IV MONEY AND SECURITIES AND MONEY MARKET

MONEY MARKET

Referring to strong inflationary pressures, the European Central Bank has continued its policy of raising interest rates. Since the beginning of 2006, the monetary policy interest rates of the euro area have been raised four times. The last rise occurred in October when the euro area's key interest rate was raised by 25 basis points to 3.25%, making it 1.25 percentage points higher than at the beginning of the upward cycle of interest rates. The elevation of the euro area's key interest rate has also brought about an increase in its money market interest rates. Since September 2005, when the euro area's money market quotations started to increase in anticipation of rising interest rates, the three-month Euribor has climbed by almost 1.5 percentage points (see Figure 4.1).

The Estonian **money market interest rates** have generally remained in line with the interest rate changes in the euro area's money market. As the Estonian money market is not particularly active and the elevation of interest rate quotations in Estonia and the euro area occurred at different times, the difference between the respective money market interest rates turned negative for a while during the weeks preceding the decision to increase monetary policy interest rates. By the middle of October, the difference between money market interest rates across various maturities in Estonia and the euro area amounted to an average of 8–18 basis points (see Figure 4.2).

The small difference between interest rate quotations which form the basis of future Estonian kroon and euro transactions (forward difference) confirms that the exchange rate of the kroon has not been under pressure in the money market. Participation in the exchange rate mechanism ERM2 has gone smoothly for Estonia.

In international financial markets, the **yield of 5-year Estonian Government Eurobonds** has been moving in line with the yields of government bonds issued in the euro area. The difference between the yield of Estonian Eurobonds and German bonds with comparable maturities has remained relatively stable during the second half of 2006 (see Figure 4.3). The small difference between long-term in-

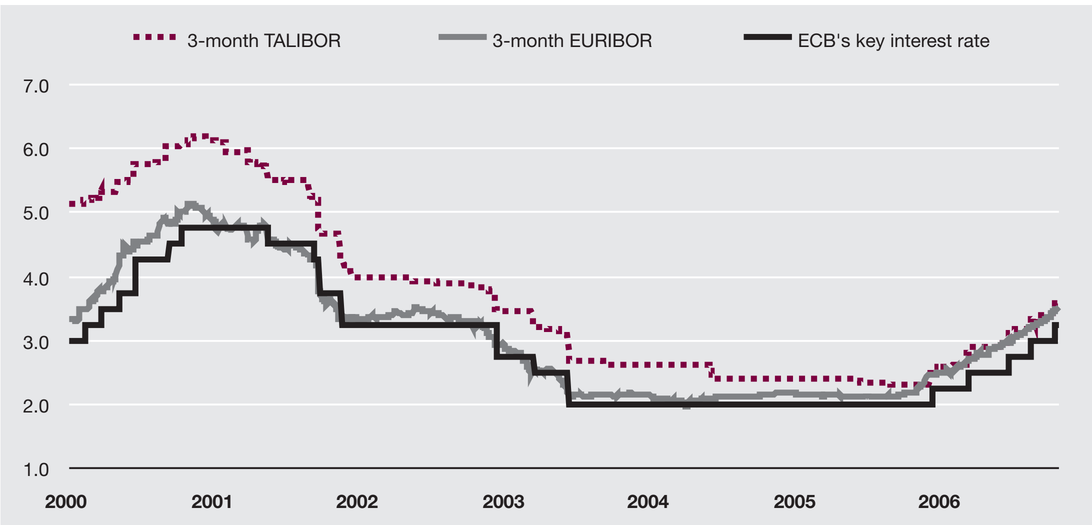

Figure 4.1. Money market interest rates in Estonia and in the euro area (%)

