III. ESTONIAN NON-FINANCIAL AND FINANCIAL SECTOR

NON-FINANCIAL SECTOR

MONETARY ENVIRONMENT

To evaluate non-financial and financial sector development trends in 2003, the expansive monetary environment should be taken into consideration, in particular in the first half of the year when the European Central Bank kept lowering key interest rates, and the margin between euro area and Estonian loan rates continued shrinking as well. Therefore Estonia's interest rates of loans (to the non-financial sector) were at historic low (see Figure 3.1). In the second half of 2003, the interest level started to stabilise, accompanied by rapid depreciation of the US dollar in early-2004. The impact of the expansive external environment was more seen on non-tradable sector businesses.

ESTONIA'S SOVEREIGN RATING

Sovereign rating, i.e. a country's credit rating is the assessment by international credit rating agencies of a country's ability to pay back foreign loans. Sovereign rating determines largely the interest rates of foreign borrowing.

In 2003, Fitch and Standard & Poor's raised Estonia's credit outlook from stable to positive whereas the level of credit rating was not changed. S&P assigned a rating of A- to long-term foreign currency liabilities and A-2 to short-term foreign currency liabilities, Fitch assigned A- and F, respectively. Since autumn 2002 when Moody's raised ratings it has not introduced any changes, and the ratings have remained at A1 and P-1, respectively.

Estonia's positive rating outlook reflects, first and foremost, growth potential in the country's creditworthiness vis-à-vis upcoming entry to the Economic and Monetary Union. According to the agencies, the euro area member status would reduce significantly risks arising from balance of payments and external shocks. Estonia's conservative fiscal policy, which is also important for meeting the EMU criteria, and relatively rapid economic growth were considered as factors contributing to the rating. The main factor undermining the rating according to the rating agencies was the large current account deficit in 2003.

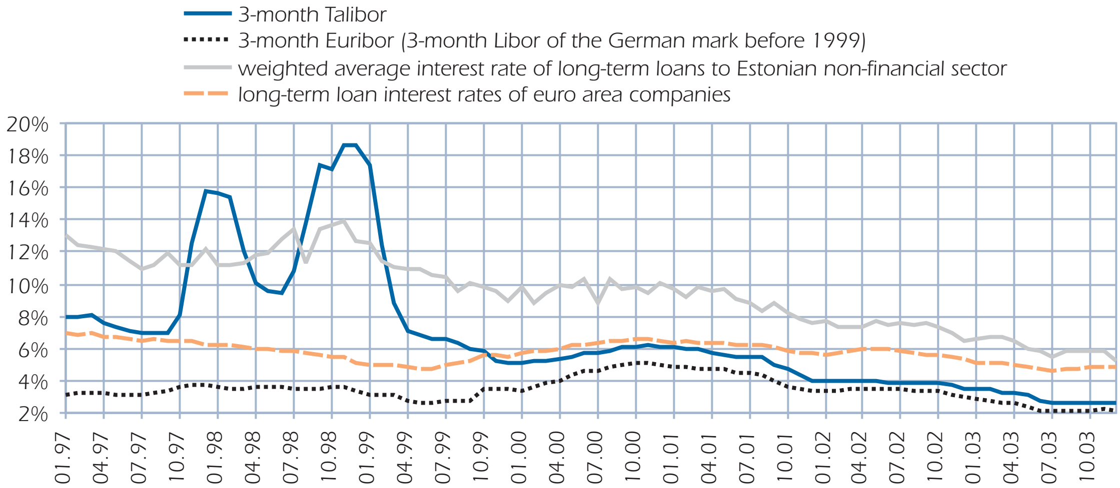

Figure 3.1. Money market interest rates of Estonia and the euro area and interest rates of long-term loans to Estonian non-financial sector

EXTERNAL AND DOMESTIC DEMAND

Estonia's economy grew at 4.7% last year, faster than in the first three quarters of 2003. In the last months of the year, GDP growth accelerated to 5.8%, being very close to the floor of the potential growth (5–6%).

It was domestic demand and not exports, which sustained economic growth, although growth in IT subcontracting accelerated growth in goods and services exports against 2002. In fact, export of goods expanded relatively rapidly (by about 6% in fixed prices) but difficult ice conditions in early-2002 stripped growth of transit trade, and services export landed at the level of end-2002.

In 2003, external demand was relatively unfavourable for Estonia: this was explicit not so much in slowly growing exports but rather in major differences in markets of various goods (see Figure 3.2). For example, food export displayed a slight growth but remained at the level of 2001 anyway. In traditional and more important industries, timber industry managed to maintain its relatively rapid growth of export. As a rule, less significant branches of manufacturing industry sustained a growth rate above average although it varied largely by branches and ranged from a 10% fall to a 20–30% increase.

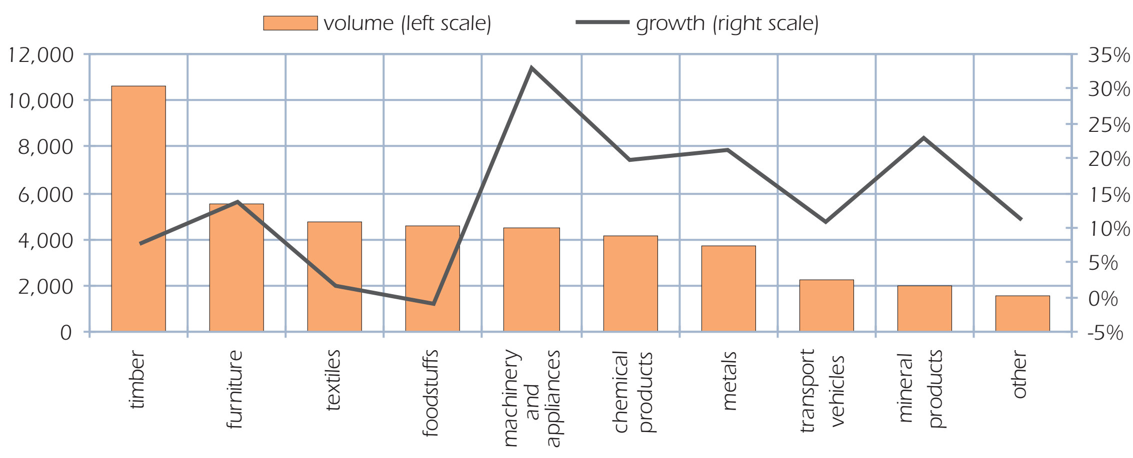

Figure 3.2. Volume (without processed goods; EEK million) and nominal growth (%) of exports by product groups in 2003

Manufacturing industry, trade, transport, and communication account for about 45% of Estonia's GDP. On the basis of nine months, only transport and communications sector sustained last year's growth rate. In trade, the annual growth slid to 4% and in manufacturing to 8% (see Table 3.1). Manufacturing exports sustained relatively rapid growth because each of the multiple branches had a relatively homogeneous share in exports. In 2003, timber processing was the only branch accounting for more than a tenth in manufacturing exports, 15%, to be more specific.

Table 3.1. Change in value added by spheres of activity in 2002 and during 9 months of 2003

	2002	9 months of 2003
Agriculture and hunting	-1.8%	-2.3%
Forestry	7.4%	-7.8%
Fishing	-6.6%	-8.7%
Mining	9.6%	10.5%
Manufacturing	10.0%	8.1%
Electricity, gas and water supply	0.3%	10.8%
Construction	13.9%	5.6%
Wholesale and retail trade	10.0%	3.9%
Hotels and restaurants	7.1%	2.7%
Transport, storage and communication	1.7%	2.9%
Real estate, leasing and business services	1.2%	2.4%
Financial intermediation	16.0%	7.9%
Public administration	3.0%	1.2%
Education	1.3%	1.2%
Health care and social maintenance	0.6%	0.3%
Other services	4.0%	4.5%
GDP total	**6.0%**	**4.4%**

For the second consecutive year, domestic demand exceeded external demand in growth. Although private consumption shrank from 9–10% in 2002 to 5–6%, investments boomed for the second successive year. Investments in fixed capital reached 30% of GDP (see Figure 3.3).

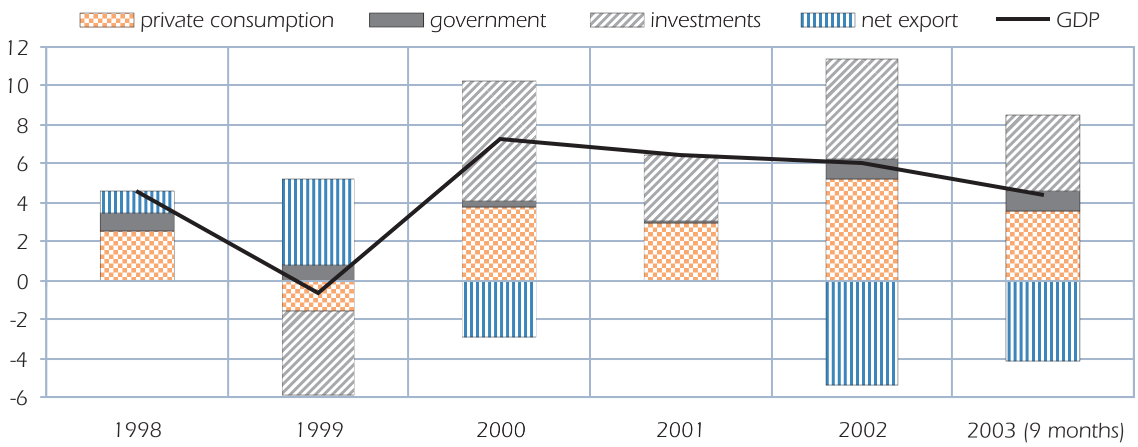

Figure 3.3. Share of GDP consumption components in economic growth (in percentage points)

Primarily new business projects, including housing, large investments in transport, and continued reconstruction of power plants sustained rapid investment growth. Most of the undertakings which have been operating in the market for a long time, preferred to invest modestly. Housing boom derived from better access to retail loan facilities. Housing loans sustained rapid growth, and vis-à-vis financial intermediation, households turned into net borrowers.

