I FINANCIAL MARKETS

GLOBAL FINANCIAL MARKETS[1]

The euro area economy will continue its recovery, with expectations that the European Central Bank will adopt exit strategies for the extraordinary measures applied to stimulate the financial markets. The last six months have seen the cancellation of the first extraordinary 12-month liquidity operations, with the market participants' lower interest in new tender operations significantly reducing excess liquidity on the inter-bank market. As a result, the three-month Euribor climbed to 1.06%, surpassing the monetary policy rate of the European Central Bank for the first time in July 2009. The key interest rate remained at a record low level of 1% in the euro area.

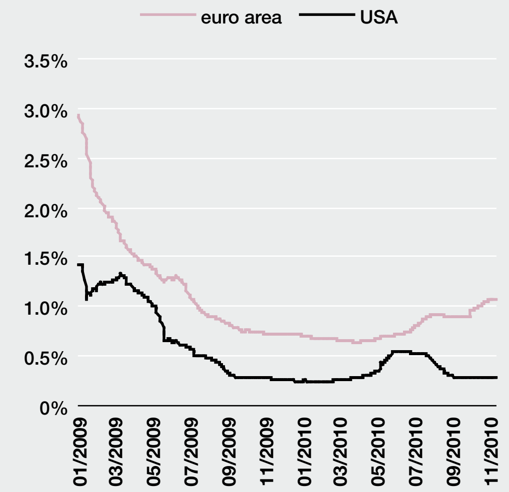
The main developments on the **money markets** revolved around the discrepancies between countries: in the euro area, the outlook for normalisation of the monetary policy brought a rise in interest rates, while in the United States and Japan, interest rates dropped owing to the implementation of the monetary policy of quantitative easing or related expectations (see Figure 1).

Due to a continual deterioration in the outlook for growth, the US Federal Reserve announced the second stage of quantitative easing for a total of 600 billion US dollars at the beginning of November. As a result, the three-month Libor dropped below 0.3%. In the United States, the federal funds rate remained between 0.0 and 0.25%. Somewhat surprisingly, the central bank of Japan returned to its original zero-interest-rate policy, bringing the key policy rate down to 0.0–0.1%. As a consequence of the recuperation of the economies of Sweden, Norway, Canada, Australia and New Zealand and an increase in the inflation outlook, the central banks of these countries have started to tighten their monetary policy.

Government bond markets were characterised in the last six months by a significant drop in long-term interest rates (see Figure 2). The European

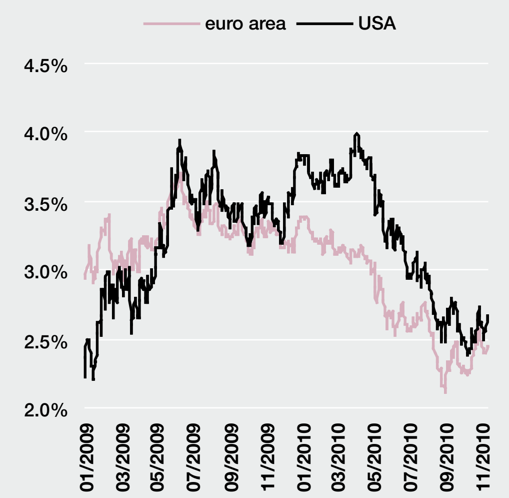
[1] The Review covers the period from 31 May 2010 to 31 October 2010.

Figure 1. Three-month interest rates in the euro area and the USA



Sources: EcoWin, Eesti Pank

Figure 2. Ten-year interest rates on euro area and US government bonds



Sources: EcoWin, Eesti Pank

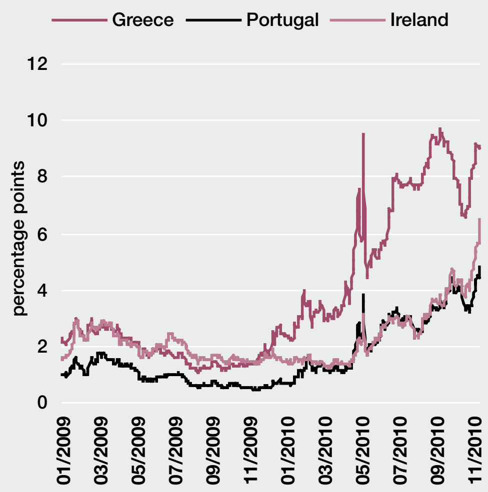
government bond market witnessed fluctuations in the interest rates of German ten-year government bonds until the end of July, as the market redirected its focus from the debt crisis of the euro area countries to the slowdown of the economic recovery in the United States. Revealing the banks' higher-than-expected resistance to the financial crisis, the results of the stress tests of major European banks triggered the sales of low-risk German government bonds on the secondary market, with interest rates rising.

Once again, tensions started brewing in the euro area in August, when uncertainties over the rescue of the Irish banking sector and the difficulties of the minority government of Portugal in cutting budget costs led to a wider-than-ever interest rate spread between the ten-year government bonds of these countries and those of Germany (see Figure 3). The progress made by Greece in consolidating its state budget was positively received by the market. Nevertheless, worries over the possibility of debt restructuring continued.

