

Eesti Pank
Bank of Estonia

Eesti Pank Annual Report 2006

2007

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Kristjan Raud's national romantic designs

The illustrations used in the insets of this yearbook are from banknote designs by Estonian artist Kristjan Raud (1865–1943). For over 50 years of Estonia's art and cultural history has been strongly influenced by his creation, teaching, national heritage conservation activities and public writings.

Kristjan Raud's national romantic pencil and charcoal drawings are well known and loved in Estonia. His drawings frequently depict mythological ghosts and other weird creatures, a motif of a flying lake from our folklore and personified forces of nature. Though rather little playfulness and ease is present in his drawings, there is plenty of vitality and original sense of humour.

The artist's personal style well known from the illustrations of the national epic Kalevipoeg is clearly evident also in his designs for banknotes. Numismatists will notice this too since his motifs from Kalevipoeg illustrations were used on the collector coins issued in 1998 for the celebration of the 80th anniversary of the Republic of Estonia.

Of all the banknotes designed by Kristjan Raud for the Republic of Estonia, only the 10-mark note went into circulation in 1919.

Kristjan Raud himself appears on the one-kroon banknote currently in circulation in Estonia.

Kristjan Raud

Main features and functions of Eesti Pank

Eesti Pank is the central bank of the Republic of Estonia and a constitutional institution analysing and running the Estonian monetary system, i.e. 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 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.

1000

TUHAT EESTI MARKA

1000

KILIA WAARTIISES RIIGI PANGA POJIT
GARANTEERITUD SAIS TA LEMNASAS TOOMEKSE

N=437523

RIIGIKOPIKATEL KORIA SEE RUMIAT
HEISAA. OLE HOOLAP IA KOKKUHOLD

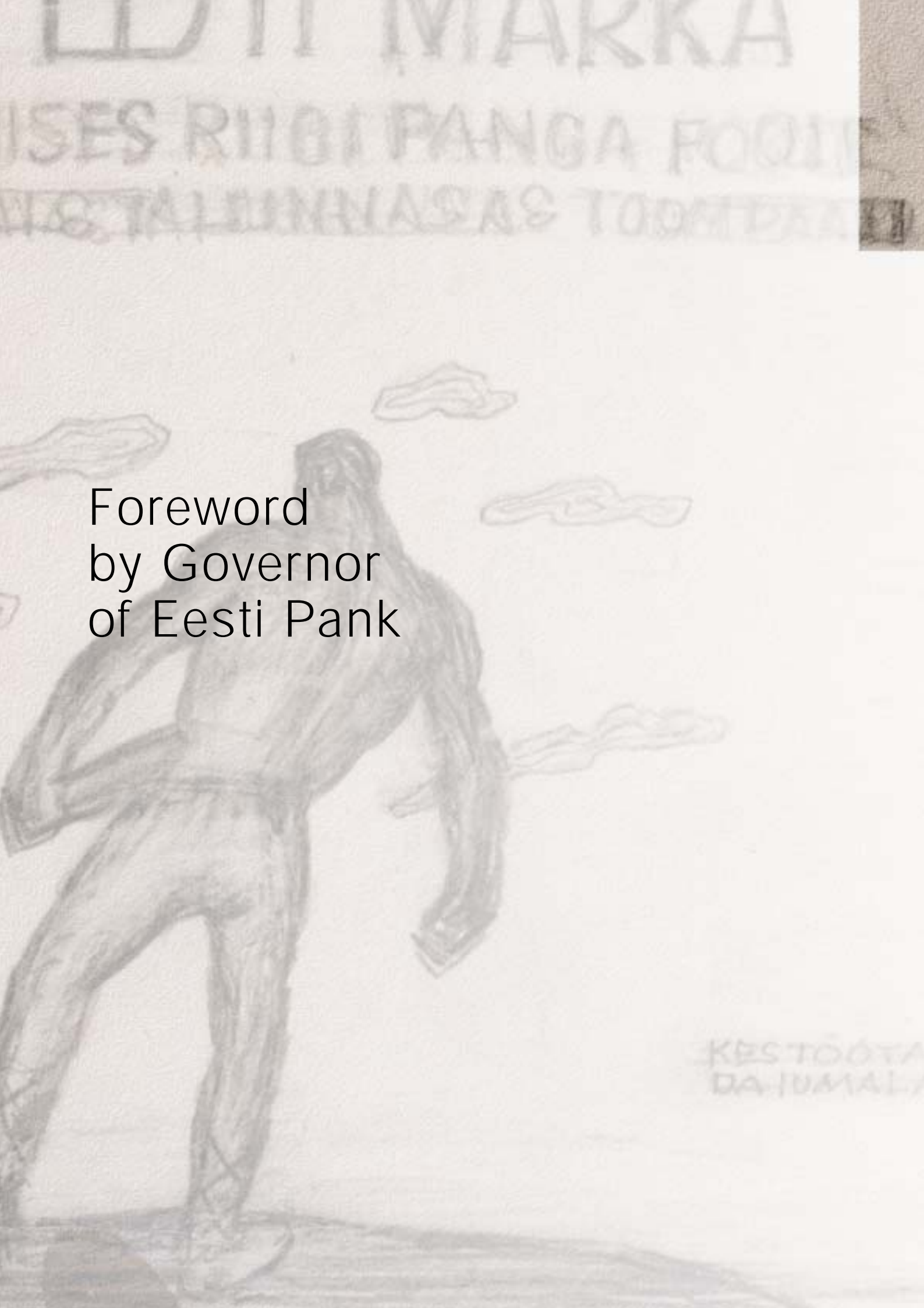
KES TOOTA SIA STUUES SPTIIE
DA ISMAG ARTOO JI OLE ATYIIE
OKTEBERIIN

RAHARTIN: EKUKK

N=437523

RIIGIKOPIKATEL KORIA SEE RUMIAT
HEISAA. OLE HOOLAP IA KOKKUHOLD

RAHARTIN: EKUKK



Foreword
by Governor
of Eesti Pank

KES TÖÖTA
DA IUMAL

Foreword by Governor of Eesti Pank

The year 2006 was successful for Estonia's economy and also the second consecutive year of extremely fast growth. The unemployment rate was the lowest of the last decade and real wages grew over 12 per cent. A lot of people decided to take a loan to improve their living conditions.

However, rapid economic expansion may also involve higher risks. The central bank drew attention to this issue several times during the year. Apparently, explanations aiming at cooling down excessive optimism have made an impact. The year 2006 showed a breakthrough in general attitudes: earlier, there was the question whether the central bank voices its concerns on risks and dangers too often, but now people would rather ask why the central bank and the Government do not take even more decisive measures to manage risks. What should the measures be like and – should there be any specific measures at all?

Eesti Pank expects the 2007 economic growth stand at 8.4% and at about 6.5% the year after. With figures like these Estonia should remain among the fastest growing EU Member States also in the years to come. Over the long term, rapid development will persist and living standards of the leading European industrial countries can be reached only if the economy will smoothly move towards a slightly slower and more sustainable growth path.

It is vital, however, that further growth is not merely based on domestic demand. Estonian exports increased robustly in 2006, exporters' future expectations at the end of the year were even more optimistic than early in the year, and the economy's competitiveness remained high. If competitiveness is maintained, also economic outlook will remain favourable.

Sustained competitiveness of Estonia's economy presumes a flexible labour market and sufficient supply of qualified labour. Recent rapid developments and integration with the European Union might imply that upward wage pressures might persist. At the end of 2006, risks related to unit labour costs (labour costs per unit of production) began to emerge. Wage pressures are expected to continue in 2007. Should this involve an increase in labour costs at the expense of profitability, it indicates a risk for competitiveness. It is important that wage growth did not exceed growth in productivity.

Estonia's economy will continue rapid development in the next few years. This suggests a strong need for investment since in Estonia's economy there is significantly less capital per employee than on average in



the EU. Therefore, the current account deficit will remain rather large, accounting for 15 per cent in 2006. The deficit displays the difference between domestic savings and investments and the share of foreign capital in financing investment made in the Estonian economy today. Foreign capital inflow into Estonia is only natural regarding the current stage and reliability of economic development. A gradual decrease in the current account deficit can be expected when the need for investment diminishes. Given the above, we should emphasise that the government's prudent fiscal policy has inhibited deficit growth. It is also worth mentioning that along with income growth residents' savings kept growing in 2006, whereas in terms of savings Estonia's economy may already be compared to industrial countries with higher income levels.

Should changeover to the euro in Estonia be indefinitely postponed, all the risks to the economy may aggravate. The changeover is an economic policy priority for Estonia and should also remain one. We are highly unlikely to meet the Maastricht inflation criterion in 2007–2009. Nevertheless, we should maintain readiness to adopt the euro at the first opportunity.

In the longer run, Estonia's rapid progress can be maintained through further changes in the production structure and an increase in productivity. From the national point of view, it entails providing favourable investment and growth environment, acknowledging the importance of business and the willingness to take risks, as well as a clear understanding of how vital for us is an educational system ensuring high quality and good results.

At the same time, we should preserve these factors that have guaranteed our success until now: sustainable and transparent fiscal policy, open and clear tax system, and economic climate conducive to business.

In conclusion, adjustment to changed conditions does not require any special or totally different economic policy but rather follows a normal course of market development. Estonia's successful economic policy should be consistently pursued.

Andres Lipstok
Governor

EESTI VABARIIGI RAHAVAARTTAKT
KINNITATUD JA VÄHAANTUD TALLINN
KS TOOM PALL 1918 AASTALE KRIS
RAHAMINJA-KUKK

TUHAT EES

1000

TI MARKA

EESTI VABARIIGI RAHAVAARTTAKT
 KINNITATUD JA VÄHAANTUD TALLINN
 KS TOOM PALL 1918 AASTALE KRIS
 RAHAMINJA-KUKK

EESTI VABARIIGI RAHAVAARTTAKT
 KINNITATUD JA VÄHAANTUD TALLINN
 KS TOOM PALL 1918 AASTALE KRIS
 RAHAMINJA-KUKK
 № 934517



KUNBERG ON SOOME LUVLETRA SURNISTE
 HELSINGIS WÄRKUNNE KOLME / EUVAAST

ASUTATU



VRI ONNIT

KUNBERG ON SOOME LUVLETRA SURNISTE
HELSEINGIS WÄRKUNNE KOLME / EUVAAST

EEJT VAG
TAHT KINN
NNAS TOON

Accountability



ACCOUNTABILITY

Over the last fifty years the central bank's independence has emerged as an inseparable part of a 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 volume 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 rules laid down for this purpose. The statistical data are published on the bank's website. The Eesti Pank Act also requires 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 annual report of the central bank 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 in the Riigikogu on the annual report of the central bank.

Accountability vis-à-vis the Riigikogu

Governor of Eesti Pank makes a presentation on the annual report every year. In addition, the bank and the Riigikogu cooperate in the form of meetings and bank representatives give explanations and comments in response to the 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 on economic processes and discuss topical issues.

Upon request of parliamentary factions the top executives of Eesti Pank present the views on economic policy developments and activities of the central bank. In 2006, the role of the central bank and the system for ensuring the quality of currency were of most interest.

Interpellations raised by members of the Riigikogu in 2006

- Interpellations raised by member of the Riigikogu Janno Reiljan on the legislative proceeding of the Eesti Pank Act Amendment Act 720 SE to specify the functions and assets of the central bank as a member of the Eurosystem.
- An interpellation by a member of the Riigikogu Urmas Reinsalu concerning the central bank's proposal to repeal the income tax incentive on housing loan interests so as to curb risks accompanying loan growth.
- An interpellation by a member of the Riigikogu Marko Pomerants regarding the release into circulation of defective 100-kroon banknotes.

- An interpellation by a member of the Riigikogu Andres Herkel concerning the details of the case of defective 100-kroon banknotes released into circulation.

Regular reporting on economic policy views and publishing economic data

The central bank's reliability for the public and the transparency of its activities are the preconditions 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 the 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 data¹). In addition to providing information on the website and in various publications², it is possible to request information directly from the bank. Information can be requested by mail, e-mail or phone. In 2006, Eesti Pank received 3,074 queries, 172 of which were registered as requests for information.

¹ 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.

² The full list of publications of Eesti Pank in 2006 is available in the Annex to the Annual Report on page 114.

500

VISSADA

*Raha väärtuse tagu
võlgadele*

500 VISSADA EESTI MARKA 500

E.W.R.

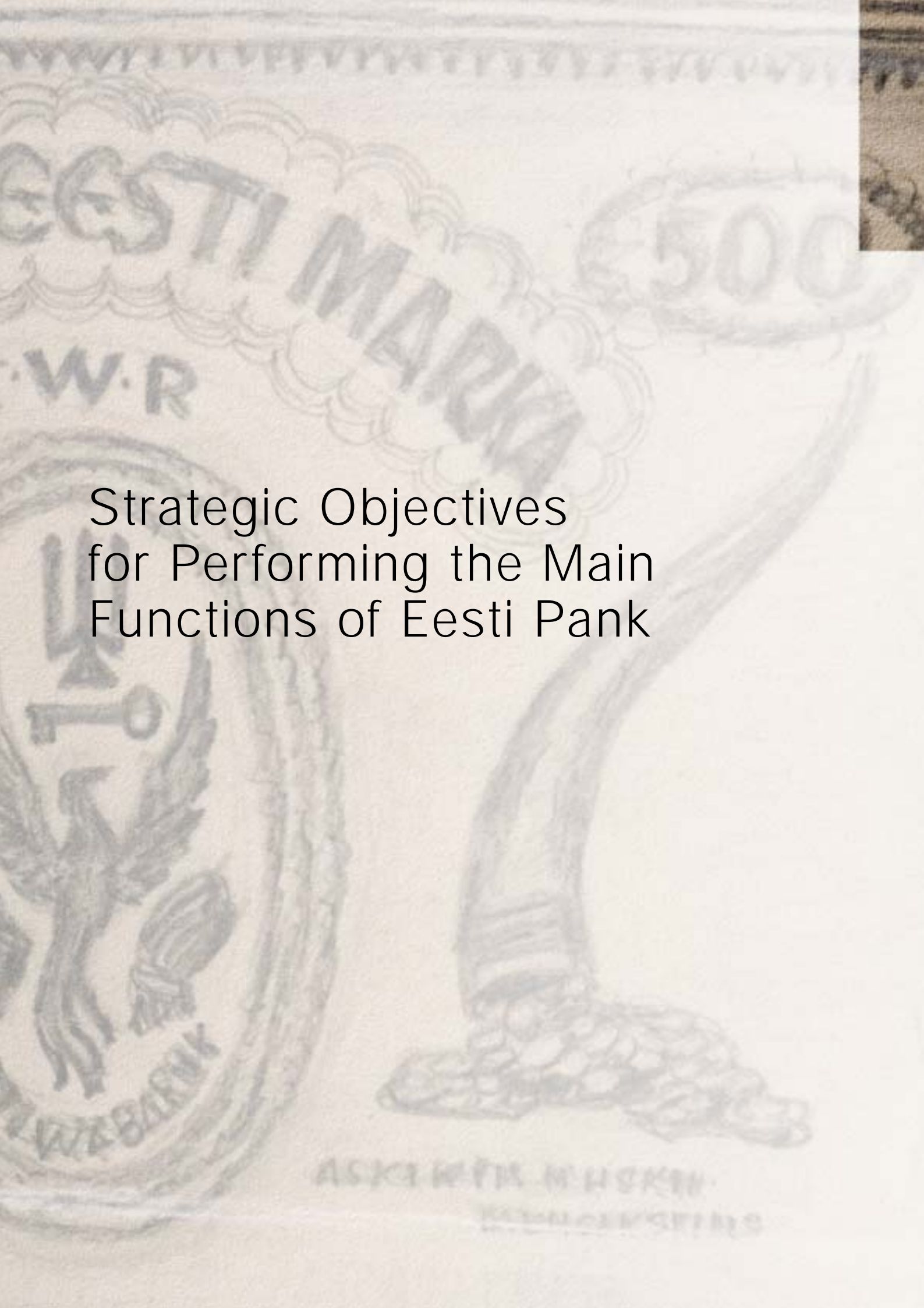
TISTAI N°7348
 AKSIONER KUNSTI
 RAHAKOOL
 TISTAI N°7349

RIISI RAIGI VARAMU SEGATA LINNASS
 KRESTI-O MATUBA OMA TUBA LINDA. N°43075

RAHAM: IKUIKE



TISTAI N°7348



Strategic Objectives
for Performing the Main
Functions of Eesti Pank

STRATEGIC OBJECTIVES FOR PERFORMING THE MAIN FUNCTIONS OF EESTI PANK¹

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 current acceleration of credit growth and the threats that may accompany the possible increase in inflationary pressures. Meanwhile, cooperation with the government on economic policy is aimed at finding ways to prevent setbacks arising from the abovementioned threats.
3. Integrating Estonia's monetary policy environment and market operations with those of the Economic and Monetary Union, taking into account the peculiarities of Estonia.
4. Amending the management of foreign exchange reserves with the goal of ensuring the optimum investment of assets when Estonia becomes a full member of the Economic and Monetary Union.
5. 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, while further developing the short-term adjustment mechanism of Estonia's economy.
6. Ensuring the consistency and quality of the compilation of financial sector and balance of payment statistics in compliance with European Union standards. Creating enhanced means of information technology for users who transmit statistical data.

II Financial stability

7. Safeguarding financial stability by focusing on the development of the financial sector's safety net. Strengthening the national crisis management capacity in cooperation with the Ministry of Finance and the Financial Supervision Authority and the cross-border crisis manage-

ment capacity in cooperation with Finland's and Sweden's central banks.

8. Preparing up-to-date financial sector regulations that would comply with the risk profile of banks' operational environments and international practices.
9. Acting as the overseer of settlement systems and publishing respective assessments regularly.

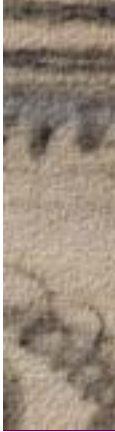
III Meeting the cash demand

10. Reducing the percentage of cash in circulation and promoting the usage of more modern means of payment. Joining the future Trans-European Automated Real-Time Gross Settlement Express Transfer system TARGET2.
11. Celebrating key events in Estonia by issuing numismatic-bonistic products.

IV Joining the euro area

12. 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.
13. Ensuring the technological readiness of cash management for the changeover to the euro.
14. Ensuring readiness for competent participation in the decision-making and cooperation mechanisms of the single European monetary policy.
15. 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. Updating the structure of the bank's information outputs.

¹ Decision of the Supervisory Board of Eesti Pank No 11-1 of 12 December 2006 (the strategic development plan of Eesti Pank for 2007–2009).



V Organisation and cooperation

16. Participating in the work of the Nordic-Baltic Constituency of the International Monetary Fund.
17. 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 in association with the Estonian Economic Association.
18. Developing the professional skills and knowledge of the staff through in-service training programmes and personal development plans.
19. Compiling an integral description of the management system, specifying the products and services of Eesti Pank, developing value-based management, reviewing the compensation system and preparing for improvement or amendment thereof. Budgeting will be supplemented by process-oriented accounting and classification possibilities.
20. Making the risk management process at Eesti Pank fully compatible with the strategic planning process.
21. Creating an interactive visitor centre using the resources of the museum and library of Eesti Pank which will present 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 money.
22. Implementing a system management model covering all systems with IT components.
23. Improving both the physical and IT working environment as well as creating teleworking opportunities.



Major Activities and
Achievements of
Eesti Pank in 2006



MONETARY POLICY

ENSURING THE SMOOTH FUNCTIONING OF ESTONIA'S MONETARY POLICY FRAMEWORK

Key features of the Estonian monetary system

Similarly to the central banks of many other countries, the mission of Eesti Pank is to ensure price stability in Estonia. A **stable**, low and easily predictable inflation level establishes favourable conditions for long-term economic growth. Already since 1992, Estonia's price stability is based on the **fixed exchange rate system under the currency board arrangement**. The current monetary policy framework, which has essentially remained unchanged during its 15 years of operation, continues to support Estonia's economic development. The Estonian kroon has maintained its reliability for domestic users as well as 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, which curbs inflation expectations and fosters economic stability. As Estonia's monetary policy based on the currency board arrangement has proved its viability, the country has taken a unilateral commitment to maintain the cur-

rent 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. In 2006, the European Central Bank raised monetary policy interest rates and this quickly and fully passed on to the interest rates of the Estonian credit market, thus influencing the price of financial instruments in Estonia.

Eesti Pank ensures the smooth operation of the monetary system **through monetary policy instruments and active participation in economic policy discussions**. The main monetary policy instrument of the central bank is the **standing facility of buying and selling foreign currency (forex window)** provided to credit institutions. Banks can use the forex window to stock up on their Estonian kroon reserves by selling to the central bank an amount of foreign currency equal to the desired sum, and vice versa – buy foreign currencies for Estonian kroons. The **reserve requirement** plays an important role among the monetary

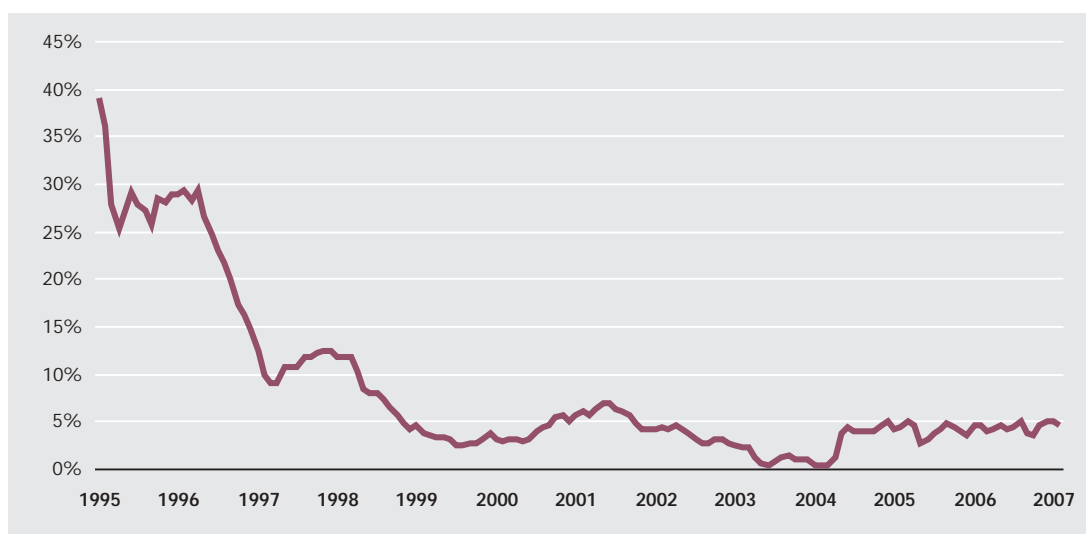


Figure 1. Estonia's inflation

Source: Estonian Statistical Office



policy instruments available for Eesti Pank, obliging banks to keep a part of their assets as buffers in the central bank or in high-quality foreign assets. Central bank applies a conservative reserve policy and supervisory measures, and regularly draws public and the Government's attention to risks associated with the macroeconomic environment. The efficiency of the monetary system based on a strictly fixed exchange rate is supported by balanced **budget policy and flexible markets**.

Monetary policy in 2006

In 2006, one of the priorities for the central bank was managing the risks deriving from strong domestic demand. In the favourable economic environment, Eesti Pank repeatedly drew public attention to **risks associated with the excessively optimistic consumption and borrowing**. In order to curb these risks Eesti Pank decided to take monetary policy and financial supervision measures.

The first regulatory changes entered into force in March 2006. They focused primarily on decreasing risks related to housing loans (for further information see Chapter „Ensuring Financial Stability“ p 33). At meetings with the representatives of banks and financial supervisors, the central bank also emphasised the general need for a conservative approach to risk assessment, and the participants agreed.

As the regulatory changes that entered into force in March did not decrease risks sufficiently, Eesti Pank decided to **raise the reserve ratio for banks from 13% to 15% as of September 1, 2006**. With this decision the bank sent a clear message concerning the seriousness of the risk of economic overheating. Eesti Pank urged both lenders and borrowers to assess economic risks more conservatively. At the beginning of 2007, the growth of housing loans moderated, but nevertheless remained too high for sustainable economic development.

In 2006, the technical aspects of the banks' reserve requirement calculation were specified.

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

One of the preconditions for a successful economic policy is **consistency between monetary policy and fiscal policy**. Thus, the central bank also urged the Government to take measures in order to alleviate the threat of economic overheating and support economic balance through fiscal policy. This is possible mainly by increasing the consolidated budget surplus. The 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 2006 government budget surplus amounted to approximately 4% of gross domestic product (GDP); the budget surplus planned for 2007 is 1.9% of GDP.

