IV
MONETARY POLICY ENVIRONMENT

In the third quarter the more moderate interest rate increase in the euro area as compared to the first half-year and the weakening of the euro on foreign exchange markets created a relatively neutral external view for Estonia's monetary policy environment. In addition, the annual growth of domestic money supply remained at the high level as well. Those factors created relatively favourable domestic environment for the financial sector and let the domestic credit growth rely on domestic saving. Thus the stable and favourable monetary environment of the first half of 2000 was sustained also in the third quarter. Therefore the need for external financing diminished and the foreign capital inflows, attracted by the real sector, were channelled abroad through the financial sector. Domestic credit growth was high, but it contained mostly credit to financial institutions. Their financial activity is not oriented towards domestic real sector alone but also towards foreign sector.

Tightening of the monetary policy in the euro area during 2000 was not fully reflected in the interest rates of Estonian real sector loans due to the favourable domestic liquidity environment. **This does not mean that the implications of the loosening monetary policy in the euro area could not be channelled into Estonian real sector interest rates when the domestic liquidity conditions remain favourable.** Therefore the factors stimulating credit growth, should be still closely monitored. At the same time the real sector's high propensity to save and the concentration of credit growth towards corporate clients have all prerequisites for sustainable economic growth. **The maintaining of this trend depends mostly on the further developments in the real sector.**

Monetary Environment in Estonia and Euro-zone

The third-quarter modest increase in the euro's money market interest rates and the continuous weakening of the euro on foreign currency markets despite the exchange rate policy measures applied by leading central banks (see European Economies, p 15) developed a relatively neutral monetary policy environment for Estonia in the third quarter (see Figure 4.1). In October the growth in the euro interest rates came to a halt. Most of the market participants anticipate a slight interest rate decline in medium-term.

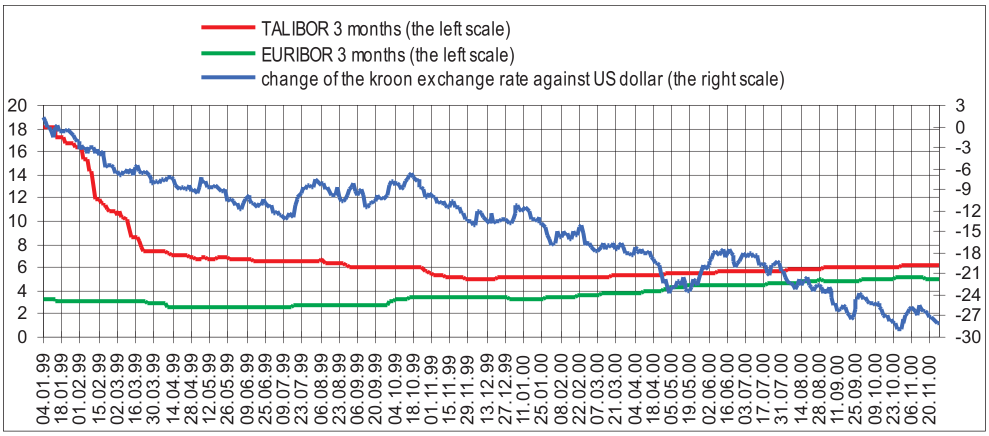

Figure 4.1. Three-month TALIBOR and EURIBOR; change of the Estonian kroon exchange rate against US dollar (%)

Capital Flows

In the third quarter the foreign currency reserves of the balance of payments increased by 271 million kroons. The net capital inflow through capital and financial account was about 1.8 billion kroons, the main source being direct investments. Those flows were mostly related to foreign investments in the financial sector in the third quarter. The financial sector kept playing an important role in the capital outflow as well, taking part of the deposit growth out of Estonia via financial institutions. Financial intermediaries paid back their previous external liabilities but also increased their investments in foreign countries.

***Summa summarum* previous trends continued on the financial account, ie the financial sector redirected real sector foreign capital inflows back abroad.** Due to these factors external capital flows had no significant implication on base money in the third quarter. The base money grew by only 89 million kroons.

