Eesti Pank

EUROSÜSTEEM

Financial Stability Review

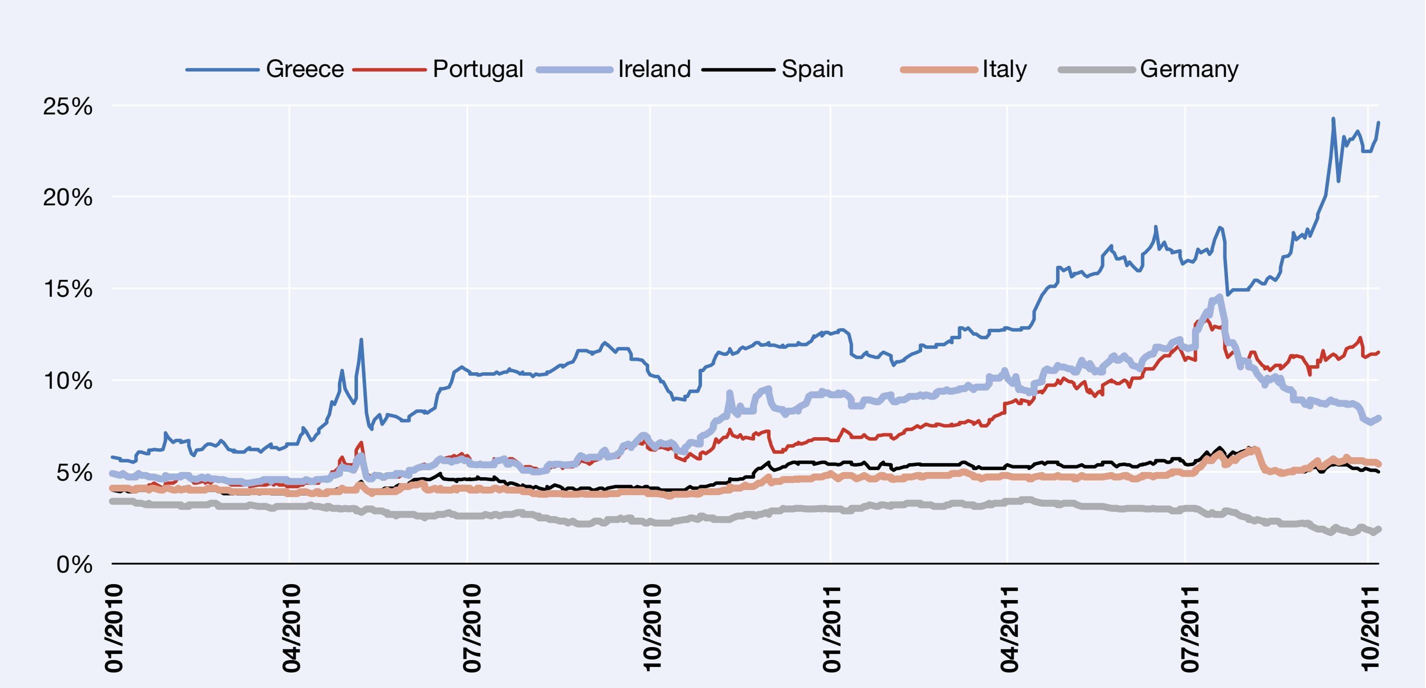
26 October 2011

The debt crisis determines developments in Estonia's economy and financial sector

- **The sovereign debt crisis in several euro-area countries has deepened and uncertainty in international financial markets has increased.**
- A further deterioration may result in serious credit restrictions and the growth of our main trading partners may slow.
- Steps taken by governments and central banks to prevent the crisis from spreading (incl. the establishment of higher capital requirements), as well as unlimited liquidity supply by the Eurosystem to commercial banks are of critical importance.
- We are still halfway in restoring confidence.

