THE SOLVENCY OF COMPANIES AND HOUSEHOLDS AS INTEREST RATES RISE

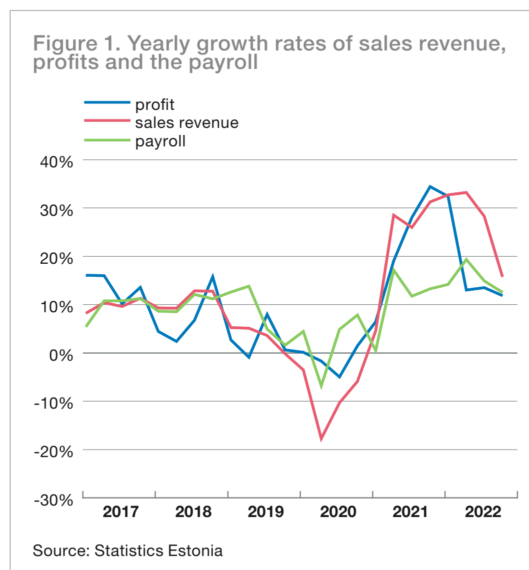
The financial results of companies have mainly been good of late and unemployment is low. The buffers built up earlier have also maintained the resilience of companies and households to the short-term downturn in the economy and the loss of incomes. This has helped companies and households cope in exemplary fashion in paying their loans. There is still a great deal of uncertainty about the future performance of the economy though. The cost of living has also risen fast and the higher interest rates have by now partly passed through into loan servicing costs. The risk consequently remains of the ability to service loans deteriorating and the volume of non-performing loans increasing. Higher interest rates have the biggest impact in sectors where financial leverage is high and interest is a large part of expenses, such as energy, real estate, transport and storage, and accommodation and food service. Households for which the higher interest rates and the rise in the cost of living affect the ability to service loans more are those where essential spending and loan repayments take a large part of income.

The financial results of businesses were mainly still good in the second half of last year (see Figure 1). Weaker demand, higher prices for inputs and the increased cost of servicing loans made conditions notably harder than before for many businesses, but profits and sales revenues still grew by over 10% in the fourth quarter of last year. This meant that companies managed to pass on most of the higher cost of inputs to consumers. It should be noted though that the growth came mainly from rising prices, while the growth in the volumes of products and services sold stopped. Evidence of this is that value added at constant prices fell in the second half of the year in many sectors and in the economy as a whole (see Figure 2).

There remains a great deal of uncertainty about future growth in demand and in the economies of Estonia and its main trading partners. Forecasts indicate that the economy will grow in the second half of this year as purchasing power recovers and confidence improves, while the uncertainty around supply chains has retreated, but the future course of the war and geopolitical tensions may well change the outlook for the economy substantially. The economies of almost all Estonia's main trading partners declined during the fourth quarter in a similar way to the Estonian economy, though in yearly comparison they remained around where they were a year earlier (see Figure 3).

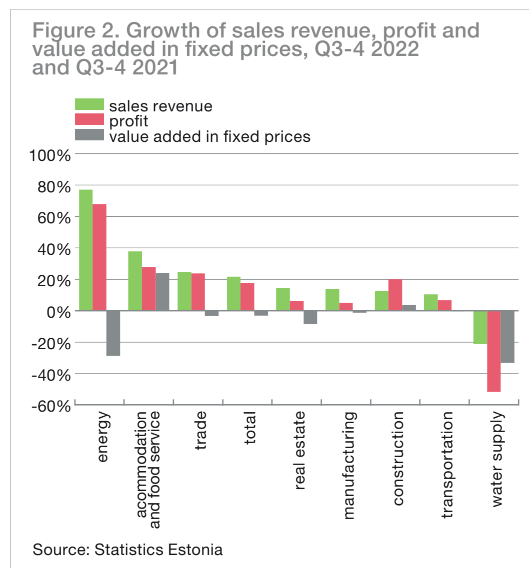
Higher production costs may start to eat into the profitability and competitiveness of companies, and so also into their capacity to pay their loans. Prices for energy and raw materials have come down from their peaks, but there remains a lot of uncertainty around them. The Estonian economy is very energy intensive and so higher prices for fuels have a broader impact and affect the competitiveness of the whole economy. Wage costs are also rising fast and will probably continue

