SUMMARY

MACROECONOMIC AND EXTERNAL ENVIRONMENT

The global economic growth remained fast in 2005 and the first months of 2006. Price pressures induced by the rapid oil price increase created preconditions for implementing a **stricter interest rate policy in the euro area**. Euro area money market interest rates, which had remained low since 2003, increased by 70–90 basis points by spring 2006. International financial markets expect the moderate interest rate rise to continue in the following months.

Estonia's economic growth also gained momentum due to the strong external demand and favourable international liquidity environment. Real GDP growth stood at 9.8% in 2005, exceeding the 10% level at the beginning of 2006. Such high growth indicators probably imply that the current economic cycle has reached its peak, i.e. the maximum growth rate, and real growth is expected to remain in the average range of 7–8% in the next few years.

Higher external demand and continuously strong domestic demand boosted significantly the turnover and profitability of Estonian companies in 2005. Real estate and construction companies achieved above average results, and turnover grew very fast also in trade. Household confidence reached its highest level of recent years at the end of 2005. This was supported by further positive developments in the labour market and the rapid increase in income along with increased savings.

CORPORATE FINANCIAL BEHAVIOUR AND RELATED RISKS

In the last quarter of 2005, also corporate financial assets increased owing to the acceleration of **deposit** growth. Although in comparison with other European countries the financial assets of Estonian companies remain at a moderate level in ratio to GDP, in recent years Estonia's net financial position has nevertheless deteriorated significantly due to the rapid loan growth.

The **corporate debt growth** started to pick up in 2005 and reached 26% towards the end of the year. This mainly stemmed from the exceptionally strong investment demand in the real estate sector, which obtained 43% of the total corporate loans granted in 2005. In addition to the real estate sector, also companies from other economic sectors engaged in profitable real estate development, although the majority of real estate investment was still probably related to the expansion of companies' primary activities.

FINANCIAL BEHAVIOUR OF HOUSEHOLDS AND RELATED RISKS

The net financial position deteriorated to 17% of GDP in 2005 due to the rapid household debt growth. Meanwhile financial assets, particularly deposits, increased considerably. At the end of 2004, the net financial assets of Estonian households were the smallest compared to other European countries, and similarly to the corporate sector, the net financial position of households in ratio to GDP deteriorated the most significantly in Estonia.

Household **debt growth rate** has been reaching a new record level every month since the middle of 2005. In March 2006, loan growth exceeded already 62%. The housing loan market has been very active with the growth rate reaching 65%. The housing loan growth was mostly affected by the hike in real estate prices, whereas the number of new loans did not grow as fast any longer, partly for seasonal reasons.

Demand far exceeded supply on the **housing loan market**, bringing about a tremendous boost in prices and transaction volumes in the second half of 2005. In view of the growing expectations on achieving another price peak, the scarce supply diminished even further, in turn putting additional pressure on prices. Thus, in the second half of 2005, the average value of notarial transactions with houses and apartments increased 41%, year-on-year (24% in the first half of 2005). However, the beginning of 2006 showed some signs of stabilisation.

Besides housing loans, other loans have also undergone robust growth. Although the high growth rate of consumer credit (125%) can largely be explained by the low base level, it still clearly reflects the fast development of this market segment. The fact that **consumer credit** is often collateralised by mortgage refers to the increased use of the housing equity withdrawal.

The indebtedness growth was even more notable than high loan growth rates. The ratio of household debt to disposable income and GDP increased by 15 and 9.5 percentage points, respectively, by the end of March 2006. At such pace, Estonia's financial deepening was one of the fastest in Europe.

BANKING MARKET

Tight competition on the banking market continued and also several newcomers entered the market. The **quality of banks' loan portfolios** has remained good during the past two quarters in case of banks as well as banking groups. For future development it is essential banks remained conservative in granting loans. Conservative risk management calls for banks to consider the further acceleration of the recent real estate price growth when assessing collaterals for granting mortgage loans.

Although risk assets grew fast, partly owing to the regulation amendment concerning the risk weights on housing loans, **banks' capitalisation** increased because banks included profits in own funds and included additional subordinated liabilities from parent banks. So far, the regulation amendment has not slowed the growth of loan portfolios.

