IV
MONETARY POLICY ENVIRONMENT

In the second and also in the early third quarter against the background of global growth slowdown the monetary policy environment was relatively unsteady and subject to partly contradictory tendencies. At the beginning of the second quarter the strengthening of the euro against the US dollar came to a halt and started weakening instead, resulting in the US dollar reaching close to the 2000 high.

In May primarily due to the support of external price pressures, inflation in Europe hit the record high of the last decade – 3.4%. At the end of the second quarter the tendency changed and inflationary pressure started easing under lower energy and food prices and the appreciating exchange rate of the euro.

Due to decreasing external price pressures and somewhat slower reduction in external interest rates, Estonia's monetary environment should be less expansive in the second half-year. Contemporaneously, money market and loan interest rates continue falling.

For the domestic real sector the second quarter meant, first and foremost, lower growth of deposits and declining interest rates. The interest rates dropped most for time deposits and housing loans. The annual growth of aggregated liabilities of the real sector continued to be above 20%, whereas leasing portfolio and direct borrowing from abroad continued preferential growth.

Monetary Environment

The strengthening of the euro to 0.93 EUR/USD in the first quarter remained temporary as deteriorating economic outlooks of the euro area, including continuous decrease in corporate and consumer confidence, brought along another weakening of the euro in the second quarter. In July the exchange rate of the euro recovered again (see Figure 4.1). The recovery was primarily due to the weakness of the US industry sector and labour market.

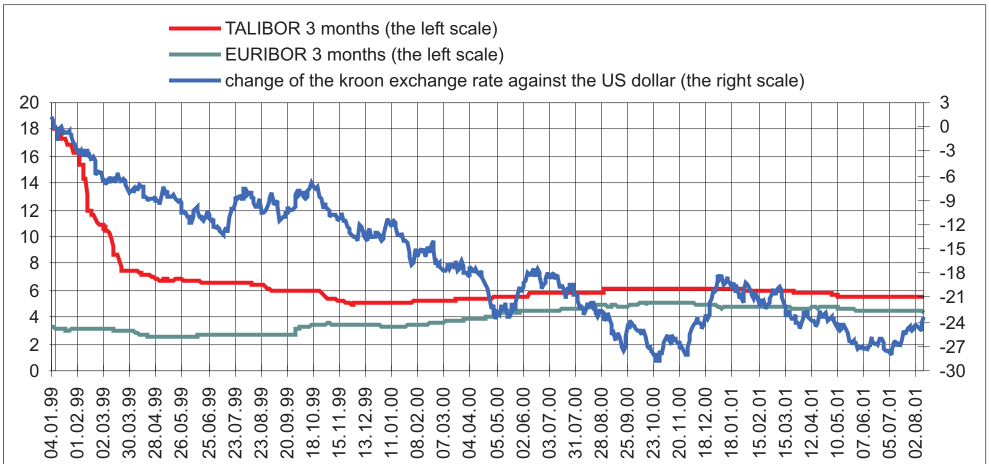

Figure 4.1. Three-month TALIBOR and EURIBOR; change of the Estonian kroon exchange rate against the US dollar (%)

During the first five months of the year the net outflow of direct investments from the euro area acted as one of the exchange rate lowering factors. The continuation of direct investment net outflows at such a high level is not very likely. Nevertheless, the further strengthening of the euro remains questionable. In the second half-year the suspended decline in the US economic activity could weaken the euro's exchange rate. **Financial markets are not forecasting major shifts in the exchange rate of the euro for the next twelve months** – in early September the euro's exchange rate in the forward market was only 0.3 percentage points higher. **Appreciation of the euro during summer months is positive in terms of lessening price pressures through the impact on import prices both in the euro area and in Estonia.**

The trend of the money market interest rates for the kroon shaping Estonia's monetary environment has been moving downward since the end-of 2000, just like that of the euro's interest rates. Between May and August money market interest rates of the Estonian kroon for more than three months dropped about 30 basis points. Compared to the interest rates of the euro, the fall was more modest.

The anticipated further decline in the money market interest rates of the kroon and the euro will continue exercising expansive impact on Estonia's monetary environment. Changes neither in the euro area nor in Estonia are transposed one-to-one to loan interest rates. Under favourable liquidity circumstances credit demand and competition determine the level of domestic loan interest rates apart from the money market interest rates of the euro.

Capital Flows

In the second quarter capital flows were exceptional – extensive outflow of direct investments took place. This was mostly related to the recapitalization of *Lietuvos Taupomasis Bankas* in Lithuania and *Hansabanka* in Latvia recently acquired by Estonian Hansapank.

FDI in Estonia maintained its regular level, reaching to 1.3 billion kroons, including one billion kroons of foreign direct investors' credit to Estonian subsidiaries.

In a net, one billion of kroons moved to Estonia through the account of portfolio and other investments, including 860 million kroons into banks. Financial institutions invested out of Estonia an estimated 700 million kroons and the private sector raised foreign debt in the extent up to 1.2 billion kroons.