Figure 1. Yearly growth rates of sales revenue, profits and the payroll

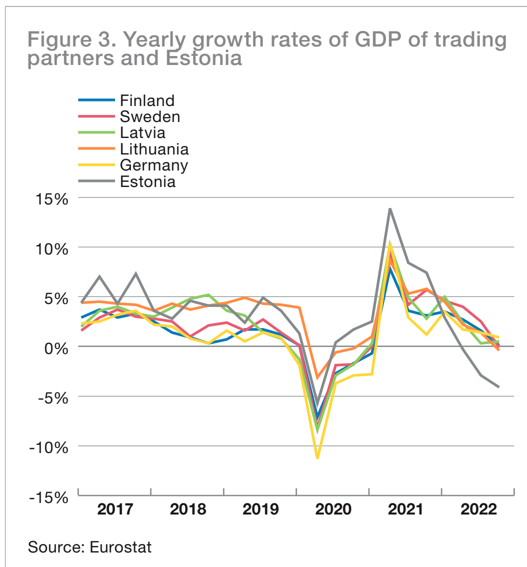


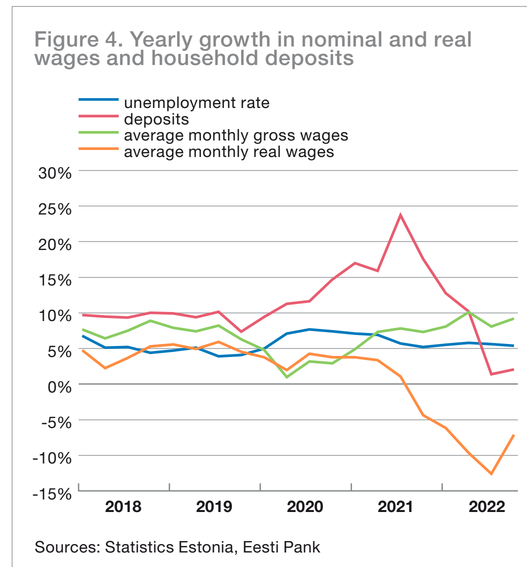
Source: Statistics Estonia

Figure 2. Growth of sales revenue, profit and value added in fixed prices, Q3-4 2022 and Q3-4 2021



Source: Statistics Estonia





to do so. Strong demand meant that companies selling in the domestic market at least were able to pass on higher production prices to end prices for consumers and so increase their profits, but this may no longer be possible if demand weakens. Becoming less competitive would probably not cause a sharp leap in the number of companies facing difficulties with loan repayments, but it would slow the long-term capacity for growth in Estonia and so lift non-performing loans to a permanently higher level.

The ability of households to repay their loans depends above all on members of the household having a job. The recession had less impact on the Estonian labour market at the end of 2022 and the start of 2023 than was feared. The unemployment rate was stable throughout 2022 and remained quite low, averaging 5.6% for the year (see Figure 4). The Eesti Pank March forecast finds that the downturn in the economy and the addition of refugees from the war in Ukraine to the statistics may raise unemployment this year to a little over 7% in places, though it will then start to come down again.

Rapidly rising nominal wages have helped households to cope with high inflation and with loan repayments increasing as interest rates rise. The rapid rise in the cost of living has put notable pressure on family budgets. The Eesti Pank March forecast finds that inflation may be expected to fall below 10% by the middle of this year, and to be around 4% by the end of the year. Inflation passing through into wages and collective wage agreements will keep wages growing fast in 2023 at a forecast rate of over 10%. Rising wages and falling inflation will continue to give some support to households in covering higher loan servicing costs.