Once again, reassessment of risks increased the demand for German bonds, with the interest rate of the ten-year government bond consequently dropping to a record low level. A deterioration of the macroeconomic indicators in the United States fuelled expectations that the Federal Reserve would apply extraordinary measures to stimulate the economy, and would buy long-term government bonds. This triggered a drop in interest rates across the yield curve.

Foreign exchange markets witnessed a broad-based depreciation of the dollar in connection with expectations that US monetary policy would ease. Despite the deep debt crisis in certain euro area countries, the euro appreciated against the dollar by over 13% from June to October. The depreciation of the dollar exchange rate could not even be halted by the intervention of several Asian central banks, which purchased the dollar against their national currencies in order to slow down the appreciation

Figure 3. Spread between 10-year bonds of Greece, Portugal and Ireland with Germany



Sources: EcoWin, Eesti Pank

of their national currencies caused by huge capital inflows. By and large, tensions on the foreign exchange markets were stoked by the prospect of currency wars, with nations accusing each other of manipulating currency exchange rates via direct intervention, restriction of capital flows or doveish monetary policy. At the G20 summit in October, the countries at the meeting agreed to refrain from competitive devaluations, and to pursue exchange rates determined by the free market.

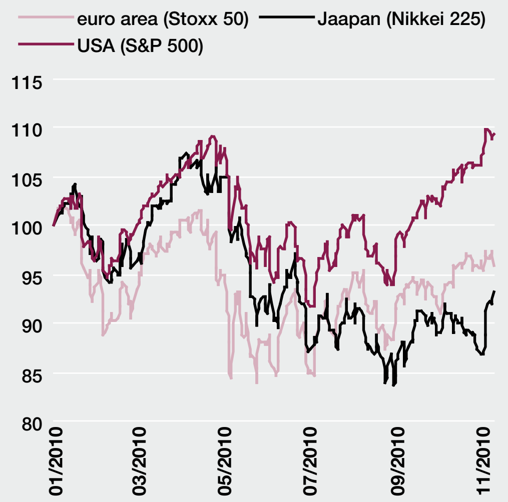
Having begun in the middle of April, the decline in major **stock markets** ceased by the end of September, when investor appetite was stimulated by the extensive measures applied to ease the debt crisis of certain euro area countries (see Figure 4). At the same time, the obscurity of the economic outlook grew, along with the risk of a double-dip recession. Interest in investing in stock markets was thus limited, and the differences in equity prices soared. In the second half-year, the appetite for risk was encouraged by positive economic results and also by a sense of security and transparency that stemmed from the results of the stress tests of European banks and public disclosure of the Basel III capital requirements. In addition, stock markets were buoyed by the record low interest rates, which continued to drop.

For the financial markets, **primary risks** in the near future are related to certain debt crisis-stricken European countries. In the longer perspective, the risks also revolve around the greater threat of price bubbles and inflation, conditioned by the doveish monetary policy of the central banks.

The euro area debt crisis has played an important role in the evaluation of the prospects of the global economy and financial markets. Due to the scale of the crisis, it takes a long time to consolidate the budgets of those countries that are affected. Their ability to reduce their government debt and budget deficit is being closely monitored, and aggressive reduction of the budget deficit will hamper economic growth in these countries. The differences between the recoveries of Member States will thus grow wider, further complicating the situation in the euro area. Germany has experienced a rapid economic recovery, but since its economic growth is mostly fuelled by exports, the recovery is jeopardised by the appreciation of the euro and the deterioration of the outlook of Germany's main trade partners. Economic growth in the euro area is thus likely to remain modest and imbalanced, with the outlook for economic growth still vague.

Developed industrial countries have applied various measures to bring interest rates to a record low level in order to stimulate the economy. Low yields and a high risk of inflation make bonds unattractive for investors, who are thus forced to search for more profitable investment yields. This search for yields increases capital inflows to developing countries, where the economic policy institutions are forced to apply protectionist measures and carry out currency intervention by buying or selling their national currency against foreign currency in

Figure 4. Stock indices in the euro area, Japan and the USA (1 Jan 2010 = 100)



Sources: EcoWin, Eesti Pank

order to control inflation, avoid price bubbles and prevent over-appreciation of the exchange rate. As a result, the money is moved back to the government bond market, exerting further downward pressure on interest rates, and the whole cycle repeats itself. In the end, there is a risk of a simultaneous overheating of both the securities markets of industrial countries and the stock markets of developing countries.

