IV
MONETARY SECTOR DEVELOPMENT

In the second quarter of 2002, weakening of nominal exchange rate of the US dollar and potential deceleration of the world economic growth inhibited anticipation that interest rates in the euro area will rise. Unlike previous forecasts, interest rate growth in more significant financial regions of the world is likely to shift into the year 2003. However, this should keep the level of interest rates low until the end of the year 2002 also in Estonia.

Under stable and low interest rates, the active credit demand of Estonian enterprises and households was sustained, exceeding the growth rate of the residents' deposits. The level of banks' liquid assets remained high, and the banking sector mobilised some additional foreign capital in order to finance domestic demand.

Liquidity Environment and Money Market

The more important key words characterising the global liquidity environment in the second quarter of the year were appreciation of the euro against the US dollar and the potential delay of the global economic growth recovery. Larger central banks in the world have not changed monetary policy interest rates this year (see Figure 4.1). On 12 September at the recent ECB Governing Council meeting interest rates remained unchanged. Risks to price stability appeared rather balanced and European economic growth outlooks modest, whereas they are anticipated to recover in the first half of the next year. From a longer-term perspective, there is concern that more liquidity is available in the euro area than would be needed to finance sustainable, non-inflationary economic growth[1]. Currently relatively low domestic demand should recover near-term and balance excessive liquidity. Decline in the bond market could influence consumer behaviour and corporate investment plans in the euro area. The strengthening euro should help to reduce inflationary pressure in 2003.

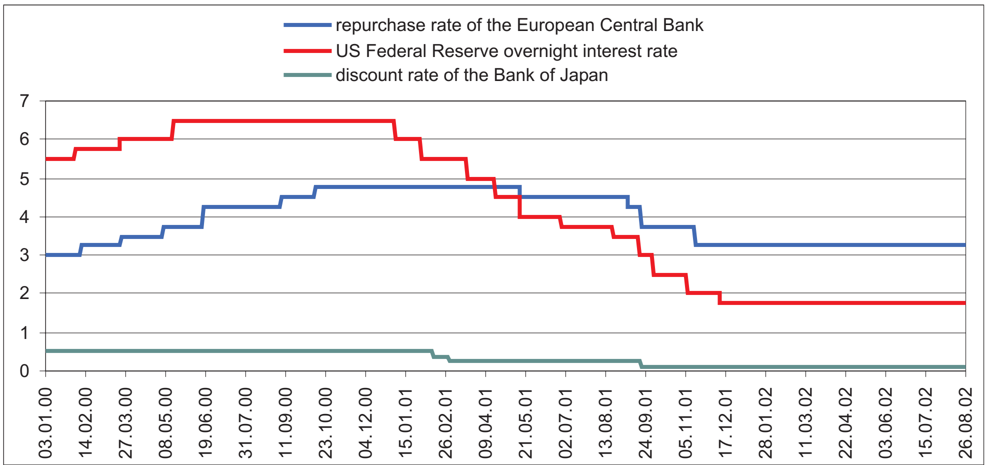

Figure 4.1. Monetary policy interest rates of world's leading central banks

[1] See ECB Press Conference on 12 September 2002, www.ecb.int/key/02/sp020912.htm

In August expectations of Euribor changed significantly in European futures market. In June the markets anticipated the European Central Bank to raise interest rates still in the autumn, while in early-September rise expectations had been postponed till summer 2003[2] (see Figure 4.2). Thus, the cost of foreign resources of Estonian banks will probably remain as favourable as today in near-term.

