IV
MONETARY ENVIRONMENT

Liquidity Environment and Interest Rates

In the third quarter, Estonia's monetary environment remained stable, as slightly recovering economy of industrial countries allowed both the US and euro area to maintain monetary policy interest rates on the level of the second quarter. Various preliminary indicators suggest economic pick-up to continue also in 2004; and, therefore, according to the markets, the interest rate decline has come to a halt and interest rates are anticipated gradually to pick up (see Figure 4.1).

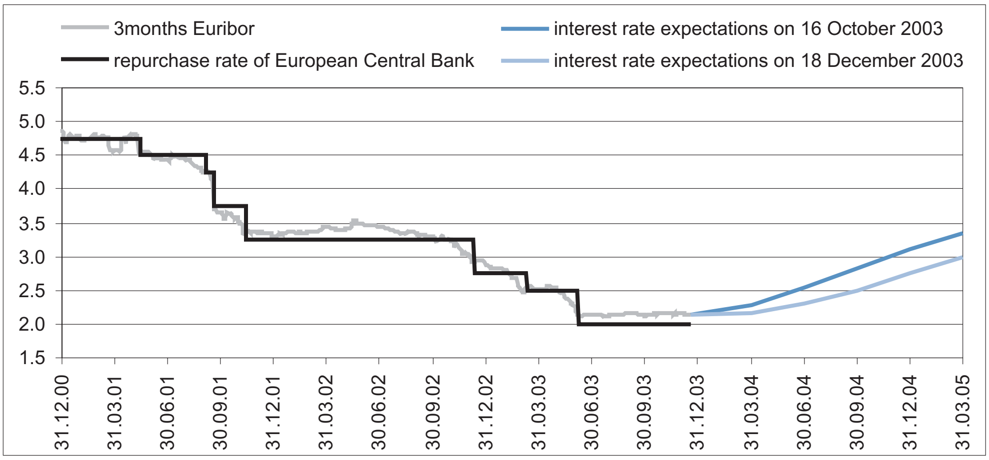

Figure 4.1. Repurchase rate of the European Central Bank and expectations of 3months Euribor in futures market

The euro area stable interest rate environment sustained Estonian money market interest rates without major changes throughout the third quarter (see Figure 4.2). Contemporaneously, the

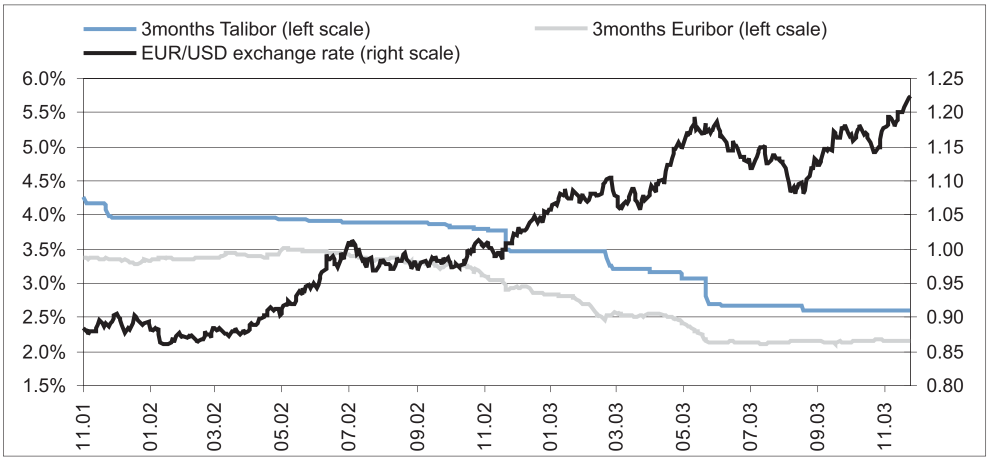

Figure 4.2. 3months money market interest rates of the Estonian kroon and euro and EUR/USD exchange rate (%)

exchange rate of the euro against the US dollar has been strengthening significantly since September and could affect euro area economic growth, weakening thus demand at Estonia's export markets.

Due to euro area interest-rate lows, Estonian real sector's interest rates reached the lowest level in July-August, but recovered slightly in October. In November, the weighted average interest rate of long-term loans for households was 5.6% and for corporate clients 5.1%. The weighted average interest rate of Estonian real sector's kroon deposits has settled at 2.4% since September (see Figure 4.3).

