NON-FINANCIAL SECTOR

Monetary policy environment

In 2008 the monetary policy environment became more and more restrictive for the Estonian economy. Upward price pressures were still high in the first half of the year and the European Central Bank (ECB) reacted by raising the monetary policy interest rates at the beginning of July. The US dollar depreciated further against the euro, which was offset by the depreciation of the currencies of some Estonia's trading partners. All in all, the monetary policy environment of the first half of 2008 could be considered almost stable.

The monetary policy environment tightened substantially only in the second half of 2008 because of the deepening global financial crisis. Although the ECB lowered the monetary policy interest rates four times, the Euribor climbed until the last months of the year. At the same time, bank loan interest rates increased, including in Estonia. At the end of 2008 and at the beginning of 2009, loan interests in Estonia started to decline again (see Figure 1).

In the second half-year the depreciation of the Russian rouble and the Swedish krona against the euro accelerated, but this was largely offset by the appreciation of the US dollar. Consequently, the real nominal exchange rate of the Estonian kroon appreciated 1.6% from 2007.

In general, the monetary policy environment was more restrictive in 2008 and in the last months of the year, the global financial crisis started to affect also Estonia's non-financial sector.

Domestic and external demand

In 2008, Estonia's economic growth was shaped by the continuing adjustment of domestic demand as well as the global economic crisis.

The slowdown in robust growth that had started already in the summer of 2007 continued at the beginning of 2008 and reached a 1.1% decline in GDP in the second quarter. In the second half of the year, the slowdown picked up pace and reached 9.4% in the fourth quarter. According to preliminary estimates, the annual average contraction stood at 3.5%.

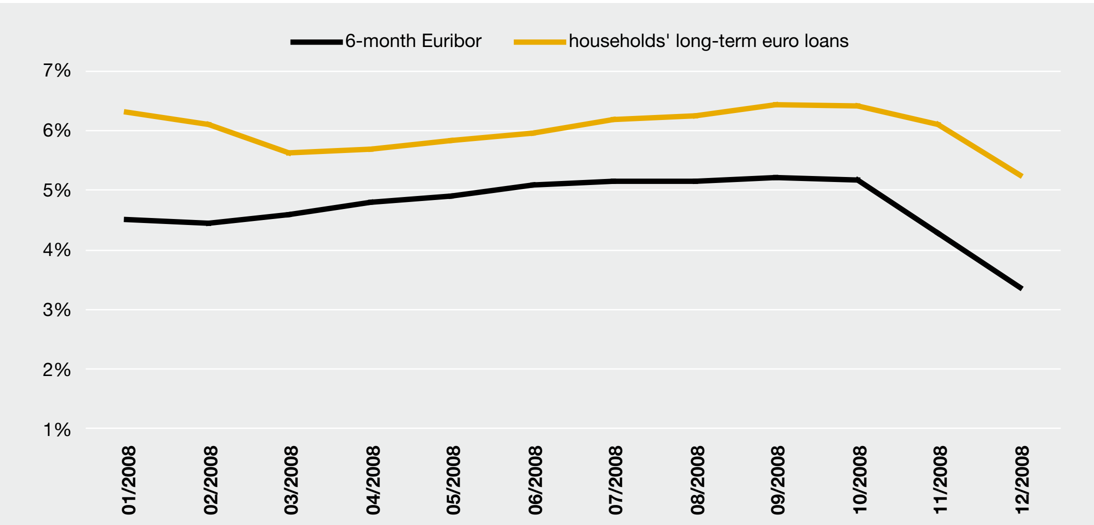

Figure 1. Changes in interest rates on long-term loans issued in Estonia and euro area money market interest rates

Until autumn, only domestic demand weakened. The building of stocks slowed by nearly two times, fixed investment diminished almost 5% and private consumption expenditure decreased 2.5% compared to the previous year.

In November and December when domestic demand slowed at a more moderate rate, a sudden decrease hit Estonia's main export markets and the European economy in general. Goods exports shrank significantly and only services exports remained close to previous levels. For the past two years, services exports have exceeded goods exports in terms of growth. In this context it is important to take into account that the trade flows that could be regarded as re-exports are still large and their volatility strongly affects foreign trade indicators, which complicates the evaluation of the export sector's contribution to growth.

GDP decreased in most fields of activity, and only a few private sector industries maintained growth also in the last months of the year (see Table 1). This was the first time since 1995 that the cost of GDP was smaller than in the previous year also at current prices.

The external balance started to improve in the second half of 2007 along with the weakening domestic demand. In 2008, the improvement process picked up speed and the average annual goods and services deficit decreased to 4.5% of GDP. This was supported mainly by a decrease in goods imports, while the goods and services export growth still remained relatively rapid. The terms of trade did not facilitate the improvement of the trade balance. The annual average price rise of import goods was 1.5 percentage points higher than that of export goods. In the second half-year, the improvement of the external balance was supported also by a decline in investment income outflow. The current account deficit decreased to about 6% of GDP in the fourth quarter. In annual terms, the current account to GDP ratio remained almost twice as low as in 2007 and stood at 9.5% (see Figure 2).

Approximately 40% of the net inflow of foreign capital consisted of foreign direct investment.

Table 1. Real GDP growth by fields of activity in 2007–2008 (%)

	2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Agriculture and hunting	-12	21.1	7.8	4	2.8
Forestry	-10.5	-12.6	1.9	36.4	7.5
Fishing	8.2	2.4	22.1	3.8	-10.3
Mining and quarrying	11.9	12.2	-4.1	-11.7	-18.8
Manufacturing	9	2.8	-1.2	-1	-16.4
Energy, gas and water supply	-3.3	-5.3	-9.7	-9.5	-7.2
Construction	10	5.3	1.2	-9.2	-17.1
Wholesale and retail trade	6.3	-5.6	-6.2	-8.5	-11.6
Hotels and restaurants	6	3.7	2.3	-7.7	-14.9
Transport, storage and communications	6.5	-5.3	-4.6	-3.8	-9.3
Financial intermediation	18.4	6.5	-1	-8.2	-10.8
Real estate, renting and business activities	2.5	-1.1	0.7	-0.2	-1.5
Public administration and defence; social insurance	2.9	7	8.6	6.7	4.6
Education	1.4	1.4	1.7	1.4	1
Health and social care	4.7	0.1	-0.2	5.1	-3
Other community, social and personal services	5.8	7.1	3.9	-0.5	-4.5
Total GDP	**5.6**	**0.4**	**-0.7**	**-3.2**	**-8.1**
Net taxes on products	11.4	-1.3	-3.8	-5.6	-19.8
GDP at market prices	6.3	0.2	-1.1	-3.5	-9.7

