

Eesti Pank
Bank of Estonia

Eesti Pank Annual Report 2009

2010

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CONTENTS

MAIN FEATURES AND FUNCTIONS OF EESTI PANK	9
FOREWORD BY GOVERNOR OF EESTI PANK	11
ACCOUNTABILITY	16
Legal framework for accountability and compulsory publications of the central bank	16
Accountability vis-à-vis the Riigikogu	16
Regular reporting on economic policy views and publication of economic data	17
STRATEGIC OBJECTIVES FOR PERFORMING THE MAIN FUNCTIONS OF EESTI PANK	20
THE FUTURE ROLE OF EESTI PANK AS A MEMBER OF THE EURO AREA	24
Monetary policy and economic analysis	24
Reserve management and foreign currency operations	25
Cash and payment and settlement systems.....	26
Statistics	26
Assets and liabilities of the central bank after the changeover	27
MAJOR ACTIVITIES AND ACHIEVEMENTS OF EESTI PANK IN 2009	
MONETARY POLICY	30
Economic analysis, forecast and research	30
Monitoring.....	30
Economic reviews	31
Economic forecast	31
Economic research.....	31
RESERVE MANAGEMENT	33
Structure of foreign exchange reserves	33
Investment process	33
Results and determinants of investment in 2009	34
Changes in the benchmark portfolio in 2009.....	34
Asset management services provided to the public sector	34
ENSURING FINANCIAL STABILITY	38
Financial sector analysis and financial stability assessment	38
Measures adopted to ensure financial stability	39
Changes in the EU financial stability framework.....	40
Payment and settlement systems oversight	43

DEVELOPMENTS IN STATISTICS.....	44
Banking and other financial statistics	44
Balance of payments statistics	45
General economic statistics	47
 PAYMENT AND SETTLEMENT SYSTEMS	 48
Development of payment and settlement systems	48
Settlements.....	48
 MEETING THE CASH DEMAND	 54
Banknotes and coins in circulation.....	54
Expert analysis and handling of cash	54
Preparation of new banknotes and coins	55
 COOPERATION	 60
International cooperation	60
Cooperation with European Union institutions	60
European Systemic Risk Board	62
Cooperation with the International Monetary Fund	64
Cooperation with the Bank for International Settlements	66
Cooperation with rating agencies.....	66
Domestic cooperation.....	66
 PUBLIC RELATIONS.....	 70
Principles of public relations	70
Media relations and public appearances	70
90th anniversary of Eesti Pank	71
Celebration of the historical premises of Eesti Pank	71
Eesti Pank Museum	71
 GOVERNANCE, ORGANISATION AND HUMAN RESOURCES POLICY.....	 76
Governing and decision-making bodies of Eesti Pank	76
Development of the management system and work organisation of Eesti Pank in 2009.....	78
e-Eesti Pank in 2009	80
Eesti Pank's human resources policy	80
 ANNUAL ACCOUNTS OF EESTI PANK	
FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2009	84

ANNEXES

GLOBAL ECONOMY IN 2009	106
United States and Japan	106
Euro area.....	108
ESTONIAN ECONOMY IN 2009	109
Non-financial sector	109
Monetary policy environment	109
Domestic and external demand	110
Inflation	111
General government	112
Sovereign rating	113
Financial sector	116
The banking sector	116
Securities markets.....	119
Other financial intermediaries.....	121
KEY POINTS OF EESTI PANK'S ECONOMIC FORECASTS IN 2009	125
DECREES, DECISIONS AND PUBLICATIONS	
DECREES OF THE GOVERNOR OF EESTI PANK IN 2009.....	128
DECISIONS OF THE SUPERVISORY BOARD OF EESTI PANK IN 2009	129
PUBLICATIONS OF EESTI PANK IN 2009.....	130

Günther-Friedrich Reindorff

1889–1974



The insets of this year's annual report display the motifs of the banknotes designed by Günther Reindorff and, a particular rarity, details of the printing plates of the ten-kroon banknotes from 1940.

The printing plates were discovered on October 27, 2000 hidden away under an old shelf in the vault of Eesti Pank, where they had been since the occupying Soviet authorities took over Eesti Pank in 1940. The Soviet occupation prevented the banknotes of 1940 entering circulation, and those that had already been printed were destroyed. The printing plates are now preserved in the Eesti Pank Museum.

Günther Reindorff (1889–1974) was an Estonian graphic artist and art teacher. He is highly acclaimed for his fine art, but his applied works are equally interesting. His most famous and popular works of applied graphic art are the series of Estonian kroon banknotes issued between 1928 and 1940. The five-kroon banknote features a self-portrait of the artist as a fisherman, and this motif can be found on one of the insets of the annual report.

Reindorff studied art in St Petersburg, and then as a young man he worked in St Petersburg and Moscow until 1920, designing Russian bank-

notes, coins and postage stamps; in spring 1918 while working in Goznak he also created a graphic design for the coat of arms of the Russian SFSR, for which Lenin himself signed the official approval. The design was similar to the RSFSR coat of arms that was adopted with the constitution of 1925.

In 1920, Reindorff moved to Tallinn where he started working at the State Industrial Art School. He was also the consulting artist of the State Printing House and cooperated with advertising agencies. He created bookplates, banknotes, signs and postage stamps and he also designed books, furniture and other articles.

After the Second World War, Soviet ornamental art dominated, and Reindorff was not able to create as much applied graphic. In 1949 and 1954, Reindorff was accused of admiring the Western style of art too strongly and not creating enough art portraying life in Soviet Estonia. Thus, he gave up creating art and focused on teaching it.

Günther Reindorff was famous not only for his applied graphic art, but also for his drawings with natural motifs. His Italian pencil drawings are highly valued, including *Sibelius' Finlandia*, which many experts consider to be his best work. His illustrations for fairytales are also very popular and were reprinted again in 1996.

G. Reindorff

EESTI PANK

KUMME
10
KROONI



1910

EESTI PANK

KUMME
10
KROONI



0123456

EESTI PANK
KUMME
10
KROONI



VALJA ANTUD S MAHARAJA
KOHALDUSE JA PANGA
POHIVIRTA ALUSEL

0123456

EESTI PANK
KUMME
10
KROONI



VALJA ANTUD S MAHARAJA
KOHALDUSE JA PANGA
POHIVIRTA ALUSEL



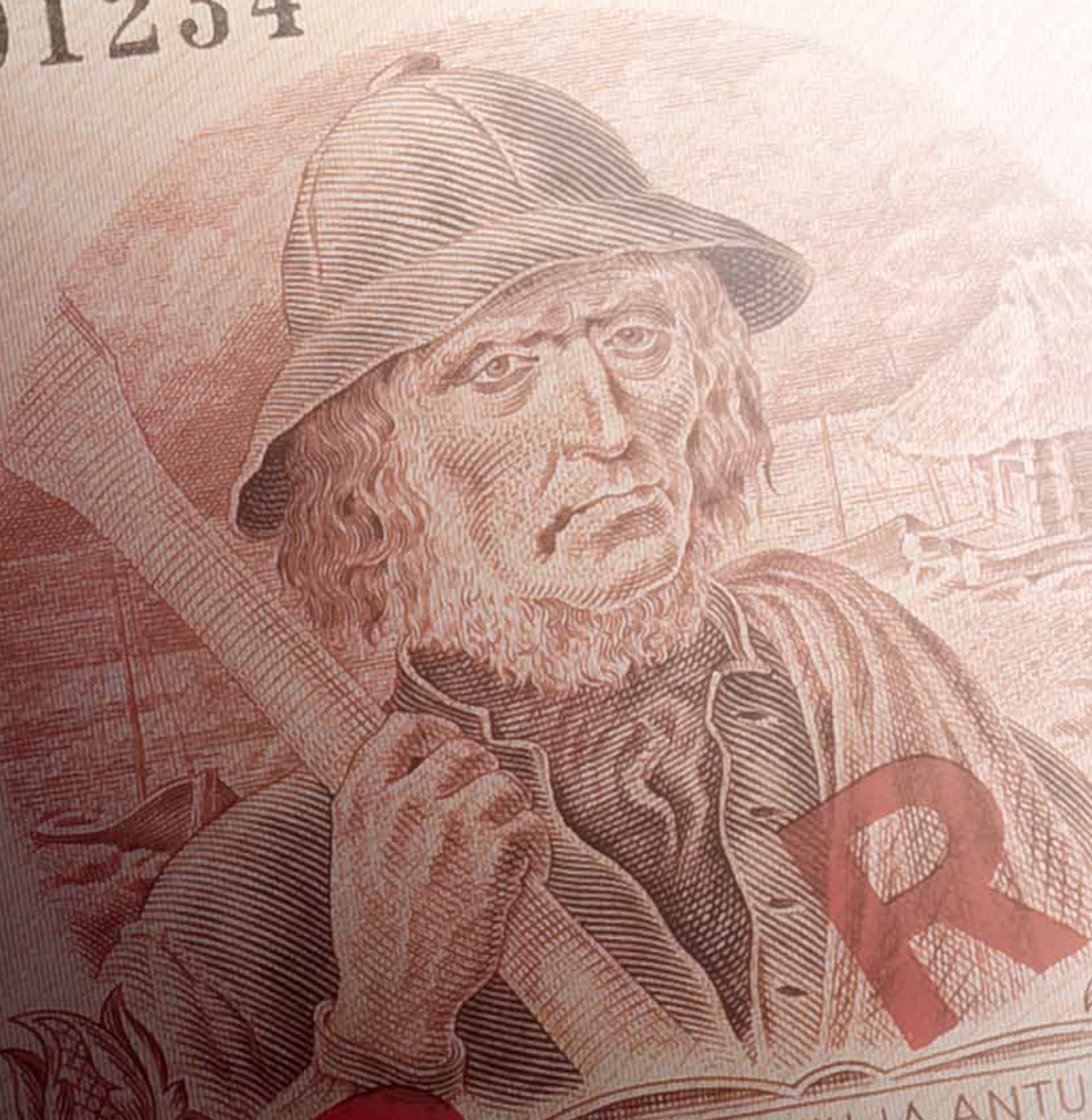
Main features and functions of Eesti Pank

Eesti Pank is the central bank of the Republic of Estonia and a constitutional institution analysing and administering the Estonian monetary system, 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 mission of Eesti Pank is to guarantee price stability in Estonia. The main tasks of Eesti Pank in carrying out its mission are as follows:

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

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SE... RAN... ATAHT ON VALJA ANTU
3... 1927 A. RAHASEADUSE
...NGA PÕHIKIRJA ALUSE

G. Reindorff

Foreword
by Governor
of Eesti Pank



Foreword by the Governor of Eesti Pank

Estonia's monetary system has been based on the currency board system for over 17 years now. This means that the exchange rate of the Estonian kroon is pegged to the euro and that all the central bank's liabilities, including the monetary base of the economy, are fully covered by gold or foreign exchange reserves.

Flexibility in the non-financial sector, especially the labour market, is the key condition for a smoothly functioning currency board system. The exchange rate may not be changed to balance the economy, so adjustments have to happen in wages and prices in the non-financial sector. It has sometimes been asked whether this monetary system is too strict for the Estonian economy, but today it is safe to say that the currency board system has helped our economy to react rapidly to the uncertainty in the rest of the world. Inflation and credit demand abated rapidly and wage growth slowed, resulting in a surplus on the current account. However, had the exchange rate been too volatile, it would have jeopardised the competitiveness of the non-financial sector and threatened financial stability.

It is important to remember here that financial stability plays an essential role in shaping future expectations. These expectations, in turn, are a major factor in how fast and flexibly the economy responds to hard times. Had Estonian business leaders not foreseen future events so clearly, they would have reacted to the global recession in demand later, which would then have prolonged the adjustment of the economy.

For many Estonian companies and households, the year 2009 was a time to revise earlier plans. By now, this reorganisation is nearing its end and a sense of security is returning. Estonia's near-term growth rate largely depends on how quickly the underused production resources will be brought back into use. In the longer term, however, the key is the attractiveness of our economic environment to new investments.

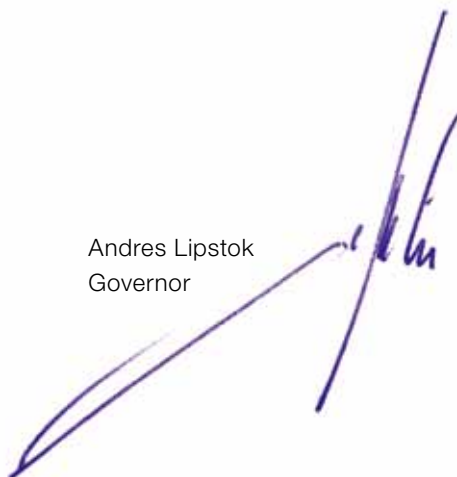
The Government's decisive actions in 2009 halted the deterioration of the imbalances in the consolidated budget. The low government debt means that Estonia has not been threatened by the turmoil in global financial markets. Our reserves have ensured that the country will not encounter short-term liquidity problems, should tax collection contract rapidly. Despite the increased uncertainty about the economic development of our region, we have remained almost entirely untouched by the crises faced by other countries in funding their government costs. Public support for balancing the state budget and curbing government debt remained strong in Estonia even during recent difficult times.

In the next few years, the central government's fiscal position must be improved further, because the recovery of economic growth does not mean that the deficit will automatically disappear. To achieve this, we must increase revenues or cut spending. The debt burden in Estonia has increased considerably over the past years, and therefore cuts in spending should be preferred.

The primary goal of the Estonian monetary system is to keep long-term inflation close to the inflation level of the euro area. During the recent boom, when domestic demand and the prices of foreign goods such as food and energy grew rapidly, this goal was more difficult to achieve than ever before in our history. Inflation expectations, however, remained relatively subdued even at the height of the boom. In the longer term, inflationary pressures should ease because even though Estonia's income level has fallen significantly, the relative price level has remained virtually the same. So far, the drop in wages has made only a modest contribution to the decline in prices. In the future, price growth is only likely to be accelerated by an increase in global commodity prices. Meanwhile, in the next few years it is essential to contain the inflation caused by administrative measures and to limit the pass-through of one-off price rises to other prices. When making economic policy decisions we must not forget that excessive price growth may hinder Estonia's economic recovery.

Joining the euro area has become an important landmark for us. The difficult decisions made in 2009 have brought us closer to achieving this goal. However, regardless of whether we adopt the euro sooner or later, we must keep in mind that the euro does not signify the end of our journey, but rather the beginning of a new one. New goals are already being set. Estonia probably does not need any major economic policy changes right now, but we need to carry out several unfinished reforms and to adhere strictly to the principles of responsible economic policy that we already adopted and successfully tested long ago.

Andres Lipstok
Governor





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G. Reindorff

Accountability



ACCOUNTABILITY

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

Legal framework for accountability and compulsory publications of the central bank

The scope of accountability of the central bank has been defined in various Estonian laws. Pursuant to the Law on the Security for the Estonian Kroon, the central bank is to publish at least once a month data on the size of gold and foreign exchange reserves and the amount of Estonian kroons in circulation. These data are published in the form of tables describing the balance sheet of Eesti Pank and foreign exchange reserves backing the kroon. Pursuant to the Official Statistics Act and the Eesti Pank Act, the central bank is entitled as well as obliged to collect and publish monetary, financial and balance of payments statistics in its field of responsibility, according to the rules laid down for this purpose. The statistical data are published on the bank's website.

The Eesti Pank Act also requires regular publication of information on the central bank's activities and the economies of Estonia and the entire European Union. In addition to the regular economic policy statements published 4–6 times a year, twice a year Eesti Pank pub-

lishes The Estonian Economy and Monetary Policy (includes a forecast) and The Financial Stability Review. 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 central bank and the Riigikogu cooperate in the form of meetings and bank representatives explain and comment on the issues raised by members of the Riigikogu.

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

Upon request of parliamentary factions the top executives of Eesti Pank introduce the central bank's economic policy standpoints and activities. In 2009, the sustainability of economic development and international economic policy relations were of particular interest.

Eesti Pank was also requested to deliver its opinion on one draft act.¹ In addition, Eesti Pank replied to two interpellations of members of the Riigikogu concerning cooperation of constitutional institutions in safeguarding economic stability and the reliability of the currency board

¹ The State Budget Act, the Foundation of and Participation in Legal Persons in Private Law by the State Act, and the Riigikogu Internal Rules Act on the request of the Constitutional Committee of the Riigikogu.

system; cooperation of Eesti Pank, the Financial Supervision Authority and the Ministry of Financial Affairs under a three-party cooperation agreement on financial crisis management; cooperation of Eesti Pank and the central banks of Sweden, Latvia and Lithuania under a cooperation agreement on financial crisis management; economic policy measures for the adoption of the euro; the credit policy measures taken by Eesti Pank, the central bank's contribution to the state budget, etc.

Regular reporting on economic policy views and publication of economic data

The central bank's reliability for the public and the transparency of its activities are the 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 data²). In addition to data available on the central bank's website and various publications³, it is possible to request information directly from the bank. Information can be requested by mail, e-mail or phone. In 2009, Eesti Pank received 3,252 inquiries, 27 of which were registered as requests for information.

² 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.

³ The full list of publications of Eesti Pank in 2009 is available in the Annex to the Annual Report on page 130.

23456



VALJA ANTUD 3 MAI 1927A
ASEMOUSE JA PANGA
KIRIA ALUSEL

G. Reindorff

Strategic objectives
for performing the main
functions of Eesti Pank



STRATEGIC OBJECTIVES FOR PERFORMING THE MAIN FUNCTIONS OF EESTI PANK

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

I Monetary policy

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

II. Financial stability

6. Ensuring financial stability by assessing the credit and liquidity risk of the financial sector and bringing the risk scenarios of the economic forecast more in line with the financial stability stress tests. Consultations are carried out with market participants as well as domestic and international cooperation partners to obtain high-quality and reliable estimates.
7. Safeguarding financial stability by developing the financial sector's safety net with special focus on the sector's infrastructure. Strengthening national crisis management capacity in cooperation with the Ministry of Finance and the

Financial Supervision Authority and cross-border crisis management capacity in cooperation with Scandinavian and other Baltic central banks.

8. Acting as the overseer of settlement systems and publishing respective assessments regularly.
9. Contributing to better integration of European financial markets, including in the field of securities settlement, by participating in the work of European Union institutions. Participating in the development of the securities settlement system TARGET2-Securities.

III Meeting cash demand

10. Promoting the usage of modern payment means in order to reduce the share of cash in currency circulation.
11. Increasing the performance of cash handling, thus avoiding growth in costs of cash handling in the medium term.
12. Celebrating key events in Estonia by issuing numismatic-bonistic products.

IV Joining the euro area

13. Reaching the stage in preparation for the launch of the euro where it can be completed within 12 months before the day the euro is launched. Estimating twice a year Estonia's readiness for the launch of the euro.
14. 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.
15. Ensuring the technological readiness of cash management for the changeover to the euro.
16. Ensuring readiness for competent participation in the decision-making and cooperation mechanisms of the single European monetary policy.
17. Informing public, private, and third sector organisations and the general public of the developments in the implementation of the sin-

gle European monetary policy and its effects on Estonia's economy, and of central bank's responsibilities upon Estonia's accession to the euro area.

V Organisation and cooperation

18. Providing central bank services cost-effectively at the national level and as a member of the European System of Central Banks (ESCB).

19. Promoting research-related scientific cooperation by strengthening collaboration with the other EU central banks through cooperative projects; continuing the visiting researchers' programme, and promoting joint research work in Estonia, including via the Estonian Economic Association.

20. Developing the professional skills and knowledge of the staff through in-service training programmes and personal development plans.

21. Developing the management system of the central bank by anchoring the bank's organisational values, preparing a comprehensive description of the organisation, specifying the bank's products and services, and determining their cost on the basis of ESCB's methods.

22. Conducting regular self-assessments of the bank's internal audit and risk management processes.

23. Enhancing the business continuity of the bank's critical processes.

24. Establishing an interactive visitor centre by using the resources of the museum and library of Eesti Pank, which will be introducing the role and tasks of Eesti Pank as a member of the ESCB as well as the history of the Estonian economy and currency.

25. Improving the physical and IT working environment and the teleworking opportunities.



10

G. Reindorff

The future role
of Eesti Pank as
a member of the
euro area



THE FUTURE ROLE OF EESTI PANK AS A MEMBER OF THE EURO AREA

If Estonia adopts the euro, Eesti Pank will become a **fully-fledged member¹ of the European System of Central Banks (ESCB)**. This will entail significant changes in those functions of Eesti Pank that fall under the competence of the European Central Bank (ECB) and the ESCB in accordance with the founding treaties of the European Union. A number of the central bank's key responsibilities, such as maintaining financial stability, will still be outside the competence of the ESCB, although they will involve close trans-European cooperation.² The changes caused by joining the euro area will be minimal in these areas. The functions that are not directly connected to EU membership will be virtually the same: monitoring and analysis of the Estonian economy, compilation of economic forecasts, management of official foreign reserves³, organisation of financial supervision, international cooperation outside the European Union, with the IMF and the BIS among others, and other similar tasks.

The ESCB consists of the European Central Bank and the central banks of the EU Member States, which are all independent institutions. All the central banks of EU Member States are part-owners of the European Central Bank and make contributions to its fixed capital and reserves. The amount of each Member State's contribution depends on its GDP and population.

The ESCB's **primary objective is to maintain price stability** and help the European Union achieve its broader economic policy goals while ensuring price stability.

The ESCB has the following key functions:

- development and implementation of the single monetary policy of the Eurosystem;

- execution of foreign currency operations;
- management of the foreign reserves of the euro area Member States;
- operation and supervision of payment and settlement systems.

In addition, the ESCB provides assistance to financial supervision institutions and helps guarantee financial stability in the European Union. The ESCB also arranges the collection of the statistical data that it needs to fulfil its responsibilities.

In conclusion, becoming a member of the euro area entails big changes in monetary policy and in the economic analysis, reserve management and foreign currency operations, statistics, cash, and payment and settlement systems of the euro area.

Monetary policy and economic analysis

The monetary policy of the euro area follows the principle of **centralised decision-making and decentralised implementation**. All monetary policy issues, enforcement of regulations and decision-making fall under the competence of the **Governing Council of the ECB⁴**. The ECB Governing Council works with the central banks of the Member States to design the monetary policy framework and set monetary policy goals. The work is done in numerous ESCB committees and task forces, where all important issues are discussed before any decisions are made. The ECB Executive Board is responsible for implementing the decisions of the ECB Governing Council through national central banks.

The primary monetary policy measures used by the ESCB are the regular **repo auctions** to give

¹ Eesti Pank currently participates in the ESCB as a member with derogation.

² The ESCB has only a limited role in guaranteeing financial stability, as it primarily provides information about events taking place in various countries. Financial sector regulations are in the competence of other EU institutions and EU Member States.

³ Not to be confused with the central bank's reserves (see "Reserve management and foreign currency operations", pp 25).

⁴ The ECB Governing Council consists of the members of the ECB Executive Board and the governors of the national central banks of the euro area. If Estonia adopts the euro, the Governor of Eesti Pank will become a member of the ECB Governing Council.

short-term loans to commercial banks and the **system of reserve requirements**. The ECB and the ESCB committees draft the materials which the ECB Governing Council then uses to set the specific inflation goal and the monetary policy interest rates that are needed for that goal to be achieved. The current priority of monetary policy is to maintain the inflation rate close to but below 2% in the medium term. The most important monetary policy interest rate is the interest rate applied to the ESCB's main refinancing operations, which stood at 1.00% before 1 January 2010.

Implementation of daily monetary policy is shared between the ECB and the national central banks. For instance, the reserve requirement and the level of regular refinancing operations, which give the total of short-term loans granted to commercial banks in the Eurosystem, are decided by the ECB, while monetary policy transactions are intermediated by the national central banks. The required reserves of commercial banks are held with the national central banks. Lending to commercial banks also takes place via the Eurosystem's central banks, meaning the partner of a commercial bank in a refinancing operation through a loan contract is generally a national central bank, not the ECB.

The ESCB could not achieve its primary monetary policy objective without monitoring, analysing and forecasting economic developments. The ECB Governing Council makes its interest rate decisions on the basis of comprehensive analyses of the euro area economy and the money supply. The analytical work is divided into two major areas. In the first

of these, both the ECB and the national central banks of the euro area carry out general monitoring of the euro area economy by analysing total demand, the interest rate levels and liquidity of financial markets, the capital and labour markets, changes in the euro exchange rate, and global economic developments. Fiscal policy is an essential part of the euro area economies. Economic analyses result in short- and medium-term assessments of inflation developments. The second focus is on the aggregate indicators of money supply and credit and their long-term impact on inflation.

All this takes place in close cooperation between the ECB and the national central banks. This requires extensive homework from the national central banks to present their standpoints and participate in the discussions, and this in turn sets high standards for the working methods and staff of the central banks.

Reserve management and foreign currency operations

The management of foreign reserves in the ESCB is divided into two parts. Each central bank of the euro area makes a **contribution to the fixed capital and foreign reserves of the ECB**. If needed, these reserves are used for currency market interventions, which are performed exclusively by the ECB, by all the central banks of the euro area or by a combination of participants. The ECB does not invest its reserves; instead, these are managed by the central banks of the Member States. To this end, the ECB's reserves are distributed among national central banks according to the capital key⁵. The income from

⁵ Under Article 29 of the Protocol on the Statutes of the European System of Central Banks and of the European Central Bank, the shares of the national central banks are weighted according to the shares of the Member States in the total population and the gross domestic product of the European Union (EU), in equal measure, as notified to the ECB by the European Commission. The weightings are adjusted every five years or whenever a country joins the EU. Accordingly, on 1 January 2009 the ECB's capital key was adjusted for the five-yearly update, on the basis of data provided by the European Commission. On 1 January 2009, the total of the subscribed capital of the ECB was EUR 5,760,652,402.58. Estonia's contribution was 0.1790%. The 11 non-euro area Member States are required to pay a minimal percentage of their subscribed capital (currently 7%), as a contribution to the operational costs of the ECB. See also http://www.ecb.int/press/pr/date/2009/html/pr090101_1.en.html.

investment belongs to the ECB and the Member States participate in distributing the profit and increasing the capital of the ECB, if needed.

In addition to the reserves of the ECB, every central bank that is a member of the ESCB independently manages its own national foreign reserves. No common rules have been laid down to regulate the management of the reserves of the Member States. The function of these reserves in the Eurosystem is to guarantee that an additional contribution can be made to the ECB's reserves if needed. However, central bank reserves also have a broader role. The central banks of the Member States, including Eesti Pank, are independent legal entities with their own assets and liabilities, which is why they need sufficient capital buffers to cover extraordinary losses. Eesti Pank also needs a sufficient capital buffer to fulfil those of its tasks that are not directly related to the implementation of the Eurosystem's monetary policy.

Cash and payment and settlement systems

The regulations pertaining to the circulation of cash are laid down by the ECB Governing Council after consultation with the national central banks. The daily management of cash circulation is the responsibility of the Eurosystem's central banks and euro cash is launched into circulation through commercial banks by national central banks, not the ECB. This means that the euro cash in circulation is also a liability of national central banks, not the ECB, and is recorded on their balance sheets.

A key task of the ESCB is to foster the smooth operation of payment and settlement systems. The central banks of the ESCB fulfil this responsibility in two ways, as managers of the payment

and settlement systems and as policy developers with oversight.

For Eesti Pank as a manager of payment and settlement systems, joining the euro area will not entail any changes.

Eesti Pank has two main obligations as a member of the ESCB in developing the policies for payment and settlement systems. First, Eesti Pank will be participating in the ESCB by shaping the policy of payment and settlement systems, which mainly means setting the ESCB standards and guidelines and writing the legislation of the European Central Bank. Second, Eesti Pank is and will be responsible for the oversight of payment and settlement systems by assessing the systems' compliance with the standards.

Statistics

The ESCB needs detailed information about the euro area economy and financial system in order to fulfil its key functions. The division of responsibilities between the ECB and the national central banks regarding the collection, processing, analysis and publication of data and the methodology for this is similar to the division in monetary policy. The ECB Governing Council approves the standardised statistics requirements and the due dates for the submission of the statistics that are needed for the work of the ESCB, having first consulted with the national central banks. The central banks are responsible for the daily collection and processing of statistics.

If Estonia joins the euro area, Eesti Pank's responsibilities in statistics will grow, since in the single currency system the euro area central banks are required to present more detailed statistics than are the non-euro area central banks.

