IV MONETARY AND FINANCIAL SECTOR

Liquidity environment and domestic financial markets

Compared to 2005, interest rates have increased slightly both in the euro area as well as in Estonia, but the **monetary environment still remains favourable for economic activity**. **The liquidity of the Estonian financial sector continues to be high** in the context of low interest rates. The share of liquid assets in the balance of banks rose to 26% by the end of February 2006. Also the liquidity of the kroon stays high. Banks have had no problems with meeting the reserve requirement.[1]

Estonian money market interest rates have developed in line with the dynamics of euro area interest rates. As the European Central Bank (ECB) raised key interest rates in December 2005 and March 2006, money market interest rates increased both in the euro area as well as Estonia (see Figure 4.1). The increase of quotations was timed differently in Estonia and the euro area, and therefore the difference between money market interest rates turned temporarily negative for a few weeks prior to the decisions to raise key interest rates. In the second half of March, the difference between interest rates on money market loans with varying maturities in Estonia and the euro area stabilised at 13–20 basis points. This is comparable to the level of 2005 before the emergence of interest rate rise expectations.

The rise of interest rates in the euro area also caused an **increase in the interest rates on loans and deposits granted to Estonian enterprises and households**. The weighted average interest rate on long-term household loans rose to 5.4% in February 2006 (4.0% in September 2005), including the interest rate on housing loans which increased to 3.7% (in October 2006 it decreased by 0.1 percentage points to 3.2%). The average interest rate on long-term corporate loans rose to 4.5% in January 2006 and declined to 4.3% in February. The weighted average interest rate on long-term kroon deposits in the non-financial sector[2] increased to 2.9% in February 2006 (see Figure 4.2).

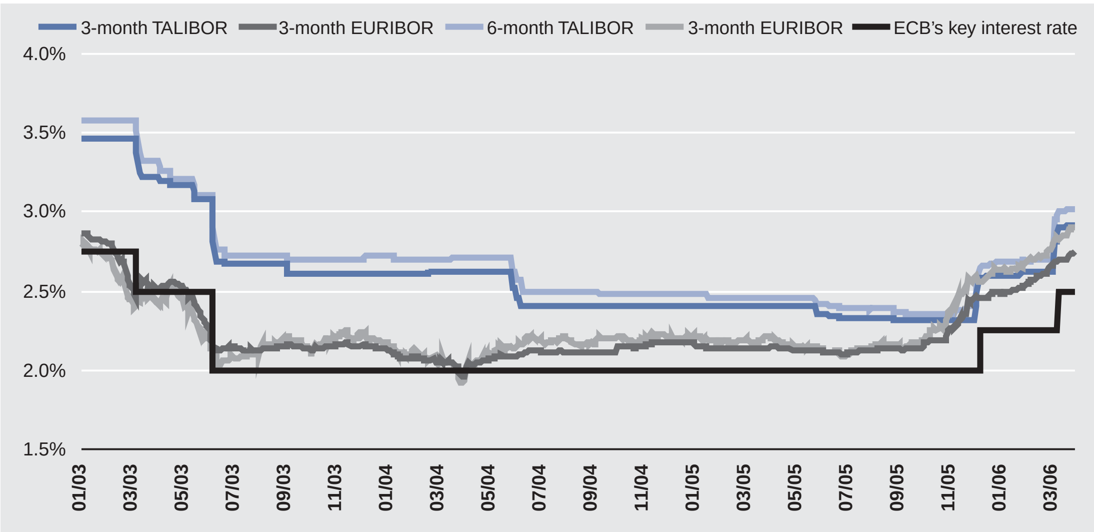

Figure 4.1. ECB's key interest rate and money market interest rates of the Estonian kroon and the euro

[1] In January 2006, the balance of the settlement account of one bank fell below the daily minimum level. This was a minor technical error (over 90% of the required minimum level was met).

[2] Non-financial sector refers to households and non-financial corporations.

