II. ESTONIAN REAL ECONOMY AND FINANCIAL SECTOR

REAL SECTOR

According to the majority of analysts, Estonia's current potential annual economic growth is 5–6%. **Despite weak external demand, GDP increased by 5.8% in 2002.** Both domestic demand and higher private sector borrowing activity sustained the growth. Together with single large investments (in Estonian context) this delivered more than a 4-percentage-point growth difference with the euro area and large variance in growth rates by quarters.

Although the economic growth was accompanied by current account deficit exceeding 12% of GDP, Estonia and its economy were increasingly credible due to the integration into the European Union and NATO. This was sustained also by the 1.2% government surplus and inflation rate drop to 3.6%[1]. Estonia's high reputation is also reflected in country ratings assigned by leading rating agencies in the world.

The annualised EU economic environment was the worst of the recent years for Estonia. **The weighted average growth rate of the economy of Estonia's main trading partners remained almost on the level of 2001 and was still substantially faster than the EU indicator.**

SOVEREIGN RATINGS: ESTONIA AND OTHER EU ACCESSION COUNTRIES

In 2002, all three leading rating agencies were of the same opinion of Estonia's sovereign rating. While in 2001 two rating agencies (Standard & Poor's and FitchRatings) had lifted Estonia into the highest group, the so-called A group, in 2002 the third rating agency (Moody's) did the same. All rating agencies outlined in reports drafted or visits made in 2002 the banking system and low national debt as strengths and current account deficit (and more broadly trade disequilibrium) as well as supplementary budget expenditure (two supplementary budgets in 2002) as problematic. Estonia as a future EU Member State faces an important task to increase

[1] In December 2002 against December 2001.

administrative capacity. The methodology the rating agencies apply to define foreign currency and local currency credit ratings varies somewhat by agencies:

1) S&P was the first rating agency to assign equal ratings to Estonia's kroon liabilities and foreign currency liabilities in November 2001 (previously, Estonia's foreign currency credit rating was a notch lower). According to the agency, this is their approach to all countries, which have a mid-term outlook to join EMU;

2) In November 2002, Moody's Investors Service informed of upgrading long-term foreign currency credit rating to long-term local currency credit rating. This was due to the change in Moody's rating policy and the prerequisite for the rating was joining EMU in the mid-term perspective;

3) FitchRatings continues monitoring the development of accession countries one by one and takes gradual decisions.

Table 2.1 displays EU accession countries' ratings.

Table 2.1. Ratings assigned to the EU accession countries by rating agencies as of 28 February 2003 (long-term foreign currency liabilities rating, it's perspective and short-term foreign currency liabilities rating)

Country	Moody's	Standard & Poor's	FitchRatings
Bulgaria	B1/positive/NP	BB/positive/B	BB/positive/B
Cyprus	A2/stable/P-1	A/stable/A-1	A+/stable/F1
Czech Republic	A1/stable/P-1	A-/stable/A-2	BBB+/stable/F2
Estonia	**A1/stable/P-1**	**A-/stable/A-2**	**A-/stable/F1**
Hungary	A1/stable/P-1	A-/stable/A-2	A-/stable/F2
Latvia	A2/stable/P-1	BBB+/stable/A-2	BBB/positive/F3
Lithuania	Baa1/stable/P-2	BBB/stable/A-3	BBB/stable/F3
Malta	A3/negative/P-2	A/stable/A-1	A/stable/F1
Poland	A2/stable/P-1	BBB+/stable/A-2	BBB+/stable/F2
Romania	B1/stable/NP	B+/positive/B	BB-/stable/B
Slovakia	A3/stable/P-2	BBB/positive/A-3	BBB-/positive/F3
Slovenia	Aa3/stable/P-1	A/positive/A-1	A/positive/F1

Monetary Environment

Unrealised global growth expectations and sharply increased geopolitical uncertainty made central banks lower benchmark rates in end-2002. Increased credibility of the state and its economy as well as accompanying shrinking risk premium amplified transmission of external interest rate signals to Estonia. As a result, **Estonia's interest rates fell and margin with euro interest rates was at the historic low** (see Figure 2.1).

Close inter-bank competition to expand credit base took also the credit price for Estonia's real sector to the lowest ever. At the end of 2002, the average interest rate of long-term real sector loans was 6.5%, being 1.1 percentage points below the year-ago level and 2 percentage points above the Finnish indicator.

Favourable credit conditions accelerated the annual growth rate of real sector domestic debt burden to 25.6% and for the first time after 1998 domestic savings did not cover credit demand. The annual growth rate of

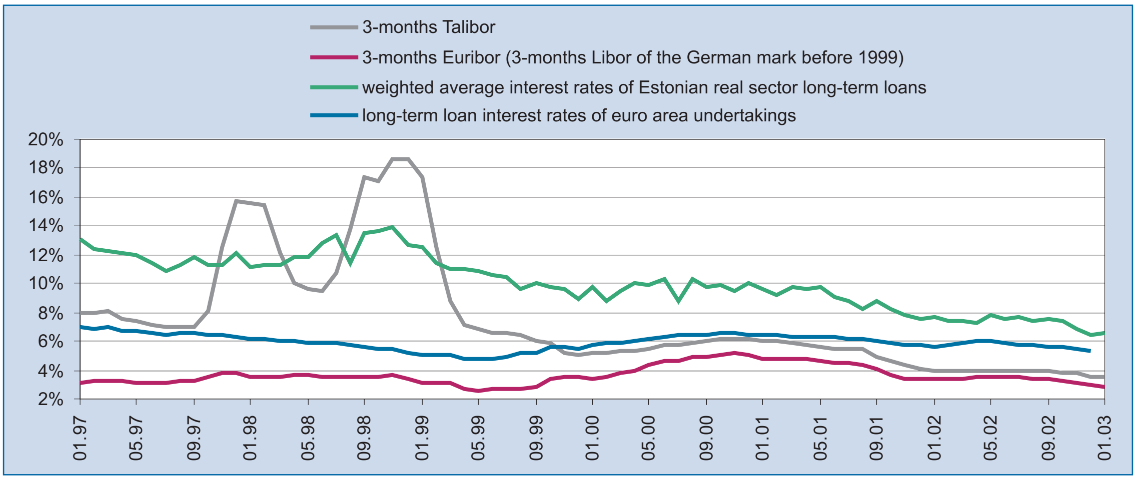

Figure 2.1. Money market interest rates of Estonia and the euro area and interest rates of Estonia's real sector long-term loans

money supply M2 shrank by 12.6 percentage points – to 11.1% and the financial sector used part of its previous reserves and borrowed from external markets to finance credit growth.

External and Domestic Demand

Weak external demand was best reflected in Estonia's deteriorating terms of trade and recession in subcontracting. During the first three quarters of 2002, prices of export goods decreased on the average by 4.1% and prices of import goods increased by 1.4%. The volume of subcontracting in current prices remained 22% below 2001.

Despite low external demand, the growth rate of Estonia's normal export (export of goods without subcontracting) **in current prices was as rapid as in 2001**, reaching 11% and exceeding considerably trade partners' average growth of import volumes. This indicates that trade turnover of Estonia's main trading partners grew above the EU average and **the market position of Estonian goods with higher value added strengthened**. In 2002 the export of raw materials continued to decline, reaching 7.5% of normal export (see Figure 2.2).

Timber industry, with its exports growth maintained at 15% in current prices throughout the year, played an important role in sustaining normal export growth rates. Earlier investments were yielding results and ensured higher level of processing. Also rapid growth in **furniture** exports, which had started a year ago, continued. These two industries were responsible for a half of the growth in normal exports. Apart from that, export of some other industries increased in summer months as well. Export quantities of other product groups (foodstuffs, textiles, garments) in Estonia's goods export remained stable throughout 2002, nominally exceeding the level of end-2001 only slightly (see Figure 2.3). The growth of direct exports was also relatively smooth across major exports markets.

Compared to the demand in major goods markets, terms for growth in services export were more favourable in 2002. World oil prices remained high and Russia was continuously increasing export of various types of fuel. Transit trade raised the nominal growth of Estonia's transport services export by about 90% in the first three quarters. Thereby, services export grew by 16% in constant prices, exceeding the year-ago period in 2001 by four percentage points.