Assets and liabilities of the central bank after the changeover

Similar to other national central banks of the euro area, Eesti Pank will still remain an independent and autonomous central bank with its own assets and liabilities after the adoption of the euro. Joining the Eurosystem will not lead to any excess assets or reserves on the balance sheet of Eesti Pank. However, the balance sheet total will decrease slightly, primarily as a consequence of a change in the reserve requirement for commercial banks.

Only two technical changes will occur on the liabilities side of the balance sheet of Eesti Pank. First, the issuance of cash, which is reflected on the balance sheet as a central bank liability, will be recorded not in kroons but in euros, meaning that the currency will change. The value of liabilities will not change, since technically the entry of the issuance of cash on the balance sheet will be an estimate of Estonia's share of the total amount of cash put into circulation in the whole region. As kroons are now, in the future the euro bank notes circulating in Estonia will remain a liability of Eesti Pank and have to be fully backed by the assets of Eesti Pank.

Second, the reserve requirement for Estonian banks will fall after the adoption of the euro, from the current 15% to 2%⁶. As a result, commercial banks will be depositing less money on their accounts in Eesti Pank.

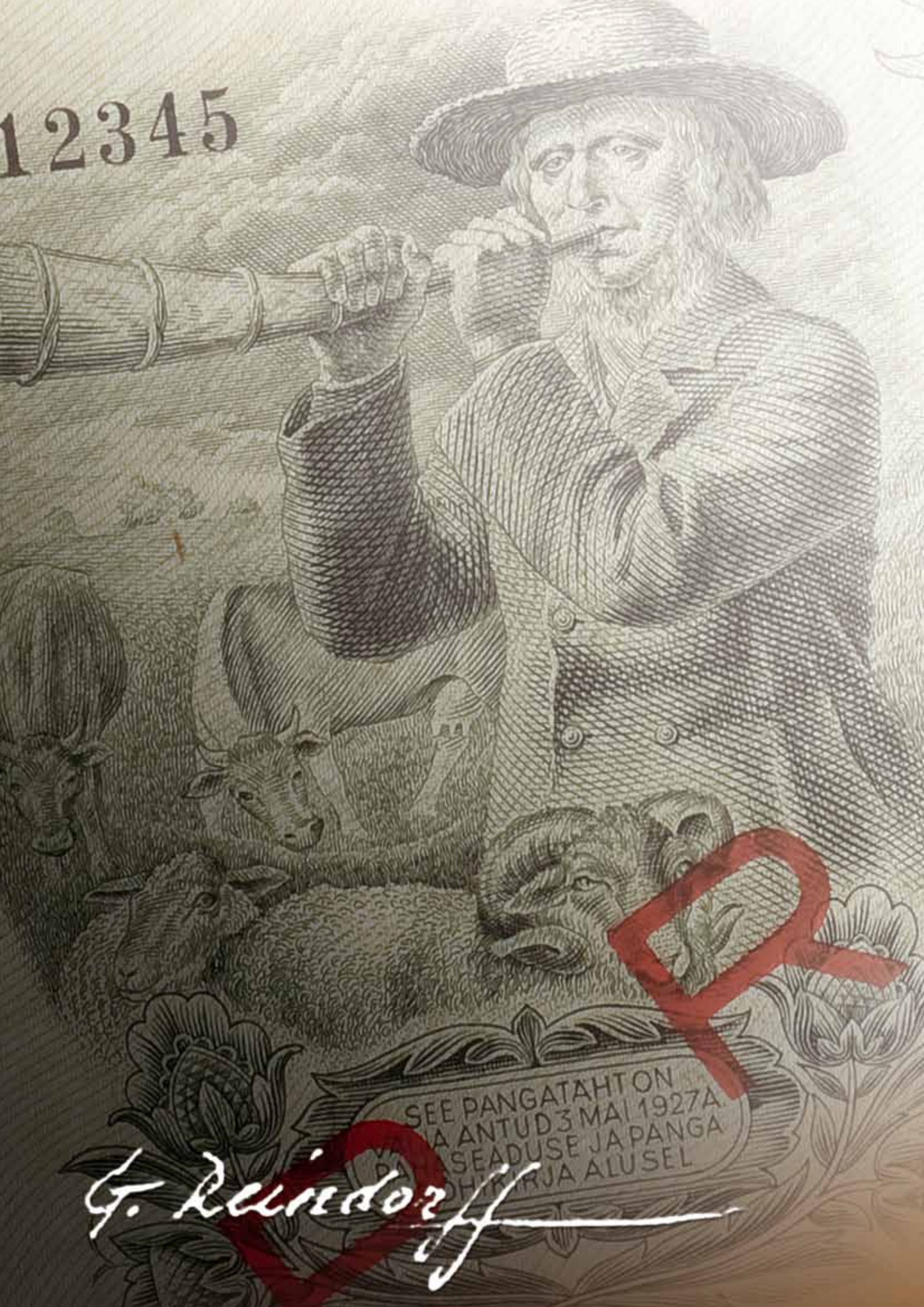
On the side of assets, two changes will occur after a changeover to the euro. First, Eesti Pank's share in the ECB will increase and some of the reserves will be transferred. Second, since commercial banks will withdraw some, but not all, of their account money from Eesti Pank once the

reserve requirement falls, Eesti Pank's external assets will also shrink.

After the changeover, the **structure of Eesti Pank's assets will start to change gradually**. In the currency board system the issue of kroons must be backed by external assets alone, whereas euro issues may be covered by domestic and external assets, with claims against the European Union and its Member States and also other countries, in accordance with the common requirements of the ESCB. Currently, the reserves backing the kroon consist of the government bonds of major industrial countries in the USA and euro area, but in the euro area the reserves backing the euro may also consist of other financial assets, such as loans granted to commercial banks.

⁶ The actual decrease in the reserves deposited in the central bank will be smaller, since banks will be allowed to fulfil about half of their reserve requirement with high-quality liquid external assets.

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Major activities and achievements of Eesti Pank in 2009

Monetary policy
Reserve management



MONETARY POLICY

The objective for Eesti Pank is to ensure price stability by maintaining the fixed exchange rate of the Estonian kroon.

Eesti Pank ensures the smooth operation of the monetary system through monetary policy instruments and through active participation in economic policy discussions. The central bank's main monetary policy instrument is the standing facility for buying and selling foreign currency, the forex window, which is available to credit institutions. The forex window enables banks to increase their Estonian kroon reserves by selling an amount of foreign currency to the central bank, and vice versa, buying foreign currency for Estonian kroons. The reserve requirement is another important monetary policy instrument used by Eesti Pank, obliging banks to keep a part of their assets as buffers in Eesti Pank or in high-quality external assets.

In 2009, the central bank left the banks' reserve requirement unchanged at a comparatively high 15%. The underlying reason for this decision was the turmoil in global capital markets. The level of liquidity and capitalisation in the Estonian banking system is still high.

Trading on the Estonian kroon money market remained thin in 2009 and the Estonian money market interest rate, the Talibor, did not affect the cost of capital for the domestic non-financial sector.

Estonia has been using the fixed exchange rate and the currency board system successfully for 17 years, and the strengths of the system have been revealed during the recent economic downturn. The flexibility of wages and prices allowed to cope well with the adjustment of the internal and external balance in the changed economic environment. Inflation, credit demand and wage growth eased rapidly, resulting in a current account surplus. Had the exchange rate been too volatile however, it would have jeopardised both

non-financial sector competitiveness and financial stability.

ECONOMIC ANALYSIS, FORECAST AND RESEARCH

Monitoring

The deepening of the global economic crisis in autumn 2008 significantly affected Eesti Pank's economic monitoring and forecast processes. The focus of the monitoring of non-financial and financial sector developments shifted more towards the external environment. Analyses were conducted on a monthly basis and ad hoc analyses were also introduced at the peak of the global crisis to provide an up-to-date evaluation of the financial situation. When the situation started to stabilise in the second half-year, these ad hoc reports were gradually dropped. Almost all of the departments responsible for shaping the central bank's monetary policy decisions were involved in additional monitoring work. The results of the monitoring provided input for the central bank's press releases and public statements. In a small and open economy such as that of Estonia, an understanding of external developments has always been an integral part of regular monitoring. The centre of focus used to be EU Member States, but during the global economic and financial crisis, the emphasis was shifted towards developments in major countries around the world.

As well as looking at developments in price stability and market flexibility, monitoring focused on the volatility of the external environment, including the possible spillover effects of the crisis and the situation of global and regional financial markets. Financial stability issues were high on the agenda in both domestic and international cooperation. Given the changed economic environment, there was an increasing need to assess the ability of companies and households with heavy loan burdens to adjust to the changing economic structure.

Cooperation and consultation with the Government on major economic policy issues heightened considerably too.

Economic reviews

In 2009, Eesti Pank increased communication with the public to better address the global financial and economic crisis and it started to release statements on Estonia's economic situation six times a year. Twice a year the central bank publishes a longer economic overview including the latest economic forecast (see also "Key points of the economic forecasts of Eesti Pank in 2009", pp 125).

Once every six months the central bank analyses the situation in the financial sector, and the results of this analysis are published in the Financial Stability Review. Due to the expected changeover to the euro in Estonia, the sustainability of Estonia's economic trends is analysed twice a year, and the results are published in the Report on the Adoption of the Euro. The flexibility of the labour market plays an important role in the fixed exchange rate regime and smooth income convergence with more prosperous countries requires flexible wage setting based on productivity growth, and so the central bank has started to publish regular Labour Market Reviews twice a year.

Economic forecast

Eesti Pank issues economic forecasts twice a year, in April and November (see "Key points of the economic forecasts of Eesti Pank in 2009", pp 125). The forecast horizon comprises the current year and the two next years and usually also includes two risk scenarios. Both the spring and autumn forecasts are published on Eesti Pank's website.

The sudden drop in global trade after the bankruptcy of Lehman Brothers in the USA required

a rapid reassessment of the economic situation, and so in January 2009 Eesti Pank compiled an additional interim forecast. This was particularly important for discussing the instruments for restoring the sustainability of Estonia's public finances and speed with which they could work.

Rapid changes in Estonia's economic structure require regular improvement of the forecast models. When the base model is updated, the forecast methods and procedures are harmonised with those of the European System of Central Banks. This is done jointly by the Research Department and the Economics Department of Eesti Pank. The Financial Stability Department is responsible for the forecasts for the financial sector and for developing the forecast methods to be used. Eesti Pank conducts regular banking sector stress tests on the basis of economic forecasts and regularly improves the methodology of the stress tests to improve their effectiveness.

Economic research

Eesti Pank's economic research projects are based on the strategic research plan, which determines the general framework for the studies conducted in the bank. The priorities for 2007–2009 included activities related to the development of the macro model of the Estonian economy and the monetary policy simulation model; research on monetary policy and financial sector, as well as analysis of the sustainability of the Estonian monetary system. In 2009, thirteen research projects on these issues were conducted.

The projects studied the impact of economic shocks on firm creation; factors of productivity and wage rigidity in Estonian companies; the impact of the opening of the Estonian labour market; long-term sustainability of the state budget; the dynamics of overdue loans during an economic cycle, etc. In 2009, further improvements were made to the credit risk model of the bank-

ing sector, the model of profitability of Estonian banks, the monetary policy simulation model and the macro model for the Estonian economy.

In addition to publication in the Eesti Pank Working Papers Series, the central bank's economic researches gain recognition on the international arena. Various research papers and articles were published in internationally recognised academic journals and introduced at international conferences.

Traditional cooperation on research at international and domestic level continued in 2009. Central bank's economists attended the Working Group of Econometric Modelling and the Wage Dynamics Network, composed of members of the European System of Central Banks. In cooperation with the European Association of Labour Economists (EALE) and the Faculty of Economics and Business Administration of the University of Tartu, Eesti Pank organised a high-level conference "European Association of Labour Economists Annual Meeting 2009" in Tallinn with altogether over 300 participants from Europe, the United States and elsewhere. Eesti Pank also participated in the preparation of an international conference "Economies of Central and Eastern Europe: Convergence, Opportunities and Challenges 2009", organised by the Tallinn University of Technology in June 2009.

In 2009 Eesti Pank introduced its own surveys and also invited several well-known foreign experts to Estonia to present their research results. For instance, Julián Messina, professor of economics at the University of Girona and economist at the World Bank, introduced a survey entitled "Educational Mismatch and Wages in Estonia". R. Anton Braun, professor of economics at the University of Tokyo, held a seminar "Spain, Japan and the Dangers of Early Fiscal Tightening". Seppo Honkapohja, member of the Executive Board of Suomen Pankki, analysed the 1990s' financial crises in Nordic countries.

The annual series of lectures dedicated to the internationally renowned Estonian economist Professor Ragnar Nurkse continued in 2009 with a lecture by Stefan Ingves, Governor of Sveriges Riksbank (central bank of Sweden).

In 2009, Eesti Pank organised twelve open seminars. Ten of them had guest lecturers from abroad and two presented the central bank's research projects.

The central bank's visiting researcher programme has contributed to research cooperation for years now. In 2009, five visiting experts took part in the economic research projects of Eesti Pank. The traditional annual research award of Eesti Pank was given to Helen Poltimäe from the University of Tartu for her research on the distributional effects of environmental taxes in Estonia.

RESERVE MANAGEMENT

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

Structure of foreign exchange reserves

The structure of foreign exchange reserves did not change considerably in 2009. The reserves are still divided into two: the liquidity buffer and the investment portfolio. A marginal part of the reserves is held in gold.

The liquidity buffer accounts for approximately 10% of total reserves and the central bank can use it at any time for Eesti kroon and foreign currency transactions with domestic credit institutions.

Assets of the other major component of the foreign exchange reserves – the investment portfolio – are invested in international financial markets. The objective of the investments is to achieve the optimum balance of risk and average return above money market interest rates over a global economic cycle. Investment portfolio assets are primarily invested in the liquid bond markets of leading industrial countries, while constantly monitoring and managing the interest rate, credit, currency and liquidity risks of the investments. For further information on risk management see the website of Eesti Pank.

In light of the global financial crisis, the Monetary Policy Committee of Eesti Pank revised and implemented a few changes to the investment rules of the foreign exchange reserves in spring 2009. As a result, the credit risk related to foreign

exchange reserves decreased even further and the diversity of investment improved.

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 it is also used for performance measurement purposes in reserve management. The benchmark portfolio does not include currency risk. Limits have been set for the allowed deviation of the actual investment portfolio from the benchmark portfolio.

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

In addition to earning on a relatively stable benchmark portfolio, or passive investment, Eesti Pank is also engaged in active investment, taking positions in global financial markets. Such investment decisions are taken based on economic analyses, market relationships and other factors. Markets and securities are chosen on the basis of the concept, expected horizon and efficiency of the investment. The main investment philosophy lies in diversification: the aim is to spread risks and make better use of market opportunities. Strategies utilise primarily fixed income and interest rate markets and exchanges of the world's developed economies. Portfolio managers make investment decisions independent of each other. This is possible because the overall risk limit is divided

into portions and the use of each portion is up to its portfolio manager.

Eesti Pank tries to keep up with the times and find its niche in today's relatively efficient markets. Two different approaches are applied in making investment decisions: the subjective approach and the model-based approach. 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. The best decisions for investment in money, capital and foreign exchange markets are made by combining these two approaches.

External asset managers also have a role in active investment. At the end of 2009, Eesti Pank had three external asset managers. Informed Portfolio Management started cooperation with the central bank in 2007. BlackRock has been investing Eesti Pank's assets since 2006 and PIMCO since 2005. The external asset management programme is based on overlay mandates and the managers express the majority of strate-

gies through derivative instruments.

In 2009, active investment resulted in 69 basis points of excess return over the benchmark portfolio.

Results and determinants of investment in 2009

The foreign exchange reserves of Eesti Pank totalled 43.26 billion kroons as at the end of 2009, having decreased around 2% from 2008. The excess reserve accounted for nearly 12% (5.3 billion kroons) of total reserves.

Investment income remained positive in 2009, though it was lower than expected. The global economy hit the bottom at the beginning of 2009 and started to regain momentum in the second half of the year. This brought about a rapid rise in stock prices. The yield, on the other hand, remained broadly unchanged. This stemmed from low inflation, continuous uncertainty about growth in economic activity and the historically lowest levels of key interest rates.

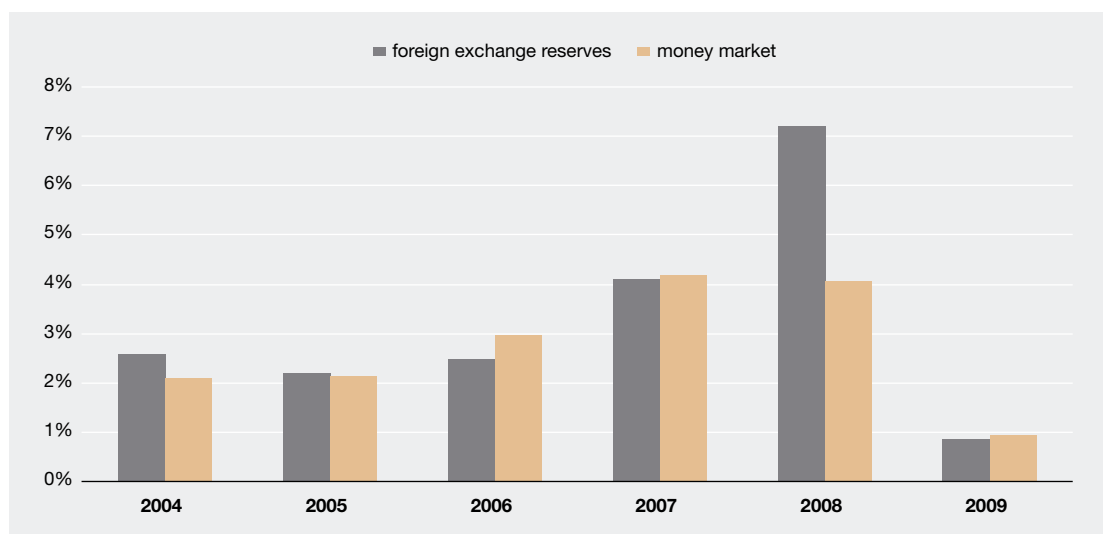


Figure 1. Return on foreign exchange reserves compared to return on money market

Given the continuous low interest rates, also the return on foreign exchange reserves was extremely low and very similar to the return on money market (see Figure 1).¹

Changes in the benchmark portfolio in 2009

As of November 2008, the investment horizon of the benchmark portfolio is 1.5 years. The interest rates on bonds dropped at the beginning of 2009 owing to the high degree of uncertainty on the markets. In April and May, however, markets started to gain some optimism and bond interest rates began to increase. Therefore, the Monetary Policy Committee of Eesti Pank decided to reduce the duration of the benchmark portfolio. Table 1 shows the benchmark portfolio with the duration of 0.6 years valid until end-2009.

Asset management services provided to the public sector

Eesti Pank has been cooperating with various public sector institutions for years already. In order to cut down on resources, the risk management contract with the Estonian Unemployment Insurance Fund was terminated. Eesti Pank continued to provide the full package of asset management services to the Guarantee Fund, whose investment portfolios totalled 2.2 billion kroons at the end of 2009.

Table 1. Structure of the benchmark portfolio

	3 months	1 to 3 y	3 to 5 y	5 to 7 y	7 to 10 y	10+ y
Euro area	88.05%	5.26%	2.71%	1.86%	1.37%	0.76%
USA	92.79%	3.50%	1.65%	1.18%	0.89%	

¹ Until 2007 the Citigroup's indices of three-month return on euro money market were used as the return on money market, calculated based on three-month interbank euro deposit rates. However, since this instrument includes considerable credit risk, which has been significantly minimized by Eesti Pank in recent years as regards foreign exchange reserves investment, in 2008 and 2009 the return on money market is calculated as the return on three-month repos.



20

G. Reinhardt

FR

Ensuring financial stability
Developments in statistics
Payment and settlement systems



ENSURING FINANCIAL STABILITY

The mission of Eesti Pank is to guarantee price stability in Estonia. Smooth functioning of the financial system is a necessary precondition for the central bank to carry out this mission. Ensuring the stability of the financial system is hence one of the most important functions that Eesti Pank has.¹ Eesti Pank assesses the risks to the financial system and takes measures to minimise the possibility of such risks materialising.

The results of the analysis of the stability of the financial sector and related risks are published twice a year in the Financial Stability Review. The review also includes assessments of the operability of and possible risks to the payment and settlement systems, which are the basic infrastructure underpinning the financial sector. To increase the transparency of the financial sector and provide market participants with the data they need, Eesti Pank publishes statistics on the operation of banks and leasing companies on a monthly basis. Since 2008, the data have been published with comments.

The Estonian financial sector and economy are globally integrated, making it essential that close domestic and cross-border cooperation be maintained with the institutions that have an influence on the sector's operational environment. The basis for cooperation between Eesti Pank, the Financial Supervision Authority and the Ministry of Finance is the Memorandum of Understanding (MoU), which was renewed in 2007. A committee of representatives of the three bodies has been set up to exchange information and coordinate operations. In addition to providing a framework for daily operations, the MoU lays out the tasks and foundations for joint operation in an emergency, such as a systemic financial crisis. However, although the operability of the financial intermediation system is a broad goal and is in the interest of the society, the main responsibility for the sustainability of each individual bank lies

with the owners and management of the bank.

In addition to its domestic operations, Eesti Pank also cooperates with the national central banks of other EU countries as a member of the European System of Central Banks to ensure financial stability and participates in shaping positions on various EU financial sector policy matters. Eesti Pank works especially closely with the Nordic and Baltic States as a result of regional integration. Since 2006 Eesti Pank has been part of the cooperation network of Nordic and Baltic central banks, where information on the functioning of the financial systems and their operating environment is exchanged regularly. In 2009, preparations were completed for the signing of a new agreement between Nordic and Baltic banking supervisory authorities, central banks and ministries of finance on ensuring cross-border financial stability. The agreement sets out the principles of cooperation and information exchange and the common code of practice for acting in a crisis situation.

Financial sector analysis and financial stability assessment

The tightening of the global financial environment in the second half of 2008 also affected the banks operating in Estonia. It became especially difficult to obtain long-term funds on financial markets and this then affected companies' and households' access to and cost of credit. Both domestic and external demand were very weak throughout 2009, and so companies and households limited consumption and investment. However, for an economy to function, the non-financial sector must have sufficient access to credit even in a recession. Although in the coming years there is no reason to expect a return to loose pre-crisis credit standards, banks are still willing to fund viable projects. Borrowers may also benefit from lower loan interest rates, as a

¹ Ensuring financial stability is one of the principal functions of the central bank (for more details see pp 20).

consequence of key interest rate cuts, and the general decline in prices.

An increase in corporate and household indebtedness in the years of strong credit growth and a decrease in income during the subsequent economic decline highlighted the lessening loan repayment ability of the non-financial sector and the resulting impact on banks' capitalisation. Economic processes in 2009 meant that an increase in loan losses was quite expected. It is essential to assess the ability of banks to cope with growing losses since losses from lending activity reduce the capital of banks. The banking sector can protect itself against less favourable times by accumulating reserves in good times, which the banks operating in Estonia also did during the economic expansion. Higher reserve requirements compared to the EU minimum requirements helped banks accumulate necessary buffers and as a result, direct state support for financial institutions was not needed in Estonia.

Eesti Pank conducts regular banking sector stress tests on the basis of economic forecasts and the methods of analysis are constantly being improved. The results of the stress test, carried out on the basis of the latest economic forecast by Eesti Pank,² confirm the resilience of the banks operating in Estonia.

According to assessments at the end of 2009, the risks to Estonia's financial stability have lessened over the year and the banking sector has sufficient buffers. However, external risks are still higher than usual and the income level and solvency of Estonian companies and households remain low compared to a year earlier. Given the increased debt burden, the factors fundamental for the development of the Estonian econ-

omy in the coming years will be the flexibility of the economy and the ability of companies and households to adjust to the requirements of the changing economic structure.

Cooperation with European central banks was focused on the impact of loan losses on the capitalisation of banks and overall financial stability in the European Union.³ In addition, the funding structures and related policies of the European banks and the impact of banks' remuneration schemes on financial stability were analysed.

Measures adopted to ensure financial stability

At the beginning of 2009, governments in Europe and elsewhere continued taking measures to ensure the functioning and liquidity of the banking sector and to avoid further deepening of the economic crisis. The measures taken by the EU Member States were based on the common action plan agreed upon within the framework of the EU Council of Economic and Finance Ministers (ECOFIN).

Given the integration of Estonia's banking sector with that of Sweden and the risks arising from changes in the global economy, Eesti Pank further reinforced cooperation with the Swedish central bank by entering into a precautionary arrangement with Riksbank in February 2009 to secure financial stability and promote confidence in the financial markets. The contract amount was for up to 10 billion Swedish kronor in exchange for Estonian kroons. The precautionary arrangement enhanced the capabilities of Eesti Pank to provide liquidity under the currency board agreement used in Estonia. The arrangement with Riksbank provided supplementary assurance during the period of uncertainty in

² 2009 autumn forecast.

³ In 2009, the European Central Bank summoned the Task Force on Credit Cycles, in which Eesti Pank also participated.

the global financial sector, in addition to the high liquidity and capital buffers of the Swedish banks' branches and subsidiaries in Estonia. The contract was not acted upon in 2009 as it was not required during the year.

State intervention in ensuring the functioning of the financial market should be temporary, so when the global financial sector had stabilised, discussions about the gradual reduction of state support of the financial sector started. Given the uncertain economic situation and the possible cross-border impact of the withdrawal of support measures, reducing such measures requires coordination and an exchange of information between countries. For this reason, Member States agreed at ECOFIN about the general principles for ending crisis measures.

At the same time, work to reinforce financial markets supervision and regulation continued. Most notably, the banks' capital adequacy framework and the EU financial stability framework were further improved (see also below). Stronger regulation and capital requirements are intended to increase banks' resilience and reduce the risk that the difficulties of one bank may pose a threat to overall financial stability.

In 2009, the European Commission established an expert group to draft legislation for tightening the capital requirements of the banking sector. Legislative amendments included stricter conditions for trading portfolios, securitisation and management remuneration. Future plans include the introduction of a requirement to hold additional capital buffers and amendments to the financial accounting rules, to reduce the cyclical impact of banks' activities. Preliminary proposals for amendments also included an additional capital requirement on housing loans issued in a foreign currency. The proportion of euro loans in Estonia is quite high, primarily for housing loans. However, given Estonia's globally integrated financial sector, its euro-based currency

board system and the expected adoption of the euro, there is no reason to consider euro-based loans a risk factor that calls for more restrictive regulation.

Alongside its cross-border cooperation, Eesti Pank engaged in ensuring domestic financial stability and improving the crisis management framework in 2009. In March, the Riigikogu approved amendments to the State Budget Act, the Foundation of and Participation in Legal Persons in Private Law by the State Act, the Riigikogu Rules of Procedure Act and the Riigikogu Internal Rules Act. The amendments aimed to improve the state's ability to manage a financial crisis, thereby ensuring financial stability.

Given the uncertainties in the economy and financial markets, in 2009 Eesti Pank decided to retain the 15% reserve requirement and 10% capital adequacy requirement for the credit institutions operating in Estonia. The baseline scenario of the 2009 autumn forecast of Eesti Pank suggests the economic crisis will ease and the prospect of the adoption of the euro will boost the confidence of foreign investors in the Estonian economy. This, in turn, will allow a possible reduction of the strict reserve requirements for banks in 2010.

Changes in the EU financial stability framework

The increasing cross-border activities of financial groups and the lessons learned from the financial crisis underline the need for closer international cooperation in financial supervision and crisis prevention. Last year, one of the most important initiatives in the financial sector was negotiations on reforming the EU supervision framework. Discussions started also on improving cooperation between Member States in financial crisis management and the harmonisation of the legal framework.

One of the most important proposals was the establishment of a European Systemic Risk Board (ESRB) and European financial supervisory authorities. It is expected that amendments to the supervision framework will be approved in 2010 and the new supervisory authorities should start work in 2011. The ESRB will be responsible for assessing potential risks to financial stability arising from the developments in macroeconomic environment and the financial system, and for issuing risk warnings and recommendations for mitigating risks. The Governor of Eesti Pank will be a member of the ESRB General Board, and will have the right to vote. The main objectives of the European System of Financial Supervisors (ESFS)⁴, which will replace the current supervisory committees, are to ensure the smooth functioning of the financial system and financial markets and to improve cooperation in supervision.