Large domestic demand and relatively rapid export growth facilitated employment both in services industry and manufacturing. The unemployment level continued to decline slowly. In most fields overoptimistic expectations of external demand sent labour costs up, which grew faster than productivity.

SOURCES OF FINANCING ECONOMIC GROWTH

The ratio of domestic saving to GDP decreased only slightly against 2002 or remained unchanged. Growing saving in the government sector could neither compensate declining household saving nor a slight fall in corporate profitability. According to preliminary estimates, the share of profit of GDP shed 0.5–1 percentage points. The slide shows that small resident-owned businesses made less profit whereas profitability in businesses with core foreign owners increased according to the balance of payments (see also Current Account Deficit and Foreign Investments in a Small Open Economy, Chapter III).

As domestic savings remained equivalent to or slightly below the level of 2002, increasing investment demand deteriorated external equilibrium. Current account deficit of GDP was 13.7% (see Figure 3.4). Foreign direct investments covered about a half of the financing gap, and similar to previous years, loans from Estonian and foreign banks were used to finance new businesses. Such practice soared Estonia's foreign debt from about 65% of GDP in 2002 to 75%. Since corporate foreign assets did not grow, unlike previous years also net foreign debt went up.

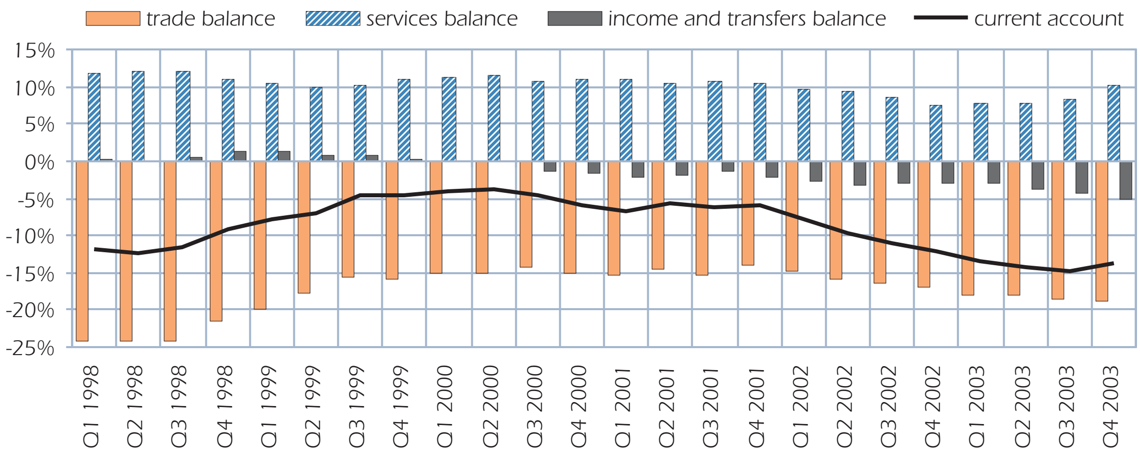

Figure 3.4. Current account and sub-balances of Estonian balance of payments, moving average of last 4 quarters (% of GDP)

GENERAL GOVERNMENT

Relatively rapid economic growth secured also high government revenue growth, and tax collection was above forecast. Despite a billion-kroon supplementary budget, the general government revenue surplus was 2.6% of GDP for the year, and revenue exceeded expenditure for the third successive year (see Figure 3.5). This is the largest general government surplus ever in Estonia. **Considering the high current account deficit, tighter fiscal policy was more than appropriate.**

The coalition government, which came to the power in spring 2003, has drafted a medium-term programme, involving both a reduction of tax burden through curbed individual income tax and an increase of certain priority expenditures, such as family and child benefits. However, both objectives are accommodated within the balanced budget principle. Drafting of the state budget for 2004 showed that integration of both objectives might be more complicated than expected. To ensure revenue-expenditure balance, the individual income

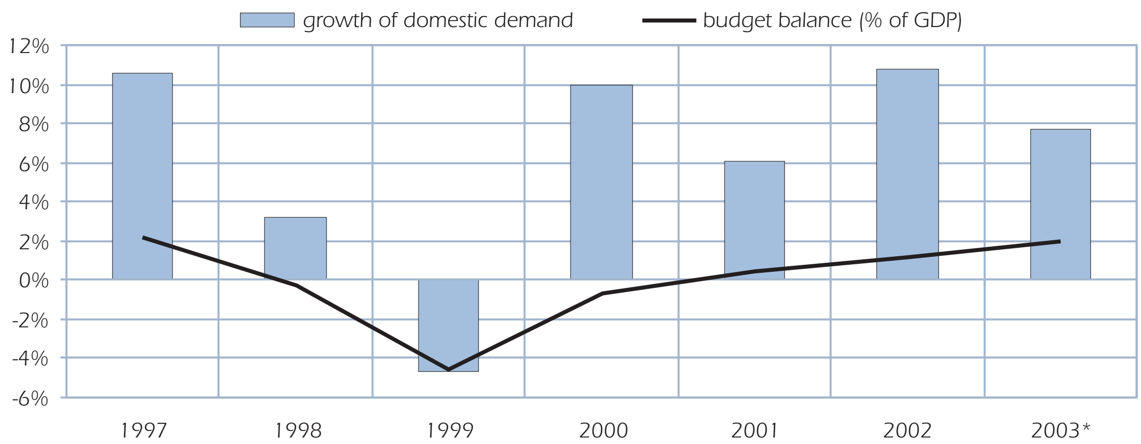

Figure 3.5. Real growth of domestic demand and general government budget balance

* forecast

tax cut was to be postponed for a year to increase social expenditure. The government has assured that a balanced budget will remain its economic policy priority.

INFLATION

In 2003, weakening external price pressure arising from food and oil prices and appreciation of the euro against the dollar had a significant impact on the price level. Together the two factors rendered price increase of tradable goods and services nearly non-existent – remaining below 0.3% as an annual mean. Also domestic competition has helped to keep prices under control. Relatively rapid economic growth secured sustained price convergence in the non-tradable sector, in which consumer prices displayed an annual 3.4% growth (see Figure 3.6).

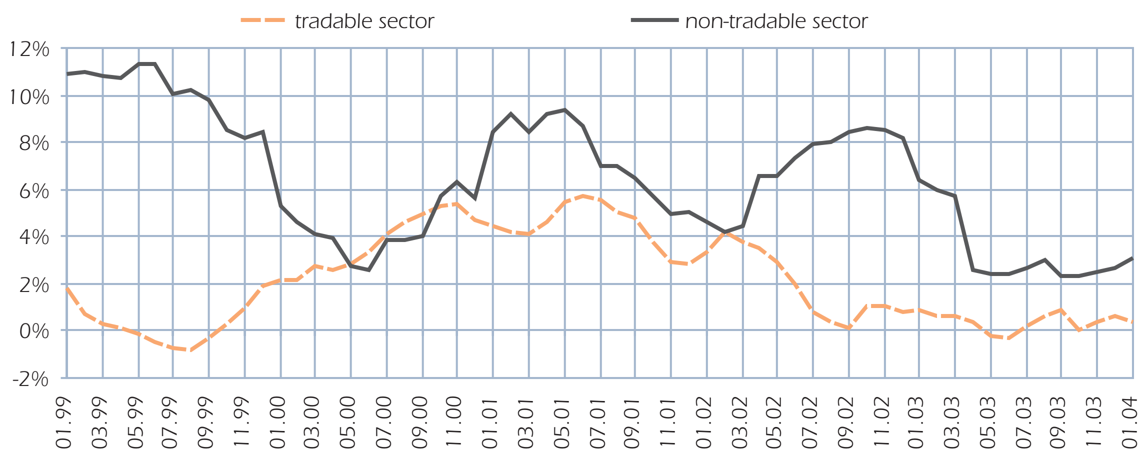

Figure 3.6. Annual growth of Estonia's tradable and non-tradable sector price indices

The annual average headline consumer price growth rate was 1.3%. Similarly to the previous year, food prices had a tremendous impact on the appreciation of the consumer basket in 2003 (see Figure 3.7). Although turbulent fuel prices influenced prices of consumer goods throughout the year, the annual impact was close to none. Assumingly, also the appreciation of the euro supported containment of fuel prices at the previous level. Due to the large share of food prices in the Estonian consumer basket, consumer prices have grown here less than in the euro area (see Figure 3.8). Core inflation index, which measures price increase by excluding such volatile indicators as food and energy prices, indicated that the inflation rate in Estonia was about a percentage point above the euro area rate, corresponding thus to medium-term expectations.