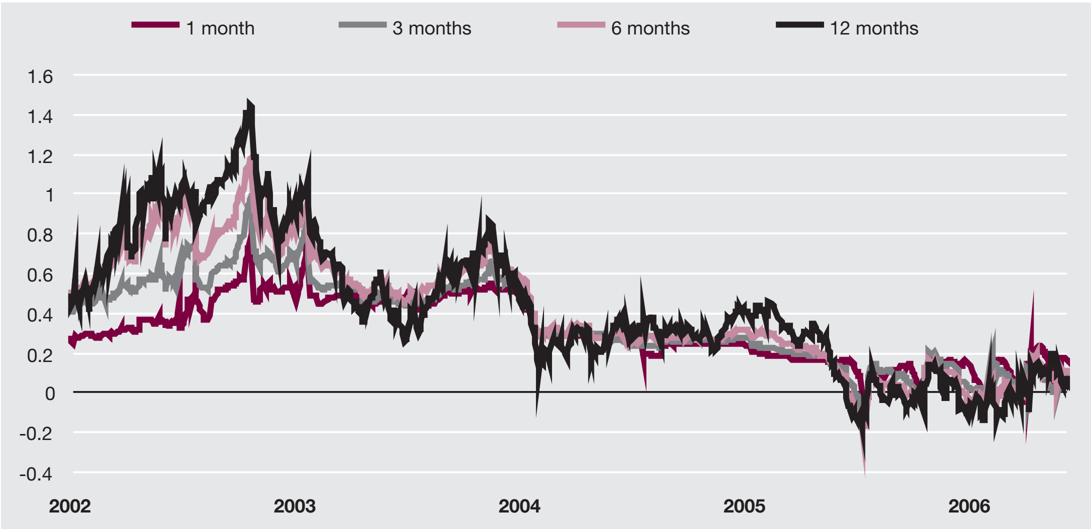

Figure 4.2. Difference between money market interest rates in Estonia and in the euro area (percentage points)

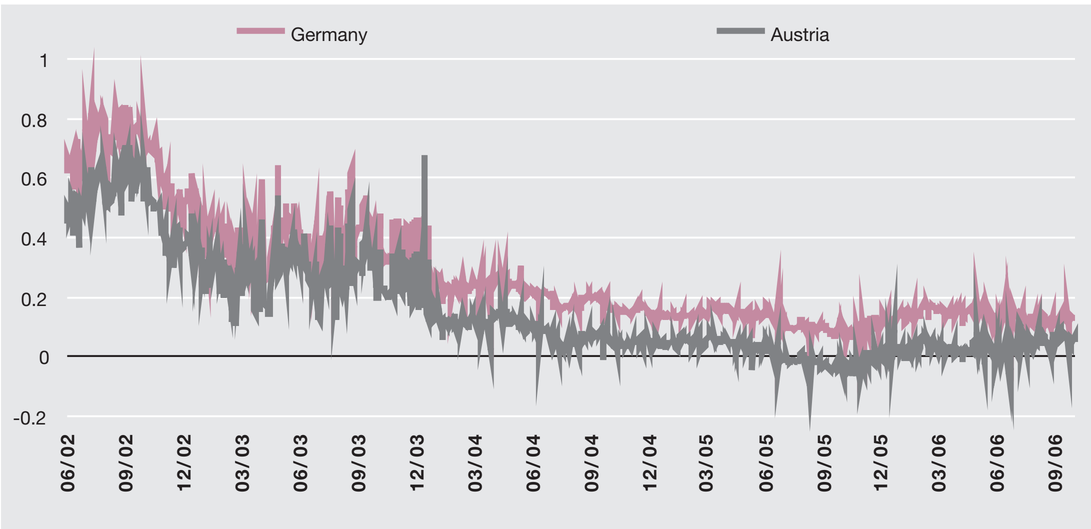

Figure 4.3. Yield difference between the Estonian Government Eurobonds and respective bonds in Austria and Germany (percentage points)

terest rates demonstrates the continuously high confidence of international financial markets in the Estonian monetary and financial system.

The turnover of Estonian kroon denominated money market loans is still strongly influenced by the great turnover of derivatives, which itself stems from large-scale intra-group currency exchange transactions (see also the Financial Stability Review of May 2006). Excluding the aforementioned transactions between parent banks and their subsidiary banks, the turnover of derivatives has remained customary.

The turnover of short-term kroon loans in 2006 was slightly greater than in previous quarters, comprising an average of 35% of the total turnover of money market loans. The transactions of non-residents comprised 90% of the short-term kroon loan market. Swedish and Finnish credit institutions continued to prevail. Meanwhile, the turnover of derivatives in foreign currencies has remained quite steady at the previous year's level.

