

### III SECURITIES AND MONEY MARKET

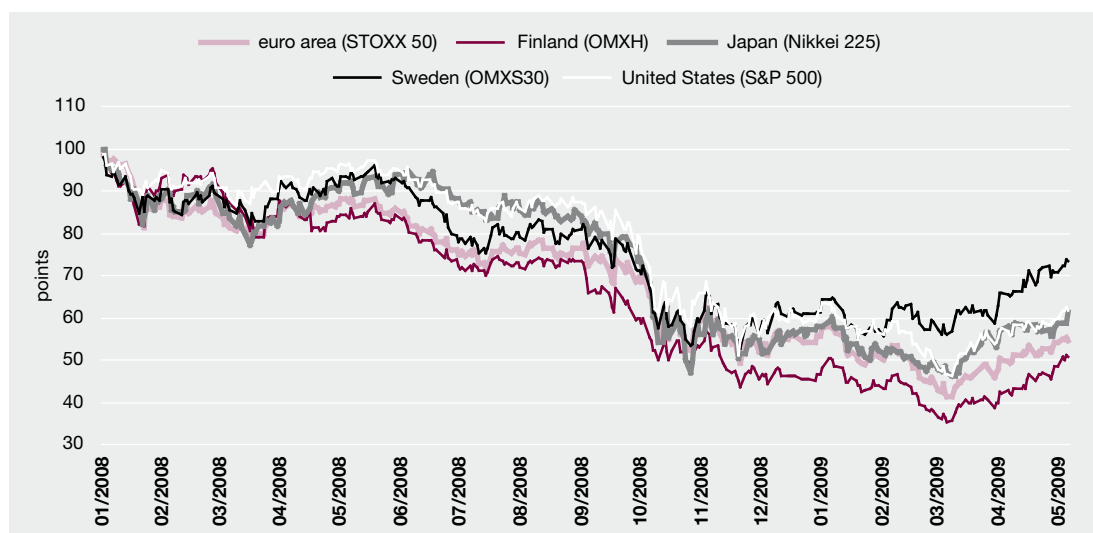
#### International financial markets<sup>1</sup>

The downward trend on major **stock markets** continued until March 2009. Besides the financial crisis, also the economic decline in leading industrial countries and continuous downward revision of growth forecasts contributed to the fall in stock prices. Yet after long-lasting pessimism and decline, prices on global stock markets have been significantly increasing since March. This has resulted from the strong monetary policy implemented by several central banks and the first signs of the stabilisation of economic indicators. The increase in stock prices was also fostered by better than expected first-quarter results of large companies (mainly in the financial sector).

By the end of April, major stock markets had recovered close to the level of the beginning of the year and the volatility of stock prices had decreased more than twice compared to the peak of the financial crisis. The euro area stock index Stoxx 50 and the US S&P 500 index kept

falling during the entire period under observation, decreasing by 8.4% and 9.9%, respectively. Japan's Nikkei 225 index, however, was 2.9% higher at the end of April compared to the end of October. The Finnish and especially the Swedish stock markets have recovered considerably: from the beginning of 2009, their stock indices have increased by 3.8% and 15.3%, respectively (see Figure 1). The Chinese stock market, which had went down even more compared to advanced economies, experienced an upward trend for the entire period under observation. The Shanghai Composite Index in China increased by 43.3%.

Developments on **bond markets** were still influenced by the monetary policy of major central banks. Almost everywhere, the **key interest rate** was cut to an unprecedentedly low level: in Japan to 0.1% (by 20 bp), in the US and Canada to 0.25% (by 75 and 225 bp, respectively), in the United Kingdom and Sweden to 0.5% (by 400 and 325 bp, respectively), in the euro area to 1% (by 275 bp), in New Zealand to 2.5% (by 325 bp) and in Australia to 3% (by 300 bp).



**Figure 1. Stock indices in the United States, the euro area, Japan, Sweden and Finland (31 December 2007 = 100)**

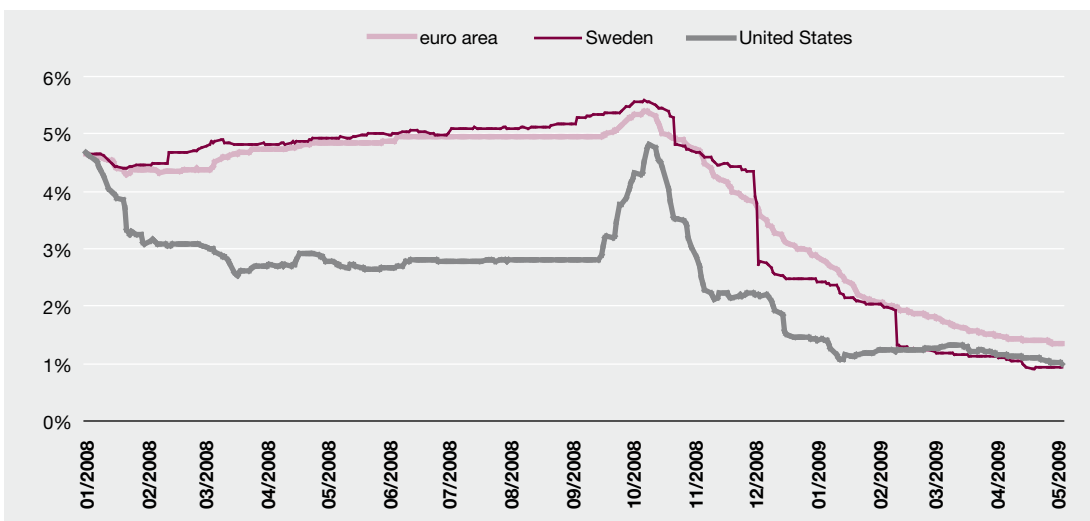
Source: EcoWin

<sup>1</sup> The Review covers the period from 31 October 2008 to 30 April 2009.

