

Eesti Pank
Bank of Estonia

Eesti Pank Annual Report 2005

2006

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Address

Estonia pst 13
15095 Tallinn
Estonia

Phone

+372 6680 719

Fax

+372 6680 836

E-mail

info@epbe.ee

Web site

www.bankofestonia.info

**Subscriptions for publications
of Eesti Pank**

Phone: +372 6680 998

Fax: +372 6680 954

E-mail: publications@epbe.ee

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Eduard Viiralt: the unknown works

Illustrations of this book take you to the early days of the Estonian kroon.

In 1927 Eesti Pank announced a design competition for the banknotes 5, 10 and 50 krooni. One of the entrants of the competition was Eduard Viiralt (1898–1954), an outstanding Estonian graphic artist in the early 20th century and the founder of print graphics in Estonia. His works are now widely appreciated for the phenomenal mastery of performance and the range of themes and sentiment.

His designs, undisclosed to the public until today, were never to be printed on banknotes but their value in terms of cultural history and aesthetic beauty is timeless.



Main features and functions of Eesti Pank

Eesti Pank is the central bank of the Republic of Estonia and a constitutional institution which analyses and runs the Estonian monetary system, i.e. the monetary policy of Estonia. The aim of monetary policy is ensuring a low and stable price rise along with guaranteeing best opportunities for economic growth. The central bank is also responsible for the security and stability of the financial system. It is the sole legal issuer of Estonian currency and bears responsibility for regulating currency circulation along with keeping the national currency stable.

The mission of Eesti Pank is to ensure price stability in Estonia. To this end, Eesti Pank fulfils the following **main tasks**:¹

- participating in the national economic policy through the implementation of independent monetary policy, advising the government, and international cooperation;
- formulating the policy of the financial sector and creating conditions for the operation of reliable and well-functioning payment systems in order to ensure financial stability in Estonia;
- regulating cash circulation in Estonia;
- making preparations for becoming one of the policy-makers among other national central banks of the euro area who design coordinated economic policy and single monetary policy in Europe.

¹ Approved by Decision No 13-1 of 5 December 2005 of the Supervisory Board of Eesti Pank (Strategic Development Plan of Eesti Pank for 2006–2008).

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Foreword
by Governor
of Eesti Pank

Foreword by Governor of Eesti Pank

For Estonia, 2005 was a year of fast economic growth, higher than expected employment, and households' growing confidence in the future. However, the rapid development was accompanied by a few risks, which the central bank repeatedly drew attention to.

As far as external risks are concerned, the central bank calls for more attention to rising oil prices in the world market and their impact on Estonian consumer prices, as well as the influence of oil price dynamics on other prices.

Internal risk monitoring entails examining the economy as a whole but also the supply and demand situation by sectors both in the labour as well as the services market. Moreover, the fast growth of household debt burden needs more attention.

Looking further ahead, most probably risks emanating from the supply-side can be expected. Estonian enterprises have to be ready for moving up in the value added chain. This means a transition to more knowledge-based products and services. However, the lack of qualified labour force sets limits here.

Robust economic growth in 2005 was boosted by exports growth and the flourishing real estate sector. While the balance of the whole Estonian economy implies long-term sustainable development, the real estate sector showed signs of imbalance. In December 2005, Eesti Pank decided to take measures to tighten the legal framework for housing loans.

The driving force behind investment activity in 2005 was household investment, which increased considerably faster than corporate fixed investment. The share of private consumption in GDP decreased and households invested a considerable amount of their savings in real estate. What is important for Estonia, however, is the further growth of export-oriented investments.

Strong economic growth ensured a fast increase in government revenue and the effective tax revenue collection exceeded expectations. The surplus of the state budget for 2005 was nearly 1.6 per cent of GDP. Nevertheless, the surplus should have been even larger, given that economic growth was faster than in previous years.

The average consumer price inflation was 4.1 per cent in 2005. Taking into account the income level convergence, the 3–4% rise in consumer prices can be considered consistent with price stability in the context of rapid and balanced (in terms of increased labour productivity) economic growth. At the same time, it is hard to comply with the inflation criterion necessary for joining the euro area.

