

2. THE REAL ECONOMY

2.1. THE LOAN REPAYMENT ABILITY OF COMPANIES

Indicators of the financial standing of companies and their ability to repay their loans worsened a little in the second half of 2014. This was mainly because corporate profits have been declining constantly for over a year now. The financial standing of companies and their capacity to repay loans can still be rated as quite good, as balance sheets have been repaired since the crisis and buffers built up. If profits were to slide further however, the difficulties in the financial standing of companies would probably show up more clearly in a corresponding deterioration in the capacity to repay loans.

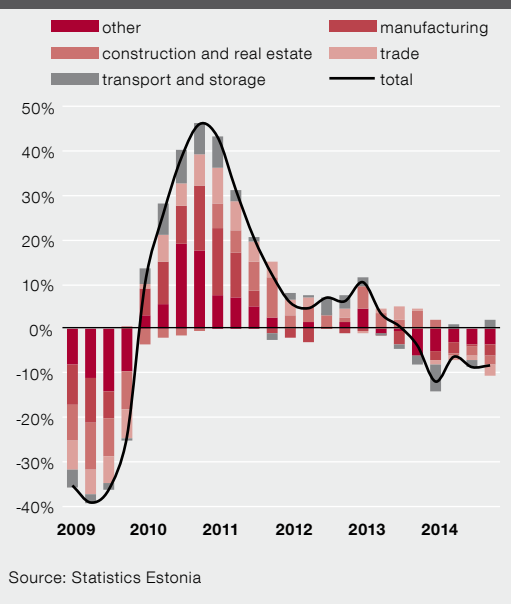
The general economic environment and corporate financial results

Developments in the external environment have remained uncertain. Having almost come to a stop in the middle of last year, economic growth in the euro area picked up in the fourth quarter to 0.3% over the quarter and 0.9% over the year. At the same time, the financing challenges in Greece and the conflict between Russia and Ukraine increased uncertainty. While growth has continued to stall in Finland, it has remained at around 2-3% in Sweden, Latvia and Lithuania, with support from domestic demand. The Russian economy stopped growing at the end of last year, and in the first months of this year its growth was negative.

The Estonian economy continued to grow steadily in the second half of 2014 as quarterly economic growth reached 1.2% and annual growth 3% in the fourth quarter, while the economy grew by 2.1% over the whole year. Growth is still mainly supported by domestic demand, but exports started to increase in the second half of 2014.

The financial results of Estonian companies deteriorated to an extent in 2014. Corporate **sales**

Figure 2.1.1. Profit (operating surplus and mixed income) growth by sectors

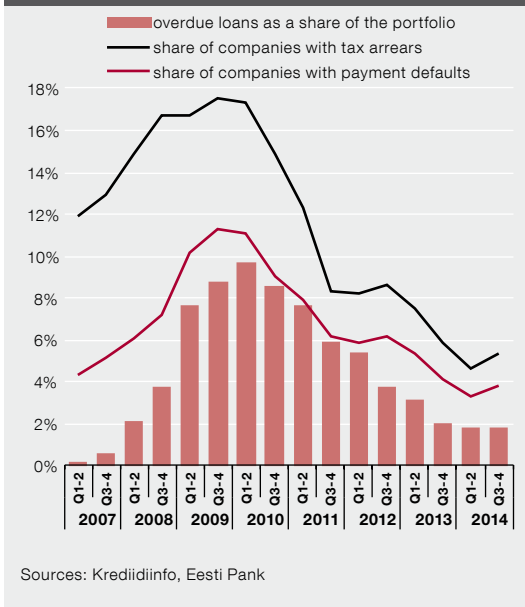


turnover was about the same in the second half of the year as it was a year earlier. Although the labour market has started to adjust gradually to moderate economic growth, wages grew faster than value added, even though they grew at a slower rate than before. Corporate **profits** fell further as a result and they have fallen in most major sectors, including manufacturing, wholesale, construction and real estate, and energy. They started to rise again in transport and storage in the fourth quarter of 2014 though, having fallen for two years before that (see Figure 2.1.1).

