SUMMARY

Macroeconomic and External Environment

Being a member of the European Union for a year and a half has given an additional boost to Estonian economic development. Regardless of the deceleration of economic activity in major economic areas in the second half of 2004, the Estonian corporate sector stands out for **good export figures, which supported the acceleration of economic growth and helped improve external balance**. The relatively strong private consumption growth and the increase in (real estate) investments reflect the continuation of favourable demand conditions also for local providers.

Growing sales figures in the first half of 2005 entailed an **increase in corporate profitability**. Profit was above average in the rapidly developing real estate sector. Similarly to positive corporate future expectations the household confidence has improved as well. However, this was hampered by higher price increase expectations evoked by the fuel price rises of 2005. Labour market trends, rapidly growing household incomes and increased savings exerted a positive impact on economic growth.

The domestic financial sector had a major role in financing fast economic growth, being able to intermediate resources to enterprises and households on very favourable terms and conditions due to the continuously low interest rates of the euro area. As the economic outlook for the euro area is expected to improve in 2006, the **euro area interest rates will probably also increase**, inevitably affecting the interest payments of Estonian companies and households.

Corporate Financial Behaviour and Related Risks

An increase in corporate profitability revealed in the faster growth of financial assets. A positive future outlook was also reflected in the increased investment demand, which boosted debt growth. The **growth rate of the corporate debt** started to accelerate in 2005, reaching 22% by the middle of the year. A positive disposition on the real estate market drove the debt growth, as the demand for new commercial and residential property has notably improved the financing portfolios of mainly domestic financial intermediaries. Meanwhile, the share of the external debt kept decreasing. In the near future, the latest trends are expected to continue, although an anticipated increase in interest rates may start to inhibit the positive impact of increased demand on corporate profit margins.

Financial Behaviour of Households and Related Risks

In the spring and summer months of 2005, the **growth in household debt** picked up speed again, aggravating the net position of financial assets and liabilities even further. This was somewhat alleviated by the **improved savings rate** of households – the deposit growth rate reached the highest level of the past four years in September 2005. In addition to bank deposits also pension savings have increased significantly, their ratio to deposits rising to 18% by the end of September.

The **housing loan market** remained very active throughout the whole summer period. By the end of September, the growth rate of housing loans reached its highest level in recent years (57%), owing to new clients as well as earlier loan customers. Although the number of households taking housing loans has increased considerably over the last year, reaching 16% of the total number of households, it is still not a high indicator in international comparison. Thus, in the long run the housing loan market has growth potential. In a shorter perspective, loan supply can be affected by banks' active sales campaigns, though the loan intentions of households have not changed substantially compared to the previous year.

In the next years, housing loan demand may be constrained by high real estate prices. During the past two years prices of residential property in Estonia have increased much faster than incomes, causing an **overpricing of housing**. Households regard real estate investments as an alternative form of saving and the share of speculative real estate investments has increased, i.e. housing is increasingly purchased for speculative purposes (including for rent). As rental prices have decreased in ratio to purchase and sales prices and the rental market is dominated by oversupply, it depends on the potential liquidity constraints of investors whether the risk pays off in the short run.

Compared to the very expansive housing loan market, other household loans have increased with the pace of previous years. As durable goods are purchased less and less by instalments due to increased incomes, the growth of consumer credit market will probably rest on more active use of credit cards and car leasing in the coming years.

Banking Sector

Tight competition in the banking sector has continued, manifesting itself in lowered interest margins and aggressive loan campaigns. This has kept the clients interested in taking credit and helped banks increase their loan portfolios. So far, the loan quality of banks has been good; however, the ratio of allowances for uncollectible claims to the total loan portfolio has decreased due to changes in financial accounting principles.

With the rapid growth of risk assets, major banks decided not to pay dividends in 2005 and retain last year's profit in their own funds. This, in turn, has contributed to higher level of **capitalisation**.

Upon the evaluation of banks' capital buffers favourable economic environment and relatively good loan-servicing ability should be taken into account. Nevertheless, the provisioning of banks' claims has decreased. Changes in the economic environment, however, may entail an increase in loan losses. Should banks increase the share of assets/operations with higher risk level in order to maintain profitability, it is important that the increase in risk level be reflected appropriately also in banks' capital buffers.

The share of liquid assets in the banking sector has decreased due to fast loan growth. Meanwhile, the share of foreign institutional funds in liabilities has remained at the level of 40%. The decrease of liquid assets and the potential increase in the share of short-term liabilities in major banks may cause a higher liquidity risk, which might make local banks more dependent on their parent banks and the market situation.

Further decline in the net interest margin and limited opportunities to increase fee and commission income have rendered earning revenues more difficult for the banking sector. Still, profitability increased thanks to the continually good quality of assets, low administrative expenses and changes arising from the adoption of international financial reporting standards (IFRS/IAS) which temporarily also affected profitability.

Based on the economic forecast, the **outlook for maintaining the present profitability is good**, although an increase in the key interest rates of the European Central Bank may restrain the loan demand, thus also slowing down growth in banks' revenues. On the other hand, the increase in key interest rates enables to keep the funding cost at a low level for a while, if the rise in deposit interest rates is postponed, and thus uphold profitability.

Securities Market and Other Financial Intermediaries

The domestic **bond market** has become much more active due to the expansive environment. The primary market and capitalisation grew in volume owing to an increase in the volume of issues by residents, especially non-financial sector[1] companies. The secondary market expanded thanks to a robust growth in the bond turnover of non-residents. This was further supported by the establishment of the single Baltic market and opportunities for cross-border trading with securities listed in Latvia and Lithuania.

