III SECURITIES AND MONEY MARKET

International financial markets

Major **stock markets** experienced a strong upward trend at end-2006 and the beginning of 2007 (see Figure 1). The rapid acceleration in the growth of stock prices was conditioned by the relatively high economic activity, which also brought along an increase in corporate profits. The euro area stock market index (Stoxx 500) and the US S&P 500 grew by 10–15% within six months. Swedish and Finnish indices witnessed even faster growth, rising by an average of 20%. However, the general upward trend also had some setbacks. The decline in the Chinese stock market that lasted from the end of February to the beginning of March spread to other leading markets and caused a sudden sales pressure in the stock markets as well as other high-risk assets markets. Nevertheless, as the macroeconomic environment remained favourable, the stock markets recovered rather quickly and in several cases even reached all-time record levels.

The last quarter of 2006 in the **Central and Eastern European stock markets** was also characterised by a strong upward trend, followed by one or more corrections at the beginning of 2007, depending on the region (see Figure 2). The growth and subsequent downfall were the highest in Russia and Estonia, where the year-on-year growth reached nearly 100% in the fourth quarter of 2006. By the end of May 2007, the greatest year-on-year growth of about 50% was achieved by the Polish and Estonian stock markets. The growth of the Russian, Romanian and Bulgarian markets was similar to that of the euro area markets.

Developments in **bond markets** were brought about by the relatively high economic activity in advanced economies. The only exception proved to be the US, where the year-on-year GDP growth dropped to 2.1% by the end of the first quarter of 2007 and the real estate market continued to cool down. Thus, the US central bank kept the key interest rate unchanged while fast growing regions kept raising it. The European Central Bank raised the key interest rate twice to 3.75%. Also the United Kingdom and Sweden raised their key interest rates twice: to 5.5% and 3.25%, respectively. As a result, the three-month LIBOR in Sweden and the euro area grew by 60–70 basis points and the long-term (10-year) interest rates reached the level of 40–50% (see Figure 3). In the US, market interest rates remained virtually unchanged.

Foreign exchange markets witnessed a depreciation of the US dollar against other major currencies, except for the yen. During the last six months, the exchange rate of the euro appreciated against the dollar by 7%, reaching the all-time peak in intraday trading, i.e. 1.3680 (see Figure 4). The depreciation of the dollar was primarily caused by the weak US economic growth and the resulting decrease in the interest rate spread with other countries. Meanwhile, the Japanese yen depreciated against the dollar by 2%, which was mainly caused by Japan's continuously low key interest rate level. The exchange rate of the Swedish krona against the euro ranged within 9.0–9.4.

Similarly to stock markets also the **commodity markets** experienced a rather dynamic upward trend, which mainly relied on the demand growth resulting from global economic activity. The CRB index reflecting the prices of 22 major commodities rose by nearly 20% within the half-year. In line with that, the price of gold also grew by 12%, up to 670 dollars per ounce. The price developments of crude oil, on the other hand, remained volatile. From the end of September until January the price dropped partly for seasonal reasons, at times even falling to 50 dollars per barrel. Later on, the oil price started to increase again and reached the range of 60–65 dollars.

Money market

Despite the restrictive monetary policy of the European Central Bank (ECB), the Estonian monetary sector still enjoys high liquidity. During the past six months, the ECB additionally raised the euro area's monetary policy interest rate from 3.25% in