In 2006, the **price growth in Estonia remained at a level ensuring sustainable economic development**, the total annual inflation rate being 4.4%. Such price growth was expected, considering the joint impact of the peak of the Estonian economic cycle and convergence with wealthier European economies. High economic activity and the resulting increase in demand fostered price growth. (After a moderate slowdown of economic growth, price growth is expected to decelerate.) Meanwhile, the Estonian economic indicators continued approaching the EU average indicators, which brought along a significantly faster income and price growth compared to the EU average (see Figure 2). The Estonian income and price levels are among the lowest in the European Union. In order to reduce these differences, incomes and prices in Estonia have to grow somewhat faster than in the European Union on average. To provide for balanced economic development, rapid income growth should be accompanied by strong produc-

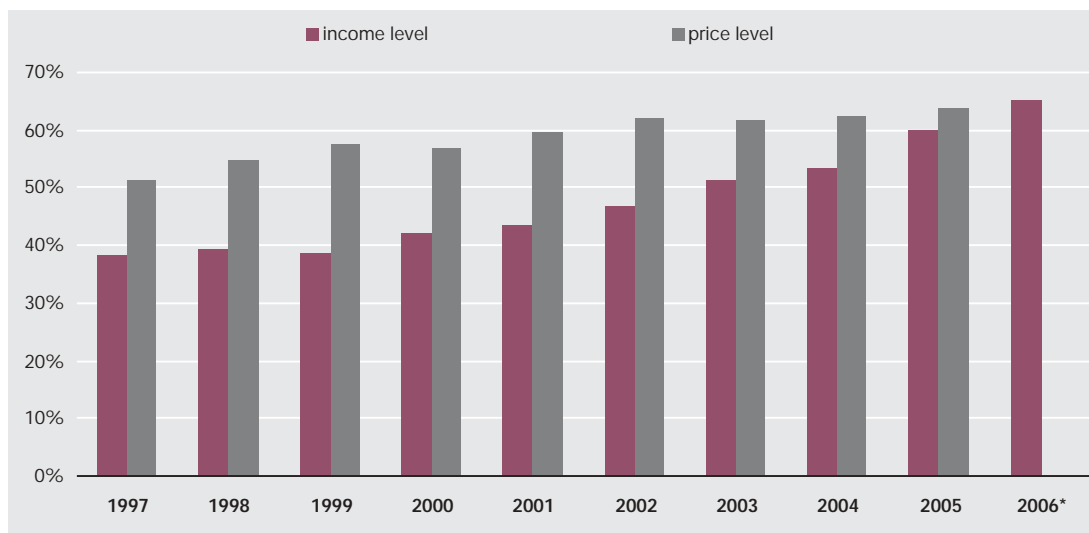


Figure 2. Income and price level in Estonia compared to the EU average

Source: Eurostat

* Preliminary data

tivity growth. If income growth is in line with productivity growth, it will also restrict the excessive price increase, supporting a moderate inflation pace.

The growth figures of rapidly developing countries catching up on wealthier economies should be viewed in the general context of the economic development of those countries, not limiting the comparison of countries to a few single economic indicators. Generally, in wealthier states the income and price levels are relatively higher and the economic growth and inflation rate lower. In countries with fairly modest economic growth, the inflation rate considered compatible with price stability is significantly lower than in Estonia, for instance. If a developing country experiencing rapid economic expansion has a price growth similar to that of advanced economies, it is an exception rather than a rule. In case of countries rapidly converging towards the average EU level, instead of a mere comparison of inflation figures it would be economically more appropriate to assess the consistency between the inflation rate and other economic indicators, also considering productivity growth.

Recently, risks to the Estonian economy have heightened and may potentially endanger sustainable economic development and cause price growth inhibiting balanced development.

As for external risks, the uncertainty related to oil and other commodity prices persisted. Internal risks were primarily related to the wage growth exceeding productivity growth and to strong domestic demand. Compared to earlier years, the labour market tightened in 2006 and some sectors experienced labour shortage and rapid wage growth. Wage growth surpassed productivity growth, increasing the risk that the rapid wage increase could affect inflation or reduce the competitiveness of Estonian companies in foreign markets. Though according to the latest statistics, competitiveness has been maintained, the risks are present.

Increased incomes and easy access to credit maintained the fast growth rate of the housing loan stock, while also consumer credit picked up. Households' readiness to spend more fostered the price growth of real estate as well as consumer goods. Strong



wage growth resulting from labour shortage enhanced the price pressures, boosting the production costs of several products and services.

The economic developments of Estonia were repeatedly discussed with international organisations, such as the International Monetary Fund, European Central Bank, European Commission and rating agencies (Moody's, Fitch, Standard & Poor's). Foreign partners had high regard for the successful monetary and fiscal policy of Estonia, but stressed the need for managing the risks accompanying the rapid growth of domestic demand. The International Monetary Fund gave the Estonian economy a positive assessment, acknowledging the reliable currency board and conservative fiscal policy. However, the IMF warned us about the risk of economic overheating, indicated by tensions on the labour market, the acceleration of inflation and the growing current account deficit. All international organisations concluded that the short-term postponement of the adoption of the euro does not jeopardise the Estonian economy, but Estonia should definitely continue its conservative economic policy.

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 in non-euro area EU Member States. The main topic of discussions involved risks surrounding balanced economic development. Debates were held over possible economic overheating on the basis of Estonia and several other new EU Member States, and the need for conservative fiscal policy was emphasised. At the meetings of ESCB committees and working groups the representatives of Eesti Pank explained Estonia's economic developments and the balancing role of the currency board within the general economic framework. Central bank representatives also took part in the discussions of other non-euro area EU economies, drawing attention to the need to consider the overall economic context and not concentrate only on single figures. Special attention was also given to the economic develop-

ment of countries belonging to the European exchange rate mechanism ERM II in order to assess their readiness to join the euro area.

Preparations for harmonising the Estonian monetary system with requirements for joining the euro area

The Estonian monetary policy framework is very similar to that of the euro area, which enables to adjust the existing system easily upon accession to the euro area. Joining the euro area will not entail significant economic policy changes. The monetary policy transition mechanisms of euro area countries are already operational in Estonia, as the Estonian economy has already adjusted to these mechanisms during the past years under the conditions of the currency board. Eesti Pank and the Government have set the goal to adopt the euro as soon as all the necessary requirements are fulfilled.

The final harmonisation of the monetary policy framework with that of the euro area is a relatively small-scale task and will not require a long-term gradual adjustment period. The required changes can also be made immediately before the adoption of the euro, if necessary. During the period of preparing to join the euro area, Eesti Pank will adjust the monetary policy framework according to the needs of economic environment, for instance by avoiding the creation of additional liquidity in the period of strong economic activity.

The Estonian kroon continues to participate in the exchange rate mechanism ERM II, which is one of the preconditions for adopting the euro. In June 2006, Estonia completed the two-year participation period required for joining the euro area, thus meeting the Maastricht exchange rate criterion. Estonia will carry on in the exchange rate mechanism until the adoption of the euro, preserving the existing monetary policy framework and the exchange rate fixed to the euro at 1 euro = 15.6466 kroons. The Estonian kroon has maintained its stability in the exchange rate mechanism, which has increased the credibility of the Estonian economy.

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

Monitoring

Making monetary policy decisions requires an effective system for monitoring and forecasting economic development, supported by targeted 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 development mostly covers Estonia and the European Union Member States, but also other major countries that play an important role in global economic developments. Understanding the external environment is very important for a small open economy, and thus developments in Estonia are always analysed in the context of trends in foreign economies. The monitoring process of the Estonian economy may be divided into two categories: monitoring the development of the non-financial and 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 public statements.

Economic reviews

Once a quarter Eesti Pank prepares an economic policy review, which serves as a basis for communicating with the public (see also "Key points of the economic forecasts of Eesti Pank in 2006", p. 107). In addition to assessments of the Estonian current economic situation, twice a year the central bank compiles short-term economic forecasts and once in six months gives an assessment to financial stability.

Under the conditions of fixed exchange rate the flexibility of the labour market plays an especially important role. 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 electronically on Eesti Pank's web site (see also "Publications of Eesti Pank in 2006", p. 114).

Forecasts

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 2006", p. 107). To this end, the current year's economic developments and the projections for the following two years are analysed. The base forecast 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 web site.

Rapid changes in the economic structure require constant updating of the base model of the Estonian economy which is one of the main tasks of the central bank's research activities. This task has been divided between the Research Department and the Forecasting Unit of 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 the semi-annual economic forecasts in the Economics Department. Owing to changes in the statistics of national accounts, the econometric model used for forecasting was re-evaluated in 2006. The second agenda of development activities was related to practical preparations for participating in the forecasting process of the European Central Bank. The representatives of Eesti Pank attended the meetings of the European Central Bank's Working Group on Forecasting, where the global economic outlook was discussed and forecast assumptions were harmonised. The exchange of information between the members of the European System of Central Banks is aimed at enhancing the accuracy of economic forecasts.

Research

Eesti Pank's economic surveys follow the **strategic research plan**, which determines the general

framework for the surveys conducted in the bank. The priorities for 2004–2006 included updating the **central bank's macromodel, creating the monetary policy's simulation model, monetary policy and financial sector research,** and the **sustainability analysis of the Estonian monetary system.** 13 research projects were carried out on these issues in 2006.

The research projects focused on the saving behaviour of Estonian households and the sustainability factors of Estonian companies; the flexibility of pricing behaviour and wage setting in Estonian companies; the credit growth of Estonian banks in the context of joining the euro area; the potential GDP growth, etc. Moreover, the macromodel of the Estonian economy was updated and the monetary policy simulation model elaborated.

Although surveys are mainly conducted in the Research Department, single research projects focusing on more specific topics are carried out also in other departments. In 2006, such research areas included, for instance, aspects related to domestic demand and financial deepening, and the analysis of business cycles.

In addition to being published in the Eesti Pank Working Paper Series, economic researches conducted by the central bank have found also international recognition. In 2006, ten research papers and articles were published in internationally recognised academic journals and publications.

The **cooperation on research at international and domestic level** continued in 2006. The economists of Eesti Pank attended the Working Group on Econometric Modelling and the network for analysing wage dynamics composed of the members of the European System of Central Banks. In cooperation with the National Bureau of Economic Research (NBER), Eesti Pank arranged a high-level economic conference "International Seminar on Macroeconomics" in the summer of 2006 in

Tallinn with renowned economists from Europe and the United States participating.

The surveys conducted by Eesti Pank were introduced at several international conferences: the annual conferences of IAES (International Atlantic Economic Society) and EACES (European Association for Comparative Economic Studies), COPE (Congress of Political Economists), seminars organised by the national central banks of the European System of Central Banks (e.g. ESCB Workshop on Emerging Markets, Research seminar of De Nederlandsche Bank). Furthermore, the central bank's experts also took part in local conferences (the first annual conference of the Estonian Economic Association, a seminar for young economists, etc.).

Along with introducing Eesti Pank's own surveys, also acknowledged **foreign experts** were invited to Estonia to present the results of their research. One of the most renowned European economists, Professor Charles Wyplosz, gave a presentation on the historic challenges of the European Economic and Monetary Union; Carlos Martinez-Mongay, head of the unit dealing with Southern European economies of the European Commission's Directorate-General for Economic and Financial Affairs, held a seminar on tax policy; Pekka Sutela, Head of the Bank of Finland's Institute for Economies in Transition, held a seminar on the current economic situation and development perspectives of Russia, etc.

In total, Eesti Pank conducted 14 open seminars during 2006. 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 2006, three foreign experts participated in conducting economic surveys.

The tradition of awarding annually a **research award** to young Estonian economists was contin-

ued also in 2006. The award was granted for the fourth time and this time to Katrin Männik, a Ph.D. student at the University of Tartu for the research “The Impact of the Autonomy on the Performance in a Multinational Corporation’s Subsidiary in Transition Countries”.

RESERVE MANAGEMENT

The foreign exchange reserves of Eesti Pank back the Estonian kroon and are used to ensure the stability of the kroon. Following the principles of the currency board, the foreign exchange reserves should completely cover all the kroon 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, namely the **preservation and liquidity of assets**. **Return** comes third on the list of objectives.

Structure of foreign exchange reserves

No major changes in the structure of foreign exchange reserves took place in 2006. The reserve is 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 Estonian 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 throughout a global economic cycle. Investment portfolio assets are mainly invested in the liquid bond markets of leading industrial countries, whereas investments’ interest rate, credit, currency and liquidity risks are constantly monitored and managed.

Investment process

Eesti Pank manages interest rate risk through the benchmark portfolio. This determines the average risk level 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 within which the actual investment portfolio may deviate from the benchmark portfolio.

The Monetary Policy Committee of Eesti Pank considers changing 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 potential price fluctuations caused by market volatility. In case of increasing the risk level more assets are invested in longer-term instruments, i.e. government bonds with the maturity of more than one year.

In addition to earnings from 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 analysis, 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. Investments are 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. Upon making investment decisions two different ap-



proaches are applied: 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 (for more information on the investment models applied see the Eesti Pank Working Papers No 6/2005 and 4/2006). Best decisions for investing in money, capital and foreign exchange markets are striven by a combination of these two approaches.

The outcome of the active investment policy was 15 basis points of excess return over the benchmark portfolio. External asset managers also have a role in active investment. In 2006, a new contract was signed with BlackRock. Pimco has been investing Eesti Pank's assets since 2005 and ABN Amro Asset Management since 2003. Developing and expanding the system of external managers is one of Eesti Pank's strategic objectives. The external asset managers use a portion of the risk limit, which is primarily invested in financial derivatives.

Investment results in 2006 and related factors

By end-2006, the foreign exchange reserves of Eesti Pank reached 33.17 billion kroons. The annual growth stood at approximately 29%. The excess reserve¹ accounted for nearly 11%, i.e. 3.7 billion kroons, of the total reserve.

Return on investment was higher than expected. It was affected by the faster than expected growth of foreign exchange reserves as well as changes in the interest rates of the euro area and the US. The US Federal Reserve raised the key interest rate altogether on four occasions (by 1 percentage point in total), whereas the European Central Bank raised the rates on five occasions (by 1.25 percentage points in total). Interest rates increased in both regions by 0.3–1.2% across the yield curve, which is why the return on foreign exchange reserves remained below return on the money market (see Figure 1) in 2006.



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

¹ The components and calculation of the excess reserve above the currency board can be followed in the table "Foreign exchange reserves backing the kroon" (see Row IX – Foreign reserves net) published on the 5th working day of each month.

Changes in the benchmark portfolio in 2006

In 2006, interest rates mostly increased in both Europe and the United States, particularly at the shorter end of the yield curve. Therefore, the Monetary Policy Committee of Eesti Pank considered it necessary to extend the duration of the benchmark portfolio on two occasions: at the beginning of April and September. As a result, the duration of both benchmark portfolios extended by 27% compared to the beginning of the year: from 1.22 to 1.56 years in case of the benchmark portfolio of the euro area and from 0.84 to 1.07 years in case of the US portfolio. All in all, the duration of the benchmark portfolio extended from 1.07 to 1.36 years. The structure of the benchmark portfolio, which the Monetary Policy Committee endorsed on 1 December 2006 and which applied until the end of 2006, is given in Table 1.

Asset management services provided to the public sector

Eesti Pank has cooperated with several public sector institutions for years already. In 2006, it started to provide the 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-2006, the Fund's portfolios stood at 1.6 billion kroons.

Eesti Pank continued to provide the full package of asset management services to the Guarantee Fund, whose investment portfolios totalled 1.3 billion kroons at the end of 2006.

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	Duration
Euro area	65.67%	15.05%	7.67%	5.44%	3.98%	2.19%	1.56
USA	73.88%	12.38%	6.28%	4.18%	3.28%		1.07

ENSURING FINANCIAL STABILITY

One of the main tasks of Eesti Pank is to ensure financial stability in Estonia by creating policies for the financial sector and operating well-functioning payment and settlement systems. The tasks of the central bank form a part of the wider **framework for ensuring financial stability** that includes the relevant legal environment and financial sector policy, efficient supervision and reliable information about the financial sector.

Financial stability means that the operation of the financial system is not interrupted or disturbed to the extent or duration that would considerably hinder financial intermediation and thus also the central bank's primary objective – price stability. In other words, the efficiency of monetary policy largely depends on the functioning of important financial institutions and infrastructure. For ensuring financial stability Eesti Pank mainly focuses on securing a smooth and integral functioning of the financial system and minimising the threat of a systemic crisis.

Forming its financial policy, Eesti Pank relies on continuous monitoring and analysis. The main output of financial sector analysis and stability assessments is the Financial Stability Review, which also includes recommendations on financial sector policy. As regards the performance of the essential components of the financial infrastructure – payment and settlement systems – Eesti Pank prepares special oversight assessments.

Pursuant to the law and the division of tasks within Estonia, Eesti Pank is also the banking sector regulator. In recent years, more attention has been paid to the development and improvement of financial crisis management framework. Being the national central bank of a European Union Member State, Eesti Pank participates in the elaboration of the single financial sector policy and legislation for the common market.

Financial sector analysis and financial stability assessment

Similarly to earlier years, also in 2006 the central topic of the financial stability analysis was the **rapid**

loan growth and related risks. Part of the loan growth of Estonian companies and households can be attributed to the relatively low level of financial deepening compared to other countries. However, the brisk growth of indebtedness compared to incomes has also brought along higher risks.

The growing indebtedness inevitably increases borrowers' vulnerability. It may be negatively affected in the coming years by the deceleration of economic growth and an increase in loan-servicing costs resulting from rising interest rates.

Signals that could have changed borrowers' attitudes (e.g. the rise of interest rates, signs of stabilisation at the Tallinn apartment market, the postponement of adopting the euro, signs pointing to possible economic overheating) did not diminish optimistic future expectations. This may be caused by the strong inertia in the behaviour of borrowers, which shows especially clearly in the case of companies initiating new real estate development projects as well as households planning to take a housing loan.

Considering the risks associated with the robust loan growth, Eesti Pank decided to curb over-optimistic expectations with preventive **supervisory and monetary policy measures** (see background information "Measures adopted by Eesti Pank in 2006, p. 34).

As the development of the Estonian banking market largely depends on the activities and objectives of Nordic banking groups, it is essential to have an updated adequate overview of the primary trends and risks in the region. Since 2003, Eesti Pank has been participating in the **cooperation network of Nordic and Baltic central banks** where regular exchange of information and assessments concerning the region's financial stability takes place.

Together with other European Union central banks and supervisory institutions, Eesti Pank participates in the compilation of analyses and assess-

MEASURES ADOPTED BY EESTI PANK IN 2006

As of 1 March 2006, the new procedure for capital adequacy calculation entered into force. Pursuant to that banks had to increase the **risk weight on housing loans** used for calculating capital adequacy to **100% instead of the earlier 50%**.

As a result, the capital buffers of banks increased and risks related to the financial sector decreased. However, this did not entail a change in the behaviour of borrowers and lenders. In order to limit the strong domestic demand driven

by loan growth, Eesti Pank decided to **raise the reserve requirement from 13% to 15%** as of 1 September 2006.

As risks remain the same during the two-year forecast period, Eesti Pank decided to **preserve the 100% risk weight on housing loans and the 10% capital requirement for the three-year transition period** within the framework of the new capital adequacy accord (Basel II) that entered into force as of 2007.

ments on financial stability and the financial sector's structure in a wider region. In 2006, the main joint outputs of cooperation were **regular reviews of the European financial stability and banking sector structure**. Special issues, more significant for Estonia, included reasons for the rapid loan growth in Central and Eastern Europe. Moreover, the strength analyses of the EU banking sector were launched.

Cross-border cooperation and other EU financial policy issues

Compared to other Member States, Estonia's financial sector is more integrated and thus Eesti Pank pays special attention to those EU financial policy issues that deal with the **cross-border integration of the financial sector** and the resulting requirements on ensuring financial stability.

One example of cross-border cooperation is the **harmonisation of supervision**, which includes establishing common procedures and requirements as well as common supervisory principles and views. An important benchmark in the harmonisation of financial supervision was the adoption of the Lamfalussy framework. However, in this context we can speak of harmonising a regulatory framework rather than practices. As most credit institutions operating in Estonia are subsidiaries of banks

registered in other Member States, the perspective of the host country in the division of tasks concerning cross-border financial stability is especially important for Estonia. In other words, as a result of harmonising practices and the improved efficiency of supervision, it is only natural that some of the competence is transferred to the supervisory authorities of the host country, but in that case also responsibility should shift together with the rights.

Another important issue in ensuring cross-border financial stability is the **organisation of crisis management** and the related principles for banking groups operating across borders.

From the central bank's viewpoint, the third important field of financial sector cross-border activities is **securities settlements**, i.e. the post-trading infrastructure of the securities market. One of the major obstacles in creating a single European Union capital market is the lack of interoperable securities settlement systems. After completing an analysis mapping the shortcomings, it was possible either to support the integration of settlement systems by non-regulatory measures or apply an approach based on common legislation. It was decided to opt for the first possibility, which is better from the perspective of free economy but has some drawbacks as to guaranteeing fair competition and



effective application. In addition, the European Central Bank proposed to start providing a central securities settlement service in the Eurosystem. The project was called **TARGET2-Securities**. A consultation round involving various interest groups began at end-2006, as a result of which a final decision concerning the creation of an appropriate central infrastructure will be made.

As regards amending EU directives, the proceedings of two draft legislation were of special importance for Eesti Pank. The first dealt with the **amendment of sections regulating mergers and acquisitions in the directive laying down provisions for the take-up and pursuit of the business of credit institutions**. The aim of the amendment is to accelerate the process of cross-border acquisitions and mergers of market participants in the European Union via a more harmonised legal framework applicable throughout the European Union. The second proceeding concerned the **directive on payment services**, which should stimulate the creation of a single market for payment services, uniform access for market participants and their equal treatment. In this area, the topics important for Eesti Pank include the supervision of payment service providers, the scope of harmonising the terms and conditions for the transparency of payment services and the scope of rights and obligations in the provision and usage of payment services.

Financial safety net

As regards the financial safety net, Eesti Pank's main priority in 2006 was developing domestic and cross-border cooperation on crisis management. Eesti Pank concluded cooperation agreements on the management of financial crises with major domestic and foreign cooperation partners and participated in crisis management exercises.

On 5 December 2006, Eesti Pank, the Financial Supervision Authority and the Ministry of Finance concluded a Memorandum of Understanding (MoU) on the management of finan-

cial crises. The goal of this agreement is to improve the readiness of institutions responsible for Estonia's financial stability to act in a crisis endangering the financial system. The MoU lays down the tasks for the parties and grounds for taking coordinated action in case of crises that threaten the financial system stability. The MoU emphasises the primary responsibility of bank owners and management boards in securing the financial soundness of the bank and bearing the costs arising from crises. The state provides liquidity or capital support for solving a crisis affecting the financial system only if private sector solutions are ineffective or insufficient.

On 18 December 2006 in Stockholm, Eesti Pank and the central banks of Latvia, Lithuania and Sweden concluded a Memorandum of Understanding (MoU) on the management of financial crises. The goal of the MoU is to enhance cooperation in the event of a financial crisis concerning cross-border banking groups. According to the MoU, the central bank that is first to identify a potential financial crisis is obliged to inform also the other parties to the agreement. In addition to information exchange in case of potential financial crises, the MoU discusses regular cooperation on sharing information and assessments under normal circumstances.

The organisation of **crisis simulation exercises** supports the elaboration of an appropriate crisis management framework. In spring 2006, a joint financial crisis exercise of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance took place. The main aim of this exercise was to harmonise participants' understanding of their and other parties' roles and test mutual information exchange and communication with the public in a crisis situation. The training provided valuable experience and improved the institutions' understanding of the needs and possibilities for effective crisis coordination.

In addition to the domestic crisis exercise, in April 2006 Eesti Pank, the Financial Supervision

Authority and the Ministry of Finance also participated in a cross-border financial crisis exercise arranged by the Economic and Financial Committee. The so far most extensive exercises (with 76 institutions participating) included testing various processes regarding domestic and cross-border information exchange, systemic crisis assessment, decision-making and cost distribution.

The results of the EU crisis exercise confirmed that current cross-border financial crisis management still has some shortcomings. For instance, problems occurred in the distribution of crisis-related costs among cross-border banking groups. Assessments of crisis solutions and situations evoked different understandings as well. Thus, the development of the cross-border crisis framework remains a priority in the EU financial sector policy. For the elaboration of the principles and procedures of solving crises and the principles of sharing costs, a high-level EU working group was formed. Eesti Pank is participating in the process of elaborating systemic crisis assessment principles via a task force composed of banking supervision authorities and central bank representatives.

Another 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 it is managed by the Guarantee Fund. Apart from the Deposit Guarantee Sectoral Fund, the Guarantee Fund comprises the Investor Protection Sectoral Fund and the Pension Protection Sectoral Fund. In 2006, the upper limit of coverage for deposits was 200,000 kroons per depositor and by end-2007 it will reach the level provided for in the EU directive (20,000 euros, i.e. 313,000 kroons).

The role of Eesti Pank is to provide analytical support to the Guarantee Fund in determining the amount of appropriate contributions for guaranteed deposits. Given the accelerating growth rate of deposits in 2006 and the necessity for guaranteeing a sufficient amount of funds in the ex-ante funded

deposit insurance scheme, the Supervisory Board of the Guarantee Fund decided to raise the quarterly contribution from 0.09% to the maximum allowed level of 0.125% of guaranteed deposits. This step takes into account the objective of sectoral funds in terms of volume, an increase in the upper limit of coverage and the growth pace of deposits.

Banking legislation

In 2006, the **national transposition of the new European Union directive laying down the principles for capital adequacy calculation** was completed, involving considerable amendments to the existing Credit Institutions Act and the elaboration of a new regulation on prudential ratios.

The provisions of the directives on the minimum capital requirements of credit institutions derive from the new procedure for calculating capital adequacy (Basel II) elaborated by the Basel Committee on Banking Supervision operating at the Bank for International Settlements (BIS). Both Basel II and EU directives are based on three pillars. The first pillar establishes a more risk-sensitive methodology for calculating capital requirements. The purpose of the second pillar is to emphasise the importance of banks' internal assessment of risk management and capital needs. The third pillar aims to help guarantee a sufficient level of capital adequacy by means of market discipline and wider public disclosure requirements.

The Credit Institutions Act lays down general rules for calculating the minimum capital requirements and a framework for interpreting the second and third pillar's principles. The importance of internal assessments and self-control has significantly increased in the new framework, whereas that of normative regulations has decreased. An important innovation is the opportunity for banks to calculate their capital needs on the basis of internal risk assessments. Furthermore, pursuant to the new framework apart from the credit risk and market risk also the operational risk has to be taken



into account in calculating the new minimum capital requirements.

For determining the rate of capital requirement on the basis of the new capital adequacy framework, detailed rules were laid down in a regulation of Eesti Pank. The focus of the regulation is on the first pillar of the new capital adequacy framework. Its main difference from the EU directive is that **in Estonia the capital requirement for credit risk as well as market risk will remain at the current level of 10%** (see background information "Measures adopted by Eesti Pank in 2006").

