IV
MONEY AND SECURITIES MARKET

Money and Capital Market

Money Market

The turnover of the Estonian kroon money market did not change significantly in the fourth quarter of 2003 and in the first quarter of 2004 (see Figure 4.1). The turnover of Estonian kroon derivative transactions was consistently below that of short-term kroon-denominated loans, which indicates the small currency risk of the kroon. The high credibility of the Estonian currency is also reflected in the fact that the forward difference between the euro and the kroon remained at 50 basis points across various maturities.

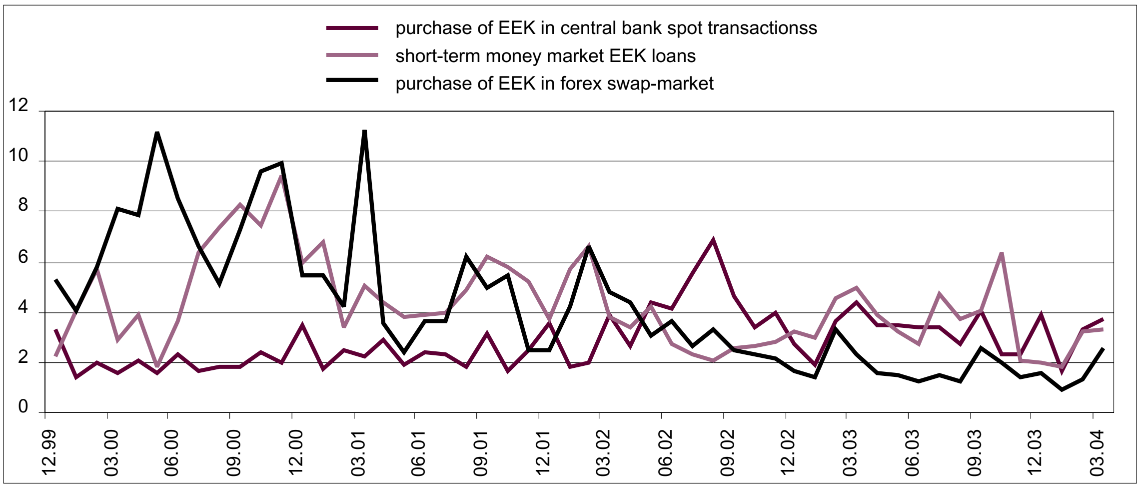

Figure 4.1. Supply of EEK liquidity in Estonian money markets (quarterly turnover, EEK billions)

Transactions by non-residents continued to dominate in the Estonian money market. In 2003, transactions by residents accounted for approximately a third of short-term kroon loans and some 40% of foreign currency swaps (see Figure 4.2). As was expected, the most active participants in the short-term kroon loan market were Finnish, Estonian, and Swedish banks, and at the end of 2003 also Latvian banks. Non-resident credit institutions participate in the Estonian kroon short-term loan market primarily through risk-hedging transactions carried out on behalf of their clients.

Due to the sustained expansionary monetary policy in the euro zone the interest rates on short-term kroon loans in the Estonian money market remained very low at the end of 2003 and at the beginning of 2004. Money market quotations of the Estonian kroon also sustained the low level established at the second half of 2003, similarly to the quotations in the euro area money market (see Figure 4.3). The spread between Talibor and Euribor remained at an average of 50–60 basis points, depending on the maturities. Above all, this reflects changes in Euribor since Talibor varied little (see Figure 4.4).

Estonia's money market remains stable, and kroon liquidity in the financial sector is strong. Banks' settlement buffers with the central bank were consistently in excess of the daily mandatory minimum reserve. Also after amendments to the procedure concerning minimum reserves entered into force on 1 March 2004[1] the banks have smoothly met the reserve requirement.

[1] As of 1 March 2004 cash is not taken into account upon meeting the minimum reserve requirement of the banks.