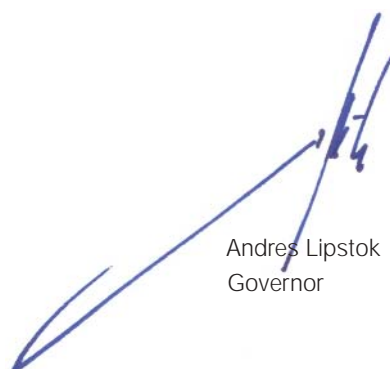


Eesti Pank and the Government have established the goal to introduce the euro as soon as Estonia meets all necessary requirements. Given that Estonia has successfully implemented the currency board arrangement with the fixed exchange rate against the euro (until 1999 equivalently against the Deutsche Mark) since the summer of 1992, the accession to the euro area will not bring about any essential changes in economic policies. Adoption of the euro will contribute to Estonian economic success and help to develop it further under more favourable conditions.

Eesti Pank's operations and activities in 2005 derived from the strategic task to ensure technical readiness to join the euro area by the second half of 2006. To this end, serious work is done in all fields of responsibility: devising of monetary and financial policies, analysis and monitoring of economic development, collection and analysis of economic and financial statistics, monitoring and improvement of the payment environment, regulation of payment intermediation and currency circulation, and distribution of economic information.

For Estonia, year 2005 was the first full year as a Member State of the European Union. For the central bank, this meant even more serious and efficient work so as to bring Estonia's positions to the forums that develop common ground on the economic policy of the European Union.

The international respectability of the central bank should always be backed by bank's reputation in its own country. According to the latest data from March 2006, 79% of the Estonian population trusts Eesti Pank. The bank highly appreciates such support from the society and will do its best to justify that trust also in the future.



Andres Lipstok
Governor



AHED ON VALJAA
A. VASTVVOETVD R



Accountability

NTVD RIIGIKOGV P
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ACCOUNTABILITY

Over the last fifty years the central bank's independence has emerged as an indispensable element of a monetary system which 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, it is the obligation to explain its monetary and financial policy vision and decisions to the citizens of Estonia and their democratically elected representatives in a clear and profound manner. Accountability and autonomy of the central bank are two counterbalancing principles.

Legal framework for accountability and compulsory publications of the central bank
The scope of accountability of the central bank has been defined in several Estonian laws. Pursuant to the Law on the Security for the Estonian kroon, the central bank is to publish at least once a month the data on the volume of gold and foreign exchange reserves, and the amount of the Estonian kroons in circulation. These data are published in the form of **tables describing the balance sheet of Eesti Pank and foreign exchange reserves backing the kroon**. Pursuant to the Official Statistics Act and the Eesti Pank Act, the central bank is entitled as well as obliged to collect and publish **monetary, financial and balance of payments statistics** in its field of responsibility, according to rules laid down for this purpose. The statistical data are published on the bank's website. The Eesti Pank Act also requires publication of a bulletin at least once a quarter and the Eesti Pank Yearbook once a year. The **quarterly bulletins focus on monetary or financial policy issues in turns**. The **yearbook** is published along with the financial report for the year. The Supervisory Board of Eesti Pank approves the annual report and, together with the auditor's report, submits it to the Riigikogu. Along with the annual report of the central bank the Riigikogu receives the annual report of the Financial Supervision Authority approved by the Supervisory Board of the Financial Supervision Authority. The Riigikogu hears the presentation of the Governor of Eesti Pank on the annual report.

Accountability vis-à-vis the Riigikogu


Governor of Eesti Pank makes the presentation on the annual report of Eesti Pank every year. Moreover, the bank and the Riigikogu cooperate in the form of various meetings and the bank gives explanations and comments in response to the issues raised by members of the Riigikogu.

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

Upon request of parliamentary factions, the top executives of Eesti Pank present the views on economic policy developments and the activities of the central bank. In 2005, the criteria for acceding the euro area and meeting these criteria, as well as the role of a national central bank of the euro area were of most interest.

Interpellations of members of the Riigikogu in 2005.

- An interpellation of the members of the Riigikogu Andres Herkel, Tõnis Lukas, Helir-Valdor Seeder, Peeter Tulviste, Mart Laar, Mart Nutt and Trivimi Velliste on the reliability of banking in Estonia and of Eesti Pank with a view of a case related to potential conflict of interest of Ain Hanschmidt, former governor of Eesti Ühispank.