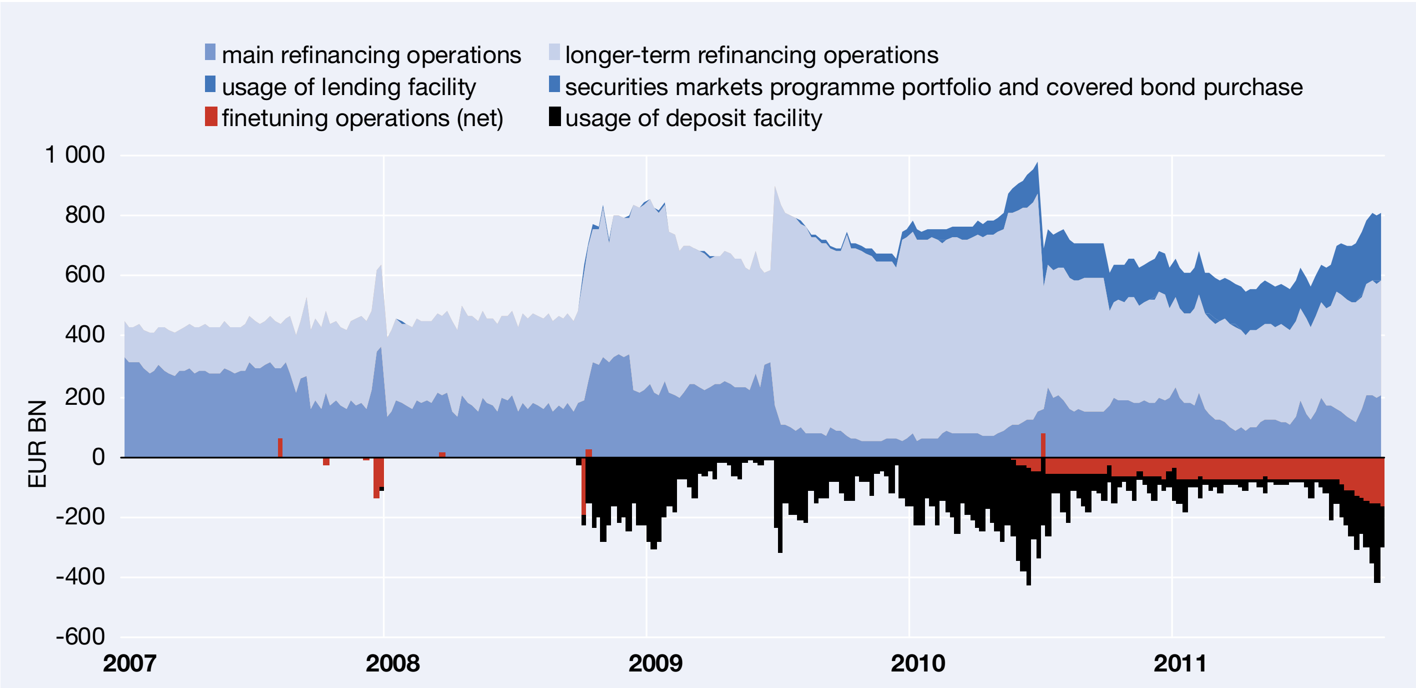
The sovereign debt crisis has deepened and spread

Interest rates on 10-year government bonds



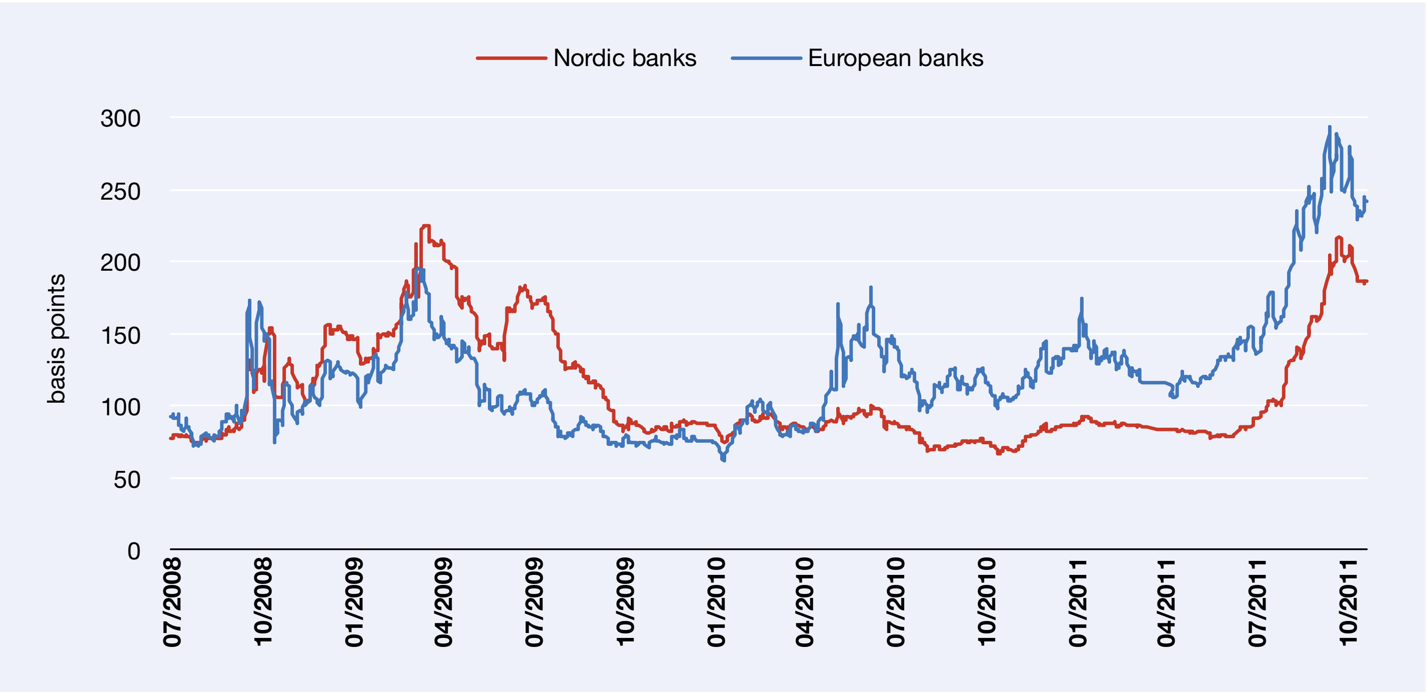
With tensions growing, the Eurosystem's role in intermediating liquidity to commercial banks has increased again

