ESTONIAN ECONOMY IN 2006

NON-FINANCIAL SECTOR

Monetary policy environment

Since December 2005, the European Central Bank (ECB) has been raising monetary policy interest rates in order to contain the risks to price stability in the euro area. Raising the ECB's monetary policy interest rates affected also the interest rates on bank loans in Estonia. The mild interest rate increase that had begun during the final months of 2005 continued throughout 2006. In light of the accelerated economic growth and strengthened inflationary pressures, the appreciation of bank loans remained minimal and the loan growth rate brisk.

Year 2006 was generally characterised by the moderate appreciation of the Estonian kroon against the US dollar and the Danish krone. Meanwhile, the Estonian kroon depreciated against the Swedish krona and therefore, on average, the nominal exchange rate of the kroon in ratio to industrial countries remained virtually unchanged.

Thus, in 2006 the monetary **policy environment** as a whole was conducive to economic growth.

Domestic and external demand

According to preliminary estimates, the Estonian economy grew by 11% in 2006. This is the **fastest growth rate in the past 15 years**. As regards the supply side, growth was broad-based, comprising almost all fields of activity and branches of manufacturing (see Table 1).

Compared to 2005, both private consumption as well as investments grew faster in constant prices. In the first half of 2006, the growth of domestic demand was further boosted mainly by the real estate sector. In the second half-year, private consumption was even more dynamic than in the first half, but investments were distributed more evenly in the economy. In conclusion, due to the increasing volume of bank loans the growth of domestic demand still exceeded the level that may be considered sustainable.

External demand reached its highest level in recent years and export growth continued to be brisk. Goods exports no longer increased as quickly as in autumn 2005, when it accelerated suddenly (in constant prices) from 20% to 30–35%. In autumn 2006, the growth rate of goods exports remained below 10% for the first time in several years. By groups of goods and fields of activity the growth rate was very diverse. A deceleration was experienced mainly in transit and subcontracting. All in all, in the second half-year the GDP growth rate remained slightly slower than in the first half-year (see also Figure 1).

Table 1. Real GDP growth by fields of activity in 2003–2005 (%)

	2003	2004	2005	2006
Agriculture, hunting, forestry	1.1	-7.1	2.4	0.4
Fishing	-5.2	-8.4	0.5	-4.0
Mining	13.5	-4.9	6.3	7.3
Manufacturing	7.0	11.5	12.6	12.8
Energy, gas and water supply	12.9	0.9	7.0	7.4
Construction	2.7	7.1	19.8	13.3
Wholesale and retail trade	14.3	7.8	16.0	12.6
Hotels and restaurants	4.2	16.3	23.6	11.7
Transport, storage and communications	9.6	12.5	7.7	10.9
Real estate, renting and business activities	4.0	5.6	8.8	9.7
Financial intermediation	18.9	22.6	25.2	22.8
Public administration and national defence	4.7	1.1	2.3	2.1
Education	-0.9	0.9	0.9	5.3
Health and social care	-0.6	4.2	6.5	6.8
Other	1.6	5.5	5.7	7.0
Total GDP	**7.1**	**8.1**	**10.5**	**11.4**

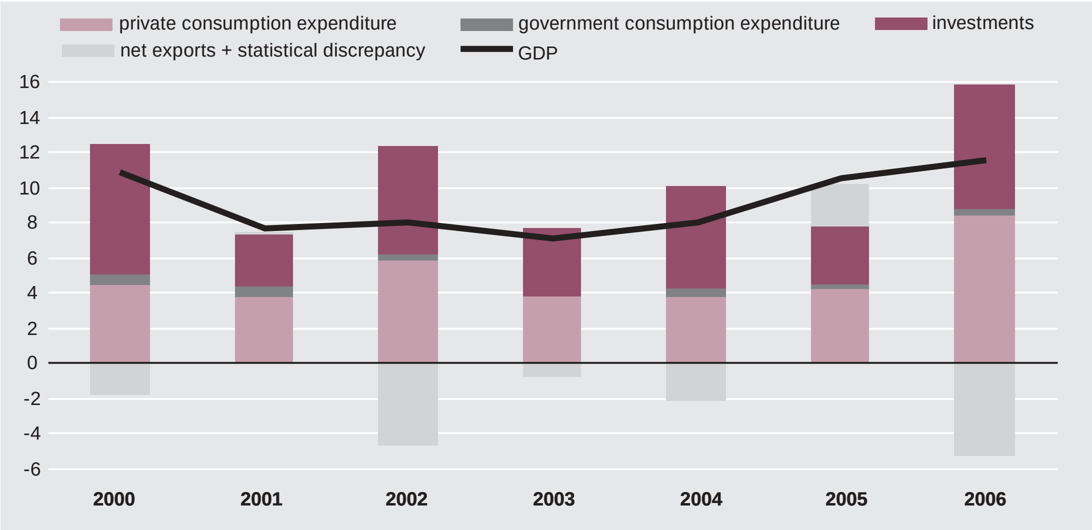


Figure 1. Contribution of GDP consumption components to economic growth (percentage points)

Similarly to earlier years, the rapid economic growth was based on external funding and, as a whole, 2006 could be characterised by increasing current account deficit. Compared to the previous year, in 2006 the current account to GDP ratio deteriorated by approximately 4 percentage points; the current account deficit reached nearly 15% (see Figure 2).