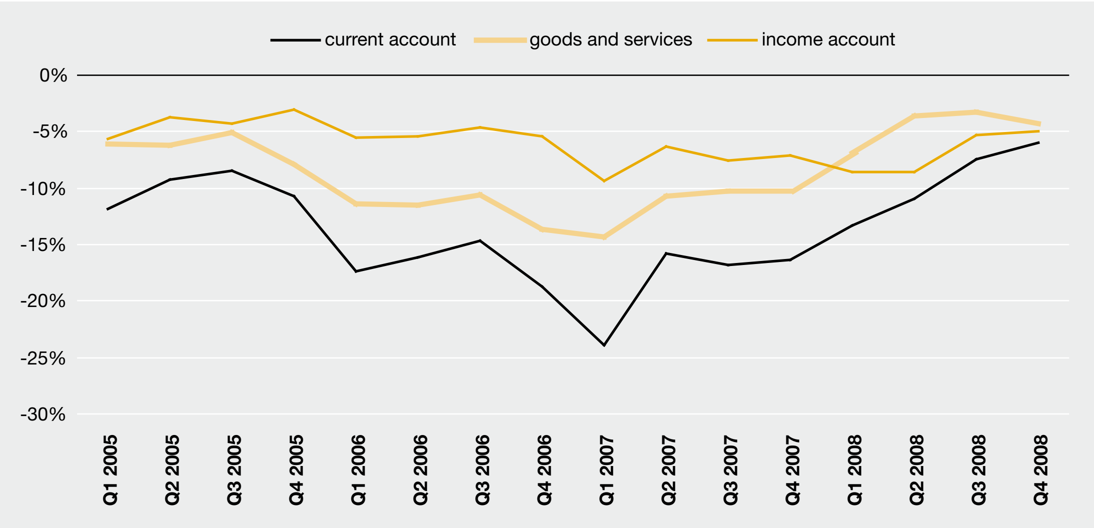

Figure 2. Current account balance and main accounts of the balance of payments (% of GDP)

The rest was by various debt-generating cash flows, and by the end of 2008, Estonia's external debt had grown to 117% of GDP. Various transfers from the EU budget increased by around one third over the year.

Inflation

Similar to the last couple of years, consumer prices grew faster than expected also in 2008. This resulted primarily from the pass-through of external price shocks to Estonia, i.e. the continuous rapid rise in the prices of energy carriers and food products.

In the light of the weakening domestic demand, also the acceleration of core inflation ended in the last months of 2007. Unfortunately, a hike in food prices on the world market started off then and continued also in 2008. The excise duties imposed on electricity and the increase in motor fuel, alcohol and tobacco excise duties raised the cost of the consumer basket to 11% in the first months of 2008. As global fuel and food prices kept rising, the inflation rate was much higher in the following months than expected. The robust price rise of import goods affected the consumer price index also in the second half-year, which is why the annual average inflation indicators were higher than in 2007, leaving the wrong impression of the consumer price increase gaining further momentum (see Figure 3).

In Estonia's case it should be taken into account that the price rise of natural gas purchased from Russia passed through to the prices of distant heating only at the end of the year; that is, when the prices of energy carriers in the world market had dropped considerably.

Although annual average inflation increased, the second half of 2007 saw an adjustment in the prices of goods and construction services oriented to the domestic market. Both, the indices of core inflation and construction prices had fallen to 6–7% by the first months of 2008 (see Figure 4). The rise in service prices slowed, being supported by the continuous weakening of wage pressures. As regards wages and labour market indicators it should be taken into account that major changes in the labour market started to occur in December and January, which is why they are not yet fully reflected in the year-on-year comparison of fourth-quarter data.

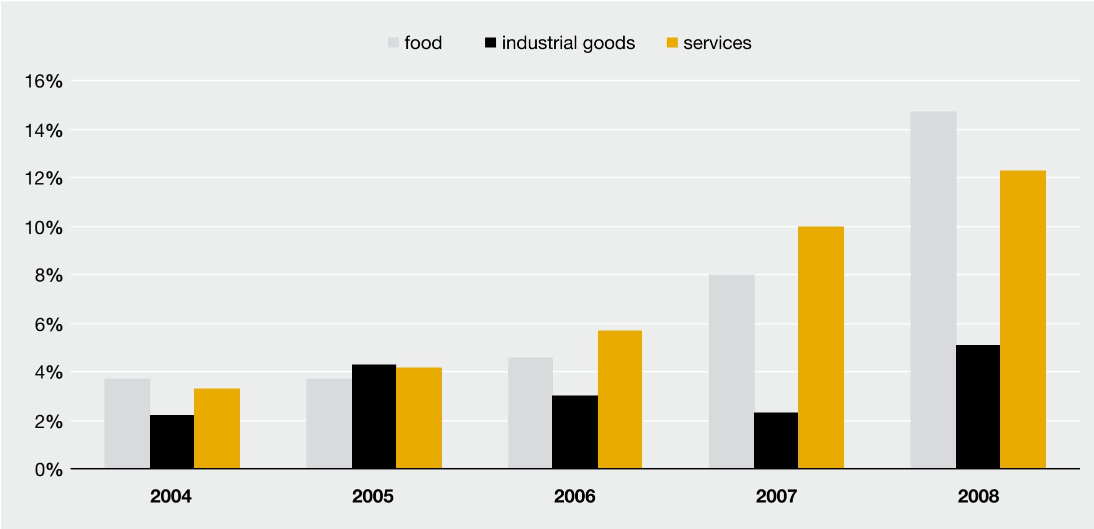

Figure 3. Changes in prices of services, food and industrial products (y-o-y)

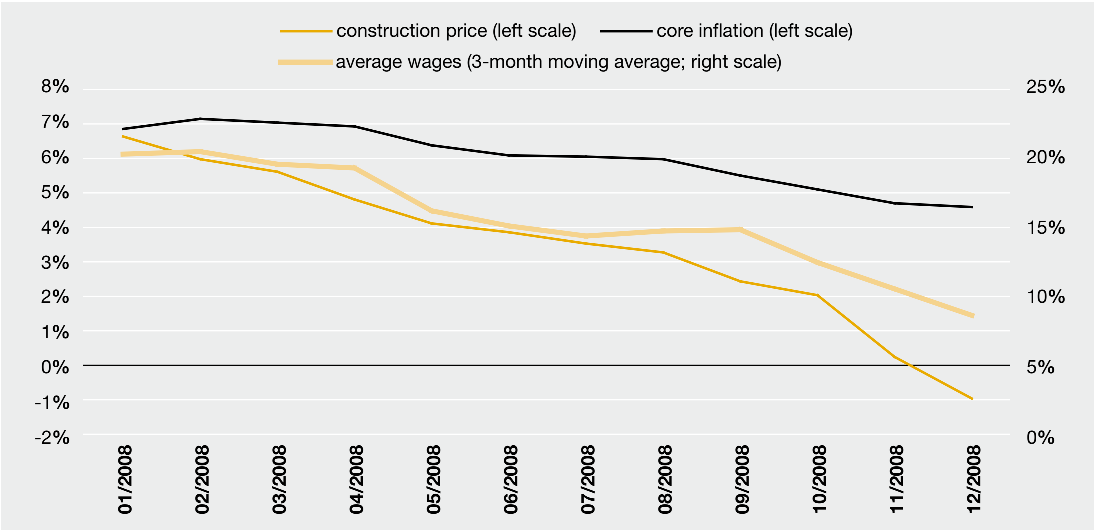

Figure 4. Changes in core inflation, construction price and average wages (y-o-y)

The annual average inflation indicators do not reflect the rapid slowdown in inflation at the end of 2008 either. The cost of the consumer basket declined in the last months of 2008, compared to previous months. This trend continued also at the beginning of 2009 (see Figure 5).