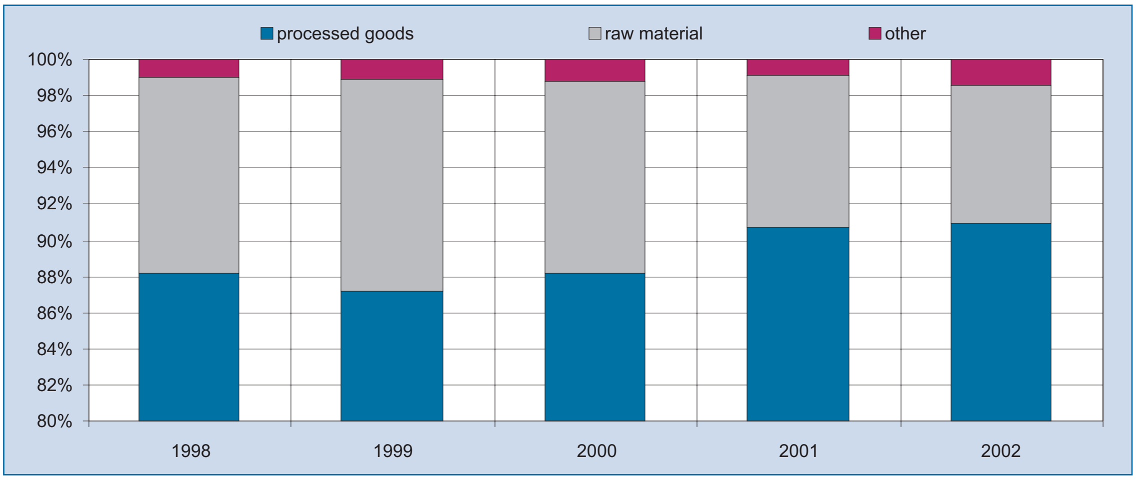

Figure 2.2. Structure of Estonia's normal export[1] by processing level

[1] Export of goods without subcontracting.

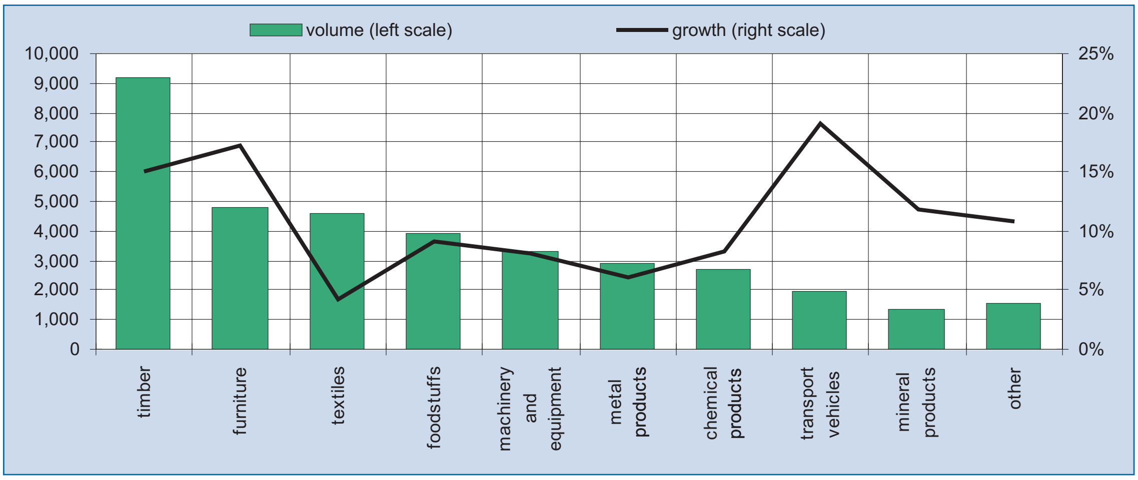

Figure 2.3. Volume (EEK m) and nominal growth (%) of normal export by groups of goods in 2002

Unlike recession in export earnings, other domestic-demand-influencing factors were more expansive in 2002. Characteristic features involved record favourable credit conditions and implementation of investment projects, large in the Estonian context, accompanied by higher domestic demand growth against exports.

Similar to 2001, also in 2002 the growth of domestic demand was primarily sustained by investments, which together with stock building gained 23% in constant prices over nine months. Although some flying investment projects aroused suspicion about their efficiency, sustained investment growth showed that even under cyclical recession of external demand the supply-side of the economy strengthened and potential increased. Besides investment activity, the favourable interest environment encouraged also private consumption, which accelerated to 12% in the third quarter and reached 8.5% in nine months (see Figure 2.4).

Rapidly growing domestic demand and investment activity was reflected in the production side of the GDP throughout 2002. During nine months, value added increased in the construction sector by more than 15% and in trade by about 10% (see Table 2.2).

Throughout 2002, the number of the employed was above the previous year and an average of 8,000 persons was employed more than a year ago. New jobs in trade and real estate had contained the

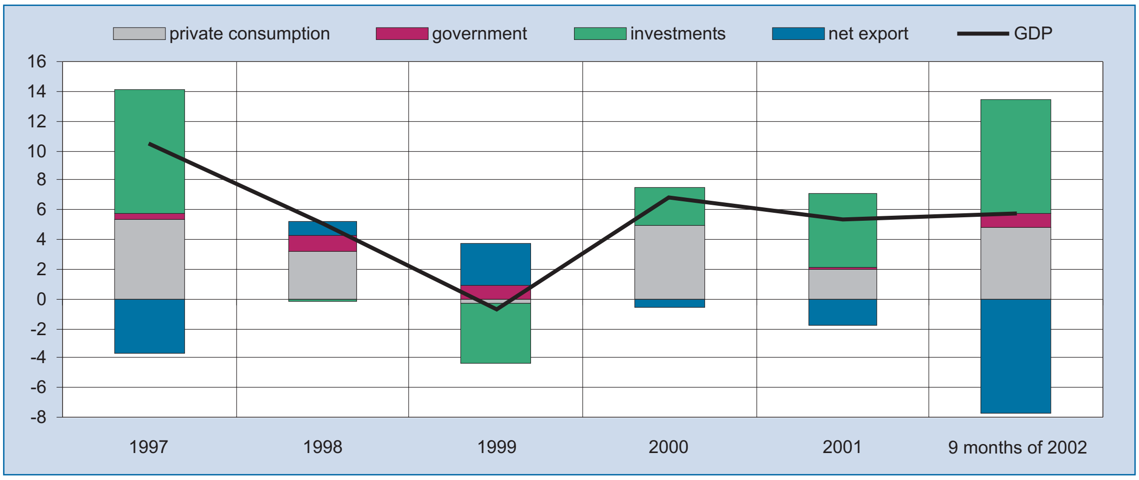

Figure 2.4. Share of GDP consumption components in the economic growth (in percentage points)

Table 2.2. Change of value added by spheres of activity in 2001 and during 9 months of 2002

	2001	9 months of 2002
Agriculture and hunting	-9.3%	-5.3%
Forestry	-2.9%	2.9%
Fishing	-6.1%	7.0%
Mining	10.0%	13.1%
Manufacturing	8.2%	9.7%
Electricity, gas and water supply	-0.7%	-3.8%
Construction	1.6%	15.2%
Wholesale and retail trade	8.1%	9.8%
Hotels and restaurants	2.0%	11.3%
Transport, storage and communication	9.3%	3.5%
Real estate, leasing and business services	4.7%	1.4%
Financial intermediation	7.6%	8.3%
Public administration	0.8%	1.8%
Education	0.7%	0.9%
Health care and social work	0.4%	-1.0%
Other services	2.1%	2.6%
GDP total	**5.0%**	**5.7%**

unemployment rate for the first time since the Russian crisis of 1998 below 10% (to 9.1%). Unlike previous years, cyclical factors had a pronounced impact – the number of jobs in the service sector went up and in the open sector – down. Therefore, employment indicators were really turbulent by quarters.

Employment growth, sustaining the 2001-trend, strengthens confidence that transition processes have come to the end also in the labour market. In short and longer term, the further growth in open sector productivity as well as in general purchasing power will encourage labour demand in different fields of the sheltered sector.

Sources of Financing Economic Growth

The growth of investments to about 30% of GDP was accompanied by a soaring current account deficit in 2002. The involvement of the largest external resource since 1997 took the deficit to more than 12% of GDP (see Figure 2.5).

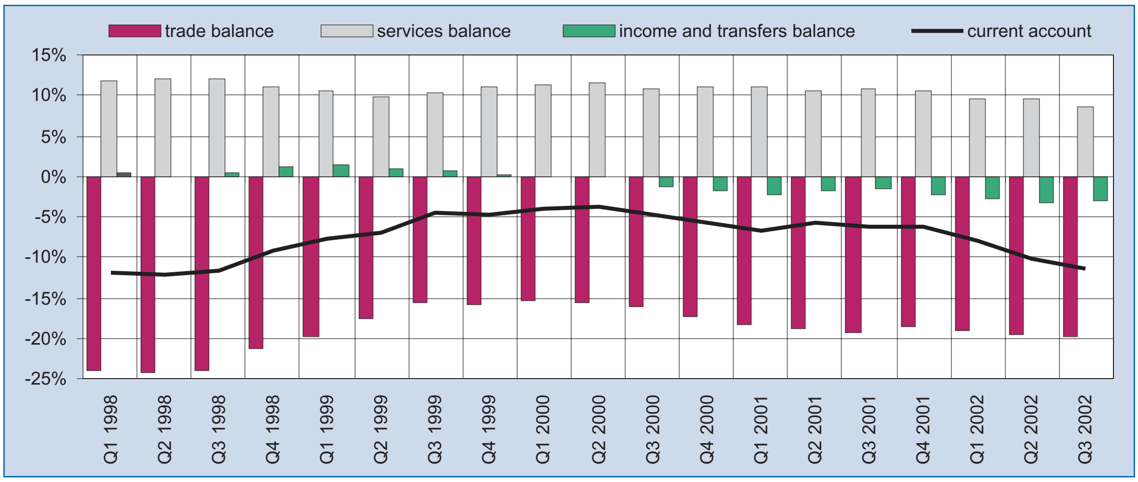

Figure 2.5. Current account and sub-balances of Estonian balance of payments, sliding average of last four quarters (% of GDP)

Apart from growing investment activity, also shrinking saving level of Estonian economy necessitated involvement of supplementary external resources. Saving shrank primarily in households, who financed their expenditure partly from previous savings and involved 40.9% of additional credit from the financial sector during a year. As a result, the deterioration of private persons' net position against the financial sector continued the trend originating from the second half of 2001 – borrowing grew faster than deposits.

