III. ESTONIAN ECONOMY AND FINANCIAL SECTOR

NON-FINANCIAL SECTOR[1]

MONETARY ENVIRONMENT

The European Central Bank maintained monetary policy rates throughout 2004 at the level of end-2003 and the margin between Estonian and euro area interest rates kept shrinking. Estonia's corporate and household loans' interest rates fell even further: the average interest rate on long-term non-financial sector loans was 4.6% at the end of the year, approximately 1 percentage point less than at the beginning of the year (see Figure 3.1). This is the lowest level in 15 years.

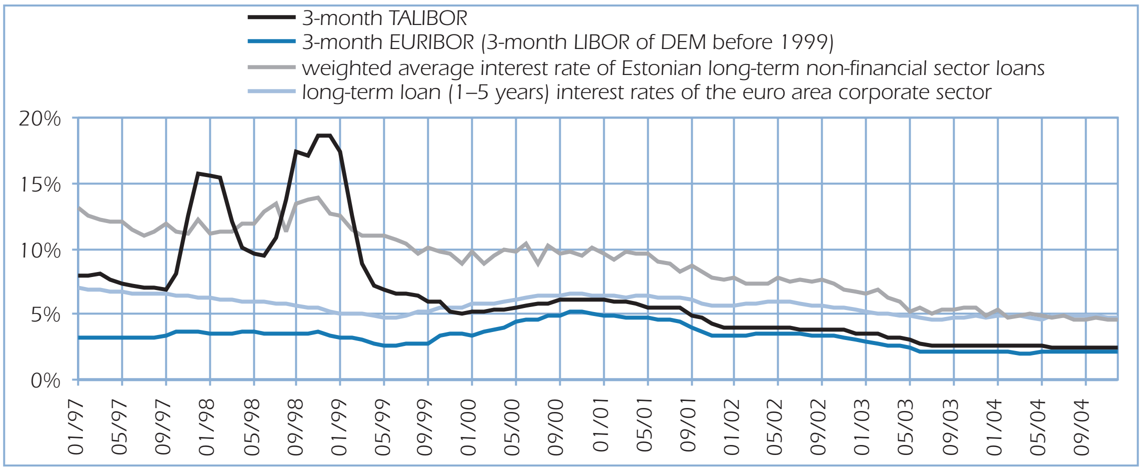

Figure 3.1. Money market interest rates of Estonia and the euro area and interest rates on long-term loans to the Estonian non-financial sector

In 2004, depreciation of the dollar was a continuous trend, accelerating at the beginning and end of the year.

In May 2004, Estonia acceded to the European Union and in June joined the exchange rate mechanism ERM II, preserving the currency board system and the fixed exchange rate of the kroon against the euro as a unilateral commitment. As these steps were in line with Estonia's long-term economic policy goals and expectations of market participants, they did not bring about any sudden changes, although supported the increase in economic credibility and kept risk premium decreasing.

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

World economic growth accelerated in 2004. Although the euro area average growth rate did not yet reach a potential level, faster growth improved significantly external demand environment for Estonia. Moreover, the economic growth of Estonia's main trade partners was continuously above the EU average.

In brief, environment both for export-oriented and non-tradable sectors was more conducive to growth than before.

EXTERNAL AND DOMESTIC DEMAND

Estonia's economic growth, supported by increasing external demand, grew from 5.2% in 2003 to 6.2% in 2004, being close to the potential rates (5.8–6.5% according to various estimates). The difference in growth with the euro area/EU average remained at about 4 percentage points.

The growth rate of goods exports picked up, facilitated by increasing external demand and recovering competitiveness as well as larger IT subcontracting[2]. In 2004, earnings improved in transit trade and also in other areas of the services sector. The contribution of travel services and tourism to economic growth increased significantly.

Despite favourable external environment, major differences in exports by product groups persisted (see Figure 3.2). For example, textile exports remained 2.2% short of last year's volume; timber exports added merely 4.5% over the first nine months. As regards traditional and more significant industries, furniture exports were able to maintain relatively rapid growth rate (13.3% in 2004). The growth rates of manufacturing sub-sectors were generally above average, reaching 24.9% in dairy products. Exports of mineral products nearly doubled due to growing exports of mineral fuels and mineral oils. The exports of means of transport and machinery and equipment increased remarkably – by 66.2% and 29.6%, respectively.

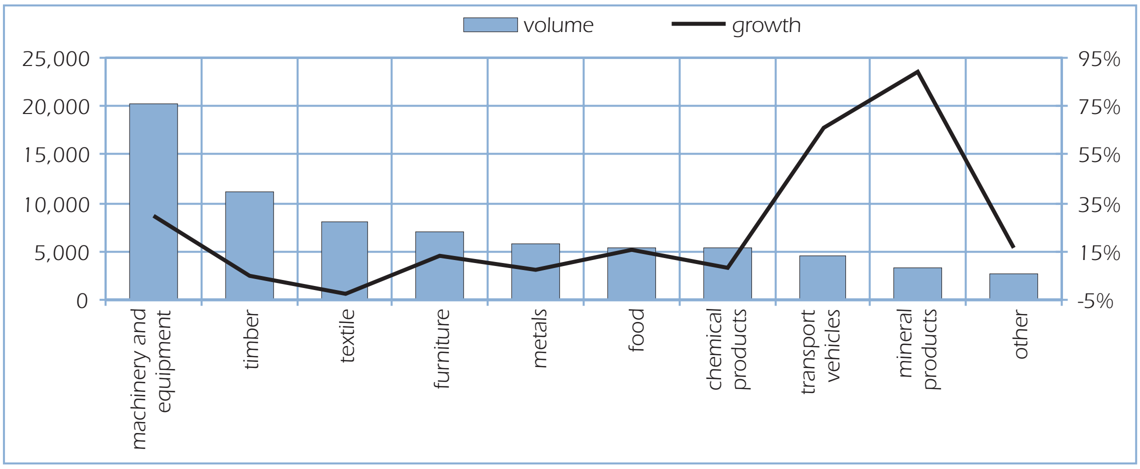

Figure 3.2. Volume (EEK million; left scale) and nominal growth (right scale) of exports by product groups in 2004

Manufacturing, trade, and transport, storage and communications account for about 45% of Estonia's GDP. In 2004, the annual growth in the value added accelerated to 10.2% in manufacturing and 5.3% in trade. In transport, storage and communications it remained slightly below the previous year's level but was still

[2] Accession to the European Union introduced significant changes to the methodology of foreign trade statistics. Thus, since May 2004, export indicators have partially reflected also transit and re-exports.

relatively high (8.2%). In other fields of activity, the growth rate gained considerable momentum also in construction, hotels and restaurants as well as in financial intermediation. Growth was broad-based as seen from the fact that with a single exception economic growth did not slow down significantly in any fields of activity on a year-on-year basis. Energy and heating were exceptional with the annual growth decelerating considerably compared to the previous year (see Table 3.1).

Table 3.1. Change in value added by fields of activity in 2003 and 2004

	2003	**2004**
Agriculture, hunting	3.6%	3.6%
Forestry	-8.2%	-3.4%
Fishery	-6.9%	-6.7%
Mining	7.2%	-7.9%
Manufacturing	8.3%	10.2%
Electricity, gas and water supply	6.5%	2.8%
Construction	7.7%	9.6%
Wholesale and retail trade	4.5%	5.3%
Hotels and restaurants	3.3%	11.3%
Transport, storage and communications	10.1%	8.2%
Real estate, renting and business activities	1.2%	5.6%
Financial intermediation	5.4%	10.8%
Public administration and national defence	1.0%	3.1%
Education	1.0%	1.2%
Health and social care	0.1%	1.2%
Other services	4.6%	3.9%
GDP total	**5.1%**	**6.2%**

Domestic demand growth picked up, reaching 6.6% (5.3% in 2003). Real private consumption growth accelerated slightly less and growth in general government final consumption even declined a little. In the second half of the year, also the growth of household deposits, primarily time deposits, accelerated. There was no major break in the upward trend of household debt burden. However, loans and leasing contracts grew 2.5–3.0 percentage points slower year-on-year. This slowdown was more characteristic of housing loans, which accounted for 75% of the household debt burden. Private corporations, especially export-oriented companies, were responsible for a large part of the growth in non-financial sector debt burden. Corporate loan stock and the volume of companies' leasing contracts gained more than 25% over the year.

Domestic demand growth was supported by investments, which together with increasing stocks amounted to 11.2% over the year. Investment at current prices accounted for more than 30% of GDP (see Figure 3.3). Domestic demand was sustained also by stocking up prior to the accession to the EU (see also Background Information *One-off Price Developments Accompanying EU Accession in the Second Quarter of 2004*).

New business projects, including residential construction, were the source of rapidly growing investments. Most of the companies already operating in the market invested rather modestly or in a volume equal to the previous year. Residential construction was brisker thanks to the improving availability of loans to households, which was also promoted by declining interest rates.

Large domestic demand and relatively rapidly growing exports brought about higher employment in the services sector and in manufacturing in the first three quarters. The unemployment rate sustained a slow downward trend. Average nominal wage growth decreased by some percentage points, which labour productivity added compared to the previous year. Due to steady and relatively rapid growth in the services sector, unit labour costs at macro level were contained close to the level of 2003.