Due to launching of the second phase of the reform of the monetary policy operational framework as of July 1, an extensive outflow of capital through commercial banks is expected in the third quarter. Similar to the launch of the first phase of the reform in January, outflow of assets in the extent of 1.4 billion koons is expected with simultaneous decline in required reserved held with Eesti Pank.

Monetary Aggregates

Consistently with slowdown in the overall economic activity, growth in monetary aggregates reflecting the real sector's money demand started declining more obviously. The annual growth rate of the narrow monetary aggregate has demonstrated a downward trend for more than eighteen months and has dropped 21 percentage points below the record height reached during the last economic growth cycle. This decline has been accelerating since April. During the last three months it has slowed by 5.6 percentage points, taking the annual growth down to 19.6%. The slowdown in the real sector's deposits is offset by the even accelerating growth in the government savings, exceeding already 100%. At the end of July, government deposits were two billion kroons above the year-ago period and were reaching to 3.7 billion kroons. Therefore, the growth rate of the broadest, government-deposits-containing, monetary aggregate is the highest (see Figure 4.2).

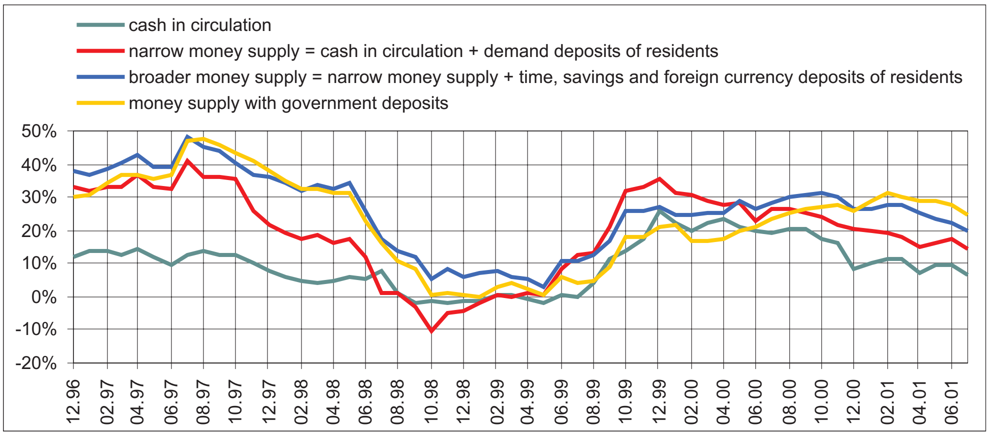

Figure 4.2. Change of monetary aggregates against the respective month of previous year

The slowing growth of the monetary aggregates is partially offset by the growth in money market and interest rate funds' shares. For the first quarter the volume of the funds grew by 480 million kroons compared to the same period in 2000 (adding 1.7 percentage points to the annual growth rate of the broader monetary aggregate). By the end of the second quarter the annual growth was 700 million kroons, adding 2.3 percentage points to the annual growth of the broader monetary aggregate.

In the domestic real sector the growth of corporate deposits has shrank most abruptly (see Figure 4.3) – the aggregated indicator fell from the average 31% of the first quarter to 11% in July. Among aggregated deposits, foreign currency deposits underwent the fastest slowdown in the growth rates, getting already close to zero.

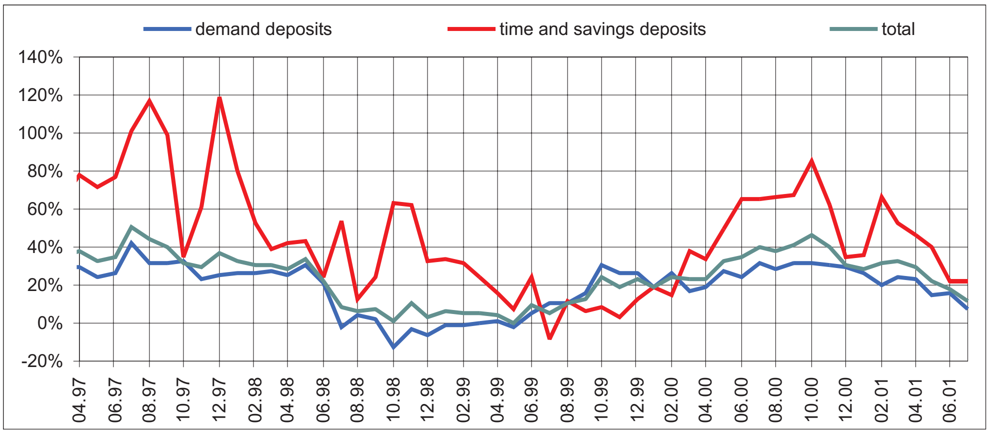

Figure 4.3. Change of deposits of resident commercial undertakings against the respective month of previous year (kroon and foreign currency)

Unlike corporate deposits, private individuals' deposits maintained stable growth (see Figure 4.4), remaining already for the second year close to 30%. In the structure of private individuals' deposits, a slow but persistent growth in the share of the time and saving deposits (primarily in foreign currency) has taken place throughout the period.

