IV
SECURITIES AND MONEY MARKET

Money Market

The key interest rates in the euro area have remained at a low level ever since mid-2003. Thus, the money market interest rates in both the euro area and Estonia remained at a stable low level in 2004 and in the first six months of 2005.

Over the last six months, the **difference between the interest rates of short-term Estonian kroon loans and respective euro area interest rates** has decreased significantly, and so has the difference in interest quotations, which form the basis for forward difference. At the end of April, the difference between the money market interest rates in Estonia and the euro area was approximately 25–30 basis points, but by mid-October it had shrunk to 10–15 basis points (see Figure 4.1). This was due to a decrease in TALIBOR quotations and a slight rise in EURIBOR quotations in October in relation to an expected rise in interest rates.

Figure 4.1. Difference between money market interest rates in Estonia and in the euro area (in percentage points)

Participation in the exchange rate mechanism (ERM II) has been going smoothly for Estonia and no pressure on the exchange rates has occurred in the foreign exchange market. This reveals also in the steady decline of the difference between interest quotations (forward difference).

The **yield of the five-year Estonian Government Eurobond** has been moving in line with the yields of government bonds issued by other euro area countries. However, here too the difference between interest rates has declined compared to the euro area. The difference between the yields on Estonian Government Eurobonds and German bonds with comparable maturity remains below 10 basis points (14–16 basis points in the first half of 2005), and the difference with comparable Austrian government bonds is even lower. Money and bond market trends indicate that the confidence of international financial markets in the Estonian economy is very high and has even deepened further over the last six months. It also shows a modest secondary market of the Estonian Government Eurobonds (see Figure 4.2). The exceptionally high yield on the government bonds of Austria, whose credit rating (AAA) is much higher than Estonia's rating (A), indirectly reflects the foreign markets' inclination to carry on with capital exports to Estonia.

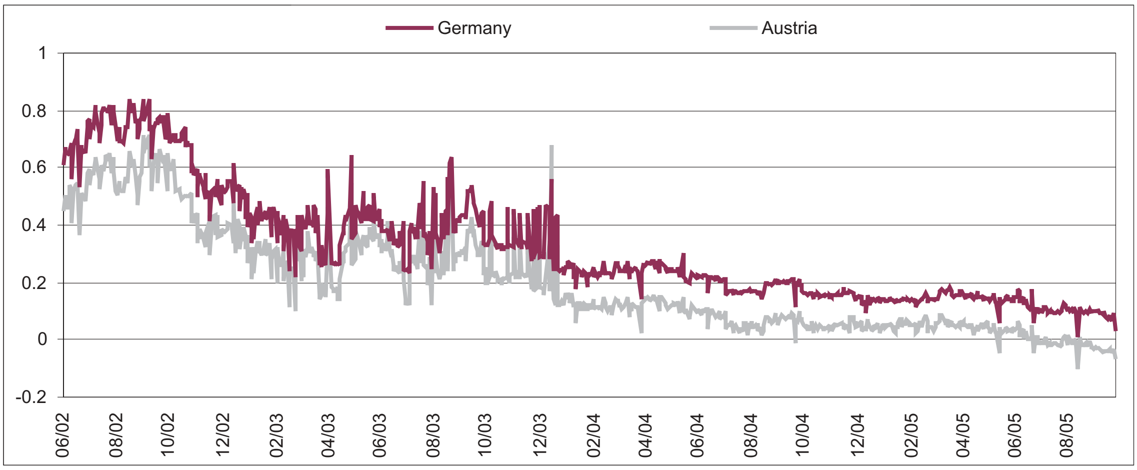

Figure 4.2. Yield difference between the Estonian Government Eurobonds and respective bonds in Austria and Germany (in percentage points)

The **turnover of derivate instruments** in Estonian kroons has held its steady course. The market of short-term loans in kroons amounted to an estimated 30% of the total money market turnover. Non-residents' transactions accounted for about 70% of the market. Swedish, Finnish and Latvian banks remained the most active market participants. The purchase-sale turnover in the central bank's forex window has been in balance also during the ERM II period, i.e. there has been no pressure for the exchange rate of the Estonian kroon either to strengthen or to weaken.

The **turnover of derivatives in Estonian kroons** over the last six months has been slightly higher than in the previous quarters, amounting to approximately 34% of the total money market turnover. Non-residents' transactions accounted for about 50% of the turnover of derivatives. While the currency market has always been the most powerful and active part of the Estonian money market, over the last few years the share of derivatives in Estonian kroons in the money market turnover has been considerably declining due to lesser activity of non-residents. This trend reflects a rise in the reliability of the Estonian kroon and a reduction in kroon risk margins (see Figure 4.3).