Monetary Aggregates

Monetary aggregates sustained their rapid growth in the third quarter. At the end of September the annualised growth of broader money supply reached 30.8% and that of narrow money supply 25.5%[1] (see Figure 4.2). The large growth of monetary aggregates reflected domestic saving in the private sector. The impact of external capital becomes mostly evident in external borrowing involved by primarily of the business sector, although it was balanced by capital outflow through the financial sector in the third quarter.

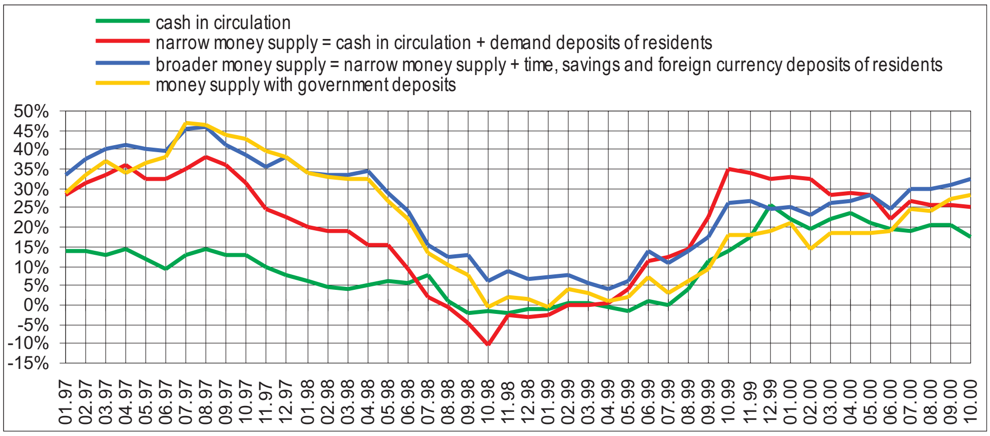

Figure 4.2. Change of monetary aggregates against the respective month of previous year

Another important development was accelerating growth of foreign currency deposits, mostly dollar deposits, on an ongoing basis from mid-second quarter. Thus, the share of foreign currency deposits in broader monetary aggregate has increased (see Figure 4.3). Partially it is due to supplementary income effect arising from exchange rate changes[2]. However, even without considering exchange rate changes the growth rate of foreign currency deposits was high, although slightly more moderate[3]. **The high growth rate of broader money supply still characterises the high level of domestic private saving.**

[1] On 30 November the annual growth of narrow money supply was 19.6% and broader money supply 30.0%.
[2] In financial accounting the volume of foreign currency deposits is entered at the exchange rate effective on the balance sheet date. Thus, changes in the exchange rate of the Estonian kroon are also reflected in the changing deposit volume.
[3] According to estimates about a third of the growth in foreign currency deposits is due to exchange rate changes.