The rise in interest rates has not yet passed through in full into interest costs, and it is not known how much further interest rates may yet rise. Most loans in Estonia use floating interest rates, and so higher interest rates pass through into interest costs much faster than they do in the euro area on average. There is however usually a lag of up to six months for floating interest rates before interest rate changes affect loan costs[1]. Higher interest rates will only affect the interest costs of loans with fixed interest rates when the loans are refinanced. Interest costs in the fourth quarter of 2022 were an estimated 9.4% of profits for businesses and 2.6% of disposable income for households. If the six-month Euribor were to rise to 4% and remain there, those figures would rise to 16% and 5% (see Figure 5). They would rise to 21% and 6% if Euribor were to reach 6%. This would mean that rising interest rates would consume a substantial part of income, but inflation remaining high would bite even harder into purchasing power.

Higher interest rates have the biggest impact in sectors where financial leverage is high and interest is a large part of expenses, such as energy, real estate, transport and storage, and accommodation and food service (see Figure 6). The debt of companies in energy, real estate

1 The reference interest rate is usually the six-month Euribor and the interest rates are reviewed every six months.

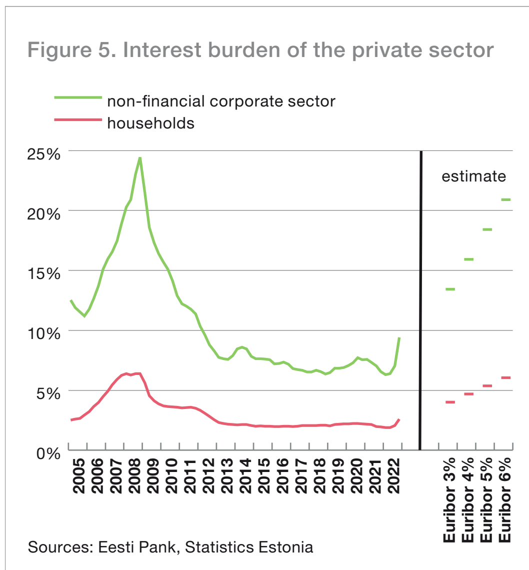


Figure 5. Interest burden of the private sector

Sources: Eesti Pank, Statistics Estonia

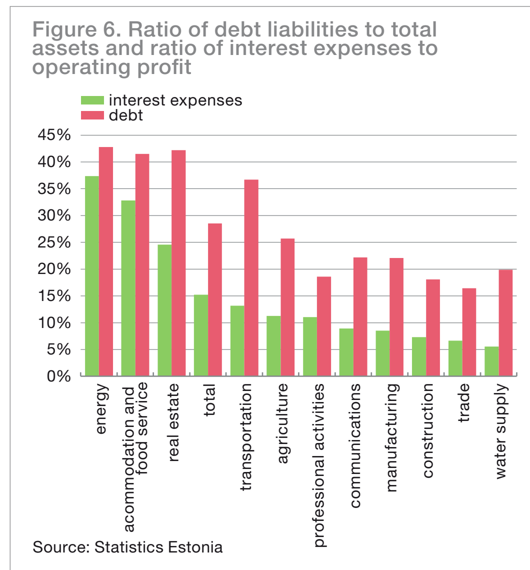


Figure 6. Ratio of debt liabilities to total assets and ratio of interest expenses to operating profit

Source: Statistics Estonia

and transport and storage is very large and loans to those sectors make up nearly half of the loans issued by the banks operating in Estonia. Whether companies in these sectors fall into difficulty with servicing their loans as interest rates rise will consequently be of great significance for the loan quality of the banks.

Households for which the higher interest rates and the rise in the cost of living affect the ability to service loans more are those where essential spending and loan repayments take a large part of income. Households with higher incomes more often have loan liabilities than those with lower incomes (see Figure 7). This means that a rise in interest rates would affect the wealthier part of society more. However, households with lower incomes that have taken a loan generally use a larger part of their income to pay the loans than wealthier households do. Such households also spend a notably larger part of their income on food and utilities costs (see Figure 8). This suggests that borrowers on lower incomes are probably the most vulnerable. Households with higher incomes probably have larger loans and larger loan payments, but their incomes allow them to cope better with higher costs.

