I. FINANCIAL MARKETS

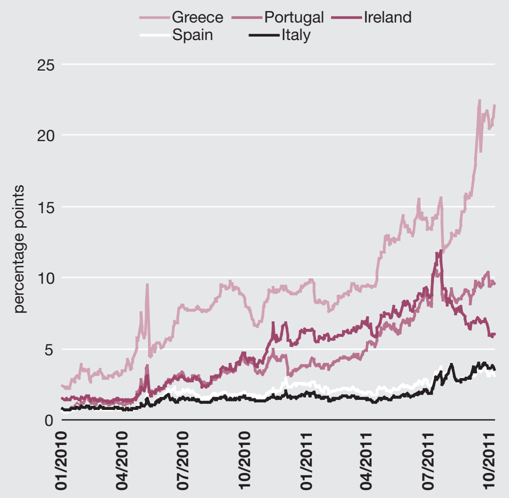
GLOBAL FINANCIAL MARKETS

The problems of government debt in the euro area have intensified since spring and have spread to other markets. This is illustrated by the rising probability of Greek insolvency, although another bailout package for the country was agreed upon in July. The crisis also spread more and more to Spain and Italy (see Figure 1). By mid-September, it threatened to affect France when the rating agency Moody's lowered its credit ratings for two major French banks on 14 September. At the beginning of October, the Belgian-French financial institution Dexia encountered problems. Movements in the markets over the last six months included a rise of over 1,200 basis points in the difference between the interest rates on Greek ten-year bonds and the rates on equivalent German bonds. Meanwhile, in Portugal, Spain and Italy this rise was between 120 and 400 basis points.

To contain the spread of the debt crisis, the Eurosystem started to purchase bonds again through the Securities Market Programme. In addition, banks started to use the deposit facility of the central bank more and more (see Figure 2). On 6 October, the Eurosystem decided to provide liquidity to the market in the form of long-term loan instruments and to start purchasing the covered bonds of banks again.

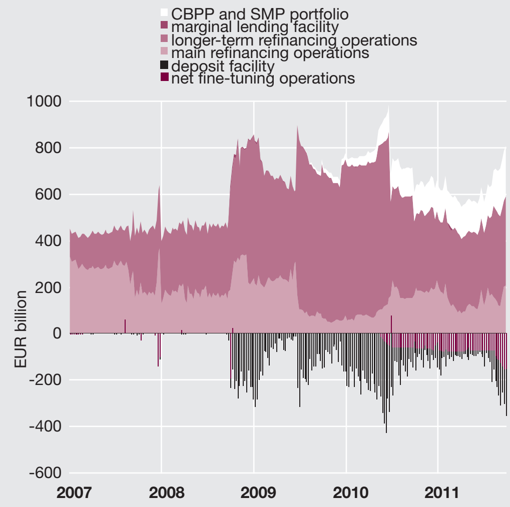
Meanwhile, the **national bond markets** of Germany and the USA witnessed a significant drop in interest rates all along the income curve. This followed a drop in economic activity and stronger demand for German and US bonds as the crisis in the euro area intensified (see Figure 3). Demand for US bonds increased despite the major political conflict over the future of US national fiscal policy and despite the fact that in August the rating agency Standard & Poor's reduced the US sovereign rating from AAA to AA+ for the first time ever.

Figure 1. Spread between 10-year bonds of Greece, Portugal, Ireland, Italy and Spain with Germany



Source: EcoWin

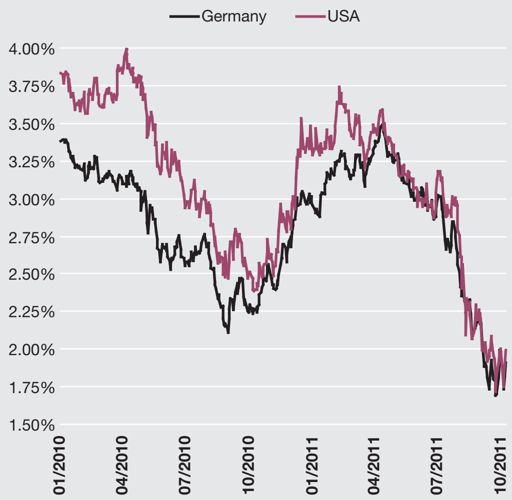
Figure 2. Eurosystem's monetary policy operations



