ESTONIAN ECONOMY IN 2010

THE NON-FINANCIAL SECTOR

The monetary policy environment

The monetary policy environment remained accommodative throughout 2010. The monetary policy rates stayed low in the euro area, as the key policy rate of the European Central Bank remained unchanged at 1%.

The risk premiums of the local money market fell significantly. At the beginning of 2010, the 6-month Talibor of the local money market was almost triple the 6-month Euribor, but the differences in interest levels faded away during the year. By the end of the year, the Talibor had retreated to the level of the Euribor. The volume of forward transaction continued to fall during the year, with market participants showing no interest in hedging the risks related to the Estonian kroon. The risk premium for the credit default swap (CDS) of the Republic of Estonia dropped by nearly half. These positive trends started in the first half of the year, nourished by the conviction that Estonian fiscal policy would be able to avoid an excessive increase in the debt burden, and that the accession to the euro area was ever more likely. The final confirmation of the accession to the euro area was received on 13 July, when the EU ministers of finance set the official conversion rate of 15.6466 kroons per euro.

In connection with the changeover to the euro, the minimum reserve requirement was gradually lowered from 15% to the 2% of the euro area from September 2010 onwards. From the beginning of 2011, all Estonian credit institutions must adhere to the 2% reserve requirement used in the euro area. As anticipated, the change in the reserve requirement did not trigger significant changes in the behaviour of the banks.

Domestic and external demand

In 2010, Estonian economic activity was affected above all by the recovery in external demand. Both global economic growth and the recovery of Estonia's main trade partners proved quicker than expected. The recovery in global demand enhanced the Nordic export indicators and it also brought in orders to the Estonian subcontracting industry. The sudden downturn in 2009 was followed by economic growth in 2010. According to the flash estimates of Statistics Estonia, GDP rose by 3.1% in 2010 compared to 2009.

The economic recovery was led by the export sector and growth in the exports of goods gained momentum throughout the year. Export indicators improved in all categories of goods, with the total exports of goods at current prices breaking the all-time record in the fourth quarter. According to preliminary estimates, the exports of goods at current prices increased by nearly 35% and the exports of services by nearly 7% in 2010, compared to 2009. The rapid growth in exports reflects the successful attempts of several exporters to improve their competitive position in the market. The advantages of Estonian businesses lie in their flexibility in serving orders, and their favourable production costs for the Nordic supply chain.

Domestic demand remained weak in 2010. The low level of incomes and the underutilisation of resources were the main reasons why the indicators for both private consumption and investments remained at low levels. Nonetheless, domestic demand ceased to decline in the second half of the year. The decline was even reversed in the retail trade at the end of the summer, with sales volumes starting to grow at the end of the year. The recovery in domestic demand was mainly driven by the labour market situation.

The unemployment rate was 19.8% in the first quarter of 2010, having declined quickly to 13.6% by the last quarter of the year. The annual average unemployment rate still peaked at 16.9%, which is the highest rate since independence was regained. Employment recovered above all in the processing industry, as a consequence of the increase in exports. In several sectors, the production capacity recovered mainly due to the rise in the number of hours worked and growth in productivity. The re-creation of jobs, however, will take time. Nevertheless, the labour market recovery exceeded expectations in 2010, fuelled by the rapid growth in exports and the competitiveness of Estonian labour force in the neighbouring countries.

Weak domestic demand held back the rise in import volumes to its pre-crisis level. According to preliminary estimates, imports at current prices grew by nearly a quarter, year-on-year. The underutilisation of production resources decreased the imports of investment goods. Private consumption was hampered by uncertainty, along with a fall in income. The main contributor to the growth in imports was the growth in exports of goods. The surplus of the services account of the balance of payments remained more or less on a par with that of 2009, with the trade deficit falling back by nearly 60%. The positive impact of the fall in the trade deficit on the current account was counteracted by the increase in the income account deficit due to the restored profitability of investments. The net outflow of income mainly consisted of reinvested income. Overall, the current account surplus remained more or less on a par with that of 2009, amounting to approximately 3.5% of the GDP according to preliminary estimates.

Estonia's gross external debt fell by 5% to 16.6 billion euros by the end of the year. The drop in the debt level was mainly caused by the decrease in the liabilities of credit institutions.

Inflation

In 2010, increased commodity prices together with economic revival brought about the acceleration of inflation. Year-on-year, prices climbed by 3% and in December, annual inflation reached 5.7%.

An annualised average rise in food prices was 2.8%, accelerating to 10.8% year-on-year in the last quarter of 2010. This was caused by the increase in the global price of raw materials for food, new export opportunities, poor weather conditions and the recovery of the food industry and of retail trade margins. The price of fresh vegetables, for example, showed a dramatic year-on-year increase of 40.4%.