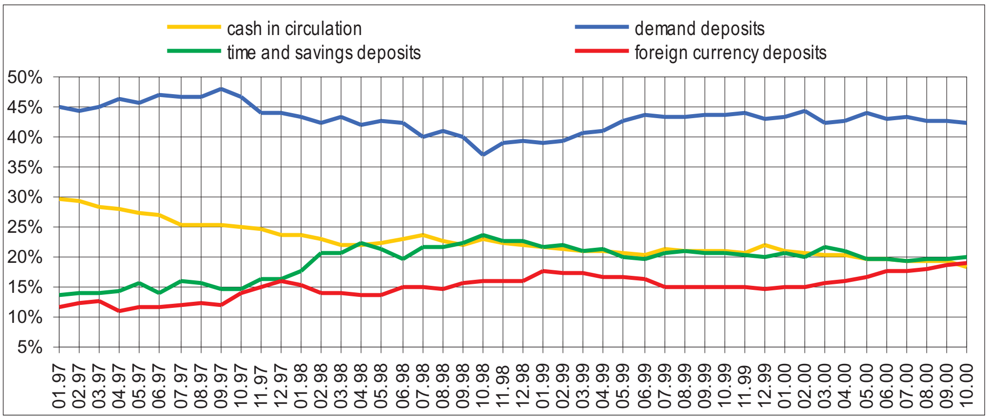

Figure 4.3. Structure of broader money supply

The growth in corporate deposits reflected high economic activity and strengthening external relations. Growing foreign currency deposits were likely due to the appreciation of the dollar and increase in transit services. Private individuals' depositing expanded through student loans issued in mid-September. The budget surplus contributed to the government sector's domestic saving. Thus, in the third sector the government restored domestic liquidity reserves that had shrank in the first half of the year.

The third trend lay in the sustained growth of non-residents' deposits in the third quarter, mostly as dollar deposits. This trend probably reflects expanding transit services and maybe also deposit inflow from CIS countries caused by slightly higher confidence towards Estonian banking sector. In October the growth in non-residents' dollar deposits in dollars was the lowest both by private individuals and undertakings in the last six months. Contemporaneously domestic private corporate dollar deposits kept going up. **In conclusion the sustained rise in domestic and external deposits means continuously favourable liquidity environment for the financial sector.**

Money and Foreign Exchange Markets

Liquidity Buffers

The share of liquid assets in banks' balance sheets maintained the previous quarter's level in the third quarter (see Figure 4.4). Contemporaneously disequilibrium in cash flows continued growing, partially due to longer-term investments (with maturity of 2 to 5 years and more) of short-term resources (see Banking, pp 39 to 42).

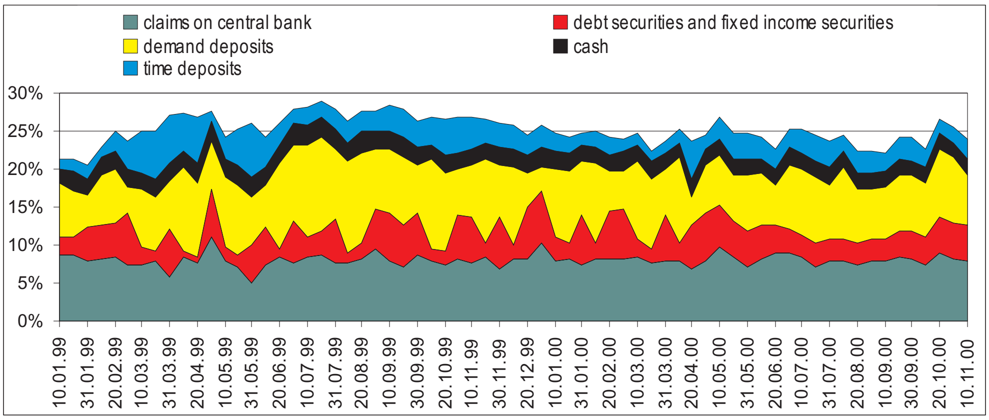

Figure 4.4. The share of liquid assets in banks' total assets

Larger end-of-the-day balance of credit institutions' clearing accounts at the beginning of the month indicates spare liquidity buffers (see Figure 4.5).