Since traditional ways of easing monetary policy have been exhausted, several central banks<sup>2</sup> have taken or are about to take exceptional measures to boost the economy or, more specifically, aim to implement the policy of quantitative easing. In essence, it means increasing the money supply: the central bank buys government bonds or private debt securities (or both) and increases its balance sheet

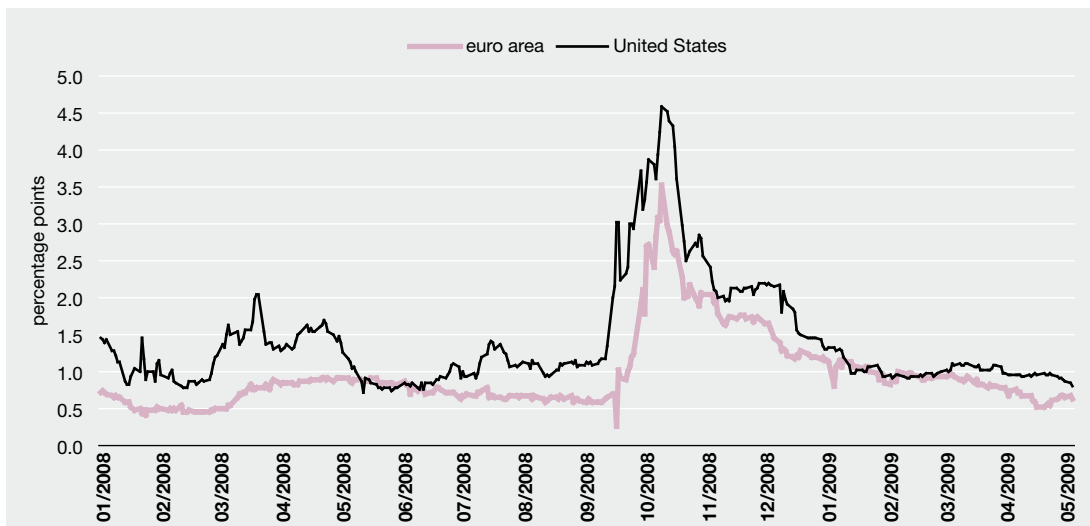
with the aim of keeping also long-term interest rates low.

Influenced by such a robust monetary policy, **short-term interest rates** (three-month Libor) on the interbank money market declined in Sweden by 376 bp to 0.94%, in the euro area by 341 bp to 1.36% and in the US by 201 bp to 1.02% (see Figure 2).



**Figure 2. Three-month government interest rates in the euro area, Sweden and the United States**

Source: EcoWin



**Figure 3. Spread between interbank money market interest rates and government interest rates in the United States and the euro area**

Source: Bloomberg

<sup>2</sup> The US Federal Reserve and the central banks of Switzerland, Japan, Canada and Sweden.

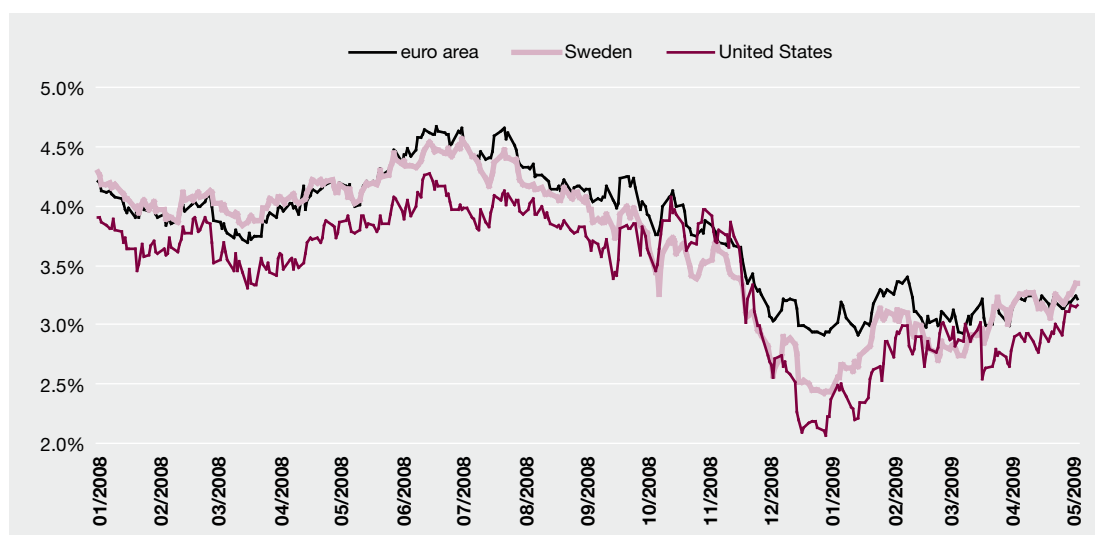
These are historically the lowest levels ever recorded. At the same time, government interest rates declined at a slower pace (in Sweden by 300 bp to 0.35%, in the euro area by 204 bp to 0.69% and in the US by 32 bp to 0.13%). Thus, there was also a significant decline in the spread between interbank money market interest rates and government interest rates, which had sharply increased in September and October 2008 along with the growing lack of confidence (see Figure 3). Therefore, money markets started to show signs of easing in terms of liquidity and stronger trust between banks.

**Long-term (ten-year) government interest rates** declined in the light of weakening economic indicators until the end of 2008 but took an upward trend in January. From the beginning of 2009, ten-year government interest rates have increased in the US by 90 bp, in the euro area by 25 bp and in Sweden by 83 bp (see Figure 4).

**Foreign exchange market** developments were quite distinctly related to the stock market

behaviour: the stock market fall and a general decrease in financial leverage<sup>3</sup> resulting from risk aversion caused the appreciation of the Japanese yen and the US dollar against other major currencies. Monetary policy decisions of central banks played an important role. Consequently, larger than expected cuts in the key interest rate in December brought about a sharp decline in the US dollar exchange rate against other major currencies. In March, the dollar depreciated considerably when the US Federal Reserve had announced of implementing the policy of quantitative easing.

