I FINANCIAL BEHAVIOUR OF COMPANIES AND HOUSEHOLDS AND THEIR RISKS

COMPANIES

Corporate business situation

Confidence

The **economic confidence indicator** calculated by the Estonian Institute of Economic Research pointed to a deteriorating outlook already in the second half of 2007. In the initial months of 2008 the outlook worsened even more. The rapidly decreasing optimism of companies and households was in line with slowing economic growth. Confidence has suffered the most in the construction sector, but also in manufacturing and trade (see Figure 1).

The optimism of **manufacturing companies** regarding the future has been replaced with a moderate pessimism (see Figure 2). This estimate refers to a further decrease in the growth rate rather than to a drop in output volume. Growth is primarily hindered by the relatively sudden decline in demand, while estimates concerning domestic demand are even more pessimistic than those regarding demand in export markets. The exploitation level of production capacity has remained relatively high (72% at the beginning of the second quarter of 2008), although compared to last year's indicator it has decreased slightly. However, the investment needs of manufacturing companies are not expected to grow in the near future.

New companies and bankruptcies

Compared to 2006, less **new companies** have been registered since the second half of 2007, which is quite characteristic of economic adjustment. The end of 2007 witnessed a substantial surge in the number of **bankruptcies**, but so far it does not exceed previous year's indicator (see Figure 3). However, moderating economic growth will probably entail a further rise in the number of bankruptcies.

Corporate economic indicators

According to the business statistics of Statistics Estonia, **total profit growth** decelerated abruptly in the second half of 2007, slowing down from 27.8% in the first half-year to 1.2%. This was mainly caused by the declining profits of real estate, transport and trading companies.

Figure 1. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

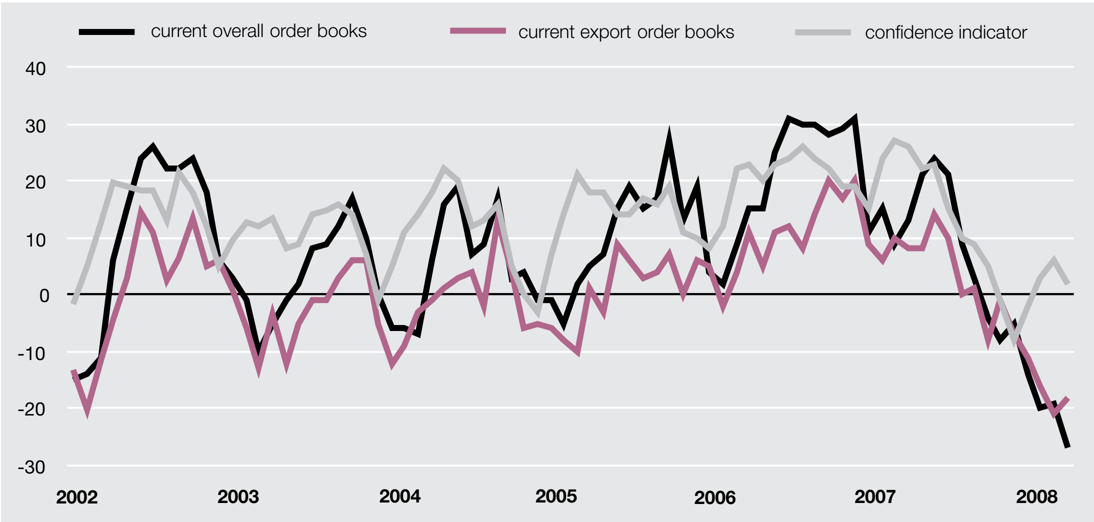

Figure 2. Demand for the production of manufacturing companies and the confidence indicator

Source: Estonian Institute of Economic Research

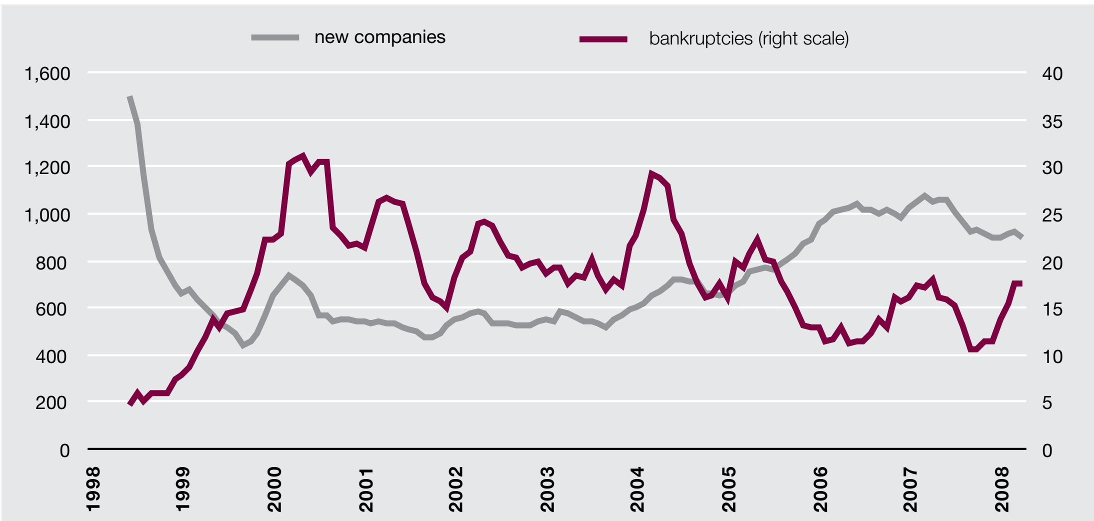

Figure 3. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-month moving average)

Source: Estonian Enterprises Register

Although in manufacturing total profit growth slowed (from 31.8% in the first half-year to 21.5% in the second half), it nevertheless remained high. The decline in profit growth was characteristic of the turning point of the economic cycle, when softening demand caused a slowdown in **sales income** growth. Growth in total costs decelerated somewhat less. The high inertia of **total costs** is primarily related to labour costs that grew by 24.3% in the second half-year compared to the same period in the previous year. In the second half of 2007, labour cost growth was still too strong compared to nominal GDP growth, and it was mostly covered at the expense of a relative decrease in profits.

Corporate profit as a ratio to GDP has been dropping since the second half of 2006: in the fourth quarter of 2007 it decreased by over 3 percentage points as an annual average, compared to the year-ago figure (see Figure 4). From 2002 to 2006 the share of labour costs in GDP did not increase considerably, whereas in 2007 it rose rapidly and returned to the level of 1999.

