RELATIONS BETWEEN THE BALANCE OF PAYMENTS, INVESTMENT POSITION AND EXTERNAL DEBT

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Estonia's economic growth is often associated with the inflow of loan money from foreign countries; that is, with the activities of local banks' parent banks. Figuratively speaking, the funds received from abroad in the form of debt liabilities become the debt claims of local banks on Estonian households. In other words, the use of loan money for house purchase manifests in the gross domestic product (GDP) in investments and in the form of imputed rental value in private consumption expenditure.

Figure 1 shows that compared to year 2000, the ratio of gross external debt to GDP has increased from 53% to 96%. The gross external debt of credit institutions alone had grown by 83 billion kroons by 2006 compared to 2000, whereas the GDP in current prices grew by 112 billion kroons.

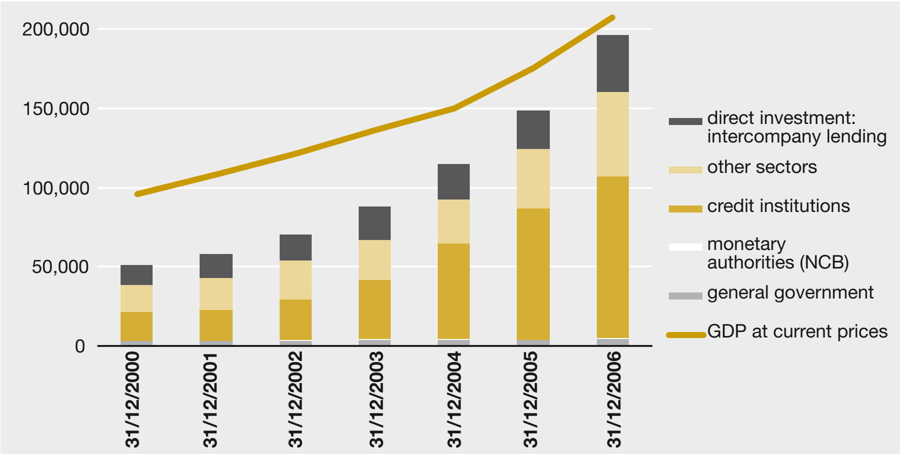

Figure 1. Gross external debt and GDP (EEK m)

The inflow of cheap loan money has enabled banks to easily grant credit to customers and the demand for housing has activated the local real estate and construction market. In the light of all this, a question arises as to which source can give a quick overview of the movement of foreign capital to Estonia and what kind of relations are provided for that purpose by the financial account of the balance of payments, investment position and external debt.

While the balance of payments reflects economic transactions with the rest of the world in a certain period, the investment position indicates financial assets and liabilities at a certain date. In the balance of payments, the sources of external financing are shown structurally not only in the capital and reserve assets accounts but also in the financial account. The latter is divided into four categories: direct investment, portfolio investment, financial derivatives and other investment. These four categories together with reserve assets form the investment position at a certain date. In addition, the debt instruments reflected in the investment position are the basis for compiling external debt statistics. Figure 2 presents the relations between the investment position and external debt.

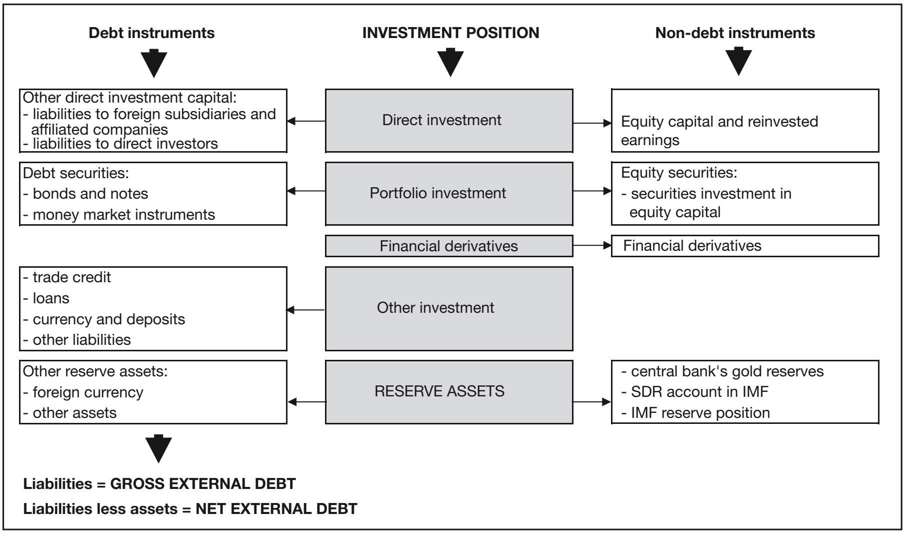

Figure 2. Relationships between the investment position and external debt

The figure reveals that not all foreign investment sources are a part of the external debt – provided that they are not subject to repayment. These instruments include:

- shares;
- financial derivatives;
- central bank's gold reserves, reserve position and SDR account in the IMF.

External debt liabilities are totalled to gross external debt. After subtracting assets from debt liabilities, we see how much of the external debt capital is held by Estonian residents. This includes the debt liabilities of the general government, the central bank, credit institutions and other sectors, and in the case of direct investment also intra-group lending. Taking a closer look at the items of the investment position, we see, inter alia, that other investment includes short-term and long-term lending between residents and non-residents. However, loans are not reflected in this item only; for example, the assets and liabilities related to lending between direct investors and companies are reflected in the direct investment account.

The share of debt assets in total external assets decreased from 96% in 2000 to 78% in 2006 due to the increased direct investment made by other sectors abroad and portfolio investment in equity securities. The share of debt liabilities in total external liabilities began to change in 2004. By the end of 2006, it had increased from 50% to 59%, mainly due to the growth in the loan liabilities of credit institutions. Because of the bigger share in loan liabilities, the net external debt of credit institutions together with intra-group debts was in 2006 altogether 75 billion kroons, whereas the net external debt of all sectors amounted to 55 billion kroons.

A large share of credit institutions' debt liabilities is comprised of long-term loans as well as currency and short-term deposits (see Figure 3). Compared to 2000, these amounts had increased by 2006 by 27 and 41 billion kroons respectively. In 2000, liabilities to parent banks in the form of other investment together with intra-group debts formed 5%, whereas at the end of 2006 they accounted for as much as 34% of the gross external debt. In the case of subsidiaries, the inflow of money has not occurred in the form of loans but deposits. This raises the question of how clearly loans and deposits can really be distinguished.

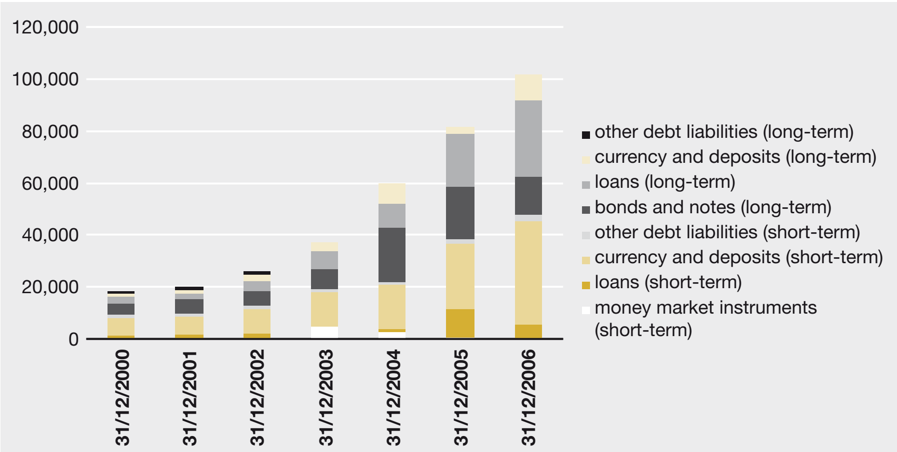

Figure 3. Debt liabilities of credit institutions (EEK m)

But what happened at the same time to debt claims? Compared to 2000, credit institutions had increased their debt claims to non-residents by 22 billion kroons by 2006. As Figure 4 demonstrates, claims in the form of deposits decreased by 10 billion kroons, compared to 2005. The underlying cause was the reorganisation of intra-group financing schemes that reduced the financing of subsidiaries through the Estonian banking sector. Including the rest of the loans, those granted by a bank to other intra-group financial institutions, the resources that were granted to non-resident subsidiaries and later redirected reached 20 billion kroons. Although this weakened the balance sheet link between those subsidiaries and the local banking sector, the continuous growth in debt liabilities indicates a stronger relation between the local banks and parent banks.