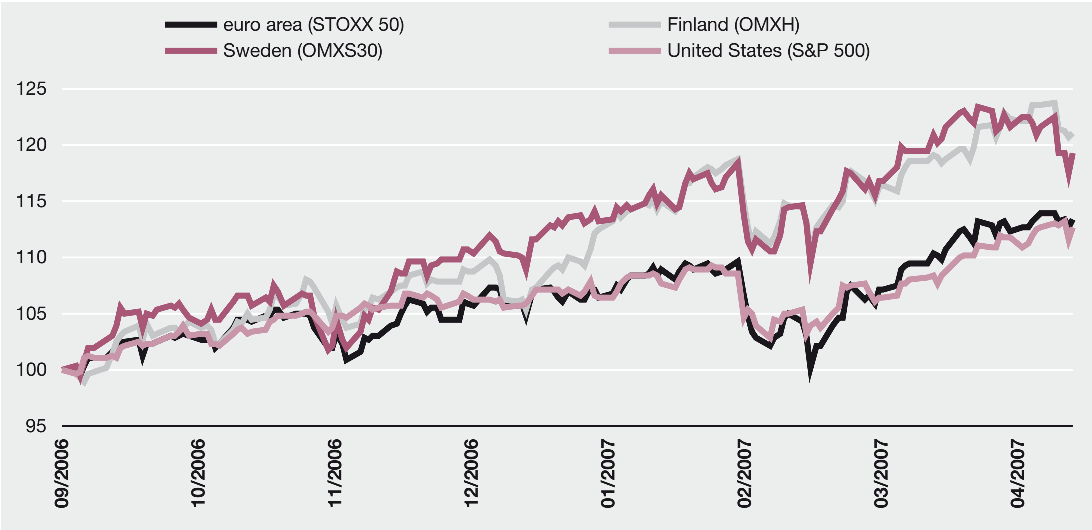

Figure 1. Stock indices in the United States, the euro area, Sweden and Finland (points; 29 September 2007 = 100)

Source: EcoWin

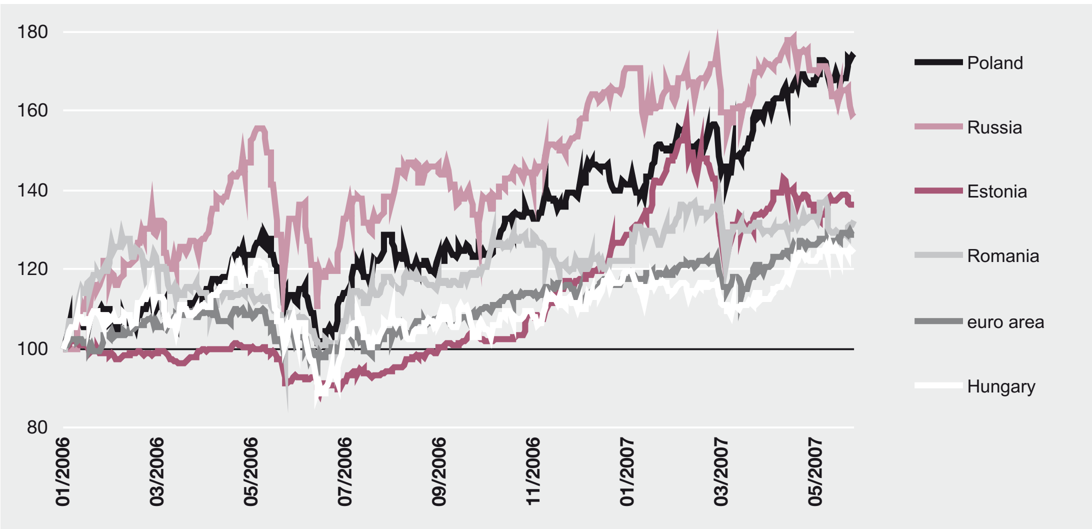

Figure 2. Dynamics of stock exchange indices of the new EU Member States, the euro area and Russia (points; 01/01/2006 = 100)