Investment

Corporate fixed investment totalled over 22.5 billion kroons in the second half of 2007, which is nearly 1.8 billion kroons more than at the same time last year (see Figure 5). Investment was mainly channelled to the construction and renovation of buildings and facilities and to machinery and equipment. The final quarters witnessed a weakening of investment growth, primarily in construction and areas related to real estate. In the second half of 2006 investment increased by 25% year-on-year, whereas in the second half of 2007 growth reached only 9%. In the future, investment in real estate will probably decline further, which is indicated also by the considerably stronger growth of stocks this year.[1]

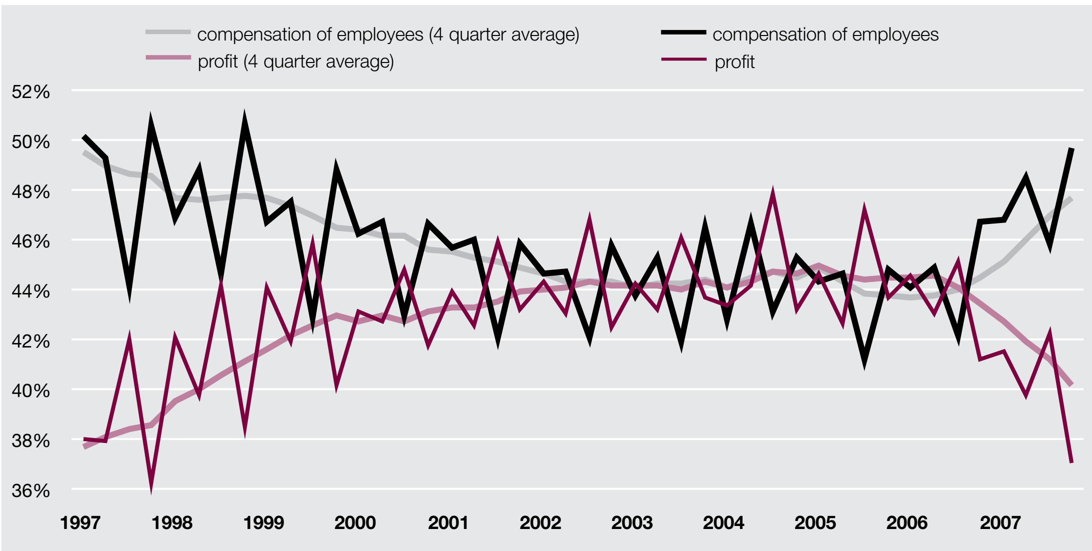

Figure 4. Compensation of employees and profit as a ratio of GDP

[1] Market participants estimate that the "clearance sale" will take at least two years at the current pace of new sales (one year based on autumn 2007 estimates).

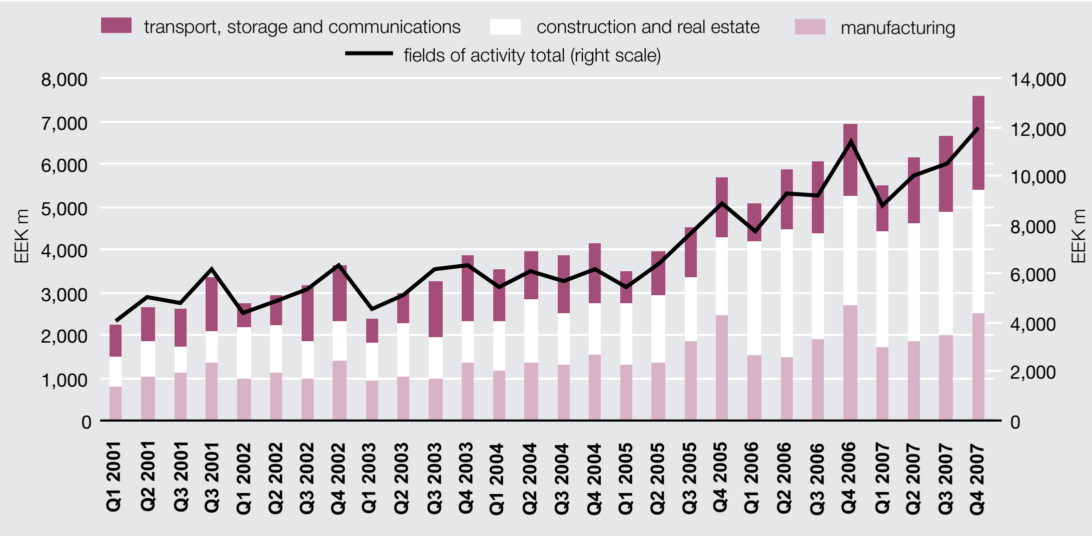

Figure 5. Corporate fixed investment

Source: Statistics Estonia

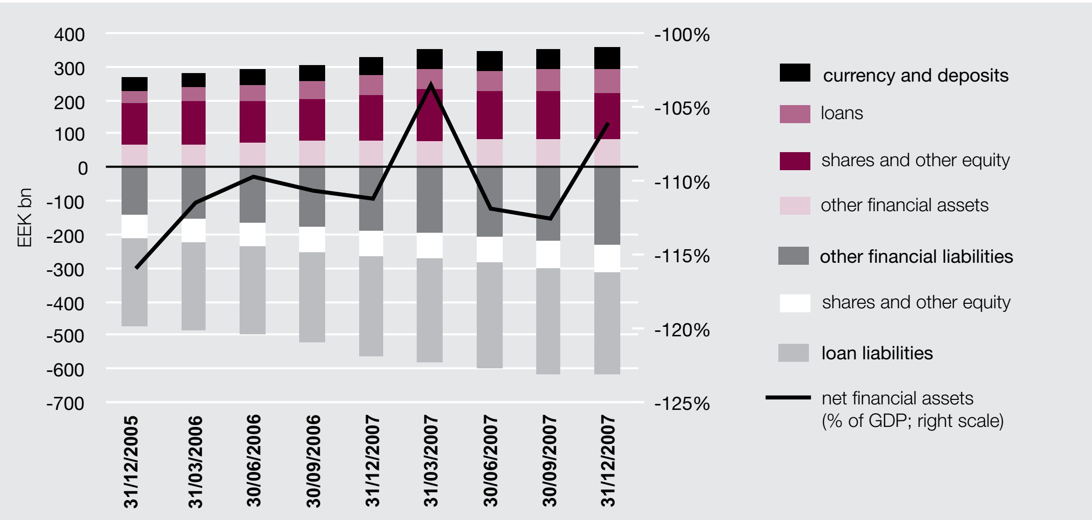

Figure 6. Corporate financial assets and liabilities and net financial assets

Corporate financial position and saving

The negative **net financial position** of companies improved in the second half of 2007 and decreased to 106% of GDP towards the end of the year. This was mainly caused by a more moderate growth in financial liabilities, as the market value of shares and other equity has decreased, as has the growth rate of debt liabilities (see Figure 6).

Growth in corporate financial assets also slowed in the second half of 2007, as deposit growth eased and the market value of shares and other equity decreased. Although **corporate deposits in domestic banks** increased considerably in the final quarter of 2007, in the first quarter of 2008 their volume decreased. Annual growth slowed to 7.5% in March 2008. As time deposit growth outpaced demand deposit growth, the share of time deposits in total deposits rose by 6% in six months to 34% by the end of March 2008 (see Figure 7).

