BACKGROUND INFORMATION

CHANGE IN DOMESTIC REAL SECTOR FINANCIAL BEHAVIOUR

Financial behaviour of domestic real sector usually stands for financial activity based on corporate and household confidence and expectations, including debt level, loan servicing ability and financial assets and liabilities. Over the last twelve to eighteen months, significant changes have taken place in this field in Estonia.

Beginning from 1999 to early 2002 Estonian financial sector covered domestic credit demand with funds involved from Estonia. Assets placed in the financial sector by Estonian companies and private individuals constantly exceeded the volume of lending. In 2002 the trend reversed and real sector lending started to exceed growth in domestic saving. ***Contemporaneously, credit demand gained space, depositing shrank and the purpose of lending changed significantly.***

Undertakings

The annual growth of corporate domestic borrowing gained space throughout the first three quarters of 2002, peaking by end-third quarter at 19.4%. ***Credit and leasing demand in the real estate sector increased above average.*** *The share of lending for business real estate in corporate loan portfolio reached 28.6% by end-September. Besides growing borrowing in the real estate sector, corporate borrowing for acquisition or renovation of real estate in other sectors has also went up (see Figure 2b).*

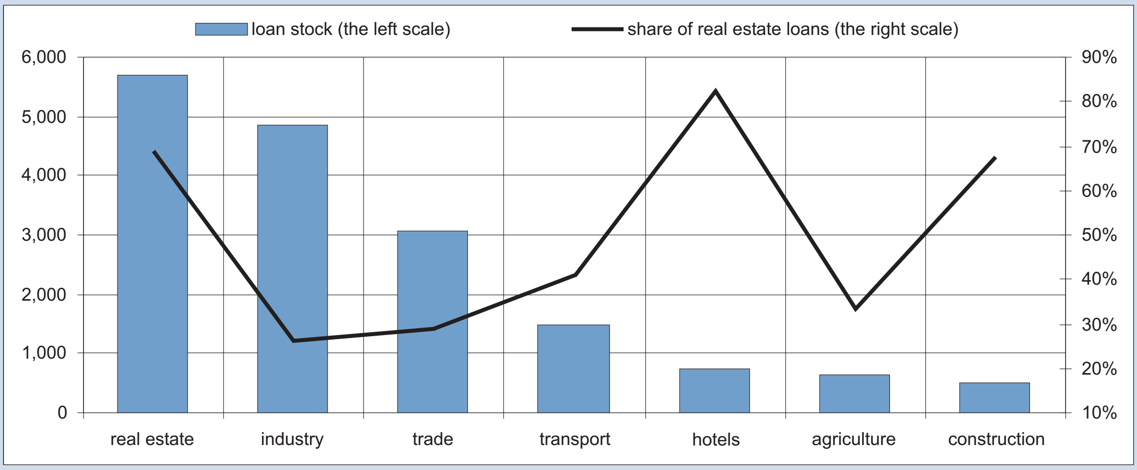

Figure 2b. Stock of undertakings' bank loans as of 30 September 2002 (EEK m) and the share of borrowing for aquisition of real estate (%)

Apart from funds from the domestic financial sector, foreign direct investment inflow into the real estate sector and construction in 2002 has increased above average as well. In the first half of the year FDI inflow was the highest in real estate development and construction (+ 901 million kroons), exceeding the total inflow for 2001 (see Figure 3b).

However, unlike loan stock, corporate deposits actually shrank by 618 million kroons during nine months in 2002. A part of this was rechannelled

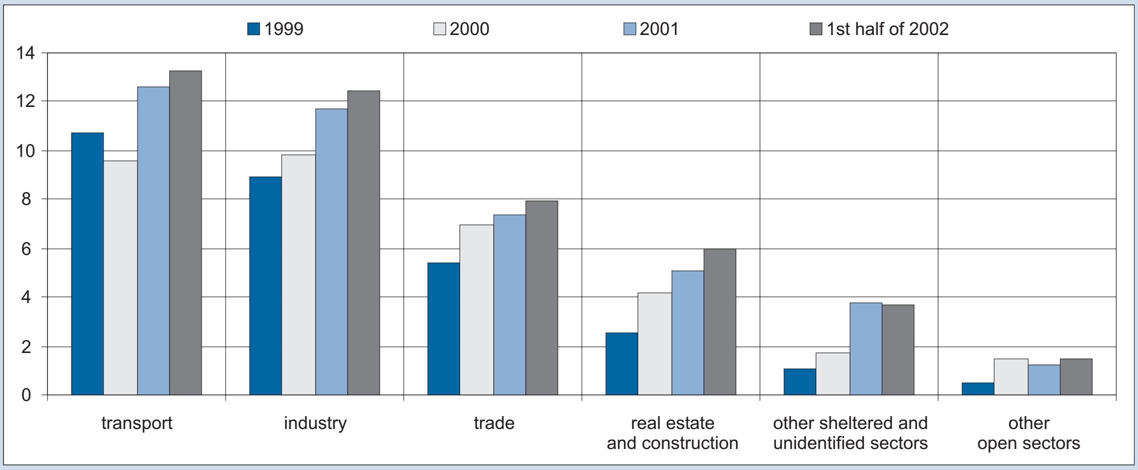

Figure 3b. Stock of foreign direct investments made into Estonia by economic sectors (EEK billion)

