IV
MONETARY POLICY ENVIRONMENT

The first half of the year 2000 is characterised by stable monetary policy environment. The interest rate increase in the euro area was not fulfilled in Estonia and margins between euro-interests and Estonia's interest rate decreased both in short- (money market) as well as long-term (housing loan) interest rates. The likely interest trend is more upward than downward oriented. The raising of interest rates by 25 basis points by the European Central Bank on 30 August upholds, at least in short term, continuous growth in the euro-interests.

After a two-year break the active role of the financial sector in involving external capital was recovered (at least temporarily), revealing also a structural shift to growing share of debt-based flows. Contemporaneous loan growth continued, mainly sustained by leasing financing whereas the money supply growth stabilised. Indirect estimates also refer to increasing direct borrowing (within the concern and/or from international markets). There are no significant signs of loan-financed consumption. The potential pace of balanced loan growth remains unclear: considering the continuously rapid growth in deposits and capital inflow, the credit growth seems to be currently lacking supply side restrictions.

Monetary Environment in Estonia and Euro-zone

The continuous growth of interest rates in Europe accompanied by slight appreciation of the euro against the US dollar had a relatively small implication on Estonia's monetary policy environment in the first half of 2000. **Regardless of the interest rate growth in Europe, Estonia's monetary environment has undergone quite insignificant tightening.** The development trends of the euro-area interest rate and exchange rate were not fully reflected in Estonia's monetary environment in the first half of the year as apart from EURIBOR dynamics TALIBOR quotation adjustment is also subject to other, primarily domestic liquidity-based factors (see Figure 4.1).

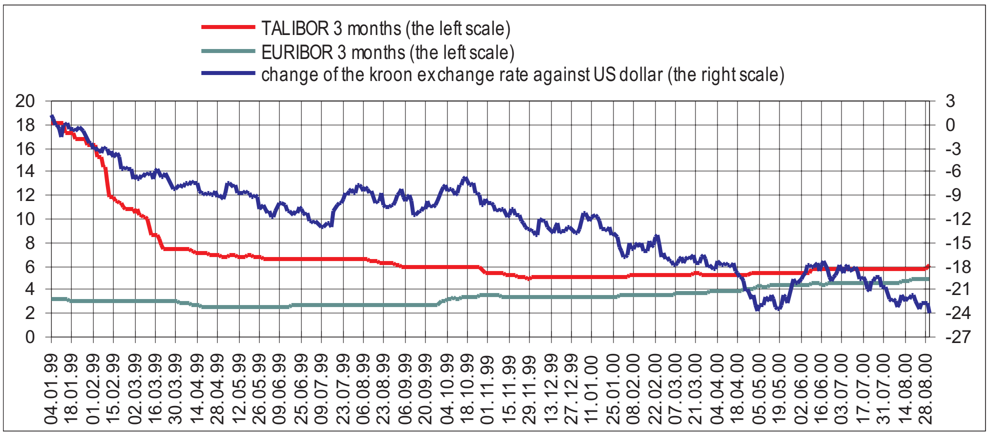

Figure 4.1. 3month TALIBOR and EURIBOR; change of the Estonian kroon exchange rate against US dollar (%)

In summer 2000 the inflationary pressure in the euro area continued. The annual growth of the harmonised index of consumer price (HICP) accelerated from 0.9% in June 1999 and 1.9% in May 2000 to 2.4% in June and July. The inflationary pressure is also reflected in both of the euro system monetary policy target indicators. Firstly, money and credit aggregates manifest continuously high liquidity in the euro area. The broad money supply and private sector credit growth both maintain their high level although somewhat lower against April and May. The annualised average growth of the last three months in broad money supply was 6% in June and in loans – 9.8%. Secondly, the HICP developments reflect favourable economic outlooks, mainly boosted by domestic demand. The latter is backed by significant growth in industrial output and continuously shrinking unemployment. High consumer and business confidence also indicate to good prospects in domestic demand.

In the second quarter the European Central Bank (ECB) raised the EMU benchmark rates twice, by a total of 75 basis points. The refinancing interest rate rose to 4.25% and standing deposit and loan facilities to 3.25% and 5.25% respectively. Therefore the interest rates continued to increase in European money markets. The overnight interest rates (EONIA) increased by 100 basis points over the quarter, reaching 4.75%. The three-month EURIBOR grew by 72 basis points, ie to 4.55%. The slight growth, although remaining below past was stretched into July, early August as well. The overnight interest rates remained on the same level. The three-month EURIBOR forward contract prices reflecting money market anticipations grew over the quarter. The three-month EURIBOR interest rates derived from forward contracts maturing in September and December this year and in June 2001 were 4.96; 5.29 and 5.39%, respectively.

