

Eesti Pank  
Bank of Estonia

# Eesti Pank Annual Report 2007

2008

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**Roman Nyman**

1881–1951

The illustrations used on the insets of this report depict motifs from Roman Nyman's designs of the Estonian kroon. Nyman was among the five artists who were invited to take part in the competition held in 1926 for the design of 10- and 50-kroon banknotes and rewarded with 20,000 marks. However, his designs were not used for the production of banknotes.

Nyman was one of the first professional theatre artists in Estonia. He was also active as a teacher, manager of the decoration studio of the Estonian art industrial school and designer of national ornaments for Langebraun, the famous porcelain manufacturer. Later he dedicated himself to painting, especially oil and watercolour painting.



## **Main features and functions of Eesti Pank**

Eesti Pank is the central bank of the Republic of Estonia and a constitutional institution analysing and administering the Estonian monetary system; that is, the monetary policy of Estonia. The aim of monetary policy is to ensure a low and stable price rise and the best conditions for economic growth. The central bank is also responsible for the security and stability of the financial system. It has the sole right to issue the Estonian currency and bears responsibility for currency circulation along with maintaining the stability of the national currency.

**The mission of Eesti Pank is to guarantee price stability in Estonia.** The **main tasks** of Eesti Pank in carrying out its mission are as follows:

- Participating in the national economic policy through the implementation of an independent monetary policy, consultancy to the government, and international cooperation;
- Ensuring financial stability in Estonia by creating policies for the financial sector and operating well-functioning settlement systems;
- Arranging the circulation of cash in Estonia;
- Making preparations to become one of the policy-makers among other national central banks of the euro area who design the coordinated economic policy and single monetary policy in Europe.



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EESTI PANGATAH

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KAKSKUMMENEVIIS KROONI

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Foreword  
by Governor  
of Eesti Pank

## **FOREWORD BY GOVERNOR OF EESTI PANK**

In 2007, Estonia's economy witnessed fundamental changes in many respects. After several years of exceptionally strong growth, we started to move towards a more stable and sustainable development path: rapid credit and wage growth slowed and the external balance started to improve as well.

The external environment, which is a major factor in the development of a small open economy, continued to deteriorate in 2007 and expectations regarding the US and other advanced economies weakened further. The pessimism of late 2007 peaked in January 2008 along with the rapid decline in global stock markets in January 2008. By the end of 2007, the price of oil barrel had reached nearly 96 dollars. Food prices kept rising throughout the year and particularly sharply in the second half.

This was particularly significant considering the relatively large share food and fuel represent in the consumer basket in Estonia. If we then consider the ongoing convergence of our economic indicators towards the EU average levels and the accompanying increase in incomes and prices, which is exceeding the EU average, the 6.6 per cent rise in inflation in 2007 was well expected.

Today prices are growing much faster in Estonia than is desirable from the point of view of long-term sustainable development but this is a temporary process and will gradually slow over the next couple of years. Inflation arising from rapid wage growth should also decelerate this year but the convergence of tax rates towards the EU levels also pushes up prices. The joint impact of various factors is therefore likely to give a significant boost to the inflation rate in 2008. Last year, real GDP growth reached 7.1 per cent in Estonia, whereas Eesti Pank forecasts a much lower growth rate this year. That points to the start of a gradual adjustment period in economy.

How smooth the adjustment period will be and how long it will take to regain higher growth rates, is largely, but not only, dependent on global economic developments. It is crucial that we use our export potential. For the entry to a new growth cycle to be smooth, the central bank deems it necessary to partly redirect domestic demand oriented resources to the export sector. We have to take into consideration that several resources underlying the strong growth of recent years have now been exhausted. On the supply side, there is much less unoccupied labour force available; however, the domestic demand reserve relying on credit use has also decreased considerably. Under such circumstances, growth can be primarily boosted through increased productivity, especially in the exporting sector. It is similarly important that the financial sector continues funding sound business projects.



The strong economic growth of recent years relied mostly on real estate investment. Now, however, the real estate sector is going through an adjustment phase, which affects also the growth of the economy as a whole. In 2005-2006, the improvement of credit availability temporarily increased demand in the real estate market, which resulted in a price hike. Today we are facing an oversupply which has brought about a decline in prices. Companies that are better capitalised and have diversified their activities will survive the difficult times; however, the number of small enterprises going bankrupt will increase. Consequently, the economic growth potential will decrease as well. Investment in production capital has not been that sensitive to the economic cycle compared to real estate investment, which allows, in their case, to expect smaller corrections.

Another precondition for sustainable and rapid economic recovery is the continuation of economic policy measures that support market flexibility and productivity growth. Moreover, EU funding should be carefully considered and used as effectively as possible. The government sector can best support economic adjustment through a responsible fiscal policy. This is crucial for maintaining Estonia's economic reliability in the phase of adjustment and supporting investment.

It is clear that 2008 will be more difficult than 2007 in many ways. The scope of further adjustments should not, however, be overestimated. The ability to cope in a different economic situation does not call for any fundamental changes in the current economic policy. It rather depends on how smooth the adjustment will be, not on how strictly we follow the principles established a long time ago.

Andres Lipstok  
Governor





Accountability

# ACCOUNTABILITY

Central bank's independence is an inseparable part of any monetary system that gives priority to ensuring price stability. At the same time, principles of modern democracies expect any independent institution performing public functions to be accountable for its actions. For Eesti Pank, the autonomous central bank of the Republic of Estonia, accountability entails explaining its economic policy vision and decisions to the citizens of Estonia and their democratically elected representatives in a clear and profound manner. Accountability and autonomy of the central bank are two counterbalancing principles.

## **Legal framework for accountability and compulsory publications of the central bank**

The scope of accountability of the central bank has been defined in various Estonian laws. Pursuant to the Law on the Security for the Estonian Kroon, the central bank is to publish at least once a month data on the size of gold and foreign exchange reserves and the amount of Estonian kroons in circulation. These data are published in the form of **tables describing the balance sheet of Eesti Pank and foreign exchange reserves backing the kroon**.

Pursuant to the Official Statistics Act and the Eesti Pank Act, the central bank is entitled as well as obliged to collect and publish **monetary, financial and balance of payments statistics** in its field of responsibility, according to the rules laid down for this purpose. The statistical data are published on the bank's website.

The Eesti Pank Act also requires the publication of a bulletin at least once every three months in addition to the Annual Report of Eesti Pank. The **quarterly bulletins focus on monetary or financial policy** issues in turns. The **Annual Report** includes the annual accounts for the year. The Supervisory Board of Eesti Pank approves the Annual Report and submits it, together with the auditor's report, to the Riigikogu. Along with the central bank's

Annual Report the Riigikogu receives the Annual Report of the Financial Supervision Authority after the report has been approved by its Supervisory Board. Governor of Eesti Pank also makes a presentation on the central bank's Annual Report in the Riigikogu.

## **Accountability vis-à-vis the Riigikogu**

Governor of Eesti Pank makes a presentation on the Annual Report every year. Other forms of cooperation between the central bank and the Riigikogu include meetings as well as explanations and comments of bank representatives in response to issues raised by members of the Riigikogu.

The top executives and specialists of Eesti Pank meet regularly with the Finance Committee of the Riigikogu in order to explain the central bank's estimates of economic processes and discuss topical issues.

Upon request of parliamentary factions the top executives of Eesti Pank introduce the central bank's economic policy standpoints and activities. In 2007, further development scenarios of the Estonian economy were of most interest.

Members of the Riigikogu did not raise any interpellations in 2007.



### **Regular reporting on economic policy views and publication of economic data**

The central bank's reliability for the public and the transparency of its activities are the prerequisites for the smooth operation of the monetary system. Eesti Pank must provide both the general public and the experts with regular, profound and high-quality information on economy. The central bank considers it important to offer easy and low-cost access to data (for example, regular publications of Eesti Pank are free of charge to subscribers and public libraries), and also to provide quality and timely information (for instance, there are very strict requirements for the system of publishing statistical data<sup>1</sup>). In addition to providing information on the website and in various publications<sup>2</sup>, it is possible to request information directly from the bank. Information can be requested by mail, e-mail or phone. In 2007, Eesti Pank received 2440 inquiries, 72 of which were registered as requests for information.

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<sup>1</sup> The data are to be published not only on a fixed date but also at a certain time of the day, and they have to meet internationally accepted quality criteria.

<sup>2</sup> The full list of publications of Eesti Pank in 2007 is available in the Annex to the Annual Report on page 131.

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Strategic objectives  
for performing the main  
functions of Eesti Pank

E. KROONI



# STRATEGIC OBJECTIVES FOR PERFORMING THE MAIN FUNCTIONS OF EESTI PANK

Eesti Pank follows these strategic objectives in order to carry out its main tasks.

## I. Monetary policy

1. Maintaining the currency board arrangement until Estonia joins the euro area.
2. Monitoring Estonia's economy with the main focus on the risks related to inflation inertia and to adjusting to the slower economic growth. Meanwhile, cooperation with the government on economic policy is aimed at finding ways to prevent setbacks arising from these risks.
3. Integrating Estonia's monetary policy environment and market operations with those of the Economic and Monetary Union, while taking into account the peculiarities of Estonia.
4. Developing economic forecasting methods that aim to achieve content-related and procedural uniformity with the economic forecasting arrangement of the European System of Central Banks.
5. Ensuring the consistency and quality of the compilation of financial sector and balance of payment statistics in compliance with European Union standards.

## II. Financial stability

6. Ensuring financial stability by assessing the credit and liquidity risk of the financial sector and bringing the risk scenarios of the economic forecast more in line with the financial stability stress tests.
7. Safeguarding financial stability by developing the financial sector's safety net. Strengthening national crisis management capacity in cooperation with the Ministry of Finance and the Financial Supervision Authority, and cross-border crisis management capacity in cooperation with Scandinavian and other Baltic central banks.

8. Acting as the overseer of settlement systems and publishing respective assessments regularly.
9. Contributing to better integration of European financial markets, including in the field of securities settlement, by participating in the work of European Union institutions.

## III. Arranging currency circulation

10. Promoting the usage of modern payment means in order to reduce the share of cash in currency circulation. Joining the future Trans-European Automated Real-Time Gross Settlement Express Transfer system TARGET2.
11. Increasing the performance of cash handling, thus avoiding growth in costs of cash handling in the medium term.
12. Celebrating key events in Estonia by issuing numismatic-bonistic products.

## IV. Joining the euro area

13. Reaching the stage in preparation for the launch of the euro where it can be completed within 12 months before the day the euro is launched. Estimating twice a year Estonia's readiness for the launch of the euro.
14. Preparing the amendments to the management of foreign exchange reserves with the goal of ensuring optimum investment of assets when Estonia becomes a full member of the Economic and Monetary Union, while proceeding from the changing tasks and environment.
15. Ensuring the technological readiness of cash management for the changeover to the euro.
16. Ensuring readiness for competent participation in the decision-making and cooperation mechanisms of the single European monetary policy.
17. Informing public, private, and third sector organisations and institutions as well as the general public of the developments in the implementation of the single European monetary policy and its effects on Estonia's economy.



## V. Organisation and cooperation

18. Promoting research-related scientific cooperation by strengthening collaboration with the other EU central banks through cooperative projects; continuing the visiting researchers' programme, and promoting joint research work in Estonia, including via the Estonian Economic Association.
19. Developing the professional skills and knowledge of the staff through in-service training programmes and personal development plans.
20. Developing value-based management; preparing a comprehensive description of the Bank's management system, and specifying the Bank's products and services.
21. Creating an interactive visitor centre using the resources of the museum and library of Eesti Pank, which will be introducing the role and tasks of Eesti Pank as a member of the European System of Central Banks as well as the history of the Estonian economy and its currency.
22. Implementing a system management model that would cover all systems with IT components.
23. Improving both the physical and IT working environment as well as creating teleworking opportunities.





Fifteen years of the  
Estonian kroon

# FIFTEEN YEARS OF THE ESTONIAN KROON

## INTRODUCTION

By 2007, 15 years had passed since the re-introduction of the Estonian kroon. During this period, the Estonian economy, financial system and the central bank have undergone considerable development.

In 1992, the foreign reserves of the central bank amounted to approximately 2.5 billion kroons only, out of which the excess reserve comprised approximately 590 million kroons. In fifteen years (by 2007), the monetary reserve of Eesti Pank has grown to 33.7 billion kroons and the excess reserve to 4.2 billion kroons. Today, Eesti Pank is a modern and effective national central bank of a small economy.

The time following the monetary reform in 1992 was difficult for both the Estonian economy and financial system. Average monthly wages reached just over 1,000 kroons in 1992 (over 12,000 kroons in the fourth quarter of 2007) and the inflation rate reached 1,077 per cent. It was necessary to reorganise the banking environment and create a legal framework that would function in the conditions of market economy.

By now, Estonia is an EU Member State and has set itself the goal of becoming a full member of the

Economic and Monetary Union. Our financial environment is strong and has earned the confidence of international investors. After the extremely strong growth period, Estonia's economy has now reached a more stable and less risky path. In 2007, growth was not as rapid as in the last couple of years, but this is actually beneficial with regard to sustainable development. Prices grew faster in 2007 compared to recent years, but a more detailed analysis of the underlying factors shows that the temporary acceleration of inflation was well expected (for more details see page 111). This reflects the ongoing convergence of income and price levels towards the EU average. In addition to comparing the economic data of the last couple of years, one should look back a little further to understand what the Estonian economy has gone through during the fifteen years of the kroon (see Figure 1).

### What has been the role of Eesti Pank in all that?

The principal tasks of Eesti Pank are and will be the same as described about 90 years ago by the then Governor of Eesti Pank, Jüri Jaakson.

*The cornerstone of each and every economy is a firm monetary unit, which is a gauge of economic*

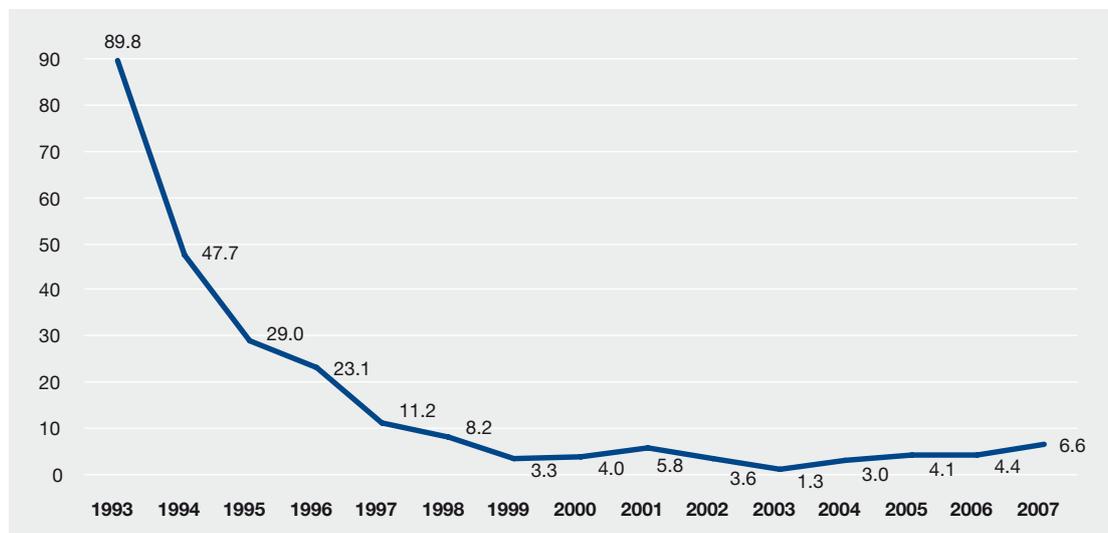


Figure 1. Consumer price index in the years after the monetary reform



*values. This monetary unit must not fluctuate, it must not be dependent on random external factors, or else it will lose its value as a stable gauge. Each industrialist, every merchant and any other entrepreneur who creates economic assets or obtains them for reselling must have the opportunity to make a definite pre-calculation as to the cost of these assets to him and the price at which he will have to pass them on in order to make both ends meet. /.../ Therefore, maintaining the firm value of a monetary unit is an enormous, difficult, and very responsible task in every country.*

Above all, the central bank has the right – and obligation – to bring stability to the economic environment. The Estonian kroon that has remained stable for fifteen years is the prime example of the appreciation of stability. The same can be said about the Estonian monetary system, which has served as the basis for central bank activities both in good and bad times.

A stable monetary system requires a stable and efficient financial system. In the course of financial sector reorganisation in the first half of 1990s, the central bank did not hesitate to liquidate poorly managed insolvent banks. Neither did the Government hesitate when it was necessary to liquidate poorly managed insolvent enterprises that were manufacturing for stock. The privatisation of public enterprises by core investors for “real cash”, and, if necessary, the liquidation of state enterprises that were operating in the red laid the foundation for the emergence of a strong business sector with free competition.

The right and obligation of the central bank to contribute to shaping Estonia’s economic policy has been set down in the Eesti Pank Act. But this task can only be performed in cooperation with the Government and other constitutional institutions. Eesti Pank has always stressed the importance of economic reforms and a stable, predictable budget in ensuring the stability of the kroon’s exchange rate and the financial system. Looking back to

the past fifteen years, we can say that economic policy cooperation has been smooth and has also produced good results.

The following is a brief insight into the most significant events of the fifteen years of the kroon within the Estonian monetary and financial environment.

### **1992–1994: MONETARY REFORM AND REORGANISATION OF THE BANKING SYSTEM**

#### **Monetary reform**

The monetary reform in Estonia, which was the first of the former rouble zone countries to introduce its own national currency, took place on June 20, 1992. The Estonian kroon was declared the sole legal tender in circulation and Eesti Pank the only regulator of monetary relations in Estonia. The official exchange rate of the Estonian kroon against the German mark was set at DEM 1 = EEK 8. Within three days, every resident natural person could exchange 1,500 roubles for kroons at the rate of EEK 1 = RUB 10 (the exchange rate corresponded to the market rate of the German mark and the Soviet rouble at that time). Almost the total amount of roubles in circulation in Estonia (deposits, money held by enterprises, etc.) was exchanged for kroons at that rate. All the laws and other regulations scheduled for the beginning of the monetary reform took effect. Eesti Pank started to publish the daily exchange rates of the Estonian kroon against the major foreign currencies.

Since the monetary reform, Estonia’s monetary policy has been based on the strict principles of the **currency board arrangement**. In order to maintain the fixed exchange rate of the kroon, the central bank’s liabilities, including the monetary base in the economy, must be fully guaranteed by gold or foreign exchange reserves. The reserves backing the kroon were composed of pre-war gold deposits of the Republic of Estonia returned by the Bank of England and the Bank for International Settlements, and of foreign currency with which Sveriges

Riksbank (State Bank of Sweden) compensated for the gold of the Republic of Estonia deposited in Sweden before the war.

Eesti Pank operates independently of other state authorities. Under the currency board arrangement, the law prohibits the central bank to credit the central government and local governments either directly or indirectly. In accordance with the law on the security of the Estonian kroon that took effect on the day of the monetary reform, Eesti Pank has no right to devalue the exchange rate of the kroon.

The most important monetary policy instruments are the standing facility of buying/selling foreign currency and the reserve requirement for banks. Arising from the currency board framework, the reserve requirement ratio is considerably higher in Estonia (currently 15% of the reserve) compared to other exchange rate mechanism countries.

#### **First years after the monetary reform**

In the years after the monetary reform, the main objective of Eesti Pank was to **create a stable financial environment and general credibility of the financial system and to develop a banking system that would meet the requirements of a market economy.**

To increase the efficiency and credibility of the monetary system and improve the ability of the financial system to absorb liquidity, Eesti Pank allowed commercial banks to maintain an unlimited German mark open position. This showed again the complete security of the Estonian kroon and the expectation for the long-term stability of the system.

In April 1994, the central bank started to conclude up to seven year futures transactions between the Estonian kroon and the German mark. This helped to further increase the credibility of the Estonian kroon and to reduce speculations on devaluation. The conclusion of futures transactions was ended

in March 1995 when the need for such instruments ceased to exist.

The legislative system that entered into force with the monetary reform and regulated foreign currency transactions (included restrictions on capital account transactions and imports and exports of foreign currency; prohibited exchange of non-convertible foreign currency; required the registration of foreign loans, etc.) was gradually loosened. With the repeal of the Foreign Currency Act in April 1994, the restrictions were completely abolished. Estonia was one of the first Eastern and Central European transition countries to abolish restrictions on the free movement of capital.

For more efficient functioning of the financial system, banks' reserve requirements were specified for several times in 1993-1994. The special reserve ratio of Hoiupank was also reduced.

In order to reduce unjustified expectations related to refinancing by the central bank, Eesti Pank launched a short-term money market project in 1993, which gave banks the opportunity to solve their liquidity problems and also increased trust between banks. For the same purpose, the bank started to issue short-term (28-day) certificates of deposits (CD). The decreasing margin of both the overnight rates and interest rates on certificates of deposits against the short-term interest rates of the German mark indicated the stability of the kroon exchange rate.

Furthermore, multilateral netting was introduced in the interbank settlement system administered by Eesti Pank, allowing banks to optimise their settlement account balance.

#### **Banking crisis and the beginning of the reorganisation of the banking sector**

In November 1992, a serious **banking crisis** erupted. Moratorium was declared on the three largest banks of that time: Tartu Kommertspank, Põhja-Eesti Aktsiapank and Balti Ühispank.



Measures taken by Eesti Pank to tackle the crisis were recognised also outside Estonia. Tartu Kommertspank's activities resulted in bankruptcy. By merging the rest of the two banks (whose difficulties arose mainly owing to the freezing of external assets, following a Soviet government decision of 1992), a new bank, Põhja-Eesti Pank, was founded. The last major bank closed in that period was Eesti Sotsiaalpank, whose problems peaked in the second half of 1994.

In order to reorganise and stabilise the banking sector, the Supervisory Board was re-established in Eesti Pank. In addition, a supervisory committee was formed and a system complying with modern requirements for the collection of banking statistics was introduced.

By establishing the mandatory renewal of activity licence and the requirement of increasing share capital, Eesti Pank created a situation where insolvent banks were no longer able to continue operating. As a result, the number of banks decreased by almost a half by the end of 1994, that is to 22, compared to the time before the monetary reform. A period of stabilisation was declared (from April 1993 to January 1994) and the issue of activity licences to new banks was stopped.

In order to increase the credibility of credit institutions, new prudential ratios were approved in 1993, and specified and supplemented in 1994. The focus was set on the organisation of supervision that would enable risk prevention and ex-ante control. However, the development of banking supervision was inhibited by the slow preparation of general legislation regulating the field of economy (there was no accounting act, no commercial code or any other necessary legislation). Therefore, the **new Credit Institutions Act** of 1994, which proceeded from the requirements established in the banking legislation of EU countries, became especially important. Moreover, operating procedures for savings and loan associations were established. Banking supervision authorities strengthened contacts with

the Basel Committee on Banking Supervision and the contact group of the Eastern European Banking Supervision as well as with relevant agencies in Latvia and Lithuania.

### **Eesti Pank Act and Bank Law**

In 1993, the Bank Law of the Republic of Estonia (1992) was supplemented and the Eesti Pank Act was passed (18 May 1993). The fixed capital of the central bank was set to 100 million kroons. In addition, the Statutes of Eesti Pank were drafted and the Executive Board was formed. The Eesti Pank Act and the Statutes of Eesti Pank were once again amended in 1994.

### **First steps towards a modern payment environment**

In October 1993, first automatic teller machines of the Baltic States were put into operation in Tallinn. In December 1993, Eesti Pank and five commercial banks joined the international banking and information transmission system SWIFT.

### **Statistics**

In 1992, the first post-war balance of payments of Estonia was compiled by Eesti Pank.

### **Increasing international contacts**

On May 25, 1992, Estonia became a member of the International Monetary Fund (IMF); on June 15, Estonia's membership in the Bank for International Settlements (BIS) was restored. Within the framework of the annual meeting of the IMF and the World Bank, an in-depth seminar on Estonia's economy and banking was held. Later on, the central bank enhanced cooperation with the IMF (Governor of Eesti Pank became a member of the IMF's Joint Procedures Committee) and also the BIS. On August 14–16, 1992, Michael Camdessus, Managing Director and Chairman of the Executive Board of the IMF, visited Estonia.

On December 1, 1992, Suomen Pankki (Bank of Finland) started to quote the Estonian kroon.

At the beginning of 1994, Kansallis-Osake-Pankki – the biggest commercial bank in Finland at that time – was the first foreign bank to open a representative office in Tallinn. At the end of the same year, two foreign banks from Finland, Kansallis-Osake-Pankki and Yhdyspankki, were authorised to open a branch in Tallinn.

### **Conclusion**

In conclusion, these years enhanced the credibility of the Estonian kroon, which helped to stabilise the economy and restore growth. Price inflation in Estonia exceeded significantly the inflation rate of Germany, the country of kroon's base currency, but this was to be expected. The main reason for the divergences between the kroon's internal and external value was the opening of economy under the fixed exchange rate and inevitable changes accompanying the relatively stronger productivity growth, including changes in the price structure.

### **1995–1998: DEVELOPMENT AND STABILISATION OF THE BANKING SECTOR**

#### **Stabilising and developing monetary policy environment**

In 1995–1998, the Estonian monetary system continued to be based on the currency board. The rigid pegging of the Estonian kroon to the German mark brought external price stability to the Estonian economy. The development of monetary policy environment proceeded mainly from three key processes:

- continuously large capital inflow to Estonia;
- changes in the exchange rates of major currencies, and
- influence of the interest rates of the German mark on the interests of the Estonian kroon.

In order to increase the credibility and transparency of the monetary policy, reduce the systemic risk arising from the expansion of the financial sector and strengthen the liquidity system, Eesti Pank

made it possible to meet the reserve requirement on a monthly average basis and started to remunerate compliance with the requirement.

As regards transactions between Eesti Pank and commercial banks, the difference between the purchase and selling rates of the German mark was eliminated in July 1996. The domestic inter-bank money market continued to operate but its importance decreased, as the banking system integrated more closely with the international money and capital market. The certificates of deposits issued by Eesti Pank lost their popularity.

The year 1997 was characterised by the relatively rapid growth of monetary aggregates (except cash), while also banks' investment in domestic loans and other equal debt instruments grew fast. Until autumn 1997 (the time of increasing uncertainty on international capital markets), interest rates on both inter-bank money market and loan and deposit market were mostly stable and with a downward trend.

In order to manage risks resulting from economic expansion, Eesti Pank took several measures to strengthen the liquidity system. With regard to the large inflow of external capital, on July 1, 1997 the amounts borrowed by banks from foreign credit institutions were included in the reserve requirement base – to the extent by which the amounts borrowed by banks exceeded their deposits held with foreign credit institutions. As of November 1, 1997 a temporary additional liquidity requirement was established for banks, amounting to 2% (3% as of December) of the reserve requirement calculation base. In addition, the daily reserve requirement was raised to 4% of the calculation base. At the same time, the interest paid on the balance exceeding the reserve requirement was increased to the level of the discount rate of the Deutsche Bundesbank (German Federal Bank) (since January 1999, the deposit interest of the European Central Bank has been used as the reference interest rate).



In order to strengthen the monetary system and increase banking sector credibility, Eesti Pank raised the capital adequacy requirement from 8% to 10%.

Measures supporting the macroeconomic balance were taken also in 1998. As of June, this part of the reserve requirement that could be regarded as met at the account of cash in hand was reduced to 20% of the total reserve requirement, and as of September 1, financial guarantees given to financial institutions and non-resident credit institutions were fully included in the reserve requirement calculation base.

### **Strengthening financial system's resistance to crises and further organisation of the banking environment**

In order to increase the banking system's resistance to crises, the banking regulation was developed further. Thorough amendments were made to the rules for calculating capital adequacy (market risk was included). All prudential ratios were to be implemented also on a consolidated basis. Rules for risk concentration, calculation of currency risk and reporting on off-balance-sheet items were improved. Liquidity reporting was changed significantly and the statement of investments was added.

The security of information systems became one of the priorities of supervision owing to the spread of ATMs and cash dispensing machines and the introduction of telebanking and Internet banking, which started to require increasingly more attention, so as to ensure the highest level of data protection. Thus, the obligation to conduct IT audits and certain requirements for the information systems of credit institutions were established. Moreover, procedural requirements for the prevention of money laundering were established for credit institutions.

These measures contributed to the convergence of the legislation adjusted to Estonian credit institutions with that of developed countries and ensured

the comparability of indicators. The objective was that the legislation implemented in Estonia would meet the requirements of the European Union. Internal integration within the Estonian financial sector and the internalisation of the banking sector led to closer cooperation with different domestic supervisory authorities as well as other countries and international supervisory authorities. In 1998, Eesti Pank, the European Bank for Reconstruction and Development and several Estonian credit institutions formed a joint committee to develop a framework for requirements for the general management system of banks.

The focus was set on the implementation of common financial supervision. The fast development of the banking sector caused a need to continue the organisational and methodical development of complex supervision.

In 1998, several acts were passed, drafted in cooperation with Eesti Pank: for instance, the Deposit Guarantee Fund Act and the Prevention of Money Laundering Act. Moreover, the new version of the Credit Institutions Act was further elaborated to adjust it to EU directives by increasing the rights and obligations of banking supervision authorities.

Stricter requirements for share capital and own funds in 1996–1997 led to mergers of credit institutions (Raepank merged with Forekspank, Keila Pank, Rahvapank and Eesti Maapank merged with Virumaa Kommertspank) as well as to the revocation of the activity licences of several banks (Eesti Sotsiaalpank, Ameerika-Balti Pank, NoWe Pank). Crisis was avoided in the case of Eesti Tööstuse ja Ehituse Kommertspank, which was reorganised and merged with Eesti Hoiupank. Under the conditions of tightening competition, not all credit institutions were able to sustain the required level of risk management and keep their market position. So the owners voluntarily liquidated INKO Balti Pank, and Eesti Innovatsioonipank lost its activity licence. In addition, the merger of Põhja-Eesti Pank with Eesti Ühispank was completed.

Due to liquidity problems, management errors and insolvency, the banking system witnessed several mergers and restructurings also in 1998. The merger of Eesti Hoiupank and Hansapank and that of Tallinna Pank and Eesti Ühispank should be mentioned here. As a result, two major banking groups emerged in Estonia with total market share of 80%. The inflow of Swedish capital to the two large banks (from Swedbank and Svenska Enskilda Banken, respectively) was also a breakthrough that contributed significantly to the whole banking system.

In the new Optiva Pank, which was the result of the merger of Eesti Forekspank and Eesti Investeerimispank, Eesti Pank acquired a temporary majority holding (the holding was sold in June 2000). Eesti Maapank, EVEA Pank and ERA Pank were declared bankrupt.

As a result of consolidation and liquidation of small banks, five banks and one branch of a foreign bank (Merita Bank) continued to operate.

### **Payment systems**

Eesti Pank began to create a new payment and settlement system between credit institutions that would comply with EU requirements. In order to increase the credibility and operational reliability of the payment and settlement system, the harmonisation of technical solutions was carried on; among other things, paper-based payment orders were replaced with electronic ones. The central bank also started to charge commercial banks for the services provided to them.

### **Currency circulation**

1998 was the first year the central bank did not need to put additional currency into circulation; the amount of currency in circulation even decreased. Eesti Pank stopped the release of one-kroon coins issued in 1992, 1993 and 1995. The new one-kroon

coin (of a new alloy and with different measures) was issued.

### **Statistics**

In addition to the balance of payments, in 1996 Eesti Pank started to prepare another review on the state's foreign trade relations, namely Estonia's international investment position. In the field of banking statistics, the project of payment statistics reports was completed.

### **First sovereign ratings**

Eesti Pank commissioned the first credit ratings for Estonia in 1997<sup>1</sup>: Fitch IBCA – BBB; Moody's Investors Service – Baa1; Standard & Poor's – BBB+.

### **Conclusion**

It can be concluded that in the given period, the Estonian economy was characterised by accelerating growth (reaching 6% as the average of the period), constantly decreasing inflation (8% in 1998), continuous economic reforms and reorganisation of banking environment. In autumn 1997, during the so-called Asian crisis, the currency board system demonstrated successfully its ability to be self-regulatory and capability to cope with the decline of confidence on international financial markets and currency speculations. Estonia was included in the first round of the EU enlargement negotiations.

## **1999–2004: CLOSER INTEGRATION WITH EUROPE**

### **Preparations for EU accession**

In 1999–2004, Estonia first enjoyed the status of an EU candidate country, then became an acceding country and finally a member state. In dealing with EU issues, Estonia implemented a decentralised model, meaning that the ministry responsible for the issue in question was also responsible for the compilation and finalisation of the national posi-

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<sup>1</sup> Credit rating is an assessment by rating agencies on government's capability and willingness to discharge future debt liabilities taken by the country.



tion. Similar to ministries, Eesti Pank was one of the institutions responsible for accession negotiations. The central bank had a major role in the preparation of issues treated under the chapters of the free movement of services and capital, Economic and Monetary Union, institutions, and statistics.

On January 1, 2002, twelve EU member states (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) adopted the euro as a single currency. In addition to the EU member states, the euro became the official currency also in several small countries such as Andorra, Monaco, San Marino and Vatican.

In 2002, the European Central Bank (ECB) invited the candidate countries' central banks (incl. Eesti Pank) to participate as observers in the work of the General Council of the ECB and the committees of the European System of Central Banks (ESCB) starting from the time of signing the Treaty of Accession. The observer status without the right to vote lasted until the entry into force of the Treaty of Accession.

The European Commission recommended to conclude accession negotiations with ten candidate countries during 2002. The other nine countries besides Estonia were Cyprus, the Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. The European Council was also convinced that these ten EU candidate countries were able to perform the obligations arising from the membership.

In December 2002, the ten candidate countries were officially invited to join the European Union. The treaty was signed on April 16, 2003 in Athens and entered into force on May 1, 2004.

In the referendum held in Estonia in September 2003, 66.9% of the votes were for the accession to the European Union.

### **Changes in the Estonian monetary system related to the third stage of the Economic and Monetary Union**

On January 1, 1999, at the beginning of the third stage of the Economic and Monetary Union, the currencies of 11 member states (including the German mark, which was the anchor currency of the Estonian kroon) were irrevocably pegged against each other and the euro was introduced as their legal tender (first as account money). In December 1998, Eesti Pank established the exchange rate between the euro and the Estonian kroon at EUR 1 = EEK 15.6466, which was equivalent to the official exchange rate of the Estonian kroon against the German mark. Apart from some formal and technical changes in the operational framework of the monetary system, for Estonia, the adoption of the euro did not bring about any direct changes in the exchange rate and monetary policies. The fixed exchange rate of the Estonian kroon against the currency covering a much larger economic area made our financial system more open and efficient, increasing also the integration of Estonian financial and non-financial sectors with the European capital markets.