To some extent, government and business sector could offset a decline in the household level of saving. Undertakings could adjust current expenditure to a weakened external demand environment. This ensured a 1.6-percentage-point growth of GDP in the share of profit. Better tax administration and favourable environment for the collection of indirect taxes increased government saving by about 1.5 percentage points against 2001.

Throughout the restored independence, foreign direct investments have financed domestic financing gap, but in 2002 the structure of both general investment cover and direct investments underwent a slight change. While the share of reinvested profits as direct investments of GDP maintained the level of previous years, bank loans were involved more than before into the formation of new companies. Bank loans replaced also borrowing from parent companies, which are recorded as direct investments. Thus, accumulated reserves and debt additionally involved from abroad financed growing current account deficit. The financial sector used external resources to meet domestic credit demand and undertakings – to finance large investment projects. **These developments have soared the gross debt of Estonian economy by 2.5 percentage points – to 63.6% of GDP during the first nine months. The net debt remained unchanged** as government surplus and funds deposited abroad balanced the private sector's deteriorating net position.

Government Sector

For the second consecutive year the government sector budget had a surplus in 2002, reaching 1.3 billion kroons, ie 1.2% of the annualised GDP (see Figure 2.6). Different levels of government displayed the trend of recent years – central government surplus (2 billion kroons) versus local government deficit (0.7 billion kroons).

Despite the surplus, the budgetary policy of 2002 could be considered neutral for economic stability. Better tax administration as well as single (launching of Unemployment Insurance Fund) and cyclical factors

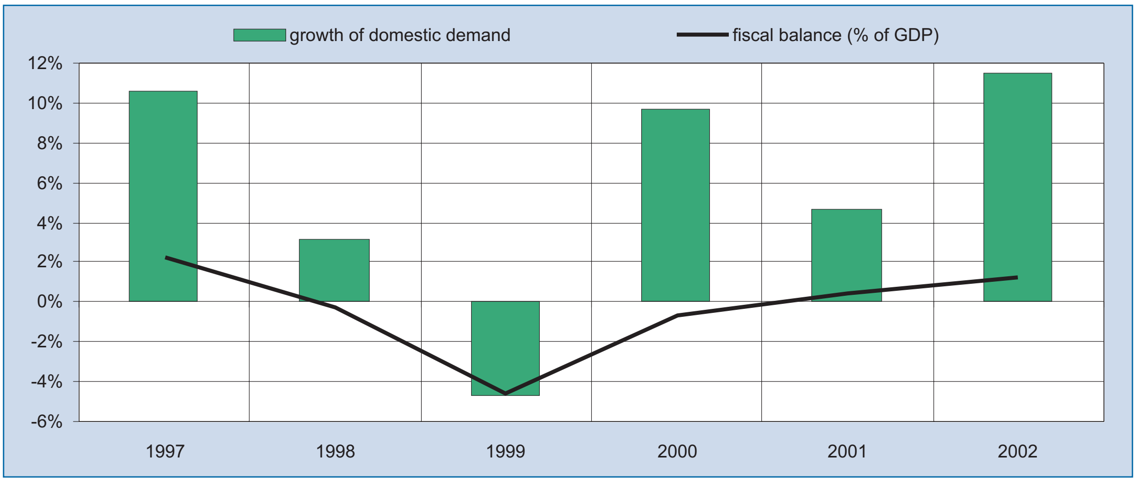

Figure 2.6. Real growth of domestic demand and balance of government sector budget

improved tax collection. Collection of corporate income tax and VAT grew most against 2001. While the former increased because corporate profitability was high in 2001 and an amendment of law favoured disbursement of foreign residents' dividends before 2003, the better-than-anticipated collection of VAT was based on temporary expansion of tax base due to the fast growth of imports.

Accelerated domestic demand expanded tax base, accompanied by higher current expenditure, which together with two supplementary budgets reached 13% during the year, ie was about 2 percentage points above the nominal GDP growth in the same period. Therefore, the structural balance of the government budget remained close to the level of 2001. At the end of the year, the gross government debt reached 5.3% and external debt 3.1% of the anticipated GDP.

Inflation

The overall price level in Estonia is subject to two main factors – a change in the price of imported goods and an accelerated increase of price in the sheltered sector against the open sector of economy induced by different rates of productivity growth. More rapid growth of open sector productivity and income level, which yield a price increase of nontradables against industrial countries, is called real and nominal convergence, respectively.

In 2002, the increase of the prices of nontradables and imported tradables had an opposite impact on consumer price index[2], which reached 3.6% (see Figure 2.7). Rapidly growing domestic demand and administrative price changes at the beginning of the year accelerated inflation. In 2002, prices in the sheltered sector increased by 7% on the average and were responsible for more than half of the consumer price growth, ie about twice above their share in the consumer basket.

Unlike price growth of nontradables, prices of imported goods slowed down Estonia's inflation rate. Weak global demand contained price pressure in most of the major industrial countries in 2002 lower than in several previous years. Prices of the goods imported to Estonia were also subject to the strengthening of the nominal exchange rate against majority of major currencies.

[2] CPI in December 2002 against the year-ago period.

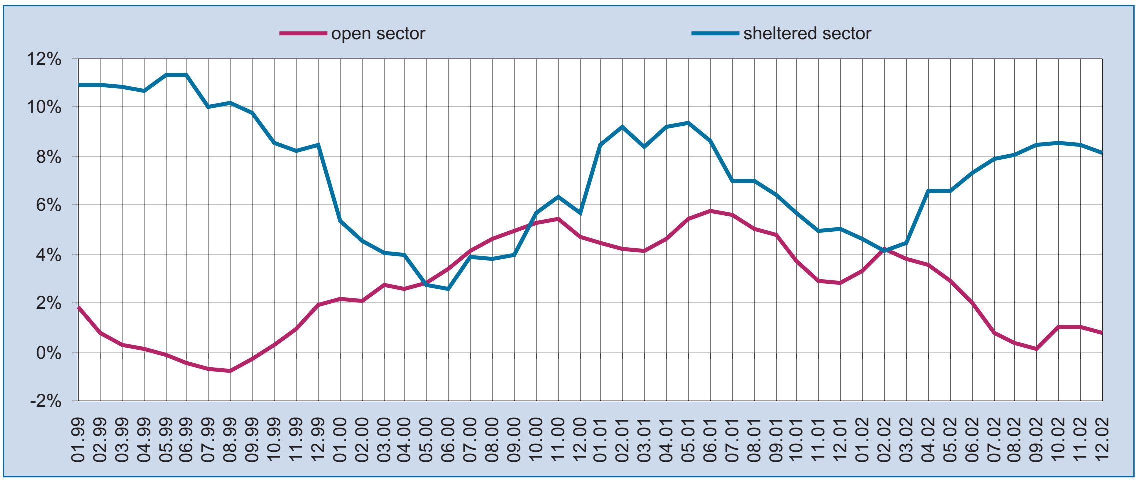

Figure 2.7. Annual growth of Estonia's open and sheltered sector price indices

Consumer prices in Estonia were primarily exposed to an oversupply-caused food price decline in Europe. Close trade relations translated the impact into consumer prices: food price increase shrank by about 4 percentage points (from 6.6% in 2001 to 2.7% in 2002). As the share of foodstuff in the consumer basket is larger in Estonia, its impact on consumer prices on the average is more visible than in the euro area and the CPI growth differential remained at the historic low (see Figure 2.8).