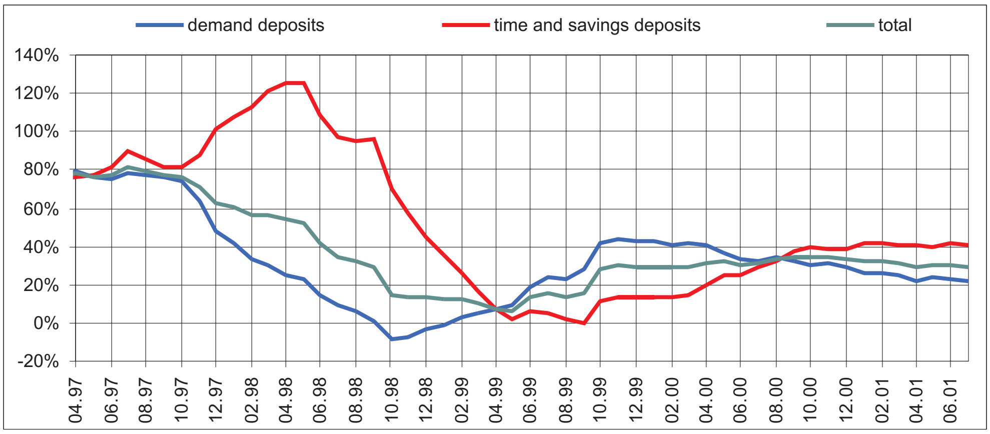

Figure 4.4. Change of deposits of resident private individuals against the respective month of previous year (kroon and foreign currency)

Due to the lower-than-average growth of cash, the share of cash in the broader monetary aggregate (without government and non-resident deposits) has been continuously decreasing (see Figure 4.5). According to rough estimates the share of cash in the monetary aggregate has shrunk slightly below two percentage points a year. The second quarter of 2001 was not an exception in this process.

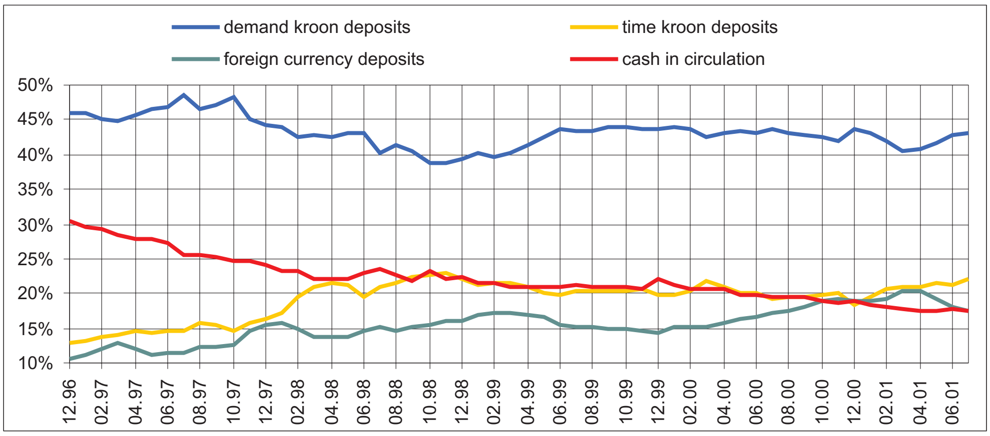

Figure 4.5. Structure of broader money supply

Liquid Assets

Despite of the decelerating deposit growth, the absolute growth of deposits exceeded the growth of domestic real sector borrowing and leasing by about 300 million kroons in the first half of the year. This ensured favourable liquidity environment in the first half-year, with the share of liquid assets in the credit institutions' balance sheets remaining relatively stable. Thereby most of the structural shifts in the liquidity portfolio were related to the reform of the monetary policy operational framework, allowing credit institutions to meet the reserve requirement to a limited extent with high quality euro-denominated securities (see Figure 4.6).

As of July 1, 2001, the second phase of the reform raised eligibility of foreign securities in the reserve requirement from 25% to 50%, ie by about 1.4 billion kroons. Consequently, the share of kroon deposits with the central bank in the liquidity buffers of the credit institutions shed from 6.4% to 4.2% between April and August. The stable overall balance of liquidity buffers was achieved through an equal increase in deposits with non-resident credit institutions.