BOND MARKET

The domestic bond market has revived further owing to the continuously expansive environment, but compared to the spring, market growth has been slightly slower. By the end of September 2006, the **primary bond market** turnover decelerated to 38% (see Figure 4.4). As a result, bond market capitalisation increased by 40% compared to a year ago, reaching 7 billion kroons, i.e. 3.6% of GDP by the end of September. The market expanded primarily due to bond issues by resident banks, which increased by 42%. At the end of September, the stock of bank bonds comprised 36% of the bond market's total capitalisation.

Thanks to the boost in turnover of the primary bond market, the **secondary bond market** also slightly picked up pace. By the end of the third quarter, it had grown by 15% compared to the previous year (see Figure 4.5). The average daily turnover increased from 13.1 million kroons the year before to 15.8 million kroons by the end of September

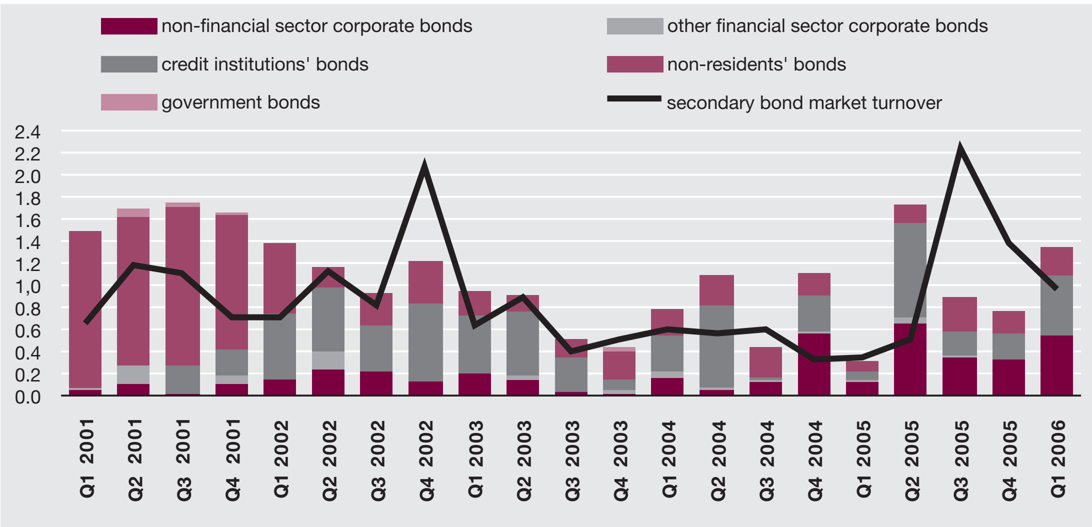

Figure 4.4. Volume of quarterly issued bonds and secondary bond market turnover (EEK bn)

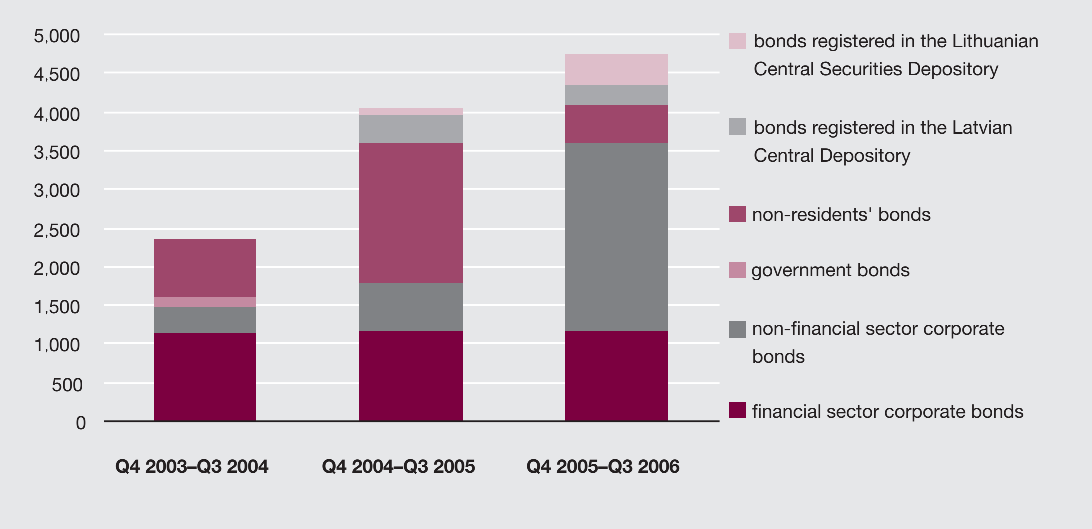

Figure 4.5. Structure of secondary bond market turnover (EEK m)

