IV
MONETARY POLICY ENVIRONMENT

In the first quarter of 2001 external conditions were more expansive for Estonia's monetary environment than in the fourth quarter of 2000. The threat of global economic growth slowing faster than expected provided the US Federal Reserve and the European Central Bank a reason to cut interest rates. The interaction of the about 5% weakening of the exchange rate of the euro against the US dollar and declining money market interests of the euro was slightly above the expectations by the end of the quarter. **Further anticipation of a slowdown in Europe's economic growth should keep short-term interest rates of the euro on the downward path.**

There were first visible signs of both monetary aggregates and credit growth stabilising. The growth of narrow monetary aggregates even slowed slightly. Nominal interest rates of short-term deposits and long-term loans have been stable for some time already. The reform of the monetary policy operational framework and the privatisation of the water company Tallinna Vesi exercised strong impact on the balance of the financial account.

Monetary Environment

Central banks of many countries responded to deteriorating growth outlooks by cutting interest rates. Contained inflation allowed the US Federal Reserve to sharply cut overnight interest rates – by 2.5 percentage points in the first five months of the year. The European Central Bank, Bank of England and Bank of Japan lowered interest rates as well in order to boost economy and neutralise external impacts.

Although US short-term interest rates dropped below the interest rates of the euro, the euro did not strengthen. Financial markets' expectations that the US economy would recover together with capital inflows brought along a just about 9% fall in the exchange rate of the euro against the dollar by the end of the first five months of the year.

Implications of the exchange rate of the euro and changes in the money market interest rates were somewhat expansionist for Estonia's monetary conditions. Considering that the growth of the global economy including the US and Europe will probably continue slowing down, the short-term interest rates are expected to keep dropping as well (see Figure 4.1).

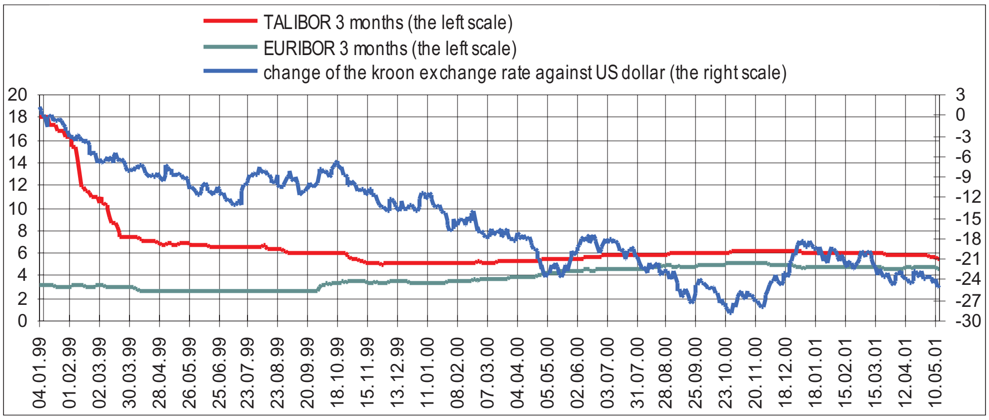

Figure 4.1. Three-month TALIBOR and EURIBOR; change of the Estonian kroon exchange rate against the US dollar (%)

Capital Flows

Capital flows have been of opposite direction as usual at the beginning of the year. Direct investments to Estonia reached about 3.3 billion kroons in the first quarter. This is about 3.5% of anticipated annual GDP, record high of the last two years. The vast majority of FDI was made in January when the privatisation of Tallinna Vesi was completed. **The FDI volume exceeded the balance of payments' current account deficit twofold**. The net inflow of portfolio investments reached 1.5 billion kroons[1]. The net outflow of capital via other investments' account reached about 5.7 billion kroons. Banks were the most active in taking out funds.

The banks' claims to non-residents grew by over 4 billion kroons, about 3 billion of which were cash and deposits in non-resident credit institutions. The position of reverse repurchase agreements with non-residents increased by 1.4 billion kroons[2]. Banks' external liabilities in the form of a debt expanded by a total of 650 million kroons. Thereby bonds for more than a billion kroons were issued to non-resident credit institutions. The 615-million-kroon shrinkage of the non-resident credit institutions' deposits had a balancing effect.

The decline in reserves of 2.5 billion kroons was more of a seasonal nature although it also reflected implications of the monetary policy framework reform. The direct impact of the operational framework change should be about 1.4 billion kroons, the remaining one billion kroons could be just regular seasonal contraction (during the previous three years the reserves have shrunk by about 1.0 to 1.3 billion kroons). The banks deposited abroad majority of the funds released as the result of the monetary policy operational framework reform. Only 0.4 billion kroons were placed in other countries' government bonds as portfolio investments. The banks placed their money abroad mainly in January and February (2 and 1.7 billion kroons, respectively).

Monetary Aggregates

The modest growth slowdown of monetary aggregates that started in the last months of 2000 continued in the first quarter of 2001 as well. Nevertheless, the growth of aggregates was still relatively rapid, reaching about 30% in case of broader monetary aggregates[3] (see Figures 4.2 and 4.3).