- 
- An interpellation of Kadi Pärnits, a member of the Riigikogu, regarding details of the case related to Ain Hanschmidt, former governor of Eesti Ühispank and his acquisition of holdings in the shipping company Tallink.
 - An interpellation of the members of the Riigikogu Marko Pomerants, Taavi Veskimägi and Olari Taal concerning preparations made for obtaining full membership in the European Economic and Monetary Union (EMU), and meeting the Maastricht price stability criterion.

Regular reporting on economic policy views and making economic data available to the public

The central bank's reliability for the public and the transparency of its activities are the preconditions for the smooth operation of a monetary system. Eesti Pank must provide both the general public and specialists with regular, profound and high-quality information on economy. The central bank considers it important to offer convenient and low-cost access to data (for example, regular publications of Eesti Pank are free of charge to subscribers as well as to public libraries), and also to provide high quality and timeliness of information (for example, there are very strict requirements concerning the system of publishing statistical data¹). In addition to providing information on the web site and in various publications², it is possible to request information directly from the bank. Information can be requested by mail, e-mail or phone. In 2005, Eesti Pank received 1,494 queries, 258 of which were registered as requests for information.

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

² The full list of publications of Eesti Pank in 2005 is available in the Annex to the Annual Report on page 112.



VARRANG



Strategic Objectives
for Performing the Main
Tasks of Eesti Pank

STRATEGIC OBJECTIVES FOR PERFORMING THE MAIN TASKS OF EESTI PANK¹

The activities of Eesti Pank are planned for a three-year period. The Executive Board of Eesti Pank defines the strategic tasks for the coming period once a year and submits a strategic development plan to the Supervisory Board of Eesti Pank for approval. The strategic objectives set in the year 2005 are as follows:

I Monetary policy

1. Achieving readiness to obtain full membership in the European Economic and Monetary Union (and to accede to the euro area) by the second half of 2006.
2. Maintaining the currency board arrangement until granted full membership in the European Economic and Monetary Union.
3. Regarding the monitoring of Estonia's economy, the main focus lies with the threats related to economic imbalances and with economic policy cooperation with the government aimed at finding ways to prevent possible setbacks arising from such threats.
4. Unifying Estonian monetary policy environment and market operations with the Economic and Monetary Union, proceeding from the peculiarities of Estonia.
5. Developing economic forecasts and moving towards unification with the economic forecasting arrangement of the European System of Central Banks regarding content and procedure.

II Financial stability

6. Supporting the international competitiveness of the financial sector and promoting domestic competition in banking.
7. Acting as a supervisor of settlement systems and publishing regular assessments of the current situation.
8. Perfecting the system of financial sector security measures in cooperation with the Ministry of

Finance and the Financial Supervision Authority, and participating in the crisis management of the international financial sector.

9. Ensuring that financial sector regulation is up to date and in compliance with international standards and practices.

III Meeting the cash demand

10. Reducing the percentage of cash in circulation by promoting usage of modern means of payment.
11. Ensuring the technological readiness of cash management for the changeover to the euro.
12. Commemorating key events in Estonia by issuing numismatic-bonistic products.