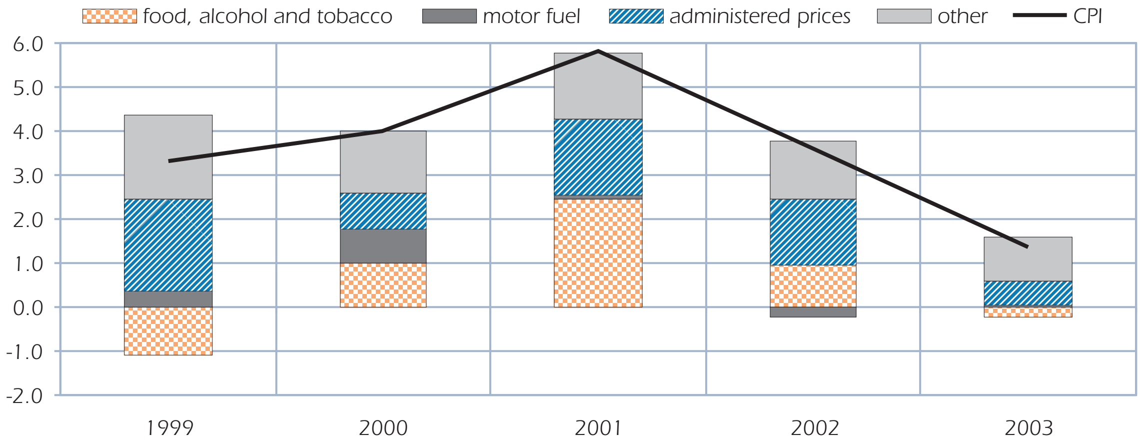

Figure 3.7. Annual change of consumer price components (percentage points)

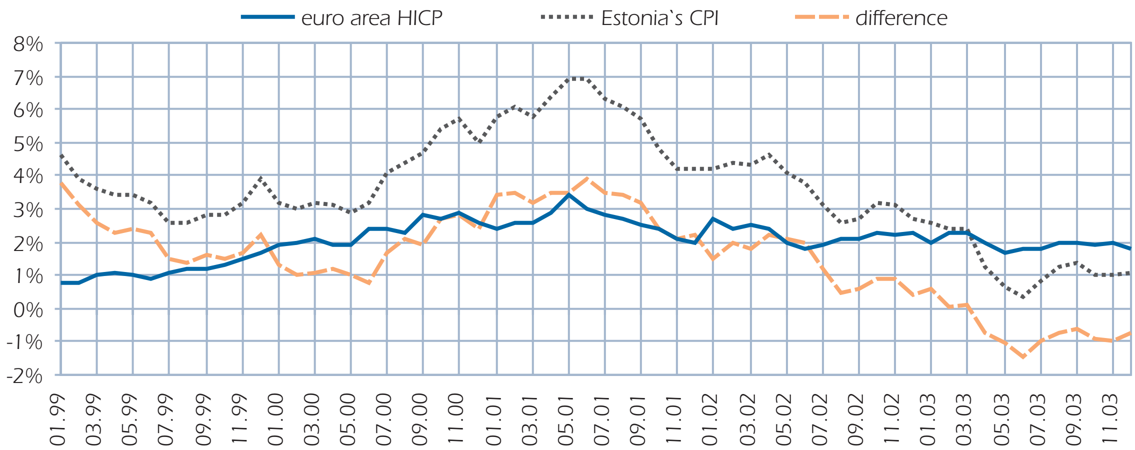

Figure 3.8. Twelve-month growth of consumer prices in Estonia and the euro area

As an annual average, the real exchange rate of the kroon gained 1.8%. The kroon appreciated against the currencies of industrial countries by 0.4%, and against the currencies of transition economies by 5.5% on the average (see Figure 3.9). The real exchange rate of the kroon took a boost from the close to 20% depreciation of the US dollar against the euro as an annual average.

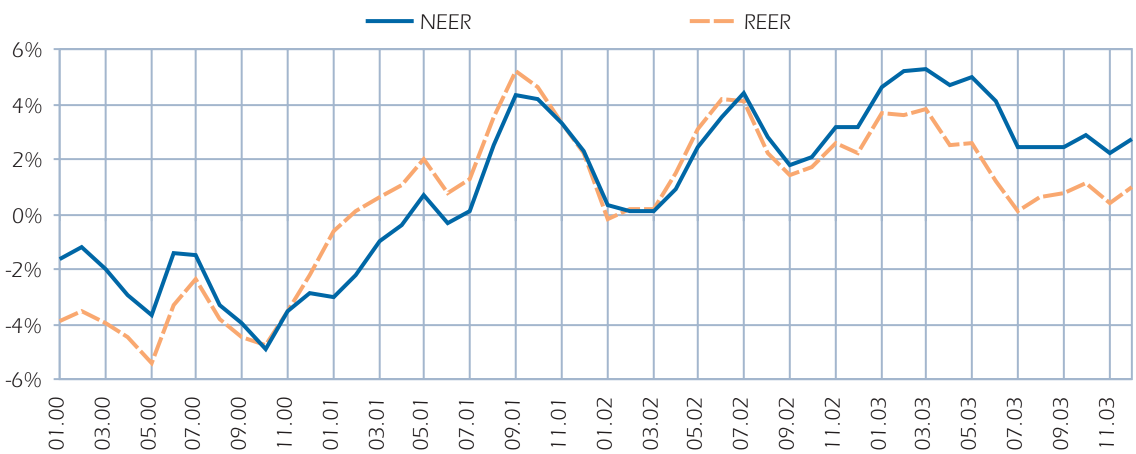

Figure 3.9. Twelve-month change of nominal and real exchange rate of the Estonian kroon

CURRENT ACCOUNT DEFICIT AND FOREIGN INVESTMENTS IN A SMALL OPEN ECONOMY

Most of the research on real convergence indicates that economic growth and capital investment are closely related. In other words, convergence of income level towards the level of developed countries would take larger-than-average investments in fixed assets for decades also in Estonia. Due to our low income and saving level, this is realistic only in the case of extensive inflow of external capital (see Figure 1b).

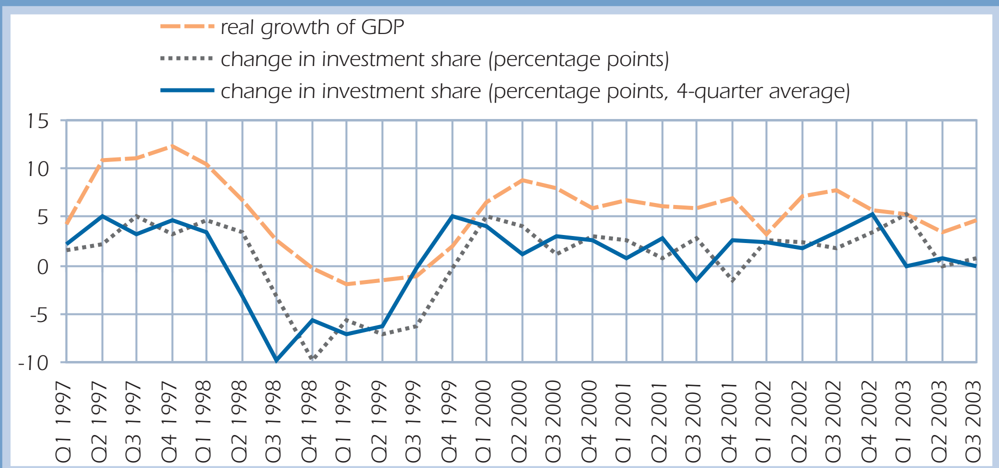

Figure 1b. Real growth of GDP in Estonia and change in investment share relative to GDP (%)

An average Estonian business is a small one in the European context, and the foreign investor in this business is, as a rule, a core investor. At the end of 2003, about 95% of the foreign investments in Estonian non-financial sector businesses were foreign direct investments.

Developing countries value foreign investments also for their accompanying know-how. The majority of studies on real convergence refer to a strong link between technology development and FDI inflow. However, there is no convincing explanation why core investors should invest and technology transfers occur only as direct investments. It is quite logical that the more open the economy, the less significant is the form of financing vis-à-vis technology transfer. Estonia can provide a sufficient number of cases of foreign investors establishing a new, high-tech undertaking which is financed by loans. Whether and to what extent the structure of capital inflow in a globalising economy will change has remained unclear despite numerous empirical studies.

That FDI in Estonia is profitable is seen in the very fact that besides reinvesting profits also distribution of dividends has started to pick up. Such trends are well displayed on the balance of payments income account (Table 1b). If all the dividends disbursed by the foreign investors and reinvested income were linked to FDI, the profitability would be 7.5–10% in the period of 2000–2003.