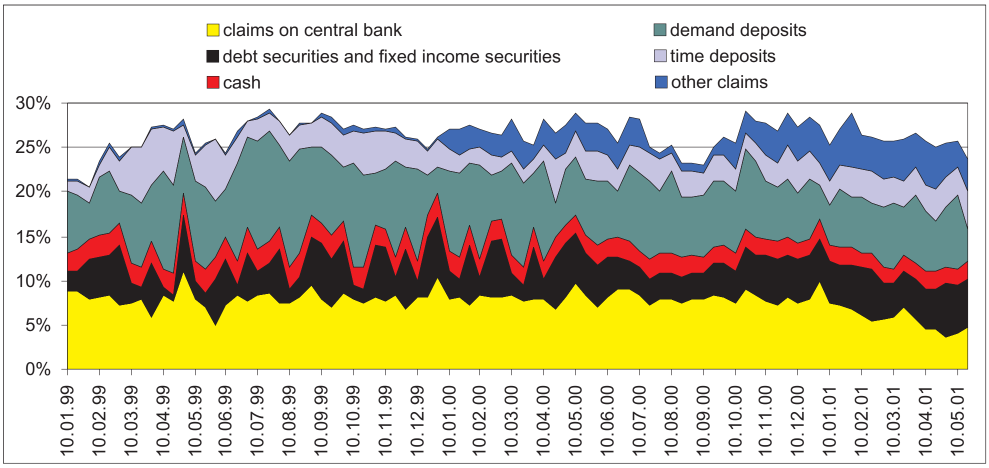

Figure 4.6. The share of liquid assets in banks' total assets

All in all, the share of liquidity buffers in credit institutions' did not change. As a side effect of the reform, the euro-denominated securities portfolio of credit institutions' was increased by about a billion kroons in July.

Money Market and Foreign Exchange Market

Money Market Interest Rates

On May 10, 2001, the European Central Bank cut the main refinancing rate by 25 basis points. **The cut was followed by a decline in longer-term euro money market interest rates, leading to the flattening of the euro zone money market yield curve in August.** The decline in the longer-term money market rates was related to deteriorating euro zone growth outlooks, which became evident at the beginning of the summer. Deceleration of euro zone growth was reflected in continuously declining growth of industrial output and shrinking corporate and consumer confidence.

On August 30, the European Central Bank cut the main refinancing rate for the second time this year – by 25 basis points to 4.25%, on the grounds of shrinking demand-side pressures on inflation in the medium-term.

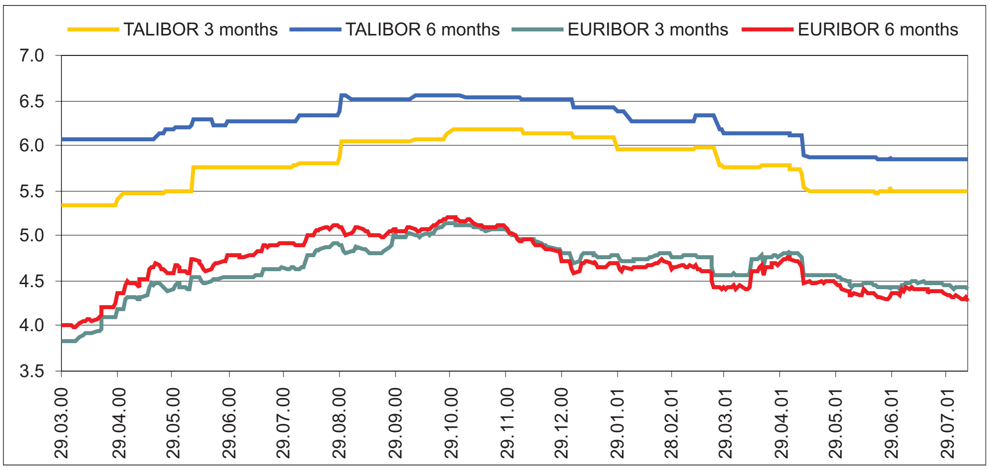

Figure 4.7. Money market interest rates of the Estonian kroon and the euro (%)

Parallel to decreasing euro zone money market interest rates, in July the yield on ten-year euro zone government bonds dropped by about 20 basis points. The fall in bond yields could reflect a decline in the US interest rates as well as contained inflation expectations in the euro zone.

Since the end of 2000, the money market interest rates of the Estonian kroon have displayed a downward trend just like the interest rates of the euro (see Figure 4.7). Between May and August the money market interest rates of the kroon with maturity over six months displayed a more modest decrease than those of the euro – 30 basis points, widening the spread between the Estonian kroon and euro interest rates by 10-20 basis points (see Figure 4.8).

In early September the international forward markets priced in the decline of euro zone short-term interest rates by another 40 basis points by the end of the year. The fall in the interest rates is anticipated to come to a halt in the second half of 2002.

