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 has been dropping since the second half of 2007. In October 2008, it reached the level of the fourth quarter of 1998. The dynamics of that indicator reflects changes in the domestic and global economic outlook as well as the impacts of the deepening financial crisis. Confidence has suffered the most in the construction sector, but also in manufacturing and trade (see Figure 1).

In October, the pessimism of **manufacturers** reached its lowest level since 1997. As the export volume has remained relatively large, the pessimism primarily reflects estimates regarding the further decline of the growth rate. The estimates are primarily shaped by global market developments, but also the expectations for domestic demand have become more negative in the past six months (see Figure 2).

Corporate investment and economic indicators

According to Statistics Estonia, the **total profit growth** of companies has slowed in 2008. In the first half of 2008, total profit was nearly 16% below the figure for last year. The decrease has been mainly caused by developments in the domestic market: demand has shrunk, consumers have become more cautious, prices have increased and labour costs have risen. The profitability of hotels and restaurants, and construction and real estate companies has suffered the most. In the first half of 2008, total profit growth slowed substantially also in manufacturing. In the first quarter, manufacturing companies earned 2.3% more profit than a year earlier, whereas in the second quarter year-on-year profit growth stood at -17.9%.

Sales income growth suffered a serious setback in the first half of 2008, dropping from **24.1% to 3.5%**, year-on-year. Although the growth of total costs has also declined from 23.8% to 5.3%, incomes have not decreased as much. The growth of labour costs[1], however, has decelerated much less than that of other costs, which

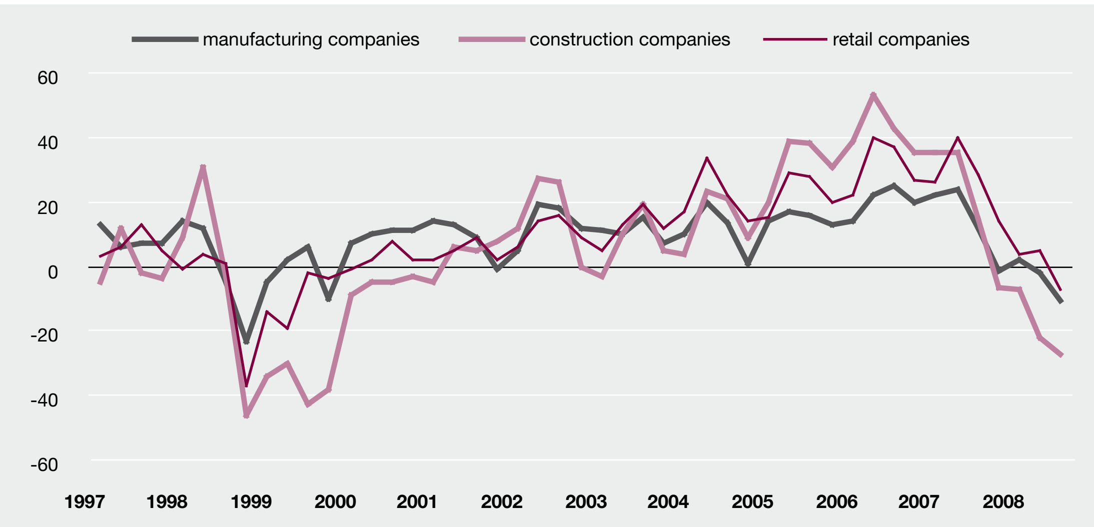

Figure 1. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

[1] Labour costs comprise approximately 13–14% of the total costs of companies.

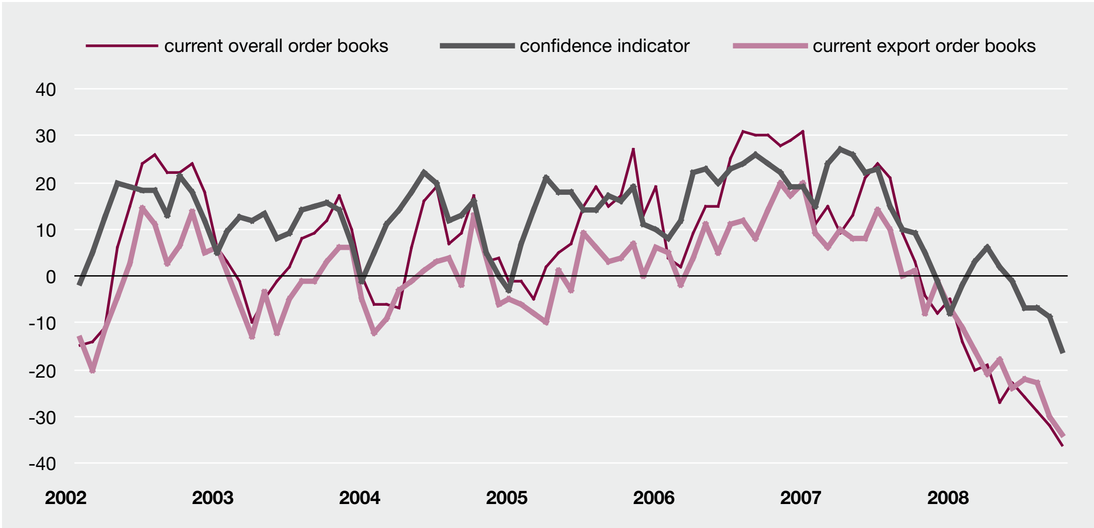

Figure 2. Demand for the production of manufacturing companies and the confidence indicator

Source: Estonian Institute of Economic Research

is why the share of labour costs in companies' total costs has risen.

Although wage growth has waned in the past six months, it still outpaces nominal economic growth. Consequently, the share of companies' labour costs in GDP has increased. The difference between the share of profits and the share of labour costs has achieved its highest level in 12 years, indicating that compensations of employees have been paid on account of profits (see Figure 3).

The **total profitability** of companies, i.e. the ratio of total profit to sales revenue, has shrunk in all sectors compared to the second quarter of 2007. The profitability of hotels and restaurants and real estate companies has suffered the most.