Capital Flows and Formation of Base Money

The gross reserves of the central bank grew by 1.3 billion kroons in the second quarter, ie about as much as they shrank in the first quarter. By the end of the half-year the reserves totalled 14.7 billion kroons. Most of the Eesti Pank's reserve shrinkage in the first quarter was due to the commercial banks' liquidity management after the potential Y2K hazards had passed. Besides external capital continued to flow in through the banking sector. The growing external reserves increased the base money as well, which reached 11.4 billion kroons by the end of the second quarter. The liabilities-free net foreign reserve of the central bank constituted 1.7 billion kroons.

The current account deficit was about one billion kroons in the second quarter. The external capital inflow through the financial account was about 2.3 billion kroons in the second quarter, most of which – 1.8 billion kroons – was due to corporate foreign direct investments and commercial credit. The capital inflow through the banking sector reached 200 million kroons in the second quarter. The funds from large bond issue were deposited abroad or invested in other Baltic countries. Anyway, **in the second quarter, after a long period of time, the banking sector involved external capital.**

By net capital inflow (about 2.3 billion kroons) the first half of 2000 was comparable to the year 1999, although it remained below 1998 whereas for the first time since 1997 it meant involving capital through the financial sector. Therefore in medium term the ratio of loan capital and direct investments in capital flows between Estonia and the rest of the world should be focused on. Taking into consideration contemporaneous large domestic saving, the money supply still grows fast. Thus, the broader liquidity is continuously high, slowing down the infusion of euro-zone interest rate developments into Estonia's money market interest rates and therefrom into the real sector. **The monetary environment in the first half of the year was characterised by contemporaneous interest rate increase imported from the euro area together with the decrease in the spread of the euro interest rates and local market interest rates. The spread decline has presumably reached its ultimate phase, therefore an interest rate increase is anticipated in the local market.**

Monetary Aggregates

The annual growth of money supply has slowed down over the recent periods. At the end of the second half of the year the annualised growth of broader monetary aggregate was 24.5%

against 26.3% in March (see Figure 4.2). The narrow money supply indicators were 21.9 and 28.4%, respectively. The preferential growth of broader money supply over the narrower was mostly due to the accelerated growth of foreign currency deposits of residents (see Figure 4.3).

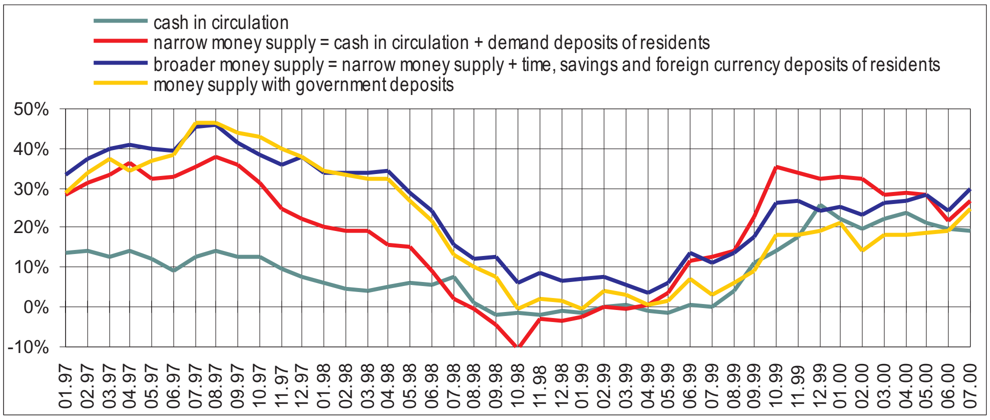

Figure 4.2. Change of monetary aggregates against the respective month of previous year