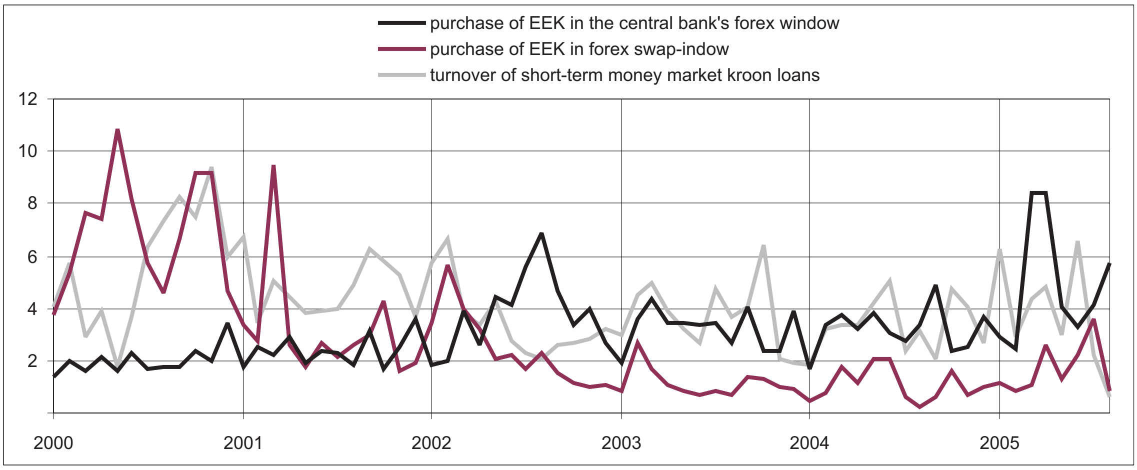

Figure 4.3. Supply of the Estonian kroon liquidity in the Estonian money market (monthly turnover; EEK bn)

A change occurred in the currency risks of Hansapank in September, which means that Hansapank and Swedbank made a large foreign exchange swap in the amount of 1.7 billion euros (26.6 billion kroons), where the EUR/EEK position in the respective amount was closed in Hansapank. The transaction resulted in a hike in the turnover of currency derivatives in September and the open net foreign exchange position of Hansapank (and of the entire financial sector) decreased significantly. Hansapank's long EUR/EEK position declined from 28.4 billion kroons at the end of August to 3.4 billion kroons by the end of September; Estonian credit institutions' long EUR/EEK position decreased from 40.5 billion to 16 billion kroons. The transaction caused no anomalies in quotations of the currency derivatives market.

The Estonian kroon liquidity environment has remained stable and there have been no major obstructions in kroon liquidity in the financial sector. The banks' settlement buffers with the central bank have consistently exceeded the mandatory daily minimum reserve and meeting the mandatory reserve requirement does not pose any difficulties for banks.

BACKGROUND INFORMATION

STRUCTURE OF THE ESTONIAN KROON MONEY MARKET

The Estonian kroon money market mainly consists of short-term (with the maturity of up to one year) kroon-denominated deposit and loan transactions and foreign exchange derivatives and swaps against the Estonian kroon[1] (see Figure 4.4). Transactions with short-term bonds in Estonian kroons are also carried out to a certain extent. However, the Estonian kroon bond market is mainly the primary market and the turnover of the secondary market remains low. Owing to the balanced budget principle and low government debt, there are no short-term kroon-denominated government bonds in Estonia, thus the government bond segment is absent in the Estonian money market. As the Estonian bond market is small, there is no repurchase transactions market either, and several other instruments common on the developed money markets are not traded with in Estonia.