2006. Most of the transactions originated through the Estonian Central Register of Securities were performed with bonds issued by the non-financial sector (51%). 24% of the transactions executed through the same Register were performed with bonds issued by non-residents. 8% of them were bonds registered with the Latvian Central Depository and 6% with the Central Securities Depository of Lithuania.

Since March 2006, one security was added to the bonds listed on the stock exchange: the bonds of Q Vara OÜ were listed in September. On the other hand, the bonds of AS Eesti Post, AS Fenniger and Sportland International Group AS went unlisted. Hence, at the end of September 2006, the market value of the bonds of the six companies listed on the Tallinn Stock Exchange amounted to 0.7 billion kroons, i.e. 10% of the total bond market volume. Although trading bonds in the over-the-counter market has become more frequent, listed bonds are still mainly acquired for holding. During the past half-year, only one listed bond was traded through the stock exchange (the bond of AS Sampo Pank in the sum of 8.3 million kroons).

STOCK MARKET

In the spring/summer of 2006, stock markets all over the world experienced one of the **greatest corrections in recent years**, which also had a direct effect on important investment regions for Estonian investors. Within a month and a half, stock prices dropped over 30% in the Russian, Hungarian and Polish markets (see Figure 4.6). In other markets, the decline was smaller. In the third quarter, the markets recovered from the correction and most stock prices started to climb in light of the profit expectations of Central and Eastern European stock market companies and interest rate decisions made by leading countries. Since the beginning of the year, the Russian market has grown the most (by 43%). Bulgaria and Poland are next (each by a third). While the index growth of the Estonian stock market reached 7%, the index of other Baltic States dropped by nearly a tenth.

The most significant events on the Tallinn Stock Exchange during the past half-year were the listing of the stocks of the construction company AS Eesti Ehitus and the casino enterprise Olympic

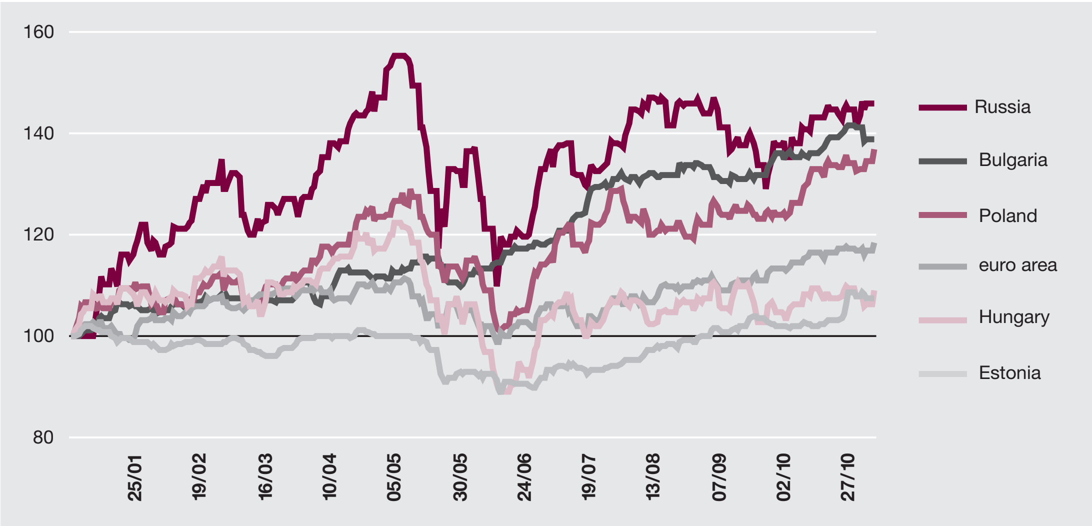

Figure 4.6. Dynamics of stock exchange indices of the new EU Member States, the euro area and Russia (01/01/2006 = 100)

Source: EcoWin

Entertainment Group on the primary list of the stock exchange. As a result, stock market capitalisation increased by about 3% and 13%, respectively (see Figure 4.7). Furthermore, for the first time in the history of the Baltic securities markets, public trading of the Olympic Entertainment Group's stock took place simultaneously in Estonia, Latvia and Lithuania.