ESTONIA'S FINANCIAL MARKETS

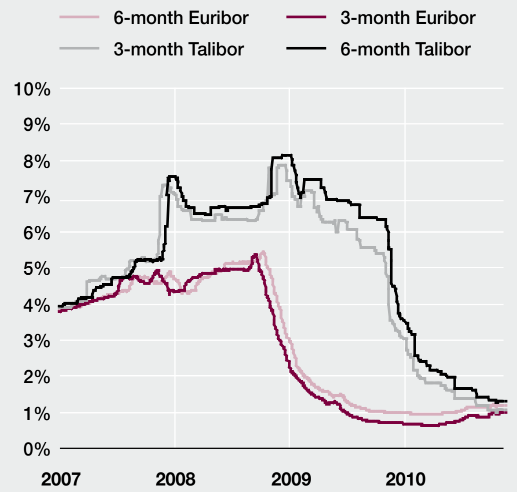
The money market

The Estonian kroon money market has never been very active – it has not been used to manage the liquidity of the kroon in the Estonian financial sector, but rather to hedge the Estonian kroon currency risk by foreign counterparties. As there will be no need for such transactions after Estonia's accession to the euro area, the local money market will diminish in 2011.

The interest rate spread between the money markets of Estonia and the euro area has declined continually in 2010. The interest rate spread between Talibor and Euribor was 8–12 base points at the end of October (see Figure 5). A small interest rate spread on the local market right before accession to the euro area has also been experienced by other countries that have adopted the euro, and is thus not unusual. The turnover of the Estonian interbank money market remains small. The volume of transactions on the Estonian kroon derivatives market has also been decreasing. Only a handful of transactions were made in September and October, as the market has no interest in hedging the kroon risk due to the imminent transition to the euro. The premiums of forward transactions have also dropped for different maturity terms (see Figure 6).

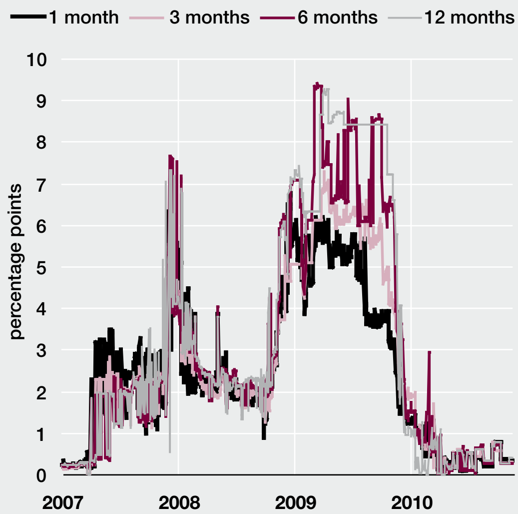
Ireland's problems with the financial sector and its debt burden, which caused anxiety on the European financial markets, have failed to have a notable effect on Estonian risk assessments. The Estonian five-year credit default swap (CDS) has fallen, and remains at a lower level than those of the other Baltic countries (see Figure 7). This reflects

Figure 5. Money market interest rates in Estonia and the euro area



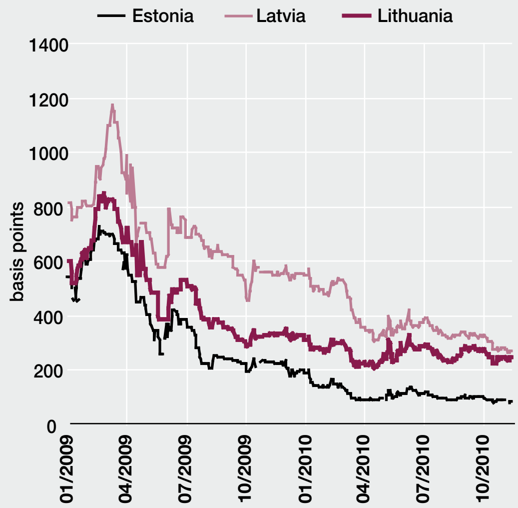
Sources: EcoWin, Eesti Pank

Figure 6. Forward premiums of the Estonian kroon against the euro



Sources: Reuters, Eesti Pank

Figure 7. Credit default swap spreads of the Baltic countries



Sources: Reuters, Eesti Pank

both the imminent accession to the euro area and the good public finances compared to those of many euro area countries.

Bond and stock markets

The banking system, which operates on a strong set of foundations, plays the predominant role in Estonian financial intermediation. The local **bond market** has thus served as an alternative way of raising funds for higher-risk investments. In the economic decline, the bond market contracted to a large degree in the second half of 2008 (see Figure 8). Capitalisation totalled 8.7 billion kroons at the end of October, worth 4% of GDP. Local non-financial sector companies remain the greatest contributor to the total capitalisation of bonds, contributing 75%.

A total of 229 million kroons worth of bonds were issued on the primary market in the last six months, comprising mostly the bonds of non-financial sector companies. The average coupon rate of these bonds exceeds 10%. The secondary market remains passive, with the average daily turnover amounting to a mere two million kroons both in the first half-year and in the last quarters – a fall of nearly half from 2009 and barely 8% of the level in 2008.

The debt crisis which began in the spring of 2010 reduced investors' appetite for risk, with the indices of the world's leading **stock markets** facing downward adjustments. The Tallinn Stock Exchange was no exception. By the beginning of summer, the OMXT had retreated close to 20% from its highs in the spring. The stabilisation of the global markets and improvement in economic indicators reversed the downward trend in the first half of July, and by the beginning of November, the OMXT had advanced by nearly two-thirds from the beginning of the year (see Figure 9).