In 2008, the real exchange rate of the Estonian kroon appreciated by nearly 4.7% on average. About two thirds of the appreciation can be attributed to stronger consumer price growth compared to that of Estonia's trade partners (see Figure 6).

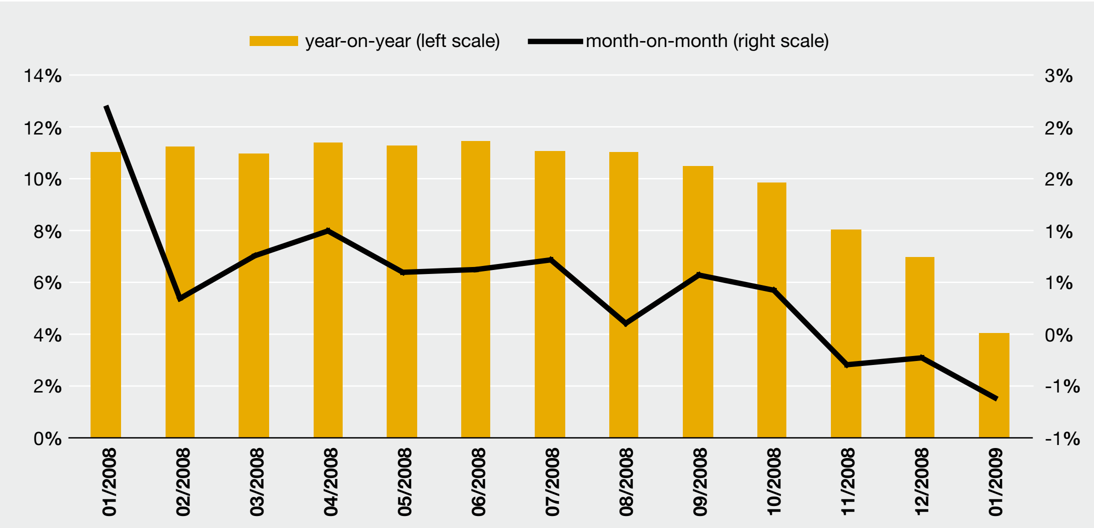

Figure 5. Consumer price changes

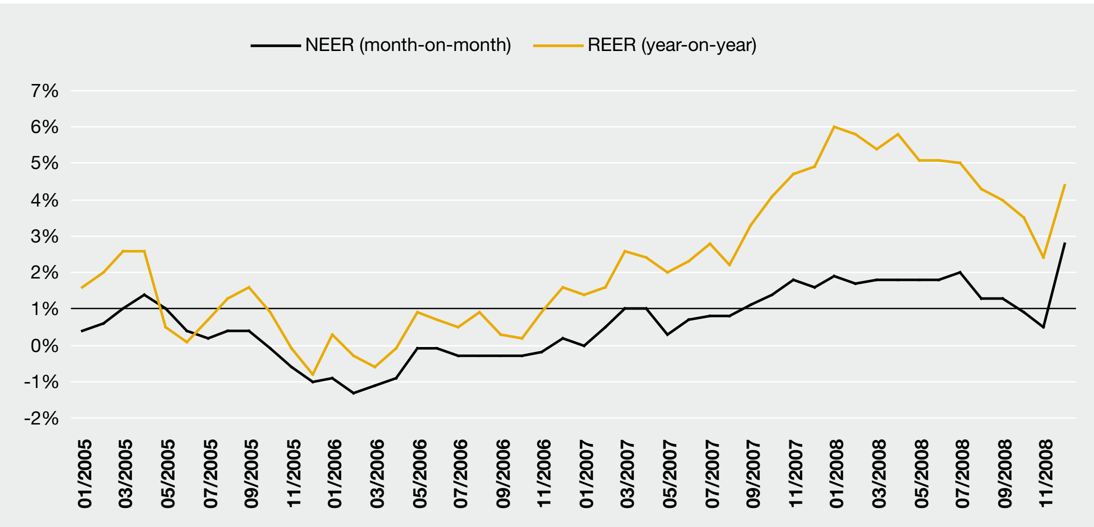

Figure 6. Changes in the real and nominal effective exchange rate of the Estonian kroon

General government

The state budget for 2008 was based on an assumption of relatively rapid growth. Therefore, the aim was to both increase expenditure and achieve a moderate budget surplus. However, economic contraction was faster than expected and the general government expenditure exceeded the revenue for the first time in six years.

As concerns the tax policy, the government continued efforts to reduce labour taxes and raise consumption taxes. At the beginning of the year, both the personal and corporate income tax rates were lowered to 21%. As the non-taxable income threshold was also raised at the same time, the actual personal income tax rate decreased by more than 1 percentage point. Yet, the general tax burden to GDP ratio remained more or less unchanged owing to the rise in consumption taxes. Tobacco and motor fuel excise duties were increased to the EU minimum level, an excise duty was imposed on electricity, and also the tax rates on alcohol were increased.

Already at the beginning of 2008 it became evident that the planned increase in expenditure was too fast given the slowing growth and revenue collection. In order to balance the revenue and expenditure, in July the government drafted a supplementary budget to curb the expenditure. The following economic decline was still stronger than expected and the budget cuts did not result in a consolidated budget balance. At the end of the year, the growth outlook deteriorated even more and ministries and other authorities made every effort to avoid the usual carry-over of certain expenditure to the next fiscal year. All in all, fiscal loosening turned out to be much more extensive than anticipated. According to preliminary estimates, the general government budget deficit constituted 2.8% of GDP in 2008.

Although most of the consolidated budget deficit was covered from reserves, the debt burden of local governments and the central government grew in 2008. In the latter case, the debt increased as a result of extensive construction activities carried out by a state-owned real estate public limited company. This public limited company operates in private law and finances its development with bank loans. Nevertheless, in comparison with other countries, Estonian general government debt is almost non-existent, constituting 4.3% of GDP at the end of 2008.