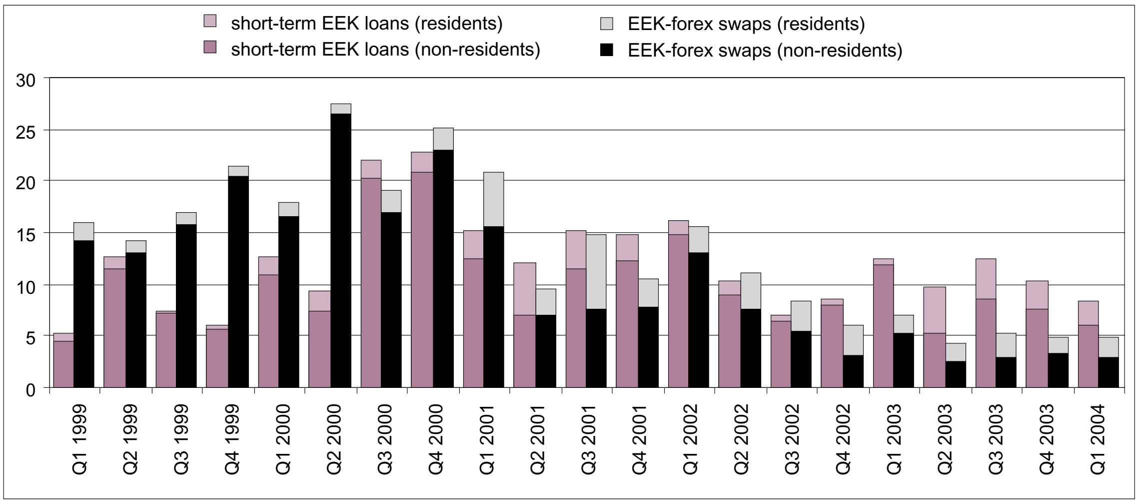

Figure 4.2. Turnover of EEK loans vs turnover of EEK-forex swap transactions (EEK billions)

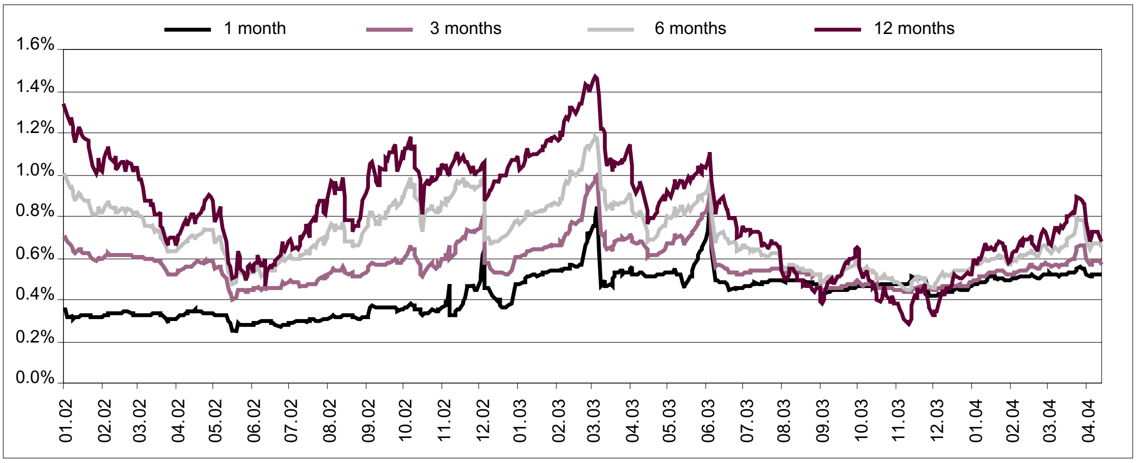

Figure 4.3. Difference between money market interest rates of the Estonian kroon and the euro (percentage points)