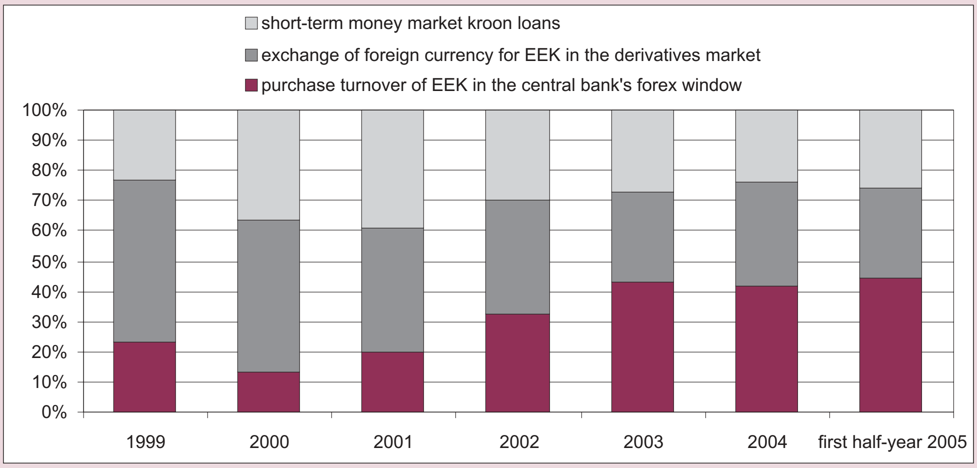

Figure 4.4. Estonian kroon money market by turnover

[1] See also the background information "Main Features of the Estonian Money Market" in the Financial Stability Review of November 2003.

The Estonian kroon money market is comparatively small and low in liquidity compared to the respective money market segments in the euro area countries. Because of the small size of the market and specific features of the currency board system local credit institutions cannot manage their liquidity only on the basis of short-term kroon loans from the local money market, and thus the liquidity of the Estonian credit institutions is mostly managed from outside Estonia. Consequently, the Estonian money market is a niche market, which is important for the non-resident and local non-banking institutions rather than the local financial sector. It is most vividly expressed when comparing the money market loans issued in euros by Estonian banks in the foreign markets and the money market loans issued in kroons by Estonian banks – the turnover of the former exceeds the latter by tens of times (see Figure 4.5).

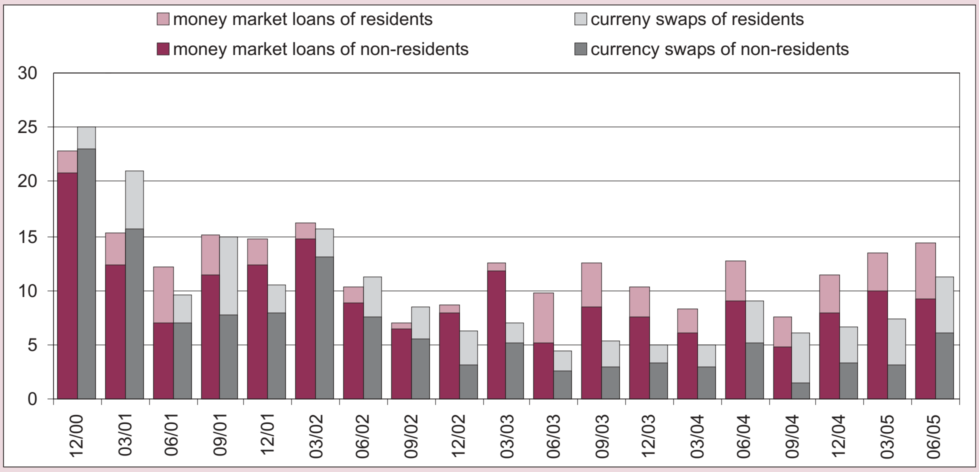

Figure 4.5. Turnover of Estonian kroon loans and derivatives (EEK bn)

The average monthly turnover of short-term kroon loans without collateral has been around 3.5 billion kroons over the last years, transactions with non-resident credit institutions account for 70% of that and transactions between resident credit institutions (mostly overnight deposits in the domestic settlement system) form 20%.

The motive for non-resident banks to operate in the Estonian kroon money market is particularly related to their customers' wish or need to cover the long-term foreign exchange position in the Estonian kroon. Such a wish may arise if a company has made large investments in Estonia and wants to increase the share of Estonian kroon liabilities in the balance sheet in order to avoid exchange rate fluctuations in accounting. The aspect of covering exchange rate risk is one of the reasons why the currency market has always been the most influential and active part of the Estonian money market. On the other hand, a major share of non-residents' derivatives in kroons is related to the US dollar, not the euro, which can evidently be associated with trading flows rather than covering the currency risk of investments.