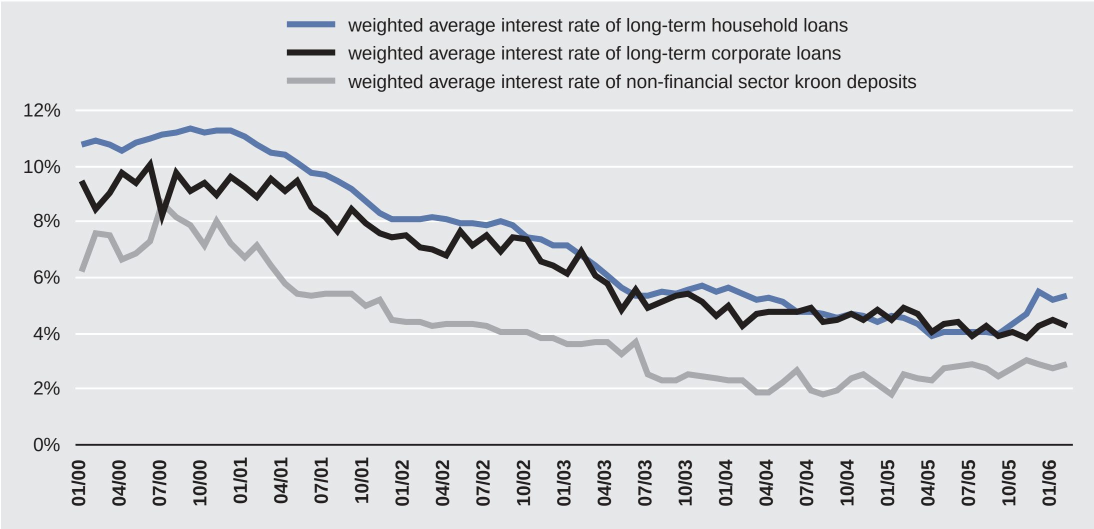

Figure 4.2. Interest rates of domestic non-financial sector

The **primary bond market** remained relatively subdued in the second half of 2005 and at the beginning of 2006. The secondary market was volatile as usual by months; the turnover was relatively high in September and December 2005. After the delisting of Hansapank from the stock exchange, trading on the **stock market** gained momentum again at the end of 2005 and at the beginning of 2006. Share prices reached their peak in September 2005, which was followed by a gradual decrease. At the beginning of 2006, share prices showed no common tendency: some rose, some fell.

Money supply

In the second half of 2005 and at the beginning of 2006, the **money supply growth accelerated even further**. Compared to the beginning of 2005, the annual growth rates of the intermediate (M2) and the narrow (M1) monetary aggregate are approximately 2.5 times higher, reaching 44% and 39% respectively in February 2006 (see Figure 4.3).

After large receipts in the second quarter of 2005, which were related to the sales of Hansapank's shares, the annual growth of monetary aggregates picked up at year-end primarily due to the **strong growth of corporate deposits**. The annual growth of corporate deposits reached 67% in February 2006, as demand deposits and time deposits increased fast in the fourth quarter of 2005. The growth of household deposits has also accelerated slightly, reaching 34% at the end of February. At the end of 2005 and at the beginning of 2006, demand deposits experienced the strongest growth, whereas time deposits started to increase fast at the beginning of 2006. The annual growth of currency in circulation has stabilised at 12-13% after a gradual pick-up from the beginning of May 2005 which lasted for almost a year.

Financing the non-financial sector

The **domestic financing**[3] **of the non-financial sector** continued rapid growth at the end of 2005 and at the beginning of 2006. After a record growth (11.9 bn kroons) in the second quarter of 2005, it slowed down slightly in the third quarter, but reached another peak in the fourth quarter (13.9 bn kroons). Active borrowing continued at the beginning of 2006 (see Figure 4.4).

[3] Includes bank loans and leasing.