Payment behaviour of companies and bankruptcies

The financial behaviour of companies worsened a little in the second half of 2014. The shares of companies with **payment defaults** and with **tax arrears** increased slightly in all the main sectors and in all size categories of company except those with over 250 employees (see Figure 2.1.2). The sectors where the largest shares of companies have payment defaults or tax arrears are accommodation and catering, and construction.

Figure 2.1.2. Payment behaviour of companies



The shares of such companies increased most in agriculture and manufacturing however, possibly partly because of the notable drop in exports to Russia. There remain very few corporate **bankruptcies** and the number is about the same as during the economic boom.

Payment capacity and financial standing of companies

Corporate **indebtedness and leverage** started to edge upwards in 2014, while corporate **deposits and other liquid financial assets** grew again, but more slowly than before. As **short-term debt liabilities** grew slightly faster at the same time, the coverage of them by liquid financial assets declined (see Figures 2.1.3 and 2.1.4).

In consequence, the financial standing of Estonian companies and their capacity to repay loans deteriorated slightly in 2014. The general situation can still be considered quite good, as

Figure 2.1.3. Indicators of the ability of companies to repay loans

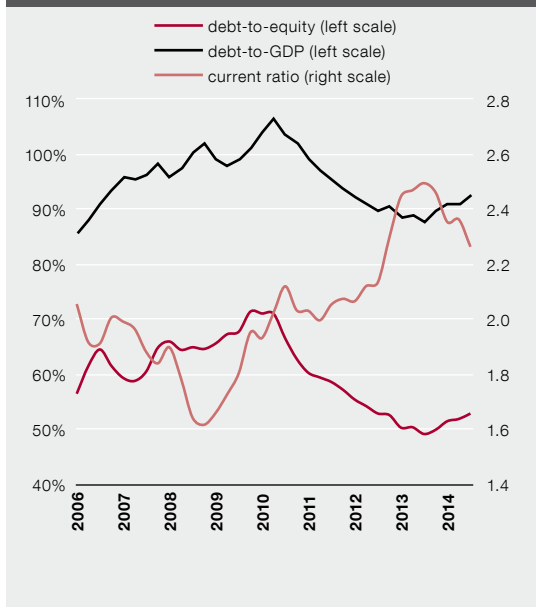
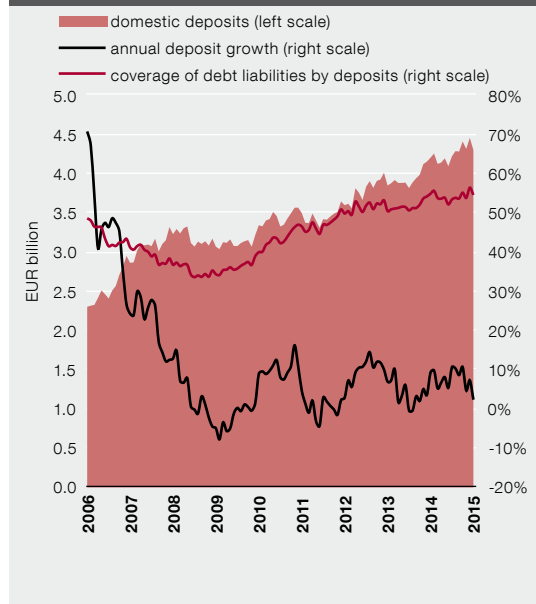


Figure 2.1.4. Volume and growth of corporate deposits



the very rapid recovery after the economic crisis and the improvement of balance sheets mean that the financial leverage of Estonian companies remains low and liquidity high in comparison to their levels in the past decade or to those in other euro-area countries¹³. The corporate **interest burden** is being held down to an extent by very low base interest rates, as it was earlier.