Arising from Estonia's accession to the European Union and the expected accession to the euro area, the importance of the currency derivatives market as part of the money market has declined over the last years. This shows that there is less need to cover the currency risk, and the difference between the yields on the money market interest rates of the kroon and the euro. The average monthly turnover of derivatives in Estonian kroons (supply of the kroon in the currency derivatives market) has been around 2.5–3 billion kroons over the last years. Derivatives have mainly involved exchanging foreign currency to Estonian kroons (over 90% of transactions); transactions with non-resident credit institutions have accounted for an estimated 45% in the past few years. Transactions of resident companies amounted to about 34% on average of the total turnover of the derivatives market. Most of the turnover of the Estonian kroon foreign exchange derivatives and swap market comes from risk-hedging transactions between the Estonian kroon and third currencies, particularly the US dollar, which local companies have recently begun using more actively in order to cover foreign trade related cash flows (see Figure 4.6).

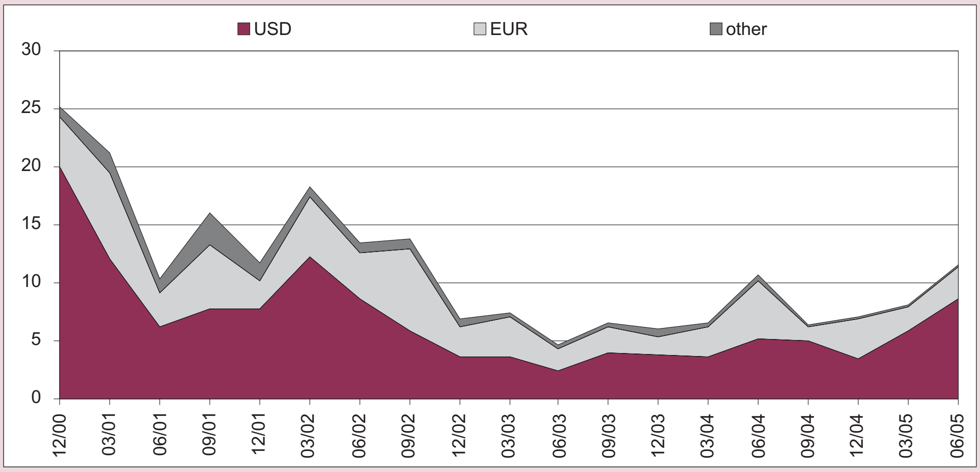

Figure 4.6. Sales of the Estonian kroon in the currency derivatives market by currencies (quarterly turnover; EEK bn)

Under the currency board system the central bank enables the local credit institutions unlimited purchase or sale of all primary currencies at the Estonian kroon exchange rate. This standing facility is called the **central bank's forex window**. Resident credit institutions mainly use the central bank's forex window for foreign exchange transactions and for managing short-term kroon liquidity, as there is no spread between the purchase and sales rates in transactions with the euro. The Estonian kroon purchase turnover in the forex window is on average 3–4 billion kroons a month and accounts for over a third of the turnover of the kroon supply transactions in the money market.

Bond Market

The domestic bond market has significantly revived in the expansive environment. The turnover of the **primary bond market** grew 45% from October 2004 to September 2005 (see Figure 4.7). Bond market capitalisation rose 64%, year-on-year, and reached 4.7 billion kroons, i.e. 3% of GDP at the end of September. The market expanded because of an 87% growth in the volume of resident companies' bond emissions, and the volume of bond emissions of the non-financial sector companies multiplied a few times. At the same time, the volume of bonds issued by non-residents fell by nearly a quarter. Even though the volume of bonds issued by credit institutions grew over 25%, the growth of the entire market still outpaced that and the stock of the volume of banks' bonds amounted to 36% of the bond market capitalisation.

Market trends and favourable interest rate environment have facilitated issuance of bonds with a longer maturity. The volume of bonds with the maturity of up to one year has increased 13%, but their share in the total volume of bonds issued over the year has fallen by 20 percentage points to 63%. The volume of short-term bonds declined, whereas the volume of bonds with the maturity of up to three months decreased over three times. However, issuance of bonds with the maturity of three to twelve months rose by a third. The volume of the primary market of bonds with the maturity of over one year doubled. Thus, bonds with the maturity of one to three years accounted for 10% and bonds with the maturity of over three years for 27% of the total volume of issues over the past year. Against the backdrop of low interest rates, bond interest rates are also following a downward trend.

