IV
MONETARY ENVIRONMENT DEVELOPMENT

Liquidity Environment and Interest Rates

Geopolitical risks and vague growth outlooks in major economic regions of the world sustained global financial markets uncertain throughout the third quarter. The uncertainty found outlet in weak stock market, turbulent financial markets and increasing investor risk aversion. Meanwhile, exchange rates of major currencies (excl Japanese yen) remained relatively stable, indicating that uncertainty was of global and not of regional character. Beginning from the second part of October financial markets stabilised slightly.

Such a development has kept monetary policy interest rates of major economic centres at a low level. In order to boost economic growth the US Federal Reserve cut benchmark rates again in November and the European Central Bank in December (see Figure 4.1).

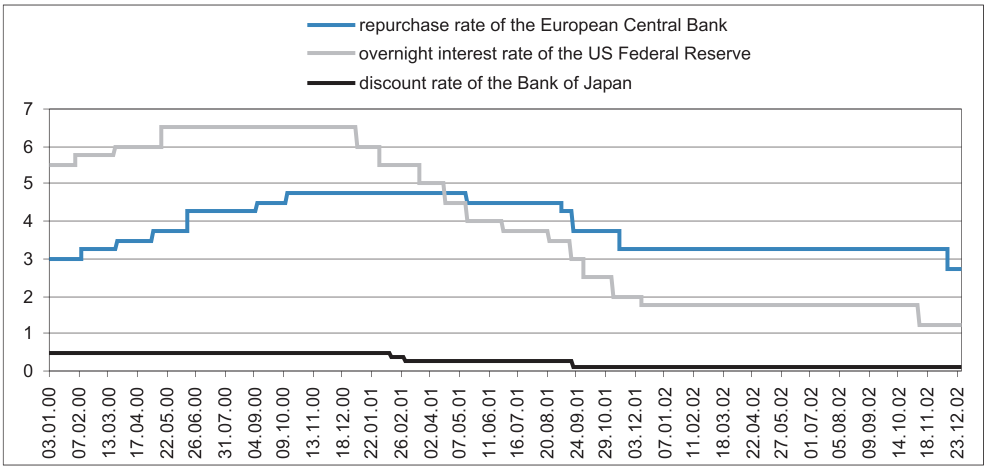

Figure 4.1. Monetary policy interest rates of world's leading central banks

Interest expectations on the market indicate that euro area benchmark rates could be revised downward even more in 2003 (see Figure 4.2). Compared to the first half of 2002, also longer-term interest rates declined in major economic regions, primarily because of deteriorating economic growth outlooks as well as growing demand for more liquid and less risky instruments. All in all, the external interest rate level remained low in the third quarter and no significant changes in the exchange rate occurred. The message for Estonia was that external monetary environment continued being expansive.

Such developments sustained Estonian short- and long-term interest rates at a record low level. **Despite Estonian financial-sector liquid assets shrinking to 19% and continued deterioration of the liquidity position of cash flows in the financial sector** (see Figure 4.3)**, Estonian money market interest rates followed Euribor and kept declining** (see Figure 4.4). Estonian money and futures market maintained its regular turnover. In brief,

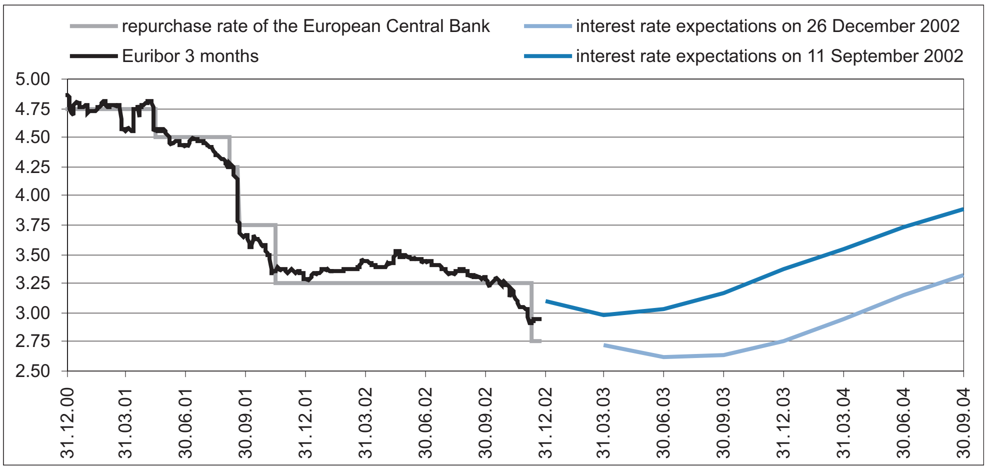

Figure 4.2. European money market interest rates and expectations of 3 months Euribor in futures market (%)