Source: European Central Bank

Movements in money markets were different in different countries. In the USA, the economy continued to be stimulated by the purchases of government bonds in the second stage of quantitative easing from March until the end of June. The key interest rate remained the same, and as economic growth slowed down, the central bank promised not to change the rate until 2013 at the earliest. For this reason, the US money market interest rates did not change significantly. However, the Eurosystem focused more on the hike in inflation and started to raise its key interest rate in April. In July the key interest rate was put up for the second time and reached 1.5%. Meanwhile, the central bank's extraordinary crisis measures to support the liquidity of the banking sector are still being implemented and new ones have been introduced. Among advanced economies, the key interest rate was raised by the Norwegian central bank, by 25 basis points to 2.25%, and by the Swedish central bank, by 50 basis points to 2%.

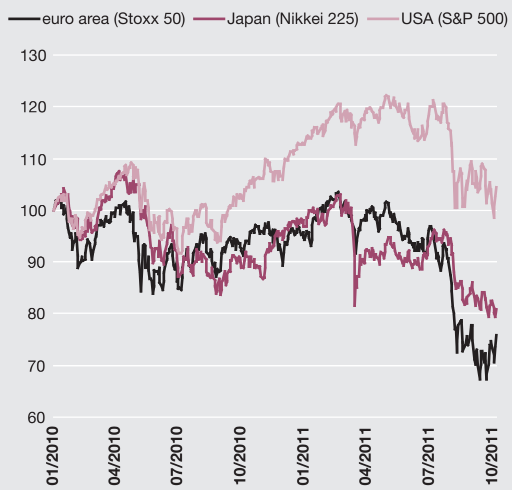
Figure 3. Ten-year interest rates on Germany and US government bonds



Source: EcoWin

Major **stock markets** fell steadily in the second and third quarters of 2011 (see Figure 4). When economic activity started waning in March, the markets were deprived of the support of improving growth outlooks. Meanwhile, the euro area's debt crisis worsened and the risk sensitivity of investors peaked in August, which resulted in an extensive wave of sales in stock markets. By the end of September share prices had dropped by 23% in the euro area, by 11% in the USA and by 15% in Japan from where they were at the beginning of the year.

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



Source: EcoWin

Currency markets saw the euro depreciate against other major currencies. This was mainly caused by the intensification of the crisis in the euro area, but also by the unexpectedly low economic indicators at the end of the period. The euro fell most against the Japanese yen, the New Zealand dollar and the Swiss franc. At the beginning of September, the Swiss central bank decided to fix the minimum exchange rate between the euro and the franc at 1.20 in order to support the export sector, and declared its willingness to protect this rate by unlimited foreign currency purchases. The euro depreciated less against the US dollar, as the dollar's exchange rate continued to drop due to the lenient monetary policy of the USA. The euro only appreciated against the Swedish krona among the G10 currencies.

The primary risk to global financial markets is the euro area's debt crisis, which threatens financial stability in Europe and elsewhere. The probability of Greek bankruptcy has surged and the implemented and planned crisis measures have not been able to stop the rapid deterioration of trust among investors. Moreover, the crisis is threatening to engulf Italy and Spain, and even France and Belgium where credit default swaps (CDS) have surged. In addition, investors have understood that German bonds, which used to be considered safe, are not in fact risk-free in a systemic crisis; for this reason, the five-year German CDS spread rose by 40 basis points to 85 basis points, which is slightly higher than that in France at the beginning of the period.

Unlike during the crisis of 2008/2009, the options of central banks and governments for implementing crisis measures are currently much more restricted. Fiscal policy options are restricted by the high public debt that forces countries to curb spending in order to guarantee the sustainability of fiscal policy in the medium and long term. The options for monetary policy are also quite limited, as a sharp cut in the key interest rate like the one that was carried out during the previous crisis is no longer an option.