As the changes are extensive and the enforced rules very different than before, in 2007 credit institutions may choose whether to calculate capital requirements according to the existing or the new procedure.

Payment systems oversight

Regarding the oversight of payment systems, the most significant activity of 2006 was the **assessment of the compliance of Estonia's payments and securities settlement systems with the requirements of the Eurosystem**. In all EU Member States whose currency is the euro or who want to join the euro area, systemically important settlement systems have to comply with the principles of the Eurosystem and these systems must be officially recognised as eligible for the Eurosystem. The settlement systems that belong to the scope of the Trans-European Automated Real-Time Gross Settlement Express System (TARGET), i.e. the Real-Time Gross Settlement (RTGS) systems operating in the Member States, as well as the systems used for the settlement of claims and liabilities arising from central bank's monetary policy operations and liquidity providing transactions, are regarded as systemically important settlement systems.

The European System of Central Banks (ESCB) assessed the following systems: the EP RTGS system managed by Eesti Pank and the securities settlement infrastructures, which, more precisely, is an

arrangement created in conjunction with international central securities depositories for concluding transactions between Estonia's central bank and commercial banks, as well as the securities settlement system managed by the Estonian Central Depository for Securities (ECSD). According to the ESCB, **all the above-mentioned systems were eligible for the Eurosystem**.

Regarding the RTGS system managed by Eesti Pank, most attention was paid to the legal basis of the system, its compliance with the security requirements of TARGET and the definition of settlement finality in the system's rules. Proceeding from the assessment given by the overseer, Eesti Pank has made or will soon make all appropriate changes.

The arrangement created for transactions with international central securities depositories was assessed to be compliant with the standards, but prior to its adoption the Governing Council of the European Central Bank must approve it as a possible arrangement to be used as an exception in the Eurosystem.

Even though Eesti Pank is not currently using the domestic securities settlement system managed by the **Estonian Central Depository for Securities (ECSD)** to conduct central bank transactions with securities as collateral, at the request of the ECSD the system managed by the ECSD was also assessed. As a member of the Eurosystem the central bank will only use the securities settlement system managed by the ECSD if it settles securities eligible as collateral for Eurosystem credit operations. According to the assessment, the securities settlement system managed by the ECSD is eligible for the Eurosystem, but there are time limits on conducting transactions for securing intraday settlement finality. Furthermore, in order to be fully compliant with the requirements of the Eurosystem, the ECSD must apply ESCB guidelines in risk management and arising from the operational requirements of TARGET.

DEVELOPMENTS IN STATISTICS

An effective system for collecting, processing and publishing statistical data is necessary as an input for monetary policy analysis as well as for assessing the developments and risks of the financial sector and the Estonian external sector. Eesti Pank's key fields in statistics are the compilation and analysis of the balance of payments, international investment position and monetary and financial statistics. Over the years, Eesti Pank has created a well-functioning, up-to-date, flexible and internationally compatible system of collecting, processing, and publishing financial sector and balance of payments statistics. The comprehensive and regularly updated statistics site on Eesti Pank's web site, which contains about 400 tables of various statistical data, makes the data compiled by the bank 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 state agencies, such as the Financial Supervision Authority, the Ministry of Finance, Statistics Estonia, etc. One of the cooperation objectives is to avoid double data collection and secure maximum data consistency.

In order to guarantee the international comparability of published statistics, data collection methods are elaborated and aggregated data compiled and published relying on international standards and guidelines. In this area our primary cooperation partners are the European Central Bank, the European Commission and the International Monetary Fund.

Banking and other financial statistics

2006 saw further gradual integration with the European System of Central Banks (ESCB) with regard to banking and financial statistics. This is confirmed both by the **increasing volume of statistical data submitted to the ECB** as well as the **conclusions drawn by the ECB mission that evaluated the level of Eesti Pank's financial statistics** in spring 2006. To this end, the com-

pliance of the banking and financial statistics submitted by Eesti Pank with the ECB methodology was studied. The mission also assessed the central bank's readiness to fulfil additional statistics requirements, which become mandatory after Estonia's accession to the monetary union, and found it to be high.

Daily cooperation with the ECB in statistics indicated a clear trend towards involving non-euro area countries, incl. Estonia more frequently in the discussions and studies of the ESCB regarding statistics. For instance, as a member of the ECB statistics working group on monetary and financial institutions and financial markets, Eesti Pank has had the opportunity to engage in **preparing amendments to legislation** concerning statistical reports collected from monetary financial institutions (MFI). In the second half of 2006, Eesti Pank participated in several studies aimed at gathering information on the significance of new data requests specified by consumers and the justification of costs related to the collection of such data. The preparation of amendments to the statistics regulations of monetary financial institutions continues in 2007.

According to the European Central Bank's schedule, **Eesti Pank updated the set of regularly forwarded data**. In the second half of 2006, Eesti Pank started submitting quarterly data on other financial institutions (investment funds, leasing companies) to the ECB. The increasing volume of submitted data also required improvements in the IT applications used for compiling the data. Meanwhile, the quality of submitted data was further improved.

In 2006, Eesti Pank continued developing the system for compiling **quarterly national financial accounts** that was initiated in 2004. The aim was to make quarterly financial accounts ready for publication by the end of 2006. This goal was successfully achieved and they were first published in January 2007. Moreover, 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 greater detail. January 2007 witnessed also the first submission of data on quarterly financial accounts to the ECB. In recent years, financial accounts have become an increasingly important source of information for the preparation of economic policy analyses in several countries. As financial accounts enable to make detailed analyses of the financial status of various economic sectors, they are a useful tool for forecasting economic development. Furthermore, analysis of financial accounts helps estimate the vulnerability of economic entities to interest rate or income changes and their financial behaviour resulting from any economic policy decision.

Eesti Pank is participating in the project of compiling and publishing **Financial Soundness Indicators (FSI)** initiated and coordinated by the International Monetary Fund (IMF). The project was launched at the beginning of 2004 in order to collect and publish comparable data on the financial soundness of the MFIs of various countries in a common format. The first financial soundness indicators on Estonia according to the FSI methodology were compiled in 2006 and submitted to the IMF. In addition to the indicators, metadata explaining the essence and specific compilation methods of FSI were included.

Regular annual **meetings on reporting** between the representatives of reporting entities, Eesti Pank and the Financial Supervision Authority continued also in 2006. As the year passed without significant changes for reporting entities, the discussions mainly focused on the changes scheduled for two forthcoming years and encompassing a large share of the existing reporting system.

Besides smaller updates in the financial statistics published on Eesti Pank's website, two major changes were made. As of May, more detailed information is provided on the interest rates on loans granted in euro or related to the euro. While to date, Eesti Pank published statistical data on the interest rates on euro loans only by maturity ranges, now

the breakdown of customers was added as well. The other major change was related to Eesti Pank's accession to the Trans-European Automated Real-Time Express Transfer system TARGET, due to which the tables reflecting payment data became more specific.

Balance of payments statistics

The main objectives for 2006 included improving the quality of initial data, intensifying cooperation with reporting agents and developing a web-based reporting channel.

The most important source of input data for the balance of payments statistics is the **survey system for companies**. In order to ensure fast and flexible data exchange for reporting entities, Eesti Pank developed an **online environment for compiling and submitting balance of payments reports** in 2006. The web portal became operational in January 2007.

The collection of operational preliminary data for monthly balance of payments statistics is based on the **settlements system**. As in 2006 banks could start making international express transfers via the TARGET system, proposals were elaborated for amending Eesti Pank's "Procedure for the declaration of international payments and submission of data required for the balance of payments statistics" approved by Eesti Pank Governor's Decree, so that the data submitted for the balance of payments would also include transactions processed via TARGET.

A significant share of the balance of payments' initial data originates from **administrative sources** (foreign trade, tourism statistics, general government statistics, etc.). Cooperation with government agencies that collect and administer such data (Statistics Estonia, Tax and Customs Board, Ministry of Finance, Unemployment Insurance Fund, etc.) went smoothly. In the area of collecting initial balance of payments data, the most important partner of Eesti Pank from among government

agencies is **Statistics Estonia** with whom several bottlenecks were solved in 2006. For instance, the current account data of the balance of payments for 2000–2003 were integrated into the system of supply and use tables compiled by Statistics Estonia¹. According to the revised data and methodological corrections received from Statistics Estonia, Eesti Pank adjusted the accounts of goods, transport services, government services, and transfers. Eesti Pank and Statistics Estonia also agreed upon the data structure for the exchange of quarterly non-financial accounts and annual financial accounts. Intense cooperation in the field of foreign trade statistics raised the question of insufficient statistical data coverage in some fields. Exporters/importers have introduced several new schemes (transactions in free zones and excise warehouses, processing of goods, etc.). In order to solve the problems, specialists from Statistics Estonia, the Tax and Customs Board, the Ministry of Finance and Eesti Pank came together at the end of 2006 to discuss how such schemes should be reflected in statistics. Several solutions were found and work continues in 2007.

The inter-agency **pilot project of sample surveys for border crossers**, where also Statistics Estonia and the Ministry of Economic Affairs are participating besides Eesti Pank, was launched in 2006 and continues in 2007. The central bank expects the estimates derived from the survey to indicate the total number and country of origin of border crossers leaving Estonia.

Another important issue raised in 2006 was the improvement of balance of payments statistics with respect to **households**. Some topics of interest include the purchase of goods and services via the Internet; the purchase, sale and renting of real estate; money transfers and labour compensations; financial investment (shares and other equity, de-

posits) made abroad by households without domestic intermediation, etc. Eesti Pank has started negotiations with Statistics Estonia on adding questions concerning households' foreign investment to the surveys conducted by Statistics Estonia. In cooperation with the **Land Board**, Eesti Pank continued to find opportunities for the regular estimation of the total volume of real estate owned by non-residents in Estonia on the basis of information provided by the databases of the Land Board and the Centre of Registers and Infosystems of the Ministry of Justice. Data exchange with the **Tax Board** enabled to estimate the wage expenditure of foreign embassies in Estonia with respect to resident employees and the taxes calculated on those wages. Information was also retrieved concerning wage costs on residents borne by non-resident companies operating in Estonia.

Eesti Pank participated in several **international statistics projects** (e.g. the Centralised Securities Database project initiated by the ECB; the IMF's survey on portfolio investment; the elaboration of an European Commission regulation on the collection of statistics of foreign-controlled subsidiaries). The follow-up assessment of the 2005 **GDP-GNI project** (external sector's income account) was carried out in cooperation with the European Commission, which entailed the specification of Estonia's inventory report (the report evaluated the calculation methodology of the gross national income and the reliability of the data). Also, cooperation in the IMF working group BOPTTEG on the elaboration of **the new manual on the balance of payments statistics** continued.

In 2006, the quality of statistical outputs was repeatedly checked. Eesti Pank participated in a large-scale **pilot project on the assessment of balance of payments statistics**, where the

¹ The supply and use tables are matrixes (rows of products and columns of economic sectors) that show how the output of an economic sector is divided by product types and how the domestic supply and imports of goods and services is distributed between intermediate and final consumption and exports. Use tables also reveal the structure of production costs and the formation of profit by economic branches.

2004–2005 balance of payments and the annual international investment position were examined. The quality of the Estonian balance of payments is good – later revisions have generally remained within acceptable limits. Together with Statistics Estonia, Eesti Pank also took part in another Eurostat study on **data discrepancies between GDP's external sector account and balance of payments**. Besides submitting statistical data, the participants were required to answer questions concerning methodology, including the recording of components, use of data sources, etc.

General economic statistics

Close cooperation continued with the ECB in the field of general economic statistics. Eesti Pank participated in compiling the **ECB's Convergence Report 2006** and the **5th progress report on the statistical readiness of the non-euro area EU Member States**.

In October 2006, Eesti Pank took part in the project on the **evaluation of resource costs related to the statistical function** carried out to determine the human resources necessary for the implementation of the ECB's statistical function. Questions included the organisational structure applied for fulfilling the statistical function, resource costs in various statistics areas (bank statistics, interests, balance of payments and investment position, central bank's balance sheet, loans, payments statistics, financial accounts and IT applications used for collecting and processing statistical data), separately identifying costs on data collection, the compilation and dissemination of statistics, development activities, IT etc. Moreover, costs related to the services outsourced for fulfilling the statistics function had to be evaluated (whether in money or in fulltime jobs).

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 the 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 2006, the payment and settlement environment was enhanced further with the aim of ensuring efficient operation of payment flows in the international environment. The key priority was preparing for connecting the Real-Time Gross Settlement System of Eesti Pank (EP RTGS) with the Trans-European Automated Real-Time Gross Settlement Express Transfers (TARGET) system. Preparations involved elaborating the system's legal basis, assessing the system's compliance with the oversight and security requirements of the TARGET, and defining the finality of a transaction in the system's rules.

Eesti Pank has been participating in the euro-area settlement system TARGET since 20 November 2006. Until then Eesti Pank managed interbank settlements only in Estonia, but now it also provides the financial sector with a channel for performing cross-border payments denominated in euro. The TARGET is an alternative channel to correspondent banking and payment systems operated by the private sector for transferring payments in euro. Besides lower costs, another advantage of the TARGET is the speed – cross-border payments are transferred from one European bank to another within five minutes.

Joining the TARGET was executed through Banca d'Italia. Besides Eesti Pank, four more members of the EP RTGS joined the TARGET:

- OMX Tallinn;
- the Estonian Branch of AS Parex Banka;

- AS Sampo Pank; and
- the Estonian Branch of Svenska Handelsbanken AB.

Joining the TARGET means that the settlement system of Eesti Pank is ready for the adoption of the euro and ensures the necessary infrastructure for conducting transactions related to the implementation of monetary policy once Estonia becomes a full member of the Economic and Monetary Union.

Along with joining the TARGET also the **working day** of the Settlement System of Ordinary Payments (**ESTA**) was extended by **one hour** – retail payments are now settled from 8 AM to 6 PM by Eesti Pank.

Today, the new challenge facing the European System of Central Banks, including Eesti Pank, is updating the current TARGET by developing the **TARGET2**. The TARGET operating today is composed of the RTGS systems of national central banks and a network linking them, whereas the new TARGET2 is a system functioning on a single shared platform. According to the schedule, the TARGET2 will be launched on 19 November 2007. Eesti Pank will join the TARGET2 in the third wave on 19 May 2008.

PAYMENT AND 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 and since joining the TARGET on 20 November 2006 also domestic and cross-border payments in euro.

The number of payments settled through the **EP RTGS system has increased by 40%** year-on-year. On average, **200 transactions a day** were settled in 2006 (see Figure 1). The growth stems

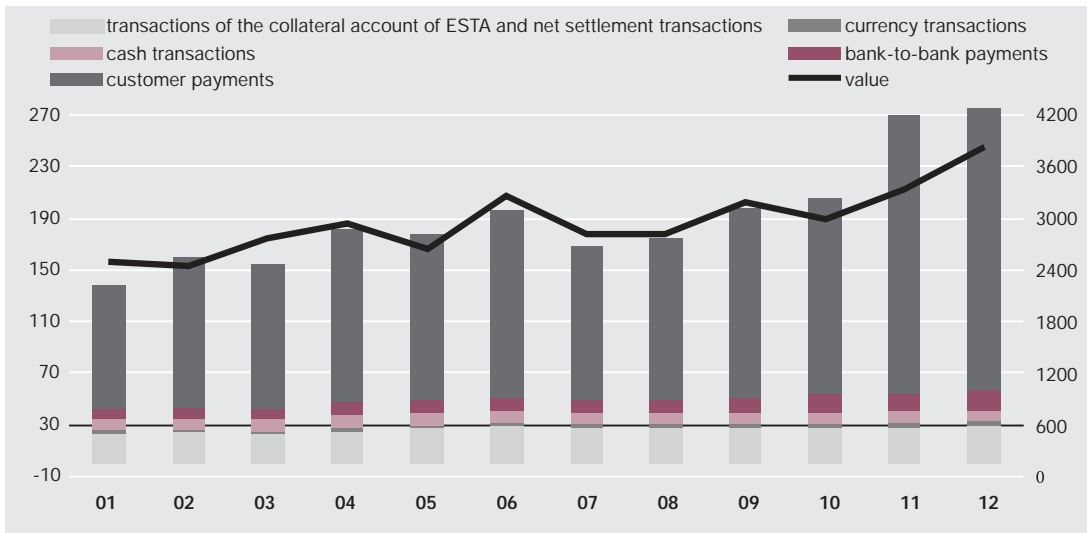


Figure 1. Number of payments processed in EP RTGS (left scale) by transaction types and their average daily value (EEK m; right scale) in 2006

from the option of making cross-border payments after joining the TARGET. The largest share (79%) of EP RTGS payments comprises payments originated by bank customers. On average, 133 domestic customer payments were settled a day. Since joining the TARGET, an average of 75 cross-border express payments were settled a day in November and December.

The average daily value of payments reached 3 billion kroons. Banks' "compulsory" payments (transactions related to the collateral account of the ESTA) accounted for the largest share of the value (50%). Year-on-year, the value of payments settled through the EP RTGS grew by 8%.

The average value of domestic customer payments of the EP RTGS stood at 3.6 million kroons, whereas that of cross-border express payments in euro was 284,000 kroons.

Further growth in the number and value of ESTA payments stems from the longer and faster

settlement day.¹ 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.

On average, **80,000 transactions a day** were settled through the ESTA in 2006 (see Figure 2). The number of payments has increased by 14%, year-on-year. An average of **1.2 billion kroons** a day were settled through the ESTA. The value of ESTA payments has increased by 39% year-on-year. The average payment settled through the ESTA was 15,100 kroons.

MEETING THE CASH DEMAND

Banknotes and coins in circulation and their structure

As at 31 December 2006, the total amount of currency in circulation was 11,763.2 million kroons (see Table 1). 1,695.4 million (14.4%) of that was in the vaults of credit institutions and savings and loan associations operating in Estonia

¹ Eesti Pank settles retail payments from 8 AM to 6 PM.

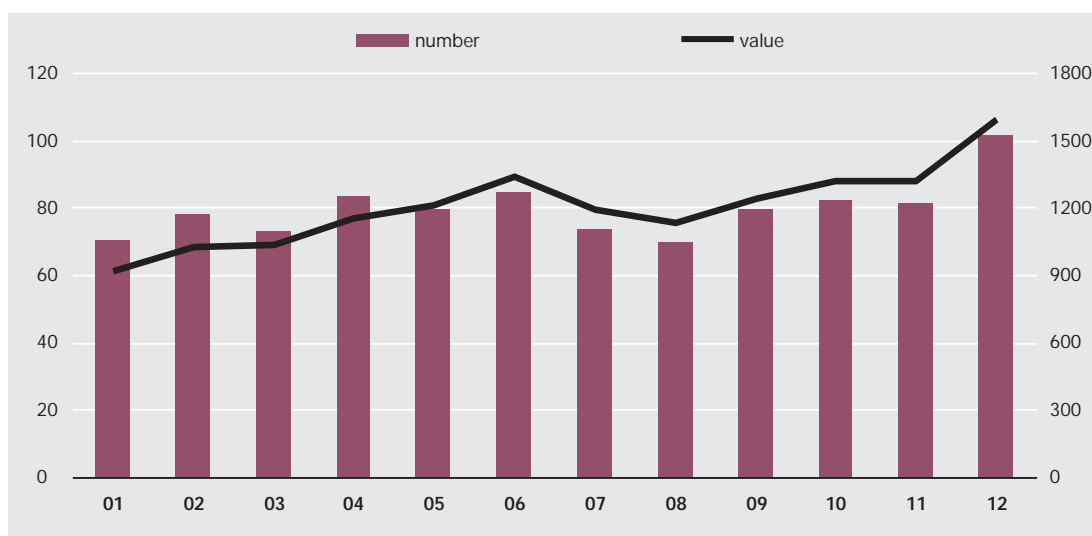


Figure 2. Number of payments processed in ESTA (thousands; left scale) and their average daily value (EEK m; right scale) in 2006

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

Nominal value	Total amount (EEK m)				Number (m)			
	31/12/2003	31/12/2004	31/12/2005	31/12/2006	31/12/2003	31/12/2004	31/12/2005	31/12/2006
1 kroon	4.7	4.6	4.6	4.6	4.7	4.6	4.6	4.6
2 kroon	23.9	26.0	29.6	33.5	11.9	13.0	14.8	16.8
5 kroon	36.7	38.8	43.1	47.8	7.3	7.8	8.6	9.6
10 kroon	66.8	70.6	77.5	85.6	6.7	7.1	7.7	8.6
25 kroon	179.6	187.4	207.1	225.4	7.2	7.5	8.3	9.0
50 kroon	49.5	45.4	46.6	49.0	1.0	0.9	0.9	1.0
100 kroon	1,068.6	1,076.1	1,122.4	1,180.1	10.7	10.8	11.2	11.8
500 kroon	6,796.8	7,337.8	8,450.3	10,001.2	13.6	14.7	16.9	20.0
Banknotes total	8,226.6	8,786.7	9,981.2	11,627.3	63.1	66.3	73.1	81.3
5 sent	2.2	2.1	2.1	2.1	43.0	42.4	42.0	41.5
10 sent	10.5	11.4	12.3	13.4	104.9	113.7	123.2	134.4
20 sent	16.2	17.7	19.8	22.3	80.8	88.7	99.2	111.3
50 sent	14.5	16.4	19.1	22.1	29.0	32.9	38.2	44.1
1 kroon	41.3	46.6	52.9	61.0	41.3	46.6	52.9	61.0
5 kroon	7.6	8.1	8.3	8.5	1.6	1.5	1.7	1.7
Coins total	92.2	102.4	114.6	129.4	300.6	325.9	357.1	394.1
Collector coins	5.4	5.9	6.0	6.4	0.1	0.1	0.1	0.1
Banknotes and coins total	8,324.1	8,895.0	10,101.7	11,763.2				

and 10,067.8 million (85.6%) was in circulation outside the credit institutions and savings and loans associations.

The growth rate of the currency in circulation was one of the fastest in recent years, reaching 16.4% (13.6%

in 2005). Compared to 2005, the quantity of all banknotes and coins has risen. This reflects directly economic expansion and rapid income growth.

The number of 2- and 500-kroon banknotes increased the most (see Table 1). The value of 500-

kroon notes posted the strongest growth (18.4%) and accounted for 85.0% of the total value of currency in circulation.

The number of coins in circulation exceeded 394 million, which means that there is an average of over 293 coins in circulation per resident. The number of 20-sent coins increased the most.

The average value of a banknote in circulation grew by 6.5 kroons, compared to 2005, and stood at 143 kroons at the end of 2006. The average value of a coin in circulation was 33 sents, i.e. 0.8 sents higher than in 2005.

Expert analysis and handling of cash

In 2006, the amount of currency issued and received by Eesti Pank grew even further. The central bank issued 12,399.0 million kroons to credit institutions and received 10,732.5 million kroons (see Table 2). In terms of amount, 118.6 million banknotes and 37.5 million coins were issued, whereas 110.4 million banknotes and 0.7 million coins were returned.

All banknotes returned to Eesti Pank are sorted with fully automatic sorting machines. In addition to the existing sorting machine De La Rue 5000, a fully automatic sorting machine CPS 1800 was purchased from Thomas De La Rue & Co Ltd in 2006. The machine can be used for sorting both euro and kroon banknotes.

Banknotes unfit for circulation are destroyed and the rest are returned to circulation. In 2006, 4.5 million banknotes totalling 640.2 million kroons were withdrawn from circulation (see Table 3).

In 2006, Eesti Pank performed expert analyses for 16,102 damaged and worn-out banknotes submitted by credit institutions and discovered 28 banknotes suspected of being counterfeit.

All in all, 251 counterfeit banknotes were discovered in Estonia during the expertise performed by the Forensic Service Centre in 2006. 50-kroon banknotes formed the largest share of counterfeit money (44.2%). Given the amount of currency in

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

Year	Total amount (EEK m)		Number (m)			
	Issued by central bank	Received by central bank	Issued by central bank		Received by central bank	
			Banknotes	Coins	Banknotes	Coins
2003	8,495.8	8,282.8	88.9	23.1	86.8	0.5
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

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

Nominal value	Total amount (EEK m)				Number (m)			
	2003	2004	2005	2006	2003	2004	2005	2006
1 kroon	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
2 kroon	3.2	0.3	0.4	0.7	1.6	0.2	0.2	0.4
5 kroon	8.6	10.0	9.3	6.3	1.7	2.0	1.9	1.3
10 kroon	13.8	5.0	5.3	2.9	1.4	0.5	0.5	0.3
25 kroon	75.3	14.4	13.5	16.3	3.0	0.6	0.5	0.7
50 kroon	31.7	27.2	10.6	12.4	0.6	0.5	0.2	0.2
100 kroon	245.5	74.0	74.7	63.7	2.5	0.7	0.7	0.6
500 kroon	631.2	701.6	751.0	537.9	1.3	1.4	1.5	1.1
Total	1,009.4	832.6	864.7	640.2	12.2	6.0	5.6	4.5

circulation, the number of counterfeit banknotes is relatively small. Since the end of 2005, Eesti Pank no longer carries out expert analyses of banknotes suspected of being counterfeit.

Eesti Pank also has a Counterfeit Analysis Centre, which has to ensure data exchange with the Counterfeit Monitoring System at the European Central Bank.

Defective 100-kroon banknotes

At the end of January 2006, the case of defective 100-kroon banknotes issued in 1999 drew considerable media attention. Eesti Pank announced on 27 January that some 100-kroon banknotes were missing a security feature, which is invisible to the eye (it becomes visible when exposed to an ultra-violet lamp).

At the beginning of 2007, Eesti Pank reached an agreement with Bundesdruckerei according to which the latter was to compensate for the costs related to the additional expertise of these banknotes. Eesti Pank is going to use the compensation for organising cash-related awareness campaigns.