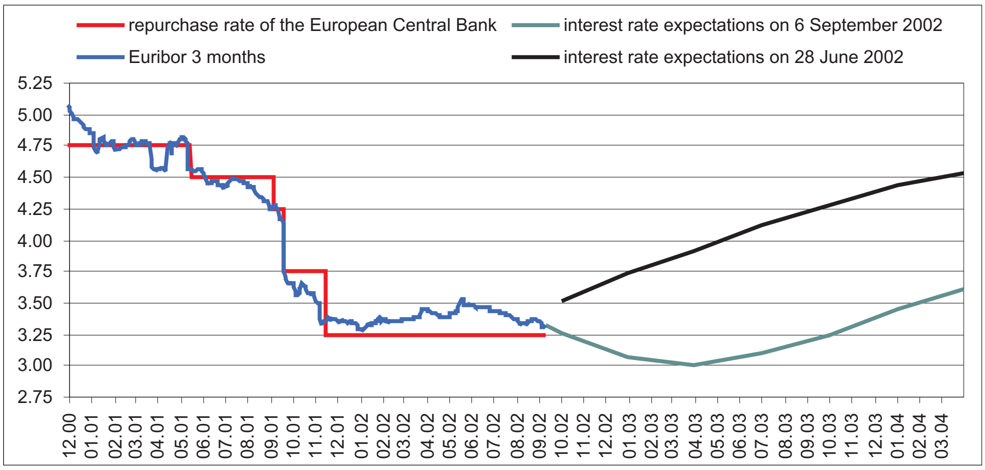

Figure 4.2. European money market interest rates and expectations of 3 months Euribor in futures market (%)

Compared to relatively stable money market interest rates in Europe, money market interest rates of the Estonian kroon declined (see Figure 4.3). Although the share of liquid assets in Estonian credit institutions' balance sheet fell to 20.1% (see Figure 4.4) by the end of August due to depositing-exceeding borrowing, the liquidity environment has remained favourable for banks and settlement system buffers (see Figure 4.5) are sufficient to secure adequate liquidity reserves for reliable operation of the currency board arrangement.

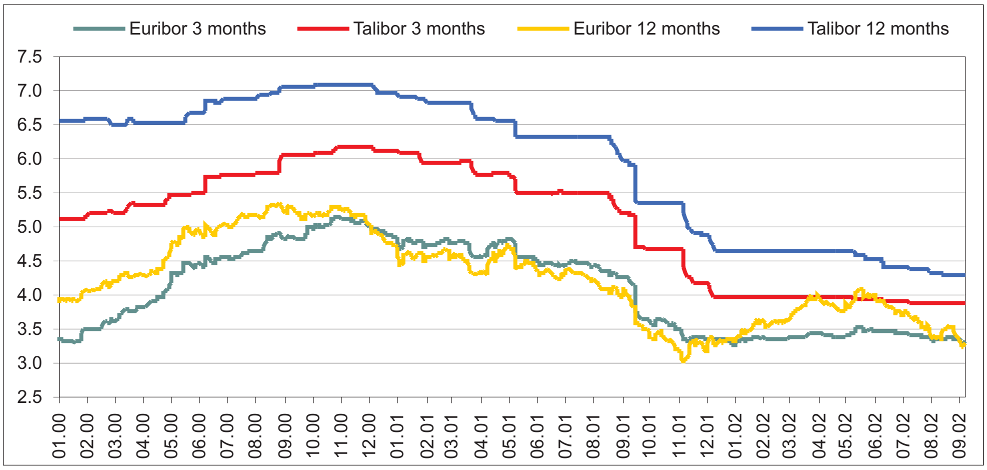

Figure 4.3. Money market interest rates of the Estonian kroon and euro (%)

[2] Some analysts interpret the situation, as a possibility that the ECB might lower interest rates in near-term instead.