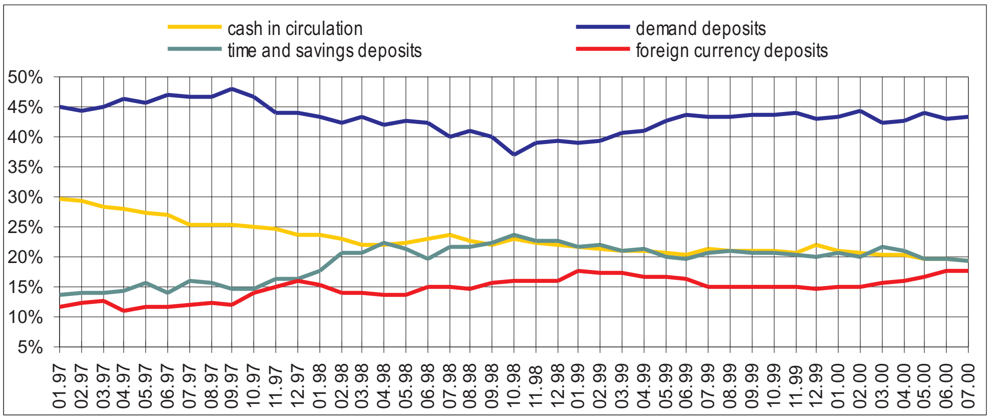

Figure 4.3. Structure of broader money supply

The rapid growth of foreign currency deposits is sustained by several factors. Primarily the corporate involvement of external capital and rapid growth in trade should be mentioned whereas the growth in dollar deposits has been encouraged also by higher interest rate against the euro.

Money and Foreign Exchange Markets

Despite the slight shrinkage in the share of liquid assets in banks' balance sheets (see Figure 4.4) from the beginning of this year, the liquidity of the banks remained stable throughout the first half-year, being sustained both by favourable domestic and external environments.

On 1 July 2000 **the first stage in the reform of the monetary policy operational framework** was launched involving the legal harmonisation of the reserve requirement and additional liquidity requirement. This brought along an efficient increase in daily minimum reserve requirement for banks' settlement accounts (see Figure 4.5) as previously it had applied only to the reserve requirement. Due to the relatively high general reserve requirement, the change did not inhibit the smooth operation of settlement system and left adequate buffer to meet the monthly average of the reserve requirement.

Another structural change in the harmonisation of reserve requirements was the arising possibility to involve cash in meeting the previous additional liquidity requirement. Nevertheless, it had