The need for external funding grew not because of small-scale savings but owing to the great investment demand. **Although the savings rate was comparable to that of advanced economies, the investment level, on the other hand, was extraordinarily high**. The volume of investments made for increasing fixed capital and stock building rose up to 38% of GDP, slightly exceeding the levels of earlier years. The inflow of foreign direct investment continued at the same pace and did not cover the total need for financing deficit. Thus, external debt increased up to approximately 96% of GDP.

Inflation

Already for the second consecutive year, the consumer price growth proved to be faster than expected. On average, the price rise of the consumer basket was 4.4%. **The initial impulse for the growth of consumer prices derived from global market prices** (see Figure 3).

Although during the year the inflation rate was strongly affected by volatile oil prices, the oil price rise proved not to be the primary factor behind price increase. The impact of oil prices was reflected through the prices of other fuels and transport services. For instance, gas prices rose by 52% and thermal energy by 16%. In addition, housing costs were affected by the increase in utility costs, rents that started rising already during the final months of 2005, and demand-driven pressures on the construction market. **The growth of housing costs caused a 5.7% price rise of the whole services basket**. The most drastic rise compared to expectations occurred in food prices, reaching a year-on-year average of 4.6% (see Figure 4).

Owing to the acceleration of consumer price inflation, the real exchange rate of the Estonian kroon appreciated against the currencies of industrial countries by 2.7%, year-on-year. On the other hand, the kroon depreciated against the currencies of other trading partners – the inflation rate in Estonia was even slower and the kroon 1.7% cheaper than a year ago (see Figure 5).

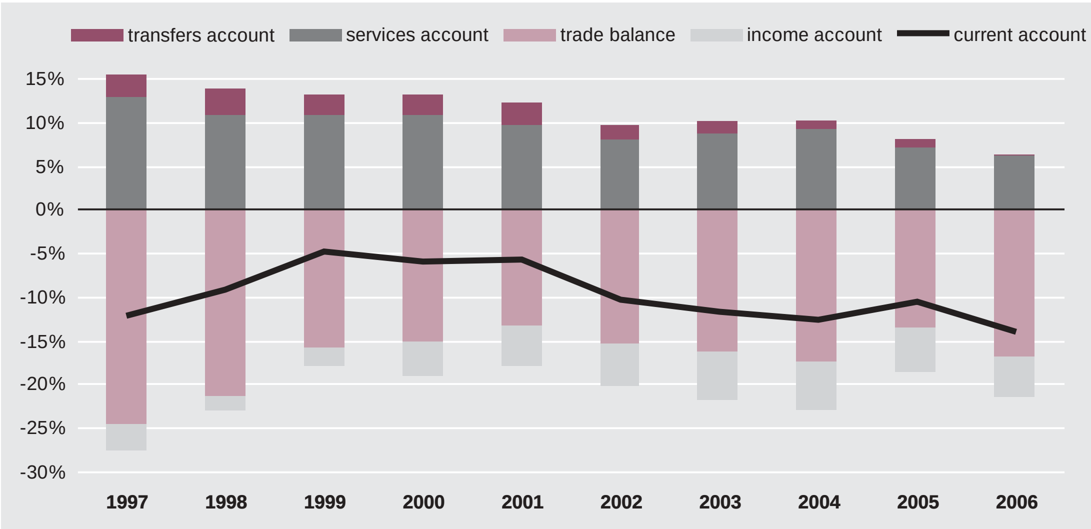


Figure 2. Current account balance and balance of payments accounts (% of GDP)

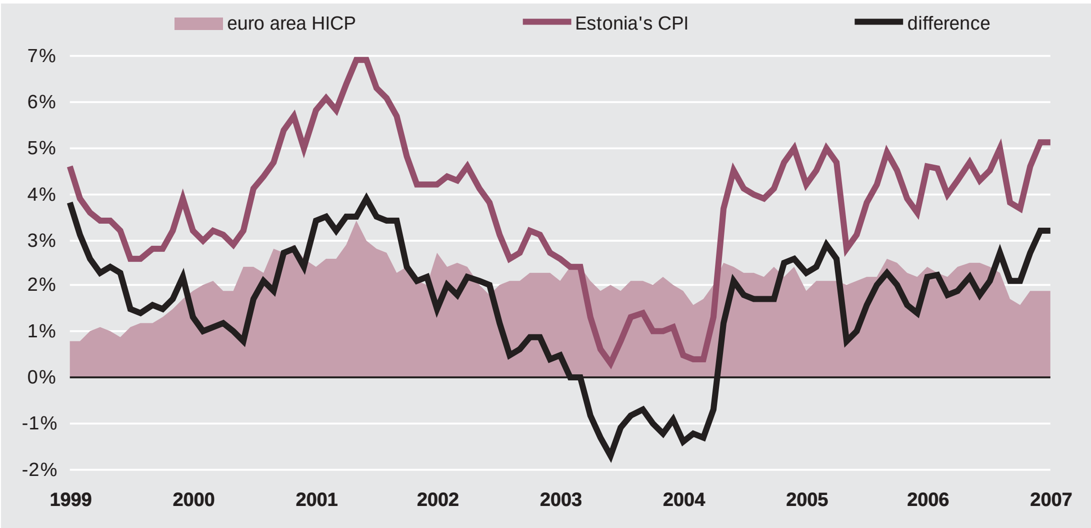


Figure 3. Twelve-month consumer price growth in Estonia and in the euro area

The materialisation of inflationary pressures was fostered by the dynamic income growth. The average wage growth turned out to be faster than in earlier years and, since summer, increased the risk that the growth rate of unit labour costs might exceed that of productivity. Wage pressures were facilitated by the enhanced demand for labour force. Employment growth was the fastest in the past ten years and on average remained in the range of 6–7% according to various estimations. The number of new jobs reached above average in the services sector, primarily in construction, trade and transport. **Employment increased thanks to new entrants to the labour market and a decreasing number of the unemployed and the discouraged**. In comparison with 2005, the unemployment rate dropped from 7.9% to 6%; furthermore, the number of the long-term unem-