In addition to supervision, safeguarding financial stability requires efficient crisis management. However, managing cross-border crises and coordinating activities is complicated, because countries have different interests and different legal systems, and also the timing of crisis measures may differ. In order to harmonise the principles of crisis management, consultations on the reform of the EU crisis management framework started last year, in line with the action plan approved by ECOFIN. The reforms are aimed at a more uniform approach to the prevention and management of crises, which would comply with the principles of the European single market and

enhance cross-border financial integration.

Eesti Pank considers efficient cooperation between supervisory authorities and other institutions to be a priority in cross-border supervision and crisis management. Cooperation between supervisory authorities is most efficient when the interests of all Member States are appropriately taken into consideration, and the rights and obligations of countries are in balance. This means that the impact of the decisions of the European supervisory authorities on the financial stability of each country should be taken into consideration, and the decisions should not entail excessive costs for the Member States.

Improvement of securities market infrastructures

One of the strategic goals of Eesti Pank is to develop the infrastructure of the financial system. To this end, Eesti Pank has been participating in the TARGET2-Securities (T2S) project, a single shared platform for settling securities in the Eurosystem. In 2009 the specification phase of the T2S platform continued (see Figure 1).

In order to facilitate the management of the project, in spring 2009 the ECB Governing Council assigned a new management body, the eight-member T2S Programme Board⁵, to manage the project and submit proposals to the ECB Governing Council regarding strategic T2S issues while considering the interests of all

2006	2007	2008	2009	2010	2011	2012	2013	2014
Preparations		T2S platform specification		T2S platform development		Testing	Migration	

Figure 1. T2S project phases

Source: European Central Bank

⁴ The European System of Financial Supervisors consists of the three European supervision authorities – the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions (CEIOPS) – and Member States' financial supervision authorities.

⁵ The T2S Programme Board has received a mandate from the ECB Governing Council and is responsible for the implementation of the T2S programme. Its responsibilities include daily management of the T2S programme and management of relations with T2S clients and external stakeholders. The T2S Programme Board also reports on the T2S programme to the ECB's decision-making bodies.

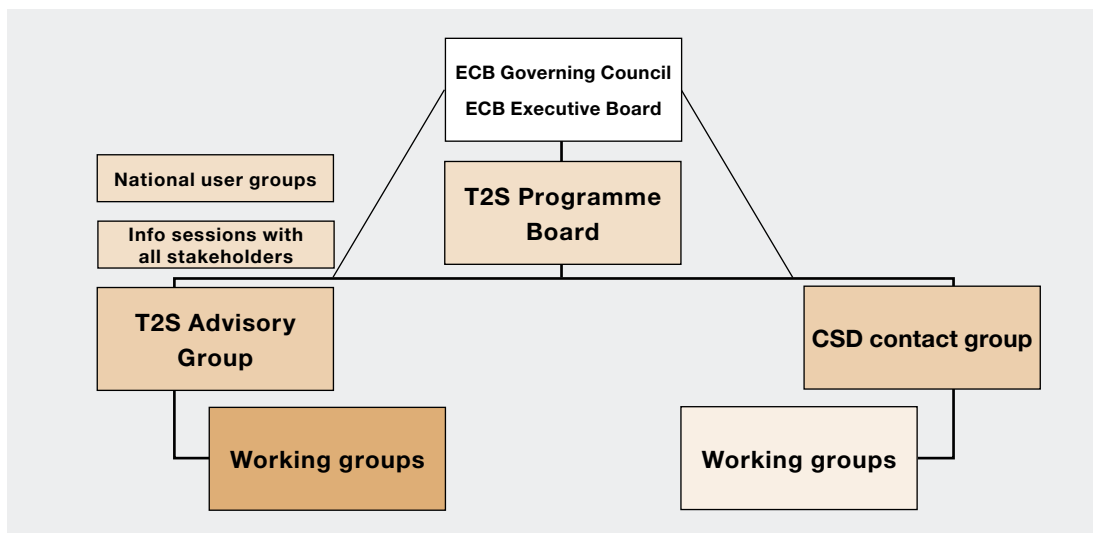


Figure 2. T2S project governance during the specification phase

Source: European Central Bank

stakeholders⁶. The project specification phase addressed the following issues:

- amendments to project governance with regard to the termination of the specification phase (see Figure 2);
- pricing of the project;
- general functionality of the T2S platform;
- legal issues.

In addition to the T2S Programme Board, a CSD (Central Securities Depositories) Contact Group will be established, which will be subject to the T2S Programme Board and consist of the representatives of CSDs and the T2S Programme Board.

The Advisory Group, which was established during the preparation phase in 2007 and consists of around 80 experts from central banks⁷, CSDs⁸, representatives of users and observers, continued work also in the T2S specification phase.

It was decided that a single price list will be established for the project for all participants, regardless of their moment of accession, and that there would be no discounts for CSDs. The ECB Governing Council approved the general functional specifications of T2S and defined five eligibility criteria for the CSDs wishing to participate in the T2S platform.

In summer 2009, a Memorandum of Understanding was signed by the CSDs interested in the Eurosystem and the T2S platform. By now, 28 CSDs in 26 European countries have signed the MoU⁹. Although the T2S platform was originally intended mainly for securities settlement with the euro on the cash side, it is now developing into a multi-currency settlement platform. Danish, Swedish and Norwegian markets have decided, with the support of their central banks, to use T2S for settlements in their domestic currencies.

⁶ Including central banks, CSDs and end-users of the T2S platform, who are mainly credit institutions.

⁷ Central banks of the Eurosystem and those central banks, which have declared to the ECB their interest in adding their national currency to the currencies of the T2S platform.

⁸ CSDs that have signed the MoU with the Eurosystem.

⁹ The list of signatories of the MoU is available at <http://www.ecb.europa.eu/paym/t2s/html/nl0509.en.html>. In autumn, the Norwegian CSD (VPS) also signed the MoU.

At the beginning of 2009, the T2S Estonian National User Group (EENUG) was set up to establish the needs of the Estonian market and formulate the positions. The responsibility of the EENUG is to represent the country's interests to the T2S project team working at the European Central Bank, to the T2S Advisory Group and to the market participants in Estonia. The most important decision adopted by the T2S EENUG in 2009 was the joining of the Estonian CSD with the MoU between the Eurosystem and CSDs, so that it could join the T2S platform for euro settlements. Adding the Estonian kroon to the T2S currencies was considered but was not found economically reasonable due to the high integration of Estonia's market, even if Estonia has not become a member of the euro area by the time the T2S platform is launched.

The EENUG was also a partner in the Nordic-Baltic cooperation measures and contributed to the development of the T2S by participating in pan-European consultations on T2S issues.

Payment and settlement systems oversight

In 2009, there were no such incidents in the operation of the Estonian interbank payment and settlement systems that could have threatened the stability of the financial sector. The functionality and principles of the systemically important payment and settlement systems (TARGET2-Eesti, EP RTGS and ESTA) have been structured so as to minimise the chances of any risks actually materialising.

In addition to Eesti Pank and the credit institutions that joined TARGET2-Eesti in May 2008, the Estonian Central Securities Depository (ECSD) also became a member of TARGET2-Eesti on 3 August 2009. The membership of the ECSD and the introduction of euro settlements for settling claims resulting from securities trans-

actions affect the operation of both TARGET2-Eesti and the securities settlement system, which is why in 2009 the central bank analysed the impact of the ECSD's project for settlement systems.

The ECSD's euro settlements project in TARGET2 introduced services in two stages:

- 1) national services, which do not include the settlement of financial claims and liabilities resulting from the purchase and sale transactions of securities (transfers primarily related to investment fund units and dividend payments), were launched on 3 August 2009;
- 2) the settlement of financial claims and liabilities resulting from the purchase and sale transactions of securities in Estonia was implemented on 4 January 2010.

Along with the introduction of national services, in particular stage 2 services, the ECSD intends to eliminate the drawbacks that have been outlined in the oversight assessments of Eesti Pank in previous years and that have so far prevented the settlement risks being fully hedged. To this end, the following measures will be applied:

- 1) real-time delivery versus payment (DVP) for securities transactions;
- 2) an integrated settlement model where settlement system participants (account managers) transfer funds to the ECSD's payment module account opened in the TARGET2-Eesti settlement system, which may be used as a collateral account for performing settlements;
- 3) amended the ECSD's data processing rules.

Eesti Pank finds that the solution offered by the ECSD is reasonable and appropriate in terms of its operation, technology and oversight.

DEVELOPMENTS IN STATISTICS

Eesti Pank is legally responsible for compiling Estonia's balance of payments statistics and monetary and financial statistics. The goal of the statistics work of the central bank is to provide the high-quality, reliable, up-to-date and unbiased statistics that are needed in the Bank's work and also by the general public. The system of collecting, processing, and publishing the statistics is flexible and compatible with international statistics standards and recommendations. The input from this system is essential for monetary policy analysis and for assessment of the risks to Estonia's financial and external sectors. The comprehensive website of the central bank is regularly updated and available to everyone and contains over 400 tables of data. Eesti Pank follows both national and international interests in its statistics and discharges its responsibilities according to the generally accepted best practices in official statistics, while adhering to the principles of efficiency and best use of resources.

In order to bring the system of official statistics in Estonia in line with these requirements, Eesti Pank continued to participate in the working group for drafting the new Official Statistics Act and the government committee for the simplification of the reporting framework. Both working groups were set up in 2008 to update the system and the legal basis of official statistics in Estonia and to facilitate the reuse of data. This is to help decrease the administrative burden from the submission of data and to lower the costs of collecting the statistics.

To make the statistics of Eesti Pank more available and user-friendly, in 2009 Eesti Pank started to develop a new structure and content for the statistics section of the bank's public website and carried out a procurement for a statistics module. Preparation and implementation of the changes will continue in 2010.

The international statistics standards are currently being updated and Eesti Pank has par-

ticipated in this process as part of the various working groups and committees of the European Commission (Eurostat) and the European Central Bank (ECB). Representatives of Eesti Pank also attended several seminars on the revision of international statistical standards. In 2014, all European countries will be implementing the new standards for national accounts and balance of payments statistics.

In 2009, the central bank's experts also participated in Estonia's accession negotiations with the OECD, providing the authors of the accession report with the necessary statistical input. Estonia's statistics passed examinations testing compliance with the OECD statistics requirements in different OECD committees.

In 2009, Eesti Pank hosted two international meetings for statistics working groups: a meeting of the European Central Bank's Working Group on General Economic Statistics and a seminar for NORDSTAT, the statistics network of the Nordic and Baltic central banks.

Banking and other financial statistics

In 2009, Eesti Pank continued its work to make data collection and its outputs compliant with the requirements of the European Central Bank. This mainly involved amending the reports for credit institutions to match the new statistics regulations of the ECB for monetary financial institutions. The decrees of the Governor of Eesti Pank that amended the current reports and introduced a new report entered into force on 1 January 2010.

The amount of statistical information submitted to the European Central Bank about the financial sector remained similar to that of 2008. In addition, preparations were made for the compilation and submission of statistics on investment funds, as required by the new ECB regulation. Until the end of 2009, the statistics of investment

funds were submitted in an aggregated and simplified form, but from 2010, the amount of statistical data on investment funds submitted to the ECB will be the same as that submitted by euro area countries.

In autumn 2009, an audit was conducted in Eesti Pank on the compilation and submission of balance sheet statistics for monetary financial institutions to the ECB. This involved a thorough review of the whole process from data collection and processing methods to the final compilation and submission of outputs. The audit was conducted along ECB guidelines and rated the collection and compilation of these statistics in Eesti Pank highly with no shortfalls in the procedures.

In spring 2009, Eesti Pank began creating an automated system for compiling quarterly financial accounts. The system uses a software created by Suomen Pankki (Bank of Finland), which is being integrated into the Eesti Pank information system. By the end of the year, preparations for the technical environment to host the application had been finished and slightly more than half of the descriptions of data sources had been completed and integrated with the software. The plan is to reach a stage where the new software could be partially used for compiling quarterly financial accounts by the end of 2010.

The statistical outputs of Eesti Pank were developed vigorously in 2009. The establishment of a subsection *Monetary financial institutions statistics* under the statistics section of the public website of Eesti Pank was particularly notable, as this is where the aggregated balance sheet and money and the credit aggregates compiled using the ECB methodology are published. Along with other monetary aggregates, the central bank now also publishes the broad monetary aggregate M3.

Regular statistical outputs were compiled and submitted to consumers in time. Ordinary out-

puts were complemented by several new ones, such as a submission of quarterly financial soundness indicators to the IMF. Plenty of queries were received also from various international organisations (e.g. ECB, IMF, BIS) and additional work load was in due to the IMF's missions to Estonia and due to preparations for joining the OECD.

Balance of payments statistics

In 2009, the priority in the compilation of the balance of payments statistics was the adoption of the 4th edition of the OECD Benchmark Definition of Foreign Direct Investment, which came into force since 2010. The statistics experts of Eesti Pank discussed over methodology issues to find the best solutions, and consulted also external experts on other matters. In order to meet the new standards it was necessary to change the reporting forms and the information system of the balance of payments statistics, BOPFACTS.

For the first time, in 2009 the central bank submitted outward Foreign Affiliated Trade Statistics (FATS; the number of companies, turnover, number of employees) for 2007 to Eurostat. Statistics Estonia is responsible for compiling inward-FATS.

In order to improve the compliance between the balance of payments and the gross domestic product, one input of which is the goods and services account of the balance of payments, in 2009 Eesti Pank started to publish the quarterly balance of payments 20 days earlier so that it came on on the same day as GDP at T + 70 days rather than the previous T + 90.

In 2009, the web-based reporting portal eAruanne was developed further, cooperation with reporting agents was improved in order to increase the quality of preliminary data and statistical outputs, and amendments were made to

the balance of payments methodology. By the end of 2009, 1,438 companies, representing 39% of the reporting agents, had subscribed to the web-based system for collecting balance of payments statistics. During the year, 349 more reporting agents subscribed, which was twice as many as a year ago, while 91 companies ceased to use the portal, mainly due to liquidation or merger. Preliminary analysis showed that the culture of statistics, the timely submission of reports and the response rate, of companies who had subscribed to the portal was higher than the average of the sample. During the year, maintenance was carried out on the portal, minor amendments were made and errors corrected, and a new maintenance contract was drawn up. The introduction of the OECD statistics requirements also entailed preparations for changing reporting forms in the information system.

Eesti Pank also continued its close cooperation with other state agencies that collect and manage statistics. Accounting for the external sector's financial intermediation services indirectly measured (FISIM) was entirely taken over from Statistics Estonia, since all the source data originate from Eesti Pank. Algorithms were created in the information system of the balance of payments statistics, so that outputs could be compiled in accordance with international requirements and the dissemination of data facilitated. In addition to changes in the content of the surveys of Statistics Estonia, the rearrangements made in the investment and pension fund report of the balance of payments (form No. 5) redundant, as in the future the data will be retrieved from the amended reports of the Financial Supervision Authority.

Eesti Pank started to work with Positium OÜ, a company owned by the University of Tartu, to compile the travel services account, as a result of which a mobile phone positioning method that can identify the number of non-residents

in Estonia was employed. The new data source became necessary because Statistics Estonia terminated its border crossing surveys of tourists. Mobile phone positioning can differentiate between visitors from up to 100 countries and can identify the duration of their stay. A new contract was also concluded with Positium OÜ to develop a methodology for assessing the number of travellers leaving Estonia by countries they visit.

Following the adoption of the new EU regulation on international payments, which increased the thresholds for declaring payments, the equivalent Eesti Pank regulation was amended in 2009. The amendments will enter into force in 2010 and will lessen the corporate reporting burden. The model of balance of payments flash estimates for direct and other estimates was also improved and preparations were made to adopt the new classification of economic activities EMTAK2008 (NACE-Rev2).

Better and more timely submission of reports was facilitated in 2009 by the introduction of penalty payment for incorrect submission. During the year around 100 companies were given warnings and penalty proceedings were initiated in eight cases.

The assessment of the quality of balance of payments statistics also continued in 2009. To this end, two quality reports were produced. The first was the annual report required by Eurostat and EU regulations for assessing the quality of the current account and direct investment data. The report confirmed the high quality of Estonia's balance of payments data, as later revisions have all remained within acceptable limits. The second report was compiled under the standards of good practice in national statistics and it contained a flash estimate of the balance of payments, the quarterly balance of payments and the international investment position. The results of the quality analysis will be published

at the beginning of 2010 on the website of Eesti Pank under the statistics section. The introduction of the Sirius software for analysing the time series and for quality control was extremely helpful. Sirius was created and is being developed further by the central bank of the Netherlands, and it makes data analysis easier for statistics experts. Sirius was also developed to check the consistency between balance of payments transactions and international investment positions.

Internationally, central bank representatives continued to participate in the ECB's Centralised Securities Database (CSDB) project. Primarily, this involved quality control and the monthly submission to the European Central Bank of data on listed shares and bond issues registered in the Estonian Central Register of Securities. Eesti Pank also continued preparations for changing over to security by security reporting of portfolio investment statistics from 2011. The ECB reporting regulations require the use of the security by security (ISIN-code based) approach in at least 90% of cases in the compilation of these statistics. This should help reduce the discrepancies between statistics across countries.

General economic statistics

Regular submission of general economic statistics to the European Central Bank and the Bank for International Settlements continued. Data are now also submitted to the Directorate General for Economic and Financial Affairs (ECFIN), which receives monthly information about external financing.

PAYMENT AND SETTLEMENT SYSTEMS

The smooth operation of the financial system is based on efficient and well-functioning payment and settlement systems. Management and development of interbank payment and settlement systems is one of the primary tasks of Eesti Pank.

Development of payment and settlement systems

2008 was the year of development and launch of the cross-border euro settlement system TARGET2. 2009 witnessed the improvement of the TARGET2 in all member countries of the European System of Central Banks as well as the European Central Bank.

In 2009 the business continuity of payment and settlement systems and related risk management were in the focus. In addition to addressing the operational reliability of the systems, Eesti Pank and other national central banks of the Eurosystem conducted further tests to the TARGET2 to ensure the system's business continuity in a financial or operational crisis.

A common statistics database was launched in 2009 to improve access to the data of TARGET2. In addition, the SWIFT Alliance LITE software was introduced to make the cost of accession to the TARGET2 more favourable for smaller banks.

In addition to the development of Estonia's interbank payment and settlement systems, Eesti Pank has set out to contribute to the harmonisation and integration of the European financial system. In 2009, Estonian banks continued preparations to join the Single Euro Payments Area (SEPA), established under the leadership of the European Payments Council (EPC). In addition to cross-border cooperation, the commer-

cial banks, Eesti Pank and the Estonian Banking Association collaborate in the Estonian working group of the EPC. In 2009, the working group made preparations for the application of the Payment Services Directive in the Estonian law.¹

The amendments to the Real-Time Gross Settlement System EP RTGS included replacement of software to minimise operational and IT risks, and system developments to enable the use of International Bank Account Numbers (IBAN).

In 2009, Eesti Pank opened accounts for several new branches of foreign banks. In addition, preparations were made to connect to the interbank settlement systems. Thus, Estonia's systemically important payment systems can expect new users in 2010.

Last but not least, preparatory work for the expected adoption of the euro on 1 January 2011 was resumed.

Settlements

Eesti Pank is managing three interbank payment and settlement systems: the Settlement System of Ordinary Payments (ESTA), the Real-Time Gross Settlement System (EP RTGS) for domestic payments and TARGET2-Eesti for cross-border euro payments.

Around 99,000 payments are settled every day via the interbank payment and settlement systems with the total value of 12.5 billion kroons.

The Settlement System of Ordinary Payments (ESTA) is among the fastest in Europe. Payments are transferred to accounts in other banks ten times a day. The payment is transferred from the originator's account to the payee's account

¹ The Directive was applied in the Estonian legislation in January 2010.

in 30 to 90 minutes, depending on the time of the origination. The ESTA also enables to settle large-value payments.

The ESTA's customer-friendly functionality enables to settle the majority of interbank domestic payments: 98,600 payments are settled daily, which accounts for 99.7% of total interbank payments. In 2009, 1.5 billion kroons a day were settled through the ESTA on average. Compared to 2008, the number of ESTA payments increased 1% in 2009, whereas the value of payments decreased 17% (see Figure 1). Moreover, also the average payment decrease 18% to 15,300 kroons.

The Real-Time Gross Settlement System (EP RTGS) processes express payments – transfers between banks take around five minutes.

The number of payments settled through the RTGS declined 28%, year-on-year, owing to the 28% decrease in customer payments. On average, 193 transactions a day were settled in 2009 (see Figure 2). The express payments originated by bank customers account for 68%

of total transactions; on average, 130 domestic customer payments were settled a day with an average value of 5 million kroons.

The average daily value of express payments was 5.8 billion kroons. Banks' "compulsory" payments (transactions related to the collateral account of the ESTA) and purchase and sale transactions accounted for the largest share of the value (39% and 29%, respectively). Compared to 2008, the value of payments settled through the EP RTGS increased 6%.

The number of payments settled via the TARGET2-Eesti slightly grew in the second year of operation. The use of the TARGET2 – the alternative channel for euro payments – started to become more widespread at the end of 2008. In 2009, an average of 70 payments with the total value of 330 million euros (5.2 billion Estonian kroons) were settled a day (see Figure 3). Estonian bank customers and banks received an average of 200 TARGET2 payments a day with the value of 330 million euros (5.2 billion kroons).

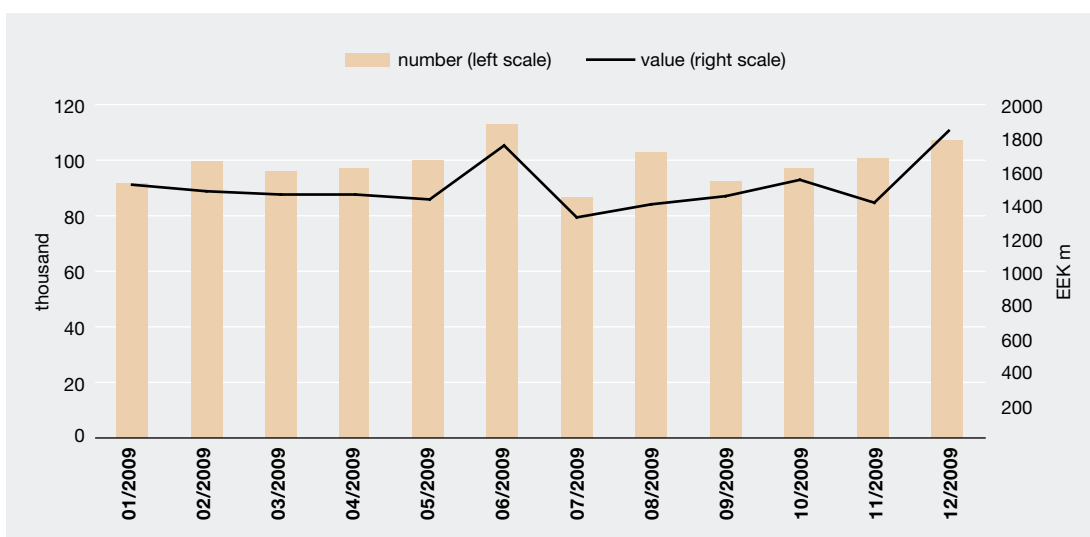


Figure 1. Number of payments processed in ESTA and their daily average value in 2009

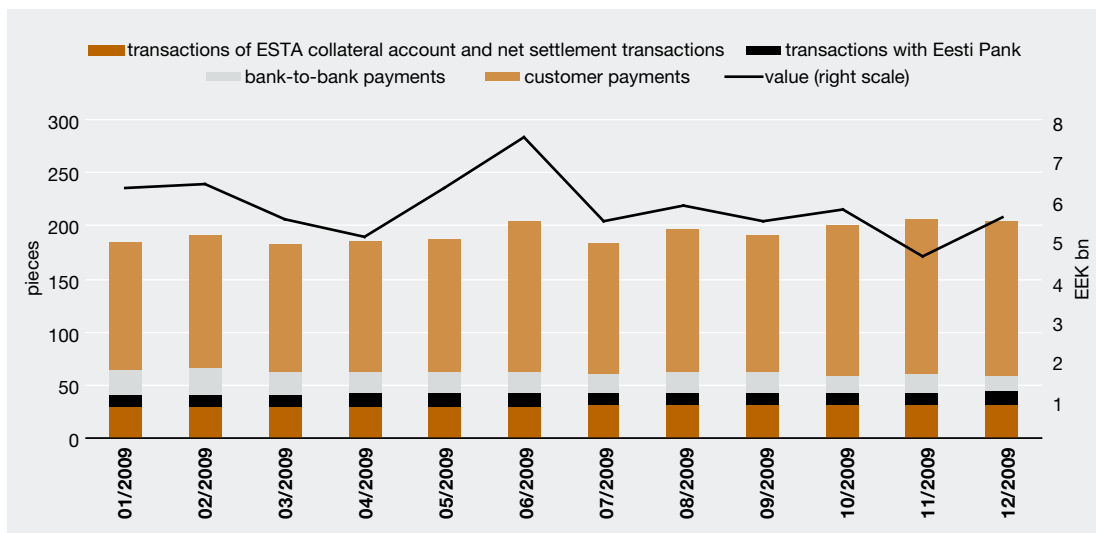


Figure 2. Number of payments processed in EP RTGS by transaction types and their average daily value in 2009

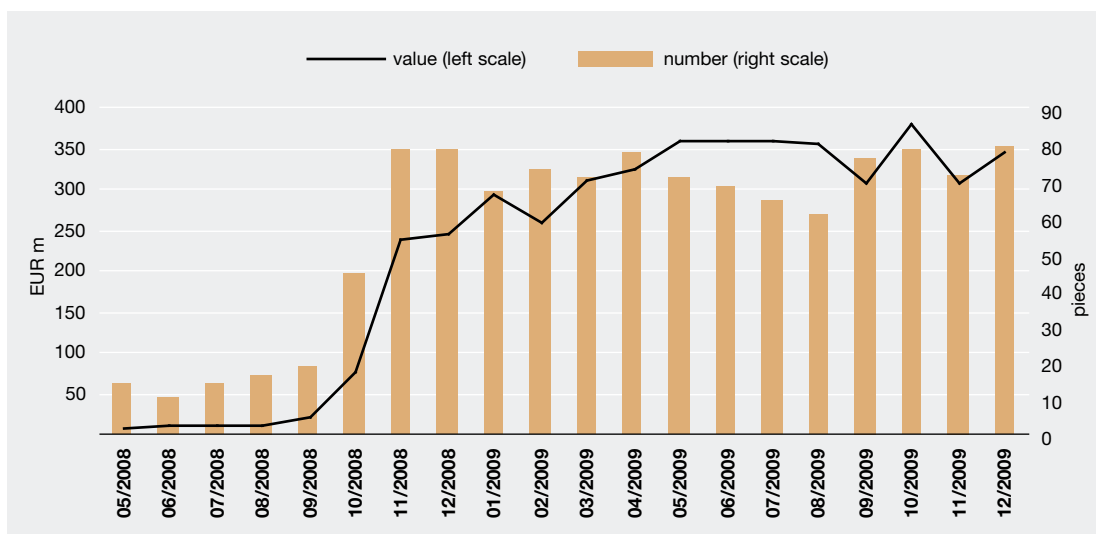


Figure 3. Number of payments processed in the TARGET2-Eesti and their average daily value



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Meeting the
cash demand



MEETING THE CASH DEMAND

Banknotes and coins in circulation

The total amount of currency in circulation as at 31 December 2009 was 9,777.4 million kroons. 1,706.8 million kroons (17%) were in the vaults of credit institutions, and savings and loan associations operating in Estonia; 8,070.6 million kroons (83%) was in circulation outside credit institutions and savings and loans associations.

In 2009, the amount of currency in circulation decreased by 2,218.8 million kroons (18.5%) to a level comparable with that of 2005. This was the largest decline in the history of the Estonian kroon, reflecting the economic downturn of the past year. The decline occurred across all banknote denominations, in particular 500-kroon notes both in terms of number and total value.

Although the amount of coins in circulation continued growth, the rate of growth was much lower than in previous years. As at year-end,

there were 460 million coins in circulation; that is, approximately 340 coins per inhabitant.

The average calculated value of a banknote in circulation stood at 120 kroons at the end of 2009. The average calculated value of a coin in circulation was 34 sents.