Eurosystem's monetary policy operations



Uncertainty has affected risk assessments of Nordic banks, but to a much smaller extent than in Europe as a whole

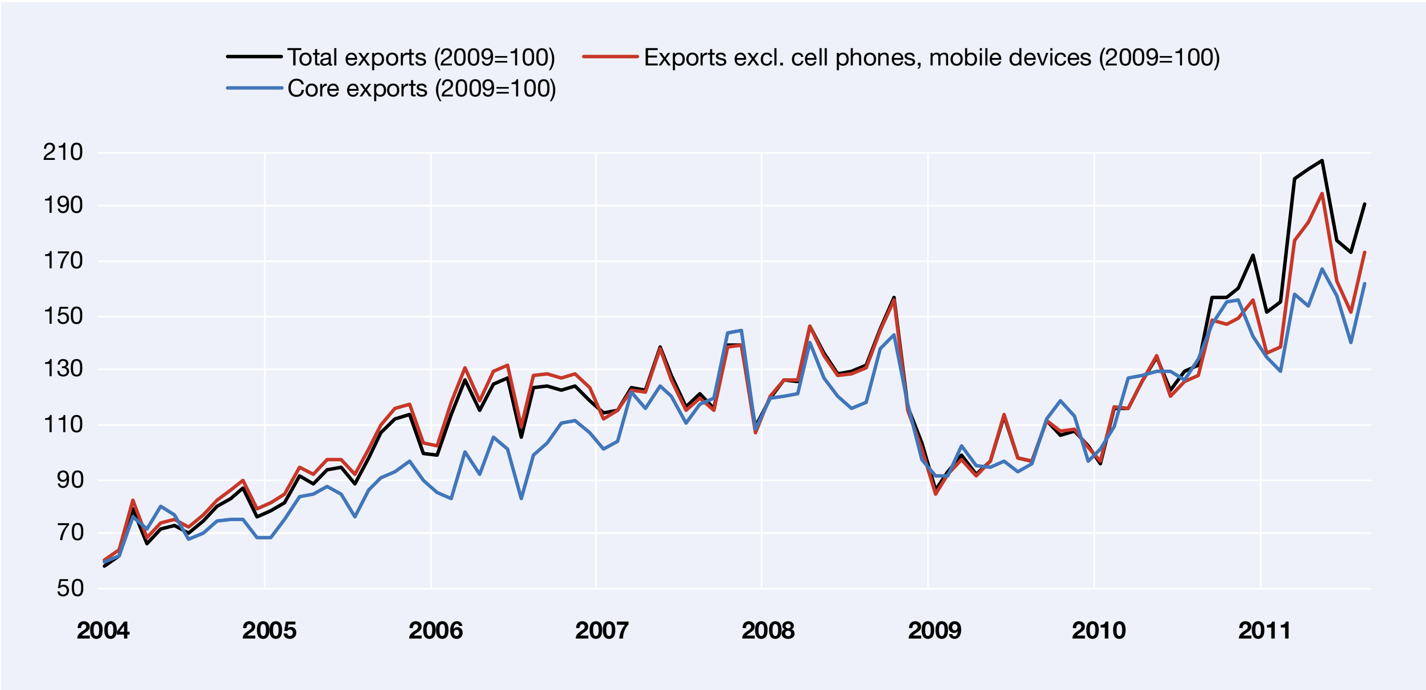
CDS premia of Nordic and European banks



Source: Bloomberg, EP calculations

Nordic banks: Swedbank, SEB, Nordea, Handelsbanken, Danske Bank
European banks: UBS, Société Générale, HSBC*, Deutsche Bank, ING, Barclays, BNP Paribas*