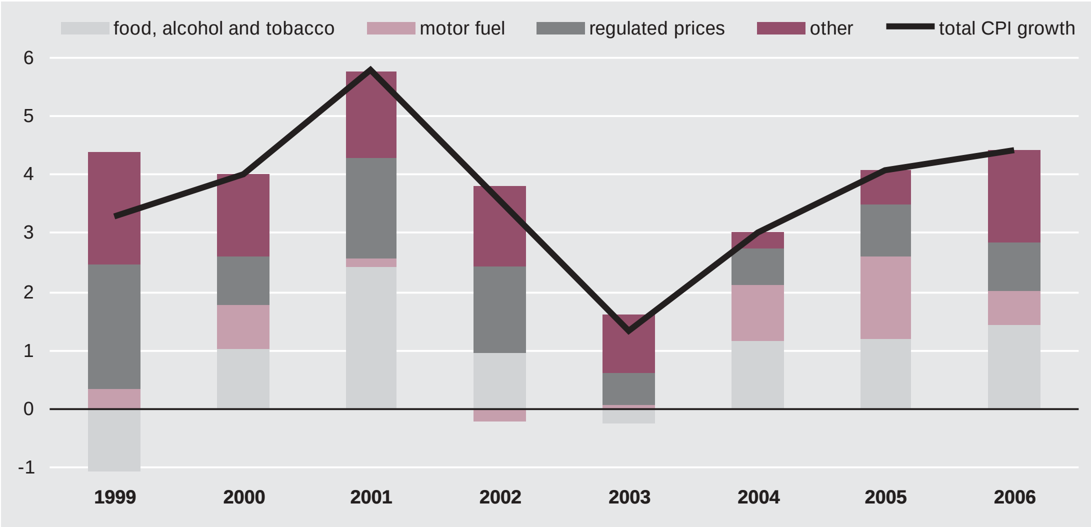


Figure 4. Consumer price growth by components (percentage points)

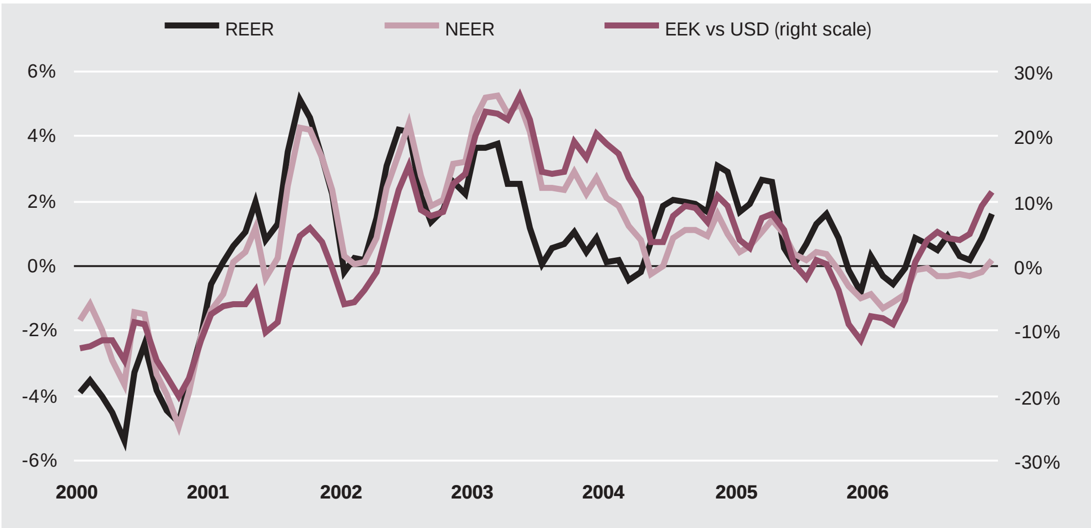


Figure 5. Changes of the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

ployed shrunk remarkably. The labour market situation was undoubtedly pressured by the increased migration within the European Union.

General government

As earlier, the main factor supporting external and domestic balance was fiscal policy. In 2006, the scheduled reduction of the income tax rate continued and as of 1 January 2006, the new 23% income tax rate stepped into force. Earlier decisions to raise indirect taxes, but also the robust increase in private consumption and wages in ratio to GDP increased tax revenues and the total tax burden of the year basically remained the same. General

government savings increased steadily throughout the year and the consolidated budget surplus of 2006 proved to be larger than that of the previous year – it reached nearly 4% of GDP. **The surplus stemmed from a deliberate increase of reserves, better than expected collection of tax revenues and a partial postponement of planned expenditures**. More precisely, supply-side constraints caused by the real estate boom did not enable ministries and local governments to fully carry out their rather ambitious investment programmes. Along with the surplus increase the public debt kept shrinking. By the end of the year, the public debt to GDP ratio dropped to 4.1%.

Following the state budget strategy drafted in spring, in December the Riigikogu approved the budget for 2007, which sets a goal of 1.9% surplus of GDP. **In light of previous years, this is quite a bold objective, but from the perspective of the economic cycle the aim remains fairly modest**.