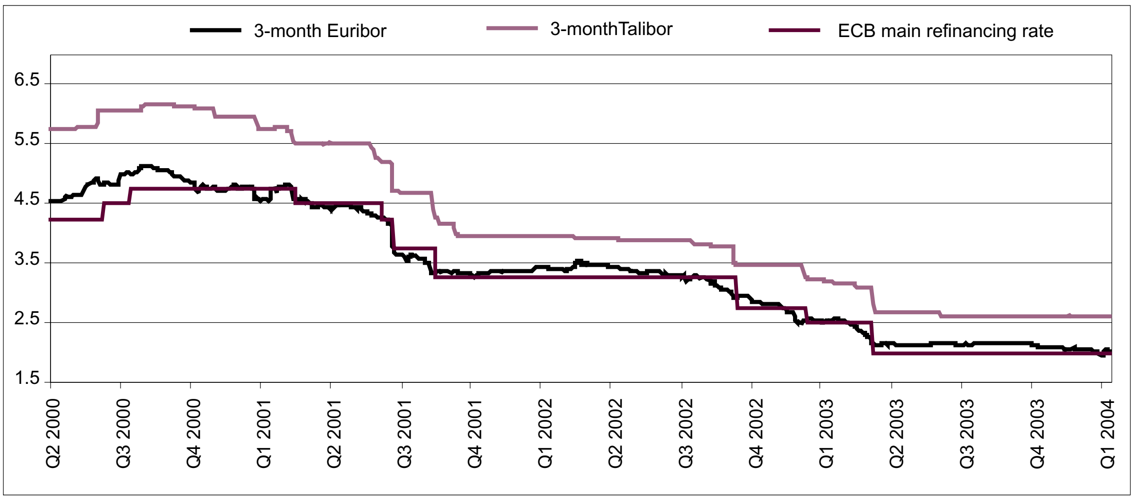

Figure 4.4. Money market interest rates of the Estonian kroon and the euro

The yield of five-year Eurobonds issued by Estonia's government changed in the international markets in line with the yields of the bonds issued by other euro area governments. The difference between the yields of Estonia's Eurobonds and Germany's Eurobonds of comparable maturity remained stable at 35–40 basis points.

Bond Market

Regardless of the expansive liquidity environment, the domestic bond market trading remained modest (see Figure 4.5). The volume of bonds issued in the primary market declined by 40%, reducing market capitalisation to 2.9 billion kroons by the end of 2003. The shrinkage in the market was caused by reduced volumes of bond issues by residents and non-residents alike. Of residents, banks and financial institutions remained the most active market participants; upon financing the real sector the bond market still played a marginal role.

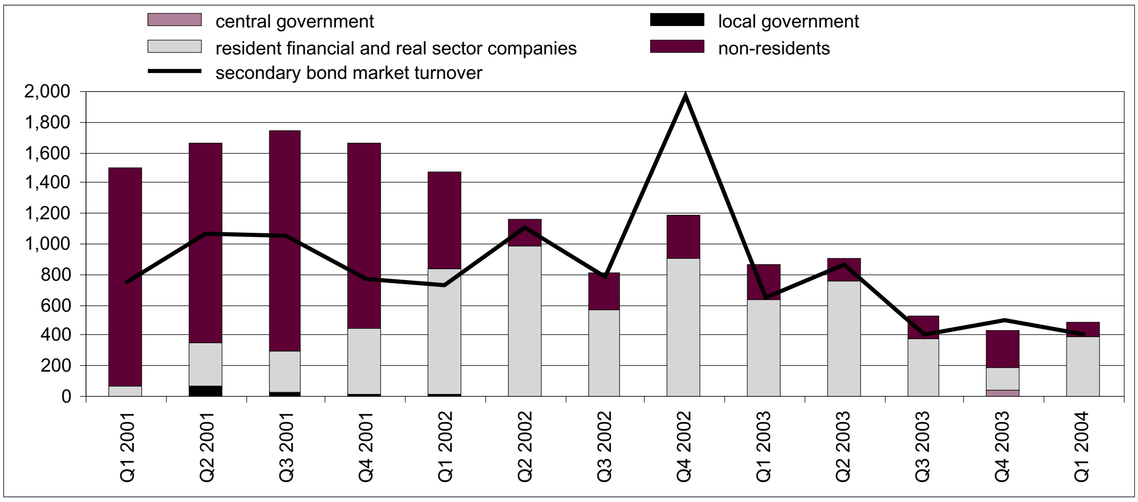

Figure 4.5. Volume of quarterly issued bonds and secondary bond market turnover (EEK millions)

Major issuers who have been in the market for a longer period of time continued to use the bond market mainly for flexible engagement of short-term capital, which is why the maturity breakdown of the bonds issued did not change. Approximately 85% of the bonds issued were with a maturity less than a year, of these every fourth was with a 3-month maturity. Smaller and lesser-known companies preferred to issue bonds with longer maturities, taking advantage of the favourable liquidity environment so as to attract longer-term capital. **Due to the favourable environment new smaller and lesser-known issuers entered the primary market in the second half of 2003.** Since the second half of 2003, similarly to Estonia, the European Union has witnessed bond issues by companies with lower loan quality and a decline in spreads, which indicates that risk premiums demanded by investors have fallen as a result of low interest rates.

