IV MONETARY AND FINANCIAL SECTOR

Liquidity environment and domestic financial markets

Since September 2005 when quotations on the euro money market started rising in the expectation of an interest rate increase, the 6-month Euribor serving as the basis for Estonian housing loans has rose by almost 1.5 percentage points.

Despite the gradual rise in euro area monetary policy rates, the Estonian monetary environment has remained expansive. Quotations on the Estonian money market have generally stayed in line with the dynamics of euro area money market interest rates. Nevertheless, the reaction of Talibor to the increase in the euro area interest rates has been relatively slow, owing to the low activity of the Estonian money market. Estonian money market interest rates rose by an average of one percentage point compared to the beginning of the year (see Figure 4.1).

The **primary bond market** was quite active in the first half of 2006 and in autumn. Bond market capitalisation increased to a record 7 billion kroons by the end of August.

Global stock markets saw a decline and thus also the value of the Tallinn Stock Exchange index OMXT fell by 8% during the first half-year, but then started to increase again. The decrease in total capitalisation at the stock exchange was slightly offset by listing the shares of the construction company AS Eesti Ehitus. In autumn, the shares of Olympic Entertainment Group incorporating casino businesses were listed. The secondary bond and stock markets were volatile as usual.

Interest rates on long-term loans granted to the non-financial sector[1] have followed the dynamics of the 6-month Euribor just as expected. Compared to the lowest interest rates of 2005, interest rates on long-term loans to the non-financial sector have increased by an average of 1.5 percentage points. Interest rates on housing loans grew even further in the third quarter, reaching 4.4% in September. The average interest rate on all long-term household

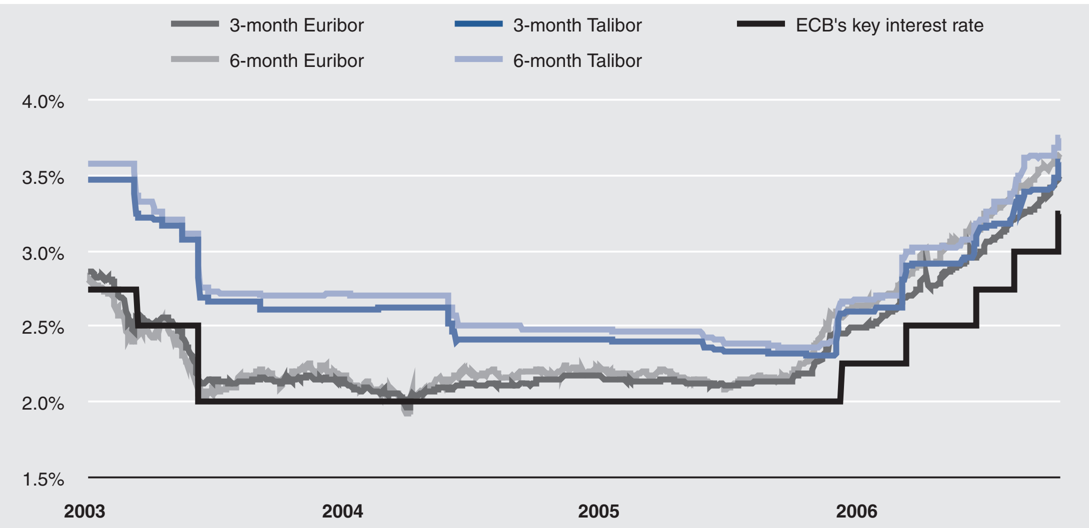

Figure 4.1. ECB's key interest rate and money market interest rates of the Estonian kroon and the euro