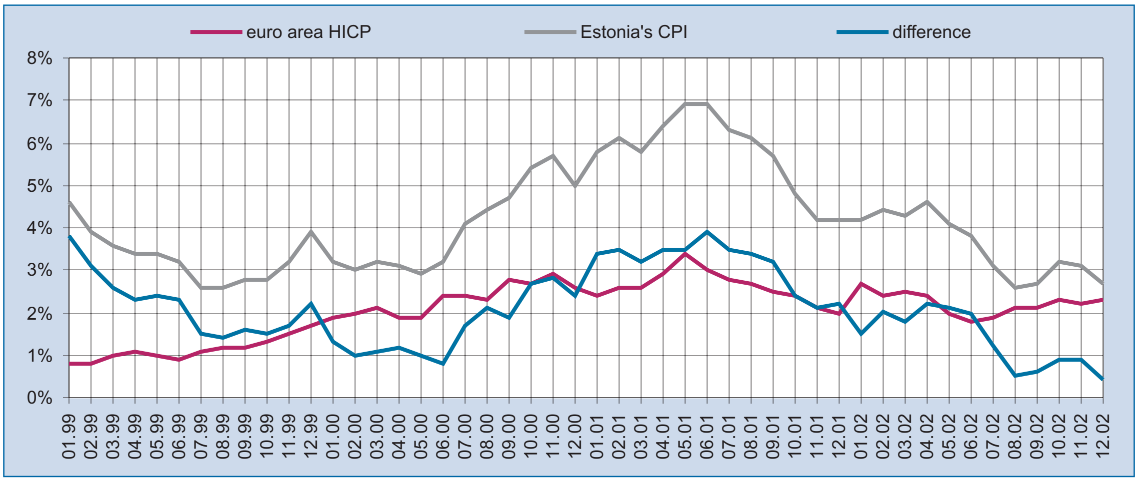

Figure 2.8. Twelve-month growth of consumer prices in Estonia and euro area

Together with shrinking inflation rate also the growth in the real exchange rate of the kroon slowed down. In 2002, the kroon strengthened by 1.9%, including 1.7% against currencies of industrial countries and 2.1% against currencies of transition countries. Unlike previous years, the real exchange rate was subject to the fluctuation of the nominal exchange rate of trade partners' currencies (see Figure 2.9). For example, the nominal exchange rate of the kroon increased on the average by 2.9% over the year, including 7.4% on the average against the currencies of transition economies. Larger deviations of the currencies of industrial countries (depreciation of the US dollar and appreciation of the Swedish krona) offset each other.

In the long term, the 1.7% appreciation of the Estonian kroon against the currencies of industrial countries can be considered close to equilibrium. Domestic increase in the real exchange rate, ie growth differential of open and sheltered sector prices, was about the same.

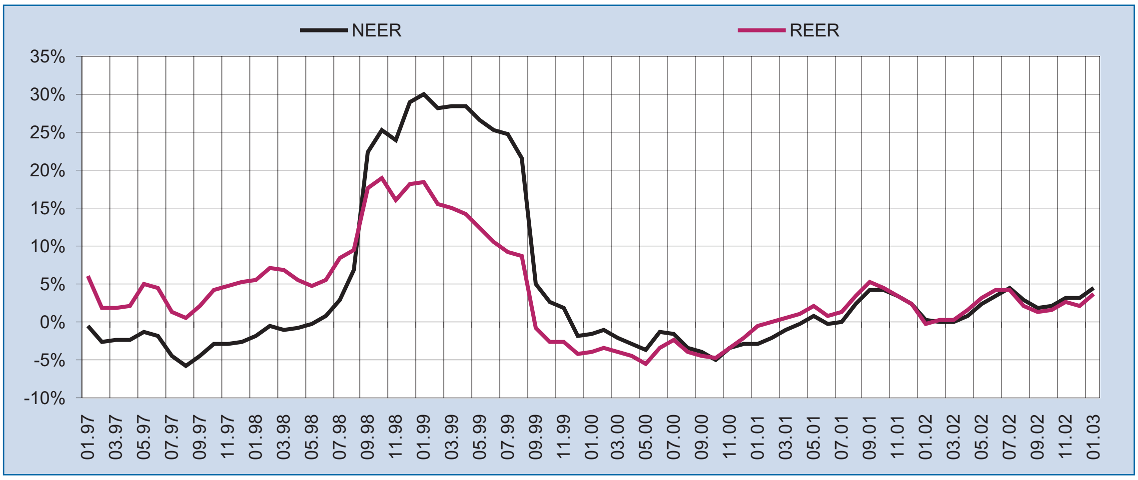

Figure 2.9. Twelve-month change of nominal and real exchange rate of the Estonian kroon

FINANCIAL SECTOR

In 2002, the Estonian financial sector continued dynamic development, characterised by constant financial deepening in all major domestic financial markets (see Figure 2.10). The growth of financial sector's consolidated assets accelerated considerably against 2001, exceeding nominal economic growth twofold.

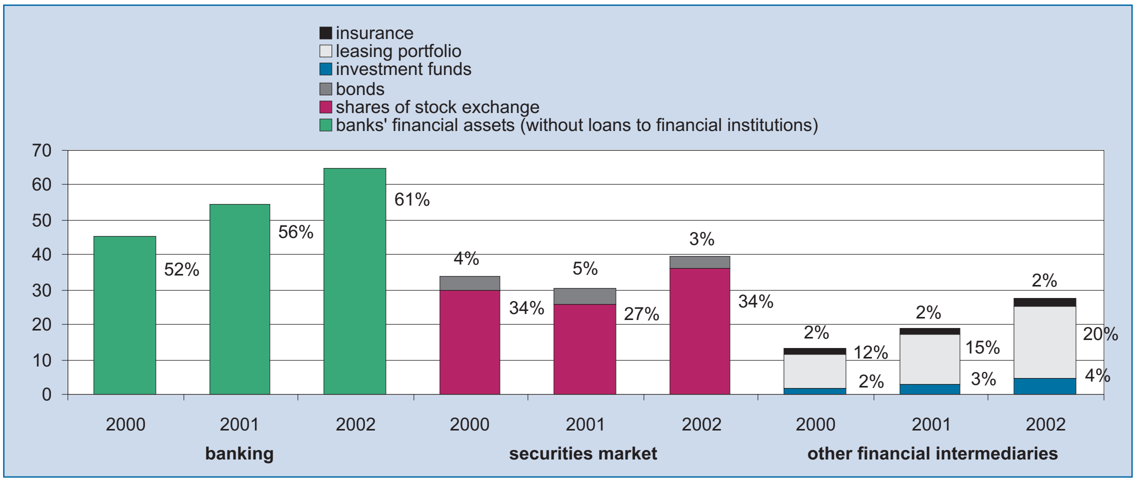

Figure 2.10. Estonian financial intermediaries (EEK billion and % of GDP)

Different markets developed in a different way. The volume of financial assets mediated through banks and bank-owned leasing companies grew most. The real sector debt burden as a percentage of GDP added 6 percentage points, reaching 47.5% by the end of the year.

The development of the securities market underwent no remarkable changes. The bond market remained less active. However, the stock market revived slightly in the second half of the year. The volume of investment funds continued to grow fast at an average of 67%, similar to 2001. From 2003 onward placements to pension funds will support investment activity more aggressively. Similar to previous periods, the volume of life insurance premiums remained modest also in 2002.

The growth of bank deposits remained below lending and leasing activities. This led to the **weakening of real sector net financial wealth** (see Figure 2.11). As the level of domestic saving did not suffice to meet loan demand, the financial sector had to involve funds outside Estonia in order to cover the gap between investments and financing need.

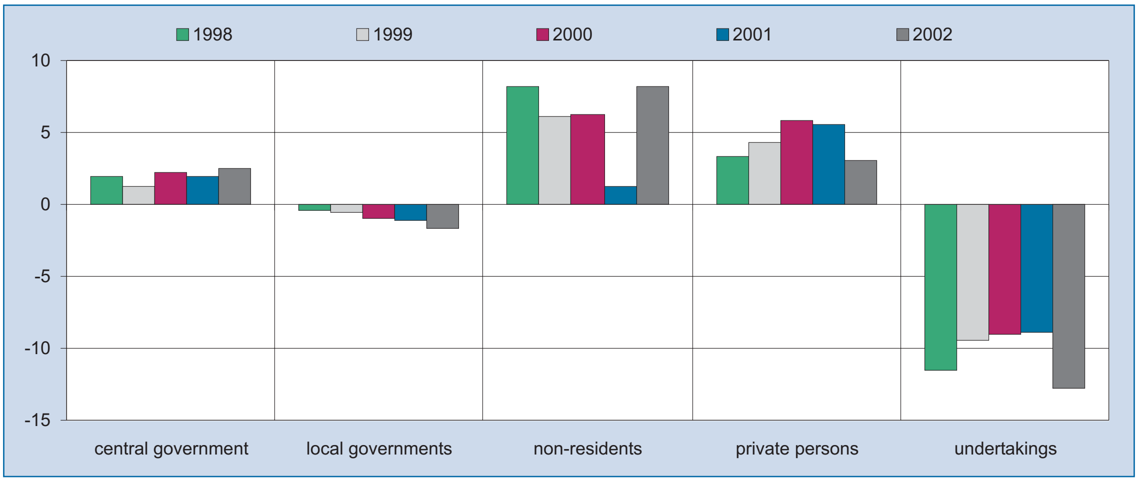

Figure 2.11. Net positions of economic sectors (EEK billion) against financial sector (incl banking, leasing and bond market)

Bank-centred financing and **dominant financial conglomerates** characterise financial intermediation in Estonia. The participation of banks in other financial intermediaries has been high in recent years (see Table 2.3). Therefore, banks share necessary know-how and liquidity also to the rest of the financing sector. Intertwined financial intermediation between sectors contributes to diversified range and structure of financial and investment products. While in 1998 leasing and factoring were responsible for a fifth of all the intermediated funds, then in 2002 already for 36%. In investment a trend is noticeable that previously mostly deposited saving is now replaced by more sophisticated fund and insurance products.