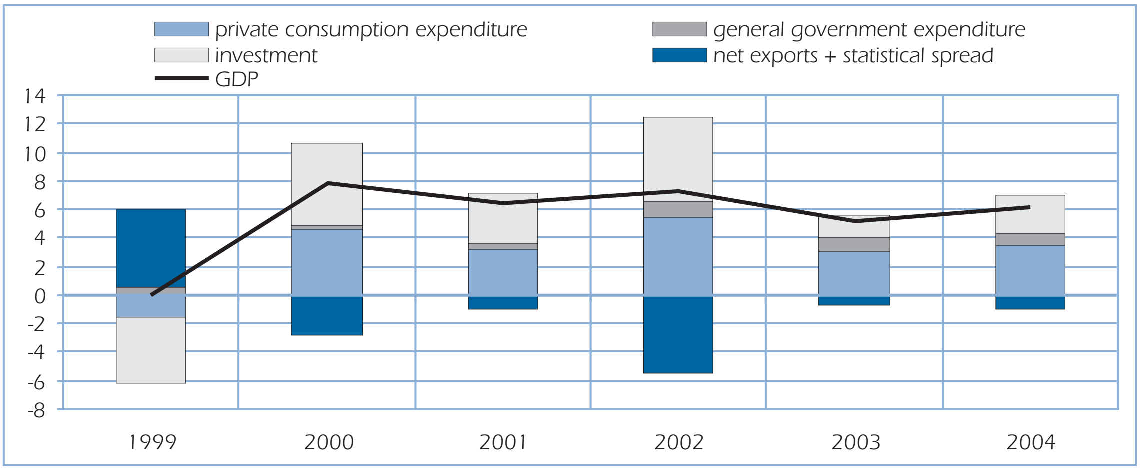

Figure 3.3. Share of GDP consumption components in economic growth (in percentage points)

SOURCES OF ECONOMIC GROWTH

According to preliminary estimates, the ratio of domestic saving to GDP recovered slightly in 2004 thanks to the private sector – first and foremost to household consumption that decelerated. Government savings remained slightly below the previous year.

Growth in both domestic and foreign capital based corporations' profitability remained approximately at the level of 2003, although resources received from the EU structural funds increased corporate earnings. As domestic saving exceeded the year-ago level, the growing investment demand was not as detrimental to external balance as in 2003 and the need for external funding even contracted slightly. However, in international comparison, the level of investment remained high and that of domestic saving low. Current account deficit stood at 12.6% of GDP (see Figure 3.4). The share of net foreign direct investment declined slightly and therefore borrowing increased. These developments took Estonia's gross external debt to about 84% of GDP and net external debt (assets less liabilities) to 19% of GDP in end-2004.

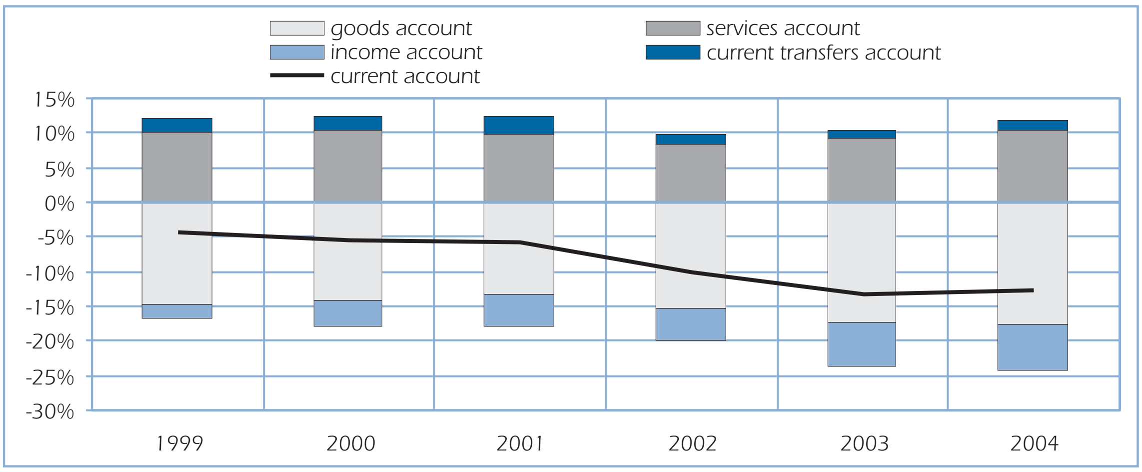

Figure 3.4. Current account and the accounts of Estonia's balance of payments (% of GDP)

GENERAL GOVERNMENT

With the accession to the EU a prescheduled change in tax policy came into force and the tax burden shifted from income to consumption. At the beginning of the year, the government raised robustly the non-taxable income threshold, followed by a rise in fuel excise duties and customs tariffs upon accession. Tobacco excise continued its gradual rise. The accession to the EU introduced a change to VAT collection: VAT payment obligation was postponed by two months. This change brought about larger deviations than expected by months and complicated revenue collection prognosis. However, despite a close to billion-kroon supplementary budget, tax revenue exceeded planned revenues and the overall tax burden decreased little against the previous year.

Although resources received from the EU structural funds grew significantly year-on-year, they fell short of the target set in budget expenditure. Therefore, it was expedient to postpone a part of co-financing of the projects, financed from the EU structural funds. Expenditure was less than planned and thus contributed significantly to general government budget surplus, supported also by lower local government deficit, compared to the level of previous years. General government revenue exceeded expenditure for the fourth consecutive year and, according to preliminary data, the surplus was about 2% of GDP in 2004.

For 2005–2007, the government is planning a considerable income tax cut. As the government programme provides also for a growth of certain priority expenditure categories, balanced budget principle presumes curbing majority of the government consumption expenditure.

Maintaining budget balance will be vital to secure sustainable economic growth in the coming years, given the forecasts that Estonia's economy will grow at its potential rate and restrictive fiscal policy will remain necessary for improving the external balance.

INFLATION

The annual growth rate of consumer prices fluctuated more than 4 percentage points over different months and quarters throughout 2004. In early-2004, inflation in Estonia remained exceptionally low due to a fall in fuel and food prices. Later on, both food and fuel prices started picking up and, in addition, the price rise was accelerated by the harmonisation of tax and trade policies delayed until the moment of accession (see also Background Information *One-off Price Developments Accompanying EU Accession in the Second Quarter of 2004*).

As a result, the annual growth of consumer price index was 3% in 2004, both according to national consumer price index and Harmonised Index of Consumer Prices (HICP). This was well in line with expectations and price developments in the euro area, where the annual average consumer price increase reached 2.2% (see Figure 3.5).

In 2004, the rise in food prices (prices grew 1.6 percentage points faster than in 2003) accounted for about 80% of the acceleration in the inflation rate, whereas about half of the rise was due to a trade regime change upon accession to the European Union. The rise in motor fuel prices (arising from increasing world market prices and excise duties) added 0.9 percentage points to the inflation rate. Growth in administered prices remained close to the year-ago level and price increase of other goods slowed down (see Figure 3.6).

According to the core inflation index, which measures price growth excluding volatile food and energy prices, Estonia's inflation rate remained below that of the euro area (see Figure 3.7).

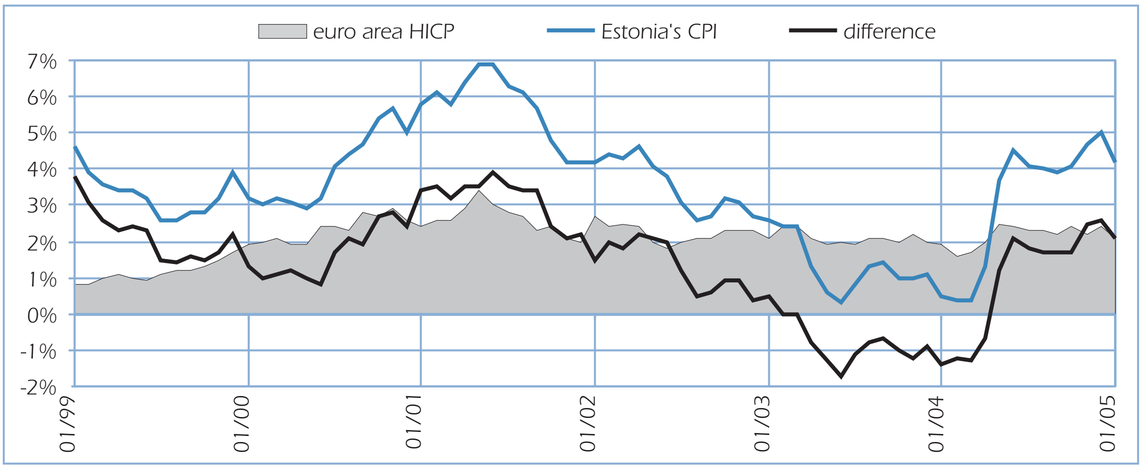

Figure 3.5. Twelve-month growth of consumer prices in Estonia and the euro area

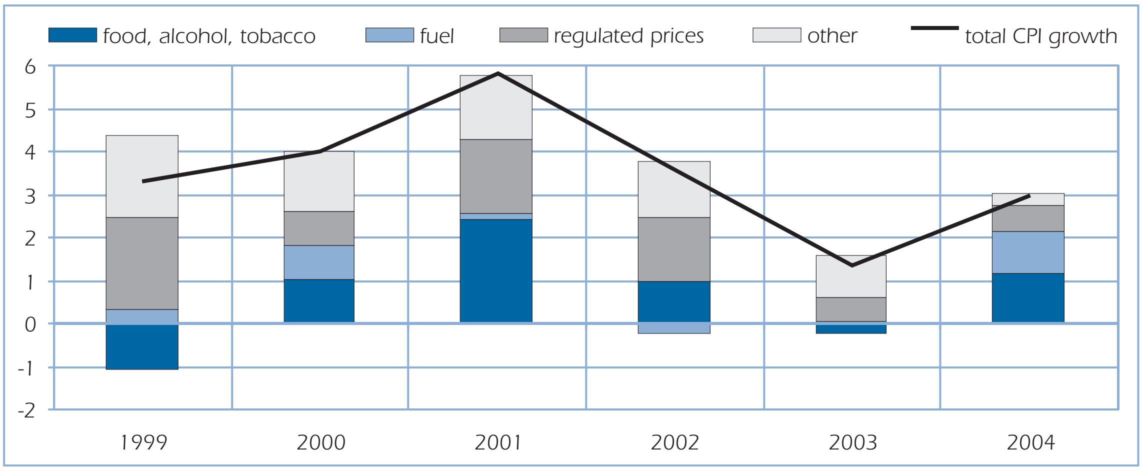

Figure 3.6. Consumer price growth by components (in percentage points)