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.

In 2008, Moody's lowered Estonia's **sovereign rating** outlook from stable to negative. Standard & Poor's affirmed the negative outlook of the credit rating. Fitch lowered the rating by one notch from A to A- (A minus), and affirmed the negative outlook. Standard & Poor's and Moody's set the rating of long-term foreign currency liabilities at A and A1, respectively. Moody's rating on the likelihood of the repayment of Estonia's loans has remained unchanged since autumn 2002 and that of Standard & Poor's since 2004.

In connection with revising Estonia's sovereign rating, in 2008 Fitch lowered Estonia's AA-level **sovereign risk rating** – the sovereign risk establishes a ceiling for the rating of companies operating in the country. Moody's and Standard & Poor's did not change Estonia's sovereign risk rating and affirmed them at Aa1 and AA, respectively.

Sovereign ratings and their key determinants in 2008

In recent years, all the rating agencies have noted that Estonia's main strengths lie in the low general government debt and the reliability of our banking system. Estonia's conservative fiscal policy, which is very important for a currency board based monetary system, has always earned the confidence of rating agencies. The country's sovereign rating has been supported also by the perspective of joining the euro area.

The rating agencies that visited Estonia in 2008 stressed the importance of general government budget surpluses of previous years, the accumulation of reserves in good times and the low debt level. Equally important are the flexible and competitive economic system, strong (high-quality and foreign-owned) banking sector, open market economy and the fact that the large current account deficit stems from the capital inflow from parent banks, not low competitiveness. Moreover, the robust economic growth of recent years has Estonia's income convergence towards the European average.

According to the rating agencies, the main weaknesses in 2008 included great external imbalances; a decrease in direct investment and an increase in debt; the extensive and growing liabilities (mostly foreign liabilities) of the private sector; rapid inflation; tightening of the labour market and its impact on competitiveness; and weak external liquidity position. Estonian economy is affected by the global economic and financial crisis, as slow growth in the euro area has an unfavourable impact on Estonia's exports. The rating agencies also pointed out that euro area membership would considerably reduce the balance of payments risks and possible external shocks for Estonia.

Rating agencies' assessments also reflect the negative sentiment prevailing on global markets and the impact of the present liquidity crisis on Estonia's economy, which jeopardises our state budget in the coming years. The liquidity crisis deepens the recession and makes economic adjustment more difficult than expected.

Rating agencies' reports on Estonia are available on the web site of Eesti Pank.[3]

[3] http://www.eestipank.info/pub/en/majandus/majandus/rating/reiting1.html

FINANCIAL SECTOR

The global financial crisis that started in 2008 has also affected the structure of Estonia's financial sector. Global economic developments have most significantly affected the volume of investment funds and stock market capitalisation, which have decreased substantially over the last year (see Figures 7–9).