IV Obtaining full membership in the Economic and Monetary Union

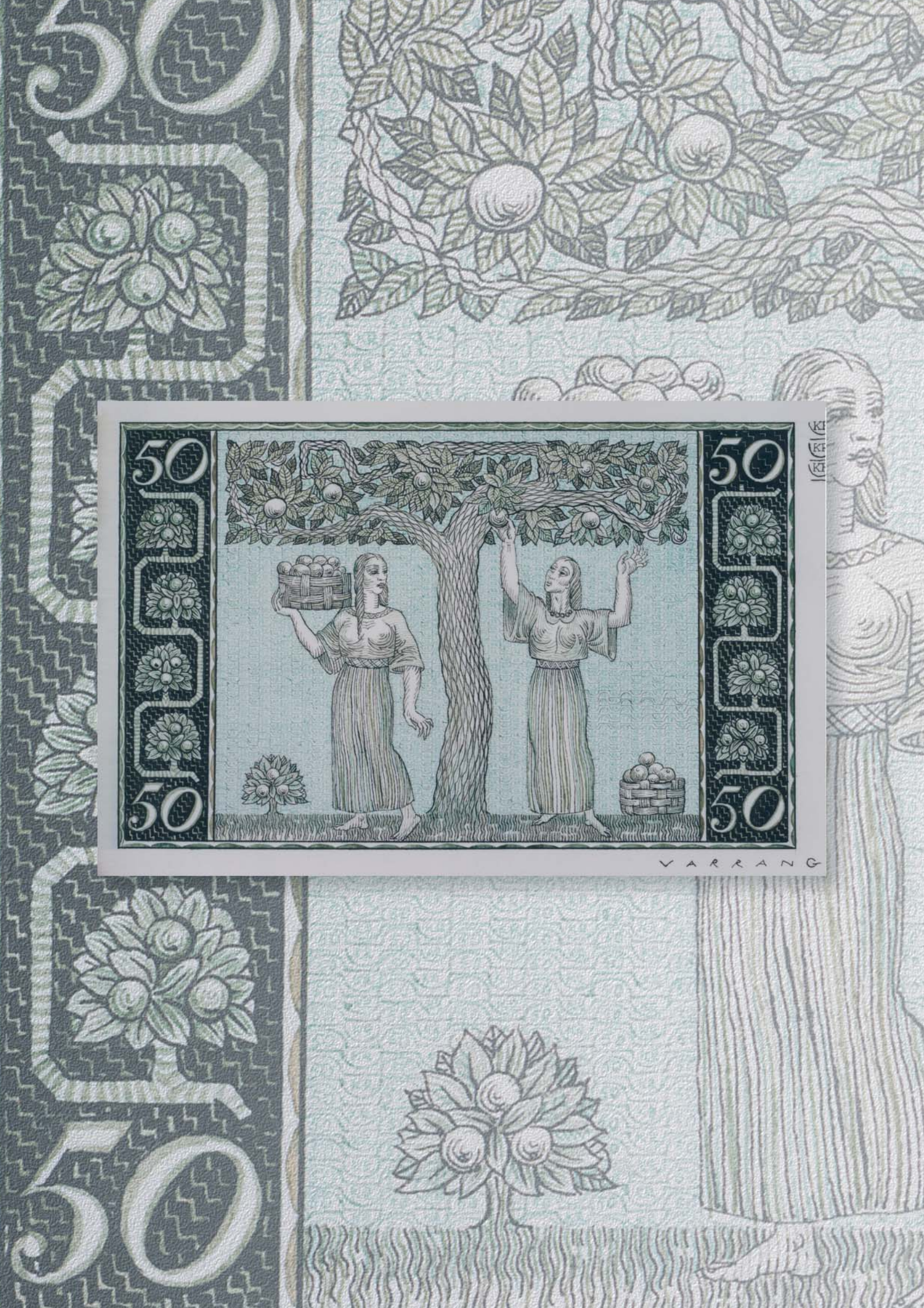
13. Proceeding from its goals and within the limits of its resources, participating in the work of the European System of Central Banks and other European Union committees and working groups.
14. Bringing Eesti Pank's financial accounting and reporting into conformity with the standards of the European System of Central Banks.
15. Ensuring the consistency and quality of compilation of financial sector and balance of payment statistics in compliance with the European Union standards.
16. Ensuring readiness for competent participation in the decision-making and cooperation mechanisms of the common European monetary policy.
17. Creating an IT infrastructure required for connecting the information system of Eesti Pank to the core network and information system of the European System of Central Banks.
18. Informing the public and cooperation partners of the economic, monetary and financial policy situations and priorities in Estonia and the European Union in a uniform, clear, and timely manner.

¹ Approved by Decision No 12-1 of 21 December 2004 of the Supervisory Board of Eesti Pank (Strategic Development Plan of Eesti Pank for 2005–2007).



V Organisation and Cooperation

19. Participating in the work of the Nordic-Baltic Constituency of the International Monetary Fund.
20. Developing the system of external managers and credit risk management in administering the foreign currency reserves to improve the overall management of financial risks.
21. Developing the management system of Eesti Pank, including quality and risk management.
22. Streamlining the records management of Eesti Pank via the implementation of a document management facility, the e-EP.



VARRANG



Major Activities and
Achievements of
Eesti Pank in 2005

MONETARY POLICY

ENSURING SMOOTH OPERATION OF ESTONIA'S CURRENT MONETARY POLICY FRAMEWORK

Primary features of Estonian economic policy in regard to monetary stability

The mission of Eesti Pank is to ensure **price stability** in Estonia. A stable, low and easily predictable inflation rate ensures most favourable conditions for long-term economic growth. A stable price environment allows corporations and individuals to plan their investment and consumption decisions more effectively and ensure efficient investment of their resources.