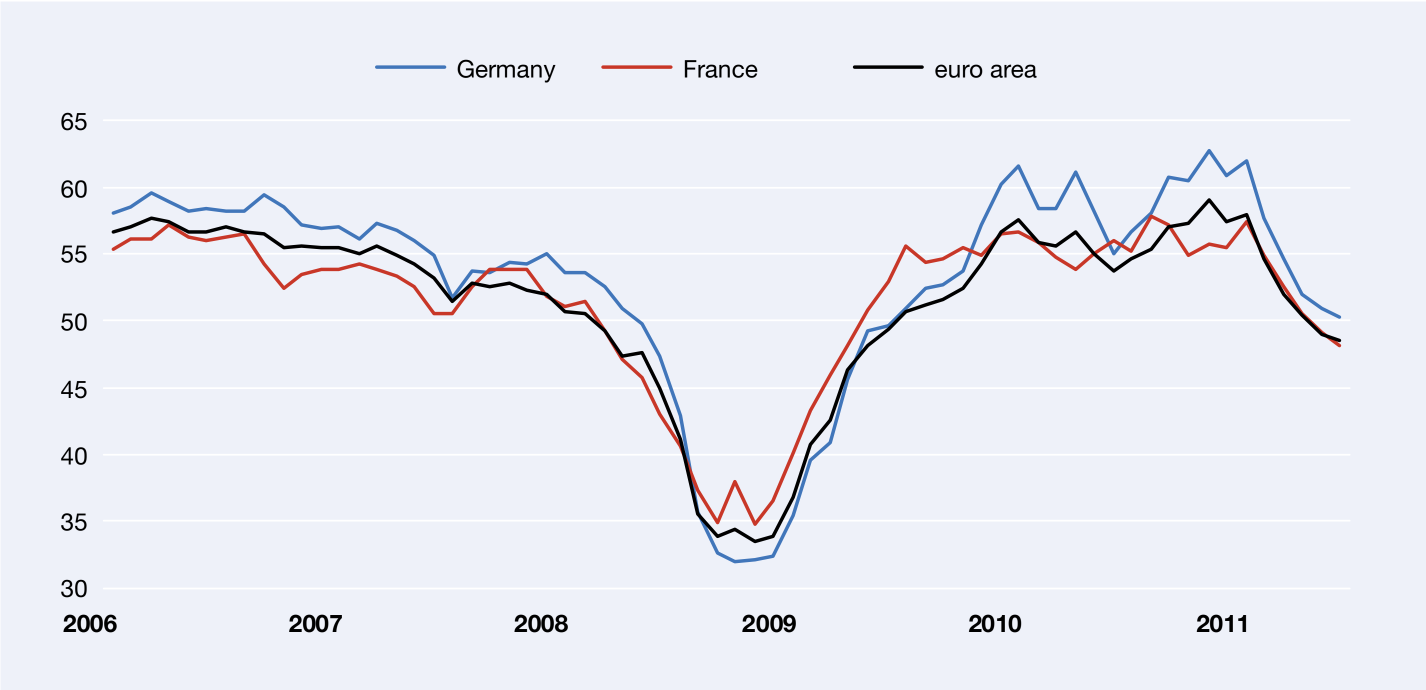
Estonia's export growth has been strong, but the risk of a setback has intensified due to the debt crisis