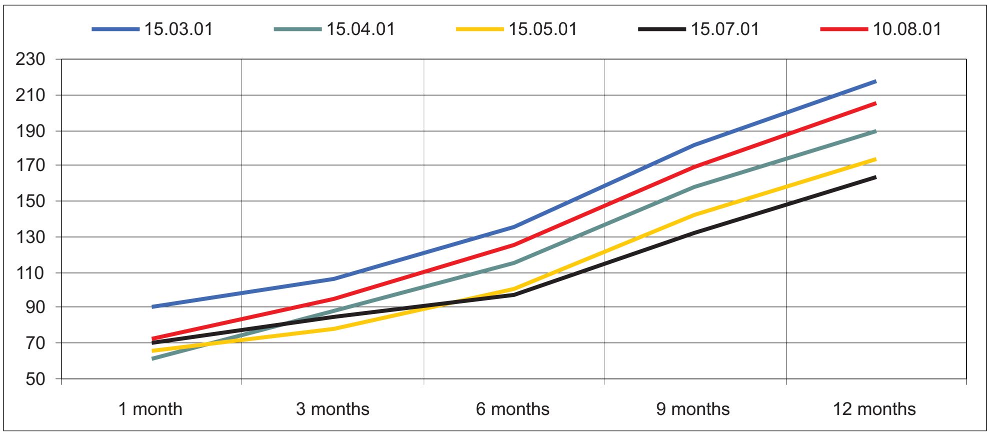

Figure 4.8. Difference between money market interest rates of the Estonian kroon and the euro (basis points)

Forward Market

In the second quarter due to seasonal factors the turnover in the Estonian kroon forward market remained about twice below the first quarter level, being close to 21 billion kroons. Transactions with non-residents gave about two thirds of the turnover. The long kroon positions of Estonian credit institutions at the forward markets have stayed, on average, at a billion kroons level in 2001 indicating low activity (see Figure 4.9).

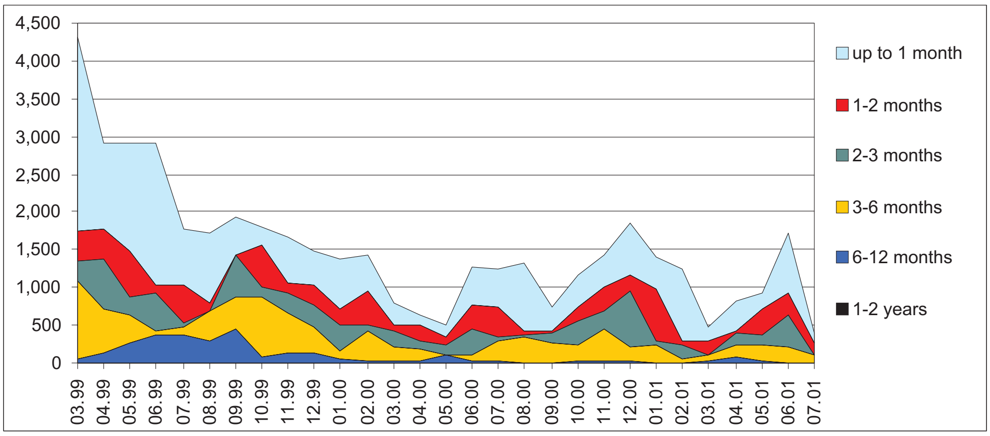

Figure 4.9. Long kroon positions of Estonian credit institutions taken against the Estonian kroon in the forward market (EEK m)

This year the credit institutions' net foreign exchange position in euro has displayed preferential growth over the previous periods, growing by five billion kroons against the beginning of the year. Consequently, credit institutions balance sheet position in euro increased by four billion kroons and short positions in the forward market declined by one billion kroons.

Real Sector Interest Rates

Similar to monetary aggregates, also interest rates clarified significantly development of the trends in the monetary sector in the second quarter. **The overall level of domestic interest rates dropped much faster than anticipated. The interest rate shrinking the most was the one of foreign currency deposits** (see Figure 4.10). The main underlying reason there could be found from the drop in the international interest rate level, primarily in case of deposits denominated in dollars[1] (in June, about two thirds of the foreign currency deposits were denominated in dollars). Comparing July with the end of the year 2000, interest rate of foreign currency deposits fell by 2.1 percentage points on the short maturities and 2.8 percentage points on the long maturities (levels are 3.6 and 4.2%, respectively). The drop in kroon deposits' interest rates has been less pronounced over the same period: 1.4 percentage points for long-term and 0.3 for short-term deposits. In July kroon deposits' interest rates were 5.5 and 4.8%, respectively.

