ESTONIA'S ECONOMY IN 2007

NON-FINANCIAL SECTOR

Monetary policy environment

Considering the aggravating inflationary pressures, the European Central Bank (ECB) continued raising monetary policy interest rates in the first half of 2007. The uncertainty arising from risky housing loans issued by the US banks spread all over the world in August and influenced also the rise of the Euribor. In Estonia, the prices of housing loans increased by 1.8 percentage points and long-term corporate loans by 1.2 percentage points, year-on-year. This together with the prospects of decelerating economic growth reduced loan demand and accelerated the slowdown in credit growth that had started already in mid-2006. By the beginning of 2008, the size of loans granted to the non-financial sector had grown only 30%, year-on-year, which is similar to the pre-boom figures. At the same time, the Estonian kroon appreciated continuously against the dollar throughout 2007 due to the euro-fix.

As a result, the **monetary policy environment** was much more **restrictive** in 2007 than in earlier years, although capital inflow was still high.

Domestic and external demand

In spring 2007, the robust **growth started to slow as expected**. Real GDP growth that had reached almost 9 percentage points in the first half-year decreased to around 5% in the second half. According to preliminary estimates, the average annual growth rate was 7.1%. Thus, economic growth slowed to the levels recorded prior to Estonia's accession to the EU.

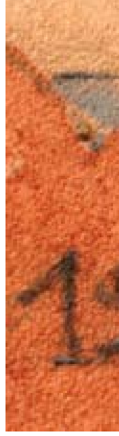
Growth decreased above all in fields related to real estate development. In the second half-year, growth in these sectors decelerated considerably and practically ceased in the last quarter. The construction sector witnessed a smaller decline owing to the continuation of the ongoing development projects (see Table 1).

Investment activity plummeted in the second half of 2007, while the amount of fixed investment remained at the previous year's level. Private consumption growth, which had picked up speed at the end of 2006, decelerated as well and reached a downward phase in the final months of the year.

Growth in the exports of goods and services remained rapid in 2007, as expected. Based on general indicators, the growth of services exports

Table 1. Real GDP growth by fields of activity in 2003–2007 (%)

	2003	2004	2005	2006	2007
Agriculture, hunting and forestry	12.0	-4.3	-0.8	4.5	3.3
Fishing	-4.6	-11.3	7.5	-14.8	10.0
Mining and quarrying	15.3	-6.0	12.3	7.5	11.8
Manufacturing	10.0	10.5	11.8	12.8	8.3
Energy, gas and water supply	12.5	0.7	3.8	6.5	-1.8
Construction	0.9	3.1	26.2	12.5	8.6
Wholesale and retail trade	10.2	15.5	10.8	13.1	6.0
Hotels and restaurants	14.4	13.7	10.4	11.7	2.6
Transport, storage and communications	8.4	8.3	7.4	11.6	6.8
Real estate, renting and business activities	3.7	4.6	10.4	8.7	1.8
Financial intermediation	19.0	24.6	23.3	23.3	23.5
Public administration and national defence	4.7	1.5	3.0	2.8	3.9
Education	0.2	2.0	3.5	6.0	2.3
Health and social care	-3.0	4.7	5.3	8.2	6.9
Other service activities	4.6	4.3	7.2	7.0	4.5
Total GDP	**7.2**	**8.3**	**10.2**	**11.2**	**7.1**



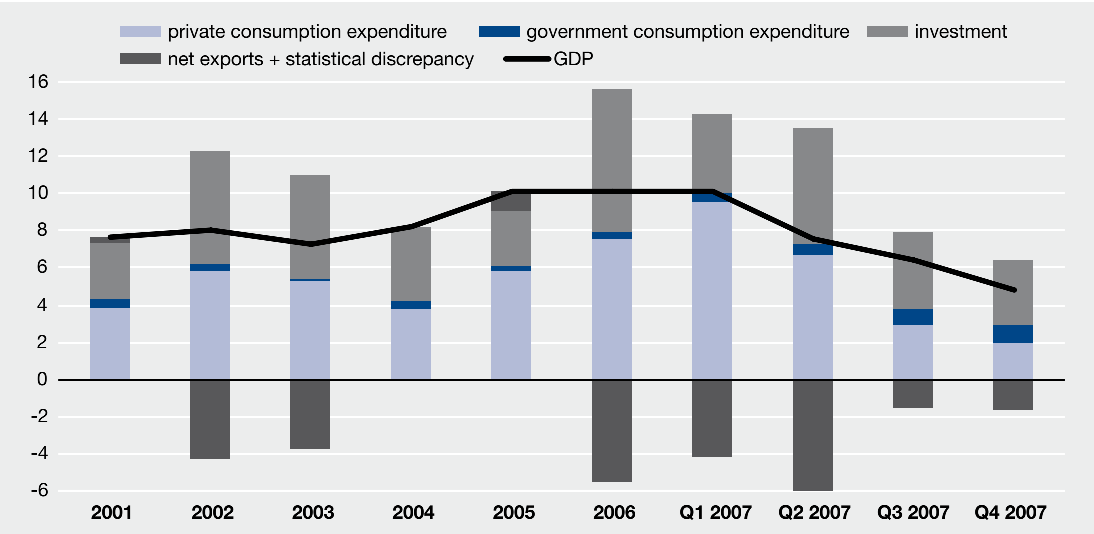


Figure 1. Contributions of GDP consumption components to economic growth (pp)

was much stronger than that of goods exports. At constant prices, the exports of services increased 8% year-on-year, while the exports of goods remained close to zero. However, these indicators are not entirely comparable. To be more explicit, in 2006 the growth of merchandise exports was accompanied by a considerable increase in goods that have only marginal value added in Estonia. In 2007, the flow of re-export type of goods did not grow any longer, and their value even decreased. This, however, might lead to the wrong conclusion that the growth of Estonia's export sector has slowed significantly. The competitiveness of goods produced in Estonia and their contribution to economic growth is better characterised by the export dynamics of manufactured goods. According to this indicator, the growth rate of goods exports in 2007 was only 1–2 percentage points lower than in the previous year (see also Figure 1).

Together with the beginning of economic adjustment, the growth period of the current account deficit also came to an end. When domestic demand growth slowed, the imports of goods decreased, which had a positive impact on trade balance. Although the trade balance deficit declined, this did not decrease the total current account deficit, as the outflow of investment income was larger than in previous years also in the second half-year. This refers to a rise in the profitability of companies based on foreign capital, which stemmed, inter alia, from stronger growth in service prices that lasted until the final months of 2007. In annual terms, the current account to GDP ratio remained the same as a year ago, comprising about 16% of GDP (see Figure 2).