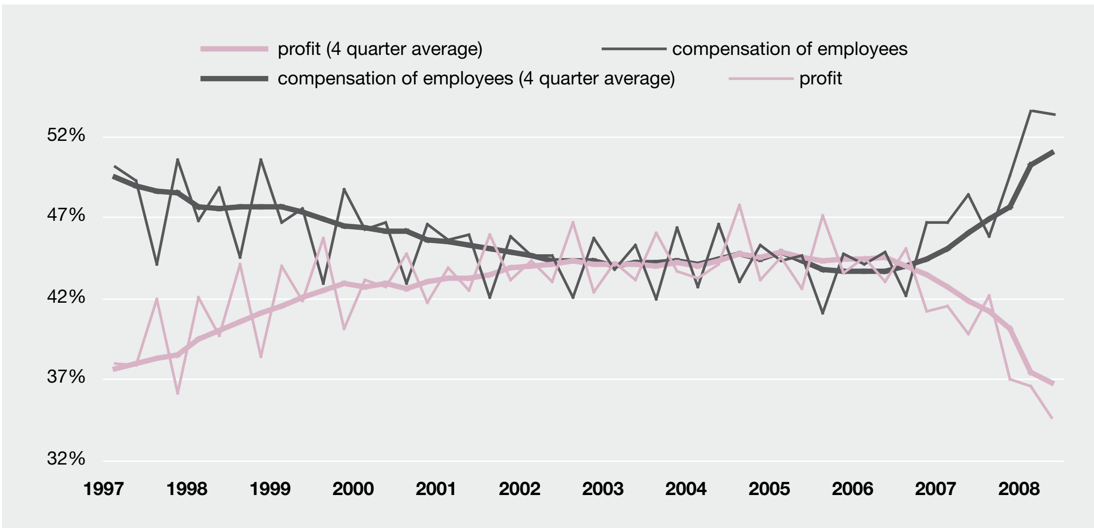

Figure 3. Compensation of employees and profit as a ratio of GDP

In the first half of 2008, corporate fixed investment exceeded last year's figures by only 3%. Investment was mainly channelled to the construction and renovation of buildings and facilities and to machinery and equipment. In the second quarter of 2008, the slowdown in investment growth turned into a decline. Investment in land decreased the most. Future real estate investment will most probably decline further, which is confirmed by the considerably stronger growth of stocks this year (see Figure 4).

New companies and bankruptcies

The turning point for establishing **new compa-**

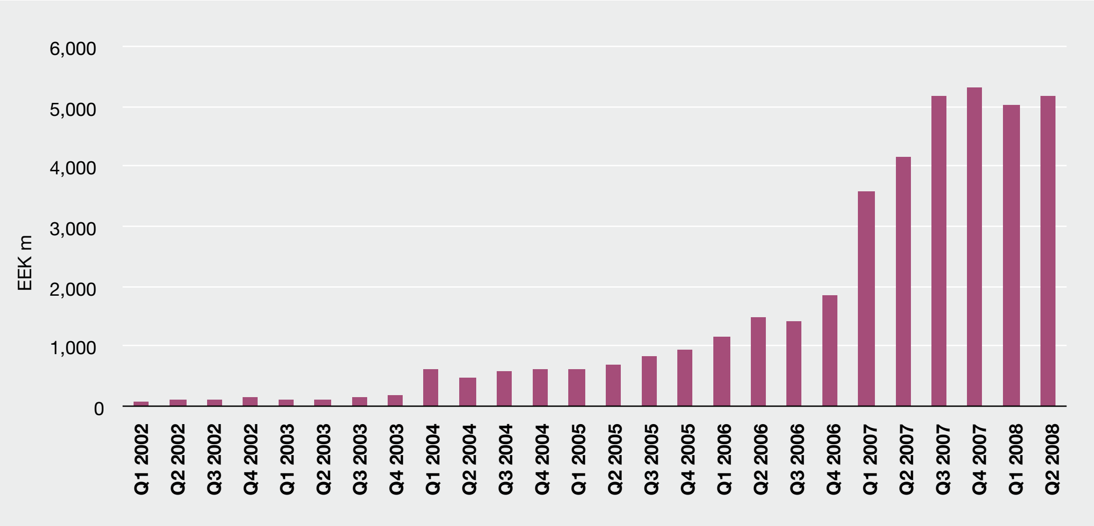

Figure 4. Stock of real estate companies (complete and incomplete projects)

Source: Statistics Estonia

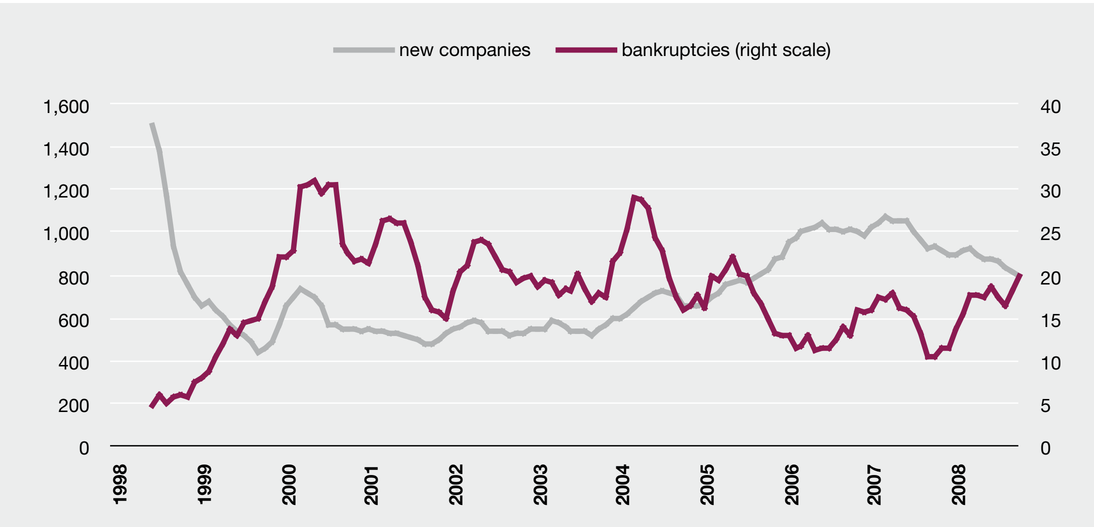

Figure 5. New and bankrupt companies on a monthly basis (6-month moving average)

Source: Estonian Enterprises Register

nies was the summer of 2007, when 160 less new companies were registered per month on average compared to earlier periods. This indicator has decreased also in 2008, but somewhat less (see Figure 5).

In August 2008, the number of **bankruptcy petitions** passed to courts rose sharply. In 2007 about 25 bankruptcy petitions were filed per month, whereas in the second half of 2008, 67 petitions were registered per month on average.

Although the number of **companies going bankrupt** has not yet risen that much, it has nevertheless grown compared to last year. Within the first ten months of 2008, 192 companies had gone bankrupt compared to the 149 registered a year earlier. Bankruptcies have mostly occurred in the trade and construction sectors.

Corporate financial position and saving

The negative **net financial position** of companies improved in the first half of 2008 and reached -103% of GDP at the end of the first half-year. This was mainly caused by two factors: the decline in the market value of the shares and other equity issued by companies and moderating growth in debt liabilities (see Figure 6).