Preparation of new banknotes and coins

In connection with the postponement of the adoption of the euro, Eesti Pank started to organise for an additional supply of new Estonian kroon banknotes and coins in 2006. To this end, the central bank prepared a procurement for 2- and 10-kroon banknotes with renewed security features.

As a result of the adjudication, the new 2-kroon banknotes were supplied by Giesecke & Devrient (Germany) and the 10-kroon notes by De La Rue Ltd (United Kingdom).

In addition, Eesti Pank also purchased new coins with 2006 as the year of issue:

- 10-sent coins from Staatliche Münze Baden-Württemberg (Germany);
- 20-sent coins from Staatliche Münze Baden-Württemberg and the Mint of Finland;

- 50-sent coins from the Royal Mint (United Kingdom);
- 1-kroon coins from the Koninklijke Nederlandse Munt (Netherlands).

Furthermore, Eesti Pank issued 10- and 100-kroon silver collector coins in 2006. The 10-kroon silver collector coin, which is partly golden, is dedicated to the Winter Olympic Games. This was an addition to the Olympics related coins issued by the central bank. The skier depicted on the silver coin symbolises the success of Estonian athletes in the Winter Olympic Games and the growing popularity of skiing and the Olympics. Altogether 5,000 coins were minted in the Mint of Finland. The coin was designed by Mati Karmin.

The silver 100-kroon coin is dedicated to the 100th anniversary of the Estonian National Opera. It was minted in the Mint of Finland, the maximum number to be minted being 10,000. The coin was designed by Tiiu Kirsipuu.

Preparations for the changeover to the euro cash

In 2006, Eesti Pank continued preparations for the euro cash changeover. Experts of the central bank took part in various working groups at the European Central Bank, e.g. the Banknote Committee (BANCO), and the European Commission as well as in relevant working groups established in Estonia.

For resolving practical issues related to the euro cash changeover, the cash working group was established involving representatives of Eesti Pank, credit institutions and the Cash Centre. This working group included separate working groups on ATMs and security issues. At present, the activities of the working groups have reached the stage that it is possible to adopt the euro within one year after the actual transition date becomes clear.

ORGANISATION AND COOPERATION

INTERNATIONAL COOPERATION

The developments taking place in Estonia, a small and open economy, are normally closely tied to external processes. Thus, international communication claims a very significant place in the work of Eesti Pank. All the principal fields of activity of Eesti Pank are involved in international cooperation.

The **central bank's international communication framework** includes regular economic policy reviews of various countries and regions (especially EU Member States and Estonia's neighbouring countries), meetings 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, etc. Prior to sessions of high-level bodies, briefings are held where experts from different departments discuss relevant information, specify the national positions and proposals for comments with the central bank representatives attending such sessions.

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. Traditional cooperation seminars and bilateral meetings, such as the joint seminar of the Baltic central banks, and a high-level seminar with the Bank of Finland, were held also in 2006.

Regular cooperation with the 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 2006, Eesti Pank's executives and experts participated in about 300 meetings in various

Table 1. Eesti Pank's participation in the work of international organisations and institutions

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

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 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 the drafting of the so-called Convergence Report¹ – 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 take place four times a year. The day-to-day cooperation takes place in the thirteen committees of the ESCB and their substructures, where common analyses are composed, preparations for the work of the decision-making bodies – the Governing Council and the General Council of the ECB – are made by representatives of NCBs, and information is exchanged. The committees cover all the fields of activity of the central bank. In 2006, representatives of Eesti Pank took part in over 220 working meetings, which shows that cooperation is very close.

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, ensuring financial stability, and guaranteeing the operation of reliable and well-functioning payment and settlement systems. The goal is to ensure the stability of the economy and the Estonian kroon, which form the foundation of a strong state.

When the euro is put into circulation, the tasks of Eesti Pank will generally remain 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 Governor of Eesti Pank as a member of the Governing Council of the ECB² 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

¹ See background information "Assessment of euro readiness in 2006: convergence reports" (p. 55) for an overview of the preparation and contents of the 2006 Convergence Reports.

² 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.



member of the euro area, Eesti Pank will participate in the joint management of reserves and development of settlement systems.

The central bank 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 interbank transfers, contribute to the sustainability of the financial system, and compile Estonia's balance of payments.

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 2006, the Governor of Eesti Pank attended the informal meetings of the Economic and Financial Affairs Council (ECOFIN), where subjects of discussion included the European and international economic situation; issues related to the EU financial stability, such as harmonisation of the supervisory practices of the EU financial sector and financial crisis management; global competition, innovation and productivity, 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 2006, such matters included implementation of the Maastricht price stability criterion; ensuring the sustainability of public finances against the background of ageing population; assessment of the 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 Payment Area; cross-border mergers and acquisitions in the financial sector, and the financial services strategy until 2010.

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. One of the main discussion subjects in 2006 was **implementation of the price stability criterion prescribed in the Maastricht Treaty**.

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

In 2006, also separate meetings took place with Commission representatives to clarify Estonia's inflation mechanisms.

Cooperation with the International Monetary Fund

The International Monetary Fund (IMF) is a very important forum for international cooperation involving most of the countries in the world (185 to be 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 avoiding financial and balance of payments crises, and promotion

of international trade. Eesti Pank is responsible for representing the interests of Estonia in the IMF.

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 ope-

rating principles of the organisation. A major part of the activities of the IMF is related to the **monitoring of the economic policies** of its member countries. Implementation of the new strategy of the IMF includes streamlining the policy and methods for monitoring.

SELECTION OF THE KEY TOPICS COVERED IN THE ECB MEETINGS IN 2006

Specifics of Estonia and other rapidly growing economies catching up with the average EU income level

It is important for Estonia to have the growth rate of its economy and the level of its inflation rate assessed against the background of a financial system having a currency-board-based fixed exchange rate regime and strong cross-border integration (primarily with Northern Europe). In the same way, it is vital these circumstances are taken into account when discussing the funding of Estonia's economic development.

In the meetings of ECB committees and working groups, experts of Eesti Pank took the opportunity to explain Estonia's economic developments and the balancing role of the currency board arrangement in the overall economic framework. They were also involved in analysing the economies of other non-euro area Member States and drew attention to the need to consider the general economic context, not just a few single indicators.

Using the economic processes of more prosperous countries as a comparison basis, it is often difficult to understand how the faster price growth and economic expansion of a country undergoing rapid development and convergence towards the EU average indicators (i.e. a country like Estonia) could be sustainable. In countries with relatively slow economic growth, the infla-

tion rate regarded to be in line with price stability implies a much more modest price growth than, for example, in Estonia.

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 price stability in the general economic context (taking into account also productivity growth) rather than merely compare the inflation indicators.

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

The survey of the economic development of the ERM II member countries aimed at assessing their readiness to join the euro area.

Estonia has not encountered any difficulties during the time of participation in ERM II.

Relations between economic growth, capital inflow and inflation in countries with different exchange rate policies

Clarification of the objective and impact of the **financial policy measures taken by Eesti Pank** in 2006 (for further details see p. 33 "Ensuring financial stability").

SELECTION OF THE KEY TOPICS ON THE 2006 AGENDA OF THE COUNCIL OF THE EUROPEAN UNION

Economic situation in the European Union.

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

Euro area expansion. Assessment of the economic development in the countries' convergence reports and interpretation of the Maastricht criteria proceeded from that framework. It is in the interests of the entire EU that expansion of the euro area should take place in full 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.

Supporting the uniform approach, Eesti Pank together with the Ministry of Finance actively participated in discussions on the economically meaningful interpretation of the Maastricht inflation criterion. In addition, at several meetings it was necessary to provide a detailed explanation about the fulfilment of the legal convergence criterion in Estonia. Consequently, by end-2006, Estonia was the first non-euro area Member State to meet all the legal requirements for the changeover to the euro.

Financial system stability in the European Union

In its statements and explanations Eesti Pank drew attention to the specifics of financial development in Estonia and similar EU countries, focusing mainly on the topics of strong credit growth and foreign currency loans. Reasons for growth and related risks were observed more closely.

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 especially important for the country to enhance cross-border cooperation in financial supervision (for further details see "Ensuring financial stability" p. 33).

EU financial services policy for the years 2005–2010.

Eesti Pank paid special attention to the preparations made for the development of single European capital market, including the elaboration of the Trans-European Securities Settlement System. Eesti Pank supported a framework based on agreements between market participants but also pointed out risks related to this solution (for further details see "Ensuring financial stability" p. 33).

Common position of the EU on issues of the International Monetary Fund (IMF)

Eesti Pank is responsible for the relations between Estonia and the International Monetary Fund. Therefore, in 2006 the central bank participated actively in various discussions on topics like IMF quotas and 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 Monetary and Financial Committee, where common positions of the EU were determined.

Euro coins. Eesti Pank closely observed discussions related to the practice of acceptance and re-use of euro coins and to the issuance of collector coins and consulted in this respect the colleagues in the Ministry of Finance.

Statistics. For years, Eesti Pank has supported the development and application of best prac-

tices in the field of statistics. In 2006, the supervision of the application of the agreed code of conduct deserved special attention. Estonia considers it important to ensure consistent quality in statistics in all the EU Member States. In

addition, by means of providing specific priorities Eesti Pank supported efficient usage of resources for collecting, processing and publishing statistics (for further details see "Developments in statistics" p. 38).

Preparations to change the operating principles of the IMF are currently under way. The member countries decided at the Annual Meeting 2006 held in Singapore to **reform the system of quotas¹ and voting power²**. The aim is to simplify the formula used for calculating quotas, increase quotas for under-represented countries and also the role of basic votes³ 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.

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 making him 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 2006,

the position of the Director of the Constituency has been held by a Finnish representative Tuomas Saarenheimo. 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 central banks of Estonia and Iceland prepared an analysis of the quality and efficiency of economic policy consultations in the Nordic-Baltic Constituency that are being carried out under Article IV of the IMF Articles of Agreement. A separate monitoring project was carried out by the IMF to analyse the close integration of the financial sector in the Nordic-Baltic region. The project included a seminar held in Tallinn. The results of the project were published in the first half of 2007.

In the framework of **cooperation in monitoring between the IMF and Estonia**, the representatives of the IMF made two visits to Estonia in 2006. In April,

¹ A quota has been established for each IMF member determining its participation (subscription) in the Fund in the form of Special Drawing Rights (SDR) calculated on the basis of a complex system of formulas, where mainly three indicators (GDP, reserves, and the volume and volatility of current account transactions) with different weighting are applied.

² The voting power of every IMF country depends on the number of basic votes and the size of the country's quota.

³ According to the Articles of Agreement, every IMF member country owns 250 basic votes.



the new Head of IMF Mission to Estonia, Franciszek Rozwadowski, made his introductory visit. In August, regular economic policy consultations were carried out under Article IV of the IMF Articles of Agreement. After a discussion in the IMF Executive Board in November 2006, the main report and a report dealing with special issues on the Estonian economy based on these consultations were published on the web sites of both the IMF and Eesti Pank. In 2007, the IMF mission to Estonia took place at the beginning of May.

Cooperation with rating agencies

Sovereign rating, more specifically the credit rating of a country, is an assessment by internation-

al (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. 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.

SELECTION OF TOPICS FROM THE INTERNATIONAL MONETARY FUND FORUMS IN 2006

Economic developments in the new European Union Member States

One of the topics was clarification 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 regular 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 related to the economic policy in Estonia. In June 2006, Susan Schadler, the Deputy Director of the IMF European Department, gave a presentation in Tallinn on the growth outlooks for the Central and Eastern European countries.

New strategy approved by the IMF in 2006

The distribution of the IMF quotas and voting power is an important issue for Estonia. The cur-

rent quota for Estonia is approximately 80% lower than it would be according to the quota formula. The ongoing discussion on increasing the role of basic votes also supports strengthening the voting power of smaller and less advanced countries.

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 the near future, a number of changes are about to be made that will have an impact on the relations between the IMF and all the member countries. For Estonia, it is important how external stability will be defined when changing the basis for exchange rate policy surveillance. Moreover, the questions whether and how the

medium-term objectives of the surveillance policy will be established and what kind of changes will be made in order to update financial sector surveillance are of significance.

Crisis prevention

In 2006, quite a lot of time was spent on the desires stemming from emerging markets to sup-

plement the Fund's list of credit lines with a large instrument enabling to support crisis prevention. Estonia considers it important that only countries with strong economic policy could use the credit line and that financial aid from the Fund would be made available as fast as possible if necessary.

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, such as the economic situation, developments in the real estate market, budget strategy, financial stability, labour market situation, etc., serve as an example of high-level internal cooperation.

The presidency of the European Union changes every six months. This affects also the **national coordination of EU-related activities** since national policy priorities and short-term objectives are always determined for the new presidency period. The Government's long-term objectives are established in the 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; the discussion of EU-related positions submitted to the Government; solving problems between various state agencies, and exchange of information on EU-related matters.

In order to participate in external working groups the experts of Eesti Pank usually meet at the **seminars and brainstorming sessions** organised by the bank. For example, the competitiveness of the Estonian economy was discussed at the spring seminar of 2006 in Kuressaare and trends in the real estate market at the autumn seminar in Jämeda.

Cooperation with the Office of the President

Members of the Executive Board of Eesti Pank have accompanied the President of the Republic during state visits at several occasions. In 2006, such visits were paid to Latvia, Georgia and Portugal. The

Table 2. Eesti Pank's participation in internal cooperation

- European Union Coordination Council
- Lisbon Working Group
- Working Group on Financial Services Legislation
- Coordination committee for the prevention of money laundering
- Inter-agency support unit for the Intergovernmental Conference
- Development Cooperation Working Group
- National Coordination Working Group of the Organisation for Economic Cooperation and Development (OECD)
- National Coordination Working Group for the preparation of the Treaty of Accession for Bulgaria and Romania
- 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



speeches held by the central bank representatives during state visits are available on the web site of Eesti Pank.

Cooperation with the Ministry of Finance

In addition to daily cooperation in the elaboration of legislation, international communication and in other fields, a joint seminar of Eesti Pank and the Ministry of Finance was organised in 2006. Representatives of both institutions presented their views on Estonia's economic outlooks and introduced surveys related to fiscal and taxation issues and the real estate market. The last such joint seminar was held three years ago. Both institutions find that such a dialogue should be initiated at least once a year.

Cooperation with the Financial Supervision Authority

At the end of 2006, Eesti Pank, the Financial Supervision Authority and the Ministry of Finance concluded a Memorandum of Understanding (MoU). The MoU sets out the distribution of responsibilities between state agencies in financial crisis management. National crisis management cooperation agreements are an integral part of the EU crisis management framework.

Close cooperation with the Financial Supervision Authority operating by Eesti Pank has focused on monitoring financial system developments, discussions related to regulations of the financial sector and, to a large extent, also on international cooperation. In the latter case cooperation between Eesti Pank and the Financial Supervision Authority is similar to that between 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

Regular meetings with members of the Estonian Banking Association, i.e. high-level representatives of commercial banks operating in Estonia, form a basis for cooperation and information exchange with the private sector. Even more often experts of commercial banks meet with representatives of Eesti Pank in order to specify the technical issues related to the development of the Estonian banking infrastructure. Cooperation in the field of payment and settlement systems should be pointed out here.

ASSESSMENT OF EURO READINESS IN 2006 – CONVERGENCE REPORTS¹

In spring and winter 2006, the European Commission and the European Central Bank assessed a number of EU Member States² with regard to their readiness to adopt the single currency euro and the single monetary policy. The assessment is based on the provisions of the Treaty on European Union or the so-called Maastricht criteria. The fulfilment of these criteria demonstrates the suitability of the econo-

mic situation, economic policy and legislation of a country for the euro changeover. In other words, they show whether the situation in these fields is sufficiently similar to that of the euro area.

Based on these assessments – the Convergence Reports – the European Commission presents its opinion on which countries are ready to join the euro area to the Council of Economic and

¹ Convergence Reports are available at the European Commission's web site http://ec.europa.eu/economy_finance/publications/convergencereports_en.htm and the European Central Bank's web site <http://www.ecb.int/pub/convergence/html/index.en.html>.

² The Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, and Sweden.

Financial Ministers (ECOFIN) and the European Council. The only country that was assessed to be ready to join the euro area was Slovenia where the single currency was adopted in January 2007.

The convergence reports are drafted on the basis of the Maastricht criteria, the fulfilment of which should guarantee the smooth functioning of the Economic and Monetary Union, including the possibility to maintain a stable price level through the single monetary policy.

An environment of Economic and Monetary Union that enables to maintain price stability can be characterised by the following:

- Strict fiscal policy (general government budget deficit must not exceed 3% and debt 60% of GDP);
- Low inflation rate (must not be more than 1.5 percentage points above the average annual inflation rate³ of the three EU Member States with the lowest interest rates);
- Low long-term interest rate (the interest rate of long-term government bonds must not exceed the average of the three EU Member States with the lowest interest rates by more than 2 percentage points);
- Stable exchange rate observed at least for two years when the country has been participating in the exchange rate mechanism ERM II.

The necessary legal prerequisites mainly relate to the compatibility of central bank's objectives with the ECB's objectives and central bank's independence.

The euro readiness of Lithuania and Slovenia was assessed in spring 2006 and that of the rest

of the non-euro area countries in autumn 2006. By the time of assessment Slovenia had fulfilled all the criteria. However, Lithuania was confronted with an obstacle of slightly higher inflation than allowed – the inflation criterion was 2.6% in spring 2006, but in Lithuania the average annual price rise was 2.7%. Lithuania's non-qualification brought about an active discussion in the EU on the appropriateness of the inflation criterion in principle in assessing price stability in rapidly growing economies. Since no common position was reached, it was preferred to continue with the old criterion in order to guarantee equal treatment of countries that have joined the euro area at different points of time.

Table a gives an overview of the results of the Convergence Reports of autumn 2006. The figures with pink shading indicate compliance with the criterion. In autumn, also Estonia was assessed, and the country appeared to fulfil the criteria the most: all requirements except for the inflation criterion were satisfied. Estonia's average annual inflation rate reached 4.3% in autumn 2006.

The next candidates to join the euro area are Cyprus and Malta. Their Convergence Reports were published in May and the decision is made in summer. By that time these two countries have presumably met all the requirements, including the two-year participation in ERM II.

ISSUES RELATED TO THE DATE FOR THE ADOPTION OF THE EURO

Owing to rapid inflation the initial date for the adoption of the euro – 1 January 2007 – became more questionable in spring 2006. Since the introduction of the euro is of great importance to the public, the issue of setting the transition

³ This inflation rate is not directly comparable to the inflation rate regularly published by Statistics Estonia due to differences in calculation methods.

date had to be made as clear as possible. To this end, forecasts of various institutions, such as the Ministry of Finance, Eesti Pank and the European Commission, were proceeded from. The spring forecast of Eesti Pank published at the end of April gave hope that Estonia would fulfil the Maastricht inflation criterion in the first half of 2007. In addition, the Government postponed the deadline until 1 January 2008. The public was immediately notified of that.

The forecast of the Ministry of Finance published on 22 August showed that Estonia's inflation rate was higher than expected. Andres Lipstok, Governor of Eesti Pank made a statement back then, saying that the consumer price increase hinders Estonia to join the euro area in 2008 and

that adopting the euro as soon as possible had remained the objective of the Government and the central bank.

On 8 November a new autumn forecast was introduced by Eesti Pank. The presentation of the forecast clarified many aspects regarding the adoption of the euro (a clear signal was given to the public that 2008 and possibly also 2009 were not an option anymore). Shortly, the Government also confirmed that the objective is to join the euro area as soon as possible; however, a clear date was not set. In any case, the exact date of the euro changeover will be known at least twelve months in advance before the changeover, so that the state and the private sector could finish necessary preparations.

Table a. Results of the Convergence Reports drafted in autumn 2006

Country	Inflation (2,8%)	Long-term interest rate (6,2%)	Exchange rate (incl. ERM II)	General government budget (up to -3% of GDP)	General government debt (60% of GDP or declining)	Legislative conformity
Estonia	4.3%	4.1%	Yes (28.06.04)	+2.3%	4.5%	Yes
Cyprus	2.3%	4.1%	No (02.05.05)	-2.3%	69.2% ↓	No
Lithuania	2.7%*	3.7%**	Yes (28.06.04)	-0.5%	18.7%	Yes
Latvia	6.7%	3.9%	No (02.05.05)	+0.1%	12.1%	No
Malta	3.1%	4.3%	No (02.05.05)	-3.2%	74.2% ↓	No
Poland	1.2%	5.2%	No	-2.5%	42.0%	No
Sweden	1.5%	3.7%	No	+2.0%	50.4%	No
Slovakia	4.3%	4.3%	No (28.11.05)	-3.1%	34.5%	No
Slovenia	2.3%*	3.8%**	Yes (28.06.04)	-1.8%	29.1%	Yes
Czech Republic	2.2%	3.8%	No	-3.6%	30.4%	No
Hungary	3.5%	7.1%	No	-7.8%	61.7% ↑	No

* At the time of drafting the reports on Lithuania and Slovenia the inflation criterion was 2.6%.

** At the time of drafting the reports on Lithuania and Slovenia the long-term interest rate criterion was 5.9%.

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 is a central bank that 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 controllable, 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. 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 web site, it is possible to send direct inquiries to Eesti Pank. Information can be requested by mail, e-mail or phone. In 2006, Eesti Pank received 3,074 inquiries, 172 of which were registered as requests for information.

Media relations and public appearances

Approximately 3,500 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 2006. The central bank held 7 press conferences, issued 54 press releases and a large number of statements. Moreover, 17 articles were published.

Both, the domestic and international media were mainly interested in the adoption of the euro and

economic developments in Estonia. Strong credit growth remained on the agenda. Eesti Pank repeatedly called for vigilance in this respect. At the end of the year, Eesti Pank paid more attention to consumer credit since their growth had increased significantly. Opinions of the IMF and rating agencies on the Estonian economy but also labour market issues similarly deserved a lot of attention.

In November, Eesti Pank informed the media about joining the euro area settlement system TARGET, which enables customers of banks and other financial institutions to make fast and secure euro payments in the European Union via Eesti Pank.

During the year, central bank representatives made presentations at a number of conferences and events on the topic of changeover to the euro and the economic situation in Estonia.

On 9 September, the fifth Open Door Day of Eesti Pank took place with the focus on wisdom in monetary affairs. The objective was to provide visitors with practical information on monetary issues as well as entertainment. Economists of Eesti Pank held a lecture on the risks related to borrowing to make people aware of various aspects to be considered when taking a loan.

Just before the Open Door Day, Eesti Pank participated in an art project "Houses, show what you've got inside!" organised in the framework of a drawing exhibition "Improvisation". During one night the portraits of Lydia Koidula and Carl Robert Jakobson were projected on the façade of Eesti Pank by artists Flo Kasearu and Alide Zvorovski.

Communication on the euro

In 2006, 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 for guaranteeing 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 2006. As the year moved on, the date for the adoption of the euro deserved more and more attention and consequently had to be treated in the communication by the state.

Seminars and presentations on the euro held in various locations in Estonia by central bank and Government representatives were extremely popular. Altogether 51 events were organised with the audience varying from school children to the elderly. The topics covered focused on the advantages of the euro changeover, whereas speakers tried to mitigate the fears accompanying the single currency. People are mostly afraid of a possible price increase.

All kinds of printed materials form an important part of the euro campaign. In cooperation with the European Central Bank and the European Commission, Estonian state institutions distributed publications on the single currency aimed at different target groups. In summer, the brochure "Hello, euro!" reached Estonian newspaper subscribers. The main objective of the materials distributed in 2006 was to introduce the birth of euro as the single currency of Europe and the visual appearance of banknotes and coins, and to give an overview how the changeover would be organised in Estonia. The topics covered included also the advantages and disadvantages of the introduction of the euro.

At the beginning of 2006, a special edition dealing with the topic of the euro, *The Ajaleheleht*, was published as a joint project of Eesti Pank and the Estonian Newspaper Association. This project, initiated by the Estonian Newspaper Association, aimed to promote reading newspapers and develop critical reading among the young. Every issue dealt with a specific topic. The newspaper was published in Estonian and Russian and included serious as well as entertaining stories on the euro.

Interviews featured also various well-known public figures. The Estonian Newspaper Association and Eesti Pank introduced the project to teachers at seminars all over Estonia.

In February, a special web site dedicated to the euro was launched (euro.eesti.ee). The web page is compiled and developed by Eesti Pank. However, the concept and technical platform of the site enables also other state institutions to make their contributions. The first months of the euro web gave a lot of feedback and many inquiries had to be answered.

GOVERNANCE, ORGANISATION AND PERSONNEL POLICY

Eesti Pank's governing bodies and decision-making processes

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 the 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 the Deputy Governors of Eesti Pank, the 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 Authority¹ appointed by Eesti Pank on the proposal of the Governor of Eesti Pank;
- approval of the statutes of the independent divisions and representations of Eesti Pank ;
- 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 upon 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.

On 17 February 2004, the Riigikogu appointed to office the current Supervisory Board of Eesti Pank, comprising Professor **Mart Sõrg** (Chairman of the Board, appointed to office on 12 June 2003), Faculty of Economics of the University of Tartu; Professor **Raul Eamets**, Faculty of Economics of the University of Tartu; Professor **Enn Listra**, Dean of the Faculty of Economics of the Tallinn University of Technology; **Mart Opmann**, Member of the Riigikogu; **Tõnis Palts**, politician and businessman; Professor **Jüri Sepp**, Faculty of Economics of the University of Tartu, and **Liina Tõnisson**, Member of the Riigikogu. After Andres Lipstok assumed the office of Governor of Eesti Pank on 7 June 2005, one position in the Supervisory Board remained vacant until 24 January 2006 when **Harri Ōunapuu** was nominated as an alternate member.