The inflow of foreign direct investment into the non-financial sector was slightly higher than in the past few years. Nevertheless, most of the external funds were raised in the form of loans and thus Estonia's external debt increased to around 108% of GDP by the end of the year.

Inflation

Like in the past few years, **consumer prices grew faster than expected** also in 2007. The average annual rise in the cost of the consumer basket was 6.6% (see Figure 3).

As long as the rapid growth period lasted, the robust increase in service prices continued as well. Housing costs grew also due to the increase in the value added tax imposed on district heating and the rise in energy prices on the world market. In the light of the weakening domestic demand, the

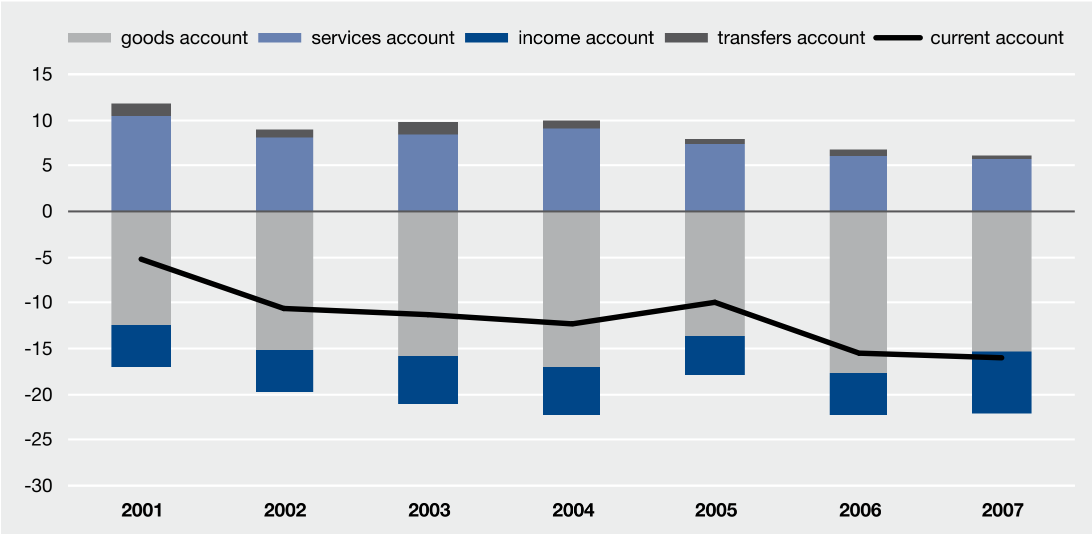


Figure 2. Current account balance and balance of payments accounts (% of GDP)

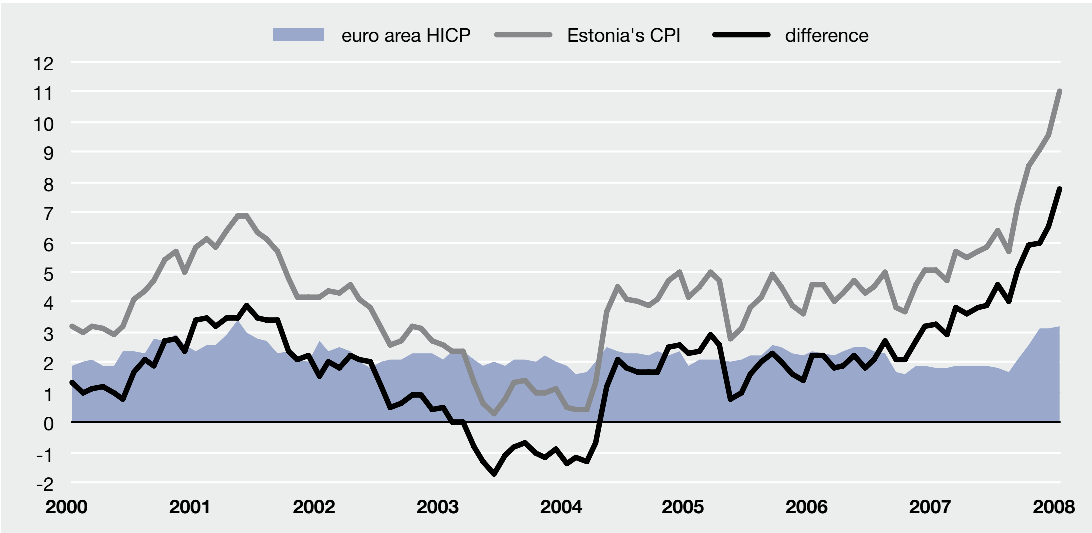


Figure 3. Twelve-month consumer price growth in Estonia and the euro area (%)

acceleration in core inflation also ended in the last months of the year. Unfortunately, a **hike in food prices on the world market** started off then. At the end of the year, inflation was boosted by another surge in oil prices (see Figure 4). Food prices increased faster than expected also at the beginning of 2008. Since at the same time excise duties were raised, the inflation rate accelerated temporarily to 11-12%.

In 2007, the real exchange rate of the kroon appreciated by nearly 3% on average. This was mainly facilitated by the stronger growth of consumer prices compared to that in the partner countries, which is why the appreciation of the real exchange rate accelerated to 4–5% in the second half-year (see Figure 5).

Until autumn, inflation was boosted by robust income growth. New jobs were created almost

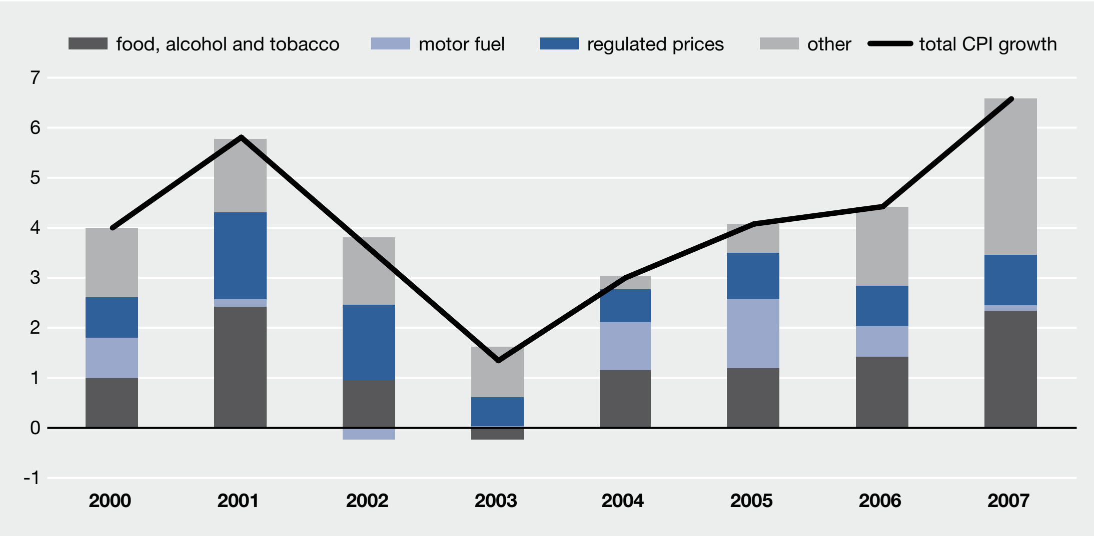


Figure 4. Consumer price growth by components (pp)