Housing costs increased by 2.9%, fuelled mainly by the increase in the price of electricity, gas and heat energy. This can be directly associated with the rapid rise in the global price of oil in 2010. For the same reason, the price of motor fuel rose by 20.1%.

The post-crisis economic adaptation through price decline came to a halt in the first quarter of 2010, with domestic price pressures remaining low throughout the year. High unemployment eased the wage pressures, while utilisation of production capacities grew, although it remained significantly below its historical average.

The hikes in alcohol and tobacco excise duties and also in motor vehicle excise duties in January 2010 were among these administrative decisions that affected the increase in price level the most. Furthermore, a 1% sales tax was established in Tallinn in June.

General government

The fiscal policy of 2010 relied on measures implemented to improve the fiscal position in

2009. The general government expenditure for 2010 remained more or less on a par with that of the previous year. At the same time, revenues were buoyed by temporary and one-off measures, including the government's decision to suspend temporarily its contributions to the second-pillar pension fund to cover other expenses, and the sale of property.

The quicker-than-expected recovery of the economy helped to boost tax revenues. Tax revenues for 2010 remained similar to those of 2009, and the forecasted decline did not materialise. Nearly 107% of the budgeted non-tax revenues were collected. Revenues were mainly collected from assets, above all emissions trading, and the EU budget.

According to preliminary estimates, the Estonian general government deficit of 1.7% of GDP in 2009 turned into a surplus of 0.1% of GDP in 2010. The deficit was mainly reduced by the sales of Kyoto Assigned Amount Units.[1] The fiscal position is expected to deteriorate to some degree in 2011.

The government has set a priority of restoring the fiscal reserves and generating a surplus in 2013. In achieving this objective, the guiding principle should be that growth in general government expenditures may not exceed growth in revenues.

Sovereign rating

Sovereign rating, or the credit rating of a country, is an assessment by private international rating agencies of a country's ability and willingness to repay its long-term foreign liabilities on time. The sovereign rating indirectly reflects the reliability of a country's economy and economic policy and it largely determines the interest rate on foreign borrowings.

The rating agency Standard & Poor's raised Estonia's sovereign rating from A–, outlook negative to outlook stable in February 2010, upgrading the rating by one level to A in June and maintaining the stable outlook. In March 2010, Moody's raised Estonia's sovereign rating outlook from negative to stable, giving a rating of A1. The rating agency Fitch raised Estonia's sovereign rating from BBB+ outlook negative to outlook stable in February 2010, and upgraded the rating by two levels to A in July, with outlook stable. The upgrade in the ratings and outlooks stemmed from a significant improvement in the Estonian economic and public finance outlook, as well as the prospects of acceding to the euro area.

In their reports for 2010, the rating agencies highlighted the following factors that support or weaken Estonia's sovereign ratings:

Supporting factors

- Strong fiscal policy to date and a considerable liquidity buffer. Government debt and deficit among the lowest in the European Union. The economic decline was addressed without significantly increasing the government debt.
- Accession to the Economic and Monetary Union in 2011, expected to lower the currency risk and enhance access to capital markets.
- A competitive and open economy which is flexible enough to cope with temporary weak demand.
- The foreign-owned banking sector lessens the state's burden of providing liquidity and supporting the domestic banking sector. This also serves to hedge the external

[1] By international methodology, the revenues from the sales of Assigned Amount Units are accounted in Government Finance Statistics within the period when the ownership of these units changes, and the "green investments" made out of these revenues are accounted accordingly in the period when the expenditures occur.

financing risk, as a majority of the external financing is made up of the capital flow between parents and subsidiary banks.

Weakening factors

- The relatively low level of incomes.
- Potentially huge incidental expenses of the financial system, partially balanced by the support of Nordic parent banks.
- Dependence on the conditions of the external markets.
- Estonia's gross and net external debt, compared to countries with similar ratings.
- The private sector's high debt burden, which exceeds the level of incomes per capita.

The rating agencies' annual reports on Estonia are available on the website of Eesti Pank.

THE FINANCIAL SECTOR

The deterioration of the banking sector's loan quality, which was triggered by the sudden economic decline in 2009, was reversed in 2010 as the economy recovered. The level of problem loans peaked in the second trimester of 2010. Even though loan quality problems of the previous cycle will continue to affect banks' balance sheets in the next few years, the proportion of problem loans is clearly shrinking. Above all, banks' assets have been affected by private sector's deleveraging, which has inhibited credit demand. Banks' assets also decreased due to writing off more uncollectible receivables.