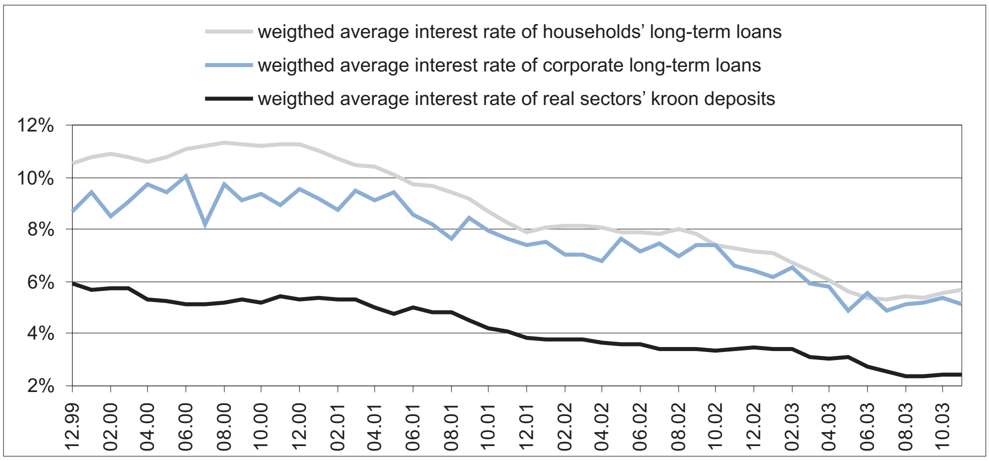

Figure 4.3. Interest rates of domestic real sector

Capital Flows

In the third quarter, Estonia's current account deficit reached 3.9 billion kroons; the inflow of capital remained high (3.7 billion kroons). In sum, foreign exchange reserves of Eesti Pank increased by 613 million kroons as recorded in the balance of payments.

In the third quarter, the share of foreign direct investment in capital inflow was slightly down from the first half of the year, reaching 1.7 billion kroons by express evaluation. FDI accounted for an estimated 45% of total capital inflow. The share of other investments in capital inflow reached 3.1 billion kroons in the third quarter. Credit institutions were responsible for a major part as their external liabilities were up 1.9 billion kroons. Thereby time deposits of foreign credit institutions with Estonian banks increased, indicating that primarily they were funds involved from parent banks. At the same time, credit institutions external claims shed 1.8 billion kroons and net capital inflow via the banking sector reached an estimated 3.7 billion kroons in the third quarter. In end-September the need for refinancing was estimated to up to a billion kroons in the fourth quarter.

Monetary and Loan Aggregates

In 2003, money supply remained stable in the third quarter, although the structure of monetary aggregates changed slightly. The preferential growth of demand deposits accelerated the annual growth rate of the narrow monetary aggregate M1 to 18% by the end-third-quarter. The annual growth of the monetary aggregate M2 remained modest against the end of the second quarter (9.6%), as comparison base – the third quarter of 2002 – was very high. In October, the annual growth of monetary aggregates did not change considerably (see Figure 4.4).

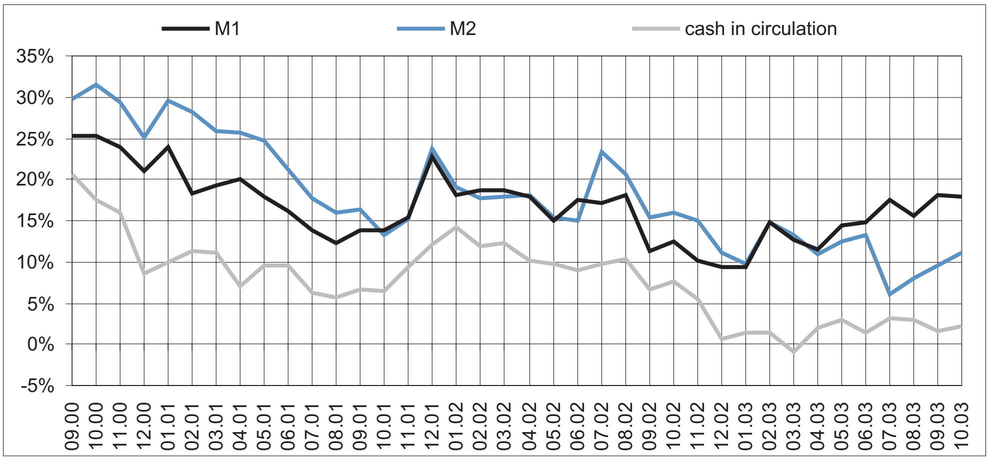

Figure 4.4. Money supply against the respective month of previous year

The following modifications took place in the structure of the monetary aggregate M2: the gradually growing share of demand deposits, sustained through the second quarter of 2003, stabilised at the level of 57%, the share of time deposits dropped to 27%. The share of time deposits in M2 has contracted primarily as the stock of households' time deposits shrank. Evidently, this suggests a lower household saving level, as besides bank deposits no other type of saving has increased, either (investment funds, etc).

In the third quarter, domestic real sector deposits displayed growth among the lowest (0.4 billion kroons) of the recent years, partially due to seasonal factors. All in all, deposit growth has been slowing down in the third quarter since private persons' deposits decreased as a result of sustained decline in the stock of time deposits and the contraction reached record high in recent years. Increment in corporate demand deposits, comparable to second-quarter level, inhibited the deposit growth slowdown in the entire sector. Also in October, real sector depositing added over a billion kroons, primarily due to unusually large growth in corporate deposits (0.8 billion kroons). Households' demand deposits underwent a slight growth as well, whereas demand deposits shrank again.