As the value of stocks decreased during this spring/summer due to a decline in global stock markets, stock market capitalisation remained at the level of 47 billion kroons just like the year before, despite the listing of new companies on the stock exchange, dropping to 24% in ratio to GDP. While the general stock market decline brought the stock index OMXT to last year's level by June, by autumn it had, similarly to previous autumns, again reached a record level with 720 points and posted a year-on-year growth of 7% (see Figure 4.8).

Mainly due to the listing of new stocks on the stock exchange, in the past half-year the average daily turnover of transactions reached 39 million kroons. Compared to the previous year's average, however, this is still nearly a tenth smaller. The main driving forces on the market were the shares of Tallink Grupp and AS Eesti Telekom – the transactions of their shares made up 23% of the stock exchange's turnover. Other more liquid securities during the same period were the shares of AS Merko Ehitus and AS Tallinna Vesi, both comprising 10% of the total turnover.

40 stock exchange members are entitled to act as brokers. Due to the integration of the Baltic and Nordic securities markets, the number of foreign stock exchange members has increased recently. Their number has reached 33, accounting for over three-quarters of all members. Although the transaction turnover of international stock exchange members is on the rise, most of the transactions were still brokered by local members. By the end of September, transactions brokered by AS Suprema Securities and Hansapank made up the majority, i.e. 86% of the total value of transactions on a rolling year basis.

Since the end of 2005, the percentage of non-residents' investments in the capitalisation of shares

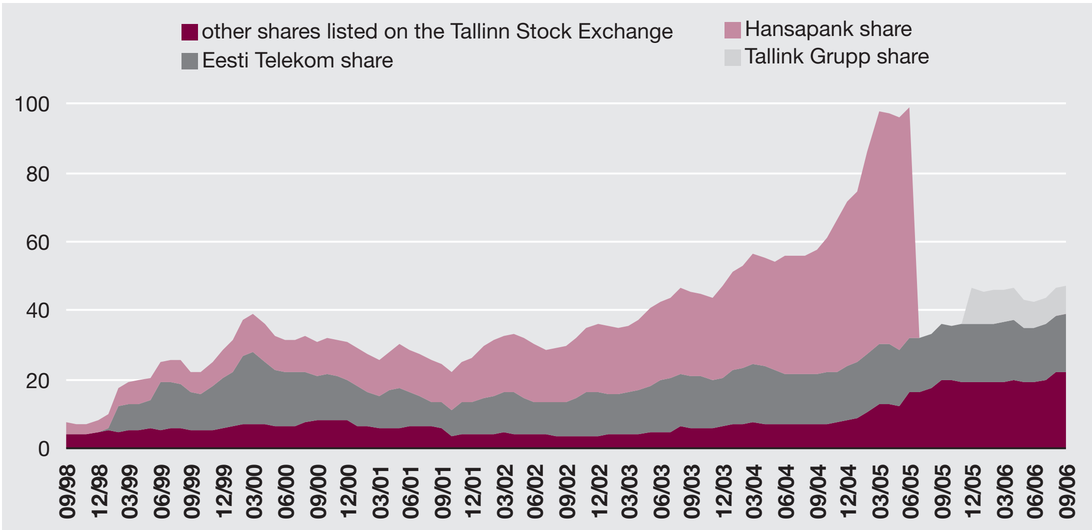

Figure 4.7. Market capitalisation of shares listed on the Tallinn Stock Exchange (end of month; EEK bn)