After the adoption of the euro in the euro area, a new procedure for foreign exchange operations between Eesti Pank and credit institutions was established, which eliminated the difference between the purchase and sale transactions between the euro, the national currencies of the countries that had introduced the single currency and the Estonian kroon.

In April 2000, the Supervisory Board of Eesti Pank approved the strategy for the monetary policy operational framework, with the ultimate goal to harmonise Estonia's current framework with that of the Eurosystem. The short-term objectives were the smooth functioning of the fixed exchange rate under the currency board arrangement and the reduction of market distortions while maintaining the required liquidity buffers.

In May 2000, Eesti Pank stopped the issuing of short-term certificates of deposit.

In July 2000, the additional liquidity requirement was included in the reserve requirement, which then increased to 13%. In 2001, the reserve requirement system became more market-based, allowing credit institutions to invest a part of the deposit held with the central bank in high-quality foreign bonds. However, in 2004, the concession that allowed covering part of the reserve requirement with cash was terminated. In addition, the convergence of methodology for the calculation of the reserve requirement base towards the Eurosystem's framework was continued.

In 2002, the revised procedure for foreign exchange transactions between Eesti Pank and credit institutions operating in Estonia was established, serving as the basis for conducting transactions between the Estonian kroon and the US dollar, the Australian dollar, the Japanese yen, the Canadian dollar, the Norwegian krone, the Swedish krona, the British pound sterling, the Swiss franc and the Danish krone.

### **Development of the financial system's operating environment and financial supervision**

The close integration of the Estonian financial sector accompanied by the rapid growth of non-bank financial intermediaries emphasised the need to unite the financial supervision authorities that had so far operated separately.

In May 2001, the Riigikogu (the Estonian Parliament) adopted the Financial Supervision Authority Act to establish the Financial Supervision Authority – an agency operating at Eesti Pank with autonomous competence and a separate budget. The Financial Supervision Authority started to operate in 2002 to conduct independent supervision over the financial sector. At the same time, the Eesti Pank Act Amendment Act, which the Riigikogu had adopted in summer 2001, entered into force in relation to

the Financial Supervision Authority becoming operational.

Eesti Pank also continued with the development of banking regulations. At the end of the testing period of reports on capital adequacy and risk concentration (in 2002), the new prudential ratios of credit institutions were laid down.

In 2002, Eesti Pank, the Ministry of Finance and the Financial Supervision Authority entered into a cooperation agreement, which laid the foundation for their joint operation as regards exchange of financial information, legislation, the financial sector's safety net, international and public relations, and training.

### **Payment systems and currency circulation**

In January 2002, Eesti Pank launched a new inter-bank settlement system that complies with international requirements. Unlike the previous settlement system, the new one was comprised of two subsystems: the Designated Time Net Settlement System (DNS) for processing retail payments and Real-Time Gross Settlement System (RTGS) for processing express payments.

In 2002, the Cash and Security Department of Eesti Pank was granted the international quality certificate ISO 9001:2000 for the managing, handling, and safeguarding of cash reserves.

Due to the merger of credit institutions, growth in the number and value of payments settled through Eesti Pank slowed. Further development was observed in electronic payment channels, the share of payment cards and the number of ATMs.

### **Statistics**

The central bank's system of statistics reaching an internationally accepted quality level was proved by the fact that Eesti Pank joined the Special Data Dissemination Standard (SDDS) of the International Monetary Fund. Eesti Pank started to implement



the ECB Regulation concerning the consolidated balance sheet of the monetary financial institutions sector. In 1999, a procedure for the disclosure of information of credit institutions or the public disclosure report was developed.

In 2002, Eesti Pank started to publish Estonia's monthly balance of payments. In 2003, a new procedure for the declaration of international payments and new forms for balance of payments reports were introduced.

In addition, reporting on payment statistics on the basis of ECB's system was established.

### **Credit ratings**

In 2002, Estonia's credit rating reached the same level in the estimates of all three major rating agencies. While in 2001 two rating agencies (Standard&Poor's and Fitch) had upgraded Estonia's rating to the group of very credible countries, i.e. to level A, then in November 2002 the third agency – Moody's – did the same.

### **Legislation**

In 1999, the Savings and Loan Associations Act was adopted.

On August 1, 2002, the Eesti Pank Act Amendment Act entered into force.

In 2002, the Securities Market Act took effect.

### **Conclusion**

The broader economic policy objectives of 1999–2004 were as follows:

- to ensure a stable macroeconomic environment,
- to maintain the reliability of the currency board and the entire economic policy, and
- to successfully complete preparations for the EU accession.

At the same time, it was important to maintain sustainable economic growth through increasing productivity, curb the current account deficit and ensure further decrease of inflation. Eesti Pank fully supported these objectives through its activities. The effectiveness of Estonia's monetary and banking policy was indicated by the fact that all international ratings given to Estonia in 1998 remained valid regardless of international crises.

## **2004–2006: ON THE WAY TOWARDS THE ECONOMIC AND MONETARY UNION AS AN EU MEMBER STATE**

### **Accession to the European Union**

In May 2004, Estonia became a member of the EU and Eesti Pank a member of the European System of Central Banks (ESCB). Therefore, Eesti Pank is one of the owners of the European Central Bank. After the accession to the EU, representatives of Eesti Pank have the right to participate and vote in about 70 committees and working groups of the ESCB, the Council of the European Union and the European Commission. Every year, the executive staff and experts of Eesti Pank take part in about 300 meetings of EU committees and working groups.

In June 2004, Estonia became a member of the Exchange Rate Mechanism ERM II. The central rate of the Estonian kroon was fixed at EUR 1 = EEK 15.6466.

In June 2004, Eesti Pank announced a design competition for the national side of the Estonian euro coins. In December, Lembit Lõhmus was named as the winner of the competition. In 2005, Eesti Pank and Suomen Rahapaja (the Mint of Finland) signed a contract according to which Suomen Rahapaja will mint Estonia's euro coins.

In February 2006, Eesti Pank launched Estonia's euro website (euro.eesti.ee). In 2007, Eesti Pank began to write reports on the different aspects of

the adoption of the euro, which are published twice a year at [www.bankofestonia.info](http://www.bankofestonia.info).

The objective of the Strategic Development Plan of Eesti Pank for 2005–2007 was to ensure readiness to become a full member of the Economic and Monetary Union (EMU) by the second half of 2006 and join the euro area.

### **Development of monetary policy and financial environment**

In order to alleviate problems accompanying rapid credit growth, Eesti Pank raised the risk weighting of housing loans in the calculation of capital adequacy, which increased the capitalisation of banks. Banks' reserve requirement ratio was raised to 15% and the procedure for calculating and complying with the reserve requirement was established.

In order to implement the international capital adequacy framework (Basel II), the new procedure for the application and calculation of the prudential ratios of credit institutions and consolidation groups of credit institutions was developed. (Thus in 2007, the procedure for the public disclosure reports of credit institutions as well as reports on the prudential ratios of credit institutions and consolidation groups of credit institutions were amended – see page 50).

Eesti Pank, the Financial Supervision Authority and the Ministry of Finance concluded a three-party cooperation agreement on financial crisis management. Another such cooperation agreement was signed between Eesti Pank and the central banks of Sweden, Latvia and Lithuania.

### **Payment environment**

In January 2004, Estonia became the 28th European country to adopt the International Bank Account Number (IBAN) standard. This helped to speed up international payments.

Eesti Pank updated the interbank Designated Time Net Settlement System (DNS) by launching the

Settlement System of Ordinary Payments (ESTA) in October 2005. The ESTA allows for faster inter-bank settlements and longer operating time of the system, thus making the whole system more efficient.

In November 2006, Eesti Pank together with the Estonian Central Register of Securities and three commercial banks joined the Trans-European Automated Real-time Gross Settlement Express Transfer system (TARGET). In relation to that, the working day of the ESTA was extended by one hour.

### **Prevention of the circulation of counterfeit cash**

In 2005, Eesti Pank and the Police Board entered into a cooperation agreement to prevent the circulation of counterfeit cash and ensure the security of euro cash distribution.

### **Statistics**

In the field of statistics, the balance of payments report forms were established for companies. Eesti Pank launched a portal eAruanne through which companies can submit balance of payments data.

### **Conclusion**

The Estonian economy and banking sector witnessed several fundamental changes in 2004–2006, primarily driven by the accession to the EU and preparations for the adoption of the euro. For further information on the central bank's activities during this period, see the Annual Reports of 2006 and 2005. The following chapters give an overview of the activities and accomplishments in 2007.





The background of the slide is a faded, light-colored image of a banknote. The word "PANK" is visible at the top, and "KROONI" is visible in the middle. There are also some decorative elements and a signature at the bottom of the banknote.

Major activities and  
achievements of  
Eesti Pank in 2007

# MONETARY POLICY

## ENSURING THE SMOOTH FUNCTIONING OF ESTONIA'S MONETARY POLICY FRAMEWORK

### Main characteristics of Estonia's monetary system

Similar to the central banks of many other countries, the mission of Eesti Pank is to ensure price stability. Stable, low and easily predictable inflation sets the most favourable conditions for long-term economic growth. Already since 1992, Estonia's price stability has been ensured by the **fixed exchange rate system under the currency board arrangement**. The monetary policy framework that has essentially remained unchanged for almost 16 years continues to support Estonia's economic development.

At the end of November 2007, there were certain tensions on the Estonian money market, stemming primarily from some foreign companies' wish to hedge their kroon positions. Most probably there was uncertainty with regard to how the Estonian economy would manage in the downward cycle that had started at the beginning of the year. Nevertheless, money market interest rates that

had consequently increased, remained at a relatively low level and in January 2008, the Estonian money market started to show signs of cooling. The **Estonian kroon has maintained its reliability** in the eyes of both the domestic users and foreign investors (see Figure 1).

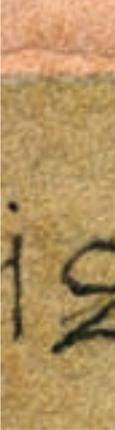
The Estonian kroon is firmly pegged to the currency of the most powerful economic area in Europe, the euro area. This helps to curb inflation expectations and supports the stability of the economic environment. Since the Estonian monetary policy has fully justified itself, Estonia has taken a unilateral commitment to continue with the currency board system and the central rate until the adoption of the euro.

Considering the strong ties of the Estonian monetary system with the Eurosystem, it is natural that our general monetary environment is largely shaped by the decisions of the European Central Bank (ECB). In the first half of 2007, the ECB raised the monetary policy interest rates, which in turn rapidly and fully passed on to the interest rates of the Estonian credit market, influencing the price of financial instruments in Estonia.



Figure 1. Estonia's inflation

Source: Statistics Estonia



Eesti Pank ensures the smooth operation of the monetary system through **monetary policy instruments and active participation in economic policy discussions**. The central bank's main monetary policy instrument is the **standing facility of buying and selling foreign currency** (forex window) available to credit institutions. The forex window enables banks to increase their Estonian kroon reserves by selling to the central bank an amount of foreign currency equal to the desired amount, and vice versa – to buy foreign currency for Estonian kroons. The **reserve requirement** plays an important role among the monetary policy instruments available to Eesti Pank, obliging banks to keep a part of their assets as a buffer in Eesti Pank or in high-quality external assets. By implementing conservative reserve policy and measures of supervision, the central bank regularly draws the public's and the Government's attention to risks associated with the macroeconomic environment. The efficiency of the Estonian monetary system that is based on a strictly fixed exchange rate is supported by **balanced budget policy and flexible markets**.

### **Monetary policy in 2007**

In 2007, Estonia's domestic demand began to cool rapidly, loan growth decelerated and wage growth started to slow. Towards the end of the year, also the external balance started to show signs of improvement. (However, on an annual basis, wage growth exceeded that of 2006 and the current account deficit was also higher than the year before.) At the same time, price pressures strengthened remarkably over the year and wage growth still exceeded that of productivity. Therefore, the emphases important with regard to monetary policy changed over the year.

Although credit growth is heavily subsiding and the ratio of loan burden to household disposable income is stabilising, the risks related to the rapidly increasing loan burden are still relatively high. Therefore, Eesti Pank decided to raise the risk weighting on housing loans in the procedure for

application and calculation of the prudential ratios of credit institutions and consolidation groups of credit institutions (Basel II, enforced on January 1, 2007) from 35% to 60% (for further details see Chapter "Ensuring financial stability" p 47).

Pursuant to the regulation that entered into force at the beginning of 2007, the daily minimum level of the settlement account was abolished, the interest penalty for failing to comply with the reserve requirement was updated and the procedures for the enforcement of reserve requirement amendments were specified.

Although credit growth is decelerating and the imbalances of the external environment are stabilising, the **banks' reserve requirement ratio** remained unchanged at 15% in 2007. This is because of the existing large economic imbalances and high inflation rate.

The precondition for efficient economic policy is the **consistency between monetary and fiscal policies**. Therefore, the central bank urged the Government to take steps to support the soft landing of the economy and economic balance through fiscal policy. This is possible, above all, by maintaining a consolidated budget surplus. Representatives of Eesti Pank discussed it with government agencies and the necessity of keeping the state budget in surplus found mutual support. According to preliminary data, the state budget surplus for 2007 remained close to 3% of GDP. The budget planned for 2008 was based on too optimistic growth expectations. Therefore, in order to make the slowdown as smooth as possible, it is necessary to curb budget expenditure by 1.0–1.5% of GDP. However, for the economy to undergo the downward phase as smoothly as possible, the consolidated budget surplus should be somewhat larger.

**The price growth in 2007 reflected the overheating of domestic demand witnessed in previous periods**, reaching 6.6% on an annual

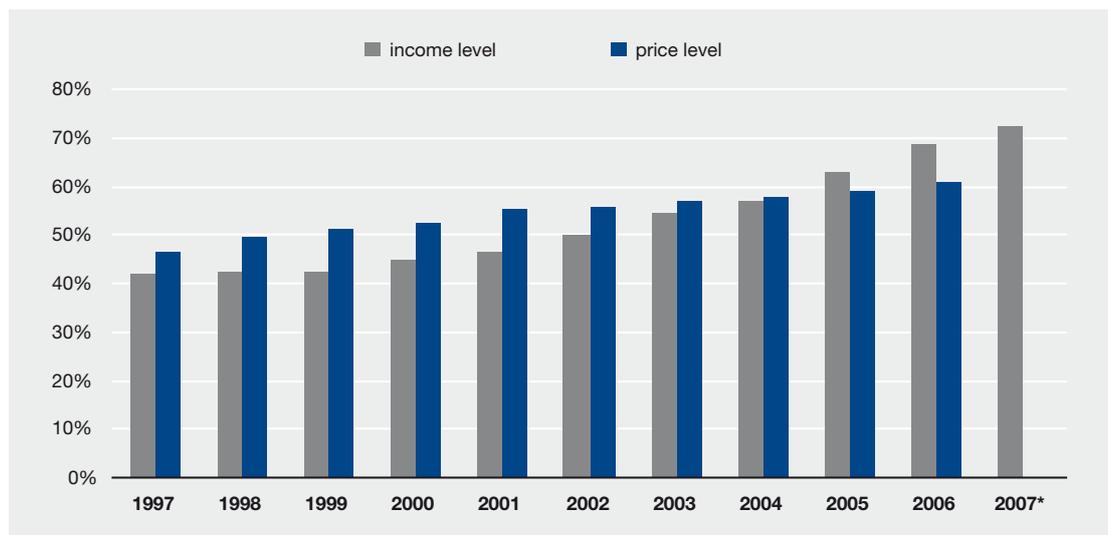
basis. Rapid price growth was also due to the unexpected increase in food and fuel prices arising from the external environment, as these components have a relatively large share in the consumer basket. With the exception of the hike in food and fuel prices, the price rise in 2007 was as expected, taking into account the lag in the emergence of price pressures and the impact of economic convergence between Estonia's economy and more prosperous European countries. (Price growth is expected to reach its peak in the first half of 2008, after which it will start to decline moderately.)

Meanwhile, convergence between Estonian economic indicators and the EU average continued, being accompanied by considerably stronger income and price growth compared to the EU average (see Figure 2). Estonian income and price levels are among the lowest in the EU. These differences will diminish if the Estonian economy grows faster and the Estonian inflation is higher than the EU on average. To ensure balanced economic development, higher than EU average growth rates of income should be accompanied by faster growth in productivity. Income growth that is in line with

productivity growth would also curb the robust price rise and help to achieve a modest inflation rate.

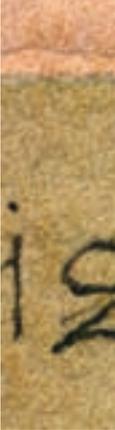
The growth indicators of rapidly developing economies should be interpreted in the overall context of their economic development of these countries. In wealthier countries both income and price levels are generally relatively higher and thus also economic growth and inflation rates lower. In countries with fairly modest economic growth, the inflation rate regarded to be in line with price stability is significantly lower than in Estonia, for instance. In a developing country with strong economic growth, price rise comparable to advanced economies is exceptional rather than a rule. In the case of countries that are rapidly catching up with the EU average, it would be much more expedient to assess the conformity of the inflation rate to other economic indicators (taking into account also productivity growth) than just merely compare the inflation indicators.

Risks to sustainable economic development have been increasing recently in Estonia. Among other things, risks related to the wage growth that exceeds productivity growth may lead to a longer recession.



**Figure 2. Income and price level in Estonia compared to the EU-27 average**

Source: Eurostat  
\* Preliminary data.



Since last autumn, the external environment has become considerably less favourable for Estonia. Uncertainty about the growth prospects of the world's leading economies increased further in the first months of 2008. Import prices continued to grow as well. Interest rate expectations, however, are more stable for Estonia. Domestic risks were mainly related to wage growth exceeding productivity growth and the cooling of the real estate market. Besides, in 2007 the situation in the labour market tightened even more, resulting in labour shortage and rapid wage growth in some sectors. Wage growth exceeded productivity growth, which increased the risk that rapid wage growth would affect inflation or undermine the competitiveness of Estonian companies in external markets. According to the latest statistics, competitiveness has been maintained; however, the risks cannot be ignored.

It is still unclear how the cooling of the real estate market is going to affect the value added produced by the construction sector. At the end of 2007, there were no obvious implications of a hard landing yet. However, in 2008, the construction sector can expect setbacks as regards both employment and investment.

**Estonia's economic policy situation was frequently discussed with international organisations in 2007**, including the International Monetary Fund (IMF), the European Central Bank, the European Commission, and rating agencies (Moody's, Fitch, Standard & Poor's). Foreign partners highly appreciated Estonia's monetary and fiscal policy and rapid convergence towards the EU average but stressed the need to manage the risks accompanying buoyant growth in domestic demand. The IMF as well as other international organisations warned about economic overheating and related risks. All were of the opinion that the short-term postponement of the adoption of the euro does not jeopardise Estonia's economy but they also stressed the importance of strong fiscal policy and financial supervision in supporting smooth economic adjustment. Moreover, it was

stressed that in order to maintain economic competitiveness it is vital that wage growth and productivity growth level off.

Being a member of the European System of Central Banks, Eesti Pank continued participating in the committees and working groups dealing with economic and monetary policy issues of non-euro area EU Member States. One topic of discussion covered risks surrounding balanced economic development. At the meetings of ECB committees and working groups, the representatives of Eesti Pank explained Estonia's economic developments and the balancing role of the currency board system within the general economic framework. Special attention was paid to the economic development of countries belonging to the European exchange rate mechanism ERM II to assess if countries participating in the ERM II were prepared to adopt the euro. The ECB and the European Commission observed that Malta and Cyprus met the convergence criteria and both countries became members of the euro area.

#### **Preparations for bringing the Estonian monetary system into conformity with the requirements for joining the euro area**

Estonia's monetary policy framework is very similar to that of the euro area, which enables a fast adjustment of the existing system when joining the euro area. The accession to the euro area will not entail significant economic policy changes. The monetary policy transmission mechanisms of euro area countries are already operational in Estonia, as the Estonian economy has adjusted to these mechanisms over the past years under the currency board system. Eesti Pank and the Estonian Government have set a goal to introduce the euro as soon as all the necessary requirements are met.

Final harmonisation of the monetary policy framework with that of the euro area is relatively small-scale and will not require any long-term or gradual adjustment phase. If needed, the required changes

can also be implemented directly before the introduction of the euro. During the preparation period for joining the euro area, Eesti Pank adjusts the monetary policy framework in accordance with the needs of the economic environment, avoiding, for instance, the creation of additional liquidity at the peak of economic activity.

The Estonian kroon continues to participate in the exchange rate mechanism ERM II, which is a prerequisite for the introduction of the euro. Estonia will carry on in the ERM II until the introduction of the euro, preserving the current monetary policy framework and the exchange rate fixed to the euro at EUR 1 = EEK 15.6466. The Estonian kroon has maintained its stability in the exchange rate mechanism, which has helped to preserve Estonia's economic credibility.

## **ECONOMIC ANALYSIS, FORECAST AND RESEARCH AS THE BASIS FOR MONETARY AND FINANCIAL POLICY-MAKING PROCESS**

### **Monitoring**

Making monetary policy decisions requires an efficient system for monitoring and forecasting economic developments, supported by target surveys on long-term processes in the Estonian economy. This system involves all departments preparing the central bank's monetary policy decisions.

The monitoring of economic developments mainly covers Estonia and the European Union member states, but also other major regions that play an important role in the global arena. Understanding the external environment is very important for a small open economy, and thus developments in Estonia are mainly analysed in the context of trends in foreign economies. The monitoring process of the Estonian economy may be divided into two categories: monitoring developments in the non-financial sector and in the financial sector. The outputs of this process are monthly reviews for internal use in

the bank, which serve as a basis for press releases and statements.

### **Economic reviews**

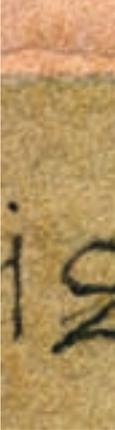
Once a quarter Eesti Pank prepares an economic policy review (see also "Key points of the economic forecasts of Eesti Pank in 2007", p 124). In addition, in the course of a year Eesti Pank publishes two economic reviews, which include the forecasts, and two financial stability reviews. Since 2007, the central bank also compiles and publishes a short-term economic statement twice a year. Estonia's economic developments in the context of the forthcoming adoption of the euro is analysed in the report on the adoption of the euro published once every six months since 2007. For internal analysis, reviews are compiled once a month.

Under the conditions of fixed exchange rate regime the flexibility of the labour market plays an especially important role. Smooth income convergence towards more prosperous countries requires flexible wage formation based on productivity growth. Labour market issues have been the topic of targeted research projects already for several years. From these projects a semi-annual labour market review has emerged for internal use in the bank. Since 2006, the review is also available on Eesti Pank's website.

### **Forecast**

Eesti Pank issues economic forecasts twice a year: a spring forecast in May and an autumn forecast in November (see "Key points of the economic forecasts of Eesti Pank in 2007", p 124). To this end, current year's economic developments and projections for the following two years are analysed. The forecast base scenario is usually also supplemented with two risk scenarios. For further information on the key points of Eesti Pank's economic forecasts see the bank's website.

Rapid changes in the economic structure require constant supplementing and updating of the base model for the Estonian macroeconomic forecast.



This task has been divided between the Research Department and the Economics Department. The Research Department is responsible for developing the quarterly economic model of the Estonian economy that serves as a basis for compiling semi-annual economic forecasts in the Economics Department. In 2007, the development of the base model for the macroeconomic forecast focused mainly on supplementing the model's financial sector block. The second item on the agenda in 2007 was related to preparations for the elaboration of a general equilibrium model. This model enables to analyse the impact of the European Central Bank's monetary policy decisions on Estonia's economy.

Representatives of Eesti Pank attended the meetings of the working group of the econometric modelling of the ESCB member states. In these meetings, experiences in developing the econometric models were exchanged and the compilation principles of models were harmonised.

### **Research**

Eesti Pank's economic surveys follow the **strategic research plan**, which determines the general framework for studies conducted in the Bank. The priorities for 2007–2009 included developing the **central bank's macromodel and the monetary policy's simulation model, monetary policy and financial sector research**, and the **sustainability analysis of the Estonian monetary system**. Ten research projects were carried out on these issues in 2007.

The projects addressed issues related to the Maastricht inflation criterion; factors affecting inflation in the Baltic States; the effects of the opening of Estonia's labour market; flexibility of price and wage formation in Estonian companies; financial behaviour of companies, etc. Moreover also the base model for the macroeconomic forecast of the Estonian economy was updated.

Although studies are mainly conducted in the Research Department, single research projects focusing on more specific topics are carried out also in other departments. In 2007, such research areas included, for instance, aspects related to monetary policy transmission mechanisms in Estonia as well as migration trends.

Besides publication in the Eesti Pank Working Papers Series, economic research conducted by the central bank has been recognised also on the international arena. In 2007, research papers and articles were published in internationally recognised academic journals and publications as well as at international conferences.

### **Cooperation on research at international and domestic level**

Continued in 2007. Central bank's economists attended the Working Group of Econometric Modelling and of the Wage Dynamic Network, comprising members of the European System of Central Banks. In cooperation with the Faculty of Economics and Business Administration of the University of Tartu, Eesti Pank arranged a high-level economic conference "IV Nordic Econometric Meeting" in the summer of 2007 in Tartu. The conference participants included many economists renowned primarily in Europe.

Along with introducing Eesti Pank's own surveys, several well-known **foreign experts** were invited to Estonia to present their research results. For example, Richard Clarida, a world-renowned economist and professor at the Columbia University made a presentation on the development perspectives of global economy; Ana Lamo, Head of the European System of Central Banks' working group that analyses labour market flexibility, held a seminar on measures for the adjustment of labour market; Katja Taipalus, economist of the Suomen Pankki (Bank of Finland), held a seminar on developments in the real estate market, etc.

In total, Eesti Pank conducted thirteen open seminars during 2007. Nine of them had guest lecturers from abroad and four included presentations on the bank's own surveys.

The **visiting researcher programme** of Eesti Pank plays a significant role in research contacts. In 2007, five foreign experts participated in conducting economic surveys.

Eesti Pank has the tradition of granting an annual **research award** to young Estonian economists. In 2007, the award was granted for the fifth time and this time to Aaro Hazak, doctoral candidate at the Tallinn University of Technology for his research "Dividend Decision under Distributed Profit Taxation: Investor's Perspective".

## RESERVE MANAGEMENT

**The foreign exchange reserves of Eesti Pank are backing the Estonian kroon and are used to ensure the stability of the kroon.** According to the currency board principles, foreign exchange reserves should completely cover all the liabilities of Eesti Pank, including the banknotes and coins issued, and the accounts of commercial banks with Eesti Pank. The central bank proceeds from strict risk constraints in investing the reserves, taking into account the primary objectives – **preservation and liquidity of assets. Return** comes third on the list of objectives.

### Structure of foreign exchange reserves

The structure of foreign exchange reserves did not change considerably in 2007. The reserves are still divided into two: the **liquidity buffer** and the **investment portfolio**. A small part of the reserves is held in **gold**.

The **liquidity buffer** accounts for approximately 10% of the total reserves and the central bank can use it at any time for Eesti kroon and

foreign currency transactions with domestic credit institutions.

Assets of the other major component of the foreign exchange reserves, the **investment portfolio**, are invested in international financial markets. The objective of the investments is to achieve the optimum balance of risk and average return above money market interest rates over a global economic cycle. Investment portfolio assets are mainly invested in the liquid bond markets of leading industrial countries, while constantly monitoring and managing the interest rate, credit, currency and liquidity risks of investment. A more detailed description of risks and risk management is available on the central bank's website<sup>1</sup>.

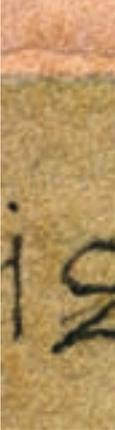
### Investment process

Eesti Pank manages interest rate risk through the benchmark portfolio. This determines the average risk level that the bank is ready to accept and is also used for performance measurement purposes in reserve management. The benchmark portfolio does not include currency risk. Limits have been set for the allowed deviation of the actual investment portfolio from the benchmark portfolio.

The Monetary Policy Committee of Eesti Pank considers changes to the benchmark portfolio when the average duration of the theoretical and actual benchmark portfolios differs by more than 10%. Lowering the risk level of the benchmark portfolio essentially means reducing the average duration of the portfolio: more assets are invested in low-volatility financial instruments providing more stable yields. As a result, the accrued interests offset the potential price fluctuations caused by market volatility. In the case of increasing the risk level, more assets are invested in longer-term instruments; that is, government bonds with the maturity of more than one year.

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<sup>1</sup> <http://www.eestipank.info/pub/en/majandus/rahasysteem/haldamine/4Riskid.html>



In addition to earning on a relatively stable benchmark portfolio, or **passive investment**, Eesti Pank is also engaged in **active investment**, taking positions in global financial markets. Such investment decisions are taken based on economic analyses, market relationships and other factors. Markets and securities are chosen on the basis of the investment idea, presumed horizon and expected efficiency.

The main investment philosophy lies in diversification: the aim is to spread risks and make better use of market opportunities. Investment is made in various markets, using different instruments, and positions are taken with different duration. Portfolio managers make investment decisions independent of each other. This is possible because the overall risk limit is divided into portions and the use of each portion is up to its portfolio manager.

Eesti Pank tries to keep up with the times and find its niche in today's relatively efficient markets. Two different approaches are applied in making investment decisions: subjective and model based. The former is mainly based on the qualitative analysis of economic processes, market psychology and the experience of portfolio managers. The latter is based on quantitative market relationships derived from investment models<sup>2</sup>. The best decisions for investment in money, capital and foreign exchange markets are made by combining these two approaches.

External asset managers also have a role in active investment. In 2007, a contract was signed with a new manager – Informed Portfolio Management. BlackRock has been investing Eesti Pank's assets since 2006, PIMCO since 2005 and ABN Amro Asset Management since 2003. The external asset managers use a portion of the risk limit, which is primarily invested in financial derivatives.

All in all, active investment did not generate any excess return over the benchmark portfolio by the end of 2007.

### **Results and determinants of investment in 2007**

By end-2007, the foreign exchange reserves of Eesti Pank totalled 33.7 billion kroons. Annual growth in reserves was approximately 3%. The excess reserve<sup>3</sup> accounted for nearly 12%, i.e. 4.2 billion kroons, of the total reserve.

Return on investment was higher than expected. It was affected by the dynamics of interest rates in the euro area and the United States, which turned out slightly different than expected. Over the year, the liquidity problems stemming from the US high-risk real estate loans passed on to the global financial sector. The Federal Reserve decreased the key interest rates three times by altogether 1 percentage point in the second half of 2007. The European Central Bank, on the other hand, raised the rates two times by altogether 0.5 percentage points. Since the interest rates increased in the euro area, the return on foreign exchange reserves was a bit lower than the return on the money market (see Figure 1). This was somewhat offset by the robust decrease in US interest rates.

### **Changes in the benchmark portfolio in 2007**

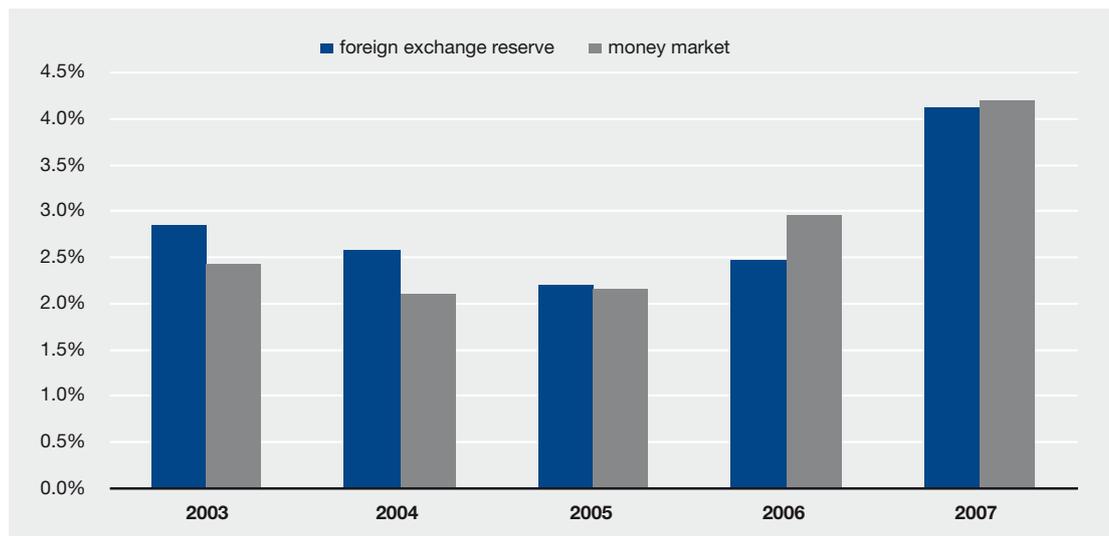
The rise in interest rates continued at the beginning of 2007 both in Europe and the United States. Therefore, the Monetary Policy Committee of Eesti Pank considered it necessary to extend the duration of the benchmark portfolio in January. By the end of the year, the duration of both benchmark portfolios extended by 5% compared to the beginning of the year: from 1.69 to 1.78 years in case of the euro portfolio, and from 1.18 to 1.33 years in case of the

<sup>2</sup> For more information on the investment models applied in the central bank, see the Eesti Pank Working Papers No 6/2005 and 4/2006.

<sup>3</sup> For further information on the components and calculation of the excess reserve, see the table of the reserves backing the kroon (see row IX – foreign currency net reserves) published by Eesti Pank on the fifth working day every month

US dollar portfolio. The duration of the total benchmark portfolio extended from 1.49 to 1.56 years. Table 1 shows the structure of the benchmark port-

folio endorsed by the Monetary Policy Committee on January 26, 2007.



**Figure 1. Return on foreign exchange reserves compared to return on money market**

**Table 1. Structure of the benchmark portfolio**

	3 months	1 to 3 y	3 to 5 y	5 to 7 y	7 to 10 y	10+ y
Euro area	57.91%	19.27%	9.29%	6.37%	4.61%	2.55%
USA	67.02%	16.02%	7.71%	5.23%	4.02%	

#### **Asset management services provided to the public sector**

Eesti Pank has been cooperating with various public sector institutions for years already. In 2006, it started to provide risk management service to the Estonian Unemployment Insurance Fund. The service includes daily monitoring of the investment activities of asset managers, drawing the reports required and, if necessary, advising the Fund in investment related matters. By end-2007, the Fund's portfolios totalled 2.3 billion kroons.

