

BACKGROUND INFORMATION

DECLINE IN NON-FINANCIAL SECTOR INTEREST RATES IN NEW EU COUNTRIES IN THE CONTEXT OF EU ACCESSION

Competition in the Estonian non-financial sector credit market has been constantly strengthening in recent years, and as a result the interest rates are at record low and credit growth is fast. Since most of the tightening competition can be attributed to the EU accession, similar tendencies should also be evident in other new EU Member States. The following is an analysis of the dynamics of the interest rates on non-financial sector loans in new Member States in order to see whether interest rate competition trends have been similar in Estonia.

With such an analysis one has to bear in mind that due to different monetary systems in the new Member States also interest rates in the retail banking market are on very different levels and are thus not directly comparable. Hence in order to evaluate interest rate competition the change in interest margins on household and corporate loans (retail banking interest – money market interest) has hereby been used. The weighted average interest rate on the existing bank loan portfolio has been used for analysis.

Price competition has strengthened most in the housing loan market. Interest margins on household housing loans (see Figure a, left side)

began to decline in almost all the new EU Member States covered by the analysis already before the expansion of the EU. Meanwhile interest margins earned by the financial sector on housing loans portfolios have by now fallen below the EU average in several new Member States. Hereby one has to take into consideration differences in the loan market structure and development dynamics. While in the EU most housing loans have been issued at fixed interest rates, then in the new EU Member States loans with floating interest rates dominate. Since money market interest rates in the euro area are currently at cyclical lows, interest rates on loans with floating rates are also considerably lower than fixed interest rates. On the other hand, this clearly indicates lack of room for further decline in the interest margins on housing loans.

Price competition of consumer loans has not grown significantly in the new Member States in recent years. It is interesting that interest margins on consumer loans have not declined in the course of harmonisation in recent years, but have risen in several countries instead (see Figure a, right side). This indicates that the interest rate level of consumer loans has not moved in line with the overall decline in

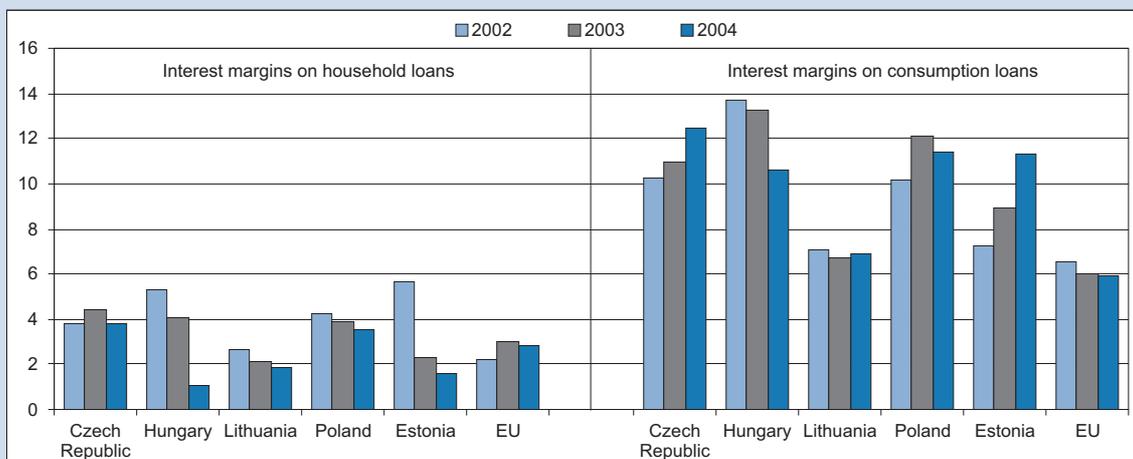


Figure a. Average annual interest margins on household loans (loan interest – money market interest) in percentage points

the interest level. The respective average interest rate in the EU is lower than in all the countries observed, which shows that respective interest margins in the new Member States in Central and Eastern Europe can also fall in the course of financial integration and strengthening competition.

Interest margins on corporate loans have remained comparatively constant (see Figure b). When early in 2002 differences in interest rate margins were occasionally as high as six times, the spread had decreased to just a few per cent by 2004. At the same time, interest margins on corporate loans have been historically low and no significant changes have occurred in recent years. Average interest margins

on loans to corporations operating in the new EU Member States are close to the respective indicators in old Member States. As regards the interest margins on loans issued in Estonia, the interest margins on housing loans are among the lowest, while the respective margins on corporate loans have been among the highest in recent years.

In conclusion, similarly to Estonia, price competition in the new Member States has been the tightest in the household housing loans area. In corporate financing interest rate competition has not changed much in recent years and the level of interest rates on household consumer loans has in some cases even increased.

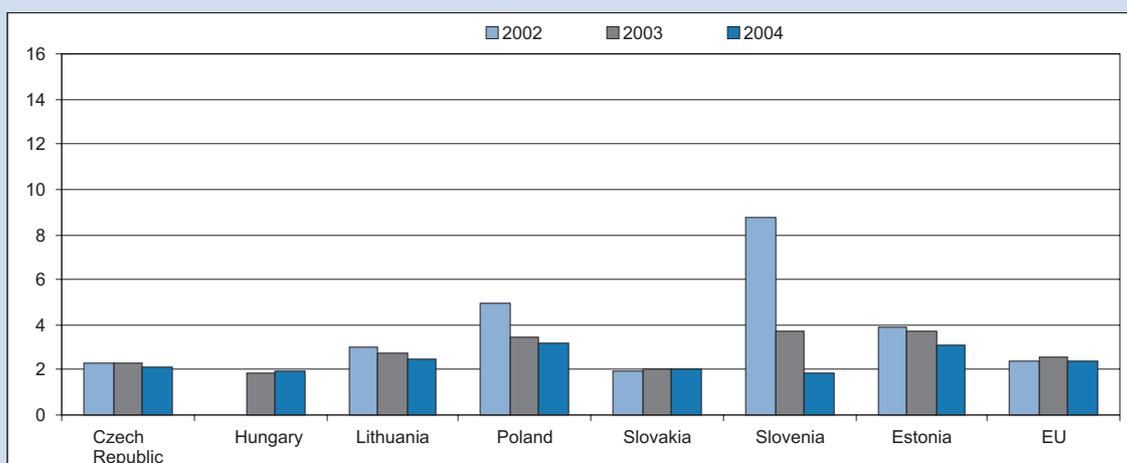


Figure b. Average annual interest margins on corporate loans in percentage points