Table 1b. Foreign investment income by balance of payments in 2000–2003 (% of GDP)

	2000		2001		2002		2003	
	EEK million	% of GDP	EEK million	% of GDP	EEK million	% of GDP	EEK million	% of GDP
Income account balance	-3,483.4	-3.58	-4,926.1	-5.52	-5,483.1	-5.07	-7,536.5	-6.40
dividends and distributed profit	-1,395.5	-1.43	-1,177.3	-1.23	-2,773.5	-2.59	-1,440.0	-1.60
reinvested income	-1,749.3	-1.84	-3,573.7	-3.98	-2,704.8	-3.15	-5,580.5	-5.40

Altough older foreign-capital based businesses are generating profit by now, the ratio of capital to GDP is merely 200% according to several studies[1], i.e. an estimated one and a half times less than in developed industrial countries. Indirectly the need to increase capital can be seen in the fact that reinvested income exceeds the size of dividends. According to accounting rules, reinvested amounts soar the income balance deficit together with current account deficit on the balance of payment (see Figure 2b).

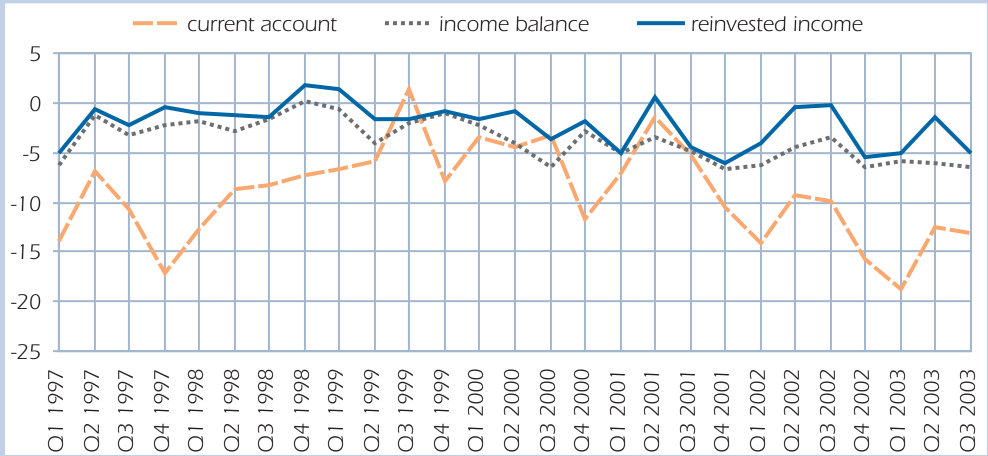

Figure 2b. Current account balance and invested income (% of GDP)

FINANCIAL SECTOR

Recovery of the world economy has taken longer than anticipated, rendering also the financial environment expansive in 2003. External factors have sustained the financial sector's intensive expansion the longest ever: for the second consecutive year the loan and leasing portfolio has grown for more than 25%.

In 2003, development trends accompanying the rapid growth of the financial sector, e.g. swift expansion of the loan portfolio and involvement of external liabilities to finance banks' business operation (see Figure 3.10), deepened. Parallel to active financing, the year was promising also in pension investment, primarily in the number of new fund members.

[1] See e.g. Cottarelli, C., Dell'Ariccia, G., Vladkova-Hollar, I. (2003), 'Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and in the Balkans', IMF Working Paper No 03/213, November.

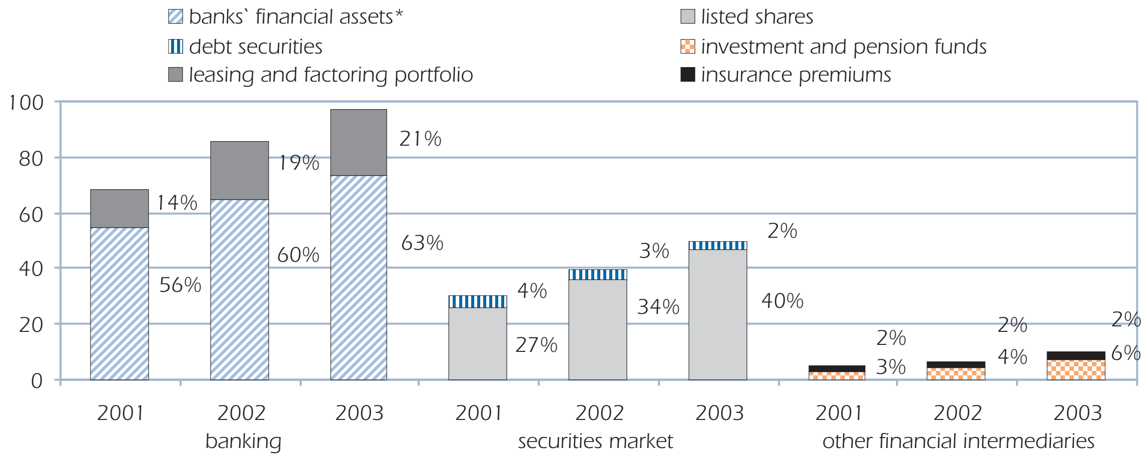

Figure 3.10. Structure of Estonian financial intermediaries (EEK billion and % of GDP)

* Excluding loans to financial institutions.

In 2003, unlike previous periods, growth in bank-facilitated lending overtook growth in leasing financing: primarily due to rapidly growing housing loans. Although car leasing and consumer loans sustained growth in claims of leasing associations, their nominal value remained fourfold below housing loans. Booming borrowing boosted non-financial sector domestic loan burden relative to GDP by 8.4 percentage points over the year, reaching 54.9% by December (see Figure 3.11).

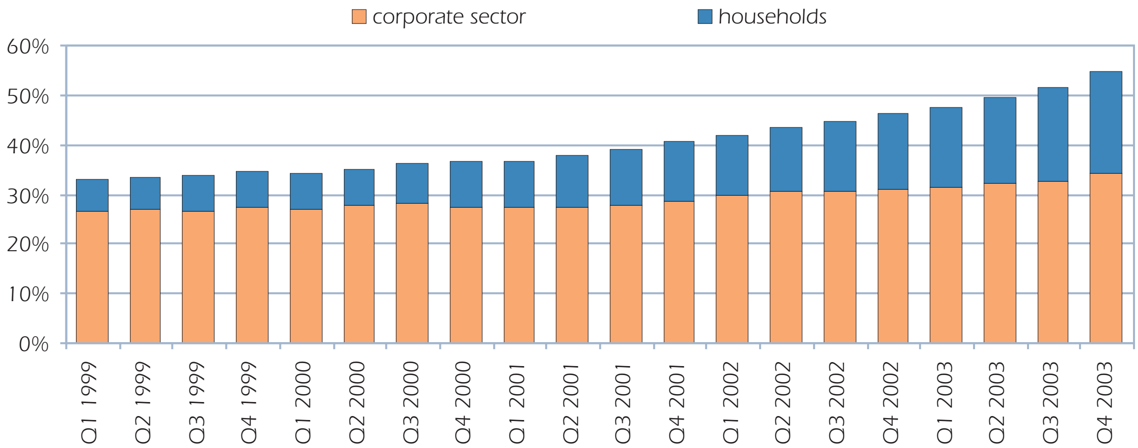

Figure 3.11. Non-financial sector domestic debt (% of GDP)

The securities market witnessed an exceptionally large appreciation of stocks against devolution in the bond market. Modest domestic saving curbed the interest in depositing and inhibited growth in investment funds. Pension investments, which accelerated also growth in life insurance, remained an exception.

Compared to 2002, both rapidly growing financial assets and poor saving helped to weaken the real sector financial positions. In the last quarter of the year, private individuals' financial position turned negative for the first time (see Figure 3.12). Despite the increasingly more unbalanced financial assets and claims, the year was productive for the financial sector, allowing reinvested profits to support sustainable development and mitigate potential risks.

Although the Estonian financial sector is moving towards a more balanced, proportionate market segmentation in the longer term, the year 2003 further amplified the dominant position of banks in

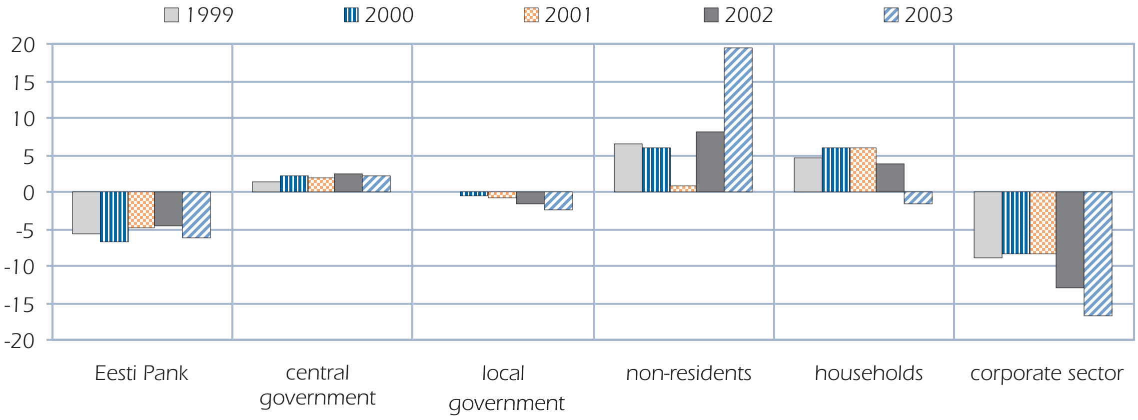

Figure 3.12. Net positions of institutional sectors against financial sector* (EEK billion)

* The financial sector includes here credit institutions, leasing companies, bond market, interest and equity funds.

financial intermediation (see Table 3.2). Leasing has integrated more deeply into banks' financing, resulting in synergy which arises from consolidation of similar businesses. Despite a broader spread of investment products, the funds accounted for merely 6% of GDP, remaining modest vis-à-vis the entire financial sector. In other financial markets, the banks' market share expanded through subsidiaries in the pension investment sector. This is why the market share of non-pension-fund managers increased slightly among investment funds.