Further slowdown in depositing boosted domestic real sector debt burden (bank loans, leasing and factoring) by 3.6 billion kroons in the third quarter. The level was all-time high, first and foremost, because of persistently active borrowing for housing (see Figure 4.5).

The resident real sector annual debt burden reached 25.4% by end-third quarter. The growth relied on slightly accelerating annual growth rate of corporate debt burden, whereas household debt burden settled at the level of the end-second quarter, despite soaring stock (see Figure 4.6). In October, real sector debt burden sustained rapid growth (1.4 billion kroons), accelerating slightly also the annual growth rate.

At the beginning of the academic year, besides housing loans also study loans, contained on the year-on-year level, contributed to the increase in the household debt burden in the third

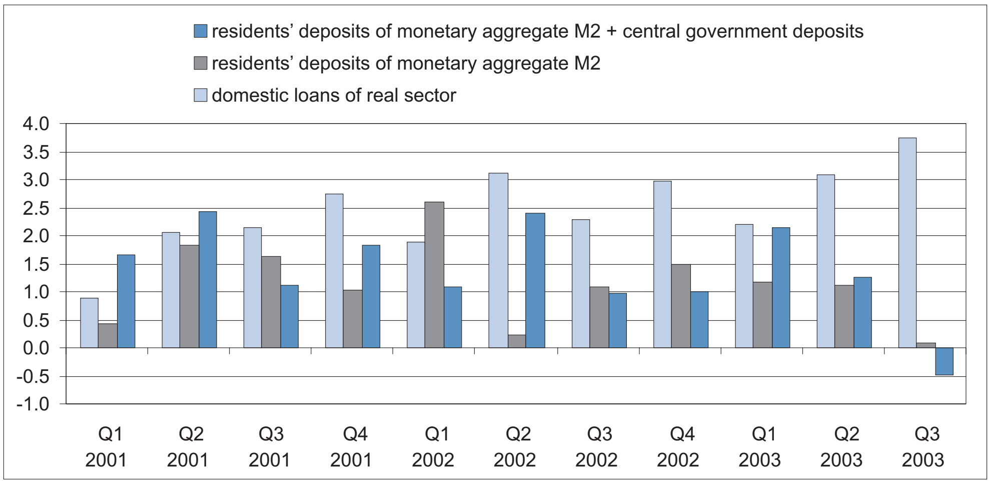

Figure 4.5. Quarterly growth of residents' deposits and domestic loans of real sector (EEK billion)

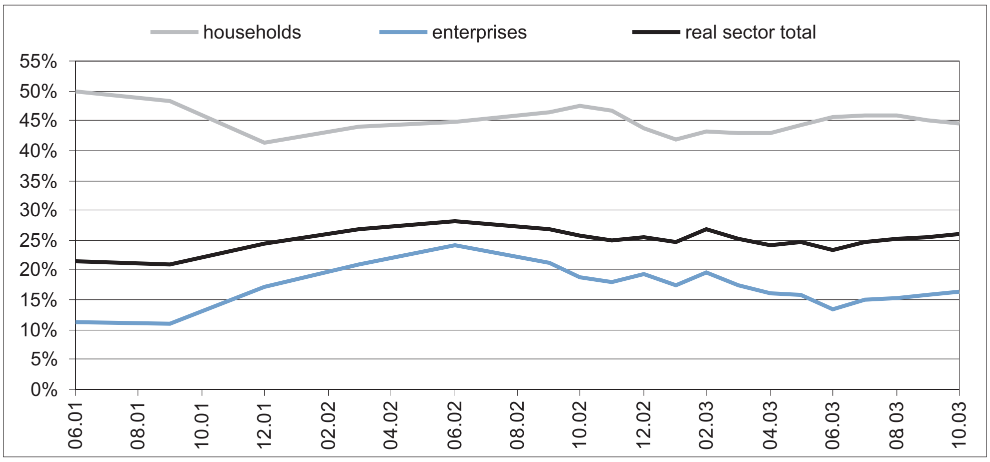

Figure 4.6. Financing of domestic real sector by financial sector (annual growth)

quarter. **Persistently soaring household debt burden and inhibited depositing turned households for the first time into net borrowers for the banking sector** (the loan stock exceeded the stock of deposits by 1.1 billion kroons in end-September). In October, the household debt load recorded an all-time high growth of 1 billion kroons, of which loans and leasing to purchase real estate accounted for 0.7 billion kroons, study loans for 0.1 billion kroons.

Corporate debt burden underwent a relatively large growth in the third quarter as well (about 40% of the total real sector's debt growth). As a result, the annual growth of corporate debt reached 15.8% by end-quarter. One of the highest increases recorded in the recent years derived from financing of corporate real estate purchases, also the leasing stock of transport and trade increased more than before. Borrowing by manufacturing remained modest. In October, the annual growth of corporate debt burden picked up but debt as a whole grew moderately (0.4 billion kroons). Real estate, leasing and business service companies accounted for 97% of the total growth.