IV
MONETARY SECTOR DEVELOPMENT

Although the first months of 2002 saw some recovery of the world economy, several threats to further progress remained. Due to low economic growth and uncertainty about development prospects, the central banks of bigger economies kept the interest rates on the level that would stimulate economic growth. For the monetary policy environment in Estonia it meant that low interest rates and a favourable liquidity environment were sustained. In the second half-year the euro area benchmark rates are expected to rise and this will spill over also into Estonian interest rates.

Credit demand in the real sector remained high also in the beginning of 2002, exceeding the growth rate of the residents' deposits. Favourable credit terms and low interest rates in the real sector fostered the demand. The banks' liquidity buffers remain to be solid thanks to additional foreign capital mobilised for the consolidation of foreign reserves.

Liquidity Environment and Money Market

The world's leading central banks, including the European Central Bank, did not change benchmark interest rates during the first five months of 2002 (see Figure 4.1)[1]. Therefore short-term (up to 3 months) money market interest rates in the euro area remained relatively stable. At the same time, the inflation rate within the euro area was higher than expected and markets became more and more convinced that the European Central Bank will raise the interest rates in the second half-year. These expectations were reflected, in addition to the derivatives market, also in the slight increase of long-term (3–12 months) money market interest rates in the euro area during the first five months.

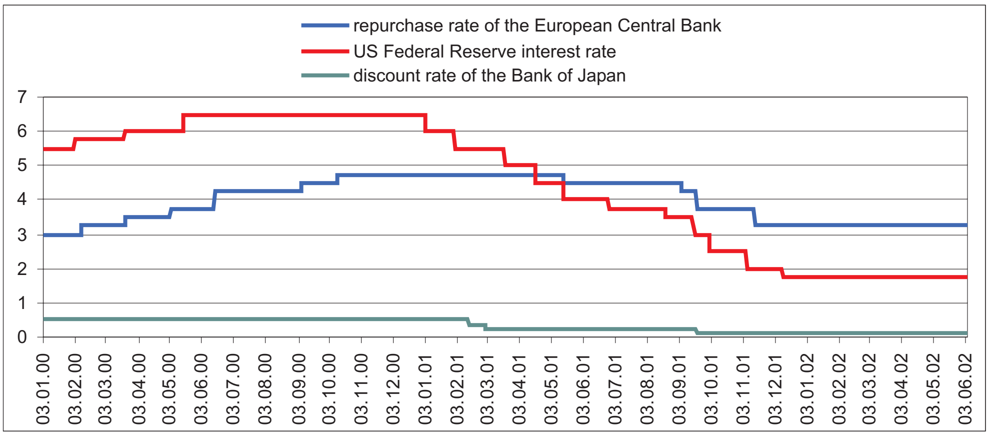

Figure 4.1. Monetary policy interest rates of world's leading central banks

The interest rates on the Estonian kroon money market – for short and long-term instruments – remained practically unchanged for the first five months of the year (see Figure 4.2). This was supported by favourable liquidity positions of the Estonian banks – despite the fact that

[1] In some open economies' central banks started to raise benchmark interest rates to suspend inflation rate in the first quarter. Eg in Australia, Sweden, Canada and New Zealand.

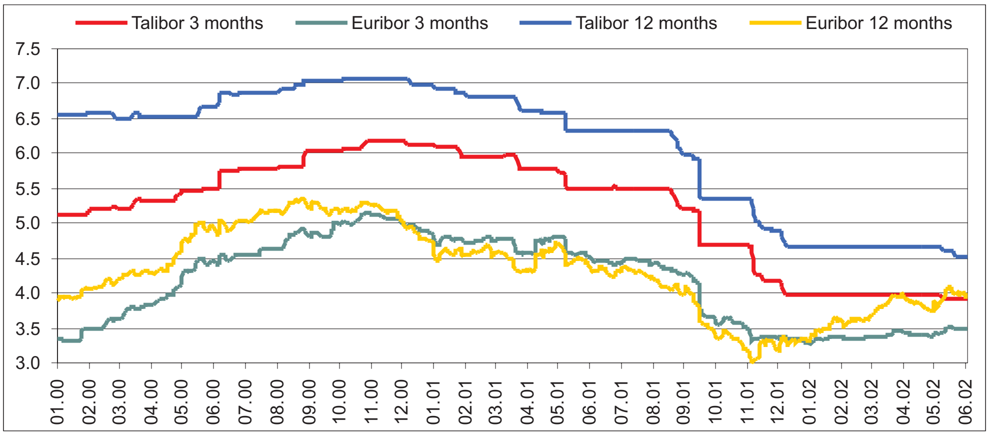

Figure 4.2. Money market interest rates of the Estonian kroon and euro (%)