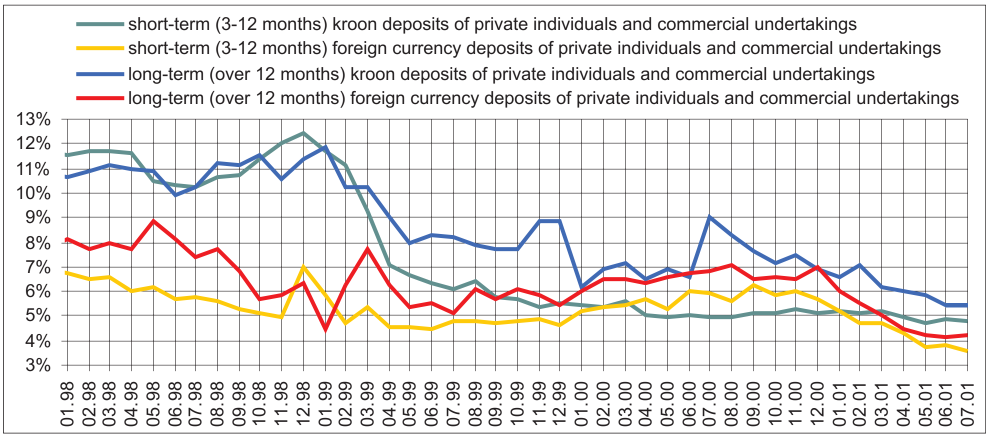

Figure 4.10. Interest rates of residents' deposits

The downward trend was also visible in all categories of loan interest rates, although decline was significantly less pronounced than in deposit interest rates. In the first half-year housing loan interest rates fell the most (1.8 percentage points), suppressing also the average level of interest rate of long-term loans issued to private individuals by 1.6 percentage points (see Figure 4.11). The new interest rate levels of 9.25% and 9.7%, respectively, are the lowest ever. Long-term lending to private individuals counted for one fifth from all bank loans issued to the real sector during the first seven months of the year.

Interest rates of long-term corporate loans (41.9% of the average turnover) and private individuals' short-term loans (2.1% of the average turnover) underwent an equal decline of 1.4 percentage points in the first half-year.

Briefly, domestic interest rates have dropped significantly faster than anticipated. The decline could continue whereas its rate should be slightly inhibited. The real sector interest rates could fall faster only if the ECB will cut interest rates more or faster than expected by markets so far.

[1] Eg the US Federal Reserve lowered interest rates by three percentage points between January and April.

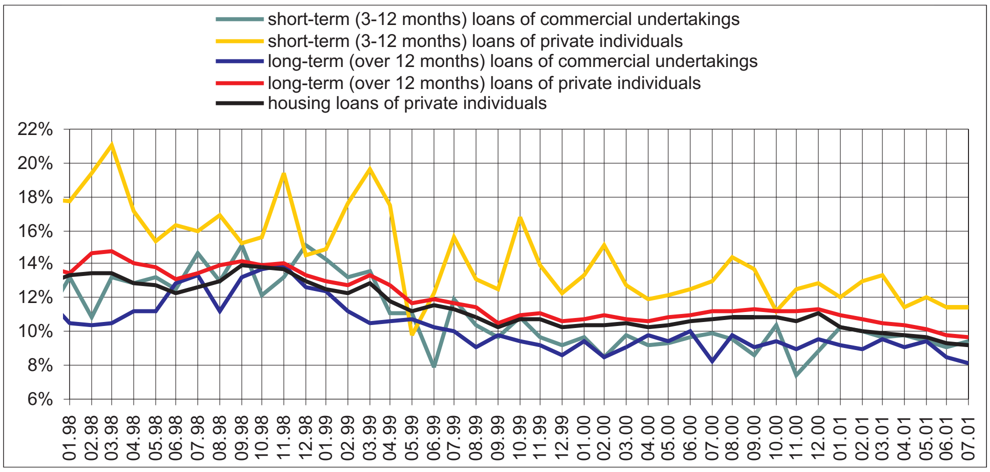

Figure 4.11. Interest rates of residents' loans

The inflation rate declining since July had an upward impact on real sector's *ex-post* interest rates, mitigating slightly the implications of sharply decreasing nominal rates (see Figures 4.12 and 4.13). In July the rapid downfall of the inflation rate even facilitated an increase in *ex-post* real lending rates. Expected further slowdown in domestic price inflation could be seen as one possible factor balancing the further potential drop in the nominal interest rates.

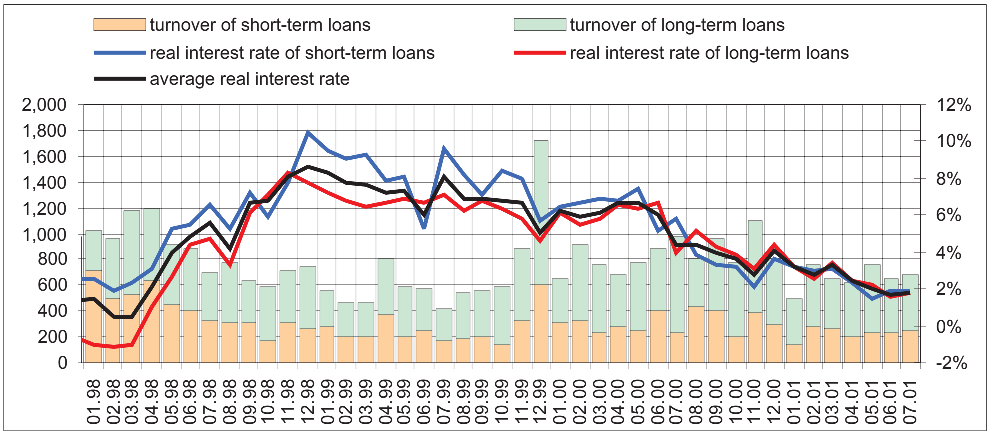

Figure 4.12. Turnover (EEK m, the left scale) and* ex-post *real interest rates of loans by CPI (the right scale) of resident commercial undertakings