Table 2.3. Banks' share in other financial intermediaries

	1998	1999	2000	2001	2002
Leasing	96.4%	97.5%	99.1%	99.7%	99.1%
Life insurance	16.6%	43.6%	74.2%	71.2%	73.0%
Non-life insurance	6.8%	11.1%	38.8%	35.6%	38.7%
Investment funds	89.9%	90.3%	91.7%	96.6%	95.2%
o/w pension funds	–	100.0%	100.0%	94.6%	73.8%
Turnover of Tallinn Stock Exchange[1]	60.0%	79.0%	71.4%	75.5%	84.5%

[1] The turnover here covers the share of transactions intermediated by banks – stock exchange members in total turnover of transactions.

Banking

Institutional Development

Seven credit institutions operate in Estonia: AS Hansapank (Hansabank), AS Eesti Ühispank (Union Bank of Estonia), AS Sampo Pank (Sampo Bank), AS Eesti Krediidipank (Estonian Credit Bank), Tallinna Äripanga

AS (Tallinn Business Bank Ltd) and AS Preatoni Pank (Preatoni Bank), as well as Nordea Bank Finland Plc Estonian Branch. In 2002, the share of foreign owners in the share capital of banks increased from 85.7% to 86.7% (see Table 2.4). According to end-of-year balance sheets, banks with high share of foreign holding owned over 97.5% of the sector's total assets, which also reflects the high concentration of foreign capital.

Table 2.4. Owners of Estonian credit institutions (%)

	31.12.98	31.12.99	31.12.00	31.12.01	31.12.02
Foreign	**55.49**	**62.23**	**83.91**	**85.74**	**86.73**
Credit institutions registered abroad	45.50	52.58	66.99	63.28	78.95
Financial institutions registered abroad[1]	2.18	1.94	0.51	17.18	3.63
Other non-resident legal persons	7.32	7.03	16.21	5.15	4.06
Non-resident natural persons	0.49	0.68	0.20	0.14	0.09
Estonia	**44.51**	**37.76**	**16.09**	**14.25**	**13.27**
Central government and local governments	0.45	0.27	0.01	–	–
Eesti Pank	13.14	11.37	–	–	–
Credit institutions registered in Estonia	1.46	4.62	0.63	0.09	0.09
Financial institutions registered in Estonia	0.74	0.34	0.15	0.36	0.17
Undertakings registered in Estonia	20.05	10.12	5.99	5.08	4.91
Non-profit institutions registered in Estonia	0.04	0.07	0.02	0.03	0.01
Estonian natural persons	8.39	10.84	9.06	8.53	8.08
Other (preferential) shares	0.24	0.13	0.23	0.16	–

[1] Since the end of 2001 the entry reflects, in adition to foreign investement funds, also shares of insurance companies and investment firms, which in previous years were reflected under other legal persons.

Besides six **representative offices of foreign credit institutions** already in operation (Landesbank Schleswig-Holstein Girozentrale, Norddeutsche Landesbank Girozentrale, Vereins- und Westbank AG, Osuuspankkien Keskuspankki OYJ, Svenska Handelsbanken and Parekss Banka), two more were added in 2002: International Bank of St Petersburg from Russia and Akciju komercbanka 'Baltikums' from Latvia. The Estonian representative office of Svenska Handelsbanken terminated its activity at the beginning of 2003.

Despite intensifying competition, changes in the division of the banking market in 2002 were insignificant (see Figure 2.12). Due to the above-average lending activity, the assets of Nordea Bank Finland

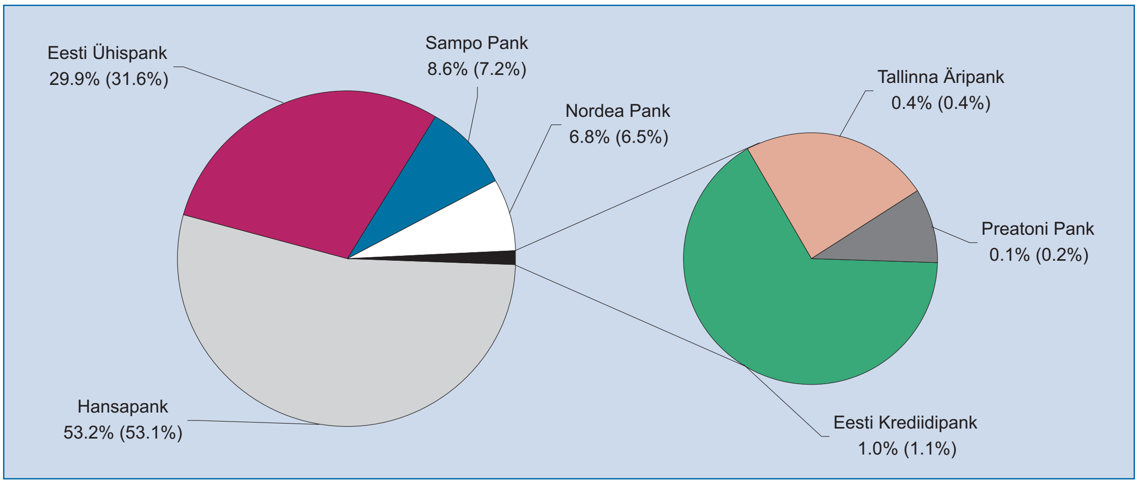

Figure 2.12. Market shares of bank groups in Estonia by volume of real and public sector financing (bank loans, leasing and factoring) as of end of 2002 (in brackets as of end of 2001)

Plc Estonian Branch grew the fastest. Taking into consideration the increasing share of financing through leasing associations, banking groups' market shares in financing domestic real and public sectors remained relatively stable. Small banks kept their role as providers of specialised services.

In external markets in Latvia and Lithuania, loan and deposit stocks in Hansapank's subsidiary banks went up and their profitability improved. More intensive restructuring of subsidiaries of the groups led to a more pronounced integral concept of the Baltic economic space by different products and risk management strategies and financial objectives. Geographical expansion of the market within the group was seen in making Hansa Leasing Russia operational in the fourth quarter of 2002.

Ratings assigned by international rating agencies to banks were mostly upgraded, reflecting relatively strong creditworthiness for a transition economy (see Table 2.5). Upgrading acknowledged strong capitalisation of banks, high profitability and sound financial standing. Upward revision of ratings reflected also a more defined perspective in the EU direction, improving Estonia's economic policy outlook.

Table 2.5. Ratings assigned to banks by Moody's Investors Service as of end of 2002

	Hansapank	Ühispank[1]	Sampo Pank
Long-term liabilities	A1	A2	A3
Short-term liabilities	P-1	P-1	P-2
Financial strength	C	C-	D+

[1] With the raiting growth which took place on 10 January 2003.

Assets and Liabilities of Banks

Banks' assets grew by a record high 13.3 billion kroons, reaching 81.5 billion kroons by end-December (see Figure 2.13). More than 42% of banks' total assets came from real and public sectors' loan portfolio, which continued its expansive development in 2002 due to a sustained interest rate decline as well as tightening competition in the financial market. Together with leasing-associations-mediated credits, the domestic debt of the real and public sectors reached 54 billion kroons by the end of the year, adding more than 30% over twelve months (see Figure 2.14).