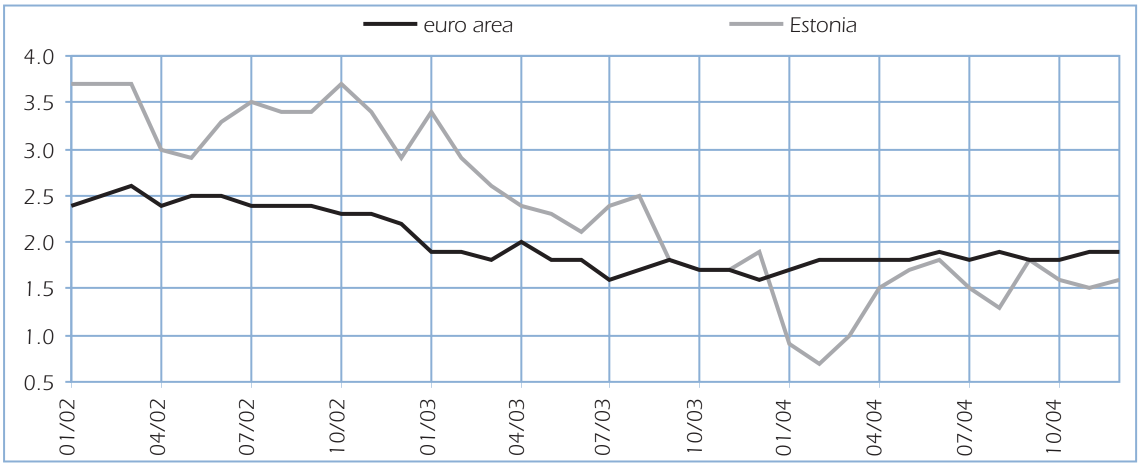

Figure 3.7. Harmonised consumer price growth without energy, food, alcohol and tobacco prices (%)

Source: Eurostat

In brief, the faster inflation rate in Estonia in 2004 against previous years did not arise from domestic pressures but rather reflects post-accession tax harmonisation and rising food and fuel price in the world market.

In 2004, the real exchange rate of the kroon appreciated against the basket of major trade partners' currencies by 1.3%, including 2.6% against the currencies of industrial countries (see Figure 3.8).

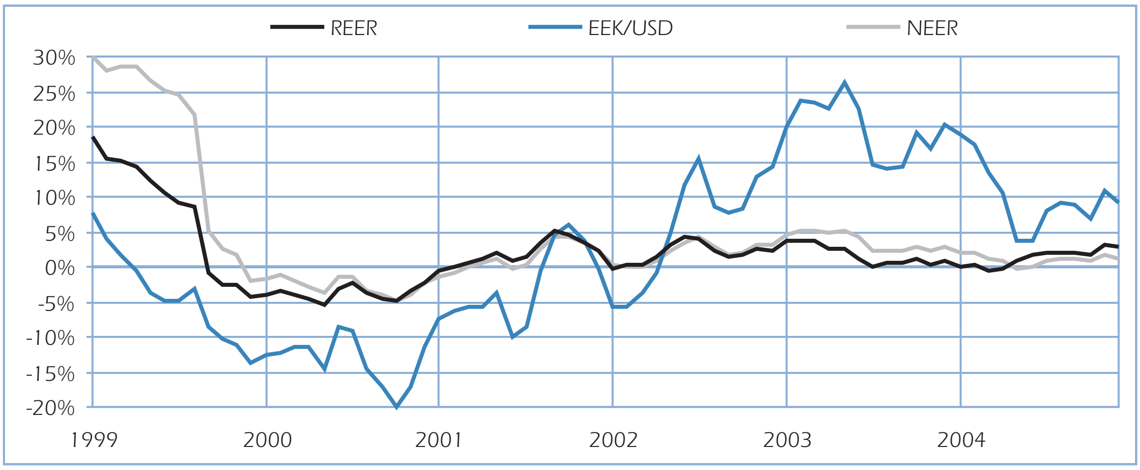

Figure 3.8. Twelve-month change of nominal and real exchange rate of the Estonian kroon

ESTONIA'S SOVEREIGN RATING

Sovereign rating, more specifically the credit rating of a country, is an assessment by international rating agencies of a country's capability to repay its foreign liabilities. Sovereign rating largely determines the interest rate on foreign borrowing.

In 2004, Estonia's ratings improved. Both rating agencies Fitch Ratings and Standard&Poor's upgraded Estonia's rating of long-term foreign currency liabilities to A. The rating of short-term foreign currency liabilities remained at the previous level: F1 (Fitch Ratings) and A-1 (Standard&Poor's). The third largest rating agency Moody's has not changed Estonia's ratings since autumn 2002, being A1 and P-1, respectively.

In autumn 2004, Estonia's country risk ratings were upgraded: Fitch Ratings assigned a new rating of AA- and Standard&Poor's assigned AA. Country risk replaced the sovereign rating as a ceiling of ratings assignable to companies operating in that particular country, allowing more viable private sector companies to get a rating above the sovereign rating.

The upgrading of Estonia's ratings reflects, first and foremost, potential strengthening of creditworthiness with a view to the forthcoming accession to the European Economic and Monetary Union. According to the rating agencies, euro area membership would significantly reduce risks arising from the balance of payment and external shocks. The factors contributing to Estonia's rating included conservative fiscal policy, which is essential to meet the EMU criteria, as well as relatively rapid economic growth. The main restraining factor, according to the rating agencies, was large current account deficit in 2004.

ONE-OFF PRICE DEVELOPMENTS ACCOMPANING EU ACCESSION IN THE SECOND QUARTER OF 2004

Estonia's inflation rate was unusually low in the first quarter of 2004 (consumer prices increased merely 0.4% year-on-year). Domestic demand growth decelerated, accompanied by decreasing trade deficit that stood at 4.2 percentage points below the previous year's level. At the beginning of the second quarter the improvement of trade balance stopped and in May also inflation accelerated remarkably. Underlying reasons are outlined below.

On 1 May 2004 Estonia acceded to the European Union. The harmonisation of Estonia's currently extremely liberal trade policy with that of the EU and the raising of fuel excise duties to the EU minimum level were timed for this date. The above steps had an immediate significant impact on trade and inflation indicators.

Pursuant to a previous agreement, upon the accession Estonia harmonised its customs tariffs vis-à-vis third countries with EU customs tariffs and introduced EU non-tariff measures (quotas, export subsidies, etc.), harmonising also existing trade agreements.

Factors, which had a major impact on inflation and/or trade, could be classified as follows:

- *Due to EU import quotas, prices of imports of various raw materials rose. Currently large quantities of ferrous metals have been imported from CIS countries. The EU has very low quotas (0.5% of the EU steel production) for the imports of ferrous metals from the CIS, whereas prices in the CIS are 2–5 times lower than in the EU. Therefore, during the pre-accession period stocking up of metals was anticipated in Estonia.*
- *The EU regulation on agriculture is more complicated than Estonia's regulation and it brought about a rise in the prices of third-country agricultural imports by customs duties (e.g. 64% for bananas) and of EU agricultural imports due to the abolition of export subsidies. The price of sugar is a most characteristic example. It increased for the above reasons by 129.3% during a month (from April to May 2004). As the price rise (more than twice) was anticipated well in advance, it had an impact apart from inflation also on the trade indicator: stocking up was above usual.*
- *According to pre-accession agreements, harmonisation of several indirect taxes with EU rates should take place in the coming years. For example, fuel excise duties should reach the EU minimum by 2010. However, several steps in harmonising indirect tax rates were timed for the accession. This amplified the one-off jump in inflation and import indicators even further. The increase in motor fuel, alcohol and tobacco excise duties had the biggest impact. Although the decision to abolish tax-free trade had caused major discussions, the actual effects were smaller than anticipated and had no major impact on the number of tourists and caused no increase in ship ticket prices.*

These were the reasons for an abrupt increase in the inflation rate in May 2004: prices grew by 2.1% against the previous month. The components of the CPI basket that influenced the growth of the Harmonised Index of Consumer Prices (HICP) most were motor fuel and sugar.

The price of motor fuel rose in May by 17.0% against April due to a rise in the excise duty rate. As the share of this component is relatively large in the consumer basket (6.56%), the HICP added

1.1 percentage points. The price of sugar rose by 129.3% over the month but its share in the CPI basket was more modest (0.39%) and therefore its contribution to the overall price increase was smaller (0.5 percentage points). Price growth of other food (bananas, fish imported from certain countries) was less significant and their overall contribution did not exceed 0.2 percentage points in HICP.