into better-yielding money market and interest rate funds, which increased by 1.4 billion kroons. In brief, net position of corporate financial assets and liabilities deteriorated significantly over three quarters (see Figure 4b).

*The main risk associated with changing financial behaviour of the business sector in 2002 lies in **high concentration on real estate financing**. This is primarily caused by aggressive development of commercial space over recent years. If purchasing power and retail trade cannot keep up with the development, resultant excessive supply of commercial space could deteriorate the quality of lending to the business real estate sector.*

*Due to Estonia's low income level and short credit history also **high corporate indebtedness**[1] should*

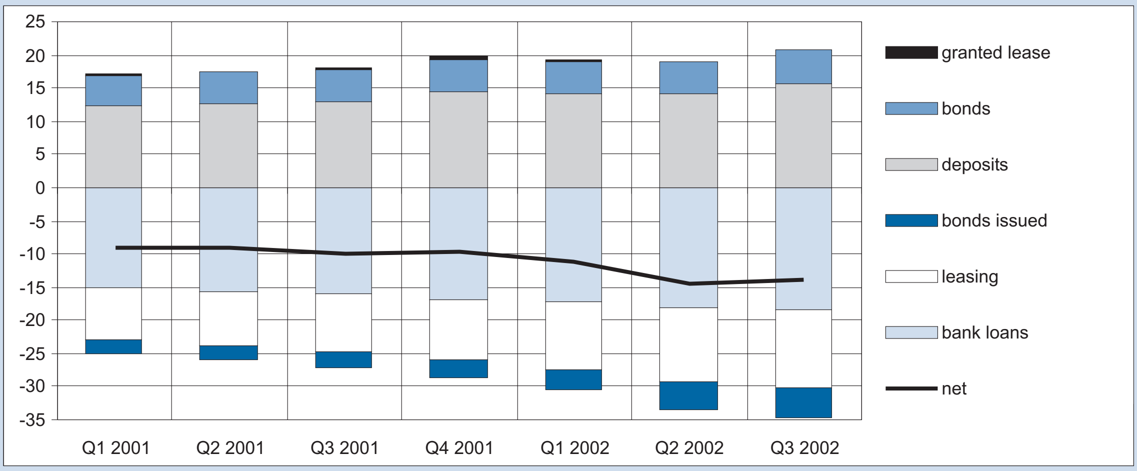

Figure 4b. Undertakings' financial assets and liabilities (EEK billion)

[1] The ratio of corporate lending by domestic banking sector of GDP is 30% in Estonia, 44% in Germany, 43% in Denmark, 23% in Finland, 28% in Hungary and 10% in Lithuania.

be considered a risk indicator, which under deteriorating economic environment could weaken corporate loan servicing ability and increase creditors' credit risk.

Households

Similar to undertakings also the net position of private persons' financial assets and liabilities has changed. Since the third quarter of 2001 the net position has been rapidly deteriorating (see Figure 5b). Increased lending activity and modest deposit growth compared to previous periods underlie such a development. By the end of the third quarter of 2002 the annual deposit growth had slowed down to 16%, whereas the share of time deposits remained relatively unchanged above 40%.

Improved lending conditions and higher living standard have boosted private persons' indebtedness. The growth rate of loans and leasing kept accelerating throughout the year and reached 47.5% by end-October. Similar to undertakings, real estate sector crediting grows fastest. The annual growth rate of these loans is close to 50% and the loan stock is already 70% of private persons' loan stock. Banks consider housing loans the least risky and, thus, lending conditions have been constantly improving.