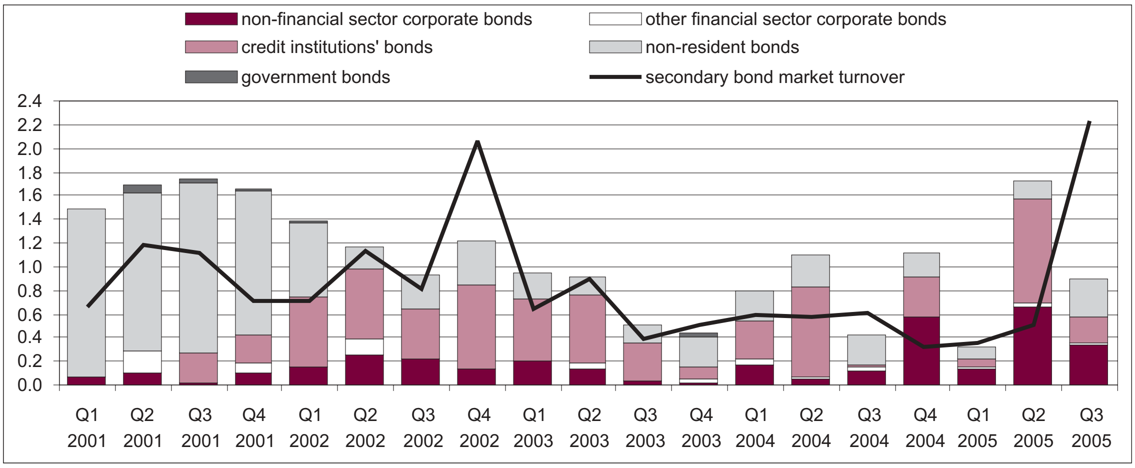

Figure 4.7. Volume of quarterly issued bonds and secondary bond market turnover (EEK bn)

Thanks to the growing primary bond market, the **secondary bond market** revived as well, increasing to over 50% as the sum of four consecutive quarters by the end of the third quarter (see Figure 4.8). The daily turnover increased from 8.8 million kroons to 13.3 billion kroons as the sum of four consecutive quarters. The secondary debt securities market was particularly active in September 2005 when the daily turnover of nearly 63 million kroons almost reached the record level of 2002. The most liquid bonds in September for their turnover were those of Kesko Oyj and Sampo Pank. On a yearly basis, most transactions were carried out with bonds issued by non-residents, whereas bonds issued on the Estonian market account for 47% of the total turnover, bonds registered in the Latvian Central Depository for 9%, and those registered in the

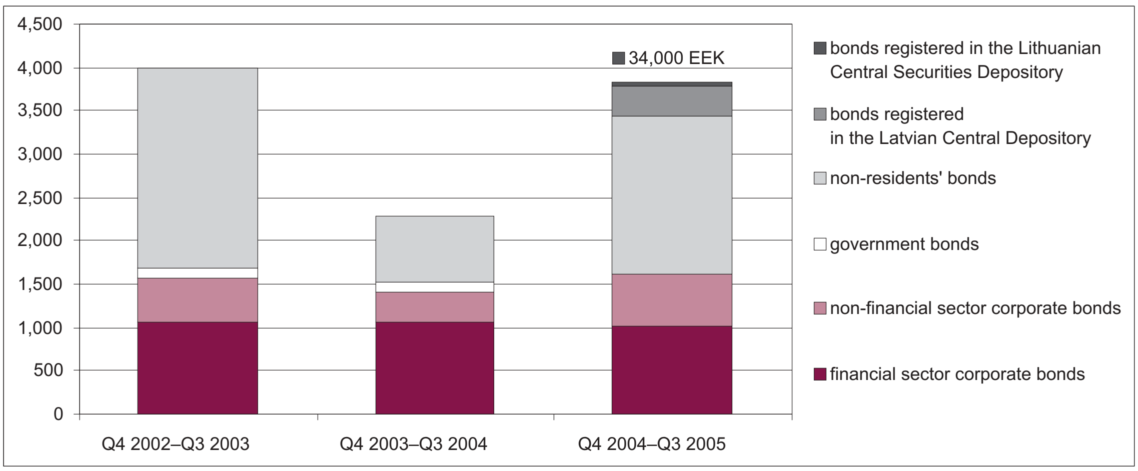

Figure 4.8. Structure of secondary bond market turnover (EEK m)

Lithuanian Central Securities Depository for 1% (for an overview of the development of infrastructures of the Baltic securities market, see Chapter VI “Assessment by the Overseer of Payment Systems”). Though the nominal volume of trading with bonds of the financial sector remained almost the same, year-on-year, their share in the total secondary market turnover has dropped to a quarter, given the growth of the entire market.