While monthly inflation indicators were subject to the above factors just once (in May 2004), the 12-month inflation indicators (price growth compared to the same month the year before) will be affected during twelve consecutive months (see Figure 3a). Without an abrupt increase in sugar and motor oil price in May, the annual average price growth in 2004 would have been merely 1.8% (actually 3.0%).

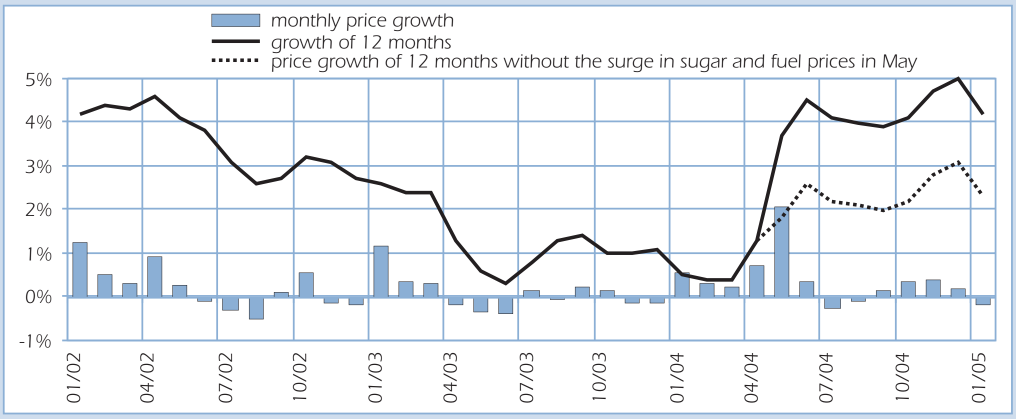

Figure 3a. Consumer price growth indicators month-on-month and year-on-year

Regulatory changes and related expectations of a price rise of single products timed for the accession to the EU brought about increasing stocks in households and to a lesser extent in the corporate sector. Thus, the imports of goods in April 2004 outpaced the previous year's indicator by 47%. After the accession imports of these goods decreased, revealing that there was no permanent change in demand (see Figure 3b).

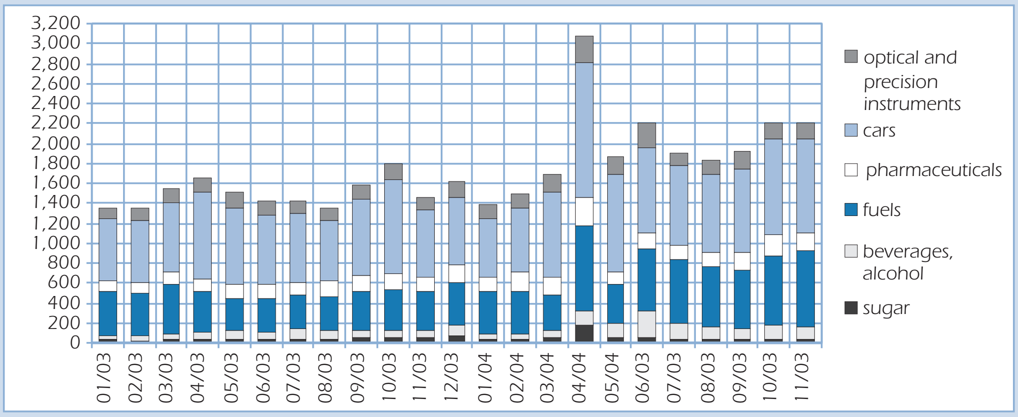

Figure 3b. Imports of certain product groups before and after the accession (EEK million)

Post-accession developments show that there was a one-off price rise in Estonia in the second quarter of 2004 and inflation indicators measured against the previous month dropped to the usual level as early as in June and July.

FINANCIAL SECTOR

MAJOR TRENDS IN FINANCIAL SECTOR IN 2004

In 2004, favourable liquidity environment and increased external confidence sustained rapid development in the financial sector. External financing gained considerable momentum in 2004 and helped banks to maintain their strongly dominant position (see Figure 3.9). The increase in banks' business volume is reflected in the growth of the non-financial sector (excluding government) debt burden from 51% in 2003 to 63% in 2004 (see Figure 3.10). Tighter competition in the banking market both between current market players and new market entrants has given additional boost to increasing business volume.

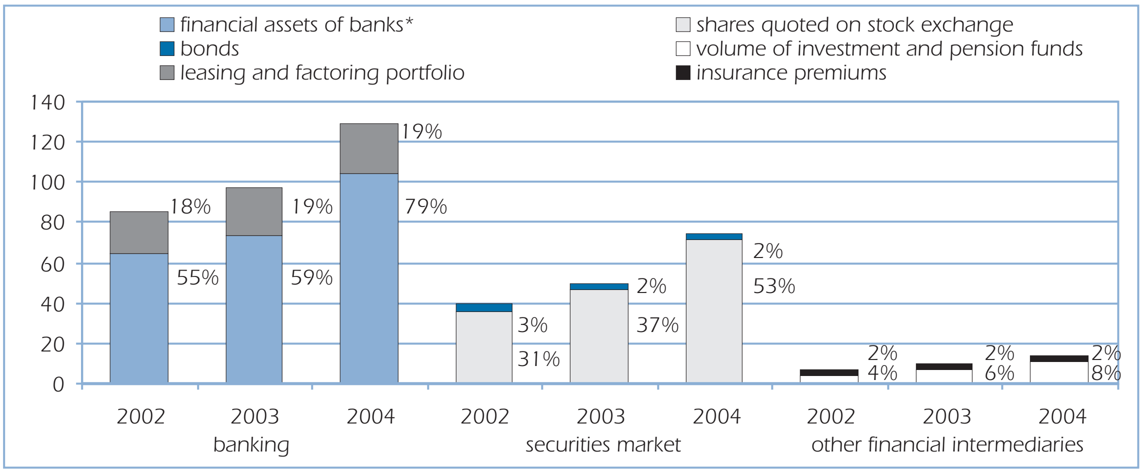

Figure 3.9. Structure of Estonian financial intermediaries (EEK billion and % of GDP)

* Excluding loans to financial institutions.

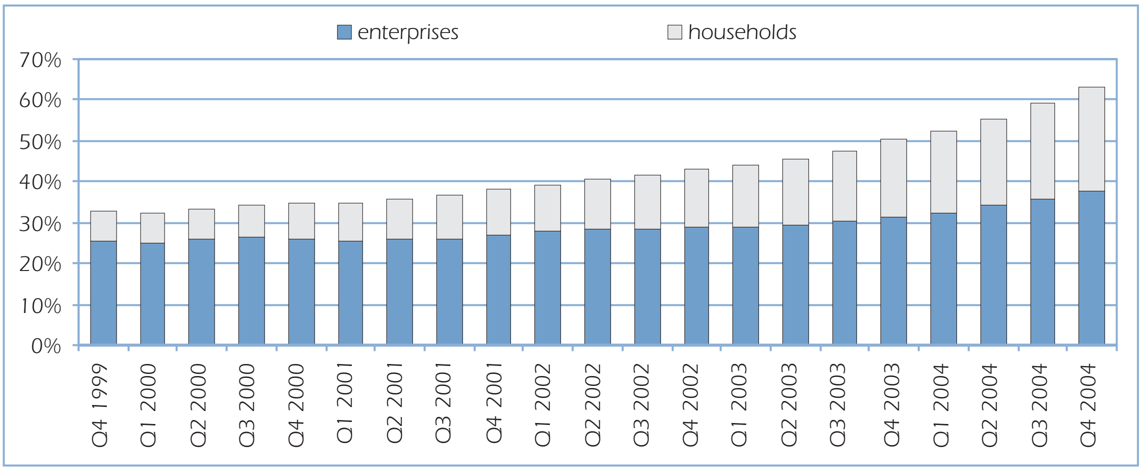

Figure 3.10. Non-financial sector debt burden (% of GDP)

In addition to the banking market volume in all other financial markets grew as well. Growing external interest after the accession have raised share prices on the Tallinn Stock Exchange to the highest since the 1997 stock exchange boom. The share of foreign investors in shares quoted on the Tallinn Stock Exchange increased. This revived slightly also the bond market: the primary market expanded and for the second consecutive year bonds were listed on the stock exchange.

Stock and pension funds were the primary trendsetters in the investment and pension fund market. Pension investments added volume mainly from the regular contributions of subscribers to the second pillar of the pension system.

BANKING

Institutional development

Rapid loan growth and tightening competition were the keywords of Estonia's banking market in 2004. Apart from **credit institutions** (AS Hansapank, SEB Eesti Ühispank (previous business name AS Eesti Ühispank), AS Sampo Pank, AS Eesti Krediidipank, Tallinna Äripanga AS, AS SBM Pank (previous business name AS Preatoni Pank), and Nordea Bank Finland Plc Estonia Branch) already operating in Estonia, also Parex Banka and Bayerische Hypo- und Vereinsbank AG, which so far had a **representative office** in Estonia, opened their branches in 2004 (see Table 3.2). In end-2004 five foreign credit institutions had a representative office in Estonia. Interest in Estonia as a potential market can be seen in more than 40 applications submitted to the Financial Supervision Authority after the EU accession to provide **cross-border banking services**.