Eesti Pank continued to provide the full package of asset management services to the Guarantee Fund, whose investment portfolios totalled 1.8 billion kroons at the end of 2007.

# ENSURING FINANCIAL STABILITY

**The primary goal of Eesti Pank is to safeguard price stability in Estonia. The precondition for achieving price stability is an efficient financial system that operates smoothly.**

In order to ensure the efficient and smooth operation of the financial system, the activities of financial intermediaries must be monitored and risks to the system assessed. This requires continuous attention and analysis. To increase the transparency of the financial sector performance, Eesti Pank collects and publishes the statistics of the banking sector. The results of the analysis of the financial sector and its operational environment and the evaluation of risks to the financial system are published twice a year in the *Financial Stability Review*. Published analysis results and risk assessments also form the basis for shaping financial sector policy. The objective is to reduce risks to the financial system while maintaining a system that operates efficiently and smoothly.

In addition to taking measures for ensuring the transparency of the financial system, Eesti Pank also sets regulatory requirements for the banks when conducting **banking policy**.

Eesti Pank's activities in ensuring the smooth operation of the financial intermediation system, that is financial stability, include the following:

- assessment of risks to the operation of the financial intermediation system;
- monitoring and development of the legal framework of the banking system;
- management of financial crises;
- oversight of payment and settlement systems.

In performing these activities, Eesti Pank adheres to the following principles:

- maintaining the credibility of the financial system;
- keeping the likelihood of systemic risk as minimal as possible;
- contributing to the efficiency of the financial system;
- ensuring sufficient transparency of the financial system.

Besides Eesti Pank, the Ministry of Finance and the Financial Supervision Authority (with whom a revised cooperation agreement was signed in December 2007) also play an important role in ensuring the smooth operation of the financial system.

In addition to domestic institutions, Eesti Pank as a member of the European System of Central Banks (ESCB) also cooperates with the national central banks of other EU countries as well as with the European Central Bank in order to ensure financial stability. Eesti Pank also takes part in devel-

## EESTI PANK'S FINANCIAL STABILITY FRAMEWORK

In assessing the performance of the financial intermediation system, Eesti Pank proceeds from whether and to what extent the operation of the system enables the central bank to achieve its primary goal; that is, price stability. To this end, the risks related to the system's performance are classified as follows:

- Risks are low – the operation of the financial intermediation system enables the central bank to achieve its primary goal, which is maintaining price stability, but further improvement of the system is necessary.
- Risks are medium and a small share of them may have materialised – the operation of the financial intermediation system enables the central bank to achieve its primary goal, which is maintaining price stability, but corrective intervention is necessary (e.g. amending regulations).
- Risks are high and have materialised to a substantial extent – the operation of the financial intermediation system is hindered; corrective measures or crisis management activities are necessary.

oping a common European financial sector policy and improving related legislation. Since Estonia's financial system is closely integrated with those of the neighbouring countries, successful cooperation with Nordic and Baltic central banks is very important.

Eesti Pank has a direct role in the creation and functioning of the infrastructure required for the operation of the financial system. The central bank has to make sure that the payment systems that it manages and other payment and settlement systems that are important for the functioning of the financial system as a whole would operate without any major failures. For this purpose, the risks to settlement systems must be identified and minimised. Eesti Pank discloses the assessment by the overseer of payment and settlement systems in the *Financial Stability Review* published twice a year (see *Payment systems oversight*).

### **Financial sector analysis and financial stability assessment**

In recent years, the emphases and assessment of financial stability analysis have been influenced primarily by strong credit growth and the increasing indebtedness of borrowers. In 2007, at the turning point of the economic and credit cycle, the key question was how sharply credit growth would decelerate and to which extent the loan risks taken in previous years would materialise.

The economic cycle has reached a phase characterised by slower income growth. Therefore, it is also natural that some of the credit risk accumulated during the economic boom will materialise. The share of non-performing loans is on the rise again. So far, their share in the loan portfolio of banks operating in Estonia has been very low. Thus, the rise is quite expected and this does not jeopardise the operation of the financial system in the short term. In autumn 2007, Eesti Pank conducted a stress test of banks' lending portfolios. Based on this test, it is quite unlikely that in the coming years, loan losses will grow so much that the banks oper-

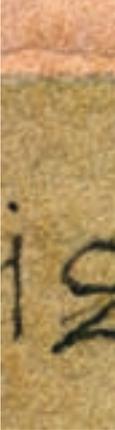
ating in Estonia will be forced to raise additional capital in order to proceed with regular operations. The capital and liquidity buffers built earlier are to alleviate the consequences of the risks that might materialise.

The global liquidity environment tightened in the second half of 2007. In relation to that, the significance of the continuous monitoring and analysis of banks' liquidity position increased. For several years, Estonia's major banks, which belong to Nordic banking groups, have been managing their liquidity primarily at the group level. Therefore, the materialisation of liquidity risk in Estonia above all depends on how and to which extent the parent banks are able to raise additional resources, if necessary. Therefore, the analysis of Estonia's banks' liquidity risk requires cross-border cooperation with institutions that exercise supervision and are responsible for financial stability in the parent bank's country. At the end of 2007, the Swedish and Baltic central banks expressed their willingness to provide to each another, in addition to regular information exchange, also latest information on the liquidity positions of different banking groups or banks belonging to groups, if necessary.

### **EU financial sector policy**

For Eesti Pank, one of the most important financial sector policy issues in EU institutions and committees in 2007 was **improving the organisation of cross-border cooperation on financial supervision in the EU**.

The problem is the current excessive decentralisation in the light of rapid cross-border financial sector integration. There are two solutions: either to head towards greater formalisation or flexible specific solutions. Estonia's financial sector mainly consists of the subsidiaries and branches of the financial intermediaries of other EU countries. Therefore, when proposing solutions and supporting initiatives, Eesti Pank has pursued the objective of achieving such an organisation of cross-border financial supervision that would best enable to protect also



the financial stability interests of the host countries. A related issue was changing the current set up of the activities of Level 3 financial sector committees (the so-called Lamfalussy framework) with regard to strengthening of the mandate and the decision-making mechanism.

Another important subject was banks' **liquidity conditions** and **organisation of liquidity monitoring and supervision**, which had emerged against the background of the uncertainty in global financial markets. So far, the legislation in this field has not been much harmonised at the EU level but closer integration calls for changes.

In addition to tackling issues related to liquidity supervision, evaluation of the need for amendments to the Capital Adequacy Directive started in 2007. From Eesti Pank's point of view, it is necessary to lay down requirements of cross-border cooperation for supervision authorities as regards systemically important branches; harmonise the definition of own funds (primarily in the case of hybrid capital instruments), and revise requirements related to risk concentration.

An important field relating to the cross-border activities of the financial sector is definitely **securities settlement, i.e. post-trading infrastructure of the securities market**. One major obstacle to creating single European capital market is the lack of interoperable securities clearing and settlement systems. The integration of securities market infrastructures in the EU fostered on the basis of a **Code of Conduct for clearing and settlement agreed upon by market participants** on the one hand, and initiatives of public institutions on the other. At the end of 2006, three bigger market participants' unions<sup>1</sup> that handle post-trading infrastructures signed the Code of Conduct. The Code focuses on three main topics: transparency of prices and services; interoperability of and access to systems, and unbundling of services and imple-

menting accounting separation. The measures in the conduct were set out to be implemented gradually by the beginning of 2008.

The most important public sector initiative for Eesti Pank in 2007 was a project of the Eurosystem called **TARGET2-Securities, a single shared platform for settlement of securities**, initiated by the European Central Bank. EU finance ministers have also expressed their support to the project. In relation to the project, two public consultations covering various interest groups were commenced. The first consultation addressed the general principles of the TARGET2-Securities platform; the second dealt with user requirements. The Eurosystem will decide on further development of the platform in summer 2008.

The goal of the institutions responsible for financial stability is to prevent financial crises. However, even with the best crisis prevention activities, there is still the possibility of a financial crisis. Thus, to ensure financial stability it is also necessary to be ready for effective crisis management.

#### **Safety net**

Failures in the functioning of the financial system may occur unexpectedly and rapidly pass on to other markets and market participants. Since a financial crisis may bring great damage to the society, public sector institutions must be well-prepared for the crisis and coordinate their activities in a crisis situation.

The tasks of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance and the foundation for their joint operation have been laid down in a **Memorandum of Understanding (MoU) on the management of financial crises** concluded at the end of 2006. Eesti Pank has also concluded multilateral MoUs with institutions responsible for the financial stability in EU countries and a MoU with the central banks of Sweden, Latvia and Lithuania.

<sup>1</sup> Federation of European Securities Exchanges (FESE), European Association of Central Counterparty Clearing Houses (EACH), European Central Securities Depositories Association (ECSDA).

The effectiveness of financial crisis management can be tested and weaknesses identified in crisis trainings. In autumn 2007, the **Nordic-Baltic regional financial crisis simulation exercise** was conducted. Participants included representatives of Nordic and Baltic central banks, supervision authorities and finance ministries. The crisis exercise gave the participants a valuable experience, pointing out different aspects that institutions should consider and for which they should be prepared when coordinating crisis management.

The development of a relevant crisis management framework to solve a banking crisis affecting several Member States is one of the most important tasks of the EU financial sector policy in the near future. In 2007, the principles of the EU cross-border Memorandum of Understanding were developed into practical recommendations, and these activities will continue in 2008.

A crucial component of the Estonian financial safety net is the **deposit guarantee schemes**. Deposit insurance is mandatory for banks operating in Estonia since 1998, and from July 2002 this issue is the responsibility of the Guarantee Fund. In addition to the Deposit Guarantee Sectoral Fund, also the Investor Protection Sectoral Fund and the Pension Protection Sectoral Fund operate at the Guarantee Fund.

At the end of 2007, the transition period agreed upon in the course of the EU accession negotiations with regard to the upper limit of coverage for deposits came to an end. Since 2008, the new upper limit of coverage for deposits in Estonia is the minimum level provided for in the EU directive, which is 20,000 euros (313,000 kroons).

### **Banking legislation**

At the end of 2007, the new regulation for the implementation and calculation of the prudential ratios of credit institutions and the consolidated groups of credit institutions (Basel II) that had entered into force on January 1, 2007 was revised. Credit insti-

tutions operating in Estonia used the opportunity to start implementing the new regulation for capital adequacy calculation from 2008. For credit institutions operating in Estonia, the receipt of permits for the introduction of more sophisticated methods for calculating capital requirements will still take some time. Therefore, the section on the risk weighting on housing loans had to be revised to establish capital requirements that would make the changeover to lower capital requirements more in line with the market situation. Instead of the 35% risk weighting on housing loans laid down by Basel II, in 2008 the credit institutions operating in Estonia have to implement a 60% risk weighting.

### **Payment and settlement systems oversight**

**There were no such incidents in the operation of the Estonian payment and settlement systems that would have jeopardised the stability of the financial sector or the smooth functioning of payment systems.** In addition to the oversight of systemically important settlement systems – the Real-Time Gross Settlement System (EP RTGS) and the Settlement System of Ordinary Payments (ESTA) managed by Eesti Pank – two new settlement services on the Estonian market were analysed. The overseer gave a positive assessment to both of them.

The first major development was made in the field of **securities settlement**. So far, financial claims and liabilities resulting from domestic securities transactions intermediated by the Estonian Central Register of Securities (ECRS) had been met only in terms of settling net positions. Since April 30, 2007 however, **the cash leg of claims and liabilities resulting from securities transactions can be settled on the basis of the Real-Time Delivery Versus Payment (RT DVP) service.** In case of a delivery versus payment settlement, the securities custodians intermediate the transfer of both the securities and the money. The purchased securities are transferred to the purchaser's securities account and the funds on the seller's settlement account



as soon as the sum has been transferred from the custodian's account of the credit institution representing the purchaser in the EP RTGS to the custodian's account of the credit institution representing the seller. As the RT DVP service reduces risks in the payment and settlement systems, the overseer considers the implementation of this service reasonable and positive.

Developing a functionality similar to the RT DVP was discussed already at the time the RTGS was introduced, but as market participants had no interest in the service at that time, it was disregarded during the launch of the RTGS at the beginning of 2002. For the smooth operation of the financial system, the functionality of the RT DVP service must guarantee that credit institutions are able to manage their liquidity themselves, which is especially crucial in the event of a crisis.

The second bigger development was the **implementation of the interbank direct debit scheme**. The absence of an interbank scheme and the resulting ineffectiveness on the retail payment market have been pointed out in the assessments of the overseer of Eesti Pank and the European System of Central Banks. Since June 14, 2007, most banks operating in Estonia have been offering the interbank use of direct debits. Above all, this has increased the effectiveness of domestic interbank retail payments. The new service enables customers to use domestic direct debits also if the accounts of the payer and the payee are not held with the same bank. The service also helps to strengthen competition in the retail payments market by improving the opportunities of smaller banks and increases effectiveness by expanding the services provided to bank customers.

## DEVELOPMENTS IN STATISTICS

Eesti Pank has applied an up-to-date, flexible and internationally compatible system for collecting, processing and publishing statistical data. This system serves as an input for monetary policy analysis and assessment of risks related to Estonia's financial and external sectors. The comprehensive and regularly updated Eesti Pank's website contains over 400 tables of data and is available to everyone.

As regards statistics, the central bank proceeds from the principles of efficiency and economic use of resources. To this end, Eesti Pank cooperates with other data collecting authorities, such as the Financial Supervision Authority, the Ministry of Finance, Statistics Estonia, etc. One of the objectives is to avoid double data collection and ensure consistency of data. Thus, Eesti Pank and the Financial Supervision Authority collect data from credit institutions within a common reporting framework and submit aggregate data also to Statistics Estonia. This way, market participants are less burdened with reporting.

The international comparability of published statistics is guaranteed through a methodology that relies on international standards and guidelines. The primary cooperation partners in this area are the European Central Bank, the European Commission and the International Monetary Fund.

### **Banking and other financial statistics**

In the field of banking and other financial statistics, 2007 was the year of **introducing changes to the reporting system**. Eesti Pank and the Financial Supervision Authority revised almost the entire set of credit institutions' reporting. Major changes were made to the forms and compilation methods of balance sheet and income statement. The new balance sheet and income statement schemes that were introduced at the beginning of 2008 are based on the Guidelines of Financial Reporting (FINREP) of the Committee of European Banking Supervisors (CEBS). FINREP draws from the international reporting standards (IAS/IFRS) and the

selections outlined there with regard to the information to be published. The compliance of forms of balance sheet and income statements submitted to Eesti Pank with the international financial reporting standards keeps the reporting burden on reporting subjects at a minimum level. The forms are virtually identical both on a solo and consolidated basis.

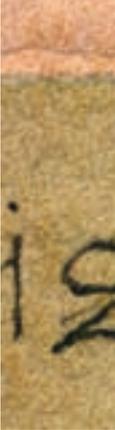
Besides the introduction of new balance sheet and income statement forms, significant changes were also made to the set of supplementary reports (solo basis), which consists of 11 reports. Since these reports provide the majority of detailed data, used for the purpose of supervision and statistics, the changes also included supplementary data requirements of the Financial Supervision Authority, Eesti Pank, Statistics Estonia and the European Central Bank.

Other major amendments were made to the reports on the prudential ratios of credit institutions, supplementary reports on the balance sheets of consolidation groups and supplementary public disclosure reports.

In January 2007, Eesti Pank started to publish **quarterly national financial accounts** on its website and submit these data to the European Central Bank. A special issue of the central bank's quarterly *The Kroon & Economy* was dedicated to national accounts and financial accounts to explain this issue in more detail.

Financial accounts are statistical statements that give a comprehensive overview of the financial assets and liabilities of every economic sector and net transactions made during the period in question. To this end, both the business entities and financial instruments have been classified on the basis of relevant international classifications to ensure comparability of data.

Financial accounts enable to analyse the financial behaviour of different sectors, assess risk concentration, etc. Currently, the published data



are relatively aggregated but will be presented in greater detail in the future. In addition, the period of publication will probably be shortened. All this should contribute to the quality of data on financial accounts. At present, Eesti Pank is constantly improving its data sources and methods of valuation of certain data to ensure high quality of statistical outputs.

Regular annual meetings on reporting between representatives of reporting agents, Eesti Pank and the Financial Supervision Authority continued also in 2007. As various extensive amendments were made in reporting in 2007, meetings with reporting agents were very useful in terms of exchanging information. Such meetings facilitate cooperation with market participants and help to plan further developments with regard to reporting.

#### **Balance of payments statistics**

In 2007, the major action lines in balance of payments statistics included the introduction of a web-based reporting portal; enhancement of cooperation with reporting agents; ensuring of methodological compliance with international standards, and improvement of the quality of initial and revised data.

At the beginning of the year, the central bank launched a **web-based system for the collection of balance of payments statistics**. First, the reporting environment was put to test but those who had subscribed to the system could already file actual reports as well. The full version of the portal was put into operation in the second quarter. The system errors detected during the testing phase were fixed and also minor additions were made to the system. Cooperation between partners proceeded smooth despite the great number of system participants (Eesti Pank, TietoEnator, Microlink, credit institutions).

In order to launch the portal, a demo was developed as well as the terms and conditions for joining the system. Then, an advertising print was prepared

and an information campaign organised to inform reporting agents about the portal (including press releases, articles, web advertisements, etc.). During the year 1,030 companies (30% of all reporting agents) subscribed to the system. A preliminary analysis showed that their culture of statistics (timely submission of reports, response rate) was higher than the average of the sample. In the long run, the central bank aims at a complete transition to web-based collection of balance of payments statistics from Estonian companies. To this end, the reporting portal will be developed further in 2008.

#### **Eesti Pank also continued close cooperation with other state agencies that collect statistics**

(e.g. Statistics Estonia, Tax and Customs Board, Ministry of Finance, Ministry of Foreign Affairs, Land Board). As Statistics Estonia shortened the period of publication of GDP from 90 to 70 days at the beginning of 2007, it was necessary to revise the dates for submission of data between the agencies. According to the new agreement between Eesti Pank and Statistics Estonia, the latter is now obliged to submit data on foreign trade and tourism services earlier. As a result, the central bank can now compile Estonia's preliminary balance of payments and submit it to Statistics Estonia within 60 days after the end of the reporting period. Eesti Pank also concluded agreements with the Ministry of Justice Centre of Registers, the Land Board and the Chamber of Notaries to receive regular and detailed information about transactions with real estate in Estonia as well as the transaction parties and real estate market prices as of the beginning of 2007. Consequently, the quality of direct investment statistics has improved significantly since then.

In 2007, the central bank reviewed the principles for the evaluation of equity and debt securities. In the case of listed companies, market prices of shares are still used for that matter. For unlisted companies, the book value of shares is applied, whereas the procedure for delisted companies foresees a gradual transition from market prices to book value over the period of four quarters. As regards

accounting of securities, nominal value based methodology was replaced by that based on accrued interests. These methodological changes affect both the international investment position and the financial account. In addition, the Bank's statistics experts explored the possibilities of better reflection of notional units in the balance of payments. To this end, they laid down the definition of notional units and mapped the related fields that are covered or uncovered in the balance of payments. The development of an evaluation model for notional units is started in 2008. For better reflection of the household sector's transactions, additional questions were added to a social survey to be conducted by Statistics Estonia in autumn 2008. These questions concern household incomes received from abroad (wages, pension, income on real estate and security investment).

In autumn 2007, a report on the quality of balance of payments statistics was drafted on Eurostat's initiative with the focus on the quality of the current account and direct investment data. The report compared preliminary statistics with most recently published data. As the results showed, the quality of Estonia's balance of payments is continuously good as later revisions have remained within acceptable limits. Furthermore, the central bank carried out a more in-depth evaluation to examine the quality of balance of payments flash estimates and quarterly time series of the balance of payments and the international investment position. The results were published in the second half of the year in an overview of statistical activities.

In the field of **international cooperation**, central bank representatives continued to participate in the ECB's Centralised Securities Database (CSDB) project. Primarily, this involved submission of data on exchange-traded shares and bond issues registered in the Estonian Central Register of Securities to the ECB. Bank's experts also took part in various

test projects related to the quality control of the CSDB.

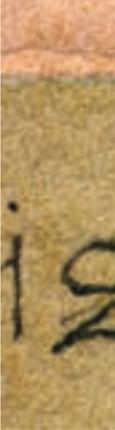
On June 20, the European Parliament and the Council adopted Regulation (EC) No 716/2007 on Community statistics on the structure and activity of foreign affiliates. This entailed new tasks for Eesti Pank. The central bank is obliged to gather statistics on Estonian enterprises' foreign affiliates outside the Community. Year 2007 is the first year to be reported on in September 2009.

In summer 2007, Eurostat conducted a survey among the agents who compile balances of payments and national accounts to explore the possibilities of simplifying the Intrastat<sup>1</sup> reporting system, while giving consideration to a transition to the so-called single flow system. To this end, the Bank's representative participated in the work of a task force called TF S-Intra doing the exploration. The task force made a proposal to the Economic and Financial Committee (EFC) of the Council to increase the exclusion threshold for declaration of imports, retain the current threshold for exports, and postpone the introduction of the single flow system to the distant future, as the system calls for smaller discrepancies in cross-border trade statistics.

Heated debates over revising the Regulation (EC No 2560/2001) on cross-border payments in euro continued in 2007. The core of the debates was the question of raising the minimum threshold of balance of payments reporting from 12,500 to 50,000 euros, considering a relevant analysis of the Parliament and the Council. Furthermore, a proposal was made to prohibit the collection of balance of payments statistics via euro payments as of 2011, as this method conflicts with the principles of the Single Euro Payments Area (SEPA). In response, the ECB presented its standpoint, which was elaborated by a task force including also a representative of Eesti Pank. Namely, the

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<sup>1</sup> Intra-Community system for declaration of goods.



ECB does not support the proposal, since the abovementioned method is the most cost-efficient way to collect such statistics. The Council and the Parliament will make the final decision on the wording of that Article in August 2008.

### **General economic statistics**

Regular submission of general economic statistics to the ECB and the BIS continued also in 2007. Another line of cooperation with the ECB was price statistics. One of the key tasks in that field was to examine the causes for the discrepancy between measured inflation and consumers' inflation expectations. Another issue examined was regulated prices, more precisely telecommunication services, in the structure of consumer price index. Based on the information from member states, the regulation of prices of telecommunication services varies largely across countries. In general, this field of services has been regulated in the EU countries, with a few exceptions (including Estonia). The ECB believes that the telecom market should be regulated uniformly across the EU and is expecting more detailed information from the national central banks with regard to the regulation of prices of telecommunication services. Eesti Pank together with Statistics Estonia and the Communications Board drafted a response to the ECB to inform the latter that the prices in questions have not been regulated in Estonia.

In order to better communicate general economic statistics to the employees of Eesti Pank, a survey was conducted in 2007 to analyse the frequency of using economic statistics and examine the main users. As a result of the survey, it was decided to reduce the number of tables of key indicators on the internal as well as public website of Eesti Pank and replace some of the existing tables with links to the website of Statistics Estonia.

# CURRENCY CIRCULATION

Well-functioning and efficient payment systems are a necessary precondition for an efficient financial system. Payment systems should meet the needs of the society as well as comply with the legal framework of a country. They should operate without any risks that might endanger the financial system. Managing and developing various payment channels, including interbank payment systems, is one of the main functions of Eesti Pank.

## DEVELOPMENT OF THE PAYMENT AND SETTLEMENT ENVIRONMENT

In 2007, the European System of Central Banks, and thus also Eesti Pank, faced a new challenge: updating of the present TARGET by developing the **TARGET2**. The TARGET is composed of the central banks' RTGS (Real-Time Gross Settlement) systems and a network linking them, whereas the TARGET2 functions on a single shared platform and provides a harmonised set of services.

The TARGET2, a new system replacing the TARGET, offers its users (credit institutions) up-to-date tools for liquidity management, including liquidity pooling within a banking group, reservation of liquidity and management of payment flows. The technological modifications of the system serve the purpose of increasing cost-effectiveness and adjusting fast to new developments, such as the enlargement of the Eurosystem. For bank customers, the new system will still be providing the possibility of making cross-border express payments in euro.

As planned, the TARGET2 was introduced on November 19, 2007, when our neighbours Latvia and Lithuania joined the system among others. Finland joined the TARGET2 in the second wave on February 18, 2008. Eesti Pank and several Estonian commercial banks<sup>1</sup> connected to the system in the third wave on May 19, 2008.

Major changes are under way also in the cross-border **retail payments market**. Under the lead-

ership of the European Payments Council (EPC), Estonian banks have been preparing to join the **Single Euro Payments Area** (SEPA). The SEPA aims at making euro payments across Europe as easy as domestic payments. This would simplify financial transactions, strengthen the European internal market and competition, and enhance efficiency. Estonian banks took the first major step towards the SEPA on January 28, 2008 by launching the service of trans-European retail payments in compliance with the SEPA standards.

On June 14, 2007, most of the banks operating in Estonia implemented the **interbank direct debit system**, which enhances the effectiveness of domestic interbank retail payments. The new service enables customers to use domestic direct debits also if the accounts of the payer and the payee are not held with the same bank. The information logistics company Itella Information AS is responsible for interbank information exchange and provision of payment information.

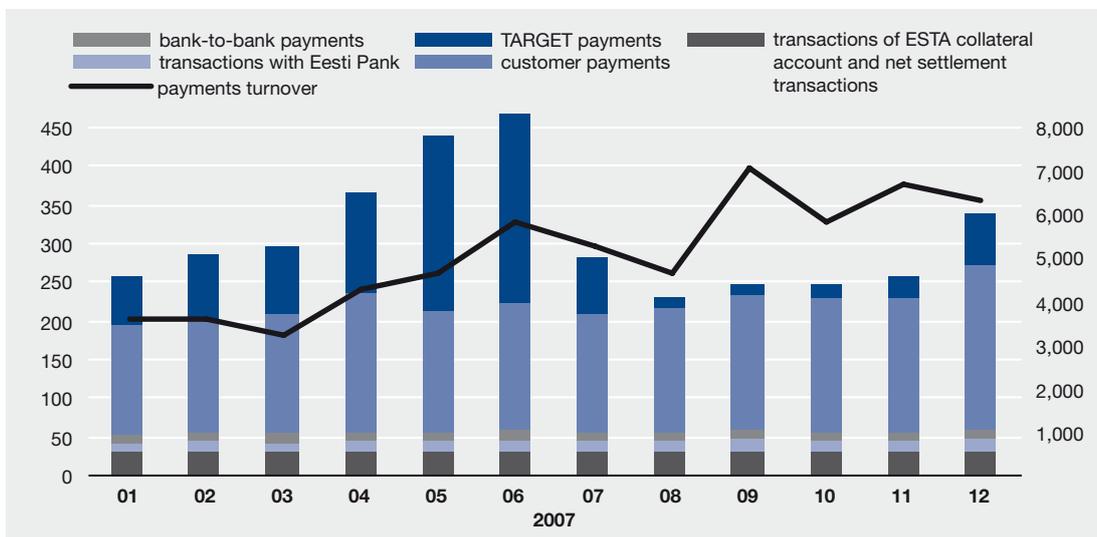
### Settlement System of Interbank Payments

The Estonian Settlement System of Interbank Payments contains two sub-systems: the Settlement System of Ordinary Payments (ESTA) and the Real-Time Gross Settlement (RTGS) System. The ESTA settles domestic interbank retail payments in Estonian kroon, whereas the EP RTGS settles domestic express payments in kroon as well as domestic and cross-border payments in euro.

The **Real-Time gross Settlement System EP RTGS** settles payments instantaneously. It takes approximately five minutes for a money transfer to be transferred from one bank to another.

The number of payments settled through the RTGS **increased 19%**, year-on-year. On average, **311 transactions a day** were settled in 2007 (see Figure 1). The growth stems from the possibility of making cross-border payments after joining the

<sup>1</sup> Hansapank, SEB Ühispank (now SEB Pank), Nordea Pank, Sampo Pank, Eesti Krediidipank, SBM Pank and Tallinna Äripank



**Figure 1. Number of payments processed in EP RTGS (left scale) by transaction types and their average daily value (EEK m; right scale) in 2007**

TARGET. In 2007, Sampo Pank settled the most transactions via the TARGET. Parex Bank and Eesti Pank made somewhat fewer settlements, and so did SBM Pank who joined the TARGET later than others, on September 17. Payments originated by bank customers form the majority (79%) of all EP RTGS payments. On average, 165 domestic and 74 cross-border customer payments were settled a day.

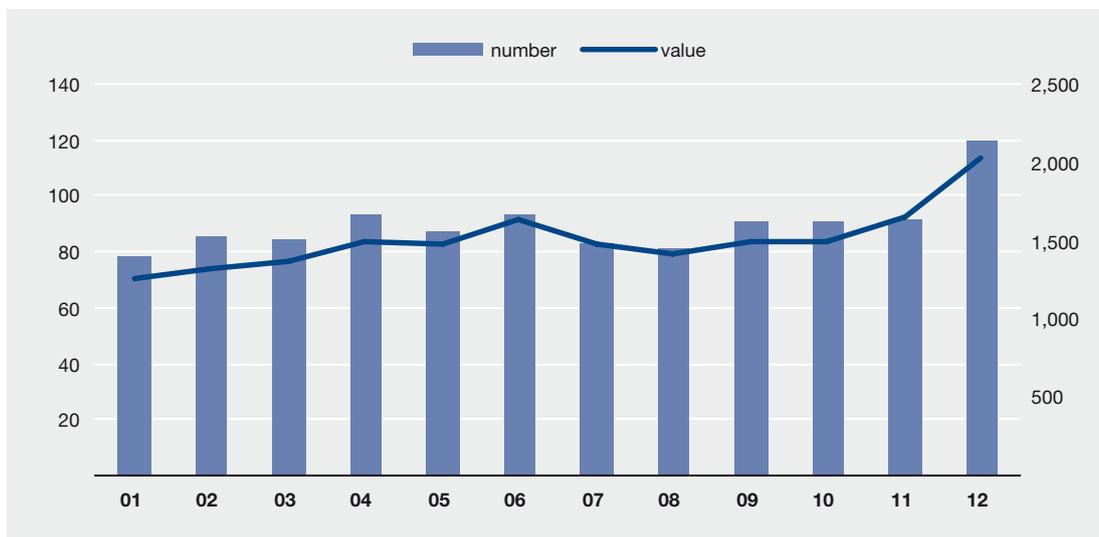
The average daily turnover of express payments stood at 5 billion kroons. In previous years, banks' "compulsory" payments (transactions related to the collateral account of the ESTA) accounted for the largest share in turnover. In 2007, however, the turnover of banks' currency purchase and sale transactions grew considerably, reaching 2 billion kroons as daily average (40% of the total turnover of transactions). Compared to 2006, the turnover of payments settled through the EP RTGS increased 69%.

The average value of domestic customer payments of the EP RTGS stood at 4.6 million kroons, whereas that of cross-border express payments in euro was 82,000 kroons.

In the **ESTA, the settlement system of retail payments**, payments made from one bank to another usually reach the beneficiary within 30 minutes but no later than in an hour and a half on a working day<sup>1</sup>.

On average, **90,000 transactions** a day were settled through the ESTA in 2007 (see Figure 2). The number of payments has increased 12%, year-on-year. An average of **1.5 billion kroons** a day were settled through the ESTA. The turnover of ESTA payments has increased 25%, year-on-year. The average payment settled through the ESTA was 16,800 kroons.

<sup>2</sup> The ESTA operates on working days from 8.15 AM to 6 PM. Payments are settled on every hour.



**Figure 2. Number of transactions processed in ESTA (thousand; left scale) and their average daily value (EEK m; right scale) in 2007**

## MEETING THE CASH DEMAND

### Banknotes and coins in circulation and their structure

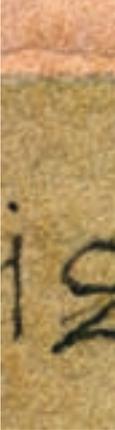
On December 31, 2007 the total amount of currency in circulation was 11,762.2 million kroons (see Table 1). 1,888.3 million kroons (16.1%) were in the

vaults of credit institutions and savings and loan associations operating in Estonia and 9,873.8 million kroons (83.9%) were in circulation outside credit institutions and savings and loans associations.

In previous years, the amount of currency in circulation increased rapidly, whereas in 2007 it decreased

**Table 1. Banknotes and coins in circulation as at end-year**

Nominal, value	Total amount (EEK m)				Number (m)			
	31/12/2004	31/12/2005	31/12/2006	31/12/2007	31/12/2004	31/12/2005	31/12/2006	31/12/2007
1, kroon	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
2 krooni	26.0	29.6	33.5	38.5	13.0	14.8	16.8	19.2
5 krooni	38.8	43.1	47.8	49.5	7.8	8.6	9.6	9.9
10 krooni	70.6	77.5	85.6	94.3	7.1	7.7	8.6	9.4
25 krooni	187.4	207.1	225.4	233.4	7.5	8.3	9.0	9.3
50 krooni	45.4	46.6	49.0	54.4	0.9	0.9	1.0	1.1
100 krooni	1,076.1	1,122.4	1,180.1	1,193.1	10.8	11.2	11.8	11.9
500 krooni	7,337.8	8,450.3	10,001.2	9,942.5	14.7	16.9	20.0	19.9
<b>Banknotes total</b>	<b>8,786.7</b>	<b>9,981.2</b>	<b>11,627.3</b>	<b>11,610.3</b>	<b>66.3</b>	<b>73.1</b>	<b>81.3</b>	<b>85.4</b>
5 senti	2.1	2.1	2.1	2.1	42.4	42.0	41.5	41.2
10 senti	11.4	12.3	13.4	14.6	113.7	123.2	134.4	146.0
20 senti	17.7	19.8	22.3	24.7	88.7	99.2	111.3	123.4
50 senti	16.4	19.1	22.1	25.1	32.9	38.2	44.1	50.2
1 kroon	46.6	52.9	61.0	69.7	46.6	52.9	61.0	69.7
5 krooni	8.1	8.3	8.5	9.0	1.5	1.7	1.7	1.8
<b>Coins total</b>	<b>102.4</b>	<b>114.6</b>	<b>129.4</b>	<b>145.1</b>	<b>325.9</b>	<b>357.1</b>	<b>394.1</b>	<b>432.3</b>
<b>Collector coins</b>	<b>5.9</b>	<b>6.0</b>	<b>6.4</b>	<b>6.7</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>
<b>Banknotes and coins total</b>	<b>8,895.1</b>	<b>10,101.7</b>	<b>11,763.2</b>	<b>11,762.2</b>				



slightly (by 1.0 million kroons). The last time this happened was in 1998 (by 47.9 million kroons). The fourth quarter was especially remarkable in that respect when currency in circulation decreased by 322.1 million kroons, instead of the usual strong growth.