The quantitative easing generally causes currency depreciation due to the increase in money supply. Consequently, also the British pound sterling and the Swedish krona have depreciated against other currencies. In March and April, an increase in the risk appetite of investors led to a growth in carry transactions<sup>4</sup>, which is why the currencies with higher interest rates (the Australian dollar, the New Zealand dollar) appreciated and the currencies with lower interest rates (the US dollar, the

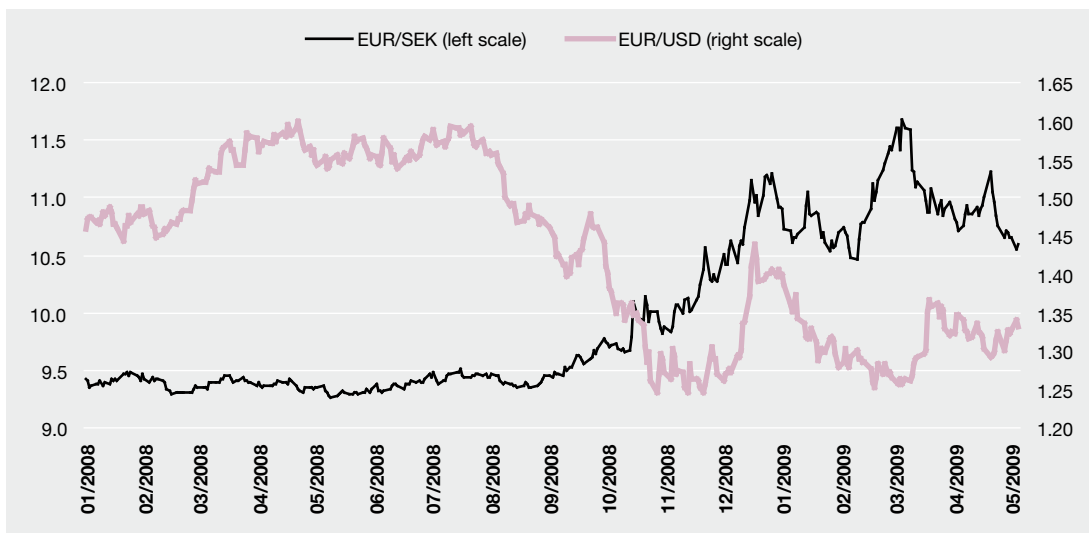


**Figure 4. Ten-year interest rates in the euro area, Sweden and the United States**

Source: EcoWin

<sup>3</sup> The ratio of investment value to borrowed capital.

<sup>4</sup> Trading strategy in the case of which differences between interest rates of two currency areas are exploited. In particular, loans are taken in currency with lower interest rate and invested in currency with higher interest rate and thereby carry is earned.



**Figure 5. Exchange rate of the euro against the Swedish krona and the US dollar**

Source: EcoWin

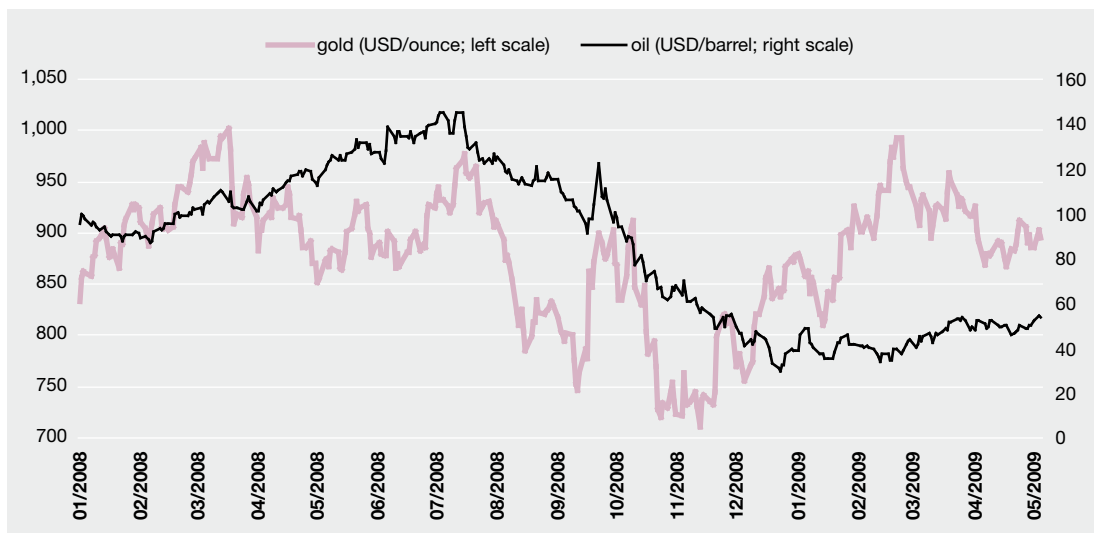
Japanese yen) depreciated. During the period under observation, the euro appreciated against the dollar by 3.9% to the level of 1.3226 and the Swedish krona depreciated against the euro by 7.9% to 10.66 (see Figure 5). The Japanese yen depreciated against the US dollar by 0.2% to 98.63. The average daily volatility of exchange rates has been gradually decreasing for the past six months.

The downward trend in the **commodity markets** stopped in the last months of 2008 when the prices of commodities stabilised at relatively low levels. Since March, the markets have demonstrated receding pessimism and growing optimism, which has manifested itself in a rise in commodity prices. The price of crude oil has also changed accordingly. After the decline that lasted until mid-December and a fall in the price of oil barrel to 31 US dollars, the price of **crude oil** stabilised. In March, the price began to rise, increasing to 50 dollars per barrel.