Expert analysis and handling of cash

In 2009, the central bank issued 10,131.5 million Estonian kroons of cash to credit institutions and received 12,337.0 million kroons, which is slightly less than in 2008 (see Table 1). The amount of cash issued by Eesti Pank has decreased significantly as the supply of 500-kroon banknotes has shrunk considerably. The amount of cash returned to Eesti Pank is somewhat smaller than in 2008. The amount of coins issued by the central bank has also substantially decreased.

All banknotes returned to Eesti Pank are sorted with fully automatic sorting machines. Banknotes unfit for circulation are destroyed and

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

Nominal value	Total amount (EEK m)				Number (m)			
	31/12/2006	31/12/2007	31/12/2008	31/12/2009	31/12/2006	31/12/2007	31/12/2008	31/12/2009
1 kroon	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
2 krooni	33.5	38.5	39.6	39.2	16.8	19.2	19.8	19.6
5 krooni	47.8	49.5	49.9	48.8	9.6	9.9	10.0	9.8
10 krooni	85.6	94.3	95.0	92.4	8.6	9.4	9.5	9.2
25 krooni	225.4	233.4	232.8	230.8	9.0	9.3	9.3	9.2
50 krooni	49.0	54.4	52.1	48.5	1.0	1.1	1.0	1.0
100 krooni	1,180.1	1,193.1	1,165.2	1,044.7	11.8	11.9	11.7	10.4
500 krooni	10,001.2	9,942.5	10,194.6	8,104.1	20.0	19.9	20.4	16.2
Banknotes total	11,627.3	11,610.3	11,833.9	9,613.2	81.3	85.4	86.3	80.0
5 senti	2.1	2.1	2.0	2.0	41.5	41.2	40.8	40.4
10 senti	13.4	14.6	15.2	15.4	134.4	146.0	152.1	154.1
20 senti	22.3	24.7	26.1	26.6	111.3	123.4	130.6	132.8
50 senti	22.1	25.1	27.2	28.0	44.1	50.2	54.4	55.9
1 kroon	61.0	69.7	74.8	74.8	61.0	69.7	74.8	74.8
5 krooni	8.5	9.0	9.4	9.7	1.7	1.8	1.9	1.9
Coins total	129.4	145.1	154.9	156.4	394.1	432.3	454.6	460.0
Collector coins	6.4	6.7	7.5	7.9	0.1	0.1	0.1	0.2
Banknotes and coins total	11,763.2	11,762.2	11,996.3	9,777.5	-	-	-	-

Table 2. Cash flows between Eesti Pank and credit institutions

Year	Total amount (EEK m)		Number (m)			
	Issued by Eesti Pank	Received by Eesti Pank	Issued by Eesti Pank		Received by Eesti Pank	
			Banknotes	Coins	Banknotes	Coins
2006	12,399.0	10,732.5	118.6	37.5	110.4	0.7
2007	12,474.8	12,472.6	114.6	38.4	110.5	0.3
2008	12,897.5	12,646.9	102.0	24.7	101.1	2.6
2009	10,131.5	12,337.0	77.1	12.0	82.7	6.7

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

Nominal value	Total amount (EEK m)				Number (m)			
	2006	2007	2008	2009	2006	2007	2008	2009
1 kroon	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.0
2 krooni	0.7	14.1	11.0	8.1	0.4	7.0	5.5	4.0
5 krooni	6.3	16.5	11.4	11.3	1.3	3.3	2.3	2.3
10 krooni	2.9	61.3	30.8	26.5	0.3	6.1	3.1	2.6
25 krooni	16.3	47.3	154.0	241.2	0.7	1.9	6.2	9.6
50 krooni	12.4	16.0	17.5	5.0	0.2	0.3	0.4	0.1
100 krooni	63.7	284.6	1,017.6	902.5	0.6	2.8	10.2	9.0
500 krooni	537.9	124.8	1,774.0	1,039.0	1.1	0.2	3.5	2.1
Total	640.2	564.6	3,016.3	2,233.4	4.5	21.8	31.2	29.8

the rest are returned to circulation. In 2009, 29.8 million banknotes in the total amount of 2,233.4 million kroons were withdrawn from circulation (see Table 2). Compared to 2008, the number of unfit banknotes has declined (see Table 3).

In 2009, Eesti Pank performed expert analyses for 23,597 damaged and worn-out banknotes and 4,010 coins submitted by credit institutions. Three counterfeit banknotes were discovered.

In total, 243 counterfeit banknotes were discovered in Estonia in the expertises performed by the Forensic Service Centre in 2009. 500-kroon banknotes accounted for the largest share of counterfeit money (63.0%). Given the number of banknotes in circulation (80 million), the number of counterfeits is relatively marginal. No counterfeit coins were found in 2009. Neither were there any failures in circulation.

Preparation of new banknotes and coins

New 10-sent coins were ordered from Staatliche Münze Berlin (Germany) also in 2009.

In April 2009, Eesti Pank issued a 10-kroon silver collector coin dedicated to the 100th anniversary of the Estonian National Museum. It is a spoke coin, which is unique in the world. The reverse of the coin depicts a notebook of a folklore collector, where the tales and stories of different people and lives have been recorded over time. The placeholder of the notebook meanders as a village road, connecting yesterday with today and tomorrow. The obverse bears the grand national coat of arms of the Republic of Estonia and the year 2009. The collector coin has been designed by Liis Dvorjanski. The coins were minted by the Mint of Finland in the total amount of 6,000 pieces.

In July 2009, Eesti Pank issued a 10-kroon silver coin (10,000 in total) and a 100-kroon golden coin (5,000 in total) dedicated to the Estonian tradition of song and dance festivals. The coins were minted by Koninklijke Nederlandse Munt (the Netherlands). The reverse depicts the song stage, which has been used since 1960 and which has become the symbol of song festivals. The golden collector coin has been designed by Merle Kasonen and Triinu Silla. The reverse of the silver collector coin depicts a men's dance circle, a symbol of time and the long tradition of the song and dance festivals. The silver collector coin has been designed by Tiiu Pirsko and Mati Veermets. The obverse bears the grand national coat of arms of the Republic of Estonia and the year 2009.






G. Reindorff

Cooperation



COOPERATION

INTERNATIONAL COOPERATION

International cooperation is an important part of the central bank's work. What happens in a small and open economy like Estonia's is closely related to events in the external environment. The central bank's international communications play a significant role in representing Estonia's economic policy interests and explaining developments in the country's economy to the international community and to foreign investors.

Well-coordinated and considered communications are of great importance for Eesti Pank and efficient collaboration is dependent on the international communication framework of the Bank. This framework includes regular economic policy reviews, particularly with EU Member States and Estonia's neighbours: working meetings to prepare for the meetings of EU committees and working groups, and to keep the Bank well informed of recent developments; management of the external communication database; and participation in various international meetings and events.

Prior to sessions of high-level bodies, working meetings are held where experts from different departments and the Eesti Pank representatives attending the sessions discuss the agenda items, set out the Bank's positions and make proposals for comments.

Communication with various European institutions and participation in EU meetings constitute the largest share of Eesti Pank's external com-

munications and reinforce cooperation with the central banks of Estonia's neighbours. In 2009, Estonia came very close to the conclusion of accession negotiations with the OECD, in which experts from Eesti Pank also took part.

Nordic and Baltic central banks have been among the major communication partners for Eesti Pank for over sixteen years. As in previous years, several seminars and meetings of the governors and vice governors of Baltic central banks were organised in 2009 too. The traditional high-level joint seminar with Suomen Pankki (Bank of Finland) was held in Estonia this time and focused on economic developments and policies in Finland and Estonia. Other topics of discussion included Nordic and Baltic financial sector policies and cooperation on crisis management. Stefan Ingves, Governor of Sveriges Riksbank (central bank of Sweden), gave a public lecture at Eesti Pank at the beginning of 2010 entitled Exit Strategies – The Importance of Coordinated Solutions After the Crisis. The lecture was part of the memorial lecture series dedicated to the internationally renowned Estonian economist Professor Ragnar Nurkse.

Cooperation with European Union institutions

Eesti Pank's representatives participate in around seventy committees and working groups set up by the European System of Central Banks (ESCB), the Council of the European Union or the Council of Ministers and the European Commission (see Table 2). In 2009, Eesti Pank exec-

Table 1. Business travel for Eesti Pank in 2008-2009

	2009			2008		
	Total	European Commission, ESCB	Other	Total	European Commission, ESCB	Other
Number of trips	594	315	279	735	327	408
Employees sent on business trip	138	81	109	148	80	117
Days spent on business trips	1,661	914	747	1,932	978	954
Cost (EEK m)	6.3	3.7	2.6	7.8	4.3	3.5
Average cost (EEK thousand)	10.7	11.8	9.3	10.7	13.2	8.6
Average length (days)	2.8	2.9	2.7	2.6	3.0	2.3

Table 2. Eesti Pank's participation in the work of international organisations and institutions

Committees and other bodies of the Council of the European Union	Informal Council of Economics and Finance Ministers Economic and Financial Committee
Cooperation bodies of the European Commission	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	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
Organisation for Economic Cooperation and Development (OECD) – participation as an observer until accession to the OECD	Economic Policy Committee Economic Development and Review Committee Committee on Financial Markets Committee on Statistics Investment Committee
Bank for International Settlements (BIS)	Board of Governors of the BIS Meetings of BIS central bank governors BIS Monetary Policy Working Party Irving Fisher Committee on Central Bank Statistics Meetings of Coordinators of Technical Assistance, organised by the BIS Heads of Security Committee

utives and experts participated in about 315 meetings in various EU institutions. Committees and working groups give Member States a good opportunity to discuss 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 by the central bank governors of the Eurosystem, is Eesti Pank's most significant partner in the EU. Eesti Pank is a full member of the European System of Central Banks (ESCB).

Until Estonia adopts the euro, the main areas for cooperation remain the economic policy of the EU, the monetary policy of the non-euro area countries, and preparations for the enlargement of the euro area including drafting of the Convergence Report. This is a report on Member States' progress in meeting the criteria for accession to

the euro area. The Governor of Eesti Pank participates together with the governors of other EU national central banks (NCBs) in the meetings of the ECB General Council, which are held four times a year. Day-to-day cooperation takes place in the thirteen committees of the ESCB and their substructures, where joint analyses are written, information is exchanged and preparations are made jointly with representatives of NCBs for the work of the decision-making bodies, the Governing Council and the General Council of the ECB. The committees cover all the areas of responsibility of the central bank.

Key topics covered in the ECB meetings in 2009

Choosing an appropriate economic policy strategy in a period of nominal convergence was on the agenda for EU institutions in 2009. It is important for Estonia to have its economic growth and inflation rate assessed in the context of a financial system with a currency-board-based

fixed exchange rate regime and strong cross-border integration, and in the same way, these circumstances are also the backdrop for the financing of Estonia's economy. To this end, central bank experts have explained the specific features of Estonia's economic developments at the meetings of ECB committees and working groups.

The economic policy framework behind exchange rate stability and the flexibility of the economy and markets, including the labour market, within the exchange rate mechanism ERM II. Once a year, the ECB assesses the functioning of the exchange rate mechanism ERM II and the fulfilment of commitments by the countries that have joined the ERM II. The report prepared by the ECB analyses the economic developments of the ERM II member countries to assess their readiness for joining the euro area. Estonia joined the ERM II on 28 June 2004. Estonia's representatives have stressed the need to keep the focus of analysis on issues that are vital for the functioning of the ERM II. The topics related to the ERM II were also on the agenda of the meetings of the Council of the European Union (see pp 63).

European Systemic Risk Board

In February 2009, the high-level working group set up by the European Commission and chaired by Jacques de Larosière issued 31 recommendations regarding the organisational structure of the supervision of EU financial institutions and markets. The working group made suggestions for how to strengthen supervision over financial stability in Europe and for early warning mechanisms and crisis management. In May 2009, the European Commission issued a notice on financial supervision in Europe, which included recommendations for revising the EU supervision framework and for establishing the European Systemic Risk Board (ESRB). The ESRB should start operating in 2011 (for further information see pp 41).

Council of the European Union

Besides participating in the committees and

other bodies of the European System of Central Banks, Eesti Pank's representatives also attend various committees and working groups set up by the Council of the European Union, or the Council of Ministers. In April and October 2009, the Governor of Eesti Pank attended the informal meetings of the Economic and Financial Affairs Council (ECOFIN). Topics of discussion included the European and global economic situation and outlook; issues related to EU financial stability, such as harmonisation of the supervisory practices of the EU financial sector; the planning of exit strategies for crisis-related measures; improvement of public finances; and developments in the five years since the EU enlargement.

In addition, central bank experts advise the officials of the Ministry of Finance preparing for the monthly ECOFIN meetings on matters within the competence of Eesti Pank. In 2009, such matters included ensuring the sustainability of public finances; assessment of Member States' economic and monetary policies; supervision of financial markets; and cross-border crisis management, including assessment of financial sector stress test results. At the end of the year, exit strategies for the financial crisis and future economic strategies were high on the agenda. The ECOFIN also adopted common EU positions for meetings with the IMF and the G20.

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 that deal with issues of the international economy and coins. Since the EFC prepares the meetings of the ECOFIN, all important ECOFIN issues were also discussed in the meetings of 2009.

Topics of discussion in the Council of the European Union in 2009

The economic situation in the European Union. The year 2009 witnessed rapid changes in the economy, including the first signs of recovery in the second half of the year. Work also became more intense at EU level, with the

assessment of measures taken under the European Economic Recovery Plan and the development of exit strategies for the crisis.

Eesti Pank's statements focused on economic policy issues that concern Estonia and other ERM II members, including long-term fiscal sustainability, inflation and structural policies. It was important for Estonia to receive an adequate and objective assessment from the EU, which was ultimately generally in line with the central bank's expectations.

Euro area expansion. Eesti Pank finds that it is in the interests of the whole of the EU that expansion of the euro area should take place in accordance with the terms of the Foundation Treaties of the European Community and under uniform rules. Otherwise, the credibility of the euro as an international reserve currency would be compromised.

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

Financial supervision and crisis management at EU level. Cross-border partnership in financial supervision and crisis management strengthened in 2009, leading to the first results from the reform of the financial supervision framework, such as the agreement to set up the European Systemic Risk Board. Given the way Estonia's financial system operates, closer cross-border cooperation in financial supervision is of utmost importance. Eesti Pank supports the clear division of roles between the national institutions of the home and host countries (Estonia is a host) in supervision over cross-border banks and financial crisis management.

Representatives of Eesti Pank participated in a high-level working group in 2009, which was initially established to prepare a pan-European crisis simulation exercise. When the global crisis erupted, the working group started to monitor the bottlenecks in the organisational aspects of financial regulation at EU level.

Common position of the EU on issues related to the IMF. The central bank made an active contribution to discussions on strengthening the monitoring of economic policies and revising credit policies in IMF member states, during which countries made joint efforts to address the global economic and financial crisis and to help restore economic and financial stability. A special focus was on strengthening the credit lines of the IMF to increase the Fund's resources, and boosting global liquidity by issuing SDRs¹ to IMF member countries. Other topics on the agenda included reform of the governance of the IMF, which also covered the issue of quotas and representation. Eesti Pank was also involved in the spring and autumn meetings of the IMF's International Monetary and Financial Committee (IMFC), for which the common positions of the EU are shaped.

Statistics. Eesti Pank has for years supported the development and application of best practice in statistics. In 2009, a lot of attention was paid to the quality and harmonisation of statistics in the EU countries. The central bank contributed to the efficient use of the resources, which are needed for collecting, processing and publishing statistics by setting the priorities for this work (see also "Statistics", pp 44).

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. These committees

¹ SDRs (special drawing rights) are units of account created by the IMF in 1969. The value of SDRs is based on a basket of four currencies (USD, EUR, JPY and GBP).

address issues related to communications, statistics, economic forecasts, payment and settlement systems, banking, banknotes and coins, and counterfeit money. Regular meetings with European Commission experts take place in Estonia and Brussels to discuss Estonia's economic outlook and to identify the data that the Commission needs to produce economic forecasts for EU Member States.

Cooperation with the International Monetary Fund

The International Monetary Fund is a very important forum for international cooperation involving 186 countries, representing most of the world. The main objectives of the IMF are to ensure the stability of the international monetary and financial system, support stable and sustainable economic growth, and through this, prevent financial and balance of payments crises, and facilitate international trade. Eesti Pank is responsible for representing the interests of Estonia in the IMF.

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

Day-to-day cooperation with the IMF traditionally takes place in the Nordic-Baltic Constituency, which represents Estonia. The Constituency contains eight countries, Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden, which elect a joint representative to the Executive Board of the IMF. In 2009 the Director of the Constituency was Jens Henriksson from Sweden and since January 2010 the Director has been Per Callesen from Denmark. The Constituency coordinates the positions of the eight countries on issues discussed in the Executive Board

for participation in the daily decision-making process of the IMF.

Strategic issues 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 daily coordinators of the Constituency meet once a year.

In 2009, IMF representatives made two visits to Estonia within the framework of bilateral surveillance. The IMF Mission visited Estonia on 12–18 May and regular economic policy consultations under Article IV of the IMF Articles of Agreement were held on 14–26 October. The Article IV Report on the autumn visit was published in January 2010 on the websites of the IMF and Eesti Pank after a discussion in the IMF Executive Board.

The next mission to Estonia is planned in autumn 2010 after a short visit in spring.

Key topics in the IMF forums in 2009

Given that the mandate of the IMF is to cover the full range of macroeconomic and financial sector policies that bear on global stability, the Fund has played a central role since the start of the global economic crisis by responding to the crisis and reforming the international financial architecture.

The IMF's lending facilities. The IMF has mainly been focusing on supporting the countries that have been most affected by the crisis. A number of IMF member states have provided additional funding to the IMF through bilateral loan agreements in order to ensure that the Fund has sufficient lending facilities and guarantees to meet the increased demand for financial aid. In addition, the IMF has decided to strengthen its credit lines by selling a limited amount of its gold reserves and issuing IMF bonds for the first time in the Fund's history. Since the global economic

environment has significantly changed and the risks to the economy remain high, the IMF has revised its lending policies and credit lines.

The Fund allocated a total of 283 billion USD worth of SDRs to its member states² to boost global liquidity. The Fund aimed to prevent a global stagnation or even recession and maintain liquidity.

IMF surveillance. Global financial tensions are gradually easing and the focus of the IMF now lies on the exit strategies. Nevertheless, surveillance remains high on the Fund's agenda. The key point of discussion is how to merge the IMF's bilateral surveillance (Article IV consultations) and its multilateral surveillance and achieve greater conformity between the macroeconomic and financial sectors. It is also important to enhance the mechanisms for detecting and analysing economic vulnerabilities and to improve risk assessments in order to avoid future crises. The IMF and the Financial Stability Board (FSB)³ are developing a more reliable early-warning system. Both organisations use their expert knowledge to identify global risks and the bottlenecks in the international financial sector more accurately.

The IMF is also included in the implementation of the Framework for Strong, Sustainable and Balanced Growth, which was adopted in September 2009 at the Summit of the G20. The G20 strives to shape the policies and strategies of its member states, so as to ensure sustainable and balanced global growth and to achieve this, the analytical skills of both the IMF and the World Bank are needed. The Fund has been required to assess the conformity of the action plans of the G20 countries and, where necessary, recommend additional policy measures. The first interim results are expected for the G20 Summit in June 2010.

Surveillance is one of the key responsibilities of

the IMF, as laid down in its mandate. Therefore Eesti Pank considers it important to strengthen IMF surveillance, in particular as regards closer monitoring of the financial sector and closer links between the surveillance outcomes and general economic surveillance. In assessing global financial and funding risks, Eesti Pank considers it crucial to develop global risk assessments at regional and group level, rather than relying on the country-based approach. In addition, cross-border crisis management should be better coordinated between countries.

Reforming the system and principles of management. Discussions on the reform of the IMF's governance also continued in 2009. The current crisis has demonstrated the ability of the IMF Executive Board to respond rapidly to the needs and expectations of the member countries. However, increasing the legitimacy of the IMF and enhancing political support by strengthening the voting power of low-income countries are still on the agenda as steps towards compliance with the mandate of the IMF.

At this point, the priority is to complete the reform of quotas and voting power that was adopted in 2008. The reform will simplify the formula for calculating the quotas and increase the quotas and voting powers of under-represented countries. The reform will be completed as soon as the member states have ratified the necessary amendments to the IMF Articles of Agreement by 30 April 2010.⁴

The next revision of quotas will take place before January 2011, two years before a regular revision, to increase the IMF's legitimacy even further. The leaders of the G20 and the IMFC have proposed raising the quotas of emerging and developing countries by at least 5% at the expense of over-represented member states. The proposal is under review in 2010.

² Estonia received 63.7 million SDRs from the IMF as a result of two allocations.

³ The Financial Stability Board was established in April 2009 to replace the Financial Stability Forum (FSF).

⁴ After the reform, Estonia's quota and voting power in the IMF will increase by 31% and 16% respectively. Under the present formula, the quota for Estonia is 65.2 million SDRs (about 1.1 billion kroons), which represents 0.03% of total quotas. Estonia currently has 902 votes (0.04% of total votes).

As a member of the Nordic-Baltic Constituency, Estonia has always supported moves to make the governance of the IMF more effective, while also ensuring appropriate representation of the European Union, including Estonia, in the governing bodies of the IMF.

Cooperation with the Bank for International Settlements

The Bank for International Settlements (BIS) is one of the oldest forums for cooperation among central banks. Eesti Pank was one of the founders of the BIS in the 1930s and the Governor of Eesti Pank attends regular meetings of the heads of central banks.

The meetings address topical monetary policy issues, including the role of the central bank, the economic and financial situation in different regions, and financial sector management and supervision.

Cooperation with rating agencies

Since 1997, Estonia has been assessed by three major international rating agencies, Moody's Investors Service, Standard & Poor's and FitchRatings. Eesti Pank coordinates relations

between Estonia and the rating agencies. This includes annual visits of the rating agencies to Estonia once a year and day-to-day communication with the analysts of the agencies (see also "Sovereign rating", pp 113).

DOMESTIC COOPERATION

Experts and executives of Eesti Pank participate in various bodies for cooperation in Estonia (see Table 3).

Quarterly meetings are held by Eesti Pank for officials of the central bank, the Ministry of Finance, the Ministry of Economic Affairs and Communications, the Prime Minister's Office, and the Economic Adviser to the President of the Republic. The topics of discussion include Estonia's economic situation and forecast, fiscal strategy, financial stability, the labour market, international cooperation, and similar issues. Joint committee meetings of Eesti Pank, the Ministry of Finance and the Financial Supervision Authority discuss financial sector policy issues.

Eesti Pank participates in the committee of experts chaired by the Ministry of Finance which is preparing for the changeover to the euro in Estonia. The last months of 2009 were especially

Table 3. Domestic cooperation of Eesti Pank

- European Union Coordination Council
- Lisbon Working Group
- National Changeover Committee and its sub-working groups
- Working Party of Foreign Relations Counsellors
- Estonian working group of the European Payments Council (EPC)
- Working Group on Financial Services Legislation
- Coordination Committee for Combating Money Laundering and Terrorism
- Development Cooperation and Development Assistance Working Group
- Accession negotiations committee of the Organisation for Economic Cooperation and Development (OECD)
- Working group for the development of national positions for representing Estonia in the European Commission, the European Court of Justice and the Court of First Instance
- Working group for the future enlargement of the European Union

busy for the committee and its working groups. As the date for the expected changeover to the euro is approaching, the experts of the central bank and other state institutions and private sector representatives have stepped up preparations in cash circulation, harmonisation of payment and settlement systems, legal issues, and public communication. The latest detailed version of the Estonian National Changeover Plan was completed and submitted to the Government in February 2010.

The Governor of Eesti Pank also belongs to the political working group that is chaired by the Prime Minister and that is responsible for monitoring compliance with the Maastricht criteria and coordinating Estonia's accession to the euro area.

The presidency of the European Union changes every six months, which means that Estonia's national policy priorities and short-term objectives must be revised for each new presidency. Eesti Pank sets the central bank's fields of priorities in the European Union and informs the Government about them. The Government's long-term objectives are established in a three-year framework programme that aims to achieve Estonia's general objectives in the European Union.

Participation in the EU decision-making process is coordinated by the European Union Coordination Council, which was set up in 2005 and which includes representatives of all ministries and the central bank. The Council coordinates the transposition of European Union legislation, discussion of EU-related positions submitted to the Government, and the exchange of information between state agencies on EU matters.

Cooperation with the Office of the President

A member of the Executive Board of Eesti Pank, Märten Ross, is a member of the President's Academic Advisory Board. The Board analyses various sides of life in Estonia and makes recom-

mendations for the balanced development of the country.

Cooperation with the Ministry of Finance

Eesti Pank and the Ministry of Finance collaborate on a daily basis on drafting legislation, in international communications and in several other areas.

A traditional joint seminar was held in 2009, with the focus on the long-term sustainability of economic and fiscal policies.

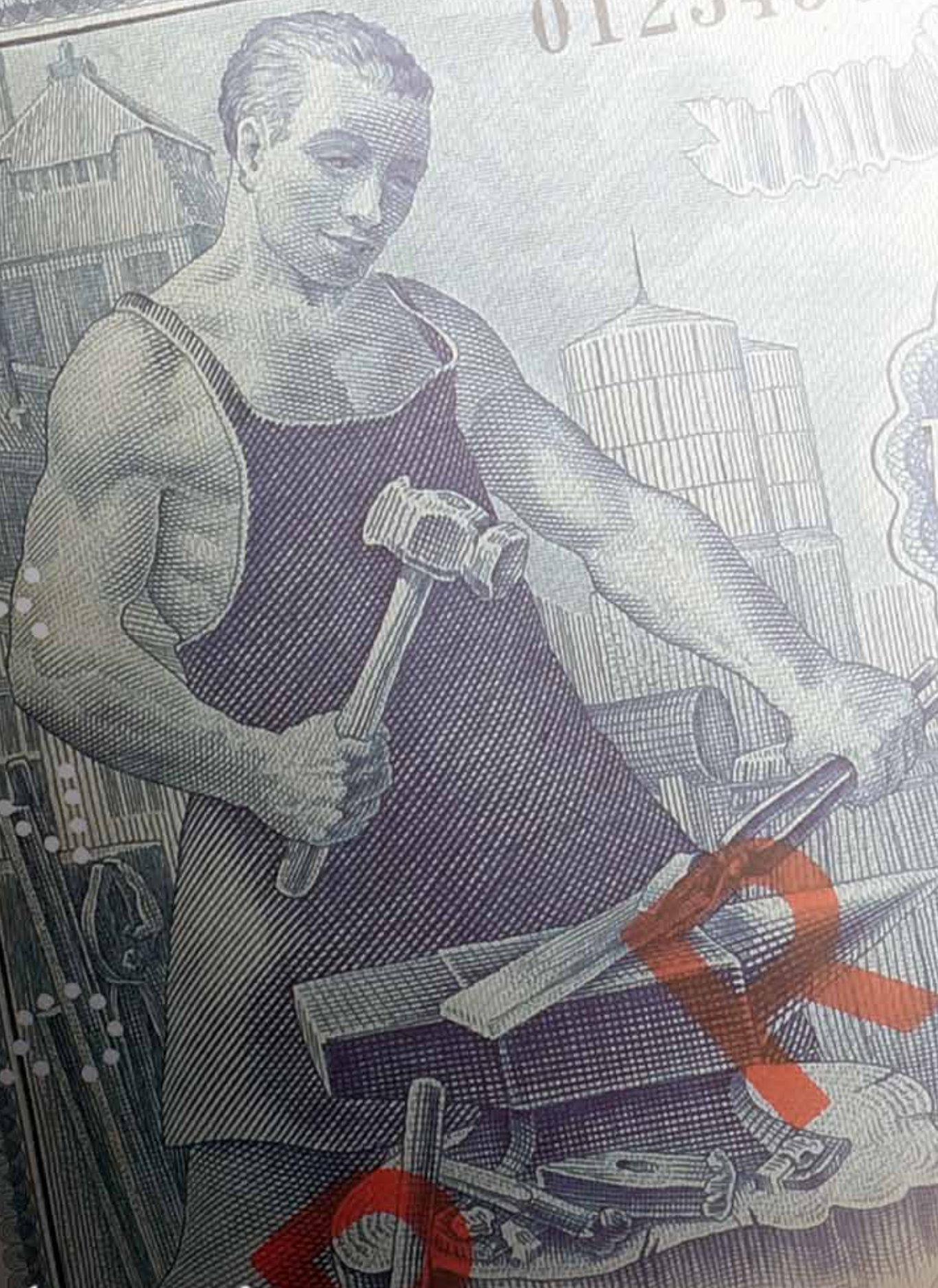
Cooperation with the Financial Supervision Authority

Cooperation with the Financial Supervision Authority involves the surveillance of financial system developments, financial sector regulation and international cooperation.

