans obtained within a month. A year ago this indicator remained below 3% (see Figure 29). However, the impact of increased risk awareness on the total loan stock still remains limited and the majority of the household loan portfolio is still exposed to interest rate risks.

In **conclusion** it may be said that the strong wage growth in the second half of 2006 has supported households' optimistic future expectations and will also continue to do so. Although loan-servicing costs are on the rise, their impact on the financial situation of households is offset by the dynamic growth of net incomes. The expected rapid economic growth in the near future will provide good outlook for further income growth and coping with loan-servicing costs. The steep fall in households' net financial assets in relation to GDP that accompanied the rapid debt growth, however, indicates that their shock-absorbing ability has decreased compared to a year ago.

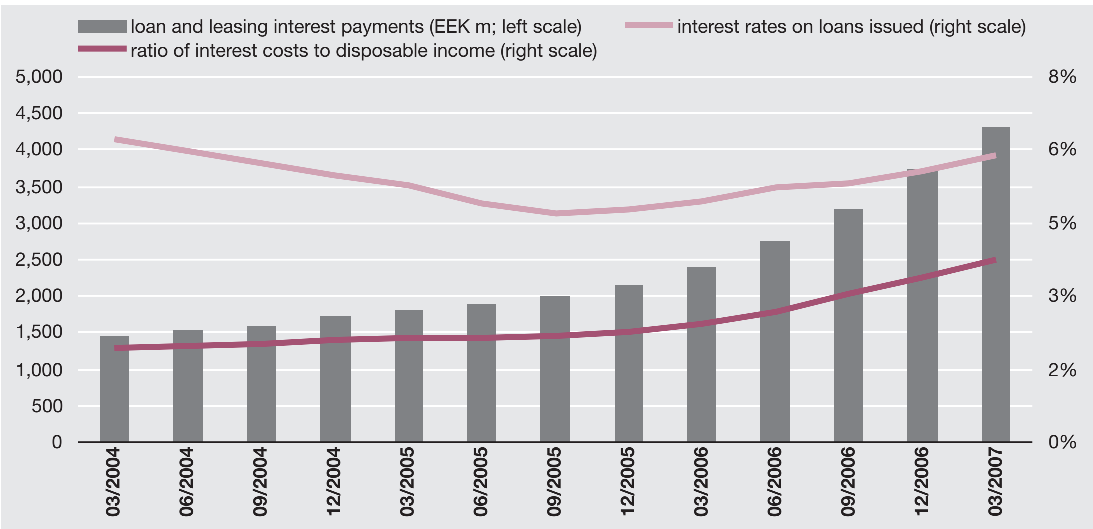

Figure 28. Households' loan and leasing interest payments during a year, interest rates on outstanding loans and ratio of interest costs to disposable income

[5] The methodology of calculating the interest burden indicator has been changed compared to the previous issue of the Financial Stability Review. Thus, the indicators have been corrected slightly downwards.

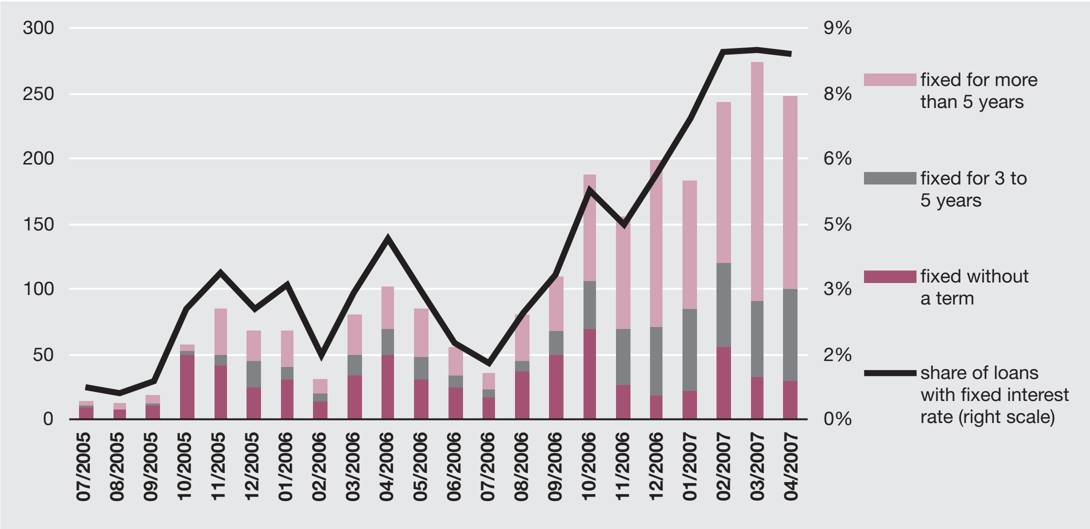

Figure 29. Volume of housing loans with fixed interest rate (EEK m) and the share of fixed interest rate loans in total housing loans granted during a month (%)