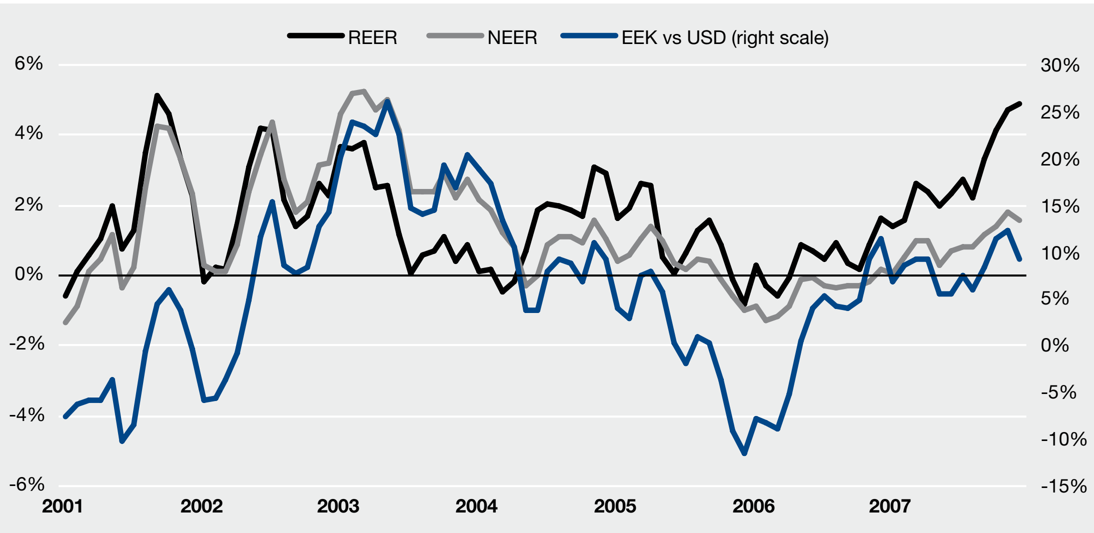


Figure 5. 12-month changes in the real and nominal exchange rate of the Estonian kroon

throughout the year, but at a slower pace compared to the previous year and considerably less in the last months of the year. The average annual employment rate increased approximately 1.5%. The unemployment rate also continued to decrease, falling to 4% in year-end. Average wage growth was stronger than a year ago, but showed signs of deceleration in the second half of 2007. Wage growth outpaced productivity growth in most economic sectors in 2007.

General government

As concerns the tax policy, the Government continued efforts to reduce labour taxes and raise consumption taxes. At the beginning of 2007, both the corporate and personal income tax rate was lowered by 1 percentage point to 22%. Since the non-taxable income threshold remained unchanged, the lower VAT rate that had been imposed on district heating and stove heating sold to households was increased to the usual level of 18% and wage growth accelerated further in the first half-year, the general tax burden increased 32.5% as a ratio of GDP. The tax burden is expected to remain relatively similar also in 2008 if along with income tax rate reduction, excise duties on alcohol, tobacco and motor fuel are increased and an excise duty is imposed on electricity. Then the excise duties will reach the minimum level agreed upon in the European Union and the harmonisation of tax policy can be considered completed.

On the expenditure side, the most significant change in 2007 was the abandoning of one-off pension increases and the introduction of a formula for calculating pensions so as to link them more closely with average wage growth.

Estonia's general government budget has been in surplus since the fiscal year of 2002 and 2007 was no exception. According to preliminary estimates, the consolidated budget surplus for 2007 was 2.8% of GDP. Even though it was higher than targeted in the state budget strategy, compared to earlier periods, the surplus decreased more than might have been expected on the basis of slower domestic demand growth. Besides moderate extra tax revenue, the surplus was induced by the planned increases in reserves and the postponement of some major projects.

Along with surplus growth also the public debt kept shrinking. By the end of the year, the public debt to GDP ratio dropped to 3.4%.

ISSUES RELATED TO THE DATE FOR THE ADOPTION OF THE EURO

Estonia's liberal and open economic policy as well as accession to the European Union has laid a good foundation for strong economic growth and also for the fulfilment of the Maastricht criteria. The openness of the Estonian economy and the fixed exchange rate of the kroon force our enterprises to be competitive under very similar economic and political conditions as the present Member States of the euro area. This, in turn, supports the stability of the Estonian kroon's exchange rate and compliance with the respective criterion without any problems. At the same time, the Estonian Government has pursued the balanced budget principle, and, as a result, Estonia meets the public finance criterion. The low long-term interest rate indicates that financial markets are internationally integrated and investors believe in the competitiveness of Estonia's economy and the sustainability of economic policy. If our economic policy makers and enterprises justify that belief, Estonia will not have any fundamental problems with fulfilling these criteria in the future either.

Meanwhile, meeting the inflation criterion in its present interpretation remains a problem for a rapidly developing economy that is converging towards the average level of the wealthier countries of the euro area. On the one hand, economic openness enhances the growth opportunities of the Estonian economy, whereas on the other hand, monetary and fiscal policies decrease the possibilities of influencing inflation in the short term. For an open economy such as Estonia has, the fixed exchange rate based on the currency board arrangement is optimal for anchoring inflation expectations and ensuring price stability.

Conservative fiscal policy is another effective tool besides the fixed exchange rate in directing domestic demand in the short term. A conservative economic policy, particularly fiscal policy, is essential to ensure the stability of Estonia's economic development and the fulfilment of the Maastricht criteria.

According to the autumn 2007 forecast of Eesti Pank, it is unlikely that Estonia will be able to meet the Maastricht inflation criterion in 2008–2009 (provided that the interpretation of the criterion remains unchanged). According to the prognosis, the inflation is expected to peak in the first half of 2008. Although thereafter the inflation rate will start to decelerate, it will still exceed 4% at the end of

2009, whereas the reference value calculated on the basis of the autumn 2007 forecast of the European Commission will most probably be around 3%.