From 7 June 2005 to 8 July 2006 also **Andres Lipstok**, Governor of Eesti Pank belonged to the Board by virtue of office, but pursuant to the Eesti Pank Act Amendment Act that entered into force on 8 July 2006 the Governor is no longer a member of the Board.

Governor of Eesti Pank

On 10 May 2005, the Supervisory Board of Eesti Pank elected Andres Lipstok as candidate for the position of Governor of Eesti Pank and made a pro-

¹ 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 removed 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.



posal to the President of the Republic of Estonia to nominate Andres Lipstok as Governor of Eesti Pank. The President appointed Andres Lipstok to office on 18 May 2005. **The new Governor of Eesti Pank commenced his duties on 7 June 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 Chairman of the Executive Board by virtue of office is the Governor of Eesti Pank. In 2006, 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

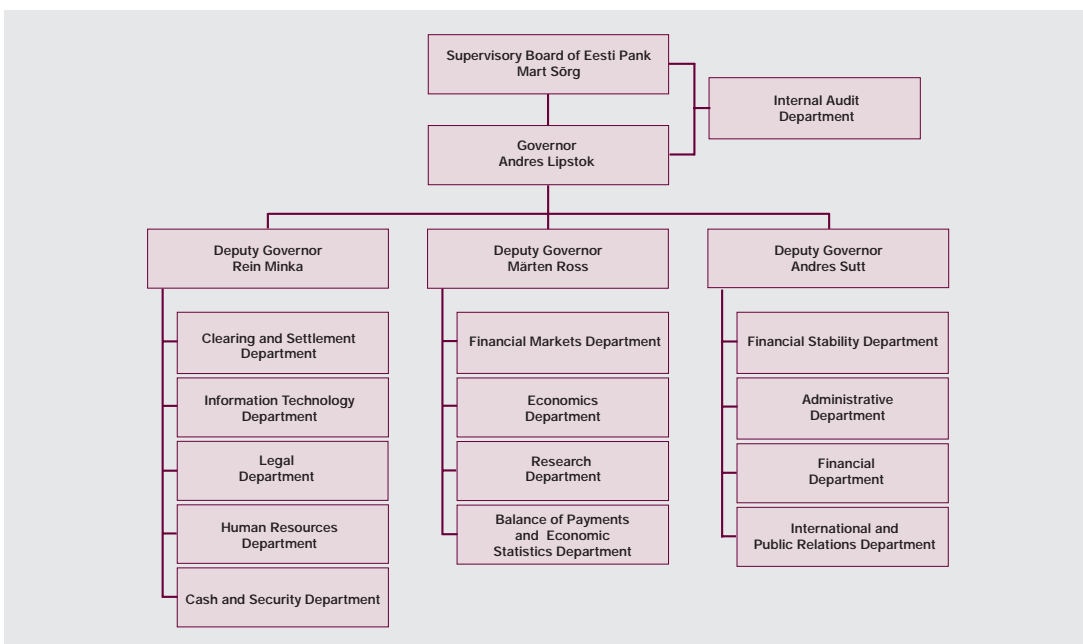
passed by the Supervisory Board and implementation of measures necessary for that purpose; approval of Eesti Pank's budget, and supervision of the execution of the tasks of the European System of Central Banks.

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 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.

Figure 1. Organisational chart of Eesti Pank as at 31 December 2006



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 administrative services, and operational working environment at Eesti Pank.

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.

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 2006, the **Monetary Policy Committee of Eesti Pank** included the member of the Executive Board **Governor Andres Lipstok**, Deputy Governors **Rein Minka**, **Märten Ross** and **Andres Sutt** as well as **Janno Luurmees**, Head of the Financial Markets Department, **Ilmar Lepik**, Head of Economics Department (until 8 November 2006), **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.

Financial Supervision Authority

The **Financial Supervision Authority**² operates as an agency of Eesti Pank. The objective of the Financial Supervision Authority is to enhance the stability, reliability, transparency and efficiency of

the Estonian financial sector, to reduce systemic risks and to promote prevention of the abuse of the financial sector for criminal purposes. The objective of financial supervision is to protect the interests of clients and investors by safeguarding their financial resources, and thereby supporting the stability of the Estonian monetary system.

The Financial Supervision Authority is governed by the Management Board chaired by Raul Malmstein. The activities of the Supervision Authority are planned by the Supervisory Board chaired by the Minister of Finance by virtue of office – by Aivar Sõerd as at the end of 2006. 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 2006

Strategic management

Eesti Pank followed the strategic management development path opted for in 2001, which involves description of the bank's development priorities and regular tasks in a three-year perspective and more precise planning of human and financial resources. In 2006, more attention was also paid to process-based budget drafting. The development of the bank's management system, particularly the recording of the usage of working time by employees, has contributed to more precise planning of required labour.

In 2005, the Executive Board approved **Eesti Pank's management system** that associates different management activities, defines the relations between these activities as well as the persons responsible for them. In 2006, the integral introduction of the management system continued. No new development works were started to allow time for

² See Section 4 of the Financial Supervision Authority Act.



adjusting to innovations. Preparations were made to introduce the elements of value-based management in the management system and first related events took place, involving the whole bank. Larger developments in that field are planned for 2007.

Financial and management accounting was developed further. At the beginning of 2006, the bank started to use the financial accounting and reporting standards obligatory for the central banks of the Eurosystem. Furthermore, the controller's function was established to monitor sustainable and efficient use of resources and submit data supporting management decisions.

For already six years now the bank has been conducting appraisal interviews. The purpose of interviews is to review and plan work and development tasks in cooperation between the executives and the staff, and to receive proposals from the personnel regarding bank's strategic directions and organisation of work.

Process management

In 2006, no major developments were carried out in the bank's process management. The focus was rather on the enhancement of the existing processes and better integration of regular improvements with the management system of Eesti Pank.

During the audit Bureau Veritas Eesti OÜ 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.

Risk management

Eesti Pank has launched a risk management system comprising all the bank's functions and aiming at reducing the adverse impact of accidental events on accomplishing bank's objectives. In order to better organise risk management in the bank, the Executive Board approved the **risk management framework** and hired a full-time **risk manager** in 2006.

The central bank has introduced a two-level risk management system. At the strategic level, decisions are made regarding the bank's risk profile across processes, departments, risk classes and major risks. Strategic risk management aims at drafting a long-term plan for changing the risk profile of Eesti Pank. This plan should serve as the basis for improving the bank's strategic plan and making tactical decisions.

At the tactical level, decisions are made with regard to implementing concrete risk management measures in units.

A more in-depth risk mapping takes place twice a year when all the bank's units submit their reports on the materialisation of risks. The first such reports were submitted in the second half of 2006. The risk manager analyses the level of risks on the basis of these reports and, if necessary, together with the heads of units and specialists adjusts the assessments on the likelihood and impacts of the materialisation of risks.

The full risk management process is conducted once a year simultaneously with the strategic planning cycle. The inputs necessary for mapping and hedging risks include a regular overview of processes and audit reports.

e-Eesti Pank 2006

The year 2006 saw further implementation of the development strategy for document and information management (e-Eesti Pank) approved in 2003. The aim of e-Eesti Pank is a stage-by-stage changeover to e-administration and building up a document creation and document management system compliant with the best international experience in a common integrated environment.

In 2006, the following developments were made in the field of document, information and records management:

- Implementation of digital work flows in order to record, deliver and process the decisions and

orders of the Governor, the Executive Board and internal audit;

- Conduct of the risk analysis of records management and presentation of results;
- Arrangement and updating of the structure and metadata of document registers;
- Preparation of a business process based structure for the e-files of Eesti Pank;
- Creation of additional document search options for e-files;
- Introduction of an application for the management of the life cycle of e-documents.

As a result, the records management of Eesti Pank became faster and more transparent. Furthermore, procedures became more expedient and resources were used more effectively.

Renovation of the building of Eesti Pank at Sakala 6

In order to guarantee the safety of the communication and IT systems of Eesti Pank and the logistics of the transport of cash, the Executive Board decided to organise the renovation of the building at Sakala 6 according to the design of the architectural firm Arhitektuuribüroo Schults ja Partnerid OÜ. AS Merko Ehitus won the construction tender. The renovated building comprises 1,647 square metres of office space and technical space prepared for the adoption of the euro.

EESTI PANK'S PERSONNEL POLICY

The objective 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 pay 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 expe-

rience is looked for. When recruiting for executives or other highly responsible posts, a competency model is used that provides the best opportunity to evaluate candidates' knowledge, skills, and personal characteristics.

The **payment of staff** 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 pay 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 pays 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 pays of top executives is affected by changes in the wage market data in the financial sector of Tallinn and its vicinity. The pay of the Governor of Eesti Pank should not be smaller than the average wages of top executives in comparable enterprises and agencies.

In 2006, the total pays (basic wages and additional pay) of the members of the Supervisory Board amounted to 2,006,164 kroons and those of the Executive Board to 5,444,714 kroons.

Non-executive jobs have been evaluated on the basis of the Hay method. Depending on the evaluation results, all jobs have been divided into wage groups listed in the classification of central bank jobs. Eesti Pank has implemented a pay scale comprising a number of pay grades. The employees (members of the Executive Board excluded) get paid on the basis of their pay grade, comparable by groups of similar work within as well as outside the bank.

In 2006, the average monthly wage of a specialist stood at approximately 19,600 kroons.

At the beginning of 2006, the bank had contracts of employment with 255 employees (233 were actually



working, as contracts with 22 employees had been suspended), whereas at the end of the year the respective figure was 259 (238 were actually working and 21 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 2006 was 41 years. The employees included 106 men (42%) and 149 women (58%).

Development and training

In 2006, a range of **internal training projects and seminars** was carried out.

The **training costs** accounted for **3.4% of the payroll**. The training costs per employee were 13,750 kroons (incl. travel expenses). In 2006, 196 employees attended training, which comprises 82% of the total staff. Training totalled 14,083 hours, an average of **seven days of training per employee**.

The main training topics in 2006 were defined in the bank's internal training plan. Departments were independent in determining their internal training needs.

All in all, the staff participated in **205 training events**, whereas 42% of them were held abroad. There were nine internal training courses, including seven in associated areas (management, communication, information technology and law) and two in core areas (economic theory and policy).

The key training topics included **management and communication aspects, economic theory and policy**, and **financial stability**. **Language training** remained popular, whereas besides English also German, French and Spanish are gaining popularity.

45 employees were engaged in **academic studies** in 2006: about half of them were acquiring the

Master's degree (23), a third the Doctor's degree (15) and the rest the Bachelor's degree. One employee participated in a secondment programme at the European Central Bank and another was a secondee at the Finnish central bank. Two employees from the Ministry of Finance were trainees at Eesti Pank for two months, participating in the economic forecasting process.

Hobbies and traditions of the staff

At the end of 2006, Eesti Pank's **Sports Club** had 221 members. Swimming, basketball, aerobics, gym, track and field, and volleyball were the most popular fields of sport. The staff also practices cycling, skiing, sailing, orienteering, chess, bowling and football. Furthermore, employees of Eesti Pank participated in several sport events held for the European national central banks, including a chess tournament in Belgium and an orienteering competition in Latvia.

The chamber choir of the employees of Eesti Pank and the Financial Supervision Authority first gathered on 15 May 1998. The choir has nearly 30 members and is conducted by Peeter Perens. Its activities are coordinated by the board which is elected every year.

In spring 2006, the chamber choir participated in the 9th Estonian Chamber Choir Festival in Viljandi and in autumn it took part in Eurochoir 2006, the festival of European national central banks. At Christmas, a concert was held at the Swedish St. Michael's Congregation in Tallinn.

VISSADA

RAHA VAA

TALLINNAS 1918 RAH



№730143

MAKSSA HOIDJA AB
KAAREL MÄRKIVIRSO



Annual Accounts of Eesti Pank

for the Financial Year Ended
31 December 2006

RANKIN

APPROVAL OF THE ANNUAL ACCOUNTS FOR THE FINANCIAL YEAR ENDED 31
DECEMBER 2006 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 2006.

The Annual Accounts have been prepared in accordance with the Eesti Pank Act and the accounting policies and procedures. As regards issues not covered by the above-mentioned regulations, international financial reporting standards are applied. The Annual Accounts give a true and fair view of the assets and liabilities, equity capital and economic performance of Eesti Pank.

Preparing the Annual Accounts in conformity with generally accepted accounting principles requires the Executive Board to provide estimates affecting 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.

The Annual Accounts disclose significant events that occurred until the date of preparation of the Annual Accounts, i.e. 19 March 2007, and that affected the valuation of assets and liabilities.

On 3 April 2007, 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 2006 AND 2005 (EEK THOUSAND)

	Item	31/12/2006	31/12/2005
ASSETS			
Gold and gold receivables	1	62,169	56,017
Claims on non-residents denominated in foreign currency		33,933,699	26,829,177
Receivables from the IMF	2	1,176,705	1,244,068
Balances with banks, security investments and external loans	3	32,756,994	25,585,109
Intra-Eurosystem claims	4	10,873	10,873
Other assets		701,609	477,777
Tangible fixed assets	5	294,895	243,117
Other financial assets	6	3,441	3,441
Off-balance-sheet instruments revaluation differences	7	37,839	11,107
Accruals and prepaid expenses	8	308,399	163,024
Sundry	9	57,035	57,088
Total assets		34,708,350	27,373,844
LIABILITIES			
Currency in circulation	10	11,763,153	10,101,716
Liabilities to residents related to the monetary policy	11	17,086,784	11,972,685
Liabilities to other residents denominated in kroon	12	90,864	84,522
Liabilities to residents denominated in foreign currency	13	7,041	0
Liabilities to non-residents denominated in foreign currency	14	368,965	0
Liabilities to the IMF	2	1,164,676	1,231,399
Other liabilities		168,787	122,403
Off-balance-sheet instruments revaluation differences	7	30,277	27,375
Accruals and income collected in advance	15	128,789	78,000
Sundry	16	9,721	17,028
Revaluation accounts	17	60,980	0
Capital and reserves	18	3,801,770	3,623,724
Capital		600,000	600,000
Reserves		3,201,770	3,023,724
Profit for the year		195,330	237,395
Total liabilities		34,708,350	27,373,844

The notes on pages 72–88 form an integral part of the Annual Accounts.

PROFIT AND LOSS ACCOUNT FOR 2006 AND 2005 (EEK THOUSAND)

	Item	2006	2005
Interest income		1,055,344	644,768
Interest expense		-487,149	-317,013
Net interest income	19	568,195	327,755
Realised gains/losses arising from financial operations		-50,473	75,242
Write-downs		-103,085	-276
Net result of financial operations, write-downs and risk provisions	20	-153,558	74,966
Net result of fees and commissions	21	10,579	9,023
Dividend income	22	951	987
Other operating income	23	15,787	11,617
Operating expenses	24	-246,624	-186,953
Personnel expenses		-97,894	-84,957
Banknote and coin production costs		-39,884	-3,716
General administration expenses		-80,678	-73,593
Depreciation of fixed assets		-28,168	-24,687
Profit	25	195,330	237,395

The notes on pages 72–88 form an integral part of the Annual Accounts.



STATEMENT OF CHANGES IN EQUITY (EEK THOUSAND)

	Fixed capital	Reserve capital	Special reserve	Profit	Total
Balance as at the end of 2004	100,000	500,000	2,835,323	251,203	3,686,526
Distribution of the 2004 profit	-	-	188,401	-188,401	-
Allocations to the state budget	-	-	-	-62,802	-62,802
Profit of 2005	-	-	-	237,395	237,395
Balance as at the end of 2005	100,000	500,000	3,023,724	237,395	3,861,119
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
Balance as at the end of 2006	100,000	500,000	3,201,770	195,330	3,997,100

The notes on pages 72–88 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 accounting policies and procedures. In 2006, the new accounting policies and procedures were approved, which proceed from the financial accounting rules obligatory for the European System of Central Banks. For issues not covered by the Eesti Pank Act or the accounting policies and procedures of Eesti Pank, international financial reporting standards are applied.

As of 2006, the main changes in the accounting policies include the following:

- The unrealised gains obtained from the revaluation of financial assets and liabilities during the year are recorded on the Balance Sheet and unrealised losses are recorded in the Profit and Loss Account at the end of the year. (In the 2005 Annual Accounts both unrealised gains and losses were recorded in the Profit and Loss Account.)
- Securities are recorded on the Balance Sheet on the settlement date. The calculation of accrued interest and the gains and losses arising from revaluation starts on the settlement date. (Until the end of 2005, the recording of securities was based on the trade date, i.e. the calculation of interests started on the settlement date, whereas the calculation of gains and losses arising from revaluation started on the trade date.)
- Foreign exchange transactions are recorded on the trade date in off-balance-sheet accounts. (Until the end of 2005, foreign exchange transactions were recorded on the trade date on the Balance Sheet.)
- Deposits and repurchase agreements are not revalued. (Until the end of 2005, deposits and repurchase agreements were revalued on a monthly basis, using the future cash flow discount method.)
- Gains and losses are calculated on the basis of the average cost method. The exchange rate differences of the foreign currency position are calculated using the average exchange rates. The return on sales of securities is calculated, comparing the selling price of a security with its average price. (Until the end of 2005, the return on sales of securities was calculated as the difference of the selling price and the acquisition price.)

The data for 2005 are presented with a different structure for the Profit and Loss Account but the data have not been revalued and are included only for informative purposes.

The structure of the Balance Sheet proceeds from the structure specified in Annex IV to the European Central Bank (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.

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". Accrued interests are recorded under other assets and liabilities.

The Annual Accounts have been prepared on the historical cost basis, except in cases explained under relevant items.



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 natural persons. Pursuant to Section 21 of the Value Added Tax Act enforced on 1 May 2004, Eesti Pank is registered as a taxable person with limited liability as of 14 May 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 off-balance-sheet accounts on the trade date (with the exception of securities). On the value date, off-balance-sheet entries are reversed and transactions are recorded on the Balance Sheet. Securities are recorded on the Balance Sheet on the value date.

Further accounting of financial assets and liabilities is based on the fair value, the acquisition cost or the adjusted acquisition cost depending on the type of a respective asset or liability. Fair 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 fair 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 31 December 2006 and 2005 were as follows:

	2006	2005
USD	11,882	13,221
SDR	17,865	18,888
EUR	15,647	15,647

Income recognition

Income and expenses are recognised in the period in which they are earned or incurred. Realised gains and losses from the sale of foreign exchange, gold and securities are taken to the Profit and Loss Account. Such realised gains and losses are calculated by reference to the average cost of the respective asset.

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 registered 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. Changes in the market value of gold at the end of the accounting period compared to the beginning of the period are recognised on the Balance Sheet under "Revaluation accounts".

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 fair value. Securities are revalued on the last banking day of the year by reference to the market prices on the last banking day, comparing the amortised cost of a security with its market price.

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. Interests payable are 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 value 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.



Investments in shares

Investments in shares are recorded at their fair value if their value can be reliably assessed. The assessment of the fair 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 their adjusted acquisition cost (initial acquisition cost less provision for any impairment in value other than temporary below balance sheet 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 recorded at their acquisition cost, including purchase price and other expenditure directly related to bringing 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. Advance payments 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:

	2006	2005
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.

The gross carrying amount of an improved asset has been increased by improvement costs if exterior dimensions of the buildings or facilities have increased, or the purpose of the existing buildings or facilities has changed. Current repair costs are recognised as expense of the period. If it is known or expected that the fair value of an assets is permanently lower than the book value, the asset has been reported at the lower value.

Development costs are recognised as expenses in the Profit and Loss Account in the period when they incur.

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 accounted 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 an offsetting entry under expenses.

Asset impairment

An assessment is carried out on every balance sheet date to identify possible signs of an impairment of financial assets recorded at acquisition cost or adjusted acquisition cost, or tangible fixed assets recorded at acquisition 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 known to have 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 acquisition 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 equal either to the net selling price or the use value of an asset, depending on which of the two is higher. The use value is the present value of cash flows expected from the use of assets and the sales of assets after use. In calculating the present value the discount factor 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 reflected on the Balance Sheet as a liability to the holder of currency. Production costs of banknotes and coins are recorded in the Profit and Loss Account when the bank's payment obligation to the supplier arises.

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.

Income and expenses

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.



Estimates

Preparing the Annual Accounts in conformity with generally accepted accounting principles requires the Executive Board to provide estimates regarding the aspects affecting the assets and liabilities of Eesti Pank and income and expenses during the accounting period as at the balance sheet date. 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 2005	8,250,171	6,789,780	56,017
Revaluation	-	-	6,152
Balance at the end of 2006	8,250,171	7,535,460	62,169

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

	2006	2005
Participation in the IMF	1,164,779	1,231,491
SDR account in the IMF	1,023	1,037
Other receivables from the IMF	10,903	11,540
Total receivables from the IMF	1,176,705	1,244,068

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	2006	2005
Balance at the beginning of the year	1,037	953
Interest and other income	80	51
Exchange rate differences	-94	33
Balance at the end of the year	1,023	1,037

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 2006 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)	2006	2005
Balance at the beginning of the year	1,231,491	1,161,271
Exchange rate differences	-66,712	70,220
Balance at the end of the year	1,164,779	1,231,491
IMF kroon accounts (liabilities)		
Balance at the beginning of the year	1,231,400	1,161,184
Exchange rate differences	-66,724	70,215
Balance at the end of the year	1,164,676	1,231,399



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	2006	2005
Balance at the beginning of the year	11,540	10,882
Exchange rate differences	-637	658
Balance at the end of the year	10,903	11,540
Eesti Pank, SBA loan-related receivable	6,005	6,362
Government, STF loan-related receivable	4,898	5,178
Total	10,903	11,540

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

EEK thousand

	Balance at the end of 2005	Structure of residual maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
	25,585,109	14,792,362	5,819,844	2,230,522	1,185,576	1,556,805
Cash and current accounts	425,782	425,782	-	-	-	-
Time deposits	998,016	998,016	-	-	-	-
Securities	21,799,053	11,006,306	5,819,844	2,230,522	1,185,576	1,556,805
Reverse repurchase agreements	2,362,258	2,362,258	-	-	-	-
	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
	32,756,994	18,385,180	5,989,708	3,555,018	2,159,327	2,667,761
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	-	-	-	-

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.

In 2006, Eesti Pank's foreign exchange reserves were mainly invested 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 slightly more than one year.

ITEM 4 – INTRA-EUROSISTEM CLAIMS

The item reflects participation of Eesti Pank in the European Central Bank (ECB).

On 1 May 2004, the Republic of Estonia joined the European Union and consequently Eesti Pank became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the ECB, Eesti Pank became a subscriber of the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years. The share of the Republic of Estonia in the ECB's capital is 0.1748%. It was calculated in accordance with Article 29 of the Statute of the ESCB on the basis of population and GDP data provided by the European Commission. As the Republic of Estonia does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Consequently, Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB on 1 May 2004. The respective contribution amounted to 694,916 euros (10.9 million kroons). 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 2006:

EEK thousand

	Buildings	Hardware	Furniture and fixtures	Software	Total
Acquisition cost					
Balance at the end of 2005	210,429	64,440	80,231	49,887	404,987
Acquired	74,937	3,460	21,441	9,472	109,310
Disposals		-19,192	-27,852	-1,087	-48,131
Balance at the end of 2006	285,366	48,709	73,820	58,271	466,166
Accumulated depreciation					
Balance at the end of 2005	40,923	56,868	66,788	38,794	203,373
Charge	8,347	5,028	7,231	7,561	28,168
Disposals		-19,192	-27,796	-1,087	-48,075
Balance at the end of 2006	49,270	42,705	46,223	45,268	183,466
Residual value					
Balance at the end of 2005	169,506	7,572	13,442	11,093	201,613
Balance at the end of 2006	236,096	6,004	27,596	13,003	282,699
Advance payments for fixed assets					
Balance at the end of 2005	15,250	17	20,811	5,426	41,504
Balance at the end of 2006	12,097	98	0	0	12,195
Total fixed assets					
At the end of 2005	184,755	7,589	34,253	16,519	243,117
At the end of 2006	248,193	6,102	27,596	13,003	294,895

The cost of fixed assets acquired in 2006 amounted to 109.3 million kroons. The majority of the procurement of buildings accounted for the building of Eesti Pank at Sakala 6 occupied in November. The cost of



the new building amounted to 77.2 million kroons. In addition, by the end of 2006 advance payments in the amount of 11.7 million kroons had been made.

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 2006		Balance at the end of 2005	
	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
Total		3,441		3,441

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 31 December 2006.

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 differences of off-balance-sheet instruments denominated in a foreign currency. The difference is calculated using the average exchange rate and the exchange rate of Eesti Pank.

ITEM 8 – ACCRUALS AND PREPAID EXPENSES

EEK thousand

	2006	2005
Interest income	286,931	108,756
Securities	278,374	101,452
Derivative instruments	6,387	6,396
Reverse repurchase transactions	1,412	154
Time deposits	588	574
Loans	170	180
Claims on the Financial Supervision Authority	9,366	12,572
Other claims	1,410	32,406
Prepaid expenses	10,692	9,290
Total	308,399	163,024

ITEM 9 – SUNDRY

This item includes mainly loans issued to employees of Eesti Pank in the total amount of 41.4 million kroons (45.2 million in 2005). Housing loans secured by real estate have been granted to employees of Eesti Pank for a maximum of 25 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 interest rate on housing loans is based on the reserves' interest rate Eesti Pank pays to credit institutions plus a risk margin. The reserves' interest rate equals ECB deposit interest rate, which remained within 1.25-2.50% in 2006. 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

	2006	2005
Banknotes	11,627,284	9,981,161
Coins	135,869	120,555
Total	11,763,153	10,101,716

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 5.1 billion kroons in 2006. 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 2006, the deposit interest rate of the ECB increased from 1.25% to 2.5%. 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. Interest has been paid on the funds in the Financial Supervision Authority's account since 2004.

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 TARGET.

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

This item includes the repurchase agreements with the maturities that were due at the beginning of January 2007.