Compared to the first half of 2010, the second half-year was much less eventful on the Tallinn Stock Exchange. June saw the delisting of the shares of Norma, which contributed 5.8% of the total market

Figure 8. Bonds issued and secondary bond market turnover on a quarterly basis

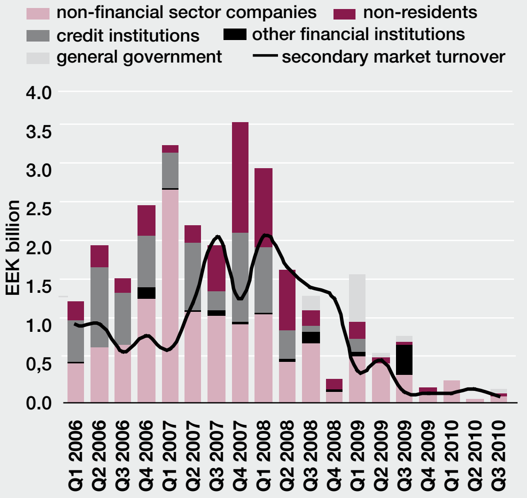
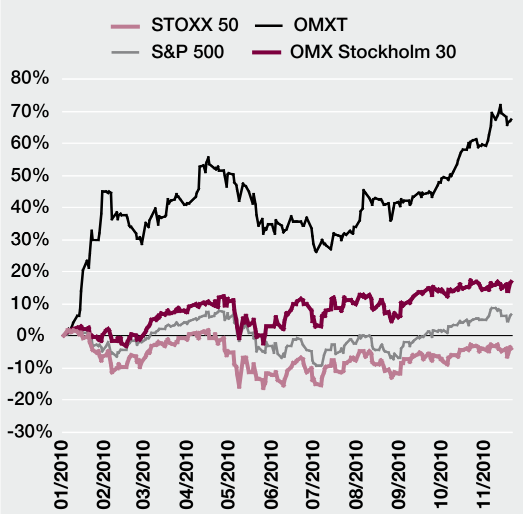


Figure 9. Developments on the Tallinn Stock Exchange compared to global stock exchanges



Sources: EcoWin, Eesti Pank

capitalisation. With Norma's departure from the stock exchange and the drop in stock prices in the summer, the total capitalisation of the Tallinn Stock Exchange fell to 21.3 billion kroons by the end of August. As stock prices then increased again, the stock market capitalisation began to grow in September. By the end of October, the capitalisation of the Tallinn Stock Exchange totalled 24.4 billion kroons, worth 11% of the GDP (see Figure 10).

The liquidity level is still low on the stock exchange. The average daily turnover in the past six months was 12.5 million kroons, which was one-third less than in 2009. The shares of Olympic Entertainment Group and Tallink Group had the highest trading volumes in the last two quarters, accounting for 31% and 19% of the total turnover respectively.

Investment funds

As a result of the drop in stock prices following the debt crisis, the yield of Estonian equity funds shrank for a few months. Thereafter, the yield growth trend continued, and at the end of October, the average yields of equity and interest funds from the beginning of 2010 were 14% and 10% respectively (see Figure 11). However, neither equity funds nor interest funds have succeeded in producing a positive yield in the medium-term. Starting in early 2007, the average annual yield of equity and interest funds has amounted to –11.1% and –2.6% respectively.

By the end of October, the value of the lowest-risk second-pillar pension fund shares had increased by an average of 5.4% and the value of high-risk fund shares by an average of 7.1% from the beginning of the year. The average annual yield of the pension funds has remained 2.9–4.8% since they were first established.

The capital outflow from the investment funds, experienced in 2009, has been replaced by capital inflow in 2010 (see Figure 12). The net contributions to investment funds in the last two quarters amounted to 154 million kroons. Fund yield

Figure 10. Market capitalisation of shares listed on the Tallinn Stock Exchange

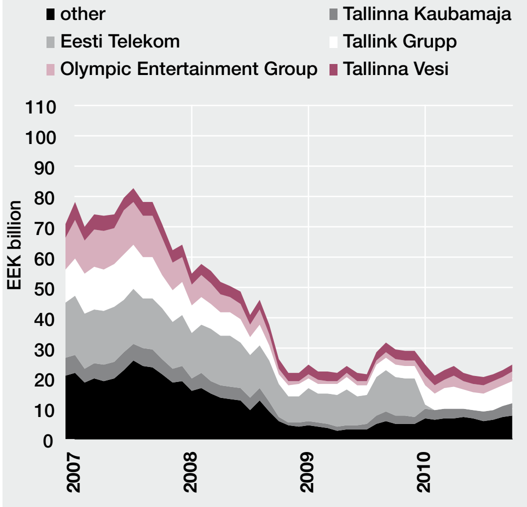
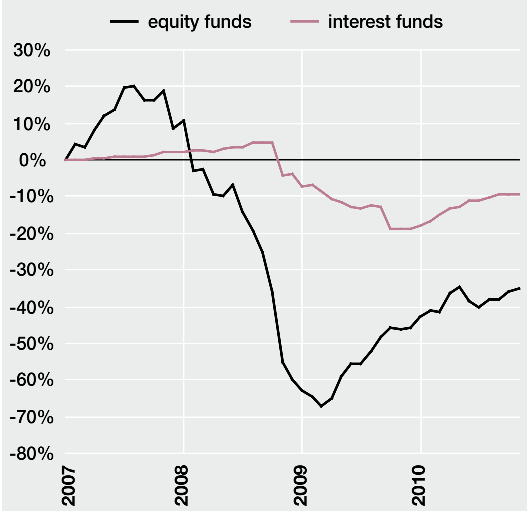