Thus, it must be concluded that the adoption of the euro will be postponed beyond 2011. Therefore, Eesti Pank and the Government have not set a new target date for the changeover to the euro. In any case, the exact date of changing over to the euro will be announced at least 12 months before the transition to the single currency so that the state and the public sector could complete their preparations. Despite the postponement of the changeover date, Estonia's accession to the euro area remains an essential economic policy objective[1].

SOVEREIGN RATING

Sovereign rating, more specifically the credit rating of a country, is an assessment by international (private) rating agencies of a country's capability and willingness to repay its long-term foreign liabilities by due date. Indirectly, sovereign rating reflects the reliability of a country's economy and economic policy. Sovereign rating largely determines the interest rate on foreign borrowing.

Since 1997 Estonia is being assessed by three main international rating agencies: Moody's Investors Service, Standard & Poor's and FitchRatings.

In 2007, Moody's changed **Estonia's sovereign rating** outlook from positive to stable; Standard & Poor's revised its outlook from stable to negative, and Fitch affirmed Estonia's outlook as stable. No rating agency changed the level of Estonian ratings during the year. Standard & Poor's and Fitch affirmed the rating of long-term foreign currency liabilities at the level A. Moody's rating on the likelihood of the repayment of Estonia's loans has remained unchanged since autumn 2002. The rating A1 is a notch higher than the ratings given by Standard & Poor's and Fitch.

Due to downgrading the sovereign rating outlook, Moody's changed Estonia's **sovereign risk rating**[2] outlook of long-term foreign currency liabilities at the level Aa1 from positive to stable in 2007. Fitch and Standard & Poor's did not change Estonia's sovereign risk rating, leaving them at the level AA.

[1] See also Eesti Pank's "Report on the Adoption of the Euro" (January 2008).
[2] Sovereign risk rating establishes a ceiling for the rating of companies operating in the country.

FINANCIAL SECTOR

Banking sector

Institutional development

At the end of 2007, seven companies licensed as credit institutions, seven branches of foreign credit institutions and over 180 cross-border banking service providers were operating in the Estonian banking market. Over 50 cross-border service providers emerged over the past year (see also Figure 6). On September 1, 2007 the name of Bayerische Hypo- und Vereinsbank AG Tallinn Branch was changed to AS UniCredit Bank Estonian Branch as a result of the expansion and merger of UniCredit Group.

As the growth of the loan market has slowed and credit institutions have responded differently to that, market shares have also changed more than usual during the past six months of 2007. Banks implementing a more conservative credit policy lost market share in 2007. Somewhat more active smaller banks, on the other hand, gained market share.

Assets and liabilities of banks

In 2007, banks' assets increased by nearly 81 billion kroons (33%) on an aggregate basis. At the end of the year, banks' total assets reached 321 billion kroons. The total value of the financing portfolios of banks and leasing companies exceeded 261 billion kroons at the end of 2007, having grown by almost 60 billion kroons over the year (7 billion kroons less than last year). The share of securities portfolios in banks' balance sheets remained more or less at the same level as last year (6% in 2007 vs. 7% in 2006).

Growth in the financing portfolios of banks and leasing companies decelerated considerably. This was caused by the stabilisation of economic growth, increasing interest rates and the adjustment of expectations to the new economic situation. Though the second quarter of 2007 may be considered a turning point in the growth of financing portfolios, the deceleration was most pronounced in the fourth quarter (see also Figure 7).

The stock of household housing loans and leasing grew 30% – at a rate two times lower compared to the 2006 figure. As at the end of December 2007,

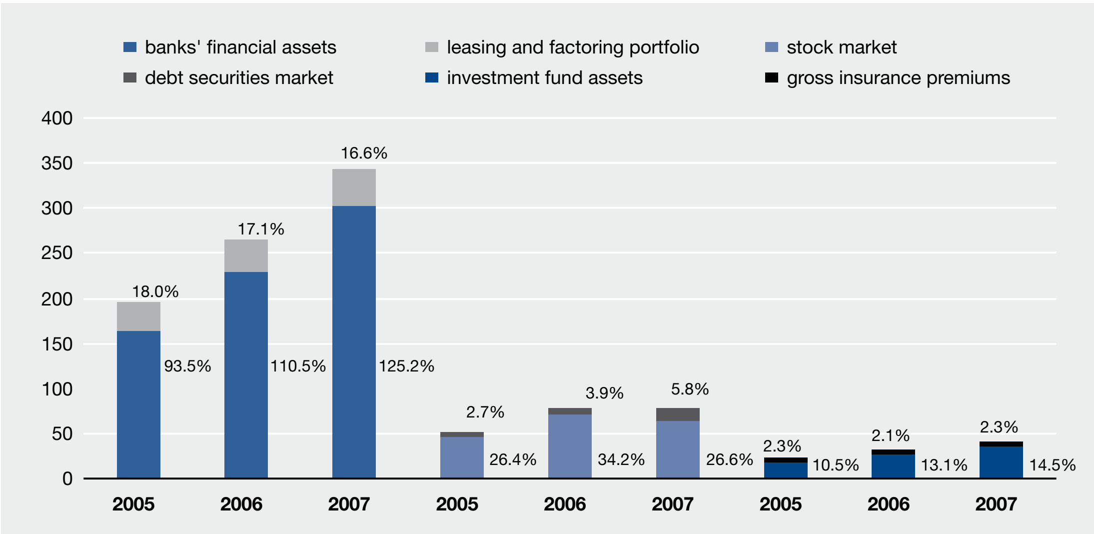


Figure 6. Structure of Estonian financial intermediaries (EEK bn and % of GDP)