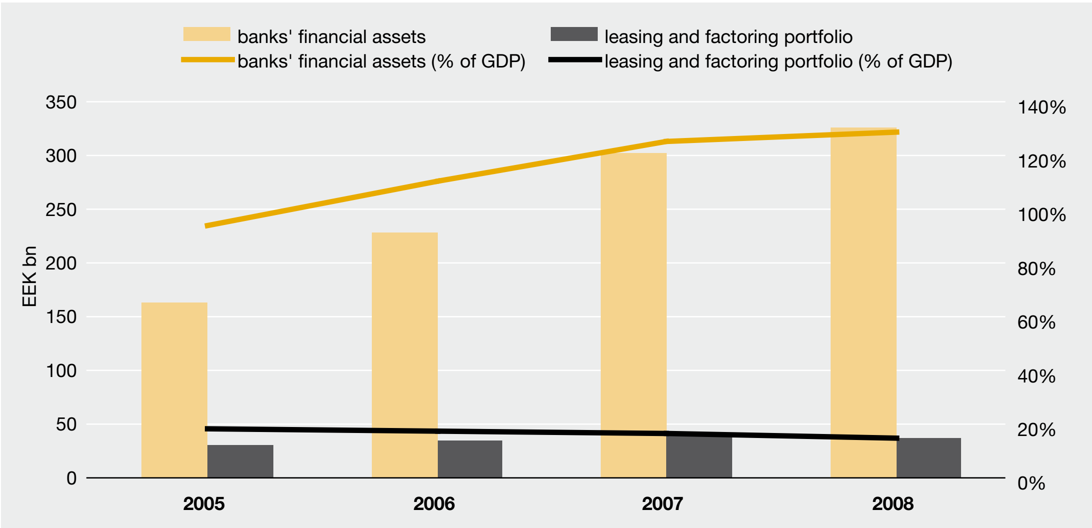

Figure 7. Banks' financial assets and leasing and factoring portfolio

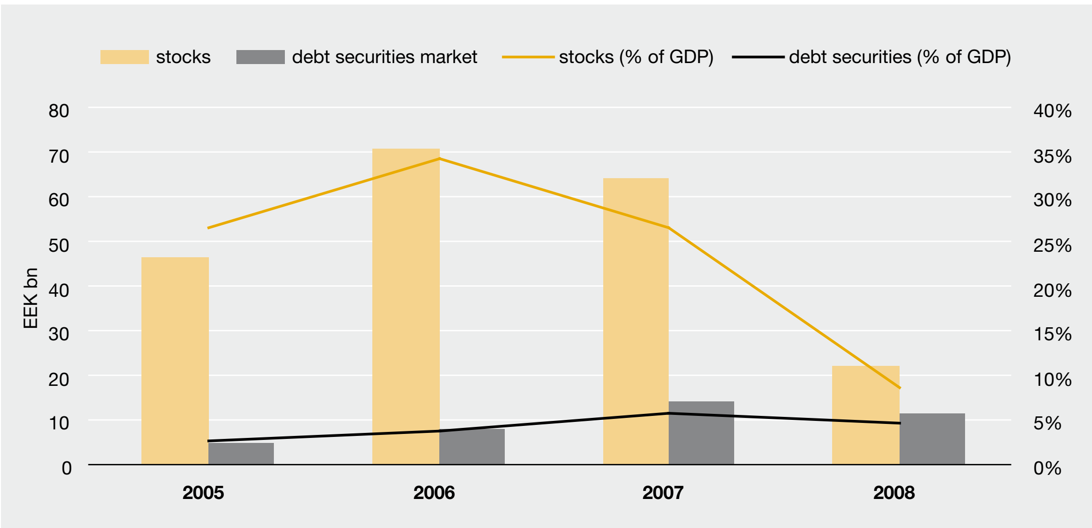

Figure 8. Stock market and debt securities market

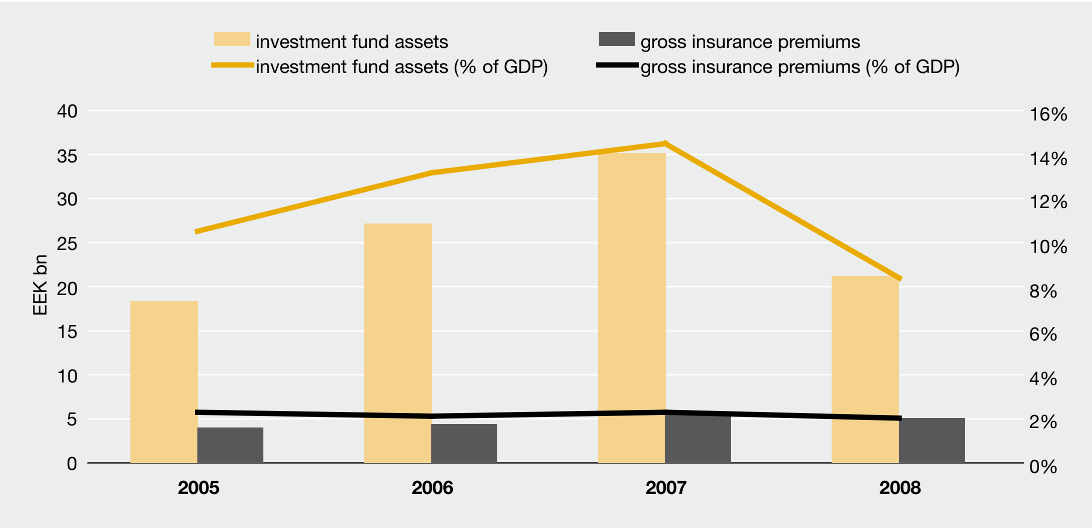

Figure 9. Investment fund assets and gross insurance premiums

Banking sector

Institutional developments

Six companies licensed as credit institutions, ten branches of foreign credit institutions and over 200 cross-border banking service providers were operating on the Estonian market at the end of 2008. As of 1 June 2008, the former Sampo Pank is operating as the Estonian branch of Danske Bank. Consequently, the branches of foreign credit institutions now hold more than 25% of the Estonian credit market.

Although growth in banks' financing portfolio slowed considerably in 2008, the market shares of banks operating in Estonia have not changed much. The four major market participants still hold 95% of Estonia's credit market.

Assets and liabilities of banks

Compared to previous years, the increase in banks' assets was modest in 2008: only 6.5% (33% in 2007). At the end of the year, banks' total assets reached 342 billion kroons. The total value of the financing portfolios of banks and leasing companies exceeded 282 billion kroons at the end of 2008, having increased by 22 billion kroons over the year. This is about three times less compared to loans and leases granted in 2007. In December, the repayments of loans exceeded the volume of new loans issued, which resulted in a decrease in banks' loan and leasing portfolio. The decrease was mainly driven by a drop in credit demand that accompanied the adjustment of the economy and the more conservative credit policies of banks. Credit demand has not increased even after the considerable decline of key interest rates in the second half of 2008. The loan and leasing portfolio is expected to decrease at least until 2010.

The stock of household housing loans and leasing increased 10%, which constitutes only a third of the previous year's figure. The aggregate portfolio of housing loans was 95billion kroons at the end of 2008. Annual growth in consumer loans was modest as well, falling back from 43% in 2007 to 13% in 2008. The volume of both the car leases and housing loans started to diminish in December 2008 (see Figure 10).

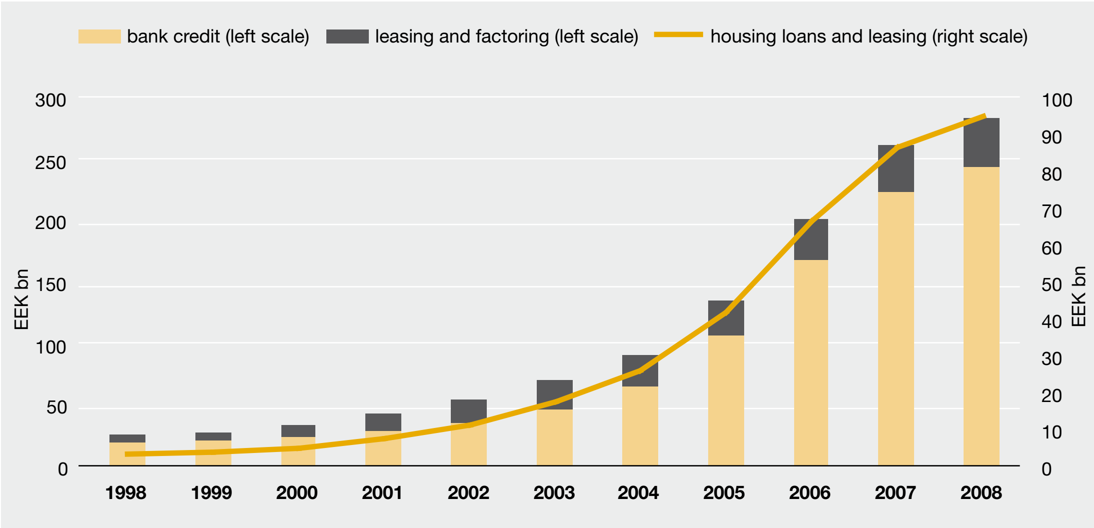

Figure 10. Public and non-financial sector financing

The portfolio of corporate bank loans and leasing increased by 10 billion kroons (7%) in 2008 and totalled 158 billion kroons at the end of the year. Portfolio growth decelerated across all sectors, referring to the fact that investment needs have declined everywhere. Besides demand-driven factors, credit growth has slowed also because of banks' more conservative lending policies that have significantly changed the definition of a project worth financing.

The difficult market situation has reduced the loyalty of customers to credit institutions. The switching of banks was probably influenced by customers' risk estimates for the whole group (incl. the parent bank), but also by the different deposit guarantee rates of banks that results from belonging to different deposit insurance schemes[4], and the offered risk premium (interest rate).

Household deposits grew by 5.5 billion kroons over the year. At the same time, corporate deposits diminished by almost 2 billion kroons. All in all, household deposits totalled 54 billion and corporate deposits 52 billion kroons in 2008. The rise in interest rates over the year increased the proportion of time and savings deposits to 60% and 41%, respectively, of total household and corporate deposits by the end of the year. Although credit growth slowed in 2008, deposits did not suffice to satisfy the demand for credit. Institutional foreign borrowing[5] increased by 21 billion kroons in 2008, and thus external funds accounted for 48% of banks' total resources.