2.2 LOAN REPAYMENT ABILITY OF HOUSEHOLDS

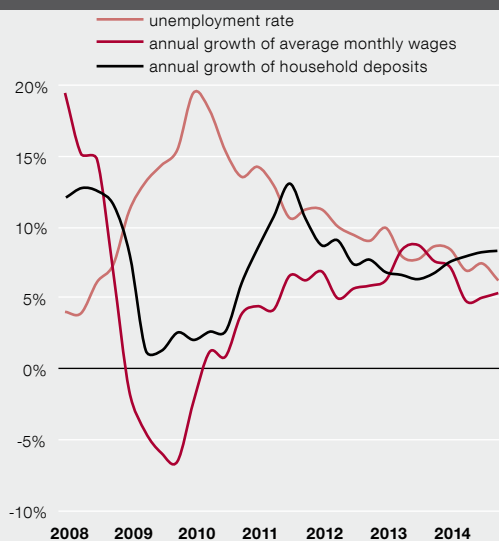
Developments in the labour market in 2014 favoured households as employment increased and so did household incomes. The **unemployment rate** was 6.3% in the last quarter of the year, which was similar to the level of 2008. **The number of people in employment** did not change a great deal last year, but the employment rate was higher in the second half of the year than it had been during the boom and it climbed to 63.6% in the last quarter.

Rising incomes have been accompanied by very low inflation in raising the purchasing power of households. **The average gross monthly wage** was 5.4% higher in the fourth quarter of 2014 than it was a year earlier (see Figure 2.2.1), while the fall in consumer prices meant that real wages had risen by an even faster 5.8%. Eesti Pank forecasts that gross monthly wages will continue rising in 2015 at a similar rate. The rise in disposable income will have been boosted further by the cut in the income tax rate at the start of the year and by increased social transfers, mainly pensions and child benefit.

Consumer confidence was volatile in the second half of last year and the early months of this, but it remained above its long-term average for Estonia (see Figure 2.2.2). Consumer confidence

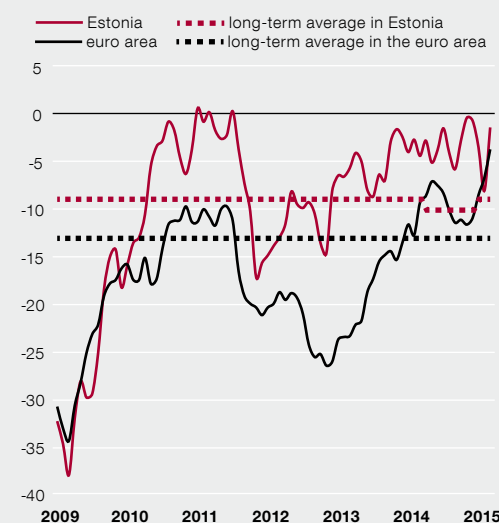
¹³ For more on the growth in debt liabilities see Eesti Pank's *Financing of the Economy 2015* page 14.

Figure 2.2.1. Unemployment rate and average gross wage and deposit growth



Sources: Statistics Estonia, Eesti Pank

Figure 2.2.2. Consumer confidence indicator



Sources: Estonian Institute of Economic Research, European Commission

Figure 2.2.3. Household deposits

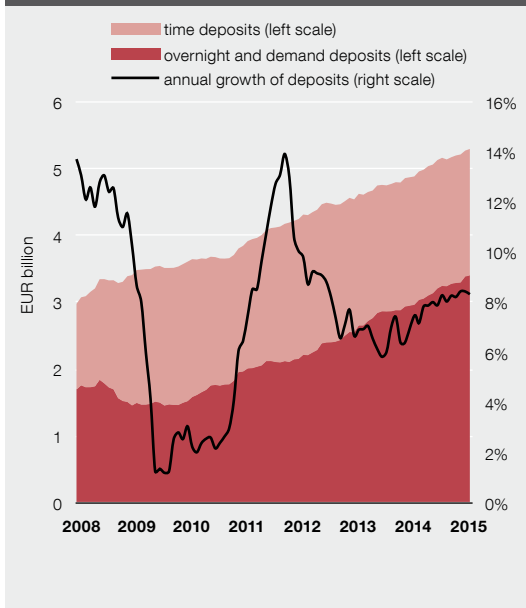
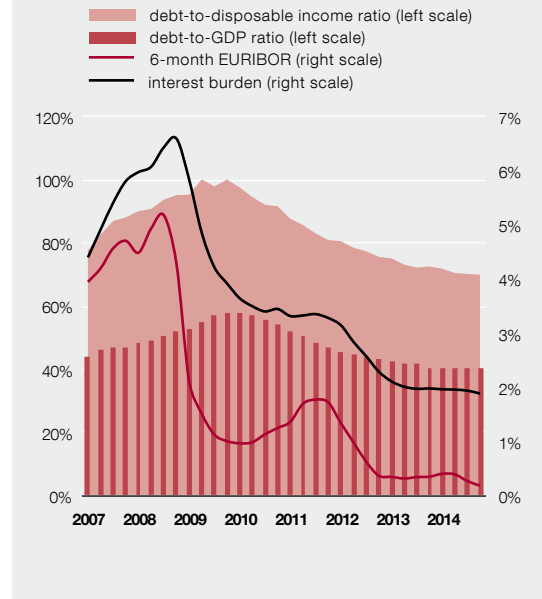