Cooperation with the Estonian Banking Association and commercial banks

Eesti Pank had several high-level meetings with members of the Estonian Banking Association (commercial banks operating in Estonia) in 2009. These meetings form a basis for cooperation and information exchange with the private sector. Experts of commercial banks often meet representatives of the central bank to clarify technical issues regarding the Estonian banking infrastructure.

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Public relations



PUBLIC RELATIONS

Eesti Pank operates a currency board system with a fixed exchange rate. The goal of central bank communication is to support the stability of Estonia's monetary system, economy and financial system. Communication draws on the strategic objectives of the Bank and the organisation's understanding of the central bank's role, and it helps shape reasonable market expectations. The principles of communication have been adopted, which state that communication should:

- ensure public understanding of and sufficient support for the monetary policy pursued by the central bank;
- maintain and respect 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, that works in a transparent and monitored way, and that is willing to communicate with all social groups;
- ensure the best possible access for economic agents to the background information they need for making economic decisions.

Principles of public relations

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

Eesti Pank has undertaken to publish information more extensively and frequently than laid down by its legal accountability requirements (see also "Accountability", pp 16). The central

bank publishes overviews of Estonia's economy six times a year. On two occasions, the overview contains an economic forecast and on two occasions a review of financial stability. Crucial developments in the economy were brought to the public in the series called Flash Reports. In addition, regular reports on preparations for the adoption of the euro and on labour market developments were published in 2009 (see also "Publications of Eesti Pank in 2009", pp 130).

The central bank considers it important to provide information that is up-to-date as possible in the most convenient and the least expensive way. Eesti Pank's regular publications are free of charge for all subscribers and libraries. Information can be received not only from the central bank's publications and website, but also from direct inquiries to Eesti Pank by mail, e-mail or phone. In 2009, Eesti Pank received a total of 3,252 inquiries: 2,180 by phone, 987 by e-mail, mail or fax, and the rest through the *Ask a question* interface on the Bank's website. Twenty-seven of the written inquiries were registered as requests for information.

Media relations and public appearances

Approximately 6,200 written articles, news items, and radio and TV news stories making reference to the functions and economic policy standpoints of Eesti Pank were published or released in the Estonian media in 2009. Interest in finance and banking heightened considerably in September 2008 and remained high throughout 2009. The key topics of interest in the first half of the year were the general well-being of the economy and the banking sector, while in the second half the focus of interest shifted to public finances and the prospects for the changeover to the euro.

Eesti Pank mainly features in the media in connection with economic developments. The top

stories in the central bank's media coverage in 2009 included the economic statements of Eesti Pank (844 articles) and comments on recession, global economic developments and general economic policy issues (760 articles). Eesti Pank's positions on the country's fiscal position and on euro-related matters were referred to in around 770 and 570 cases respectively. The central bank's statements about the situation in the banking and loan market received somewhat less media coverage with around 470 articles. References to Eesti Pank and its assessments are also made in other media coverage and used by other analysts or experts.

In 2009, the central bank gave ten press conferences and presentations, and issued 171 press releases and statements, and around 50 economic policy articles and longer interviews. The Bank's staff made also around 50 public presentations and appearances in Estonian or English.

90th anniversary of Eesti Pank

Eesti Pank was established in 1919, a year after the founding of the Republic of Estonia. The regular work of Eesti Pank commenced on 3 May 1919. After Estonia regained independence in 1992, the current central bank was declared the legal successor of the Eesti Pank that was established in 1919.

The 90th anniversary of the founding of Eesti Pank was celebrated in May 2009 with a number of events that aimed to confirm the role and responsibilities of the central bank. For instance, public lectures were held in the Bank once a week throughout May to give an overview of the current and future responsibilities of Eesti Pank once Estonia becomes a member of the euro area, and to present the work of the Financial Stability Department, the Cash and Security

Department, the Financial Markets Department and the Clearing and Settlement Department. In addition, excursions were held in the historical premises of the central bank. At the beginning of May, an exhibition dedicated to the 90th anniversary was opened in the Eesti Pank Museum while another exhibition dedicated to the Bank's anniversary by artist Siim-Tanel Annus was exhibited in the gallery of Eesti Pank.

Celebration of the historical premises of Eesti Pank

Among other events dedicated to the 90th anniversary of the founding of Eesti Pank, the historical premises of Eesti Pank all over the country received special memorial tablets. Eesti Pank had 12 departments across Estonia during the period 1922–1940, five in rented buildings and seven in new premises. Nine of the twelve offices received memorial tablets to commemorate the anniversary. The ceremonies included presentations by members of the Executive Board on the economic situation in Estonia, the latest economic forecast and the prospects for joining the euro area.

Eesti Pank Museum

In 2009, the Eesti Pank Museum received a total of 8,026 visitors, of whom 4,586 were exhibition visitors and 3,440 were coin purchasers. The value of coins sold totalled 8.6 million kroons.

There were three temporary exhibitions in the Museum in 2009:

- one in February, featuring various medals;
- one in May to celebrate the 90th anniversary of Eesti Pank;
- one in June dedicated to the tradition of song and dance festivals.

For the XII Festival of Estonian Museums, the Eesti Pank Museum prepared an exhibition on bank cards. The travelling exhibition *Estonian Money from the Mark to the Euro* visited Rakvere and Tallinn.

Yet another exhibition dedicated to the anniversary of Eesti Pank, *Our Own State, Our Own Money: Monetary Reforms in the Republic of Estonia*, was shown in Kohtla-Järve.

The Eesti Pank Museum also took part in the Museum Night in Tallinn on 16 May. The Museum was open from 7.00 pm to 12.00 midnight and offered special programmes, quizzes and games for over 800 visitors, who provided very positive feedback.





G. Reindorff

Governance,
organisation
and human
resources policy



GOVERNANCE, ORGANISATION AND HUMAN RESOURCES POLICY

Governing and decision-making bodies of Eesti Pank

Supervisory Board of Eesti Pank

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

- 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; appointment and removal of two members to the Supervisory Board of the Financial Supervision Authority¹ on the proposal of the Governor of Eesti Pank;
- Approval of the Statute of Eesti Pank, the statutes of its independent divisions and representations and the Statute of the Internal Audit Department;
- Supervision over the execution of the Eesti Pank budget;
- 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;
- Making decisions regarding the denomination and design of new banknotes and coins;

- Making decisions regarding the establishment, reorganisation and liquidation of the independent divisions of Eesti Pank on the proposal of the Governor;
- Reviewing and approving 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, and the implementation of the central bank's budget.

The Riigikogu appointed the current Supervisory Board of Eesti Pank to office on 18 February 2009. The Board includes Jaan Männik (Chairman of the Board, appointed to office on 13 June 2008); Kalev Kallo, Member of the Riigikogu; Irene Kull, jurist; Enn Listra, Dean of the School of Economics and Business Administration at Tallinn University of Technology; Tõnis Palts, public figure and economist; Liina Tõnisson, public figure and economist; and Professor Urmas Varblane, University of Tartu. In relation to the appointment of Jürgen Ligi as Minister of Finance on 4 June 2009, his membership of the Supervisory Board of Eesti Pank has been suspended. For the time of Mr Ligi's position as a member of the Government, the Riigikogu appointed Valdo Randpere the alternate member of the Supervisory Board of Eesti Pank as of 26 January 2010.

Governor of Eesti Pank

Andres Lipstok commenced his duties as Governor of Eesti Pank 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

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.

and organising the tasks of the central bank. The Governor of Eesti Pank is, by virtue of office, the Chairman of the Executive Board.

In 2009, the Executive Board comprised Governor Andres Lipstok and Deputy Governors Rein Minka and Märten Ross. Until termination of employment at Eesti Pank (31 July 2009) the Board also included Deputy Governor 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 public and international relations, development of the legal environment, supervision of the bank's management systems, internal administrative services and the operational working environment.

Deputy Governor Rein Minka is responsible for coordinating the tasks related to currency circulation; safety of the working environment; development and implementation of financial sector policies; coordination of collection, handling and disclosure of financial sector information; supervision of payment and settlement systems; reliable, cost-efficient and integrated development of the settlement system of Eesti Pank; the information technology working environment, and human resources management.

Deputy Governor Märten Ross is responsible for the preparation and implementation of monetary policy decisions; management of the financial assets of Eesti Pank; coordination of collection, compilation, and disclosure of national statistics; financial accounting and reporting; 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 2009, the Committee included members of the Executive Board – Governor Andres Lipstok and Deputy Governors Rein Minka and Märten Ross – and Janno Luurmees, Head of the Financial Markets Department; Ülo Kaasik, Head of the Economics Department; Tanel Ross, Head of the International and Public Relations Department (until termination of employment at Eesti Pank on 30 November 2009); Rait Roosve, Head of the Cash and Security Department, and Jaak Tõrs, Head of the Financial Stability Department. Until termination of employment at Eesti Pank (31 July 2009) the Committee also included Deputy Governor Andres Sutt. On 7 December 2009 Martti Randveer, Head of the Research Department, was appointed a member of the Committee.

Cooperation with the Financial Supervision Authority

The Financial Supervision Authority (FSA) operates as an agency of Eesti Pank. It exercises national supervision over banks, insurance companies, financial intermediaries, investment funds and management companies licensed and operating in Estonia as well as the securities market.

The FSA is governed by the Supervisory Board chaired by Raul Malmstein. The activities of the FSA are planned by the Supervisory Board chaired by the Minister of Finance by virtue of office

(Ivari Padar and Jürgen Ligi in 2009). Members of the Supervisory Board include Governor of Eesti Pank Andres Lipstok and as of 20 October 2009 Deputy Governor Rein Minka (until 20 October 2009 Deputy Governor Andres Sutt).

Development of the management system and work organisation of Eesti Pank in 2009

Organisational values and value-based management

The Executive Board of Eesti Pank has defined the following values of Eesti Pank.

Competence

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

Cooperation orientation

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

Reliability

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

Consideration

- We keep each other informed in regard with our work and give feedback

- We give recognition to good employees
- We have consideration for others and we are helpful and obliging

These values are part of the Bank's management system. They are used in the daily and case-by-case analysis of work as well as in more general analysis conducted in annual development interviews. In order to keep the values better in mind, team building trainings were organised for the staff of Eesti Pank at the end of 2009.

Regular study of management quality and development interviews

In autumn 2009, the central bank and TNS EMOR conducted a regular study on commitment and quality of management. This study has been conducted since 2001 and involves the entire organisation. Its purpose is to identify the strengths and development needs of the Bank in terms of the key determinants of management quality. The feedback from employees on the structural and human capital of management has provided useful input for management decisions. Feedback on commitment and its key determinants is valuable information for top executives and the Human Resources Department with regard to motivation of employees.

In 2009, 78% of the employees participated in the study, which enabled to produce representative results. One of the most significant indicators, namely the indicator of general commitment, had considerably improved from earlier levels. However, much of it is likely to be attributed to the turbulent external environment. Members of management received personal feedback across management competencies. This feedback is used also in appraisal interviews to make personal development plans.

For the second time the survey also established how the employees perceive the Bank in light of the defined values or, in other words, how these values are taken notice of in everyday work situations. Departments could compare their own valu-

ation with the Bank's average and top executives could see whether the values are perceived similarly or whether there are considerable differences across departments.

The traditional appraisal interviews were conducted also in 2009. The Human Resources Department compiled a summary of the interviews with the focus on the staff's proposals concerning the organisation. The summary was presented at a seminar for all employees and also at the traditional spring seminar where members of the Executive Board and the management could debate on the proposals.

For the first time feedback on appraisal interviews was required from the entire staff, using the study on commitment and quality of management for that purpose. The feedback will be used to make the appraisal interviews even more efficient.

Development of the management system of Eesti Pank

The Process Management Development Committee and the Risk Management Committee commenced their work in 2009. In autumn 2009 the Management System Development Committee started work. This Commission is responsible for making and analysing proposals regarding the development of the management system of Eesti Pank. The main activities in 2009 included the launch of the Commission and discussion over the issues of business continuity and risk management. In addition, the introduction and methods of activity-based budgeting and the improvement of the public strategy document of Eesti Pank were on the agenda.

Bureau Veritas Eesti OÜ carried out a compliance audit in Eesti Pank and validated the ISO 9001:2000 Quality Certificate issued to the Cash and Security Department in 2008. 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.

In financial and management accounting, a new business management software SAP, which is also used by various other banks of the European System of Central Banks, was introduced. The objective is to adopt accounting principles and procedures that comply with the needs of Eesti Pank and are similar to the principles and procedures employed by other central banks of the euro area. This contributes to the improvement of the Bank's financial and management accounting, provide the management system with comparable and high quality data, and ensure readiness for the accession to the euro area.

Risk management

The management of risks and business continuity continued in 2009 in compliance with the established principles and procedures. The transition of the responsibilities of the Risk Management Committee to the Management System Development Committee slightly increased the role of heads of department and the risk manager of Eesti Pank in tactical risk management. The Committee focuses on the issues of general and strategic risk management.

The total cost of risks decreased 17% with the year and stood at 556 million kroons in December 2009. Compared to 2008, risks related to the processes of monetary policy, administration and human resources management declined. At the same time, risks related to the working environment and information systems increased.

In 2009, the security concept of Eesti Pank and thus also the risks to physical security were revised in light of the expected accession to the euro area. Analysis showed that the introduction of euro cash might increase the security risks of Eesti Pank by several times. Consequently, the security concept was improved and risk management methods were integrated in the departments' work schedules.

In order to improve business continuity, the Man-

agement Board decided to develop business continuity plans for two more processes: monetary policy making and ensuring financial stability. These plans will be adopted in March 2010 at the latest. Then seven processes will be covered with business continuity plans, which will facilitate better preparedness for emergencies. To this end, also some offices of Eesti Pank were customized to be used as substitute spaces in case the operation of any critical process is no longer possible on its original site.

The objectives of business continuity in 2010 include testing of the plans, the implementation of the amended Emergency Preparedness Act and various activities related to accession to the euro area.

e-Eesti Pank in 2009

In 2009 the technical specifications for the document and information management of Eesti Pank (e-Eesti Pank) were developed. In other words, the internal records of the central bank are digital and they can be approved, confirmed and submitted through specific electronic workflows. It is also possible to digitally compile, approve, sign and submit external documents.

In 2009, the resolution workflow was established for processing incoming and internal electronic documents. The incoming paper documents are scanned and stored in the digital repository.

For digital correspondence, a contact database was developed in 2009.

Eesti Pank's human resources policy

The aim of Eesti Pank's human resources policy is to ensure the recruitment of employees needed for accomplishing the main objectives of the bank, to develop and train as well as motivate and provide fair remuneration to the staff.

Employees

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

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

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

In 2009, the total remuneration (basic wages and additional remuneration) paid to the members of the Supervisory Board amounted to 1,798,400 kroons and that of the Executive Board to 5,903,918 kroons.

Non-managerial positions have been assessed on the basis of the Hay method. Depending on the assessment results, all positions have been divided into wage groups listed in the classification of central bank positions. Eesti Pank has implemented a wage scale that comprises all wage

grades. The employees (members of the Executive Board excluded) receive remuneration on the basis of their wage grade, comparable by groups of similar work within as well as outside the bank.

The average monthly wages (including holiday pay and additional remuneration for working during evening and night hours, on days off and public holidays) in Eesti Pank amounted to 28,880 kroons in 2009. This includes the top executives as well as the support staff, but the majority of the central bank employees (nearly 85%) are specialists. The intermediate-level specialists employed in Eesti Pank must have a Master's degree, at least three years of professional experience and proficiency in written and oral English. They are also expected to attend some EU or European Central Bank working group. The monthly wages of a specialist complying with these requirements is approximately 22,430 kroons.

At the beginning of 2009, the bank had contracts of employment with 257 employees (238 were actually working, as contracts with 19 employees had been suspended), whereas at the end of the year the respective figure was 254 (232 were actually working and 22 contracts had been suspended). The 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 2009 was 42.5 years. The employees included 101 men (40%) and 153 women (60%).

Development and training

Development costs totalled 3.6 million kroons in 2009, which accounts for 3.1 % of the staff's payroll. In total, 191 employees (82% of the staff) attended trainings. On average, an employee received 5.2 days of training with the total cost of 15,642 kroons.

The most common core fields of training in 2009

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

In 2009, 54 employees were engaged in academic studies: 75% of them were acquiring a Master's or Doctor's degree.

Three employees participated in secondment programmes at the European Central Bank.

Hobbies and traditions of the staff

At the end of 2009, Eesti Pank's Sports Club had 227 members. Fitness, swimming, basketball, yoga, badminton, volleyball, gym, tennis, aerobics and water aerobics were the most popular fields of sport. In addition, winter and summer sports days. Some of the staff also attended the Tartu Ski Marathon.

In-house competitions were held in bowling, tennis and chess. Some employees participated in the sports events held by other European central banks: skiing in the Czech Republic, basketball in Belgium and chess in Hungary. There were also football and basketball competitions with the Financial Supervision Authority.

The chamber choir of the employees of Eesti Pank and the Financial Supervision Authority first gathered on 15 May 1998. The choir has 25 members and it is conducted by Peeter Perens, a conductor and singer at the Estonian Academy of Music and Theatre. The choir is coordinated by the board that is elected every year. In 2009, the choir attended the Estonian Song Festival and also hosted Euro-choir, the song festival of the choirs of European central banks.

Eesti Pank has also its own band, which first gathered in May 2009. The band plays rock and pop music and it includes eight employees. In 2009, two concerts were given.

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G. Reindorff

Annual
accounts
of Eesti Pank

for the financial year ended
31 December 2009



**APPROVAL OF THE ANNUAL ACCOUNTS FOR THE FINANCIAL YEAR ENDED
31 DECEMBER 2009 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 2009.

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

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

On 16 April 2010, 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

BALANCE SHEET AS AT 31 DECEMBER 2009 AND 2008 (EEK THOUSAND)

	Note	31/12/2009	31/12/2008
ASSETS			
Gold and gold receivables	1	99,057	79,553
Claims on non-residents denominated in foreign currency		43,459,024	43,610,202
Receivables from the IMF	2	2,173,802	1,126,856
Balances with banks, security investments and external loans	3	41,285,222	42,483,346
Intra-Eurosystem claims	4	11,294	10,745
Other assets		1,206,222	1,900,031
Tangible fixed assets	5	304,300	276,676
Other financial assets	6	3,397	3,441
Off-balance-sheet instruments revaluation differences	7	15,078	481,847
Accruals and prepaid expenses	8	133,199	280,148
Sundry assets	9	750,248	857,919
Total assets		44,775,597	45,600,531
LIABILITIES AND EQUITY			
Currency in circulation	10	9,777,491	11,996,322
Liabilities to residents related to the monetary policy	11	25,979,554	25,691,517
Liabilities to other residents denominated in kroon	12	99,684	102,017
Liabilities to residents denominated in foreign currency	13	838,663	179,828
Liabilities to non-residents denominated in foreign currency	14	109,636	0
Liabilities to the IMF	2	2,165,650	1,118,218
Other liabilities		161,648	205,186
Off-balance-sheet instruments revaluation differences	7	43,670	57,366
Accruals and deferred income	15	92,357	112,275
Sundry liabilities	16	25,621	35,545
Provisions	17	2,070	6,955
Revaluation accounts	18	102,154	740,987
Capital and reserves	19	4,853,501	4,312,407
Capital		600,000	600,000
Reserves		4,253,501	3,712,407
Profit for the year		685,544	1,247,094
Total liabilities and equity		44,775,597	45,600,531

The Notes on pages 88–101 form an integral part of the Annual Accounts.

PROFIT AND LOSS ACCOUNT FOR 2009 AND 2008 (EEK THOUSAND)

	Note	2009	2008
Interest income		853,103	2,353,608
Interest expense		-329,118	-1,353,434
Net interest income	20	523,984	1,000,174
Realised gains/losses arising from financial operations		395,530	587,408
Write-downs		-20,531	-46,073
Net result of financial operations, write-downs and risk provisions	21	374,999	541,335
Net result of fees and commissions	22	12,968	12,854
Dividend income	23	1,134	1,152
Other operating income	24	29,736	51,085
Operating expenses	25	-257,277	-359,506
Personnel expenses		-118,718	-125,996
Banknote and coin production costs		-22,087	-103,218
General administration expenses		-82,259	-94,665
Depreciation of fixed assets		-34,213	-35,627
Profit for the year		685,544	1,247,094

The Notes on pages 88–101 form an integral part of the Annual Accounts.

STATEMENT OF CHANGES IN EQUITY (EEK THOUSAND)

	Fixed capital	Reserve capital	Special reserve	Profit	Total
Balance at the end of 2007	100,000	500,000	3,348,268	485,519	4,433,787
Distribution of the 2007 profit	0	0	364,139	-364,139	0
Allocations to the state budget	0	0	0	-121,380	-121,380
Profit of 2008	0	0	0	1,247,094	1,247,094
Balance at the end of 2008	100,000	500,000	3,712,407	1,247,094	5,559,501
Distribution of the 2008 profit	0	0	541,094	-541,094	0
Allocations to the state budget	0	0	0	-706,000	-706,000
Profit of 2009	0	0	0	685,544	685,544
Balance at the end of 2009	100,000	500,000	4,253,501	685,544	5,539,046

The Notes on pages 88–101 form an integral part of the Annual Accounts.

NOTES ON THE ANNUAL ACCOUNTS OF EESTI PANK

ACCOUNTING POLICIES USED IN THE ANNUAL ACCOUNTS

General principles

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

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

Preparing the Annual Accounts 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.

The Executive Board of Eesti Pank is of the opinion that the publication of the Bank's Cash Flow Statement does not provide significant relevant information to the readers of the Annual Accounts of Eesti Pank, given its role as the central bank.

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

Financial assets and liabilities

Assets and liabilities are recorded in the Balance Sheet in case Eesti Pank is likely to achieve economic gains or losses from an asset or a liability in the future; nearly all 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 reliably.

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.

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

Financial assets recorded at adjusted acquisition cost are written down in case the recoverable amount of an asset is likely to be smaller than its carrying amount. The impairment of significant financial assets is assessed for each object separately. The impairment of financial assets that are not individually significant and that are not expected to be impaired is assessed for all assets together. Write-downs of financial assets are recorded as an expense of the accounting period in the Profit and Loss Account.

Recording of foreign currency transactions

The functional currency of Eesti Pank is the Estonian kroon. The transactions of financial instruments (except securities) denominated in foreign currency are recorded in off-balance-sheet accounts on the trade date. On the settlement date, off-balance-sheet entries are reversed and transactions are recorded on the Balance Sheet. The purchase and sale of foreign currency affect the net foreign-exchange position on the trade date; the sales proceeds are also calculated on the trade date. The interest accrued on financial instruments denominated in foreign currency and the premiums or discounts are calculated and recorded on a daily basis. These receivables also affect the foreign currency position on a daily basis.

Transactions in 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 2009 and 2008 were as follows:

	2009	2008
USD	10.8653	11.1052
SDR	17.0276	17.1521
EUR	15.6466	15.6466

Income recognition

Income and expenses are recorded in the Profit and Loss Account in the period in which they are earned or incurred, regardless of when cash was received or paid.

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

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

In the event of an unrealised loss on any item at the year-end, the average cost of that item is reduced to the year-end exchange rate or market price.

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 market value as at the year-end, equal to Eesti Pank's daily fixing of the Estonian kroon and gold.

Foreign currency claims on non-residents

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 foreign currencies are recorded at their year-end market value. Debt instruments are revalued on the last banking day of the year by reference to the market prices on the last banking day.

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

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

Investment in shares

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

Fixed assets

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

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

	2009	2008
Buildings	3%	3%
Utility systems of buildings	20%	20%
Hardware	33%	33%
Software	20–50%	20–50%
Other fixed assets	20%	20%

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

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

Currency in circulation

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

Claims on and liabilities to the Financial Supervision Authority

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

Off-balance-sheet instruments

Currency instruments, namely foreign exchange forward instruments, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses.

Interest rate instruments are revalued on an item-by-item basis. Daily changes in the variation margin of open interest rate futures contracts are recorded in the Profit and Loss Account. The valuation of forward transactions in securities and of interest rate swaps is based on generally accepted valuation methods using observable market prices and rates and the discount factors from the settlement dates to the valuation date.

Contingent liabilities

Contingent liabilities are recorded in the Notes to the Annual Accounts and include commitments, guarantees and other liabilities which may, under certain conditions, become liabilities in the future, whereas the probability of their realisation is considered lower by the management of the Bank than the probability of their non-realisation.

Post-balance-sheet events

Assets and liabilities are adjusted for events that occur between the balance sheet date and the date of compilation of the Annual Accounts but are related to transactions during the accounting period or earlier periods and/or materially affect the condition of assets and liabilities on the balance sheet date. Important post-balance-sheet events that do not affect the condition of assets and liabilities on the balance sheet date are disclosed in the Notes.

Notes on the Balance Sheet

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 2008	8,250.171	9,642.60	79,553
Revaluation	-	-	19,504
Balance at the end of 2009	8,250.171	12,006.70	99,057

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

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

Item 2 includes the SDR account in the IMF, participation in the IMF and other receivables. The value of SDR is determined on the basis of a basket of currencies. It is the weighted average of the exchange rates of the four main currencies (the euro, the Japanese yen, the pound sterling and the US dollar).

EEK thousand

	31/12/2009	31/12/2008
Participation in the IMF	1,110,200	1,118,317
SDR account in the IMF	1,056,172	1,054
Other receivables from the IMF	7,431	7,485
Total receivables from the IMF	2,173,802	1,126,856
IMF kroon accounts (liabilities)	1,110,102	1,118,218
Distribution of SDR	1,055,548	0
Total liabilities to the IMF	2,165,650	1,118,218

SDR account in the IMF

An SDR account is generated for every IMF Member State for conducting loan transactions and various other similar operations between a Member State and the IMF.

On 7 August 2009, the IMF decided to increase the SDR issues for all of its member states to increase global liquidity by providing support to the foreign reserves of the member states. As a result, Estonia received 61,965,241 SDRs.

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 2009, 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 "Liabilities to the IMF". These debt instruments do not bear interest.

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 about 0.1%.

EEK thousand

Other receivables from the IMF	31/12/2009	31/12/2008
Eesti Pank, SBA loan-related receivable	5,724	5,766
Government, STF loan-related receivable	1,707	1,719
Total	7,431	7,485

ITEM 3 – BALANCES WITH BANKS, SECURITY INVESTMENT AND EXTERNAL LOANS

EEK thousand

	Balance at the end of 2008	Structure of residual maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
	42,483,346	18,770,815	10,580,620	6,025,691	2,994,279	4,111,941
Cash and current accounts	632,850	632,850	0	0	0	0
Time deposits	2,567,965	2,567,965	0	0	0	0
Securities	37,686,577	13,974,046	10,580,620	6,025,691	2,994,279	4,111,941
Reverse repurchase agreements	1,595,954	1,595,954	0	0	0	0
	Balance at the end of 2009	Structure of residual maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
	41,285,222	23,958,788	13,815,399	1,640,000	811,189	1,059,847
Cash and current accounts	1,236,331	1,236,331	-	-	-	-
Time deposits	3,240,103	3,240,103	-	-	-	-
Securities	33,946,987	16,620,552	13,815,399	1,640,000	811,189	1,059,847
Reverse repurchase agreements	2,861,801	2,861,801	-	-	-	-

In 2009, 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 0.6 years.

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

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

ITEM 4 – INTRA-EUROSISTEM CLAIMS

Item 4 reflects participation of Eesti Pank in the European Central Bank (ECB). Pursuant to Article 28 of the Statute of the European System of Central Banks (ESCB), the national central banks of the ESCB are the sole subscribers of the capital of the ECB. Subscriptions depend on the capital key weighting established in compliance with Article 29.3 of the ESCB Statute. The capital key weighting is adjusted every five years, last on 1 January 2009. Consequently, Eesti Pank's share in the subscribed capital of the ECB increased from 0.1703% to 0.1790%.

Since the Republic of Estonia is not member of the euro area, the transitional provisions of Article 48 of the Statute apply. Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB. Owing to the change in subscription, the capital key share paid by Eesti Pank increased from 686,727 euros (10.7 billion kroons) on 31 December 2008 to 721,810 euros (11.3 billion kroons) on 1 January 2009. Eesti Pank is obliged to pay the remaining 93% after Estonia's accession to the Economic and Monetary Union.