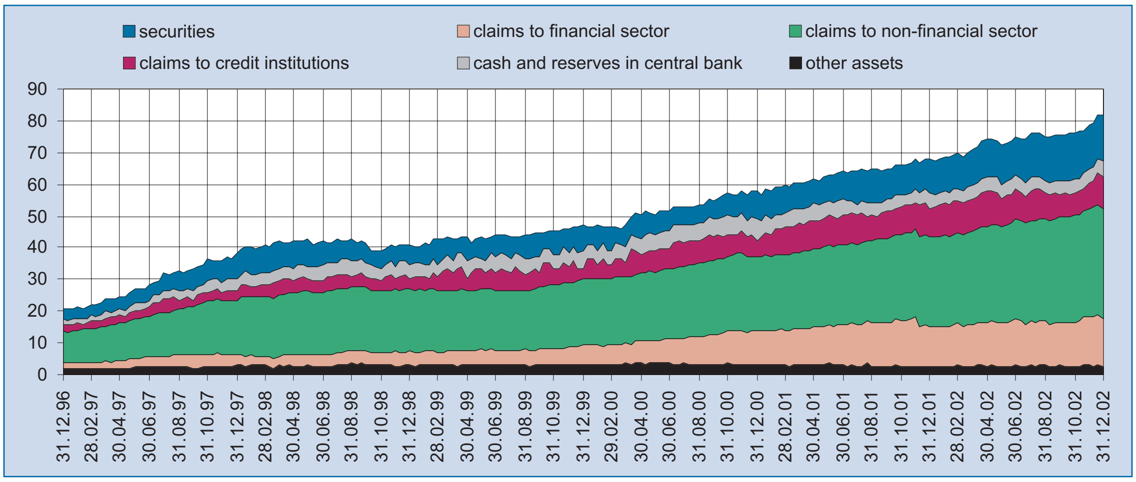

Figure 2.13. Banks' total assets (EEK billion)

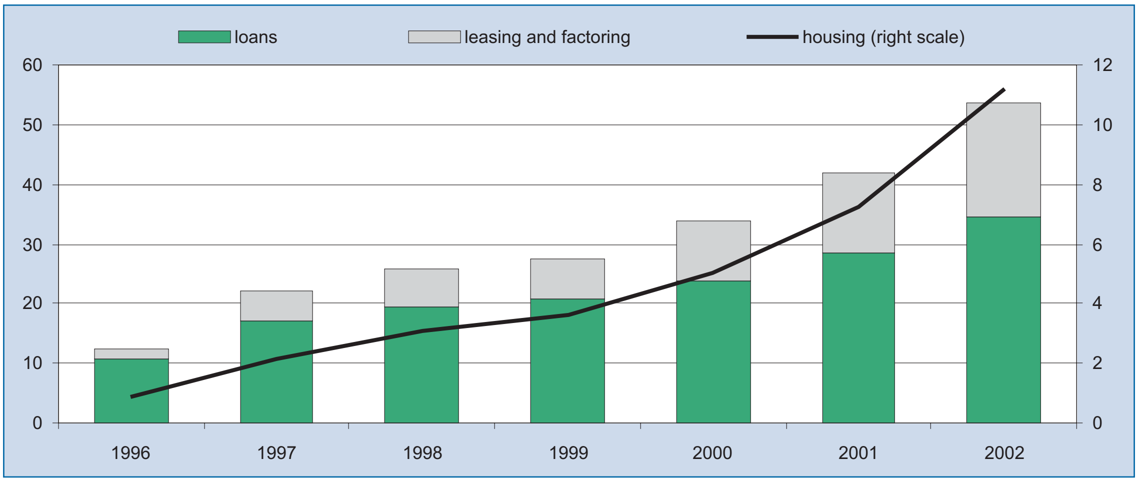

Figure 2.14. Financing of public and real sector (EEK billion)

Financing of housing and commercial real estate displayed the most aggressive growth whereas the annualised growth of housing loans and leasing reached close to 54%. Besides real estate loans, lending to public sector (primarily industry and transport) undertakings increased; and slightly also financing of hotel and catering services. The growth of funds channelled into commerce and construction remained on the level of 2001.

Apart from ample growth in lending, also a growing share of **securities portfolio** characterised total assets of banks in 2002; the main reason lying in funding of banks' affiliated leasing companies becoming more bond-based.

Due to the changes in market conditions, the banks preferred bonds to deposits in foreign banks in the structure of their liquid assets.

On the liabilities' side of credit institutions the growth of **deposits** could not keep up with the growth of loans. The growth of the largest and most stable source of resources for banks – private depositing (40% of all deposits) was contracting in 2002 also in nominal terms (see Figure 2.15). The all-time low interest rate inhibited placement primarily in low-return time deposits, sending the share of demand deposits up by a

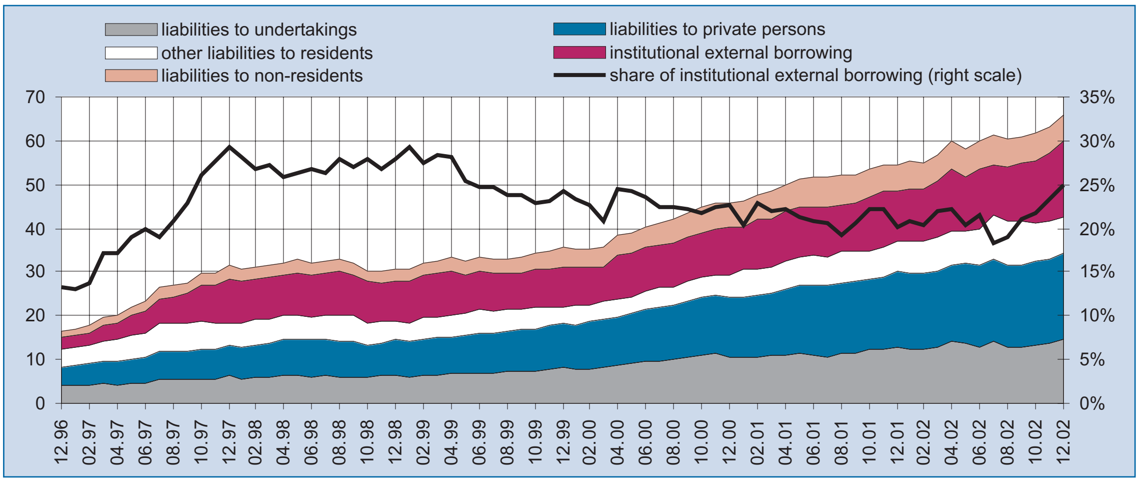

Figure 2.15. Banks' resources (EEK billion) and share of external borrowing

couple of percentage points, approximately to 60%. However, the successfully launched mandatory funded pension scheme (the so-called II pillar) manifests that household propensity to save is developing towards long-term, more profitable and sophisticated products.

At a modest deposit growth, banks have had to involve external resources in order to cover loan demand. While in the first half of the year the share of **external resources** was kept stable, beginning from July the share of external borrowing started to grow fast, reaching a quarter of all liabilities by end-year. Parent banks played a significant role in the sharp growth of external reserves, their share in involved resources more than tripled in a year, accounting for over 40% of external borrowing at end-year.

Profitability and Risks

In 2002, banks maintained a relatively good profit-earning ability, facilitated largely also by an expanding loan base. However, the trend can continue only if lending quality remains high.

According to unaudited data, the banking sector earned 1.2 billion kroons profit in 2002 whereas all banks ended the year at a profit. The main source of the profit was net interest income of 2.4 billion kroons, growing due to expanding interest-earning loan portfolio of the banks and lower financing cost.

Shrinking funding cost is linked not only to interest downfall in domestic and international money markets but also to changes in the structure of the borrowing involved. Although domestic resources remain the least costly, the difference against borrowing from parent banks is narrowing down.

Although the banks receive most of their income from interests, the share of non-interest income has been growing from year to year. This trend continued also in 2002 when the share of non-interest income reached 38% in banks' profit base. Service charge income grew most in the banks with a large market share, who, besides an increase in the volume of service charges accompanying growing lending, expanded their profit base by introducing service charges for some previously free services. The Pay-with-card campaign organised jointly by banks had an encouraging impact on the growth of non-interest income as well. The income from the volume of card payments accounts for 15–20% of total service charge income in the banking sector.

Banks' profitability is also seen in better efficiency and inhibited growth of administrative costs. As a result, the cost-income ratio improved from 69% in 2001 to 65%. Productivity gain in financial intermediation is seen in the spread contraction by 45 basis points, to a record low 3.7% (see Figure 2.16).

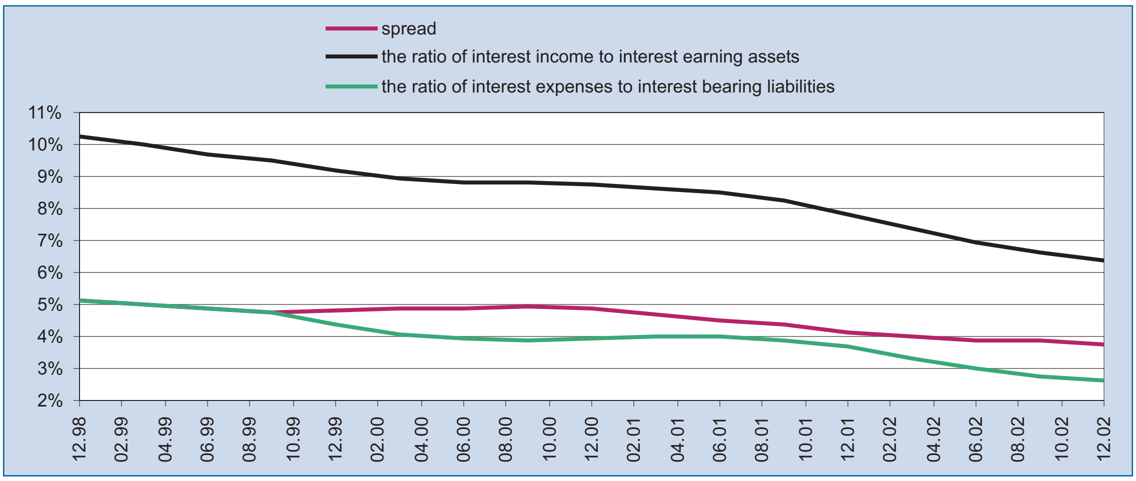

Figure 2.16. Banks' spread, average interest rate income and interest rate expenses (%)

Capital adequacy rose from 14.4% in December 2001 to 15.3% twelve months later (see Figure 2.17), despite the rapidly growing loan portfolio (and accompanying risk assets). Primarily reinvested profits of 2001, to some extent also new capital adequacy guidelines enforced on 2 July 2002, contributed to the growth in capital adequacy. Namely, the new normative permits not to deduct particular investments from equity capital. By categories the huge housing loan supply in 2002 increased, first and foremost, the volume of assets with 50% risk weight.