domestic real sector financing exceeded in the first five months domestic real sector savings growth, the share of liquid assets on the banks' balance sheets has been kept on a good 25% level (see Figure 4.3). The banks' liquidity positions were not significantly affected by the introduction of euro notes and coins in the beginning of this year. The buffers of the settlement system are still adequate to ensure the liquidity reserves necessary for upholding the credibility and functioning of the currency board system (see Figure 4.4).

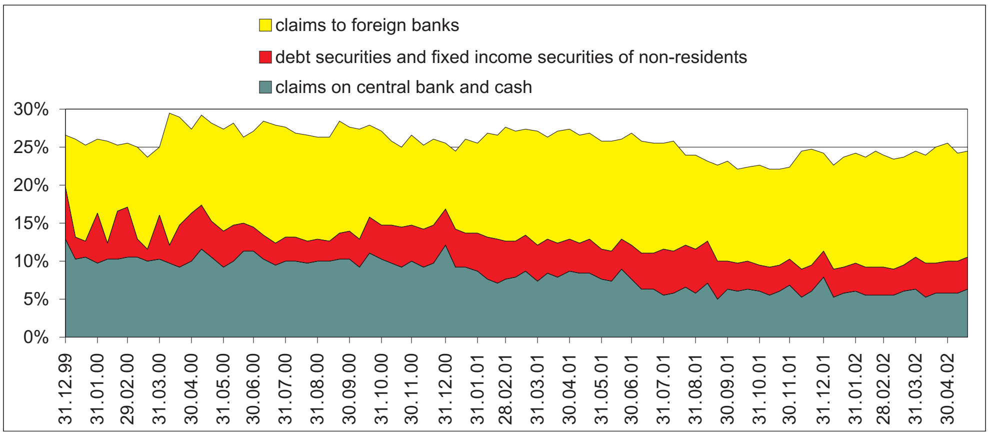

Figure 4.3. The share of liquid assets in banks' total assets

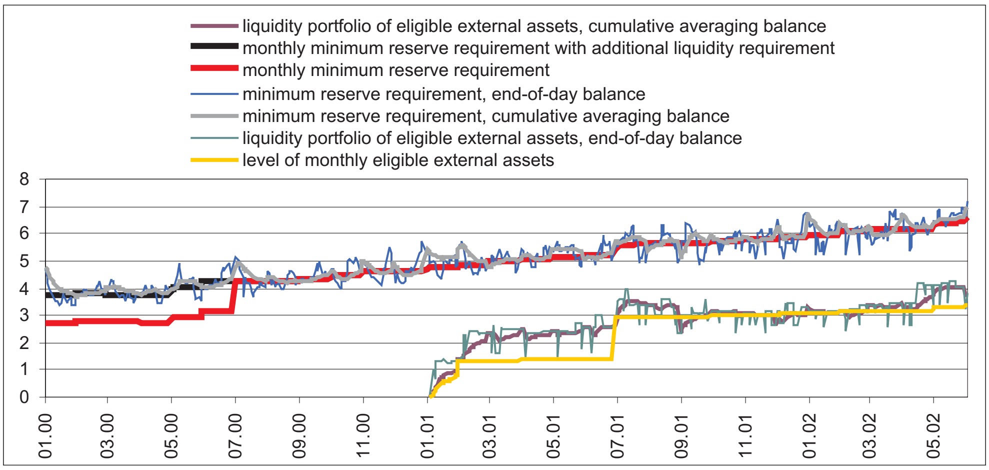

Figure 4.4. Bank's mnimum reserve requirement and its meeting (EEK billion)

The euro exchange rate did not change much during the first quarter – it remained within 0.87–0.88 EUR/USD range. In the first weeks of the second quarter the US dollar became weaker against the euro that led to a slight increase in the Estonian kroon-dollar exchange rate. In conclusion, one can say that the monetary environment has been stable for Estonia in the first months of 2002 and the liquidity environment favourable (see Figure 4.5). As the spread between the Estonian kroon and the euro interest rates is small, the dynamics of euro interest rates will continue to influence also the movement of the money market interest rates in Estonia.