The year was quite unfavourable for securities markets. Stock market capitalisation fell significantly and local bond market activity dropped to a record low level. In total, the assets of financial system participants as a ratio of GDP declined during the year (see Figure 1).

The banking sector

Institutional developments

At the end of 2010, seven credit institutions were operating in Estonia. Among those offering private financing, Folkia joined the ten branches of foreign credit institutions operating in the market. In addition, Parex Banka Estonian branch was transformed into Citadele Banka branch. A total of 251 foreign credit institutions provided cross-border banking services.

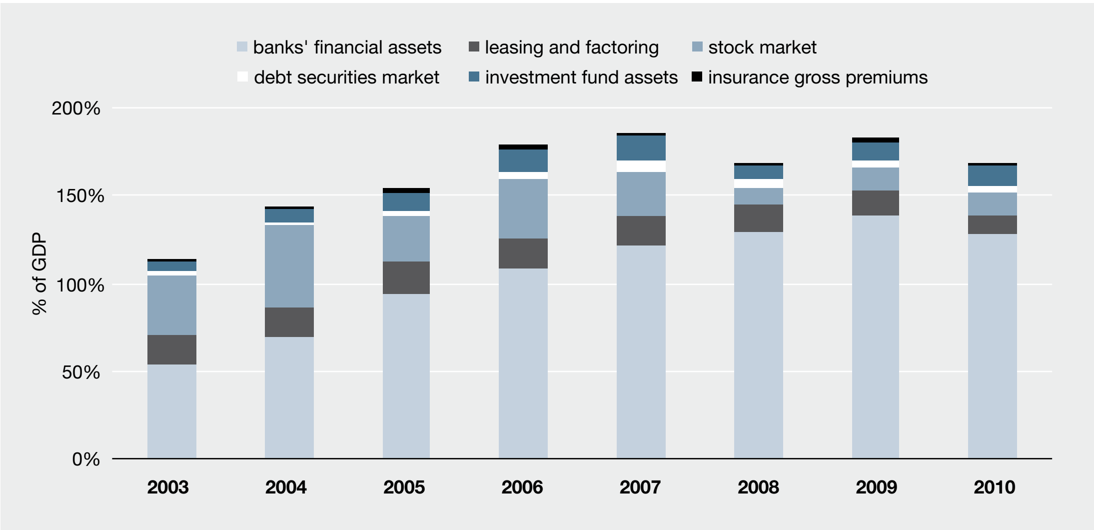

Figure 1. Structure of Estonia's financial system

The re-division of the market, which began in 2009 against the backdrop of a change in the operating environment, continued in 2010. The branches of foreign credit institutions and small banks increased their market share at the expense of larger banks (see Figure 2).

Assets and liabilities of banks

Banks' assets continued to fall in 2010 as companies and households reduced their financial leverage. The loan portfolio, which makes up the bulk of assets, contracted throughout the year, shrinking by a total of over 4.8% as a result of loan amortisation and low level of new lending (see Figure 3). The stock of new loans is very small. In consequence, the banks continued investing their assets in other instruments in 2010, bonds above all. This means that the banks' assets are much more liquid than they were a few years ago.