The **coverage of debt liabilities by deposits** has been decreasing since the second quarter of 2007, arising from slower deposit growth. The coverage of debt liabilities by liquid assets[2] did not decrease in the second half of 2007 owing to rapid growth in loans and bonds probably related to the intra-sectoral positions. Loans issued by domestic banks in the first quarter of 2008 and domestic deposits of companies indicate that though the negative financial position of companies will probably not change significantly, the coverage of debt by deposits will continue to decrease.

Corporate debt

Corporate debt growth has decelerated further in the second half of 2007 due to slower corporate investment growth and weaker confidence (see Figure 8). By the end of 2007, the annual growth rate had fallen to 21%. Thus, the **indebtedness** of Estonian companies has not increased compared to mid-2007, standing at 76% of GDP also at the end of 2007. The share of foreign debt liabilities in total debt eased further and reached 22% at the end of the year.

In the second half of 2007, corporate debt grew almost as much as in the first half of 2007 in nominal terms. As regards economic sectors, real estate companies still obtained the most debt, although less than in the first half of 2007. Growth in the debt liabilities of manufacturing and trading companies was also lower in the second half of 2007, compared to the first half (see Figure 9).

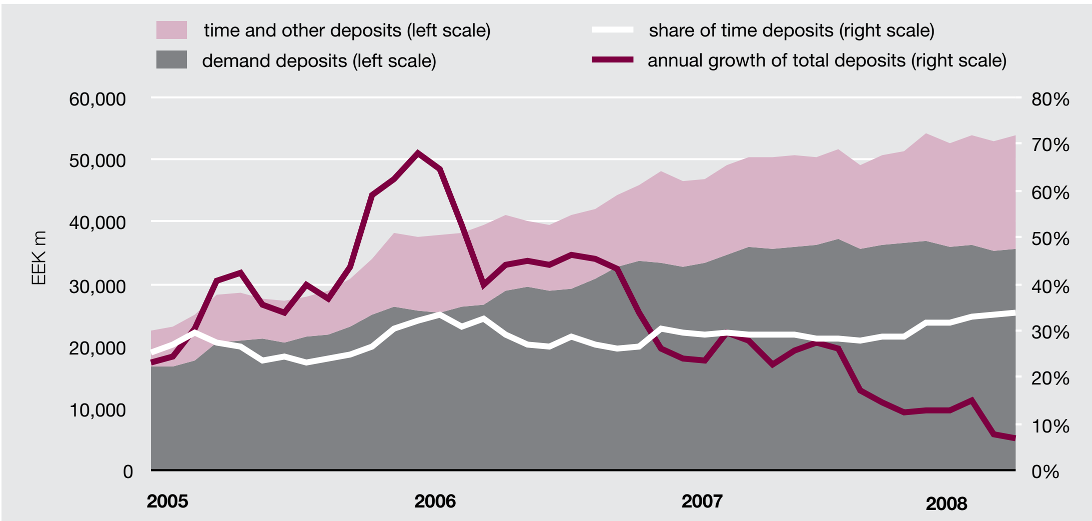

Figure 7. Volume and growth of corporate deposits and share of time deposits

[2] Liquid financial assets are currency and deposits, securities other than shares, loans and mutual funds shares.

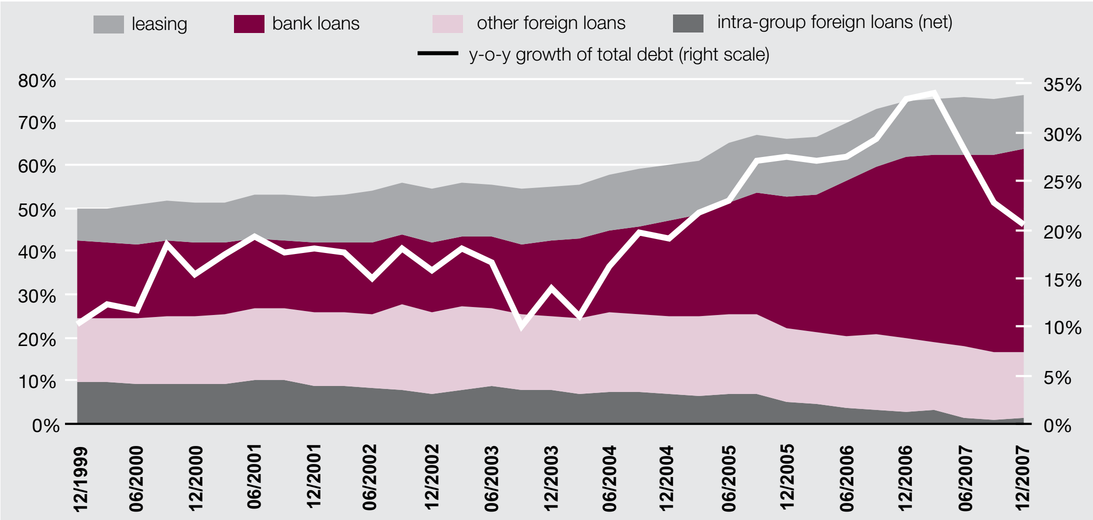

Figure 8. Corporate debt (% of GDP)

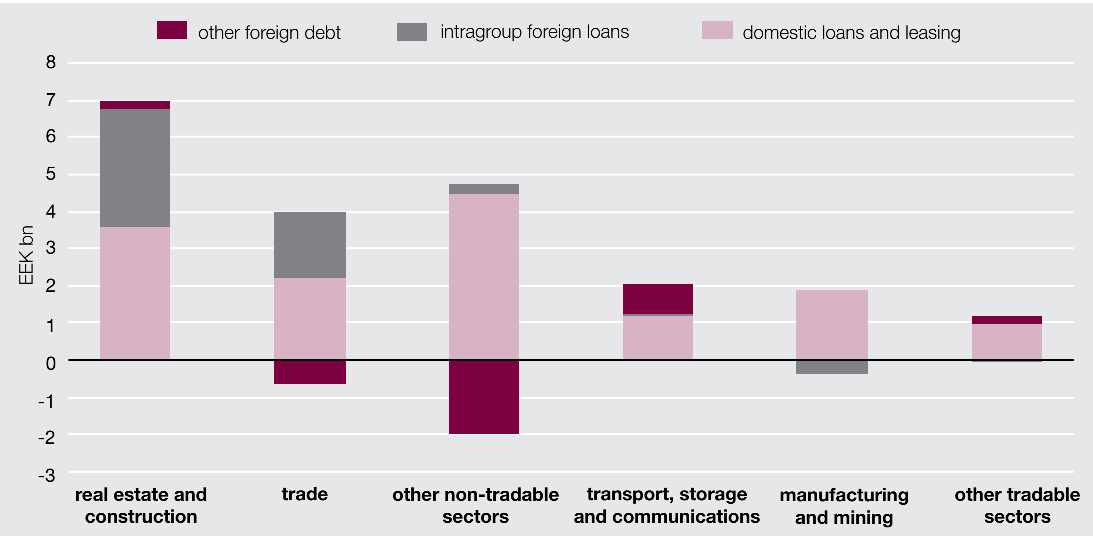

Figure 9. Corporate net borrowing in the second half of 2007

By the end of the first quarter of 2008, the growth rate of **domestic corporate debt** had declined to 23%. The moderation in debt growth was the most pronounced in the real estate sector. The credit growth of export-oriented sectors, including manufacturing, has not eased and has remained higher than companies' average. According to the forecast base scenario of Eesti Pank, in 2008–2009 corporate investment and credit growth will be weaker than in 2007. True, in the first quarter of 2008 domestic corporate debt grew slightly faster than expected.