Although the growth of corporate **financial assets** has outpaced that of financial liabilities, growth in assets still decelerated considerably in the first half of 2008. This was mainly brought about by the decreasing value of the shares and other equity of companies. The growth of corporate financial assets has substantially been stimulated by the increase in trade credit and advance payments, which might actually point to growing solvency problems in companies.

Companies' **deposits** in local banks have increased by only 1.7 billion kroons (3.6%) over the year. As companies prefer time deposits, the share of such deposits in total deposits has climbed from 28% a year ago to 35% at the end of September 2008 (see Figure 7). Growth in corporate savings has probably been inhibited by slower growth in profit and the need to finance investment and current expenses with savings rather than loans.

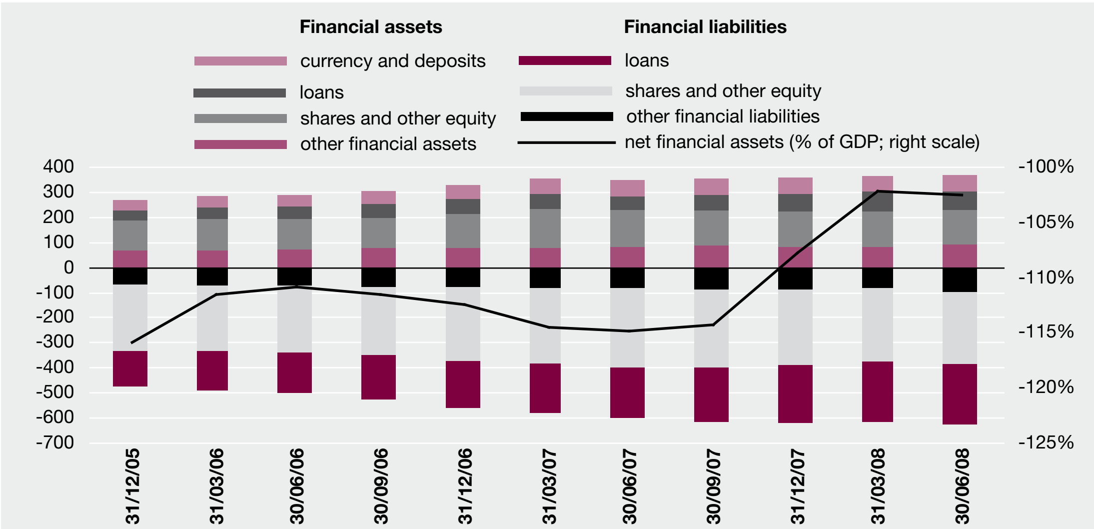

Figure 6. Corporate financial assets and liabilities and net financial assets

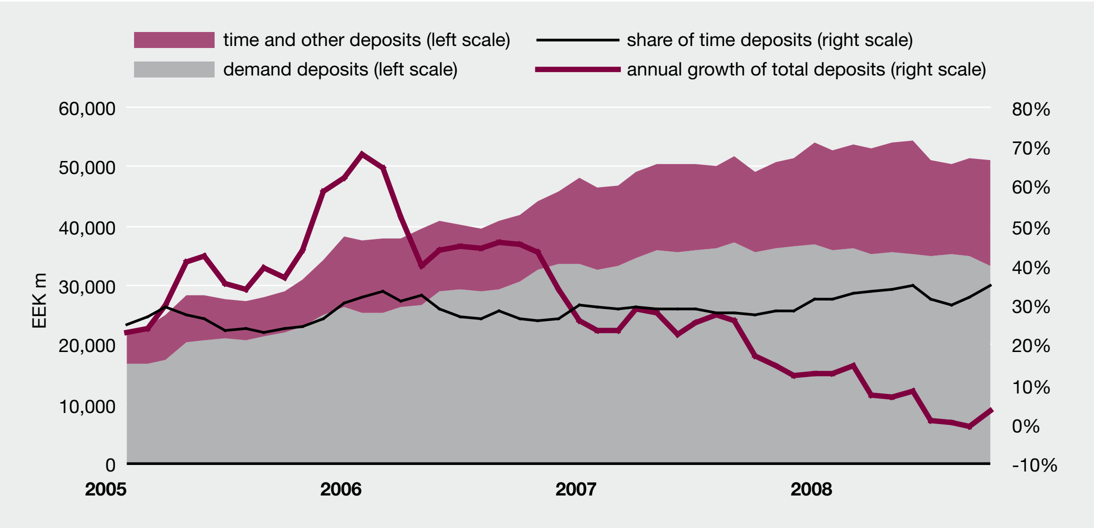

Figure 7. Volume and growth of corporate deposits and share of time deposits

Various financial ratios also point to tightening in the business sector. As deposits have grown rather modestly in 2008, the coverage of debt liabilities by deposits has decreased further. The ratio of liquid financial assets to debt liabilities has declined too. Changes in these financial ratios indicate a decrease in the financial buffers of companies.

Corporate debt

Net corporate **debt growth** slowed in the first half of 2008, owing to demand-side factors (lower investment and confidence) and banks' conservative credit policies. Annual debt growth reached 13% at the end of the first half of 2008 (28% a year ago). The indebtedness of Estonian companies declined in the first half of 2008 compared to end-2007, dropping by 0.4 percentage points to 74.4% of GDP. Foreign debt decreased to 20% of total corporate debt and posted the lowest rate in ten years (see Figure 8).

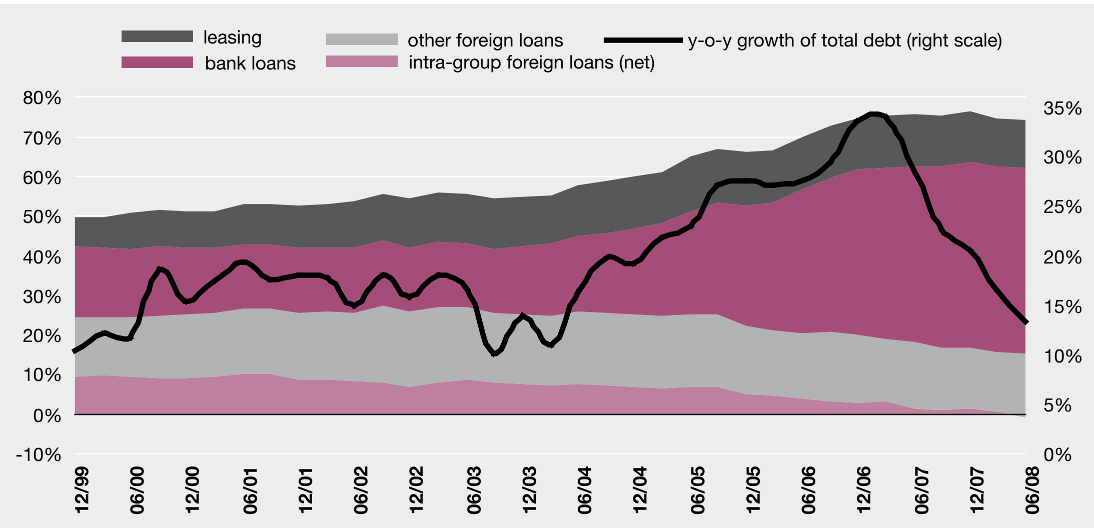

Figure 8. Corporate debt (% of GDP)

