THE FUNCTIONING OF THE CREDIT MARKET AND POSSIBILITIES OF STATE INTERVENTION

Flash report, 27 March 2009

The recent years' rapid credit growth in Estonia has markedly increased both households' and corporate debt burden. By end-2008, corporate debt rose above the euro-area average, but it is expected to drop slightly in 2009-2010. This will be an anticipated correction resulting in a decrease in the corporate debt burden as a whole and in the volume and loan portfolio share of the loans issued to the real estate sector.

Owing to previous years' record profits, banks in Estonia are well-capitalised. They have all the necessary preconditions for continuing to finance good business projects and support companies in the changed conditions as well. It is important to look beyond the current situation, i.e., to consider the medium-term and longer-term economic outlook. Since global demand has changed, business plans should be reviewed in the entire economy.

Both enterprises and the government need to take into account that loan margins (in the case of Estonia primarily the spread between interest rates on bank loans and Euribor) will remain at a higher level than earlier. The 200-300 basis point difference is not likely to decline much in the next years.

It is important for the share of direct investment to increase in financing the economy and enterprises in 2009 and next years. Corporate debt is relatively big and the economy needs new investments to enlarge the capital base of enterprises and reorganise their activities.

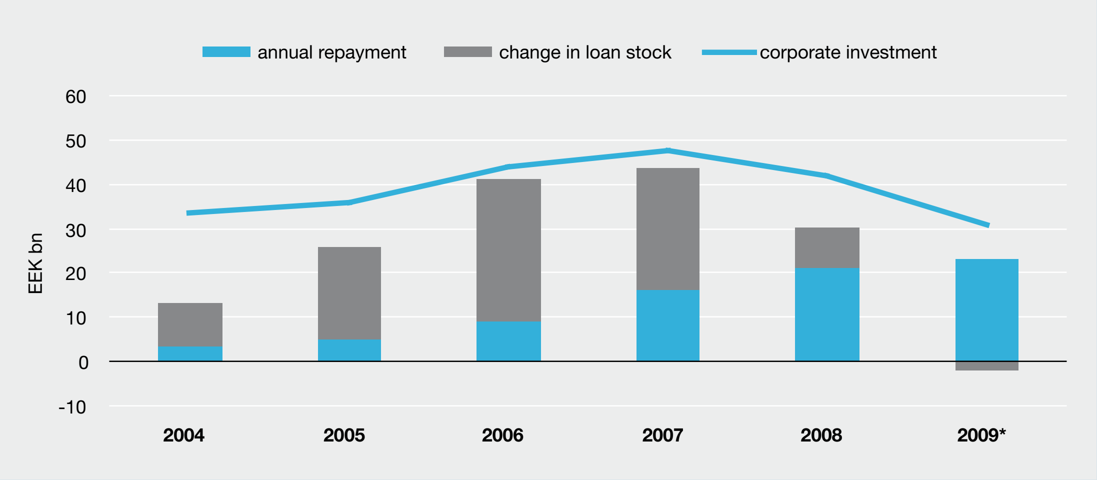
The primary task of the government is to maintain the country's open investment climate facilitating foreign investment inflow and the expansion of the circle of owners of Estonia's enterprises. Once the market situation normalizes, the government should consider expanding the ownership structure of state-owned enterprises and the inclusion of private capital.

The lending resources of the banks operating in Estonia are sufficient

The global financial environment, which tightened in the second half of 2008, has impacted also the banks operating in Estonia. The financing possibilities of banks have deteriorated across the globe, which means it is more difficult to get a loan and risk margins have soared. Although extensive state aid programmes have been implemented in different regions of the world, the normal functioning of the market is still disrupted. Obtaining long-term resources in the financial markets is especially difficult.

When assessing the financing situation of Estonia's banks, it should be noted their capitalisation and liquidity are relatively high. The primary factor lowering the liquidity risk of banks is their domestic liquidity buffers. In order to increase the buffers Eesti Pank took measures already in 2006, when the reserve requirement ratio in Estonia was set at 15% of all liabilities (in the euro area the ratio is 2%). Since nearly 50% of the liabilities are loans from parent banks, the immediately available liquidity reserve covers approximately 30% of bank customers' deposit volume. When speaking about the banks' liquidity risk, attention should be drawn to the ownership structure of the banks operating in Estonia and to liquidity risk management at the banking group level. An additional guarantee to the banks operating in Estonia is provided by the measures adopted in the banks' home countries to support the financial system.