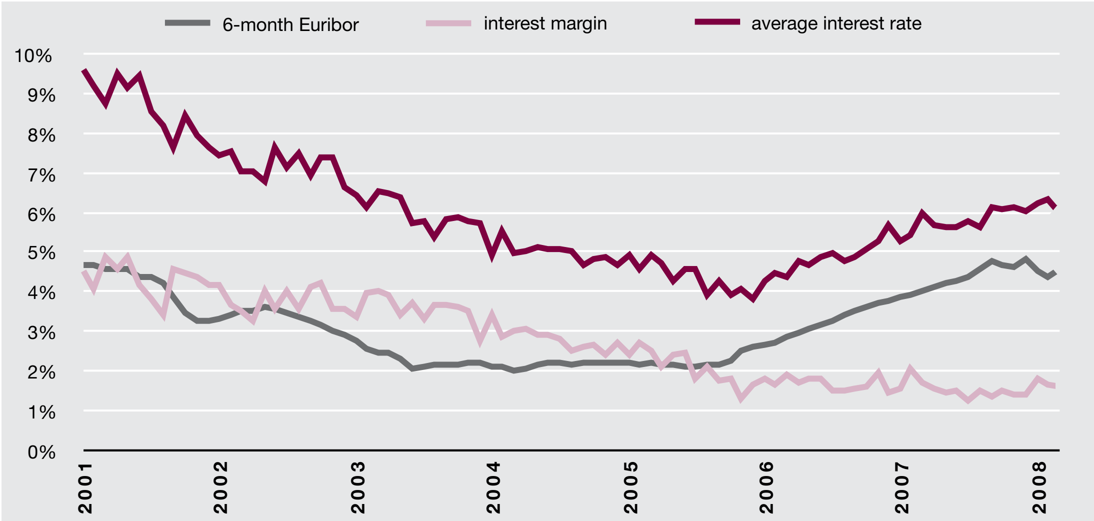

Figure 10. Average interest rate, 6-month Euribor and average interest margin on long-term corporate loans

The **average interest rate on long-term corporate loans** had not changed significantly by March 2008 compared to autumn 2007, reaching 6.2% (see Figure 10). The increased volatility of key interest rates at the end of 2007 and the beginning of 2008 also increased the volatility of the **average interest margin** calculated as a ratio of the key interest rate. However, the average interest margin on corporate loans has not risen because of tight competition among banks.

HOUSEHOLDS

Economic situation of households

Confidence

In the second half of 2007, **household confidence** started to weaken rapidly and continued to decline also at the beginning of 2008 (see Figure 11). According to the consumer barometer of the Estonian Institute of Economic Research, consumers became more sceptical about their future income growth and the general economic outlook. Compared to earlier periods, fear of unemployment increased the most. Moreover, the expectations of saving were also more pessimistic compared to a year ago. There has been a significant shift in inflation estimates: although in the first quarter of 2008 inflation was the highest of recent years (11.1%), consumers see this as a one-off event and expect the inflation rate to be lower in the next twelve months.

Labour market

The year 2007 stands out for strong tensions in the labour market: unemployment reached its lowest level in ten years, whereas wage growth peaked. The tensions started to abate in the second half of 2007. Compared to 2006 when the number of the employed grew by 6.4%, in 2007 **employment** growth slowed and reached only 1.4%. The average **unemployment rate** dropped to 4.7%, declining in terms of both the short-term and long-term employed[3] (see Figure 12). For 2008, the economic forecast of Eesti Pank expects a decline in employment, an increase in unemployment and moderation of wage growth.

[3] Persons who have been seeking employment for a year or longer.