Table 3.2. Owners of Estonian credit institutions (%)

	31/12/99	31/12/00	31/12/01	31/12/02	31/12/03	31/12/04
Non-residents	**62.24**	**83.91**	**85.74**	**86.73**	**85.66**	**89.75**
Credit institutions registered abroad	52.58	66.99	63.28	78.95	80.11	68.21
Financial institutions registered abroad*	1.94	0.51	17.18	3.63	3.05	18.71
Other non-resident legal persons	7.03	16.21	5.15	4.06	2.40	1.39
Non-resident natural persons	0.68	0.20	0.14	0.09	0.09	1.44
Estonia	**37.76**	**16.09**	**14.25**	**13.26**	**14.33**	**10.24**
Government of the Republic, incl. local governments	0.27	0.01				
Eesti Pank	11.37	0.00				
Credit institutions registered in Estonia	4.62	0.63	0.09	0.09	0.18	0.20
Financial institutions registered in Estonia	0.34	0.15	0.36	0.17	0.58	0.19
Commercial undertakings registered in Estonia	10.12	5.99	5.08	4.91	6.37	6.59
Non-profit associations registered in Estonia	0,07	0.02	0.03	0.01	0.00	0.00
Estonian natural persons	10.84	9.06	8.53	8.08	7.20	3.27
Other (preferred) shares	0.13	0.23	0.16			

* As of the end of 2001, the item encompasses in addition to the foreign investment funds also the participation of insurance companies and investment firms, which were recorded under non-resident legal persons in previous years.

In 2004, tight competition characterised the development of Estonia's banking market. Declining loan margins kept customer interest alive. Rapidly growing loan volumes were accompanied by changes in market shares (see Figure 3.11). Year-on-year, Hansapank has lost some of its domestic market share to Nordea Bank Finland Plc Estonia Branch and SEB Eesti Ühispank.

In addition to the domestic market, external markets are playing an increasing role as regards banking groups' profitability. Most of the external profits are earned in Latvian and Lithuanian banking markets; however, expanding towards the eastern market has gained momentum as well. In 2004, Hansapank entered

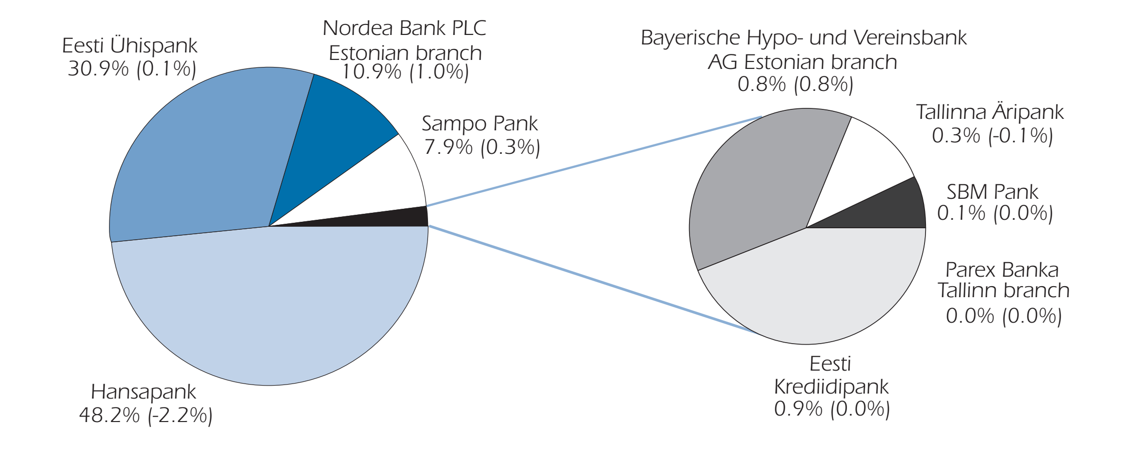

Figure 3.11. Market shares of banking groups in Estonia by volume of non-financial sector financing (bank loans, leasing and factoring) at the end of 2003 (in brackets annual change)

into an agreement to buy Kvest Bank in Moscow. Earlier, Hansapank and SEB Eesti Ühispank have provided financing service in the Russian Federation using their affiliated leasing companies.

In 2004, international rating agencies further upgraded ratings assigned to Estonian banks (see Table 3.3). Ratings of three major banks were revised upwards. Upgrading acknowledged increasing creditworthiness of parent banks as well as mutual influence between parent banks and subsidiaries.

Table 3.3. Ratings assigned to banks by Moody's Investors Service at the end of 2004

	Hansapank	Ühispank	Sampo Pank
Long-term liabilities	A1	A1	A2
Short-term liabilities	P-1	P-1	P-1
Financial strength	C	C-	D

Assets and Liabilities of Banks

In 2004, mainly due to the rapid growth of loan portfolios, banks' assets increased by more than a third (35%), i.e. nearly 35 billion kroons, and banks' total assets reached about 134 billion kroons by end-year (see Figure 3.12). The non-financial sector debt to credit institutions licensed in Estonia and leasing associations, members of the Estonian Leasing Association, grew by 30% over the year, reaching approximately 90 billion kroons by end-December. Banks' securities portfolio has seen a rather moderate growth in 2004, while funds in foreign credit institutions have gained a larger share in the consolidated balance sheet.

Financing of housing and commercial real estate loans continued rapid growth in 2004 (see Figure 3.13). The stock of household housing loans and leasing added about another half in 2004. At the end of the year, household housing loans amounted to nearly 26 billion kroons. Both moderate key interest rates and declining loan margins arising from competition have facilitated loan growth. The growth rate of other household borrowing rather decelerated: the loan stock grew by nearly the same amount, adding 1.6 billion kroons.

As to the corporate sector the loan stock of commercial real estate companies continued fast growth: the sector's loan stock increased by about 2.6 billion kroons over the year. The loan stock of export-oriented companies gained 18% in 2004 of which transport companies' borrowing increased the most.

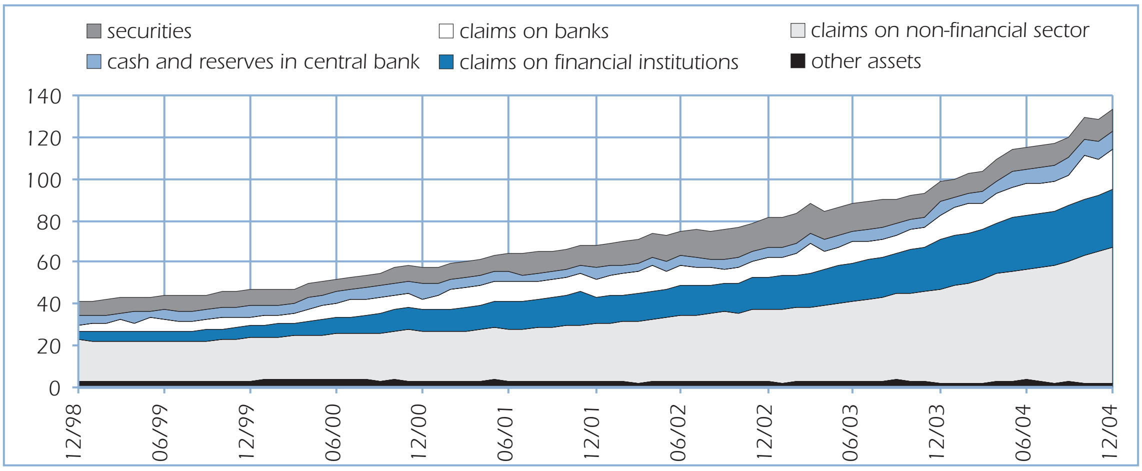

Figure 3.12. Structure of banks' total assets (EEK billion)

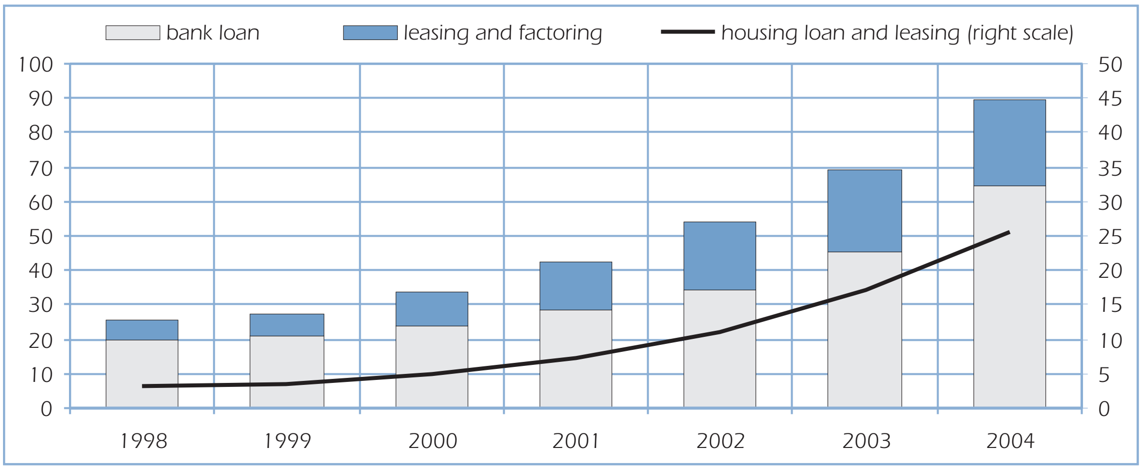

Figure 3.13. Public and non-financial sector financing (EEK billion)