The share of residents among bond investors fell from 92% in 2004 to 77% at the end of September 2005. The share of non-residents rose as a result of investments of foreign banks in the Estonian bond market, of which they owned 11% at the end of the third quarter. Companies accounted for 50%, investment funds for 28% and the social security fund for 10% of local investors at the end of September. General government, households and credit institutions accounted for the rest.

Two more debt securities added to the bonds of companies listed on the stock exchange[2] after the end of March 2005: bonds of SBM Pank were listed in July and bonds of LHV Ilmarise Kinnisvaraportfell in October. Consequently, at the end of October 2005 the market value of bonds of seven companies listed on the Tallinn Stock Exchange reached 0.5 billion, i.e. a tenth of the total bond market volume. Year-on-year, the turnover of the bonds listed turned upward at the end of the third quarter as the sum of four consecutive quarters, the average daily turnover over that period reaching nearly 0.8 million kroons.

Stock Market

Stock markets of Central and Eastern European countries and Russia followed a strong upward trend from spring 2005 to early October (see Figure 4.9). Share prices increased due to the growth potential of these countries, declining risk margins, as well as a low level of key interest rates and a rise in raw material prices. Correction, specific to the fast growth of Eastern European and Russian markets, took place in October. This stemmed from investors’ wish to realise profits, and also from an expected future rise in the key interest rates in developed economic areas. However, share prices in these countries started to pick up in late October. From January to autumn 2005[3], the highest rise (nearly 70%) occurred on the Lithuanian stock exchange, followed by Russian and Estonian stock exchanges with 58% and 51%, respectively. Indices of

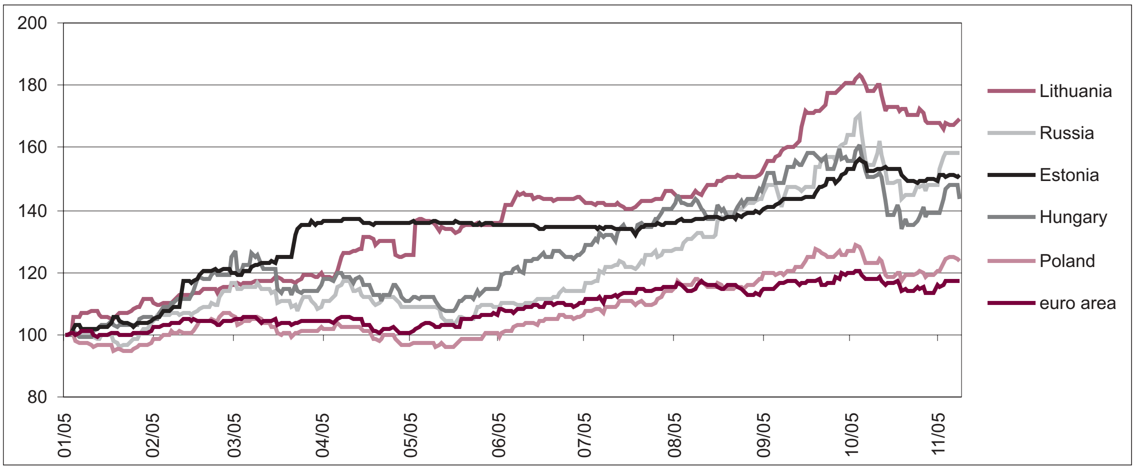

Figure 4.9. Dynamics of stock exchange indices of the new EU Member States, the euro area and Russia (points; 01/01/2005 = 100)

Source: EcoWin AB

[2] Baltika, Eesti Post, Fenniger, Sampo Pank, and Tallinna Sadam.
[3] Until 8 November 2005.

the Polish stock market have most closely followed trends of euro area indices, but have increased more than the latter (24%). Hungarian and Czech stock market developments remained in between the above market trends (Russia and the Baltic countries, on one hand, and Poland on the other). Analysts remain positive about further rise in the Central and Eastern European as well as Russian markets, considering the expected economic growth of those regions, possible euro area accession for some countries in the coming years, and future EU enlargement (Bulgaria, Romania, Croatia).