Most of the bonds are bought to be held, which is why the secondary market is moderate. In line with the decline in the primary market volumes also the turnover of the secondary market declined in 2003 compared to 2002, amounting to 9 million kroons per day. At the beginning of 2004 the market was even more modest (an average of 6 million kroons per day).

In 2003, bonds were again listed on the Tallinn Stock Exchange and by the end of the first quarter of 2004 four corporate bonds had been quoted[2] (see Figure 4.6) with their market value amounting to 495 million kroons, i.e. 17% of the total volume of the bond market. Arising from investment restrictions[3] applied

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[2] Tallinna Sadam, Eesti Post, Hansa Capital, and Sampo Pank.
[3] According to the Investment Funds Act in force, funds are allowed to invest 90% of their resources into securities traded only on stock exchanges.

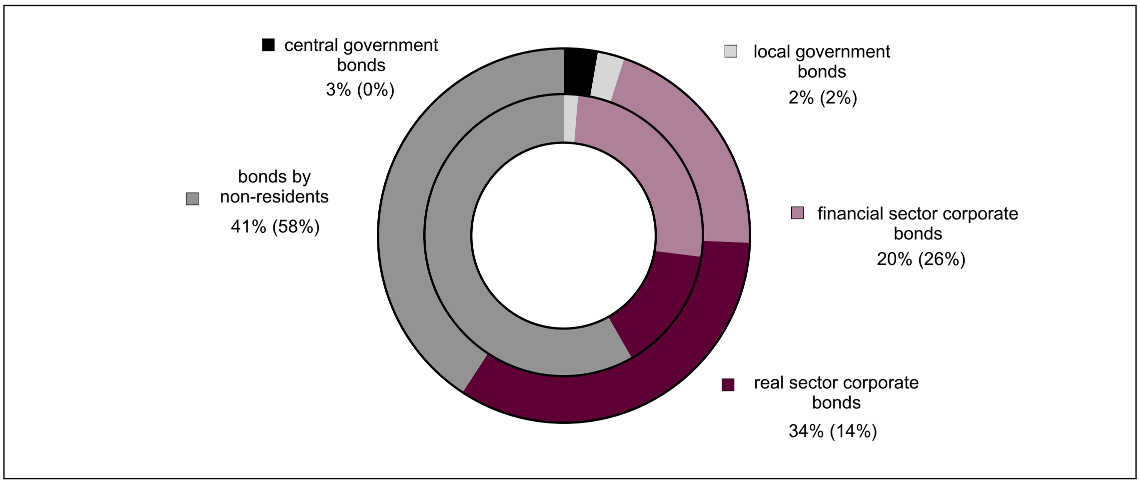

Figure 4.6. Structure of secondary bond market turnover in 2003 (2002 structure in brackets)

to investment and pension funds and also to insurance companies, stock exchange listing attracts interest of a wider circle of investors, which also secures a more favourable interest rate level. Bonds listed on the stock exchange are also predominantly obtained for holding, which is why the turnover of debt securities has remained comparatively small. The average daily turnover in 2003 was 1.1 million kroons and only 300,000 kroons in 2004.

Stock Market

For Central and Eastern European stock exchanges the expectations related to joining the European Union are still topical, which along with increased risk-taking willingness of the investors arising from the lower interest rates spurred a surge on Central and Eastern European bourses in 2003 (see Figure 4.7). Even though the surge ebbed in the fourth quarter, stock indices started to soar again in the first quarter of 2004.

