IV
MONETARY ENVIRONMENT

Interest Rates

Estonia's interest rate environment remained expansive in the first half of 2004. Monetary policy interest rates within the euro area have not changed since the reduction in June last year, which has secured a consistently low level of money market interest rates (see Figure 4.1).

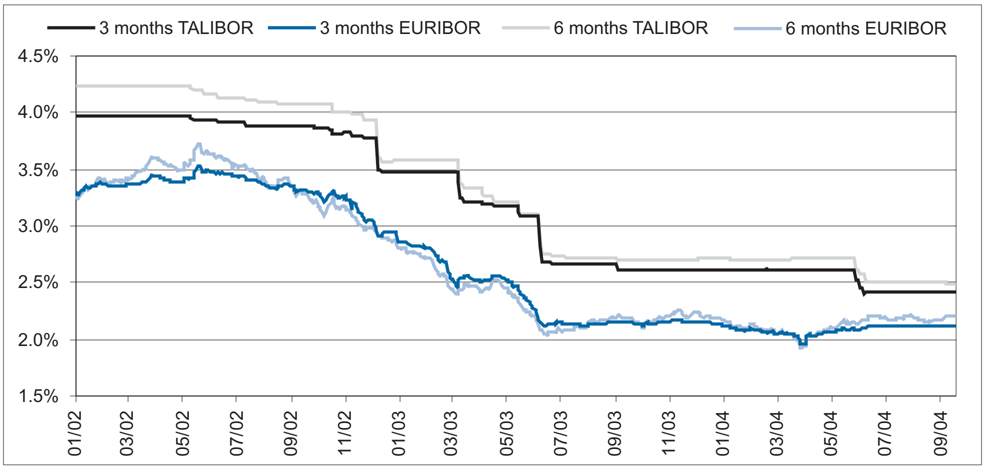

Figure 4.1. Money market interest rates of the Estonian kroon and the euro

Meanwhile low interest rates have consistently promoted loan growth in the non-financial sector[1] while the rise in deposits has remained slow. Interest rates are expected to increase in the first half of 2005.

The non-financial sector interest rates continued to fall slightly in the first half of 2004. The long-term interest rates (with maturity of over one year) on loans to households were at the 5% level in August, which marks a decline of one percentage point from the beginning of the year. Long-term interest rates on corporate loans were even lower, reaching the 4.7% level in August (see Figure 4.2). Due to the low interest rate environment deposit rates of the non-financial sector continued at a low level as well (1.8% in August).

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

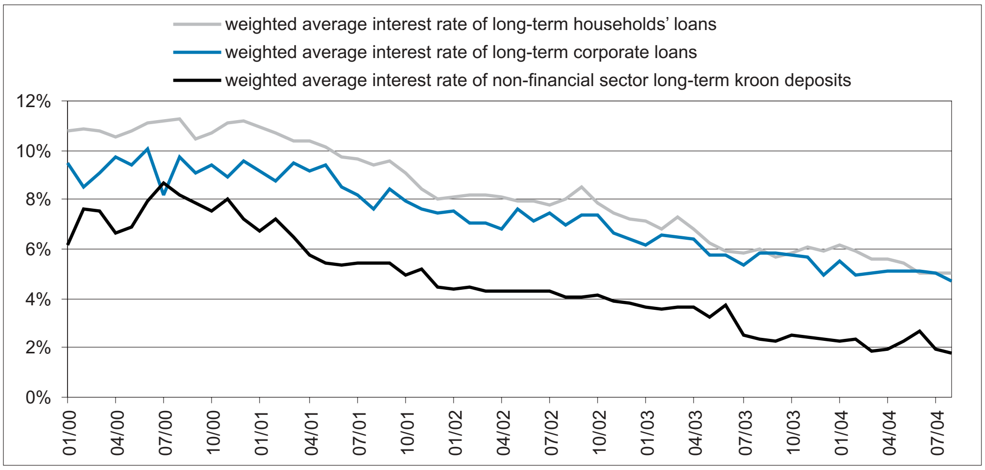

Figure 4.2. Interest rates of non-financial sector

Capital Flows

Despite a significant slowdown in the growth of internal demand at the beginning of the year, total capital inflow turned out to be larger in the first half of the year than a year before. Estonia's balance of payments current account deficit amounted to 7.4 billion kroons in the second quarter of 2004. The large current account deficit was fully covered by capital inflow through the financial account, which also led to a growth in the foreign exchange reserves. The foreign exchange reserves of Eesti Pank increased by 725 million kroons in the second quarter. Direct investments accounted for 40–50% of the capital inflow both in the first and second quarter.