Figure 2.2.4. Household indebtedness and interest burden

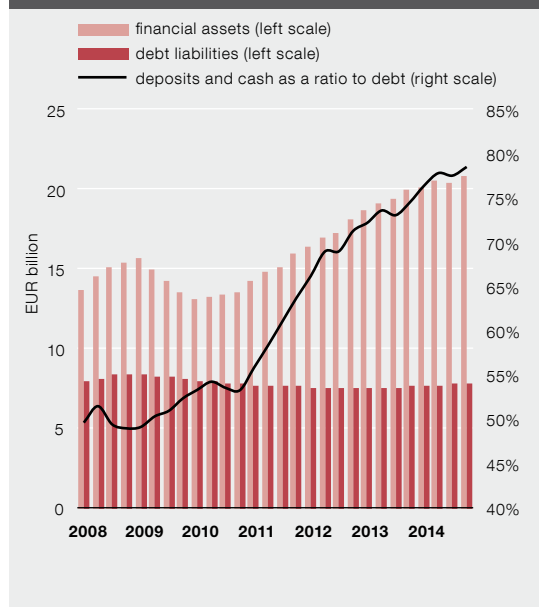


in the euro area was similarly volatile. The confidence of Estonian households has been shaken most by **fear of unemployment** and somewhat by continuing geopolitical tensions around the globe, but the attitude towards the future is still optimistic.

Rapid wage growth led **household deposits** to rise too, and they were up 8.3% during the year (see Figure 2.2.3). As the return from interest on term deposits is very small, most of the funds have been put in overnight and demand deposits.

Household **loan liabilities** continued to increase gradually last year, with **housing loans** accounting for the majority of such liabilities and increasing by 2.6%. Rising incomes meant that **indebtedness** did not increase and household debt stood at 70% of disposable income and 40% of GDP in the second half of 2014 (see Figure 2.2.4). As deposits grew at a similar rate to

Figure 2.2.5. Financial position of households



loan liabilities, **the ratio of deposits and cash to debt for households** remained relatively high and stood at 78.6% in the last quarter (see Figure 2.2.5).

The household interest burden was affected by the mild growth in loan liabilities and the fall in base interest rates, and remained at 2% throughout the year. The 6-month EURIBOR, which is the base interest rate for the majority of housing loans, fell in response to the monetary policy measures of the Eurosystem to 0.09% by the end of March 2015.

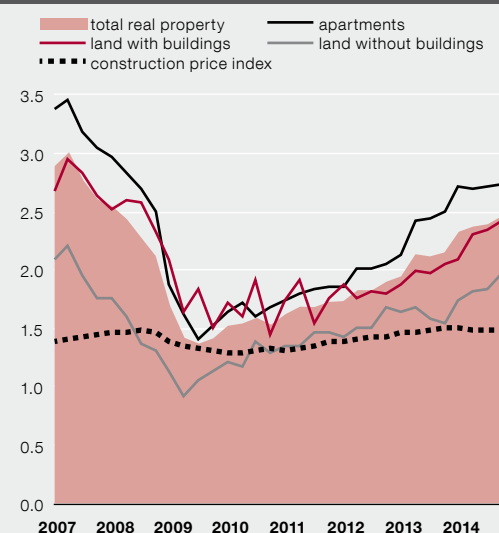
The financial standing of households and their ability to repay their loans remain good in 2015 due to the rise in incomes and low interest rates, and so the risks to financial stability arising from households are small.