Tabel 3.2. Credit institutions' share in other financial intermediaries

	1998	1999	2000	2001	2002	2003
Leasing	96.4%	97.5%	99.1%	99.7%	99.1%	99.2%
Life insurance	16.6%	43.6%	72.7%	66.8%	66.3%	68.3%
Non-life insurance	2.4%	0.2%	0%	0%	0%	0%
Investment funds	89.9%	93.4%	94.3%	98.3%	96.5%	90.3%
Pension funds	–	100.0%	100.0%	94.6%	73.8%	87.8%
Turnover of Tallinn Stock Exchange	60%	79%	71.4%	75.5%	84.5%	61.4%

BANKING

Institutional Development

Seven credit institutions operate in Estonia: AS Hansapank, AS Eesti Ühispank, AS Sampo Pank, AS Eesti Krediidipank, Tallinna Äripanga AS, AS Preatoni Pank, and Nordea Bank Finland Plc Estonian Branch. At the end of 2003, the share of foreign owners in the banks' share capital was 85.7%, with an increasingly larger share belonging to foreign credit institutions (see Table 3.4).

In end-2003, seven foreign credit institutions had their representative offices in Estonia: Akciju Komercbanka Baltikums, International Bank of St Petersburg, HSH Nordbank AG, NORD/LB Norddeutsche Landesbank Girozentrale, OKO Bank, Parekss-Banka, and Vereins- und Westbank AG. The number of agencies of Russian and Latvian banks has increased over the recent years. On 10 March 2004, the Financial Supervision Agency authorised AS Barekss-Banka to open its branch in Estonia.

Table 3.3. Owners of Estonian credit institutions (%)

	31.12.98	31.12.99	31.12.00	31.12.01	31.12.02	31.12.03
Non-residents	**55.49**	**62.24**	**83.91**	**85.74**	**86.73**	**85.66**
Credit institutions registered abroad	45.50	52.58	66.99	63.28	78.95	80.11
Financial institutions registered abroad*	2.18	1.94	0.51	17.18	3.63	3.05
Other non-resident legal persons	7.32	7.03	16.21	5.15	4.06	2.40
Non-resident natural persons	0.49	0.68	0.20	0.14	0.09	0.09
Estonia	**44.51**	**37.76**	**16.09**	**14.25**	**13.26**	**14.33**
Central government incl. local government	0.45	0.27	0.01			
Eesti Pank	13.14	11.37	0.00			
Credit institutions registered in Estonia	1.46	4.62	0.63	0.09	0.09	0.18
Financial institutions registered in Estonia	0.74	0.34	0.15	0.36	0.17	0.58
Companies registered in Estonia	20.05	10.12	5.99	5.08	4.91	6.37
Non-profit organisations registered in Estonia	0.04	0.07	0.02	0.03	0.01	0.00
Estonian natural persons	8.39	10.84	9.06	8.53	8.08	7.20
Other (preference) shares	0.24	0.13	0.23	0.16		

* Since the end of 2001, non-resident financial institutions include beside investment funds also insurance companies and investment firms, which were recorded under other non-resident legal persons in previous years.

Intensified competition and loan offers beyond the growth of the customer base have changed market distribution (see Figure 3.13). The year 2003 was successful primarily for medium-sized banks. Nordea's aggressive market access policy was fruitful and added about 2% to its market share. By the end of the year also Sampo had enlarged its share in the market. Hansabank's loan and leasing portfolio shed 2.4% in the market. The market share of small banks shrank to 1.3%. Ühispank maintained its stable position in the leasing and credit market. A specific feature of Estonia is the relatively modest share of savings and loan associations in financing economy. In end-2003, their balance sheet volume was 76 million kroons and loan portfolio 54 million kroons, accounting for 0.1% of the leasing and loan portfolio of banks and their subsidiaries.

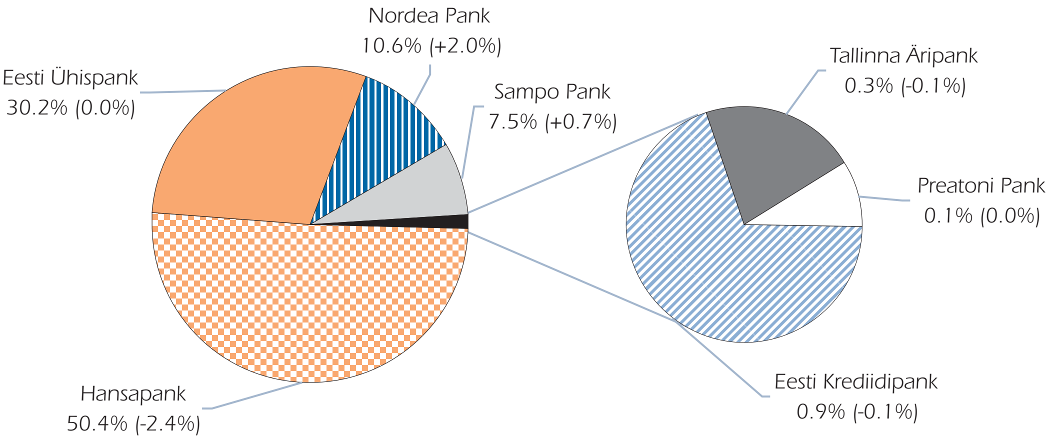

Figure 3.13. Market shares of banking groups in Estonia by volume of real and public sector financing (bank loans, leasing and factoring) at the end of 2003 (in brackets annual change)

Ratings assigned by international rating agencies to Estonia's banking sector creditworthiness have continuously improved (see Table 3.4). In November 2003, Fitch upgraded Hansapank's short-term liabilities rating to F-1, mostly due to Estonia's positive outlook for long-term foreign currency rating, underlining close cooperation prospects with the parent bank (Swedbank) in the EU single financial market. On 18 February

Table 3.4. Ratings assigned to banks by Moody's Investors Service at the end of 2003

	Hansapank	Ühispank*	Sampo Pank
Long-term liabilities	A 1	A 1	A 3
Short-term liabilities	P-1	P-1	P-2
Financial strength	C	C-	D+

* Ratings for Ühispank encompass an increase in ratings on 18 February 2004.

2004, Moody's upgraded the long-term deposit rating of Ühispank of the SEB Group from A2 to A1, reasoning it with the upgrading of Ühispank's sole owner SEB AB ratings, and the significance of the latter's role in managing Ühispank.

Assets and Liabilities of Banks

In 2003, banks' assets grew more than 17 billion kroons, reaching nearly 99 billion kroons (see Figure 3.14). At the end of 2003 real and public sectors' loan portfolio accounted for 46% of banks' total assets. The debt of the real and public sectors to credit institutions licensed in Estonia, to Nordea Bank Finland Plc Estonian Branch, and leasing companies of the Estonian Leasing Association increased more than 27% over the year, exceeding 69 billion kroons by end-December.

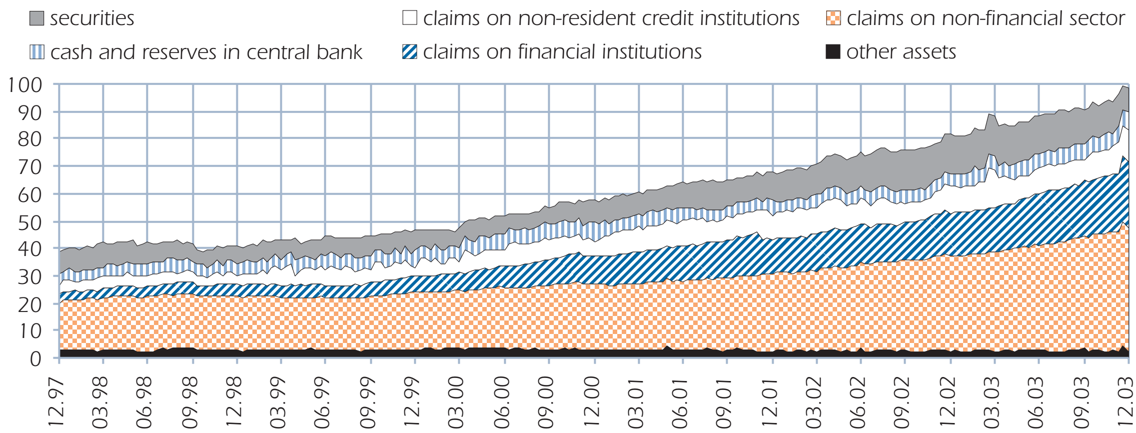

Figure 3.14. Structure of banks' aggregated assets (EEK billion)

In 2003, housing and commercial real estate loans continued soaring. The stock of housing loans and leasing gained more than six billion kroons, i.e. 55%. Private individuals' other liabilities increased by over 1.5 billion kroons. Car leasing continued thriving, and growth of consumption loans accelerated. Besides a two-billion-kroon annual increment in financing commercial real estate in 2003, financing increased primarily in the transport, storage, and communication sectors as well as wholesale and retail trade. The growth in debt of industrial enterprises to domestic credit institutions and leasing associations slowed down last year. Figure 3.15 shows financing of public and real sectors.