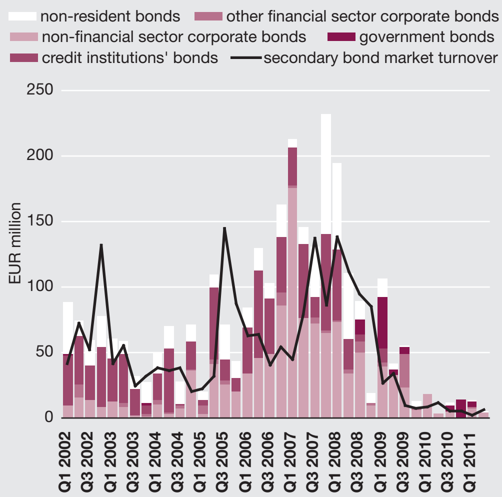
Secondly, financial markets may be threatened by the **significant deceleration in global economic growth**. As general confidence decreases, this may turn into an economic decline and further exacerbate the imbalances in the global economy. Whereas the forecasts for economic growth in the second half of 2011 were previously relatively upbeat and expected a surge in activity, the latest forecasts have been much more pessimistic. Major economies are now expected to experience only minimal economic growth during this period. The confidence of investors and consumers has plummeted sharply, and if this tendency continues it may lead to a new economic decline. We must also remember that although the economy has recovered slightly, unemployment in the USA and the euro area still remains relatively high, and this curbs solvent demand.

ESTONIA'S FINANCIAL MARKETS

Bond and stock markets

The Estonian bond and stock markets are small in both volume and turnover, having a minor influence on the Estonian financial system. The primary **bond market** has seen very little activity since the second half of 2008 (see Figure 5). A monthly average of 3.1 million euros worth of bonds were issued in the first half of 2011, with

Figure 5. Bonds issued and secondary bond market turnover on a quarterly basis



the bonds of local non-financial companies contributing nearly two-thirds. The total volume of bonds issued dropped to 515 million euros – i.e. 3% of the GDP – by the end of August.

The secondary bond market has also remained passive, with the total monthly turnover contributing a mere 0.25% of the total capitalisation of bonds in the last two years.

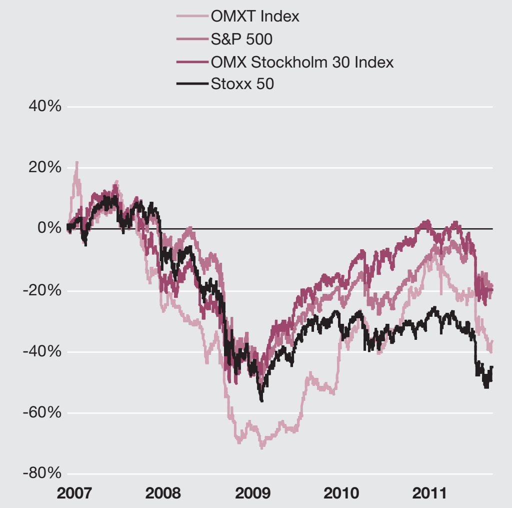
Positive trends on the **Tallinn Stock Exchange** at the beginning of 2011 were reversed in the middle of March, with the OMXT dropping below the level achieved at the beginning of the year (see Figure 6). At the beginning of August the downward pressures on global stock exchanges conditioned a 16% drop in the OMXT, tripling short-term daily turnovers, compared to the average daily turnovers in the first half of 2011. Stock exchange capitalisation dropped to 1.4 billion euros by the end of August (see Figure 7). The share of foreign investors on the Tallinn Stock Exchange has shown no major changes compared to the beginning of the year, amounting to 37% at the end of August.

Liquidity of the Tallinn Stock Exchange remains low. The average monthly turnover for 12 months amounted to 19 million euros at the end of August 2011 – 25% less than in the same period last year. Tallinn Stock Exchange is expected to remain volatile in the near future, conditioned by the size of the market and low liquidity, on the one hand, and uncertainties on global stock markets on the other.

