APPENDIX. POSSIBLE IMPACTS OF THE CONFLICT BETWEEN RUSSIA AND UKRAINE ON THE ESTONIAN FINANCIAL SECTOR

The European Union has imposed economic sanctions on Russia for its role in destabilising Ukraine. Most of the sanctions aimed at the economy came into force on 1 August this year, and they were extended on 12 September to a list of non-financial sector companies and by even tighter funding restrictions for banks.

Russia imposed its own counter-sanctions in response on several groups of European Union goods, principally products imported from the agricultural sector. The value of the goods exported from Estonia to Russia last year to which the sanctions will now apply was 76 million euros, accounting for 0.6% of total exports, and 65 million euros of that was produced in Estonia. The impact of the Russian import restrictions on the Estonian economy, given the internal product chains within the European Union, will be around 0.3% of GDP. The restrictions will principally affect companies in food production, agriculture, transport and wholesale.

If sanctions should affect the ability of companies to service their loans, it will still take time for that effect to be felt as an increase in problem loans. There was some increase in short-term overdue loans in the primary sector at the start of summer even before the sanctions were introduced, but after that the increase stopped. In any case, the quality of loans to the primary sector is generally notably better than the average for the business sector, as 0.8% of loans to the primary sector were overdue by more than 60 days in August, while on average 1.8% of loans to the business sector were. The quality of loans to other sectors that are affected by the sanctions is also quite good.

If the impact of the conflict between Russia and Ukraine is limited to the sanctions that have already been imposed, then it will probably be fairly small for the Estonian non-financial economy and for the loan quality of the banks here. However, if the conflict widens, the effect could be much larger, and so the relations of Estonian companies and banks with Russia also needs to be considered.

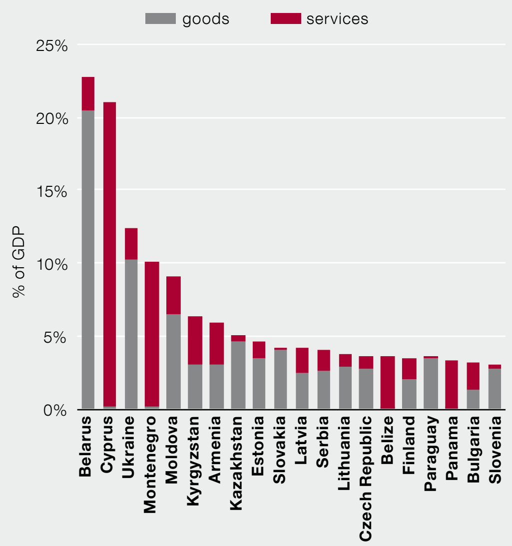
The economic links between Russia and Estonia are smaller than might be expected given the proximity of the two countries and the size of the Russian market. Exports to Russia are large, but are to a significant extent made up of production from other countries that has little connection with the local economy. Estonian exports of goods and services to Russia, including intermediary goods and tourism, are about the same as Estonia's exports to Latvia. Exports of goods and services to Russia are worth 8.8% of GDP according to the methodology used for the Estonian balance of payments. However the foreign trade database of the UN shows that exports of goods and services of Estonian origin to Russia are much smaller at around 5% of Estonian GDP, which is about the same as the figure for Latvia, the Czech Republic or Slovakia (see Figure A.1).

As foreign inputs are used in production, including energy imported from Russia, the direct impact of exports to Russia could be in the order of 3–4% of Estonian GDP. Russia's total impact on GDP is slightly more than that though, as Estonia exports quite a lot to countries that trade closely with Russia, and that are thus exposed to any shock to the Russian economy. International product chains could make Estonia's economic links to Russia some of the tightest in Europe.

Alongside exports, imports of raw materials are also important, as Russia exports raw products that are used as inputs in the European manufacturing sector. Estonian imports from Russia declined after the riots in Tallinn in April 2007, and have remained low since, accounting for around 6% of total Estonian imports in 2013. Gas accounts for a large share of the inputs imported from Russia, though its importance in total Estonian energy consumption is small at around 6% of primary energy.