**Gold** price developments, on the other hand, were quite different. General uncertainty supported the rise in gold price until end-February; then investors' risk appetite led to a price fall. During the period under observation, the price of gold increased altogether 22.5% to 885.5 dollars per ounce, whereas the price of crude oil dropped 26.2% to 50.25 dollars per barrel (see Figure 6). The CRB index, which reflects the prices of 22 major commodities, decreased only 1.3% from end-October to end-April.

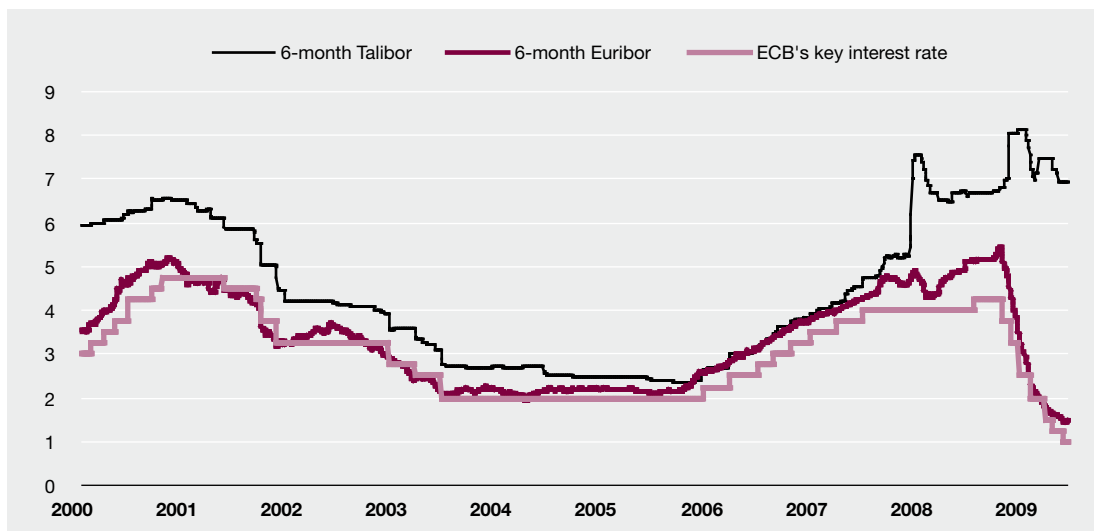
#### **Money market**

Owing to the extensive economic downturn in the euro area, the European Central Bank continued with the easing of monetary policy in the first quarter of 2009, in the light of weak inflationary pressures. The interest rate on the main refinancing operations declined from 3.75% in last autumn to 1% by mid-May 2009. Moreover, the last decision to cut interest rates also



**Figure 6. Prices of gold and crude oil (WTI)**

Source: EcoWin



**Figure 7. Money market interest rates in Estonia and the euro area (%)**

Source: EcoWin

narrowed the earlier 2% range of interest rates: as of 13 May, the euro area interest rates on marginal lending and deposit facilities are 0.25% and 1.75%, respectively.

**Money market interest rates** in the euro area have also sharply dropped from October 2008 and reached an extremely low level in the middle of the second quarter of 2009 (see Figure 7).

Although by the beginning of May, the interest rate quotations in the Estonian money market had slightly decreased, the spread between the Talibor and Euribor has remained quite large. This is partly due to the fact that the Talibor is less sensitive to changes in the more general liquidity environment and also because of the general lack of confidence in the Baltic States. The interbank transactions in the Estonian kroon

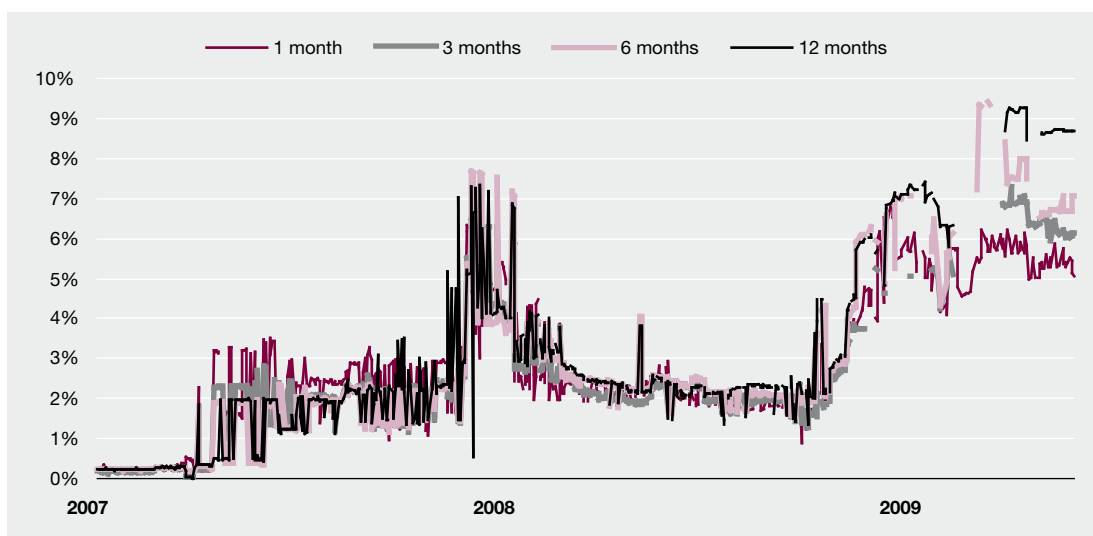
money market have actually taken place with considerably lower interest rates, which have also declined somewhat faster.

Arising from the small number of transactions, also the **Estonian kroon derivatives market** responded to the easing of tensions on the region's money markets, which had started in March, with some delay. The difference between interest rate quotations that form the basis of future Estonian kroon and euro transactions (forward premiums) started to decrease slightly more notably only in April (see Figure 8). The above-mentioned rise and constantly high level of price quotations still have not put any pressure on the exchange rate of the Estonian kroon. Neither did the growing speculations on the domestic market considerably increase distrust in the kroon. The share of kroon deposits and loans in the retail market was not much affected by the events at the end of last year. Participation in the exchange rate mechanism (ERM II) has proceeded smoothly for Estonia.