Source: EcoWin AB

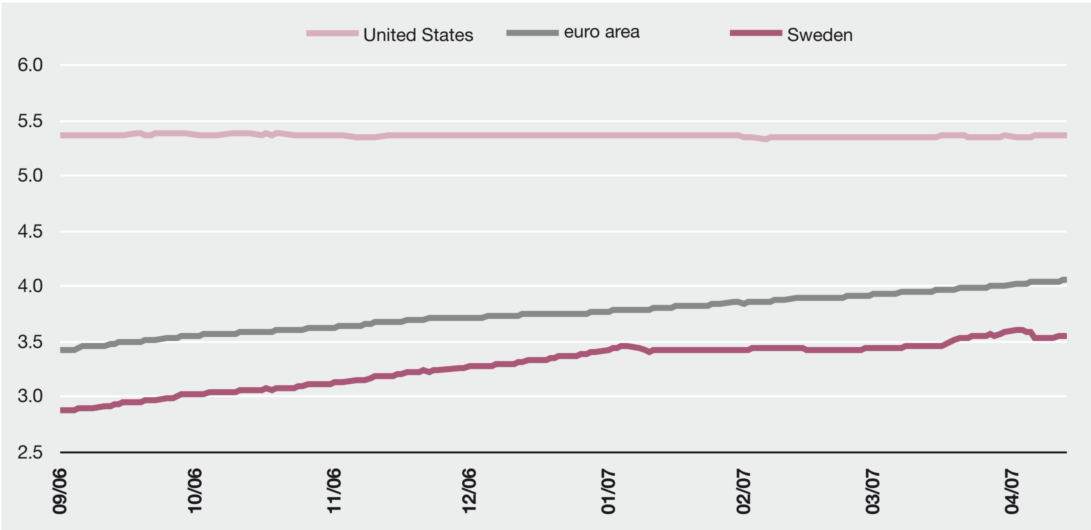

Figure 3. 3-month interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

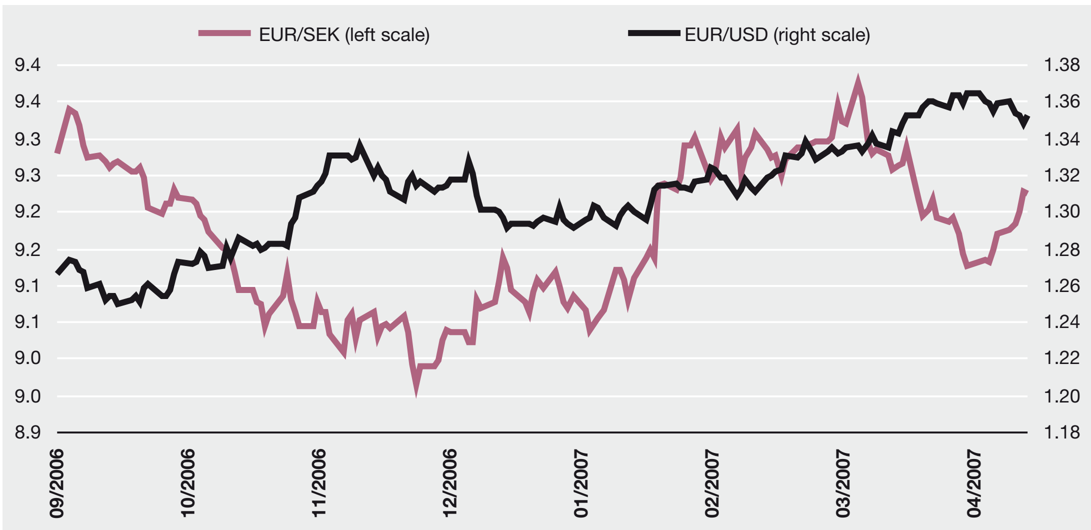

Figure 4. Exchange rate of the euro against the Swedish krona and the US dollar

Source: EcoWin

October 2006 to 3.75% in April 2007. The rise in the euro area key interest rate has entailed a gradual increase in the euro area **money market interest rates.** Since the fourth quarter of 2006 the three-month Euribor has climbed by an additional 60 basis points and compared to the beginning of the upward phase of the interest rate cycle the money market interest rates in the euro area have risen by almost 2 percentage points.

The Estonian money market interest rates have generally remained in line with the developments of the euro area money market interest rates (see Figure 5). Nevertheless, in this year's April money market interest rates increased at a slightly faster pace in Estonia compared to the euro area. In February, the confidence of foreign investors in the Latvian economy deteriorated slightly, which also affected neighbouring countries. The heightened interest in the economy of the Baltic States and the potential risks was brought about by the desire of some foreign investors to close the currency positions of the Estonian kroon. The growing interest of companies in Estonian kroon derivatives caused an increased demand for kroon loans in the interbank money market, which is why also the interest rate quotations of the Estonian money market rose, mostly across short-term maturities.

The rise in the interest rates on kroon loans on the domestic money market does not exert direct pressure on the Estonian financial sector, as the Estonian money market is relatively small and has low liquidity compared to euro area countries. Moreover, local credit institutions manage their liquidity in euros via their parent banks or directly on external markets, using the central bank's forex window to convert euros to kroons (see also the background information "Structure of the Estonian kroon money market" in the Financial Stability Review of November 2005). Rather, the increase in the interest rates on kroon loans influences the transaction costs of non-resident companies and banks who require kroon liquidity on the domestic market yet who do not have access to the central bank's forex window.

The slightly stronger demand for risk-hedging transactions related to the kroon's exchange rate also caused an increase in the difference between interest rate quotations that form the basis of future Estonian kroon and euro transactions (forward premiums). Banks' EUR/EEK net position in euros became short as well (see Figure 6). Despite this, there have been no pressures on the kroon exchange rate and participation in the exchange rate mechanism ERM II has gone smoothly.