The **stock market** became more active in spring when Swedbank, the strategic owner of Hansapank, the stock market leader, made a bid for the bank's takeover. New issues of shares, which took place after a break of several years, enlivened the market even further. The Tallinn Stock Exchange index TALSE[2] achieved its peak level at the beginning of October with 700 points and the annual growth of the index totalled 90%. After the takeover of Hansapank the structure of investors changed substantially. In spring, the share of non-residents on the market stood at its all-time high with 84% of the market value of listed companies, declining, however, to 59% in autumn.

Due to the dynamic growth of developing markets and low key interest rates the increase in **investment fund** assets that had lasted already for several years shot up suddenly. Majority of that could be attributed to the manifold growth in stock fund assets. The development of East European and Russian markets during the past half-year as profitable investment regions brought about a rise in the share of external assets up to three quarters of the assets of companies registered in Estonia. The volume of the steadily increasing second pillar **pension funds** exceeded 4 billion kroons, but their future increase will depend on the wage growth of current subscribers rather than the payments of new customers. Along with investments in mandatory pension funds, household savings include payments to voluntary pension insurance.

Positive developments in the **insurance market** stemmed mainly from the flourishing real estate market, the spread of voluntary pension insurance and successful car sales to households. The growth rate of the life insurance market has considerably picked up pace; the non-life insurance market also keeps expanding steadily.

Payment Systems

According to the overseer, the payment systems operating in Estonia witnessed no such cases that would have posed a threat to the country's financial stability.

On 3 October 2005, an interbank Settlement System of Ordinary Payments (ESTA) was launched, which is an updated version of the Designated Time Net Settlement System (DNS) used so far. The new settlement system should expand the opportunities of smaller banks and help boost competition in the banking market. In the near future, it would be expedient to implement also an interbank direct debiting system. In order to prevent card frauds, Pankade Kaardikeskuse AS (Card Centre of Banks) in cooperation with banks is enhancing the security of the card payment environment. This process also involves transition to using payment terminals supporting processor cards based on the EMV standard[3].

The payment environment has been developing steadily and according to expectations, following the trends of recent years. As for the means of receiving income and making regular payments, bank account settlements are increasingly preferred to cash – this year 6-7% of households have ceased to pay just in cash.

Summary and Financial Stability Risks

The current financial stability can be considered good, but the accumulation of loan-related risks into the future renders our economy increasingly vulnerable. Optimism springing from the positive trends

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[1] Here and below the non-financial sector refers to households and non-financial corporations, excluding general government.
[2] As of 3 October 2005, the new name of the Tallinn Stock Exchange index (TALSE) is OMX Tallinn (OMXT).
[3] The name is derived from the initials of international card organisations Eurocard, Mastercard and Visa.

on the recent years' macroeconomic level has contributed to expansive developments in the loan market, thus increasing the possibility that companies, households and the financial sector have overestimated the borrowers' future loan-servicing ability and underestimated the risks.

Favourable loan terms and conditions have boosted household loan growth. As a result of tight competition, loan maturities have lengthened and interest margins have declined. However, given the achieved level, loan terms and conditions cannot improve much further. Therefore, the future **loan demand will be more dependent on the increase in incomes and growth expectations**.

The **overpriced housing market** involves risks caused by potential misjudgements or inaccurate expectations as to the continuation of present trends. Since the present favourable loan terms and conditions are unlikely to improve further, the difference between real estate prices and household incomes may start to diminish. As a result, the increase in residential property prices may slow down in ratio to income growth and level off thereafter. Purchasing real estate on credit and for profit-making purposes is thus a speculative investment, which might turn less profitable than expected.

The good quality of banks' loan portfolios shows that the **macroeconomic environment has been favourable for borrowers**. Though households' interest burden in ratio to disposable income has increased along with the growth of the housing loan market, no major loan-servicing difficulties have occurred at the microeconomic level. However, the impacts of fast loan growth have not been tested under weaker economic conditions, i.e. we have no experience as to the flexibility of borrowers' financial behaviour. Considering the modest financial assets of borrowers compared to their relatively large financial liabilities, financial behaviour cannot possibly be very flexible. Thus, borrowers and creditors might have underestimated the buffers necessary to hedge their risks.

For the sustainable operation of banks they should retain a conservative approach to assessing the future solvency of borrowers as well as the market value of collaterals (incl. real estate prices) despite the tightening competition. As to loan quality it is essential that in addition to the sufficiency of collaterals also the solvency of the client would be properly assessed.

The current capitalisation of banks meets present requirements. This year's change in the financial accounting principles of banks does not allow making provisions for covering potential loan losses. Therefore, profits depending on the economic cycle should be retained in own funds, which should now be higher by the unallocated provision.

Close convergence with international markets has led to a situation where factors influencing financial stability can be pinpointed less and less as being economic decisions of a certain country. The financing volume of the Estonian economy and fast loan growth mainly depend on the decisions of Nordic financial groups. As the rapidly developing Baltic loan market has been able to offer a great return-risk combination, there are virtually no supply-side constraints to loan growth. At the same time, Estonian business entities may not have sufficient resources for coping in times of economic recession, as risk management and decision-making at the group level of financial intermediaries does not clearly indicate whether buffers maintained for covering the risks of Estonian business entities do exist. Moreover, potential usage of these buffers proceeds solely from the specific business interests of the respective financial group. In order to ensure financial stability it would be safer if taking risks were in line with maintaining their buffers.