2.3. THE REAL ESTATE MARKET

The housing market

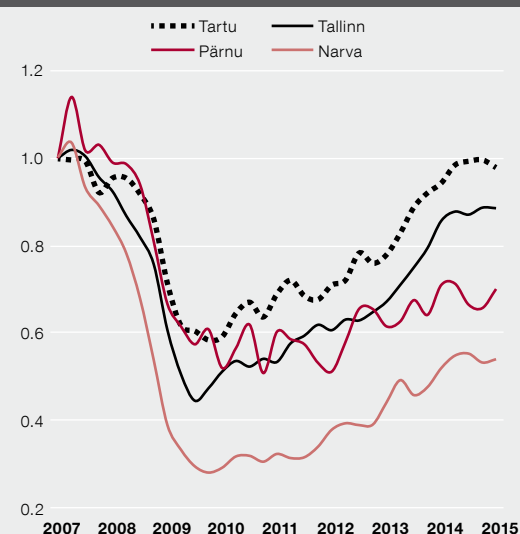
The Estonian real estate market stabilised to an extent in 2014. Prices rose less quickly in the **apartment market**, which is the largest share of the total real estate market, and rose by less than those of **residential land with buildings and land without buildings** (see Figure 2.3.1). Prices rose most in the first half of the year, but the difference between prices in large towns and those in small towns remains substantial. The median price for a square metre of an apartment in Tartu was 1151 euros in the fourth quarter of 2014, which is close to the peak price seen in 2007. Prices of apartments in other large population centres remain some way off the peaks they reached in the boom and the prices of apartments in smaller centres even fell slightly in the second half of the year (see Figure 2.3.2).

Figure 2.3.1. Real property price indices, 2003 Q2=1

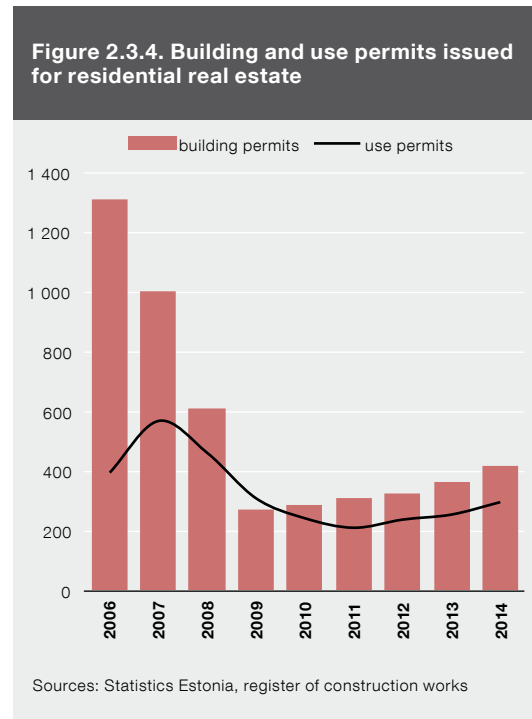
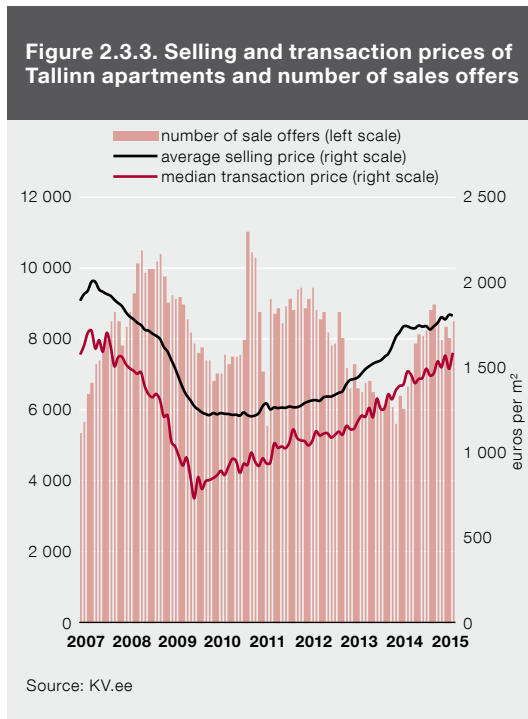


Sources: Estonian Land Board, Statistics Estonia, register of construction works

Figure 2.3.2. Change in the median price of transactions with apartments, 2007 Q1=1