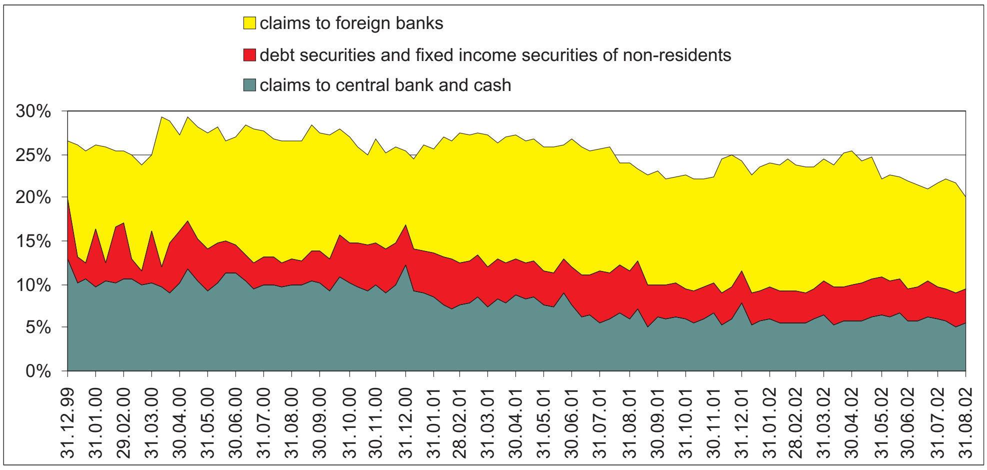

Figure 4.4. The share of liquid assets in banks' total assets

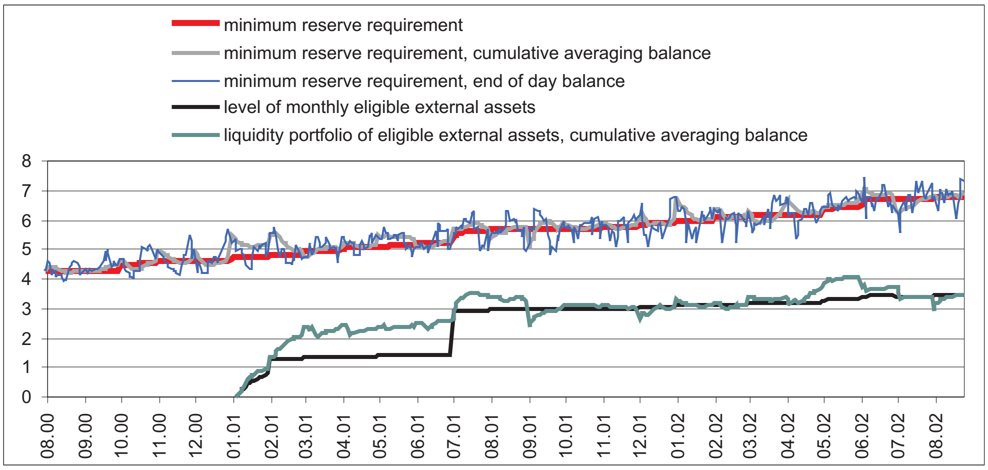

Figure 4.5. Banks' minimum reserve requirement and its meeting (EEK billion)

Capital Flows

The rapid inflow of capital continued in the second quarter as well. Although the current account deficit improved against the first quarter, it reached three billion kroons. The capital inflow through financial account could not cover it fully and foreign reserves declined by 226 million kroons.

The share of foreign direct investment in financing deficit was below customary level and replaced by long-term loans, including borrowing in the form of bonds. Capital inflow through bonds comprised primarily government-issued *eurobonds* worth 1.6 billion kroons. Government-sector budget execution displays that assets involved through the issue were used to pay back about 700 million kroons of previous foreign loans in the second quarter (about 90% of the volume of the issue is going to be used for refinancing). The remaining assets were channelled to Estonian commercial banks as seen in the rapid growth of government sector deposits.

To finance domestic demand banking sector used its foreign reserves and some additional foreign capital (about 700 and 400 million kroons, respectively).