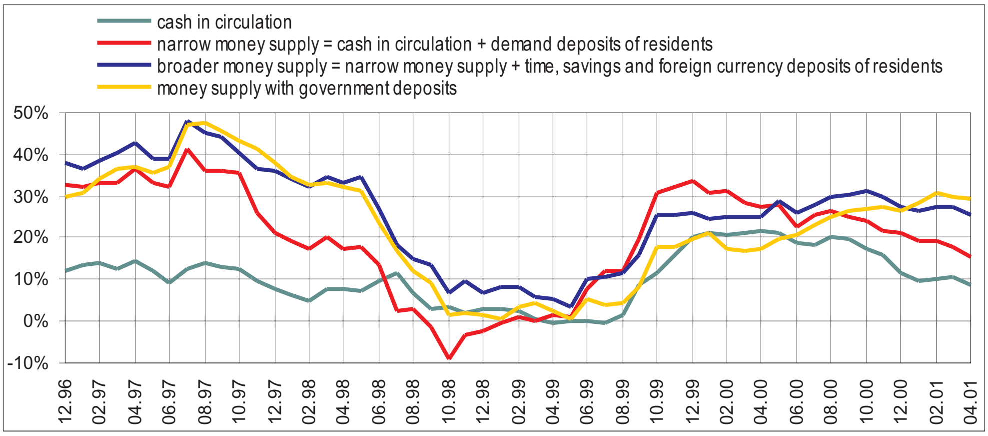

Figure 4.2. Change of monetary aggregates against the respective month of previous year (residents)

[1] Mostly bank liabilities.
[2] The change is a clear implication of the monetary policy framework reform.
[3] Unlike previous surveys this one reflects also residents' and non-residents' deposits together for the sake of comparison. In the category of private individuals residents and non-residents are handled together as amendments to the residency guidelines had quite a significant impact on the volume of private individuals' time deposits.

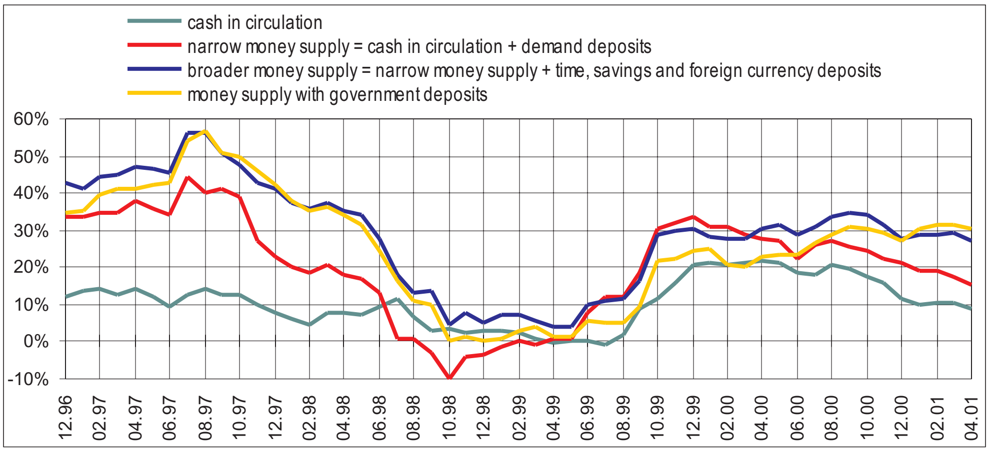

Figure 4.3. Change of monetary aggregates against the respective month of previous year (residents and non-residents)

The growth in the volume of the cash in circulation in economy has shown a most pronounced inhibition. In March the average cash volume in circulation was only 600 million kroons, merely 11% above the year-ago period. The increasing use of electronic modes of payment also inhibits the growth of cash.

Household savings continued to grow rapidly. The private demand deposits displayed an increase of a mere 1.7 billion kroons (23%) over the year. The decline in the growth of demand deposits was balanced by the accelerated growth of time deposits whereby total household deposits increased by 3.8 billion kroons (30%; see Figure 4.4). Faster growth of time deposits characterised also changes in the deposits of commercial undertakings (see Figure 4.5).

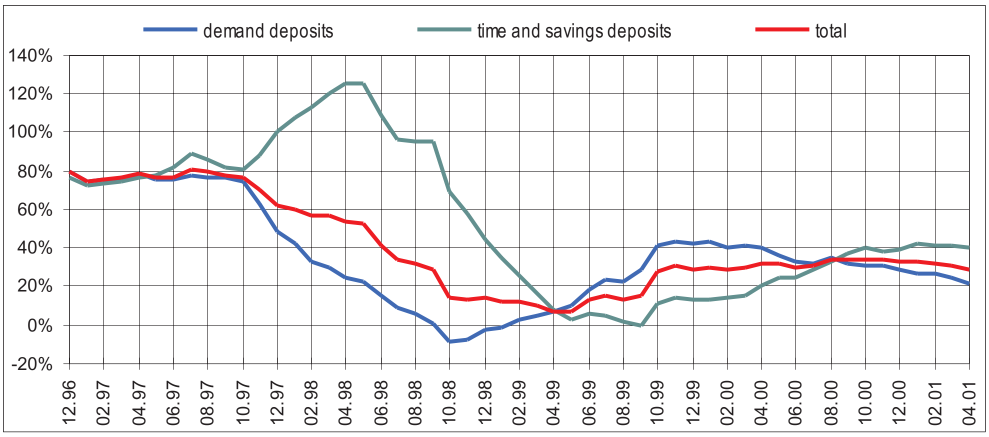

Figure 4.4. Change of deposits of resident private individuals against the respective month of previous year (kroon and foreign currency)

Due to the above mentioned development trends (inhibited growth of cash and increased depositing of free funds) the share of time kroon deposits in the broader monetary aggregate increased by about 3 percentage points (see Figures 4.6 and 4.7). Whereas the share of foreign currency deposits is growing as a long-term trend. The relatively slow growth sustained the linear decline in the share of cash. The share of cash in the monetary aggregate is shrinking by about 2 percentage points a year.