As regards the longer maturities of the yield curve, the yield of the **five-year Estonian Government Eurobonds** on international markets has moved in line with the yield of other euro area government bonds. In the second half of 2006 and this year's first quarter, the spread between the average yield of the five-year Estonian Government Eurobond and German and Austrian government bonds with comparable maturities remained similar to previous periods (see Figure 7). The small spread between long-term interest rates indicates continuous confidence in the Estonian financial system.

The turnover of the Estonian kroon denominated money market loans is still strongly influenced by the great turnover of the derivatives market, caused by large-scale currency exchange transactions between a local bank and its parent bank in the first half of 2006 (see also Chapter IV of the Financial Stability Review of May 2006). Aside from the currency exchange transactions between the parent and subsidiary bank, the turnover of money market loans has slightly increased during the past six months. For the above reasons, the turnover of foreign currency derivatives increased by the beginning of this year. In the first quarter of 2007, foreign currency derivatives comprised more than a third of the total money market turnover (an average of 25% in previous quarters). Non-residents' transactions comprised over half of the turnover of foreign currency derivatives.

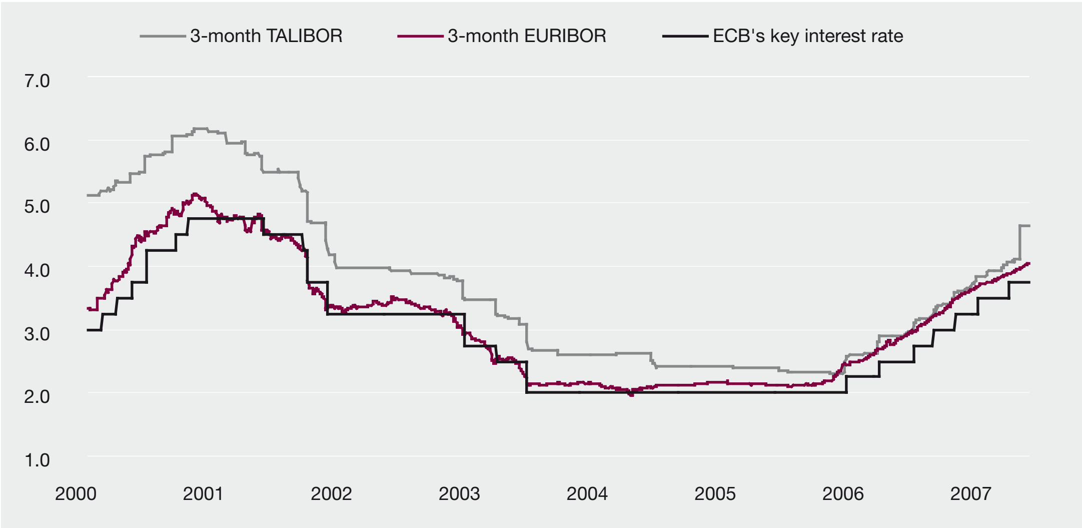

Figure 5. Money market interest rates in Estonia and in the euro area (%)