The trends on the Tallinn Stock Exchange in 2005 have been affected by contradictory factors. The market enlivened significantly in spring due to trading with Hansapank's shares when its strategic owner Swedbank made a takeover bid. This resulted in the leading company of the Tallinn Stock Exchange eventually leaving the exchange at the end of June. The shares of Hansapank were deleted from the list. At the same time, primary issuance of shares took place on the Tallinn Stock Exchange again over several years. As of 1 June, the stock exchange primary list includes the shares of Tallinna Vesi, a public utility company, at market value of 4.5 billion kroons, and as of 28 June the shares of Starman, a telecommunications company, at market value of 0.8 billion kroons.[4]

Consequently, **stock exchange capitalisation** rose to a record 99.3 billion kroons by the end of June, but declined a month later by two thirds to 32.6 billion kroons due to Hansapank's delisting from the stock exchange (see Figure 4.10). The market value of companies listed on the Tallinn Stock Exchange started to increase again in August and reached 36.8 billion kroons, i.e. 24% of GDP, by the end of the third quarter. According to 2003 data of other EU Member States, this indicator shows that after the leading company's delisting from the stock exchange Estonia has fallen behind Cyprus and Malta who are the leading countries among new EU Member States.[5]

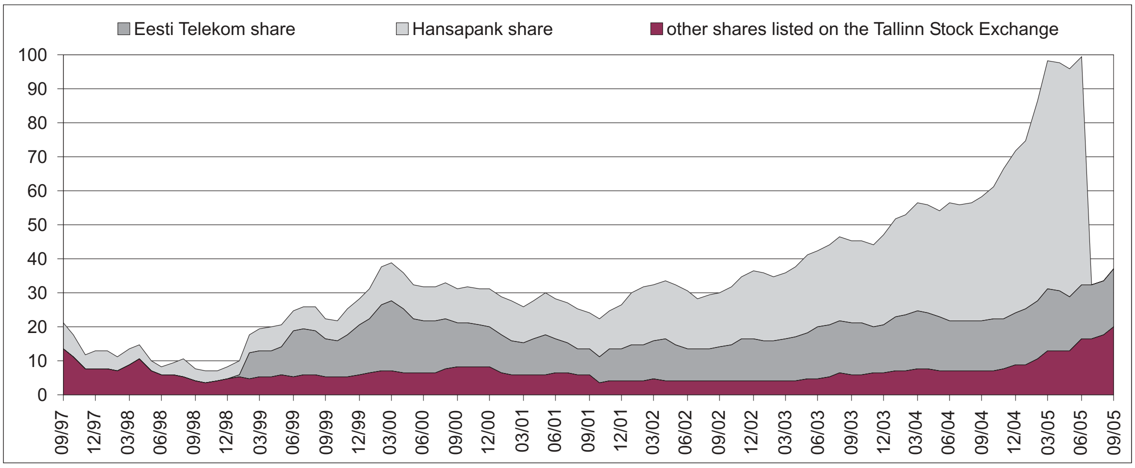

Figure 4.10. Market capitalisation of shares listed on the Tallinn Stock Exchange (end of month; EEK bn)

The **stock index TALSE**[6] achieved its record level on 4 October 2005 at 700 points (see Figure 4.11) owing to the takeover bid for Hansapank and listing of shares of new companies on the Tallinn Stock Exchange. By late September the annual growth of the index came to 90% and after that TALSE underwent a correction (about 5%) specific to very fast growth.

[4] Market values as at 31 October 2005.
[5] Source: European Central Bank, "Banking Structures in the New Member States", January 2005.
[6] As of 3 October 2005, OMX harmonised the index name structure for all OMX exchanges, including in Tallinn. The new name of the Tallinn Stock Exchange index (TALSE) is OMX Tallinn (OMXT).