Rapidly growing customer deposits played an important role in **funding** the banking sector. Therefore, the share of institutional foreign borrowing in total liabilities did not increase remarkably despite active borrowing, remaining at the level of 42.5%. The share of funding from parent banks located in Nordic countries increased even further in the banking sector's funding structure. Due to the better availability of parent bank funds, the level of **liquid assets** declined. Therefore, the banking sector became more dependent on parent banks in terms of funding as well as liquidity.

In the upward phase of the interest rate cycle, the banks that have a large share of loans with floating interest rates and demand deposits are in a favourable position because the increase in key interest rates boosts interest income over expenses. Although the **profit margin** has increased slightly on solo basis due to the rapid growth of net interest income and net fee and commission income, the return on equity nevertheless decreased by 1 percentage point to 21.3% compared to September 2005.

SECURITIES MARKET AND OTHER FINANCIAL INTERMEDIARIES

The domestic **bond market** picked up due to the expansive environment. The growth of primary market and capitalisation grew in volume largely thanks to the increase in the volume of issues by residents, especially non-financial sector[1] companies. The secondary market expanded owing to a remarkable increase in the turnover of local non-financial sector companies' and non-residents' bonds.

The most significant event of the past half-year on the **Tallinn Stock Exchange** was listing the shares of AS Tallink Grupp in the primary list of the stock exchange. The growth of the stock index OMXT, which had reached its peak due to the takeover of Hansapank and the addition of new companies to the stock market in October 2005, slowed down by spring to 9% – a level similar to the economic growth rate.

The growth in **investment fund** assets that has been lasting for several years decelerated because of the high comparison basis. The majority of

[1] Here and below the non-financial sector refers to households and non-financial corporations.

growth could be attributed to stock fund assets, which doubled in volume. Moreover, investment fund assets were boosted by the addition of eight new funds to the list of funds registered in Estonia. The most popular investment region for the new funds is Central and Eastern Europe.

The volume of second pillar **pension funds** increased to 5.3 billion kroons by the end of March 2006. Also the volume of voluntary pension insurance has risen drastically. The further increase in second pillar funds is primarily affected by wage growth, whereas the third pillar volume growth depends on the addition of new subscribers.

The **non-life insurance market** has been developing quite steadily in recent years, being mainly influenced by loan growth and overall favourable economic environment. The **life insurance market** has increased more dynamically, growing 62% year-on-year. The main contributors to the growth were unit-linked life insurance products, which had increased 141% as at March 2006, compared to a year ago.

CONCLUSION AND FINANCIAL STABILITY RISKS

Similarly to autumn 2005, financial stability can be considered good, since the non-financial as well as the financial sector have secured positive income flows and accumulated wealth under favourable economic conditions. The good quality of banks' loan portfolios testifies to the fact that so far households and companies have not experienced major difficulties in fulfilling their financial obligations.

Nevertheless, the danger persists that in making their decisions driven by positive expectations, companies, households and the financial sector may have overestimated the future loan servicing ability of borrowers and underestimated the risks accompanying the potential deceleration of economic growth. The extremely rapid debt growth has made the borrowing households and companies considerably more vulnerable to risks that might materialise in case of unfavourable economic developments.

The indebtedness of Estonian companies and households is one of the fastest growing among European countries. Modest saving compared to other countries has diminished the financial buffer even more. In addition to the strong housing loan demand, households' optimism for the future is also reflected in the considerably increased volume of consumer credit.

So far, the rise in interest rates has failed to reduce such highly optimistic expectations or change financial behaviour significantly. It is also too early to assess the impact of measures taken by Eesti Pank and entered into force in March 2006. However, the loan environment and housing market have shown initial signs that expectations and attitudes may start changing in the future. Whether these signs can be interpreted as the replacement of optimistic expectations with more realistic ones and less risky financial behaviour should become clearer in the following months.

In the near future, the housing loan demand of households will be affected by real estate price developments. The high price level achieved in some market segments at the end of last year may start to restrict the market potential because of insufficient purchasing power as well as increasing risk awareness among households. The net wage growth stemming from wage pressures and tax amendments partly helps households to offset the negative affects of rising interest rates. Meanwhile, the growth in production input prices and loan interest rates increase corporate costs, potentially damaging competitiveness and endangering the macroeconomic and financial stability of the entire economy.