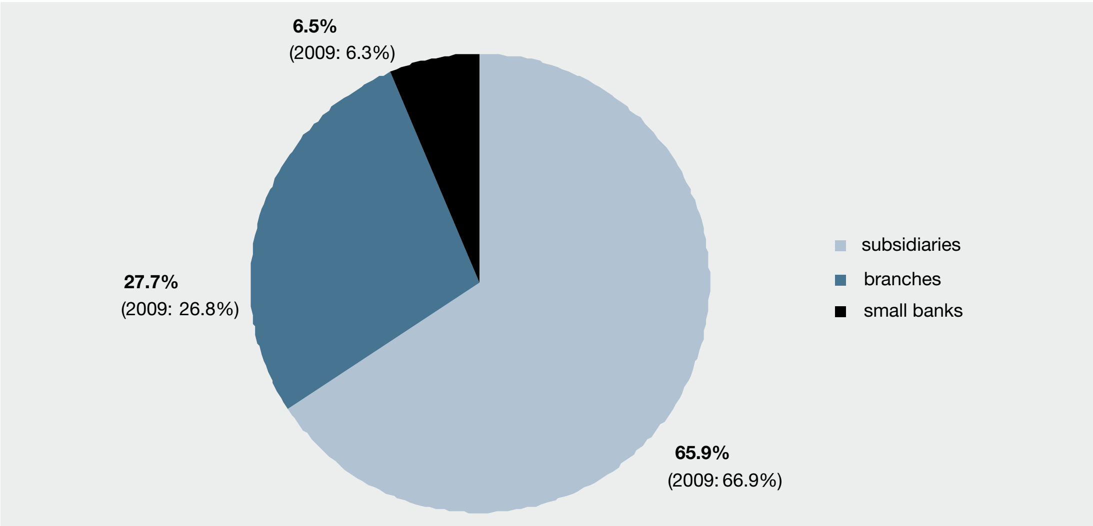

Figure 2. Banks' market share by total lending

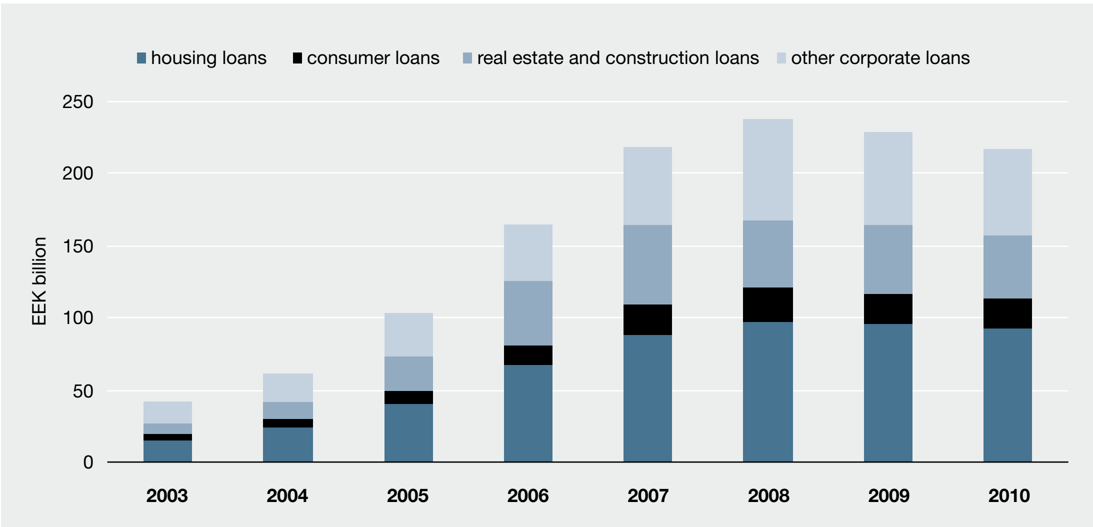

Figure 3. Banks' loan portfolio at year-end

Loan stock decreased mainly through the contraction of the corporate loan portfolio as low domestic credit demand cut the corporate loan stock by 6.4%. The loan stock of the construction and real estate sectors and manufacturing and logistics shrank the most. At the same time, the stock of loans issued for infrastructure development and to the farming and fishing industry was higher than it was at the end of 2009. Bank loans to households also shrank by a total of 3.3% against the backdrop of high unemployment and weak domestic demand. Even though the housing loan stock dropped by 2.3%, the slow amortisation of long-term loans raised the share of these loans in the total loan portfolio to 43%. The stock of consumer loans fell by 8.1% over the year.

Low demand for financing was reflected in the leasing and factoring portfolio which contracted by over 20% in 2010. Corporate leasing showed the biggest decline and private car leasing fell by nearly 16% over the year.

Domestic deposits showed a rapid increase in 2010, which changed banking sector funding to a more traditional retail deposit based one. Deposits grew by 5.3% in the banks operating in Estonia in 2010, to a total of nearly 158 billion kroons at the end of the year. The lowering of the deposit interest rates to a level comparable with that of the euro area reduced the appetite for term deposits, with the share of term deposits in total deposits thus dropping by 8 percentage points to 43%. Against the growth in deposits and modest credit demand, funds borrowed from foreign banks were repaid during the year. At the end of the year, funding from foreign banks totalled 102 billion kroons, or a little more than 37% of the total liabilities. As a result, the loan-to-deposit ratio decreased by over 14 percentage points to 140% at the end of the year.

Quality of the loan portfolio

With the recovery of economic activity, the negative trends were reversed in the second half of 2010 after a natural time-lag, and the quality of the banks' loan portfolio started to improve. The share of loans overdue for more than 60 days in the loan portfolio amounted to 7.6% in August, and had dropped to 6.5% by the end of the year. This was prompted by non-performing loans starting to perform again, and by the write-off of uncollectible receivables.

Even though the share of uncollectible corporate loans decreased during the year, the dynamics differed greatly across sectors. The biggest increase could be seen in loans overdue for more than 60 days, issued to the manufacturing, transport and trade sectors, while the overdue loans of real estate and construction companies decreased.