The tensions on global money and capital markets, which started to reveal last autumn,

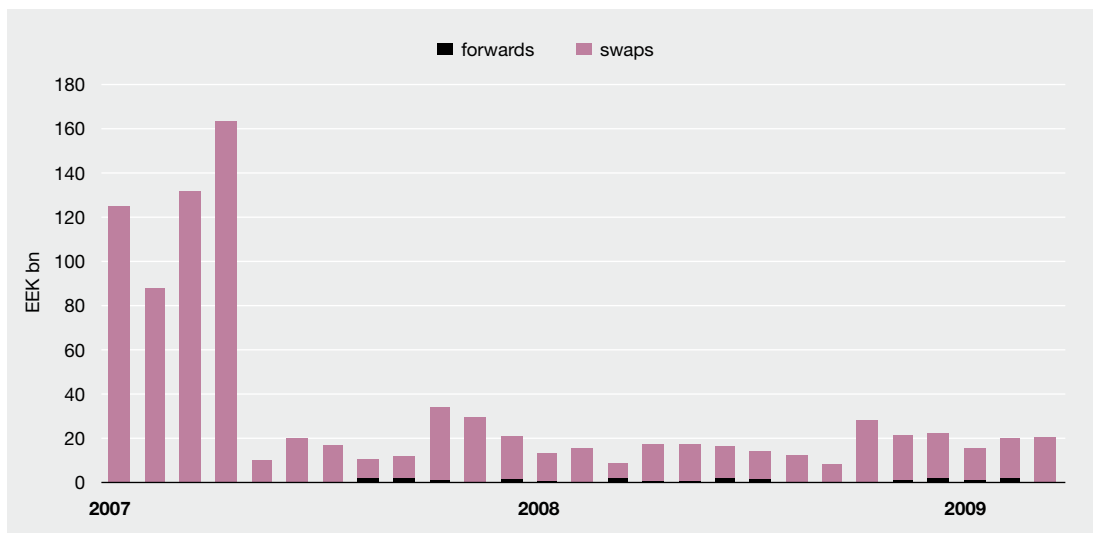
did not lead to a noticeable growth in turnover on the Estonian kroon derivatives market. This is partly because of the smallness of the market and difficulties in finding another counterparty. Although from October, the average turnover has somewhat increased, this has not been sufficient to be considered a clear sign of growing lack of confidence in the sustainability of Estonia's monetary policy framework (see Figure 9). In the first quarter of 2009, transactions by non-residents accounted for approximately 60% of the turnover of the foreign exchange derivatives market. Since last August, commercial banks have, through Eesti Pank's forex window, sold more kroons on the spot market than purchased. The reason lies in a decline in the demand for base money, which has resulted from the contraction of the economy both in the real and nominal terms. This reflects automatic adjustment to the changed economic environment, and is characteristic of the currency board system.

The turnover of short-term kroon loans has been relatively large since the beginning of 2008, and increased further in the first months of 2009 (see Figure 10). Nevertheless, this cannot be

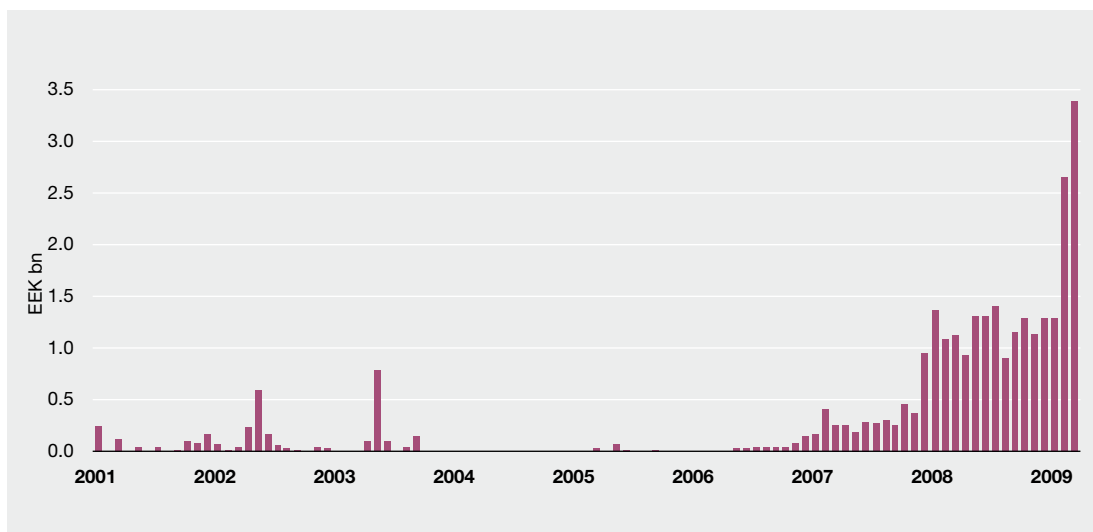


**Figure 8. Forward premiums of the Estonian kroon against the euro**

Source: Reuters



**Figure 9. Monthly turnover of derivatives transactions with Estonian credit institutions**



**Figure 10. Turnover of short-term kroon loans**

considered a significant structural change for banks with regard to their liquidity management, as the higher activity has been recently driven by a single bank, which has been covering its foreign exchange position through the money market. Estonian credit institutions still manage their liquidity mainly in euro via parent banks or directly on external markets, using the central bank's forex window to convert euros to kroons.

The liquidity of the Estonian kroon has remained stable and there have been no major failures in the kroon liquidity in the financial sector. **Banks' settlement buffers in the central bank** are still larger than the daily minimum reserve requirement and banks have not had difficulties in fulfilling this requirement.