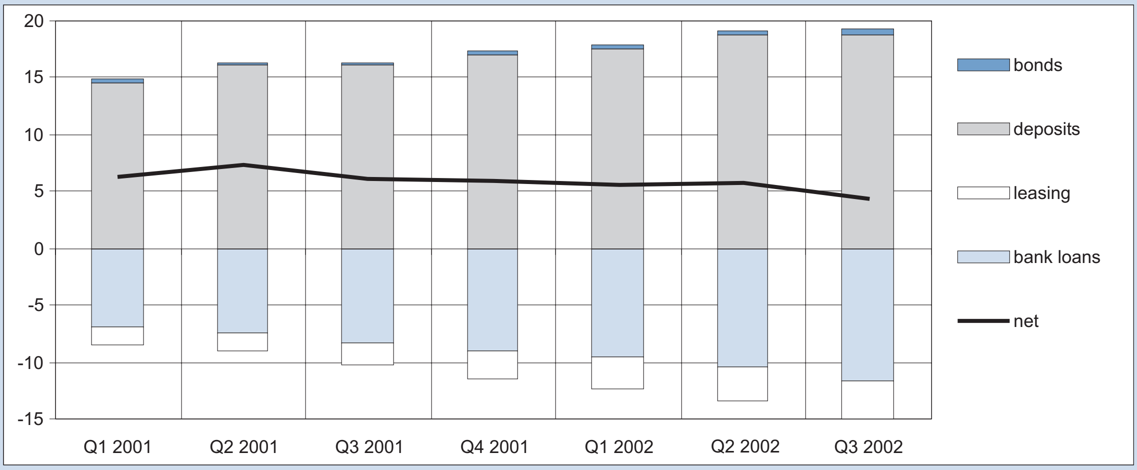

Figure 5b. Private persons' financial assets and liabilities (EEK billion)

However, banking statistics could overestimate the share of housing loans. *For example, a study of household financial behaviour by market research company Emor conducted in fall 2002 reveals that only 7% of respondent families have taken a mortgage during the last ten years. However, more than a quarter of families have a financial commitment (including 19% of families with a loan commitment, 7% with a leasing commitment and 11% with a hire purchase commitment). Similar to banking statistics, also the study by Emor confirms that the population is going to take larger and longer loans during the next year.*

The study also indicates a growth in savings for self-financing, especially in families with medium and above-average income. Simultaneously, macro indicators of economy show shrinking household saving.

The growth rate of private persons' debt level exceeds the growth for disposable income and GDP by six and four times, respectively. By the

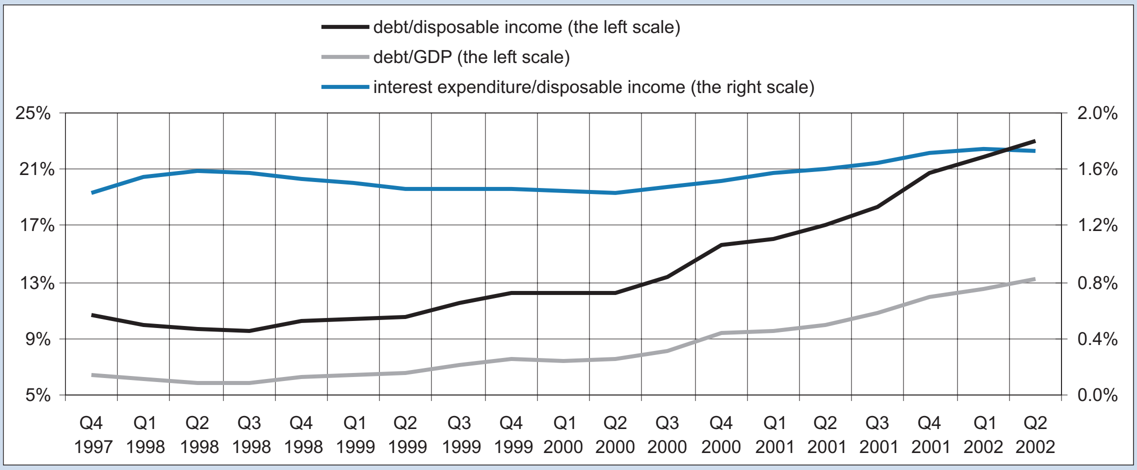

Figure 6b. Households' debt level and debt servicing ability

end of the first half of 2002 the debt level as a ratio of disposable income had reached 23% and as a ratio of GDP 13%. (According to the preliminary estimates of the third quarter, the ratio of household debt of GDP was 14.4%; see Figure 6b). Although compared to developed countries, the indicators are relatively low[2], the living standard in Estonia as well as expenditure structure differ significantly from industrial countries.

In household budgets loan and leasing commitments, insurance and monetary gifts totalled from 11% in 2001 to 13% in the first half of 2002. Decreasing interest rates have exercised counter effect. Among other expenditure, industrial goods and services (42% of total) as well as food (25%) remain the largest.

*The main risk for households lies in their sustained optimism. Under currently favourable lending conditions, borrowers do not consider **potential decrease in debt servicing ability** in changing market environment and Estonia's strong dependence on world economic developments, expressed either in higher interest expenditure or lower income. Although interest rates are not likely to rise in the near future, it is probable that, upon eventual increase, growing income cannot take care of adverse consequences.*

[2] The debt-to-income ratio is 130% in Norway, 110% in Sweden and 100% in Great Britain; the debt-to-GDP ratio is 48% in the euro area, 74% in Japan and 75% in USA.