RATINGS

In their decisions regarding Estonia's sovereign rating outlook in 2006 the rating agencies have considered the estimated impact of the adoption of the euro on the country's creditworthiness.

In 2006, Moody's raised Estonia's **sovereign rating** outlook from stable to positive, while Standard&Poor's and Fitch downgraded it from positive to stable. No rating agency changed the level of Estonian ratings during the year. Standard&Poor's and Fitch confirmed the rating of long-term foreign currency liabilities at level A. Moody's rating on the likelihood of the repayment of Estonia's loans has remained unchanged since autumn 2002. The rating A1 is a notch higher than the rating given by Standard&Poor's and Fitch.

Estonia's **sovereign risk ratings**, which set an upper limit to the rating of enterprises operating in the country, remained the same. In 2006, also Moody's started to use a credit risk methodology different from that of the sovereign rating level. The Estonian risk rating is now Aa1 according to Moody's, AA according to Standard&Poor's and AA- according to Fitch.

The positive outlook by Moody's is indicative of a long-term process oriented towards joining the euro area. The stability reflected by the ratings given by Standard&Poor's and Fitch is caused by the postponement of the euro adoption further than 2008. According to the agencies, euro area membership would significantly decrease risks stemming from the balance of payments and potential external shocks. The further rise of the Estonian sovereign rating is also inhibited by the considerably higher standard of living in other countries with the same rating. Estonia's sovereign rating is mainly supported by the strong fiscal policy, rapid economic growth arising from the flexible and competitive economic system and the strong banking sector. The analyses of rating agencies regarding Estonia are available on the web site of Eesti Pank.

In 2006, in the circumstances of rapid economic growth mainly stimulated by domestic demand, also loan and leasing demand remained strong. Similarly to 2005, the share of loans granted for acquiring and developing real estate in banks' financing portfolios rose. Besides the income base growth, banks' profitability was supported by the continuous increase in key interest rates. As for the domestic debt securities market, the primary market was more active than in previous years. The development of the Tallinn Stock Exchange in 2006 was affected by the price correction on global stock markets in spring/summer and the listing of new companies. The correction of stock markets also affected the yield and profitability of investment and pension funds and the insurance sector, entailing a slight slowdown of the brisk growth rate of assets. As regards payment methods, the share of non-cash payments kept increasing.

Banking

Institutional developments

In 2006, seven **credit institutions** and seven **branches** of foreign credit institutions were operating in Estonia. As at 31 December 2006, four foreign credit institutions had representative offices in Estonia. By the end of 2006, the number of applications submitted to the Financial Supervision Authority for providing **cross-border banking services** in Estonia reached 130.

The development of the Estonian banking market in 2006 was characterised by strong loan demand and thus also by the rapid growth of financing portfolios, which was not inhibited even by the rise of monetary policy interest rates (see Figure 6). For obtaining loans, enterprises still preferred the local banking sector to foreign credit providers. In addition to purchasing and renovating housing, individuals have also begun to obtain more credit for consumption.

Assets and liabilities of banks

In 2006, banks' assets increased due to the great loan demand by a total of 54 billion kroons, i.e. by 30%. At the end of the year, the total assets of banks exceeded 240 billion kroons. The total volume of the financing portfolios of banks and leasing companies reached over 201 billion at the end of 2006, having grown by almost 67 billion kroons year-on-year. The share of secu-

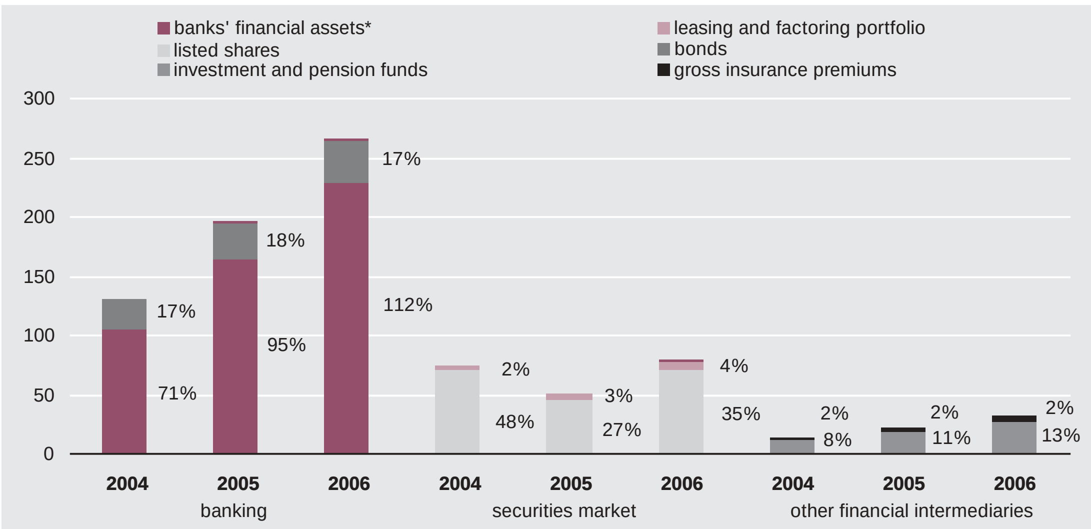
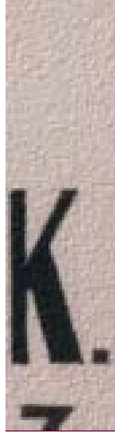


Figure 6. Structure of Estonian financial intermediaries (EEK bn and % of GDP)

* except loans to financial institutions



rities portfolios in banks' balance sheets remained at the previous year's level. The share of claims and liabilities in the aggregate balance sheet decreased as a result of changing intra-group financing schemes.