Money Supply

The growth of money supply slightly declined in the second quarter compared to the first quarter of 2002. The annual growth rate of M1 and M2 at the end of the first quarter was 18.6% and 17.9%, respectively, while at the end of the second quarter – 17.5% and 15.0%. During the first half of July, the annual growth rate of M2 was still below the first quarter (16%). The growth rate slowed down due to slightly inhibited depositing by the private sector compared to the year-ago period. Also the annual cash growth in the second quarter remained below the first quarter (see Figure 4.6).

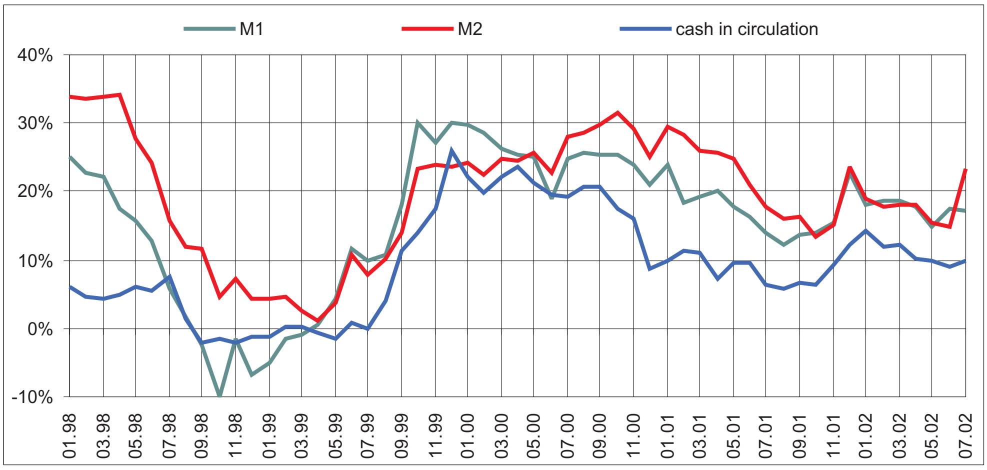

Figure 4.6. Growth of money supply against the respective month of previous year

In July the supply of M2 surged upward, caused by a leap of 2.6 billion kroons in corporate time deposits. This had a major impact also on the structure of M2 (see Figure 4.7). **Partially state-owned Eesti Energia (Estonian Energy Ltd) borrowed from the external sector for investments, bringing along a sharp increase in the time deposits.** Despite the single large intake, the money supply trend has not significantly changed.

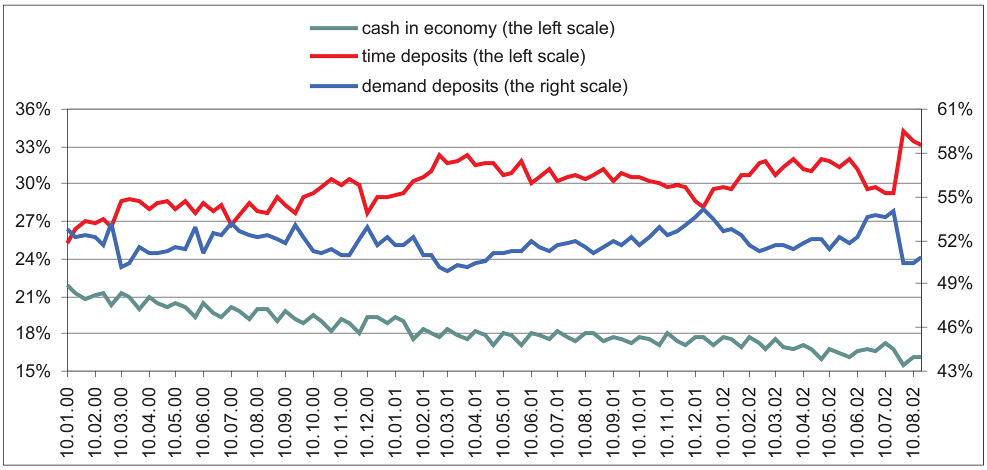

Figure 4.7. Structure of money supply M2

Similar to previous years, the annual growth of the real sector deposits declined also in the second quarter of this year, down to 15.3%. The real sector deposits increased by 1.3

billion kroons, primarily due to the growth of demand deposits. The average three months inflow of private and corporate deposits reached 392 million kroons, proportionally comparable to the indicator of the first quarter. The change of the real sector deposits by months has considerably fluctuated and, for example, in June real sector deposits declined, primarily because corporate time deposits decreased by 1.1 billion kroons.