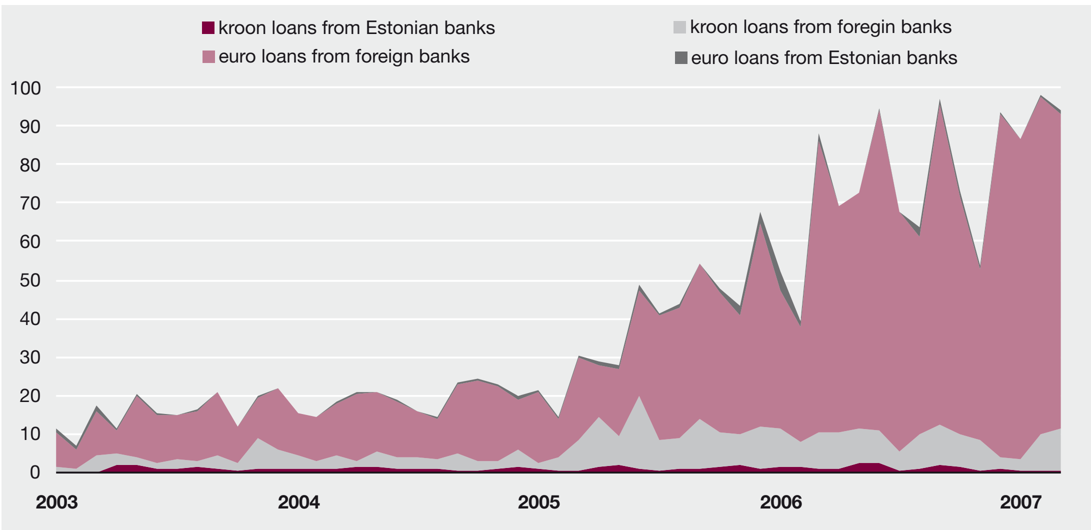

Figure 6. Loans of Estonian credit institutions received from the inter-bank loan market (EEK bn)

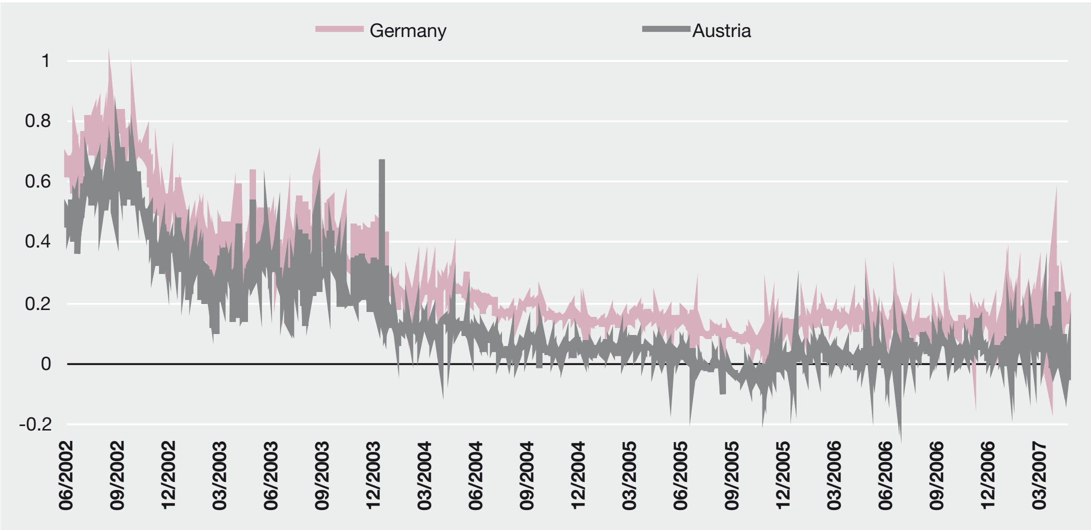

Figure 7. Yield difference between the Estonian Government Eurobonds and respective bonds in Austria and Germany (percentage points)

At the end of 2006 and in the first quarter of 2007, the turnover of short-term kroon loans was also slightly higher than in earlier quarters. The transactions of non-residents accounted for about 90% of the short-term kroon loan market. The most active participants were credit institutions from Sweden, Finland and Latvia.

Bond market

The growth of the domestic bond market has been robust for the past six months. By the end of March 2007, the growth in the **primary bond market** turnover accelerated to 81% (see Figure 8). While in 2006, the average quarterly turnover amounted to slightly below 2 billion kroons, in the first quarter of 2007 it even exceeded 3.3 billion kroons. Bond capitalisation increased by 76% year-on-year, reaching 10.4 billion kroons by the end of March and comprising already 4.9% of GDP. The largest contribution to growth came from the bond issues by resident companies, which more than doubled (170%). Real estate and other financial intermediary companies were the most active to issue bonds. The volume of banks' issues grew by 36%. The greatest contributor to the bond issues of banks was AS Sampo Pank. The volume of non-residents' bond issues has slightly decreased compared to earlier periods.

The **secondary bond market** has remained relatively subdued compared to the increasing turnover of the primary market. At the end of the first quarter of 2007, the secondary market turnover was a half smaller than the year before. Also the average daily turnover had declined, amounting to 12.9 million kroons (about 20 million kroons a year ago). Most of the transactions originated through the Estonian Central Register of Securities (ECRS) were performed with bonds issued by the financial sector (48%), but almost as many transactions were performed with bonds issued by the non-financial sector (43%; see Figure 9). The share of transactions with bonds issued by non-residents has diminished even further. Only 9% of the transactions executed through the ECRS were performed with bonds issued by non-residents. Most of them were transactions performed with bonds registered with the Central Securities Depository of Lithuania (44.4%) and a third were bonds registered with the Latvian Central Depository.