The 21% deposit growth (11.3 billion kroons) was also in 2004 insufficient to finance banks' rapidly growing loan portfolios. Growth in financing was achieved with additional 21 billion kroons borrowed from abroad (see Figure 3.14). In 2004, the share of institutional foreign borrowing increased from 34% to 42% in the total

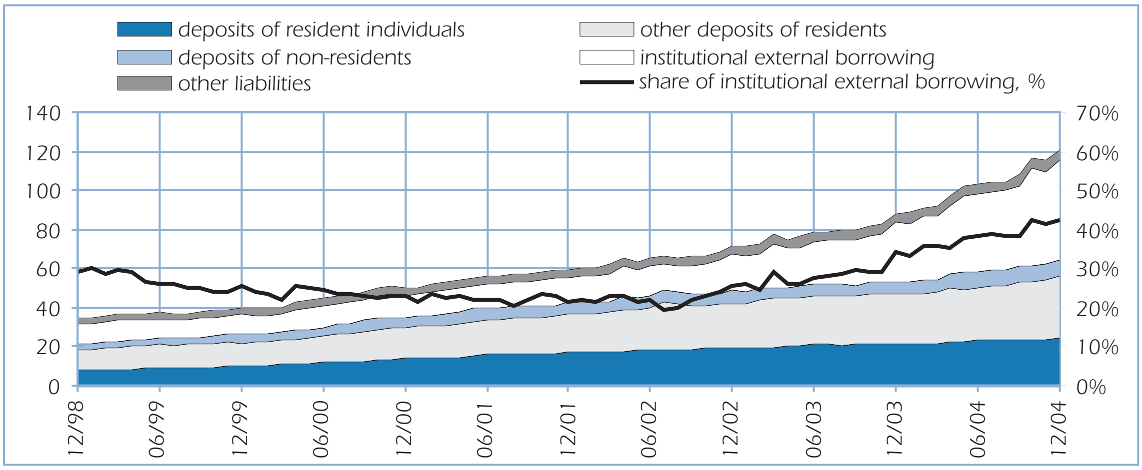

Figure 3.14. Structure of banks' resources (EEK billion; left scale) and share of foreign borrowing (right scale)

liabilities of the banking sector. Additional funds were received from parent banks but also by issuing bonds on international markets.

PROFITABILITY AND RISKS

Profitability

Robust growth in the income base, as reflected in rising interest and fee and commission income, facilitated banks' profit growth. Profit growth was supported by the satisfactory quality of the credit portfolio; loan losses remained low while volumes increased. Income earned by subsidiaries from neighbouring markets is playing an increasing role in banks' and banking groups' profits. In 2004, dividend income from non-resident subsidiaries accounted for 28% of banks' profit on a solo basis.

According to unaudited data, the banking sector earned 2.5 billion kroons profit in 2004 whereas the consolidated profit was 3.7 billion kroons. The main source of profit growth is still, despite declining margins, net interest income growth (see Figure 3.15).

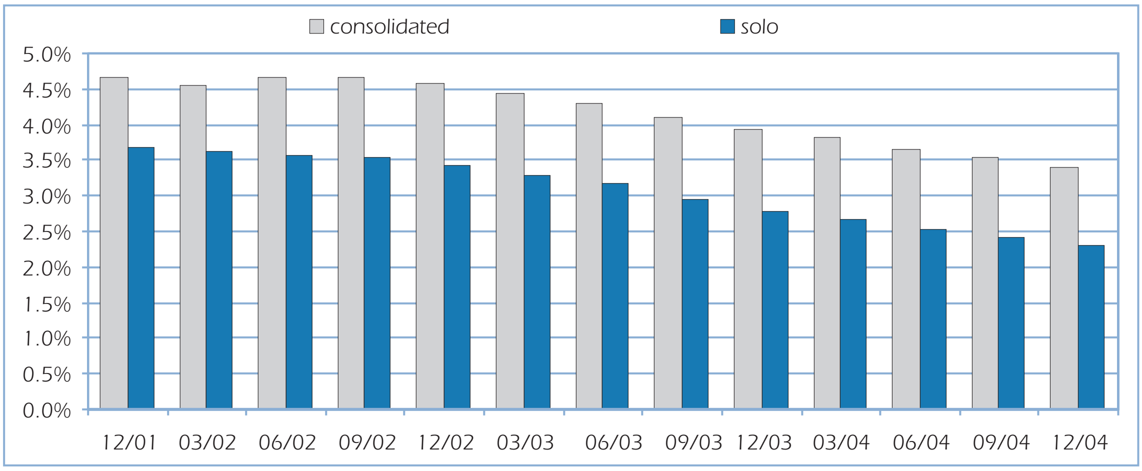

Figure 3.15. Banks' margins on a solo and consolidated basis

Although fee and commission income in the banking sector grew due to aggressive expansion of the income base, developments vary across banks. While some banks still attempt to attract customers with low service charges, others apply cost-based service charges.

Growing profitability is supported by continuously improving efficiency, which can be considered a noteworthy achievement in the light of expanding business volumes. The cost-income ratio decreased by about 7 percentage points over the year, reaching 46% in December. The ratio of administrative costs to loan and leasing portfolio has continued improving as well: from 2.8% in 2003 to 2.3% in 2004. Thanks to robust profits the annual return on equity was 19.9% (14.2% in 2003).

Capital Adequacy and Risks

Although rapidly growing risk-weighted assets decreased capital adequacy in 2004, inclusion of audited profits as own funds could slightly reduce the respective impact. While risk adjusted items added 25%, own funds gained less than 20%. Consequently, banking sector's capital adequacy was 13.4% on a solo basis and 11.5% on a consolidated basis by end-December (see Figure 3.16).

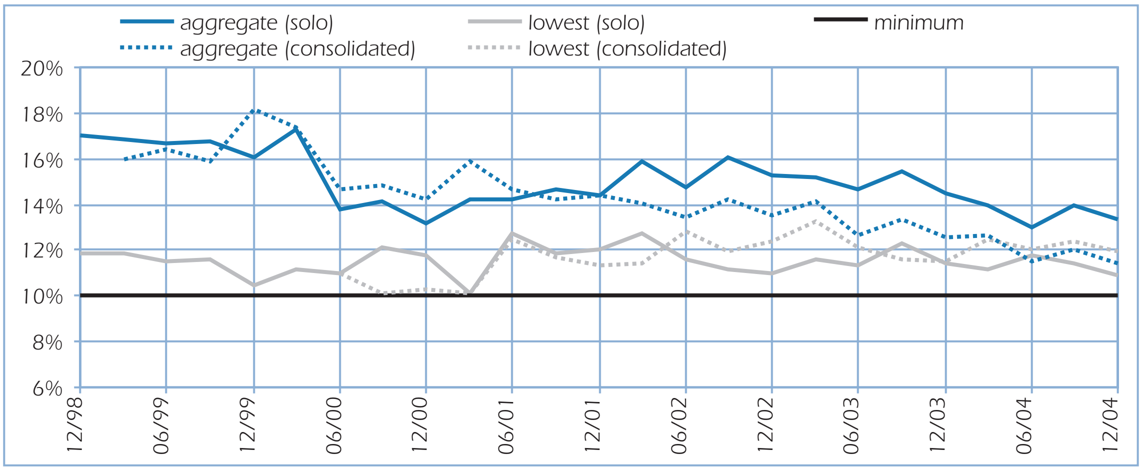

Figure 3.16. Capital adequacy of banks on a solo and consolidated basis

The quality of the banking sector's loan portfolio has not revealed any signs of deterioration while loan volumes have grown rapidly. The share of overdue loans decreased throughout the banks' loan portfolio. The share of loans overdue for more than 60 days decreased from 1.4% in 2003 to 0.7% in 2004 (see Figure 3.17). The share of overdue loans was the largest in loans issued to the manufacturing sector (2.3%), being the only sector showing a slight growth in loans overdue as compared to year 2003. The share of other loans overdue for more than 60 days remained below 2% of the loan portfolio. The share of allowance for uncollectible claims in the aggregate loan portfolio of banks was 1.0% in December 2004 (1.2% in 2003). **However, rapid growth of the credit portfolio as well as a possibility that changes in economic environment could make loan-servicing problems more frequent should be taken into account.**

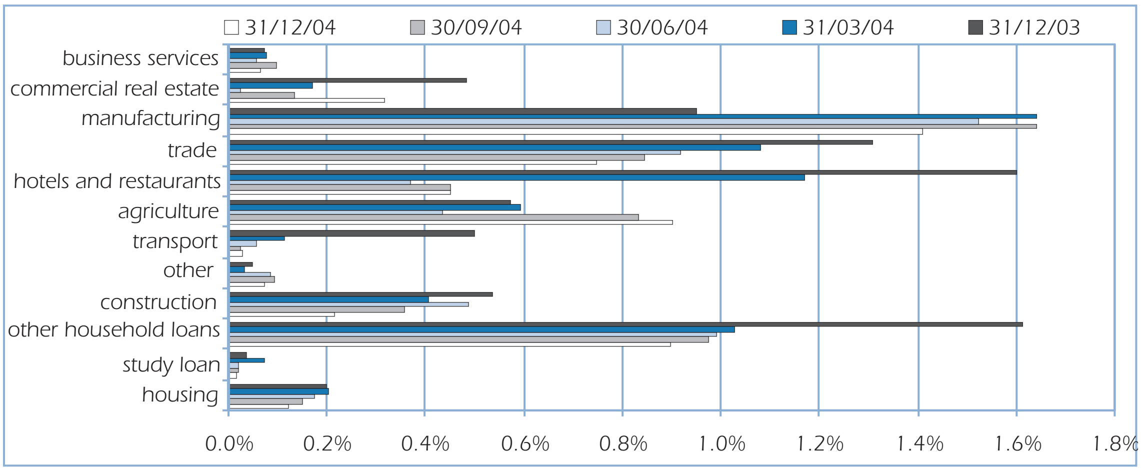

Figure 3.17. Share of loans overdue for more than 60 days in the loan portfolio by economic sectors

The banks' liabilities structure has become more volatile due to slower domestic depositing and accelerating external financing. Most of the banks' foreign funds are received either as loans or deposits by parent banks but about a half of banks' foreign liabilities are market-based, usually attracted in single large volumes.