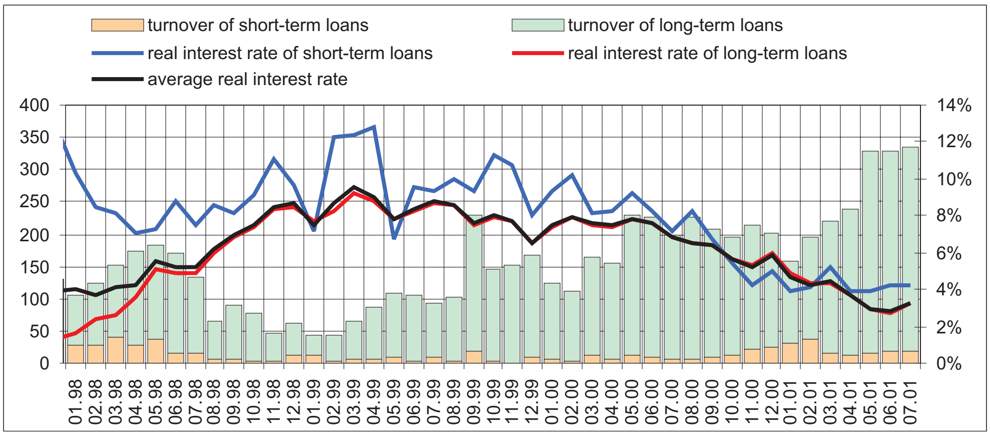

Figure 4.13. Turnover (EEK m, the left scale) and* ex-post *real interest rates of loans by CPI (the right scale) of resident private individuals

Credit Market

According to preliminary data[2], the growth of the real sector indebtedness accelerated also in the second quarter, reaching to 24.9% year-on-year (see Figure 4.14). Direct foreign borrowing stood continuously on the most prominent level. In the second quarter 2.2 billion kroons was borrowed directly from abroad of which one billion was borrowed from foreign direct investors (total foreign direct investments to Estonia accounted for 1.3 billion kroons). **This could be seen as an indication of the adoption of different financing schemes but not necessarily of the extraordinarily rapid growth in domestic loan burden.**

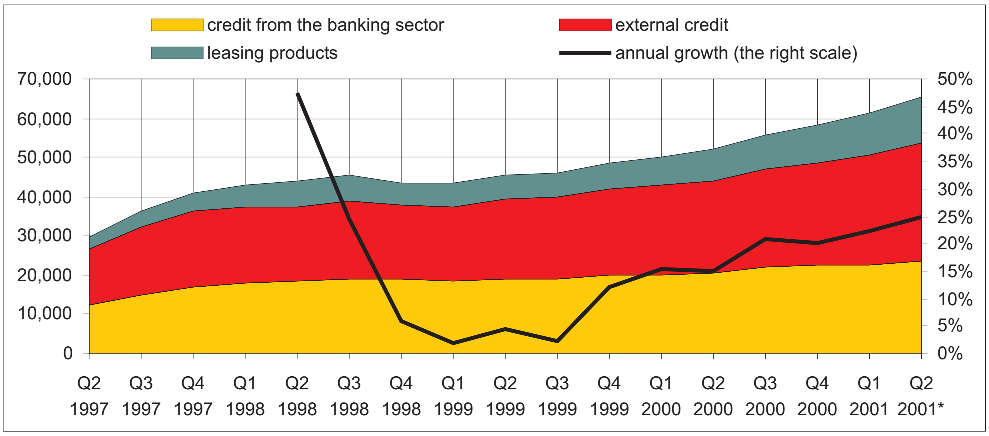

Figure 4.14. Debt burden of the domestic real sector (EEK m, the left scale) and its annual growth (%, the right scale)

* Leasing and external credit data for the 2nd quarter of 2001 are estimated.

Similar to two previous quarters, the absolute growth of the banking loans (and commercial banks' financial investments into residents' debt securities) did not exceed that of the leasing portfolio in absolute terms. According to preliminary data, the leasing portfolio increased by 1.27 billion kroons and bank loans by 796 million kroons in the second quarter (year-on-year growth rates were 42 and 13.6%, respectively).

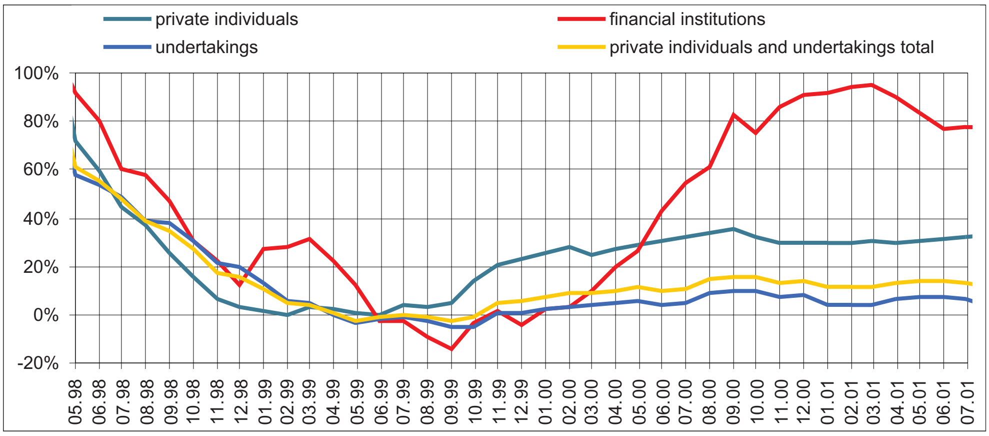

Figure 4.15. Banks' debt claims on resident customers (change against the respective month of previous year)