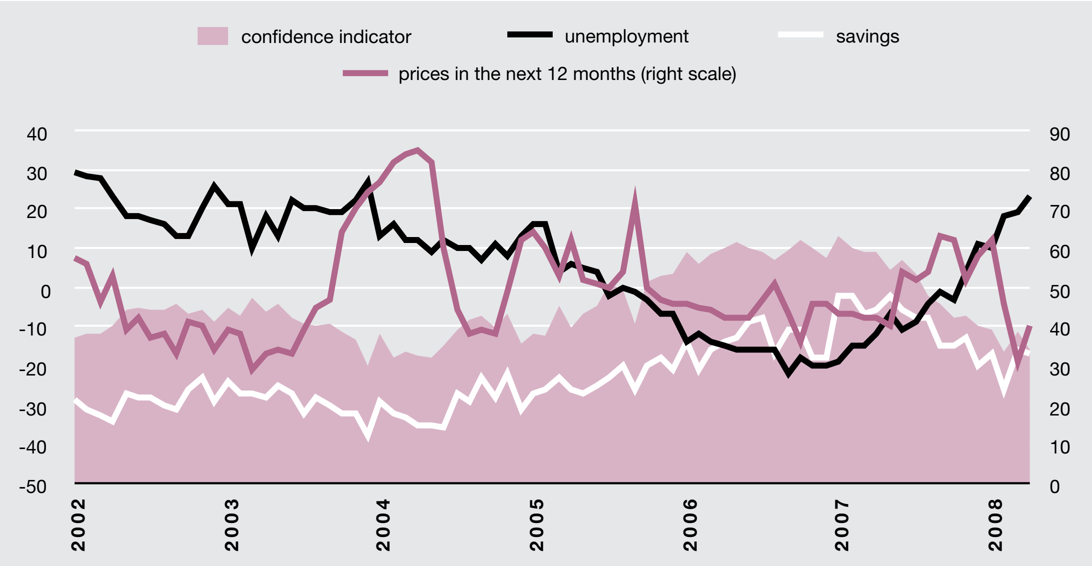

Figure 11. Consumer confidence indicators

Source: Estonian Institute of Economic Research

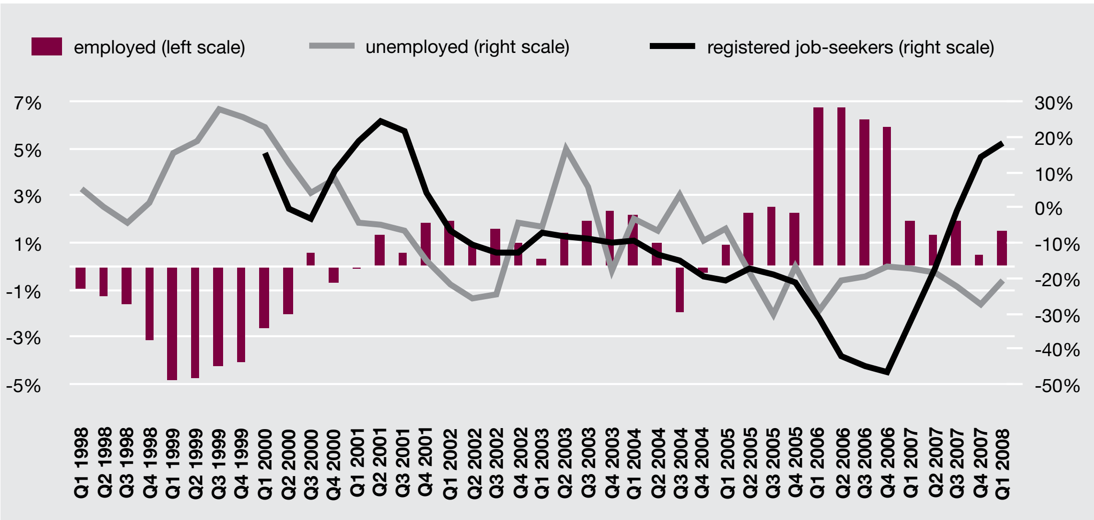

Figure 12. Annual change in the number of the employed, the unemployed and registered job-seekers

Source: Statistics Estonia

Figure 13. Average annual wage growth

Source: Statistics Estonia

Wages

Supported by strong demand and limited labour supply, **average gross monthly wages** continued rapid growth also in 2007, although in the second half-year growth started to stabilise (see Figure 13). In 2007, gross monthly wages increased by an average of 20.4%; that is, by over 4 percentage points more than in the previous year. The amounts of bonuses and additional remunerations were usual.

In the fourth quarter of 2007 **real wage** growth started to adjust too. Compared to the robust growth in the first half of 2007, the growth rate of real wages declined by almost 5 percentage points to 10.1%. The main reason for the drop was the sudden acceleration of inflation (9.1% in the fourth quarter).

Structure of expenditures

According to Statistics Estonia[4], the average expenditure per household member amounted to 4,358 kroons and net income to 5,286 kroons in 2007. Compared to 2006, expenditures increased by 17% and incomes by 22%.

Rapid growth in household **income** was primarily driven by considerable growth in wage income, which increased by 24.8% with the year, and by pensions that grew by nearly a sixth (16.1%). Increase in child allowances was slow (4.4%), other incomes diminished, and both lost share in the income structure.

Large differences in **expenditure** by income brackets persisted in 2007. The share of unavoidable costs (expenditure on food and housing) in the lowest and highest income quintile differed about two times. In 2007, a household member in the lowest income quintile spent 58% of consumption expenditure on food and housing; the respective figure in the highest income quintile stood at 29%[5]. The share of unavoidable costs in total expenditure declined even further: the average monthly expenditure of a

[4] The estimates are based on the data of the Household Budget Survey, which Statistics Estonia has been conducting since 1995. 3,400 households took part in the survey in 2007. Household budget surveys are conducted by statistics organisations based on a harmonised methodology in all EU Member States.

[5] Loans are not included in income and expenditure: taking a loan is treated as using savings, and the repayment of loan as savings.

household member on food and housing amounted to 39% of total costs. The share of expenditure on transport and leisure continued to increase.

Financial position and saving

The positive **net financial position** of households declined also in the second half of 2007. At the end of 2007, the net financial assets of households comprised 2.3% of GDP. While earlier the net financial position had deteriorated because of rapid growth in households' financial liabilities, in the second half of 2007 weaker growth in financial assets (in particular household deposits) was the underlying cause. For the same reason, the second half of 2007 saw a rapid rise in **household debt as a ratio to liquid financial assets**, even though growth in loan liabilities decelerated (see Figure 14).

Figure 14. Household financial assets and liabilities

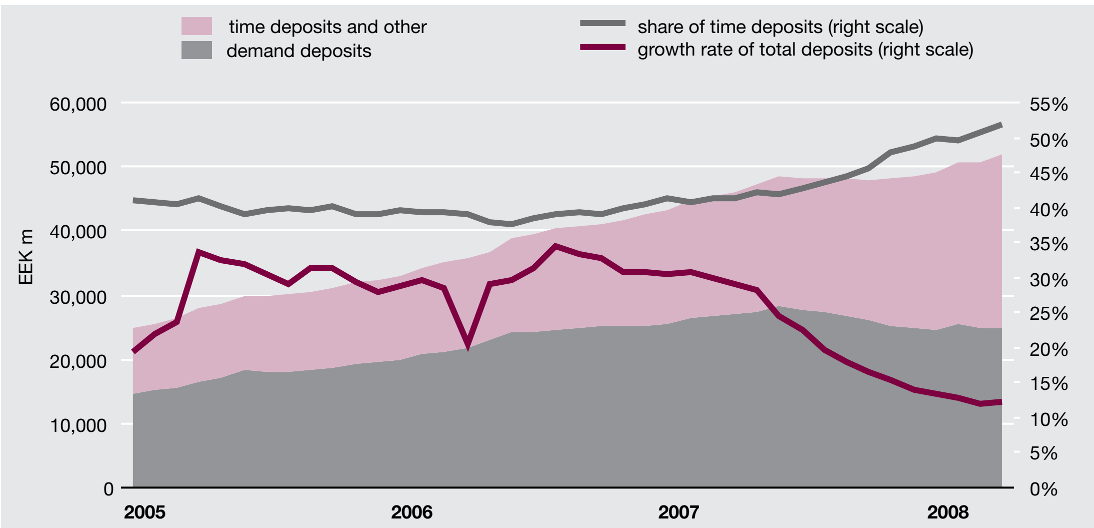

Figure 15. Household deposits in domestic banks and deposit growth

Growth in **household deposits in domestic banks** eased further in the second half of 2007 and the beginning of 2008, reaching 12% by the end of March 2008 (see Figure 15). Weaker deposit growth can be attributed to demand deposits, which started to decrease in volume in the second half of 2007. However, growth in time deposits has not waned and reached as high as 37% at the end of March 2008. This means that time deposits comprise about a half of total household deposits in domestic banks. Households have thus continued to save, which has also been stimulated by a rise in deposit interest rates. Funds available for daily settlements, on the other hand, have decreased.

In addition to deposits, growth in financial assets has been affected by the fact that households reduced their positions of **mutual fund shares** in the second half of 2007. Moreover, the volume of mutual funds shares, shares and other equity has decreased owing to a decline in their market value. Thus, the percent of shares and other equity in household financial assets has continued to decline in favour of **pension assets and insurance reserves:** from 39% in mid-2007 to 36% at year-end. The net equity of pension fund reserves and the volume of life insurance reserves comprised 16% of total household financial assets at the end of 2007.