## Bond market

In recent months, the primary bond market experienced an even deeper decline in activity than in earlier periods: annual turnover growth turned negative for the first time in four years, amounting to -52%. The total bond market capitalisation has decreased by 2.8 billion kroons over the last six months. The capitalisation of short-term bonds decreased by 1.7 billion kroons. At the end of March, the total capitalisation of bonds was 11.3 billion kroons and accounted for 4.7% of GDP, having declined by 50 basis points from 5.2% in September.

The average amount of issues decreased 43% to 911 million kroons in the past six months compared to the preceding six months (see Figure 11). In the fourth quarter of 2008, bond market activity was the lowest of more than ten years with the issues totalling only 308 million kroons. The first quarter of 2009 was again more active and total issues amounted to 1.5 billion kroons. At the beginning of 2009, also government bonds were issued over several years, accounting for 40% of total issues. The largest issue was made by the City of Tallinn: 491 million

kroons for three years with the price of 3-month Euribor plus 3%. The last time government bonds were issued was almost six years ago but this time the amount of issues was record high.

The bonds of non-financial and public sector enterprises comprised 44% and 34% of the total bond turnover of the fourth quarter of 2008 and the first quarter of 2009 (1.8 billion kroons), respectively. Resident issuers were relatively active in the past six months and their share in total capitalisation increased from 76.6% in September 2008 to 86.7% at the end of March 2009 (see Figure 12).

The percentage of issues in the Estonian kroon decreased further in the last six months and constituted an average of 9% of total issues per quarter.

The secondary bond market was relatively active in earlier periods unlike the primary bond market, whereas at the end of 2008 and at the beginning of 2009 also the secondary market was subdued. The average turnover shrank by almost a half over the past six months; at the end of March, the daily turnover was 14 million kroons.

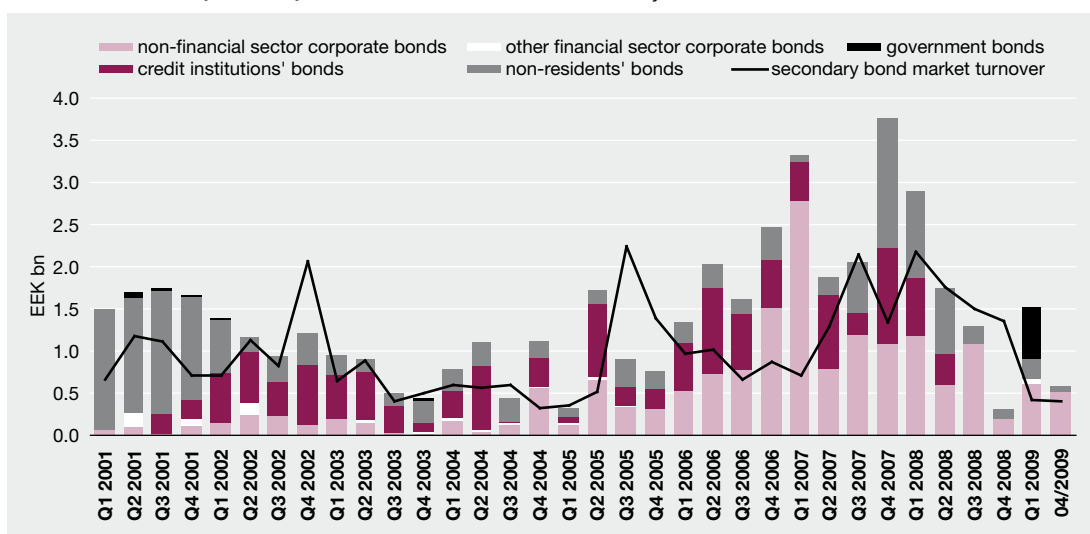
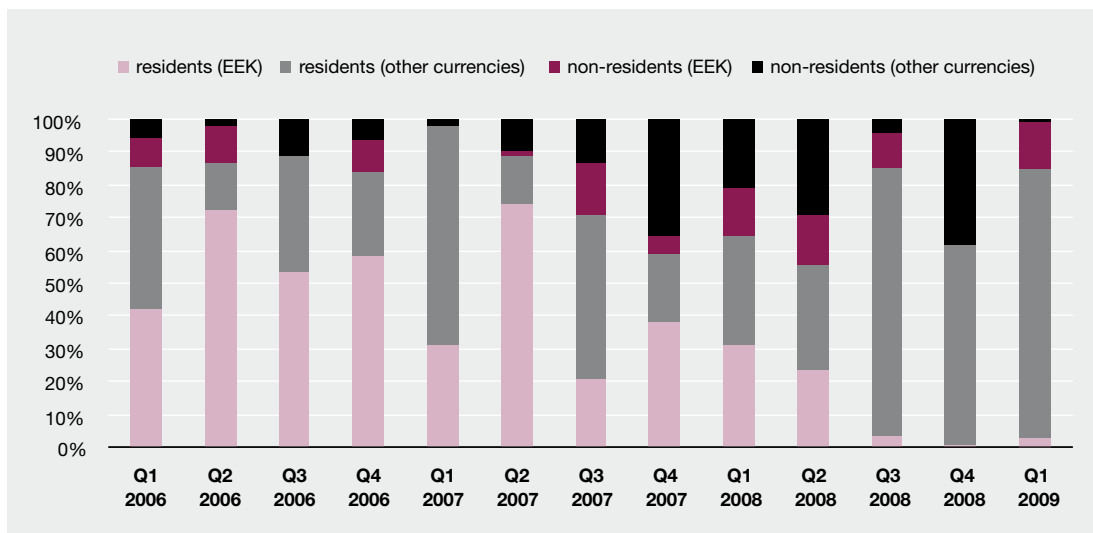


Figure 11. Bonds issued and secondary bond market turnover on a quarterly basis

<sup>5</sup> SEB Pank, ABC Grupp and LHV Ilmarise Kinnisvaraportfell.