This stemmed from the decline in the amount of 500-kroon banknotes, the biggest denomination in circulation. The amount of all other denominations in circulation, however, increased.

Coins in circulation continued rapid growth and amounted to 432.3 million at the end of 2007. Thus, there were already as much as 320 coins in circulation per resident.

As the share of 500-kroon notes in circulation diminished, the average calculated value of a banknote in circulation decreased by 7 kroons, year-on-year, and totalled 136 kroons at the end of 2007.

The average calculated value of a coin in circulation remained at the level of 2006 and stood at 33 sents.

#### Expert analysis and handling of cash

The central bank issued 12,474.8 million kroons to credit institutions and received 12,472.6 million kroons in 2007 (see Table 2). The figures of issued and received cash indicate changes in circulation. Compared to 2006, the amount of banknotes issued decreased by 4 million notes, remaining at the previous year's level. The amounts of cash received, on the other hand, grew considerably.

All banknotes returned to Eesti Pank are sorted with fully automatic sorting machines. Banknotes unfit for circulation are destroyed and the rest are returned to circulation. In 2007, 21.8 million banknotes in the total amount of 564.6 million kroons were withdrawn from circulation (see Table 3).

Compared to 2006, the number of unfit banknotes increased significantly in 2007: every fourth banknote was withdrawn from circulation. Over half of the unfit banknotes were 2- and 10-kroon notes, which were replaced by new ones. The decrease of 500-kroon banknotes was exceptional. As a result, also the total amount of unfit banknotes decreased year-on-year.

In 2007, Eesti Pank performed expert analyses for 5210 damaged and worn-out banknotes submitted by credit institutions and discovered 20 banknotes with counterfeit features.

All in all, 238 counterfeit banknotes were discovered in Estonia in the expertises performed by the Forensic Service Centre in 2007. 500-kroon banknotes accounted for the largest share (47.9%) of counterfeit money. Given the amount of currency in circulation (85.4 million pieces), the number of counterfeit banknotes is relatively marginal. No counterfeit coins were found in 2007.

#### Preparation of new banknotes and coins

In 2007, the central bank put into circulation 2- and 10-kroon banknotes with renewed security features. The 2-kroon banknotes were supplied by Giesecke

**Table 2. Movement of currency between Eesti Pank and credit institutions**

Year	Total amount (EEK m)		Number (m)			
	Issued by Eesti Pank	Received by Eesti Pank	Issued by Eesti Pank		Received by Eesti Pank	
			Banknotes	Coins	Banknotes	Coins
2004	8,881.7	8,306.0	93.7	26.1	90.5	0.7
2005	10,445.0	9,237.8	105.8	31.7	99.0	0.6
2006	12,399.0	10,732.5	118.6	37.5	110.4	0.7
2007	12,474.8	12,472.6	114.6	38.4	110.5	0.3

**Table 3. Banknotes unfit for and withdrawn from circulation as at year-end**

Nominal value	Total amount (EEK m)				Number (m)			
	2004	2005	2006	2007	2004	2005	2006	2007
1 kroon	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
2 krooni	0,3	0,4	0,7	14,1	0,2	0,2	0,4	7,0
5 krooni	10,0	9,3	6,3	16,5	2,0	1,9	1,3	3,3
10 krooni	5,0	5,3	2,9	61,3	0,5	0,5	0,3	6,1
25 krooni	14,4	13,5	16,3	47,3	0,6	0,5	0,7	1,9
50 krooni	27,2	10,6	12,4	16,0	0,5	0,2	0,2	0,3
100 krooni	74,0	74,7	63,7	284,6	0,7	0,7	0,6	2,8
500 krooni	701,6	751,0	537,9	124,8	1,4	1,5	1,1	0,2
<b>Total</b>	<b>832,6</b>	<b>864,7</b>	<b>640,2</b>	<b>564,6</b>	<b>6,0</b>	<b>5,6</b>	<b>4,5</b>	<b>21,8</b>

& Devrient (Germany) and the 10-kroon notes by De La Rue Ltd (United Kingdom).

In order to renew banknotes in circulation and raise their quality, Eesti Pank made procurements for new 100- and 500-kroon notes. The new banknotes were delivered to Eesti Pank by Giesecke & Devrient (Germany), the winner of adjudication.

Moreover, new coins were procured:

- 10-sent coins from Staatliche Münze Baden-Württemberg (Germany);
- 20-sent coins from Staatliche Münze Baden-Württemberg;
- 50-sent coins from Monnaie de Paris (France);
- 1-kroon coins from the Koninklijke Nederlandse Munt (Netherlands).

In 2007, the central bank issued a gold collector coin with the nominal value of 100 kroons to celebrate the 15th anniversary of the monetary reform and re-adoption of the kroon. This coin differs from all earlier collector coins for its triangular shape. It is unique since triangular coins are quite rare in the world. The coin depicts the national flower of Estonia – the cornflower. The coin was designed by Ivar Sakk. It was minted by the Mint of Finland Ltd. in the total amount of 6,000 pieces.

# ORGANISATION AND COOPERATION

## INTERNATIONAL COOPERATION

The developments taking place in Estonia, a small and open economy, are normally closely tied to external processes. All the principal fields of activity of Eesti Pank are involved in international cooperation. The central bank's international communications play an important role in protecting Estonia's economic policy interests and explaining the problems related to the country's economic development to the international public and foreign investors.

**Eesti Pank's international communication framework** includes regular economic policy reviews of various countries and regions (especially EU Member States and Estonia's neighbouring countries); discussions to prepare for the meetings of EU committees and working groups and to obtain an overview of recent developments; management of the external communication database and participation in various meetings and events. Prior to sessions of high-level bodies, working meetings are held where experts from different departments together with Eesti Pank's representatives

attending such sessions discuss relevant information, specify the national positions and, if necessary, make proposals for comments.

Communication with various **European institutions** and participation in EU meetings constitute the largest share of Eesti Pank's external communication and provide an additional dimension to cooperation with the central banks of Estonia's neighbouring countries. The **central banks of the Nordic and Baltic States** have held a special place among the communication partners of Eesti Pank for nearly fifteen years already. Several joint seminars of the Baltic central banks and meetings at the level of presidents and vice presidents were held also in 2007. The traditional high-level joint seminar with Suomen Pankki (Bank of Finland) was held in Helsinki this time. The seminar covered Finland's and Estonia's economic developments and economic policy and issues related to the integration of the Nordic and Baltic financial sector, focusing mainly on challenges that it offers to the central banks and financial supervision authorities.

**Table 1. Eesti Pank's participation in the work of international organisations and institutions  
Cooperation bodies of the Council of the European Union**

<b>Cooperation bodies of the Council of the European Union</b>	<ul style="list-style-type: none"> <li>• Informal Council of Economics and Finance Ministers</li> <li>• Economic and Financial Committee</li> </ul>
<b>Cooperation bodies of the European Commission</b>	<ul style="list-style-type: none"> <li>• European Banking Committee</li> <li>• Committee of European Banking Supervisors</li> <li>• Committee on Monetary, Financial and Balance of Payments Statistics</li> <li>• Balance of Payments Committee</li> </ul>
<b>Cooperation bodies of the European System of Central Banks</b>	<ul style="list-style-type: none"> <li>• General Council of the European Central Bank</li> <li>• Accounting and Monetary Income Committee</li> <li>• Banking Supervision Committee</li> <li>• Banknote Committee</li> <li>• External Communications Committee</li> <li>• Human Resources Conference</li> <li>• Information Technology Committee</li> <li>• Internal Auditors Committee</li> <li>• International Relations Committee</li> <li>• Legal Committee</li> <li>• Market Operations Committee</li> <li>• Monetary Policy Committee</li> <li>• Payment and Settlement Systems Committee</li> <li>• Statistics Committee</li> </ul>
<b>International Monetary Fund (IMF)</b>	<ul style="list-style-type: none"> <li>• Board of Governors of the IMF</li> <li>• Nordic-Baltic Monetary and Financial Committee, incl. the Committee of Alternates</li> <li>• Meetings of coordinators of the Nordic-Baltic Constituency</li> </ul>
<b>Bank for International Settlements (BIS)</b>	<ul style="list-style-type: none"> <li>• Board of Governors of the BIS</li> <li>• Meetings of BIS central bank governors</li> <li>• BIS Monetary Policy Working Party</li> <li>• Meetings of Coordinators of Technical Assistance, organised by the BIS</li> </ul>

### **Regular cooperation with European Union institutions**

Eesti Pank's representatives participate in around seventy committees and working groups set up by the European System of Central Banks (ESCB), the Council of the European Union or the Council of Ministers and the European Commission (see Table 1). In 2007, Eesti Pank executives and experts participated in about 260 meetings in various EU institutions. Collaboration in committees and working groups provides a good opportunity to the Member States for discussing their political and expert views, enabling each participant to substantiate and clarify their standpoints.

### **European Central Bank**

The European Central Bank (ECB), where euro-area monetary policy decisions are made, is the most significant cooperation partner for Eesti Pank in the EU. Eesti Pank is a full member of the European System of Central Banks.

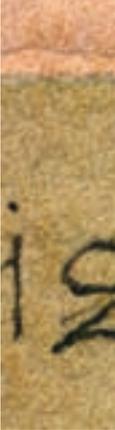
Until Estonia has not yet adopted the euro, the main fields of cooperation are the economic policy of the EU, the monetary policy of the non-euro area countries, and preparations for the euro area enlargement, including drafting of the so-called Convergence Report – an account of meeting the euro area accession criteria. The Governor of Eesti Pank participates together with the governors of other EU national central banks (NCB) in the meetings of the ECB General Council, which are held four times a year. Day-to-day cooperation takes place in the thirteen committees of the ESCB and their substructures, where common analyses are composed, information exchanged and preparations for the work of the decision-making bodies – the Governing Council and the General Council of the ECB – are made together with representatives of NCBs. The committees cover all the fields of activity of the central bank. In 2007, representatives of Eesti Pank took part in over 230 working meetings, which shows that cooperation is very close.

### **Selection of the key topics covered in the ECB meetings in 2007**

**Selection of a suitable economic policy strategy in an economy converging towards the EU level.** In 2007, EU institutions expressed continuous interest in Member States' economic policy strategies in the period of nominal convergence. As a result of the discussions, it was found that the economic policy package ensuring stable and sustainable development still depends on the specifics of each country. Fiscal and structural policy measures as well as the preventive and supervisory measures of the financial sector were regarded as very important.

Eesti Pank considers the measures taken by new EU countries to ensure stable economic development important, as they facilitate the recognition and shaping of best practice and policies in the Member States. The Estonian central bank explained Estonia's economic developments in 2007 and the importance of supporting the ongoing smooth economic adjustment. Estonia's economy is based on the currency board arrangement, which means that the fixed exchange rate allows to maintain long-term inflation low.

**Economic policy framework ensuring the exchange rate stability and the flexibility of the economy and markets (incl. the labour market) within the exchange rate mechanism ERM II.** Once a year, the ECB assesses the functioning of the exchange rate mechanism ERM II and the fulfilment of commitments by the countries who have joined the ERM II. The report prepared by the ECB analyses the economic developments of the ERM II member countries with the aim of assessing their readiness to join the euro area. Estonia joined the ERM II on June 28, 2004 and has not encountered any difficulties during the time of participation so far. In 2007, the topic of ERM II was added also to the agenda of the meetings of the Council of the European Union (see page 64).



### **Aspects of the Economic and Monetary Union in the EU Lisbon Treaty.**

On December 13, 2007 EU leaders signed the Lisbon Treaty, which will become the new founding treaty of the European Union. EU leaders have expressed their expectation that the Treaty will enter into force before the next European Parliament elections in June 2009. Estonia intends to ratify the Lisbon Treaty in the first half of 2008.

The ECB has stated that the changes in economy and finance brought about by the new Treaty are rather institutional and that, in general, the Treaty supports the current structure of the Economic and Monetary Union. The ECB is one of the seven main institutions of the European Union and maintains its independence under the new Treaty as well. The Lisbon Treaty has separate provisions for the euro area countries. At the same time, the role of the so-called Eurogroup (finance ministers of the euro area) in the decision-making process will increase and strengthen.

### **Uncertainty in financial markets started in summer 2007.**

Problems that arose in summer 2007 in the US real estate and financial sector rapidly spread also to the European financial markets. The assessment of the positions of European banks exposed to the risks surrounding the US real estate market through complicated financial instruments became impossible, which is why trust between market participants faded, the money market shrunk and the ECB was forced to make several liquidity injections into the market. Europe's economic outlook is still considered to be relatively good, although the slowdown in US economic growth and continuous decline of the dollar are undoubtedly risk factors. Despite the ECB's concern about inflation pressures, it was decided to suspend the upward cycle of interest rates until the influence of the financial crisis on real economy has become clear.

### **Council of the European Union**

Besides participating in the cooperation bodies of the European System of Central Banks, Eesti Pank's representatives also partake in the work of committees and working groups set up by the **Council of the European Union**, i.e. the Council of Ministers. For example, in April and September 2007, the Governor of Eesti Pank attended the informal meetings of the **Economic and Financial Affairs Council (ECOFIN)**. Subjects of discussion included the European and global economic situation and outlook; issues related to the EU financial stability, such as harmonisation of the supervisory practices of the EU financial sector and financial crisis management; the code of conduct for the securities clearing and settlement approved under an agreement between the market participants; rationalisation of public finances, and formation of common positions for the annual meeting of the International Monetary Fund.

In addition, central bank experts advise the officials of the Ministry of Finance participating in the monthly ECOFIN meetings in matters within the competence of Eesti Pank. In 2007, such matters included ensuring the sustainability of public finances against the background of ageing population; assessment of Member States' economic policy; preparation and fundamental approval of the code of conduct for the EU securities payment and settlement system; creation of the Single Euro Payments Area; cross-border mergers and acquisitions in the financial sector; financial markets supervision and cross-border crisis management.

One of the most important substructures of the Council of the European Union, where Eesti Pank's representatives participate, is the **Economic and Financial Committee (EFC)** and its working groups dealing with issues of international economy and coins. Since the EFC prepares the meetings of the Council of Economic and Financial Ministers (ECOFIN), all important ECOFIN issues were also discussed in the meetings of 2007. One of the main

<sup>1</sup> Since Estonia's accession to the EU, Eesti Pank has been taking part in the work of the so-called transition body or General Council of the ECB, where representatives of the NCBs of all EU Member States participate.

discussion subjects was the harmonisation of the supervisory practices of the EU financial sector and financial crisis management.

### **Selected topics on the 2007 agenda of the Council of the European Union**

#### **Economic situation in the European Union.**

Eesti Pank's statements concentrated mainly on topics related to the economic policy of Estonia and other ERM II members, including long-term fiscal sustainability, inflation and structural policies, developments in the credit and real estate markets and their influence on the economy.

**Euro area expansion.** In 2007, the economic development of several new EU Member States was assessed in special convergence reports prepared at their request. Eesti Pank finds that it is in the interests of the entire EU that expansion of the euro area should take place in compliance with the provisions of the Treaty establishing the European Community and according to uniform rules. Otherwise, the credibility of the euro as an international reserve currency would be compromised.

Eesti Pank observed closely the economically meaningful interpretation of the criteria for joining the euro area at different meetings in Estonia as well as in the EU. Eesti Pank considers it important that the concept of ERM II commitments would be objective and that the interpretation of the criteria would not become restrictive. The importance of the equal treatment of the old and new Member States must also be stressed.

#### **Strengthening the EU financial stability framework.**

Finance ministers and representatives of Eesti Pank and supervision authorities have been discussing prevention of financial crises and organisation of crisis cooperation for years already. The topicality of this issue increased along with the uncertainty in global financial markets that had started in 2007 and by related implications on the EU monetary system. In October 2007, the finance ministers agreed on further steps to be taken by

the Member States and the European Commission. Planned activities cover the period 2007–2009. Supervisory issues were also discussed in 2007 and in connection with that, decisions were taken at the December meeting of ECOFIN to improve the so-called Lamfalussy framework (for more details, see “Ensuring financial stability” p. 47).

#### **Cross-border cooperation and division of tasks between financial supervision authorities in the European Union.**

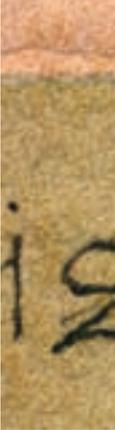
Given the specifics of Estonia's financial system, it is vital for us to enhance cross-border cooperation in financial supervision. Eesti Pank supports the approach that requires clear division of roles between the home and host country's (Estonia's) national institutions in organising supervision related to cross-border banks and in managing financial crises. The central bank also supports consistent implementation and development of the Lamfalussy framework, including strengthening cooperation in supervision at the EU level (for more details, see “Ensuring financial stability” p. 47).

#### **Common position of the EU on issues of the International Monetary Fund.**

In 2007, Eesti Pank participated actively in various discussions on topics like IMF quotas, representation in the IMF and strengthening the monitoring of economic policy in the Member States. Eesti Pank was similarly involved in the spring and autumn meetings of the IMF's International Monetary and Financial Committee (IMFC), where common positions of the EU were specified.

#### **Statistics.**

For years Eesti Pank has supported the development and application of best practices in the field of statistics. A lot of attention was paid to the quality of statistics and its harmonisation in all EU countries also in 2007. In addition, the Bank supported efficient use of resources for collecting, processing and publication statistics by defining specific priorities for that purpose (for more details, see “Developments in statistics” p. 52).



### **European Commission**

Representatives of Eesti Pank participate in the Banking Advisory Committee, Banking Supervisory Committee, Balance of Payments Committee, and Committee on Monetary, Financial and Balance of Payments Statistics set up by the European Commission, as well as in working groups covering statistics, economic forecasting, payment systems, banking issues, issuance of banknotes and coins, counterfeit money, and communication.

Regular meetings with Commission experts take place twice a year to discuss Estonia's economic outlook and specify the forecast assumptions drawn up for all Member States by the Commission.

### **Role of Eesti Pank after the adoption of the euro**

Until accession to the euro area, Eesti Pank is in charge of implementing Estonia's monetary policy, arranging currency circulation, contributing to financial stability, and ensuring the operation of reliable and well-functioning payment and settlement systems. The goal is to maintain the stability of the economy and the Estonian kroon, which form the foundation of a strong state.

When Estonia adopts the euro, the tasks of Eesti Pank will be largely the same, but the international significance of the institution will increase, as Estonia starts to participate in the euro area financial policy making hand in hand with other national central banks and the ECB. Eesti Pank is currently responsible for ensuring the reliability of the Estonian kroon, whereas in the future, the central bank will be engaged in ensuring the reliability of the euro. As transition to the euro means that one currency will be replaced by another one, the issuer of the euro in Estonia will be Eesti Pank as agreed with the European Central Bank.

Eesti Pank will continue to perform all the tasks of a central bank in the Eurosystem. The objective of the euro area national central banks is to ensure price

stability and to this end they implement the single monetary policy in the euro area. Eesti Pank will be participating in the monetary policy decision-making (e.g. fixing of interest rates), where the Governor of Eesti Pank as a member of the Governing Council of the ECB<sup>1</sup> has the same role as, for example, the Governors of the Deutsche Bundesbank or Banca d'Italia.

Eesti Pank is already analysing the economic indicators of Estonia as well as the rest of the world. Euro area membership and participation in the euro area monetary policy decision-making means that the central bank will have to deepen and expand international economic analysis even further. As a member of the euro area, Eesti Pank will participate in the joint management of reserves and development of settlement systems.

As a member of the Eurosystem, Eesti Pank will maintain its important role in communication with other central banks and international organisations (e.g. the IMF, rating agencies).

Eesti Pank will be ensuring the smooth operation of payment and settlement systems also in the future so as to guarantee fast and efficient inter-bank transfers, contribute to the sustainability of the financial system, and compile Estonia's balance of payments.

### **Cooperation with the International Monetary Fund**

The International Monetary Fund is a very important forum of international cooperation involving most of the countries in the world (185 to be more specific). The main objectives of the IMF include ensuring the stability of the international monetary and financial system, supporting stable and sustainable economic growth, and through this, preventing financial and balance of payments crises, and promotion of international trade. Eesti Pank is responsible for representing the interests of Estonia in the IMF.

The Governor of Eesti Pank is a member of the highest decision-making body of the IMF, the **Board of Governors**, which makes him the Governor of Estonia, and the Secretary General of the Ministry of Finance is the alternate member of the Board of Governors, or the Deputy Governor of Estonia. Both members attend the IMF Annual Meeting every year. The **International Monetary and Financial Committee** (IMFC), the advisory board to the Board of Governors, meets twice a year (in April and September).

Day-to-day cooperation with the IMF is conducted, first and foremost, through the **Nordic-Baltic Constituency** representing inter alia Estonia. The Constituency includes eight countries (Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden) that elect a common representative to the Executive Board of the IMF. As of January 2007, the position of the Director of the Constituency has been held by a Swedish representative Jens Henriksson. To participate in the daily decision-making process of the IMF, the Constituency coordinates the positions of the eight countries on issues discussed in the Executive Board.

The strategic issues and related problems within the sphere of interests of the **Nordic and Baltic countries are discussed twice a year in the Nordic-Baltic Monetary and Financial Committee** (NBMFC). Each constituent country is represented in the Committee by a representative of the government and of the central bank. The experts daily involved in coordinating the work of the Constituency, i.e. the coordinators, meet once a year.

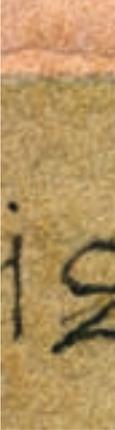
In 2006, the IMF approved of a new strategy, which brings along changes in both the day-to-day work in achieving the key objectives of the Fund and the operating principles of the organisation. A major part of the IMF's activities is related to **monitoring the economic policies** of its member countries. The implementation of the new strategy includes streamlining the policy and methods for monitoring.

The main objective is to facilitate the ensuring of external stability.

Preparations to change the operating principles of the IMF are currently under way. At the Annual Meeting 2006 held in Singapore the member countries decided to **reform the system of quotas and voting power**. The aim is to simplify the formula used for calculating quotas, increase quotas for under-represented countries and also the role of basic votes, which will bring about a change in the IMF Articles of Agreement. This presumes an approval from the parliament in several member countries, including Estonia. Discussions to change the operating principles of the IMF continued also in 2007. At the 2008 spring meeting of the International Monetary and Financial Committee (IMFC), final proposals as regards the IMF's income model as well as reform of quota and voting power will be made; these proposals are expected to be approved at the annual meeting in autumn.

**In the framework of cooperation in monitoring between the IMF and Estonia**, the representatives of the IMF paid one visit to Estonia in 2007. On May 2–14, regular economic policy consultations were carried out under Article IV of the IMF Articles of Agreement. After a discussion in the IMF Executive Board, the main report and a report dealing with special issues of the Estonian economy based on these consultations were published on the websites of both the IMF and Eesti Pank. The next IMF spring mission to Estonia takes place in May 2008.

**Selected topics from the International Monetary Fund forums in 2007**  
**Economic developments in the new EU Member States.** One of the topics attracting a lot of attention was identification of the specifics of economic developments in Estonia and other rapidly growing countries that are catching up with the average living standard in the European Union. Inflation and current account developments



in countries with fixed exchange rate were similarly explained.

Eesti Pank has discussed these questions with the IMF analysts, has submitted statements for the IMF World Economic Outlook but also concerning specific research papers of the IMF, and has invited the IMF representatives to introduce their positions on topics important to the economic policy conducted in Estonia. In November 2007, Philip Schellekens and Juha Kähkönen, representatives of the IMF European Department, gave a presentation in Tallinn on the growth outlook for the Central and Eastern European countries.

**IMF reform.** The distribution of the IMF quotas and voting power is an important issue for Estonia. The current quota for Estonia is approximately 84% lower than it would be according to the quota formula. The ongoing discussion on increasing the role of basic votes supports strengthening the voting power of smaller and less advanced countries. The reform of quota and voting power is planned to be finished in 2008, after which the current participation of the IMF member states will be adjusted according to the new quota formula. Changing the quota formula would increase Estonia's quota as well.

**Changes in the principles of funding IMF's administrative costs.** The planned changes may bring about the establishment of principles that differ from those used so far in obtaining funds from the member countries. As a member of the Nordic-Baltic Constituency, Estonia has supported zero per cent real growth of the Fund's budget and a more transparent funding of different fields of activity.

**Economic policy monitoring in member countries.** In June 2007, the new Decision on Bilateral Surveillance, which included also specifications of the exchange rate policy surveillance, was approved by the Executive Board of the IMF. In principle, the IMF is now obliged to clearly assess in the final report of every Article IV consultation, whether and how much a country's real exchange rate is over-

estimated or underestimated as far as long-term balance is concerned, and whether a country's external position (current and capital accounts) is in line with economic development. In conclusion, the IMF assesses whether the country's exchange rate policy is in compliance with the objective of maintaining stable economic development and external balance.

**Crisis prevention.** The uncertainty in financial markets that started in the summer months of 2007 has led the IMF to actively participate in discussions on the liquidity and risk management of the global financial sector and also on financial sector supervision. According to the IMF, both the market participants and supervision authorities should learn from the current problems. Above all, the IMF has stressed that better information on the positions of financial institutions and on the development of the prices of financial instruments is required.

In the field of crisis prevention, work continued on the development of a new credit line, which would serve as a kind of security instrument and would help the developing countries with strong economic policy to avoid liquidity crises.

#### **Cooperation with rating agencies**

Since 1997, Estonia is being assessed by three major international rating agencies: Moody's Investors Service, Standard&Poor's and Fitch-Ratings. Eesti Pank manages relations between Estonia and the rating agencies. This includes rating agencies' visits once a year and day-to-day communication with the analysts (for more details, see "Sovereign rating" p. 115).

## COOPERATION WITHIN ESTONIA

Experts and executives of Eesti Pank participate in different cooperation bodies in Estonia (see Table 2).

The quarterly four-partite meetings held on Eesti Pank's initiative, where officials of the central bank, the Ministry of Finance, the Ministry of Economic Affairs and Communications and the Prime Minister's Office discuss various topical issues of economic policy, serves as an example of domestic high-level cooperation. Issues covered include the economic situation and forecast, budget strategy, financial stability, Estonia's labour market situation, etc. Joint committee meetings of Eesti Pank, the Ministry of Finance and the Financial Supervision Authority on financial sector policy issues should also be mentioned here.

Eesti Pank participates in the committee of experts chaired by the Ministry of Finance, which deals with preparations for the adoption of the euro in Estonia. In 2007, Eesti Pank together with representatives of other state institutions and the private sector continued with preparations in the field of communication on the changeover to the euro. The communications working group under the expert committee for the euro changeover, which was established in 2004 by the Government to ensure a smooth adoption of the euro, had regular discussions on the issues related to informing the public and updated the communication action plan. Technical preparations for starting the euro campaign continued at the beginning of 2007.

The presidency of the European Union changes in every six months. National policy priorities and short-term objectives are always determined for the new presidency period. The Government's long-term objectives are established in a three-year framework programme to achieve Estonia's general objectives in the European Union. For the national coordination of participation in the EU decision-making process, the European Union Coordination Council has been set up. Eesti Pank participates in the work of that council. The Council deals with the coordination of the transposition of European Union legislation and the discussion of EU-related positions submitted to the Government, solves problems between state agencies and exchanges information on EU-related matters.

### Cooperation with the Office of the President of the Republic

A member of the Executive Board of Eesti Pank, Märten Ross, is a member of President's Academic Advisory Board. Members of the Executive Board of Eesti Pank also accompanied the President during state visits; for instance, in 2007 a visit was paid to Georgia.

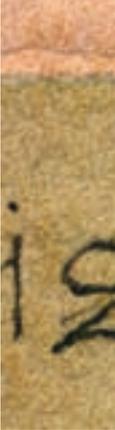
### Cooperation with the Ministry of Finance

Eesti Pank and the Ministry of Finance cooperate on a daily basis in legislative drafting, international communication and several other fields.

Similar to previous years, a joint seminar of Eesti Pank and the Ministry of Finance was organised in 2007, this time on the fulfilment of the Maastricht inflation criterion.

**Table 2. Eesti Pank's participation in internal cooperation**

- European Union Coordination Council
- Lisbon Working Group
- Expert committee for the euro changeover
- Working Group on Financial Services Legislation
- Coordination committee for the prevention of money laundering
- Development Cooperation and Development Assistance Working Group
- Accession negotiations committee of the Organisation for Economic Cooperation and Development (OECD)
- Working group for the development of national positions for representing Estonia in the European Commission, the European Court of Justice and the Court of First Instance
- Working group for the future enlargement of the European Union



### **Cooperation with the Financial Supervision Authority**

In December, Eesti Pank, the Financial Supervision Authority and the Ministry of Finance updated the three-party Memorandum of Understanding (MoU) that determines the division of tasks between state agencies in financial crisis management and lays the foundation for developing financial sector related legislation and procedures. National MoUs on crisis management are an integral part of the EU crisis management framework.

Cooperation with the Financial Supervision Authority operating by Eesti Pank has focused on monitoring financial system developments, discussions on financial sector regulation and, to a large extent, also on international cooperation. In the latter case the joint activities of Eesti Pank and the Financial Supervision Authority are similar to those of the central bank and the Ministry of Finance: if necessary, joint preparations are made for meetings with foreign experts (e.g. officials from the International Monetary Fund or rating agencies) or for participation at meetings of EU institutions.

### **Cooperation with the Estonian Banking Association and Estonian banks**

In 2007, there were several high-level meetings with members of the Estonian Banking Association; that is, representatives of commercial banks operating in Estonia. These meetings form a basis for cooperation and information exchange with the private sector. Experts of commercial banks often meet with representatives of Eesti Pank in order to specify the technical issues related to the development of the Estonian banking infrastructure.

## **PUBLIC RELATIONS AND COMMUNICATION**

The main objective of central bank communication is maintaining relations with financial markets and other important target groups. Markets observe central bank communication and shape their expectations according to the relevant messages.

Eesti Pank operates in the framework of the currency board system with a fixed exchange rate.

**The objective of central bank communication is to support with its messages the stability of Estonia's monetary system, economy and financial system.** The strategic objectives of the bank and the organisation's understanding of the central bank's role form the basis for communication.

The communication policy of Eesti Pank proceeds from the following objectives:

- To ensure public understanding of and sufficient support to the monetary policy pursued by the central bank;
- To maintain and value the reputation of Eesti Pank as a competent, independent, and credible institution that plays a significant role in guiding Estonia's economic policy and economic development, whose activities are transparent and monitored, and that is willing to communicate with all social groups;
- To ensure the best possible access for economic agents to background information necessary for making economic decisions.

### ***Principles of informing the public***

Transparency and reliability are vital in the central bank's activities. The general public but also more specific target groups, both domestic and foreign, must be able to receive regular, sufficient and high-quality information on economic policy from Eesti Pank.

Eesti Pank has undertaken the commitment to notify the public of Estonia's economic situation and developments at least six times a year. The notification includes Eesti Pank's economic forecasts presented twice a year and more in-depth financial stability reviews.

The central bank considers it important to provide as up-to-date information as possible in the most convenient and the least expensive way. For example, Eesti Pank's regular publications are

free of charge for subscribers and among others all the county libraries receive them. In addition to various publications and information published on the website it is possible to send direct inquiries to Eesti Pank. Information can be requested by mail, e-mail or phone. In 2007, Eesti Pank received 2,440 inquiries, 72 of which were registered as requests for information.

### **Media relations and public appearances**

Approximately 4100 writings, news texts, radio and TV news reflecting the activities of Eesti Pank and its economic policy standpoints were published or released in the Estonian media in 2007. The central bank held 7 press conferences, issued 98 press releases, 37 statements and a large number of interviews and answers to inquiries. Moreover, 13 economic policy articles were published.

In 2007, the media focused mainly on issues related to the general development of the economic environment. When in the first half-year, the media focused mainly on the loan market (real estate market and interest rates), in the second half-year, it concentrated mostly on the slowdown in Estonia's economic growth. But the event that was addressed the most at the end of the year was the panic in connection with the alleged devaluation of the kroon, which managed to excite even the international media. Opinions of the IMF and rating agencies on the Estonian economy also deserved a lot of attention, as did the labour market issues.

During the year, central bank representatives made presentations at a number of conferences and events mainly on the topics of the current economic situation and the economic development in Estonia.

On 23 May 2007, Eesti Pank held an international conference titled "Opportunities of the Estonian Economy in Global Competition" to mark the 15th anniversary of the re-establishment of the Estonian kroon. Presentations and discussions were focused

on the opportunities of Europe in the context of international competition, about which the views were expressed by the representatives of international institutions, and on the competitiveness of Europe and the Nordic-Baltic region, which was discussed by the representatives of the private sector.

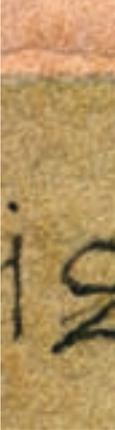
The conference started an annual series of lectures dedicated to the internationally renowned Estonian economist Professor Ragnar Nurkse. The first economic policy lecture was delivered by Siim Kallas, European Commission Vice-President.

Top-level speakers from Europe, the United States and China participated in the conference. The conference was attended by the representatives of international organisations, Estonia's public and private sector, financial institutions, academic institutions, and the press.

On September 8, the sixth Open Door Day of Eesti Pank took place, which was also dedicated to the 15th anniversary of the Estonian kroon. During the four-hour event, visitors could get acquainted with Eesti Pank and its activities, have conversations with the employees and executives of the central bank on topical economic issues, mint coins and do many other things. The Open Door Day of Eesti Pank was visited by more than 1,100 people.

The opening of the memorial stone in Käru in the honour of the 100th anniversary of birth of the economist Ragnar Nurkse also took place in autumn. The event was initiated and organised by Eesti Pank.

In the second half-year, a photo gallery of the members of Otto Tief's Government was opened in Eesti Pank to celebrate the 63rd anniversary of the establishment of Otto Tief's<sup>2</sup> Government. The portraits of fifteen members of the Government were set up in the room where the then Government was established and where it held its meetings. The room is in the former Maapank building, which is now the oldest building in the Eesti Pank quarter.