Shrinking of banks' aggregate securities portfolio in 2003 reflects also a change in intra-group financing schemes: earlier bond-based financing of affiliates is becoming more lending-focused.

Last year banks used more external funds than before to finance loan portfolio growth (see Figure 3.16). Banks' external liabilities increased more than 11 billion kroons (66%) over the year, accounting for a third of banks' total liabilities by end-year. Depositing by resident private individuals and businesses displayed modest growth against the increment in external liabilities.

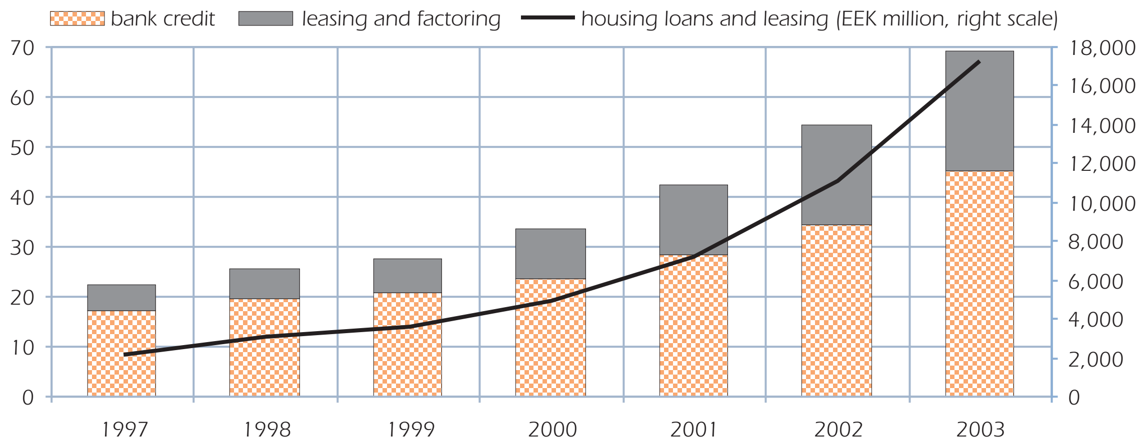

Figure 3.15. Financing of public and real sector (EEK billion)

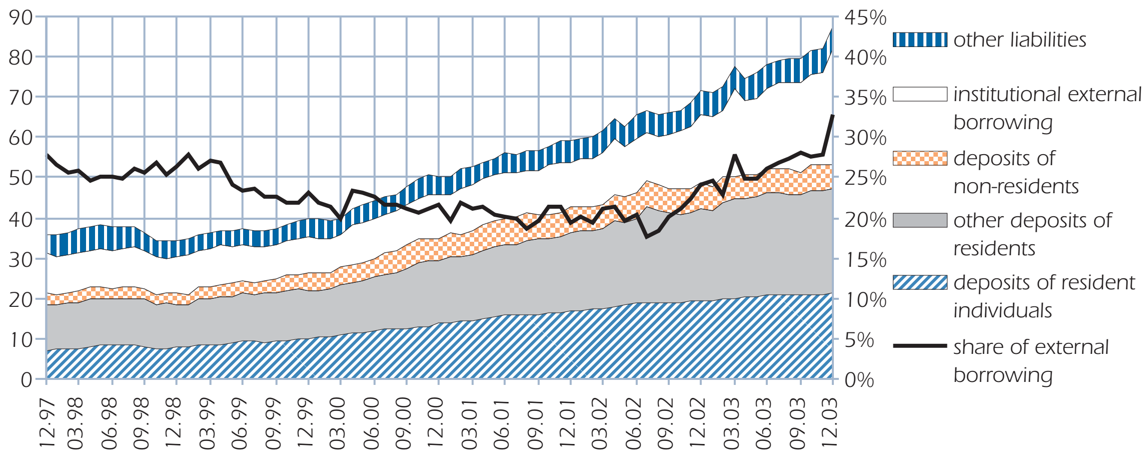

Figure 3.16. Structure of banks` resources (EEK billion, left scale) and share of external borrowing (right scale)

RETURN ON EQUITY AND RISKS

Profitability

Despite the shrinking interest margins, banks' profit sustained growth at the previous rate in 2003. Banks' aggregate spread was the lowest ever – 3% (see Figure 3.17). In the second half of the year interest income shrank but did not tear down growth in total profits, based on service charge income and earnings on financial transactions. On the expenditure side, administrative costs were kept stable, and strong loan portfolio allowed saving at the expense of loan provisions.

According to unaudited data on a solo basis, in 2003 the banking sector earned 1.3 billion kroons of profit, the consolidated profit was 2.7 billion kroons. All market participants generated profit. Although the 2.3-billion-kroon net interest income remained the main source of profit, the share of (net) non-interest rate income displayed aggressive growth, adding more than 35%. The market participants with a stable broad client base earned more service charge income, which indicates growth in card payment turnover and improved service charge income from routine banking operations. The days when banks attracted each other's customers with low service charges have become history. Today the main emphasis is on developing key clientele and providing an integrated service packages.

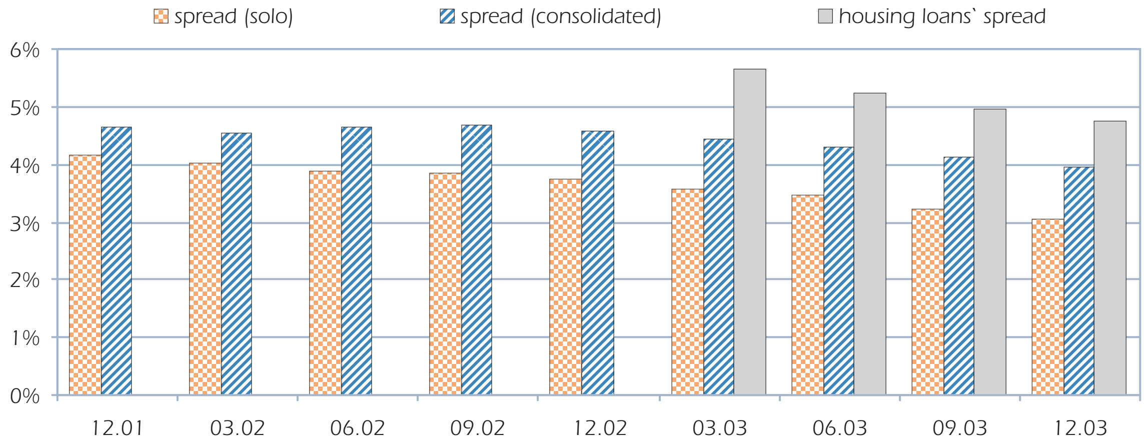

Figure 3.17. Banks' spread on a solo and consolidated basis (%)

By the second half of 2003, the more significant sources to reduce resource costs (refinancing of previous liabilities, lowering of deposit interest rates) were exhausted, and declining lending rates also decreased net interest rate income. As depositing remained slow, banks had to involve more interest-rate sensitive and usually also more expensive credit resources. Although financing by parent banks keeps resource costs under control, it cannot cover the cap in domestic credit base. Recent developments have led to conclusions that even if deposits can be considered not interest sensitive in the short term, a long-term reduction in real interest rates would inhibit deposit growth.

Decline in interest margins was offset by consistently better efficiency of the banking sector. Cost-income ratio shrank by more than five percentage points over the year and was at 56% in December. Rapidly growing business volumes sent the ratio of administrative cost to the loan and leasing portfolio from 3.9% in 2002 to 2.8% in end-2003, indicating a more efficient use of the banks' internal potential. Banks return on equity was 12.6% by end year (12.2% in 2002).

Capital Adequacy

Against 2002, capital adequacy shrank but on a solo basis remained still an ample 4–5 percentage points above the 10% minimum rate (see Figure 3.18). However, on a consolidated basis capital adequacy was 12.5% by the end of the year. Reinvested profits could not offset the buoyant boost in assets. Risk positions gained by a third whereas own funds gained merely 21%.