Despite the rise in key interest rates and a halt in the decrease of loan margins, the number of housing and commercial real estate loans grew even more drastically than before (see Figure 7). The stock of private housing loans and leasing shot up by nearly 60%, approaching 66 billion kroons towards the end of the year. Besides housing loans, the demand for private consumer credit also continued to be high. Thus, the share of loans obtained for other purposes than purchasing housing in the total household debt burden remained at a level comparable to that of end-2005 (22%).

As regards the corporate sector, the share of loans granted to commercial real estate companies has increased the most. Within a year, the stock of loans granted to such enterprises grew by over 15 billion kroons. By the end of the year, their share in banks' loan and leasing portfolios accounted for almost a third. From among tradable sector companies, financing the industrial sector gained the most in terms of volume (by 3 billion kroons), whereas financing the operations of hotels and restaurants grew the fastest (66%, i.e. by 1.3 billion kroons).

As the 27% year-on-year growth of deposits (25 billion kroons) did not suffice for satisfying the strong loan demand, banks obtained over 20 billion kroons of additional funds from parent banks. The growth would have been even stronger, but non-resident parent banks partly started financing their subsidiaries directly. Due to tightening capital requirements the share of own funds (incl. subordinated liabilities) in banks' aggregated balance sheet increased in 2006.

Profitability

In 2006, banks' **profitability** was supported by the continuing growth of both the loan volume and key interest rates as well as by the relatively low costs of loan write-downs (see Figure 8). As the majority of loans in Estonia have been granted with a floating interest rate, the rise in key interest rates is reflected in interest income rather than in interest expenses. Thus, the price spread and net interest margin indicators that had rather followed a downward trend in the first half of 2006 began climbing in the second

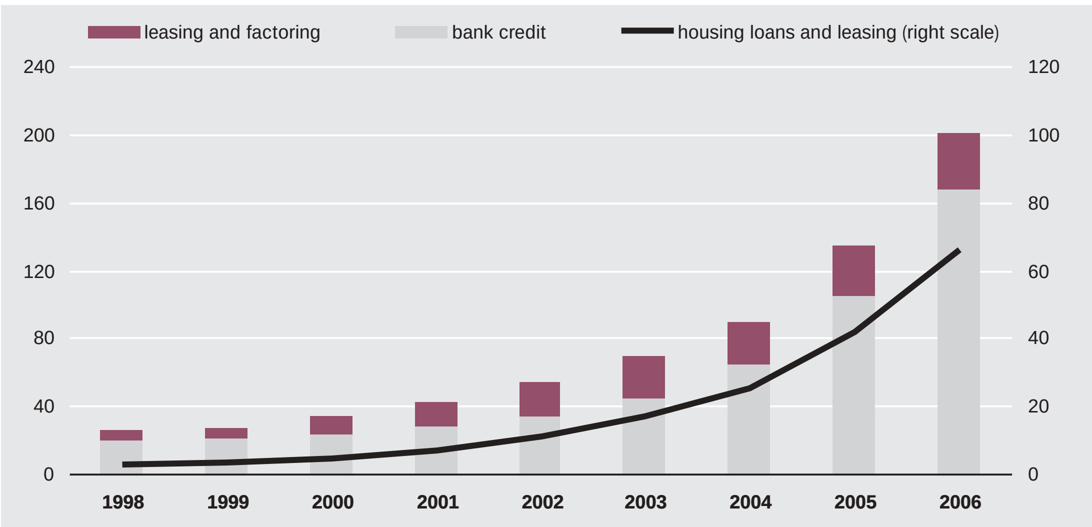


Figure 7. Public and non-financial sector financing (EEK bn)

half of 2006, reaching 2.1% and 2.2% by the end of the year, respectively.

Compared to the previous year, the aggregate indicator of the banking sector profitability in 2006 was influenced by lower investment income. However, dividend income mainly shrunk because the profit earned by subsidiaries was not withdrawn as dividends.

Despite the rapid growth of operating volumes, banks have managed to keep the increase of administrative costs lower than that of returns. Banks' total costs comprised 46% of returns in 2006. However, despite lower dividend income and the requirement to increase the share of own funds[1], the banking sector's return on equity in 2006 reached nearly 20%, which does not substantially differ from the indicator of 2005 (21%). The consolidated return on equity of banking groups exceeded 25%.

Capital adequacy and risks

Tightening the requirement on the share of own funds (i.e. establishing a 100% risk weight instead of the former 50% on housing loans for the calculation of capital adequacy) expectedly brought along a rise in the capitalisation of banks. In 2006, banks' aggregate risk assets grew by 49%, whereas their own funds increased by more than two thirds. Thus, at the end of December 2006, the aggregate capital adequacy ratio of the banking sector stood at 13.2% and at 10.8% on consolidated basis (see Figure 9).

Although key interest rates rose further in 2006, the loan-servicing capability of bank customers remained good. The share of loans overdue for more than 60 days in the loan portfolio remained close to 0.3% throughout the whole year. The provisioning principles of banks, however, may still be considered quite conservative. By the end of 2006, the total volume of write-downs exceeded that of loans overdue for more than 60 days by nearly 50%.