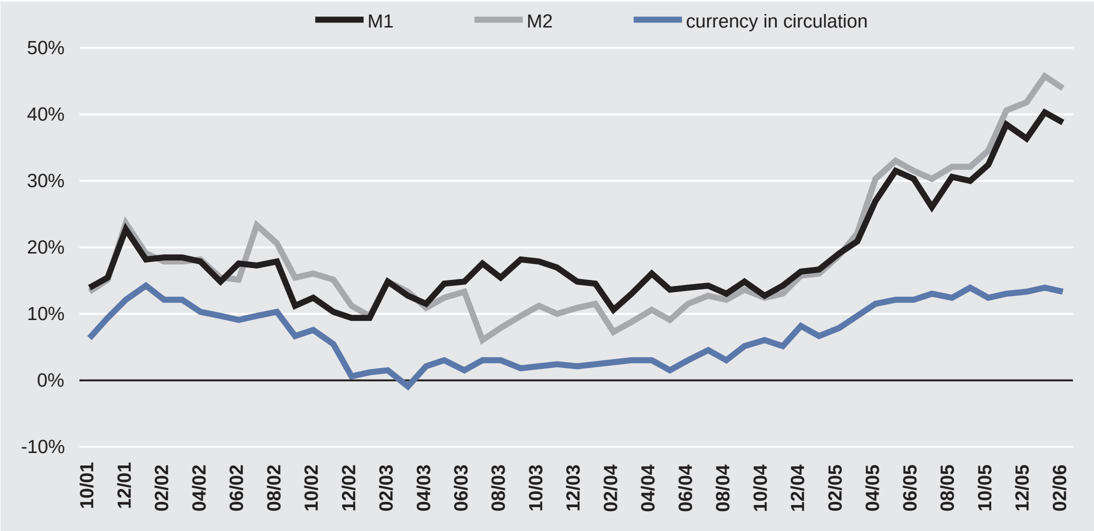

Figure 4.3. Annual growth in money supply

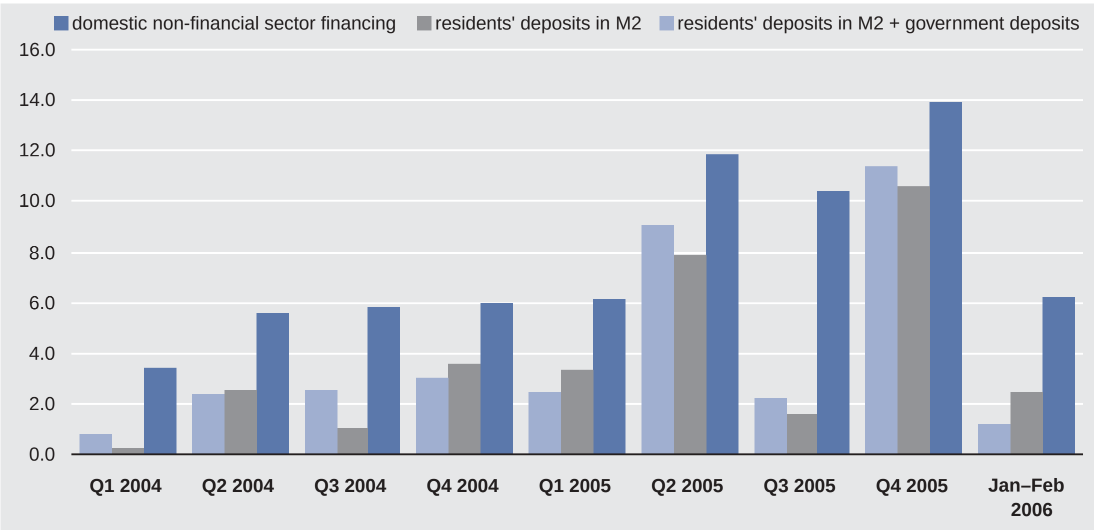

Figure 4.4. Quarterly growth in residents' deposits and domestic non-financial sector financing (EEK bn)

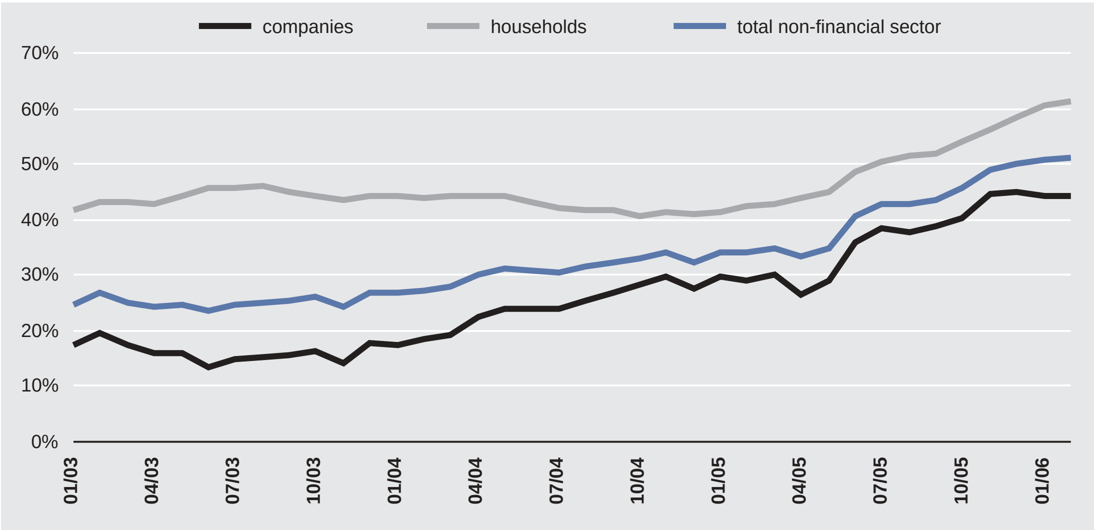

Figure 4.5. Domestic bank loans and leasing of resident non-financial companies and households (annual growth)

The annual growth of the non-financial sector's domestic financing gradually picked up to 51% from June 2005 to February 2006. The annual growth of domestic corporate financing stabilised at 44%, while that of household loans and leasing reached 61% (see Figure 4.5).

Corporate and household loans and leasing have gained quite similarly by quarters. By fields of activities, as of September 2005 the credit to real estate companies again grew the most. The loan growth of trading companies has been fast as well. In recent months, also the loan and leasing volume of manufacturing companies has increased more than in earlier periods. Household loans are still dominated by real estate loans, which have receded to the level of the second quarter after their robust growth in the fourth quarter of 2005. Other household loans increased rapidly as well.

Capital flows

The net capital inflow picked up strongly in the second half of 2005, reaching 11.7 billion kroons (the total of 2005 was 20.2 bn kroons). The net capital inflow mainly relied on credit institutions' capital attracted through loans and deposits of foreign banks. In the second half of 2005, some capital net outflow was experienced among direct as well as portfolio investment in relation to the growth in foreign investment of Estonian residents.

The volume of external liabilities as well as external assets grew considerably in the banking sector in the fourth quarter of 2005 and at the beginning of 2006. The total volume of banks' net external debt reached its peak in November 2005 (51 bn kroons). It decreased at the end of the year, but reached 49 billion kroons again at the beginning of 2006. The volume of external resources decreased slightly at year-end due to the robust rise of deposits in the non-financial sector. Although deposits grew significantly, the share of institutional foreign borrowing remained at 40%.