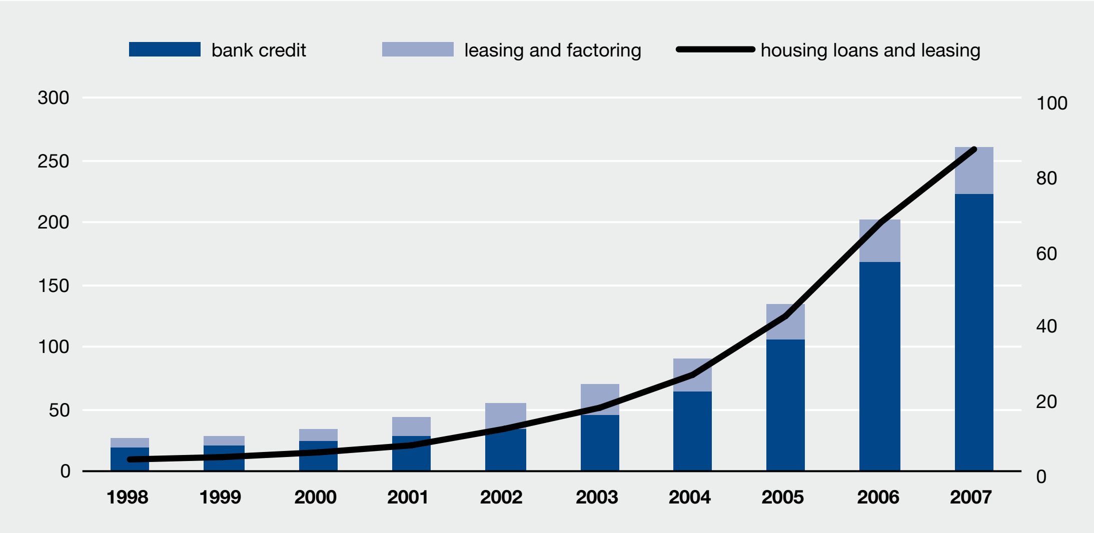


Figure 7. Public and non-financial sector financing (EEK bn)

the total value of the housing loan portfolio stood at 86 billion kroons. Also household demand for consumer credit started to decrease in the second half of 2007. Meanwhile, the share of other loans in the total debt burden of households increased 2% compared to 2006; that is to 24%.

As regards the corporate sector, banks' financing portfolios were most significantly influenced by a decrease in the loan demand of real estate companies. In 2006, the loan stock of those companies increased by 23 billion kroons, whereas in 2007 it grew by 14 billion kroons, comprising 64% and 46%, respectively, of the new loans issued during the year. From among export oriented companies the financing of the industrial sector increased the most (by 3.8 billion kroons), whereas financing the operations of hotels and restaurants grew the fastest (41%, i.e. by 1.3 billion kroons).

As deposit growth remained relatively modest in 2007 compared to credit growth, deposits did not suffice to satisfy the demand for credit. Thus, banks obtained nearly 50 billion kroons of additional funds from parent banks. Although credit growth slowed at the end of the year, banks also had to increase their own funds considerably in 2007 to comply with the capital adequacy requirements. Banks' consolidated balance sheet witnessed a rise mainly in the share of subordinated liabilities.

Profitability

Although growth in loan portfolios moderated and the cost of loan resources rose, profitability nevertheless remained high in 2007 (see Figure 8). It was boosted by growing loan portfolios and the withdrawal of exceptional profit from subsidiaries. The rising cost of loan resources was, to the most extent, passed on to customers, as the majority of loans were with floating interest rates.

In 2007, the return on assets was primarily curbed by slowing growth in fee and commission incomes. Although banks receive the majority of fee and commission incomes on payment intermediation, income growth has also been inhibited by the lower level of borrowing and changes in credit conditions.

Growth in administrative costs moderated in 2007, but an increase in the write-downs of assets reduced the favourable impact of the cut-down on expenses. Thus, also return on assets decreased in the second half of the year. Growth in write-downs

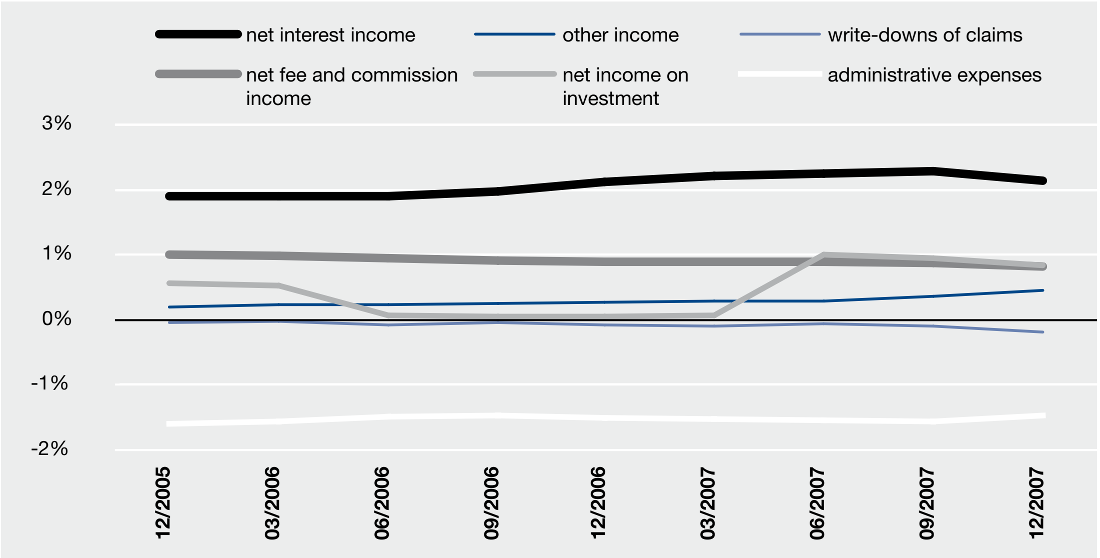


Figure 8. Income and expense items (% of total asstes)

remained nevertheless rather modest. Owing to the extraordinary income received from subsidiaries, banks' costs comprised 35.3% of their incomes on an aggregate basis in 2007. Banking sector's return on equity was 30% as a result of extraordinary profit, which is substantially more than in 2006 (20%).

Capital adequacy and risks

Banks' aggregate risk weighted assets grew by 30% and own funds by 46% in 2007. Consequently, at the end of December 2007 banks' aggregate capital adequacy ratio was 14.8% and that of banking groups 10.8% (see Figure 9).