Investment funds

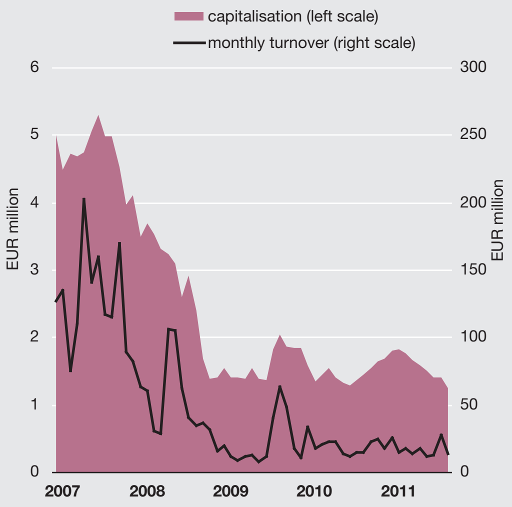
The decline in stock prices has significantly affected the **yield** of stock funds. By the end of August, the net asset value of stock fund units dropped by an average of 16.6% from the beginning of the year (see Figure 8). Bond funds, on the other hand, have generated a positive yield. By the end of August, the net asset value of bond

Figure 6. Developments on the Tallinn Sock Exchange compared to global stock exchanges



Sources: EcoWin, NASDAQ OMX

Figure 7. Market capitalisation of shares listed on the Tallinn Stock Exchange and monthly turnover



fund units rose by nearly 2.1%, compared to the beginning of the year. Similarly to investment funds, pension funds investing in bonds have generated a positive yield from the beginning of the year, with the net asset value of units rising by an average of 1.6%. The net asset value of equity strategy-based pension fund units has dropped from the beginning of the year (see Figure 9).

The investors' reduced risk appetite has scaled down contributions to stock funds. While contributions exceeded disbursements at the beginning of the year, outflows have exceeded inflows since May. By the end of July, the **assets** of investment funds dropped by 2% to 522 million euros, compared to the beginning of the year.

The restoration of state contributions at the beginning of the year significantly increased cash inflow into second-pillar pension funds. The volume of contributions has nearly quadrupled, compared to 2010. Contributions to third-pillar pension funds have shown no changes, compared to last year. The volume of second-pillar and third-pillar pension funds has grown by 6% from the beginning of the year, amounting to 1.2 billion euros at the end of August.

The **share of external assets** in the investment structure of investment and pension funds amounted to 83% at the end of August, showing no major changes since the spring (see Figure 10). The proportion of shares and fund units invested in shares in the total assets of investment and pension funds has decreased from the beginning of the year. This has been conditioned by the drop in share prices on the stock exchange. As at the end of August, investments in shares and fund units made up 67% of the total assets of investment and pension funds.

The geographical breakdown of investments reveals that a majority (more than two-thirds) of the investments have been made in securities registered in Europe (excluding Estonia)

Figure 8. Changes in the average price for investment fund units since 2007

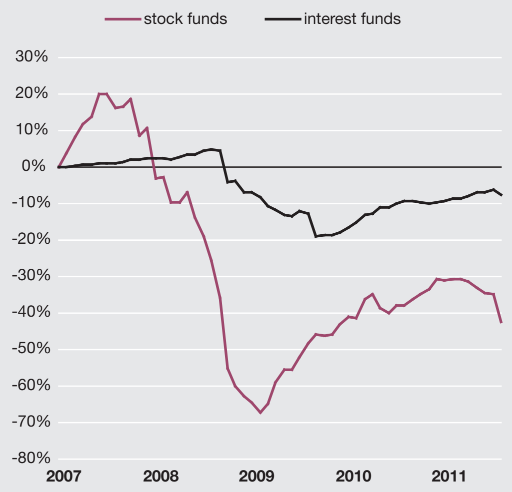


Figure 9. Changes in second-pillar pension fund indices since beginning 2007

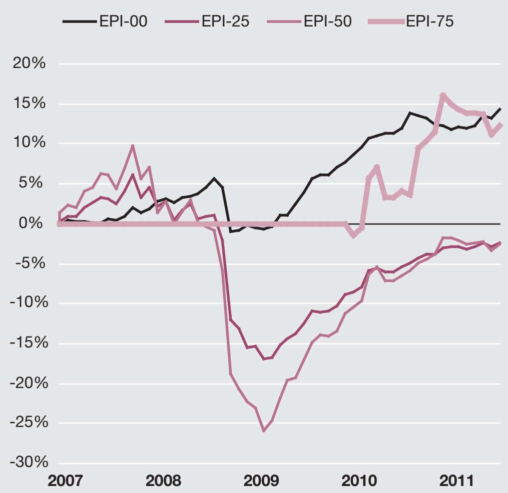


Figure 10. Structure of investment and pension fund assets and the share of foreign assets