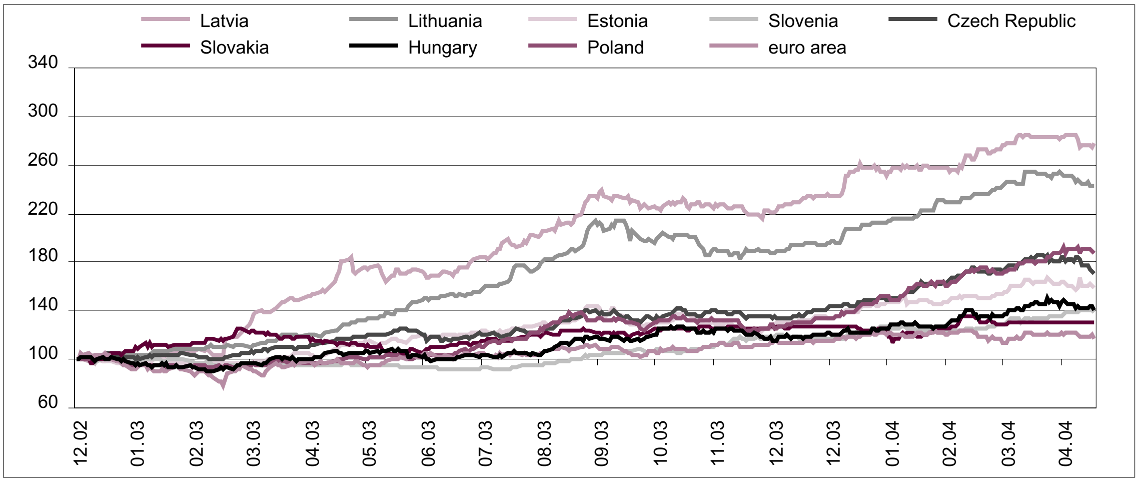

Figure 4.7. Dynamics of stock exchange indices of the new EU Member States in 2003 and 2004 (31 December 2002 = 100)

The Tallinn Stock Exchange index Talse rose by 34% in 2003 (see Figure 4.8). There was some correction in the fourth quarter, but at the beginning of 2004 prices began to rise fast again, and as a result the index stood at 340 points at the end of March, which was 19% higher that at the beginning of the year. This development

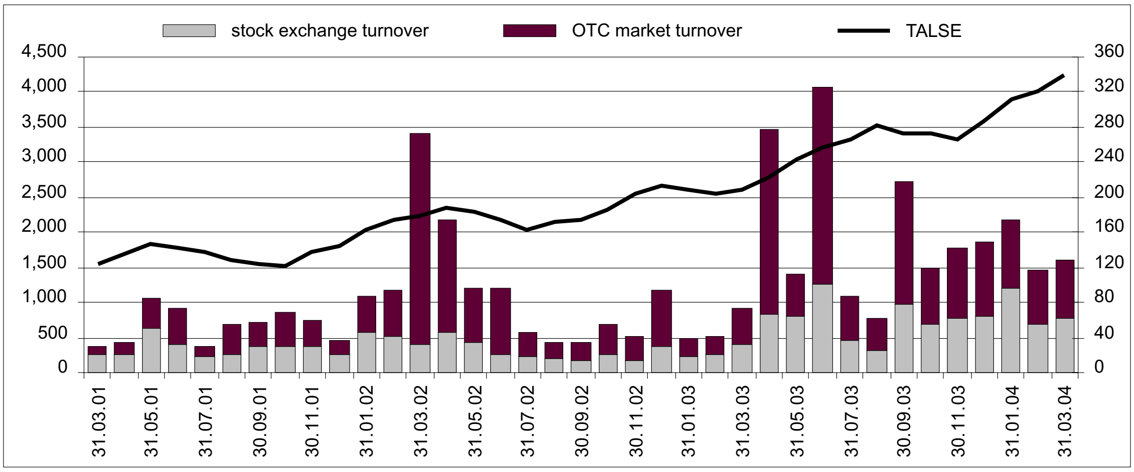

Figure 4.8. Monthly turnover of shares on the Tallinn Stock Exchange and OTC market (EEK millions, left scale) and Tallinn Stock Exchange index TALSE (points, right scale)

brought up the market value of the companies quoted on the stock exchange by 10.7 billion kroons in 2003 and by another 8.9 billion kroons in the first quarter of 2004. The stock exchange capitalisation rose to 56 billion kroons, i.e. to 48% of GDP.

The growth in market activity is also reflected in the increased stock exchange turnover. The average daily turnover in 2003 amounted to 30.6 million kroons, which was twice as much as in 2002. Along with the new price records the average daily turnover rose further in the first quarter of 2004 – to 42.5 million kroons. 94% of the stock exchange turnover accounted for transactions with the shares in three of the four largest listed companies (Hansabank 73%, Eesti Telekom 15%, and Norma 6%). Since the last quarter of 2003 the focus has been even more on the shares in Hansabank (an average of 81% of the transaction turnover).

Market participants are sceptical about a further rise in stock prices, regardless of the fact that Estonia belongs to the European Union investment area since May, which enables foreign funds to expand their positions in the markets of the new Member States. The impediments include the small number of listed companies, small volume of liquid assets arising from strategic stakes[4], and the price level that has climbed high during the past few years.