In 2007, Eesti Pank participated also in the Investment fair in October, where bank representatives introduced the Bank's activities and the history of money, and made a presentation, which turned out very popular.

### **Museum of Eesti Pank**

In 2007, it was the 10th anniversary of the Museum of Eesti Pank: on June 12, 1997 the Museum opened its doors to visitors.

The mission of the Museum is to introduce to the public the functions of Eesti Pank as the central bank of the Republic of Estonia and as a central bank of the EU member countries, to record the history of Eesti Pank and to collect, preserve and introduce the means of payment in circulation in the Republic of Estonia from 1918 until today.

The permanent exhibition reflects the history of Eesti Pank and provides a thorough introduction to different currencies that have been in circulation in the territory of Estonia since the establishment of the Republic of Estonia.

The Museum has 55.5 metres of exhibition area; the permanent exhibition presents 418 museum objects. The Museum's fund has currently 7,587 museum objects, including a collection of most of the different currencies that have been in circulation in Estonia in different times.

The Museum also sells commemorative coins and banknotes and provides the publications issued by Eesti Pank. The sales turnover of 2007 was about 6.5 million kroons.

In the jubilee year, the Museum opened three temporary exhibitions.

From March 21 until April 21, there was an exhibition titled "**Estonian honorary decorations – selection of honorary decorations of agencies and organisations**". The exhibition displayed a selection of the honorary decorations of the Defence Forces of Estonia, the National Defence League, the Female Civil Defence, the Rescue Board, the Border Guard Administration, the Police Board and other institutions as well as honorary decorations of local governments, citizens' associations and other organisations.

On June 12, the 10th anniversary of the Museum of Eesti Pank, the Museum opened an exhibition titled "**Designs of the Estonian kroon**", dedicated to the 15th anniversary of the Estonian kroon. The exhibition gave an overview of entries received for the design competition for Estonian banknotes in 1989. On the birthday week, the Museum also opened its jubilee exhibition "**Exhibition of exhibitions**", which gave an overview of exhibitions that had taken place over the last ten years.

From November 2007 until February 2008, there was an exhibition on the history of Latvian money from ancient times to today. The visiting exhibition "**Money in Latvia: History and Today**" was prepared in cooperation with Eesti Pank, the National History Museum of Latvia, the Bank of Latvia and the Latvian Embassy in Estonia.

In 2007, the Museum of Eesti Pank was visited by over 6,500 people.

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<sup>2</sup> Prime Minister of the last Estonian Government before Estonia regained independence from Soviet occupation

## **GOVERNANCE, ORGANISATION AND PERSONNEL POLICY**

### **Eesti Pank's governing and decision-making bodies**

#### ***Supervisory Board of Eesti Pank***

Pursuant to the Eesti Pank Act, the **Supervisory Board of Eesti Pank** is the highest body of Eesti Pank, exercising supervision over all activities of the central bank. The Supervisory Board of Eesti Pank has the exclusive competence in the following issues:

- making a proposal to the President of the Republic for appointment of the Governor of Eesti Pank;
- Appointment to office and release of Deputy Governors of Eesti Pank, heads of the independent divisions and representative offices and Head of the Internal Audit Department of Eesti Pank, as well as the two members of the Supervisor Board of the Financial Supervision Authority<sup>1</sup> appointed by Eesti Pank on the proposal of the Governor of Eesti Pank;
- Approval of the Statute of Eesti Pank, the statutes of its independent divisions and representations and the Statute of the Internal Audit Department;
- supervision of the implementation of the budget of Eesti Pank;
- Appointment of the internal auditors of Eesti Pank and approval of the internal audit work schedule;
- Appointment of the independent auditors of Eesti Pank;
- Approval of Eesti Pank's Annual Report on the proposal of the Governor;
- Decision-making regarding the denomination and design of new banknotes and coins;

- Deciding on the establishment, reorganisation and liquidation of the independent divisions of Eesti Pank on the proposal of the Governor;
- Review and approval of written proposals and other documents submitted to the Riigikogu in the name of Eesti Pank.

The Governor of Eesti Pank reports regularly to the Supervisory Board on the situation in Estonia's economy, monetary policy and financial sector as well as on the implementation of the central bank's budget.

The Riigikogu appointed the current Supervisory Board of Eesti Pank to office on February 17, 2004. The Board comprises Professor **Mart Sõrg** (Chairman of the Board, appointed to office on June 12, 2003), Faculty of Economics of the University of Tartu; Professor **Raul Eamets**, Faculty of Economics of the University of Tartu; Professor **Enn Listra**, Faculty of Economics of the Tallinn University of Technology; **Mart Opmann**, public figure and economist; **Tõnis Palts**, public figure and economist; Professor **Jüri Sepp**, Faculty of Economics of the University of Tartu; **Liina Tõnisson**, public figure, and **Harri Õunapuu**, Member of the Riigikogu.

#### ***Governor of Eesti Pank***

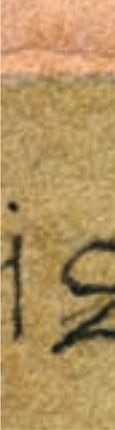
Andres Lipstok commenced his duties as Governor of Eesti Pank on June 7, 2005.

#### ***Executive Board of Eesti Pank***

Pursuant to the Eesti Pank Act, the Executive Board of Eesti Pank is responsible for planning and organising the central bank's activities. The Governor of Eesti Pank is the Chairman of the Executive Board by virtue of office.

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<sup>1</sup> The Supervisory Board of the Financial Supervision Authority comprises six members: two of them – the Minister of Finance and the Governor of Eesti Pank – are members by virtue of office while four are appointed. The Board is chaired by the Minister of Finance. Half of the members are appointed and released by the Government of Estonia on the proposal of the Minister of Finance and half by the Supervisory Board of Eesti Pank on the proposal of the Governor of Eesti Pank.



In 2007, the Executive Board comprised **Governor Andres Lipstok** and **Deputy Governors Rein Minka, Märten Ross** and **Andres Sutt**.

**Governor Andres Lipstok** is in charge of the **overall governance** of the activities of Eesti Pank. His exclusive competence involves organising the designing of monetary and banking policies and the overall governance of the activities of Eesti Pank; supervision of the enforcement of the decisions passed by the Supervisory Board and implementation of measures necessary for that purpose; approval of Eesti Pank's budget, and supervision of the execution of the tasks of the European System of Central Banks.

The Governor reports to the Riigikogu and responds to interpellations concerning Eesti Pank's activities submitted. The Governor regularly reports on his activities to the Supervisory Board of Eesti Pank.

The Governor controls the work of Deputy Governors and is responsible for supervising the Bank's management mechanisms.

**Deputy Governor Rein Minka** is responsible for coordinating the activities related to currency circulation; safety of the working environment; reliable, cost-efficient and integrated development of the settlement system of Eesti Pank; development of the information technology working environment and legal environment, as well as personnel management.

**Deputy Governor Märten Ross** is responsible for the preparation and implementation of monetary policy decisions; management of the financial assets of Eesti Pank; coordination of collection, compilation, and disclosure of national statistics, and for the coordination of economic research and activities related to in-service economic training.

**Deputy Governor Andres Sutt** is responsible for international and public relations of Eesti Pank; development and implementation of financial sector policies; coordination of collection, handling and disclosure of financial sector information; supervision of payment and settlement systems, as well as for financial accounting and reporting, internal

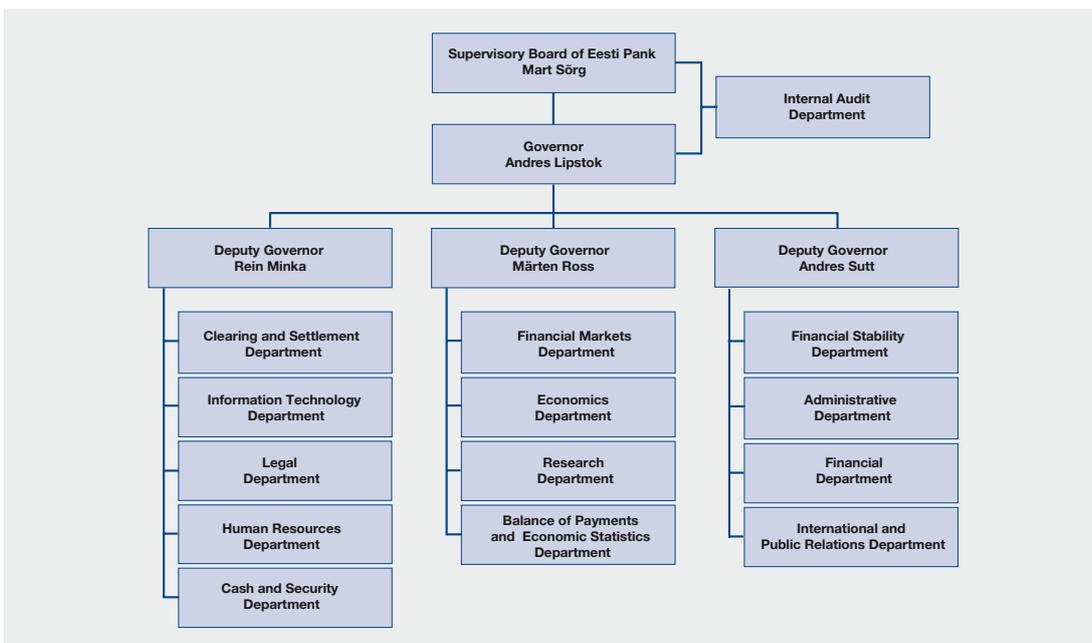


Figure 1. Organisation chart of Eesti Pank as at 29 February 2008

administrative services, and operational working environment at Eesti Pank.

### **Monetary Policy Committee**

A standing Monetary Policy Committee has been established to develop positions on monetary, economic and financial policies and coordinate the activities of Eesti Pank.

In 2007, the Monetary Policy Committee of Eesti Pank included members of the Executive Board, namely Governor Andres Lipstok and Deputy Governors Rein Minka, Märten Ross and Andres Sutt, as well as Janno Luurmees, Head of the Financial Markets Department, Ülo Kaasik, Head of Economics Department (since February 14, 2007), Tanel Ross, Head of the International and Public Relations Department, Rait Roosve, Head of the Cash and Security Department, and Sven Meimer, Head of the Financial Stability Department.

### **Cooperation with the Financial Supervision Authority**

The Financial Supervision Authority<sup>2</sup> operates as an agency of Eesti Pank. It exercises national supervision over banks, insurance companies, financial intermediaries, investment funds and management companies licensed<sup>3</sup> and operating in Estonia as well as the securities market.

The supervision activities of the Financial Supervision Authority are aimed at protecting the interests of clients and investors and ensuring by safeguarding their financial resources, and thereby supporting the stability of the Estonian monetary system. The Authority helps to enhance the efficiency of the Estonian financial sector, reduce systemic risks and prevent the abuse of the financial sector for criminal purposes.

The Financial Supervision Authority is governed by the Management Board chaired by Raul

Malmstein. The Authority's activities are planned by the Supervisory Board chaired by the Minister of Finance by virtue of office (by Aivar Sõerd at the beginning of 2007 and by Ivari Padar since April 2007). Members of the Supervisory Board include Governor of Eesti Pank Andres Lipstok and Deputy Governor Andres Sutt.

## **DEVELOPMENT OF THE MANAGEMENT SYSTEM AND WORK ORGANISATION OF EESTI PANK IN 2007**

### **Definition of organisational values and value-based management**

Preparations for the definition of the values of Eesti Pank started already at the end of 2006. The Bank's cooperation partner in this project was OÜ Implement Baltic, who has experience and know-how in that field, including with respect to public sector organisations.

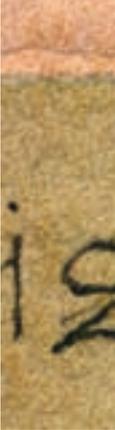
The definition of values consisted of several stages. At the end of 2006 and the beginning of 2007, there were a number of brainstorming sessions together with the management to introduce the issue of values and make a preliminary selection.

At the beginning of 2007, the Human Resources Department introduced the topic in all other departments. Among other things, the strengths of value-based management were outlined as well as the positive impacts it would have on increasing the efficiency of the Bank's activities. In addition, a further action plan was outlined.

Then, consultants of OÜ Implement Baltic had brainstorming sessions on value-based management, which were open for participation for all employees of the central bank. Based on the collected information, the Bank's management defined the following values of Eesti Pank.

<sup>2</sup> See § 4 of the Financial Supervision Authority Act.

<sup>3</sup> Supervision over branches of banks, insurance companies and investment funds operating in Estonia is exercised by the supervision authority of the country of origin of the branch.



### **Competence**

- We keep ourselves informed on our long-term goals and follow them in our activities
- The messages we communicate are clear and understandable
- Our employees have the best qualification and a broad basis of knowledge
- We value self-education and individual development and we learn from the best
- The sharing of employee skills and knowledge is skilfully organised
- We are committed to fulfilling our main goals and we are prudent in our activities

### **Cooperation orientation**

- We are flexible and innovative
- We engage the necessary expertise and make contributions where relevant
- We act in good will and trust each other
- We work as a team

### **Reliability**

- We are loyal to our organisation and committed to our work
- Our words match with our deeds
- We are candid and self-critical
- We are consistent

### **Consideration**

- We keep each other informed in regard with our work and give feedback
- We give recognition to good employees
- We have consideration for others and we are helpful and obliging

These values are part of the Bank's management system. They are used in the daily and case-by-case analysis of work as well as in more general analysis conducted in annual appraisal interviews.

### **Regular study of management quality and appraisal interviews**

In 2007, TNS Emor conducted a regular study on commitment and quality of management. This study has been conducted since 2001 and involves

the entire organisation. Its purpose is to identify the strengths and development needs of the Bank in terms of the key determinants of management quality. The feedback from employees on the structural and human capital of management has provided useful input for management decisions. Feedback on commitment and its key determinants is valuable information for top executives and the Human Resources Department with regard to motivation of employees.

In 2007, 70% of the employees participated in the study, which enabled to produce representative results. One of the most significant indicators, namely the indicator of general commitment, was similar to the 2005 figure. What is important here is that the main factors affecting the commitment indicator were different in the last two studies. For the first time feedback was given on the values of the Bank; more precisely on how employees perceive the validity of these values. Departments could compare their own valuation with the Bank's average and top executives could see whether the values are perceived similarly or whether there are considerable differences across departments. Members of management received personal feedback across management competencies. This feedback is used also in their appraisal interviews for planning their personal development.

The results of the study and further use of them attracted a lot of interest in the Bank, proving that such studies should be conducted also in the future.

In 2007, the appraisal interviews were held in the traditional form but somewhat later than usual. This was due to the definition of organisational values. Thus, it was the first time when the manager and employee could give mutual feedback on whether their work had been in line with the values.

### **Process management**

The Internal Audit Department audited process management in the first half of 2007. To this end,

the process management activities laid down in the Bank's management system were examined, including whether these activities were being carried out in a similar way in the organisation. The auditors also identified organisational improvements that would enhance process management.

As a consequence of the audit, several immediate reorganisations were implemented. In addition, a number of issues remained on the agenda to be solved by the process management development committee established for that purpose and chaired by Deputy Governor Rein Minka.

In 2007, Bureau Veritas Eesti OÜ carried out a compliance audit in Eesti Pank and validated the ISO 9001:2000 Quality Certificate issued to the Cash and Security Department in 2002. The certificate serves as a proof that cash handling and security processes in Eesti Pank are compliant with the requirements set forth in the standard.

### **Management accounting**

Financial and management accounting was developed further. In 2007, the accounting information system and internal control measures were enhanced. In order to improve the quality of data on process-based budget drafting, the rules for describing participation in processes were harmonised and the calculation model refined.

### **Risk management**

Eesti Pank has launched a risk management process that comprises all Bank's functions and is aimed at reducing the adverse impact of accidental events on accomplishing Bank's objectives.

In 2007, various risk descriptions and their parameters were revised. The risks were revised primarily owing to changes in the external environment and in order to assess the impacts of these risks in greater detail. A report on the materialisation of risks provided information about the incidence of risks. Based on that, also the likelihood of a number of

risks was reassessed. All in all, the risks surrounding Eesti Pank did not change considerably.

As regards risk management measures, in 2007 the focus was on planning the business continuity of the Bank's main processes. To this end, the requirements and principles of business continuity were defined. More specific business continuity and recovery plans are drawn, tested and supplemented in 2008.

### **e-Eesti Pank 2007**

The main activities related to the development strategy for document and information management (e-Eesti Pank) in 2007 included renewal of technology and preparations for the next stage of development. A new database engine Oracle and Version 9.7 of the document management software LiveLink were implemented. Moreover, one component of the management system, namely the regulation workflow, was prepared and tested, and the creation of a complex application of correspondence was started.

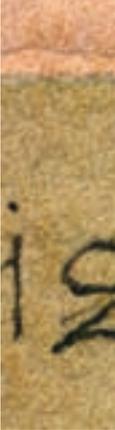
At the autumn seminar, the key activities of the next development stage of e-Eesti Pank for 2008–2010 were introduced:

- further reorganisation of information assets;
- creation of applications necessary for the joint management of information and business processes (correspondence, business trips, etc.);
- increasing the capabilities of users of e-Eesti Pank;
- assessment of risks and implementation of supervision procedures.

The implementation of e-Eesti Pank was also introduced at the joint seminar of Baltic central banks in March and the joint seminar of Estonian and Finnish central banks in October.

### **Eesti Pank's personnel policy**

The aim of Eesti Pank's personnel policy is to ensure the recruitment of employees needed for accomplishing the main objectives of the bank, to develop



and train as well as motivate and provide fair remuneration to the staff.

### **Employees**

Internal competition is preferred in **recruitment** in order to motivate the staff by providing horizontal career opportunities within the bank. External competition is used in case internal competition has failed or in case an employee with different experience is looked for. When recruiting for executives or other highly responsible posts, a competency model is used, which provides the best opportunity to evaluate candidates' knowledge, skills, and personal characteristics.

**Staff remuneration** derives from the need to recruit and retain highly competent staff and motivate them to work effectively and contribute to the good reputation of the bank. The average compensation should be competitive in the labour market where the bank competes for employees. Generally, it means the financial sector labour market in Tallinn.

When determining the remuneration of the top management, the Supervisory Board of Eesti Pank takes into consideration top executives' wages in state and private enterprises with turnovers larger than 500 million kroons. The size of the remuneration paid to top executives is affected by changes in the wage market data in the financial sector of Harju County. The remuneration of the Governor of Eesti Pank should not be smaller than the average wages of top executives in comparable enterprises and agencies.

In 2007, the total remuneration (basic wages and additional remuneration) paid to the members of the Supervisory Board amounted to 2,408,000 kroons and that of the Executive Board to 6,129,423 kroons.

Non-managerial positions have been assessed on the basis of the Hay method. Depending on the assessment results, all posts have been divided into

wage groups listed in the classification of central bank posts. Eesti Pank has implemented a wage scale comprising all wage grades. The employees (members of the Executive Board excluded) receive remuneration on the basis of their wage grade, comparable by groups of similar work within as well as outside the bank.

In 2007, the average monthly wage of a specialist stood at approximately 20,800 kroons.

At the beginning of 2007, the bank had contracts of employment with 253 employees (235 were actually working, as contracts with 18 employees had been suspended), whereas at the end of the year the respective figure was 254 (236 were actually working and 18 contracts had been suspended). The main reasons for suspending contracts of employment were maternity leave, work at the European Central Bank or other international organisations.

The average age of the staff in 2007 was 42 years. The employees included 98 men (39%) and 156 women (61%).

### **Development and training**

For 2007, Eesti Pank had planned 4.3% of the wage budget on training. By the end of the year, nearly 4 million kroons had been spent on training activities, which accounts for 3.75% of the staff's payroll. All in all 188 employees were engaged in trainings, that is 80% of the total staff. Every employee spent an average of seven days on training over the year. The training costs per employee were 17,000 kroons (incl. travel expenses).

Traditionally, the most common fields of training were economic theory and policy, management/communication and language studies. Many of the trainings in core fields take place abroad. Group trainings mostly include in-house training courses and open seminars.

38 employees were engaged in academic studies in 2007: about half of them were acquiring the

Master's degree, eleven the Doctor's degree and the rest the Bachelor's degree or a diploma.

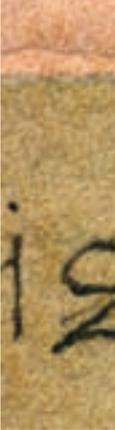
Three employees participated in trainee programs on financial accounting and financial markets at the European Central Bank. Two of them continue at the ECB also in 2008. One economist went to work for the ECB for a longer period (3 years).

### ***Hobbies and traditions of the staff***

At the end of 2007, Eesti Pank's Sports Club had 217 members. Swimming, basketball, aerobics, volleyball, gym, yoga and tennis were the most popular fields of sport. In 2007, also winter and summer sports days were held. In addition, the staff practices bowling, sport dancing, chess, skiing, cycling and kayaking. Competitions between public officials were held in basketball, volleyball and football. In-house competitions were held in bowling and chess. In the sport events of European central banks, representatives of Eesti Pank took part in a skiing competition in Italy, track and field and basketball events in Portugal, and a chess tournament in Germany.

The chamber choir of the employees of Eesti Pank and the Financial Supervision Authority first gathered on May 15, 1998. The choir has nearly 25 members and is conducted by Peeter Perens. Its activities are coordinated by the board which is elected every year.

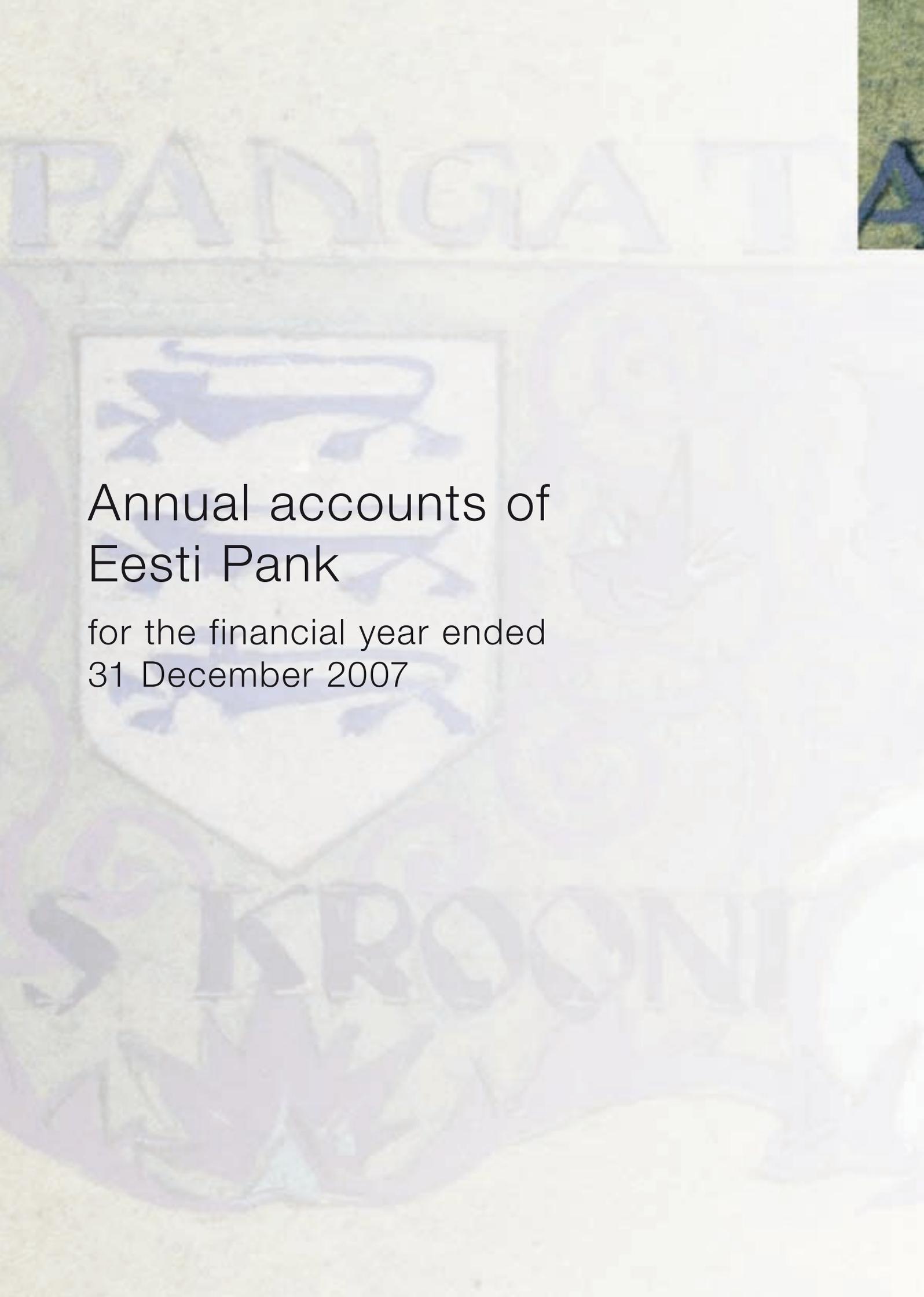
In 2007, the choir had concerts in the Tallinn Art Hall, St George church in Tori and at the 15th anniversary of the Estonian kroon. In autumn, the choir gave a concert of the favourite songs of its members together with composer Mart Siimer, soprano Iris Oja from the Estonian Philharmonic Chamber Choir and saxophonist Danel Aljo. At Christmas, a traditional concert was held at the Swedish St Michael's Congregation in Tallinn.



EESTI



5 VII



Annual accounts of  
Eesti Pank

for the financial year ended  
31 December 2007

**APPROVAL OF THE ANNUAL ACCOUNTS FOR THE FINANCIAL YEAR  
ENDED 31 DECEMBER 2007 BY THE EXECUTIVE BOARD OF EESTI PANK**

The Executive Board acknowledges its responsibility for the Annual Accounts of Eesti Pank for the financial year ended 31 December 2007.

The Annual Accounts have been prepared in accordance with the Eesti Pank Act and the internal accounting policies and procedures of Eesti Pank. The Annual Accounts give a true and fair view of the assets and liabilities, equity capital and economic performance of Eesti Pank.

In order to prepare the Annual Accounts in conformity with the requirements outlined in the previous section, the Executive Board is expected to provide estimates which affect the assets and liabilities of Eesti Pank as at the accounting date and income and expenses during the accounting period. These estimates are based on the information available about Eesti Pank, its intentions and risks as at the date of preparation of the Annual Accounts. The final outcome of the economic transactions reflected in the Annual Accounts may differ from the estimates of the Executive Board.

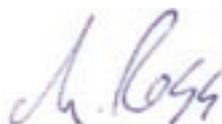
On March 24, 2008, all members belonging to the Executive Board of Eesti Pank on that day signed the Annual Accounts.



Andres Lipstok  
Governor of Eesti Pank,  
Chairman of the Executive Board



Rein Minka  
Deputy Governor,  
Member of the Executive Board



Märten Ross  
Deputy Governor,  
Member of the Executive Board



Andres Sutt  
Deputy Governor,  
Member of the Executive Board



## BALANCE SHEET AS AT 31 DECEMBER 2007 AND 2006 (EEK THOUSAND)

	Note	31/12/2007	31/12/2006
<b>ASSETS</b>			
Gold and gold receivables	1	73,544	62,169
Claims on non-residents denominated in foreign currency		35,488,407	33,933,699
Receivables from the IMF	2	1,107,004	1,176,705
Balances with banks, security investments and external loans	3	34,381,403	32,756,994
Intra-Eurosystem claims	4	10,745	10,873
Other assets		976,517	701,609
Tangible fixed assets	5	286,535	294,895
Other financial assets	6	3,441	3,441
Off-balance-sheet instruments revaluation differences	7	99,462	37,839
Accruals and prepaid expenses	8	471,522	308,399
Sundry	9	115,557	57,035
<b>Total assets</b>		<b>36,549,213</b>	<b>34,708,350</b>
<b>LIABILITIES</b>			
Currency in circulation	10	11,762,182	11,763,153
Liabilities to residents related to the monetary policy	11	17,521,306	17,086,784
Liabilities to other residents denominated in kroon	12	100,366	90,864
Liabilities to residents denominated in foreign currency	13	1,387	7,041
Liabilities to non-residents denominated in foreign currency	14	1,129,347	368,965
Liabilities to the IMF	2	1,095,648	1,164,676
Other liabilities		277,584	168,787
Off-balance-sheet instruments revaluation differences	7	55,517	30,277
Accruals and income collected in advance	15	171,194	128,789
Sundry	16	50,873	9,721
Revaluation accounts	17	227,606	60,980
Capital and reserves	18	3,948,268	3,801,770
Capital		600,000	600,000
Reserves		3,348,268	3,201,770
Profit for the year		485,519	195,330
<b>Total liabilities</b>		<b>36,549,213</b>	<b>34,708,350</b>

The notes on pages 86–101 form an integral part of the Annual Accounts.

**PROFIT AND LOSS ACCOUNT FOR 2007 AND 2006 (EEK THOUSAND)**

	<b>Note</b>	<b>2007</b>	<b>2006</b>
Interest income		1,895,334	1,055,344
Interest expense		-1,045,049	-487,149
<b>Net interest income</b>	<b>19</b>	<b>850,285</b>	<b>568,195</b>
Realised gains/losses arising from financial operations		-18,632	-50,473
Write-downs		-93,218	-103,085
<b>Net result of financial operations, write-downs and risk provisions</b>	<b>20</b>	<b>-111,850</b>	<b>-153,558</b>
<b>Net result of fees and commissions</b>	<b>21</b>	<b>10,294</b>	<b>10,579</b>
<b>Dividend income</b>	<b>22</b>	<b>1,009</b>	<b>951</b>
<b>Other operating income</b>	<b>23</b>	<b>19,348</b>	<b>15,787</b>
<b>Operating expenses</b>	<b>24</b>	<b>-283,567</b>	<b>-246,624</b>
Personnel expenses		-108,732	-97,894
Banknote and coin production costs		-51,827	-39,884
General administration expenses		-89,132	-80,678
Depreciation of fixed assets		-33,876	-28,168
<b>Profit for the year</b>	<b>25</b>	<b>485,519</b>	<b>195,330</b>

The notes on pages 86–101 form an integral part of the Annual Accounts.



## STATEMENT OF CHANGES IN EQUITY (EEK THOUSAND)

	Fixed capital	Reserve capital	Special reserve	Profit	Total
<b>Balance as at the end of 2005</b>	<b>100,000</b>	<b>500,000</b>	<b>3,023,724</b>	<b>237,395</b>	<b>3,861,119</b>
Distribution of the 2005 profit	-	-	178,046	-178,046	-
Allocations to the state budget	-	-	-	-59,349	-59,349
Profit of 2006	-	-	-	195,330	195,330
<b>Balance as at the end of 2006</b>	<b>100,000</b>	<b>500,000</b>	<b>3,201,770</b>	<b>195,330</b>	<b>3,997,100</b>
Distribution of the 2006 profit	-	-	146,498	-146,498	-
Allocations to the state budget	-	-	-	-48,832	-48,832
Profit of 2007	-	-	-	485,519	485,519
<b>Balance as at the end of 2007</b>	<b>100,000</b>	<b>500,000</b>	<b>3,348,268</b>	<b>485,519</b>	<b>4,433,787</b>

The notes on pages 86–101 form an integral part of the Annual Accounts.

# NOTES ON THE ANNUAL ACCOUNTS OF EESTI PANK

## ACCOUNTING POLICIES USED IN THE ANNUAL ACCOUNTS

### General principles

The Annual Accounts have been prepared in accordance with the Eesti Pank Act and the internal accounting policies and procedures of Eesti Pank. The internal accounting policies of Eesti Pank have been drawn from the European Central Bank's (ECB) guidelines for accounting financial instruments. The accounting of other assets and liabilities is based on the accounting principles generally accepted in Estonia.

The structure of the Balance Sheet proceeds from the structure specified in Annex IV to the ECB Guideline ECB/2006/16. The ECB Balance Sheet items are grouped by residency (euro area, non-euro area) and currency (euro, other currency). The assets and liabilities related to the monetary policy are recorded on separate rows.

The structure of the Profit and Loss Account is based on the structure outlined in Annex IX to the ECB Guideline ECB/2006/16.

Until Estonia joins the euro area, Eesti Pank is recording all claims in foreign currency (except interests) under "Claims on non-residents denominated in foreign currency" and all liabilities in foreign currency under "Liabilities to non-residents denominated in foreign currency" (except interests and liabilities in the Special Drawing Rights (SDR) of the International Monetary Fund). Accrued interests are recorded under other assets and liabilities.

The Annual Accounts have been prepared on the historical cost basis, except in cases explained in the following accounting principles.

Pursuant to Subsection 30(7) of the Eesti Pank Act, Eesti Pank does not pay income tax or any other taxes related to its economic activities to the state budget or local budgets, except taxes related to individuals. Pursuant to Section 21 of the Value Added Tax Act enforced on May 1, 2004, Eesti Pank is registered as a VAT taxable person with limited liability as of May 14, 2004 and calculates the value added tax from the supply of intra-Community acquisition or imports of goods and services.

The Annual Accounts have been prepared in thousands of Estonian kroons (EEK thousand) unless indicated otherwise.

The main accounting principles applied in preparing the Annual Accounts of Eesti Pank are presented below.

### Financial assets and liabilities

Financial asset is any asset that is cash, or a contractual right to receive cash or any other financial assets from another entity, or a contractual right to exchange financial assets with another entity under conditions that are potentially favourable. Financial liability is any liability that is a legal obligation to deliver cash or any other financial assets to another entity or to exchange financial assets with another entity under conditions that are potentially unfavourable.



Assets and liabilities are recorded on the Balance Sheet in case Eesti Pank is likely to achieve economic gains or losses from an asset or a liability in the future; most of the risks and rights related to assets and liabilities have been taken over; the value of an asset or a liability and the resulting gains or losses can be assessed in a reliable way.

The purchase and sale transactions of financial instruments are recorded in the balance sheet on the settlement date.

Subsequent measurement of financial assets and liabilities is based on the market value, cost or amortised cost depending on the type of a respective asset or liability. Market value is the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction. Financial instruments recorded at market value are revalued on every balance sheet date.

#### **Recording of transactions in a foreign currency**

Transactions in a foreign currency are recorded on the basis of the official daily fixings of Eesti Pank as quoted by Eesti Pank on the trade date. Assets and liabilities denominated in foreign currencies are translated into Estonian kroons at the official daily fixings effective on the balance sheet date.