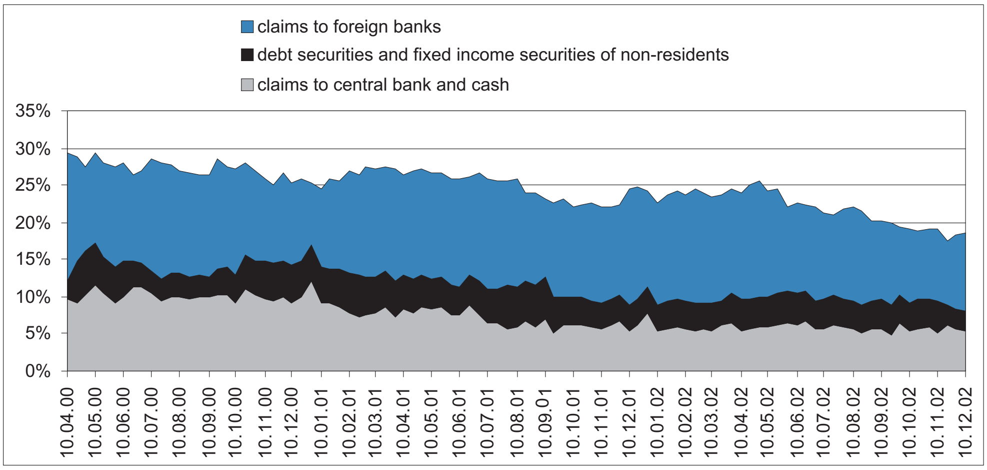

Figure 4.3. The share of liquid assets in banks' total assets

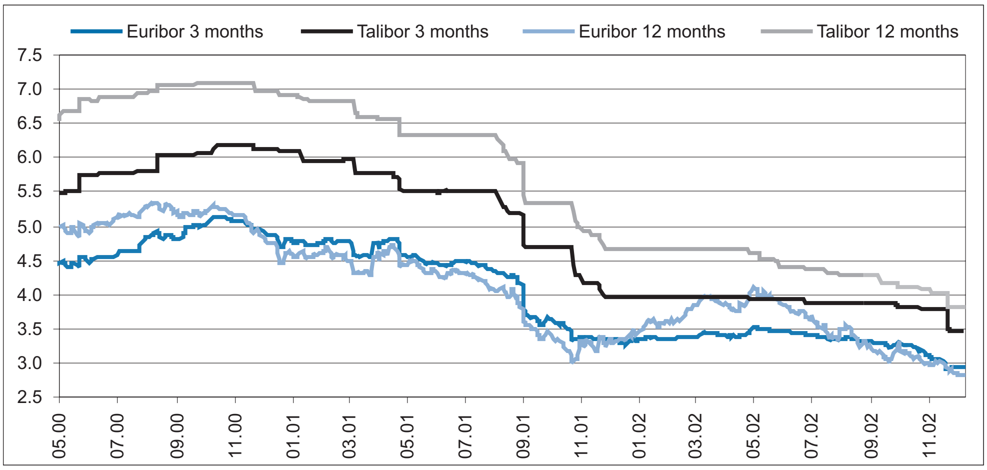

Figure 4.4. Money market interest rates of the Estonian kroon and euro (%)

however, domestic liquidity environment could be considered favourable for the financial sector, securing adequate liquidity buffers for banks (see Figure 4.5).