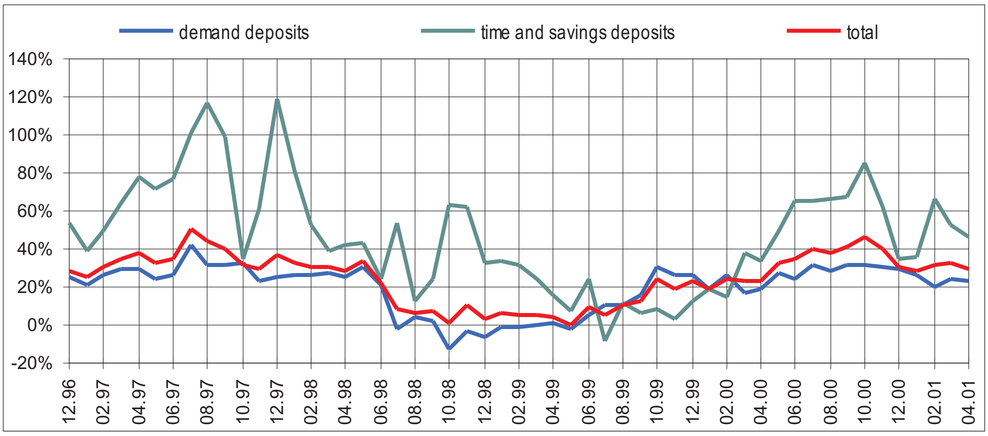

Figure 4.5. Change of deposits of resident commercial undertakings against the respective month of previous year (kroon and foreign currency)

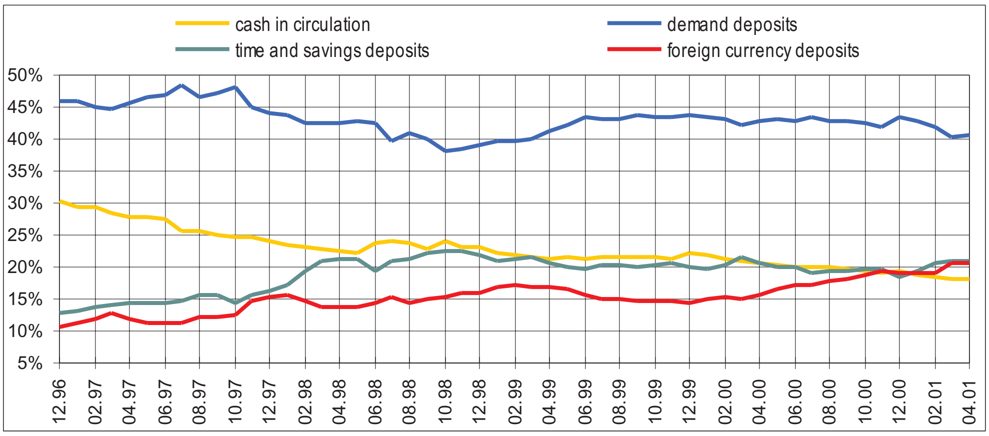

Figure 4.6. Structure of broader money supply (residents)

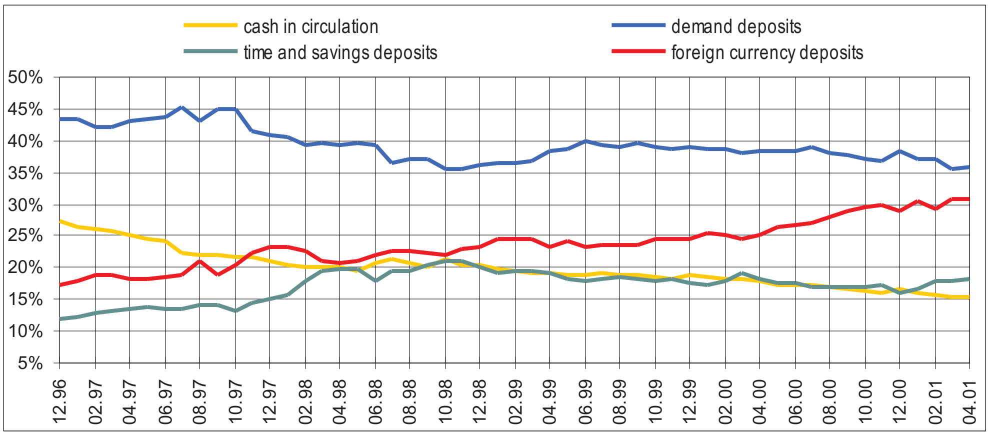

Figure 4.7. Structure of broader money supply (residents and non-residents)

Liquid Assets

Parallel to the slower growth of monetary aggregates, the liquidity environment remained favourable for credit institutions throughout the first quarter. In the first months of the year the banks involved apart from domestic deposits also external funds through bond issues. A part of the involved external resources were replaced in external buffers whereas **the share of liquid assets in the banks' balance sheets remained stable in the first quarter** (see Figure 4.8). Larger liquidity buffers are necessary to offset the increasing liquidity risk, arising from unbalanced cash flows.