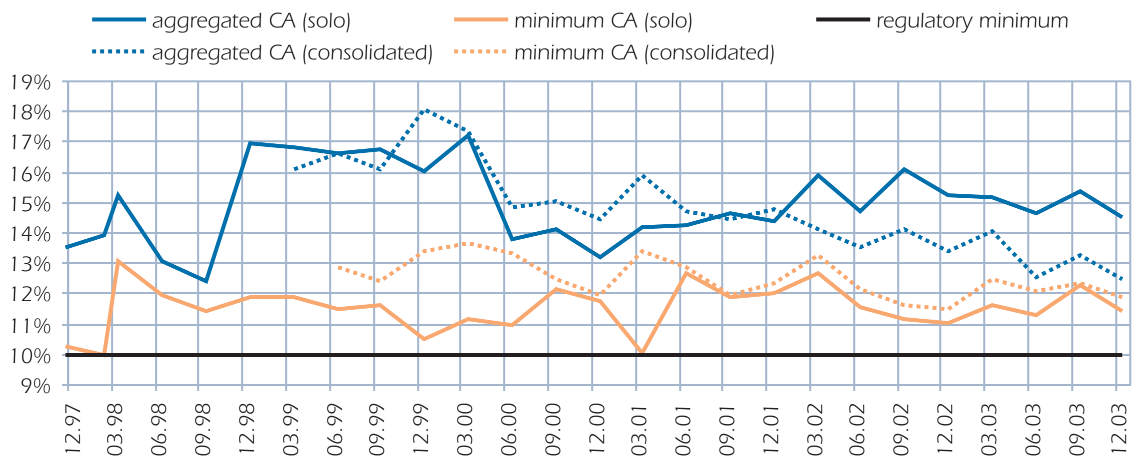

Figure 3.18. Banks' capital adequacy on a solo and consolidated basis

Credit Risk

Due to the growing share of housing loans with high mortgage rates, the volume of banks' allowance for uncollectible claims has dropped to below 0.6% of total assets. On the other hand, corporate and retail loan servicing does not warrant heightened threat anticipation. Lower interest rates reduced loan-servicing costs but allured clients to take new loans or increase their current loan burden. Although interest rates are going to rise in future, and this could deteriorate the loan quality, it is not only interest expenditure but also the borrower's financial status and consistent income that are significant.

As an annual average, the share of loans overdue 60 days remained the highest for private individuals' consumption loans (2.9%) but was significantly less than in 2002 (3.6%). The share of overdue loans exceeded 2% also in business service, manufacturing, commercial real estate, and hospitality sectors. In housing loans the share of overdue loans was merely 0.8%. The share of overdue loans in banks' total loan portfolio is down to 1.5% in 2003 from 2.3% in 2002. During the year, 102 million kroons of loans and 208 million kroons of leasing claims were written off (net). As of the third quarter, leasing losses exceeded banks' lending losses more than twofold.

Liquidity Risk

As an annual average, the share of more liquid assets in the balance sheet remained comparable to 2002 at 14.9%. At the same time liquidity management has become increasingly volatile: primarily because more flexible instruments, in particular reverse repo agreements, have been used more extensively. While domestic liquidity buffer, i.e. cash and reserves with the central bank remained mostly unchanged by months, volatility of liquid foreign assets exceeded domestic reserves more than twofold. A flexible foreign reserve management allows cost saving but is riskier. However, the external environment has become considerably more open for Estonian banks, and liquidity buffers can be adjusted more rapidly.

In December 2003, the trend of longer maturity was replaced by growing short-term resources. As in March long-term euro bonds were issued to refinance previous bonds, the share of short-term liabilities[2] in all liabilities shed a tenth and reached the historic low in September (69%). The share of liabilities with longer maturity thrived also because depositing displayed modest growth. However, short-term euro bonds issued in December lifted the share of short-term deposits again by about two percentage points. This is the first such an extensive short-term bonds issue programme, corroborating creditworthiness of Estonian banking among foreign investors, but also signalling a potential threat that the liquidity buffer might be sustained by short-term loans.

By maturity breakdown, long-term claims with maturity over five years reached more than a quarter of the balance sheet. Such a development was fed by rapidly growing housing loans and pushed the indicator up by three percentage points against 2002.

Currency Risk

Also in 2003, the open exchange rate position displayed a modest growth, primarily due to housing loans linked to the euro. Although livelier financial intermediation vis-à-vis Russia has slightly increased the significance of the positions of the rouble, they still account for merely 0.05% of the total open foreign exchange position (including the euro). In brief, the volatile, real foreign exchange risk related positions remained stable in their development, and capital requirement for foreign exchange risk declined.

[2] This includes all demand and time deposits, loans, and other commitments with a remaining maturity below a year.

SECURITIES MARKET

Bond Market

In 2003, the bond market was mostly subject to controversial developments. The shrinking number and volume of emissions in the primary market inhibited securities market capitalisation and the turnover in the secondary market. The Tallinn Stock Exchange relaunched listing of bonds.

Market capitalisation dropped to 2.9 billion kroons by end-2003 since foreign banks discontinued bond issues, a process which had started already in 2001. Also resident banks and other businesses involved fewer resources from the bond market. As a result the volume of new issues in primary bond market shed 40% – dropping from 4.6 billion kroons to 2.7 billion kroons (see Figure 3.19).

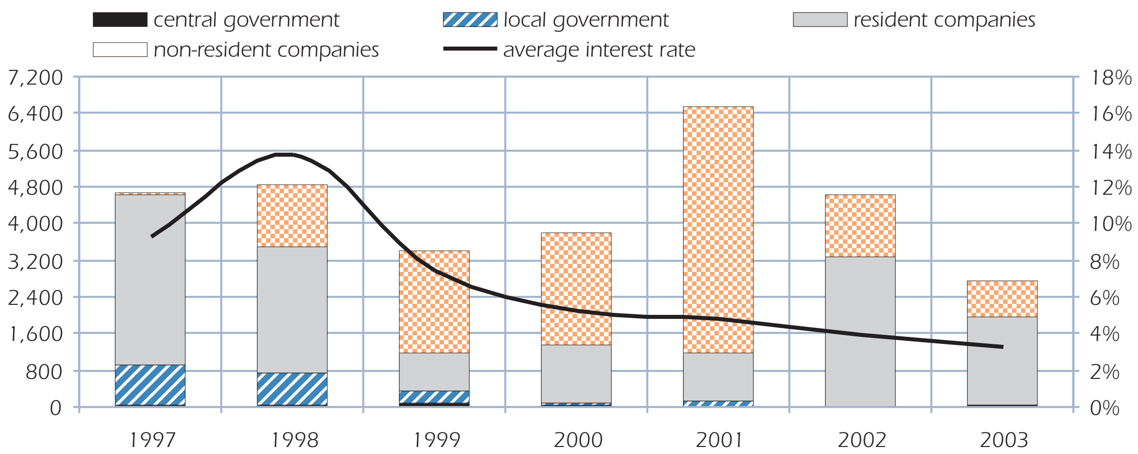

Figure 3.19. Annual bond issues by issuers (EEK million, left scale) and average interest rates (%, right scale)

The shrinking primary bond market reduced the average monthly turnover in the secondary market from 291 million kroons in 2002 to 200 million kroons in 2003. As the primary bond market is highly concentrated, the turnover of the secondary market is dominated by bond issues by major issuers.

Despite a general contraction of the bond market, the list of bonds listed on the Tallinn Stock Exchange opened after a two-year break. Tallinna Sadam, Hansa Capital, and Eesti Post listed their bonds in 2003. However, the annual turnover of bonds on the stock exchange remained modest. The average monthly transaction turnover with the above bonds reached 10 million kroons, whereas the capitalisation of the listed bonds reached 242 million kroons.

Stock Market

Stock prices soared in the Tallinn Stock Exchange at the end of 2003. Tallinn Stock Exchange Index Talse reached 286 points by end-year, being 34% above the level of end-2002 (see Table 3.5). Shares of manufacturing and construction businesses appreciated the most. Also the increased turnover indicated market recovery (see Figure 3.20). The average daily turnover on the stock exchange increased twofold against 2002, up to 31.6 million kroons.

Although according to market participants, the price rise of listed shares was brought along primarily by foreign investors' purchase interest within the thin market, the share of non-resident investments in stock exchange

Table 3.5. Securities market indicators (EEK billion)

	1996	1997	1998	1999	2000	2001	2002	2003
Securities market capitalisation*	**10.2**	**18.6**	**12.2**	**31.6**	**34.3**	**31.6**	**42.2**	**53.5**
Instruments								
Listed shares	7.5	12.6	7.9	28.0	30.1	26.1	36.2	47.3
Bonds	2.4	4.0	3.7	3.2	3.7	4.4	3.3	2.9
Investment fund shares registered in ECSD	0.3	1.8	0.5	0.4	0.4	0.9	1.7	2.6
Subscription rights	–	0.1	0.2	0.0	0.0	0.2	1.0	0.7
Securities market turnover	**3.2**	**34.1**	**33.7**	**15.2**	**14.3**	**14.1**	**23.1**	**27.9**
Stock exchange capitalisation	8.0	13.1	8.3	28.3	31.0	26.4	36.2	47.3
o/w non-resident investors	36%	42%	54%	74%	77%	77%	80%	80%
Stock exchange turnover	2.3	21.8	13.4	4.5	5.5	4.1	4.2	7.8
Securities market capitalisation/GDP	19%	29%	17%	41%	39%	33%	40%	46%
Securities market turnover/capitalisation	31%	183%	276%	48%	42%	45%	55%	52%
Stock exchange turnover/capitalisation	29%	167%	161%	16%	18%	16%	12%	17%

* Securities market capitalisation does not include unlisted shares.