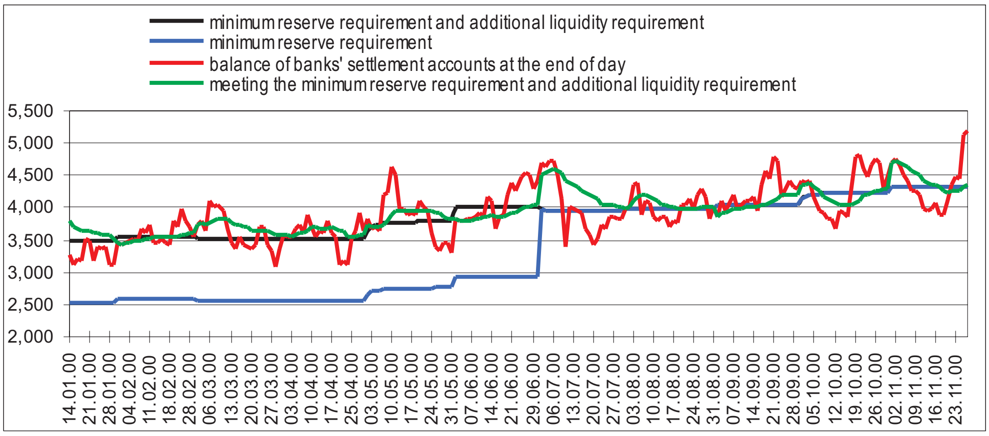

Figure 4.5. Balance of banks' settlement accounts with Eesti Pank and meeting the reserve requirement and additional liquidity requirement (EEK mn)

Money Market Interest Rates and Turnover

In the third quarter money market interest rates continued to rise in the euro-zone, spurred by the European Central Bank (ECB) decisions to raise its main refinancing rate on 31 August by 25 basis points and again on 5 October by the same amount. By early November the ECB refinancing interest rate had climbed to 4.75%.

The interest rate developments in the euro-zone spilled over to the Estonian money market pushing up interest rates (see Figure 4.6). The influence from euro short-term money market rates in the third quarter was stronger than earlier. In November TALIBOR did not precisely follow the decline in euro interest rate, leading to the widening of the interest differentials (see Figure 4.7). The latest developments confirm the statement made in the September issue of Monetary Developments & Policy Survey that the margin would be restricted in its shrinkage.

On international futures markets a further rise in euro short-term interest rates is considered unlikely in 2000. Rather a drop is forecast by mid-2001. Taking into account the continuing inflationary pressure in the euro-zone, at least in the first quarter of 2001 no significant downward revision of short-term euro interest rates could be expected.

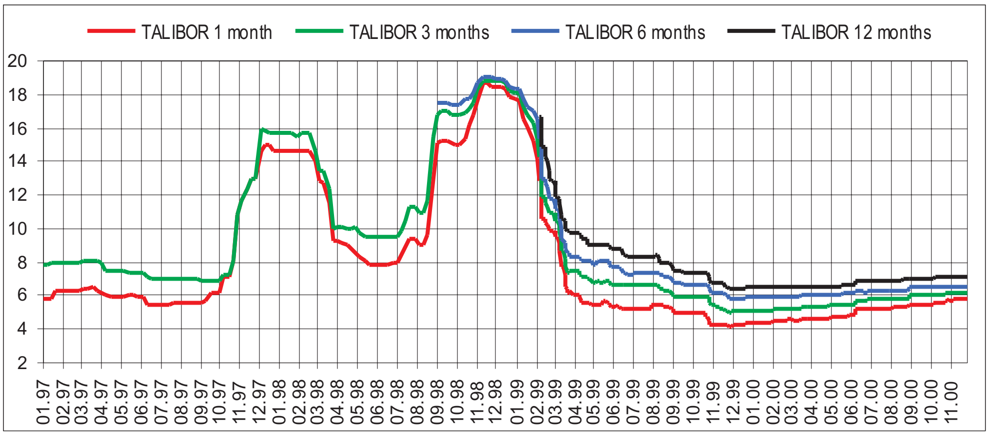

Figure 4.6. Interest rates of the Estonian money market (%)