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

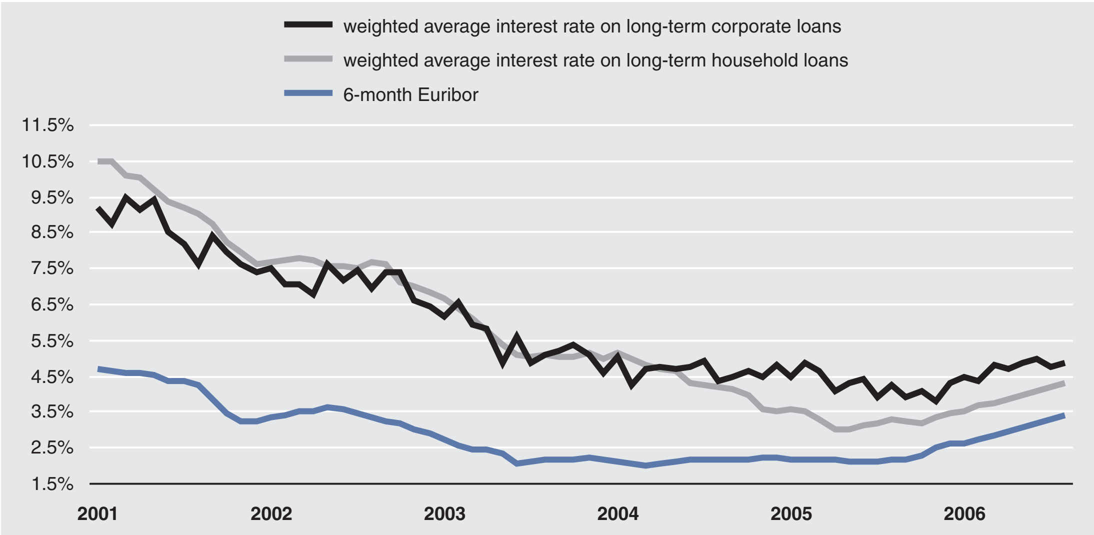

Figure 4.2. Interest rates of the domestic non-financial sector

loans increased to 5.8% in September, whereas the average interest rate on long-term corporate loans reached 5.1% (see Figure 4.2). The further growth of interest rates on loans granted to the non-financial sector should also be fostered by **raising the minimum reserve requirement ratio for banks**. The new ratio entered into force on 1 September 2006.[2]

Money supply

The money supply growth remained strong in the first half of 2006. The annual growth in the intermediate monetary aggregate (M2) stood at an average of 38% in the first and second quarter of 2006, while that of the narrow monetary aggregate (M1) was 35% (see Figure 4.3).

The growth of M2 continued to be influenced mostly by its liquid components, i.e. currency in circulation and demand deposits. Due to the beginning of the summer vacation period, the second quarter witnessed a larger than expected increase in the currency in circulation, namely by 0.7 billion kroons.

In the second quarter, the demand deposits of the non-financial sector grew by a total of 6 billion kroons, whereas the share of households was more or less equal with that of companies. In the third quarter of 2006, the respective increase of 1.7 billion kroons was slightly more modest compared to the second quarter. This was mainly related to an increase in the stock of corporate demand deposits.

The time deposits of the non-financial sector grew relatively modestly in the second quarter, but increased by 1.7 billion kroons in the third quarter. This resulted mainly from an increase in the stock of household time deposits (by 1.4 billion kroons), which shows that saving has increased.

Non-financial sector borrowing

The **loan and leasing stock of the non-financial sector** set a new record in the second quarter of 2006, increasing by a total of 18.8 billion kroons quarter-on-quarter. Despite such remarkable growth indicators, the annual growth of the non-financial sector's domestic financing[3] slowed down

[2] See background information "Measures of Eesti Pank implemented in 2006" on page 7.
[3] Includes bank loans and leasing.