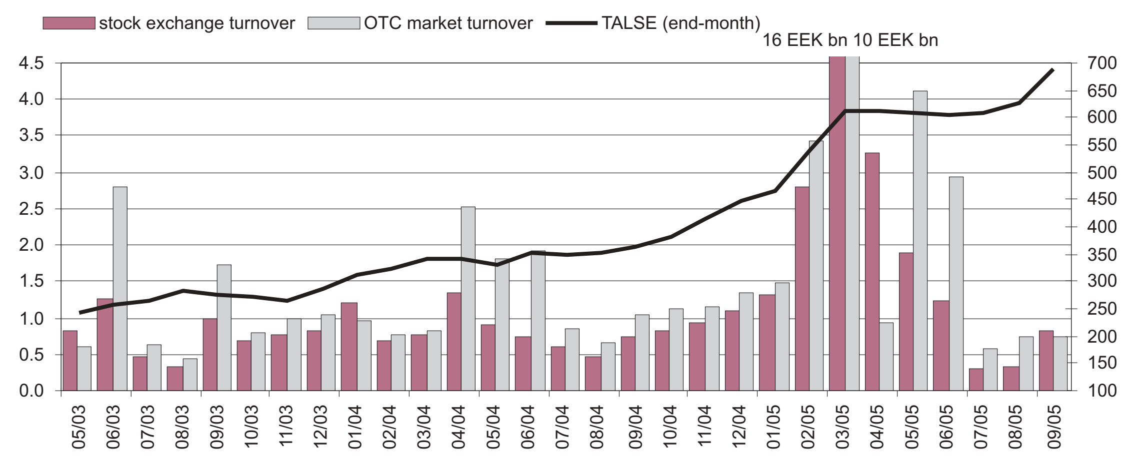

Figure 4.11. Stock turnover on the Tallinn Stock Exchange and OTC market (EEK bn; left scale) and Tallinn Stock Exchange index TALSE (points; right scale)

After Hansapank's takeover transactions, the **average daily turnover** of stock exchange transactions exceeded 101 million kroons in the second quarter, outpacing the annual average level more than twice[7]. The main driving force of stock exchange growth was Hansapank's share – respective transactions amounted to 53% of the stock exchange turnover. Most liquid securities in the given period included the shares of Eesti Telekom and Tallinna Vesi, which accounted for 24% and 13%, respectively, of the total turnover. Trading in the third quarter was rather modest as usual in the summer period with the daily turnover reaching 22 million kroons. September accounted for a major share of the turnover when trading with shares picked up again and the average daily turnover reached about 38 million kroons. 83% of the stock exchange turnover in the third quarter accounted for transactions with the shares of three companies: Eesti Telekom (36%), Tallinna Vesi (26%), and Baltika (22%).

After the takeover of Hansapank the **share of non-residents' investments** increased to its all-time high in spring 2005, i.e. to 84% of the total stock exchange capitalisation, and shrank then to 59% of the market value of the listed companies by the end of the third quarter (see Figure 4.12). Thus, Estonian investors had the largest share (41% of the total capitalisation) at the end of September. That of Swedish investors, who

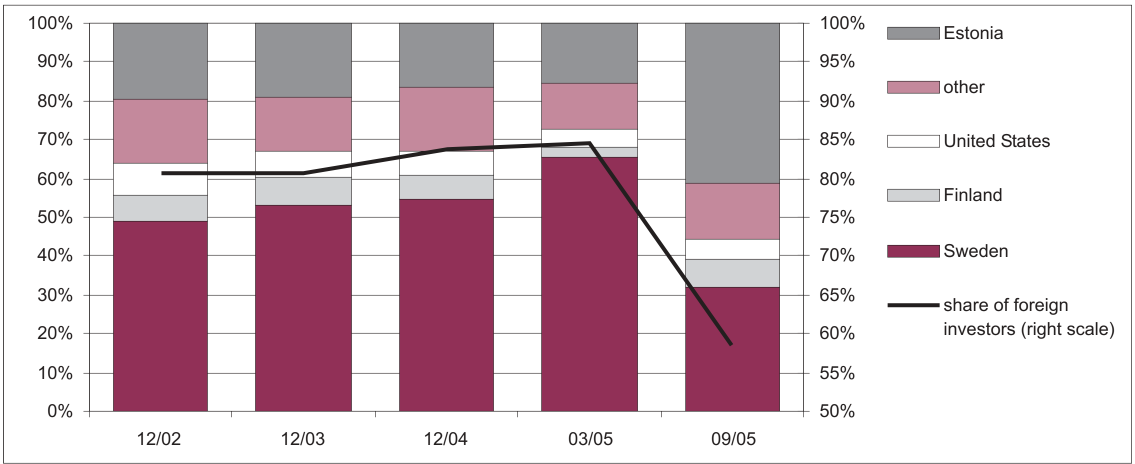

Figure 4.12. Structure of investors by residency (%; left scale) and share of foreign investors (%; right scale) of shares listed on the Tallinn Stock Exchange

[7] Average daily turnover from July 2004 to June 2005 (February to April 2005 excluded) was 47.5 million kroons.

previously had had the largest share as investors in Hansapank, decreased to 32% now. Resident investors were predominantly financial and non-financial sector companies that controlled listed shares with the value of 13.5 billion kroons, i.e. 37% of the total stock exchange capitalisation. Retail investors held 1.5 billion kroons worth share holdings, reaching 4% of the total value of listed shares. The share of pension funds has slightly risen but only accounted for 0.6% of the total capitalisation.