ITEM 15 – ACCRUALS AND INCOME COLLECTED IN ADVANCE

EEK thousand

	2006	2005
Interest expense	-59,413	-20,340
on deposits with credit institutions	-34,655	-11,959
on derivative instruments	-10,845	-8,381
on repurchase agreements	-613	0
Amortisation of securities	-13,300	0
Tax liabilities	-9,820	-8,875
Other liabilities	-59,556	-48,785
Total	128,789	78,000

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

	2006	2005
Foreign currencies	34,251	-
Derivative instruments	25,664	-
Securities	1,065	-
Total	60,980	0

These accounts represent revaluation reserves arising from unrealised gains on assets and liabilities as of 2006.

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 2006:

EEK thousand

	Balance at the end of 2006	Distribution of 2005 profit	Balance at the end of 2005
Fixed capital	100,000	-	100,000
Reserve capital	500,000	-	500,000
Special reserve	3,201,770	178,046	3,023,724
Total	3,801,770	178,046	3,623,724

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

EEK thousand

	2006	2005
Net interest income	568,195	327,755
Interest income	1,055,344	644,768
Securities	799,762	496,182
Reverse repurchase agreements	143,738	71,966
Derivative instruments	85,320	60,734
Time deposits	25,099	14,179
Loans to personnel	1,417	1,700
Other	8	7
Interest expense	-487,149	-317,013
Securities	-51,391	-152,933
Repurchase agreements	-35,964	-10,687
Derivative instruments	-143,823	-52,641
Time deposits	-276	-124
Credit institutions' deposit interests	-255,050	-100,112
Other	-645	-516

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

EEK thousand

	2006	2005
Net result of financial operations	-153,558	74,966
Realised gains/losses arising from financial operations	-50,473	75,242
Securities	-64,195	85,929
Derivative instruments	13,182	-15,090
Income/expense of exchange rate differences	-14,970	4,243
Financial asset management costs	-683	0
Other	16,193	160
Write-downs	-103,085	-276
Securities	-77,306	0
Derivative instruments	-26,133	0
Net change of loan portfolio write-downs	354	-276

In 2005, the item "Realised gains/losses arising from financial operations" included, besides realised gains and losses, also unrealised gains and losses arising from the revaluation of financial instruments. As of 2006, this item reflects only realised results. The unrealised losses at the end of the year are recognised under "Write-downs".

In 2006, the item "Realised gains/losses arising from financial operations" also includes the gains arising from changes in the accounting principles that occurred at the beginning of 2006, amounting to 16.2 million kroons.

ITEM 21 – NET RESULT OF TRANSACTION AND COMMISSION FEES

EEK thousand

	2006	2005
Transaction and commission fees	10,579	9,023
Settlement service costs	10,937	9,515
Commissions on futures and options	-642	-798
Fines, arrears and other	284	306

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. In 2005, this item also included dividend income from the shares of the Tallinn Stock Exchange in the total amount of 97,000 kroons.

ITEM 23 – OPERATING INCOME

Most of other operating income (7.7 million kroons) comprises income for 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 2005 and 2006. 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.

In 2006, income from the sale of numismatic-bonistic products amounted to 6 million kroons. Income from the sale of collector coins accounted for most of that.

Income on asset management includes the service fee paid by the Guarantee Fund and the Health 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 stocks unnecessary for Eesti Pank.

EEK thousand

	2006	2005
Operating income	15,787	11,617
Expenses compensated by financial supervision	7,744	7,826
Income from the sale of collector coins and numismatic-bonistic products	5,970	2,154
Rental income	952	703
Income on asset management	896	657
Income from the sale of assets	83	223
Other income	142	53

ITEM 24 – OPERATING EXPENSES

Compared to 2005, operating expenses increased 32% in 2006.

EEK thousand

	2006	2005
Staff costs	-97,894	-84,957
Wages	-71,755	-62,191
Compensation and benefits	-1,907	-1,653
Social tax	-24,033	-20,826
Unemployment insurance	-199	-287

Staff costs increased 15%, year-on-year. Staff costs included mainly wage costs, including taxes. Wage costs grew owing to a general wage increase as well as wage increase arising from 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 and the expenditure on writing off study loans and on benefits increased somewhat as well.

Eesti Pank had 238 staff members at the end of 2006 (233 at the end of 2005).

In 2006, Eesti Pank participated in the voluntary pension investments of its staff and members of the Supervisory Board of Eesti Pank, contributing the total of 0.9 million kroons. 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 2006, the costs of the special merit pension stood at 0.3 million kroons.

The production costs of banknotes and coins increased by 36.2 million kroons, year-on-year. The production costs of banknotes and coins included the cost of manufacturing banknotes and coins for 35.7 million kroons and the production costs of numismatic products for 2 million kroons. In 2006, coins of 10 senti, 20 senti, 50 senti and 1 kroon were minted and 2-kroon and 10-kroon banknotes were issued. In addition, collector coins dedicated to the Winter Olympic Games and the Estonian National Opera were minted.

General administrative expenses grew by 7 million kroons year-on-year, mostly owing to increased financial asset management costs and real estate repair and administration expenses. Compared to 2005, financial asset management costs increased by 2.8 million kroons. Growth resulted mainly from an increase in the costs of foreign reserves maintenance.

Real estate repair and administration expenses increased by 1.7 million kroons, year-on-year. Most of that accounted for the procurement of furniture and fittings for the new building of Eesti Pank at Sakala 6.

The increase in training and travel expenses arose from the enhanced volume of business trips. Business trip expenses are the travel expenses incurred by the officials on assignment, accommodation expenses, subsistence allowances, and conference or seminar participation fees.



Public relations and publications costs grew by 1.4 million kroons owing to the expenses related to the information campaigns on the euro and the increased number of public events.

IT maintenance costs increased by a million kroons in 2006. Software maintenance costs accounted for 56%, hardware repair and maintenance costs for 22%, data communication costs for 21% and other costs for 1% of IT maintenance costs. Compared to 2005, IT maintenance costs increased owing to higher software maintenance costs.

The main cost items among other expenses were office expenses totalling 4.7 million kroons, and the cost of seminars and events organised by the bank totalling 3.7 million kroons.

	<i>EEK thousand</i>	
	2006	2005
General administrative expenses	-80,680	-73,593
Information technology maintenance costs	-17,548	-16,558
Real estate renovation and administration expenses	-14,839	-13,103
Financial asset management costs	-14,295	-11,446
Training and business travel expenses	-11,686	-10,995
Public relations and publications	-7,664	-6,311
Communications and transportation costs	-2,920	-3,361
Legal and arbitration costs	-457	-770
Other expenses	-11,271	-11,049

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 before joining the Economic and Monetary Union.

Having evaluated the Profit Distribution Strategy in April 2006, the Supervisory Board of Eesti Pank decided to continue with the above-mentioned strategy and transfer 59.3 million kroons from the profit of 2005 to the state budget and 178 million kroons to the special reserve fund.

ITEM 26 – DERIVATIVE INSTRUMENTS

	<i>EEK thousand</i>
	Contractual value
Derivative instruments	
Total as at 31 Dec 2005	10,389,426
Foreign currency forward transactions	1,431,171
Interest rate swap transactions	836,496
Foreign currency swap transactions	1,323,749
Futures transactions	6,798,010
Options	0
Total as at 31 Dec 2006	21,770,865
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

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

ITEM 27 – CONTINGENT LIABILITIES

EEK thousand

	Balance at the end of 2006	Balance at the end of 2005
Contingent liabilities	180,928	161,355
Uncalled share capital (75%) of BIS	8,651	9,625
Uncalled share (93%) of ECB participation	144,456	144,456
Contractual obligations to produce banknotes and coins	27,821	7,274

Bank for International Settlements (BIS)

Since 1930 Eesti Pank has a contingent liability to the Bank for International Settlements. This liability is the uncalled part of the share capital (75%) of BIS denominated in Swiss gold francs, totalling 8.7 million kroons on the balance sheet date (see Item 6).

European Central Bank (ECB)

In 2004, the Republic of Estonia joined the European Union and consequently Eesti Pank became a member of the ESCB. In accordance with Article 28 of the Statute of the ESCB and the ECB, Eesti Pank became a subscriber of the capital of the ECB. Eesti Pank has paid a minimal contribution of 7% of its subscribed capital to the ECB amounting to 694,916 euros (10.9 million kroons). Eesti Pank is obliged to pay the remaining 93% amounting to 9.2 million euros (144 million kroons) upon Estonia's accession to the Economic and Monetary Union.

Printing of banknotes and minting of coins

At the end of 2006, the contractual liabilities of Eesti Pank for printing banknotes and minting coins in 2007 amounted to 27.8 million kroons.

To the Supervisory Board of Eesti Pank:

We have audited the accompanying annual accounts (page 67 to 88) of Eesti Pank, which comprise the balance sheet as at 31 December 2006, the statement of profit and loss and statement of changes in equity for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management Board's Responsibility for the Annual Accounts

Management Board is responsible for the preparation and fair presentation of these annual accounts in accordance with the Eesti Pank Act and the accounting principles stated in the "Accounting Policies used in the Annual Accounts". This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of annual accounts 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 annual accounts 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 annual accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the annual accounts, 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 annual accounts 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 annual accounts.

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 annual accounts present fairly, in all material respects, the financial position of Eesti Pank as at 31 December 2006, and its financial performance for the year then ended in accordance with the Eesti Pank Act and the accounting principles stated in the "Accounting Policies used in the Annual Accounts".


Veiko Hintsov
Certified Auditor
3 April 2007


AS Deloitte Audit Eesti

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RIIGIKASSA-TÄH
REICHSKASSE

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**SADA MARKA · HUNDERT MARK.
ETT HUNDRA MARK · СТО МАРКЪ.**

RIIGIKASSA-TÄHT-ON EESTI-VABARIIGI-PHIIDES-SEADUSLIK · MAKSIABINÜ--DIESER
REICHSKASSENSCEIN IST · INNERMALB · DER · GRENZEN · DER · ESTNISCHEN · REPUBLIK
DAS · GESETZLICHE · ZAHLUNGSMITTEL -- DENNA · RIIGIKASSA · SEDEL · ANVAANDES · I · HELA
ESTLÄNSKA · REPUBLIKEN · SOM · OBLIGATORISK · BETALNINGSMEDEL -- СЕЙ · КАЗНАЧЕЙ ·
СКИ · ЗНАКЪ · ВЪ · ПРАВАХЪ · ЕСТОИХОИ · РЕСПУБЛИКИ · ЯВЛЯЕТСЯ · ЗАКОНЫМЪ
ПЛАТЕЖНЫМЪ · СРЕДСТВОМЪ.

*RIIGIKASSA TÄHTEDE ÜBEEETSEPHINE ENK VÕETAMINE NÄEMIS KUI
REICHSKASSE ENK FÖLJETTUD KASSA TÄHTED JA RÄLLLÄUTAMINE DV
KAZNITZITV NÖVI ÖBUSTE NÄSTÖMISIK IN IJUNNIDÖÖR KUNN BAKTTAN*



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ANNO 1919

MARKA · HUNDERT MARK.
HUNDRA MARK · СТО МАРКЪ.

ON EESTI VABARIIGI PIIRIDES SEADUSLIK MAKSUABINÕU...
NSCEIN IST INNERHALB DER GRENZEN DER ESTNISCHEN RE
CHE ZAHLUGSMITTEL... DENNA RIKSKASSA SEDEL ANVANDES
REPUBLIKEN, SOM OBLIGATORISK BETALNINGSMEDEL... СЕЙ КАЗ
Ъ ПРЕДЪЛАХЪ ЕСТОНСКОЙ РЕСПУБЛИКИ ЯВЛЯЕТСЯ ЗАКОН
ПЛАТЕЖНЫМЪ СРЕД

Annexes

RIIGIKASSA TÄHTEDE JÄRELTEGEMINE EHK VÕLTSIMINE NIISAMA
JÄRELTEHTUD EHK VÕLTSITUD KASSA TÄHTEDE LAIALILLOTTAM
KARISTATAV KOIGI ÕIGUSTE KAO TAMISEGA JA SUNNITÕÕGA KUNNI 8 M



MARKA

GLOBAL ECONOMY IN 2006

Global economic activity remained in line with general trends in 2006. According to the International Monetary Fund, the gross domestic product of advanced economies grew by 3.1% in 2006 (2.5% in 2005, see Table 1)¹. By 2007, economic growth is expected to slow down to 2.7% and growth is likely to continue similarly also in 2008.

By regions, growth varied relatively much in 2006. It remained the highest in developing Asian industrial countries. China's economic growth amounted to 10.7%. The total US economic growth was brisk (3.4%), being much higher in the first half-year compared to the second one. The euro area economic growth stood at 2.8% and that of Japan at 2.2%. Compared to forecasts at the beginning of the year², the actual economic growth remained precisely at the anticipated level in the US, being 1.0 percentage points higher than expected in the euro area and 0.1 percentage points higher in Japan.

In 2006, global economic growth was supported by the relatively stable geopolitical environment and the small number of natural disasters. In the second half-year, the US real estate sector's situation started deteriorating rapidly, but the oil price decrease that began in August slightly offset the sector's negative impact on other economic sectors. The oil price rise in the first half-year temporarily boosted global inflationary pressures, but these abated in the second half. Labour market statistics revealed that unemployment remained close to its record low level in all major economic areas.

UNITED STATES AND JAPAN

In the first half of 2006, the **United States** maintained its role as the driving force of global economic growth but in the second half economic activity in the US started waning. The trend-setter was the real estate sector with growth dropping fast after the record levels of end-2005. The real estate sec-

Table 1. Economic indicators of advanced economies

	GDP growth (%)		Annual average CPI growth (%)		Annual average unemployment rate (%)		State budget surplus or deficit (% of GDP)		Current account balance (% of GDP)	
	2005	2006*	2005	2006*	2005	2006*	2005	2006*	2005	2006*
World	4,8	5,3								
Advanced economies	2,5	3,1	2,3	2,3	6	5,6	-2,5	-1,9	-1,4	-1,7
United States	3,2	3,4	3,4	3,2	5,1	4,7	-3,7	-2,6	-6,4	-6,4
Japan	1,9	2,2	-0,6	0,2	4,4	4,1	-4,8	-4,3	3,6	3,9
Euro area	1,4	2,8	2,2	2,2	8,6	7,8	-2,4	-1,8	-0,1	-0,5
Germany	0,9	2,7	1,9	1,8	9,1	8,1	-3,2	-1,9	4,0	3,9
France	1,2	2,0	1,9	1,9	9,9	9,3	-2,9	-2,6	-1,6	-2,3
Finland	2,9	5,8	0,8	1,3	8,4	7,7	2,5	2,9	4,9	5,7
Other EU Member States										
United Kingdom	1,9	2,7	2,0	2,3	4,8	5,4	-2,9	-2,6	-2,4	-2,9
Sweden	2,9	4,8	0,8	1,6	5,8	5,5	2,8	2,8	7,1	6,0

* Data for 2006 are preliminary.

Source: IMF World Economic Outlook, February 2007

¹ IMF World Economic Outlook, April 2007.

² Consensus Forecasts, January 2006



tor's adverse impact on other sectors was somewhat alleviated by the slight decrease in oil prices, which in turn enhanced private consumption. The US external balance remained poor and the current account deficit exceeded 6% of GDP. The budget balance improved during the year and the budget deficit decreased below 2% of GDP by the end of the year. The current account and budget deficits were covered by the continuously great capital net inflow into US securities throughout the whole year.

As economic growth continued to follow the trend and inflationary threats arose as a result of the oil price increase, the US Federal Reserve carried on with normalising the expansionary monetary policy during the first half-year: the key interest rate was raised four times by 25 basis points from 4.25% to 5.25%. In the second half-year the key interest rate remained unchanged owing to the deceleration of economic growth and the oil price drop which alleviated inflationary pressures.

By the end of the first half-year, inflation in the United States rose to 4.3% owing to the oil price rise, but decreased back to the range of 2.0–2.5% by the end of the year. Unemployment decreased from 4.7% in January to 4.4–4.5% by the end of 2006 (the lowest in five years). The employment increase remained moderate throughout the whole year, dropping slightly in manufacturing.

Japan's economic growth followed the trend in 2006. The industrial sector continued to grow the most vigorously: the year-on-year growth of industrial production ranged within 3–6% and the year-on-year growth of exports remained steady over 10%. Private consumption posted weaker results: the year-on-year growth of retail sales was negative at the end of the year. The annual economic growth stood at 2.2%. The growth of Japanese consumer

prices became positive in the middle of the year, rising to 0.9% in August. In the final months of the year price growth slowed down again. Unemployment decelerated from 4.4% at the beginning of the year to 4.0% at year-end (the lowest level in eight years). Owing to the positive economic growth and inflation, the Japanese central bank also ended its zero interest rate policy that had lasted for several years, raising the key interest rate to 0.25%.

EURO AREA

The economic growth of the euro area countries accelerated throughout 2006 and the year-on-year GDP growth (2.8%) significantly exceeded the forecasts made at the beginning of the year. By components, the economic growth was balanced: positive contributions were made by private consumption, private investment, the general government as well as net exports.

The inflation dynamics were similar to that of the US: the price pressures resulting from the oil price rise boosted the year-on-year growth of consumer prices to 2.5% in July, whereas by the end of the year inflation dropped to 1.9%. The core inflation of consumer prices rose from 1.2% in January to 1.5% in December. Unemployment in the euro area kept decreasing throughout the year, declining from 8.3% in January to 7.5% in December.

As economic growth remained close to trend and the growth of core inflation and money supply picked up, the European Central Bank continued to normalise the level of the key interest rate, raising it in each quarter by 25 basis points from 2.25% to 3.25%.

The economic outlook of the euro area for 2007 is positive, but growth is nevertheless expected to decelerate slightly to 2.0%³.

³ Consensus Forecasts, January 2007.

INTERNATIONAL FINANCIAL AND COMMODITY MARKETS

Major **stock markets** continued the upward trend in 2006, supported primarily by the upward phase of the global economic cycle and high corporate profits. Although in May and June a rather abrupt and extensive price fall occurred, it did not influence the generally favourable economic environment and the upward trend picked up again in the second half-year. From among major economic areas the euro area stock index FTSE Eurobloc 300 experienced the strongest growth (19.1%). Also the US stock market was more successful than last year with the SP 500 index rising by 13.6%. The Japanese stock index Nikkei 225 increased by 6.9%.

In the **bond markets** short-term interest rates were mostly influenced by the monetary policy of major central banks, which was oriented on avoiding overheating of the economy and decelerating inflation. The US Federal Reserve continued to raise the key interest rate as expected, raising it from 4.25% to 5.25% in the first half-year. In the second half the rate remained unchanged, as economic growth started to decelerate mainly because of the cooling housing market. The European Central Bank increased the key interest rate five times by a total of 1.25 percentage points. In Japan, the key interest rate was raised to 0.25%, confirming the revival of the Japanese economy and recovery from the deflation period. In the conditions of high economic activity and stricter monetary policy, long-term interest rates increased as well. In the US, the interest rate of the ten-year government bonds increased by 0.31, in the euro area by 0.64 and in Japan by 0.21 percentage points.

The **currency exchange markets** faced another turn in the US dollar trend. While in 2005 the dollar strengthened, in 2006 it started depreciating again against other major currencies, as economic growth began to show signs of deceleration. Thus, the euro exchange rate against the dollar rose to

1.32, i.e. by 11.4%. The dollar changed little compared to the Japanese yen, however, because the yen largely retained its status as a lending currency. The weakening yen could not be sufficiently supported by the raising of the key interest rate by the Japanese central bank either, as other banks raised their key interest rates even more. The yen depreciated by 1.1% against the US dollar and 12.7% against the euro.

As one of the most significant trends, the price increase of crude oil, continued in the **commodity markets**, being boosted by strong demand-side pressures. The price level peaked at the beginning of August, when a barrel of crude oil cost 77 dollars in the US. Later, the oil price decreased to the level reached at the beginning of the year (61 dollars) and remained virtually unchanged year-on-year. The price of gold also fluctuated within a rather wide range, rising to 636.7 dollars per ounce (23.2%) year-on-year. Due to the brisk global economic activity and the resulting increase in demand, the CRB index reflecting the general price level of major commodities rose by 21.5%, which is considerably more than in the previous year.

ESTONIAN ECONOMY IN 2006

NON-FINANCIAL SECTOR

Monetary policy environment

Since December 2005, the European Central Bank (ECB) has been raising monetary policy interest rates in order to contain the risks to price stability in the euro area. Raising the ECB's monetary policy interest rates affected also the interest rates on bank loans in Estonia. The mild interest rate increase that had begun during the final months of 2005 continued throughout 2006. In light of the accelerated economic growth and strengthened inflationary pressures, the appreciation of bank loans remained minimal and the loan growth rate brisk.

Year 2006 was generally characterised by the moderate appreciation of the Estonian kroon against the US dollar and the Danish krone. Meanwhile, the Estonian kroon depreciated against the Swedish krona and therefore, on average, the nominal exchange rate of the kroon in ratio to industrial countries remained virtually unchanged.

Thus, in 2006 the monetary **policy environment** as a whole was conducive to economic growth.

Domestic and external demand

According to preliminary estimates, the Estonian economy grew by 11% in 2006. This is the **fastest**

growth rate in the past 15 years. As regards the supply side, growth was broad-based, comprising almost all fields of activity and branches of manufacturing (see Table 1).

Compared to 2005, both private consumption as well as investments grew faster in constant prices. In the first half of 2006, the growth of domestic demand was further boosted mainly by the real estate sector. In the second half-year, private consumption was even more dynamic than in the first half, but investments were distributed more evenly in the economy. In conclusion, due to the increasing volume of bank loans the growth of domestic demand still exceeded the level that may be considered sustainable.

External demand reached its highest level in recent years and export growth continued to be brisk. Goods exports no longer increased as quickly as in autumn 2005, when it accelerated suddenly (in constant prices) from 20% to 30–35%. In autumn 2006, the growth rate of goods exports remained below 10% for the first time in several years. By groups of goods and fields of activity the growth rate was very diverse. A deceleration was experienced mainly in transit and subcontracting. All in all, in the second half-year the GDP growth rate remained slightly slower than in the first half-year (see also Figure 1).

Table 1. Real GDP growth by fields of activity in 2003–2005 (%)

	2003	2004	2005	2006
Agriculture, hunting, forestry	1.1	-7.1	2.4	0.4
Fishing	-5.2	-8.4	0.5	-4.0
Mining	13.5	-4.9	6.3	7.3
Manufacturing	7.0	11.5	12.6	12.8
Energy, gas and water supply	12.9	0.9	7.0	7.4
Construction	2.7	7.1	19.8	13.3
Wholesale and retail trade	14.3	7.8	16.0	12.6
Hotels and restaurants	4.2	16.3	23.6	11.7
Transport, storage and communications	9.6	12.5	7.7	10.9
Real estate, renting and business activities	4.0	5.6	8.8	9.7
Financial intermediation	18.9	22.6	25.2	22.8
Public administration and national defence	4.7	1.1	2.3	2.1
Education	-0.9	0.9	0.9	5.3
Health and social care	-0.6	4.2	6.5	6.8
Other	1.6	5.5	5.7	7.0
Total GDP	7.1	8.1	10.5	11.4

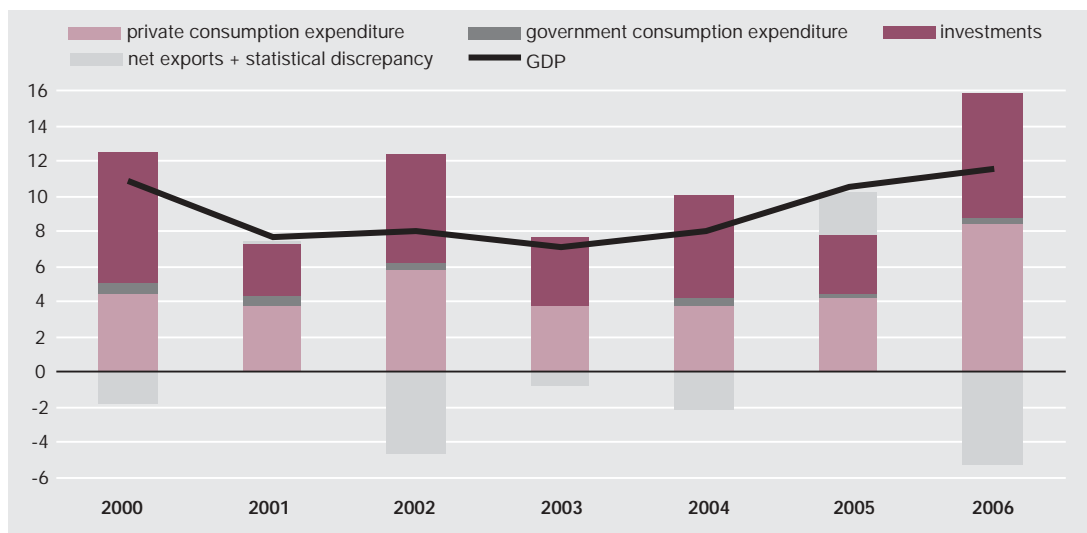


Figure 1. Contribution of GDP consumption components to economic growth (percentage points)

Similarly to earlier years, the rapid economic growth was based on external funding and, as a whole, 2006 could be characterised by increasing current account deficit. Compared to the previous year, in 2006 the current account to GDP ratio deteriorated by approximately 4 percentage points; the current account deficit reached nearly 15% (see Figure 2).

The need for external funding grew not because of small-scale savings but owing to the great investment demand. **Although the savings rate was comparable to that of advanced economies, the investment level, on the other hand, was extraordinarily high.** The volume of investments made for increasing fixed capital and stock building rose up to 38% of GDP, slightly exceeding the levels of earlier years. The inflow of foreign direct investment continued at the same pace and did not cover the total need for financing deficit. Thus, external debt increased up to approximately 96% of GDP.