Loan-servicing capability and risks

As key interest rates rose, growth in banks' loan portfolios decelerated and the overall economic development stabilised, the loan-servicing capability of bank customers started to deteriorate in 2007. The share of loans overdue for more than

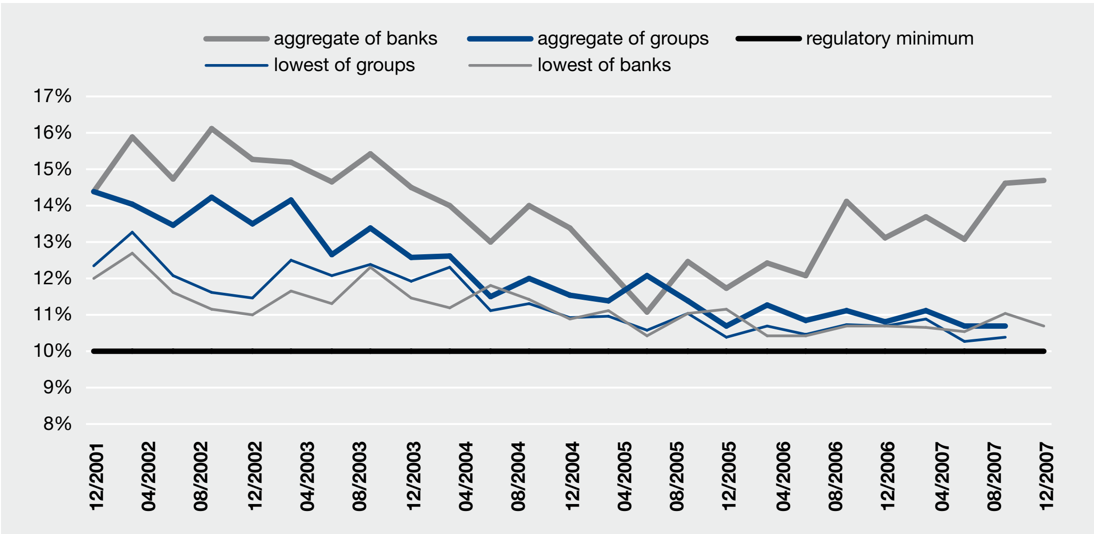


Figure 9. Capital adequacy of banks and banking groups

60 days in the loan portfolio climbed from 0.3% at the beginning of the year to 0.7% at year-end. This was well expected and banks are strong enough to cope with overdue loans also in the future.

Securities market

Bond market

In 2007, the primary bond market was even more active compared to previous years: annual growth was 41% (see Figure 10). Bond market capitalisation growth accelerated to 76% and capitalisation reached 15 billion kroons at the end of 2007. The market expanded primarily due to bond issues by resident non-financial and financial sector companies. As the annual growth rate of bond issues by non-resident companies exceeded the average (120%), the share of those bonds in the total volume increased from 14% to 22%.

The secondary bond market was also very active. The average daily turnover was 8 million kroons higher than in 2006 and totalled 22 million kroons. By end-2007, the share of residents among bond investors had dropped to 65% (80% in 2006). The share of non-residents increased mainly owing to investors from non-financial sector companies.

Stock market

In 2007, two corrections occurred on the Tallinn Stock Exchange; the second one is influencing stock market developments even at present time. At the beginning of the year, the Tallinn Stock Exchange index OMXT increased rapidly and peaked with 1042 points. This was, however, followed by the first correction at the beginning of March. After a slight fluctuation another rise occurred (see Figure 11 and Table 2). In the second half of the summer, also the value of OMXT started shrinking due to a decline in global stock markets. By the end of the year, the annual decrease of the index reached 11% and its value stood at 742 points. The average daily turnover of stock exchange transactions was twice as high in 2007 compared to the average of the previous year, reaching 94 million kroons.

Two new companies were listed on the primary list of the Tallinn Stock Exchange: the media and publishing company AS Ekspress Grupp and the real estate development and services and construction company AS Arco Vara. In addition, AS Viisnurk was divided into two: AS Trigon Property Development and AS Viisnurk. PTA Grupp changed its business name to AS Silvano Fashion Group.

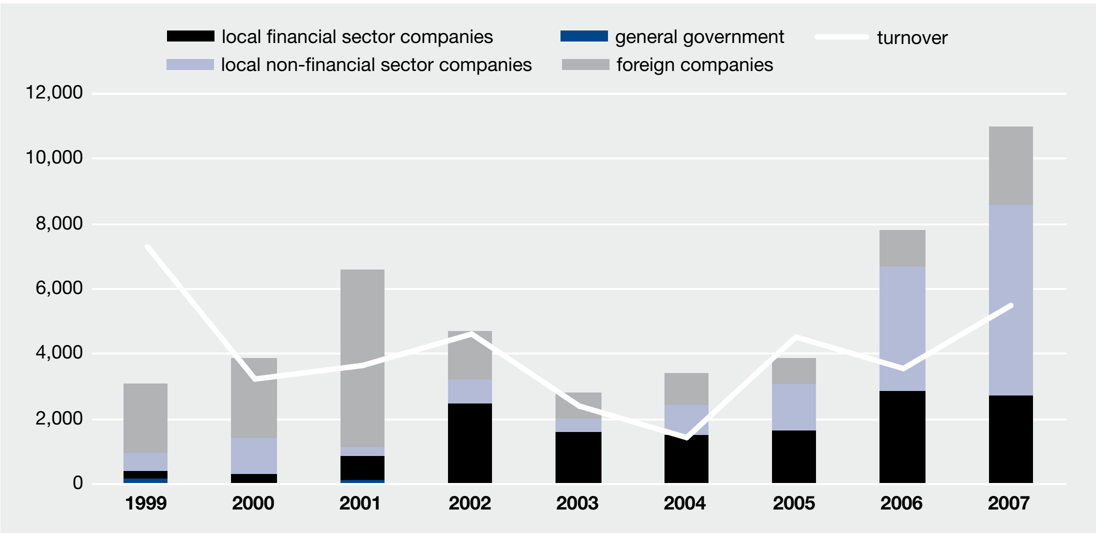


Figure 10. Amount of debt securities by issuers and secondary market turnover (EEK m)

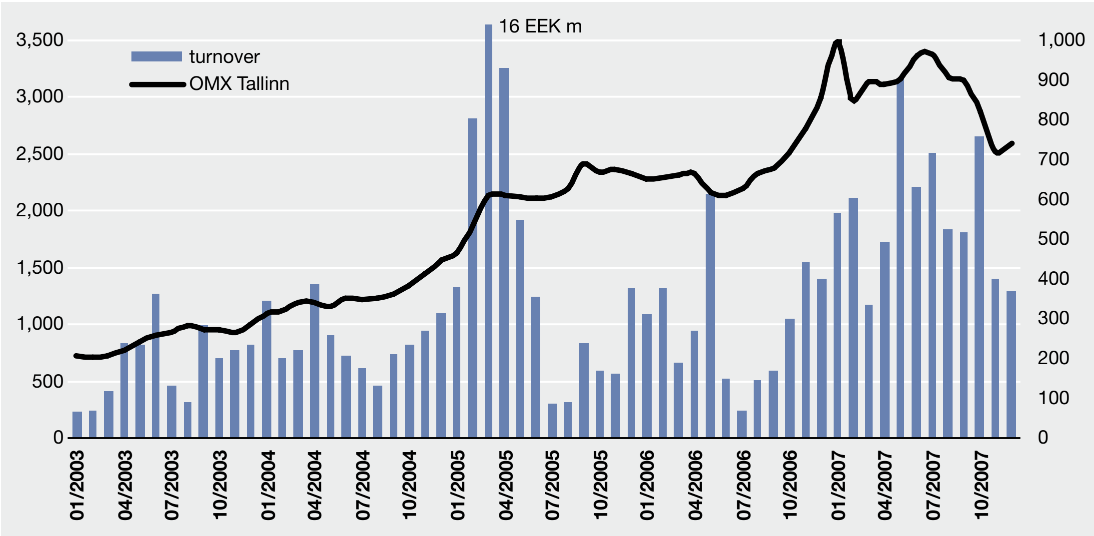


Figure 11. Monthly turnovers of the Tallinn Stock Exchange (EEK m; left scale) and index OMXT as at month-end (points; right scale)