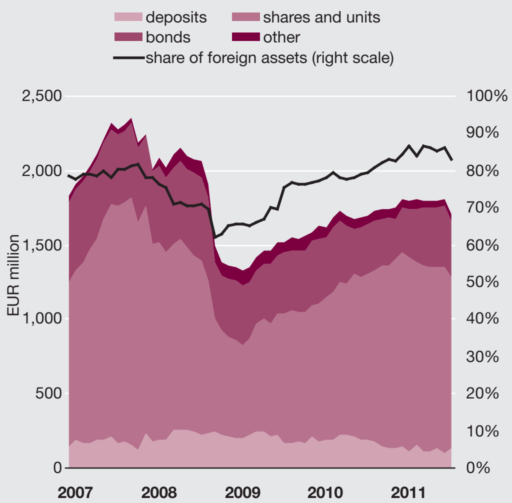
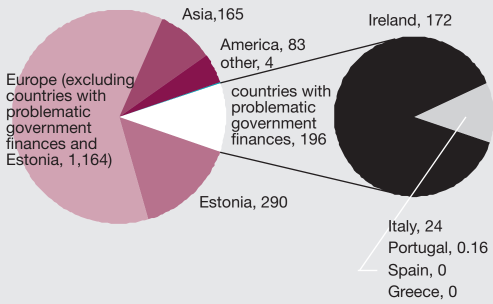


Figure 11. Geographical distribution of investment and pension fund assets in August 2011 (EUR million)



(see Figure 11). At the end of August, securities investments in countries with problematic public deficit and sovereign debt[1] made up 11% of the total assets of investment and pension funds. A majority of these investments have been made in the shares and fund units of Ireland.

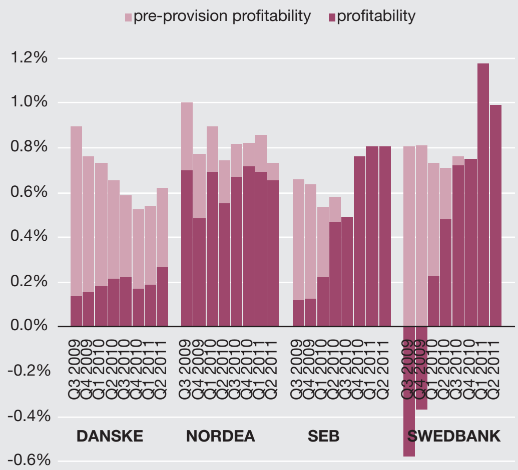
MARKET-BASED FINANCING OF BANKING GROUPS

Financial strength of the groups of parent banks

The **profit** figures for the first half of 2011 of the parent bank groups of four of the largest banks operating in Estonia have risen, compared to the same period last year (see Figure 12).

The enhancement of operating profit has largely been supported by the decrease in loan provisions and recoveries. Majority of the banking groups witnessed a growth in net interest income in the first half of 2011, compared to the same

Figure 12. Profitability of banking groups



Sources: public reports of banks

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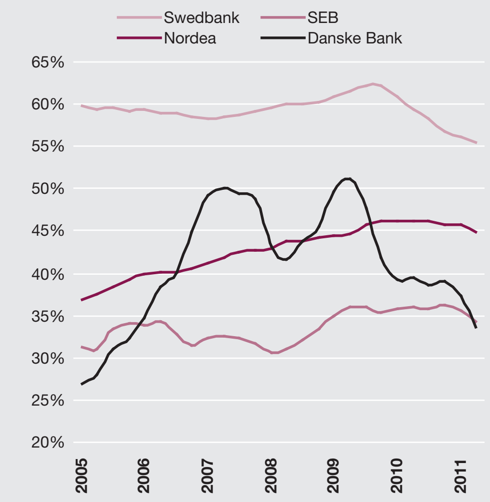
[1] Ireland, Greece, Spain, Portugal, Italy.

period last year. At the same time, this growth differed by banking groups, depending on loan turnover, margins, deposit and loan interest rates. The profitability of banking groups will continue to be positively influenced by the drop in loan provisions in the near future. At the same time, the potential increase in the cost of financing, fuelled by growing uncertainties in the European banking sector, may have a negative effect on net interest income.