[2] A more precise information about the domestic real sector indebtedness will be available upon the release of the international investment position.

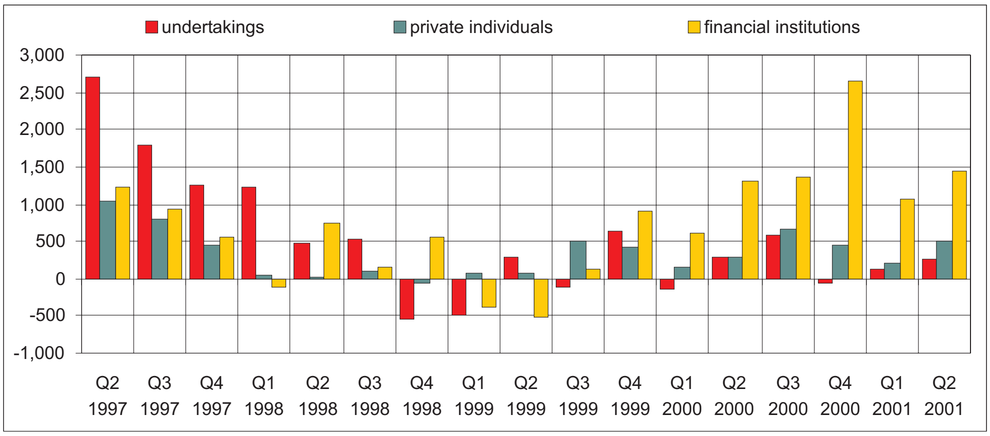

Figure 4.16. Banks' debt claims on resident customers (EEK m)

Lending to financial intermediation continued its preferential growth among bank loans (see Figures 4.15 and 4.16). The stock of loans issued to domestic financial intermediaries increased in the second quarter by 1.4 billion kroons, ie 10.6% (year-on-year growth was 77.5%), being responsible for 69% of the annual growth of the total stock of loans. Estonian financial intermediaries are estimated to have channelled up to 200 million kroons again out of Estonia.

Among domestic real sector bank lending the volume of private individuals' borrowing grew the most, constituting 80% of the real sector bank loans and 20% of the annual absolute growth of the consolidated loan portfolio. Such a development has been observable for the last eighteen months and the annual growth has been close to 30%, similar to the growth rate of private individuals' deposits. 80% of the growth in private individuals' loan stock was coming from housing loans.

The corporate sector's indebtedness increased by 3% compared to the same period last year. Real estate, renting and business activities companies have contributed the most, their borrowing from banks reached an annual growth of 149% (see Table 4.1). Lending to wholesale and retail trade grew by 33% and to agriculture, hunting and forestry by 17%. The stock of loans to electricity, gas and water supply companies as well as to other community, social and personal service activities shrank.

Table 4.1. Share of resident commercial undertakings in the annual growth of the total stock of loans by spheres of activity

	As of the end of month			Annual average		
	07.01	06.01	03.01	2000	1999	1998
Construction	0.2%	-2.2%	0.9%	-19.9%	132.8%	12.8%
Electricity, gas and water supply	-46.0%	-33.1%	17.6%	33.0%	-5.4%	0.3%
Education	-11.4%	-7.4%	-7.0%	-1.4%	-33.3%	0.3%
Hotels and restaurants	6.4%	4.2%	2.7%	0.4%	-49.9%	4.0%
Wholesale and retail trade	32.6%	60.9%	46.0%	21.3%	243.7%	17.7%
Fishing	-6.3%	-4.9%	-4.9%	-2.6%	-11.0%	-0.9%
Real estate, renting and business activities	148.7%	105.2%	88.5%	32.4%	-634.7%	19.5%
Mining and quarrying	0.5%	0.5%	1.1%	-0.8%	59.4%	0.9%
Agriculture, hunting and forestry	17.2%	18.7%	7.5%	-0.8%	26.9%	-1.5%
Health and social care	3.0%	1.9%	0.7%	2.3%	8.7%	0.1%
Transport, storage and communication	14.4%	14.3%	21.5%	14.9%	67.7%	7.3%
Industry	15.5%	-5.5%	7.3%	29.9%	19.6%	32.6%
Other community, social and personal service activities	-74.9%	-52.5%	-81.9%	-8.7%	265.9%	8.9%