Profitability

Over the last year, the profitability of banks has been curbed by loan write-downs, unfavourable developments in financial markets and slowing credit growth (see also Figure 11). On the other hand, cut-down on expenses, sale of assets, one-off incomes from the reduction of the reserves accumulated earlier, and the decrease of contributions to the Guarantee Fund have all contributed to profitability[6]. The net profit of banks

[4] Since the banking groups operating in Estonia belong to different deposit guarantee schemes in different countries, the upper limits of guaranteed deposits vary.
[5] Deposits and loans, issued securities and subordinated liabilities from other banks.
[6] While the credit institutions under the Estonian deposit guarantee scheme were so far required to pay annual contributions in the amount of 0.5% of the stock of guaranteed deposits, starting from the third quarter of 2008 the rate is 0.0032%.

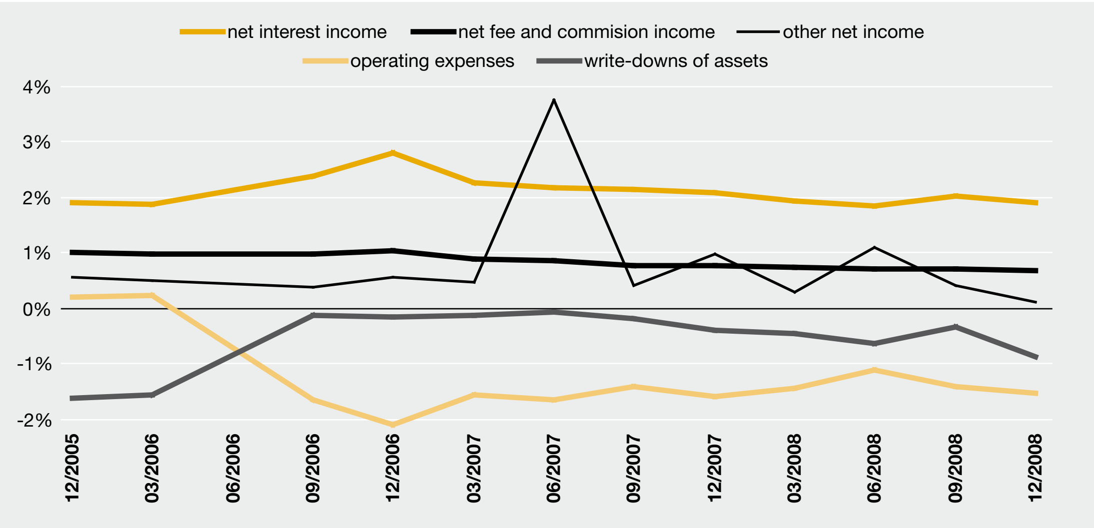

Figure 11. Income and expense items (% of total asstes)

in 2008 was 4 billion kroons, which is about half less than in 2007.

Loan write-downs grew by 1.9 billion kroons in 2008. Provisions constituted 1.5% of the banks' loan portfolio at the end of 2008. Although write-downs may increase, given the general economic outlook and banks' positions, the high rate of provisions already made in relation to overdue loans gives reason to believe that the established buffers will reduce the impact of possible future loan losses. Banks have had to bear losses also on financial assets and liabilities held for trading owing to adverse capital market developments. The slowdown in credit growth has brought about a decrease in fee and commission income. The average return on assets was 1.2% in 2008 (2.4% in 2007). The high return on equity of the banking sector fell to 13.6% by the end of 2008.

Capital adequacy and risks

On 1 January 2008, the more risk-sensitive capital adequacy framework (Basel II) became mandatory for all credit institutions operating in Estonia. The quantitative impact studies conducted beforehand showed that capital requirements might decrease considerably. Although Estonia has established a 60% risk weighting on housing loans instead of the customary 35%, the capital requirements decreased about 9% as a result of the new procedure. The more risk-sensitive calculating methods and the slowdown in credit growth reduced banks' risk assets approximately 16% in 2008. As the own funds necessary for covering the risks have remained at the same level, the aggregate capital adequacy ratio rose to 18.8% by the end of the year (see Figure 12).

Loan repayment ability and risks

The deterioration of the economic environment in 2008 quite expectedly brought about more problems with loan repayments. By the end of 2008, the share of loans overdue for more than 60 days in the loan portfolio had increased from 0.7% to 2.9%, year-on-year. Commercial real estate and construction sectors had the most overdue loans both in proportion and amount. The volume of overdue loans in the construction sector grew from 1.2% to 5% and that of the commercial real estate sector from 0.5% to 5.3%, year-on-year. In total, the overdue loans of the business sector formed 3.3% of the credit portfolio.

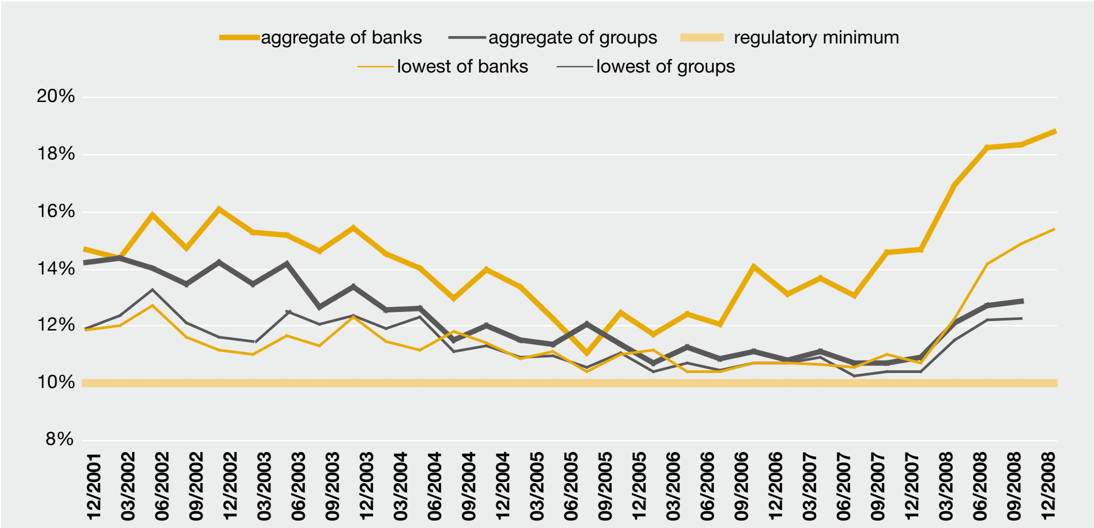

Figure 12. Capital adequacy of banks and banking groups

Household overdue loans also increased in 2008. Traditionally, consumer credit include the most loans overdue for more than 60 days with their share growing from 3.2% to 5.8%, year-on-year. The quality of housing loans, on the other hand, is better compared to other loan segments: loans overdue for more than 60 days accounted for 1.9% of the housing loan portfolio at the end of 2008.

Securities market

Bond market

The primary bond market was more subdued in 2008 compared to the previous year. The total volume of bonds issued during the year formed only 58% of that of 2007 (see Figure 13).