Securities market

Debt securities market

In 2006, the debt securities market was characterised by a much more active primary market compared to the previous year. In 2006, the securities market capitalisation that has been increasing since 2004 grew by 69%, i.e. to more than 8 billion kroons. The market expanded mainly due to the bonds issued of local non-financial and financial sector companies.

Unlike the lively primary market, the daily turnover of the secondary market decreased from 17 billion kroons in 2005 to 14 billion kroons in 2006. Similarly to the previous year, 80% of bond investors as at end-2006 were residents. The majority of them were local credit institutions and investment funds.

Stock market

The development of the Tallinn Stock Exchange was contradictory in 2006. In spring/summer, global stock markets witnessed one of the greatest corrections in recent years that also affected trends at the Tallinn Stock Exchange quite significantly. The market was stirred up by listing the shares of the construction company AS Eesti Ehitus and casino enterprise Olympic Entertainment Group AS on the stock exchange. The listing of new shares increased the capitalisation of the stock market by almost 16%. Furthermore, for the first time in the history of Baltic securities markets, public trading with the stocks of Olympic Entertainment Group took place simultaneously in Estonia, Latvia and Lithuania. In the second half-year, prices on the Tallinn Stock Exchange started increasing rapidly again.

[1] Due to increasing the risk weight on housing loans in calculating the capital adequacy of banks.

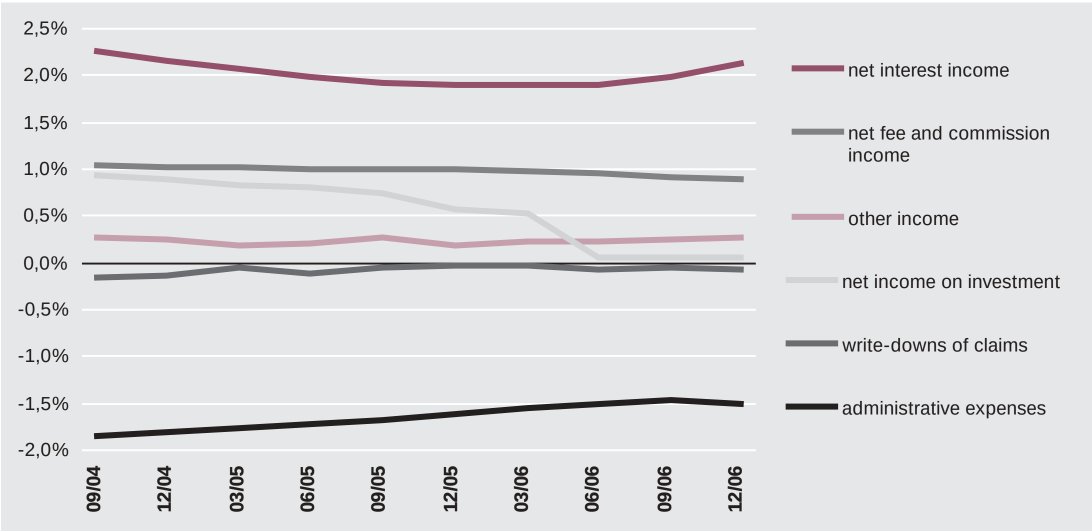


Figure 8. Income and expense items of banks (% of total assets)

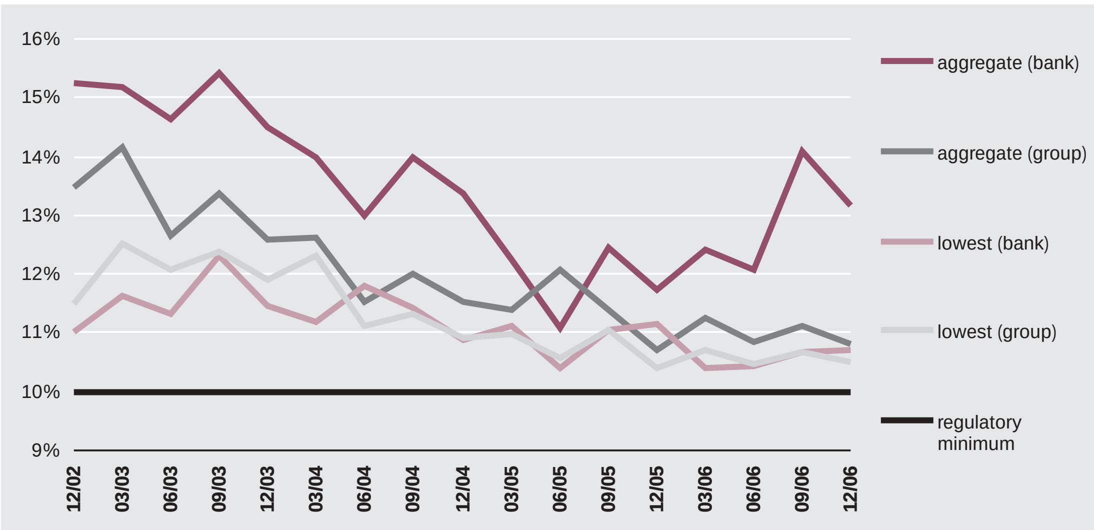


Figure 9. Banks' capital adequacy on solo and consolidated basis

At the end of 2006, the stock index OMX Tallinn reached another record level with 856 points owing to the growth of stock prices during autumn and winter (see Table 2 and Figure 10). Although in May and June 2006, the value of the index dropped as a result of the stock market correction, at the end of 2006 its year-on-year growth still reached 29%.