Despite persistent unemployment, the quality of housing loans improved in the year. At the end of the year, loans overdue for more than 60 days made up 4% of the loans issued. At the same time, the quality of consumer loans deteriorated. By the end of the year, overdue loans accounted for 8.4% of the sector's loans.

Profitability and capitalisation

The banking sector posted a net profit of 1.1 billion kroons in 2010[2] (see Figure 4). Banks' profitability has been enhanced primarily by the decline in provisions for loan losses. The previously established provisions were even charged to profit by some banks in the last quarters of the year.

The ratio of the banks' net interest income to assets showed moderate but stable growth. This growth has been encouraged by the

[2] Unaudited net profit as at the preparation of the Annual Report.

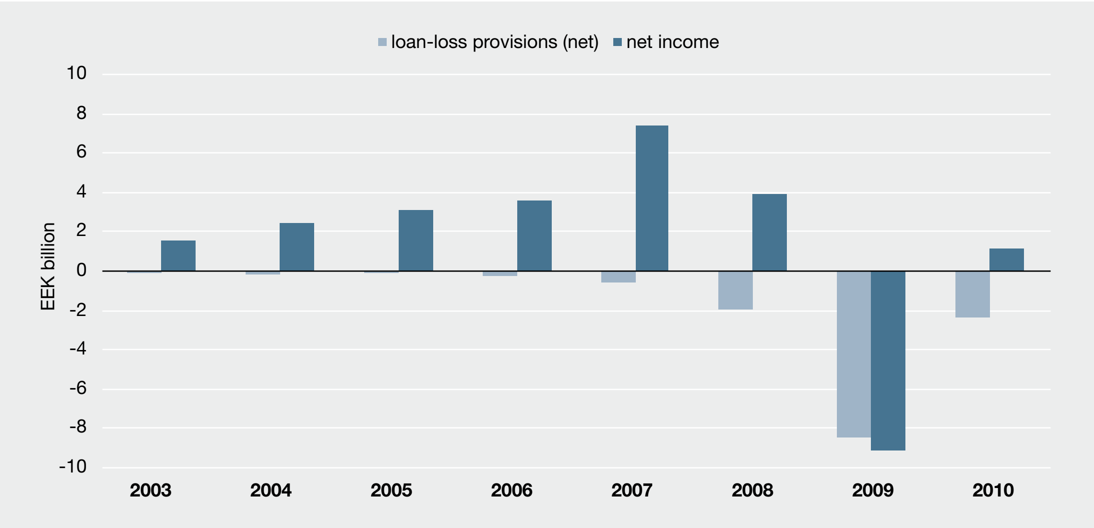

Figure 4. Banking sector profitability

decline in interest expenses, which gained momentum in the autumn of 2009 as the banks gradually lowered the interest rates for kroon deposits.

The banks' administrative expenses went up by 4% in 2010. The acceleration in the growth in expenditure in the second half of the year was fuelled by the preparation for the adoption of the euro. Nevertheless, banks succeeded in maintaining their high profitability. Profitability before provisions and write-offs also grew in the last quarter.

The banks' consolidated capital adequacy ratio reached 16.2% at the end of the year, significantly exceeding the 10% minimum requirement. Stress tests confirm the sufficiency of the capital buffers even in the worst case scenario.

Securities markets

Bond market

The primary bond market was very quiet in 2010. The volume of new bond issues constituted only 15% of the volume in 2009. Issuers were mainly local non-financial sector companies (see Figure 5).

On account of the small volume of bonds issued and the redemption of bonds, bond market capitalisation fell by 7.3% in the year. At the end of the year, capitalisation totalled 8.9 billion kroons, or 4.0% of GDP, with the bonds of non-financial sector companies contributing 74%. No bonds were listed on the Tallinn Stock Exchange after June, when the last two listed bonds were redeemed.

The year 2010 also saw some changes among bond investors. Compared to last year, insurance companies and pension funds decreased their share of bond-holding, while the proportion of bonds held by the non-financial sector, credit institutions and private persons increased. The proportion of local investors fell for the first time in three years, accounting for 71% of the total bonds issued at the end of the year.

The secondary bond market was also very quiet. The average daily turnover decreased and at the end of 2010, reaching a half of the average daily turnover for 2009.