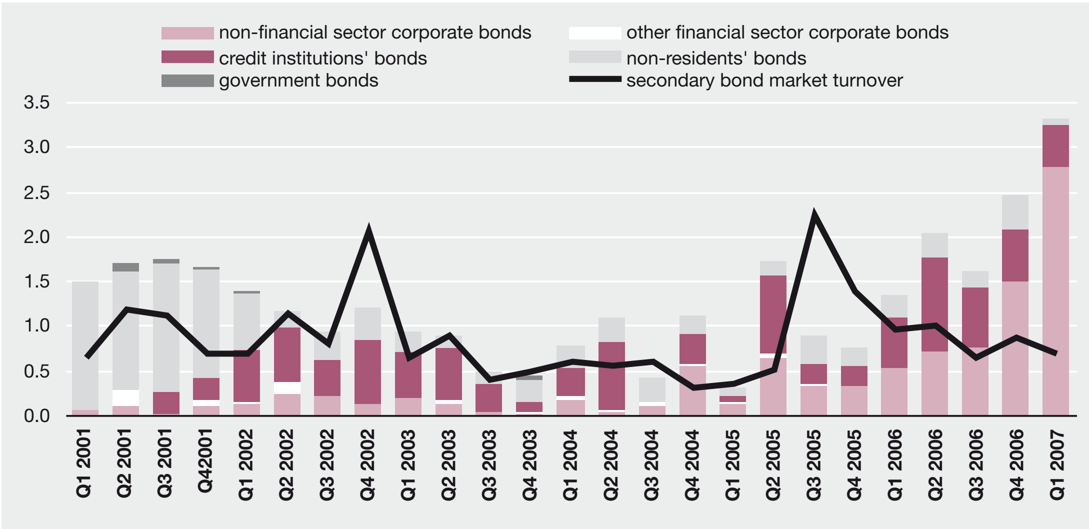

Figure 8. Volume of quarterly issued bonds and secondary bond market turnover (EEK bn)

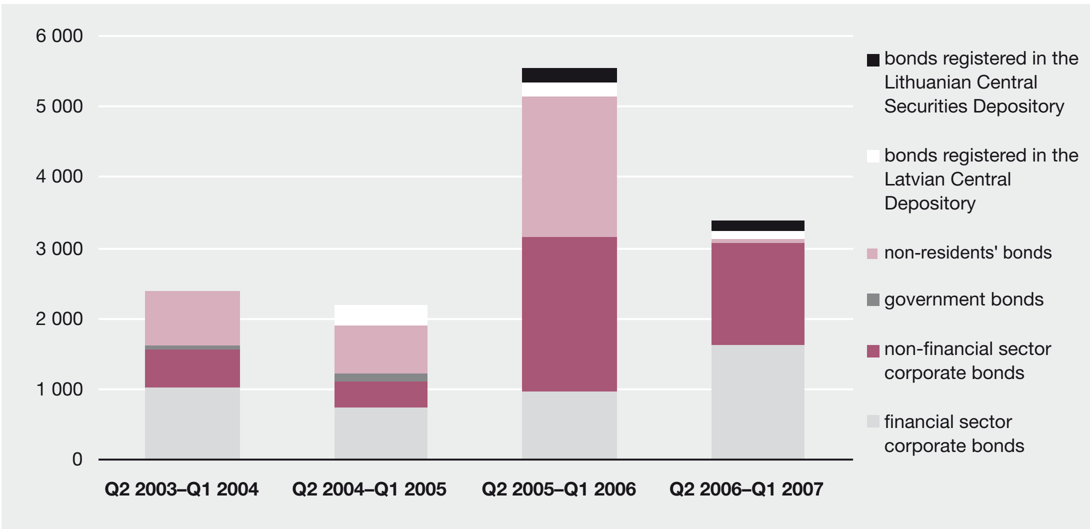

Figure 9. Structure of secondary bond market turnover (EEK m)

During the past six months no new bonds listed on the Tallinn Stock Exchange. One company was delisted from the stock exchange. Sampo Pank withdrew their subordinated debt liability. Moreover, in April SBM Pank's bonds became due. At the end of March 2007, the bonds of five companies were listed at the Tallinn Stock Exchange with a total market value of approximately 462 million kroons, i.e. 4.4% of the total capitalisation of the bond market. During the past six months, again only the bonds of Sampo Pank were traded on the stock exchange (four transactions in the total value of 8.5 billion kroons).