The banking sector played an important role in attracting the foreign capital, particularly in the second quarter. In April-June the banks' external liabilities increased by an estimated 8.5 billion kroons. The banks involved external resources mainly through time deposits and by issuing bonds (the latter are reflected in the balance of payments under portfolio investments). The resources involved were used mainly for financing continuous active loan demand and refinancing earlier liabilities. During the same period banks' foreign assets grew by 4.8 billion kroons, which translates into an estimated 3.7 billion kroon net capital inflow through the banking sector in the second quarter.

Besides banks non-financial corporations were also active as usual in attracting capital. In April-June capital inflow through the non-financial sector accelerated and stood at more than 3 billion kroons according to the balance of payments, of which an estimated 1.8 billion was related to capital inflow through direct investments and the rest accounted for trade credit.

Monetary and Loan Aggregates

The growth in Estonia's money supply remained moderate during the first six months of the year, following previous trends. The annual growth rate of the monetary aggregate M2 turned out to be 10.5% in the second quarter and that of the narrow monetary aggregate amounted to 14.5% (see Figure 4.3). The growth in the money supply was mainly supported by rising stock of demand deposits of the non-financial sector. Even though the annual growth in demand deposits was as rapid as 18% in the second quarter and their volume grew by a record 3.0 billion kroons in a quarter, the rise in non-financial sector deposits can still be estimated as modest.

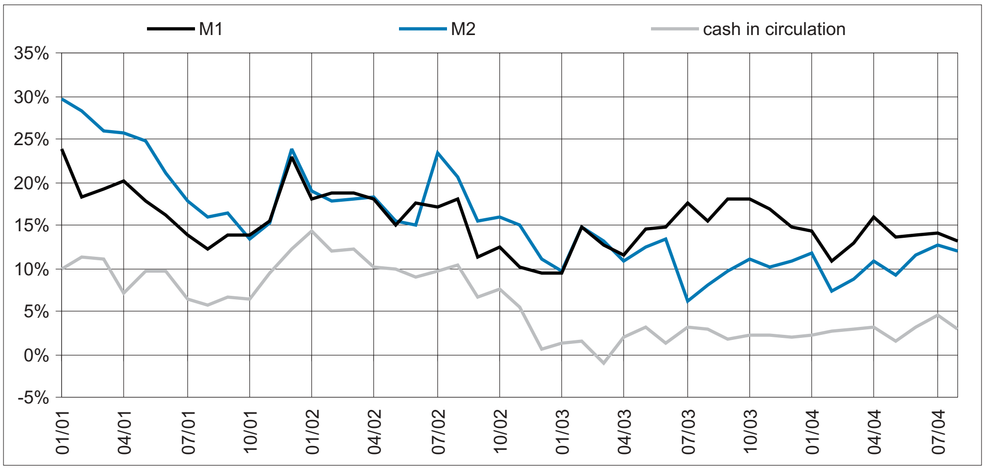

Figure 4.3. Money supply growth compared with the same month last year

Household deposits predictably outpaced corporate deposits and the growth amounted to 1.4 billion kroons in April-June. 80% of the household deposits growth accounted for demand deposits, while time deposits increased at a modest rate. The growth in household demand deposits was somewhat smaller at the beginning of the third quarter.

Resident companies' deposits grew by a relatively substantial 1.2 billion kroons in the second quarter, while non-resident deposits increased by as much as 1.8 billion kroons. Corporate time deposits decreased, however. The growth in non-financial sector deposits slowed down at the beginning of the third quarter, which arose from a slightly smaller increase in household demand deposits when compared to the second quarter. The stock of corporate deposits even fell early in the third quarter.

The growth of non-financial sector debt burden continued to accelerate in the second quarter. The total value of bank loans, bonds, and leasing and factoring contracts increased by a record 5.6 billion kroons during the second quarter. The annual growth was fast regarding both households and companies, reaching an average of 30.7% in the second quarter (see Figure 4.4).