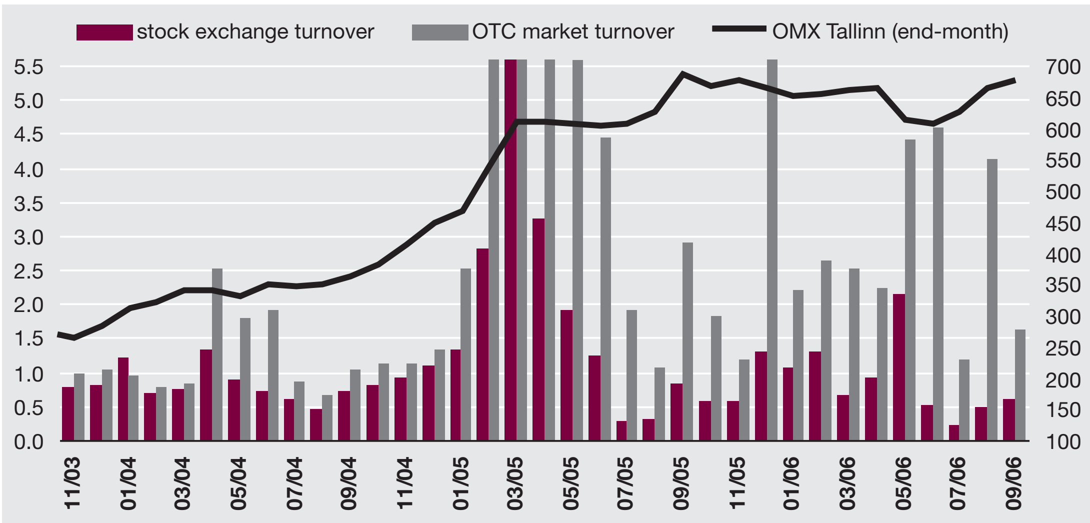

Figure 4.8. Stock turnover on the Tallinn Stock Exchange and OTC market (EEK bn; left scale) and Tallinn Stock Exchange index OMX Tallinn (points; right scale)

listed on the stock market has remained steady at 59% (see Figure 4.9). In nominal terms, during the first nine months of 2006, investors from the USA, Latvia and the United Kingdom increased their investments in the listed shares most actively (by 2.5 billion kroons). At the end of September, the percentage of investments made by resident companies in shares on the stock market amounted to 34%, i.e. the same as in spring. The percentage of private investors rose to 4.5% of the total value of shares on the stock market.

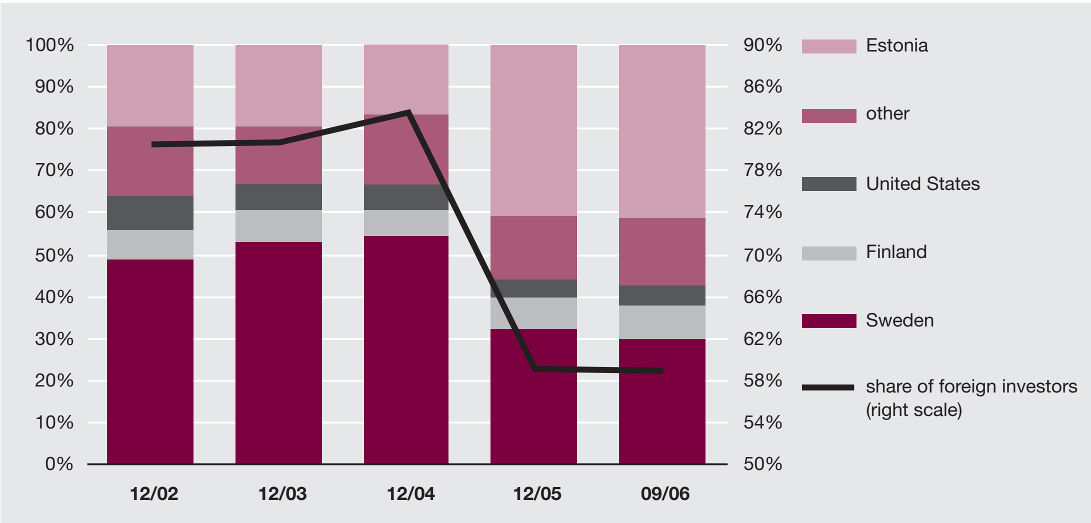

Figure 4.9. Structure of investors by residency and share of foreign investors of shares listed on the Tallinn Stock Exchange (%)