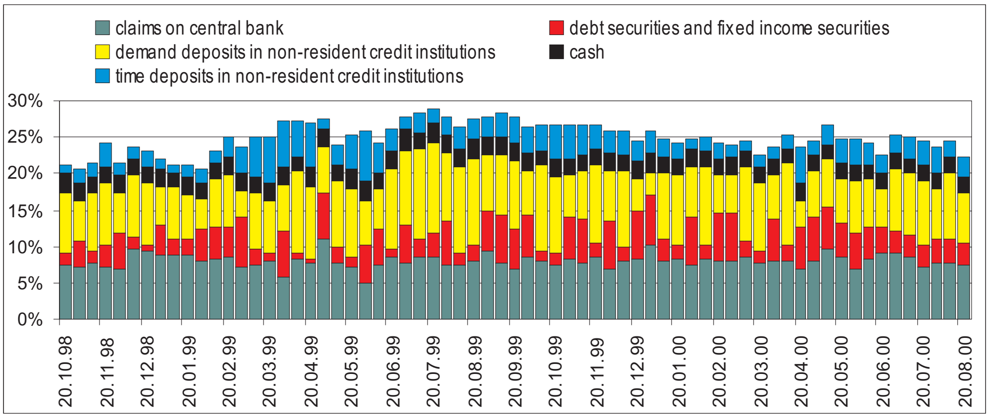

Figure 4.4. The share of liquid assets in banks' total assets

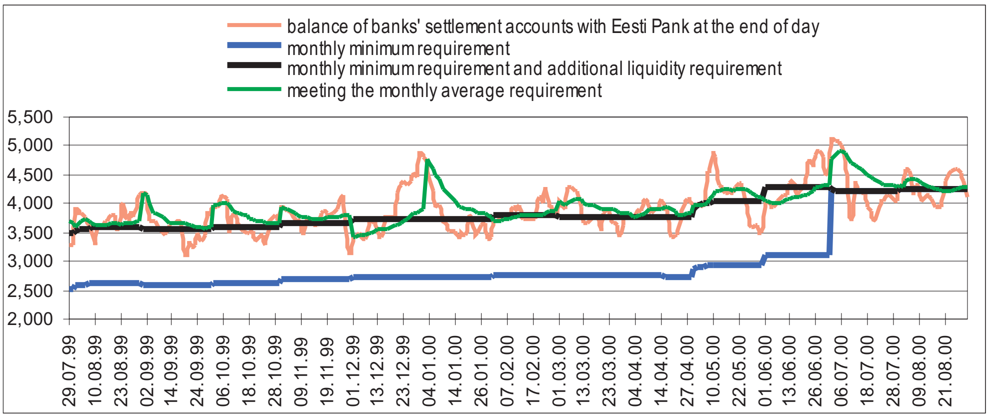

Figure 4.5. Balance of banks' settlement accounts with Eesti Pank and meeting the reserve requirement and additional liquidity requirement (EEK mn)

barely marginal implication on the reserve requirement[1] as the actual cash in several banks accounted for less than the reserve requirement calculation basis framework would have allowed.

Money Market Interest Rates

Throughout the year 2000 the money market interest rates have been subject to upward pressure (see Figure 4.6) whereas since end-May the previously stable long-term quotations started to

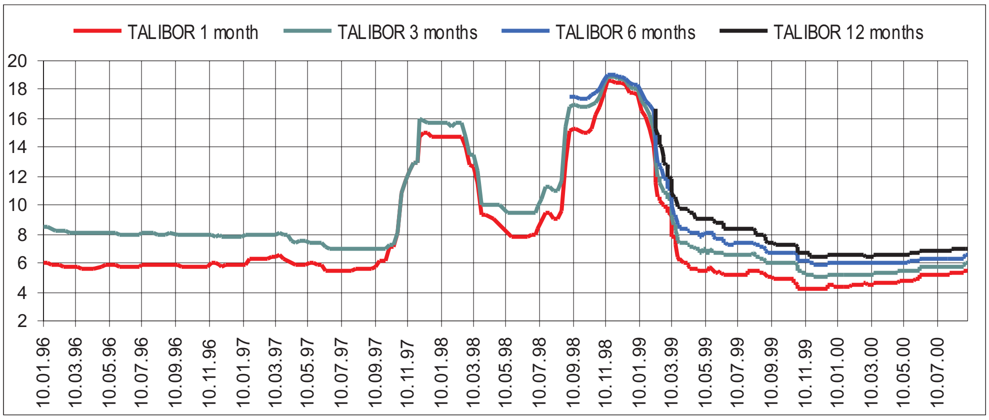

Figure 4.6. Interest rates of the Estonian money market (%)

[1] Due to the possibility to use cash the reserves shrank by 56 million kroons, ie by 1.3%.

increase as well. At the low kroon demand of the last months, the main interest rate boost came from the increase of the short-term interest rates of the euro-zone. The money market interest rates of the Estonian kroon have still been inhibited below the money market interest rates of the euro, suppressing the interest rate margin for all maturities over the last half-year (see Figure 4.7).

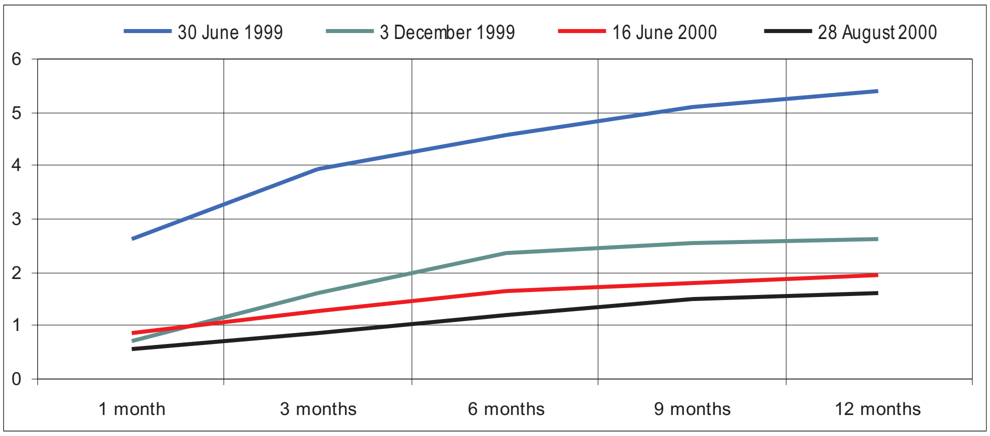

Figure 4.7. Difference between money market interest rates of the Estonian kroon and euro (%)

Considering the record low level of the kroon and euro interest margin and the slight decrease in the commercial banks' liquid assets, the margin would probably be restricted in its shrinkage. In the euro area money market interest rates are anticipated to increase.