ITEM 5 – TANGIBLE FIXED ASSETS

EEK thousand

Acquisition cost	Buildings	Hardware	Furniture and fixtures	Software	Total
Balance at the end of 2008	318,854	50,568	74,478	60,796	504,696
Acquisitions	24,589	4,555	2,959	3,383	35,486
Disposals	0	5,124	1,960	1,700	8,784
Balance at the end of 2009	343,443	49,999	75,477	62,479	531,398
Accumulated depreciation					
Balance at the end of 2008	82,684	40,600	58,261	50,382	231,927
Depreciation charge	17,376	5,770	6,095	4,972	34,213
Disposals	0	5,124	1,960	1,700	8,784
Balance at the end of 2009	100,060	41,246	62,396	53,654	257,356
Carrying amount					
at the end of 2008	236,170	9,968	16,217	10,414	272,769
at the end of 2009	243,383	8,753	13,081	8,825	274,042
Prepayments for fixed assets					
Balance at the end of 2008	3,892	0	15	0	3,907
Balance at the end of 2009	26,859	0	0	3,400	30,259
Total fixed assets					
at the end of 2008	240,062	9,968	16,232	10,414	276,676
at the end of 2009	270,242	8,753	13,081	12,225	304,301

The cost of fixed assets acquired in 2009 amounted to 35.5 million kroons (24.2 million kroons in 2008). The majority of the procurement of buildings was composed of costs related to the major repair of Eesti Pank's building at Sakala 4.

Hardware procurement included computers, servers, printers and data communication equipment. The majority of purchases of fittings included business machines, security devices and furniture. Software purchases included primarily system software and additional user licences for existing software.

ITEM 6 – OTHER FINANCIAL ASSETS – investment in shares and units

Shares held by Eesti Pank:

	Balance at the end of 2009		Balance at the end of 2008	
	Holding (%)	EEK thousand	Holding (%)	EEK thousand
Bank for International Settlements (BIS)				
214 shares (200 voting shares)	N/A	3,397	N/A	3,397
NASDAQ OMX Tallinn				
29 shares with nominal value à 4,000 kroons	-	-	1.1	44
Total		3,397		3,441

N/A – not available

On 18 November 2009, Eesti Pank sold its NASDAQ OMX Tallinn shares to NASDAQ OMX Nordic Oy.

ITEM 7 – OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

Item 7 reflects valuation changes in swap and forward transactions in foreign currency outstanding at year-end. These valuation changes are the result of the conversion of such transactions at the central exchange rates of Eesti Pank on the balance sheet date, compared with the values resulting from the conversion of the transactions at the average cost of the respective foreign currency on that date.

Valuation gains in outstanding interest rate swap transactions are also included in this item.

ITEM 8 – ACCRUALS AND PREPAID EXPENSES

EEK thousand

	2009	2008
Interest income	109,901	258,403
Securities	108,133	226,641
Derivative instruments	1,094	31,302
Time deposits and settlement accounts	555	302
Loans	118	158
Prepaid expenses	10,469	13,318
Claims on the Financial Supervision Authority	8,108	5,696
Other claims	4,720	2,731
Total	133,199	280,148

ITEM 9 – SUNDRY ASSETS

Item 9 consists mainly of euro cash in the total amount of 663.4 million kroons (751 million kroons in 2008) and loans issued to employees of Eesti Pank in the total amount of 63.5 million kroons (51 million kroons in 2008).

This item also includes positive balances related to swap and forward transactions in foreign currency that were outstanding on 31 December 2009 and totalled 11.8 million kroons (53 million kroons in 2008).

The balances related to swap and forward transactions arise from the conversion of such transactions into their Estonian kroon equivalents at the respective currency's average cost on the balance sheet date, compared with the kroon values at which the transactions were initially recorded.

Housing loans secured by real estate have been granted to employees of Eesti Pank for a maximum of 30 years and consumption loans for up to 2 years. The Supervisory Board of Eesti Pank establishes the interest rate on consumption loans for every 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 the standing deposit facility interest payable to credit institutions plus the risk margin but not more than the minimum loan interest rate established by the minister of finance. The deposit facility rate equals ECB deposit interest rate, which remained within 0.25–2% in 2009. In addition, study loans have been granted for a maximum of 10 years and with a 5% interest rate. Additional information on write-downs of loans is provided under Item 21.

ITEM 10 – CURRENCY IN CIRCULATION

EEK thousand

	2009	2008
Banknotes	9,613,196	11,833,949
Coins	164,295	162,373
Total	9,777,491	11,996,322

ITEM 11 – LIABILITIES TO RESIDENTS RELATED TO THE MONETARY POLICY

Item 11 includes the settlement accounts of credit institutions with Eesti Pank. The deposits of credit institutions increased by 288 million kroons in 2009. 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 2009, the deposit interest rate of the ECB decreased from 2% to 0.25%. 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

Item 12 reflects the funds in the account of the Financial Supervision Authority held with Eesti Pank, which subjects of financial supervision pay as supervision fees. Interests on the funds in the Financial Supervision Authority's account are calculated quarterly on the basis of the average balance of the settlement account. The interest rate is equal to the yield of the foreign exchange reserves.

In addition, this item reflects the settlement accounts of NASDAQ OMX Tallinn 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. Item 13 reflects the euro settlement accounts of Estonian credit institutions that have joined the TARGET.

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

Item 14 reflects repurchase agreements.

ITEM 15 – ACCRUALS AND DEFERRED INCOME

EEK thousand

	2009	2008
Interest expense	6,464	55,867
on deposits with credit institutions	5,770	44,555
on derivative instruments	694	11,312
Tax liabilities	10,539	11,161
Other liabilities	75,353	45,247
Total	92,357	112,275

ITEM 16 – SUNDRY LIABILITIES

Item 16 mainly includes negative balances related to swap and forward transactions in foreign currency that were outstanding on 31 December 2009 and totalled 10.2 million kroons (27.8 million kroons in 2008). These balances arise from the conversion of such transactions into their Estonian kroon equivalents at the respective currency's average cost on the balance sheet date, compared with the kroon values at which the transactions were initially recorded.

This item also includes 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).

Other entries include the settlement accounts of non-residents with Eesti Pank, contingent loan liabilities, the market value of options and the amounts paid as collateral for outstanding interest rate swap transactions.

ITEM 17 – PROVISIONS

Item 17 consists of performance bonuses to employees of the Financial Markets Department for the results of the financial year. The amount of bonuses is approved by the Deputy Governor in charge of the Financial Markets Department after the audited Eesti Pank Annual Report has been approved by the Supervisory Board of Eesti Pank.

ITEM 18 – REVALUATION ACCOUNTS

EEK thousand

	2009	2008
Foreign currencies	49,965	41,796
Securities	48,395	648,663
Derivative instruments	3,794	50,528
Total	102,154	740,987

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

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

ITEM 19 – CAPITAL AND RESERVES

Changes in capital and reserves in 2009:

EEK thousand

	Balance at the end of 2009	Distribution of 2008 profit	Balance at the end of 2008
Fixed capital	100,000	0	100,000
Reserve capital	500,000	0	500,000
Special reserve	4,253,501	541,094	3,712,407
Total	4,853,501	541,094	4,312,407

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 Estonia's accession to Economic and Monetary Union.

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.

The Supervisory Board of Eesti Pank decided to transfer 706 million kroons from the profit for 2008 to the state budget and 541.1 million kroons to the special reserve fund.

Notes on the Profit and Loss Account

ITEM 20 – NET INTEREST INCOME

	<i>EEK thousand</i>	
	2009	2008
Net interest income	523,984	1,000,174
Interest income	853,103	2,353,608
Securities	684,870	1,503,419
Derivative instruments	131,155	558,155
Reverse repurchase agreements	25,464	231,134
Time deposits	7,834	47,990
Settlement accounts	2,391	10,666
Loans to personnel	1,389	2,243
Other	0	1
Interest expense	-329,118	-1,353,434
Securities	-134,412	-94,480
Credit institutions' deposit interests	-102,514	-734,374
Derivative instruments	-89,796	-478,134
Settlement accounts	-1,130	-1,764
Repurchase agreements	-543	-39,893
Other	-722	-4,789

ITEM 21 – NET RESULT OF FINANCIAL OPERATIONS, WRITE-DOWNS AND PROVISIONS

EEK thousand

	2009	2008
Net result of financial operations	374,999	541,335
Realised gains/losses arising from financial operations	395,530	587,408
Securities	348,210	466,177
Derivative instruments	74,445	48,162
Income/expense of exchange rate differences	1,678	87,430
Financial asset management costs	-30,699	-14,361
Other	1,896	0
Write-downs	-20,531	-46,073
Securities	-9,065	-124
Derivative instruments	-7,571	-42,692
Exchange rate write-downs	-2,527	-3,189
Net change of loan portfolio write-downs	-113	-68
Other provisions	-1,255	0

ITEM 22 – NET RESULT OF TRANSACTION AND COMMISSION FEES

EEK thousand

	2009	2008
Transaction and commission fees	12,968	12,854
Settlement service costs	14,245	14,024
Commissions on futures and options	-1,405	-1,723
Fines, arrears and other	127	553

Item 22 mainly reflects income on servicing credit institutions' settlement accounts.

ITEM 23 – DIVIDEND INCOME

Item 23 includes dividends on the shares of the Bank for International Settlements and NASDAQ OMX Tallinn.

ITEM 24 – OPERATING INCOME

EEK thousand

	2009	2008
Operating income	29,736	51,085
Expenses compensated by financial supervision	15,245	9,598
Income from the sale of collector coins and numismatic-bonistic products	11,876	38,904
Income on asset management	1,538	1,677
Rental income	507	692
Income from the sale of assets	182	87
Other income	389	127

Income on services provided to the Financial Supervision Authority totalled 15.2 million kroons. The Financial Supervision Authority reimbursed as monthly payments 100% of the cost of the support services provided by Eesti Pank. Eesti Pank provides the Financial Supervision Authority with information technology, accounting, real estate, and administration services. The Financial Supervision Authority covers also the depreciation costs of fixed assets used.

Income from the sale of numismatic-bonistic products mainly consisted of income from the sale of collector coins.

Income from asset management includes the service fee paid by the Guarantee Fund to Eesti Pank for investing their assets.

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

ITEM 25 – OPERATING EXPENSES

	<i>EEK thousand</i>	
	2009	2008
Staff costs	-118,718	-125,996
Wages	-86,444	-92,657
Social tax	-29,086	-31,080
Compensation and benefits	-2,335	-1,988
Unemployment insurance	-853	-271

Staff costs include mainly wage costs, including taxes, but also performance bonuses to employees of the Financial Markets Department for the results of the financial year.

Compensation and benefits include pension benefits and fringe benefits tax calculated on the preferential interest rate on housing loans and the preferential price for the rent of the training centre.

The production costs of banknotes and coins mainly consist of the production costs of numismatic-bonistic products.

	<i>EEK thousand</i>	
	2009	2008
General administrative expenses	-82,259	-94,665
Information technology maintenance costs	-19,999	-19,306
Financial asset management costs	-17,174	-17,295
Real estate renovation and administration expenses	-13,760	-16,575
Business travel expenses	-6,777	-8,262
Public relations and publication costs	-5,695	-9,547
Training expenses	-3,637	-4,638
Office costs	-3,637	-4,189
Communications and transportation costs	-751	-1,326
Legal and arbitration costs	-510	-485
Other expenses	-10,318	-13,042

The costs of financial asset management and settlements comprise the cost of market information, fees and costs of cross-border payments, and management costs of foreign reserves.

The procurements of public relations and publications include the costs of public events, publications, market information, information agencies, the public web and online databases, public relations research polls, information campaigns, advertising and the Museum of Eesti Pank.

Business travel expenses reflect costs related to the representation of Eesti Pank and cooperation with international organisations and financial institutions. There were a total of 594 business trips in 2009 (735 in 2008).

Other expenses primarily consisted of costs of security, sovereign rating, the foreign representative of Eesti Pank, and economic research.

ITEM 26 – DERIVATIVE INSTRUMENTS

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

Futures purchase transactions with a contract value of 601.8 million kroons and futures sale transactions with a contract value of 3.008 billion kroons were outstanding as at 31 December 2009 (in 2008, 8.269 billion and 230 million kroons, respectively). The contract value of outstanding interest rate swaps totalled 1.209 billion kroons (in 2008, 1.542 billion kroons). Foreign exchange swap and forward transaction claims of 1.840 billion and liabilities of 1.862 billion kroons remained outstanding as at 31 December 2009 (in 2008, 5.539 and 5.087 billion kroons, respectively).

ITEM 27 – CONTINGENT LIABILITIES

EEK thousand

	Balance at the end of 2009	Balance at the end of 2008
Contingent liabilities	190,274	150,840
Uncalled share capital (75%) of BIS	7,911	8,085
Uncalled share (93%) of ECB participation	150,047	142,754
Contractual obligations to produce banknotes and coins	32,317	0

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 7.9 million kroons on the balance sheet date (see Item 6).

European Central Bank

In 2004, the Republic of Estonia joined the European Union and consequently Eesti Pank became a member of the ESCB. Since the Republic of Estonia is not member of the euro area, the transitional provisions of Article 48 of the ESCB's Statute apply. Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB. Eesti Pank is obliged to pay the remaining 93% in the amount of 9.6 million euros (150 million kroons) upon Estonia's accession to the Economic and Monetary Union.

Printing of banknotes and minting of coins

At the end of 2009, the contractual liabilities of Eesti Pank for printing banknotes and minting coins in 2010 amounted to 32.3 million kroons, which primarily arises from the potential costs related to the minting of euro coins.

Translation of the Estonian Original

INDEPENDENT AUDITOR'S REPORT

To the Supervisory Board of Eesti Pank

We have audited the financial statements of Eesti Pank, which comprise the balance sheet as at 31 December 2009, the report on revenues and expenses and statement of changes in equity for the year then ended, and a summary of significant accounting policies and other explanatory notes. The audited financial statements, which we have identified on the accompanying pages 84 to 101, are enclosed with the current report.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Eesti Pank as at 31 December 2009, and its financial performance for the year then ended in accordance with Eesti Pank Act and the accounting principles stated in the "Accounting Policies used in the Annual Accounts" of the accompanying financial statements.

Tallinn, 16 April 2010



Ivar Kiigemägi
Ernst & Young Baltic AS



Tiina Sõmer
Authorised Auditor

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G. Reindorf



Annexes



GLOBAL ECONOMY IN 2009

The year 2009 was still a difficult year for the global economy, mainly because advanced economies faced an extensive economic downturn. According to the IMF, global growth fell from 3% to -0.8% in 2009. However, the bottom of the recession in advanced economies came in the first and the second quarters, and in the second and the third quarters, there was a shift towards recovery as a result of the wide-ranging monetary and fiscal policy measures taken by the central banks and governments of these countries. Monetary policy interest rates were reduced to historical lows of 0.0–0.25% in the USA and to 1% in the euro area, and state budget deficits increased to almost 10% of GDP in some advanced countries. Together with shrunken inventories, these measures laid the foundation for the recovery of growth and the abatement of the credit and liquidity crisis that had hit the financial sector. At the end of 2009, economic growth accelerated, but the crisis was so extensive and deep that a rapid return to sustainable growth in advanced countries is still not expected. The global economic outlook is better, and GDP growth in 2010 is estimated at 3.9%.

Regionally, economic growth was very uneven in 2009 and the differences between advanced countries also deepened over the year. While the decline in GDP in advanced economies totalled to 3.2%, growth in emerging economies remained positive, although it slowed to 2.1%. The fastest economic growth was seen in developing Asian countries, where it was 6.5%, while China's economic growth was 8.7%, only one percentage point lower than in 2008. Central and Eastern Europe, in contrast, witnessed a deep recession, with the GDP of the region declining by 4.3% compared to the previous year. Among advanced economies, the GDP of the USA fell by around 2.5%. The economic downturn in the euro area was even deeper at 3.9%, and in Japan, GDP contracted by as much as 5.3%. Lower economic activity led to a rapid rise in unemployment, which reached 10% in the USA

and the euro area and 5.7% in Japan.

As total demand weakened, the inflation rate dropped remarkably in 2009, and was negative in all the G3 countries in the middle of the year. In advanced economies, total inflation dropped from 3.4% to 0.1%, which was caused, inter alia, by the base effect as a result of a decline in the prices of energy commodities. However, the return of commodity prices to growth at the beginning of 2009 and economic revival in the second half of the year laid the ground for the recovery of inflation. Inflationary pressures nevertheless remained weak in advanced economies due to high unemployment and underutilised production capacity. Japan still faced deflation with a 0.8% annual price decline.

In 2009, global financial markets showed signs of stabilisation, lower volatility and an improved economic outlook. The main stock indices of the G3 countries increased by 20–25% over the year, offsetting nearly half of the decline of 2008. As already noted, commodity prices also started to go up; the CRB index, which covers the prices of 22 major raw materials, increased by 34% over the year. The price of crude oil rose by 78% and there was still strong demand for gold, the price of which rose by 24% to over 1,000 dollars per ounce. The lowering of monetary policy interest rates and state support for the financial sector contributed to the fall in interest rates in the interbank money market. On the government bond market, short-term interest rates remained relatively low and stable due to weak economic growth while long-term interest rates rose somewhat.

UNITED STATES AND JAPAN

In 2009, the US faced an economic downturn, as GDP was 2.5% down compared to the previous year. The scale of the downturn is reflected by annual growth in industrial production, which had fallen to -13.3% by June. The bottom of the

recession was reached in the second quarter, and in the second half of the year a significant revival in economic activity could be observed. In the fourth quarter, annual GDP growth was already positive at 0.1%.

Falling production forced companies to cut costs and dismiss employees more vigorously. Unemployment, which had started rising in 2008, continued to grow at a fast pace almost throughout most of the year, increasing from 7.4% to 10% in 12 months. Unemployment peaked in October at 10.1%, then in the final months of the year the labour market stabilised.

Rising unemployment and the uncertain economic outlook had a negative impact on private consumption. Private consumption bottomed out in April when annual growth in the retail trade had fallen to -10%. In the second half of the year, the retail trade started to pick up again and in December annual growth stood at 5.4%. The housing market, which had played a major role in triggering the economic crisis, stabilised slightly and sales of non-new houses started to rise in the second half of the year. However, the depth of the depression in the housing market is still reflected in the fact that the sales of new homes continued to fall and at the end of the year, stood at their lowest level in 30 years. Consumer confidence started to increase a little in the first quarter but was still low.

The external balance of the US economy improved in 2009 as the current account deficit fell to 2.6% of GDP, a fall which was mainly caused by a considerable slowdown in domestic demand. Economic revival was accompanied by a turnaround in foreign trade, and in the second half of the year, goods turnover started to grow again.

The economic decline led to a fall in inflation, and in annual terms, the economy even recorded

deflation of 0.4%. Annual consumer price growth was negative from March to October and inflation recovered only in November. Excluding energy and food prices, inflation fluctuated between 1.4% and 1.9%.

In order to boost the economy and alleviate the financial crisis, the US Federal Reserve kept the key interest rate at its historical low (0.0–0.25%) throughout 2009 and adopted a policy of quantitative easing. Along with administrative measures, the government also supported the economy with an expansionary fiscal policy, which is why the state budget deficit increased from 5.8% to 12.5%.

In Japan, economic decline was deeper than in any other G3 country, as the economy shrank by 5.3%. The main reason was the heavy dependence of the Japanese economy on external demand, which fell sharply in the global crisis. Annual growth in industrial production dropped dramatically, to -36% in March, due to the decline in exports and weak domestic demand. In addition to sluggish external demand, the fall in exports was exacerbated by the strengthening of the yen. Japan's domestic demand has been relatively weak for years, and annual growth in the retail trade was negative throughout 2009. Unemployment rose from 4.3% to 5.1% in 12 months.

Due to robust growth in China and other Asian countries, the Japanese economy also started to grow in the second quarter, and was the first among the G3 countries. Despite the recovery of economic activity, inflation was still negative at the end of the year, with annual consumer price growth registering -1.7% in December. In order to reduce deflationary pressures and boost the economy, the central bank kept its key interest rate close to zero throughout 2009, and the state budget deficit increased to 10.5% as a result of the expansionary fiscal policy.

EURO AREA

In 2009, the euro area countries also experienced an extensive economic downturn. Compared to 2008, GDP in the euro area fell by around 3.9%. As in the USA and Japan, the activity of the industrial sector and the services sector of the euro area decreased significantly. In April, the growth rate of industrial production fell to its lowest level of -20.2%. The recession was deepest in the first half of the year, then in the second half growth gained momentum again and there was a moderate improvement. This was reflected mainly in the recovery of production growth, while private consumption and domestic demand remained quite weak. Unemployment rose from 8.2% to 10% in 12 months.

The euro area inflation dynamics were similar to those of the United States and Japan. Economic downturn and the decline in commodity prices led to a decrease in consumer prices in the middle of the year, but in the final months, price growth recovered slightly. Consumer prices in the euro area increased by 0.3% on average, compared to 2008.

The euro area monetary policy in 2009 was decisively aimed at alleviating the financial crisis and boosting economic growth. The key interest rate was lowered from 2.5% to 1.0% and was kept at that level throughout the year.

The economic discrepancies between the euro area countries became more pronounced as growth slowed further. Consequently, the spreads between the interest rates on long-term government bonds posted their strongest growth since the adoption of the euro. Given the deep economic downturn, the euro area countries were unable to keep their budget deficits within the limit of 3% set in the Stability and

Growth Pact. The total budget deficit of the euro area rose to 6.2%, while in some countries, notably Greece, Spain and Ireland, it exceeded 10%. This led to a significant increase in the interest rate spread of the bonds of these countries over the interest rates for German bonds. Although the situation improved somewhat in the first half of the year, at the end of the year, the problem became more acute and the need for a common strict fiscal policy was felt again.

The outlook for the euro area for 2010 has improved, owing to the economic revival. The International Monetary Fund expects growth of 1% in 2010 and the European Central Bank may start normalising its extremely loose monetary policy in the middle of the year.¹

¹ IMF "World Economic Outlook Update", January 2010.

ESTONIAN ECONOMY IN 2009

NON-FINANCIAL SECTOR

Monetary policy environment

The monetary policy environment remained accommodative throughout 2009 and helped reduce the impact of the global financial crisis. The majority of central banks saw a clear need to keep the interest rates low and not to rush to reduce economic stimulation measures. In the first half of the year, the European Central Bank lowered its monetary policy interest rate to 1%. The low interest rate was further facilitated by deflationary pressures that stemmed from a decline in commodity prices, which in turn resulted from an easing in global demand and declining wage pressures.

The dollar continued to depreciate throughout 2009 until December, when the trend turned. Despite this, at the end of 2009 the dollar was

approximately 3% cheaper than it had been at the beginning of the year. The Russian rouble depreciated by almost 5% against the Estonian kroon, but the impact of the cheapening of these currencies was mitigated by the appreciation of the Swedish krona.

Although global interest rates declined in 2009, this did not push down domestic interest rates (see Figure 1). Growth in the net interest margin offset the impact of the fall in the key interest rate.

All in all, crediting conditions in 2009 in Estonia turned out to be significantly tighter than in 2008. As the global interest rate environment eased, the interest payments on loans with a floating interest rate fell. On the other hand, growth in the interest margins on new loans considerably reduced the demand for credit.

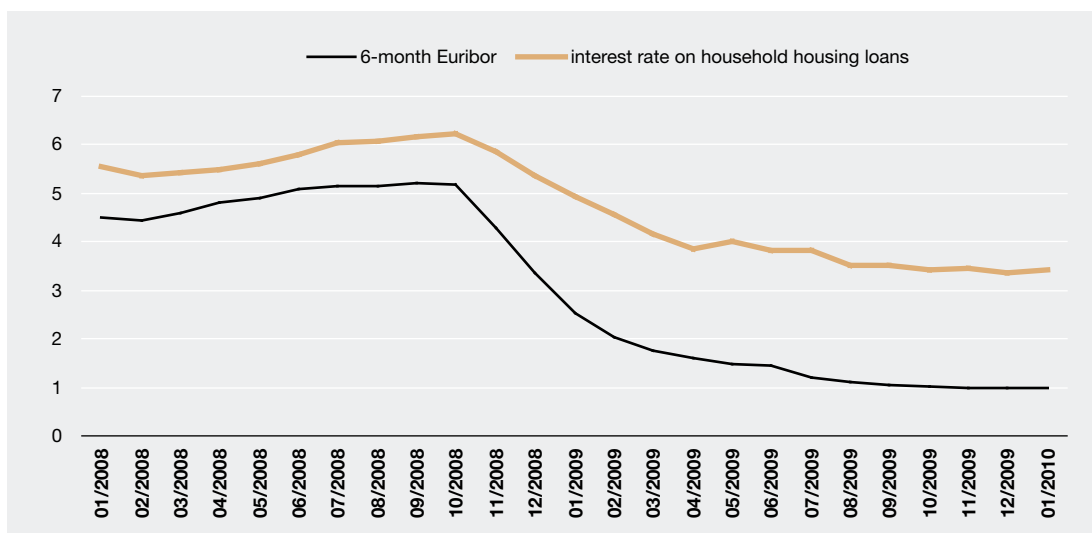


Figure 1. Changes in the interest rates on long-term loans issued in Estonia and euro area money market interest rates in 2008-2009

Domestic and external demand

Estonian economic activity declined drastically at the beginning of 2009 as a result of the global financial crisis, and this was reflected in both domestic and external demand. This led to a recession in which the economy shrank by 14%. In the second half of the year, the decline in GDP slowed, and in the fourth quarter the downward trend reversed on a quarter-by-quarter basis (see Table 1).

The export sector contributed the most to the economic recovery. According to preliminary estimates, goods exports fell by nearly a third over the year. At the end of the year, the decline in exports slowed, and in December it was comparable to the decline of December 2008, although this was also partly attributable to the base effect. According to balance of payments flash estimates, services exports contracted by 12% and imports by 22%.

Domestic demand weakened throughout 2009 and the underutilisation of production resources also hampered investment. Private consumption fell back as purchasing power declined as a consequence of high unemployment and tax rises. As a result, the retail trade contracted by 15% in 2009 compared to 2008. Consumption also declined because of higher saving as consumers became more cautious. At the end of the year, the planned rise in excise duties led intermediaries and distributors to build up their reserve stocks, but this was only a one-off contribution to the rise in economic activity.

A sharp fall in imports as a result of weak domestic demand significantly improved Estonia's external balance. According to balance of payments flash estimates, the surplus on the current account in 2009 amounted to 10 billion kroons, or 5% of GDP. In 2008, the current account had had a deficit of 9% (see Figure 2). The improvement in the external balance was

Table 1. Real GDP growth by economic sectors in 2008-2009 (%)

	2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	2009
Agriculture and hunting	-2.5	0.2	-11.4	-22.8	-4.2	-10.2
Forestry	7.6	15.8	-11.7	25.4	36.3	16.6
Fishing	5.6	3.5	-8.5	3.5	22.5	5.8
Mining and quarrying	-8.5	-13.6	-26.5	-6.7	3.2	-11.1
Manufacturing	-4.2	-29.0	-31.2	-26.9	-14.3	-25.8
Energy, gas and water supply	-7.4	-0.5	-18.3	-24.4	-11.7	-12
Construction	-5.3	-31.5	-30.6	-31.7	-26.3	-30.1
Wholesale and retail trade; repair of motor vehicles and household appliances	-8.6	-20.9	-20.9	-21.2	-15.5	-19.7
Hotels and restaurants	-7.9	-25.2	-26.9	-17.0	-23.0	-22.9
Transport, storage and communications	-4.1	-17.1	-16.8	-16.6	-12.8	-15.9
Financial intermediation	-2.9	-26.1	-28.4	-29.7	-21.2	-26.5
Real estate, renting and business activities	-0.5	-8.0	-8.4	-5.3	-6.1	-7
Public administration and defence; statutory social insurance	6.8	1.5	2.0	0.5	1.2	1.4
Education	1.2	-5.1	-3.0	-3.6	-4.5	-4.1
Health and social care	-0.4	-0.6	-1.1	-4.9	-2.9	-2.3
Other community, social and personal services	0.0	-12.8	-18.4	-15.8	-13.5	-15.1
Total GDP	-3.0	-15.3	-17.5	-17.0	-10.7	-15.2
Net taxes on products	-7.2	-13.0	-5.0	-4.4	0.5	-5.4
GDP at market prices	-3.6	-15.0	-16.1	-15.6	-9.5	-14.1

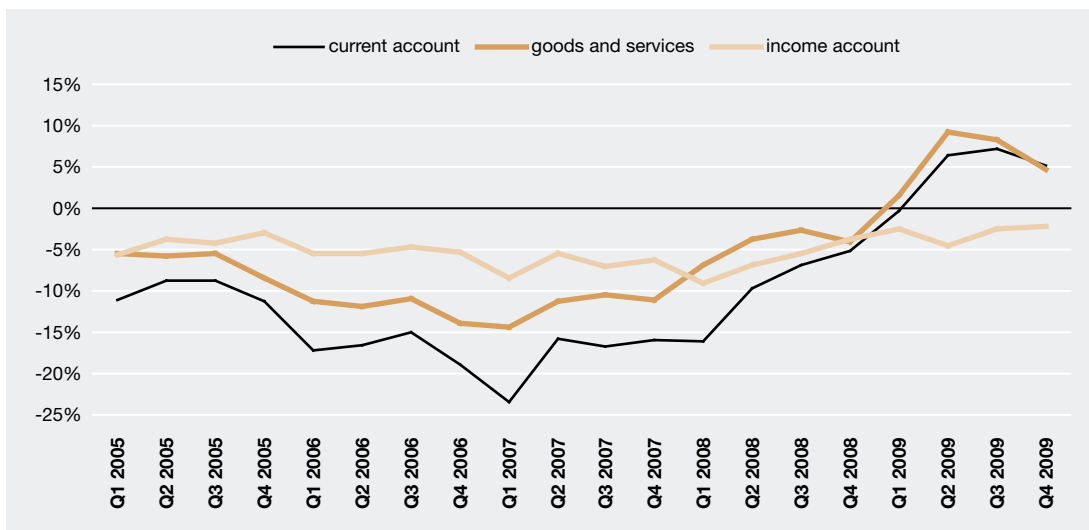


Figure 2. Current account balance and main accounts of the balance of payments (% of GDP)

also supported by a decline in the net outflow of income to 0.3 billion kroons in December. The negative income account was offset by a drop in income earned by non-residents in Estonia.