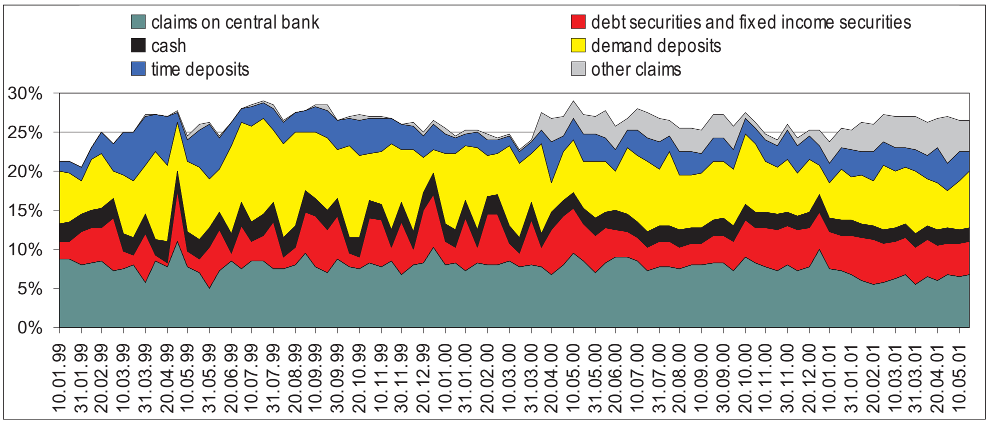

Figure 4.8. The share of liquid assets in banks' total assets

The forecast shift took place in the first quarter – external assets replaced a part of kroon deposits. Contemporaneously liquidity buffers shed by about 1.7% in the share of credit institutions' kroon deposits with the central bank. This structural shift was initiated by the new procedure of averaging provisions in the reserve requirement system entering into force on 1 January 2001. As of the beginning of 2001 the banks are permitted to hold 25% of the reserve requirement in high quality euro-denominated foreign instruments. **Within the second phase of the monetary policy operational framework the share of foreign instruments in the reserve requirement is intended to raise to 50% as of 1 July. Thereby the credit institutions' reserve requirement will maintain its volume whereas the share of foreign assets in liquidity buffers will increase.** As a side effect of the reform the share of high quality euro-denominated bonds will increase in banks' bond portfolios, expanding in long term banks' window of opportunity to use for liquidity management the euro's money and capital markets.

Money Market

During the last year the money market interest rates of the Estonian kroon have relatively closely followed trends observed in the interest rates of the euro with a slight delay (see Figure 4.9).

The first signs of the economy in the euro-zone, including Germany, cooling down and continuously unclear US economic outlooks sent the interest rates of the euro downward in the first quarter. The interest rates of the euro, having been relatively stable in January and February, started to fall in March, primarily due to the inhibited growth of the German industrial output and lower confidence indicators. The market participants' expectations that interest rates will decline, made money market yield curve to reverse and brought along an undersupply in the repurchase auction of the European Central Bank in April.

The short-term interest rates of the euro displayed a more moderate fall in the first four months of the year than in the fourth quarter of 2000. This was caused by relatively strong private

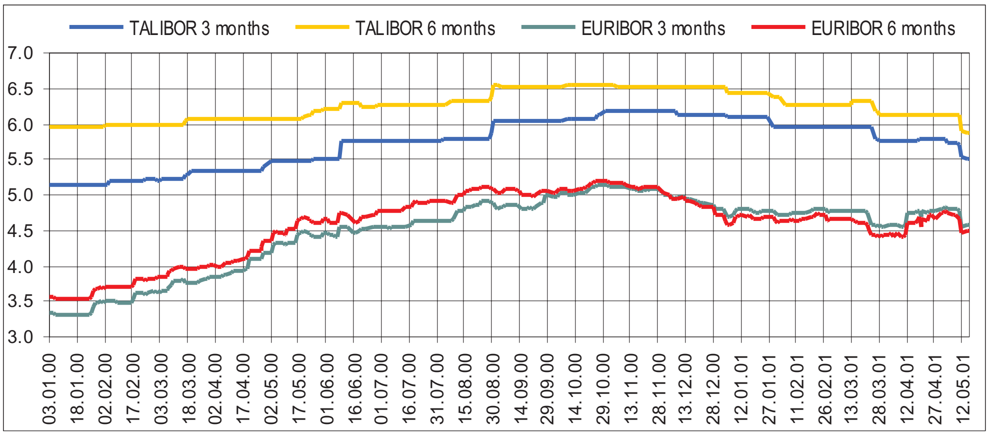

Figure 4.9. Money market interest rates of the Estonian kroon and euro (%)

consumption and consumer confidence and to a lesser extent by persisting inflationary pressures. On 10 May also the European Central Bank cut the refinancing rate from 4.75% to 4.5%, referring to decreasing inflationary pressures in longer term.