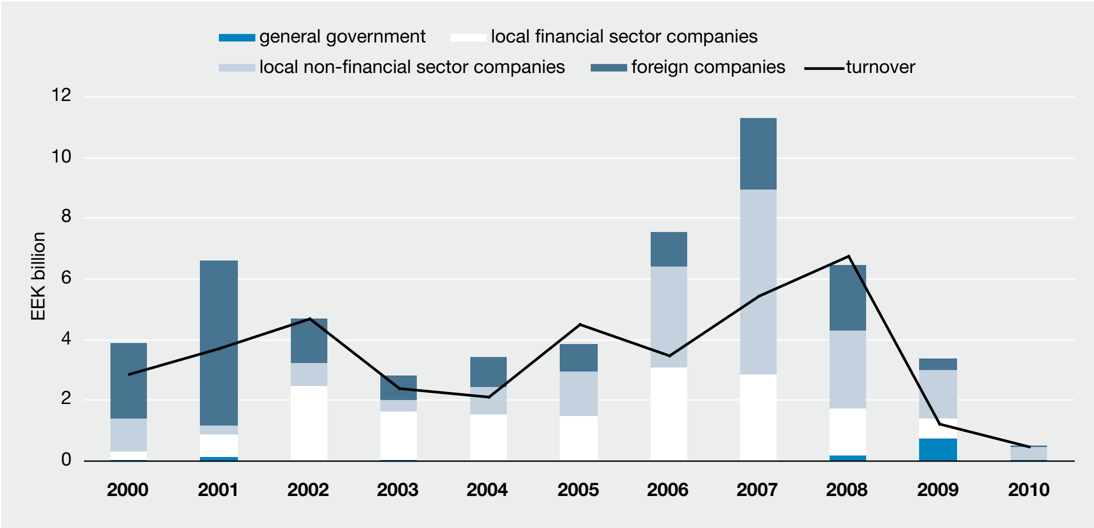

Figure 5. Debt securities by issuers and secondary market turnover

Stock market

At the beginning of 2010 the shares of Eesti Telekom and Norma were delisted from the primary exchange and in May the shares of Premia Foods were listed on the primary exchange. As at the end of the year, the shares of 15 companies were listed on the Tallinn Stock Exchange, with the total transactions concluded with the shares of three companies contributing more than half of the total turnover.

The OMXT index advanced by nearly 73%, reaching its level of the beginning of 2008 (see Figure 6). Stock exchange capitalisation fell by 9%, following the delisting of one of the biggest companies, Eesti Telekom, at the beginning of 2010.

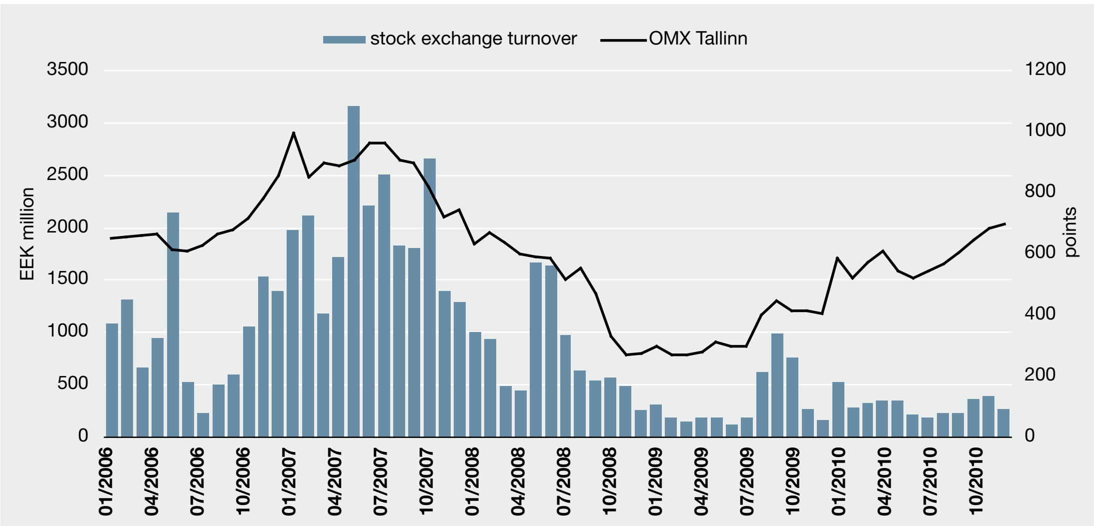

Figure 6. Monthly turnover of the Tallinn Stock Exchange and OMX Tallinn index as at month-end

The delisting of two companies resulted in a fall of nearly 30 percentage points in the share of the market held by non-resident investors to 37% at the end of 2010. At the same time, private persons held 10% of the listed shares.

Other financial intermediaries

Investment and pension funds

Two new stock funds, a real estate fund and two second-pillar pension funds were launched in the Estonian market in 2010, while two stock funds and an interest fund were eliminated. At the end of 2010, 41 investment funds and 35 pension funds were registered in Estonia.