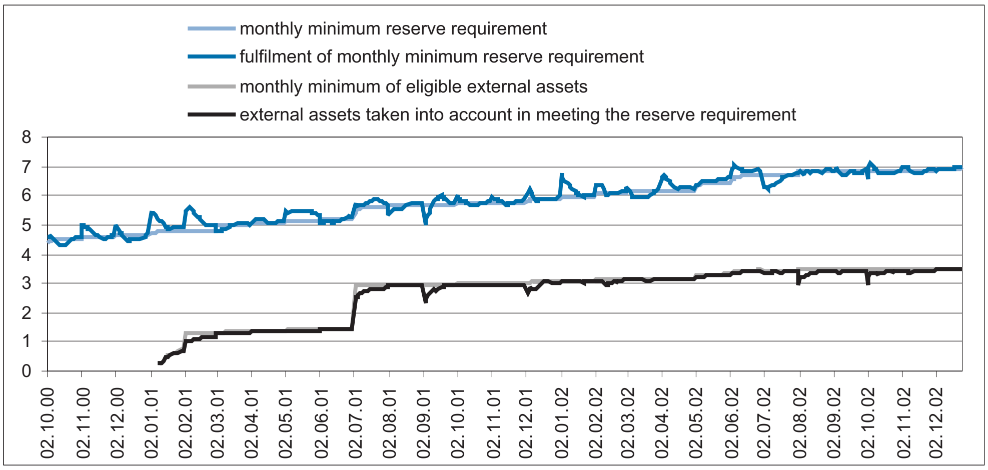

Figure 4.5. Banks' minimum reserve requirement and its meeting (EEK billion)

The weighted average interest rate of Estonian real sector's short-term (with 3–12 months maturity) kroon deposits remained on the average at 3.4% throughout the third quarter and October and that of long-term (over 12 months) deposits at 4.1% (see Figure 4.6). Without considering targeted kroon loans, the households' average loan interest rate was 7.8% at the end of the third quarter, remaining 0.1 percentage points below end-second-quarter. The average interest rate of corporate long-term loans fluctuated in the third quarter, being 7.4%, ie 0.2 percentage points above the level of the end of the second quarter. The average lending rate for private persons was largely subject to study loans, which raised the weighted average lending rate to 8.5% by end-September.

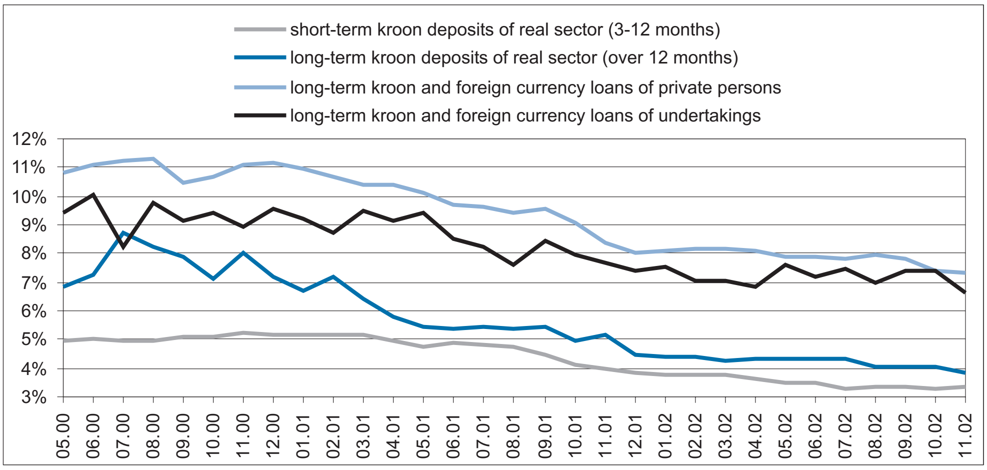

Figure 4.6. Interest rates of domestic real sector

Capital Flows

Over the last twelve to eighteen months, the inflow of capital has remained high in Estonia. The third quarter of 2002 was no exception. **However, the share of foreign direct investment in the capital inflow shrank also in the third quarter. It was exceptional that the balance of FDI was negative in the extent of 60 million kroons.** Thereby the FDI inflow into Estonia during nine months remained about half below the year-ago level. Borrowing from parent companies had contracted most – supposedly they were replaced by borrowing from the market. Direct investments in the fixed capital remained below 2001; less new FDI-financed projects were launched. As foreign investors kept coming to Estonian economy, the question whether and to what extent the financing schemes of foreign-owned undertakings have changed, remains on the agenda.