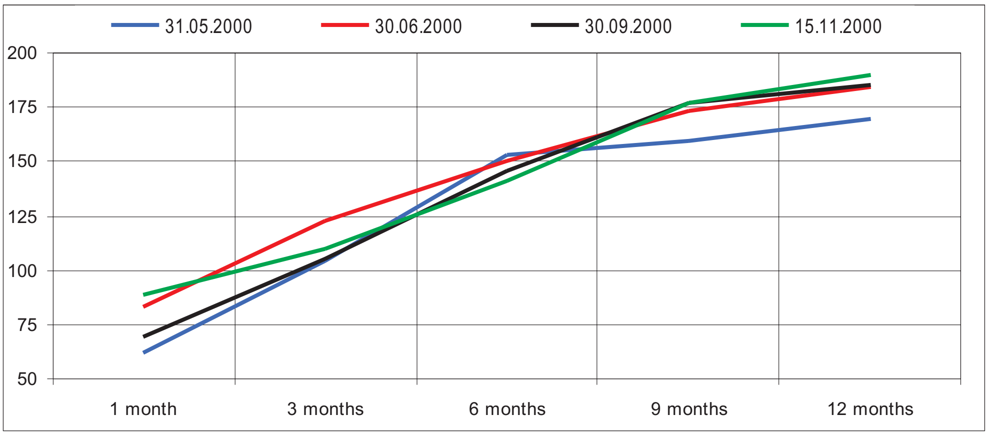

Figure 4.7. Difference between money market interest rates of the Estonian kroon and euro (%)

In the third quarter the turnover of Estonian money market was slightly above two previous quarters whereas most of the transactions were still short-term – below three months maturity. As of August instruments with longer than three-months maturities have been traded as well[4].

Forward Market

Like in the first half of 2000 foreign exchange forward market has been not very active in the third quarter, too. The turnover of euro forward contracts grew in October, climbing to a two-year high, mainly due to swap transactions conducted by one bank. In November quotations of euro/kroon forward contracts with more than 12months maturity grew slightly. Contemporaneously quotations of shorter-term swaps have manifested a decline. This happened in November as well when the shrinking margin of the kroon and euro money market interest rates came to a halt. **In summary there is no reason to think that markets' risk assessments have changed.**

Credit Market

Loan Aggregates

Simultaneously with domestic deposits, bank lending grew rapidly, too, in the third quarter. The annual growth of residents' borrowing reached 32.2% at the end of September and together with bank-owned bonds 28.8%. Financial institutions had contributed a significant part, with annualised lending growth being 92.0% in end-September (see Figure 4.8). In the domestic real sector bank loans underwent a relatively stable 15–16% growth in the third quarter. Private corporate borrowing was 11.0% and private individuals' borrowing 31.3% above the year-ago period[5].

The 1.8 billion kroon loan growth to the financial institutions in the third quarter (see Figure 4.9) was not fully matched with the growing leasing – leasing and factoring issued to the real sector rose by less than 0.6 billion kroons, reflecting primarily financing of the domestic corporate sector. ***Summa summarum* the annualised growth in financing the real sector undertakings together with leasing and external financing was an estimated 17–20% in the third quarter. This figure reflects partially also the year-ago standstill in financing the real sector.**

[4] In October the turnover of 3–6months unsecured kroon loans was 188 million kroons, in September only 10 million kroons and in August 50 million kroons.
[5] As of 30 November the annual growth rates were as follows: financial institutions 106.6%, private undertakings 13.5%, private individuals 29.2% and residents total 36.4%.

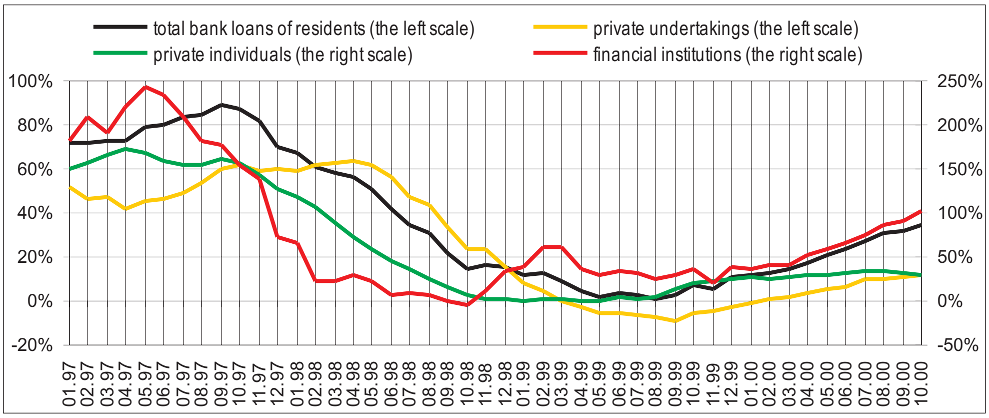

Figure 4.8. Annual growth of the loan stock issued to resident private individuals, private undertakings and financial institutions (%)