Forward Market

The forward market activity has varied by months, partially also due to seasonal factors. This February the sales turnover of euro forward contracts reached about 3.4 billion kroons whereas in summer the market participants were significantly more passive in their positions, never reaching the one billion turnover. The idle market was also reflected in swap interest quotations, which unlike TALIBOR have shown a pronounced downward trend throughout the year. In autumn with financial markets recovering, the transaction demand would probably leap upwards. This could bring along an increase in the swap interest rates.

Credit Market

Considering, on one hand, the recovered rapid economic growth and supportive external environment[2] and, on the other hand, the continuous improvement of consumer and corporate anticipation[3], the economic situation for growing credit demand was favourable. Although on the supply side the further growth of borrowing was inhibited by interest rate pressure coming from the euro area, any further signs of tightening credit market are still unclear. Mainly because of the deposit inflow supportive of credit expansion and highly liquid banking sector. **Thus, sustained rapid growth in credit balance is characteristic of the credit market** (see Figures 4.8 and 4.9). By end-June the annual growth of bank loan stock issued to residents reached 23.3%, the annual growth of fixed-income bonds – 20.8%. The accelerating trend continued over the first months of the third quarter. Unlike bank loans the bank-owned fixed-income bonds (primarily bonds of private undertakings as well as of financial institutions) continued to shrink in volume slightly, reflecting undergoing reorganisation in the banks' financing principles.

[2] Excluding the interest rate developments in the euro-zone, the tightening impacts thereof remained still vague in the first half of 2000.
[3] According to the Estonian Institute of Economic Research both the business sector and consumer confidence picked up significantly during the first half-year.

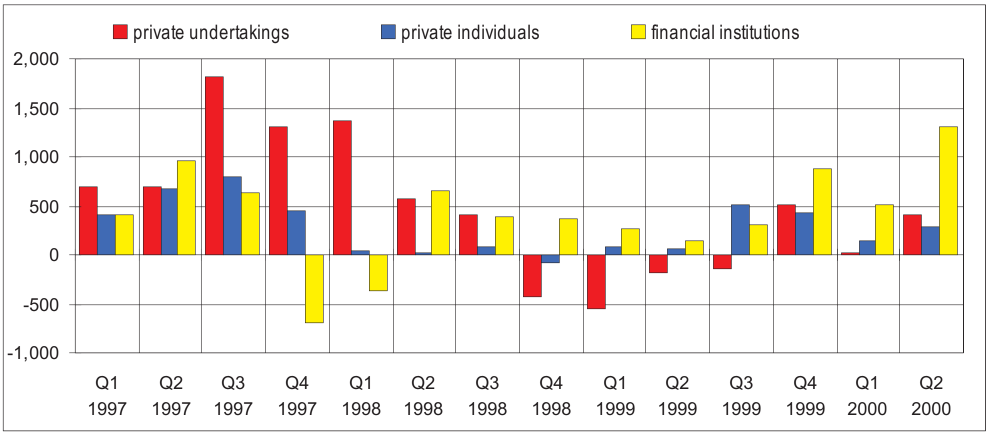

Figure 4.8. Growth of residents' loan stock (EEK mn)