The official daily fixings applied on December 31, 2007 and 2006, were as follows:

	<b>2007</b>	<b>2006</b>
USD	10.6382	11.8818
SDR	16.8059	17.8647
EUR	15.6466	15.6466

#### **Income recognition**

Income and expenses are recorded in the Profit and Loss Account during the accounting period on an accrual basis regardless of when cash was received or paid.

Unrealised gains are not recognised as income but are transferred to a revaluation account.

Unrealised losses are recorded in the Profit and Loss Account under "Write-downs" if they exceed previous revaluation gains recorded in the corresponding revaluation account. Unrealised losses in any one currency, security or in gold are not netted against unrealised gains in other currencies, securities or gold.

Premiums or discounts arising on purchased securities are recorded as part of interest income and are amortised over the remaining life of the securities on a straight-line basis.

#### **Gold**

Gold reserves are valued at the market value prevailing at the year-end, equal to Eesti Pank's daily fixing of the Estonian kroon and gold.

### **Claims on non-residents denominated in foreign currency**

Claims on non-residents denominated in foreign currency are divided into two: "Receivables from the IMF" and "Balances with banks, security investments and external loans".

Foreign debt instruments and other quoted securities denominated in convertible foreign currencies are recorded at their year-end market value. Debt instruments are revalued on the last banking day of the year by reference to the market prices on the last banking day.

Repurchase transactions (sale/repurchase transactions) are recorded as collateralised loans taken at their fair value, i.e. securities are recorded as assets on the Balance Sheet and the repurchase sum as a liability. Interest payable is recorded on accrual basis on the Balance Sheet under "Accruals and prepaid expenses".

Reverse repurchase transactions (purchase/resale transactions) are recorded as collateralised loans granted. Interest receivable is recorded on accrual basis on the Balance Sheet under "Accruals and income collected in advance". Securities used as collateral for reverse repurchase transactions are not recorded on the Balance Sheet of Eesti Pank.

### **Derivative instruments**

Derivative instruments are used to manage foreign exchange risks and interest rate risks and they include foreign exchange forwards, swaps, futures and options. The purchase and sale transactions of derivative instruments are recorded in off-balance-sheet accounts on the trade date. On the settlement date, transactions are recorded on the Balance Sheet. The prices of derivative instruments are revalued at the end of the year by reference to the market prices on the last banking day or the yield curve in case of interest swaps. Eesti Pank does not apply hedge accounting to derivative instruments.

### **Investment in shares**

Investment in shares is recorded at market value if it can be reliably assessed. The assessment of the market value of shares is not reliable if they are not actively traded and there are no alternative methods to assess their value in a reliable way. In this case, shares are recorded at amortised cost (cost less provision for any impairment in value). Gains and losses on the sale of shares are recorded in the Profit and Loss Account after all conditions of sale are fulfilled. Dividend income is recorded as income for the period.

### **Fixed assets**

Fixed assets are assets with useful life over a year and acquisition cost in excess of 50,000 kroons. Fixed assets are initially recorded at cost, which includes purchase price and other expenditure directly related to bringing the assets to the location and condition necessary for their intended use. Land, buildings, utility systems of buildings, IT hardware, software, and other assets with long-term useful lives are recorded as fixed assets on the Balance Sheet. Prepayments for fixed assets are also recorded as fixed assets.

Land and objects of art and culture are not depreciable assets. Other fixed assets are depreciated on a straight-line basis over the estimated useful lives of the assets at the following rates:

	2007	2006
Buildings	3%	3%
Utility systems of buildings	20%	20%
Hardware	33%	33%
Software	20–50%	20–50%
Other fixed assets	20%	20%

The need to differentiate between software depreciation rates arose due to the introduction of application software with high acquisition cost and different useful life.

Subsequent expenditures incurred for items of fixed asset are recognised as fixed assets when it is probable that Eesti Pank will derive future expected benefits from the asset and the cost of the asset can be measured reliably. Other maintenance and repair costs are expensed at the time they are incurred.

#### **Write-downs of loans and other claims**

Allowance is made for uncollectible loans and other claims. Expenses of the accounting period arising from the allowance are recorded in the Profit and Loss Account of the reporting period. At the same time, respective assets on the Balance Sheet are reduced.

A general allowance is set up for losses of the loan portfolio to cover potential but unidentified losses in the loan portfolio. The general allowance is applied only to low-risk loans. It reflects the estimates of the Executive Board of Eesti Pank on the volume of potential losses, based on the risk group of the loans and previous experience.

Loans and other claims are recorded on the Balance Sheet until they are received or written off. Loans and other claims are written off only after all measures prescribed by the law to recover them have been exhausted, or if such recovery is economically not feasible. Loans previously written off but collected during the accounting period are recorded as a reduction of expenses under the same cost account.

#### **Asset impairment**

An assessment is carried out at each balance sheet date to identify possible signs of an impairment of financial assets recorded at cost or amortised cost, or tangible fixed assets recorded at cost.

The impairment of significant financial assets is assessed for each object separately. The impairment of financial assets that are not individually significant and that are not expected to be impaired is assessed for all assets together. Write-downs of financial assets are recorded as an expense of the accounting period in the Profit and Loss Account.

The recoverable amount of an asset is identified during testing the value of tangible fixed assets recorded at cost. If it is not possible to identify the value of a single asset (object) through testing, the value is tested across the smallest possible group of assets. The recoverable amount is determined as the higher of an asset's fair value less costs to sell and its value in use. The value in use is the present value of cash flows expected from the use and sales of assets after use. The discount factor used to calculate the net present value is the expected profitability of investments with similar risk level. If the recoverable amount of an asset

is smaller than its carrying amount, the asset is written down. The write-down is recorded in the Profit and Loss Account as an expense of the accounting period on an accrual basis.

### **Liabilities**

All known liabilities and provisions are recorded on the Balance Sheet, if reliable estimates can be made of the amount and they are likely to be realised. Contingent liabilities are recognised as off-balance-sheet items.

### **Currency in circulation**

Currency in circulation comprises banknotes and coins issued by Eesti Pank at their nominal value and recorded on the Balance Sheet as a liability to the holder of currency. Currency in the cash desk of Eesti Pank is deducted from this liability.

### **Claims on and liabilities to the Financial Supervision Authority**

The Balance Sheet of Eesti Pank contains a claim on the Financial Supervision Authority in relation to services provided by Eesti Pank and acquisition of current assets, and a liability to the Financial Supervision Authority in relation to its settlement account held with Eesti Pank.

### **Estimates**

Preparing the Annual Accounts in conformity with the above-described requirements requires the Executive Board to provide estimates as at the balance sheet date regarding the aspects affecting the assets and liabilities of Eesti Pank and income and expenses during the accounting period. These estimates are based on the information available about Eesti Pank and its intentions and risks as at the date of preparation of the Annual Accounts.



## ITEM 1 – GOLD

Changes in the value of Eesti Pank's gold reserves are as follows:

	Amount (ounces)	Market price per ounce (kroons)	Market value (EEK thousand)
Balance at the end of 2006	8,250.171	7,535.4600	62,169
Revaluation	-	-	11,375
<b>Balance at the end of 2007</b>	<b>8,250.171</b>	<b>8 914.2400</b>	<b>73,544</b>

The market price for an ounce is equal to Eesti Pank's daily fixing of the Estonian kroon and gold.

## ITEM 2 – RELATIONS WITH THE INTERNATIONAL MONETARY FUND (IMF)

This asset includes the SDR account in the IMF, participation in the IMF and other receivables.

*EEK thousand*

	2007	2006
Participation in the IMF	1,095,744	1,164,779
SDR account in the IMF	1,003	1,023
Other receivables from the IMF	10,257	10,903
<b>Total receivables from the IMF</b>	<b>1,107,004</b>	<b>1,176,705</b>

### SDR account in the IMF

An SDR account is generated for every IMF Member State and it is used for conducting loan transactions and several other related operations between a Member State and the IMF. The following table reflects the dynamics in the account the Republic of Estonia holds with the IMF.

*EEK thousand*

SDR account in the IMF	2007	2006
Balance at the beginning of the year	1,023	1,037
Interest and other income	78	80
Exchange rate differences	-98	-94
<b>Balance at the end of the year</b>	<b>1,003</b>	<b>1,023</b>

### Participation in the IMF

Eesti Pank acts as a fiscal agent between the Republic of Estonia and the IMF and as a depository of IMF's kroon deposits and debt instruments. A quota has been established for each IMF member determining its participation (subscription) and voting power in the IMF. Participation in the IMF is recorded under assets on the Balance Sheet and equals to the country's quota. At the end of 2007 the quota of the Republic of Estonia in the IMF was 65,200,000 SDRs.

The Republic of Estonia has paid its subscription in government debt instruments deposited with Eesti Pank, which are recorded under the item "IMF kroon accounts". These debt instruments do not bear interest.

EEK thousand

Participation in the IMF (assets)	2007	2006
Balance at the beginning of the year	1,164,779	1,231,491
Exchange rate differences	-69,034	-66,712
<b>Balance at the end of the year</b>	<b>1,095,745</b>	<b>1,164,779</b>
<b>IMF kroon accounts (liabilities)</b>		
Balance at the beginning of the year	1,164,676	1,231,400
Exchange rate differences	-69,028	-66,724
<b>Balance at the end of the year</b>	<b>1,095,648</b>	<b>1,164,676</b>

### Other receivables from the IMF

Since March 1997 this item has reflected the amounts that the IMF has reserved to strengthen its financial situation. The source of these amounts is the percentage added to the interest rate on the Stand-by Arrangement (SBA) and the Systemic Transformation Facility (STF), which is currently about 0.1%.

EEK thousand

Other receivables from the IMF	2007	2006
Balance at the beginning of the year	10,903	11,540
Exchange rate differences	-646	-637
<b>Balance at the end of the year</b>	<b>10,257</b>	<b>10,903</b>
Eesti Pank, SBA loan-related receivable	5,649	6,005
Government, STF loan-related receivable	4,608	4,898
<b>Total</b>	<b>10,257</b>	<b>10,903</b>

### ITEM 3 – BALANCES WITH BANKS, SECURITY INVESTMENTS, EXTERNAL LOANS

EEK thousand

	Balance at the end of 2006	Structure of residual maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
	<b>32,756,994</b>	<b>18,385,180</b>	<b>5,989,708</b>	<b>3,555,018</b>	<b>2,159,327</b>	<b>2,667,761</b>
Cash and current accounts	434,952	434,952	-	-	-	-
Time deposits	879,084	879,084	-	-	-	-
Securities	27,256,223	12,884,409	5,989,708	3,555,018	2,159,327	2,667,761
Reverse repurchase agreements	4,186,735	4,186,735	-	-	-	-
	Balance at the end of 2007	Structure of residual maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
	<b>34,381,403</b>	<b>18,940,596</b>	<b>3,576,085</b>	<b>5,556,200</b>	<b>2,685,022</b>	<b>3,623,500</b>
Cash and current accounts	459,717	459,717	-	-	-	-
Time deposits	634,368	634,368	-	-	-	-
Securities	30,974,385	15,533,578	3,576,085	5,556,200	2,685,022	3,623,500
Reverse repurchase agreements	2,312,933	2,312,933	-	-	-	-

In 2007, Eesti Pank's foreign exchange reserves were mainly placed in the markets of low-risk government bonds of leading industrial countries of the euro area and the United States with an average maturity of about 1.5 years.

The guidelines for managing Eesti Pank's foreign exchange reserves allow only transactions with highly rated international banks and financial institutions and limit any credit risk the bank can take in managing its foreign assets. The issuer risk is allowed for the following minimum credit ratings assigned by international rating agencies (S&P, Moody's):

- A-1 or P-1 for bonds with the maturity of up to one year;
- AA- or Aa3 for bonds with the maturity of over one year.



#### ITEM 4 – INTRA-EUROSISTEM CLAIMS

The item reflects participation of Eesti Pank in the European Central Bank (ECB). Pursuant to Article 28 of the Statute of the European System of Central Banks (ESCB), the national central banks of the ESCB are the sole subscribers of the capital of the ECB. Subscriptions depend on the capital key weighting established in compliance with Article 29.3 of the ESCB Statute and adjusted every five years. In accordance with Article 49(3) of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital is automatically increased when a new Member state joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Upon Bulgaria's and Romania's accession to the EU on January 1, 2007, the share that Eesti Pank held in the subscribed capital of the ECB decreased from 0.1784% to 0.1703%.

As the Republic of Estonia does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB. In connection with the change in the capital key weighting, the paid-up capital contribution of Eesti Pank decreased from 694,916 euros (10.9 million kroons) as at December 31, 2006, to 686,727 euros (10.7 million kroons) as at January 1, 2007. Eesti Pank is obliged to pay the remaining 93% upon Estonia's accession to the Economic and Monetary Union.

#### ITEM 5 – TANGIBLE FIXED ASSETS

Changes in fixed assets in 2007:

*EEK thousand*

	Buildings	Hardware	Furniture and fixtures	Software	Total
<b>Acquisition cost</b>					
Balance at the end of 2006	285,366	48,709	73,820	58,271	466,166
Acquisitions	24,077	8,689	1,359	2,448	36,573
Disposals	0	-3,536	-1,817	-4,692	-10,045
<b>Balance at the end of 2007</b>	<b>309,443</b>	<b>53,862</b>	<b>73,362</b>	<b>56,027</b>	<b>492,694</b>
<b>Accumulated depreciation</b>					
Balance at the end of 2006	49,270	42,705	46,223	45,268	183,466
Depreciation charge	16,053	4,715	7,802	5,307	33,877
Disposals	0	-3,536	-1,811	-3,532	-8,879
<b>Balance at the end of 2007</b>	<b>65,323</b>	<b>43,884</b>	<b>52,214</b>	<b>47,043</b>	<b>208,464</b>
<b>Carrying amount</b>					
Balance at the end of 2006	236,096	6,004	27,596	13,003	282,699
<b>Balance at the end of 2007</b>	<b>244,120</b>	<b>9,978</b>	<b>21,148</b>	<b>8,984</b>	<b>284,230</b>
<b>Prepayments for fixed assets</b>					
Balance at the end of 2006	12,097	98	0	0	12,195
<b>Balance at the end of 2007</b>	<b>1,172</b>	<b>0</b>	<b>59</b>	<b>1,074</b>	<b>2,305</b>
<b>Total fixed assets</b>					
At the end of 2006	248,193	6,102	27,596	13,003	294,895
<b>At the end of 2007</b>	<b>245,292</b>	<b>9,978</b>	<b>21,207</b>	<b>10,058</b>	<b>286,535</b>

The cost of fixed assets acquired in 2007 amounted to 36.6 million kroons (109.3 million kroons in 2006). The majority of the procurement of buildings composed costs related to the repair and construction of the Eesti Pank's building at Sakala 6.

Hardware procurement included computers, servers, printers and various accessories. The majority of purchases of fittings included business machines, security devices and furniture. Software purchases included mainly system software and additional user licences for existing software.

## ITEM 6 – OTHER FINANCIAL ASSETS – INVESTMENTS IN SHARES AND UNITS

Shares held by Eesti Pank:

	Balance at the end of 2007		Balance at the end of 2006	
	Holding (%)	EEK thousand	Holding (%)	EEK thousand
Bank for International Settlements (BIS)				
214 shares (200 voting shares)	N/A	3,397	N/A	3,397
Tallinna Börs (Tallinn Stock Exchange)				
29 shares with nominal value à 10 000 kroons	1,1	44	1,1	44
<b>Total</b>		<b>3,441</b>		<b>3,441</b>

N/A – not available

## ITEM 7 – OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This item reflects the unrealised results arising from the revaluation of derivative instruments that were outstanding on December 31, 2007.

Derivative instruments are revalued by reference to the market prices on the last banking day of the month, if available, and the yield curve in case of interest swaps. This item also includes the unrealised exchange rate difference of derivative instruments denominated in a foreign currency. The difference is calculated using the average exchange rate and the daily fixing of Eesti Pank.

## ITEM 8 – ACCRUALS AND PREPAID EXPENSES

	<i>EEK thousand</i>	
	2007	2006
Interest income	427,463	286,931
Securities	394,264	278,374
Derivative instruments	29,459	6,387
Reverse repurchase transactions	2,775	1,412
Time deposits	811	588
Loans	154	170
Claims on the Financial Supervision Authority	10,418	9,366
Other claims	1,558	1,410
Prepaid expenses	32,083	10,692
<b>Total</b>	<b>471,522</b>	<b>308,399</b>



## ITEM 9 – SUNDRY

This item includes mainly loans issued to employees of Eesti Pank in the total amount of 45 million kroons (41.4 million in 2006) and euro cash in the total amount of 46.9 million kroons. Housing loans secured by real estate have been granted to employees of Eesti Pank for a maximum of 30 years and consumption loans for up to two years. The Supervisory Board of Eesti Pank establishes the interest rate on consumption loans for every fiscal year. The interest rate on consumption loans is comparable to the interest rate charged by Estonian credit institutions under similar conditions. The loan interest rate is the standing deposit facility interest payable to credit institutions plus the risk margin but not more than the minimum loan interest rate established by the minister of finance. The reserves' interest rate equals ECB deposit interest rate, which remained within 2.5–3.0% in 2007. In addition, study loans have been granted for a maximum of ten years and with a 5% interest rate. Additional information on write-downs of loans is provided under Item 20.

## ITEM 10 – CURRENCY IN CIRCULATION

*EEK thousand*

	2007	2006
Banknotes	11,610,325	11,627,284
Coins	151,857	135,869
<b>Total</b>	<b>11,762,182</b>	<b>11,763,153</b>

## ITEM 11 – LIABILITIES TO RESIDENTS RELATED TO THE MONETARY POLICY

This item includes the settlement accounts of credit institutions with Eesti Pank. The deposits of credit institutions increased by 434.5 million kroons in 2007. Eesti Pank has imposed the deposit interest rate of the European Central Bank effective on the last banking day of the accounting month as the interest rate on credit institutions' deposits held with the central bank. In 2007, the deposit interest rate of the ECB increased from 2.5% to 3%. The interest rate is calculated on the basis of the monthly average balance of the settlement account (see Item 15).

## ITEM 12 – LIABILITIES TO OTHER RESIDENTS DENOMINATED IN KROON

This item reflects the funds in the account of the Financial Supervision Authority held with Eesti Pank, which subjects of financial supervision pay as supervision fees. Interests on the funds in the Financial Supervision Authority's account are calculated quarterly on the basis of the average balance of the settlement account. The interest rate is equal to the yield of the foreign exchange reserves.

In addition, this item reflects the settlement accounts of the Tallinn Stock Exchange and the Estonian Central Register of Securities.

## ITEM 13 – LIABILITIES TO RESIDENTS DENOMINATED IN FOREIGN CURRENCY

In November 2006, Eesti Pank joined the Trans-European Automated Real-Time Gross Settlement Express Transfer system TARGET. This item reflects the euro settlement accounts of Estonian credit institutions that have joined the TARGET.

## ITEM 14 – LIABILITIES TO NON-RESIDENTS DENOMINATED IN FOREIGN CURRENCY

This item includes repurchase agreements.

## ITEM 15 – ACCRUALS AND INCOME COLLECTED IN ADVANCE

*EEK thousand*

	2007	2006
Interest expense	103,559	59,413
on deposits with credit institutions	55,518	34,655
on derivative instruments	32,694	10,845
on repurchase agreements	2,832	613
Amortisation of securities	12,515	13,300
Tax liabilities	10,969	9,820
Other liabilities	56,666	59,556
<b>Total</b>	<b>171,194</b>	<b>128,789</b>

## ITEM 16 – SUNDRY

The majority of this item accounts for the Republic of Estonia's claim on the IMF, which is recorded on the Balance Sheet of Eesti Pank as the bank's liability to the Government of the Republic of Estonia. The claim is related to the participation of the Republic of Estonia in strengthening the financial situation of the IMF through premium calculated on the Systemic Transformation Facility (STF).

## ITEM 17 – REVALUATION ACCOUNTS

*EEK thousand*

	2007	2006
Foreign currencies	75,832	34,251
Derivative instruments	50,125	25,664
Securities	101,649	1,065
<b>Total</b>	<b>227,606</b>	<b>60,980</b>

These accounts represent revaluation reserves that arise from unrealised gains on assets and liabilities.

The unrealised losses at the end of the year are recognised in the Profit and Loss Account as expenses under "Write-downs".

## ITEM 18 – CAPITAL AND RESERVES

Changes in capital and reserves in 2007:

*EEK thousand*

	Balance at the end of 2007	Distribution of 2006 profit	Balance at the end of 2006
Fixed capital	100,000	-	100,000
Reserve capital	500,000	-	500,000
Special reserve	3,348,268	146,498	3,201,770
<b>Total</b>	<b>3,948,268</b>	<b>146,498</b>	<b>3,801,770</b>

According to Section 30 of the Eesti Pank Act, at least 25% of the annual profit must be allocated for increasing both statutory and reserve capital. After these allocations, part of the profit can be allocated for establishing and supplementing foundation capital and funds for specific purposes, based on the decision of the Supervisory Board of Eesti Pank. The remaining profit is transferred to the state budget.

## ITEM 19 – NET INTEREST INCOME

The higher interest income in 2007 arose from the steep fall in interest rates in the United States in comparison with the stable and relatively high interest rates in the euro area.

*EEK thousand*

	2007	2006
<b>Net interest income</b>	<b>850,285</b>	<b>568,195</b>
Interest income	1,895,334	1,055,344
Securities	1,224,263	799,762
Reverse repurchase agreements	349,975	143,738
Derivative instruments	266,496	85,320
Time deposits	53,300	25,099
Loans to personnel	1,290	1,417
Other	10	8
<b>Interest expense</b>	<b>-1,045,049</b>	<b>-487,149</b>
Securities	-46,004	-51,391
Repurchase agreements	-158,638	-35,964
Derivative instruments	-290,619	-143,823
Time deposits	-757	-276
Credit institutions' deposit interests	-546,002	-255,050
Other	-3,029	-645

## ITEM 20 – NET RESULT OF FINANCIAL OPERATIONS, WRITE-DOWNS AND PROVISIONS

*EEK thousand*

	2007	2006
<b>Net result of financial operations</b>	<b>-111,850</b>	<b>-153,558</b>
<b>Realised gains/losses arising from financial operations</b>	<b>-18,632</b>	<b>-50,473</b>
Securities	12,984	-64,195
Derivative instruments	-15,678	13,182
Income/expense of exchange rate differences	-14,583	-14,970
Financial asset management costs	-1,355	-683
Other	0	16,193
<b>Write-downs</b>	<b>-93,218</b>	<b>-103,085</b>
Securities	-47,764	-77,306
Derivative instruments	-43,355	-26,133
Exchange rate write-downs	-2,719	0
Net change of loan portfolio write-downs	620	354

## ITEM 21 – NET RESULT OF TRANSACTION AND COMMISSION FEES

	<i>EEK thousand</i>	
	<b>2007</b>	<b>2006</b>
<b>Transaction and commission fees</b>	<b>10,294</b>	<b>10,579</b>
Settlement service costs	12,022	10,937
Commissions on futures and options	-1,763	-642
Fines, arrears and other	35	284

The majority of this item accounts for income from servicing credit institutions' settlement accounts.

## ITEM 22 – DIVIDEND INCOME

This item reflects dividends from the shares of the Bank for International Settlements and the Tallinn Stock Exchange.

## ITEM 23 – OPERATING INCOME

Most of other operating income (7.6 million kroons) comprises income from services provided to the Financial Supervision Authority. Pursuant to the cooperation protocol between the Financial Supervision Authority and Eesti Pank, the Financial Supervision Authority reimbursed, in monthly payments, 100% of the cost of the support services provided by Eesti Pank in 2006 and 2007. Eesti Pank provides the Financial Supervision Authority with the following services: information technology, accounting, real estate, and administration services. The Financial Supervision Authority covers also the depreciation costs of fixed assets used.

In 2007, income from the sale of numismatic-bonistic products amounted to 8.1 million kroons. Most of that was income from the sale of collector coins.

Income on asset management includes the service fee paid by the Guarantee Fund and the Unemployment Insurance Fund to Eesti Pank for investing their assets.

Income from the rent of the training centres of Eesti Pank is recorded under "Rental income". Income from the sale of assets reflects income from the sale of fixed assets and inventories unnecessary for Eesti Pank.

The majority of other income contains contractual penalties for defective banknotes and the delayed completion of a building.

	<i>EEK thousand</i>	
	<b>2007</b>	<b>2006</b>
<b>Operating income</b>	<b>19,348</b>	<b>15,787</b>
Expenses compensated by financial supervision	7,597	7,744
Income from the sale of collector coins and numismatic-bonistic products	8,147	5,970
Rental income	963	952
Income on asset management	1,308	896
Income from the sale of assets	176	83
Other income	1,157	142



## ITEM 24 – OPERATING EXPENSES

Compared to 2006, operating expenses increased 15% in 2007.

*EEK thousand*

	<b>2007</b>	<b>2006</b>
<b>Staff costs</b>	<b>-108,732</b>	<b>-97,894</b>
Wages	-79,776	-71,755
Compensation and benefits	-1,948	-1,907
Social tax	-26,778	-24,033
Unemployment insurance	-230	-199

Staff costs grew 11% year-on-year and consisted mainly of wage costs, including taxes. Wage costs increased owing to a general rise in wages as well as single wage increases related to the career and individual development of employees.

The expenditure on compensations and benefits consisted mainly of single benefits and pension insurance compensations paid to employees of Eesti Pank. Year-on-year, the expenditure on compensations and benefits slightly increased. Pension costs grew the most in 2007.

Eesti Pank had 236 members in the staff at the end of 2007 (238 at the end of 2006).

In 2007, Eesti Pank participated in the voluntary pension investments of its staff and members of the Supervisory Board of Eesti Pank by contributing one million kroons in total. Moreover, Eesti Pank paid a special merit pension to two individuals in recognition of their special merits in the development of the Estonian monetary and banking system. The special merit pension amounted to 1.6 times the Estonian average monthly wage. In 2007, the costs of the special merit pension stood at 0.4 million kroons.

The production costs of banknotes and coins increased by 11.9 million kroons, year-on-year. The production costs of banknotes and coins included the cost of manufacturing banknotes and coins for 33.1 million kroons and the production costs of numismatic products for 16.4 million kroons. In 2007, coins of 10 senti, 20 senti and 50 senti were minted and 100-kroon and 500-kroon banknotes were issued. In addition, a golden coin dedicated to the 15th anniversary of the monetary reform was issued in 2007.

General administrative expenses grew by 8.5 million kroons year-on-year, mostly owing to increased real estate repair and administration expenses and IT maintenance costs. Real estate repair and administration expenses grew by 2.6 million kroons, year-on-year. The growth was due to the increased amount of construction and repair works and the rise in prices.

The rise in training and travel expenses arose from the increased amount of trainings and business trips. Business trip expenses are the travel expenses incurred by the officials on assignment, accommodation expenses, daily allowances, and conference or seminar participation fees.

IT maintenance costs increased by two million kroons in 2007. Software maintenance costs accounted for 64%, hardware repair and maintenance costs for 17% and data communication costs for 19% of IT maintenance costs. Compared to 2006, IT maintenance costs increased owing to higher software maintenance costs.

Other expenses consisted of the costs of seminars and events organised by the bank and costs related to economic research, personnel studies and recruitment.

*EEK thousand*

	<b>2007</b>	<b>2006</b>
<b>General administrative expenses</b>	<b>-89,132</b>	<b>-80,678</b>
Information technology maintenance costs	-19,503	-17,548
Real estate renovation and administration expenses	-17,434	-14,839
Financial asset management costs	-14,992	-14,295
Training and business travel expenses	-12,818	-11,686
Public relations and publications	-8,056	-7,664
Office costs	-4,518	-4,701
Communications and transportation costs	-3,249	-2,920
Legal and arbitration costs	-519	-457
Other expenses	-8,043	-6,568

## **ITEM 25 – PROFIT DISTRIBUTION**

The profit distribution strategy of Eesti Pank is based on the principle of avoiding too rapid decrease of Eesti Pank's own capital and net foreign exchange reserves against key economic indicators prior to joining the Economic and Monetary Union.

After the evaluation of the profit distribution strategy in April 2007, the Supervisory Board of Eesti Pank decided to continue with the above-mentioned strategy and transfer 48.8 million kroons from the profit of 2006 to the state budget and 146.5 million kroons to the special reserve fund.

## **ITEM 26 – DERIVATIVE INSTRUMENTS**

*EEK thousand*

	<b>Contractual value</b>
<b>Derivative instruments</b>	
<b>Total as at 31 Dec 2006</b>	<b>21,770,865</b>
Foreign currency forward transactions	6,610,880
Interest rate swap transactions	4,263,428
Foreign currency swap transactions	0
Futures transactions	7,557,771
Options	3,338,786
<b>Total as at 31 Dec 2007</b>	<b>26,895,225</b>
Foreign currency forward transactions	1,274,609
Interest rate swap transactions	12,157,094
Foreign currency swap transactions	3,819,936
Futures transactions	7,452,126
Options	2,191,460

Derivative instruments are used for risk hedging in the management of foreign exchange reserves.



## ITEM 27 – CONTINGENT LIABILITIES

*EEK thousand*

	<b>Balance at the end of 2007</b>	<b>Balance at the end of 2006</b>
<b>Contingent liabilities</b>	<b>223,477</b>	<b>180,928</b>
Uncalled share capital (75%) of BIS	7,745	8,651
Uncalled share (93%) of ECB participation	142,754	144,456
Contractual obligations to produce banknotes and coins	72,978	27,821

### **Bank for International Settlements (BIS)**

Eesti Pank has a contingent liability to the Bank for International Settlements since 1930. This liability is the uncalled part of the share capital (75%) of the BIS denominated in Swiss gold francs, totalling 7.7 million kroons on the balance sheet date (see Item 6).

### **European Central Bank**

In 2004, the Republic of Estonia joined the European Union and consequently Eesti Pank became a member of the ESCB. As Estonia does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB. Owing to the change in subscription, the share capital paid by Eesti Pank decreased from 694,916 euros (10.9 million kroons) as at December 31, 2006, to 686,727 euros (10.7 million kroons) as at January 1, 2007. Eesti Pank is obliged to pay the remaining 93% in the amount of 9.1 million euros (143 million kroons) upon Estonia's accession to the Economic and Monetary Union.

### **Printing of banknotes and minting of coins**

At the end of 2007, the contractual liabilities of Eesti Pank for printing banknotes and minting coins in 2007 amounted to 73 million kroons.

## INDEPENDENT AUDITOR'S REPORT

(Translation of the Estonian original)\*

To the Supervisory Board of Eesti Pank

We have audited the accompanying financial statements of Eesti Pank which comprise the balance sheet as of 31 December 2007 and the report on revenues and expenses and statement of changes in equity for the reporting year then ended and a summary of significant accounting policies and other explanatory notes.

### Management Board's Responsibility for the Financial Statements

Management Board is responsible for the preparation and fair presentation of these financial statements in accordance with Eesti Pank Act and the accounting principles stated in the "Accounting Policies used in the Annual Accounts" of the accompanying financial statements. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the accompanying financial statements give a true and fair view of the financial position of Eesti Pank as of 31 December 2007, and of its financial performance for the reporting year then ended in accordance with Eesti Pank Act and the accounting principles stated in the "Accounting Policies used in the Annual Accounts" of the accompanying financial statements.



Urmas Kaarlep  
AS PricewaterhouseCoopers



Stan Nahkor  
Authorised Auditor

24 March 2008

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*\* This version of our report is a translation from the original, which was prepared in Estonian. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.*

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# Annexes



## GLOBAL ECONOMY IN 2007

2007 was a successful but also pivotal year for global economy – mainly for the US but also for the economic cycles of other G3 countries. According to the International Monetary Fund, annual global economic growth totalled 4.9%, which is almost as much as in 2006 (5%; see Table 1). In 2008, growth is expected to decelerate to 4.1%.<sup>1</sup>

Regionally, growth was relatively different in 2007. Developing Asian countries were in the lead with 9.6%, China's growth even accelerating to 11.4%. In Central and Eastern European countries growth diminished from 6.4% to 5.5%. US economic growth decelerated further and reached an estimated 2.2% (2.9% in 2006). Euro area's growth figure stood at 2.6% and Japan's at 1.9%; growth decelerated also in these regions but less than in the US. Compared to the forecasts made at the beginning of the year, US economic growth was 0.2 percentage points below the target, whereas in the euro area 0.6 and in Japan 0.1 percentage points above the target.<sup>2</sup>

Meanwhile, inflation picked up in advanced economies. In OECD countries it rose to 3.3% by the end of the year; that is the highest level in six years.

Inflation was driven by the continuing oil price surge from 60 dollars per barrel to almost 100 dollars at year-end, and also by upward price pressures stemming from heightened demand for consumption. Labour market trends reflected the differences in the economic situation of the G3 countries quite accurately: unemployment increased in the US, but decreased in the euro area and fluctuated up and down in Japan.

Significant developments took place in global financial markets. The first half of 2007 saw a continuation of the upward trend that had prevailed in the stock markets in earlier years, whereas mid-July witnessed a clear downturn. The key determinant was the ongoing decline of the US housing sector, which passed on to other economic sectors and caused problems related to credit quality and liquidity conditions in money markets all over the world. These problems and the worsened economic outlook increased investors' risk aversion and caused a significant drop in interest rates in the second half-year. The increasing uncertainty was also reflected in the great increase in gold price during that period.

**Table 1. Economic indicators of advanced countries**

	GDP growth (%)		Annual average CPI growth (%)		State budget surplus or deficit (% of GDP)		Current account balance (% of GDP)	
	2006	2007*	2006	2007*	2006	2007*	2006	2007*
<b>World</b>	5.0	4.9						
Advanced economies	3	2.7	2.4	2.2	-2.6	-2.2	-1.5	-1.2
United States	2.9	2.2	3.2	2.9	-2.6	-2.5	-6.2	-5.3
Japan	2.4	2.1	0.3	-	-3.8	-3.4	3.9	4.9
<b>Euro area</b>	2.8	2.6	2.2	2.1	-1.4	-0.6	-0.1	-0.2
Germany	2.9	2.5	1.8	2.3	-1.6	-	5.0	5.6
France	2.0	1.9	1.9	1.6	-2.5	-2.4	-1.3	-1.3
Finland	4.9	4.4	1.3	1.6	4.1	5.3	4.6	4.6
<b>Other EU countries</b>								
United Kingdom	2.9	3.1	2.3	2.3	-2.6	-3	-3.9	-4.9
Sweden	4.1	2.6	1.5	1.7	2.3	3.2	8.5	8.3

\* Data for 2007 are preliminary.