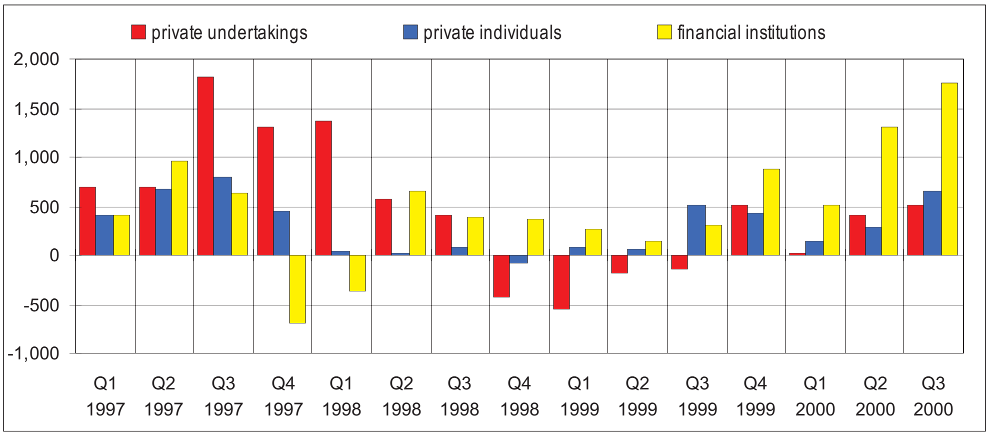

Figure 4.9. Growth of residents' loan stock (EEK mn)

Throughout 2000 private individuals' borrowing has reflected primarily expanding housing loans. Student loans (an estimated 323 million kroons) have been another regular seasonal factor affecting private individuals' borrowing in the third quarter, also maybe slightly encouraging private consumption. In September the annualised growth rate of private borrowing started to fall, displaying implications of the year-ago comparison base [6]. Private individuals' leasing and factoring reached 52 million kroons in the third quarter, ie 10% above the 1999 level. **The development of both monetary aggregates and capital flows shows that domestic loan growth is financed primarily from domestic saving, not from external borrowing of the financial sector.**

Interest Rates in Real Sector

The interest rates in the real sector did not fully follow the trend in the euro area. This could indirectly indicate that demand side factors increasingly inhibit further loan growth in the real sector and any future growth of credit requires better loan conditions. Volatility of the interest rates was partially due to several non-structural factors (eg student loans). In the real sector's deposit rates, the shrinking short-term kroon interest rates and growing foreign currency interest rates reflected the controversy of the euro-area interest rate rise and a remarkable growth in domestic saving (see Figures 4.10 and 4.11).

[6] In September 1999 apart from student loans also rearrangement of entries within the banking group expanded the volume of private borrowing.

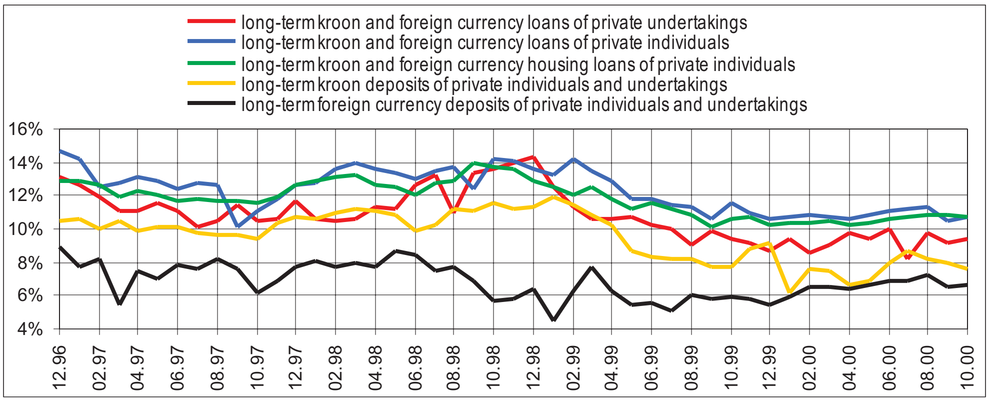

Figure 4.10. Weighted average interest rates of long-term kroon and foreign currency loans and deposits of resident private individuals and private undertakings of non-financial sector