Second, banks have used their previous years' profits to form considerable capital buffers, which can be used to cover loan losses in the current complex economic situation. The minimum regulatory capital adequacy ratio in Estonia is 10% (8% in most of the EU countries), and banks have met this requirement with a sufficient buffer – in the first months of 2009 the average capital adequacy ratio was above 19%.



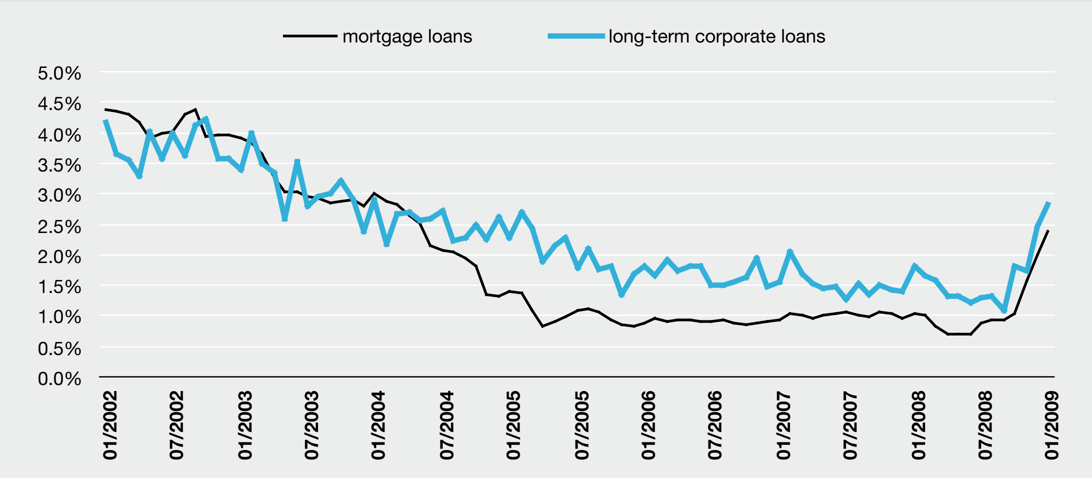
Amortisation of long-term corporate loans and investment demand

* The forecasted values are based on Eesti Pank's February 2009 flash estimate.

Estonia's economy started adjusting already before the international financial markets were hit by the credit crunch. The volume of new loans has been on the fall since the spring of 2007. In the fourth quarter of 2008 it turned out smaller than the repayments of earlier loans, thus the volume of the loan portfolio started to decrease. This is a normal development against the background of diminishing investment demand due to economic recession, and lending activity can be expected to increase again when economic growth recovers.

Smaller credit demand means a smaller need for external financing. Thus, the global credit crunch may not have a direct impact on the adjustment of the Estonian economy and credit market through the financial sector. It is more likely to have an indirect effect, since external demand is weakening considerably.

Looking at the investment forecast of the economy and the expected annual amortisation of corporate loans (the loan amount paid back to the bank per year), it is possible the credit demand deriving from corporate investment need could be covered on account of bank loan repayments.