Inflation

Already for the second consecutive year, the consumer price growth proved to be faster than expected. On average, the price rise of the consumer basket was 4.4%. **The initial impulse for the**

growth of consumer prices derived from global market prices (see Figure 3).

Although during the year the inflation rate was strongly affected by volatile oil prices, the oil price rise proved not to be the primary factor behind price increase. The impact of oil prices was reflected through the prices of other fuels and transport services. For instance, gas prices rose by 52% and thermal energy by 16%. In addition, housing costs were affected by the increase in utility costs, rents that started rising already during the final months of 2005, and demand-driven pressures on the construction market. **The growth of housing costs caused a 5.7% price rise of the whole services basket.** The most drastic rise compared to expectations occurred in food prices, reaching a year-on-year average of 4.6% (see Figure 4).

Owing to the acceleration of consumer price inflation, the real exchange rate of the Estonian kroon appreciated against the currencies of industrial countries by 2.7%, year-on-year. On the other hand, the kroon depreciated against the currencies of other trading partners – the inflation rate in Estonia was even slower and the kroon 1.7% cheaper than a year ago (see Figure 5).

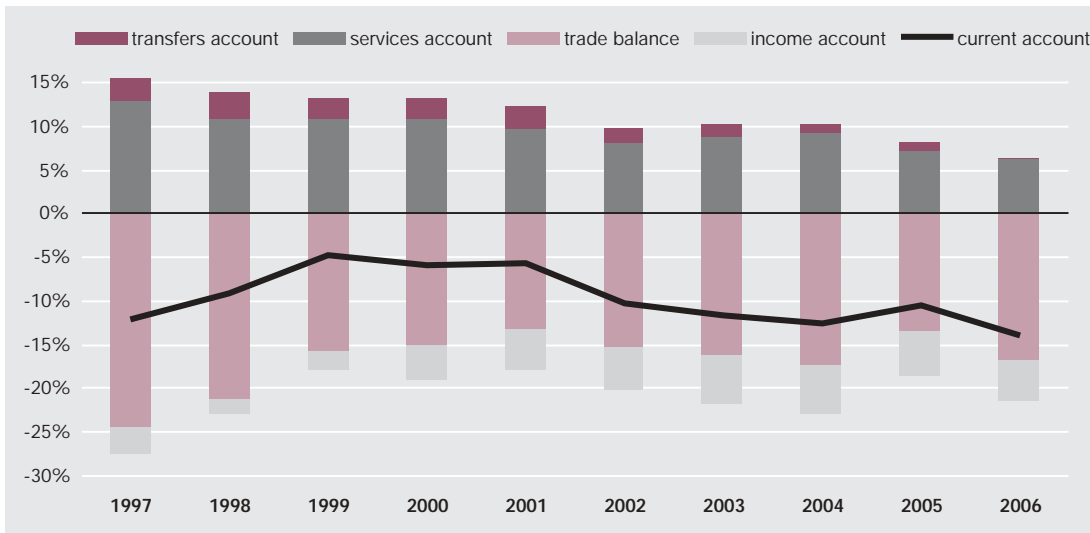


Figure 2. Current account balance and balance of payments accounts (% of GDP)

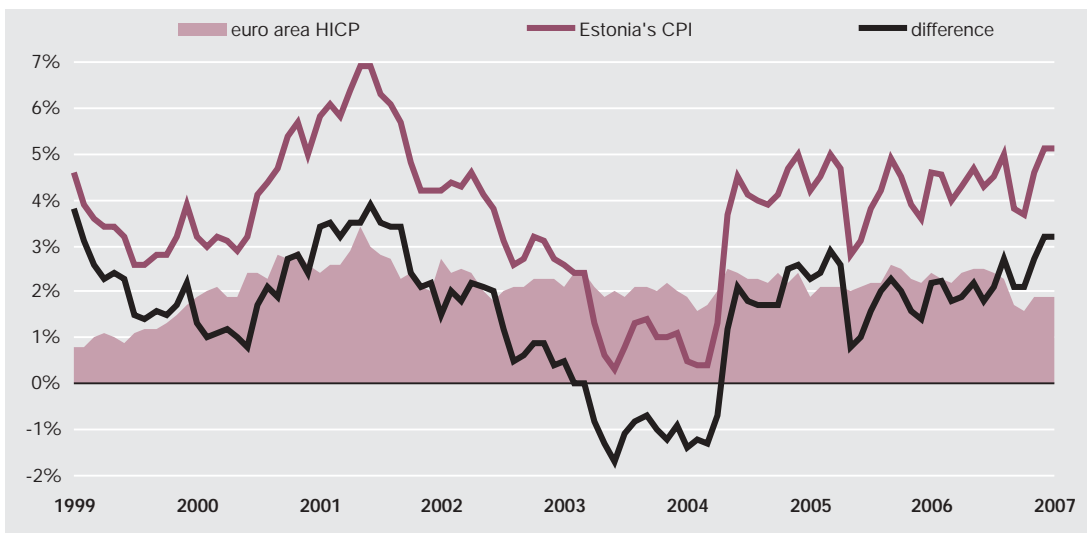


Figure 3. Twelve-month consumer price growth in Estonia and in the euro area

The materialisation of inflationary pressures was fostered by the dynamic income growth.

The average wage growth turned out to be faster than in earlier years and, since summer, increased the risk that the growth rate of unit labour costs might exceed that of productivity. Wage pressures were facilitated by the enhanced demand for labour force. Employment growth was the fastest in the past ten years and on average remained in

the range of 6–7% according to various estimations. The number of new jobs reached above average in the services sector, primarily in construction, trade and transport. **Employment increased thanks to new entrants to the labour market and a decreasing number of the unemployed and the discouraged.** In comparison with 2005, the unemployment rate dropped from 7.9% to 6%; furthermore, the number of the long-term unem-

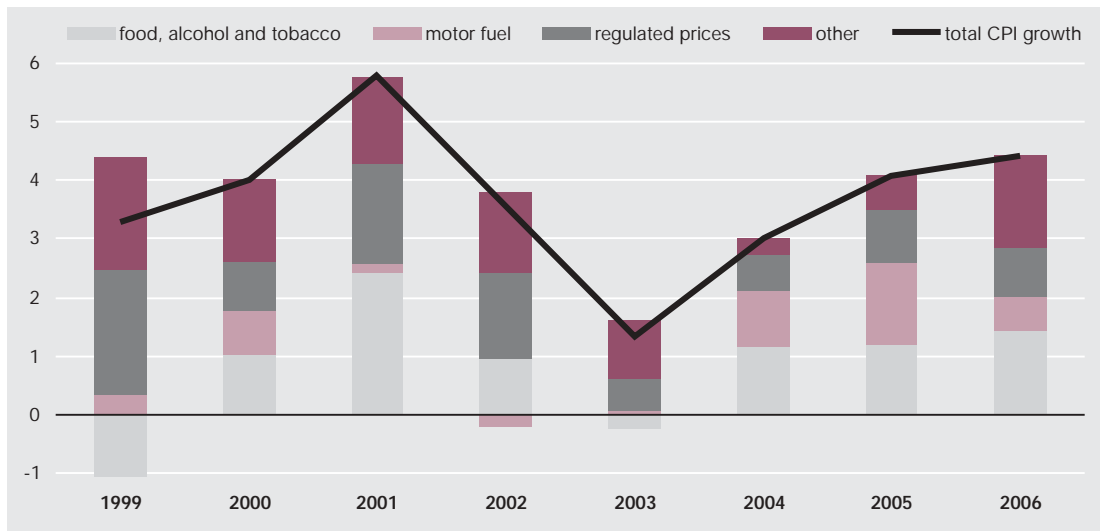


Figure 4. Consumer price growth by components (percentage points)

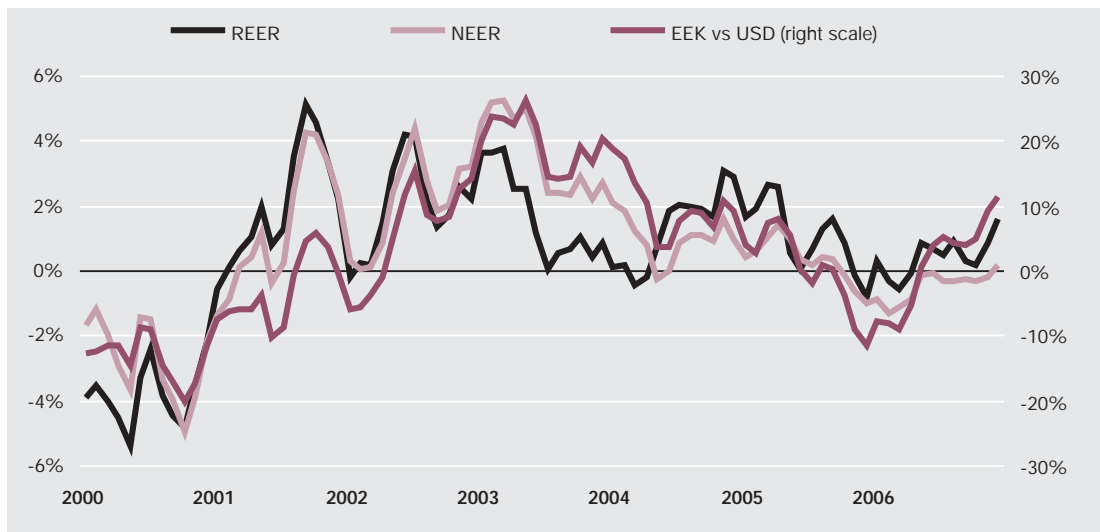


Figure 5. Changes of the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

ployed shrunk remarkably. The labour market situation was undoubtedly pressured by the increased migration within the European Union.

General government

As earlier, the main factor supporting external and domestic balance was fiscal policy. In 2006, the

scheduled reduction of the income tax rate continued and as of 1 January 2006, the new 23% income tax rate stepped into force. Earlier decisions to raise indirect taxes, but also the robust increase in private consumption and wages in ratio to GDP increased tax revenues and the total tax burden of the year basically remained the same. General



government savings increased steadily throughout the year and the consolidated budget surplus of 2006 proved to be larger than that of the previous year – it reached nearly 4% of GDP. **The surplus stemmed from a deliberate increase of reserves, better than expected collection of tax revenues and a partial postponement of planned expenditures.** More precisely, supply-side constraints caused by the real estate boom did not enable ministries and local governments to fully carry out their rather ambitious investment pro-

grammes. Along with the surplus increase the public debt kept shrinking. By the end of the year, the public debt to GDP ratio dropped to 4.1%.

Following the state budget strategy drafted in spring, in December the Riigikogu approved the budget for 2007, which sets a goal of 1.9% surplus of GDP. **In light of previous years, this is quite a bold objective, but from the perspective of the economic cycle the aim remains fairly modest.**

RATINGS

In their decisions regarding Estonia's sovereign rating outlook in 2006 the rating agencies have considered the estimated impact of the adoption of the euro on the country's creditworthiness.

In 2006, Moody's raised Estonia's **sovereign rating** outlook from stable to positive, while Standard&Poor's and Fitch downgraded it from positive to stable. No rating agency changed the level of Estonian ratings during the year. Standard&Poor's and Fitch confirmed the rating of long-term foreign currency liabilities at 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 rating given by Standard&Poor's and Fitch.

Estonia's **sovereign risk ratings**, which set an upper limit to the rating of enterprises operating in the country, remained the same. In 2006, also Moody's started to use a credit risk methodology different from that of the sovereign rating level. The Estonian risk rating is now Aa1 according to

Moody's, AA according to Standard&Poor's and AA- according to Fitch.

The positive outlook by Moody's is indicative of a long-term process oriented towards joining the euro area. The stability reflected by the ratings given by Standard&Poor's and Fitch is caused by the postponement of the euro adoption further than 2008. According to the agencies, euro area membership would significantly decrease risks stemming from the balance of payments and potential external shocks. The further rise of the Estonian sovereign rating is also inhibited by the considerably higher standard of living in other countries with the same rating. Estonia's sovereign rating is mainly supported by the strong fiscal policy, rapid economic growth arising from the flexible and competitive economic system and the strong banking sector. The analyses of rating agencies regarding Estonia are available on the web site of Eesti Pank.

FINANCIAL SECTOR

In 2006, in the circumstances of rapid economic growth mainly stimulated by domestic demand, also loan and leasing demand remained strong. Similarly to 2005, the share of loans granted for acquiring and developing real estate in banks' financing portfolios rose. Besides the income base growth, banks' profitability was supported by the continuous increase in key interest rates. As for the domestic debt securities market, the primary market was more active than in previous years. The development of the Tallinn Stock Exchange in 2006 was affected by the price correction on global stock markets in spring/summer and the listing of new companies. The correction of stock markets also affected the yield and profitability of investment and pension funds and the insurance sector, entailing a slight slowdown of the brisk growth rate of assets. As regards payment methods, the share of non-cash payments kept increasing.

Banking

Institutional developments

In 2006, seven **credit institutions** and seven **branches** of foreign credit institutions were op-

erating in Estonia. As at 31 December 2006, four foreign credit institutions had representative offices in Estonia. By the end of 2006, the number of applications submitted to the Financial Supervision Authority for providing **cross-border banking services** in Estonia reached 130.

The development of the Estonian banking market in 2006 was characterised by strong loan demand and thus also by the rapid growth of financing portfolios, which was not inhibited even by the rise of monetary policy interest rates (see Figure 6). For obtaining loans, enterprises still preferred the local banking sector to foreign credit providers. In addition to purchasing and renovating housing, individuals have also begun to obtain more credit for consumption.

Assets and liabilities of banks

In 2006, banks' assets increased due to the great loan demand by a total of 54 billion kroons, i.e. by 30%. At the end of the year, the total assets of banks exceeded 240 billion kroons. The total volume of the financing portfolios of banks and leasing companies reached over 201 billion at the end of 2006, having grown by almost 67 billion kroons year-on-year. The share of secu-

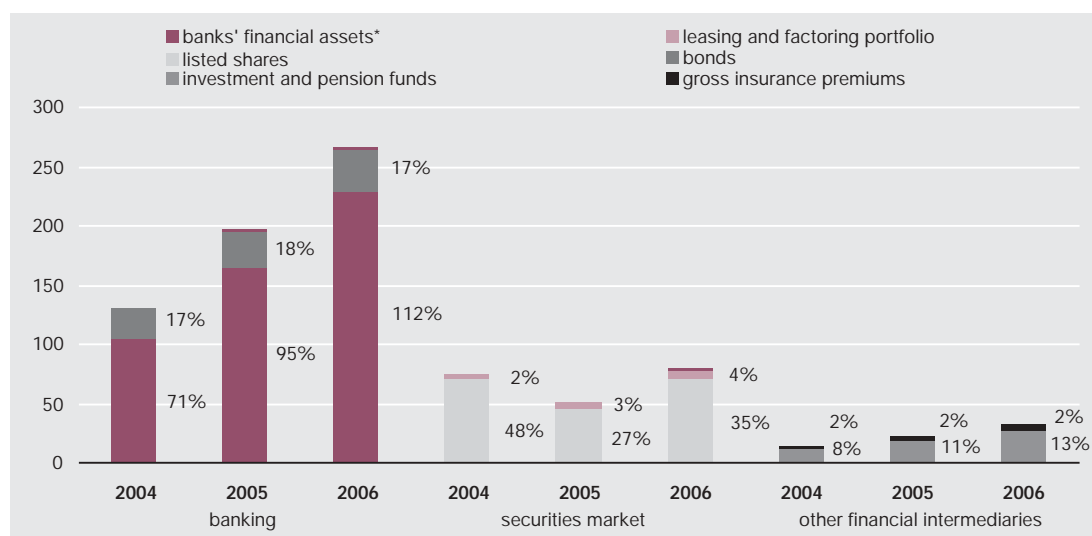


Figure 6. Structure of Estonian financial intermediaries (EEK bn and % of GDP)

* except loans to financial institutions



rities portfolios in banks' balance sheets remained at the previous year's level. The share of claims and liabilities in the aggregate balance sheet decreased as a result of changing intra-group financing schemes.

Despite the rise in key interest rates and a halt in the decrease of loan margins, the number of housing and commercial real estate loans grew even more drastically than before (see Figure 7). The stock of private housing loans and leasing shot up by nearly 60%, approaching 66 billion kroons towards the end of the year. Besides housing loans, the demand for private consumer credit also continued to be high. Thus, the share of loans obtained for other purposes than purchasing housing in the total household debt burden remained at a level comparable to that of end-2005 (22%).

As regards the corporate sector, the share of loans granted to commercial real estate companies has increased the most. Within a year, the stock of loans granted to such enterprises grew by over 15 billion kroons. By the end of the year, their share in banks' loan and leasing portfolios accounted for almost a third. From among tradable sector compa-

nies, financing the industrial sector gained the most in terms of volume (by 3 billion kroons), whereas financing the operations of hotels and restaurants grew the fastest (66%, i.e. by 1.3 billion kroons).

As the 27% year-on-year growth of deposits (25 billion kroons) did not suffice for satisfying the strong loan demand, banks obtained over 20 billion kroons of additional funds from parent banks. The growth would have been even stronger, but non-resident parent banks partly started financing their subsidiaries directly. Due to tightening capital requirements the share of own funds (incl. subordinated liabilities) in banks' aggregated balance sheet increased in 2006.

Profitability

In 2006, banks' **profitability** was supported by the continuing growth of both the loan volume and key interest rates as well as by the relatively low costs of loan write-downs (see Figure 8). As the majority of loans in Estonia have been granted with a floating interest rate, the rise in key interest rates is reflected in interest income rather than in interest expenses. Thus, the price spread and net interest margin indicators that had rather followed a downward trend in the first half of 2006 began climbing in the second

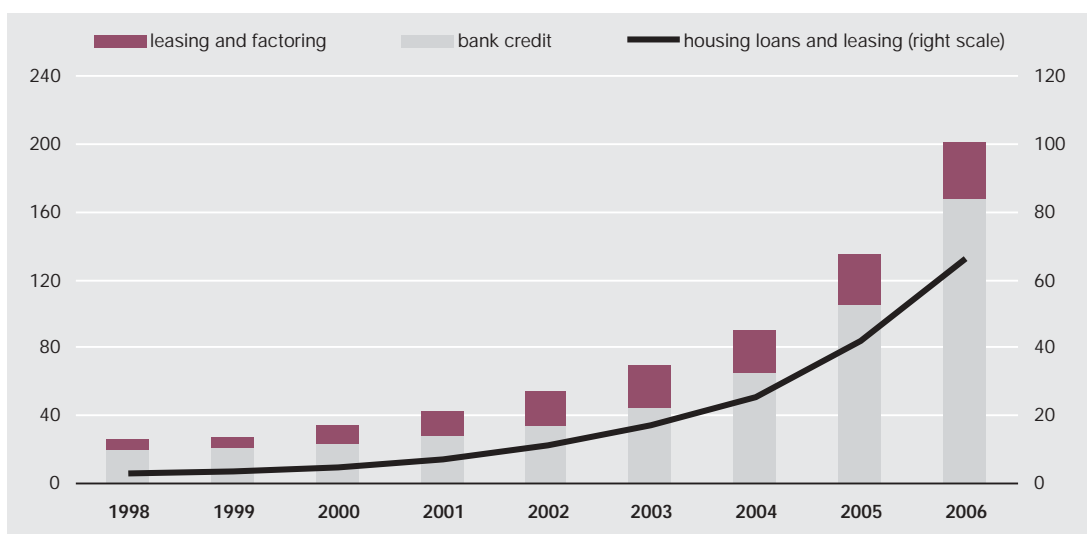


Figure 7. Public and non-financial sector financing (EEK bn)

half of 2006, reaching 2.1% and 2.2% by the end of the year, respectively.

Compared to the previous year, the aggregate indicator of the banking sector profitability in 2006 was influenced by lower investment income. However, dividend income mainly shrunk because the profit earned by subsidiaries was not withdrawn as dividends.

Despite the rapid growth of operating volumes, banks have managed to keep the increase of administrative costs lower than that of returns. Banks' total costs comprised 46% of returns in 2006. However, despite lower dividend income and the requirement to increase the share of own funds¹, the banking sector's return on equity in 2006 reached nearly 20%, which does not substantially differ from the indicator of 2005 (21%). The consolidated return on equity of banking groups exceeded 25%.

Capital adequacy and risks

Tightening the requirement on the share of own funds (i.e. establishing a 100% risk weight instead of the former 50% on housing loans for the calculation of capital adequacy) expectedly brought along a rise in the capitalisation of banks. In 2006, banks' aggregate risk assets grew by 49%, whereas their own funds increased by more than two thirds. Thus, at the end of December 2006, the aggregate capital adequacy ratio of the banking sector stood at 13.2% and at 10.8% on consolidated basis (see Figure 9).

Although key interest rates rose further in 2006, the loan-servicing capability of bank customers remained good. The share of loans overdue for more than 60 days in the loan portfolio remained close to 0.3% throughout the whole year. The provisioning principles of banks, however, may still be considered quite conservative. By the end

of 2006, the total volume of write-downs exceeded that of loans overdue for more than 60 days by nearly 50%.

Securities market

Debt securities market

In 2006, the debt securities market was characterised by a much more active primary market compared to the previous year. In 2006, the securities market capitalisation that has been increasing since 2004 grew by 69%, i.e. to more than 8 billion kroons. The market expanded mainly due to the bonds issued of local non-financial and financial sector companies.

Unlike the lively primary market, the daily turnover of the secondary market decreased from 17 billion kroons in 2005 to 14 billion kroons in 2006. Similarly to the previous year, 80% of bond investors as at end-2006 were residents. The majority of them were local credit institutions and investment funds.

Stock market

The development of the Tallinn Stock Exchange was contradictory in 2006. In spring/summer, global stock markets witnessed one of the greatest corrections in recent years that also affected trends at the Tallinn Stock Exchange quite significantly. The market was stirred up by listing the shares of the construction company AS Eesti Ehitus and casino enterprise Olympic Entertainment Group AS on the stock exchange. The listing of new shares increased the capitalisation of the stock market by almost 16%. Furthermore, for the first time in the history of Baltic securities markets, public trading with the stocks of Olympic Entertainment Group took place simultaneously in Estonia, Latvia and Lithuania. In the second half-year, prices on the Tallinn Stock Exchange started increasing rapidly again.

¹ Due to increasing the risk weight on housing loans in calculating the capital adequacy of banks.

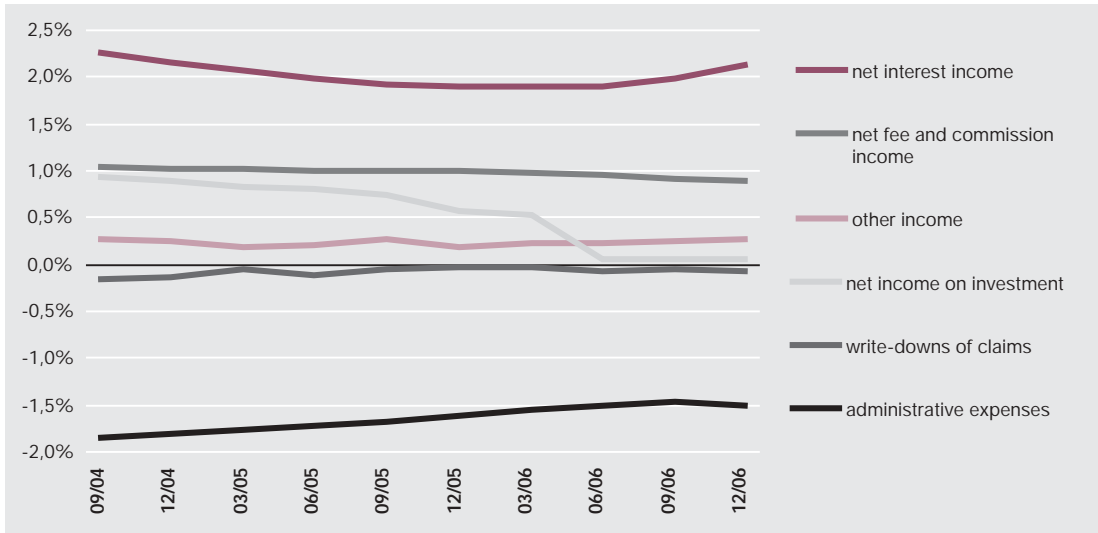


Figure 8. Income and expense items of banks (% of total assets)

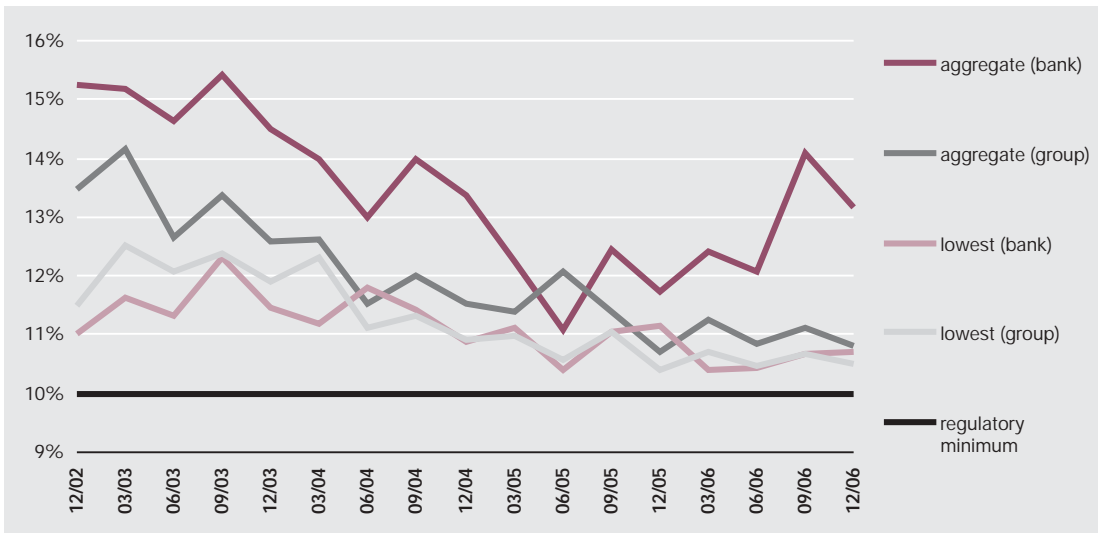


Figure 9. Banks' capital adequacy on solo and consolidated basis

At the end of 2006, the stock index OMX Tallinn reached another record level with 856 points owing to the growth of stock prices during autumn and winter (see Table 2 and Figure 10). Although in May and June 2006, the value of the index dropped as a result of the stock market correction, at the end of 2006 its year-on-year growth still reached 29%.