Investment fund assets totalled 9.8 billion kroons at the end of 2010, which is more or less the same as at the end of 2008 (see Figure 7). Despite the positive annual yield of interest funds, the interest fund assets dropped by 10% due to the elimination of a fund. Stock fund assets grew by nearly 23% as a result of the yield and the addition of new stock funds.

Contributions to the second-pillar pension funds dropped by nearly three times in 2010. This was mainly caused by the suspension of state contributions in the second half of 2009. At the same time, the second-pillar pension fund assets have grown by 13%, fuelled by the yield, amounting to 16.8 billion kroons at the end of the year. The assets of the third-pillar pension funds grew by 23% during the year. Together with insurance contracts, the assets of the third-pillar pension funds totalled 3.9 billion kroons as at the end of 2010.

Insurance

In 2010, insurance companies collected 5% fewer insurance premiums from Estonian residents than they did in 2009, with the result that the local insurance market sank for the third year in a row. At the same time, indemnities also dropped by 5%, so the operating results of insurance companies remained very good. As at the end of 2010, 13 life insurance and non-life insurance companies were authorised to operate in Estonia, with five branches of foreign non-life insurers registered.

Life insurance companies collected 1.2 billion kroons in life insurance premiums in 2010, which was 7% more than in 2009. Despite the growth

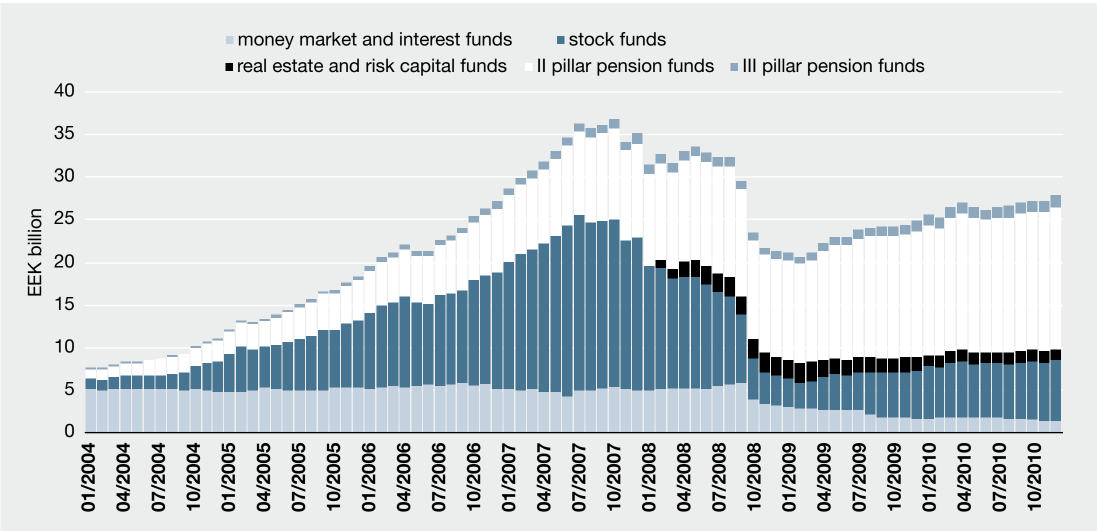

Figure 7. Value of investment and pension fund assets as at month-end

in insurance premiums, the difficulties in agreeing new contracts and maintaining existing contracts continued. Half of the Estonian life insurance market is still focused on unit-linked life insurance products. In unit-linked life insurance, the risk is borne by the policy holder, so the risks for insurance companies have been lower and the operations more profitable than those in other EU Member States. Life insurance companies posted a net profit of 407 million kroons (unaudited) in 2010.

Even though the state capital-based KredEx Krediidikindlustus entered the non-life insurance market in 2010 by engaging in export credit risk insurance, total insurance premiums still dropped by 9% to 3.4 billion kroons in 2010. Growth in the sale of new cars heralds an upturn that is expected to boost revenues from third party liability motor insurance and voluntary motor insurance of land vehicles. Despite the drop in sales, non-life insurance companies posted a net profit of 548 million kroons (unaudited) in 2010. Profitability was buoyed by cost cutting and by a 7% drop in indemnities compared to the last period. A total of 2.1 billion kroons were paid in indemnities over the course of the year.

Payment instruments

After a fall in 2009, the value of inter-bank payments started to rise in 2010, which was mainly due to the increase in non-cash payments. The value of non-cash payments increased by 3.3% to an average of 14.7 billion kroons per day, while the value of cash payments decreased by 8.5% to an average of 4.6 million kroons per day (see Figure 8). This change can be attributed to the recovery of economic growth.