In FDI outflow supplementary investments into companies operating in Latvia and Lithuania were prevailing whereas the specificity of the third quarter lay in high share of reinvestments. **Increasing or decreasing direct investments into neighbouring countries do not reflect changes in Estonian business climate but tactical considerations of foreign investors in engaging markets in the Baltic Sea Region**.

In the third quarter of 2002 the capital inflow was mainly in the form of portfolio investments, reaching 3 billion kroons. Capital inflow via debt instruments was responsible for most of the inflow, primarily bonds issued for the renovation of the energy sector.

As the volume of deposits grew more slowly than that of loans, banks involved external capital both in the third and fourth quarters whereas in the third quarter up to 1.9 billion kroons. Simultaneously, external reserves of credit institutions declined by an estimated 2.8 billion kroons during the third quarter. The external reserves were partially used to refinance previous external liabilities and partially to finance domestic credit demand. Other Estonian financial intermediaries (including leasing companies and investment funds) were responsible for less than a billion-kroon capital outflow in the third quarter.

In order to curb back an extensive domestic credit growth, the government sector took abroad about 1.5 billion kroons in the third quarter. A part of the budget surplus was placed abroad and deposits in domestic banks were reduced to a certain extent.

Monetary and Loan Aggregates

The third quarter revealed some controversial trends in money supply – the annual growth rate of the narrow monetary aggregate M1 slowed to 11.1% by end-November while that of M2 maintained the level of the first half-year, being 15.7% at the end of November. However, the higher growth rate of M2 was due to single factors, otherwise also the broad money supply had shown inhibited growth (see Figure 4.7).

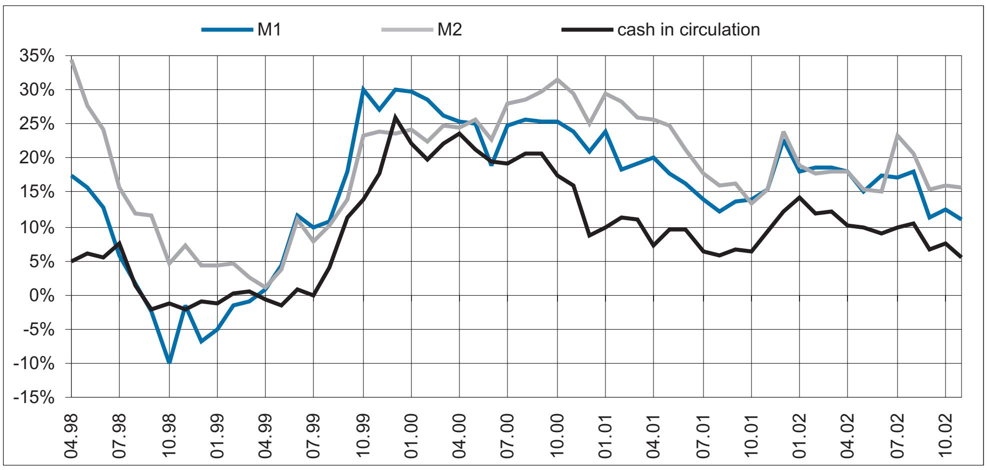

Figure 4.7. Growth of money supply against the respective month of previous year

The annual growth rate of M1 declined both because cash in circulation as well as increment of demand deposits suffered a slight decline in end-third-quarter. The annual growth of cash in circulation shrank to 6.6% in end-September, being 2.5 percentage points slower than at the end of the second quarter (see Figure 4.8). Although the annual growth of M1 was more in pace with the nominal growth rate of economy in the third quarter, it is difficult to draw parallels due to volatile velocity. **The annual growth rate of M2 accelerated as time deposits underwent an exceptional growth** (see Figure 4.9). Most of the growth was due to large depositing in Estonia by one company. All in all, the real sector saving in the form of deposits remained below the average of the first half of the year.

