SUMMARY

Macroeconomic and External Environment

Even though market participants had already for some time regarded Estonia as a future EU member state in their risk estimates, 1 May 2004 was still an important milestone, which marked the beginning of a new era in Estonian economy. Together with political integration the deepening of economic integration also gained a new impetus and meaning. **The increase in credibility that came along with the accession** was reflected in yet another decline in money market interest margins. The average spread between Estonian and euro area interest rates is below 30 basis points.

Global economic development in 2004 has generally supported Estonian macroeconomics and financial sector. Owing to improved external demand and consistently strong domestic demand, **sales revenue figures have been high and the profit growth rate has accelerated compared to previous years**. Households have benefited from that as well – the labour market has improved slowly but steadily, which is reflected in increasing employment. The positive outlook is also supported by improved corporate and household confidence estimates.

Although global economic growth indicators have improved significantly year-on-year, the economic recovery in Europe has remained comparatively modest. In that context, **no significant rise in interest rates is anticipated in the euro area in 2005**.

The main source of uncertainty in the external environment concerns the recovery of European economic growth rate. From the Estonian economy's point of view one might ask whether our domestic economy is competitive enough to benefit from the expected European economic recovery. Should European economic growth pick up more slowly than expected or should there be a decline, it might cast doubt on the future profitability of several recent investments.

Corporate Financial Behaviour and Risks

Corporate debt growth, which had peaked in the first half of 2003, has started to slow down. Similar developments have occurred also in most of the EU-15 Member States where declining interest margins have helped to improve corporate balance sheets while reducing their debt burden. Estonian companies have witnessed a clear trend of improved loan conditions leading to faster growth in domestic bank loans and leasing at the expense of foreign debt. While domestic debt has increased at an average rate of 25% in the past six months, foreign debt growth decreased to 9.0% in mid-2004. Along with domestic and foreign debt, foreign equity investments (particularly in the real estate and construction sector) have also largely increased.

The growth in (domestic) loan portfolio has remained faster than average in the past two years, mainly in the industries focused on internal demand (such as trade and real estate). Meanwhile, since the end of 2003 transport and communications companies have become clearly more active in attracting resources in the local market. However, these growth figures are statistically expanded by large loan projects of a few major corporations.

Loan interest rates that have promoted fast growth in domestic corporate debt have fallen significantly as a result of competition between banks. Estonian companies are predominantly small or medium-size in the European context, and generally higher interest margins are applied to them in developed European countries. Nevertheless, should competition between banks persist, further decline in loan interest rates in the confined Estonian market could be expected.

Regarding commercial real estate risks, the evaluation is more positive compared to the period six months ago since the expected increase in office space vacancies has not materialised at current economic activity. The development of retail space has shifted from large shopping centres to smaller spaces.

Financial Behaviour of Households and Their Risks

The net position of households' financial assets and liabilities has continued to deteriorate. Annual growth in **deposits**, which has steadily declined in the course of more than three years, took a slight upward trend in 2004. However, such developments cannot be explained by a change in households' behaviour; this rather indicates the lack of alternative saving opportunities against steady income growth. In recent years the main alternative savings instruments have been either "the piggy bank" (according to a survey by TNS Emor) or real estate investments. Even though real estate prices have risen strongly in recent years, in the future real estate investments might not provide better returns than financial investments (adjusted for risk or servicing costs). Deposit growth rate will mainly be affected by increased loan burden, savings into pension system pillars, and low interest rates.

Households' loan demand has been very strong in the past six months. **The annual growth rate of housing loans** remained close to 55% for almost two years, yet began to decline slowly but steadily as of May 2004 (owing to the higher base level), reaching to a level below 50% by the end of September. Interest rates on new housing loans continued to decline in 2004, stabilising at 4.2% in September. Thus, the difference with the respective euro area interest rate has diminished nearly two times this year, being currently by an estimated 70 to 80 basis points higher. In the **consumer credit** market the banks have to compete against hire purchase opportunities offered by retailers, therefore no major growth acceleration can be expected in this segment in the coming year.

Based on the banks' statistics on overdue loans, there have been no major obstructions in households' **loan servicing** so far. The housing loan portfolio stands out for comparatively good quality. However, compared to the Scandinavian countries, the loan burden of Estonian households regarding loan-servicing has already risen to a relatively high level, which might involve potential risks to macroeconomics as well as to financial stability. Even though no interest rate rise is expected in the near future, the comparatively high interest sensitivity of Estonian households (approximately 98% of housing loan contracts are based on a floating interest rate) should be taken into account in the longer run.

Banking Sector

Competition in the banking market has remained tough. In addition to Latvia's Parex Banka, the branch of German Vereins- und Westbank AG also entered the Estonian banking market. Since the growth in profits earned in the local banking and leasing market is showing signs of potential slowdown, Estonian banks have continued to look for opportunities to expand their operations to neighbouring markets so as to maintain **profitability**.