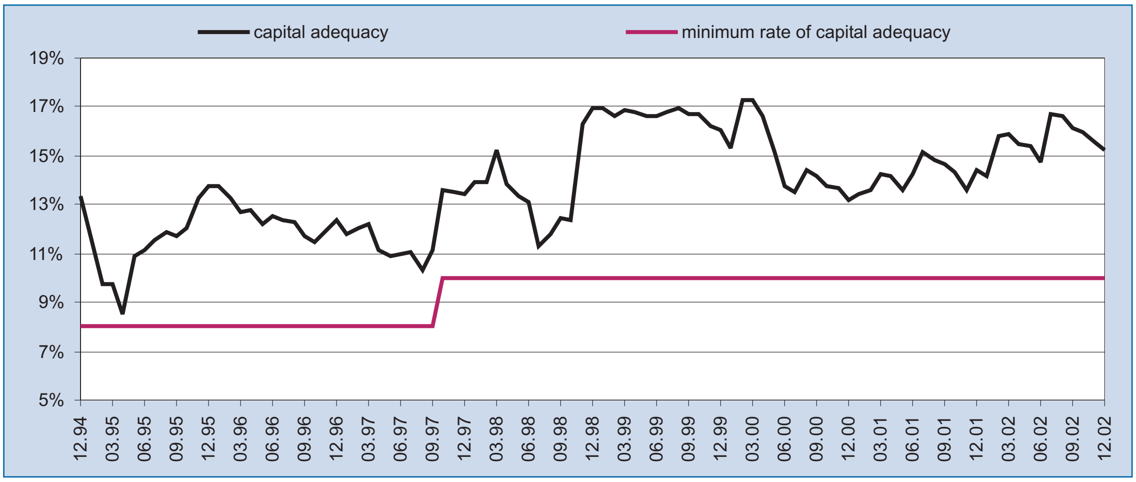

Figure 2.17. Banks' capital adequacy

Despite weaker economic growth outlooks and contemporaneous expansive lending, the quality of the loan portfolio did not deteriorate significantly in 2002. By segments housing loans grew most rapidly whereas loans overdue over 60 days accounted for merely 1.2%. The quality of the commercial real estate was below average and overdue loans exceeded 3%. Loans overdue over 60 days were responsible for an annualised 2.2% of the loan portfolio whereas provisioned loans reached 1.7%.

Banks' liquidity buffer did not change much against 2001: the share of liquid assets in banks' balance sheets remained at the same level. At the same time, the maturity of banks' liabilities became significantly shorter, which was increasingly evident in the second half of the year – while domestic depositors preferred demand deposits to time deposits, also the remaining maturity of the resources involved from international market shrank. Due to a sharp growth in highly liquid assets at the end of the year, the liquidity indicator recovered slightly in December. **The ratio of liquid assets and liabilities**[3] **was 58% in end-2002 against 54% a year ago.** By maturities the weak growth of deposits somewhat curbed disequilibrium between short-term claims and liabilities. On the other hand, as long-term housing loans added volume, the net position of claims with maturity over 5 years lengthened significantly.

The open foreign exchange position gained about a half in 2002. Primarily foreign exchange assets grew, reflecting, first and foremost, major growth in euro-based real estate lending. Despite increasing external borrowing, foreign exchange liabilities displayed modest growth against 2001. At the turn of the year and in the first months of 2002, forward transactions and swaps bounced up only to manifest a downward trend in the second quarter.

[3] With the remaining maturity up to a month.

Securities Market

Bond Market

The bond market was mostly subject to changes in the structure of issuers. While in earlier years primarily foreign credit institutions were the issuers, in 2002 the volume of their issues shrank (see Figure 2.18). This led to a one-third contraction in the volume of bond issues – from 6.4 billion kroons in 2001 to 4.6 billion kroons in 2002. Local banks and undertakings increased the volume of issue and their share has risen to 80% of the total volume of the issues. Also new issuers from among local undertakings have entered the market.

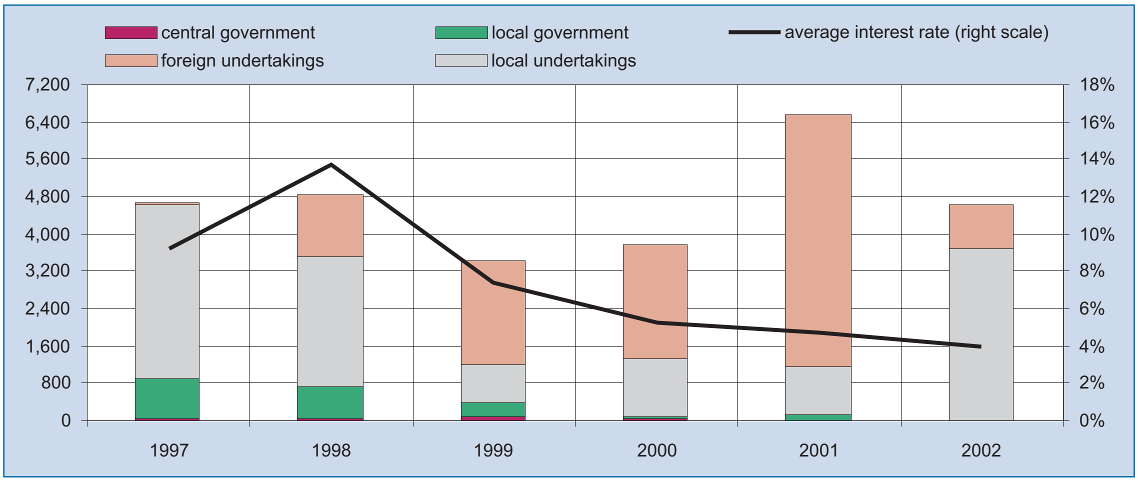

Figure 2.18. Volume of bonds issued in a year by issuers (EEK m) and average interest rate of kroon-denominated bonds

In 2002, the maturity of bond issues continued to accumulate between 6 to 12 months. Copying money market interest rates, the weighted median interest rate of kroon bonds declined from 4.0% to 3.7%. Longer maturity and an increasing number of higher credit-risk issues by local undertakings have slightly inhibited the decline of the average interest rate of the bonds. The turnover of the secondary bond market reached 4.6 billion kroons, primarily due to growing investment funds and new pension funds under the second pillar.

Stock Market

An exceptional rise was characteristic of the stock market in 2002 against other developed countries and stock exchanges in other Central and Eastern European countries. Tallinn Stock Exchange Index Talse rose by 47%, reaching 212 points (see Figure 2.19). Nevertheless, there was a setback: deepening recession of international stock exchanges hit also Tallinn Stock Exchange in April. In August the stock exchange started to recover due to foreign investor interest and the stock exchange index exceeded the level of April by November. Listed shares revealed a broad price increase in 2002: besides listed shares also prices for less market-capitalised undertakings went up. The price growth was not accompanied by growth in turnover; the average daily turnover remained at the level of 2001 (16 million kroons; see Table 2.6).

At the end of February 2002, the transfer to the Helsinki Stock Exchange (HEX) trading system took place in the Tallinn Stock Exchange, as Helsinki Stock Exchange Group had become a majority shareholder. Four foreign brokers[4] joined the Tallinn Stock Exchange and three of them have become operational. Parallel to the

[4] Credit Suisse First Boston, Mandatum Stockbrokers, Nordea Securities and Kaupthing Sofi.