The gross level of **corporate debt** obtained in the first half of 2008 remained virtually unchanged compared to the first half of the year (see Figure 9). As regards economic sectors, real estate companies still obtained the most foreign funds, and even more than in the second half of 2007. The debt liabilities of the trade sector grew considerably less than in the previous six months. However, the structure of new loans has changed: a substantial share of the new liabilities raised in the first half of 2008 consisted of foreign loans. In the first half of 2007 foreign debt accounted for 12% of the debt accumulating since 1999, whereas the figure for the first half of 2008 was 40%.

The growth rate of **domestic corporate debt** decreased to 13.4% by the end of the third quarter of 2008, having dropped by 8 percentage points over the past six months. Growth in loans and leasing granted to real estate companies has been the most sluggish. In agriculture and manufacturing, on the other hand, the stock of loans and leasing has increased faster than average.

The **average interest rate on long-term corporate loans** increased slightly in October 2008 and reached 7% (see Figure 10). Banks' expectations concerning raising interest margins remained high throughout this year and materialised in the October figures. The average interest rate on long-term corporate loans has risen despite the slight fall of the Euribor and loan terms have become much stricter.

As the investment demand of companies will probably weaken in the coming years in comparison with earlier periods, the loan supply might meet the estimated market needs in line with tight liquidity constraints. Given the greater liquidity constraints of banks it cannot be ruled out that the companies' will be needing more funds for investment than banks are able to supply. According to Eesti Pank's economic forecast, which considers the impact of constrained external financing to be relatively neutral, the loan growth of companies will reach a bottom in 2009. Corporate loan demand is expected to start growing again in 2010.

To sum up, although the aggregate figure of the corporate financial position has improved in the past six months, several indicators point to weakening loan-servicing capability of companies. Furthermore, banks have considerably tightened loan terms. Thus, sectors that used to be the drivers of growth are now having difficulties with obtaining loans.

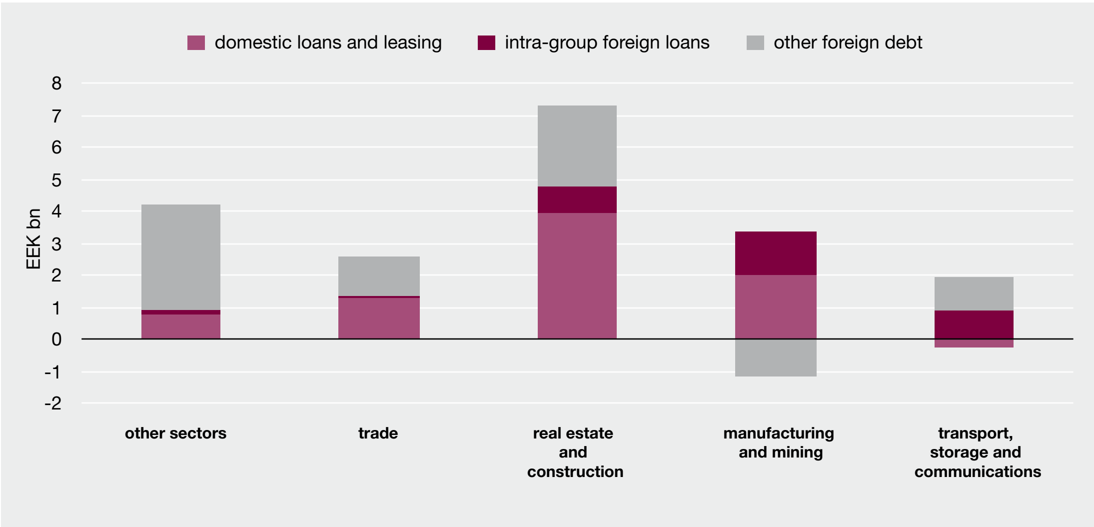

Figure 9. Corporate net borrowing in the first half of 2008

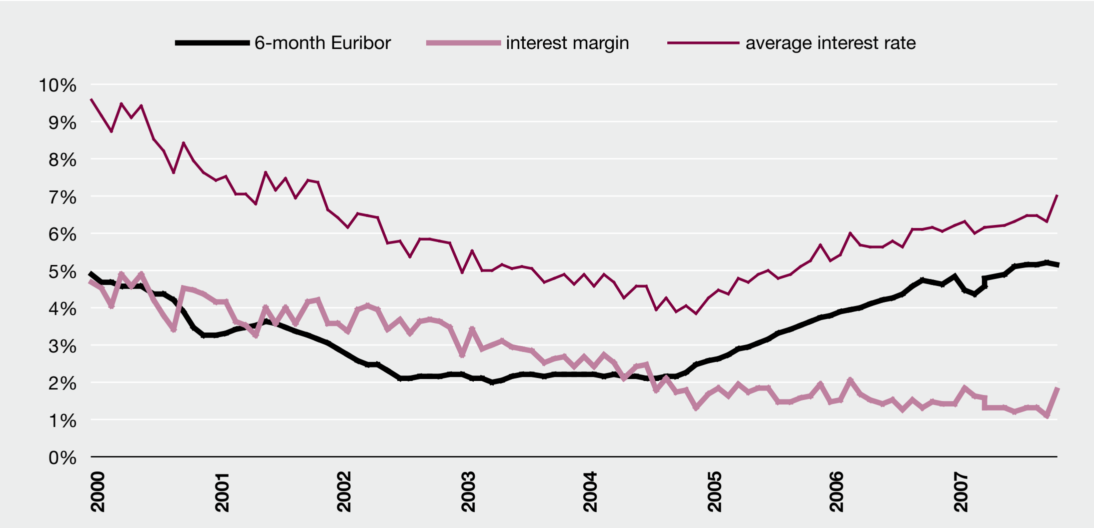

Figure 10. Average interest rate, 6-month Euribor and average interest margin on long-term corporate loans

HOUSEHOLDS

Economic situation of households

Confidence

Household confidence began to deteriorate in the second half of 2007 and reached a record low in October 2008. Consumers' expectations have become more pessimistic regarding future income growth, savings and the economic outlook. The fear of unemployment has increased the most. However, households believe high inflation to be temporary and inflation expectations for the next 12 months are lower (see Figure 11).