While the share of liquid assets remained at 20.5% as an annual average, being comparable to the 2003 level, the increased volatility of liabilities brought changes to the structure of liquid assets, as seen in a growing share of more liquid foreign assets in the balance sheet, allowing more flexible liquidity management.

Banks' net open currency positions increased primarily because of euro-based housing loans. Due to the activities of banks' subsidiaries, the open net position of the Latvian lat was responsible for over 90% of the open position with a real foreign-exchange risk (excluding the euro), also growing over the year. Therefore, the capital requirement increased as well to cover foreign-exchange risk. Although the expansion of business activities to Russia has increased the open net position of the Russian rouble, it is still below 2% of all other net open currency positions (excluding the euro).

HOUSING LOANS AND LEASING MARKET

Favourable loan conditions, increasing employment and income as well as optimistic future outlooks have sustained households' loan demand high for the fourth consecutive year. Banks are willing to provide housing loans as in general these have a high loan servicing quality. Housing is among the primary needs of an individual; therefore, households would rather curb consumption than fall overdue with their loan repayments and risk losing their home. Housing loans, unlike consumption loans, are usually sufficiently collateralised. Intense competition between banks to attract customers has made loan conditions more favourable, which, in turn, has boosted demand.

The joint impact of these factors has sustained annual housing loan growth above 50% for the third successive year (see Figure 3c). Borrowing for purchase or renovation of housing accounts for close to 75% of the household loan stock. Household debt burden has risen from 11% in 2001 to 25% of GDP in 2004. Housing loans and leasing constitute the largest share in the banks' loan and leasing portfolio (29% of the non-financial sector's loan and leasing portfolio in end-2004), the quality of which is thus of significant importance for banks' financial performance. The quality of housing loans has remained satisfactory, as merely 1% of housing loans were more than 60 days overdue as an annual average in 2004. The share of leasing in housing financing is constantly decreasing, partly due to internal structural changes in banking groups. At the end of 2004, the volume of leasing financed loans accounted for a tenth of the total housing loans and leasing portfolio.

Booming loan offers have influenced also the housing market, as most of the housing purchased is either loan or leasing financed. According to various estimates, prices of apartments in Tallinn have added annually 15–20% over the last three years, whereas the number of housing related

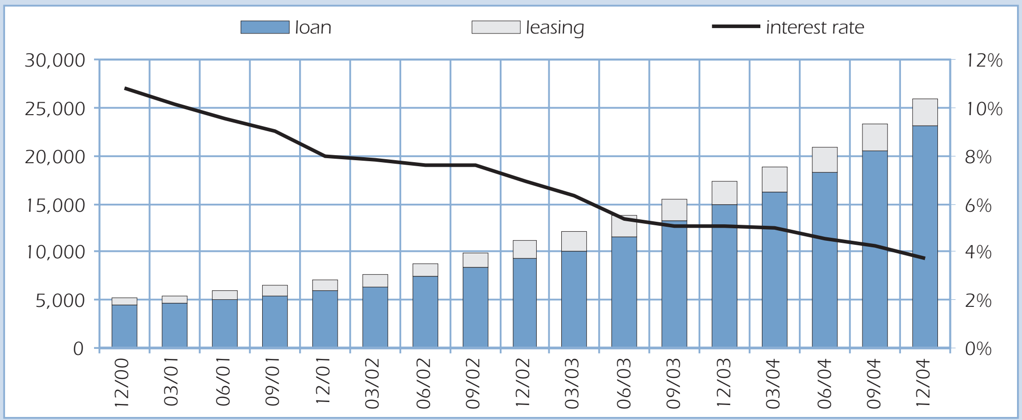

Figure 3c. Volume of housing loans and leasing (EEK million; left scale) and average interest rate (%)

notarial transactions has increased by a fifth (according to the Estonian Statistical Office). Eesti Pank estimates that customers replacing a smaller loan with a larger one account for approximately 40% of the increase in the housing loan and leasing portfolio. However, this is temporary. Besides, income growth of the new housing loan takers of the lower income group remains below the growth rate of the housing loan portfolio. These factors indicate a slowdown in borrowing in the long term.

SECURITIES MARKET

Bond Market

The bond market had an active primary market against the more modest secondary market in 2004. Growing emission volumes and market capitalisation have not increased bonds' attractiveness in the secondary market and they are still, first and foremost, acquired for holding.

Unlike the last two years when bond market capitalisation displayed a downward trend, bond market capitalisation increased by 6% in 2004, i.e. from 2.9 to 3.1 billion kroons. Capitalisation increased due to a 40% growth in the bond issues of resident companies. In 2004, 80% of the new bonds were issued by local non-financial and financial sector companies, a half thereof being capital attracted by banks from the bond market. Year-on-year, the volume of issues in the primary bond market added about a fifth in 2004, i.e. from 2.8 to 3.4 billion kroons (see Figure 3.18).

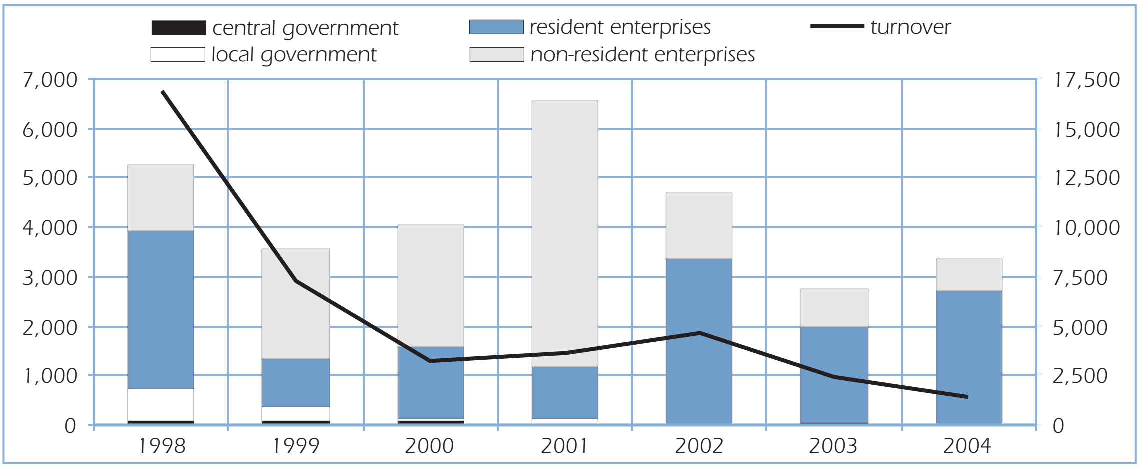

Figure 3.18. Annual bond issues by issuers (EEK million; left scale) and turnover (EEK million; right scale)

Although most of the bonds issued were with the maturity of up to one year, the issuance of longer-term debt securities increased considerably in 2004. Bonds with the maturity of over three years grew in volume as well, accounting for 30% of all issues.

Counterbalancing a more active primary market, the monthly turnover of the secondary market dropped from 200 million kroons in 2003 to 121 million kroons in 2004. 75% of the bond investors are residents, mostly private companies and investment funds.

Apart from bonds listed in 2003, Baltic Investment Group, Fenniger and Sampo Pank got listed in 2004. All in all, bonds of five enterprises were listed by the end of 2004, totalling 452 million kroons.

Stock Market

The Tallinn Stock Exchange witnessed a rapid growth in share prices in 2004. The Tallinn Stock Exchange Index TALSE reached 449 points, marking a 57% annual growth, the highest rise after the 1997 stock exchange boom (see Table 3.4). The annual growth of the Tallinn Stock Exchange Index exceeded growth in major Western European stock markets more than sevenfold and in other Baltic markets by more than a third. Estonia's market was more active in the last months prior to the EU accession and in autumn with several record highs in price and turnover. The average monthly turnover outpaced that of 2003 by 30%, reaching 40 million kroons (see Figure 3.19).

Table 3.4. Securities market indicators (EEK billion)

	1997	1998	1999	2000	2001	2002	2003	2004
Securities market capitalisation*	**18.6**	**12.2**	**31.6**	**34.3**	**31.6**	**42.2**	**53.5**	**80.0**
Instruments								
Listed shares	12.6	7.9	28.0	30.1	26.1	36.2	47.3	71.9
Debt securities	4.0	3.7	3.2	3.7	4.4	3.3	2.9	3.1
Shares and units of investment funds	1.8	0.5	0.4	0.4	0.9	1.7	2.6	4.5
Subscription rights	0.1	0.2	0.0	0.0	0.2	1.0	0.7	0.5
Securities market turnover*	**34.1**	**33.7**	**15.2**	**14.3**	**14.1**	**23.1**	**27.9**	**13.9**
Capitalisation of Tallinn Stock Exchange	13.1	8.3	28.3	31.0	26.4	36.2	47.3	71.9
incl. non-resident investors	42%	54%	74%	77%	77%	80%	80%	84%
Turnover of Tallinn Stock Exchange	21.8	13.4	4.5	5.5	4.1	4.2	7.8	10.3
Securities market capitalisation*/GDP	29%	17%	41%	39%	33%	40%	46%	58%
Securities market turnover/capitalisation	183%	276%	48%	42%	45%	55%	52%	17%
Stock exchange turnover/capitalisation	167%	161%	16%	18%	16%	12%	17%	14%

* Securities market capitalisation and the market turnover do not include unlisted shares.