Figure 11. Changes in the average price for investment fund units since 2007



included, the assets of the investment funds totalled 9.7 billion kroons by the end of October.

At the end of October, the **assets** of the second-pillar pension funds were a record-breaking 16.3 billion kroons (see Figure 13). The assets of the high-risk second-pillar pension fund showed the biggest growth from the beginning of the year, increasing by 968 million kroons to 12.4 billion kroons. The total assets of the third-pillar pension funds and insurance contracts amounted to 3.8 billion kroons at the end of October, of which 34% or 1.3 billion kroons comprised assets invested in the funds.

The beginning of 2010 saw a change in the structure of the second-pillar pension funds, with a significant portion of the new contributions directed to a fund managed by another management company. At the same time, the proportion of management companies in the total asset structure of the second-pillar pension funds has not changed significantly.

The share of external assets in the **investment structure** of the investment and pension funds has grown somewhat in the past six months (see Figure 14), and reached 82% at

Figure 12. Monthly net inflow and outflow of investment funds

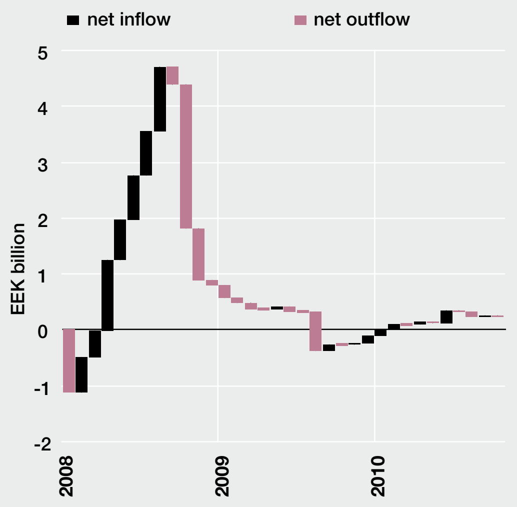


Figure 13. Value of pension fund assets at end-period

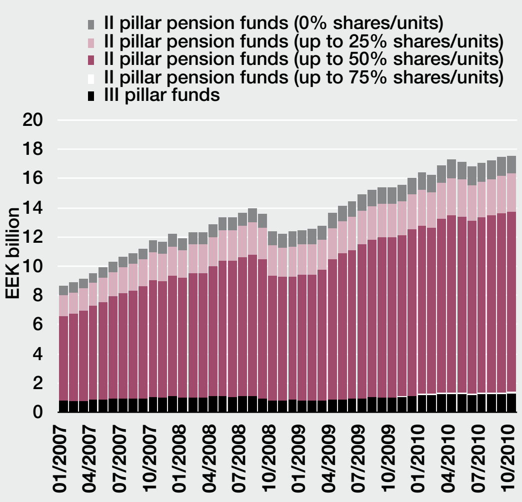
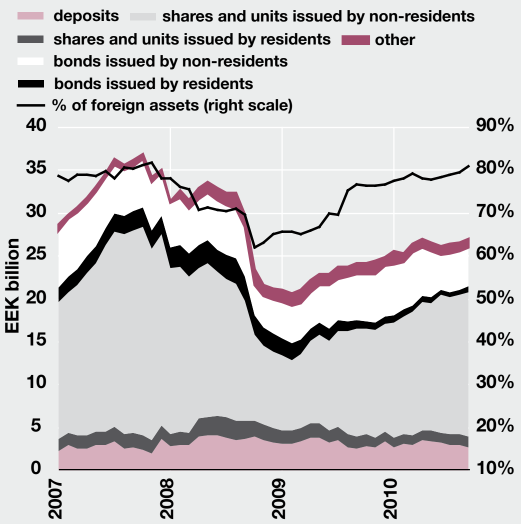


Figure 14. Structure of investment and pension fund assets and the share of foreign assets



the end of October. As regards asset categories, a trend towards higher-risk assets is evident, as the proportion of equities and shares has grown by 8 percentage points in the last two quarters, reaching 67%, while the share of bonds and deposits has shrunk by 8 percentage points to 29%. The value of the assets invested in the funds may thus become more volatile in the future.