Household debt and loan-servicing capability

Level and growth of debt

By March 2008, annual growth in loans and leasing granted to households had dropped to 27%, being over two times slower than a year ago (see Figure 16). As growth in household debt has slowed, household **indebtedness** has remained at the level recorded in autumn 2007. At the end of March 2008, it accounted for 46% of GDP and 83% of disposable income.

Future developments in household loan stock will primarily be shaped by the situation in the housing market. According to the forecast base scenario of Eesti Pank, a new growth cycle in household investment is not expected before 2009–2010. Given that, household credit growth should decelerate further in 2008–2009 and indebtedness should remain at the level of 2007 for the next three years (see Figure 17).

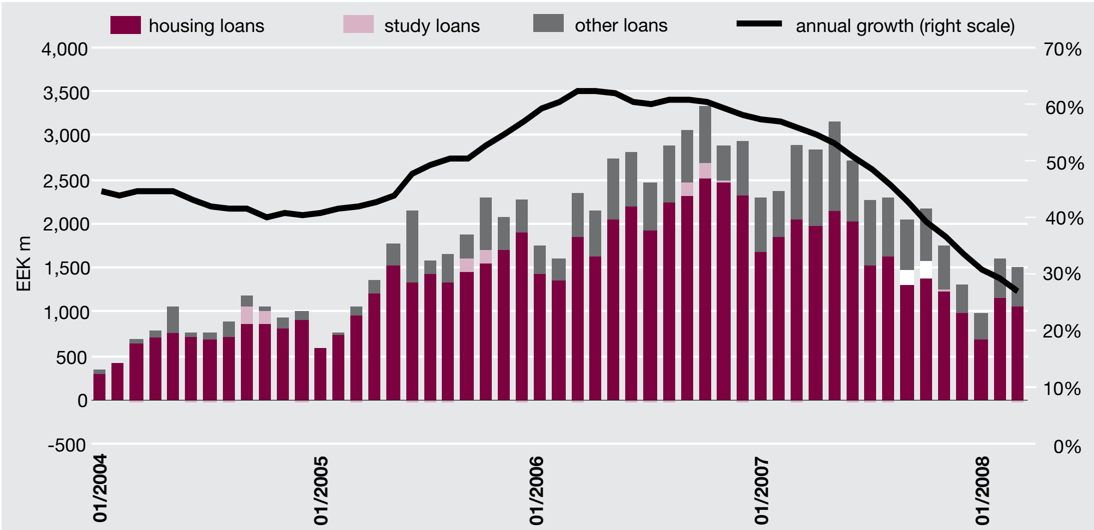

Figure 16. Monthly change and annual growth in household loans

The indebtedness of Estonian households is still substantially smaller compared to most of the Nordic countries. Finland is an exception, because at the end of 2007 their household debt as a ratio to GDP was only 2% above Estonia's indicator. Financial deepening was the fastest in the most highly indebted Denmark and Iceland, where the debt-to-GDP ratio rose considerably faster in 2007, compared to Estonia and Latvia who had posted exceptional growth figures in earlier periods (see Figure 18).

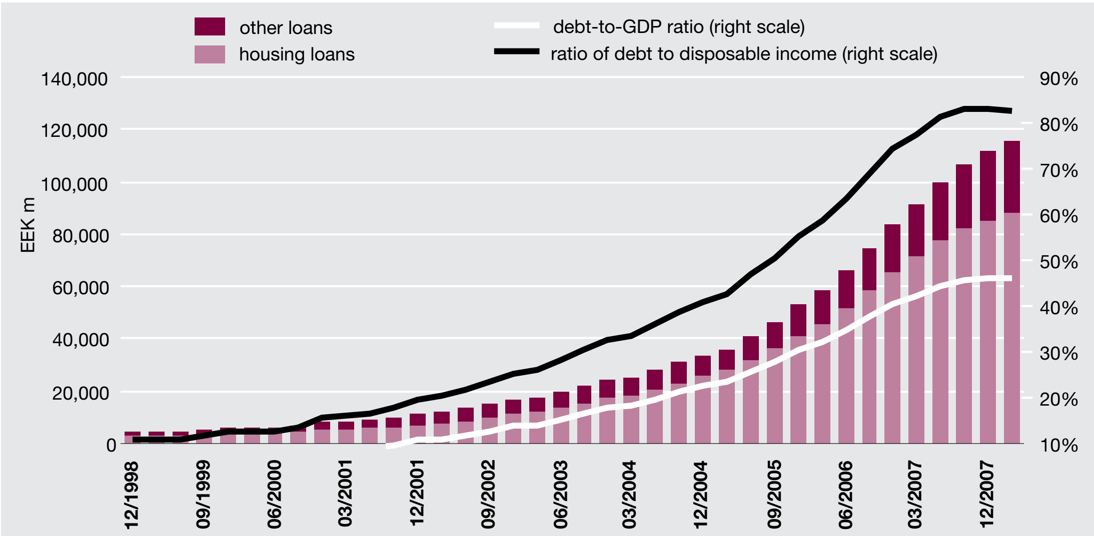

Figure 17. Household debt and indebtedness

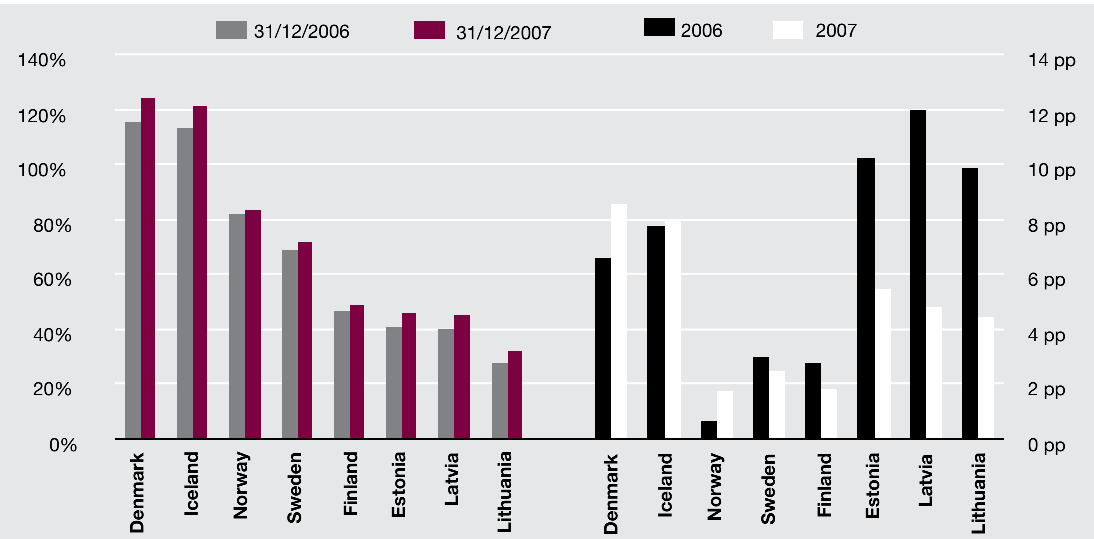

Figure 18. Household debt to GDP (left scale) and change in debt-to-GDP ratio (right scale) in Nordic and Baltic countries

Source: national central banks

Housing loans

Transaction activity on the **housing market** decreased even more in spring 2008, when the number of transactions performed with houses, apartments and plots of land dropped to the levels of 2004. According to the Land Board, by April 2008 the median price of Tallinn apartments had fallen by 14% compared to the peak reached in April 2007 (see Figure 19). The number of dwellings up for sale increased further in spring 2008. In light of the decreasing transaction volume this means longer sales periods and additional price pressures.