Estonia's monetary strategy for achieving price stability is based on the **fixed exchange rate system with the currency board arrangement**. Since 1992, the domestic currency kroon is pegged to the euro (until 1999 equivalently to the Deutsche Mark) at the rate 1 EUR = 15.6466 EEK. As Estonia's monetary policy based on the currency board arrangement has proved its viability, Estonia has unilaterally committed to maintain the current system and the central rate until the adoption of the euro.

Other features of Estonian economic policy throughout re-independence have been relying on the principles of **balanced budget and economic policy that supports open and free competition**.

Since the Estonian monetary system is related to the euro and capital mobility is quite extensive, in a broader perspective **our monetary policy environment is largely shaped by the operations and activities of the European Central Bank** which proceeds from the development of the euro area economy. The impact of monetary policy decisions of the European Central Bank is quickly transmitted into Estonia's economy, our loan and deposit interest rates, and into the Estonian kroon exchange rate vis-à-vis the other currencies. This, in turn, affects the behaviour of the non-financial sector (households and non-financial corporations) and the formation of price stability in Estonia. The range

of additional monetary policy instruments available to Eesti Pank is rather limited as active monetary policy is not efficient under the currency board arrangement. The current regime has successfully anchored inflation expectations confirming the effectiveness of the currency board arrangement. What Eesti Pank can do is to draw the attention of the public and the government to macro-economic environment risks, exercise pressure to the financial sector, and implement strict reserve requirements and supervisory measures.

Monetary policy in 2005

Eesti Pank continued to participate in domestic as well as wider **discussions on monetary policy** in 2005. Major cooperation partners were the Government and ministries, the EU institutions, the International Monetary Fund (IMF) and international rating agencies (Moody's, Fitch, Standard&Poor's).

Eesti Pank continued close cooperation with the Government in order to ensure stronger economic policy support to the monetary policy the central bank exercises. Among other important cooperation fields, central bank employees participated in the regular compilation of the convergence programme led by the Ministry of Finance and submitted to the European Commission.

Representatives of Eesti Pank took part in discussions on monetary policy in the EU Economic and Financial Committee (EFC), the General Council of the European Central Bank and the Monetary Policy Committee (MPC) of the European System of Central Banks (ESCB). As Estonia is a Member State with a derogation in the Economic and Monetary Union, Eesti Pank takes part in the work of those institutions of the ESCB which above all include the non-euro area EU Member States. Eesti Pank will be able to participate in the discussions directly related to the euro area only after the accession to the euro area. Developments of Estonian economy and monetary policy were treated as part of regular reviews of the monetary policy of non-euro area Member States, also covering the functioning of the exchange rate mechanism ERM II.



Along with participation in general discussions on monetary policy the representatives of Eesti Pank gave detailed explanations to foreign partners on Estonian economic development and the sustainability of economic policy (including monetary and fiscal policies) that aims at balanced economic development.

International institutions gave high ratings to Estonia's monetary and fiscal choices also in 2005; rating agencies upgraded Estonia's sovereign rating outlook to positive. Nevertheless, Eesti Pank and international institutions emphasised that in the environment of the current rapid growth, economic developments must be very closely monitored and imbalances prevented when necessary.

In 2005, the average annual inflation rate reached 4.1% in Estonia. Faster price growth mainly stems from a rise in oil and energy prices and the resulting volatility of consumer prices. Domestic price pressures arising from labour costs remained subdued.

Taking into account income level convergence, the 3–4% rise in consumer prices can be considered consistent with price stability in the context of fast and balanced (in terms of increased labour productivity) economic growth. However, **in 2005 Eesti Pank repeatedly drew the attention of the public, the financial sector and the Government to external and domestic risks that pose a threat to balanced development.**

External risks imply to the rise in oil prices on the world market and consequent impact on Estonian consumer prices as well as the impact of oil price dynamics on the prices of other energy carriers.

As for **domestic risks**, the central bank denoted risks in some sectors. Although estimates on the domestic balance of Estonian economy as a whole did not point to any deviation from the long-term sustainable course of development, surveys of the real estate market suggested imbalances. Housing loans and residential property prices kept growing, supply-side constraints appeared and labour costs

in the construction sector rose faster than the average of the whole economy. A key issue was the further rapid growth of household debt dominated by housing loans. The European Central Bank kept monetary policy rates unchanged almost throughout the year and raised them by 25 basis points in December. Only then did the interest rates of housing loans issued in Estonia start rising. In December 2005, Eesti Pank decided to take measures to make the legal framework for housing loans more rigid.

