SUMMARY

The sovereign debt crisis in some euro area countries still causes concerns over funding related vulnerabilities for a number of EU banks. While the contagion to other euro area economies has so far been largely contained, the funding conditions of EU banks in general have improved over the last six months. The gradual recovery of financial markets and the favourable interest rate level provide fertile grounds for covering the growing loan demand of the non-financial sector. Although economy is gaining momentum, borrowing is still relatively modest in most euro area countries.

In Estonia, which survived quite a deep recession, the recovery of the loan stock of Estonian companies and households will take more time. From autumn 2008 until April 2011, the loan and leasing portfolio of banks dropped by over 15%, and this trend is not expected to turn anytime soon in most loan segments.

Along with increasing economic activity, the credit demand of companies grows, as inventories and production capacity may become insufficient to maintain or increase the current growth rate. In 2010, companies covered their financing needs mostly from their internal cash flows, such as sales revenues and profit growth. However, the first months of 2011 also witnessed a substantial increase in the turnover of short-term loans. Nonetheless, bank loans are still obtained rather modestly to fund investments.

In the new economic cycle, the structure of investments will probably focus less on real estate, although the demand for high-quality housing and infrastructure objects is already evident. Considering smaller need for real estate investments and the fact that apart from construction and real estate development the majority of other fields of activity use less credit, the volume of loans provided by banks is not expected to rise to the level of the previous economic cycle in the coming years. The financing demand of the Estonian economy is additionally covered by external borrowing, which increased to the pre-crisis level of 25% by the end of 2010, owing to the funds obtained from foreign parent companies.

Improved confidence and stronger loan demand of households is primarily reflected in the swiftly growing car leasing market, where the first four months of 2011 recorded an over 80% growth in sales compared to a year ago. The rise in the volume of new housing loans, however, is more modest than expected, although the price level of real estate has remained considerably lower relative to average incomes. Activity in the housing loan market has been curbed by the scarcity of supply in the housing market that would correspond to demand and also by the relatively high debt burden of households. As the financial behaviour of households is still cautious, they prefer to finance consumption from their incomes and savings, instead of taking loans.

Banks' readiness and willingness to offer credit has risen over the year. The capitalisation of banks has further improved and the funding base is much stronger owing to deposit growth. Although the share of overdue loans in the loan portfolio remains high, the main focus of banks has shifted from the quality of existing portfolios to issuing new loans again, and competition on the loan market has increased considerably. This has brought along the expected drop in interest margins, which is most clearly manifested in the housing loan market.

The forecast of loan growth for 2011 is largely influenced by the changed structure of loan demand and the rapid depreciation of the loan portfolio. Despite the fact that more loans are granted to companies and households than a year ago, their turnover remains smaller than the repayments of earlier loans. Therefore, the loan portfolio will also shrink in 2011 and, by the year-end, Eesti Pank expects the stock of loans issued to companies and households to be over 3% lower than a year ago. According to the forecast, the loan portfolio, which has been in decline for almost four years, may start showing positive annual growth rates in spring 2012.