The spread between the money market interest rates of the Estonian kroon and the euro has been decreasing with the support of continuously favourable liquidity environment as well as the restrained demand for kroons (see Figure 4.10). Trading in the money market of the Estonian kroon was far below the fourth quarter of 2000. This happened mainly because the non-resident credit institutions were not very active. **The decline in the money market interest rates of the Estonian kroon did not spread to the short-term interest rates of the kroon loans in the first quarter.**

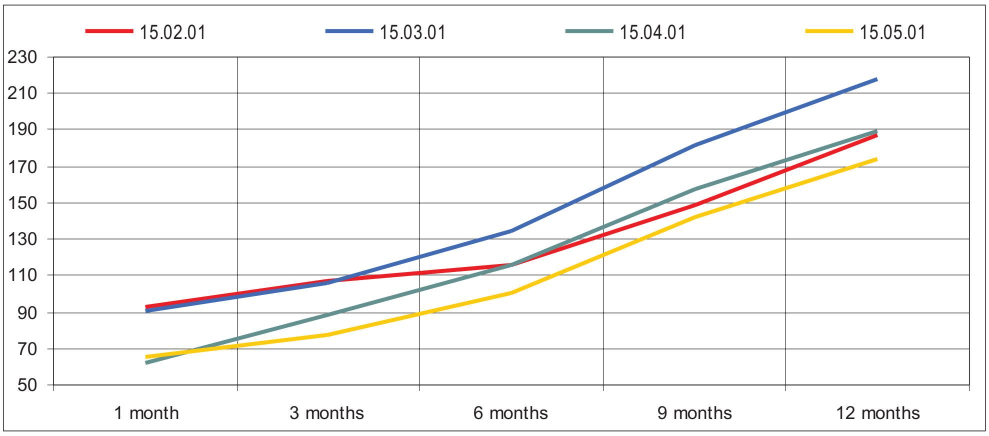

Figure 4.10. Difference between money market interest rates of the Estonian kroon and euro (basis points)

Forward Market

Due to seasonal factors the forward market in the first quarter of 2001 remained less active. Low demand inhibited the volume of positions taken against the Estonian kroon in the forward market (see Figure 4.11). Forward quotations have remained relatively low for long already (the spread between the interest rates of the Estonian kroon and the euro has been in case of six-months and one-year transactions within 150 and 190 basis points).

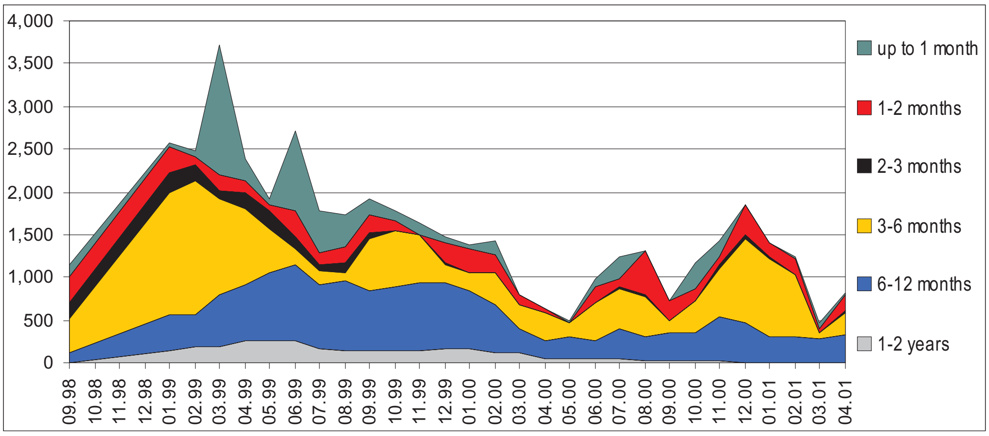

Figure 4.11. Long kroon positions of Estonian credit institutions taken against the Estonian kroon in the forward market (EEK mn)

Credit Market

The growth in the debt burden of the domestic real sector[4] is revealing firm signs of stability. The real sector's debt burden has against the first quarter of 2000 increased by 21%, ie about 11 billion kroons, of which about 2 billion were added in the first quarter of 2001 (see Figure 4.12). **In the first quarter of 2001 the domestic real sector involved most of debt liabilities from the external sector (according to preliminary estimates over one billion kroons) and leasing companies (526 million kroons). Only 360 million kroons were borrowed from the banking sector** (see Figure 4.13).