Source: IMF World Economic Outlook (April 2008)

<sup>1</sup> IMF World Economic Outlook Update, January 2008.

<sup>2</sup> Consensus Forecasts, January 2007.



## THE UNITED STATES AND JAPAN

US economic growth weakened in 2007 and economic problems became more pronounced. The year-end even witnessed speculations of a potential economic recession. This was mainly induced by the continually deteriorating situation in the real estate sector, comparable to the period of economic downturn in early-1990s. Namely, housing prices dropped and the country faced a crisis of subprime mortgage loans. This was the burst of the real estate bubble that had evolved in earlier years, followed by a stock market decline in the second half of the year.

This situation had a negative impact on other sectors too. At the beginning of 2007, industrial activity improved slightly but started to decrease again in the second half-year. In December, the industrial sector's activity index fell even below 50 points (the borderline between growth and contraction). Private consumption was also relatively weak: annual growth in retail trade ranged within 3–6%. Employment growth slowed further and in 12 months unemployment increased from 4.4% to 5.0%. In the second half-year when the stock market decline added to other economic difficulties, also consumer confidence suffered considerably.

As concerns US external balance, a slight decrease in the current account deficit could be noted, which may be related to the downward trend of the dollar's exchange rate and weakening domestic demand. Nevertheless, the deficit was still 5–6% of GDP. Budget balance did not change significantly, as its deficit stayed in the range of 1–2%.

Inflation remained mostly at the level of 2–3%. Headline inflation exceeded 4% towards year-end, whereas core inflation stood at 2.4% in December; thus, inflationary pressures mainly stemmed from the prices of energy and food.

In the light of heightened risks surrounding economic growth, problems in financial markets and the financial sector and the increasing possibility of an economic decline, the Federal Reserve started to lower the key interest rate in September. By the end of the year, it had declined from 5.25% to 4.25%.

Japan's growth rate decreased from 2.4% to 1.8% over four quarters. Thus, last year faced a moderation in growth; estimated average annual growth was 1.9%. Industrial activity declined primarily in the first half of the year, and thus second-quarter growth posted negative results. In the second half-year, industrial activity gained momentum again. No clear trends could be identified in the labour market; unemployment ranged within 3.6–4.0%. The growth rate of retail trade was negative in the first half-year but became positive later on. However, the situation is far from being stable, as the decline in stock markets and deterioration of economic outlook entailed a significant decrease in consumer confidence in 2007. Inflation rose to 0.7% by the end of the year but was still close to zero with energy and food prices excluded. Since economic growth was close to its potential rate at the beginning of the year, the Japanese central bank increased the monetary policy interest rate from 0.25% to 0.5% in February and retained this level until the year-end.

## EURO AREA

Growth in the euro area decelerated from 2.8% to an estimated 2.6% in 2007. Activity weakened in the industrial as well as service sector; industrial output growth slowed to 1.7% by the end of the year. This was mainly brought about by the consistent tightening of monetary policy over the past two years (the key interest rate was last raised in June 2007 – to 4%), the strengthening euro exchange rate and the decrease in external demand (growth decelerated in the US as well as Japan). Yet another contributor was the rise in food and energy prices. Similar to the US and Japan, the decline in stock markets and

difficulties in the financial sector prompted a sharp fall in consumer confidence also in the euro area in the second half-year.

Inflationary developments of the euro area were similar to those of the US: by the end of the year, price pressures arising from the oil price increase drove annual consumer price growth to the highest level since the adoption of the euro; that is, to 3.2%. Meanwhile, within 12 months the core inflation (CPI excluding food, energy, alcohol and tobacco) increased from 1.5% to 1.9%. Unemployment in the euro area continued to decrease and eased to 7.2% by the year-end.

The economic outlook of the euro area was relatively positive in the first half of 2007. Consequently, the European Central Bank raised the key interest rate twice to 4% in that period. However, later developments deteriorated the outlook, which is why the key interest rate was maintained at the same level until the end of the year.

Euro area's economic outlook for 2008 is considerably weaker compared to the 2007 figures. The International Monetary Fund expects a 1.5–1.6% growth in all G3 countries (1.6% in the euro area) in 2008.<sup>3</sup>

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<sup>3</sup> IMF World Economic Outlook Update, January 2008.



# ESTONIA'S ECONOMY IN 2007

## NON-FINANCIAL SECTOR

### Monetary policy environment

Considering the aggravating inflationary pressures, the European Central Bank (ECB) continued raising monetary policy interest rates in the first half of 2007. The uncertainty arising from risky housing loans issued by the US banks spread all over the world in August and influenced also the rise of the Euribor. In Estonia, the prices of housing loans increased by 1.8 percentage points and long-term corporate loans by 1.2 percentage points, year-on-year. This together with the prospects of decelerating economic growth reduced loan demand and accelerated the slowdown in credit growth that had started already in mid-2006. By the beginning of 2008, the size of loans granted to the non-financial sector had grown only 30%, year-on-year, which is similar to the pre-boom figures. At the same time, the Estonian kroon appreciated continuously against the dollar throughout 2007 due to the euro-fix.

As a result, the **monetary policy environment** was much more **restrictive** in 2007 than in earlier years, although capital inflow was still high.

### Domestic and external demand

In spring 2007, the robust **growth started to slow as expected**. Real GDP growth that had reached almost 9 percentage points in the first half-year decreased to around 5% in the second half. According to preliminary estimates, the average annual growth rate was 7.1%. Thus, economic growth slowed to the levels recorded prior to Estonia's accession to the EU.

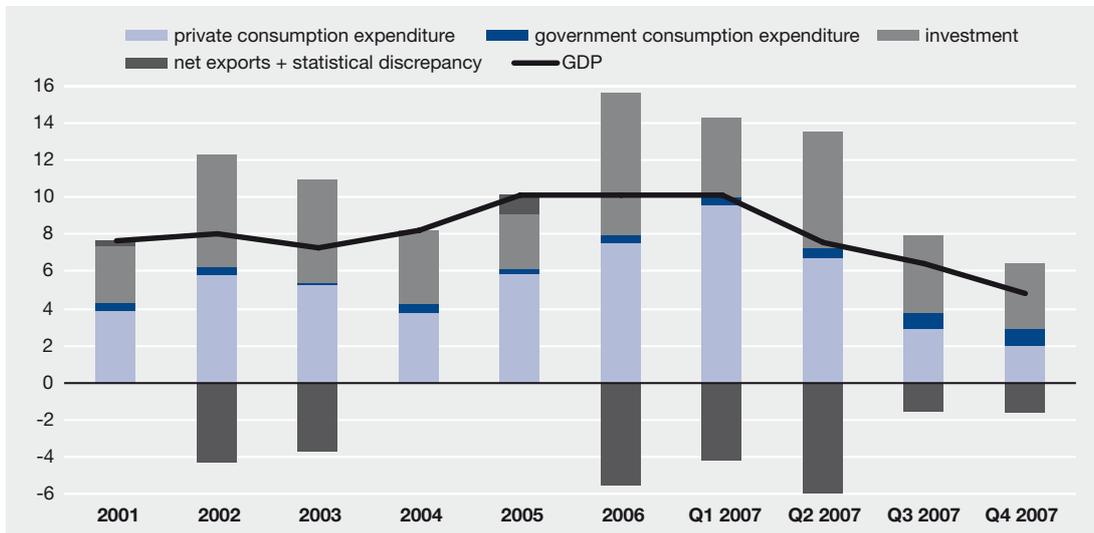
Growth decreased above all in fields related to real estate development. In the second half-year, growth in these sectors decelerated considerably and practically ceased in the last quarter. The construction sector witnessed a smaller decline owing to the continuation of the ongoing development projects (see Table 1).

Investment activity plummeted in the second half of 2007, while the amount of fixed investment remained at the previous year's level. Private consumption growth, which had picked up speed at the end of 2006, decelerated as well and reached a downward phase in the final months of the year.

**Growth in the exports of goods and services remained rapid in 2007, as expected.** Based on general indicators, the growth of services exports

**Table 1. Real GDP growth by fields of activity in 2003–2007 (%)**

	2003	2004	2005	2006	2007
Agriculture, hunting and forestry	12.0	-4.3	-0.8	4.5	3.3
Fishing	-4.6	-11.3	7.5	-14.8	10.0
Mining and quarrying	15.3	-6.0	12.3	7.5	11.8
Manufacturing	10.0	10.5	11.8	12.8	8.3
Energy, gas and water supply	12.5	0.7	3.8	6.5	-1.8
Construction	0.9	3.1	26.2	12.5	8.6
Wholesale and retail trade	10.2	15.5	10.8	13.1	6.0
Hotels and restaurants	14.4	13.7	10.4	11.7	2.6
Transport, storage and communications	8.4	8.3	7.4	11.6	6.8
Real estate, renting and business activities	3.7	4.6	10.4	8.7	1.8
Financial intermediation	19.0	24.6	23.3	23.3	23.5
Public administration and national defence	4.7	1.5	3.0	2.8	3.9
Education	0.2	2.0	3.5	6.0	2.3
Health and social care	-3.0	4.7	5.3	8.2	6.9
Other service activities	4.6	4.3	7.2	7.0	4.5
<b>Total GDP</b>	<b>7.2</b>	<b>8.3</b>	<b>10.2</b>	<b>11.2</b>	<b>7.1</b>



**Figure 1. Contributions of GDP consumption components to economic growth (pp)**

was much stronger than that of goods exports. At constant prices, the exports of services increased 8% year-on-year, while the exports of goods remained close to zero. However, these indicators are not entirely comparable. To be more explicit, in 2006 the growth of merchandise exports was accompanied by a considerable increase in goods that have only marginal value added in Estonia. In 2007, the flow of re-export type of goods did not grow any longer, and their value even decreased. This, however, might lead to the wrong conclusion that the growth of Estonia's export sector has slowed significantly. The competitiveness of goods produced in Estonia and their contribution to economic growth is better characterised by the export dynamics of manufactured goods. According to this indicator, the growth rate of goods exports in 2007 was only 1–2 percentage points lower than in the previous year (see also Figure 1).

Together with the beginning of economic adjustment, the growth period of the current account deficit also came to an end. When domestic demand growth slowed, the imports of goods decreased, which had a positive impact on trade balance. Although the trade balance deficit declined, this did not decrease the total current account deficit, as the outflow of investment income was larger

than in previous years also in the second half-year. This refers to a rise in the profitability of companies based on foreign capital, which stemmed, inter alia, from stronger growth in service prices that lasted until the final months of 2007. In annual terms, the current account to GDP ratio remained the same as a year ago, comprising about 16% of GDP (see Figure 2).

The inflow of foreign direct investment into the non-financial sector was slightly higher than in the past few years. Nevertheless, most of the external funds were raised in the form of loans and thus Estonia's external debt increased to around 108% of GDP by the end of the year.

### **Inflation**

Like in the past few years, **consumer prices grew faster than expected** also in 2007. The average annual rise in the cost of the consumer basket was 6.6% (see Figure 3).

As long as the rapid growth period lasted, the robust increase in service prices continued as well. Housing costs grew also due to the increase in the value added tax imposed on district heating and the rise in energy prices on the world market. In the light of the weakening domestic demand, the

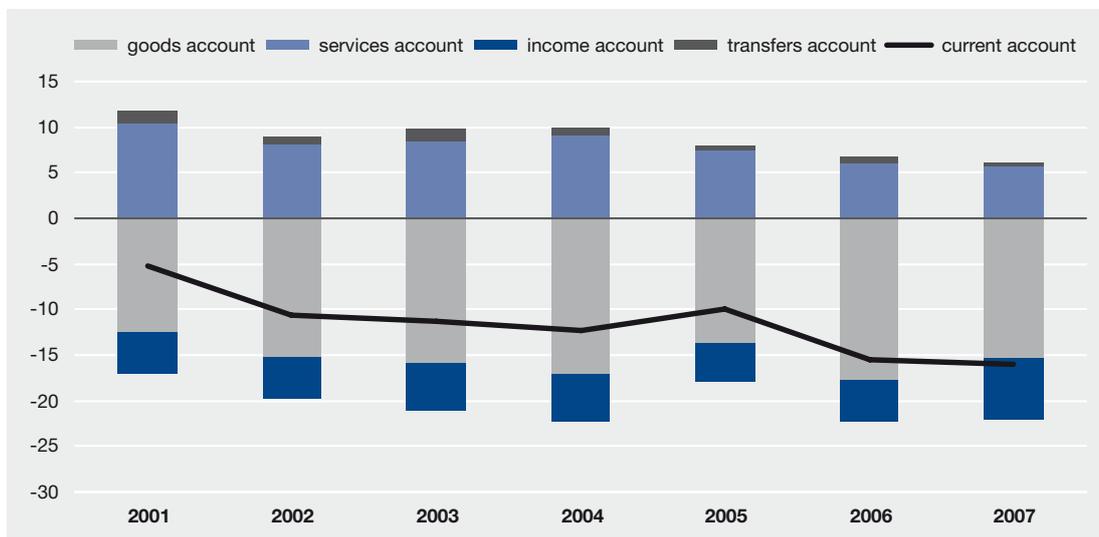


Figure 2. Current account balance and balance of payments accounts (% of GDP)

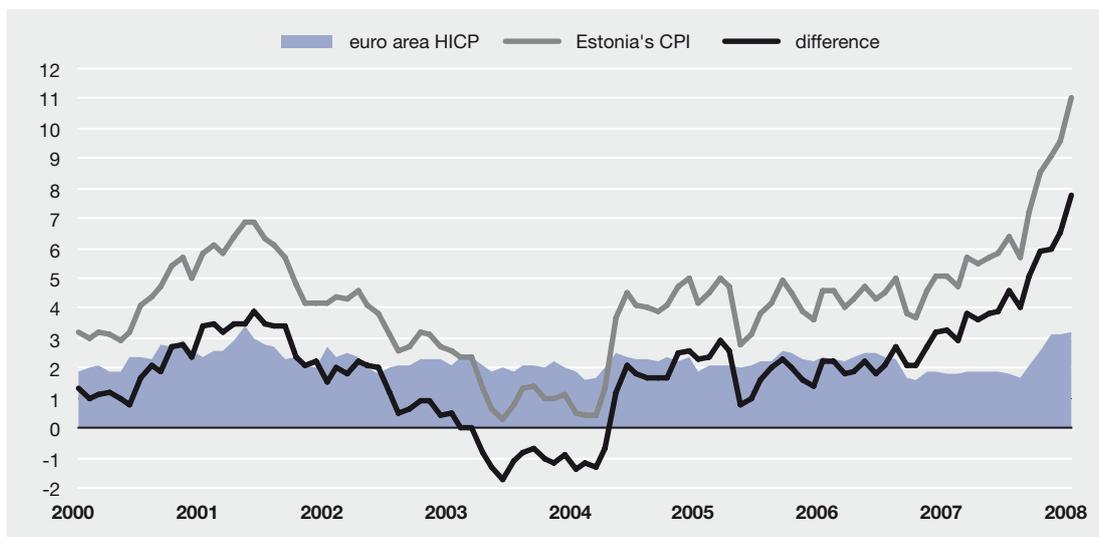


Figure 3. Twelve-month consumer price growth in Estonia and the euro area (%)

acceleration in core inflation also ended in the last months of the year. Unfortunately, a **hike in food prices on the world market** started off then. At the end of the year, inflation was boosted by another surge in oil prices (see Figure 4). Food prices increased faster than expected also at the beginning of 2008. Since at the same time excise duties were raised, the inflation rate accelerated temporarily to 11-12%.

In 2007, the real exchange rate of the kroon appreciated by nearly 3% on average. This was mainly facilitated by the stronger growth of consumer prices compared to that in the partner countries, which is why the appreciation of the real exchange rate accelerated to 4–5% in the second half-year (see Figure 5).

Until autumn, inflation was boosted by robust income growth. New jobs were created almost

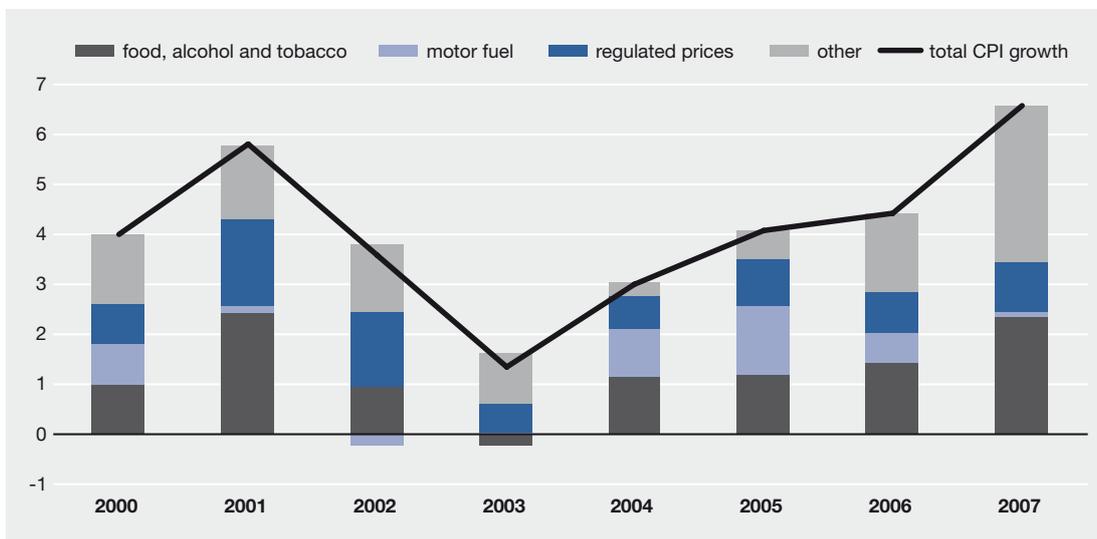


Figure 4. Consumer price growth by components (pp)

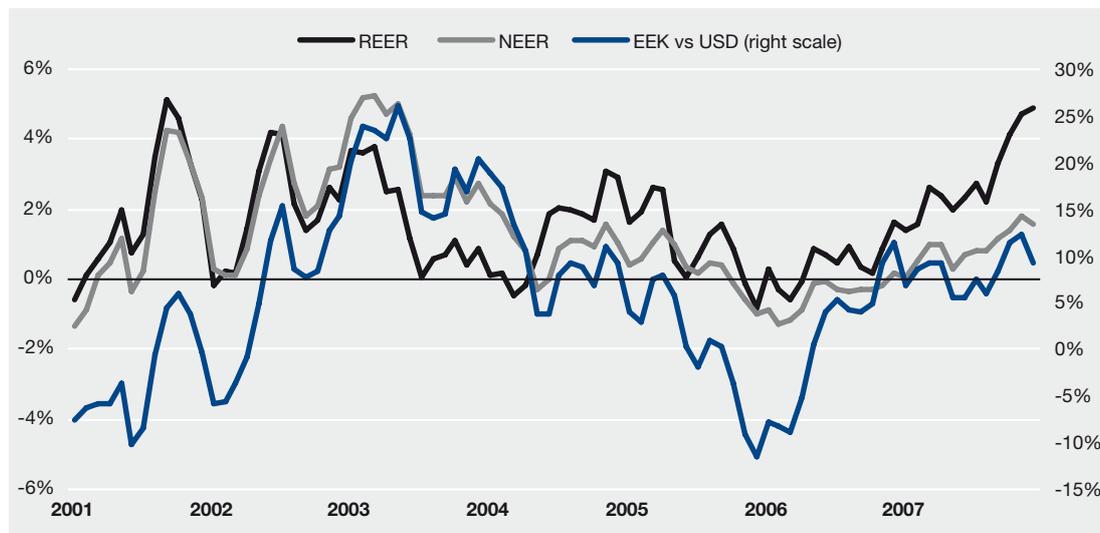


Figure 5. 12-month changes in the real and nominal exchange rate of the Estonian kroon

throughout the year, but at a slower pace compared to the previous year and considerably less in the last months of the year. The average annual employment rate increased approximately 1.5%. The unemployment rate also continued to decrease, falling to 4% in year-end. Average wage growth was stronger than a year ago, but showed signs of deceleration in the second half of 2007. Wage growth outpaced productivity growth in most economic sectors in 2007.

#### General government

As concerns the tax policy, the Government continued efforts to reduce labour taxes and raise consumption taxes. At the beginning of 2007, both the corporate and personal income tax rate was lowered by 1 percentage point to 22%. Since the non-taxable income threshold remained unchanged, the lower VAT rate that had been imposed on district heating and stove heating sold to households was increased to the usual level of 18% and

wage growth accelerated further in the first half-year, the general tax burden increased 32.5% as a ratio of GDP. The tax burden is expected to remain relatively similar also in 2008 if along with income tax rate reduction, excise duties on alcohol, tobacco and motor fuel are increased and an excise duty is imposed on electricity. Then the excise duties will reach the minimum level agreed upon in the European Union and the harmonisation of tax policy can be considered completed.

On the expenditure side, the most significant change in 2007 was the abandoning of one-off pension increases and the introduction of a formula for calculating pensions so as to link them more closely with average wage growth.

Estonia's general government budget has been in surplus since the fiscal year of 2002 and 2007 was no exception. According to preliminary estimates, the consolidated budget surplus for 2007 was 2.8% of GDP. Even though it was higher than targeted in the state budget strategy, compared to earlier periods, the surplus decreased more than might have been expected on the basis of slower domestic demand growth. Besides moderate extra tax revenue, the surplus was induced by the planned increases in reserves and the postponement of some major projects.

Along with surplus growth also the public debt kept shrinking. By the end of the year, the public debt to GDP ratio dropped to 3.4%.

## **ISSUES RELATED TO THE DATE FOR THE ADOPTION OF THE EURO**

Estonia's liberal and open economic policy as well as accession to the European Union has laid a good foundation for strong economic growth and also for the fulfilment of the Maastricht criteria. The openness of the Estonian economy and the fixed exchange rate of the kroon force our enterprises to be competitive under very similar economic and political conditions as the present Member States

of the euro area. This, in turn, supports the stability of the Estonian kroon's exchange rate and compliance with the respective criterion without any problems. At the same time, the Estonian Government has pursued the balanced budget principle, and, as a result, Estonia meets the public finance criterion. The low long-term interest rate indicates that financial markets are internationally integrated and investors believe in the competitiveness of Estonia's economy and the sustainability of economic policy. If our economic policy makers and enterprises justify that belief, Estonia will not have any fundamental problems with fulfilling these criteria in the future either.

Meanwhile, meeting the inflation criterion in its present interpretation remains a problem for a rapidly developing economy that is converging towards the average level of the wealthier countries of the euro area. On the one hand, economic openness enhances the growth opportunities of the Estonian economy, whereas on the other hand, monetary and fiscal policies decrease the possibilities of influencing inflation in the short term. For an open economy such as Estonia has, the fixed exchange rate based on the currency board arrangement is optimal for anchoring inflation expectations and ensuring price stability.

Conservative fiscal policy is another effective tool besides the fixed exchange rate in directing domestic demand in the short term. A conservative economic policy, particularly fiscal policy, is essential to ensure the stability of Estonia's economic development and the fulfilment of the Maastricht criteria.

According to the autumn 2007 forecast of Eesti Pank, it is unlikely that Estonia will be able to meet the Maastricht inflation criterion in 2008–2009 (provided that the interpretation of the criterion remains unchanged). According to the prognosis, the inflation is expected to peak in the first half of 2008. Although thereafter the inflation rate will start to decelerate, it will still exceed 4% at the end of



2009, whereas the reference value calculated on the basis of the autumn 2007 forecast of the European Commission will most probably be around 3%.

Thus, it must be concluded that the adoption of the euro will be postponed beyond 2011. Therefore, Eesti Pank and the Government have not set a new target date for the changeover to the euro. In any case, the exact date of changing over to the euro will be announced at least 12 months before the transition to the single currency so that the state and the public sector could complete their preparations. Despite the postponement of the changeover date, Estonia's accession to the euro area remains an essential economic policy objective<sup>1</sup>.

## SOVEREIGN RATING

Sovereign rating, more specifically the credit rating of a country, is an assessment by international (private) rating agencies of a country's capability and willingness to repay its long-term foreign liabilities by due date. Indirectly, sovereign rating reflects the reliability of a country's economy and economic policy. Sovereign rating largely determines the interest rate on foreign borrowing.

Since 1997 Estonia is being assessed by three main international rating agencies: Moody's Investors Service, Standard & Poor's and FitchRatings.

In 2007, Moody's changed **Estonia's sovereign rating** outlook from positive to stable; Standard & Poor's revised its outlook from stable to negative, and Fitch affirmed Estonia's outlook as stable. No rating agency changed the level of Estonian ratings during the year. Standard & Poor's and Fitch affirmed the rating of long-term foreign currency liabilities at the level A. Moody's rating on the likelihood of the repayment of Estonia's loans has remained unchanged since autumn 2002. The

rating A1 is a notch higher than the ratings given by Standard & Poor's and Fitch.

Due to downgrading the sovereign rating outlook, Moody's changed Estonia's **sovereign risk rating**<sup>2</sup> outlook of long-term foreign currency liabilities at the level Aa1 from positive to stable in 2007. Fitch and Standard & Poor's did not change Estonia's sovereign risk rating, leaving them at the level AA.

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<sup>1</sup> See also Eesti Pank's "Report on the Adoption of the Euro" (January 2008).

<sup>2</sup> Sovereign risk rating establishes a ceiling for the rating of companies operating in the country.

## FINANCIAL SECTOR

### Banking sector

#### *Institutional development*

At the end of 2007, seven companies licensed as credit institutions, seven branches of foreign credit institutions and over 180 cross-border banking service providers were operating in the Estonian banking market. Over 50 cross-border service providers emerged over the past year (see also Figure 6). On September 1, 2007 the name of Bayerische Hypo- und Vereinsbank AG Tallinn Branch was changed to AS UniCredit Bank Estonian Branch as a result of the expansion and merger of UniCredit Group.

As the growth of the loan market has slowed and credit institutions have responded differently to that, market shares have also changed more than usual during the past six months of 2007. Banks implementing a more conservative credit policy lost market share in 2007. Somewhat more active smaller banks, on the other hand, gained market share.

#### *Assets and liabilities of banks*

In 2007, banks' assets increased by nearly 81 billion kroons (33%) on an aggregate basis. At the end of the year, banks' total assets reached 321 billion kroons. The total value of the financing portfolios of banks and leasing companies exceeded 261 billion kroons at the end of 2007, having grown by almost 60 billion kroons over the year (7 billion kroons less than last year). The share of securities portfolios in banks' balance sheets remained more or less at the same level as last year (6% in 2007 vs. 7% in 2006).

Growth in the financing portfolios of banks and leasing companies decelerated considerably. This was caused by the stabilisation of economic growth, increasing interest rates and the adjustment of expectations to the new economic situation. Though the second quarter of 2007 may be considered a turning point in the growth of financing portfolios, the deceleration was most pronounced in the fourth quarter (see also Figure 7).

The stock of household housing loans and leasing grew 30% – at a rate two times lower compared to the 2006 figure. As at the end of December 2007,

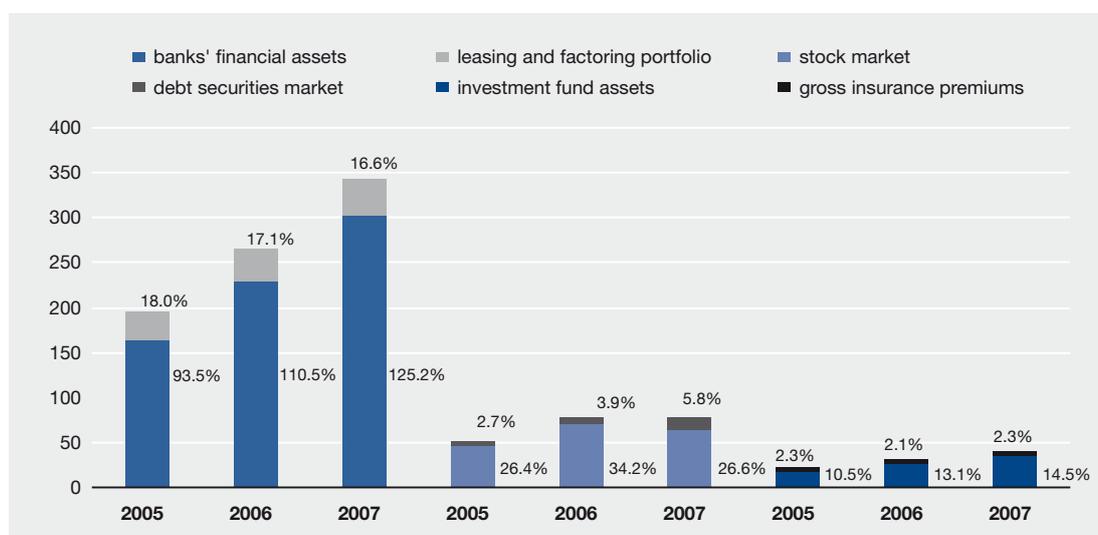
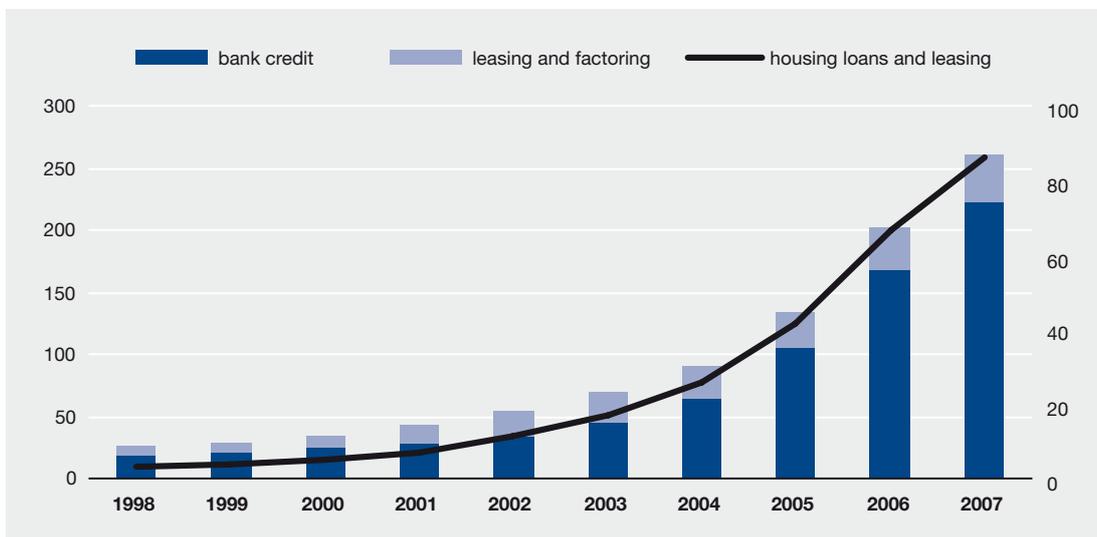


Figure 6. Structure of Estonian financial intermediaries (EEK bn and % of GDP)



**Figure 7. Public and non-financial sector financing (EEK bn)**

the total value of the housing loan portfolio stood at 86 billion kroons. Also household demand for consumer credit started to decrease in the second half of 2007. Meanwhile, the share of other loans in the total debt burden of households increased 2% compared to 2006; that is to 24%.

As regards the corporate sector, banks' financing portfolios were most significantly influenced by a decrease in the loan demand of real estate companies. In 2006, the loan stock of those companies increased by 23 billion kroons, whereas in 2007 it grew by 14 billion kroons, comprising 64% and 46%, respectively, of the new loans issued during the year. From among export oriented companies the financing of the industrial sector increased the most (by 3.8 billion kroons), whereas financing the operations of hotels and restaurants grew the fastest (41%, i.e. by 1.3 billion kroons).

As deposit growth remained relatively modest in 2007 compared to credit growth, deposits did not suffice to satisfy the demand for credit. Thus, banks obtained nearly 50 billion kroons of additional funds from parent banks. Although credit growth slowed at the end of the year, banks also had to increase their own funds considerably in 2007 to comply with

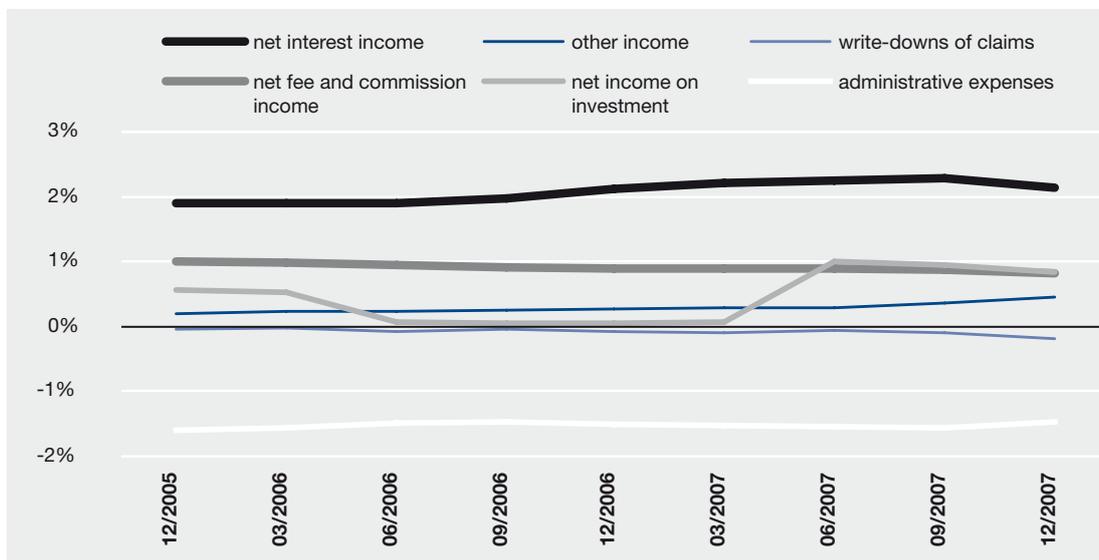
the capital adequacy requirements. Banks' consolidated balance sheet witnessed a rise mainly in the share of subordinated liabilities.

#### **Profitability**

Although growth in loan portfolios moderated and the cost of loan resources rose, profitability nevertheless remained high in 2007 (see Figure 8). It was boosted by growing loan portfolios and the withdrawal of exceptional profit from subsidiaries. The rising cost of loan resources was, to the most extent, passed on to customers, as the majority of loans were with floating interest rates.