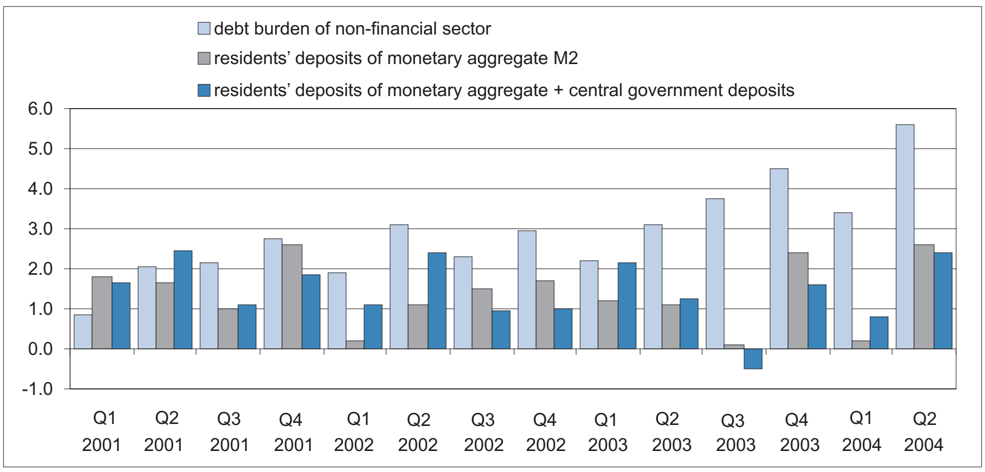

Figure 4.4. Quarterly growth in residents' deposits and debt burden of non-financial sector (EEK bn)

The annual growth in the household debt burden still outpaced that of corporate debt burden, but regardless of a major increase in loan and leasing commitments (2.6 billion), the pace slowed down slightly to an average of 44.4% in the second quarter (see Figure 4.5). As expected, the rise was the biggest in households' housing loans and leasing facilities, reaching a record 2.2 billion kroons. Private individuals' car leasing commitments increased relatively fast in the second quarter (by 0.2 billion kroons), which was partly affected by keener buying interest prior to Estonia's accession to the European Union.

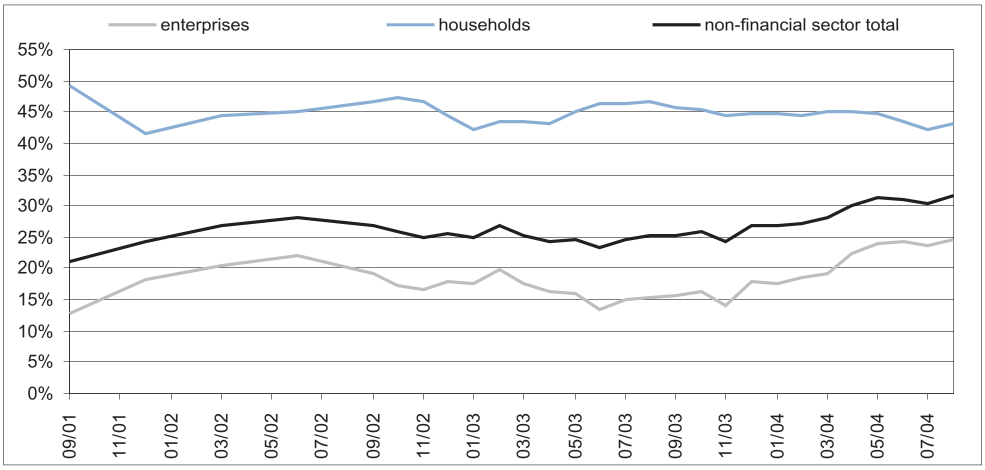

Figure 4.5. Financing of non-financial sector by financial sector (annual growth)

The annual growth in corporate debt burden has been consistently increasing during the past year, reaching the highest level in recent years, i.e. 23.4%, in the second quarter. Corporate liabilities to banks and leasing companies increased by a record 2.9 billion kroons during the quarter.

Global improvement in the economic situation resulted in levelling out the annual growth in the debt burden of the tradable and non-tradable sector in the second quarter (in earlier periods the debt burden of non-tradable sector companies grew considerably faster). The increasing annual growth in the debt burden of the tradable sector arose mainly from the fast rise in the loans and leasing facilities of transport companies, while the year-on-year increase in the debt burden of manufacturing companies remained under 10%.