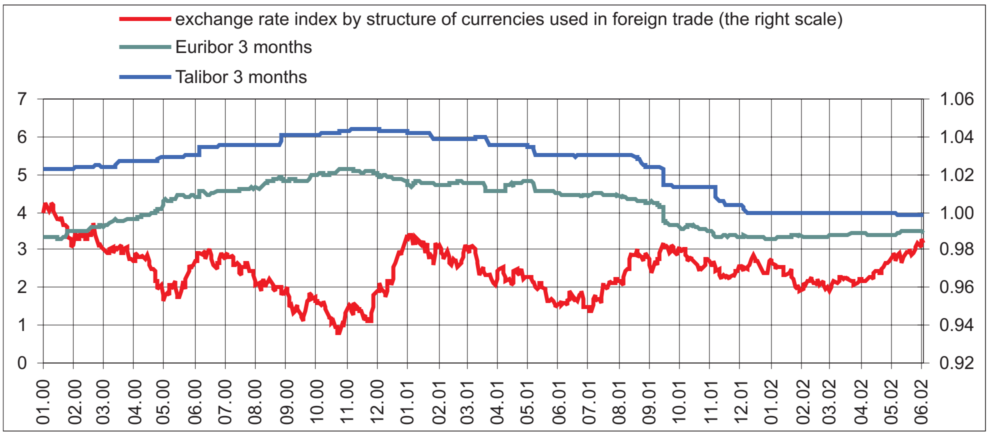

Figure 4.5. Three-month Talibor and Euribor (%) and Estonian kroon exchange rate index by structure of currencies used in foreign trade (January 2000 = 1)

Capital Flows

In the first quarter the reserves of the balance of payments grew by more than 0.7 billion kroons. Due to some one-off factors, the current account deficit amounted to 3.5 billion kroons in the first quarter, out of which income sub-balance and transfers sub-balance accounted for about 1.5 billion kroons.

One of the significant sources of capital inflow once again were FDI, which amounted to about 1.8 billion kroons. This figure partly reflects income reinvested by investors and shifts between portfolio and direct investments. Among other investments the most noteworthy were refinancing of external liabilities by the banking sector in the first quarter in the amount of approximately two billion kroons. In addition, the banks mobilised from the external sector additional resources in the first quarter. As lending pace exceeded domestic savings pace, the above measures helped the banks to maintain the high level of their foreign reserves.

Money Supply

The annual growth rate of both M1 and M2 during the first five months of 2002 averaged 18%, whereas the annual cash growth was characterised by a slightly falling trend (see Figure 4.6). The average monthly inflow of resident private and corporate deposits remained stable. With the exception of some temporary ups and downs, the 400–450-million-kroon increase in deposits on the average every month as well as the 18–19% annual growth rate that was sustained, correspond roughly to the level of the last six months of 2001.

Despite low interest rates on deposits, the ratio of demand deposits to time deposits has remained relatively constant over a longer period of time – the share of time deposits in M2 that had temporarily dropped to 28% at the turn of the year has risen again to the 2001-average of 31–