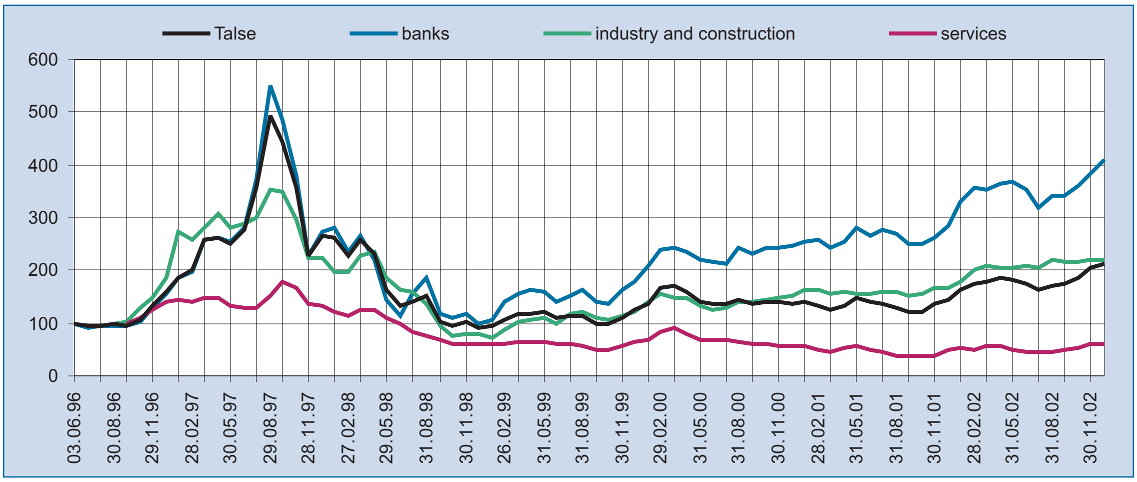

Figure 2.19. Talse and indices of stocks traded on the Tallinn Stock Exchange by sectors of economy (points)

Table 2.6. Most important indicators of stock market (EEK billion)

	1996	1997	1998	1999	2000	2001	2002
Capitalisation of stock market	**10.2**	**18.6**	**12.2**	**31.6**	**34.3**	**31.6**	**42.2**
Instruments							
Shares	7.5	12.6	7.9	28.0	30.1	26.1	36.2
Bonds	2.4	4.0	3.7	3.2	3.7	4.4	3.3
Investment fund stocks and shares	0.3	1.8	0.5	0.4	0.4	0.9	1.7
Subscription rights	–	0.1	0.2	0.0	0.0	0.2	1.0
Turnover of the whole market	**3.2**	**34.1**	**33.7**	**15.2**	**14.3**	**14.1**	**23.1**
Capitalisation of Tallinn Stock Exchange	8.0	13.1	8.3	28.3	31.0	26.4	36.2
o/w non-resident investors	36%	42%	54%	74%	77%	77%	80%
Turnover of Tallinn Stock Exchange	2.3	21.8	13.4	4.5	5.5	4.1	4.2
Capitalisation of the whole market/GDP	19%	29%	17%	41%	39%	33%	40%
Turnover of the whole market/capitalisation	31%	183%	276%	48%	42%	45%	55%
Turnover of Tallinn Stock Exchange/capitalisation	29%	167%	161%	16%	18%	16%	12%

transfer, thorough changes and amendments in the rules of the Tallinn Stock Exchange took place to comply with the new Securities Act and HEX listing requirements. Harmonisation with the EU directive amended also conditions for the admission of securities to stock exchange listing, prospectus and information disclosure. The above amendments will help to make the securities market more transparent and reliable.

Investment Funds

In 2002, investment funds sustained rapid growth similar to 2001. By the end-year total assets of funds reached 4.3 billion kroons (see Figure 2.20). Interest and money market funds accounted for about a half of the asset growth whereas higher-yield interest rate funds continued preferential growth against money market funds. Thus, the share of money market and interest rate funds reached 58 and 31%, respectively, by the end of the year. The overall drop in interest rates in the world money and capital markets sent the average productivity of investment funds downward.

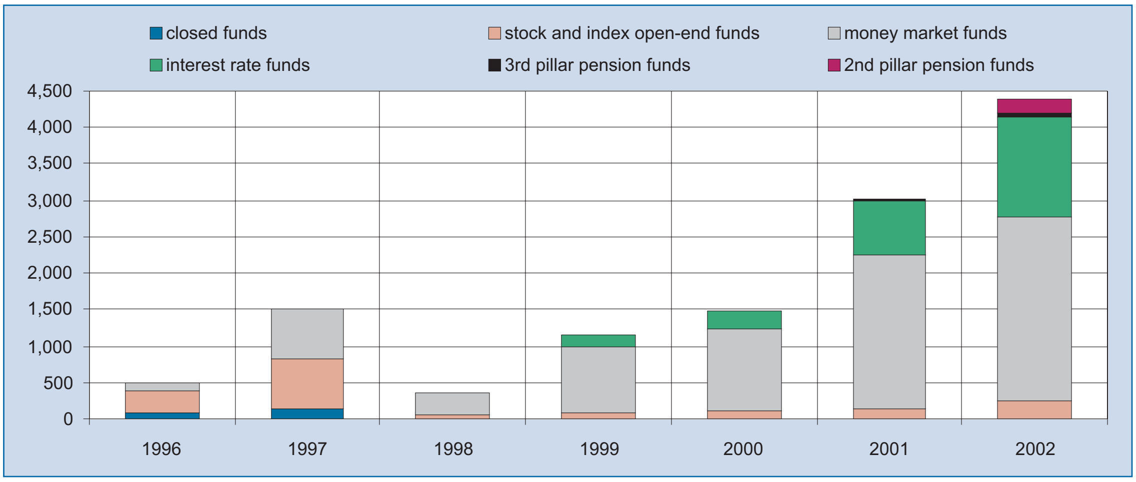

Figure 2.20. Volume of investment funds (EEK m)

In 2002, the successful launch of the last phase of the pension reform – mandatory funded pensions, ie the second pillar of the reform – had its impact on the fund market as well. The reform brought two new management companies from insurance companies and now we have 15 pension funds and six management companies in the II-pillar fund market. From early May to end-October 207,200 persons, ie 35% of the employed joined the II pillar. Pension funds have collected contributions of about 37,000 individuals since September 2002 and of 170,000 since March 2003. By the end of the year the volume of mandatory pension funds exceeded 170 million kroons.

Insurance

Balanced development continued in the **life insurance market**. Parallel to the final implementation of the pension reform also voluntary pension schemes gained popularity. Contributions under the supplementary funded pension scheme added 35% over the year. The growth accounted for about a half of the 445-million-kroon total volume of gross premiums[5] (see Figure 2.21). The transfer of the portfolio of Nordika Elukindlustus

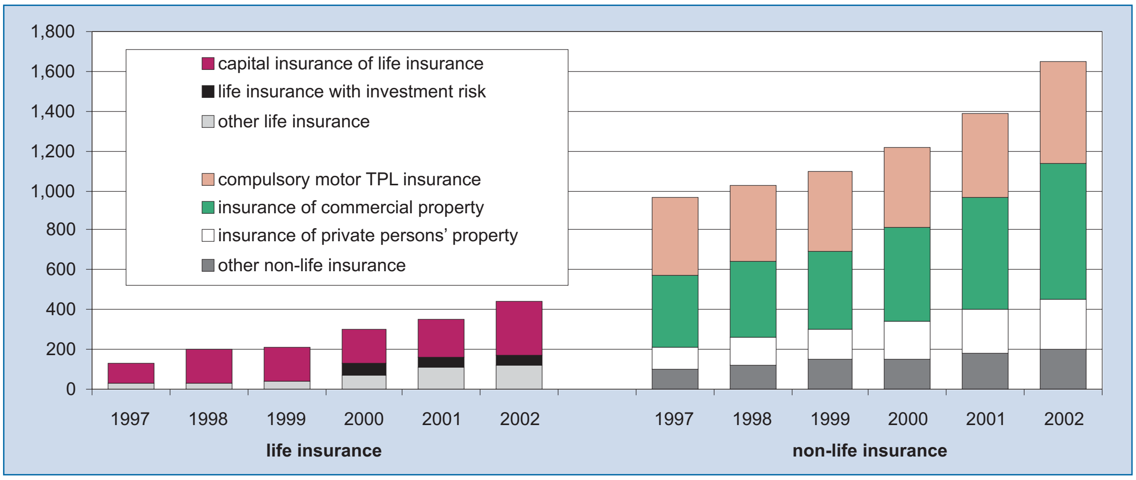

Figure 2.21. Gross premiums collected by insurance companies (EEK m)

[5] According to the Estonian Insurance Association.

(Nordika Life Insurance) to ERGO Elukindlustus (ERGO Life Insurance) as of 1 July, as a result of a special regime imposed on Nordika Elukindlustus to protect policy holders, changed the structure of market participants. The reconstruction of the market brought along sustained growth in the productivity of insurance companies.

Due to the rapidly developing real estate and consumer market, also growth in the **non-life insurance market** accelerated, leading to a total of 1.6 billion kroons of gross premiums in 2002, which is 18% more than in 2001. The biggest increase was recorded in compulsory motor TPL insurance and insurance of commercial and private persons' property, which accounted for 31; 42 and 15%, respectively, of total premiums.