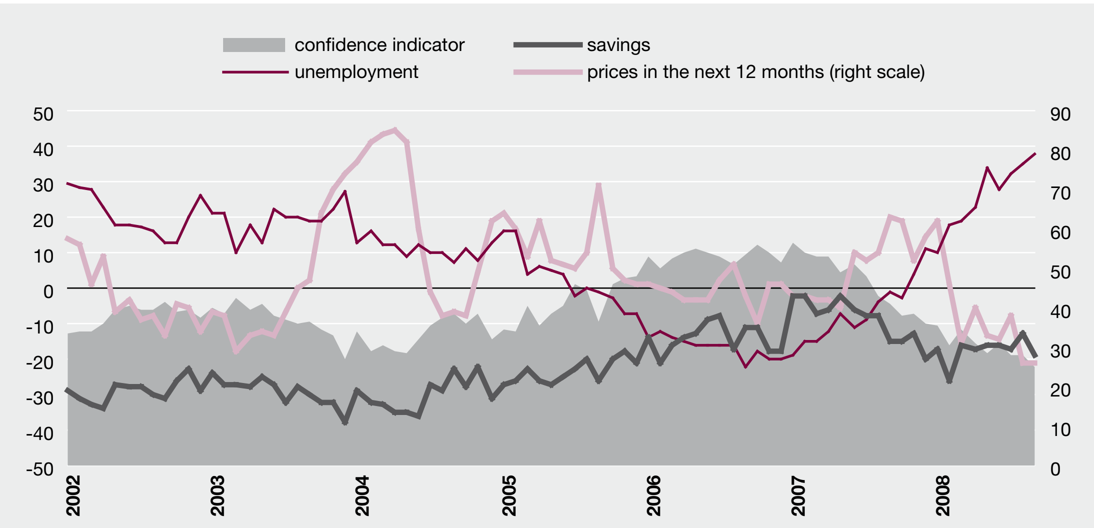

Figure 11. Consumer confidence indicators

Source: Estonian Institute of Economic Research

Labour market

The current decline of the Estonian economic cycle differs drastically from the earlier experience (e.g. the Russian crisis), which is why it is difficult to draw any parallels between the developments of labour market indicators.

At the time of the previous cyclical decline the **unemployment rate** responded relatively fast to macroeconomic developments (in three years, unemployment rose by 5 percentage points and reached 14.6% in the first quarter of 2000), but not this time. On the contrary, in the second quarter of 2008 unemployment achieved its record low in recent years (4.0%). In the near future, however, unemployment is expected to grow, though less than during the previous crisis.[2]

The change in the **employment rate** in the second quarter of 2008 is so far the only evidence of an adequate response of the labour market to the economic situation. Although in the first quarter the number of the employed kept growing, in the second quarter the figure was 2,000 smaller than the year before. In other words, growth in employment was replaced by a -0.3% decline (see Figure 12).

The adjustment of the labour market to the decreasing economic activity is most apparent in wage growth. Growth in **average gross monthly wages** started to decelerate rather quickly (see Figure 13). In the second quarter of 2008, average gross monthly wages amounted to 13,306 kroons (year-on-year growth 15.2%) with the growth rate falling to 12.2% in June. The slowdown of growth has been particularly pronounced in the private sector.

Real **wages** started to adjust in the fourth quarter of 2007. Real wage growth slowed to 7.6% in the first quarter of 2008 as a result of rapid inflation. In the second quarter the growth rate fell even further – to 3.4%[3] – although inflation only changed by 0.3%

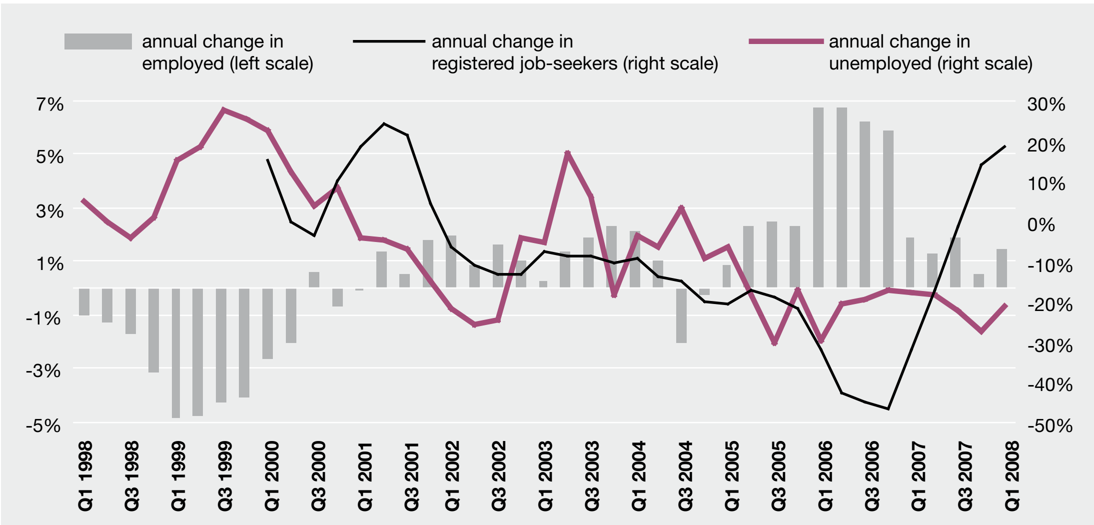

Figure 12. Annual change in the number of the employed, the unemployed and registered job-seekers

Source: Statistics Estonia

[2] As the experience of other countries has shown, the unemployment rate responds to the cooling of the economy with a 2 to 6 quarter lag.
[3] The last time real wage growth was so slow was in the fourth quarter of 2004.

Figure 13. Average annual wage growth

Source: Statistics Estonia

Financial position and saving

In 2008, the net financial position of households became negative for the first time, comprising -0.6% of GDP at the end of the first half-year (see Figure 14). The net financial position has worsened because of the decreasing value of the shares and other equity, and the considerably stronger growth of households' financial liabilities compared to financial assets. Meanwhile, the ratio of household debt to liquid financial assets[4] has slightly improved in the past six months. However, third-quarter developments point to a further deterioration of the net financial position (deposits did not increase in the third quarter, whereas the volume of credit grew by nearly 3 billion kroons).