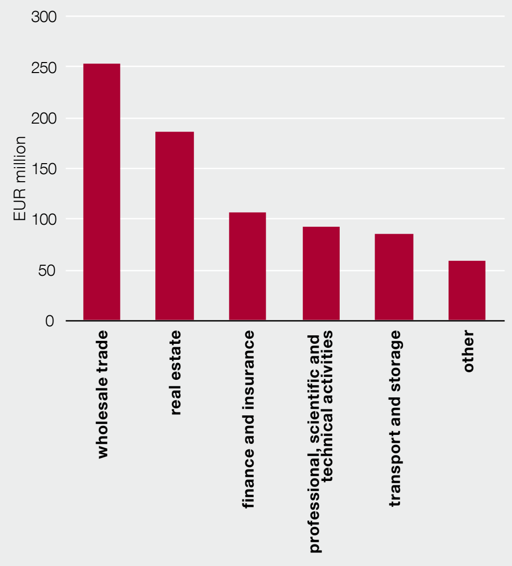
Direct investment in Estonia by Russian residents was 785 million euros at the end of the second quarter of this year, or about 5% of total foreign investment in Estonia and about 4% of GDP. More than half of direct investment went into wholesale trade and real estate (see Figure A.2). Investment in Russia by Estonian residents at the same time was 211 million euros, or slightly more than 1% of GDP (see Figure A.3). The main investments in Russia are in manufacturing, finance and insurance activities, and trade. Both Russian investment in Estonia and Estonian investment in Russia are among the largest in Europe in terms of GDP.

Figure A.1. Russian imports from individual countries as a percentage of GDP in 2012, 20 countries



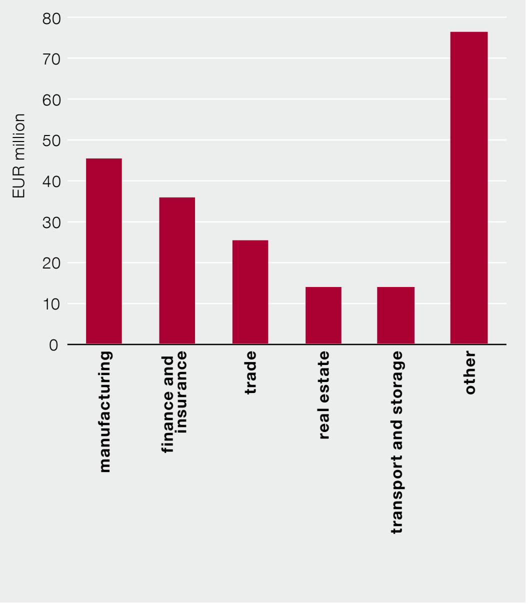
Sources: Trade Map, IMF World Economic Outlook

Figure A.2. Russia's foreign direct investment in Estonia as at 30 June 2014



On top of quantifiable economic links, the effect on confidence and through that on economic decisions is also important. The expectations for future production of the Estonian manufacturing sector declined sharply after the annexation of Crimea by Russia. Such changes in expectations for production are usually accompanied by falls in orders and changes in inventories, but that has not happened to the same extent with this decline in expectations.

Figure A.3. Estonia's foreign direct investment in Russia as at 30 June 2014



The links of the financial sector to Russia and possible risks

The positions of the banks operating in Estonia with Russian residents are generally very small. The aggregate claims of the banking sector on Russian residents was less than 0.2% of assets at the end of August and did not exceed 1% of total assets for most banks.

Banks may be vulnerable not only to direct claims, but also to non-resident deposits if they were to flow out of the banks in the expectation of further sanctions or a sharp deterioration in the economic environment. Deposits have so far behaved as normal. The deposits of Russian residents are fairly small at a total of 232 million euros, which is 1.1% of total banking assets, and although they are a larger share of the assets of some banks, nowhere do they exceed 10% of total assets.

Russian companies and households may also have put assets in Estonian banks through third countries. Non-resident deposits make up 11% of total bank assets, and that has not changed since the end of last year. The share of non-resident deposits is mainly larger than average at smaller banks, whose liquidity buffers are equally above average (see section 3.1 Liquidity and funding of banks).

The direct impact on banks operating in Estonia and on financial stability here of the sanctions that have so far been imposed is quite minor. Firstly this is because the direct positions of local banks with Russia are small and secondly because the impact of the sanctions on the business sector as a whole is quite modest, even if some individual companies are affected a great deal, and so the credit risk to the banks is only small. If the conflict spreads further, the impact may be larger as the positions and funding of individual banks are exposed to risks related to Russia, and connections with Russia remain important for several sectors of the economy.