The average daily turnover of stock exchange transactions stood at 48 billion kroons in 2006, which is almost two-and-a-half times less than in 2005 when the takeover of Hansapank by Swedbank occurred.

Other financial intermediaries

Investment and pension funds

The growth of investment fund assets decelerated in 2006 due to the high comparison basis and stock market correction. In total, the

Table 2. Aggregate indicators of securities markets (EEK bn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Securities market capitalisation*	**10.6**	**19.1**	**12.6**	**31.9**	**35.2**	**31.9**	**42.2**	**53.5**	**80.0**	**60.1**	**79.2**
Instruments											
shares listed on stock exchange	8.0	13.1	8.3	28.3	31.0	26.4	36.2	47.3	71.9	46.9	71.0
debt securities	2.4	4.0	3.7	3.2	3.7	4.4	3.3	2.9	3.1	4.8	8.5
shares and units of investment funds	0.3	1.8	0.4	0.4	0.4	0.9	1.7	2.6	4.5	8.4	10.2
subscription rights	-	0.1	0.2	0.0	0.0	0.2	1.0	0.7	0.5	0.0	0.0
Securities market turnover*	**3.2**	**32.8**	**32.8**	**12.4**	**10.1**	**10.2**	**13.0**	**14.9**	**13.9**	**68.4**	**37.4**
Capitalisation of Tallinn Stock Exchange	8.0	13.1	8.3	28.3	31.0	26.4	36.2	47.3	72.4	46.9	72.3
non-resident investors	36%	42%	54%	74%	78%	78%	81%	81%	83%	58%	49%
Turnover of Tallinn Stock Exchange	2.3	21.8	13.4	4.5	5.5	4.1	4.0	7.6	10.3	30.3	12.0
Securities market capitalisation* / GDP	19%	29%	17%	39%	38%	31%	36%	42%	58%	46%	39%
Securities market turnover / capitalisation	30%	172%	260%	39%	29%	32%	31%	28%	17%	90%	59%
Stock exchange turnover / capitalisation	29%	167%	161%	16%	18%	16%	11%	16%	14%	47%	24%

* Securities market capitalisation and market turnover do not include unlisted shares.

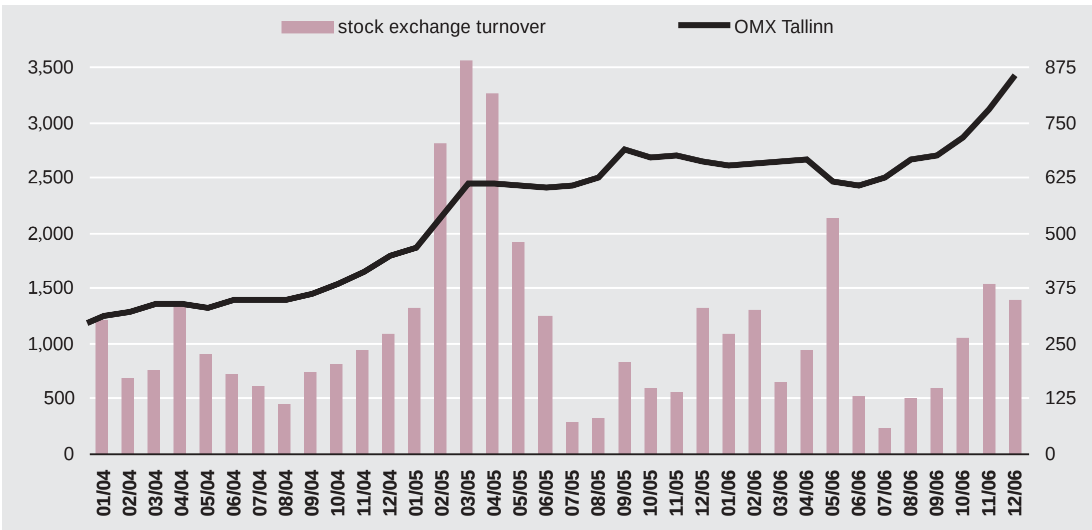
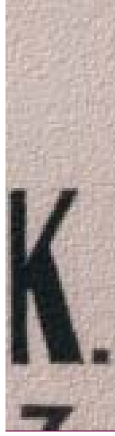


Figure 10. Monthly turnover of the Tallinn Stock Exchange (EEK m; left scale) and index OMX Tallinn as at end of month (points; right scale)



volume of investment fund assets increased by 8.8 billion, exceeding 27 billion kroons. Like before, the growth rate was primarily affected by investments in equity funds and mandatory pension funds (see Figure 11).

Insurance

The growth of the **life insurance market** in 2006 remained slightly slower than in the three previous years. However, compared to 2005 the collection of gross premiums gained by 21%. In 2006, the volume of gross premiums collected by life insurance companies exceeded 1.5 billion kroons. The majority was comprised of unit-linked life insurance and capital insurance gross premiums.

Gross premiums collected by **non-life insurance companies** increased 16% in 2006. The total volume of gross premiums amounted to 3.1 billion kroons.

Two new insurance providers entered the non-life insurance market in 2006: AS Hansa Varakindlustus and D.A.S. Õigusabikulude Kindlustuse AS. Hansa Varakindlustus focuses mainly on insuring property and land vehicles, whereas D.A.S Õigusabikulude Kindlustus specialises in legal expenses insurance.