In 2007, the return on assets was primarily curbed by slowing growth in fee and commission incomes. Although banks receive the majority of fee and commission incomes on payment intermediation, income growth has also been inhibited by the lower level of borrowing and changes in credit conditions.

Growth in administrative costs moderated in 2007, but an increase in the write-downs of assets reduced the favourable impact of the cut-down on expenses. Thus, also return on assets decreased in the second half of the year. Growth in write-downs



**Figure 8. Income and expense items (% of total assets)**

remained nevertheless rather modest. Owing to the extraordinary income received from subsidiaries, banks' costs comprised 35.3% of their incomes on an aggregate basis in 2007. Banking sector's return on equity was 30% as a result of extraordinary profit, which is substantially more than in 2006 (20%).

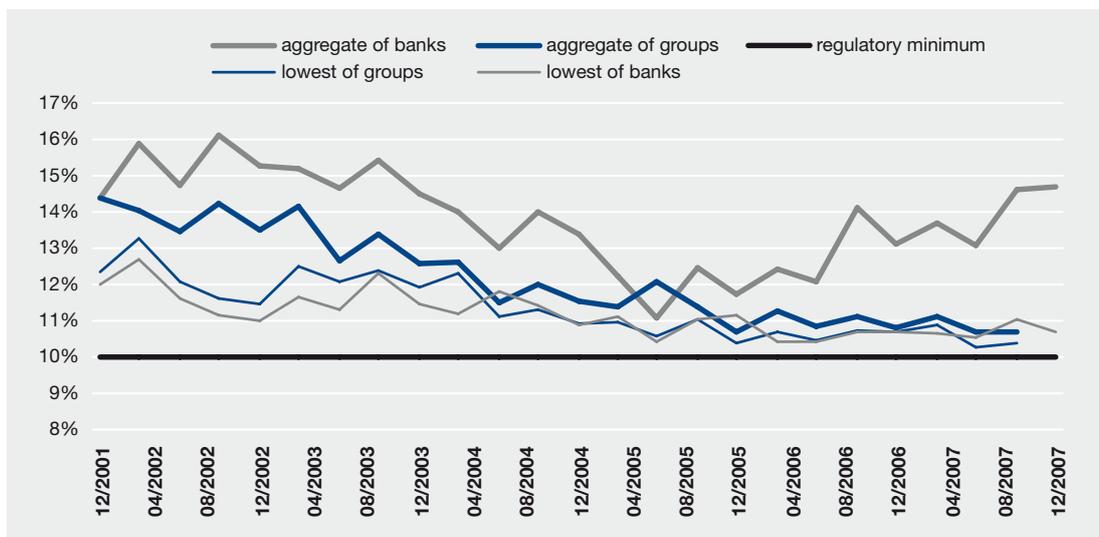
**Capital adequacy and risks**

Banks' aggregate risk weighted assets grew by 30% and own funds by 46% in 2007. Consequently,

at the end of December 2007 banks' aggregate capital adequacy ratio was 14.8% and that of banking groups 10.8% (see Figure 9).

**Loan-servicing capability and risks**

As key interest rates rose, growth in banks' loan portfolios decelerated and the overall economic development stabilised, the loan-servicing capability of bank customers started to deteriorate in 2007. The share of loans overdue for more than



**Figure 9. Capital adequacy of banks and banking groups**



60 days in the loan portfolio climbed from 0.3% at the beginning of the year to 0.7% at year-end. This was well expected and banks are strong enough to cope with overdue loans also in the future.

## Securities market

### Bond market

In 2007, the primary bond market was even more active compared to previous years: annual growth was 41% (see Figure 10). Bond market capitalisation growth accelerated to 76% and capitalisation reached 15 billion kroons at the end of 2007. The market expanded primarily due to bond issues by resident non-financial and financial sector companies. As the annual growth rate of bond issues by non-resident companies exceeded the average (120%), the share of those bonds in the total volume increased from 14% to 22%.

The secondary bond market was also very active. The average daily turnover was 8 million kroons higher than in 2006 and totalled 22 million kroons. By end-2007, the share of residents among bond investors had dropped to 65% (80% in 2006). The share of non-residents increased mainly owing to investors from non-financial sector companies.

### Stock market

In 2007, two corrections occurred on the Tallinn Stock Exchange; the second one is influencing stock market developments even at present time. At the beginning of the year, the Tallinn Stock Exchange index OMXT increased rapidly and peaked with 1042 points. This was, however, followed by the first correction at the beginning of March. After a slight fluctuation another rise occurred (see Figure 11 and Table 2). In the second half of the summer, also the value of OMXT started shrinking due to a decline in global stock markets. By the end of the year, the annual decrease of the index reached 11% and its value stood at 742 points. The average daily turnover of stock exchange transactions was twice as high in 2007 compared to the average of the previous year, reaching 94 million kroons.

Two new companies were listed on the primary list of the Tallinn Stock Exchange: the media and publishing company AS Ekspress Grupp and the real estate development and services and construction company AS Arco Vara. In addition, AS Viisnurk was divided into two: AS Trigon Property Development and AS Viisnurk. PTA Grupp changed its business name to AS Silvano Fashion Group.

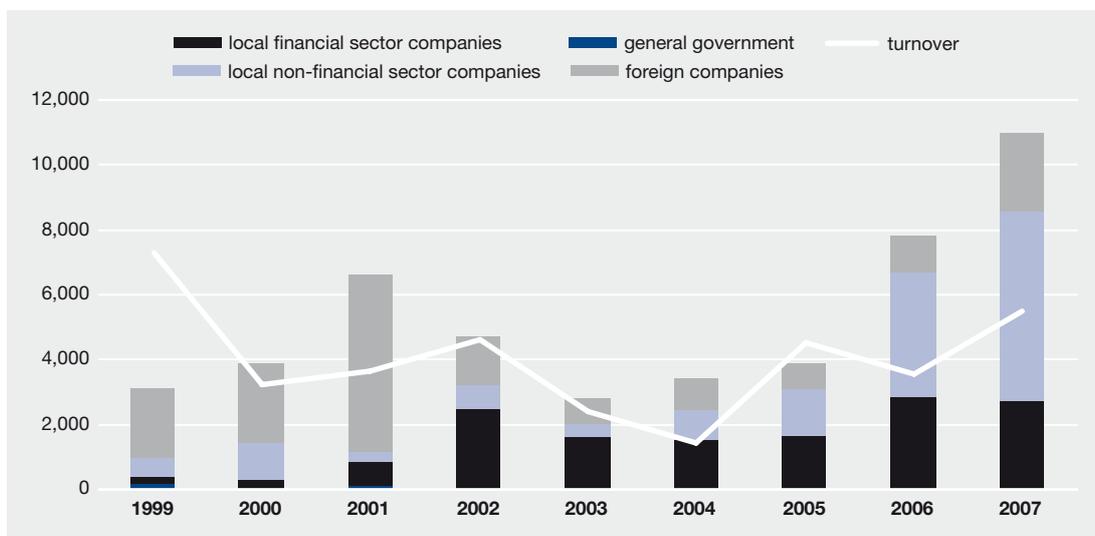
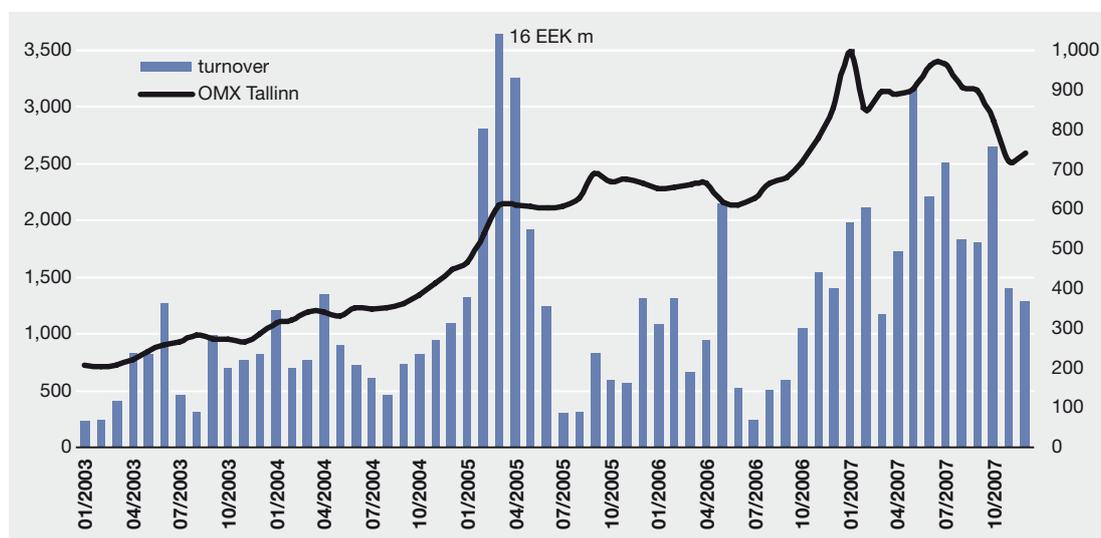


Figure 10. Amount of debt securities by issuers and secondary market turnover (EEK m)



**Figure 11. Monthly turnovers of the Tallinn Stock Exchange (EEK m; left scale) and index OMXT as at month-end (points; right scale)**

**Table 2. Aggregate indicators of the securities market (EEK bn)**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>Securities market capitalisation*</b>	<b>19.1</b>	<b>12.6</b>	<b>31.9</b>	<b>35.2</b>	<b>31.9</b>	<b>42.2</b>	<b>53.5</b>	<b>80.0</b>	<b>60.1</b>	<b>89.7</b>	<b>90.3</b>
Instruments											
shares listed on stock exchange	13.1	8.3	28.3	31.0	26.4	36.2	47.3	71.9	46.9	71.0	64.0
debt securities	4.0	3.7	3.2	3.7	4.4	3.3	2.9	3.1	4.8	8.5	15.0
shares and units of investment funds	1.8	0.4	0.4	0.4	0.9	1.7	2.6	4.5	8.4	10.2	11.1
subscription rights	0.1	0.2	0.0	0.0	0.2	1.0	0.7	0.5	0.0	0.0	0.0
<b>Securities market turnover*</b>	<b>32.8</b>	<b>32.8</b>	<b>12.4</b>	<b>10.1</b>	<b>10.2</b>	<b>13.0</b>	<b>14.9</b>	<b>13.9</b>	<b>68.4</b>	<b>37.4</b>	<b>74.0</b>
Capitalisation of Tallinn Stock Exchange	13.1	8.3	28.3	31.0	26.4	36.2	47.3	72.4	46.9	72.3	64.8
non-resident investors	42%	54%	74%	78%	78%	81%	81%	83%	58%	49%	55%
Turnover of Tallinn Stock Exchange	21.8	13.4	4.5	5.5	4.1	4.0	7.6	10.3	30.3	12.0	24.0
Securities market capitalisation* / GDP	29%	17%	39%	38%	31%	36%	42%	58%	46%	43%	37%
Securities market turnover / capitalisation	172%	260%	39%	29%	32%	31%	28%	17%	90%	59%	76%
Stock exchange turnover / capitalisation	167%	161%	16%	18%	16%	11%	16%	14%	47%	24%	33%

\* Securities market capitalisation and market turnover do not include unlisted shares.

## Other financial intermediaries

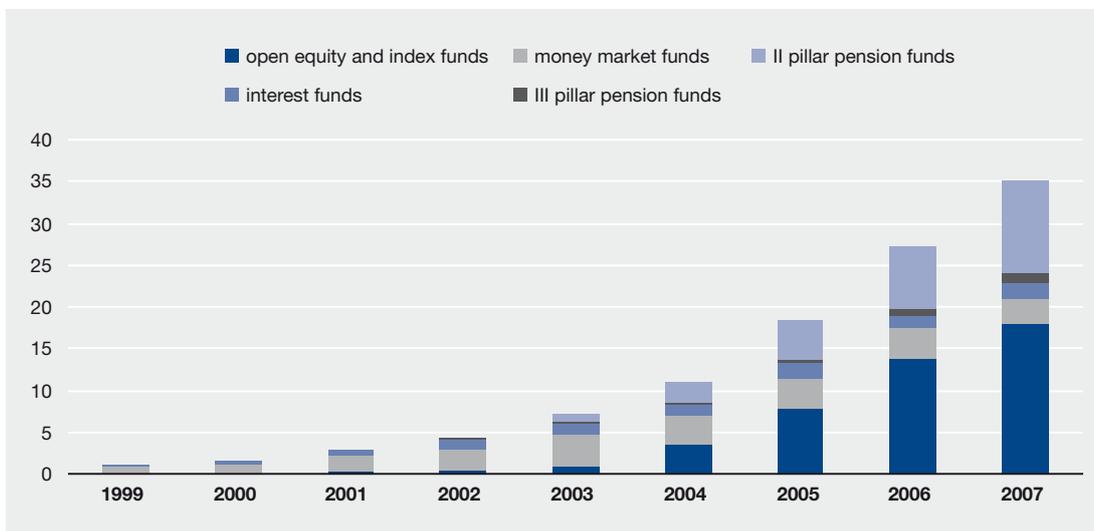
### Investment and pension funds

In the first half of 2007, the volume of investment fund assets increased rapidly and remained at a high level until the end of the year. By the end of December, the total volume of investment funds was 35 billion kroons and annual growth reached about 30%. Like in previous years, the greatest contributors to growth were assets of equity funds

and mandatory pension funds, which increased by 4.2 and 3.6 billion kroons, respectively. Last year, the volume of money market funds decreased by over 800 million kroons (see Figure 12).

### Insurance

In 2007, developments in the life insurance market could generally be characterised by the establishment of European companies in Estonia. This means that some life insurance companies coordi-



**Figure 12. Total volume of investment funds as at year-end (EEK bn)**

nate their activities in the Baltic States via companies established in Estonia. The gross premiums collected on insurance contracts concluded by Estonian residents grew by 24% and amounted to 1.9 billion kroons. The gross premiums collected on unit-linked life insurance contracts increased the most.

As competition has tightened, the distribution of market shares of non-life insurance companies changed considerably with the year. Hansa Varakindlustus has grown its market share considerably, winning a 10% share of the market during its first year of activity.

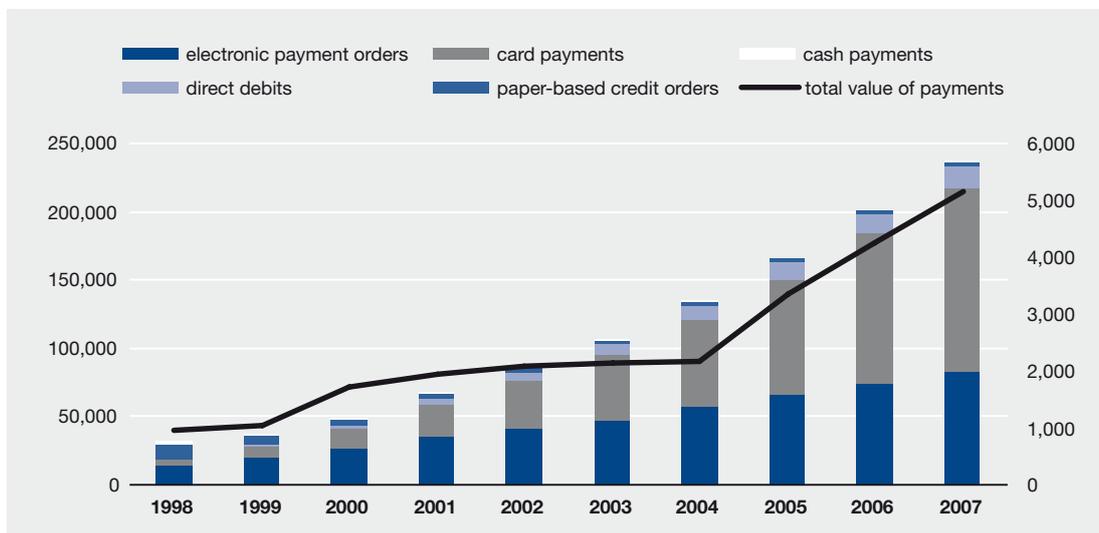
Gross premiums collected by non-life insurance companies increased 19% in 2007 and totalled 3.7 billion kroons at the end of the year. Similar to earlier years, the volume of gross premiums collected on land vehicle insurance increased the most.

### **Payment instruments**

In the past ten years, the total number of payments has multiplied by more than seven times and the total turnover has increased over five times (see

Figure 13). Although in 1998 direct debit was already available as a payment instrument in Estonia, it did not gain much popularity at first. Given that, the number of payments initiated by direct debits has risen the most rapidly – by nearly 160 times by the end of 2007. Card payments have been the prevailing form of payments (56% of all payments); their number has increased by over 27 times over the last decade. However, their share in the total turnover of payments intermediated by credit institutions is marginal (approximately 1%).

The next in popularity have been Internet and tele-bank credit orders, which comprise a significant share of the payments initiated by credit orders, considering the turnover as well as the number of payments. Cash payments and paper-based credit orders have not been very popular among Estonian residents lately; they rather prefer efficient electronic payment instruments and the use of cash payments and paper-based credit orders has been diminishing year by year. In 2007, the share of cash payments was only 0.2% in terms of the number and 0.04% in terms of the turnover of payments made through banks.



**Figure 13. Number (thousands; left scale) and turnover of payments (EEK bn; right scale) by payment instruments**

At the end of 2007, altogether 1.8 million payment cards were in use in Estonia, which is 10% more than at the end of 2006. Owing to developments in the financial services market, the share of debit cards dropped to 76% (1.4 million cards issued), whereas that of credit cards rose to 24% (over 421,000 cards) of the issued cards. As credit cards are used less frequently, 30% of all payments cards were passive. By the end of 2007, credit institu-

tions had issued one debit card per resident and three credit cards per ten residents. At the end of December 2007, there were 1,000 ATMs in Estonia, of which 85% enabled interbank use. 82 new ATMs were added in 2007; that is slightly more than in the previous year. At the end of the year, card payments were possible in 15,885 points of sale. The number of POS accepting card payments increased slower than earlier. Year-on-year growth was only 8%.



### Developments in the real estate market

The slowdown in economic growth brought along a decrease in the demand for and number of transactions in the real estate market in 2007. The first signs of stabilisation in the number of real estate transactions appeared already in the second half of 2006, whereas demand for real estate started to drop considerably in the third quarter of 2007. The number of transactions was significantly lower compared to the same period a year ago. In total 49,464 real estate transactions were performed in 2007, which is 20% less than in 2006.

The biggest gap between demand and supply can be seen in the case of new apartments, as their supply grows by the new dwellings brought to the market by real estate developers as well as by the dwellings sold in the secondary market. The number of completed dwellings in 2007 exceeded the 2006 figure by 40%, whereas the number of housing transactions was over 20% smaller than

a year ago. As construction costs and land prices have increased too, not all real estate developers may be able to decrease their sales prices sufficiently. Thus, some of them are likely to encounter difficulties in fulfilling their loan liabilities.

Although the average transaction value is affected, among other things, by changes in the structure of transactions, by the fourth quarter of 2007 the average value of transactions with plots of land had declined the most (see Figure 14). Compared to the same period a year ago, it had decreased by nearly 50%. Year-on-year, the average value of transactions with apartments – the most liquid part of the real estate market – dropped 15% by the last quarter of 2007. According to the Land Board, the median price of Tallinn apartments, for which the demand is broad-based, was 6% lower in the fourth quarter of 2007, compared to the same period last year. The adjustment of real estate prices most probably continues also in the first half of 2008.

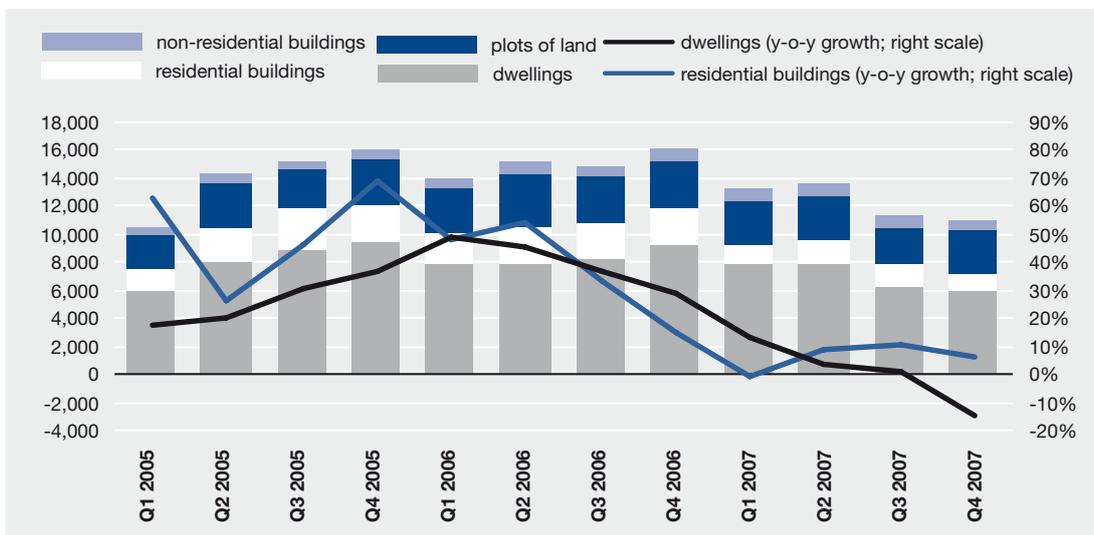


Figure 14. Number of purchase-sale contracts of real estate and annual growth of contract's average value

## KEY POINTS OF EESTI PANK'S ECONOMIC FORECASTS IN 2007

Eesti Pank published the spring forecast of 2007 in May and the autumn forecast in October. The following summary is primarily based on the autumn forecast and the information available at that time. Updates were introduced to the base model for the Estonian macroeconomic forecast. This mainly concerned the segment of the labour market, but also the credit market's block.

In 2005–2006 the Estonian economy grew by over 10%, whereas in 2007 growth slowed as expected. In spring 2007 we estimated a 8.4% growth for 2007 and in autumn we revised it slightly down to 7.3%. Actual growth stood at approximately 7%. Economy will cool further also in 2008 due to slowing growth in domestic demand and weakening external environment. It is highly unlikely that economic activity will gain a new momentum before 2009. The continuing inflow of loan money supports a new growth cycle, which should, however, rely more on productivity growth.

Generally, 2007 was relatively favourable for Estonia in terms of external demand, despite the emergence of several negative circumstances. In summer, global financial markets were overwhelmed by uncertainty, which is why external demand will be slightly weaker in 2008. Another negative factor was the political tension, which affected the volume of re-exports that largely rely on Russia's natural resources. In 2008, the neighbouring economies will grow slower compared to earlier periods and thus also the export growth potential will be smaller. This also applies for 2009. External balance will improve along with an adjustment in domestic demand, but at a very moderate pace.

Inflation offered more surprises. At the beginning of 2007, Eesti Pank expected the price rise to be 5.1% and in autumn 6.3%, whereas the actual price level increased 6.6%. The autumn forecast anticipated the culmination of domestic inflation factors, i.e. upward price pressures stemming from robust economic growth, at the end of 2007 and the beginning of 2008. Inflation will continue to rise also in 2008, as several excise duties were raised at the beginning of the year. However, in 2009 the price rise will probably decelerate.

The inflation forecast largely relies on the assumption that the labour market will cool. The market's macroeconomic indicators for 2007 still indicated rapid changes. Employment growth slowed considerably and although the decline in unemployment halted, wage growth continued at an accelerating pace. Rapid wage growth in the conditions of a cooling economy increased discrepancies between productivity and wage growth. This trend will remain one of the key factors undermining our economic competitiveness also in the forthcoming years, which, in turn, hinders balanced economic development.

In 2007, the risk of a steep slowdown in growth increased when the real estate sector entered a phase of adjustment. Substantial decline in activity in that sector curbs economic growth considerably, as real estate investment has been making large contributions to growth in recent years. Another risk surrounding economic sustainability is the possibility of Estonian banks encountering difficulties with raising capital from external markets. In that case, an extensive correction is in store for domestic demand.



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EESTI



Decrees, decisions  
and publications

# DECREES OF THE GOVERNOR OF EESTI PANK IN 2007

## **No 1, 18/1/2007**

Amendments to Eesti Pank Governor's Decree No 25 of 19 October 1999 "Public Disclosure Reports of Credit Institutions"

## **No 2, 23/1/2007**

Amendments to Eesti Pank Governor's Decree No 21 of 16 December 2002 "Procedure for the declaration of international payments and submission of data required for the balance of payments statistics"

## **No 3, 5/2/2007**

Repeal of Eesti Pank Governor's decrees

## **No 4, 27/3/2007**

Reports on prudential ratios of the own funds of credit institutions and consolidation groups of credit institutions

## **No 5, 23/4/2007**

Amendments to Eesti Pank Governor's Decree No 9 of 7 November 2006 "Approval of documentation of the Real-Time Gross Settlement System of Eesti Pank"

## **No 6, 30/5/2007**

Issue of collector coin

## **No 7, 18/6/2007**

Rules for fixing the Estonian inter-bank interest rate on loans and deposits

## **No 8, 22/6/2007**

Establishment of substantive and formal requirements for the balance sheet and income statement of a credit institution and a consolidation group of credit institution

## **No 9, 13/7/2007**

Establishment of supplementary reports on credit institutions' balance sheet

## **No 10, 23/8/2007**

Establishment of reports on payments statistics submitted pay credit institutions

## **No 11, 1/10/2007**

Establishment of the report on deposits guaranteed by the Guarantee Fund and the report on quarterly contributions paid to the Guarantee Fund

## **No 12, 1/10/2007**

Amendments to Eesti Pank Governor's Decree No 11 of 8 December 2006 "Establishment of Procedure for Calculating and Complying with the Reserve Requirement"

## **No 13, 1/10/2007**

Amendments to Eesti Pank Governor's Decree No 8 of 19 September 2006 "Establishment of Foreign Currency Purchase and Sale Report"

## **No 14, 1/10/2007**

Establishment of balance of payments reports of credit institutions

## **No 15, 1/10/2007**

Amendments to Eesti Pank Governor's Decree No 9 of 13 July 2007 "Establishment of supplementary reports on credit institutions' balance sheet"

## **No 16, 9/11/2007**

Establishment of off-balance-sheet reporting of credit institutions

## **No 17, 26/11/2007**

Amendments to Eesti Pank Governor's Decree No 4 of 27 March 2007 "Reports on prudential ratios of credit institutions and consolidation groups of credit institutions"

## **No 18, 26/11/2007**

Amendments to Eesti Pank Governor's Decree No 13 of 29 December 2006 "Procedure for application and calculation of prudential ratios of credit institutions and consolidation groups of credit institutions"

## **No 19, 7/12/2007**

Establishment of supplementary reports on the balance sheet of a credit institution's consolidation group



**No 20, 21/12/2007**

Information disclosed on credit institutions' risk management, own funds and capital adequacy and additional reports subject to disclosure

**No 21, 28/12/2007**

Amendments to Eesti Pank Governor's Decree No 20 of 13 December 2002 "Approval of the rules on fixing daily exchange rates of the Estonian kroon"

# **DECISIONS ADOPTED BY THE SUPERVISORY BOARD OF EESTI PANK IN 2007**

**No 2-1, 13/3/2007**

Approval of the Statute of Eesti Pank

**No 3-1, 24/4/2007**

Profit distribution strategy of Eesti Pank

**No 3-2, 24/4/2007**

The 2006 Annual Report of Eesti Pank

**No 3-3, 24/4/2007**

Appointment of the auditor

**No 3-4, 24/4/2007**

Design and minting of a collector coin

**No 5-1, 12/6/2007**

Amendment of the rules of procedure of the Supervisory Board of Eesti Pank

**No 5-2, 12/6/2007**

Appointment of the members of the Supervisory Board of the Financial Supervision Authority

**No 6-1, 18/9/2007**

Amendment of the work schedule for 2007 of the Internal Audit Department of Eesti Pank

**No 7-1, 23/10/2007**

Design and minting of collector coins

**No 9-1, 11/12/2007**

Approval of the work schedule for 2008 of the Internal Audit Department of Eesti Pank

## PUBLICATIONS OF EESTI PANK IN 2007

The website of Eesti Pank is located at [www.bankofestonia.info](http://www.bankofestonia.info). The website contains information on Eesti Pank and its activities, as well as on the **Estonian monetary system, economy and financial environment**. Other topics available on the site include **banking legislation**; information on **Estonian banknotes and coins** (including guidelines for collectors); information on the **European Union** and the **euro**; **publications and press releases of Eesti Pank**, and a glossary. There is also a comprehensive **statistics database** and the **daily fixings of currencies**. In addition, there is a **virtual library** (in Estonian only), which links to other libraries in the field of economy.

### **Economic policy statement by Eesti Pank**

The economic policy statements provide prompt and concise opinions of the central bank on the most relevant issues concerning economic and banking policies. The statements are available on the bank's web site, published as press releases and often presented at a press conference.

### **Annual Report**

The Annual Report includes the analysis of the monetary and economic policy environment during a calendar year; a survey of changes taking place in the financial and non-financial sectors and the central bank; an overview of bank's international cooperation; the annual accounts, etc.

### **Monetary Developments & Policy Survey**

The Monetary Developments & Policy Survey is a periodical publication of Eesti Pank, where changes in the Estonian financial and non-financial sectors are analysed. Issues published in 2007:

- Monetary Developments & Policy Survey (March)
- Monetary Developments & Policy Survey (September)

### **Financial Stability Review**

The Financial Stability Review is a periodical publication of Eesti Pank, which covers various aspects of financial stability. Issues published in 2007:

- Financial Stability Review (May)
- Financial Stability Review (November)

### **Balance of payments**

The balance of payments gives an overview of Estonia's foreign trade activities, including the country's international investment position and external debt. It contains a lot of statistical data.

Issues published in 2007:

- Estonian Preliminary Balance of Payments for the Year 2006
- Estonian Preliminary Balance of Payments for the First Quarter of 2007
- Estonian Preliminary Balance of Payments for the Second Quarter of 2007
- Estonian Preliminary Balance of Payments for the Third Quarter of 2007
- Estonian Balance of Payments Yearbook 2006

### **Kroon & Economy**

The quarterly includes surveys and analyses on topical economic issues, comments, translated articles, statistics, etc.

Issues published in 2007:

Kroon & Economy No 4/2006 & 1/2007

- Current state and future prospects of Estonia's population (K. Täht, E-M. Tiit)
- Change in the European labour force and its impact on migration (M. Ainsaar)
- Labour market review (D. Tur, N. Viilmann, A. Saarniit)

Kroon & Economy No 2/2007

- Factors influencing developments in the real estate market (A. Kallakmaa-Kapsta)
- Housing finance in Estonia: a short note on recent developments (M. Tamm)
- Factors affecting household saving behaviour in Estonia (D. Kulikov, A. Paabut, K. Staehr)
- Estonian residents' attitude towards taking a housing loan (survey by TNS Emor)
- Evaluation of financial sector development (M. Tamm)

Kroon & Economy No 3/2007

- Meeting the Maastricht criteria for exchange rates and inflation during a period of nominal convergence (J. Lewis)
- Baltic economies through the eyes of rating agencies (E. Tamla, K. Moor)
- Financial standing of Estonian and Polish companies – a comparative study (G. Golebiowski)

Kroon & Economy No 4/2007

- The Estonian energy sector in comparison to other countries (E. Kisel)
- The prices of energy carriers in 1992–2007 (A. Saarniit)
- Russia's gas – the solution to Europe's energy demand? (K. Pollisinski)
- Estonian residents' opinion on the state of Estonia's economy and banking sector (survey by TNS Emor)
- Labour market review (D. Tur, N. Viilmann)

### **Labour Market Review**

The Labour Market Review is a periodical publication of Eesti Pank, which analyses labour market trends and developments in employment. Issues published in 2007:

- Labour Market Review (April – D. Tur, N. Viilmann, A. Saarniit)
- Labour Market Review (October – D. Tur, N. Viilmann)

### **Working Papers**

Each Working Paper is a short summary of a particular economic study. It is published in Estonian (Eesti Panga toimetised) or in English (Working Papers of Eesti Pank).

In 2007, the following Working Papers were published:



- *Working Papers 2007 No 1:* R. Kattai. Constants do not stay constant because variables are varying
- *Working Papers 2007 No 2:* A.H. Hallett, R. Kattai, J. Lewis. Early Warning or Just Wise After the Event? The Problem of Using Cyclically Adjusted Budget Deficits for Fiscal Surveillance
- *Working Papers 2007 No 3:* K. Staehr. Fiscal Policies and Business Cycles in an Enlarged Euro Area
- *Working Papers 2007 No 4:* K. Männasoo. Determinants of firm sustainability in Estonia
- Toimetised 5/2007: A. Paabut, R. Kattai. Kinnisvara väärtuse kasvu mõju eratarbimisele Eestis [Does the increase in housing value influence private consumption in Estonia?]
- *Working Papers 2007 No 6:* L. Uusküla. Firm entry and liquidity
- *Working Papers 2007 No 7:* A. Dabusinskas, D. Kulikov. New Keynesian Phillips curve for Estonia, Latvia and Lithuania
- *Working Papers 2007 No 8:* D. Kulikov, A. Paabut, K. Staehr. Microeconomic Analysis of Household Saving in Estonia: Income, Wealth and Financial Exposure
- *Working Papers 2007 No 9:* Ch. Schulz. Forecasting Economic Growth for Estonia: Application of Common factor Methodologies
- *Working Papers 2007 No 10:* A. Hazak, K. Männasoo. Indicators of Corporate Default – An EU Based Empirical Study
- *Working Papers 2007 No 11:* J. Lewis, K. Staehr. The Maastricht Inflation Criterion: What is the Effect of Expansion of the European Union?
- Toimetised 12/2007: T. Rõõm. Haridus ja tööturg Eestis [Education and labour market in Estonia]

### **Other publications**

- Eesti kunstnikud Põhjamaades / Estonian artists in the Nordic Countries. Eesti Pank. Tammerraamat, 2007
- Eesti Panga muuseum [10th anniversary of the Eesti Pank Museum]. Tallinn: Eesti Pank, 2007
- Eesti Vabariigi mündid / Coins of the Republic of Estonia. Eesti Pank. Tammerraamat, 2007
- Eesti Vabariigi rahatähed / Banknotes of the Republic of Estonia. Eesti Pank. Tammerraamat, 2007
- Report on the Adoption of the Euro (May)

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