The contraction in the corporate deposits in June was partially seasonal, which reflects seasonal transfers to other sectors of economy, first and foremost, disbursement of holiday pay to individuals. Besides large lending, the relatively modest growth in domestic real sector deposits indicates constantly high investment demand. Nevertheless, the corporate financial condition in Estonia remains sound according to the credit institutions.

Due to good tax collection and resources created while issuing eurobonds, central government deposits continued growing in the second quarter. The government sector deposits increased by 1.2 billion kroons and the annual growth was 48.9%. The loan stock of local governments remained constant at about 0.5 billion kroons. The government deposits with domestic banks have reached 5 billion kroons, having added 2 billion kroons since the beginning of the year. Non-residents' deposits that had declined in the first quarter, increased in the second quarter by 0.5 billion kroons.

The clearly pronounced trend of cash demand was sustained and cash in circulation remained within 7 billion kroons. Hot August weather slightly delayed the seasonal contraction of the post-holiday cash demand. The annual growth in cash demand was 9.1% on the average in the second quarter, remaining below the first quarter and being similar to the second quarter of 2001 (see Figure 4.8).

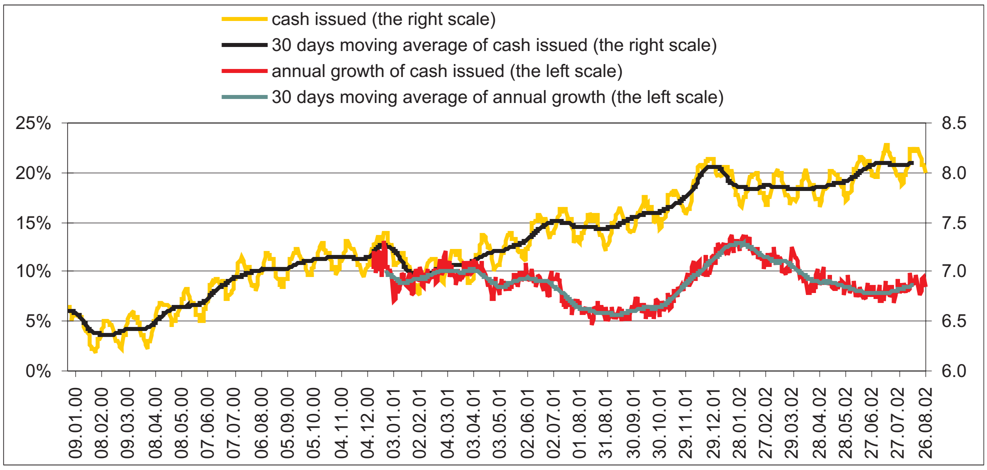

Figure 4.8. Cash demand (EEK billion) and its annual growth

Credit Market

Sustained financing of domestic demand through lending remained active also in the second quarter of 2002: the real sector's borrowing underwent the record high growth – 3.1 billion kroons. Thus, the annual growth rate of residents' bank loans and bonds issued slightly accelerated, reaching 26.5% by end-June. The leasing and factoring financing of the real sector continued smooth growth and the annual growth reached 43.7% in the second quarter.

The annual growth of the domestic debt load together with leasing financing of the real sector reached 28.1% by the end of the second quarter. This confirmed the trend of the

recent quarters that borrowing accelerates by 2–3 percentage points every three months (see Figure 4.9). High credit demand has been sustained by favourable liquidity environment, continuously soaring domestic economic activity and low interest rate level, also strong corporate and private confidence and optimism in the future, reflected in the indicators of the Estonian Institute of Economic Research.