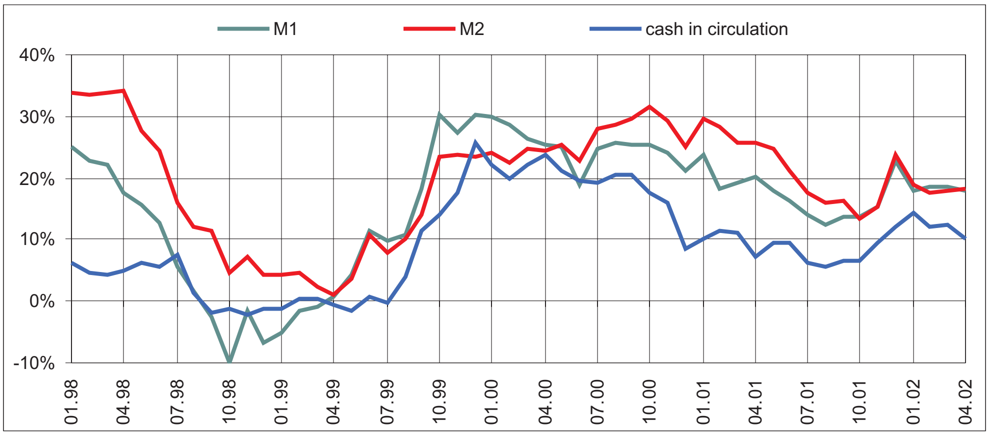

Figure 4.6. Growth of money supply against the respective month of previous year

32%. Thus low interest rates on deposits have not substantially influenced the maturity structure of deposits (see Figure 4.7). In conclusion, in the first months of 2002 there were no big changes in depositing by the private sector in Estonia.

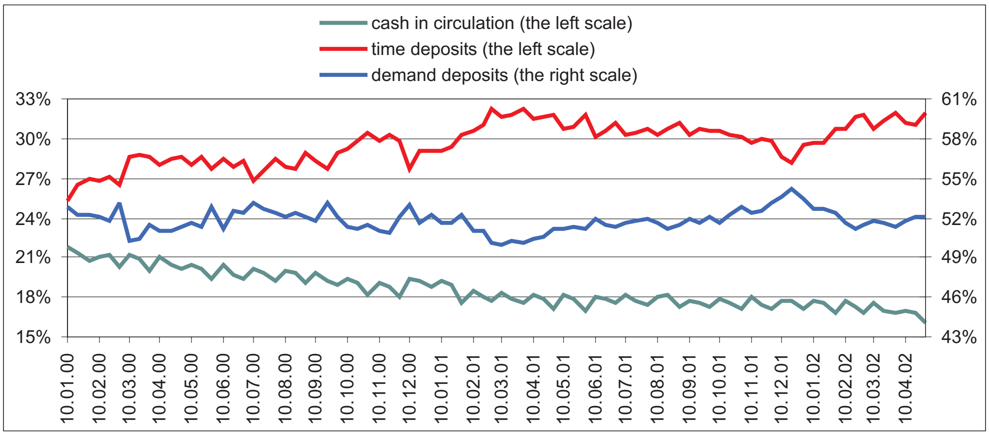

Figure 4.7. Structure of money supply M2

Cash demand has also been stable. The introduction of the euro in 12 countries of the EMU did not influence strongly the Estonian kroon cash demand or its impact was moderate. However, in the first weeks of January the traditional abatement in cash demand after the turn of the year