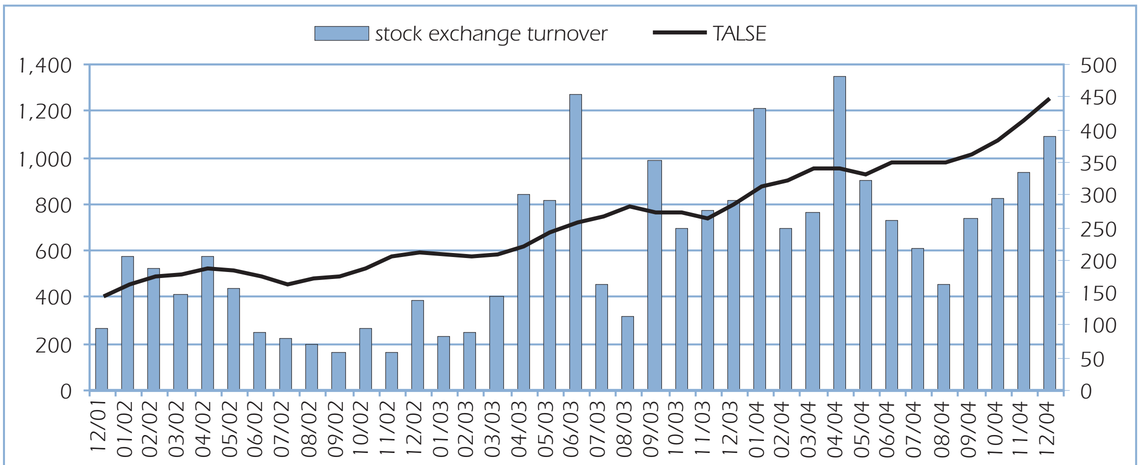

Figure 3.19. Monthly turnovers (EEK million; left scale) and index TALSE (points; right scale) of the Tallinn Stock Exchange

Shares of pharmaceuticals industry, banking sector, construction and commercial businesses appreciated most in 2004. The price growth of listed shares was brought about by foreign institutional investors' interest, resulting in the share of non-resident investments in stock exchange capitalisation reaching 84% by end-2004. Swedish investors again accounted for most of it (55%). Investors from the United Kingdom were responsible for 8.5%, the US for 6.5%, and Finland for 6%.

Within the integration process of Nordic-Baltic securities markets, the Tallinn Stock Exchange together with Riga and Helsinki Stock Exchanges joined NOREX, the alliance of Nordic and Baltic stock exchanges in 2004. The common trading system SAXESS was also successfully launched and by the end of 2004 all Nordic, Estonian as well as Latvian stock exchanges had applied the system. The next phase of integration foresees the application of the Global Industry Classification Standards (GICS), which serve as a basis for listing companies in four categories[3].

OTHER FINANCIAL INTERMEDIARIES

Investment and Pension Funds

In 2004, the volume of investment funds sustained the rapid growth of previous years, although a higher reference base slightly slowed it down against 2003. The investment funds added 3.8 billion kroons over the year, totalling 11 billion kroons. Investments in shares and mandatory pension funds accounted for most of the growth (see Figure 3.20). Growth in Central and Eastern European stock exchanges supported the increase in equity funds about 3.5 times year-on-year, i.e. to 3.5 billion kroons. The second pillar of the pension system has been successful, funds increasing 2.5 times in volume. The yields of money market and interest funds declined due to lower interest rates, funds shrinking in volume against end-2003.

By the collection deadline of 2005 (31 October 2004), the number of subscribers to the second pillar of the pension system had reached 424,000 (71% of the employed and 64% of the labour force). The volume of the second pillar funds reached 2.5 billion kroons by the end of the year. 75,500 individuals, i.e. 12.5% of the labour force, had joined the third pillar of the pension system by end-2004. About a billion kroons of savings (with the value of funds being 19%) had been placed in voluntary pension schemes (including pension funds and insurance) by the end of 2004.

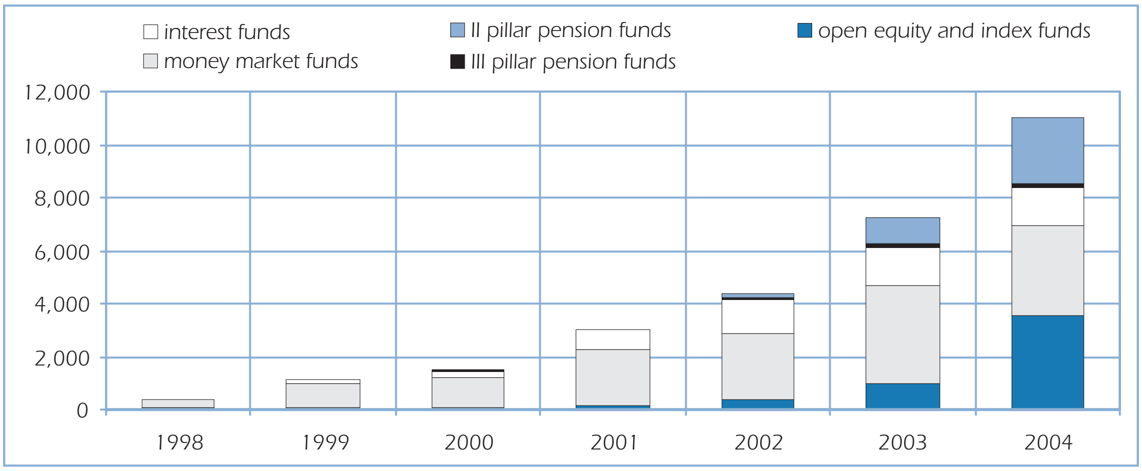

Figure 3.20. Total volume of investment funds as at the end of 2004 (EEK million)

[3] GICS classification provides four levels of industry analysis: by sectors, industry groups, industries, and sub-industries.

Insurance

The life insurance market continued to grow for the fourth consecutive year, reaching an annual average of 39%. Primarily premiums collected under unit-linked life insurance contracts boosted the volume of premiums, including also third pillar pension insurance premiums based on income tax incentives. Insurance companies collected 806 million kroons in gross premiums, capital insurance of life insurance and unit-linked life insurance accounting for most of it (see Figure 3.21).

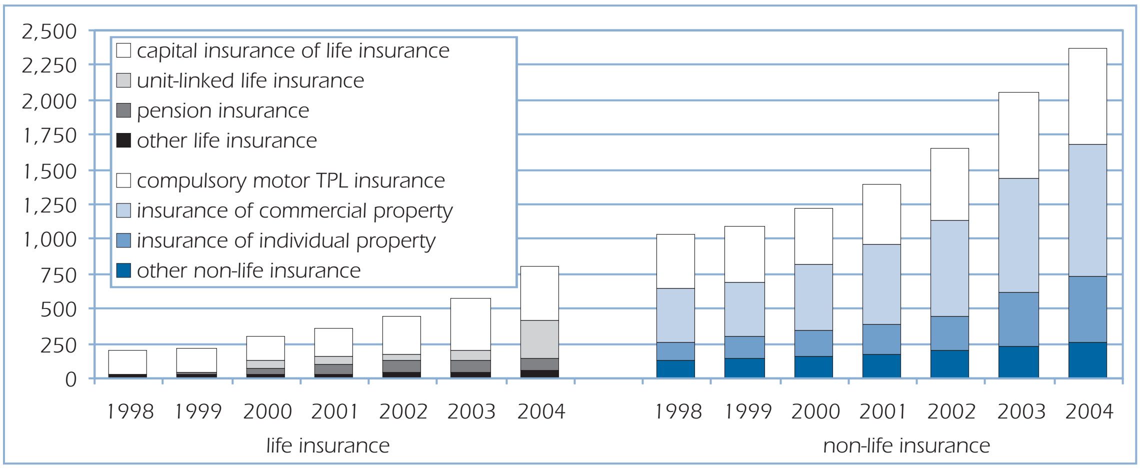

Figure 3.21. Gross premiums collected by insurance companies (EEK million)

In 2004, the non-life insurance market displayed a more modest growth year-on-year, reaching 15%. Lively real estate market and rapidly growing housing loan market were the main driving forces behind market growth. In addition, corporate and household casco insurance premiums contributed greatly to the volume of non-life insurance premiums.

While the institutional structure of the life insurance market had been established by early-2004, the non-life insurance market was still involved in market redistribution. Zürich Kindlustus Eesti (Swiss) left the market in 2004; its portfolio went to If Eesti Kindlustus.

In the first nine months of 2004, the consolidated profit of non-life insurance companies had nearly doubled year-on-year, reaching a record high of 258 million kroons. Contrary to non-life insurance profit numbers, the consolidated profit of life insurance companies decreased about 10% over the same period.