The **positions** of bonds of European states with a large public deficit and high sovereign debt, held by the parent bank groups of the banks operating in Estonia, have remained modest. The direct effect of the euro area debt crisis on the banking groups is thus minor.

The groups' capitalisation has remained stable in recent quarters. Albeit the capital adequacy ratio differs by banking groups, the adequacy ratio exceeds 12% for most banks, with the Tier 1 ratio exceeding 10%.

Figure 13. Banking groups' share of wholesale funding in total loans (4-quarter moving average)



Sources: public reports of banks

Funding of parent banks

In addition to deposits, Nordic banking groups have been using market-based funding for serving their need for financing (see Figure 13). Riksbank's latest financial stability report[2] reveals that securities issued in other currencies (mainly US dollar and euro) make up over 60% of the market-based financing. The US dollar is especially popular in short-term financing, contributing over a half of the total volume. The banks' market-based financing structure is thus vulnerable to the external environment.

Several Nordic banking groups issued new **bonds** in the first half of 2011. Banks continue preferring longer-term bonds over shorter-term bonds, thus extending the term of the liabilities (see Figure 14).

Figure 14. Net borrowing of Swedish banking groups in SEK instruments

Source: Statistics Sweden

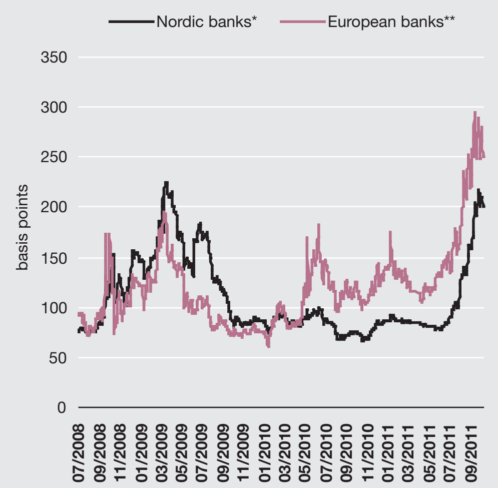
[2] Riksbank's Financial Stability Report, May 2011.

The deepening of the debt crisis in Europe, along with the general growth in uncertainty, had a negative effect on the market participants' risk assessment of the banking sector. The credit default swap (CDS) spreads of both European and Nordic banks have widened, compared to the beginning of the year (see Figure 15). Regardless of doubling in CDS spreads, Nordic banks are still considered less risky than other European banks. At an average, the CDS spreads of Nordic banks were 50 basis points lower than those of other European banks.

The Swedish central bank has raised the repo interest rate twice since the spring – by a total of 50 basis points to 2%. The key interest rates have risen also since the beginning of the year, affecting, in addition to the increased risk assessments of market participants, the cost of market-based financing. The **bond risk premiums** of banks have advanced by an average of 13 basis points from the beginning of the year (see Figure 16).

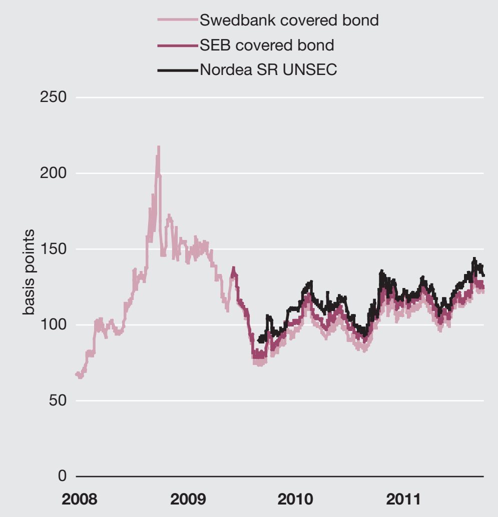
Overall, market participants have considered Nordic banks to be safer than other European banks. It has thus been easier for Nordic banks to engage resources from the financial market. At the same time, Swedish banks are vulnerable to the sudden developments on the financial markets owing to their high share of market-based financing while using a foreign currency. The deepening of the debt crisis in Europe could thus increase the cost of market-based financing for Swedish banks.

Figure 15. CDS premiums of Nordic and European banks



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

Figure 16. Banks' 3-year bond spreads against Swedish government bond



Source: Bloomberg