Growth in the stock of **household housing loans and leasing** has continued to slow along with the decreasing transaction activity on the housing market. In March 2008, the growth rate was 24%. The monthly increase in loan stock was two times lower than in the same period of the previous year.

As the key interest rate dropped slightly at the beginning of 2008, the **average interest rate on household housing loans** has also declined compared to the end of 2007. In March, it returned to the level of last July, that is 5.4%. The average interest margin calculated as a ratio of the key interest rate did not change from 2007 levels (see Figure 20).

Consumer credit

The decline in household confidence has been accompanied by a slowdown in consumer credit growth. Annual growth in the stock of **non-housing loans and leasing** decreased from 50% in September 2007 to 37% at the end of March 2008. In the first quarter of 2008, the increase in loans and leasing was over two times smaller compared to its peak in the second quarter of 2007. Though the volume of car leasing also grew less than in the summer and autumn of 2007, the slowdown has been slightly smaller compared to other loans (see Figure 21).

The volume of consumer credit together with car leasing and study loans amounted to 27.4 billion kroons at the end of March 2008. As a ratio to GDP it did not grow compared to autumn 2007 and still stood at 11%. As the economic forecast of Eesti Pank expects quite an abrupt deceleration in household consumption in 2008, consumer credit growth is likely to continue decreasing.

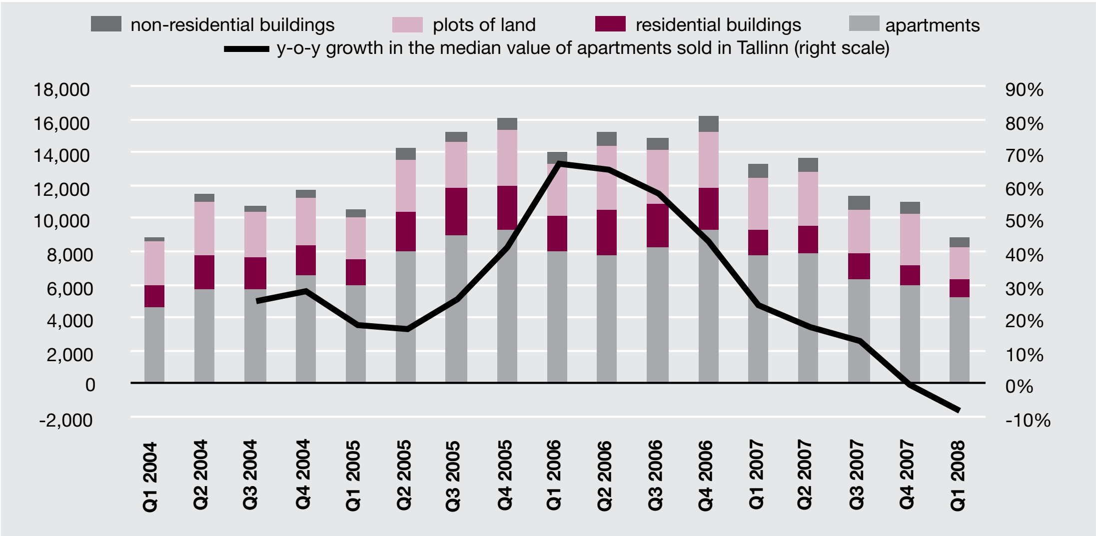

Figure 19. Number of notarised purchase-sale contracts and annual growth in the average value of real estate

Sources: Statistics Estonia, Land Board

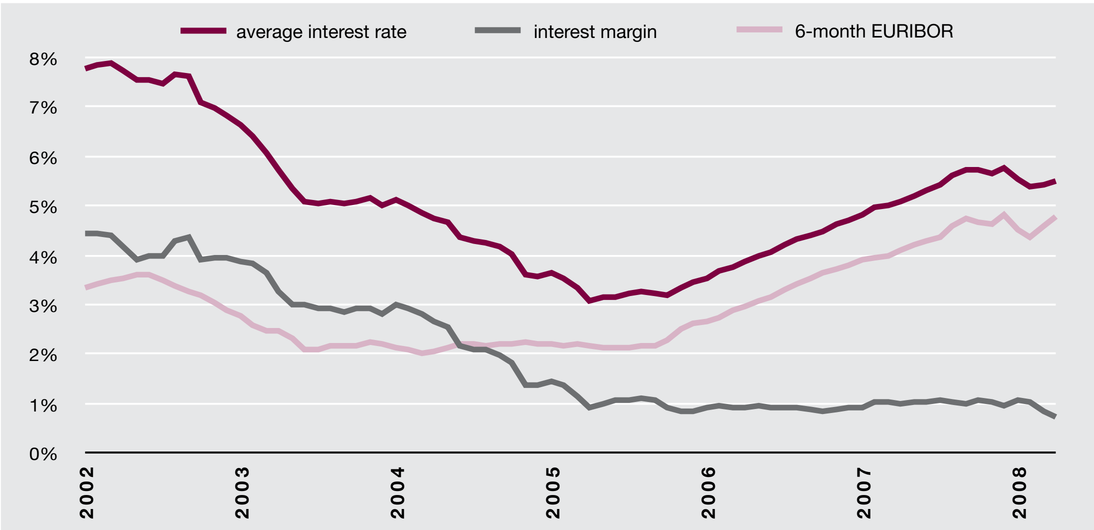

Figure 20. Average weighted interest rate, 6-month Euribor and interest margin of housing loans