Source: Statistics Estonia, Eesti Pank

The export partners' growth expectations are declining

PMIs of the manufacturing sector

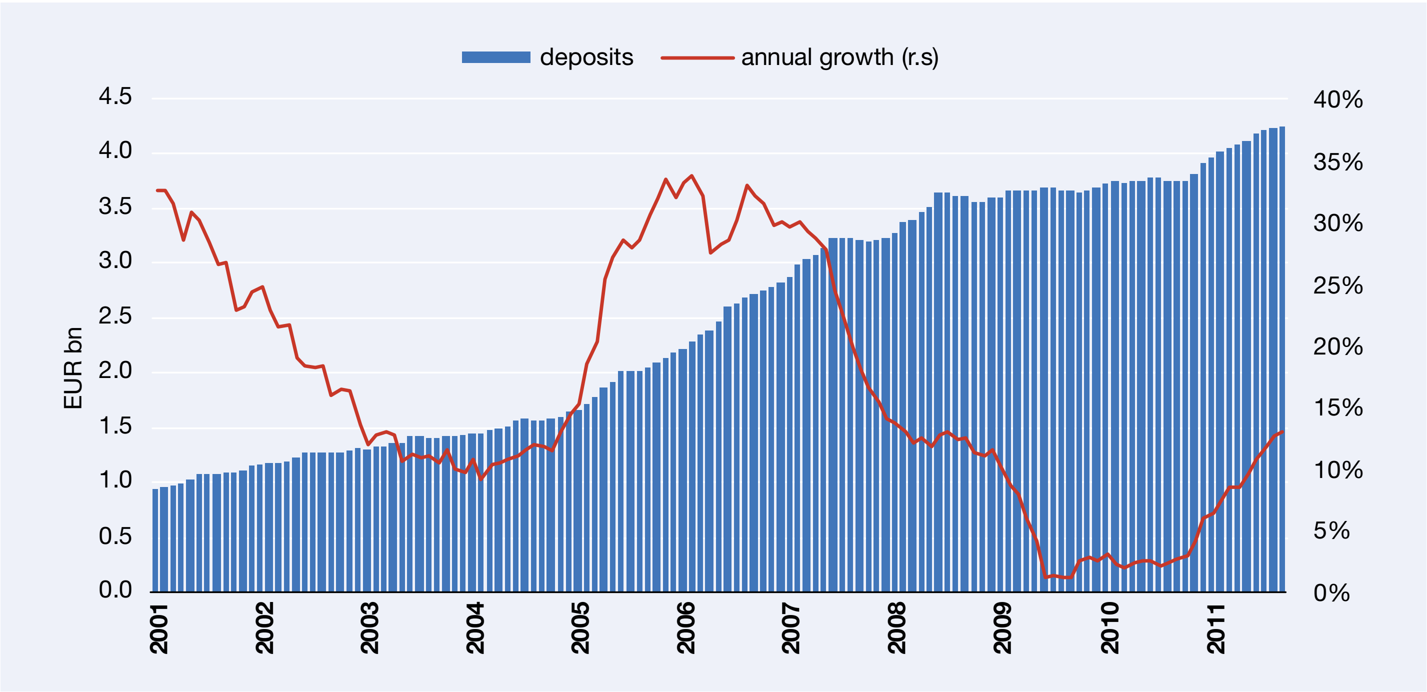


Source: Bloomberg

- With external demand shrinking, it may become more difficult to pay back loans.

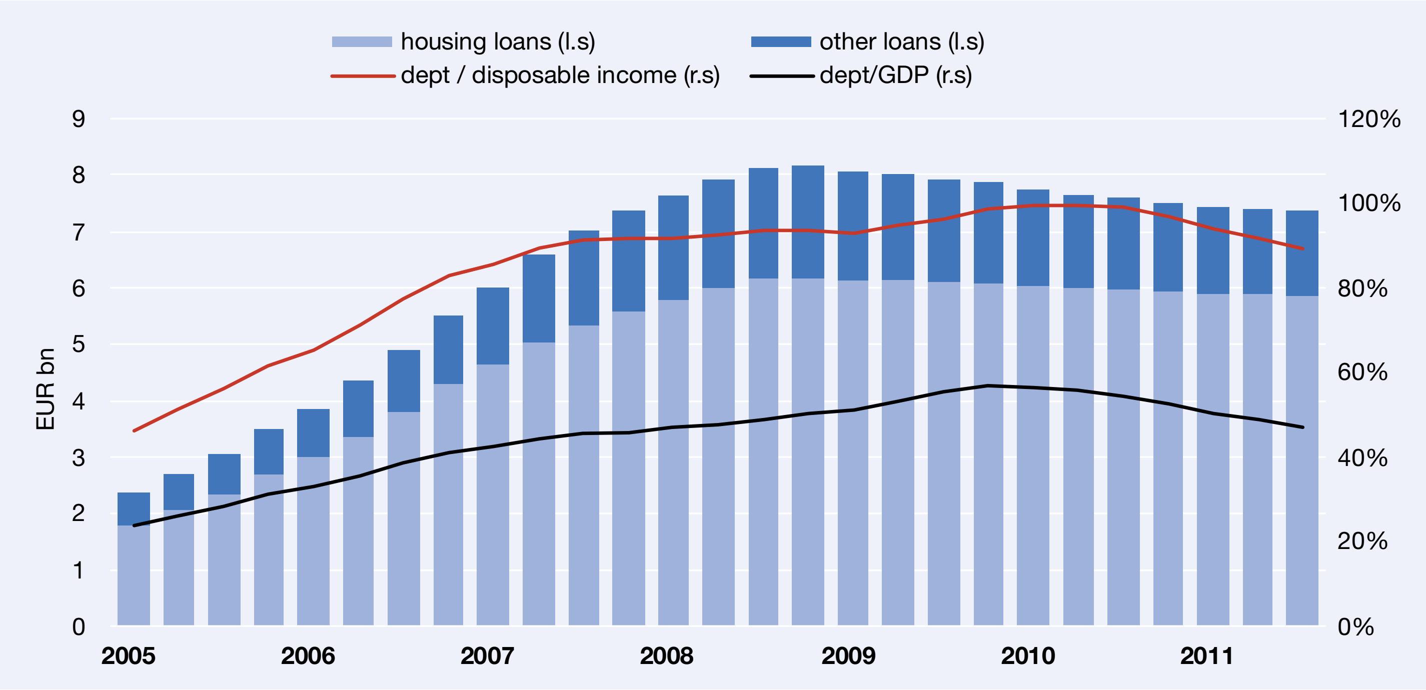
Households have bolstered their financial buffers