Stock market

One of the most significant events of the past six months was the listing of shares of Ekspress Grupp on the primary list of the Tallinn Stock Exchange. The price hike of the Ekspress Grupp's share on the very first day was the fastest in three years (20.3%) and in terms of turnover the third best issue in three years. The total turnover of the share amounted to 138 million kroons. The **total market capitalisation of listed companies** increased to 74 billion kroons by the end of March. In April, the listing of the shares of Ekspress Grupp added approximately 1.8 billion kroons.

The **value of the Tallinn Stock Exchange index OMXT rose** rapidly at the beginning of the year, achieving its highest level in three years, i.e. 1,043 points, and a year-on-year growth of 60% by the beginning of February (see Figure 10). The robust increase was followed by a correction in February and the value of the index dropped back to the end-2006 level. By the end of March, the stock market capitalisation reached 74 billion kroons, having grown by 62% year-on-year and comprising 34.8% of GDP (see Figure 11). Nearly 58% of the capitalisation growth stemmed from price growth and the rest, i.e. 12 billion kroons, from the inflow of new capital.

The **average daily turnover** of the past half-year's stock exchange transactions was about twice higher than the average of the previous period. Year-on-year, it has grown by about 70%, reaching 73 million kroons. During the last six months, transactions with the shares of Olympic Entertainment Group and Tallink Grupp were in the lead, comprising 28% and 21% of the stock market turnover, respectively. Though the shares of Eesti Telekom did not post the greatest turnover, they were nevertheless very liquid, comprising 9% of the stock market turnover. The shares of Baltika in the stock market turnover comprised 8%.

26 stock exchange members are entitled to act as brokers, two of whom are currently inactive. The number of foreign members is relatively high compared to domestic brokers. There are currently seven local members, comprising only 27% of all members. Most of the brokered transactions, however, are nonetheless intermediated by local members. Again, transactions brokered by AS Suprema Securities and Hansapank made up the majority, i.e. 78% of the total value of transactions on a rolling year basis.

Since the end of 2006, the **share of foreign investors** in the capitalisation of the shares listed on the stock market has decreased slightly (53%; see Figure 12). Within the past six months, investors from Luxembourg and Latvia have multiplied their investments in the stock exchange – by 1.5 and 3.8 billion kroons, respectively. At the end of March, the investments of resident companies accounted for 47% of the total value of listed shares. The share of private investors has slightly declined, totalling about 4%.

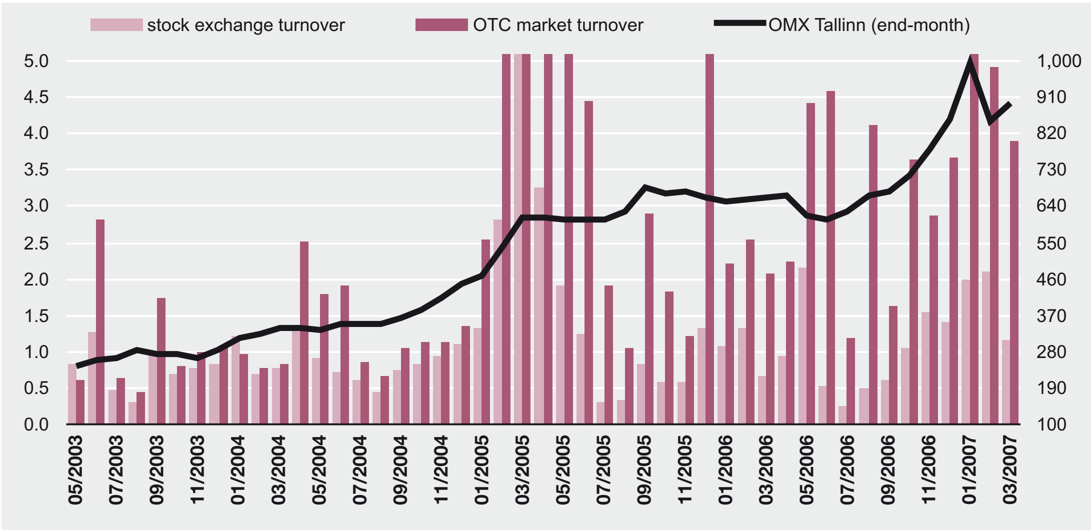

Figure 10. Stock turnover on the Tallinn Stock Exchange and OTC market (EEK bn; left scale) and Tallinn Stock Exchange index OMXT (points; right scale)