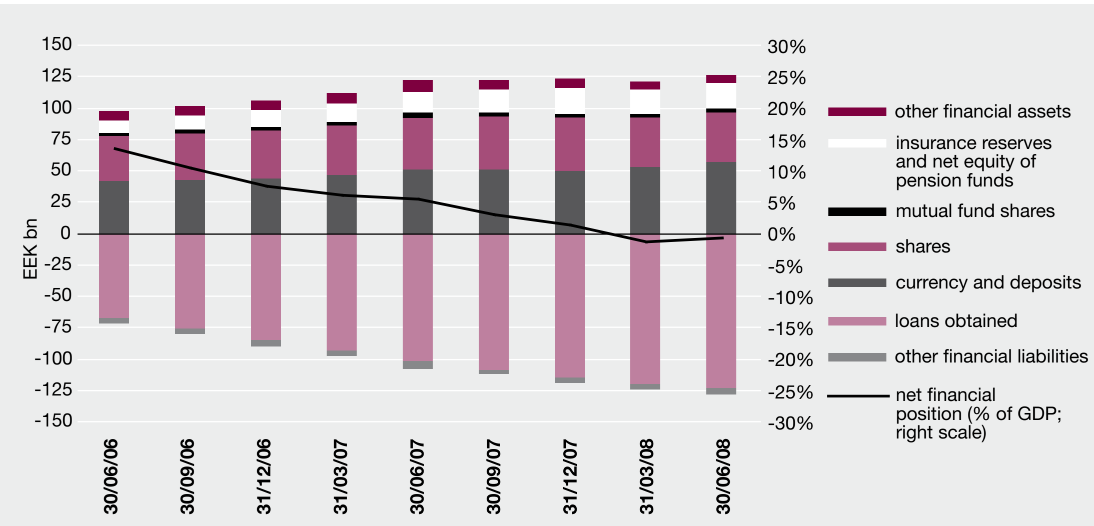

Figure 14. Household financial assets and liabilities

[4] Liquid financial assets are currency and deposits, securities (excl. shares and other equity), loans and units of contractual funds.

The growth rate of **domestic deposits** has remained at 12% throughout 2008 and the trends that began in the second half of 2007 have continued (see Figure 15). In particular, the annual growth of demand deposits has been negative since the fourth quarter of 2007 and their volume has shrunk over the last year. The annual growth of time deposits, on the other hand, has picked up; at the end of the third quarter of 2008 they comprised 55% of total household deposits. Time deposits have increased by 8 billion kroons over the year. The average interest on household kroon deposits has climbed by 1.3% to 5.2% year-on-year.

Household debt and loan-servicing capability

Level and growth of debt

In September 2008, the **annual growth** of household loans and leasing slowed to 15.5% (see Figure 16). The growth rates have substan-