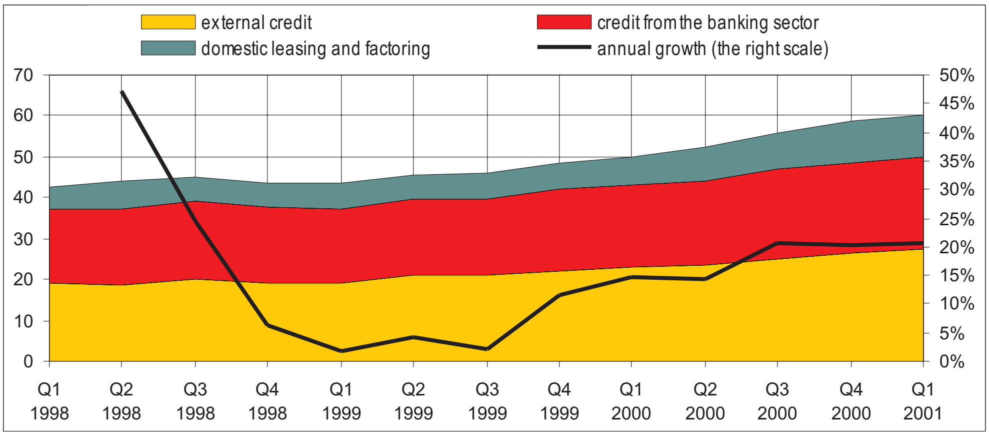

Figure 4.12. Debt burden of the domestic real sector (EEK billion)

The relatively low growth in absolute terms against the second half of 2000 is primarily due to seasonal factors, like traditionally low economic activity in the first quarter. Percentage-wise the growth of the annual debt burden was contained on the level of previous periods, without any potential indication of trend reversal.

[4] Here: the real sector involves all domestic commercial undertakings, private individuals and non-profit organisations.

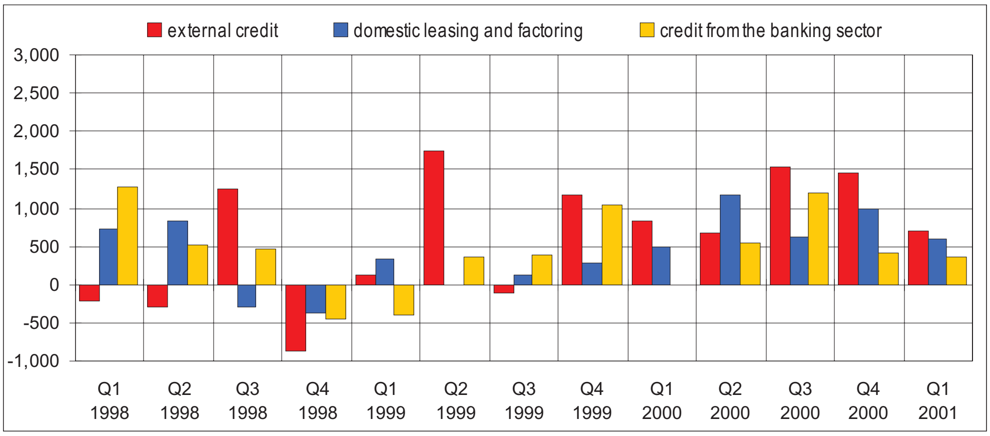

Figure 4.13. Change of the debt burden of the domestic real sector (EEK mn)

Under stable or marginally decreasing nominal interest rates, with real sector's borrowing outlooks improving and banks operating in a relatively favourable liquidity environment, slower growth could only be linked to demand contraction. Nevertheless, there are first signs of domestic direct financial intermediation (bond issues; see Financial Sector, p 51). Unfortunately it is difficult to estimate the actual growth of debt burden in the form of commercial undertakings' bonds.

Among banks' claims (loans and bonds) financial institutions' liabilities continued to grow, just by over one billion kroons in the first quarter (see Figures 4.14 and 4.15). Using relatively robust methodology[5], it is presumed that about half of the money moved out of the country. In the fourth quarter of 2000 this figure could have reached about 1.5 billion kroons. **While in end-2000 in order to finance the above (presumably decided by the banking group) cash flows, about a third was to be covered from external resources whereas in the first quarter of 2001 bank deposits covered the entire growth in the loan portfolio.** In the first quarter the bank deposits and claims to customers increased by 2.5 and 1.6 billion kroons, respectively, against 1.55 and 3.5 billion kroons, respectively, in the last quarter of 2000.

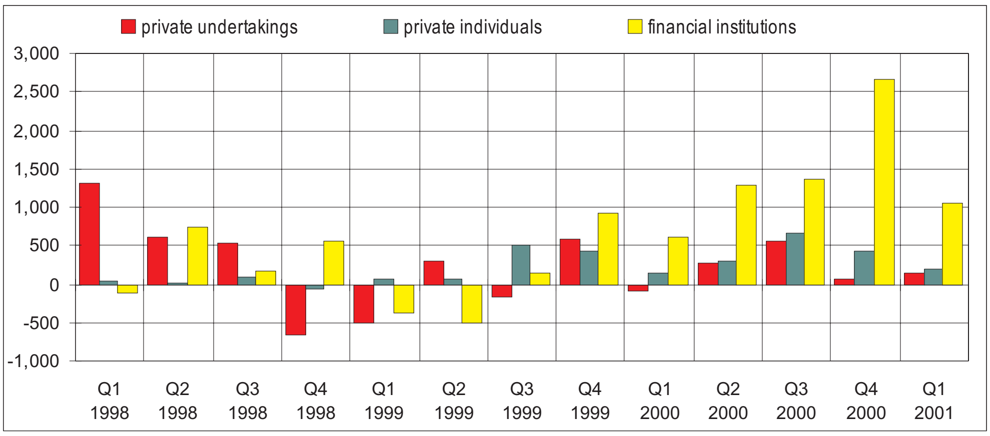

Figure 4.14. Banks' claims on residential customers (EEK mn)

[5] The growth of leasing portfolios has been subtracted from loans to financial institutions.