New borrowing has clearly declined in the past half year, but the growth in debt remains fast. Companies and households have taken a cautious stance in making decisions about investment and borrowing because of the uncertainty in the economy and the rapid rise in interest rates and so have reduced their new borrowing. Both corporate debt and household debt were still

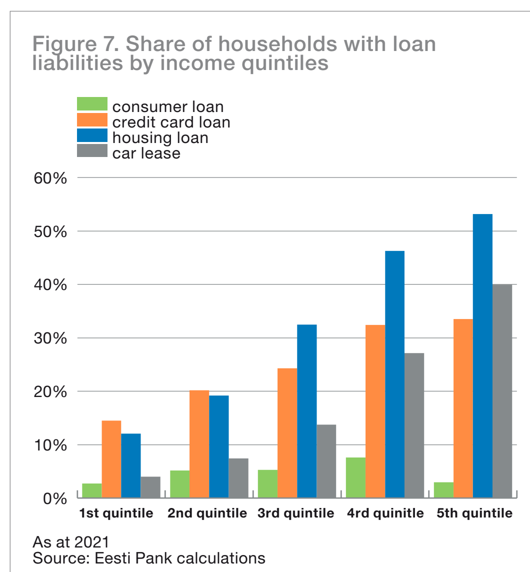


Figure 7. Share of households with loan liabilities by income quintiles

As at 2021
Source: Eesti Pank calculations

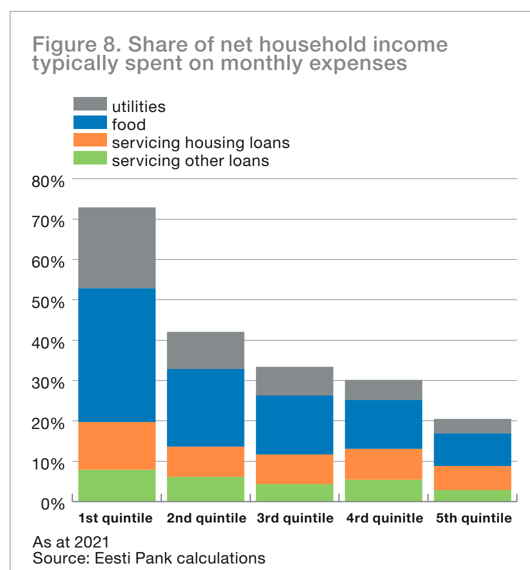


Figure 8. Share of net household income typically spent on monthly expenses

As at 2021
Source: Eesti Pank calculations

growing by around 11% at the end of 2022. Loans issued to real estate companies drove the growth for corporate loans[2], and for households it was housing loans, but the growth in consumer loans has also been fast (see Figure 9). The Eesti Pank March forecast finds that growth in both corporate and household debt will slow in the coming years to around 7%.

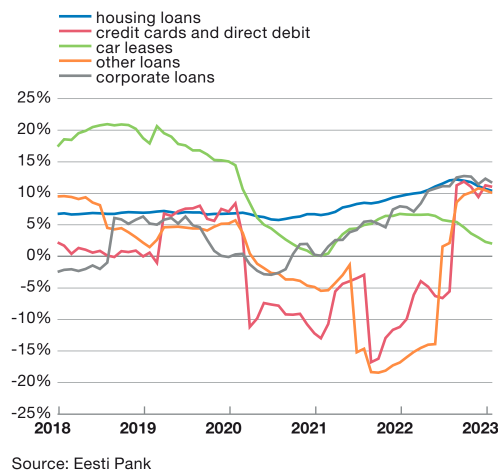
The resilience of companies to a short-term downturn in the economy and to rising interest rates is good. The financial leverage of Estonian companies was low at the end of last year and their liquidity was good in comparison both over the past two decades and internationally. Some change is indicated though by the gradual decline in corporate deposits that started from October. Corporate indebtedness, or the debt-to-GDP ratio, in Estonia is also at a level that should not be overwhelming for businesses (see Figure 10).

Households are supported in their ability to pay their loans by the savings built up over the past decade and by their manageable levels of debt. If the incomes of households should fall or disappear altogether for a time, their ability to service their loans may be preserved by the savings they have. Deposits grew fast until 2022 before the growth slowed sharply to around 2% last year. The ratio of deposits to debt fell a little (see Figure 11), which also shows that households have started to use their savings more than previously over the past year.