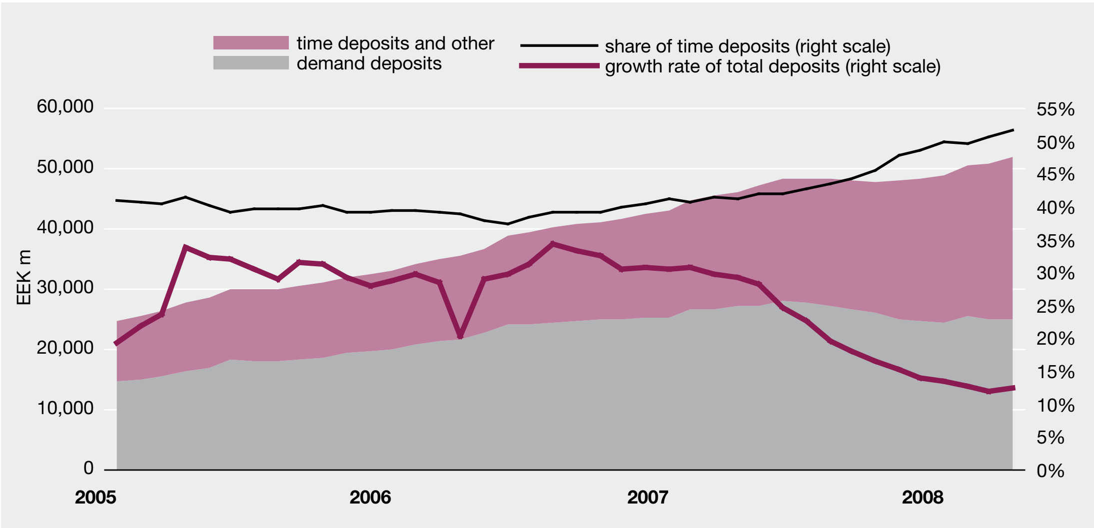

Figure 15. Household deposits in domestic banks and deposit growth

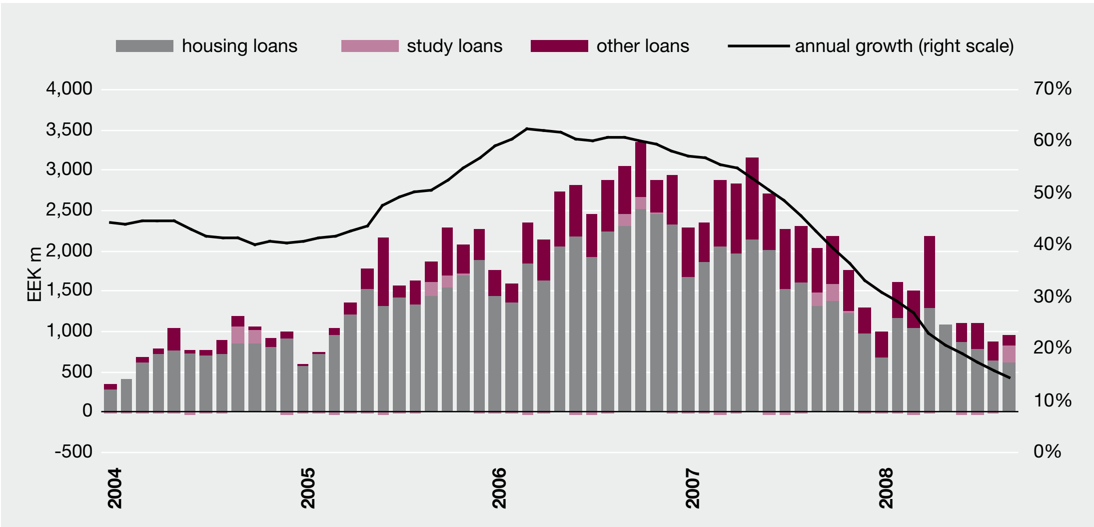

Figure 16. Monthly change and annual growth in household loans

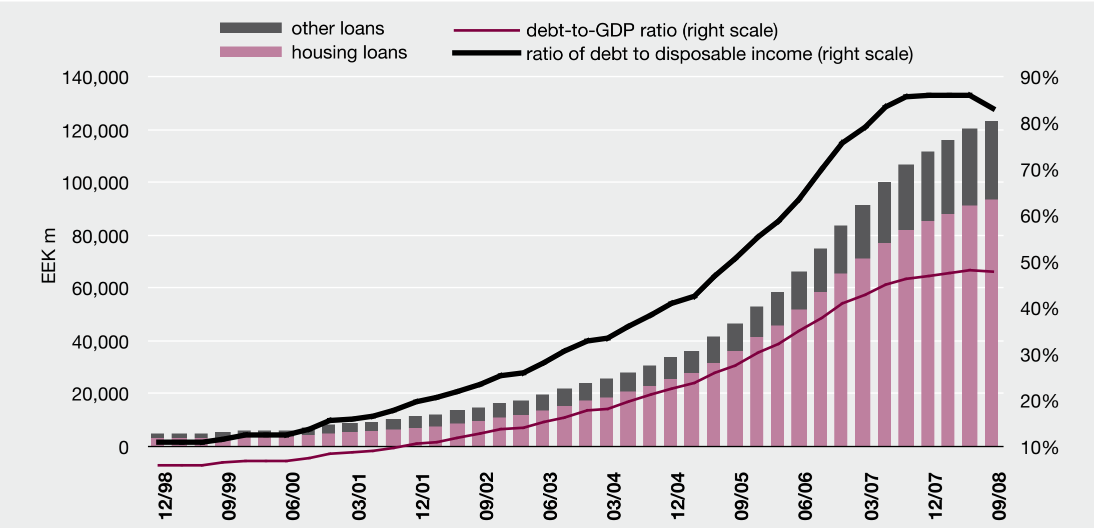

Figure 17. Household debt and indebtedness

tially declined compared to last year's figures (42.6% in October 2007). As household debt growth has subsided, **indebtedness** has risen only marginally in the last quarters. At the end of September 2008, it reached 48% of GDP and 83% of disposable income (see Figure 17).

Housing loans

The housing market has cooled down further to the moderate levels recorded before the robust growth period. Increasing economic tensions and stricter financing conditions are curbing the demand for housing, thus also putting downward pressure on housing prices. According to the Land Board, the median prices of apartments in Tallinn had dropped by 25% by October 2008 from the peaks of April 2007. In order to reach the more affordable pre-boom levels, prices should fall further. Nearly a half less housing loans and leasing were granted in the first nine months of 2008 compared to the same period in 2007. Year-on-year growth was 14.4% in September 2008.

According to TNS Emor's survey on the financial behaviour of households, 22% of (131,000) families have taken a loan to renovate, purchase or build real estate (about 20% or 116,000 in 2007). Housing loan customers primarily include households with higher incomes who are likely to cope with loan servicing also at the time of decline.

The autumn forecast of Eesti Pank expects a considerable drop in real estate transactions in the near future. This is due to the more cautious behaviour of households and more conservative loan conditions.

The **average interest rate on housing loans** has increased to 6.2% as a result of a rise in the key interest rate in the second half of 2008 (see Figure 18). The last time the interest rate on housing loans was so high was at the beginning of 2003. In October, the average interest margin of major Estonian commercial banks, calculated as a ratio to the key interest rate (6-month Euribor), grew considerably. In addition to raising the margin banks have increased the down payment rate to 30%.

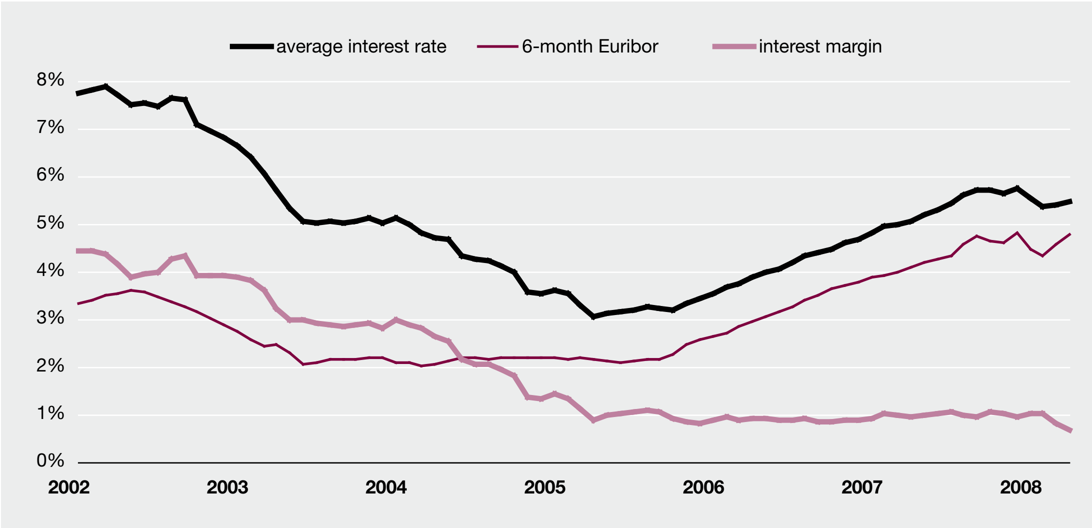

Figure 18. Average weighted interest rate, 6-month Euribor and interest margin of housing loans

Consumer credit

As the general optimism in the economy has evaded, households are weighing consumer credit decisions more carefully. The **year-on-year growth** in the stock of non-housing loans and leasing has declined from 24% in March 2008 to 15% in September (see Figure 19).

The stock of new loans issued in the last six months comprises only 41% of the stock added in the same period last year. The growth rate of other household loans (incl. credit card loans) has fell faster than average, while the growth of car leasing has decelerated somewhat less. At the end of September 2008, the stock of consumer credit (incl. car leasing and study loans) totalled 29.3 billion kroons. It has not increased as a ratio to GDP compared to March 2008 and still accounts for 11% of GDP.