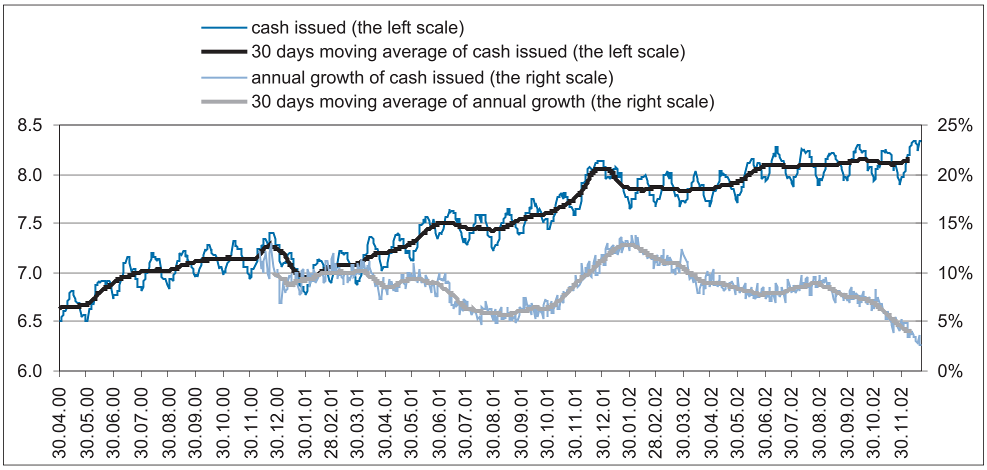

Figure 4.8. Cash demand (EEK billion) and its annual growth

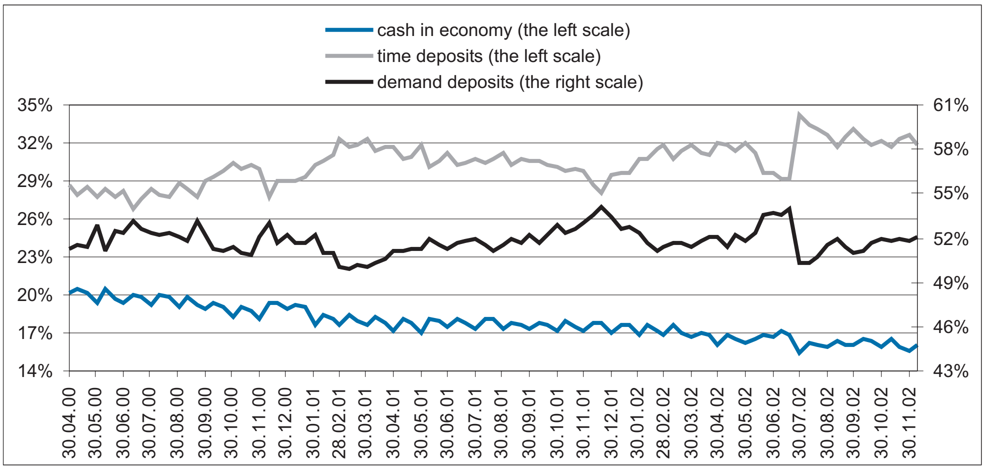

Figure 4.9. Structure of money supply M2

In order to balance Estonian economy, a part of the government sector deposits were taken out of Estonia at the end of the third quarter and in October-November. In the third quarter government deposits in Estonian credit institutions shrank by 0.4 billion kroons and in October-November by another 0.7 million kroons. As government deposits have been taken out, the increment in resident deposits fell to the record low of the recent years in the third quarter (see Figure 4.10). Non-resident deposits shrank by 0.4 billion kroons in the third quarter, by end-November the stock of non-resident deposits was at the level of the third quarter.

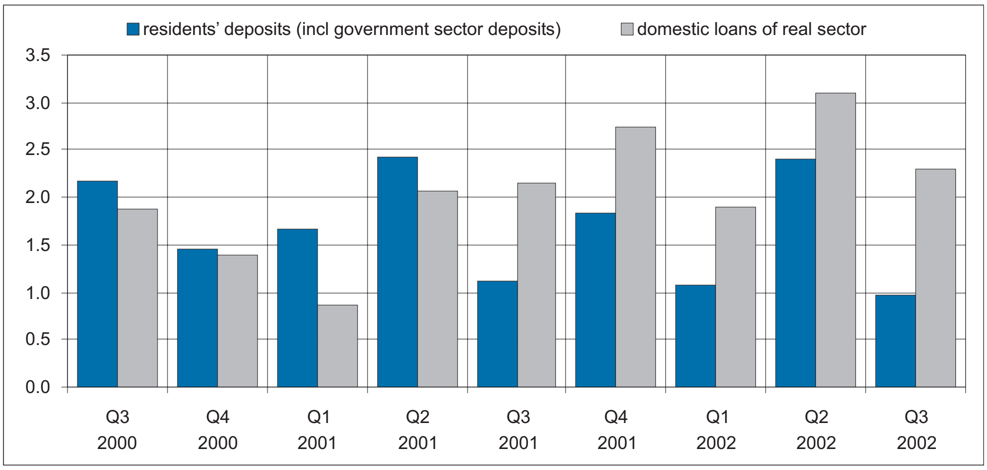

Figure 4.10. Quarterly growth of residents' deposits and domestic loans of real sector (EEK billion)