No significant changes are evident in the geographical distribution of the investments, compared to the spring. At the end of October, a majority (66%) of the funds' assets had been invested in securities registered in Europe excluding Estonia, followed by Asia (11%) and North America (3%). In Europe, the assets invested in securities registered in Western Europe grew by 8 percentage points to 45%, while the share in other regions of Europe decreased. Even though the share invested in the securities of those euro area countries that are suffering public finance problems is relatively small, a deepening or widening of the debt crisis may affect the overall situation in the financial markets, thus negatively affecting the value of the assets invested in funds registered in Estonia.

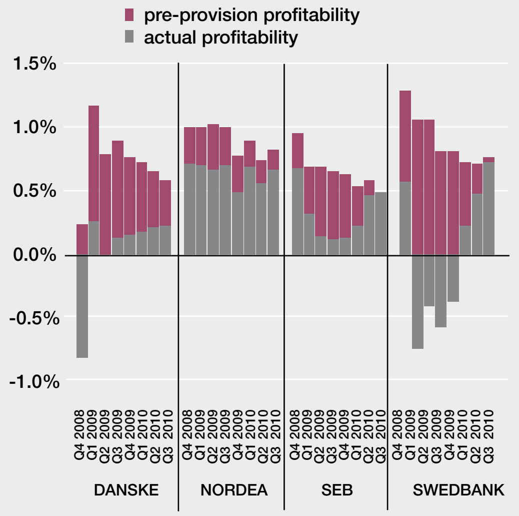
MARKET-BASED FINANCING OF BANKING GROUPS

Financial strength of the groups of parent banks

The revenue of parent bank groups operating in Estonia was smaller in 2010 than in the previous period. The drop in revenue was mainly caused by a decrease in the volume of new loans and an increase in the cost of financing, which curbed the net interest income.

The banks' **profitability**, on the other hand, has improved remarkably, compared to the previous period (see Figure 15). This was mainly caused by the reduction of loan provisions and fewer write-downs due to a smaller increase in problem loans. The profitability levels and the changes differ between banking groups. Because

Figure 15. Profitability of banking groups and pre-provision profitability



Sources: public reports of banks, Eesti Pank

of fewer write-downs, profitability showed a more significant improvement in groups that had previously done more provisioning.

The groups' **capitalisation** has remained stable in recent quarters. Capitalisation is higher than in the beginning of 2008. The capital adequacy ratio has advanced by more than 2 percentage points and the Tier 1 ratio by 4 percentage points. The Tier 1 ratio of the parent bank groups of the four largest banks operating in Estonia exceeded 10% in the third quarter of 2010.

Given the developments in the last few months, the bank's profitability is likely to show further improvement, fuelled, above all, by the reduction of loan provisions.

Funding of parent banks

The funding of Nordic banking groups depends largely on market-based financing. The need for such funding varies, depending on the bank's business model. Swedbank stands out as the bank most dependent on **market-based financing**.

The bank has reduced its need for market-based financing in the last three quarters by cutting loan volumes and boosting deposits, but still shows the biggest need for financing among the banking groups (see Figure 16). The share of market-based financing for other groups has shown no significant change in the last quarters, with at least 35% of the loans issued to customers requiring financing from other sources, leaving the banks quite vulnerable to developments on the financial markets.

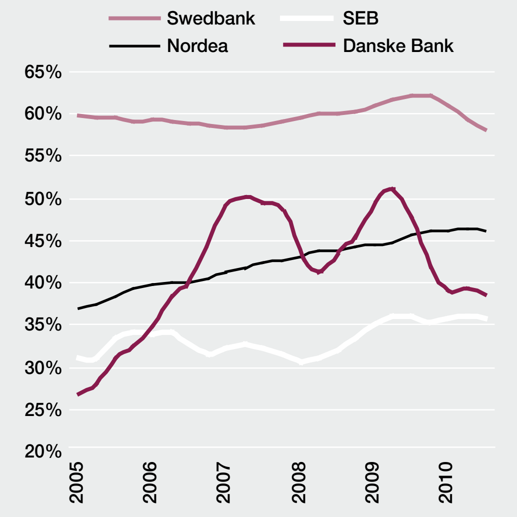
The Nordic countries have avoided[2] the worst effects of the debt crisis that shook European financial markets, with investors considering the region safer than others. Moreover, uncertainties over the possibility of huge loan losses accumulating in the Baltic States have started to wane. The better situation of the Nordic banking groups is also reflected in **credit default swap** (CDS) spreads, which have been significantly – nearly 40 basis points – lower than those of other European banks since the spring of 2010 (see Figure 17).

Unlike the banks operating in Southern Europe, the major Scandinavian banks have had no permanent trouble in raising funds on the financial markets. Quite the contrary, Nordic banks have succeeded in raising more and more **long-term funds**[3], thus making their funding base more stable (see Figure 18).

The vulnerabilities exposed by the financial crisis have compelled banks to pursue a more stable and long-term structure for liabilities with the aim of reducing sensitivity to abrupt changes in the external environment. The banks have also started to raise longer-term funds due to changes expected in the legal framework regulating the banking sector.