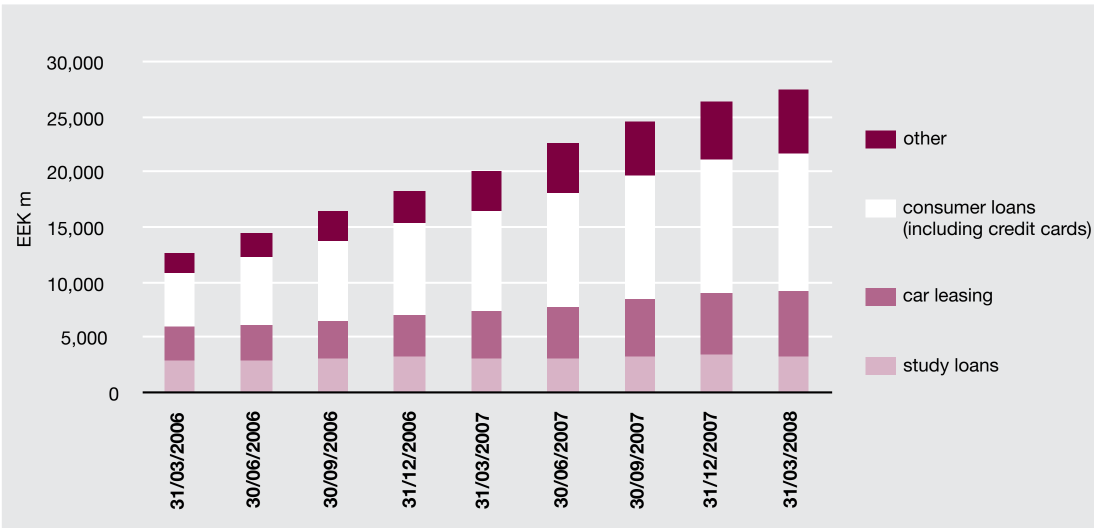

Figure 21. Stock of non-housing household loans/leasing

Loan-servicing capability and risks

The **interest burden** of households (the ratio of interest expenditure to disposable income) had increased to 5.1% by the end of March 2007. As the key interest rates did not increase that much any longer in the last six months and credit growth has abated, growth in interest costs may also start to slow. At the same time, household disposable income growth is moderating as well and thus, the interest rate burden is not expected to decrease in the near future.

Compared to the Nordic countries, where debt burden is much higher, the interest burden of Estonian households was relatively high at the end of 2007 (see Figure 22). For instance, it was comparable to Sweden where debt burden is considerably higher (150% of disposable income) and where the interest burden remained even 40 basis points lower than Estonia's indicator at the end of 2007. Meanwhile, the interest burden of Estonian households is not significantly larger compared to Latvia and Hungary. This may be caused by the high share of loans with floating interest rates, in which case interest costs increase faster during an upward cycle of interest rates than in the case of fixed interest rates.

As the key interest rates have been constantly rising in recent years, the popularity of fixed interest rates is increasing among households who wish to protect themselves against interest rate risk. The share of **loans with fixed interest rates** among new housing loans has been growing rapidly since the third quarter of 2007, when the key interest rates rose suddenly along with the tensions in financial markets. In the first quarter of March 2008, loans with fixed interest rates accounted for 11% of new housing loans; that is 3% more than a year ago (see Figure 23).

Rapid growth in indebtedness in recent years has contributed to the rise in household interest burden, whereas the increase in financial assets has remained smaller than debt growth. Therefore, also financial buffers have decreased as a ratio to debt. In 2008, the expected moderation in wage growth

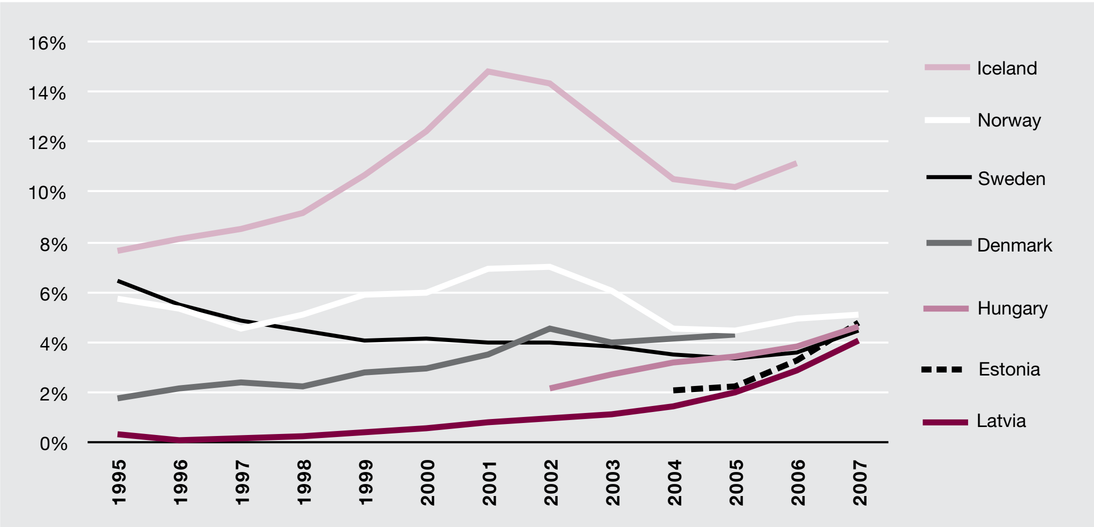

Figure 22. Interest burden in selected Nordic and EU countries (% of household net disposable income)

Source: national central banks

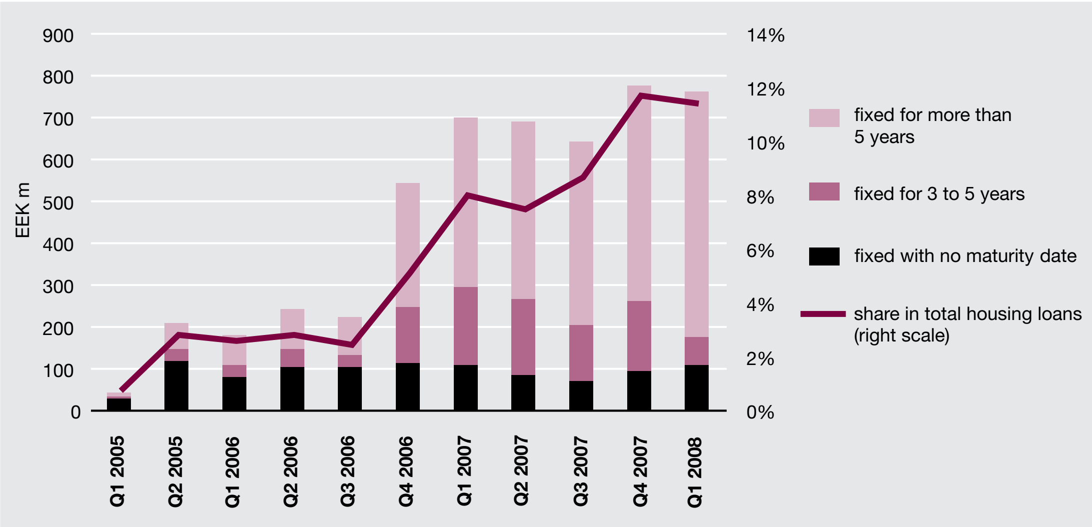

Figure 23. Volume and share of housing loans with fixed interest rate

and decreasing employment along with a relatively high inflation rate will put pressure on household budgets and loan servicing. Although according to the economic forecast of Eesti Pank wage growth will still be relatively strong and inflation will decrease in the coming years, unexpected shocks cannot be ruled out. Therefore, households should continue saving, should incomes be lower than expected or expenditures increase.