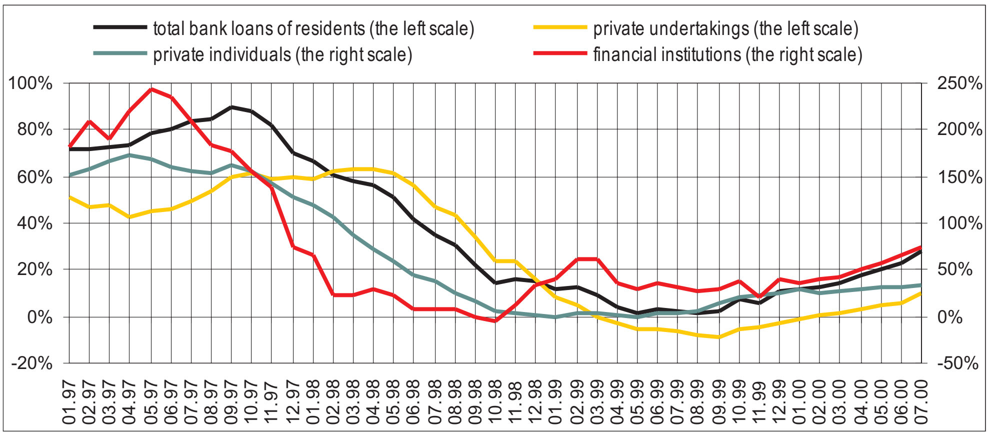

Figure 4.9. Annual growth of bank loan stock issued to resident private individuals, private undertakings and financial institutions (%)

Throughout the first half of the year the main source of growth in banks' lending was crediting of financial institutions, reaching an annualised 66.1% growth by the end of the second quarter. The annual growth of private corporate borrowing was slightly inhibited as compared to financial institutions, although it reached 6.1% by the end of the second quarter. Contemporaneously the accelerating borrowing by financial institutions reflects growing domestic leasing financing, which reaching 1.2 billion kroons (including factoring) was channelled to the private undertakings in the second quarter. Thus, a significant structural shift from borrowing to leasing took place in the financing principles of the real sector. **Apart from that after the Asian and Russian crises borrowing from external markets, either intermediated by direct investors or independently, mostly in export-oriented undertakings has become a significant financing source.** As the result of such structural shifts, the actual credit growth in the real sector is more difficult to estimate, as the co-impact of all financing channels should be considered. **Taking into account the implications of the structural shifts in financing principles, the annualised corporate borrowing is said to underestimate and that of the residents' loan portfolio to overestimate the actual corporate financing level in the first half of the year.**

The annual private borrowing manifested moderate growth throughout the second quarter, reaching 31.7% [4]. Although most of the private borrowing was still comprised of housing loans

[4] The 31.7% annual growth of the private loan stock is mostly due to the low comparison base of targeted loans (mostly study loans) in 1999 and growth of housing loans.

in the first half of 2000, the share of other loans (ie of consumption loans) in credit turnover is slowly adding volume. Thus, presumably the inflow of borrowed money into consumption has slightly increased whereas the significance and share of consumption loans in private credit turnover continues to be modest and there are no signs yet of an arising private consumption boom of bank lending. The balanced expansion of private real estate loans and slightly shrinking leasing volumes in the first half of the year are characteristic of the conservative nature of financing decisions.

Interest Rates in Real Sector

The euro-zone interest rate pressure has its partial implication on the real sector interest rates as well. Nevertheless, it has not been fully transferred to Estonia's real sector interest rates, mostly due to the sustained inflow of deposits and high liquidity in the banking sector. The increase in euro-zone interest rates had still quite noticeable implication on private corporate foreign exchange borrowing in the second quarter and the interest rates of long-term kroon and foreign exchange loans increased by 0.9 percentage points during the quarter, reaching 10.0% (see Table 4.1). **The weighted average interest rates of private corporate short-term loans revealed a slight upward trend whereas in June the interest statistics was blurred by several low-interest-rate kroon loans** [5] (see Figure 4.10).

Table 4.1. Weighted average annual interest rates of loans[1] (%)

	31.12.97	31.12.98	31.12.99	31.03.00	30.04.00	31.05.00	30.06.00	31.07.00
Short-term kroon loans	**20.0**	**16.7**	**8.7**	**7.4**	**7.4**	**7.3**	**6.3**	**7.7**
financial institutions	19.3	15.3	7.3	4.7	4.7	4.9	5.8	5.5
commercial undertakings	19.9	17.2	10.2	9.8	10.2	9.5	6.3	9.1
private individuals	26.4	12.4	12.1	11.4	11.0	12.0	11.2	11.9
Long-term kroon loans	**11.2**	**16.3**	**8.6**	**8.6**	**10.6**	**9.0**	**9.2**	**7.2**
financial institutions	10.0	8.5	8.0	5.2	7.5	5.9	5.9	6.3
commercial undertakings	12.3	16.8	8.7	8.2	10.5	9.6	9.2	7.4
private individuals	11.0	15.2	11.4	11.3	11.3	12.1	12.7	12.8
Short-term foreign currency loans	**10.6**	**13.8**	**8.3**	**7.4**	**7.0**	**7.7**	**8.0**	**7.9**
financial institutions	9.3	-	4.1	5.6	3.9	4.2	4.9	4.7
commercial undertakings	11.4	13.7	10.1	11.0	9.5	10.3	10.7	11.3
private individuals	15.6	14.5	12.0	11.7	10.7	11.3	15.8	11.4
Long-term foreign currency loans	**11.6**	**10.5**	**8.3**	**9.2**	**8.2**	**8.1**	**8.3**	**8.5**
financial institutions	8.7	8.6	7.5	7.6	5.9	5.9	7.0	6.3
commercial undertakings	11.6	13.5	8.7	9.2	9.8	9.1	10.0	8.7
private individuals	13.6	13.0	10.4	10.7	10.4	10.5	10.8	10.9