Table 2. Aggregate indicators of the securities market (EEK bn)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Securities market capitalisation*	**19.1**	**12.6**	**31.9**	**35.2**	**31.9**	**42.2**	**53.5**	**80.0**	**60.1**	**89.7**	**90.3**
Instruments											
shares listed on stock exchange	13.1	8.3	28.3	31.0	26.4	36.2	47.3	71.9	46.9	71.0	64.0
debt securities	4.0	3.7	3.2	3.7	4.4	3.3	2.9	3.1	4.8	8.5	15.0
shares and units of investment funds	1.8	0.4	0.4	0.4	0.9	1.7	2.6	4.5	8.4	10.2	11.1
subscription rights	0.1	0.2	0.0	0.0	0.2	1.0	0.7	0.5	0.0	0.0	0.0
Securities market turnover*	**32.8**	**32.8**	**12.4**	**10.1**	**10.2**	**13.0**	**14.9**	**13.9**	**68.4**	**37.4**	**74.0**
Capitalisation of Tallinn Stock Exchange	13.1	8.3	28.3	31.0	26.4	36.2	47.3	72.4	46.9	72.3	64.8
non-resident investors	42%	54%	74%	78%	78%	81%	81%	83%	58%	49%	55%
Turnover of Tallinn Stock Exchange	21.8	13.4	4.5	5.5	4.1	4.0	7.6	10.3	30.3	12.0	24.0
Securities market capitalisation* / GDP	29%	17%	39%	38%	31%	36%	42%	58%	46%	43%	37%
Securities market turnover / capitalisation	172%	260%	39%	29%	32%	31%	28%	17%	90%	59%	76%
Stock exchange turnover / capitalisation	167%	161%	16%	18%	16%	11%	16%	14%	47%	24%	33%

* Securities market capitalisation and market turnover do not include unlisted shares.

Other financial intermediaries

Investment and pension funds

In the first half of 2007, the volume of investment fund assets increased rapidly and remained at a high level until the end of the year. By the end of December, the total volume of investment funds was 35 billion kroons and annual growth reached about 30%. Like in previous years, the greatest contributors to growth were assets of equity funds and mandatory pension funds, which increased by 4.2 and 3.6 billion kroons, respectively. Last year, the volume of money market funds decreased by over 800 million kroons (see Figure 12).

Insurance

In 2007, developments in the life insurance market could generally be characterised by the establishment of European companies in Estonia. This means that some life insurance companies coordi-

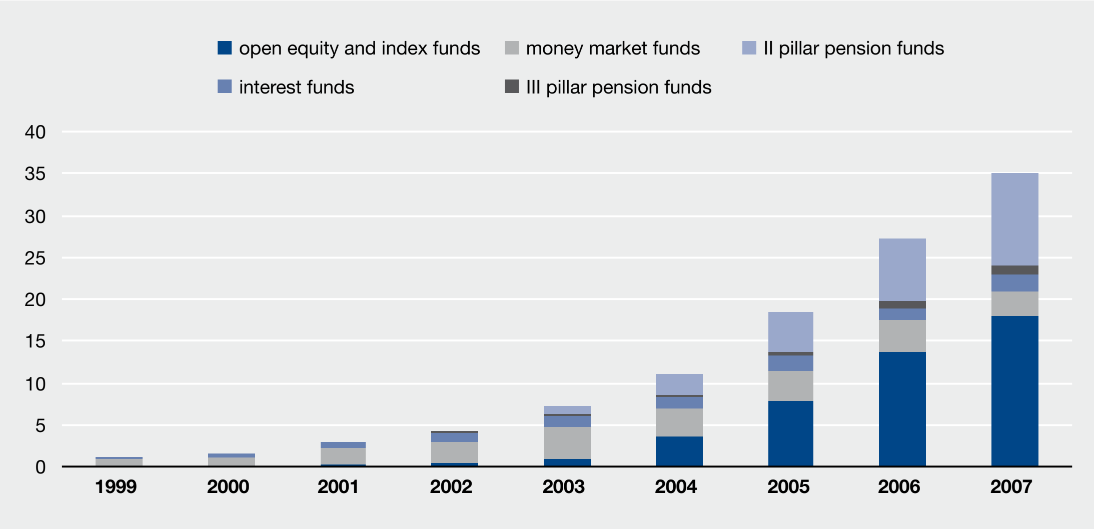


Figure 12. Total volume of investment funds as at year-end (EEK bn)

nate their activities in the Baltic States via companies established in Estonia. The gross premiums collected on insurance contracts concluded by Estonian residents grew by 24% and amounted to 1.9 billion kroons. The gross premiums collected on unit-linked life insurance contracts increased the most.

As competition has tightened, the distribution of market shares of non-life insurance companies changed considerably with the year. Hansa Varakindlustus has grown its market share considerably, winning a 10% share of the market during its first year of activity.

Gross premiums collected by non-life insurance companies increased 19% in 2007 and totalled 3.7 billion kroons at the end of the year. Similar to earlier years, the volume of gross premiums collected on land vehicle insurance increased the most.

Payment instruments

In the past ten years, the total number of payments has multiplied by more than seven times and the total turnover has increased over five times (see Figure 13). Although in 1998 direct debit was already available as a payment instrument in Estonia, it did not gain much popularity at first. Given that, the number of payments initiated by direct debits has risen the most rapidly – by nearly 160 times by the end of 2007. Card payments have been the prevailing form of payments (56% of all payments); their number has increased by over 27 times over the last decade. However, their share in the total turnover of payments intermediated by credit institutions is marginal (approximately 1%).