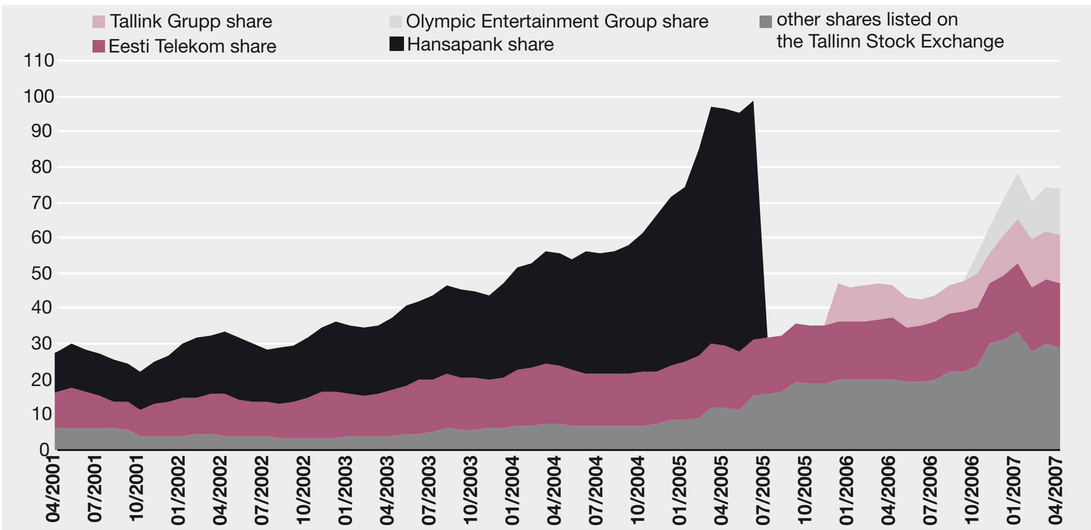

Figure 11. Market capitalisation of shares listed on the Tallinn Stock Exchange (end of month; EEK bn)

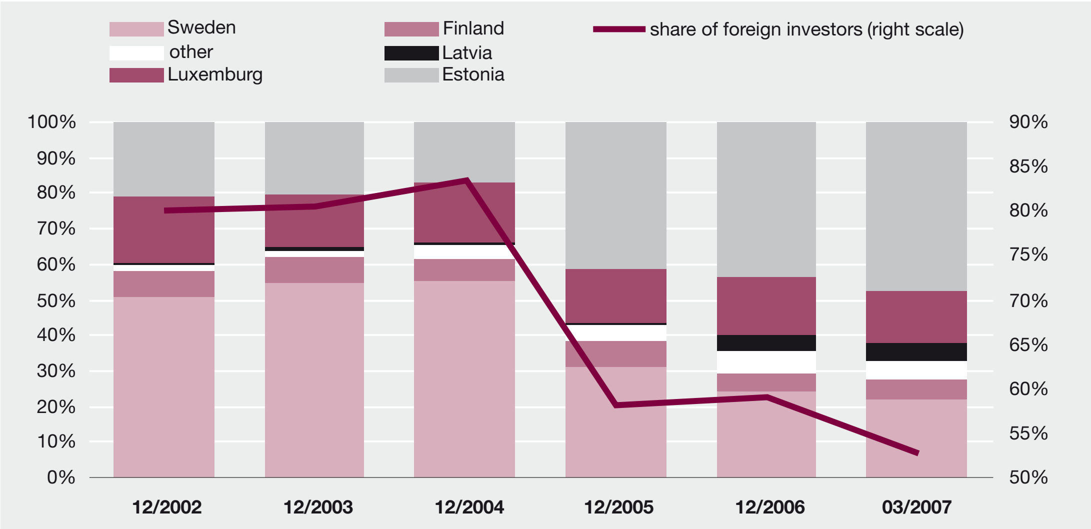

Figure 12. Structure of investors by residency and share of foreign investors of shares listed on the Tallinn Stock Exchange (%)