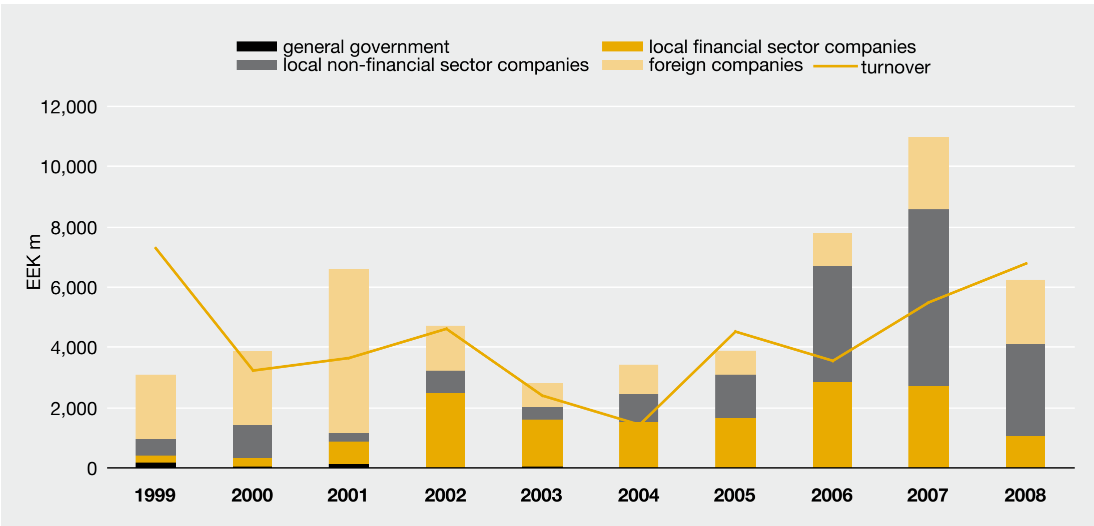

Figure 13. Amount of debt securities by issuers and secondary market turnover

Bond issues decreased in all fields of activity; non-financial sector companies and non-residents made the biggest contribution to the primary market turnover.

Although the share of kroon issues dropped to only 1% by the end of the year, they still comprised 34% of total bond issues in 2008. Total bond market capitalisation fell approximately 22% to 11.6 billion kroons over the year.

The secondary bond market, however, was very active. The average daily turnover grew by 6 million kroons compared to the previous year and reached 28 million kroons.

The structure of bond investors has remained unchanged over the past years. Resident investors account for about 67% of total bond capitalisation.

Stock market

The most important strategic event in the Estonian stock market in 2008 was the merger of the Baltic and Nordic stock exchange group OMX AB, the majority shareholder of the Tallinn Stock Exchange, with NASDAQ Stock Market, Inc., a company operating mainly in the US stock exchange. The outcome of the merger is NASDAQ OMX Group – currently the world's largest exchange company.

The decline on the Tallinn Stock Exchange that had started already in the summer of 2007 continued in 2008 (see Figure 14 and Table 3). The Tallinn Stock Exchange index OMXT reached its lowest level (260 points) in mid-December. The index was this low five years ago. Year-on-year, the index went down 53%, and 72% compared to the record high of 2007. The average daily turnover of the stock market was 39 million kroons in 2008 (94 million in 2007) owing to the uncertainty on financial markets and the price drop on the stock exchange.

The primary list of the Tallinn Stock Exchange included 18 companies at the end of 2008. In September, Saku Õlletehas left the stock exchange. In addition, Merko Ehitus was split into AS Järvevana and AS Merko Ehitus.

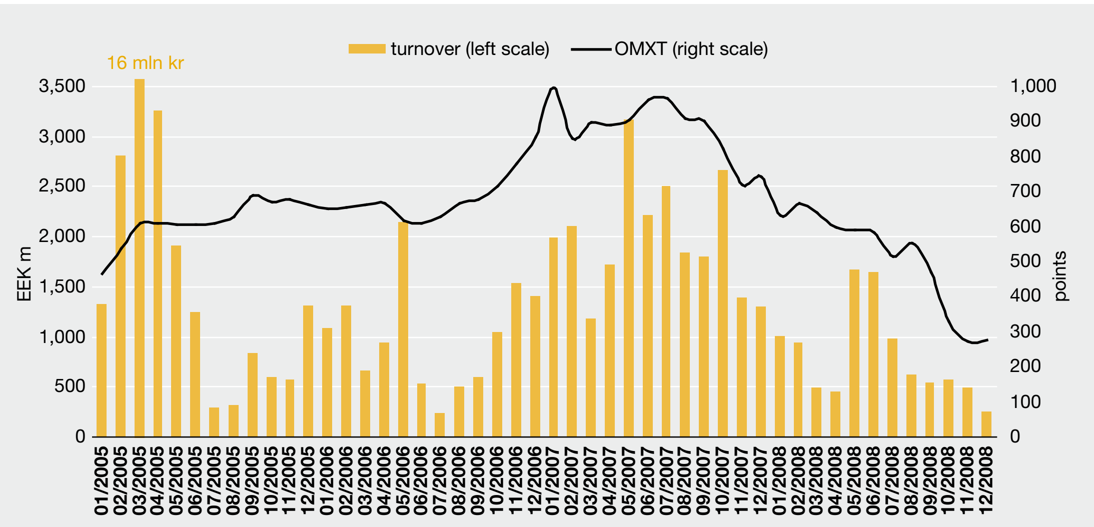

Figure 14. Monthly turnovers of the Tallinn Stock Exchange and index OMXT as at month-end

Table 3. Aggregate indicators of the securities market (EEK bn)

	2003	2004	2005	2006	2007	2008
Securities market capitalistaion*	**53.5**	**80.0**	**60.1**	**89.7**	**90.3**	**38.5**
Instruments						
shares listed on stock exchange	47.3	71.9	46.9	71.0	64.0	21.9
debt securities	2.9	3.1	4.8	8.5	15.0	11.7
shares and units of investment funds	2.6	4.5	8.4	10.2	11.1	4.8
subscription rights	0.7	0.5	0.0	0.0	0.0	0.0
Securities market turnover*	**14.9**	**13.9**	**68.4**	**37.4**	**74.0**	**37.2**
Capitalisation of Tallinn Stock Exchange	47.3	72.4	46.9	72.3	64.8	21.9
non-resident investors	81%	83%	58%	49%	55%	52%
Turnover of Tallinn Stock Exchange	7.6	10.3	30.3	12.0	24.0	9.7
Securities market capitalisation* / GDP	42%	58%	46%	43%	37%	15%
Securities market turnover / capitalisation	28%	17%	90%	59%	76%	59%
Stock exchange turnover / capitalisation	16%	14%	47%	24%	33%	23%

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

Other financial intermediaries

Investment and pension funds

Investment fund assets lost about a third of their value in 2008 and stood at 21.3 billion kroons at the end of the year (see Figure 15). The assets of equity and interest funds decreased the most: by 14.5 and 1.4 billion kroons, respectively. The primary reason for the decrease was the case of SEB Liquidity Fund, which made a 13% write-down on its units. The assets of mandatory pension funds increased by 419 million kroons over the year, constituting only up to 20% of the growth rates of the three previous years.