Companies and households have so far coped well with meeting their financial liabilities and there are few overdue loans (see Figure 12). There was some increase over the year in February in overdue loans at real estate and construction companies, but the loan quality in those sectors remains even better than in other sectors. The share of household loans overdue has increased a little for consumer loans. People who need to delay loan payments are more likely to do so for their consumer loans first, and people who have taken consumer loans probably have lower incomes on average than those who have housing loans, and so overdue loans will increase in this segment first.

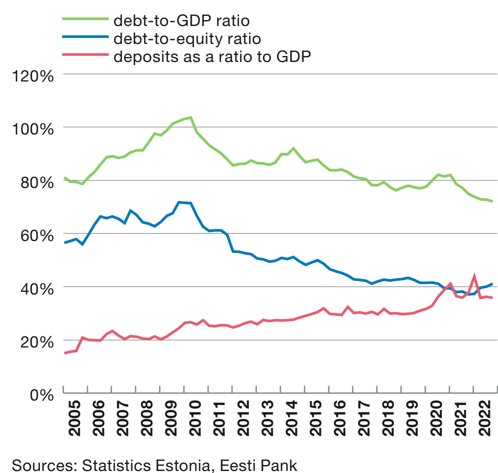
If the economy follows the path in the main scenario of the March macroeconomic forecast from Eesti Pank, the share of overdue

Figure 9. Annual growth in the portfolio of household and corporate loans



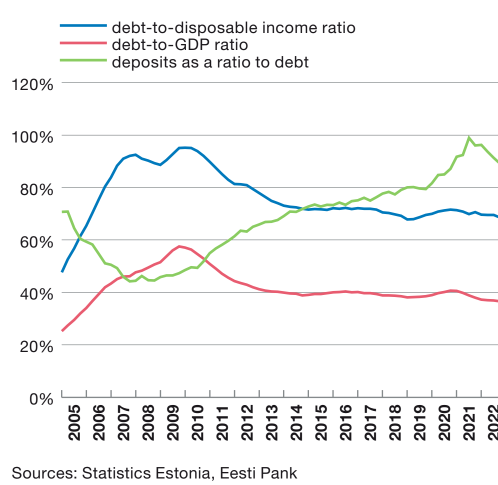
Source: Eesti Pank

Figure 10. Corporate sector leverage, debt and deposits



Sources: Statistics Estonia, Eesti Pank

Figure 11. Household indebtedness and deposits

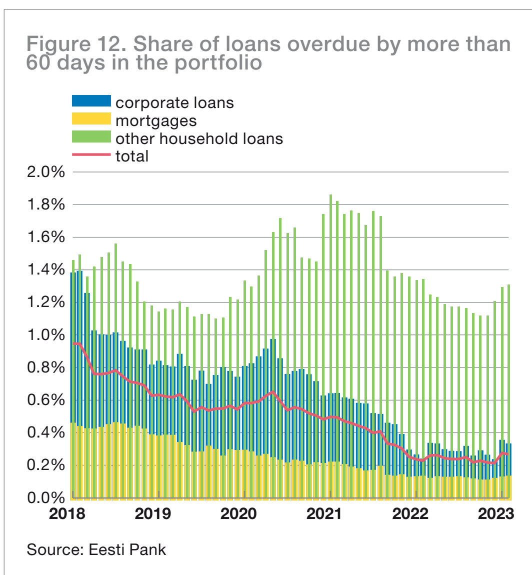


Sources: Statistics Estonia, Eesti Pank

2 See *The risks to the loan portfolio of the banks from the real estate market have increased.*

loans will increase from 0.3% in February 2023 to 0.6% next year. Overdue loans increase as higher interest rates tighten demand, cutting corporate income and raising unemployment, which reduces people's income. If base interest rates rise higher than forecast, the level of overdue loans will be higher, especially corporate loans and consumer loans, and they will remain at that level for longer. Euribor rising to 6% would cause the share of overdue loans to rise from 0.3% in February 2023 to 1.2% for corporate loans, from 1.2% to 2.5% for consumer loans, and from 0.1% to 0.4% for housing loans. The direct impact of changes in interest rates on the capacity to repay loans is limited, but a rise in interest rates reduces economic activity, causing unemployment to increase and so reducing the capacity to pay.