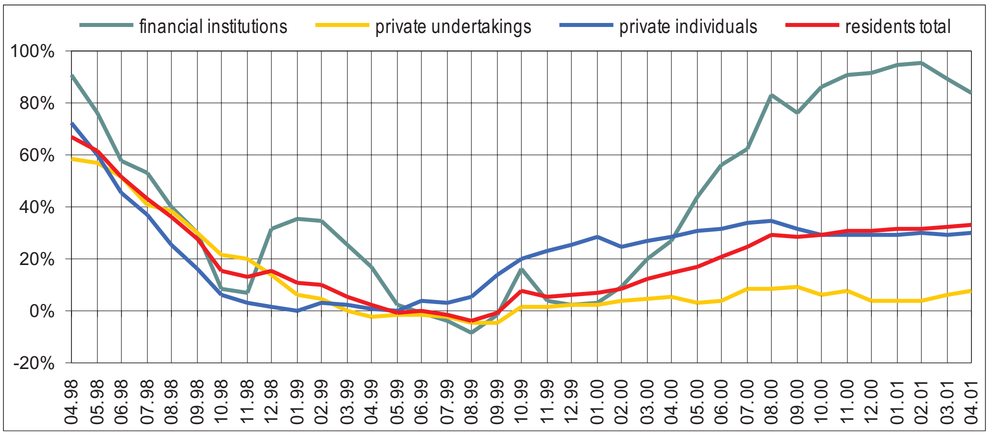

Figure 4.15. Banks' claims to resident customers (change against the respective month of previous year, %)

Banks' claims to commercial undertakings increased by 170 million kroons during the first quarter of 2001. The three main bank-credited branches of economy continued to be real estate, leasing and business services (change in debt liabilities +271 million kroons); wholesale and retail trade (+114 million kroons) and transport, warehousing and communication (+93 million kroons). In the fourth quarter of 2000 the figures were 173; 155 and –23 million kroons, respectively. In the first quarter banks' debt claims to construction companies decreased most (by 101 million kroons).

The household loan stock increased by 190 million kroons in the first quarter. Housing loans were responsible for the vast majority – 150 million kroons (78%) and consumption loans for 16 million kroons (8.2%). Inhibited household borrowing seems surprising, especially under the circumstances in which banks are relatively actively promoting new products. Ever more customers have recently preferred leasing products[6].

It is quite difficult to define changes in new lending, as loan turnover is traditionally turbulent (see Figures 4.16 and 4.17). In the first quarter we can notice a slight growth in the turnover of

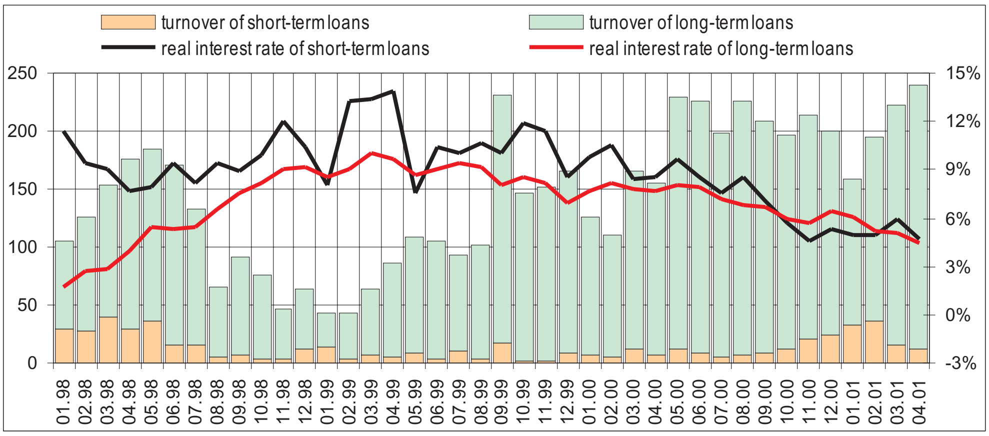

Figure 4.16. Turnover (EEK mn, the left scale) and ex post real interest rates of loans by CPI (the right scale) of resident private individuals

[6] As accounting methodology was changed at the end of the last year, it is not possible to single out growth in household leasing portfolios whereas the estimated growth could be about 140 million kroons.