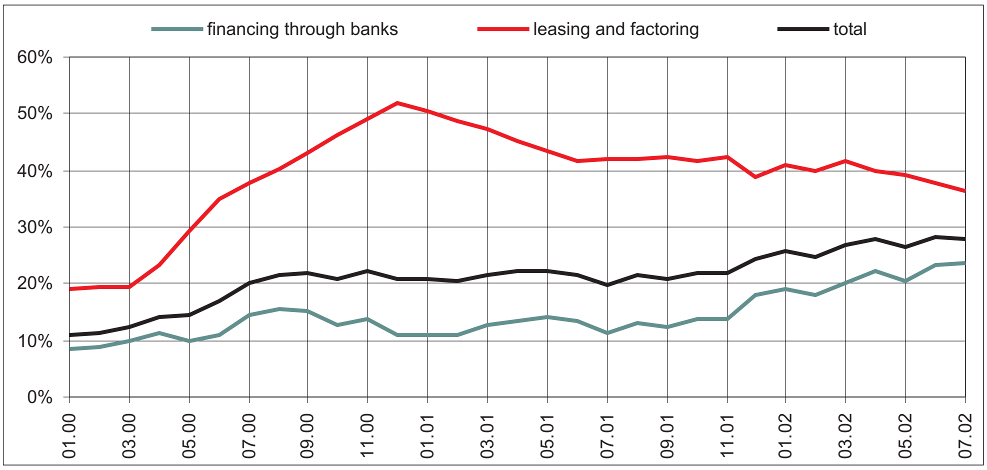

Figure 4.9. Financing of domestic real sector by financial sector (annual growth)

By sectors both households' and corporate credit demand remained high throughout the second quarter. Active financing of the real sector through leasing companies continued as well. Individuals keep leasing apartments and passenger cars; among loans prevail real estate loans, with the loan stock increasing by 0.8 billion kroons in the second quarter (by 0.4 billion kroons in the first quarter). The stock of other loans and leasing of households went up as well but less.

The annual growth rate of corporate bank financing accelerated to 15.6% by the end of the second quarter, being 0.9 percentage points above the first quarter. The loan stock increased by 807 million kroons, about twice more than in the first quarter. In the first months of the year lending to industrial sector increased most, while in the second quarter primarily the sheltered sector was financed: construction, real estate development and commerce. By the purpose of borrowing acquisition or renovation of real estate prevailed over other investment loans and overdraft facility. Lending to industrial sector recovered significantly in July. Banks used lending to acquire bonds. In general corporate borrowing maintained its structure and there were no signs of significant preferential financing of the sheltered sector.

Active corporate financing through leasing and factoring continued. The annual growth in the second quarter was 38.8% and the stock grew by 1.1 billion kroons compared to the first quarter. Leasing of passenger cars, production equipment and commercial premises was dominant. The real estate and transport sectors were the largest lessees, followed by wholesale and retail sector and industry.

Growing government depositing has been responsible for most of the domestic credit resource inflow. At the same time, the government deposits are highly unstable: they can rapidly decline under deteriorating economic circumstances, sustaining a financial sector demand for additional external resources. Despite large growth in the government deposits, the rise of the debt in the real sector exceeded the growth in the residents' deposits in the second quarter (see Figure 4.10).