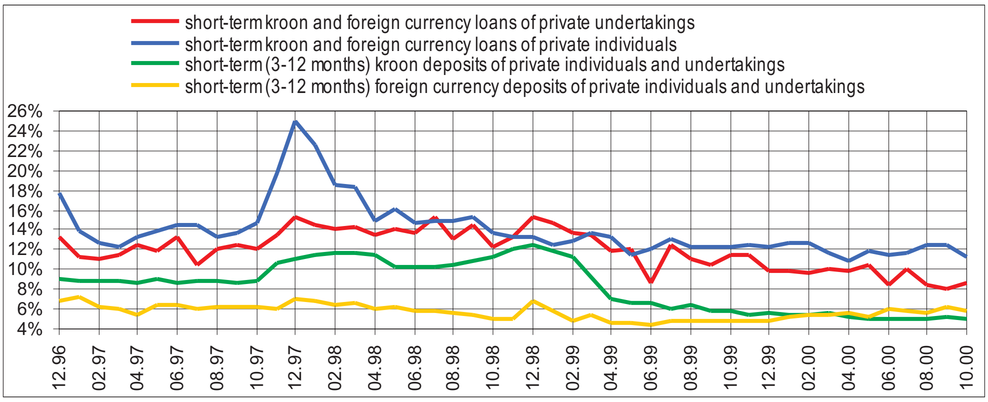

Figure 4.11. Weighted average interest rates of short-term kroon and foreign currency loans and deposits of resident private individuals and private undertakings of non-financial sector

Signals of European restrictive monetary policy have not been fully reflected in the interest rates of Estonia's real sector in 2000. **This does not exclude the infusion of Europe's loosening monetary policy implications into the real sector's interest rates under favourable liquidity environment in Estonia. Taking into consideration the inflation-induced decrease in the real interest rates** (see Figure 4.12), **it is evident that further credit market developments should remain under scrutiny.**

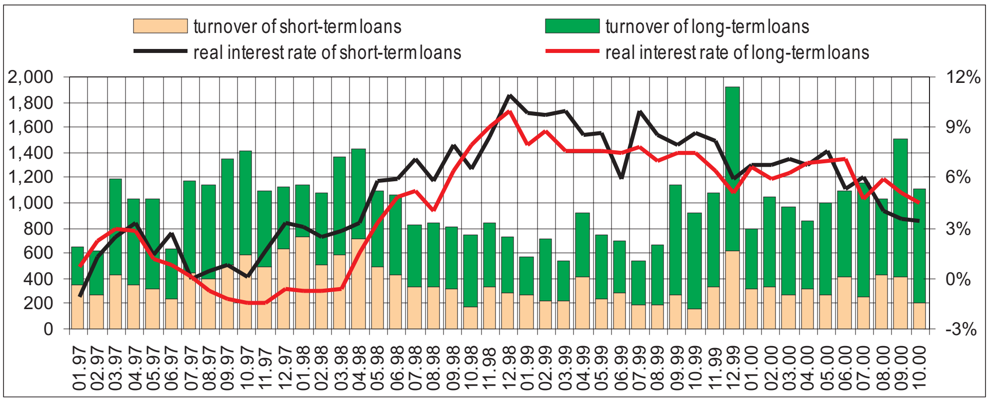

Figure 4.12. Turnover (EEK mn, the left scale) and weighted average ex post real interest rates of kroon and foreign currency loans by consumer price index (the right scale) of resident private individuals and private undertakings of non-financial sector