[1] includes interest rates of loans issued to residents and non-residents.

The interest rate increase in private housing loans has been quite small despite the EURIBOR developments: it increased just a marginal 0.2% during the second quarter [6]. The weighted average interest rates of private individuals have remained unchanged and no sign of increase is visible as yet. One of the reasons being the fact that the interest rates of the consumption loan, unlike those of the housing loan are mostly fixed and therefore the increase is somewhat delayed. Such a development may also show that in the favourable monetary environment and close competition, the banks are less motivated to raise interest rates.

[5] In June the decline in private corporate long-term loan interest rates was due to a couple of large low-interest-rate transactions and does not reflect the overall trend.
[6] The housing loan interest rate is mostly linked to the 6month EURIBOR. The latter increased by about 0.5 percentage points more than the interest rates of private housing loans in the second quarter.

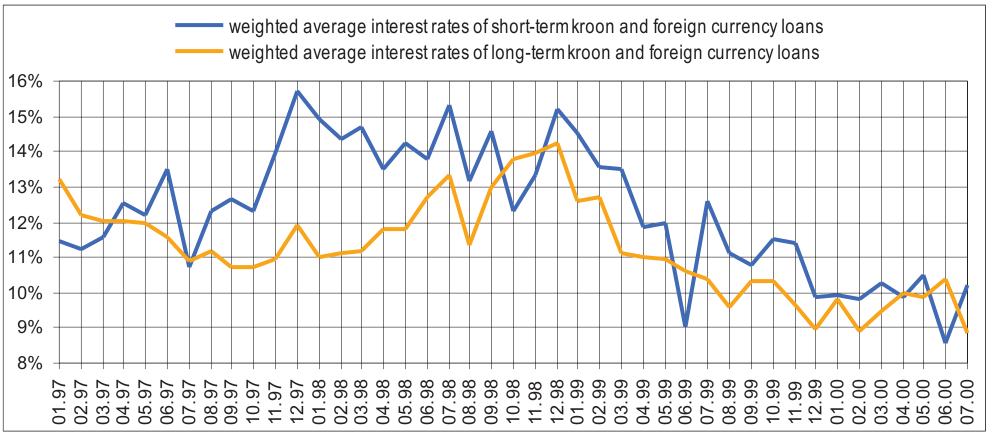

Figure 4.10. Weighted average interest rates of kroon and foreign currency loans of resident private individuals and private undertakings of non-financial sector

In the real sector's deposit interest rates a pronounced upward trend in the interest rates of both short and long-term foreign interest deposits is noticeable (see Table 4.2). The same trend is detectable also in the interest rates of long-term kroon deposits (see Figure 4.11). The interest rates of short-term kroon deposits reflect a downfall induced by scarce kroon demand. The real interest rates in the first half of the year did not change significantly (see Figure 4.12).

Table 4.2. Weighted average interest rates of time deposits[1] (%)