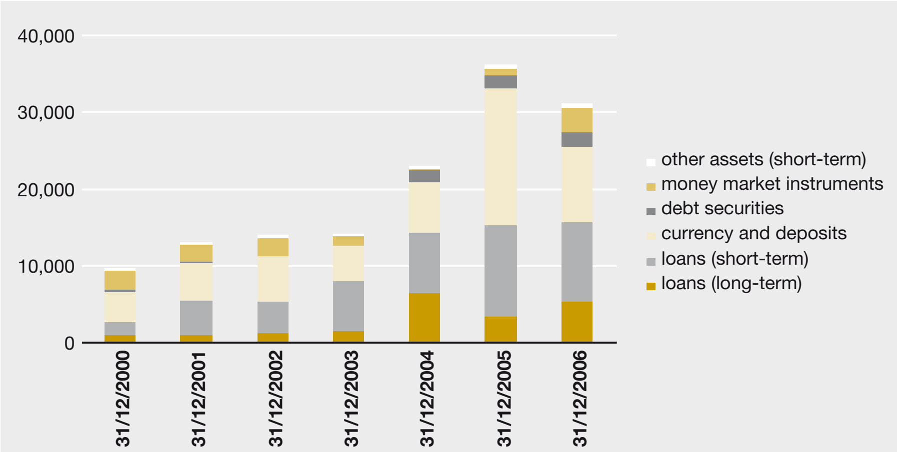

Figure 4. Debt assets of credit institutions (EEK m)

Altogether, the net external debt (i.e. debt liabilities less debt claims) of credit institutions increased by 24 billion kroons in 2006 (see Figure 5). This means that the transfer of funds from Estonian company's balance sheet to the balance sheet of a company located in another country did not decrease Estonia's external debt at all.

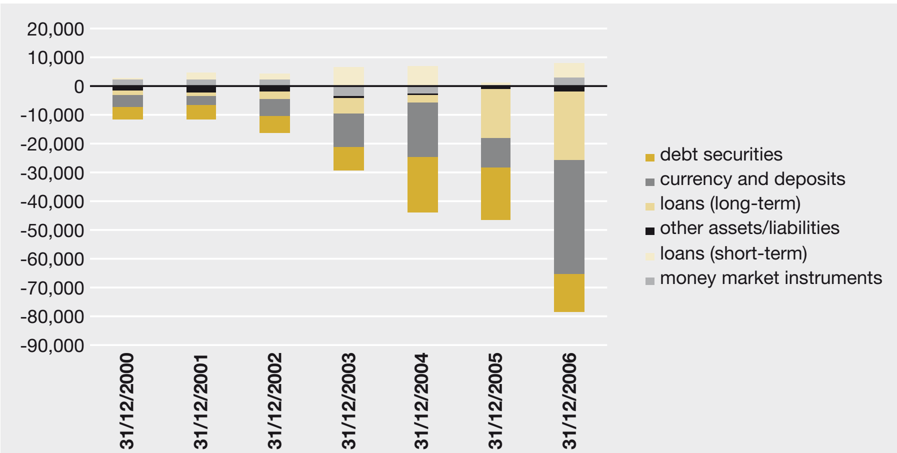

Figure 5. Net external debt of credit institutions (EEK m)

CONCLUSION

During the credit boom it was often argued whether the excessive dependence of economic growth on credit growth should be diminished by limiting foreign capital inflow through raising the reserve requirement ratio of commercial banks. Eesti Pank has raised the reserve requirement ratio from 10% in 1996 to 13% in 2003 and to 15% in 2007. Yet, this has not decreased the amount of money lent by commercial banks, since the foreign ownership of the majority of credit institutions provides easy access to parent banks' funds. Neither has foreign asset based lending been limited by the fact that in Estonia the reserve requirement base consists of, in addition to deposits and issued bonds, debt liabilities to foreign credit institutions (net debt since 1997; gross debt since 2003). After joining the euro area, the liabilities between the euro area credit institutions are no longer included in the reserve requirement base. Thus, the purpose of the higher reserve requirement ratio is rather to hedge liquidity risks, not to limit the credit supply.