Even though the banks have been capable of managing declining margins, toughening competition in the domestic market indicates that income from interests and fee and commission income have become tenser. As the decline in the price of external financing has been slowing down further interest expense reduction possibilities are running out despite an increase in the share of market-based resources as a result of growing confidence abroad. Therefore, should the margins continue to fall in the near future, it would lead to a decrease in the banks' ability to bear potential losses.

The capitalisation of the banks has remained at a high level – the capital adequacy ratios of consolidated groups have remained above 11%. Further rapid loan growth and difficulties with maintaining profitability due to declining interest margins might, however, drive the banks' capital buffers towards a minimum level. Nevertheless, banks' **loan quality indicators** have been high against favourable interest rate environment accompanied by rapid loan growth.

The banks competing for market shares against the backdrop of tough competition have financed robust **financing portfolio** growth by attracting market-based resources more extensively, which leads to a situation where liabilities are more dependent on foreign investors' attitude towards Estonian economic development. In order to balance the situation, banks have opted for more flexible liquidity management by replacing bonds with deposits and reverse repos in liquid assets. In other words, these trends increase the vulnerability of the banking sector to interest and liquidity risks arising from the external environment, thus placing higher demands on the internal risk management of the banks.

Securities Market and Other Financial Intermediaries

Bond market developments are characterised by modest volumes of new issues and moderate secondary market turnover. Against the backdrop of declining non-resident bond issues the number of issues by local financial and private sector companies has increased.

Hand in hand with other fast-growing stock exchanges in the new EU Member States, **stock prices** have continued to rise on the Tallinn Stock Exchange (27% in the first nine months of 2004). Trading in securities was more active mainly in the months prior to the EU accession; after a moderate trading period in summer the stock exchange has again been setting new price and turnover records in autumn. As a result, the market value of tradable shares has grown to 44% of GDP in a year.

Further development of the securities market is affected by the ongoing integration with the Nordic and other Baltic markets and possible new stock and bond listings on the Tallinn Stock Exchange.

In line with a rather modest increase in the financial savings of the non-financial sector[1], the growth in **investment funds'** assets has slowed down. Higher returns arising from the rapid growth in the Central and Eastern European stock exchanges and the recovery in other markets have promoted interest in stock investments and more than doubled the assets of equity funds year-on-year. The assets of second pillar **pension system** funds, which have been increasing steadily, rose above the threshold of two billion kroons in September, while the number of subscribers increased to more than 400,000. Besides investments into the second pillar of the pension system, payments into supplementary funded pension funds form an increasing share in household savings, accounting for nearly 11% of household financial savings.

Positive developments in the **insurance market** arose from increased domestic demand, including the enlivened real estate market and successful car sales, as well as from the spread of voluntary pension insurance. By actively selling third-pillar pension system products the insurance companies tied to the banks have increased their market shares in the life insurance sector.

Payment Systems

According to the overseer, systemically important payment systems have been performing in line with the established requirements and no risks to financial stability have been detected in their functioning. In response to a proposal included into the previous assessment by the overseer of the payment systems, legislation regulating access to the interbank payment systems managed by Eesti Pank has been amended and made available to the public.

In 2004 there have been no major changes in the **payment environment** and thus the trends of previous years continued. The position of credit institutions operating in Estonia is strengthening in the daily lives of individuals. The network of bank offices and electronic payment channels has reached the level that meets the market demand. The popularity of direct debits is growing since the use of this payment method is easy and convenient.

The structure of Estonia's payment environment resembles that of the Nordic countries. As of the moment of accession to the European Union charges for domestic and cross-border euro-denominated transactions within the EU dropped for the payment originator.

[1] Here and below the non-financial sector refers to households and non-financial corporations, excluding general government.

Summary and Financial Stability Risks

The current situation of financial stability can be considered good, as improvement of the economic environment and good prospects for economic growth ensure that both companies and households are able to meet their loan commitments.

The **rate of households' loan growth** reached its peak in the middle of 2004, and from there on the growth rate is likely to decline. The strong confidence on the one hand, and the aggressive lending behaviour of banks on the other still continuously inject households optimism to borrow.

Although the speed of loan growth is reducing, and the current economic environment is supporting loan servicing, it is still appropriate, taking into account the risen debt burden, to consider the **possible risks**.

In the longer term, reducing loan growth could avert serious macroeconomic problems. Decreasing demand might endanger the growth prospects of companies, which in turn might bring along worsening of the labour market situation and finally also bigger solvency problems for loan customers. That gives even more reason to stress the importance of creating financial assets as buffers (especially bank deposits) to level off the possible future loan servicing difficulties.

Another longer-term risk is related to the situation, when banks enter more risky sectors with the view to preserve high profitability. This results in the danger that in case the economic environment proves to be worse than expected, the risk premium of higher-risk customer projects will turn out to be too low, and the necessary capital buffers will be underestimated.

In case the growth rate of loans does not retard and no substantial changes take place in the saving behaviour, the increasing volume of debt accompanied with growing servicing costs might hinder the growth of domestic demand in the future and thus reduce the growth potential of the economy.