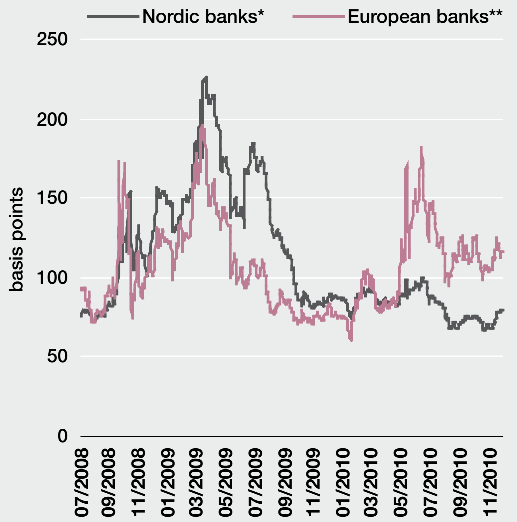
Until the end of the third quarter, the banks' financing conditions improved as there was a

Figure 16. Banking groups' share of wholesale funding in total loans (4-quarter moving average)



Sources: public reports of banks, Eesti Pank

Figure 17. CDS premiums of Nordic and European banks



Sources: Bloomberg, Eesti Pank

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

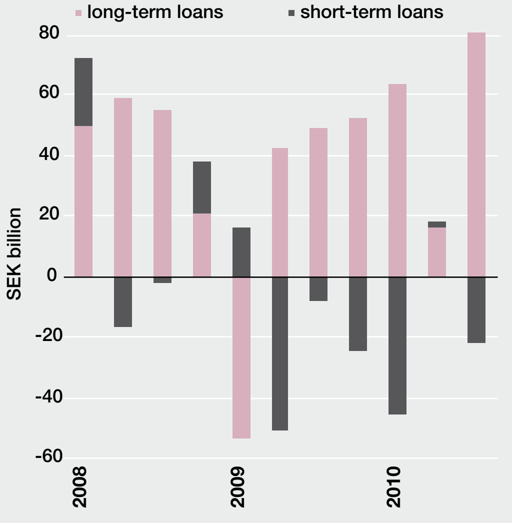
[2] Even though they faced problems at the height of the crisis in May and June 2010.
[3] With a maturity of over 12 months.

decline in the **risk premium** (see Figure 19). The spread between the long-term bonds of banking groups and government bonds even showed a downward trend until the middle of September. Even so, the volume of new issues attested to the banks' relatively strong demand for debt financing.

As the economy was showing positive development, the public sector continued to cut back its extraordinary support measures. Even though the Swedish government extended its guarantee programme for the fourth time this summer (until the end of 2010), this constitutes a merely theoretical measure, unused by any major bank in the past six months. The Swedish central bank Riksbank already stopped issuing long-term three- and six-month loans to market participants in the spring of 2010, replacing them with shorter 28-day loans. In July 2010, Riksbank set limitations on the use of this measure, raising the margin from 0.3 percentage points to 0.5 percentage points above the key policy rate, thus pushing the banks to opt for market-based financing instead.

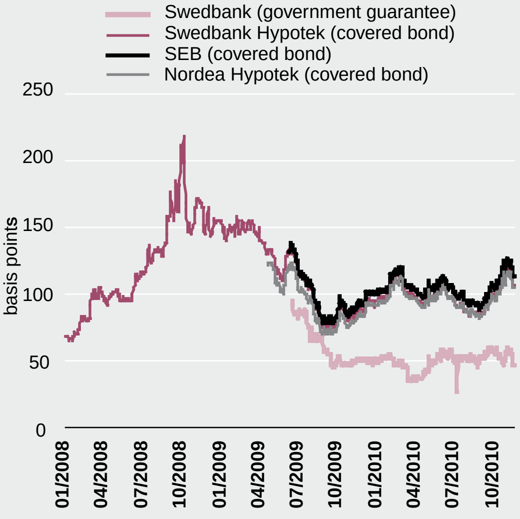
By the middle of September, it looked as if the gradual cutback on the support measures had had no ill effects on the banks, and as if, with the recovery of the credit markets, the transition to market-based financing had been smooth. Riksbank thus resolved to stop issuing extraordinary long-term 28-day loans to market participants. As soon as the decision was made public in the middle of September, the Swedish covered bonds market witnessed quite an abrupt change of sentiment. The cost of financing jumped. By November, the spread of long-term covered bonds of banking groups had risen by approximately 20–30 basis points compared to September. One of the apparent reasons was the reduced demand for the bonds, as major buyers – the banks – no longer had access to favourable financing through the central bank.