Like earlier, Eesti Pank again suggested offering the best possible support to improve economic balance through fiscal policy, mostly through increasing the consolidated balance surplus.

PREPARATIONS FOR BRINGING ESTONIAN MONETARY SYSTEM INTO ACCORDANCE WITH REQUIREMENTS FOR JOINING THE EURO AREA

Eesti Pank and the Government have established the goal to introduce the euro as soon as Estonia meets all necessary requirements. Given that Estonia has successfully implemented the currency board arrangement with the fixed exchange rate against the euro (until 1999 equivalently against the Deutsche Mark) since the summer of 1992, the accession to the euro area will not bring about any essential changes in economic policies. The preparations for joining the Economic and Monetary Union mainly comprise institutional and technical issues, for example harmonisation of legislation, development of the operational framework for monetary policy and payment systems, and preparations for euro cash handling. Eesti Pank's operations and activities in 2005 derived from the strategic task to ensure technical readiness to join the euro area by the second half of 2006 (for the framework for technical preparations see the chapter on the changeover to the euro).

In order to join the euro area Estonia must first fulfil the Maastricht convergence criteria. To this end, Eesti Pank has been working closely with the Government (see also Chapter "Preparations

for full membership in the European Economic and Monetary Union (changeover to the euro)". In 2005, Estonian economy met all general convergence criteria but the inflation rate, though being in line with the price stability objective, exceeded the reference value of the inflation criterion. In the coming years, inflation is expected to decline. Estonia fulfilled the criteria for budget balance and government debt along with the interest rate criterion in 2005. The exchange rate criterion was also met as required. Estonia joined the exchange rate mechanism ERM II on 27 June 2004, maintaining the exchange rate of the Estonian kroon pegged to the euro (1 EUR = 15.6466 EEK) and the currency board arrangement as a unilateral commitment. As expected, functioning in the ERM II framework has not caused any problems for Estonia in terms of the functioning of the monetary system.

ECONOMIC ANALYSIS, FORECAST AND RESEARCH AS THE BASIS FOR GROUNDING MONETARY AND FINANCIAL POLICY DECISIONS

Monitoring of the current economic situation, forecasting economic developments and analysing economic mechanisms form an important and resource-intensive part of the central bank operations and activities. The quality of domestic monetary and financial policy decisions along with successful participation in economic and political discussions at the EU level are dependent on the above.

Along with the **current economic monitoring and analysis** of the Estonian economy Eesti Pank also conducts research on the recent developments in the European Union and our neighbouring countries. Eesti Pank closely follows developments in the acceding countries (Bulgaria and Romania) and the accession countries (Croatia and Turkey). Several developing countries in Asia (incl. China and India) attract attention as they make a considerable impact on global economic developments (especially in the light of demand pressure currently exercised by commodity markets).

The economists of Eesti Pank also draw up analyses of various special issues if required. For instance, in 2005 risks related to fuel price developments had a great impact on the focus of economic analysis. These risks called for more attention to issues such as the transfer of world market prices into Estonian consumer prices and the impact of the schedule for harmonising fuel and energy prices and excise duties on the consumer basket. It was necessary to launch quarterly monitoring of the euro area monetary policy in view of the upcoming introduction of the euro. The analysis of domestic demand mainly focused on the real estate market both in short and long term perspective. The outcomes of the current economic analyses and monitoring by Eesti Pank are available to the public in the **comments and reviews published quarterly** (see page 93 for an overview of the development of Estonian financial and non-financial sectors in 2005).

Eesti Pank **publishes economic** forecasts twice a year. Along with the quarterly model of the Estonian economy the indicator models were implemented for forecasting consumer price inflation and economic growth. The latter are also used in current monitoring.

The primary process of forecasting was founded on a new base model, which increases the theoretical substantiation of forecasts and ensures better consistency between short and long term projections (see Annex on page 108 for an overview of the basic points in the 2005 economic forecasts).