The share of non-resident investors in the stock market capitalisation stood at around 79–80% in 2003 and in the first quarter of 2004. Resident investors predominantly included financial and real sector companies, who owned 8.7 billion kroons worth of shares listed on the stock exchange, i.e. 15% of the total stock exchange capitalisation. Stock market investments of small individual investors amounted to 1.8 billion kroons, i.e. 3.2% of the total value of listed shares. The growth in stock investments by local investment funds at the expense of other residents in the second half of 2003 reflects certain positions taken by mandatory funded pension funds. However, the share of funds among local stock market investors remains very modest (around 0.5% of the total capitalisation).

Representatives of investment companies have noted that when investing in shares private individuals increasingly prefer more liquid foreign markets. An indication of the retreat of small investors from the domestic stock market is also seen in the fact that while private individuals hold most of the securities accounts with listed shares, the number of such accounts has consistently decreased in years. Meanwhile the number of non-resident accounts has tended to grow during the past couple of years (see Figure 4.9).

[4] Without considering nominee accounts the volume of shares under qualified holding (over 10% of the share capital) amounts to 65% of the total stock exchange capitalisation.

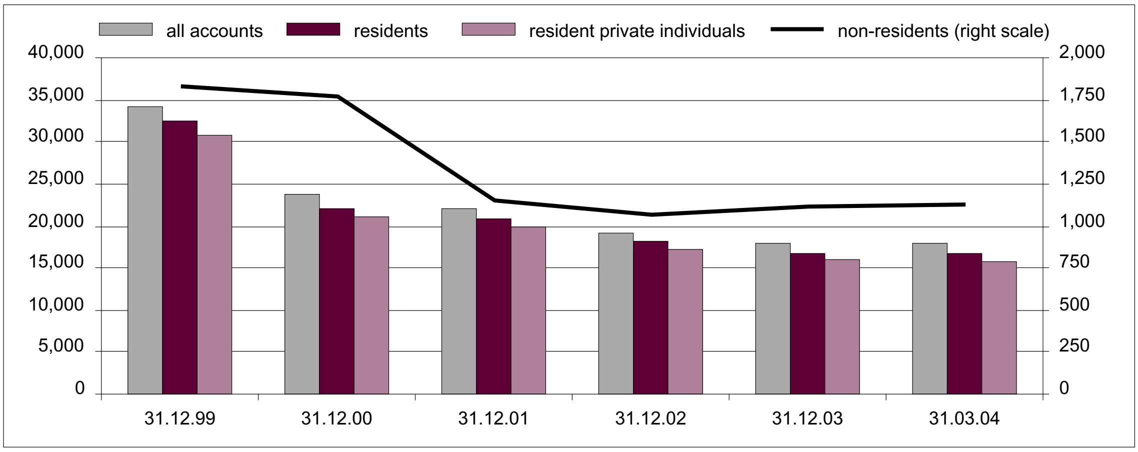

Figure 4.9. Number of accounts holding shares quoted on the Tallinn Stock Exchange

Arising from the fact that several publicly traded companies have strategic majority owners, the predominant trend for the time being is the departure of companies from the stock exchange[5]. There have been no initial public offerings, even though some companies have declared such initial intentions in the press and according to representatives of the stock exchange. It is cheaper for companies to attract capital from alternative sources than from the stock exchange; moreover, attracting capital in the expansive liquidity environment is not a problem.

13 stock exchange members, of whom two are temporarily inactive, have the right to act as brokers. Most of the deals (92%) are brokered by Hansapank and Suprema Securities. A member of the Finnish Sampo Group, Mandatum Stockbrokers, has given up its member status since it is going to trade on the Tallinn Stock Exchange through its Estonian subsidiary, Sampo Pank. As of June also Krediidipank, who brokered just 0.05% of the total market turnover during the past year, is to give up its membership status.

[5] In April the holder of 49% of the Eesti Telekom shares, Baltic Tele AB, a subsidiary of TeliaSonera AB, made a takeover bid to the other shareholders of Eesti Telekom, which accounts for 30% of the stock market capitalisation. Besides, AS Rondam, which took over 95% of AS Estiko has submitted a notice of withdrawing from the stock exchange also as a result of the takeover bid.