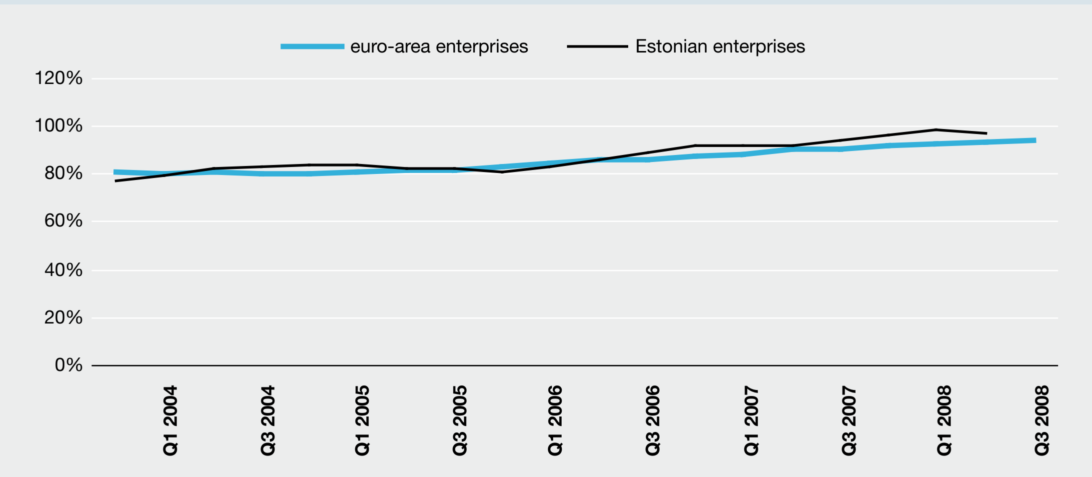


Average loan margin ratio to 6-month Euribor

The credit market has to adjust to changes – margins are increasing and debt burden is on the fall

Loan margins have risen due to the tense economic situation and increasing uncertainty. The recent years' low margins, which sent too optimistic signals to the market (the average housing loans margin was below 1% and the average corporate credit margin hovered around 1.5%), have risen and reached levels that are more sustainable in the longer term and more risk conscious. The years 2006-2008 will probably be remembered for extraordinarily favourable credit conditions, which are unlikely to become so borrower-friendly any time soon.

A halt or a slight drop in the growth of corporate debt in Estonia is an absolutely natural development against the backdrop of the declining economic volume. According to Eesti Pank's winter flash estimate, the volume of nominal GDP will be below 3% in 2009, causing credit demand to decline as well.



Corporate debt in Estonia and in the euro area (gross debt as a ratio to GDP)

Source: financial account

In order to prepare for a new economic growth cycle, the corporate financing need and structure need to be reassessed. For example, compared with the corporate debt burden and debt ratios of developed Western European countries, the debt liabilities of Estonia's enterprises are at an extraordinarily high level[1]. However, to ascertain whether the debt burden level per sector as a whole is reasonable or not, one should look at the relevance and cost-effectiveness of the investments made with the borrowed money.

In 2004-2007, the growth of credit issued to real estate and construction projects was 2-3 times faster than in other sectors of the economy. These are the fields of activity where credit growth has decreased the most notably in recent years, whereas credit volume growth in exports-related sectors has remained relatively steady. Loan statistics on the last months of 2008 and first months of 2009 confirm that the international financial crisis has not brought along relevant changes in credit volume.

Still – irrespective of the field of activity, it is important to assess each current project or line of operation to decide whether it would be viable in the changed economic environment. Rapid restructuring decisions may be vital for maintaining the viability of enterprises.

The role of the state

Considering everything said above, possible state intervention has to be clearly limited to abolishing market failures. Thus, it is important to concentrate on using the measures already taken more extensively, especially as regards export guarantees and capital support to enterprises. However, increasing the volume of such measures must be only temporary.

On the other hand, the financial sector should contribute to economic restructuring and adjustment by providing companies with sufficient loan resources. Banks have expressed readiness to continue financing good business projects, although the steep economic deterioration and tightening credit conditions have made it more difficult for borrowers and lenders to come to an agreement. Therefore, in addition to short-term financial support, it is essential to restructure companies by, for example, merging them or changing the ownership structure. Neither state support nor the financial sector must prevent these processes from taking place.

In the current situation there is no need for measures aiming at replacing bank loans or intermediating funds to banks. First of all, the capitalisation and liquidity of the banks operating in Estonia are sufficient to cover credit demand. Second of all, it must be emphasised that compared to the government, the price of the funds included from the market is lower for parent banks, i.e., the banks operating here are able to obtain resources at a lower cost and interest rate. Third of all, it is natural for the corporate debt burden to decrease in the current economic situation and enterprises should focus on restructuring instead of borrowing.

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1 The loans taken by Estonia's enterprises from domestic financial institutions accounted for 57% of GDP. Compared with Nordic countries, only Denmark has a higher indicator. Moreover – the debt ratio (the ratio of loan to own capital) of Estonia's enterprises is among the highest in Western Europe.

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