Inflation

The rapid rise in prices seen in earlier years was replaced by a fall in 2009. In December, the price level in Estonia was 1.8% lower than in December 2008, although the annual average inflation rate was still 0.2% higher. Since November, the inflation rate has been lower than the Maastricht inflation criterion.

In 2009, the prices of food and the housing costs dropped the most, by 6.4% and 7.1% respectively. This was caused primarily by external factors as lower global oil prices brought down household heating costs and the price of motor fuel, and the raw materials for food became cheaper. The low point for external inflation factors has probably by now been passed.

With the global crisis and the following extensive economic decline in Estonia, households already became more cautious in their consumption decisions in 2008. In addition, there was a considerable decline in incomes and credit demand, and as a result, domestic demand contracted significantly, forcing companies to reduce prices. The drop in prices was also facilitated by companies' wish to reduce stocks, to achieve which they held discount sales campaigns. Apart from housing rental and hotel accommodation, the prices of services have responded less to the contraction of the economy on average than have the prices of goods (see Figures 3-4).

In summer 2009, several tax rises were passed in order to improve the budget position, but this did not stop the fall in prices. In July, the VAT rate rose from 18% to 20% and motor fuel excise duties increased as well. The majority of retailers, however, did not pass the VAT increase fully on to customers.

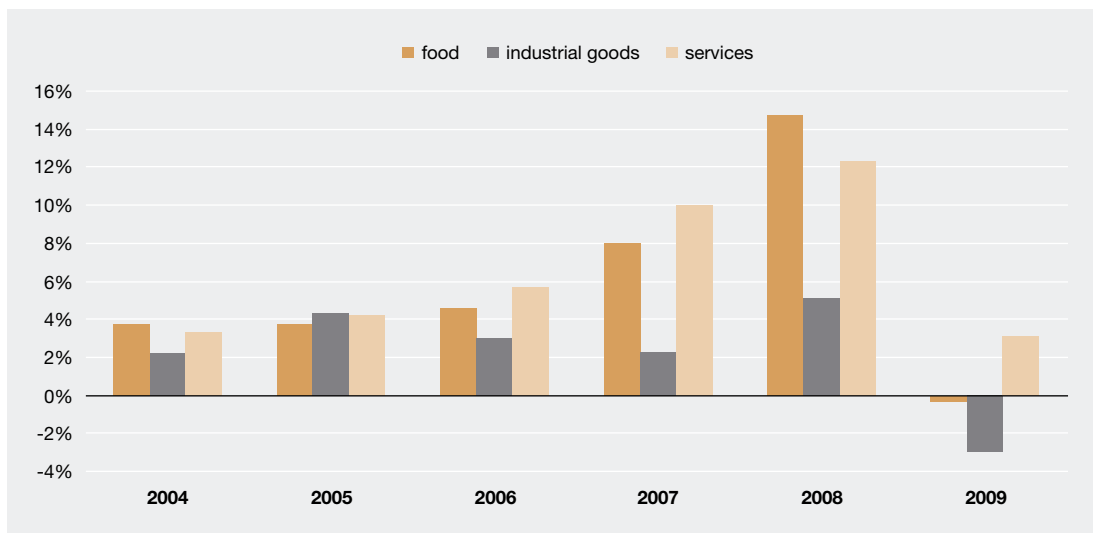


Figure 3. Changes in the prices of services, food and industrial goods (y-o-y)

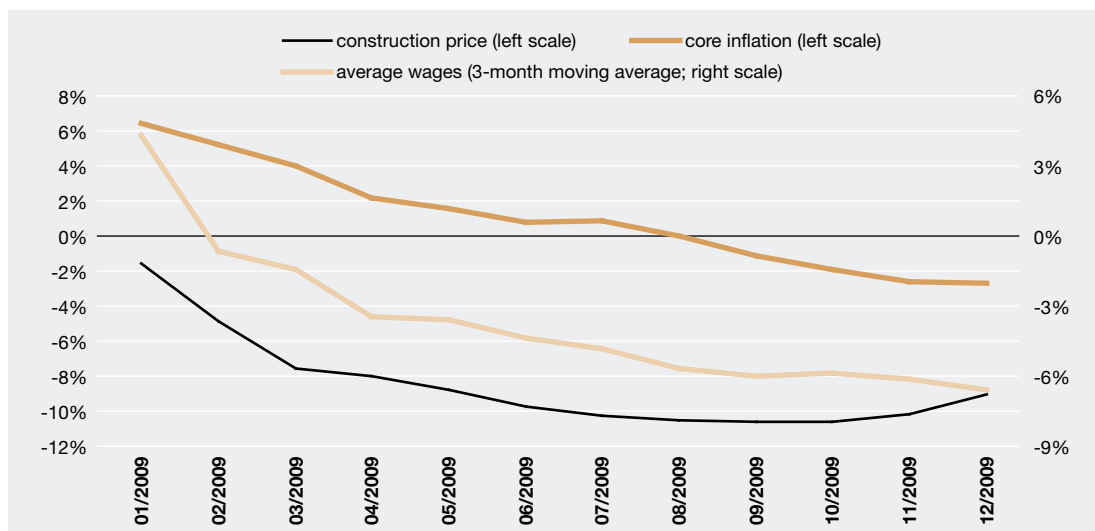


Figure 4. Changes in core inflation, construction prices and average wages (y-o-y)

General government

The economic decline in Estonia turned out to be deeper than expected due to the joint impact of a decline in domestic demand after the real estate boom and a sharp contraction in global trade. As a consequence, since the second half of 2008 the Government has been taking measures to improve the consolidated budget bal-

ance. The total consolidation package put forward in 2009 was worth nearly 9% of Estonia's annual GDP. The measures included a rise in consumption taxes and cuts in budget expenditure in 2009–2011. The cuts touched almost all categories of expenditure, with the exception of social benefit transfers to households. Another exception among the fiscal measures was the 5% increase in old age pensions. Around a third

of the measures were temporary, including the suspension of state contributions to the mandatory pension funds and a larger withdrawal of dividends from state companies.

These measures helped cut the large state budget deficit, and in the second half of the year the consolidated budget surplus was already more than 3.5% of the GDP of that period. The annual consolidated budget deficit fell to 1.7% of GDP.

In 2009, the consolidated budget deficit was mainly financed from the reserves accumulated in the years of strong growth. Loans to local governments and non-profit associations pushed the general government debt up to about 7% of GDP by the end of 2009. At the same time, the sales of assets increased cash reserves and at the end of the year, the Estonian government was still a net lender.

SOVEREIGN RATING

Sovereign rating, or the credit rating of a country, is an assessment by private international rating agencies of a country's ability and willingness to repay its long-term foreign liabilities on time. The sovereign rating indirectly reflects the reliability of a country's economy and economic policy. Sovereign rating largely determines the interest rate on foreign borrowings.

In 2009, Estonia's sovereign rating was constantly scrutinised by all of the three rating agencies, and they all officially revised and/or changed Estonia's sovereign ratings. In 2009, Moody's and Fitch visited Eesti Pank, two telephone conferences were held with Standard & Poor's and Fitch, and experts from the central bank also met Standard & Poor's separately in London. Communication with Estonian analysts and exchanges of information were intensified. The key topics at the meetings in 2009 were:

1. **Financial sector issues**, including relations between subsidiaries and parent banks such as refinancing and the potential nationalisation of the Swedish parent banks. As earlier, the agencies drew attention to Estonia's large external debt and its financing difficulties.
2. **Estonia's fiscal policy situation and outlook**, including the possible use of economic policy measures and the timing of decisions to improve Estonia's fiscal position.
3. **The prospect of joining the euro area and an action plan for this.**
4. **The impact of economic developments in Latvia on Estonia**, primarily the potential for change in the exchange rate change of the Latvian lat.
5. **The labour market situation and outlook**, notably the impact of increased unemployment on the repayment of loans, and wage developments in 2009.
6. **Estonia's competitiveness** in the region, given the depreciation of the Swedish, Polish and Russian currencies and for other factors.

On 24 February 2009, **Standard & Poor's** decided to start revising the ratings of Estonia's short-term and long-term foreign currency liabilities (A/A-1/negative), and to downgrade them if necessary. On 21 April, the rating committee confirmed the ratings of Estonia's long-term and short-term foreign currency liabilities at the same level as before. In its decision the agency noted that Estonia's sovereign ratings draw from the strength of state institutions and also from the low government debt and considerable fiscal reserves. In addition, the ratings are supported by Estonia's competitive, flexible and open economy and the prospect of joining the euro area. Despite this, on 10 August 2009, Standard & Poor's downgraded Estonia's long-term and short-term sovereign ratings from

A/A-1 to A-/A-2. The sovereign rating outlook remained negative. The rating decision made in August 2009 reflected the agency's opinion that Estonia's problems would worsen, as the country's economy must make great adjustments to lower its dependence on foreign funding. This, however, might postpone Estonia's accession to the Economic and Monetary Union. The negative outlook is based on the probability that the rating will drop if economic adjustments fail to increase Estonia's competitiveness or if tensions in the external environment, such as a major trading partner of Estonia choosing to devalue its currency.

Moody's decided to start revising Estonia's sovereign rating (A1/negative) on 10 February 2009, and was considering the possibility of a downgrade. On 23 April 2009, Moody's affirmed Estonia's sovereign rating at A1, but retained the negative outlook. The rating has remained at A1 for nearly eight years, since November 2002. The agency believes that in a deepening and prolonged economic decline, the creditworthiness of the Estonian general government would probably remain strong enough. The Government is trying to reduce the budget deficit and liquidity is guaranteed. In April 2009, Moody's said that Estonia's budget deficit in 2009 would probably remain within the limit of the Maastricht criterion of below 3% of GDP, following prudent fiscal policy in the years of rapid growth and impressive budget adjustments. This result – one of the best in the EU – should enable Estonia to follow its crisis management strategy and officially adopt the euro in January 2011.

Fitch Ratings decided to downgrade the ratings of Estonia's, Latvia's and Lithuania's short-term and long-term foreign currency liabilities and the rating of long-term kroon liabilities on 8 April 2009. The sovereign ratings of long-term foreign currency liabilities for the three countries are BBB+, BB+ and BBB respectively.

The agency stated that Estonia's ratings were downgraded due to a worsening outlook for growth, which increased pressure on macro-economic policies. The downgrading of Estonia's and Lithuania's ratings also reflected their vulnerability to negative events in Latvia, where risks had increased at that time through three risk sources: trade, a lack of diversity among owners of the banking sector, and people's confidence in the local currency and banking system. Although the devaluation of the Latvian lat was not anticipated in Fitch's baseline scenario, any such event would have put heavy pressure on the Estonian kroon and the Lithuanian litas. In April 2009, Fitch believed that with the backdrop of Estonia's rapid economic decline, further measures to improve the country's fiscal position would be difficult to implement and that the budget deficit for 2009 could easily exceed the goal of 2.9% of GDP. Fitch also noted that thanks to fiscal reserves worth 9% of GDP at the end of 2008, the Estonian general government is at least partly able to finance its budget deficit. Estonia's rating was supported by the low general government debt, which stood at 4.8% of GDP as at the end of 2008. In the near future the demand for external financing is expected to remain high in all three Baltic States.

In their reports, the rating agencies highlighted the following factors that support or weaken Estonia's sovereign ratings:

Supporting factors:

- political and institutional strength together with EU membership;
- strong fiscal policy to date and a considerable liquidity buffer, low government debt (the lowest in the EU);
- no state-owned banks in Estonia, with 98% of the banking system's assets belonging to foreign owners;
- a competitive and open economy, which is flexible enough to cope with temporary weak demand;

- the chance of joining the European Economic and Monetary Union in the next few years, which lowers the currency risk.

Weakening factors:

- Estonia's continuous strong demand for external financing; most of the need for external funds is related to foreign-owned parent banks or companies;
- Estonia's gross and net external debt, compared to countries with similar ratings;
- the performance of the banks increases credit risks that are related to market risks, through the high share of foreign currency loans compared to foreign currency deposits;
- Estonia's options for domestic budget financing are limited, which increases the country's dependence on fiscal reserves or foreign loans;
- the high debt burden of the private sector and the relatively low level of incomes;
- the need to restrain the earlier large foreign trade imbalances, which has led to a serious decline in economic growth and a drop in incomes.

Rating agencies' annual reports on Estonia are available on the website of Eesti Pank.

FINANCIAL SECTOR

The year 2009 was a difficult one for the banking sector especially, even as securities markets gained momentum from the recovery of confidence in the global economy. There were no significant changes in the structure of Estonia's financial sector in 2009, but the financial assets of banks grew in relative terms as GDP fell (see Figure 1). The relative shares of investment funds and the stock market increased as assets and capitalisation grew and GDP dropped.

The banking sector

Institutional developments

In May 2009, a new player joined the Estonian banking market, when AS LHV Group, which had previously only engaged in asset management, received a licence to operate as a commercial bank. Consequently, there are now seven credit institutions and ten branches of foreign credit institutions operating as banks in Estonia, and approximately 230 foreign credit institutions providing cross-border banking services.

Changes in the operational environment have

resulted in some changes in the strategies of market participants. Risks have increased and so former market leaders have lost some of their market share, while larger banking groups operating as branches on the local market have increased theirs.

Assets and liabilities of banks

In 2009 the uncertain economic environment pushed the assets of banks down by 5.6% to 322 billion kroons. In the previous year they had risen by 6.5%. The total value of the financing portfolios of banks and leasing companies was 264 billion kroons in 2009, a fall of around 18 billion kroons or 6.3% over the year. This was the first year since the recession at the end of the 1990s that the total value of the financing portfolios of banks shrank.

The value of financing portfolios declined evenly throughout the year, although there were some differences between sectors. In the household loans segment, it was consumer loans that dropped the most, at 11% down compared to a year earlier. This led to housing loans increasing as a percentage of loans granted to households (see Figure 2).

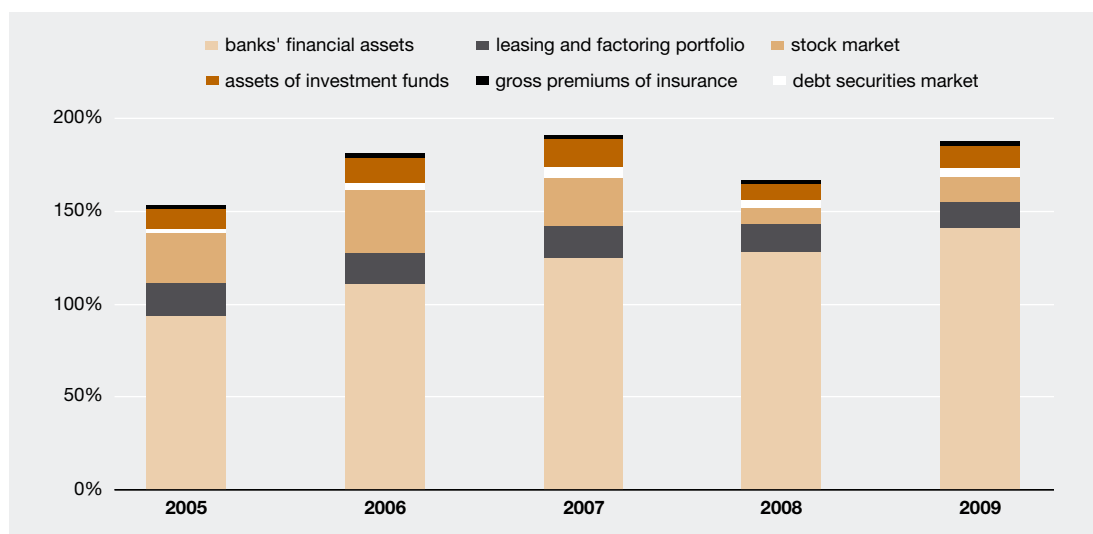


Figure 1. Structure of Estonia's financial intermediaries

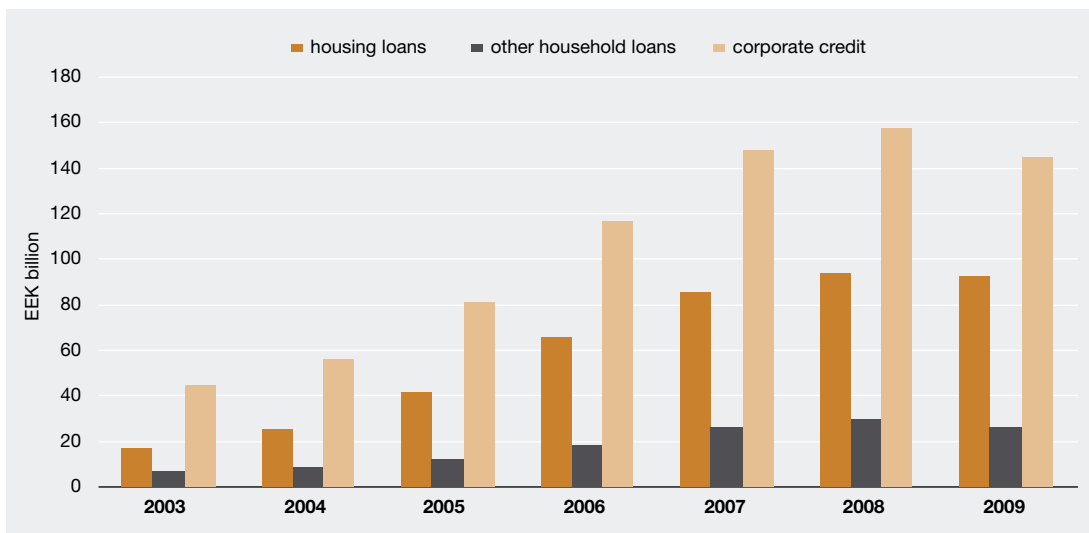


Figure 2. Non-financial sector loans

The dynamics of loans and leases issued to companies differed greatly across sectors. The falls in the loans and leases granted to business services companies and wholesale and retail trade companies were considerable at 28% and 24% respectively. The loan stock of the hotel and restaurant sector increased 28% and that of the energy sector grew by 13%.

The assets of banks fell by 19 billion kroons and funds borrowed from foreign banks by around 10 billion kroons in 2009. The share of deposits among the funds raised by banks increased despite the deep recession, with household deposits growing by 1.5 billion kroons and corporate deposits by 0.6 billion kroons in 2009. Total household deposits and corporate deposits stood at 55.4 billion kroons and 52.6 billion kroons, respectively.

Quality of the loan portfolio

The loan portfolios had already started to deteriorate at the end of 2008 as the economic environment worsened, but the deterioration gained considerable momentum in the first half of 2009. The share of loans overdue for more than 60

days in the loan portfolio rose from 2.9% at the end of 2008 to 6.5% by August 2009 and then remained at that level (see Figure 3). The quality of loans to the construction sector deteriorated the most, with the percentage of overdue loans rising from 5% to 19.2% over the year. Transport has been the business sector least affected by the crisis, and the percentage of overdue loans in that sector grew by only 0.5 percentage points to 1.4% in 2009.

The percentage of overdue household loans was highest among household consumer loans, reaching 9.9% of the loan portfolio while the proportion of overdue housing loans increased modestly from 1.8% to 4.2% despite the deep recession and the decline in incomes.

Profitability

In 2009, the profitability of banks was curbed mainly by two factors: the need to adjust the value of loan portfolios, which had the bigger impact, and the low level of key interest rates. In 2009, the banks operating in Estonia earned 4 billion kroons of net interest income in total, which was over a third less than in 2008.

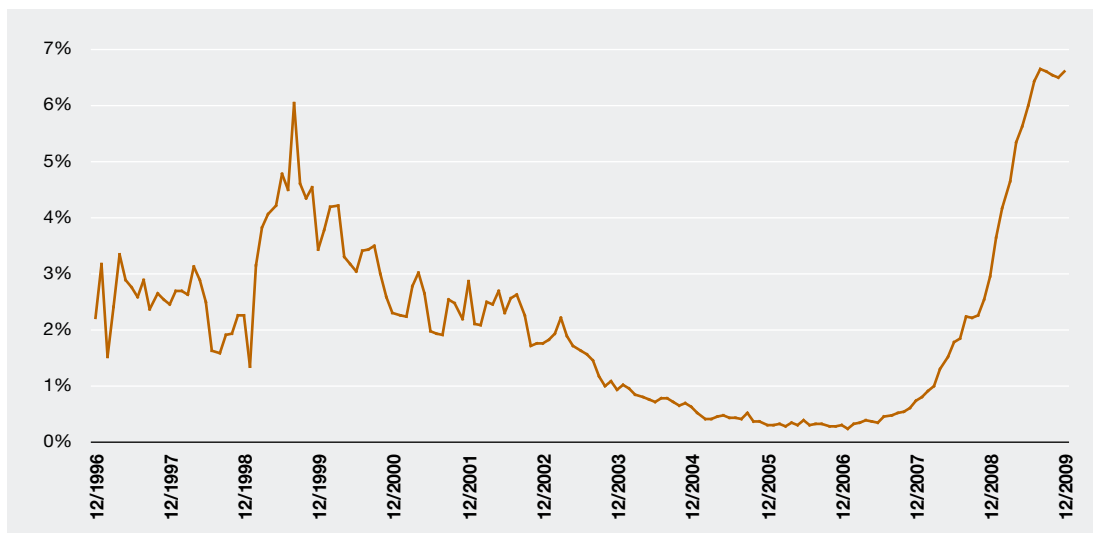


Figure 3. Percentage of loans overdue for more than 60 days

The decline in net interest income slowed in the second half of 2009 and banks earned pre-provision profits on a consolidated basis in 2009, though these were still insufficient to cover the provisions. In total, banks earned a loss of 8.9 billion kroons in 2009. Additional write-downs during the year amounted to 8.1 billion kroons, or nearly 3.5% of the total loan portfolio of banks. Banks also had to bear losses due to write-downs of investments in subsidiaries totalling around 3.4 billion kroons.

Since banks' incomes and loan portfolios decreased in 2009, they had to cut expenses. Compared to 2008, operating expenses were reduced by 10% in 2009, partly because of the elimination of the bonus reserve.

Capital adequacy and risks

In 2009, the capital adequacy ratio of the banks was mostly affected by a decrease in risk assets,

which had two causes. First, in addition to SEB Pank, Swedbank also introduced the internal ratings based method for calculating the capital requirements for credit risk. Second, in 2009 the banks' capital requirements for credit risk also fell in tandem with the decline in the loan portfolio. In addition, banks increased the amount of capital required for covering the risks by adding the retained profits of previous periods under Tier 1 equity.

The aggregate capital adequacy ratio of banking groups increased from 13.3% at the end of 2008 to 15.7% in 2009 (see Figure 4), and the lowest capital adequacy ratio among the banking groups was 13.7%. The capitalisation ratios of the banks operating in Estonia confirm that they have sufficient capital buffers to cope with large loan write-downs.

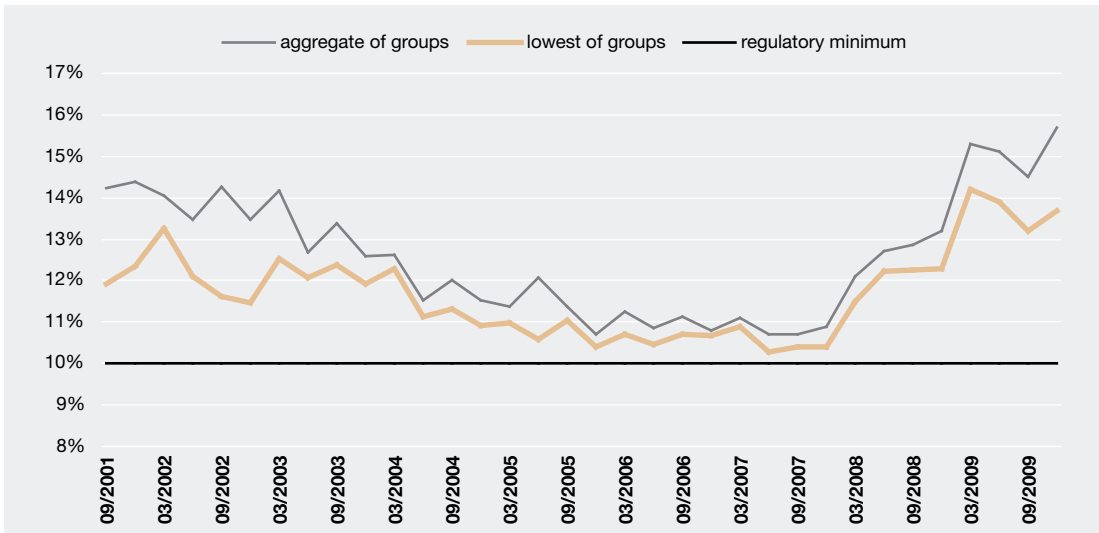


Figure 4. Capital adequacy of banking groups

Securities markets

Bond market

The primary bond market was very quiet in 2009 compared to 2008, although in the first half of the year it was stimulated by bond issues from the general government and from financial institutions. The number of bond issues fell 50% from 2008 and the monthly average totalled only 270 million kroons (see Figure 5).

Bond capitalisation fell 2 billion kroons to 9.6 billion kroons, or 4.4% of GDP, in 2009. This was mainly caused by a drop in the stock of debt securities issued by non-financial sector companies and credit institutions.

The percentage of local issuers increased to around 91% by the end of the year owing to the low levels of activity in the primary bond market.

There were also some changes among bond investors, as non-financial sector companies decreased their share of bond-holding to 25%, while the share of bonds held by insurance companies and pension funds fell to 9%. At the same time, the proportion of bonds held by credit institutions increased to 34%. The share of resident investors in bond capitalisation continued to increase in 2009 and at the end of the year amounted to 72% of total bonds issued, of which around 2.8% belonged to private persons.

In 2009, the bonds of four companies were redeemed on the Tallinn Stock Exchange. At the end of the year, only two companies had bonds listed on the stock exchange with a total value of 101 million kroons.

The secondary bond market was also very quiet. The average daily turnover of bonds was only 5 million kroons, which is 19% of the average daily turnover in 2008.