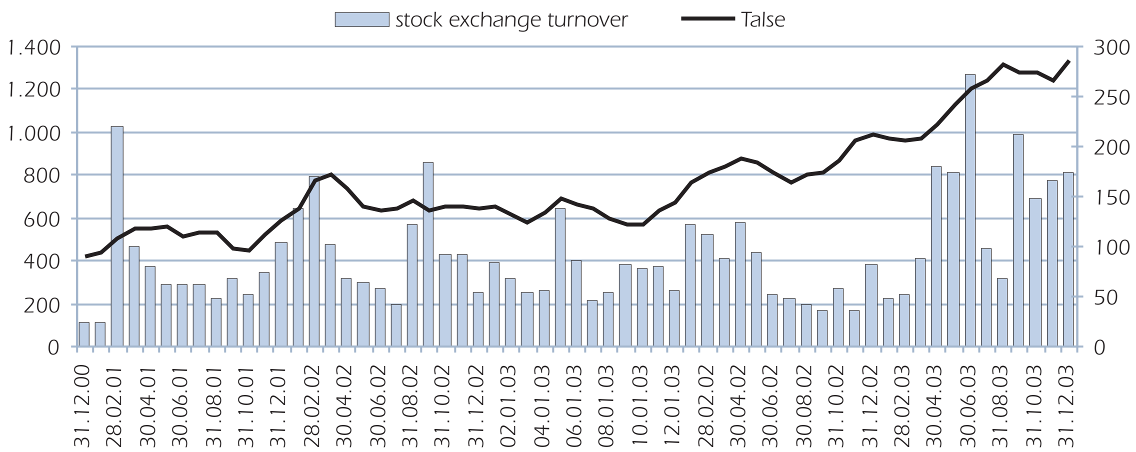

Figure 3.20. Tallinn Stock Exchange annual turnovers (EEK million, left scale) and index TALSE (points, right scale)

capitalisation did not increase, being still 80%. The foreign investor structure changed slightly: in December the share of Swedish investors increased to 66% of the whole market capitalisation at the expense of a shrinking Dutch share. The market share of other major investors remained unchanged: Finland and Great Britain account for 9% each and the US for 8%.

In 2003, the Finnish exchange operator and majority shareholder on Tallinn Stock Exchange HEX and OM Gruppen of Sweden merged to form OMHEX, comprised of stock exchanges and central depositories from Finland, Sweden, Estonia and Latvia. The merger aims at creating a common securities market for Nordic and Baltic countries, open also for Danish, Norwegian, Icelandic, and Lithuanian stock exchanges and depositories. Step One would involve harmonisation of the marketplace, which will clear ground for further steps in integrating the markets.

OTHER FINANCIAL INTERMEDIARIES

Investment and Pension Funds

Investment funds had grown throughout 2002 and sustained the trend also in 2003, although slightly less against the high reference base. The volume of investment funds gained 2.0 billion kroons over the year, reaching 6.2 billion kroons, of which money market and interest rate funds accounted for 1.8 billion kroons (see Figure 3.21). Recovering external markets and rapidly growing prices on the Baltic stock exchanges nearly doubled their volume. The average annual yield of stock funds went up while the yield of money market and interest rate funds went down.

Joining pension funds within the mandatory funded pension scheme was successful throughout 2002 and also in 2003. The number of people who joined the mandatory funded pension scheme, i.e. the II pillar, reached about 350,000 people (60% of the employed) by 31 October, the deadline for certain age groups. The volume of the II-pillar funds was at one billion kroons by end-year. Also joining the third pillar accelerated, totalling about 62,000 people, i.e. 10% of the employed, and the volume of total assets (pension insurance reserves and funds) 730 million kroons. Indices of riskier funds under the mandatory funded pension scheme as well as the average yield of the voluntary III pillar funds displayed accelerated growth in the second half of the year, whereas indices of the II pillar bond funds remained stable.

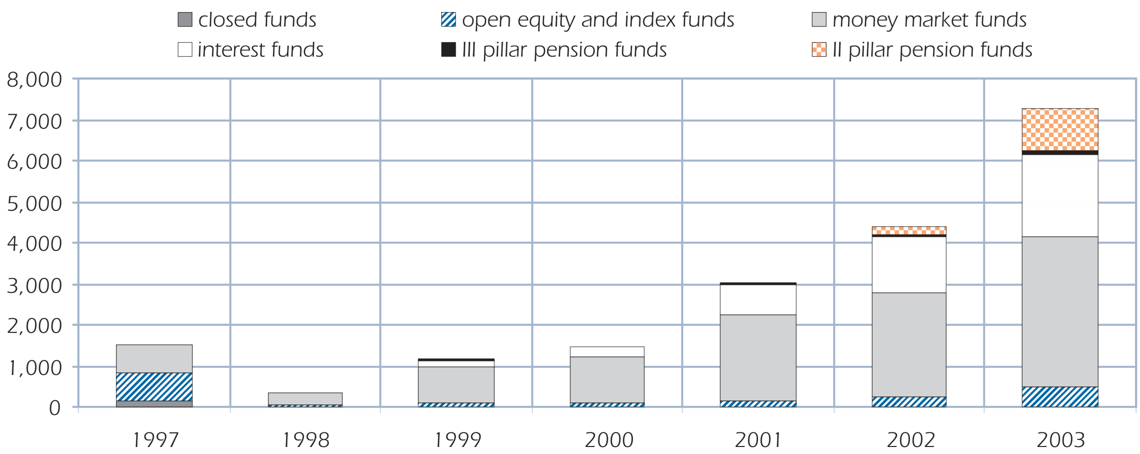

Figure 3.21. Volume of investment and pension funds (EEK million)

Insurance

In 2003, growth in the life insurance market accelerated considerably, reaching an annual average of 28% (11% in 2002). A total of 579 million kroons of gross premiums were collected. Life insurance market expanded primarily due to growing premiums collected under policies of capital insurance and life insurance with investment risk but also to premiums under the III-pillar pension insurance contracts based on income tax incentives.

The non-life insurance market gained steadily. The annual growth rate of gross premiums collected by insurance companies remained at the level of 2002 (at about 20%), taking the volume of gross premiums to two billion kroons (see Figure 3.22). The compulsory motor TPL insurance with its increased rates arising from increased losses supported the market expansion. Non-life insurance added volume also with the help of premiums from corporate and private motor vehicle liability insurance and other property insurance.

While the institutional structure of life insurance seems to be stable, non-life insurance market underwent slight restructuring in 2003. The structure became complete with the transfer of Nordika Kindlustus, a badly-off

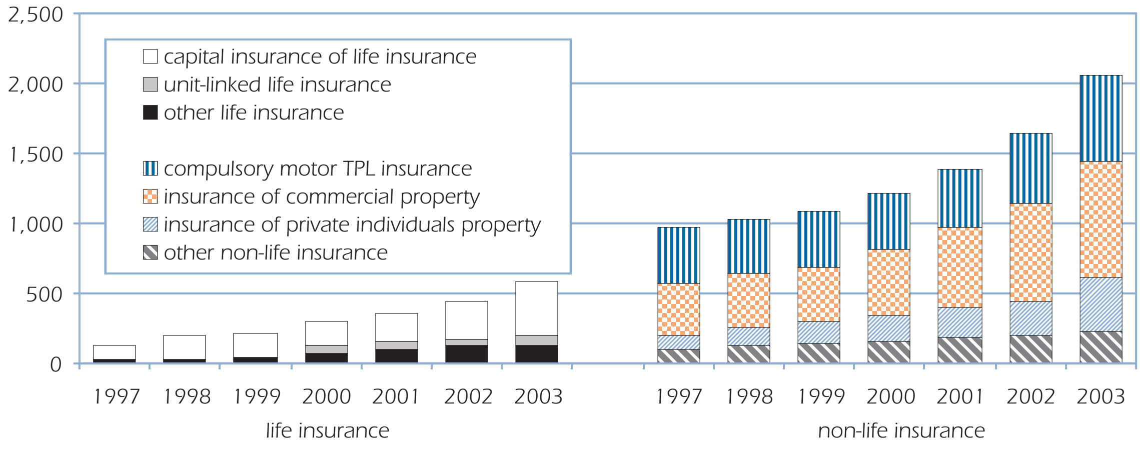

Figure 3.22. Gross premiums collected by insurance companies (EEK million)

insurance company to Nordea Kindlustus, and the exit of Zürich Kindlustus of Swiss origin from the market. The consolidated profitability of both life and non-life insurance companies recovered significantly in the first nine months of 2003. The reasons were that the takeover of problematic insurance portfolios sustained no more losses, operational costs decreased, and amended accounting principles sent net investment income up.