**Figure 12. New bonds by issuer's residence and currency on a quarterly basis**

Of all the bonds listed on the Tallinn Stock Exchange as at autumn 2008, the bonds of four companies have been redeemed during the last six months. In addition, the bonds of the new BIGBANK were listed as well as redeemed during the period under observation. The bonds of three companies<sup>5</sup> had been listed on the stock exchange as at the end of March. Their total market value was 209 million kroons; that is, 1.9% of the total bond market capitalisation.

The general structure of bond investors developed by the end of 2007, and since then the percentages of investors have fluctuated in the range of a few percentage points only. Resident investors accounted for about 66% (7.5 billion kroons) of the bond market at the end of March 2009, approximately 2.7% of that belonging to private investors. Resident investors include mainly credit institutions (25%), insurance companies and pension funds (22%) and non-financial sector companies (20%). The "unspecified" group held a large share among residents as well as total investors with 23% and 19%, respectively.

### Stock market

The value of the Tallinn Stock Exchange Index OMXT exceeded 300 points at the beginning of 2009. Although the second half of the first quarter saw a drop of 50 points, by the second half of May the index had increased again to 315 points. The index fluctuated between 250–315 points during the period under observation. It was over two times lower than a year ago, reaching the level recorded at the beginning of 2004, when the shares of 14 companies had been listed on the stock exchange with the total capitalisation of 50 billion kroons on average. Compared to the indices of the euro area and other selected Central and East European countries, the value of the Tallinn Stock Exchange index OMXT has decreased considerably more from the record high pre-crisis levels. Since the beginning of 2009, the value of OMXT has grown approximately 15%, increasing relatively faster than the euro area average or the indices of Romania, the Czech Republic, Poland and Bulgaria (see Figure 13).

The capitalisation of the Tallinn Stock Exchange has lost approximately 15.6 billion kroons in value over the past two quarters (see Figure 14).

<sup>5</sup> SEB Pank, ABC Grupp and LHV Ilmarise Kinnisvaraportfell.