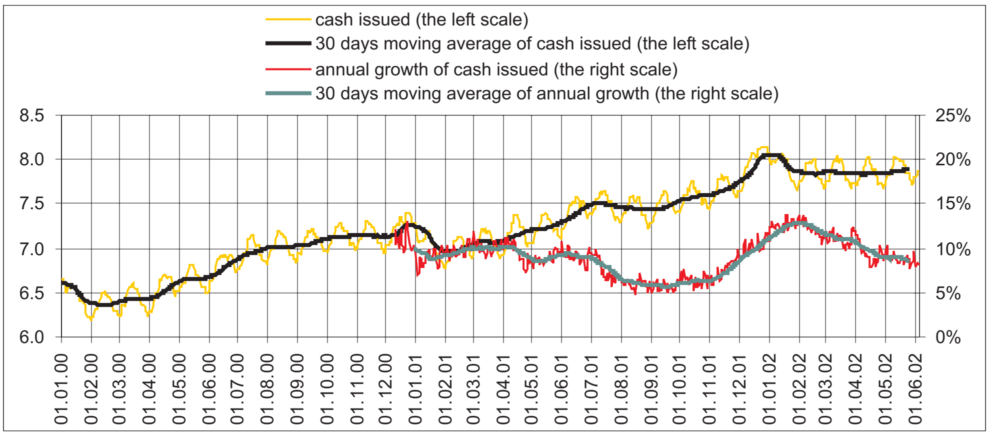

Figure 4.8. Cash demand (EEK billion) and its annual growth

was slightly slower than in 2001 and the annual growth rate of cash in circulation in the economy increased from 12.1% of end-December to 15.2% by mid-January. This kind of acceleration was, however, temporary – by end-May the cash demand annual growth rate settled back to 10%. All in all, cash in circulation remained throughout the entire first quarter as well as in April-May without substantial deviations within 7-billion-kroon limits (see Figure 4.8).

Credit Market

The private sector borrowing from the domestic financial sector has been continuously growing in 2002. As a result, the annual growth rate of domestic financing in real sector (bank loans, real sector bonds held by the banks, financing through leasing and factoring) reached almost 28% by end-April (see Figure 4.9), which is by 5–6 percentage points higher than the 2001 average and proves that credit demand in the real sector remains high. Within the sectors earlier trends continued, including growing financing through leasing companies.

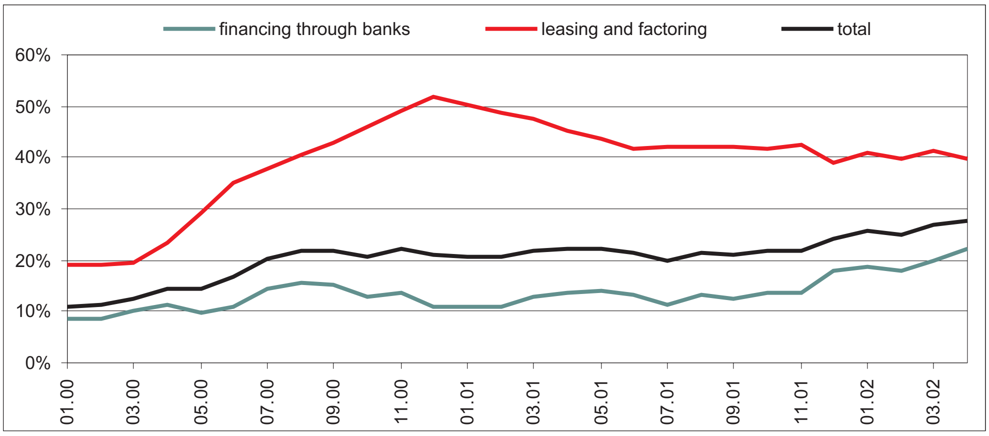

Figure 4.9. Financing of domestic real sector by financial sector (annual growth)

The annual growth rate of bank loans taken by private individuals continued to increase slightly also in 2002 – at the end of 2001 it had been 33.9%, while at the end of April this year it was 38.7%. From the beginning of the year until the end of April the volume of bank loans granted to private customers grew by 762 million kroons. Leasing financing provided to private customers expanded and its annual growth rate reached almost 80% by end-April (368-million-kroon gain since the beginning of the year). Although lending to private customers grew in all spheres in the first quarter, housing loans were predominant, facilitated both by the banks as well as leasing companies.

The annual growth rate of bank financing to corporate customers reached 14.7% at end-April, ie was somewhat higher than in the fourth quarter of 2001 (976-million-kroon increase since the beginning of the year). The annual growth of financing through leasing and factoring to corporations was almost 36% (1.4-billion-kroon increase in four months of 2002). By sectors of economy, the most active borrower in the first quarter was the industrial sector and this trend continued in April as well.

In conclusion, during the first months of 2002 borrowing in the real sector in Estonia grew quicker than residents' deposits (see Figure 4.10) – persistently favourable conditions, including availability of all kinds of leasing instruments, continued to nourish and sustain a high credit demand.