The next in popularity have been Internet and telebank credit orders, which comprise a significant share of the payments initiated by credit orders, considering the turnover as well as the number of payments. Cash payments and paper-based credit orders have not been very popular among Estonian residents lately; they rather prefer efficient electronic payment instruments and the use of cash payments and paper-based credit orders has been diminishing year by year. In 2007, the share of cash payments was only 0.2% in terms of the number and 0.04% in terms of the turnover of payments made through banks.

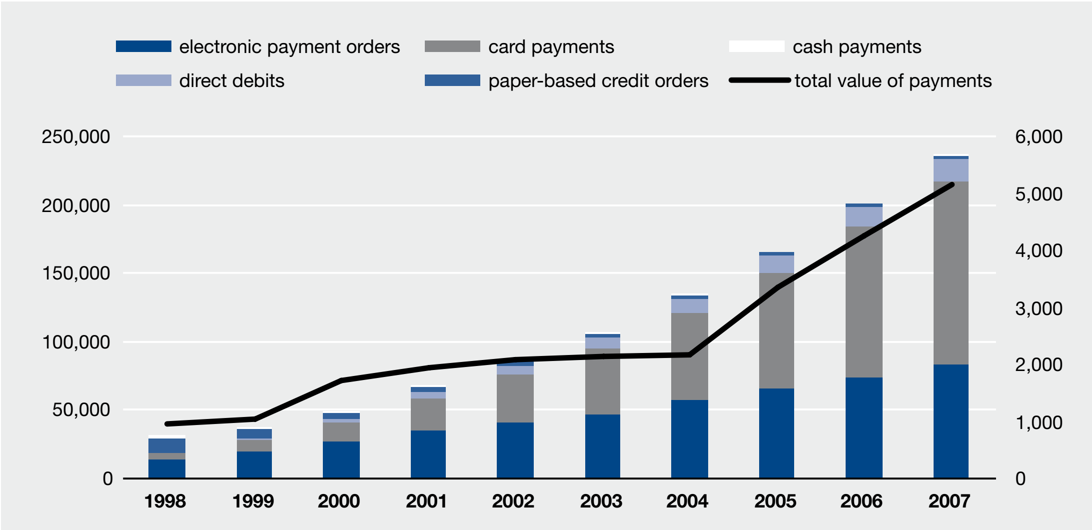


Figure 13. Number (thousands; left scale) and turnover of payments (EEK bn; right scale) by payment instruments

At the end of 2007, altogether 1.8 million payment cards were in use in Estonia, which is 10% more than at the end of 2006. Owing to developments in the financial services market, the share of debit cards dropped to 76% (1.4 million cards issued), whereas that of credit cards rose to 24% (over 421,000 cards) of the issued cards. As credit cards are used less frequently, 30% of all payments cards were passive. By the end of 2007, credit institutions had issued one debit card per resident and three credit cards per ten residents. At the end of December 2007, there were 1,000 ATMs in Estonia, of which 85% enabled interbank use. 82 new ATMs were added in 2007; that is slightly more than in the previous year. At the end of the year, card payments were possible in 15,885 points of sale. The number of POS accepting card payments increased slower than earlier. Year-on-year growth was only 8%.

Developments in the real estate market

The slowdown in economic growth brought along a decrease in the demand for and number of transactions in the real estate market in 2007. The first signs of stabilisation in the number of real estate transactions appeared already in the second half of 2006, whereas demand for real estate started to drop considerably in the third quarter of 2007. The number of transactions was significantly lower compared to the same period a year ago. In total 49,464 real estate transactions were performed in 2007, which is 20% less than in 2006.

The biggest gap between demand and supply can be seen in the case of new apartments, as their supply grows by the new dwellings brought to the market by real estate developers as well as by the dwellings sold in the secondary market. The number of completed dwellings in 2007 exceeded the 2006 figure by 40%, whereas the number of housing transactions was over 20% smaller than a year ago. As construction costs and land prices have increased too, not all real estate developers may be able to decrease their sales prices sufficiently. Thus, some of them are likely to encounter difficulties in fulfilling their loan liabilities.

Although the average transaction value is affected, among other things, by changes in the structure of transactions, by the fourth quarter of 2007 the average value of transactions with plots of land had declined the most (see Figure 14). Compared to the same period a year ago, it had decreased by nearly 50%. Year-on-year, the average value of transactions with apartments – the most liquid part of the real estate market – dropped 15% by the last quarter of 2007. According to the Land Board, the median price of Tallinn apartments, for which the demand is broad-based, was 6% lower in the fourth quarter of 2007, compared to the same period last year. The adjustment of real estate prices most probably continues also in the first half of 2008.

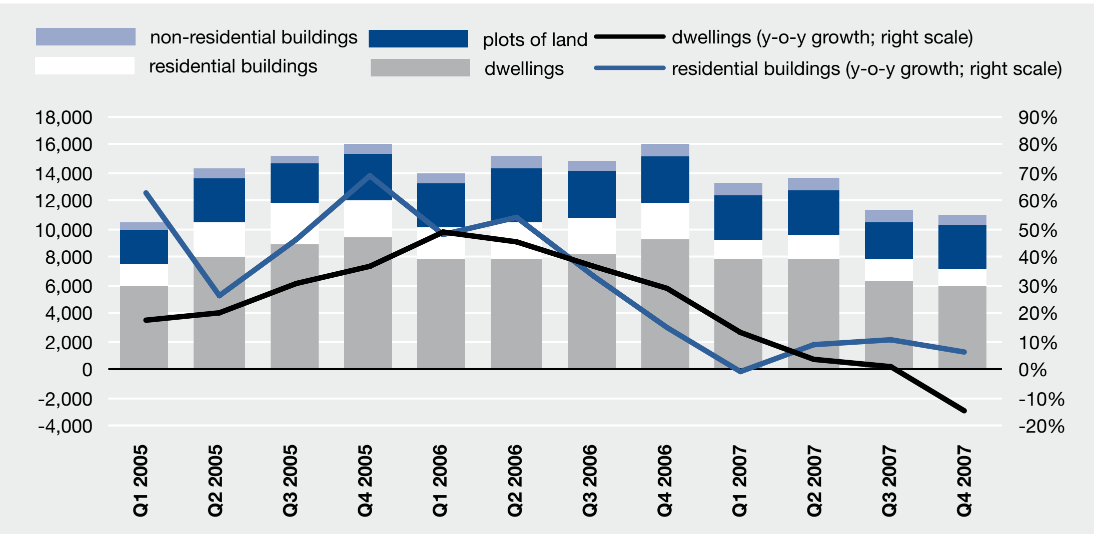


Figure 14. Number of purchase-sale contracts of real estate and annual growth of contract's average value