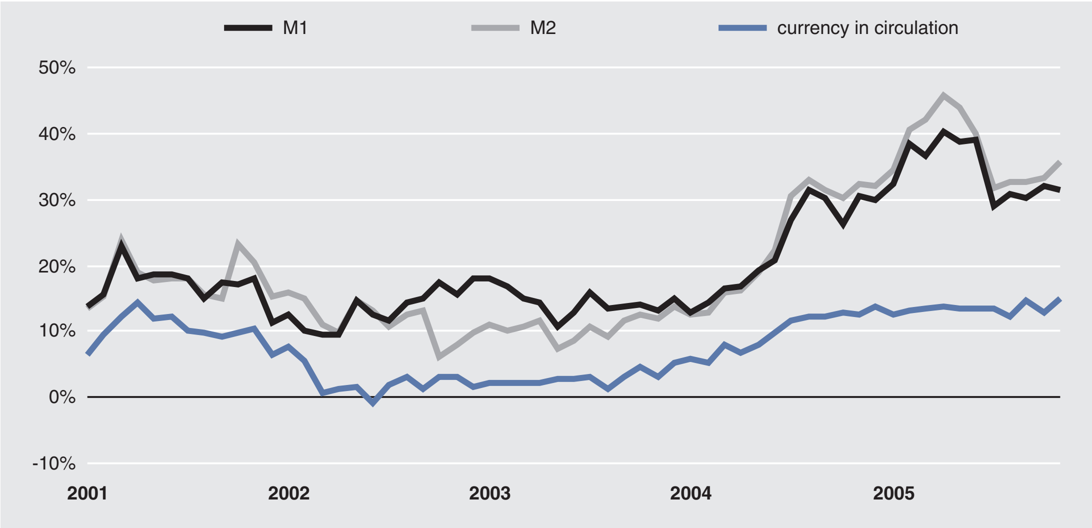

Figure 4.3. Annual growth in money supply

slightly by the end of the second quarter, amounting to 52.7% in June. In July and August, the loan and leasing stock grew by nearly 11 billion kroons and year-on-year growth picked up to 53.9% by the end of August.

The **stock of household loans and leasing** increased by 7.8 billion kroons in the second quarter and by another 5.6 billion kroons in July and August. Due to the high basis of comparison, the annual growth of domestic household financing has still decelerated by 2 percentage points compared to record levels in the first quarter of 2006. As expected, the year-on-year growth of household loans and leasing consisted mostly of housing loans, which increased by 6 billion kroons in the second quarter. The rapid growth of housing loans continued in July and August, when the loan stock grew by approximately 4 billion kroons. In addition, the share of other loans in the annual growth of household financing has risen further. As to the increase in other loans, household consumer credit prevailed. In the second quarter, consumer credit increased by 1.1 billion kroons (up to 6.1 billion kroons) and year-on-year growth accelerated to 92.6% by the end of the quarter.

The **stock of corporate loans and leasing** soared by a record 11 billion kroons in the second quarter. Consequently, compared to the end of the first quarter also the year-on-year growth of domestic corporate financing accelerated by 2.6 percentage points, i.e. to 47.3%. In July and August, the corporate loan and leasing stock increased by an additional 5 billion kroons and the year-on-year growth accelerated to 48.7% by the end of August. By sectors, approximately 90% of the growth in the stock of corporate loans and leasing derived from an increase in the non-tradable sector which is oriented to the domestic market. The majority of the stock consisted of loans and leasing to the real estate sector. The volume of loans and leasing of export companies increased modestly compared to that of the non-tradable sector. A slight acceleration in the year-on-year growth of domestic financing in manufacturing could be detected (see also Figures 4.4 and 4.5).

Capital flows

The **rapid inflow of foreign capital** continued in the first half of 2006. The foreign exchange reserves of Eesti Pank grew by 1.8 billion kroons in the second quarter. The net capital inflow mainly