Household deposits



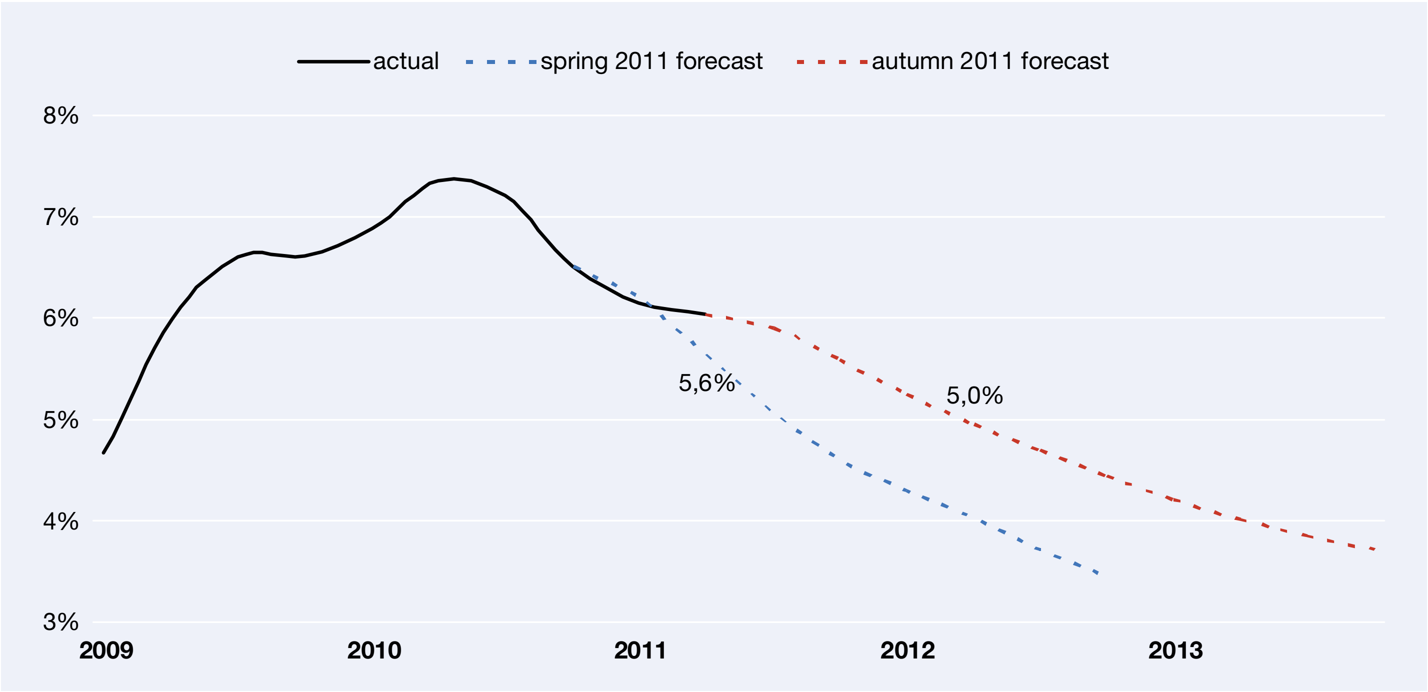
There are controversial processes in the solvency of households: slower growth reduces it, whereas the postponement of interest increases improves it

Debt burden of households



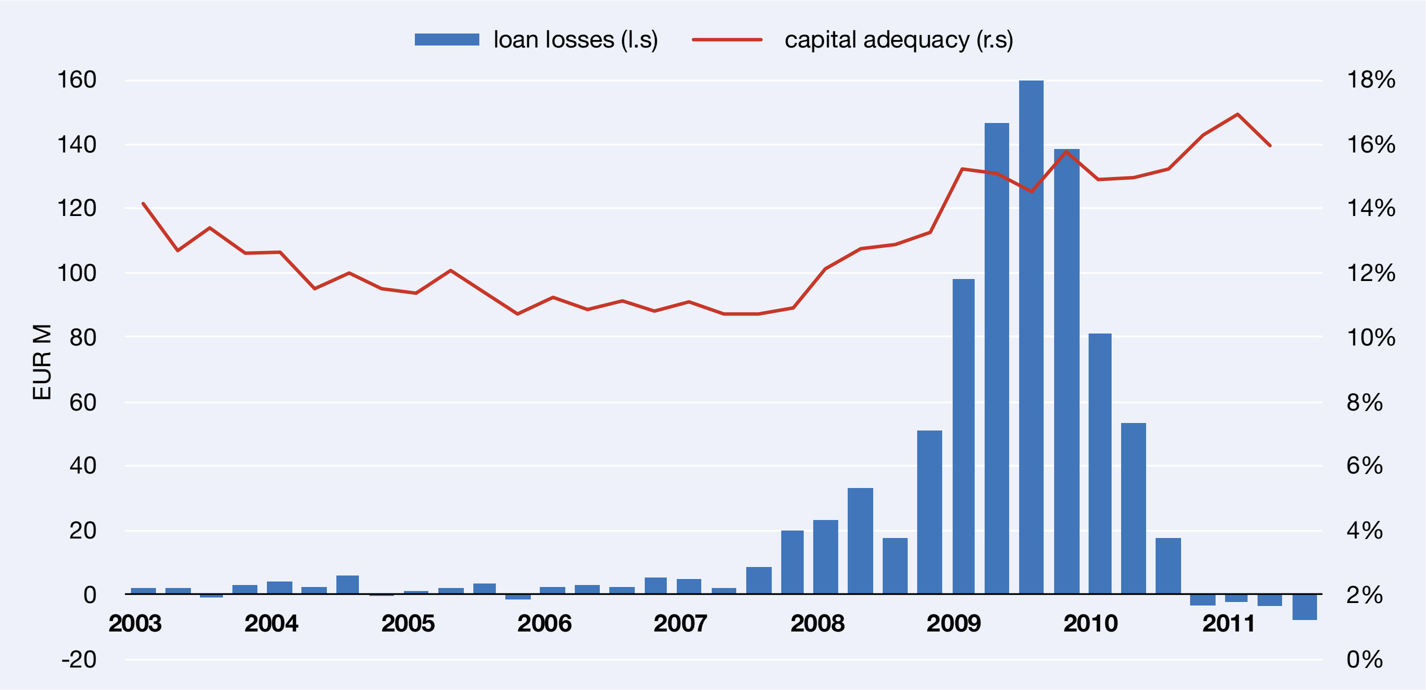
The share of problem loans has shrunk, but the pace thereof will slow soon