Economic surveys contribute to current analysis and forecasting, and provide opportunities to participate in domestic as well as international discussions on economic and political issues. The general framework for Eesti Pank's economic research is determined by the strategic research plan. The priorities for 2004–2006 include **updating the central bank's macromodel, creating the monetary policy's simulation model, monetary policy and financial sector research, and the sustainability analysis of the Estonian monetary system**. 11 research projects on these issues were carried



out in 2005, focusing on the principles of price and wage setting behaviour in Estonian enterprises, indicators of banking sector vulnerability in Estonia and Central and Eastern European countries, productivity in Estonian enterprises, and issues related to the Economic and Monetary Union. The results of economic research have been published in the working paper series (see Annex on page 113 for the full list) and presented at the open seminars of Eesti Pank (see "Open seminars of Eesti Pank" under "Research" on the bank's web site).

Open seminars included presentations on the research conducted by Eesti Pank as well as by distinguished foreign experts. In 2005, Prof. David Laidler from the University of Western Ontario delivered a presentation on the theoretical foundations of monetary policy; Prof. Lars Ljungqvist from the Stockholm School of Economics analysed European unemployment issues, and Carsten Olsson from the Eurostat made a presentation on the experiences of various EU countries in relation to the adoption of the euro. Moreover, a research seminar on productivity and foreign direct investment was held in cooperation with the University of Tartu, attracting a large number of participants.

The results of the research projects conducted at Eesti Pank have been presented at various **international and domestic academic conferences**, for instance at the annual conference of IAES (International Atlantic Economic Society) and GEP (The Leverhulme Centre for Research on Globalisation and Economic Policy), as well as the 13th international academic conference on economic policy in Tartu and Võrska (Estonia), the Vello Vensel Memorial Conference organised by the Tallinn University of Technology, and the annual international conference of the Estonian Economic Association.

Central bank economists took part in various **international projects**, such as the joint research seminar organised by the University of Helsinki and the University of Tartu, and the EACES (The European Association for Comparative Economic Studies) research seminar in Halle.

The **visiting researcher programme** and the **research award** of Eesti Pank play a significant role in research contacts. Two economists from abroad were employed in Eesti Pank as visiting researchers in 2005. Eesti Pank's annual **research award** for 2005 was granted to the research "Does an Increase in Unemployment Income Lead to Longer Unemployment Spells? Evidence using Danish unemployment assistance data" by Ott-Siim Toomet, a Ph.D. student at the University of Tartu.

RESERVE MANAGEMENT

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

Structure of foreign exchange reserves

No major changes in the structure of foreign exchange reserves took place in 2005. The reserve is still divided into two: the **liquidity buffer** and the **investment portfolio**. A small part of the reserves is held in **gold**.

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

Assets of the other larger component of the foreign exchange reserves – the **investment portfolio** – are invested in international financial markets. The objective of investments is to achieve the optimum balance of risk and average return above money market interest rates throughout a global economic cycle. The assets of the investment portfolio are mainly invested in the liquid bond markets of lead-

ing industrial countries, whereas investments' interest rate, credit, foreign exchange and liquidity risks are constantly monitored and managed.

Investment process

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

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

In addition to earnings from a relatively stable benchmark portfolio, or *passive investment*, Eesti Pank is also *actively investing*, taking positions in global financial markets. Such investment decisions are taken based on economic analysis, market relationships and other factors. Markets and securities are chosen on the basis of the investment idea, presumed horizon and expected efficiency. The main investment philosophy lies in diversification: the aim is to spread risks and make better use of market opportunities. Investments in several markets and various instruments are used, as well as positions with different duration. Portfolio managers make in-

vestment 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 attempts to discover its niche in today's rather efficient markets. In investment decisions two different approaches are applied – subjective and model-based. The former is mainly based on the qualitative analysis of economic processes, market psychology and the experience of portfolio managers. The latter is based on quantitative market relationships derived from investment models (for more information on the investment models applied see the Working Paper of Eesti Pank No 6/2005 "Application of Investment Models in Foreign Exchange Reserve Management in Eesti Pank"). Best decisions for investing in money, capital and foreign exchange markets are striven by a combination of these two approaches.

The outcome of the active investment policy was 7 basis points of excess return over the benchmark portfolio. External asset managers also have a role in active investments. In mid-2005, a contract was signed with a new manager PIMCO who is well known for successful bond investments. State Street Global Advisors have been investing Eesti Pank's assets since 2002 and ABN Amro Asset Management since 2003. One of Eesti Pank's strategic objectives lies in developing and expanding the system of external asset managers. The external asset managers use a portion of the risk limit, which is primarily invested in financial derivatives.