	31.12.97	31.12.98	31.12.99	31.03.00	30.04.00	31.05.00	30.06.00	31.07.00
Kroon deposits total	**12.2**	**8.1**	**3.3**	**3.4**	**3.5**	**3.2**	**3.8**	**4.2**
financial institutions	9.6	11.1	3.0	3.3	3.5	2.7	3.7	5.1
commercial undertakings	10.0	6.9	3.1	3.3	3.4	3.1	3.9	4.4
private individuals	10.8	9.7	5.0	4.4	4.3	4.4	4.3	4.5
up to 3 months	12.2	7.9	2.9	3.1	3.2	3.0	3.5	4.1
3 - 6 months	11.9	10.7	4.4	4.4	4.2	4.2	4.6	4.6
6 -12 months	12.4	12.9	6.1	6.0	5.6	5.3	5.4	5.4
over 1 year	10.8	8.9	8.9	7.2	6.6	6.9	6.6	9.1
DEM	**4.6**	**4.7**	**2.9**	**3.2**	**3.3**	**3.7**	**3.9**	**4.2**
USD	**5.8**	**4.8**	**5.1**	**5.2**	**5.6**	**5.8**	**6.1**	**6.1**
EUR			**3.0**	**3.9**	**3.5**	**3.7**	**3.9**	**4.1**

[1] includes interest rates of residents and non-residents deposits in Estonian banks.

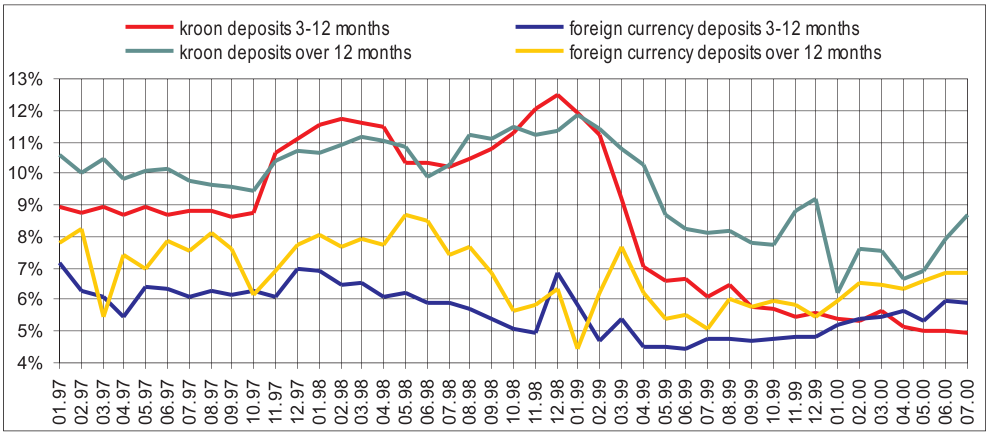

Figure 4.11. Weighted average interest rates of kroon and foreign currency deposits of resident private individuals and private undertakings of non-financial sector

Any forecast of further interest rate developments remains difficult due to high capitalisation and liquidity of banks and growing credit demand. Based on the second-quarter developments and anticipated sustained growth of interest rates in the euro area, the interest rates in the real sector are more likely to continue increasing than to decrease. Contemporaneously the factors curbing interest rate growth are in compliance with the need to ensure sustained development of the economy.

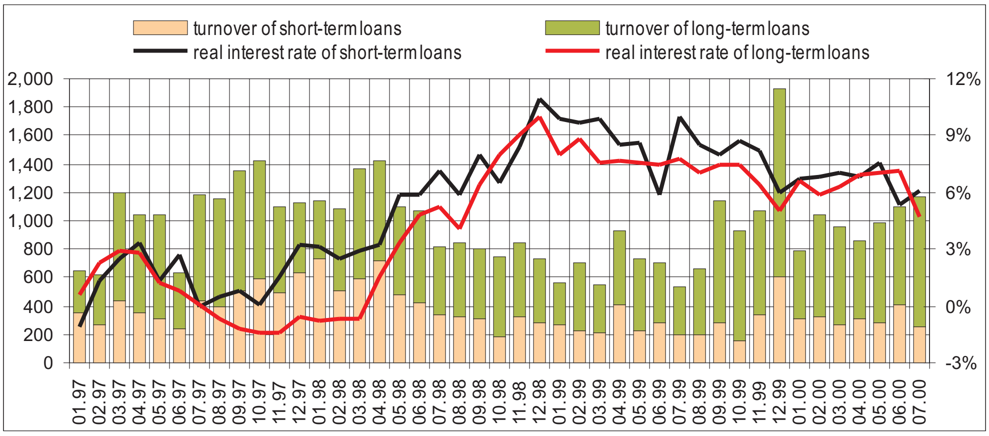

Figure 4.12. Turnover (EEK mn, the left scale) and weighted average ex post real interest rates of kroon and foreign currency loans by consumer price index (the right scale) of resident private individuals and private undertakings of non-financial sector