Figure 12. Share of loans overdue by more than 60 days in the portfolio



Source: Eesti Pank

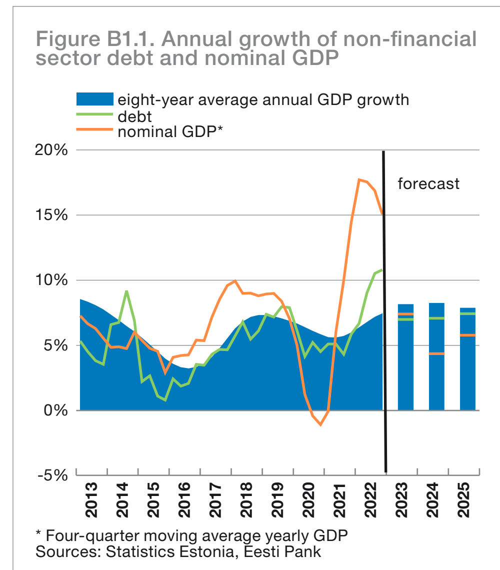
Box 1: The countercyclical buffer requirement will remain at 1.5%

Eesti Pank decided in November 2022 to raise the applicable countercyclical capital buffer requirement for the banks from 1% to 1.5%. The higher requirement will apply from 1 December 2023. The requirement was raised because of the rapid growth in lending during the previous year and a half, which had increased the cyclical risks.

The yearly growth in debt in the non-financial sector accelerated to 11% in 2022, exceeding the long-term nominal growth in the economy of around 7% (see Figure B1.1).

The uncertain economic climate and the rapid rise in interest rates meant that there was less borrowing by companies and households in late 2022 and the first months of 2023, but the confidence to invest and borrow is expected to recover gradually as the outlook for economic growth improves. The March economic forecast from Eesti Pank expects the debt of the non-financial sector to grow by some 6% this year, and by 7% in the next two years. This means the growth in debt will be relatively fast moving forwards, and it will start to exceed the current nominal growth in GDP next year.

Figure B1.1. Annual growth of non-financial sector debt and nominal GDP

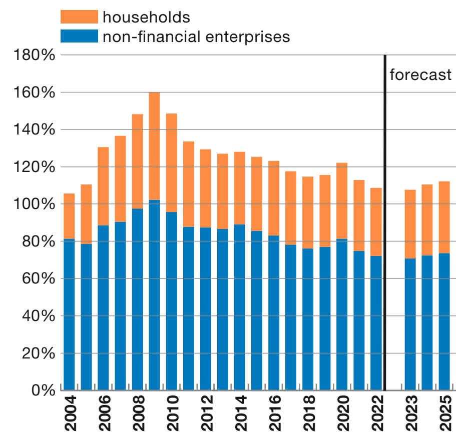


* Four-quarter moving average yearly GDP
Sources: Statistics Estonia, Eesti Pank

High inflation has caused nominal GDP to grow faster than the debt of the non-financial sector for more than a year, and so the indebtedness of the non-financial sector shown by the debt-to-GDP ratio has fallen despite the rapid growth in debt, and it was 109% by the end of 2022 (see Figure B1.2). Indebtedness is forecast to stop declining as nominal GDP growth slows this year and it will start to increase again gradually next year.

Fast growth in lending means that the risks from the Estonian financial sector will remain highly topical for the next year and a half. If the macroeconomic circumstances should unexpectedly and sharply deteriorate, there could be problems in repaying loans that could be made worse by the earlier rapid growth in borrowing. It has consequently been necessary to raise the countercyclical capital buffer requirement to ensure that the banks have large capital reserves to cover the accumulated risks. The volume of credit will grow at a more moderate rate in the short term than when it was previously growing very fast, and so it is not currently necessary to raise the countercyclical capital buffer rate above 1.5%.

Figure B1.2. Ratio of non-financial sector debt to GDP



Sources: Statistics Estonia, Eesti Pank