The average daily turnover of stock exchange transactions stood at 48 billion kroons in 2006, which

is almost two-and-a-half times less than in 2005 when the takeover of Hansapank by Swedbank occurred.

Other financial intermediaries

Investment and pension funds

The growth of investment fund assets decelerated in 2006 due to the high comparison basis and stock market correction. In total, the

Table 2. Aggregate indicators of securities markets (EEK bn)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Securities market capitalisation*	10.6	19.1	12.6	31.9	35.2	31.9	42.2	53.5	80.0	60.1	79.2
Instruments											
shares listed on stock exchange	8.0	13.1	8.3	28.3	31.0	26.4	36.2	47.3	71.9	46.9	71.0
debt securities	2.4	4.0	3.7	3.2	3.7	4.4	3.3	2.9	3.1	4.8	8.5
shares and units of investment funds	0.3	1.8	0.4	0.4	0.4	0.9	1.7	2.6	4.5	8.4	10.2
subscription rights	-	0.1	0.2	0.0	0.0	0.2	1.0	0.7	0.5	0.0	0.0
Securities market turnover*	3.2	32.8	32.8	12.4	10.1	10.2	13.0	14.9	13.9	68.4	37.4
Capitalisation of Tallinn Stock Exchange	8.0	13.1	8.3	28.3	31.0	26.4	36.2	47.3	72.4	46.9	72.3
non-resident investors	36%	42%	54%	74%	78%	78%	81%	81%	83%	58%	49%
Turnover of Tallinn Stock Exchange	2.3	21.8	13.4	4.5	5.5	4.1	4.0	7.6	10.3	30.3	12.0
Securities market capitalisation* / GDP	19%	29%	17%	39%	38%	31%	36%	42%	58%	46%	39%
Securities market turnover / capitalisation	30%	172%	260%	39%	29%	32%	31%	28%	17%	90%	59%
Stock exchange turnover / capitalisation	29%	167%	161%	16%	18%	16%	11%	16%	14%	47%	24%

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

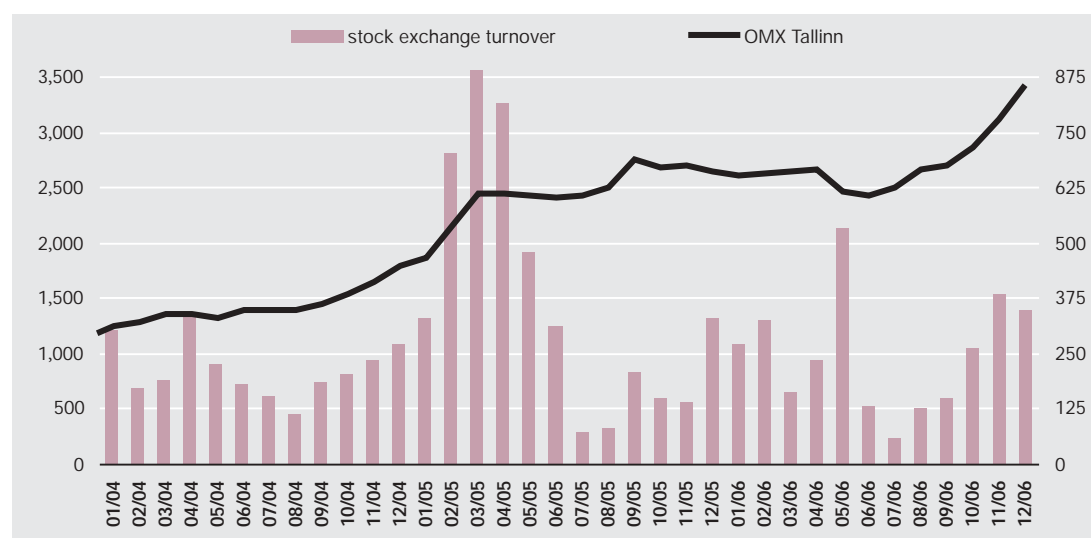


Figure 10. Monthly turnover of the Tallinn Stock Exchange (EEK m; left scale) and index OMX Tallinn as at end of month (points; right scale)



volume of investment fund assets increased by 8.8 billion, exceeding 27 billion kroons. Like before, the growth rate was primarily affected by investments in equity funds and mandatory pension funds (see Figure 11).

Insurance

The growth of the **life insurance market** in 2006 remained slightly slower than in the three previous years. However, compared to 2005 the collection of gross premiums gained by 21%. In 2006, the volume of gross premiums collected by life insurance companies exceeded 1.5 billion kroons. The majority was comprised of unit-linked life insurance and capital insurance gross premiums.

Gross premiums collected by **non-life insurance companies** increased 16% in 2006. The total volume of gross premiums amounted to 3.1 billion kroons.

Two new insurance providers entered the non-life insurance market in 2006: AS Hansa Varakindlustus and D.A.S. Õigusabikulude Kindlustuse AS.

Hansa Varakindlustus focuses mainly on insuring property and land vehicles, whereas D.A.S. Õigusabikulude Kindlustus specialises in legal expenses insurance.

Payment methods

The **total number of payments** in 2006 exceeded that of 1998, the initial year of collecting payment statistics, six-fold and the total turnover of payments was four times bigger (see Figure 12). Within nine years, the volume of payments made via direct debits has grown most drastically (142 times). The number of card payments has increased nearly 25 times. Lately, cash payments and paper-based credit orders have not been very popular among residents who prefer effective electronic payment methods and their use has been decreasing year after year.

Card payments formed the largest share (55%) in the number of payments in 2006, although the relative importance of their turnover remained below 1% of the total payment turnover. The next popular payment methods were Internet bank and telebank credit orders. In 2006, the share

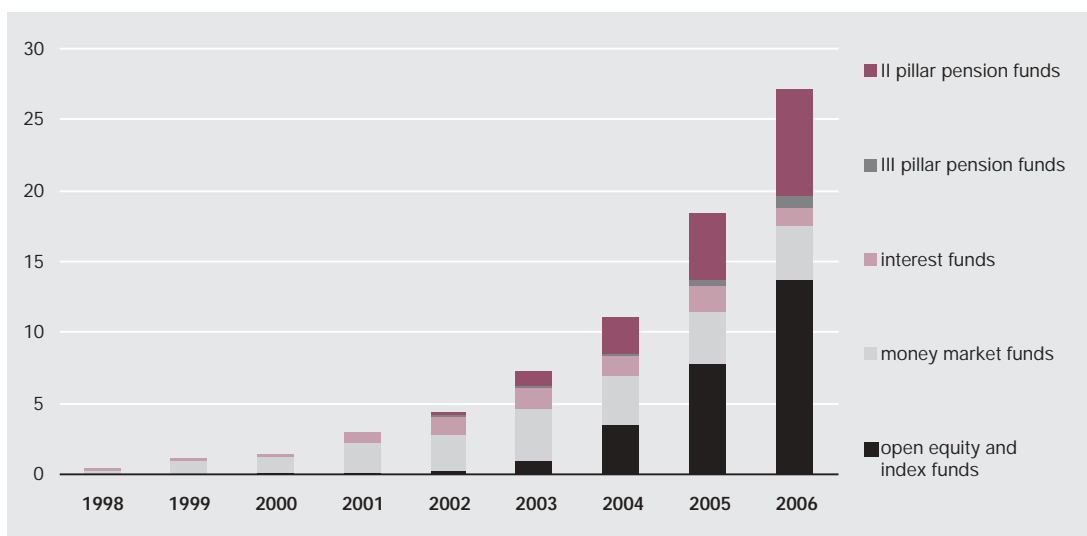


Figure 11. Total volume of investment funds as at year-end (EEK bn)

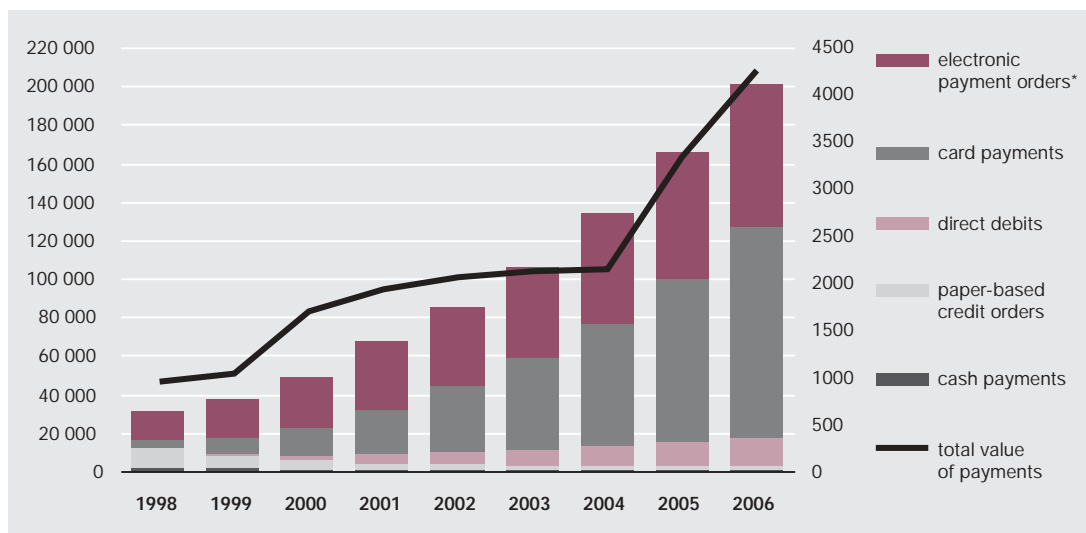


Figure 12. Number of payments (thousands; left scale) and their turnover (EEK bn; right scale) by payment methods

of **cash**² among payments made through banks comprised only 0.3% of the total number of payments and 0.04% of the turnover.

By the year-end, Estonian credit institutions had issued a total of **1.6 million payment cards**, exceeding the result of 2005 by 14%. 79% of the bank cards issued were debit cards (1.3 million) and 21% were credit cards (over 340,000). 25% of all payment cards were passive³. At the end of 2006, 95% of the population had debit cards and a quarter owned credit cards.

By the end of December, Estonia had **918 ATMs** and 85% of them enabled cross-usage. Within the year, 77 new ATMs were installed, i.e. approximately as much as in 2005. The number of points of sale (POS) that accept card payments increased 15% compared to the previous year and as at year-end, **14,665 POS provided the opportunity of using payment cards**.

² Cash payments made through banks are payments initiated with a cash down-payment or cash card transactions.

³ Bank cards that were not used for making any payment transactions during the quarter.

KEY POINTS OF THE ECONOMIC FORECASTS OF EESTI PANK IN 2006

Forecasts of Eesti Pank

Eesti Pank publishes forecasts twice a year: a spring forecast in May and an autumn forecast in November. To this end, the current year's economic development and the outlook for the two following years is analysed. This summary is based on the autumn forecast of 2006, which elaborates on economic developments in 2006–2008 and draws on the information available in October 2006. In addition to the base scenario, there are also two risk scenarios. A more thorough overview of the forecasts of Eesti Pank is provided on the web site of the central bank.

Key points of forecasts

Estonia's economic growth was swift in 2006, but the two-digit growth rate will no longer be feasible in the coming years. The increase in domestic demand, which has caused upward price pressures and the deterioration of external balance, will remain strong in 2007–2008. On the production side of the economy the rapid creation of new jobs will cease and further development should be stimulated more by the growth of productivity. The risk of facing a period of abrupt readjustment has increased.

Global economic growth in 2006 was one of the fastest in recent decades and in the following years the external environment will remain favourable for Estonia. The GDP growth will slow down slightly in the US, where the fast accumulation period of real estate wealth is nearing its end. The European economic growth is gaining momentum and should continue likewise also in the next two years. Owing to the rapid economic growth in the various regions of the world, 2006 saw a rise in the prices of natural resources and production resources. Though at the end of the year the oil price dropped, other commodity prices primarily followed an upward

trend. Based on future transactions, the following years promise a slight rise in oil prices, as the decrease of demand pressures is only temporary. Despite the increase in commodity prices, long-term inflation expectations have remained reserved. Thus, markets no longer expect the monetary policy to tighten much further.

In the near future, the Estonian economic cycle will be shaped by three essential factors. These are demand, resources engaged and competitiveness. The inflow of foreign loan capital has helped to create a very strong domestic demand environment. Several enterprises suffer from a scarcity of qualified labour force, machinery and materials, thus finding it easier to raise prices instead of expanding production. Arising from the appreciation of production inputs companies will partially lose their competitive abilities, but in the main forecast scenario this entails no major setbacks. There is no need for a significant reallocation of production resources on the production side of the economy.

In the near future, rapid economic growth can mainly persist on the support of productivity growth, as the workforce shortage concerns nearly all fields of activity. The production output of many companies has increased suddenly, overshadowing the aim of optimal resource usage. Thus, at least in the short-term perspective it is possible to increase productivity by smarter use of production inputs. In the long run, the growth of productivity will be in line with technological development, which requires investments in new machinery and equipment as well as in technological solutions.

In 2006, Estonia's economic growth was mainly based on domestic demand, which

will remain the primary growth factor also in the next two years.

If the increase in incomes is halted and/or the inflow of cheap loan money starts decreasing, Estonia's economic growth can only decelerate. The question is how drastic the change will be. According to the main scenario, there will be enough growth stimuli throughout the whole forecast horizon and demand pressures will gradually abate. **The first sign of a slowdown in domestic demand growth is that wages start to increase on the account of profits.** So far, data do not confirm such developments and rapid wage growth may also be expected in 2007. Private consumption expenditure will remain the most dynamically growing domestic demand component over this forecast horizon. **In case of brisk economic growth the investment activity should remain high, although presumably investments achieved their growth peak in 2006.** In some segments of the real estate sector, the price growth rate has decelerated and for households with lower incomes real estate prices have climbed too high. Nevertheless, there is no reason to claim that the real estate market has reached the level of long-term balance, as fast developments are presently taking place outside the capital city Tallinn. As to corporate investments, it is essential that the share of investments in machinery and equipment would increase. To date, however, statistics have not provided sufficient confirmation on this.

The Estonian labour market has developed rapidly in recent years and reached a situation where wage pressures are increasingly evident.

In the conditions of brisk economic expansion and the opening of the labour market, the number of available employees is virtually non-existent. The demand for labour force is strong in all fields of activity and the resulting wage pressures will persist throughout the whole forecast period. The acceleration of wage growth

has brought about greater mobility among employees – both in terms of countries and different regions within Estonia as well as across fields of activities and professions. The number of employees heading abroad for employment doubled within the first months of 2006 and this tendency will also continue in the following years. On the other hand, the number of the employed will decrease in the more labour-intensive fields of activity, such as furniture, textile, clothing and leather industry. So far, the released workforce has moved into the services sector without significant problems.

In the autumn forecast of 2006, Eesti Pank estimated the inflation in the coming years to be higher than it did in the spring forecast.

Inflation has become more broad-based, which is typical of fast economic growth. Meanwhile, the core inflation increasingly depends on wage growth, but the latter will remain fast in the near future. From the point of view of stable economic development, it is essential that inflationary expectations remained contained and would not affect the principles of price or wage formation. In addition, in autumn 2006 it became apparent that in the forthcoming winter the increase in food prices might considerably exceed the usual seasonal price rise. Weather conditions were unfavourable in the summer and this affected food prices throughout Europe. In the next few years, the gradual convergence of energy prices towards global market prices will continue and this is one of the main risks in the price growth forecast. As to regulated prices, in 2007 the VAT on thermal energy will be raised. At the beginning of 2008, inflation will increase abruptly due to the rise in the alcohol, tobacco and fuel excise duties. Without raising the excise duties the inflation rate would start decelerating already in 2008.

Owing to the great domestic demand the external balance is not expected to improve

any time soon, although the external environment fosters export growth. The current account deficit will decrease only in 2008, when internal demand starts waning. The price convergence pace of production inputs will determine how much Estonian enterprises can take advantage from the strong external demand. According to the primary scenario Estonia will not encounter serious competition problems, although the danger persists.

Major short-term risks are related to the danger of the economy becoming overheated, and long-term risks refer to problems with decreasing competitiveness. If those risks materialise, the adjustment speed of the economy will depend on the flexibility of the labour market and the recovery from overheating may take place only after 2008.

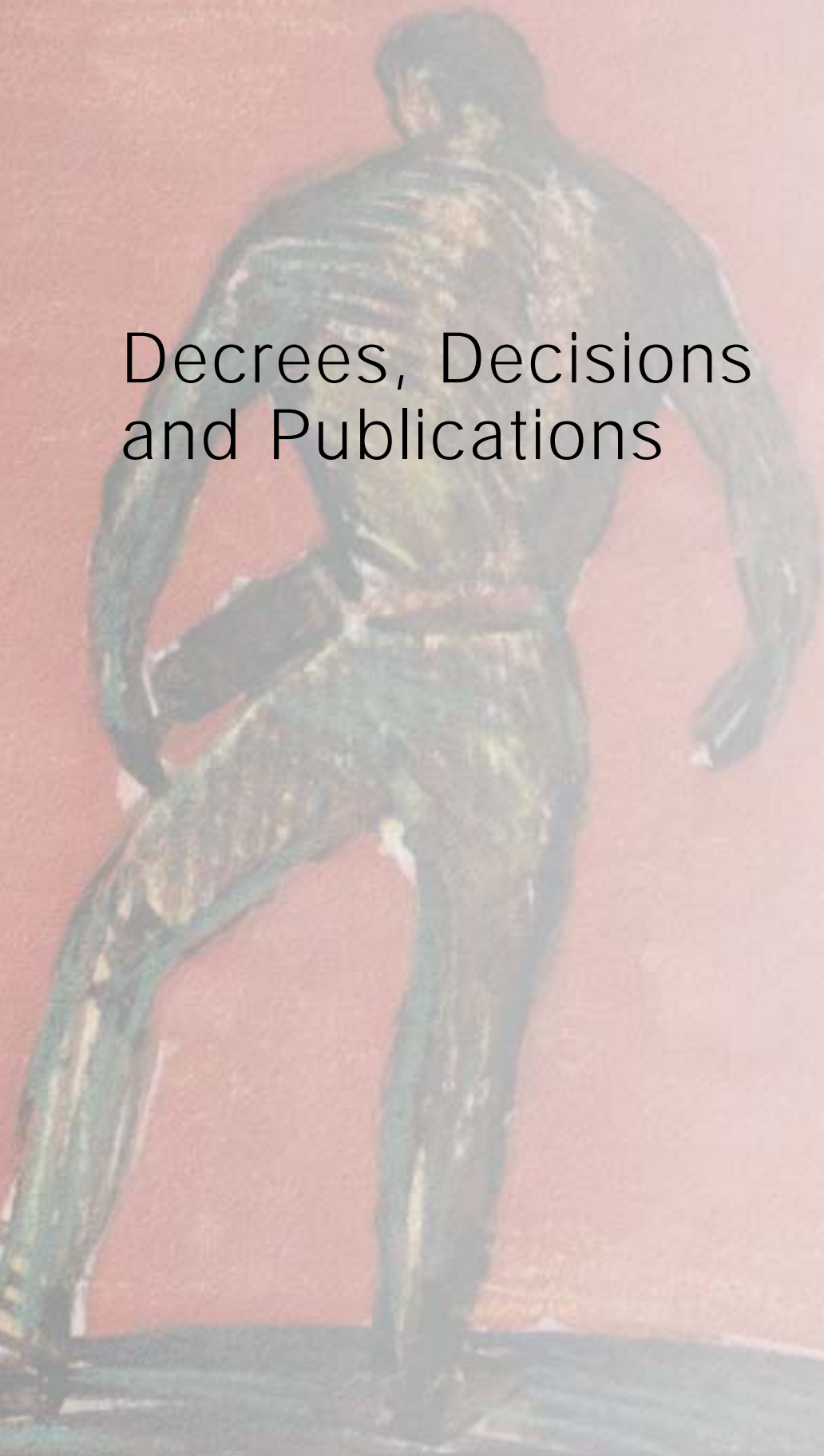
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СКИН ЗНАКЪ ЭТОИИИИИИИИ



Decrees, Decisions
and Publications

DECREES OF THE GOVERNOR OF EESTI PANK IN 2006

No 1, 19 January

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"

No 2, 30 January

Issue of a collector coin

No 3, 2 February

Amendments to Eesti Pank Governor's Decree No 12 of 2 July 2002 "Prudential Ratios of Credit Institutions"

No 4, 2 February

Establishment of procedure for calculating and complying with the reserve requirement

No 5, 17 March

Balance of payments reports of commercial undertakings

No 6, 14 July

Amendments to Eesti Pank Governor's Decree No 4 of 2 February 2006 "Establishment of procedure for calculating and complying with the reserve requirement"

No 7, 28 August

Issue of a collector coin

No 8, 19 September

Establishment of foreign currency purchase and sale report

No 9, 7 November

Approval of documentation of the Real-Time Gross Settlement System of Eesti Pank

No 10, 10 November

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"

No 11, 8 December

Establishment of procedure for calculating and complying with the reserve requirement

No 12, 15 December

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"

No 13, 29 December

Procedure for application and calculation of prudential ratios of credit institutions and consolidation groups of credit institutions

DECISIONS ADOPTED BY THE SUPERVISORY BOARD OF EESTI PANK IN 2006

No 4-1, 25 April

Periodic overview of the profit distribution strategy of Eesti Pank

No 4-2, 25 April

2005 Annual Report of Eesti Pank

No 6-1, 8 June

Appointment of the auditor

No 6-2, 8 June

Design and minting of a collector coin

No 7-1, 5 September

Amendments to the Statute of Eesti Pank

No 11-1, 12 December

Strategic Plan of Eesti Pank

No 11-2, 12 December

Approval of the work schedule for 2007 of the Internal Audit Department of Eesti Pank

PUBLICATIONS OF EESTI PANK IN 2006

The **web site of Eesti Pank** is at www.bankofestonia.info. The web site includes information on Eesti Pank and its activities, as well as on **Estonian monetary system, economy and financial environment**. The web site also contains **banking legislation**, information on **Estonian banknotes and coins** (including guidelines for collectors), on the **European Union** and the **euro**, as well as **publications and press releases of Eesti Pank**. Moreover, the site includes 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.

Quarterly Economic Policy Statement of Eesti Pank

The quarterly economic policy statements provide prompt and concise opinions of the central bank on the most relevant issues concerning economic and banking policies. The quarterly statement is available on the bank's web site. It is published as a press release and often presented at a press conference.

Annual Report

The Annual Report includes the annual 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 of the central bank, 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.

Financial Stability Review

The Financial Stability Review is a periodical publication of Eesti Pank, which covers various aspects of financial stability.

Labour Market Review

The Labour Market Review is a periodical publication of Eesti Pank, which analyses labour market trends and developments in employment.

Estonian Balance of Payments Yearbook¹

The Yearbook provides a survey of Estonia's foreign economic activities, including the international investment position and the external debt of the country. It contains lots of statistical data. The Yearbook is published only electronically on the bank's web site. On request, subscribers can receive by e-mail.

Kroon&Economy

Kroon&Economy is published quarterly. It includes surveys and analyses on topical economic issues, comments, translated articles, statistics, etc. In 2006, the following articles were published:

Relations between the European Union and Russia (K. Pollisinski)

Recent upgrade in Russia's credit rating – background aspects (K. Pollisinski)

Russian banking system (K. Pollisinski)

¹ The Estonian Balance of Payments Yearbook is published in August after the final data on the previous year have been received.

Russian trade with Finland, Estonia, Latvia and Lithuania (K. Keinast)
Share of transit in Estonian economy (A. Saarniit)
Investments between Estonia and Russia (J. Kroon)
Balance of payments between Estonia and Russia in 2003–2005 (R. Kirt)
The structure and development of the Estonian housing market (R. Lättemäe, K. Touart)
Household loan growth in European countries: comparing the incomparable (J. Kask)
Problems related to the EU framework for deposit guarantee schemes (J. Tõrs)
Financial accounts in the national system of accounts (S. Korasteljov)
Gross domestic product calculations and revisions (T. Mertsina)

Working Papers of Eesti Pank

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 2006, the following Working Papers were published:

Business Cycle Regimes in CEECs Production: A Threshold SUR Approach (N. Aslanidis)
Sources of Capital Structure: Evidence from Transition Countries (K. Jõeveer)
Forecasting Measures of Inflation for the Estonian Economy (A. Consolo)
The Profitability of simple trading strategies exploiting the forward premium bias in foreign exchange markets and the time premium in yield curves (A. Vesilind)
Palgakujunduse põhimõtted Eesti ettevõtetes (Wage formation principles in Estonian enterprises – T. Rõöm, L. Uusküla)
Price Setting Behaviour and Price Setting Regulations at the Euro Changeover (T.A. Eife)
The Role of Innovation and Competition (P. Vahter)
Comparison of Pricing Behavior of Firms in the Euro Area and Estonia (A. Dabusinskas, M. Randveer)

All publications of Eesti Pank are published in Estonian and in English, except the Working Papers that are, as a rule, published in their original language in which the summary of a study in prepared.

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