Share of loans overdue by more than 60 days in the loan portfolio



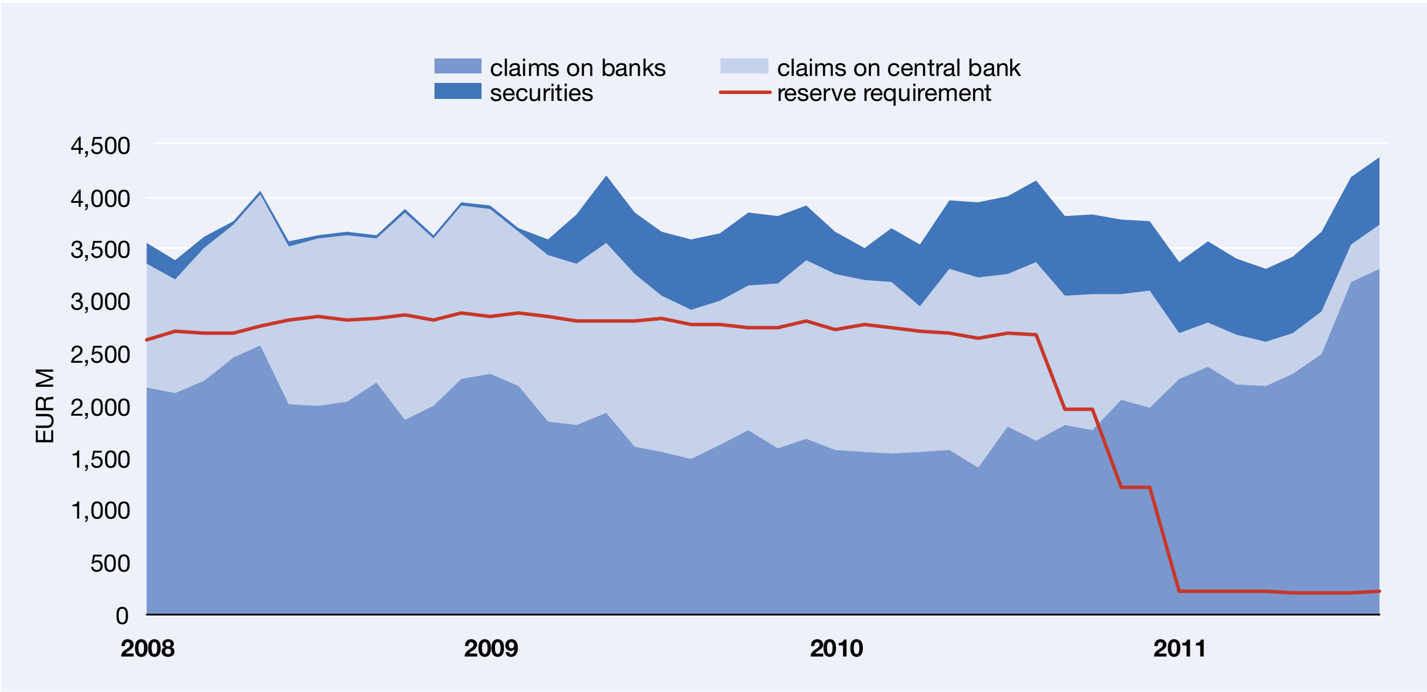
Banks' current capital buffers could cover double the volume of the current overdue loans