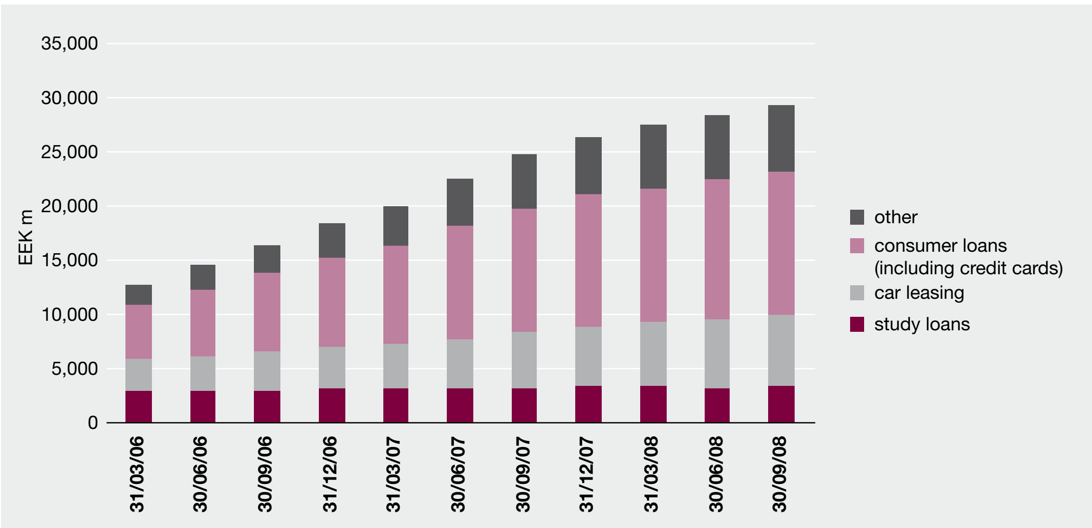

Figure 19. Stock of non-housing household loans and leasing

Based on TNS Emor's 2008 survey on financial behaviour, the number of households planning to take a loan has not changed over the year. However, there is a growing need for smaller loan amounts and shorter maturities. Households mainly want to borrow in order to pay for current expenses, and also the number of potential credit card customers has risen.

Loan-servicing capability and risks

Household interest burden (the ratio of interest expenditure to disposable income) stood at 5.6% at the end of September 2008 (see Figure 20). Expenditure grew after an increase in the key interest rate in 2008. The interest burden is likely to remain at the current level also in the coming periods, as household credit growth is slowing, the key interest rate is expected to decline and growth in household disposable income has moderated.

The interest burden has risen quite robustly even given the modest credit growth. The reason lies in the small share of loans with **fixed interest rates** in the total loan portfolio (see Figure 21). About 9% of the housing loans obtained in the second and third quarters of 2008 had a fixed interest rate. Compared to last year the period of interest rate fixation has shortened. As the key interest rate is expected to drop in the coming periods, the share of housing loans with fixed interest rates may also shrink.

Household indebtedness (interest payments plus loan payments) as a ratio to household disposable income increased to 4.7% by the end of the third quarter of 2008. However, the growth of the loan burden has not picked up significantly over the last months. Thus, if the interest rate growth comes to a halt, the housing loan burden may decrease as a ratio to household disposable income in the coming periods.

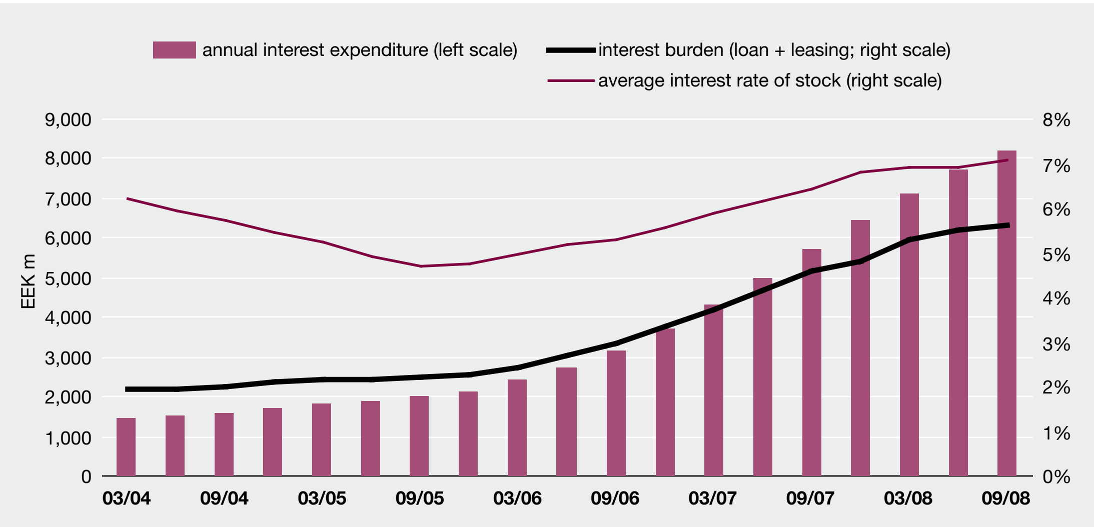

Figure 20. Annual interest expenditure and interest burden of households

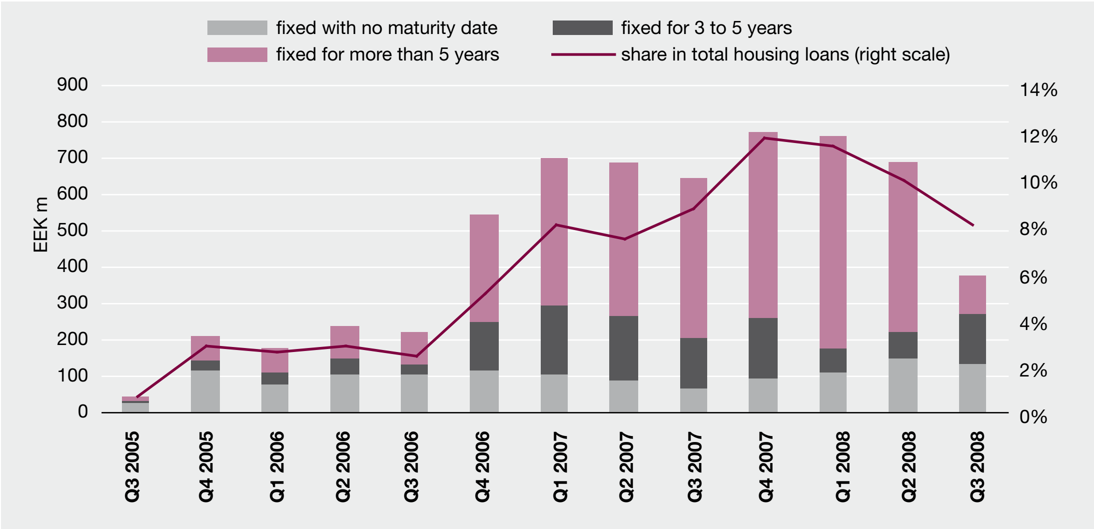

Figure 21. Volume and share of new housing loans with fixed interest rate