Domestic borrowing was actively sustained against the above development in the third quarter and the annual growth rate of resident financing remained high despite a slight slowdown. The annual growth of real sector debt burden (loan and leasing financing together) reached 26.8% by end-third-quarter (see Figure 4.11). The growth remained 1.3 percentage points below the end of the second quarter, but surpassed the growth of domestic monetary aggregates by about ten percentage points. The growth in the volume of the real sector debt burden exceeded also the growth of real sector bank deposits – in the third quarter the change was 2.3 and 1.5 billion kroons, respectively. Therefore, the financial sector had to reduce liquid external resources and involve additional external saving in order to finance loan growth. These tendencies were sustained also in the fourth quarter – the annual growth rate of the real sector debt load continued to decelerate (the estimated annual growth was 24.6% in end-November), but the volume of borrowing still exceeded the growth of depositing in the real sector.

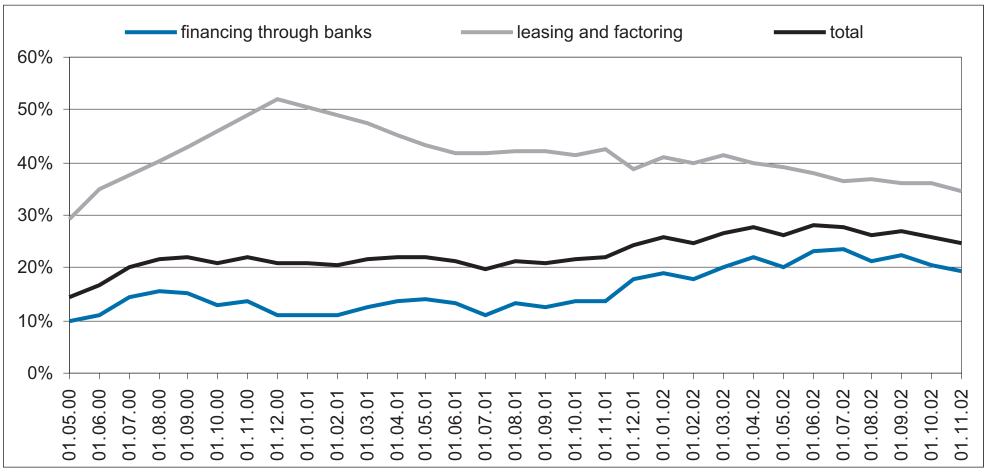

Figure 4.11. Financing of domestic real sector by financial sector (annual growth)

By client groups disequilibrium remained highest among households whereas the difference in depositing and borrowing growth rates reached 30 percentage points. While the annual growth rate of household deposits stayed within 16-17% in the third quarter, remaining below the growth rate at the beginning of the year, then household financing demand reached 47.5% at the end of October. In the third quarter the stock of household financing exceeded the second quarter by a third, reaching 1.5 billion kroons. Private persons keep financing primarily real estate acquisition from loans and leasing. Contemporaneously, also other loans, mainly overdraft facility grew fast. External resources involved for the acquisition of real estate exceeded 1.5 times (ie 50%) and other household debt burden 1.4 times (including the stock of overdraft facility about 2.5 times) the year 2001. The beginning of the academic year sent the stock of study loans slightly upward (159 million kroons), although it remained considerably modest against previous years.

The annual growth in corporate financing demand reached an estimated 21% by end-third-quarter. In absolute volume the debt burden of the real estate sector increased most, although it remained below the second quarter. The debt burden in transport and industry grew faster than in the second quarter whereas in trade it shrank in the third quarter. By purpose of use, mostly acquisition of corporate real estate and renovation projects and somewhat less also acquisition of fixed assets was financed in the third quarter.