Payment methods

The **total number of payments** in 2006 exceeded that of 1998, the initial year of collecting payment statistics, six-fold and the total turnover of payments was four times bigger (see Figure 12). Within nine years, the volume of payments made via direct debits has grown most drastically (142 times). The number of card payments has increased nearly 25 times. Lately, cash payments and paper-based credit orders have not been very popular among residents who prefer effective electronic payment methods and their use has been decreasing year after year.

Card payments formed the largest share (55%) in the number of payments in 2006, although the relative importance of their turnover remained below 1% of the total payment turnover. The next popular payment methods were Internet bank and telebank credit orders. In 2006, the share

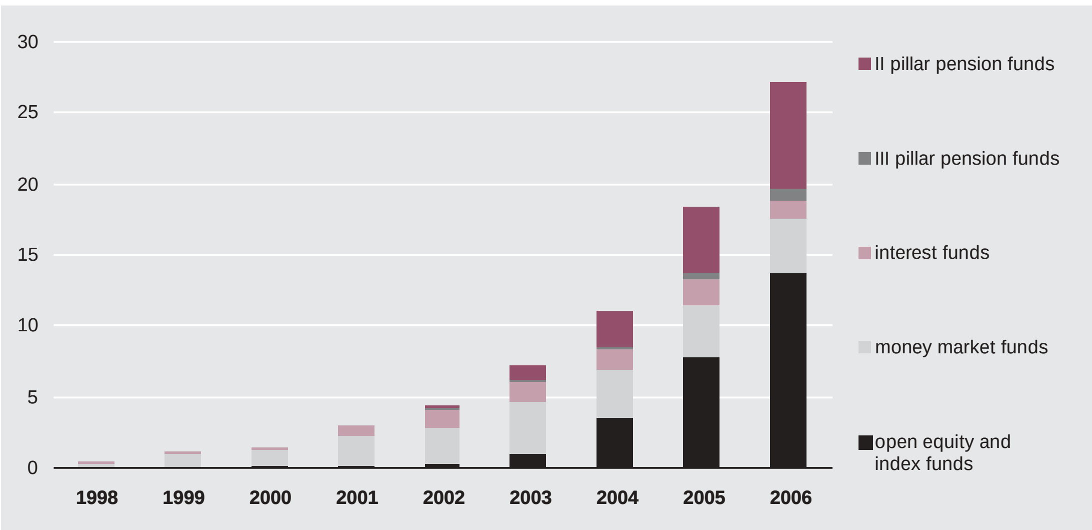


Figure 11. Total volume of investment funds as at year-end (EEK bn)

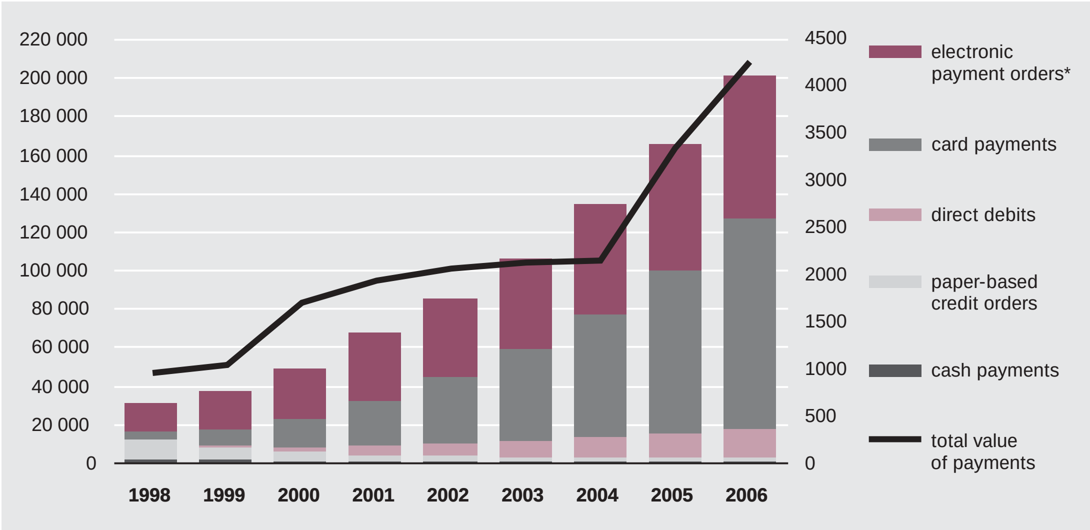


Figure 12. Number of payments (thousands; left scale) and their turnover (EEK bn; right scale) by payment methods

of **cash**[2] among payments made through banks comprised only 0.3% of the total number of payments and 0.04% of the turnover.

By the year-end, Estonian credit institutions had issued a total of **1.6 million payment cards**, exceeding the result of 2005 by 14%. 79% of the bank cards issued were debit cards (1.3 million) and 21% were credit cards (over 340,000). 25% of all payment cards were passive[3]. At the end of 2006, 95% of the population had debit cards and a quarter owned credit cards.

By the end of December, Estonia had **918 ATMs** and 85% of them enabled cross-usage. Within the year, 77 new ATMs were installed, i.e. approximately as much as in 2005. The number of points of sale (POS) that accept card payments increased 15% compared to the previous year and as at year-end, **14,665 POS provided the opportunity of using payment cards**.

[2] Cash payments made through banks are payments initiated with a cash down-payment or cash card transactions.
[3] Bank cards that were not used for making any payment transactions during the quarter.