Nine new pension funds (four second pillar funds and five third pillar funds), three equity funds, one interest fund, four real estate funds and three risk capital funds entered the market in 2008.

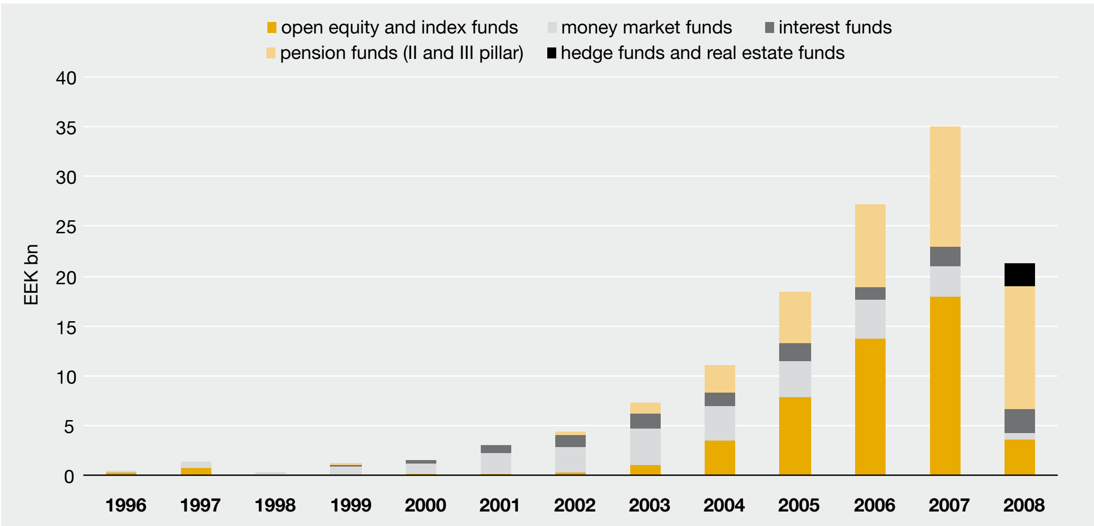

Figure 15. Total volume of investment funds as at year-end

Insurance

Households' cautious investment decisions and the growing uncertainty about the future has largely affected the development of the **life insurance market**. The volume of insurance premiums, which had been growing for seven years in a row, decreased 33% in 2008. Life insurance companies collected 1.3 billion kroons in premiums, with unit-linked life insurance and capital insurance accounting for most of it (83%). The recent profitability of the life insurance sector was replaced by a 297 million kroon loss (unaudited) in 2008.

Meanwhile, the profitability of the non-life insurance market increased 27% (539million kroons) from 2007, even though the annual growth of insurance premiums was much more modest compared to 2007 because of low domestic consumption. Premiums collected by Estonian non-life insurance companies grew only 3% in 2008, totalling 3.8 billion kroons at the end of the year. Including the branches of foreign insurance companies, gross insurance premiums totalled 4.2 billion kroons.

Payment instruments

The use of different payment instruments has increased every year, both in terms of the number and the turnover of transactions (13% and 15%, respectively, in 2008). The most popular payment instrument is still card payments that constitute 57% of all transactions. Even though card payments comprise the majority of transactions, their share in the total turnover of payments is marginal (1%).

Internet and telebank credit orders are also widely used. The use of direct debits and standing orders has grown too. In the case of standing orders, both the transactions and the turnover increased more than 100% year-on-year. Yet the share of direct debits and standing orders in total non-cash payments is still very low. Paper-based credit orders have been losing popularity over the years and also the share of cash payments has decreased (see Figure 16).

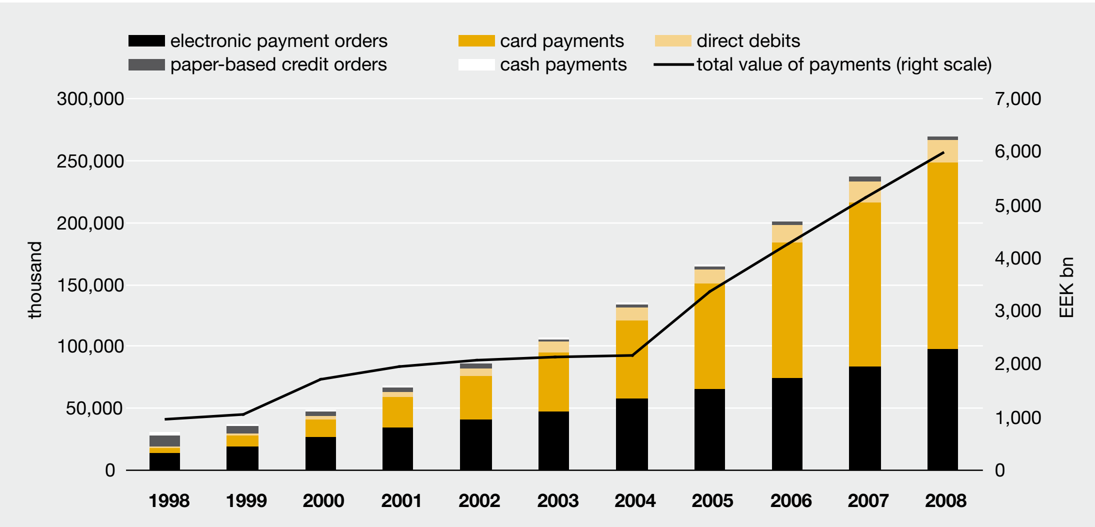

Figure 16. Number and turnover of payments by payment instruments

The number of payment cards in use grew slower (4.5%) in 2008, compared to previous years. At the end of the year, there were 1.84 million payment cards in use in Estonia, 70% of which are used actively. Passive cards mainly include credit cards, which are used less often. Their proportion did not change from 2007, forming 24% of all payment cards issued. By the end of 2008, one debit card had been issued per resident. Over the year, both the number of points of sale (POS) accepting payment cards and that of automatic teller machines (ATM) grew, standing currently at 16,194 and 1,018, respectively. About 86% of the ATMs provide for cross-usage between banks. The number of ATMs grows mainly owing to the increase in cash dispensing machines. The number of self-service payment terminals and POS accepting mobile payments has decreased notably over the year, standing currently at 76 and 345, respectively.