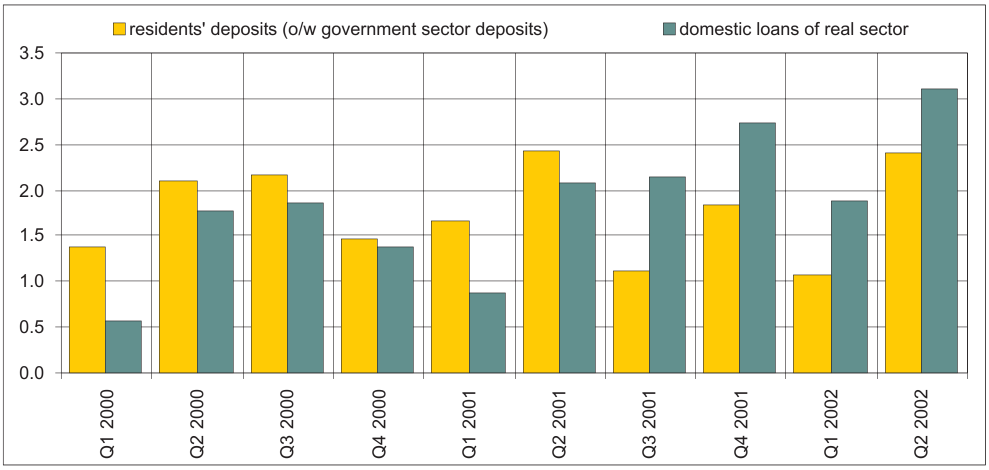

Figure 4.10. Quarterly growth of residents' deposits and domestic loans of real sector (EEK billion)

Interest Rates in Real Sector

In the second quarter, short-term interest rates in the euro area did not change. Therefore, deposit interest rates in the Estonian real sector remained relatively stable. The average weighted interest rate level of kroon deposits shrank by 0.1–0.2 percentage points, reaching 3.5% for short-term kroon deposits and 4.3% for long-term kroon deposits. The level was sustained throughout July.

In the second quarter, also the real sector loan interest rates remained close to the average level of the first quarter (7.5%). Whereas interest rates were the highest in May (7.8%), corresponding to the euro area interest rate dynamics. The average weighted interest rates individuals' long-term loans decreased by 0.1–0.3 percentage points in the second quarter – to 7.9%, in case of housing loans even down to 7.6%. Corporate long-term loan interest rates underwent a 0.2 percentage-point rise – up to 7.2%. The interest rate level of the second quarter was broadly maintained also in July: the long-term loan interest rate of individuals declined to 7.8%, that of corporate loans rose to 7.7% (see Figure 4.11).

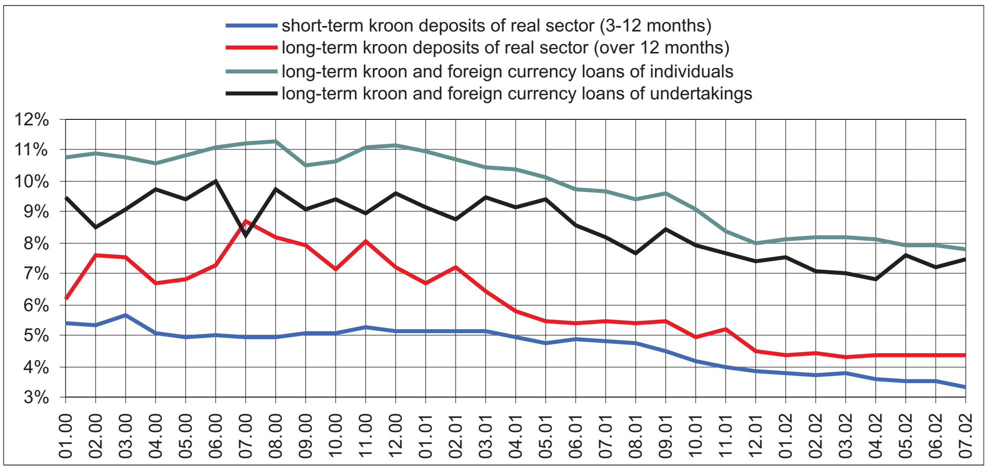

Figure 4.11. Interest rates of domestic real sector

As the beginning of the growth cycle in the euro area interest rates will be delayed for at least one or two quarters, no near-term significant interest rate changes are anticipated in Estonia.