Figure 18. Net borrowing of Swedish banking groups in SEK instruments



Sources: Statistics Sweden, Eesti Pank

Figure 19. Banks' 4-year bond spreads against Swedish government bond



Sources: Bloomberg, Eesti Pank

Even though the trends in Sweden suggest the conclusion that confidence has returned and that financial markets are functioning, abrupt changes in the financial environment may quickly undermine such confidence and exert strong negative pressure on the financial markets. The financing risks faced by Nordic banks in connection with the European debt crisis have somewhat decreased, given the recovering economy and sound public finances of the Nordic countries and the better distinction between countries. However, a widening of the debt crisis followed by a wide-scale panic could render the financing situation for the Nordic banks also problematic. A new threat lies in market disturbances following cancellation of the extraordinary monetary policy measures by central banks. In addition, Sweden is facing domestic risks related to the local real estate market, which is seeing price rises and increasing household indebtedness (see background information *Developments in the Swedish real estate market*).

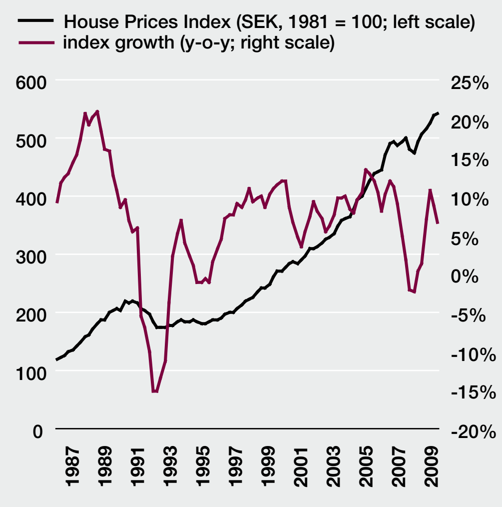
Developments in the Swedish real estate market

Although several countries witnessed a decline in the prices and activity of their real estate markets as they collapsed after the global financial crisis, this is not the case in Sweden. Real estate prices fell there slightly, by 2%, but they have been on the rise again since the second quarter of 2009 and have currently reached a higher level than where they were before the crisis. In the third quarter of 2010, the real estate index that reflects the movements in real estate prices was 6.7% higher than it was a year ago (see Figure 20).

Household debt has acted similarly. In October 2010 the stock of housing loans, which comprises 80% of the loan stock of households, had grown by 9.1% from a year earlier. The ratio of the debt of Swedish households to their disposable income has been high for 30 years by now, but in 2010 it reached a record level of 175%. Although the risks to the loan repayment ability of households have increased along with the rise of the debt burden, the loan repayment ability of Swedish households is still considered strong. This is supported by low interest rates (the average interest rate on new loans was 3% in October 2010), a high savings rate and increasing disposable incomes.

The gradual rise in real estate prices and the debt burden has, however, increased domestic financial stability risks for Swedish banking groups. The Swedish central bank (Sveriges Riksbank) and Financial Supervision Authority have acknowledged the risk that if real estate prices fall in the context of excess loan burden, it may cause a sudden deterioration in banks' ability to refinance mortgages in international capital markets. The risks are most likely to materialise through mortgage-backed bonds, should foreign investors lose confidence in these securities.

Figure 20. House prices developments in Sweden



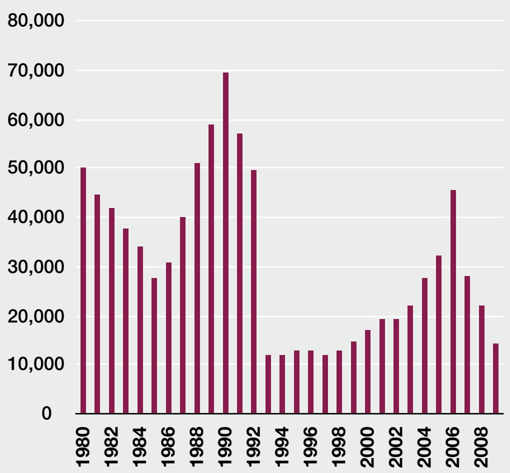
Sources: Riksbank, Statistics Sweden, Eesti Pank

The drop in confidence could spread to the entire financial system and also affect other markets. In consequence, on 1 October 2010 the Swedish Financial Supervision Authority established a rule that the loan to value (LTV) ratio may not exceed 85%.

Although the present situation in Sweden is very similar to that in the 1990s, a significant drop in real estate prices is quite unlikely, as there is little active development of new housing projects in Sweden. The investments that are currently being made in housing construction are relatively modest and fewer new residential spaces are being built than in 2006–2008 (see Figure 21). After the recession in the 1990s, real estate prices contracted by almost 30% and housing investment recovered slowly. However, having suffered another setback in the last global crisis, investment has recently begun to increase again and the construction of new residential premises is expected to pick up. The Swedish central bank states that the relatively stable housing market is one of the reasons why structural problems in the Swedish economy have been avoided[4]. Although housing investment in Sweden continues to be modest in both international and historical terms, its considerable growth may create risks for the Swedish economy. Accordingly, the Swedish real estate market is seeing some imbalances, the risks to financial stability are nonetheless smaller than those of the over-investment which happened in Estonia and also in Sweden at the end of 1980s and at the beginning of 1990s.

[4] Riksbank, "Why higher growth in Sweden than in the eurozone and the United States?" (October 2010).

Figure 21. Number of housing starts in Sweden



Sources: Statistics Sweden, Eesti Pank