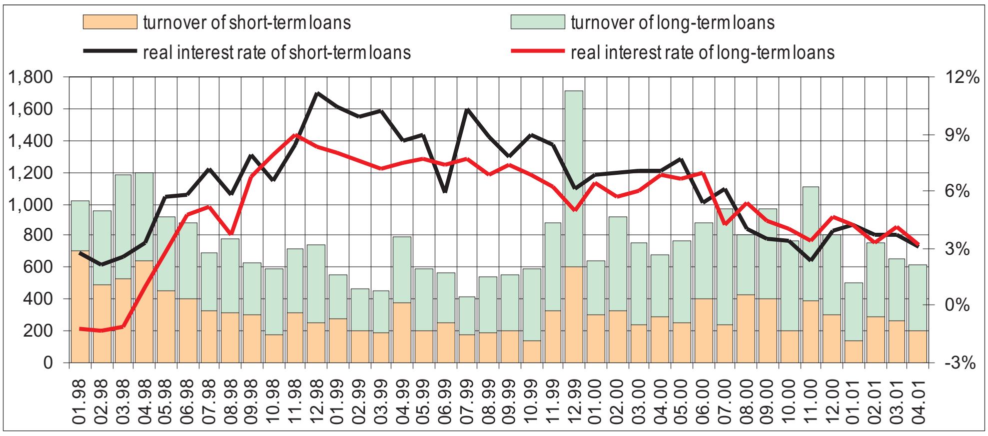

Figure 4.17. Turnover (EEK mn, the left scale) and ex post real interest rates of loans by CPI (the right scale) of resident commercial undertakings

private borrowing, although due to the repayment of previous loans this trend is not traceable in the change of the loan stock.

Real Sector Interest Rates

Real sector deposit interest rates remained relatively stable (see Figure 4.18). **The only pronounced exception was a decline in long-term deposit interest rates.** The turnover of short-term kroon and foreign currency deposits was far above the long-term ones, the ratio being about 1/15 (in the third and fourth quarters of 2000 1/16 and 1/8, respectively), ie 120 million kroons, 96 million of which were deposits by resident private individuals.

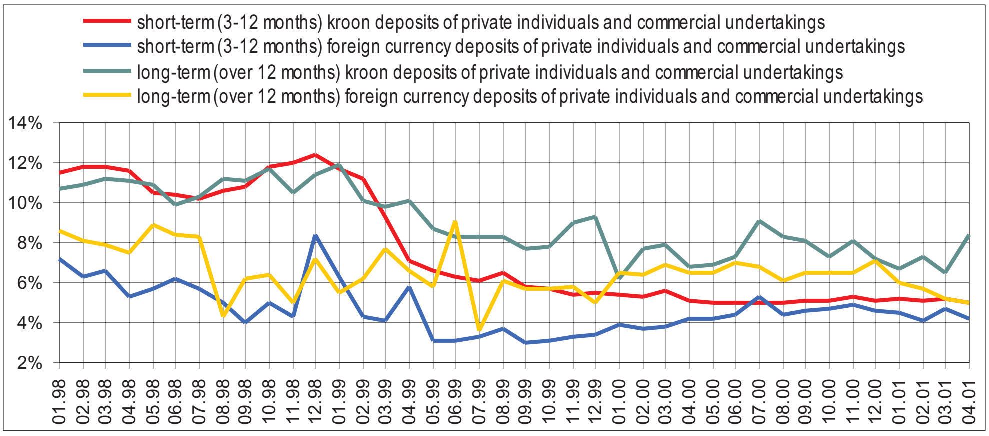

Figure 4.18. Interest rates of residents' deposits

The private sector loan interest rates have been also relatively stable (see Figure 4.19). **Only short-term loans display a fluctuation of above one percentage point.** This is primarily due to low turnover as each loan has a relatively large impact on the average indicator. A slight downward trend is traceable in long-term borrowing by private individuals, especially in housing loans.

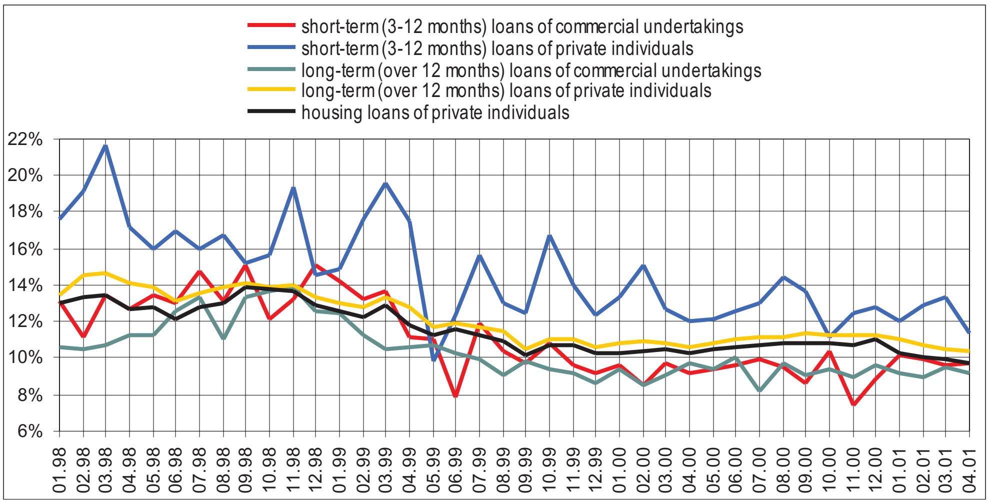

Figure 4.19. Interest rates of residents' loans

The impact of the ECB interest rate cut[7] on domestic bank interest rates will probably be modest although this spread fast to Estonia's inter-bank money market (see Figure 4.1, p 32). The modest impact is due to the low ECB interest rate cut and larger interest cut expectations integrated by markets into longer maturity already previously.

[7] The European Central Bank cut rates by 25 basis points on 11 May this year.