Banks’ loan losses and capital adequacy



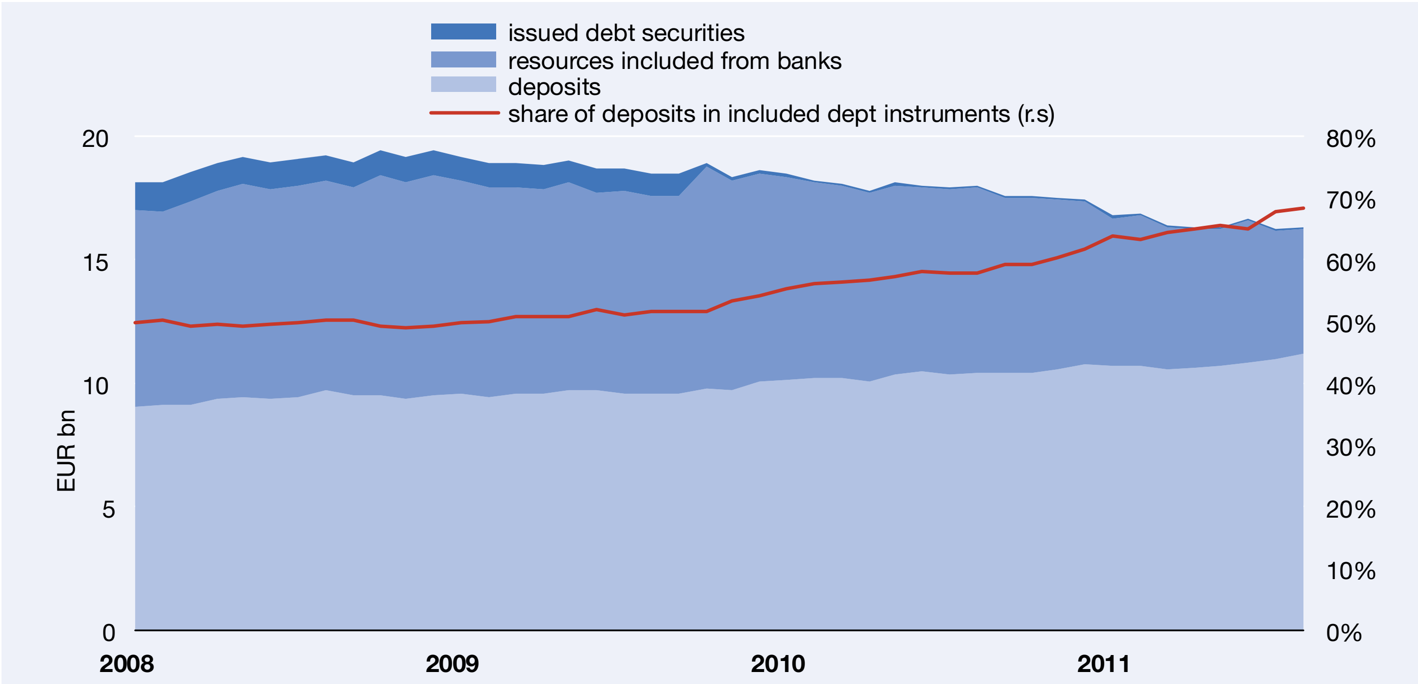
The share of banks' liquid assets is at the highest level of the past three years, since deposits are growing fast

Liquid assets of banks and the reserve requirement



Banks' dependence on parent banks' financing has decreased

Structure of banks' liabilities



ECONOMIC POLICY CONCLUSIONS

Risks to financial stability

- So far, risks related to parent banks have been alleviated by the financial markets' high confidence in the Nordic banking system and economic and fiscal policy.
  - If euro-area liquidity and financing problems start having a stronger effect on the Nordic parent banks, their subsidiaries and branches operating in Estonia will also face more expensive financing costs.

- Financial-market volatility and the debt crisis in several countries may hinder the further development of the real economy. If external demand were to shrink to a great extent, the banking sector's loan quality and profitability may suffer a setback.
  - The capitalisation of the Estonian banking sector is currently sufficient to manage with risks arising from a possible downturn.

Steps taken by Eesti Pank to ensure financial stability

- One of the key factors in tackling the financial crisis is cross-border cooperation with the home countries of the banking groups. To this end, Nordic and Baltic countries have signed a memorandum of understanding on ensuring financial stability and solving the financial crisis.
- We offer, with the rest of the Eurosystem, unlimited liquidity supply to commercial banks. In addition, we have extended the maturities of monetary policy loans and are going to start purchasing covered bonds.
- We ensure smooth and sustainable functioning of clearing and settlement systems.
- Strong capital and liquidity buffers help manage with higher risks and improve market confidence. We support setting higher capital requirements to banks and, if necessary, curbing their profit distribution.

Uncertainties in the external environment set very high requirements to the Estonian fiscal policy

- We back the government's objective to keep the consolidated budget in a surplus over the medium term and reach the latter in 2013.
- As to the next year's budget, we recommend that the government should proceed from the risk scenario of the Ministry of Finance's forecast.
- In addition, it is important to avoid the excessive volatility of general government expenditure and to ensure that reserves are sufficient.

What can we do to avoid a downturn and to diminish the effect of the debt crisis in the euro area and the EU?

In shorter term:

- Restoration of confidence in the economic policy of the euro area countries that are in difficulty.
- Adherence to existing agreements as regards fiscal policy.

In longer term:

- To consider how to better ensure fiscal policy discipline and larger financial buffers in the general government sector.
- A more efficient crisis management framework for the euro area.
- Euro area countries must take active economic policy measures to avoid possible risks to stability.
- The single currency area cannot function if there is no flexibility.

Thank you!