The preferred choice of payment instruments follows the trend for pursuing the most efficient solution. The Estonian payment environment is sufficiently well-established, and a payment instrument is usually preferred for its convenience, speed and price rather than its novelty. In addition, international surveys suggest that the pricing of payment services in Estonia is relatively transparent, compared to that in a majority of EU countries, and this makes the choice of a suitable payment instrument easier for the client.

In 2010, the greatest increase could be seen in the value of internet bank payment orders and other types of credit orders. The value of direct

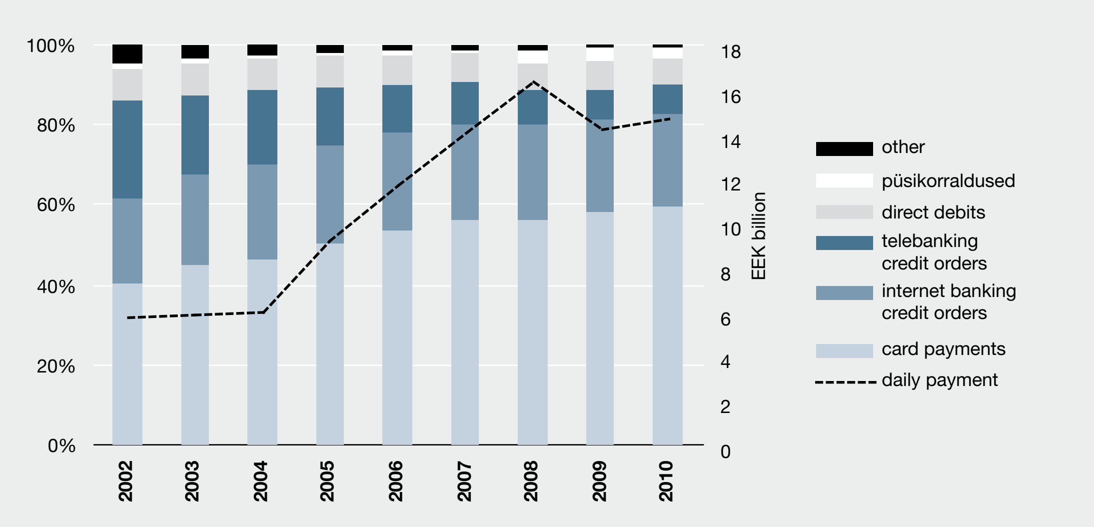

Figure 8. Most common payment instruments in Estonia and average daily payment turnover

debits and card payments, the most common payment instrument, increased 17% and 5.5%, respectively. The value of paper-based and telebank credit orders continues to decrease. The value of mobile payments – a new service which gained momentum a short time ago – dropped by 19.6% to an average of 1,227 kroons per day.

The number of payment cards issued fell by approximately 41,000 to 1.8 million in 2010 or 1.3 cards per person. Even though the numbers dropped for all types of payment cards, the biggest decrease could be seen in the number of credit cards. The number of credit cards dropped by 35,000, with credit cards accounting for 22% of all payment cards issued at the end of 2010[3]. The shares of instalment cards and charge cards showed the biggest decline among credit cards, dropping by 20,977 and 11,841, respectively. The numbers of actively used debit and credit cards grew by 2% and 4%, respectively. This means that the number of payment cards issued dropped mainly at the expense of cards which were not previously used in daily payment transactions.

The most popular debit cards are the international VISA cards, which made up 68.4% of all cards, and 87.5% of debit cards. The international VISA and MasterCard cards are equally popular among credit cards.

The number of ATMs decreased by four, owing to a fall in the number of payment ATMs. The number of points of sale (POS) and POS terminals decreased sharply in 2010. The number of points of sale dropped by 338 to 17,333 for points of sale accepting both card and mobile payments[4]. The number of POS accepting mobile payments started to fall rapidly in earlier periods, with only 29 mobile payment points of sale remaining by the end of 2010. The number of POS terminals dropped by 616 to 26,287. Even though the number of POS terminals accepting cards grew by 234, the number of cash register systems dropped by a total of 981[5].

[3] Four types of credit cards are issued in Estonia: revolving credit cards, charge cards, instalment cards and other credit cards with several different options for repaying the credit generated upon use of the card.
[4] Three types of points of sale can be distinguished: points of sale accepting card payments, those accepting mobile payments and those accepting both card and mobile payments.
[5] There are five types of POS terminals: POS-terminals, cash register systems, imprinter, e-commerce and MOTO (mail order/telephone order).