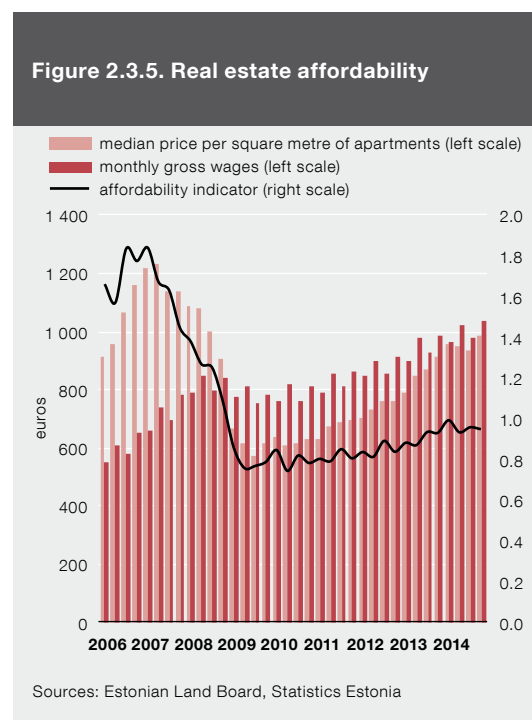


Source: Estonian Land Board



Following the rapid rise in apartment prices at the end of 2013 and in early 2014, the **supply of real estate** in Tallinn increased, which was seen in the rise in the number of offers on real estate websites (see Figure 2.3.3). The increase in supply was driven not only by the increase in market activity in response to the rise in prices, but also by the number of **construction permits** issued, which hit a post-boom record at the start of the year (see Figure 2.3.4). The prices of newly built apartments affect the average transaction price. There has been some change in the structure of the market, which can be seen in the average price rising faster than the median price, as the average price in January 2015 was 12.7% higher than a year earlier, while the median was up by 9.8%.

Although real estate prices are gradually rising and those in Tartu and Tallinn are around the peaks they reached in 2007, the situation in the real estate market is quite different from what it



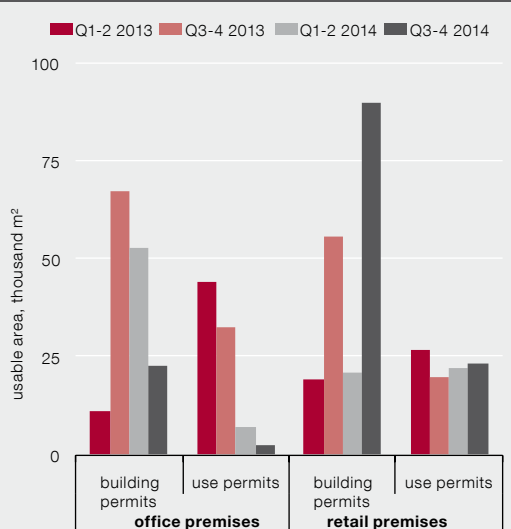
was during the economic boom. This is best reflected by the figures for **real estate affordability**, which compares the median square metre price of apartments to gross monthly wages. The affordability indicator reached 1.8 at the peak of the price boom in 2007 and then fell to 0.8 during the market correction in 2009. It stood at 0.95 in the last quarter of 2014, which means that real estate prices are now **mainly rising together with gross monthly wages** (see Figure 2.3.5).

The commercial property market

There remains high demand in the commercial property market for **class A office buildings**, and real estate agencies estimate 5-10% of such buildings are vacant. To meet the demand, large numbers of new top-class office buildings are being built, some in districts where there were earlier mainly class B buildings. Interest in class B and class C buildings has waned a little, and 10-30% of them stand vacant, depending on their location, and the client base for them is more variable.

Demand continues to be high for new **retail space** and the construction of retail premises picked up in 2014, as the usable retail space with construction permits was around half as large again as in 2013. It is large individual projects that are behind this extraordinarily fast growth however (see Figure 2.3.6)¹⁴.

Figure 2.3.6. Building and use permits issued for commercial real estate



Source: Statistics Estonia

14 The development of Tartu Kaubamaja, a department store, accounted for more than half of the total usable area for which construction permits were issued in the last quarter of 2014.