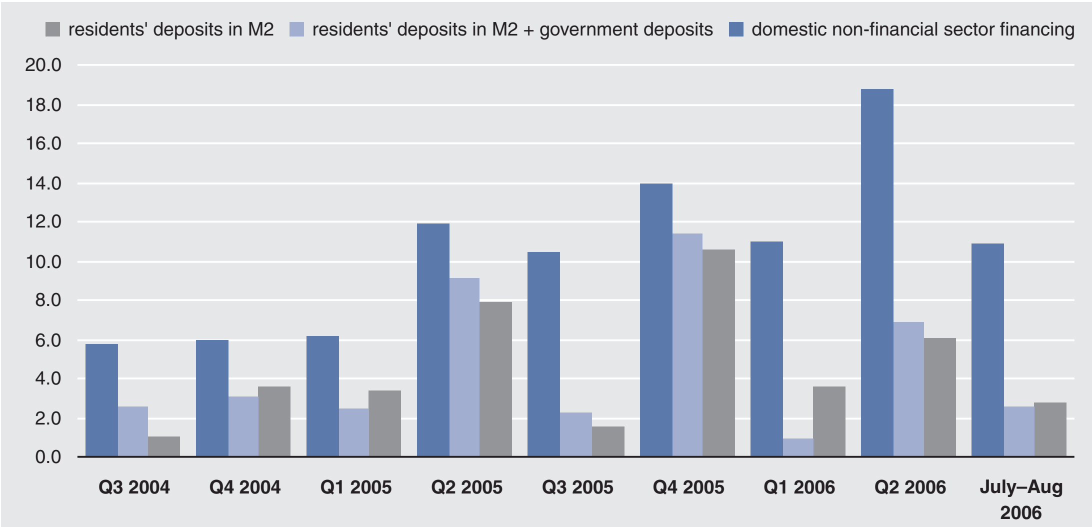

Figure 4.4. Quarterly growth in residents' deposits and domestic non-financial sector financing (EEK bn)

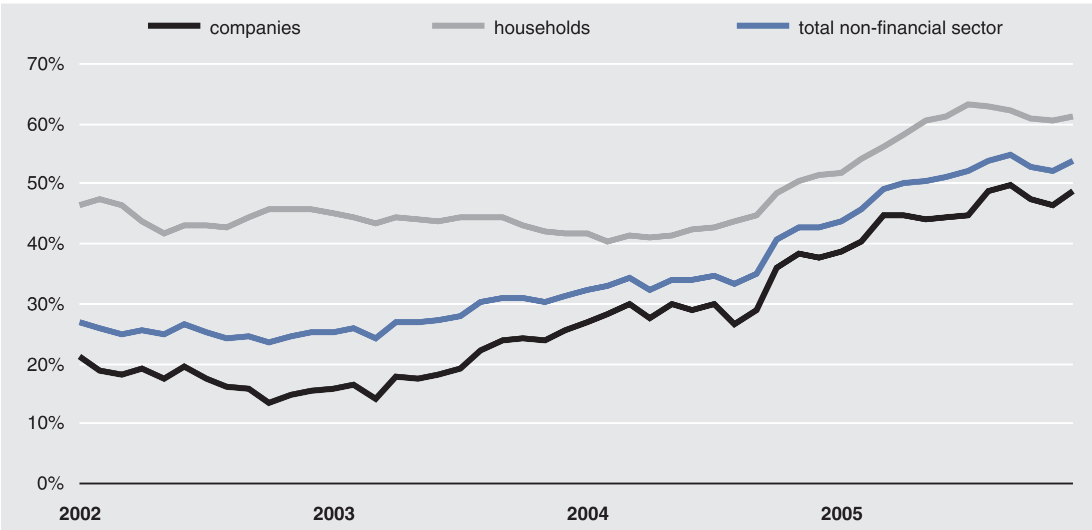

Figure 4.5. Domestic bank loans and leasing of resident non-financial companies and households (annual growth)

relied on credit institutions' loans and deposits. The net capital inflow via the banking sector reached 7 billion kroons in the second quarter. Banks' external assets decreased by 3 billion and external liabilities increased by 4 billion kroons. As for direct and portfolio investment, a slight net capital outflow occurred in the second quarter of 2006 owing to the increased foreign investment made by Estonian residents. This happened due to the general government budget surplus as well as banks' decision to increase the equity capital of their subsidiaries in Lithuania and Latvia.