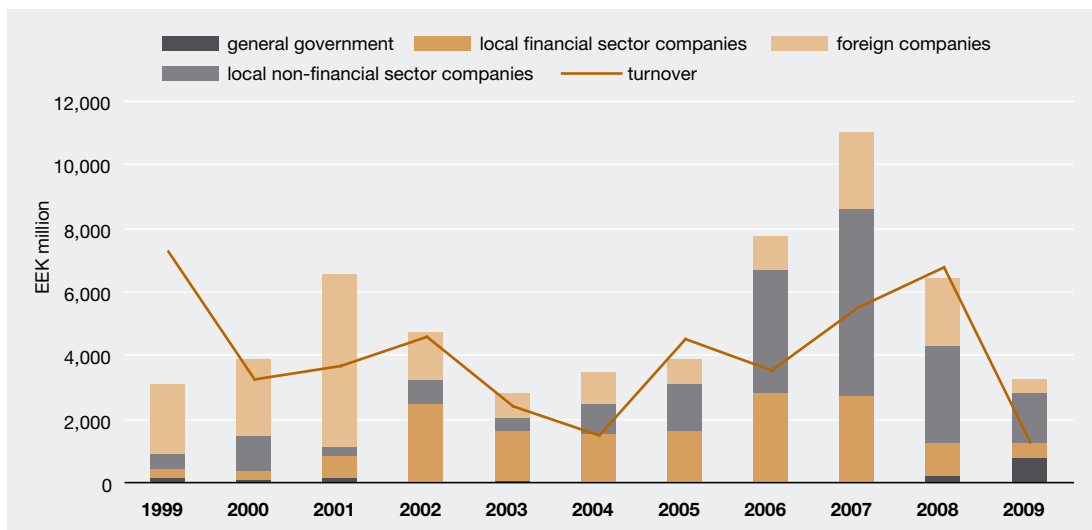


Figure 5. Debt securities by issuers and secondary market turnover

Stock market

The takeover bid of TeliaSonera AB for Eesti Telekom in the second half of August breathed life into the Estonian stock market. There was a small correction at the end of the year when the value of the index declined from its 2009 peak of 456 points to 404 points, and capitalisation contracted by 3 billion kroons to 29 billion

(see Figure 6). The average daily turnover of the stock exchange was 16 million kroons.

The primary list of the Tallinn Stock Exchange contained 16 companies at the end of 2009. Active trade involved the shares of three companies, which accounted for 67% of the total turnover of the year. The shares of AS Starman and AS Luterma were delisted from the primary

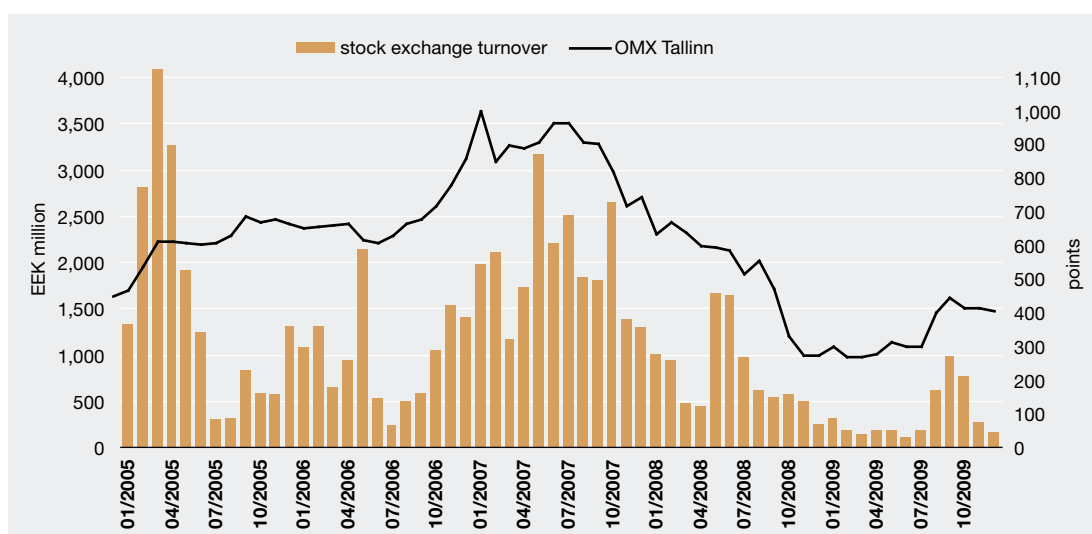


Figure 6. Monthly turnovers of the Tallinn Stock Exchange and OMX Tallinn index as at month-end

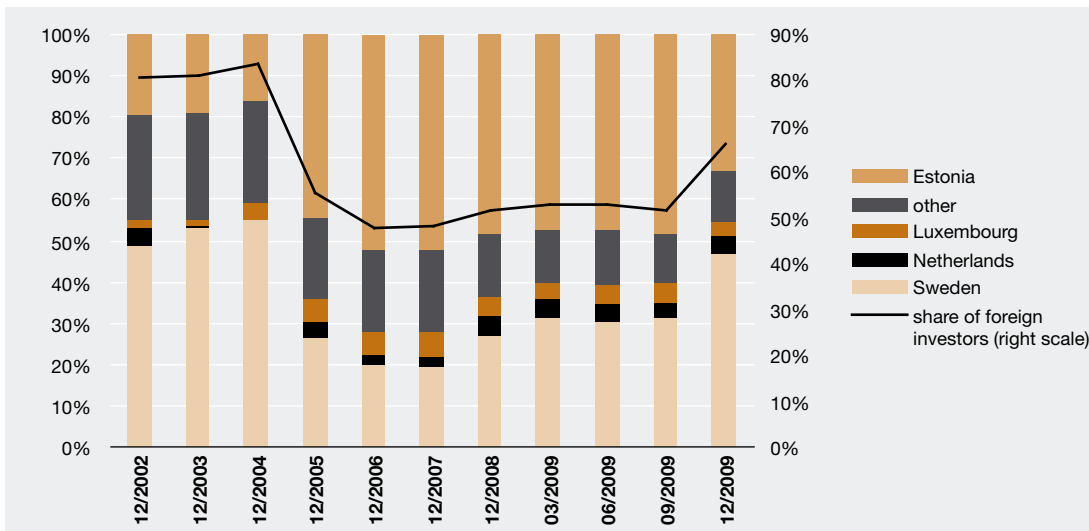


Figure 7. Structure of investors on the Tallinn Stock Exchange

exchange and the shares of AS Järvevana were listed on the secondary exchange. In October Eesti Telekom applied for delisting, which took place at the beginning of 2010 when the company's capitalisation comprised 44% of the total stock exchange capitalisation.

In the fourth quarter of 2009 the structure of the Tallinn Stock Exchange, which had been relatively similar since 2006, changed considerably (see Figure 7). The stock of shares held by Swedish residents increased significantly, which raised their share in the stock market capitalisation to 48% by the end of the year and the share of foreign investors to 66%. Local investors held around 9.7 billion kroons, or 34%, of the capitalisation. The stock of shares held by households increased to 14% in the fourth quarter.

At the end of 2009, the Tallinn Stock Exchange had 33 registered members, of which three companies accounted for 76% of total stock exchange transactions.

Other financial intermediaries

Investment and pension funds

In summer 2009, the Government ceased making payments into the second pillar pension funds. The state's payments will be resumed in 2011, but almost 40% of the current subscribers have decided to continue making payments in 2010. In 2009, many switched pension fund. Around 28% of the 220,000 subscribers who decided to continue paying in 2010 have opted for a different pension fund. People mainly shifted their payments from the major high-risk funds of Swedbank and SEB to smaller or new pension funds.

In 2009, one real estate fund and two mandatory pension funds entered the market. Meanwhile, Swedbank Investment Funds eliminated three of its funds, including the Swedbank Money Market Fund, which means that there are no money market funds in Estonia any longer. Of the three risk capital funds registered in 2008, the only one

left is the Gild Arbitrage Risk Capital Fund, which was made into a non-public fixed-term fund and whose loan liabilities were reconstructed into long-term bonds. At the end of the year, there were in total 43 investment funds and 33 pension funds registered in Estonia.

Investment fund assets totalled 8.9 billion kroons at the end of 2009, which is approximately as much as in 2008 (see Figure 8). Since the yield of interest funds has declined and two funds have been eliminated, the assets of funds have fallen by around 1 billion kroons in total and their share in the total assets of investment funds has dropped to 18%. The share of risk capital funds fell in the same way, and was 8% at the end of the year. Equity fund assets increased, mainly as a result of an increase in asset prices, rising by more than 2.2 billion kroons in total. Consequently, the share of these assets rose to 65% of the total investment fund portfolio.

Even though many have suspended payments for the time being, the assets of pension funds increased by almost 3.6 billion kroons in 2009, reaching a historical high of 15.9 billion kroons (see Figure 9). The assets of third pillar pen-

sion funds and second pillar high-risk pension funds grew relatively faster in 2009, at 34%, than did the assets of other pension funds. This led to a rise in the share of high-risk pension fund assets to 77% of total second-pillar pension fund assets. Including pension insurance, the assets of third pillar pension funds stood at 3.4 billion kroons at the end of 2009, of which pension funds comprised 33.4%.

Insurance

In 2009, the Estonian insurance market sank in line with the contraction in the real economy. At the end of 2009, 19 life insurance and non-life insurance companies were still operating in Estonia but the total of insurance premiums had fallen by 11% over the year. Total market profitability improved in 2009 despite a significant decline in sales, a high contract termination rate and fierce competition between market participants. This largely resulted from the cost-effective operations of insurance companies and a somewhat better return on investment. Aggregate profitability was also affected by the merger of two insurance companies, with the joint company being based in Estonia.

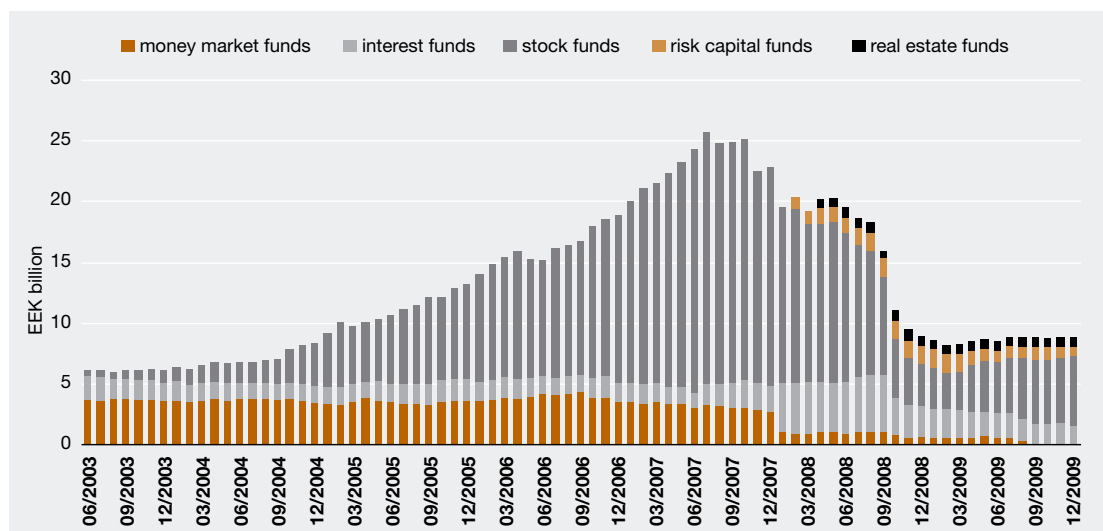


Figure 8. Value of investment fund assets as at month-end

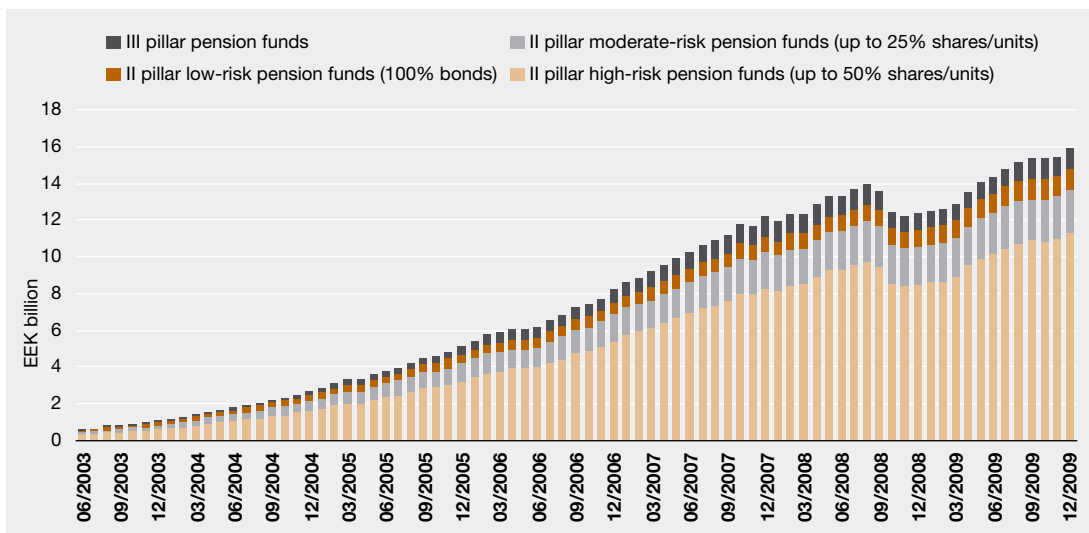


Figure 9. Value of pension fund assets as at period-end

The life insurance sector had already adjusted to market developments in 2008. Although the insurance premiums collected in Estonia at 1.1 billion kroons in 2009 represented a fall of 9.4% over the year, the performance of the insurance companies indicates rather more of a stabilisation in the market. Insurance companies finished 2009 with a 453 million-kroon unaudited profit, which facilitated growth in equity and capitalisation. The life insurance sector is very concentrated with three major insurance companies holding 85% of the total market.

Estonia's annuity insurance market opened in 2009¹. In accordance with the Funded Pensions Act, insurance companies have been concluding pension contracts for mandatory funded pension payments since 1 January 2009.

The non-life insurance sector adjusts to changes in the economy with a lag. This saw the sale of insurance suffer a major drop of 16% in 2009, when 3.2 billion kroons of insurance premiums

were collected in Estonia. Even though the percentage of vehicle insurance is 65%, and interest in new vehicles was lower, insurance companies still earned a record unaudited profit of 890 million kroons. Profitability was also curbed by low loss given defaults and partly also by the profits of the previous years and earlier contracts. As is the case in the life-insurance market, the non-life insurance market is dominated by three major companies, but foreign branches have also significantly increased their market share from 9% to 14%.

Payment instruments

The value of payments, which had witnessed relatively robust growth in the previous years, suffered a decline of around 13% in 2009 (see Figure 10). The value of both cash and non-cash payments declined to a similar extent. People's payment habits show that one chosen payment instrument is usually preferred for its ease, convenience and cost of use. Among non-cash pay-

¹ Since 2009, those who reach pensionable age are entitled to payments from the second pillar funds. For those whose pension account exceeds or equals 50 times the national pension rate (starting from 95,657.01 kroons), the only way to receive payments is to conclude an annuity contract with an insurance company (source: www.pensionikeskus.ee).

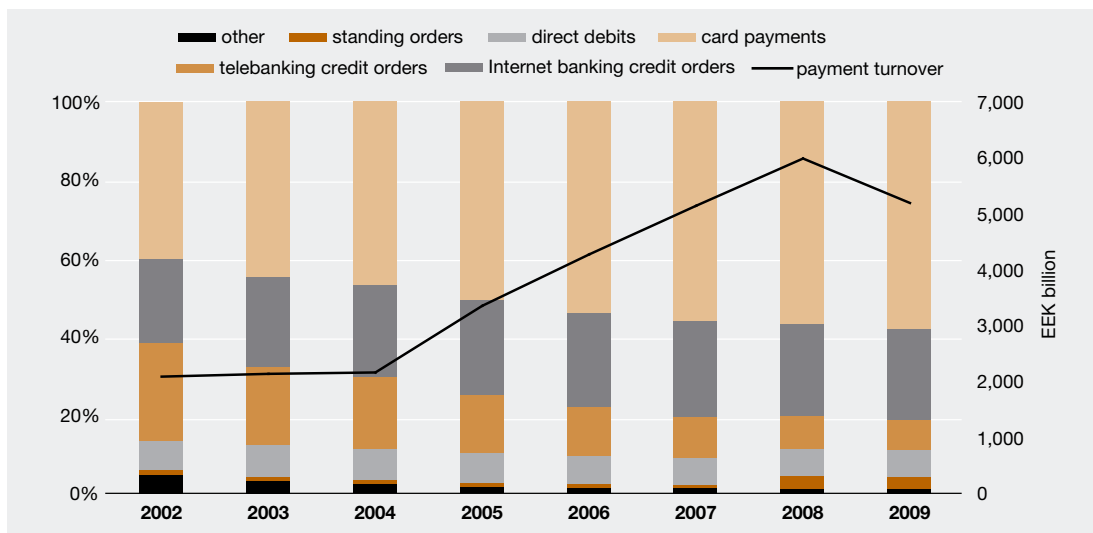


Figure 10. Most common payment instruments in Estonia

ment transactions, the share of both card payments and direct debits has increased, to 58% and 7% respectively, while the number of telebanking payments has fallen to 8%.

The number of payment cards issued in 2009 remained at the same level as in 2008: altogether 1.84 million payment cards were in use at the end of 2009, which is 1.3 payment cards per one person. The majority, or 77%, of the payment cards issued are debit cards, of which more than 80% are in active use. The use of credit cards is still low, at only 55%. Compared to 2008, the total number of credit cards contracted by almost 16,000, while conversely the number of revolving credit cards grew by more than 13,000 and their percentage increased to 32%.

The number of points of sale (POS) and payment terminals accepting electronic payments increased to 17,671 and 26,903, respectively. The number of POS went up mainly due to a rise

in the number of POS accepting card payments, which are a majority of all POS. The number of POS accepting mobile payments fell sharply and by the end of 2009 only 89 POS out of 716 were left. The number of automatic teller machines (ATM) decreased slightly to 1,006 ATMs, largely owing to a decline in the number of payment terminals.

KEY POINTS OF EESTI PANK'S ECONOMIC FORECASTS IN 2009

In 2009, Eesti Pank published a spring forecast in April and an autumn forecast in November. The forecast consists of a baseline scenario and risk scenarios for the economic developments in the current year and the next two. The forecast is compiled using the output of a macroeconomic model and expert assessments. The risk scenarios address the key risks to the economy.

In 2009, the global economy was gripped by the deepest recession of the past few decades. At the beginning of the year it became evident that the crisis had hit global trade, although just a few months before it was thought to be limited to financial markets. Estonia's major export markets in the Nordic and Baltic States suffered more from the crisis than initially expected in the central bank's 2009 spring forecast. Growth in the euro area was barely positive in the second half of the year, being supported by extensive economic policy measures. External demand stabilised by the time of compiling the autumn forecast, but was still weak and did not provide any substantial support to Estonia's exports. At this point, the question is whether the global economy is strong enough to retain growth also without help from governments.

The first signs of a shock in Estonia's domestic economy appeared at the beginning of 2009. The spring forecast underestimated the scope of adjustment in the non-financial economy, especially with regard to unemployment. Household started to save considerably more because of great uncertainty about future incomes, which in turn reduced consumption almost 25%. Corporate investment plummeted even more. This was partly owing to the fact that the Estonian economy, which had been enjoying credit boom based growth, was now facing much tighter credit conditions. Banks and investors turned more cautious. Therefore the prospect of the

euro changeover becoming clearer in the second half of the year was especially important in terms of the forecast. The expected changeover to the euro will boost growth in various ways: facilitates local investment, reduces loan margins and increases the country's credibility for foreign investors.

Consumer price growth eased in 2009 in line with the forecasts and in November Estonia was able to meet the Maastricht inflation criterion. The rise in excise duties and VAT in July did not have a significant impact and passed through to consumer prices only partially. The prices of tradable goods, in particular food and durables, responded quickly to the economic slump. Price adjustments in the services sector were expected to take place through a decline in wages, which is a process that takes more time. Based on current data, the nominal adjustment of the non-tradable sector in the next years has been smaller than expected at the onset of the crisis. Downward price rigidity is particularly characteristic of regulated prices.

The challenge in the coming years is the capability of the product and labour market to adjust to the rapidly changing economic situation. Estonia's economy that had operated at full blast only a couple of years ago is entering an environment of abundant unused resources. The steep downturn in output and accompanying expenditure cuts have strongly reduced labour force demand. A considerable amount of production capacity is still underutilised, especially in the construction sector, which hampers the future outlook of the Estonian economy. Looking further ahead, Estonia has several competitive edges compared with euro area countries. These are mostly based on the lower wage and price level and allow Estonia to expand faster once the recession is over.

KROON

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G. Reindorff

Decrees, decisions
and publications



DECREES OF THE GOVERNOR OF EESTI PANK IN 2009

No 1, 18/3/2009

Issue of collector coin

No 2, 20/5/2009

Issue of collector coin

No 3, 19/6/2009

Amendments to Eesti Pank Governor's Decree No 16 of 9 November 2007 "Establishment of off-balance-sheet reporting of credit institutions"

No 4, 30/6/2009

Amendments to Eesti Pank Governor's Decree No 9 of 13 July 2007 "Establishment of supplementary reports on credit institutions' balance sheet"

No 5, 20/7/2009

Amendments to Eesti Pank Governor's Decree No 4 of 9 May 2008 "Approval of TARGET2-Eesti rules"

No 6, 22/9/2009

Amendments to Eesti Pank Governor's Decree No 14 of 1 October 2007 "Establishment of balance of payments reports of credit institutions"

No 7, 20/10/2009

Amendment of Eesti Pank Governor's Decree No 15 of 4 November 2005 "Procedure for sending banknotes and coins to Eesti Pank"

No 8, 2/11/2009

Information subject to disclosure concerning risk management, own funds and capital adequacy of credit institutions"

No 9, 4/11/2009

Amendment of Eesti Pank Governor's Decree No 10 of 7 November 2008 "Establishment of requirements to the contents and form of savings and loan associations' balance sheet statement and income statement"

No 10, 17/11/2009

Amendments to Eesti Pank Governor's Decree No 4 of 9 May 2008 "Approval of TARGET2-Eesti rules"

No 11, 11/12/2009

Amendments to Eesti Pank Governor's Decree No 21 of 16 December 2002 "Procedure for the declaration of international payments and submission of data required for the balance of payments statistics"

Nr 12, 28. detsember 2009

Issue of collector coin

DECISIONS OF THE SUPERVISORY BOARD OF EESTI PANK IN 2009

No 1-1, 3 March 2009

Design and minting of collector coins

No 2-1, 31 March 2009

Remuneration of the Executive Board of Eesti Pank

No 2-2, 31 March 2009

Tender for an audit of the Annual Accounts of the Eesti Pank Annual Report

No 3-1, 28 April 2009

The Profit Distribution Strategy of Eesti Pank

No 3-2, 28 April 2009

Eesti Pank Annual Reports 2008

No 4-1, 2 June 2009

Amendments to the 2009 work schedule for the Internal Audit Department of Eesti Pank

No 4-2, 2 June 2009

Release from office of a Deputy Governor and a member of the Executive Board of Eesti Pank

No 5-1, 29 September 2009

Appointment of auditors

No 5-2, 29 September 2009

Design and minting of a collector coin

No 6-1, 20 October 2009

Appointment to office of members of the Supervisory Board of the Financial Supervision Authority

No 8-1, 15 December 2009

Amendment of the Decision of the Supervisory Board of Eesti Pank No 6-1 of 20 October 2009 "Appointment of the members of the Supervisory Board of the Financial Supervision Authority"

No 8-2, 15 December 2009

The Profit Distribution Strategy of Eesti Pank and distribution of the 2008 profit

No 8-3, 15 December 2009

Approval of the work schedule for 2010 of the Internal Audit Department of Eesti Pank

No 8-4, 15 December 2009

Eestablishment of the interest rate on consumer loans issued to employees of Eesti Pank

PUBLICATIONS OF EESTI PANK IN 2009

The **website** of Eesti Pank is located at **www.bankofestonia.ee**. The website contains information on Eesti Pank and its activities, as well as on the Estonian monetary system, economy and financial environment. Other topics available on the site include banking legislation; information on Estonian banknotes and coins (including guidelines for collectors); information on the European Union and the euro; publications and press releases of Eesti Pank; a glossary, etc. There is also a comprehensive statistics database and the daily fixings of currencies. In addition, there is a virtual library (in Estonian only), which links to other libraries in the field of economy.

Economic policy statement of Eesti Pank

Eesti Pank publishes economic policy statements six times a year. The statements provide prompt and concise opinions of the central bank on the most relevant issues concerning economic and banking policies. The statements are available on the bank's website, published as press releases and usually also presented at a press conference.

Annual Report

The annual report provides an overview of the central bank's activities during the reporting year and the financial statement. The annexes of the annual report include an overview of the economic and financial environment, the list of Eesti Pank Governor's decrees issued during the year, and the list of publications of the year.

Estonian Economy and Monetary Policy

The Estonian Economy and Monetary Policy is a biannual publication presenting a thorough economic review and an **economic forecast**. Issues published in 2009:

- Estonian Economy and Monetary Policy (1/2009)
- Estonian Economy and Monetary Policy (2/2009)

Financial Stability Review

The Financial Stability Review is a biannual publication examining the financial behaviour of Estonian enterprises and households, as well as risks, financial markets, payment systems, etc. If necessary, more thorough articles about topical economic issues are added. Issues published in 2009:

- Financial Stability Review (1/2009)
- Financial Stability Review (2/2009)

Balance of payments

The balance of payments gives an overview of Estonia's foreign trade activities, including the country's international investment position and external debt. It contains a lot of statistical data.

Issues published in 2009:

- Estonia's Balance of Payments for 2008
- Estonia's Balance of Payments for the First Quarter of 2009
- Estonia's Balance of Payments for the Second Quarter of 2009
- Estonia's Balance of Payments for the Third Quarter of 2009
- Estonia's Balance of Payments Yearbook 2008

Flash report

The Flash Reports of Eesti Pank focus on the most topical economic issues and are published on an ad hoc basis. Issues published in 2009:

- Estimates of Estonia's economy in light of deepening global financial crisis (5/2/2009)
- The functioning of the credit market and possibilities of state intervention (27/3/2009)
- Sustainability of public finances (10/6/2009)
- Loan losses of banks and assessments of capital adequacy in the economic decline stage (22/7/2009)

Report on the Adoption of the Euro

With the "Report on the Adoption of the Euro" we wish to share with the public the information at the disposal of Eesti Pank about Estonia's readiness to change over to the single currency of the European Union – the euro – and also introduce the points of view of Eesti Pank. Issues published in 2009:

- Report on the Adoption of the Euro (February 2009)
- Report on the Adoption of the Euro (July 2009)
- Report on the Adoption of the Euro (December 2009)

Kroon & Economy

The quarterly includes surveys and analyses of general interest on topical economic issues, comments, translated articles, statistics, etc.

Issues published in 2009:

Kroon & Economy (1/2 2009)

- Inflation in the Baltic countries (K. Benkovskis, D. Kulikov, D. Paula, L. Ruud)

Kroon & Economy (3/4 2009)

- Development of the time series of core exports (K. Musting)
- Methods of productivity measurement and analysis in OECD countries (N. Viilmann)
- Labour market review (N. Viilmann)

Labour Market Review

The Labour Market Review discusses the most important trends in the Estonian labour market, labour supply and demand, institutional developments of the labour market, and other related issues.

Issues published in 2009:

- Labour Market Review 1/2009 (March 2009)
- Labour Market Review 2/2009 (September 2009)

Working Papers

The Working Papers are summaries of the economic studies conducted at Eesti Pank. The target group of the Working Papers includes, above all, economists and economic experts, and are often published in English only. In 2009, the following Working Papers were published:

- Working Papers 1/2009: M. Randveer, T. Rõõm. The Structure of Migration in Estonia: Survey-Based Evidence
- Working Papers 2/2009: A.H. Hallett, R. Kattai, J. Lewis. Can We Rely on Real Time Figures for Cyclically Adjusted Budget Balances?
- Working Papers 3/2009: J. Babecky, P. Du Caju, T. Kosma, M. Lawless, J. Messina, T. Rõõm. Downward Nominal and Real Wage Rigidity: Survey Evidence from European Firms
- Working Papers 4/2009: J. Babecky, P. Du Caju, T. Kosma, M. Lawless, J. Messina, T. Rõõm. The Margins of Labour Cost Adjustment: Survey Evidence from European Firms
- Working Papers 5/2009: P. Gelain, D. Kulikov. An Estimated Dynamic Stochastic General Equilibrium Model for Estonia

Other publications

- Estonian National Silver Jewellery. Eesti Pank, 2009
- Security features of the Estonian banknotes. Eesti Pank, 2009

Information on publications

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