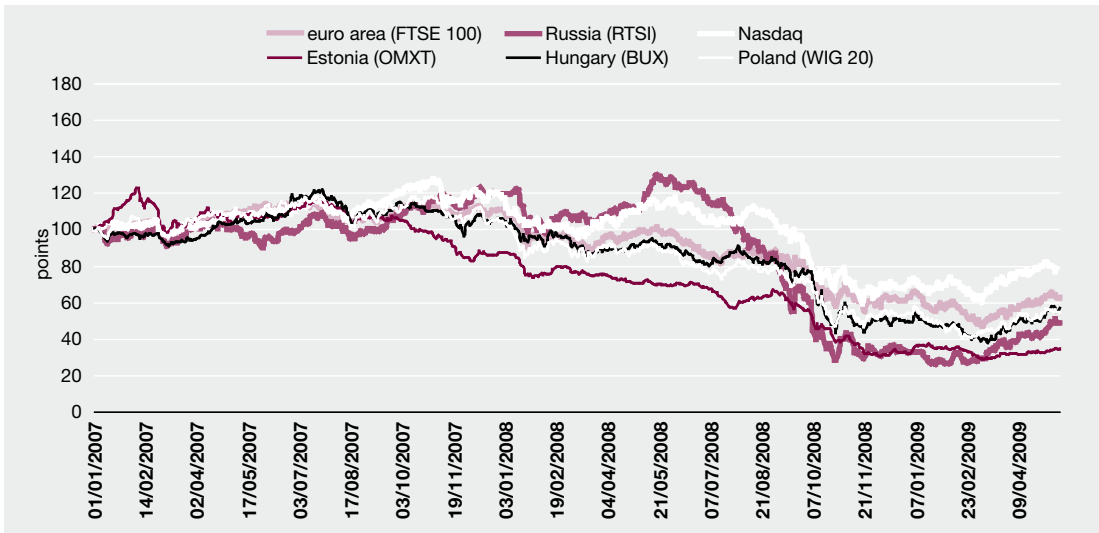


Figure 13. Changes in stock indices

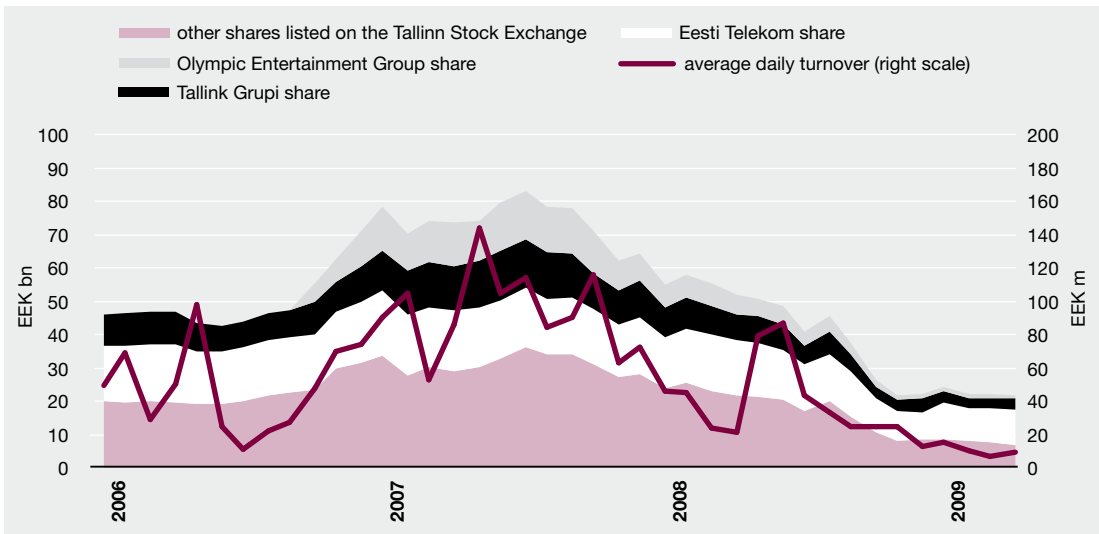


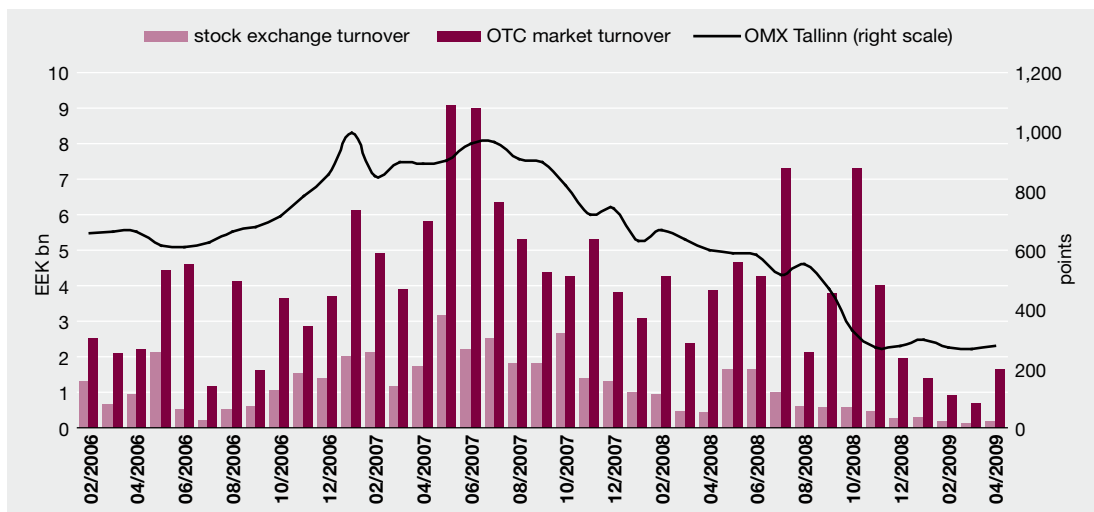
Figure 14. Market capitalisation of shares listed on the Tallinn Stock Exchange (end-month)

By end-2008 capitalisation had returned to the level recorded ten years ago and remained there until the end of the first quarter of 2009 when the value of the 18 companies listed on the stock exchange<sup>6</sup> totalled 22 billion kroons and constituted 9.2% of GDP, having declined by 80 basis points. On 1 April 2009, the shares of Starman were delisted from the primary exchange.

In February 2009, the trading period of NASDAQ

OMX Baltic stock exchanges was extended by two hours to 16:00. The liquidity on the Tallinn Stock Exchange remained low because of the uncertainty in financial markets. The average daily turnover for the last two quarters was approximately 16 million kroons, which is three times smaller than during the previous six months (see Figure 15). In March 2009 liquidity reached a historical low with the average daily turnover of only 7 million kroons.

<sup>6</sup> The business name of Kalev was changed to Luterma. In April, also Eesti Ehitus changed its business name to Nordecon International.



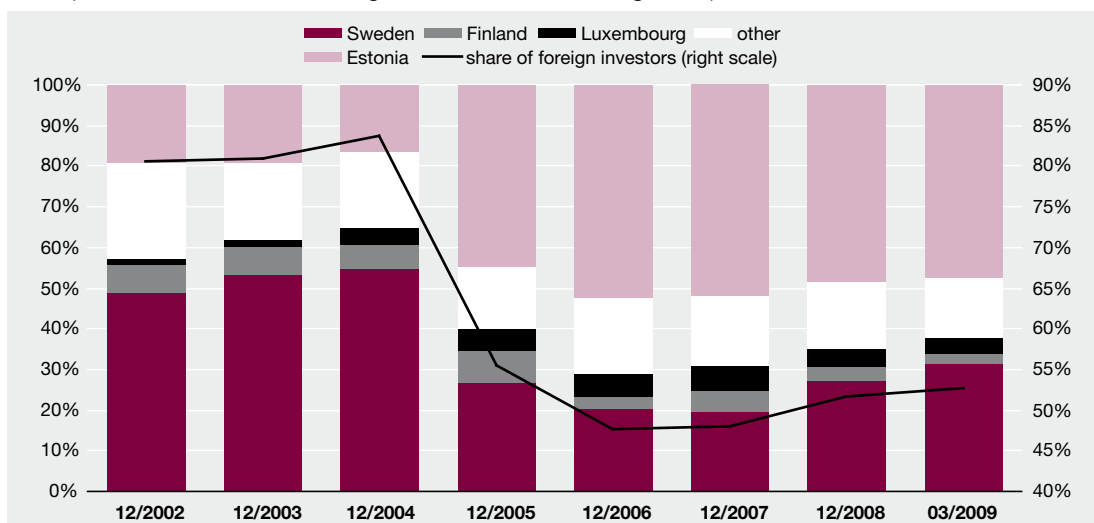
**Figure 15. Stock turnover on the Tallinn Stock Exchange and OTC market and Tallinn Stock Exchange index OMX Tallinn (end-month)**

In terms of volume, the most transactions were made with the shares of Eesti Telekom, Tallink Grupp, Tallinna Vesi and Olympic Entertainment Group. Their transactions accounted for 25%, 19%, 15% and 12%, respectively, of the total turnover.

The Tallinn Stock Exchange has 32 members, the newest of which is DnB NORD Pank who was listed in November 2008. Swedbank, SEB Pank and LHV were the most active traders also in the past six months, accounting for 39%, 20%

and 17% of total transactions, respectively.

At the end of 2008, the share of foreign investors exceeded 50% of the total capitalisation of listed companies (see Figure 16). At the end of March 2009, foreign investors accounted for 53% (11.6 billion kroons) of the total market capitalisation; two thirds of foreign investors are Swedish. The structure of resident investors remained more or less unchanged. At the end of March, approximately 12% of residents' investment belonged to private investors.



**Figure 16. Structure of investors on the Tallinn Stock Exchange**