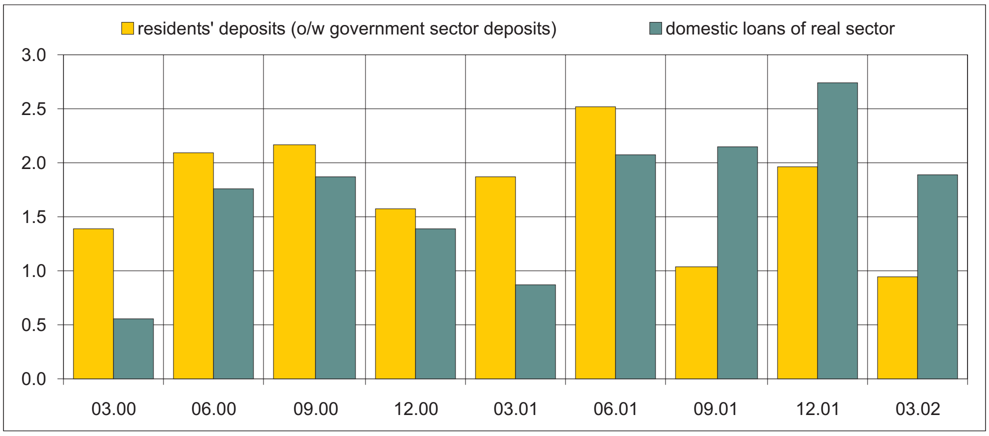

Figure 4.10. Quarterly growth of residents' deposits and domestic loans of real sector (EEK billion)

Interest Rates in Real Sector

In 2002 interest rates of short-term money market instruments in euro area have remained stable, whereas long-term instruments (3–12 months) have experienced a slight rise. This influenced also the dynamics of interest rates on deposits in Estonia's real sector – it checked the downward move of short-term as well as long-term interest rates. By April the real sector weighted average interest rate for short-term deposits was 3.6% and for long-term deposits 4.3% (see Figure 4.11).

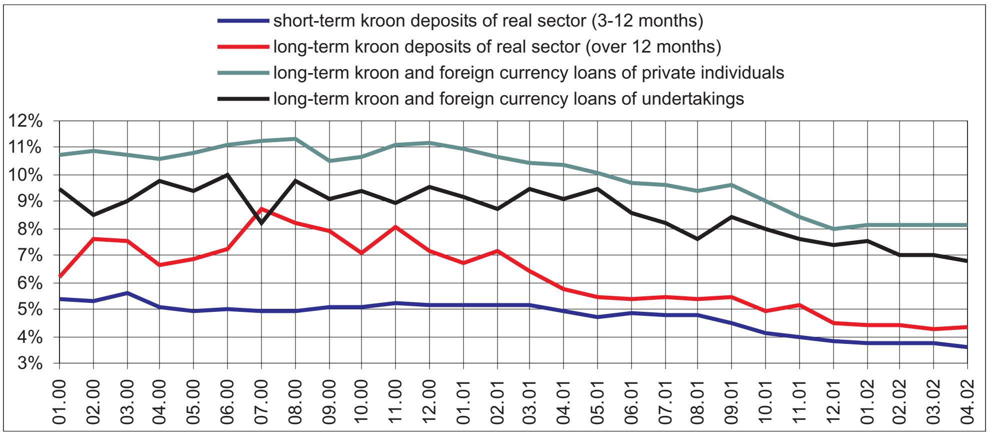

Figure 4.11. Interest rates of domestic real sector

When the fall of interest rates in the euro area slowed down a little, it inhibited to some extent also the lowering of interest rates on loans in Estonia's real sector. This was especially noticeable with respect to long-term loans of private individuals, in which case the rate has remained at 8.1% in 2002. The weighted average interest rate of foreign currency and kroon-denominated loans of Estonian enterprises was 7.0% in February as well as in March, remaining still slightly lower than in the fourth quarter of 2001. The interest rates on corporate loans continued to fall in April and reached the lowest level of all times – 6.8%. This plunge took place at the expense of the declining banks' interest margin.

As the interest rates in the euro area have hit the bottom and there is very little chance that the banks will agree to the further shrinking of their interest margins, it is unlikely that interest rates on loans will continue to fall in Estonia's real sector. On the contrary, the anticipated increase of the interest rates in the euro area will influence the behaviour of the loan interest rates in Estonia in the second half-year.