Investment results in 2005 and related factors

By end-2005, the foreign exchange reserves of Eesti Pank reached 25.7 billion kroons. The annual increase was around 28%. The excess reserve¹ accounted for approximately 14% of the total reserve, i.e. 3.6 billion kroons. The development of return on

¹ For the components of the excess reserve and their calculation see the table on the reserves backing the kroon (row IX – foreign reserves net) published on the web site of Eesti Pank on the fifth working day of each month.



foreign exchange reserves (compared to forecasts) are shown in Figure 1. These dynamics were affected by changes in the foreign exchange reserves across months along with changes in the interest rates of the euro area and the US. The US Federal Reserve raised the key interest rate altogether on eight occasions (by 2 percentage points in total) causing a rise in interest rates nearly along the entire extent of the yield curve. The European Central Bank raised the key interest rate by only 0.25 percentage points and movements occurred in both directions: the interest rates on bonds with the maturity of up to 5 years rose, while longer-term rates fell.

In recent years, the return on foreign exchange reserves has exceeded that of the money market (see Figure 2).

Changes in the benchmark portfolio in 2005

The euro area interest rates were rather stable early in the year, in the second quarter longer-term rates even dropped slightly. The last quarter of 2005, however, saw a rapid rise in the short-term interest rates of the euro area. In the US, 10-year interest rates kept increasing throughout the year. This resulted in the average duration of the benchmark portfolio at the beginning of December being over 10% shorter than the duration of the optimum portfolio. Therefore the risk level of the benchmark portfolio needed to be increased. The duration of the new benchmark portfolio of the euro area extended by 15% (from 1.06 to 1.22 years) and the US portfolio by 9% (from 0.77 to 0.84). The average duration of the new benchmark portfolio was 1.07 years. The structure of the new benchmark portfolio, which the Monetary Policy Committee of Eesti Pank endorsed on 1 December 2005, is given in Table 1.

Asset management services to the public sector

Eesti Pank has cooperated with several public sector institutions for years already. The central bank provides its services to the Ministry of Finance in risk management and trade execution for the Stabilisation Reserve. Investment decisions on the

placement of these funds are still made by the State Treasury. Eesti Pank provides full package of asset management services to the Guarantee Fund.

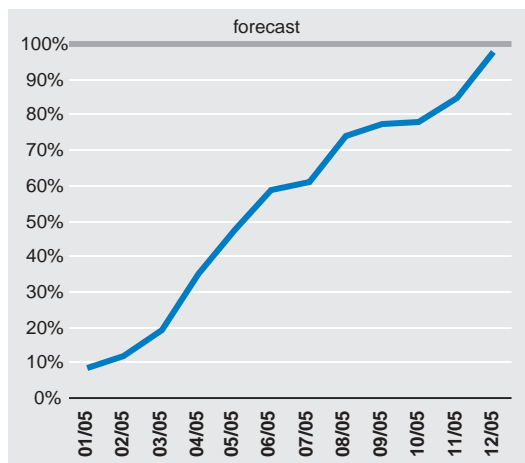


Figure 1. Development of return on foreign exchange reserves

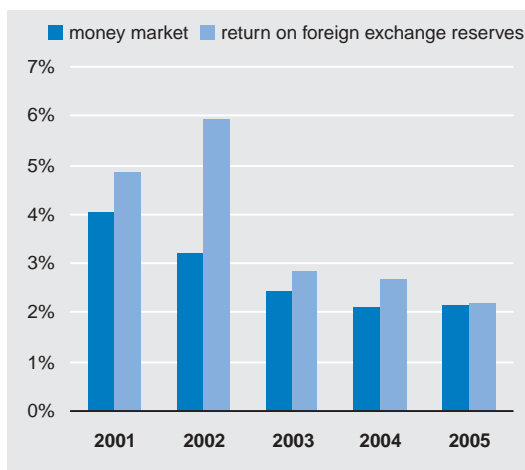


Figure 2. Return on foreign exchange reserves compared to return on money market

Table 1. Structure of the benchmark portfolio

	3 months	1-3 y	3-5 y	5-7 y
Euro area	74.40%	11.26%	5.76%	4.03%
USA	80.98%	9.03%	4.44%	3.19%
	7-10 y	10+ y	Duration	
Euro area	2.95%	1.60%	1.22	
USA	2.35%		0.84	

SAFEGUARDING FINANCIAL STABILITY

Safeguarding a smooth and efficient financial system is one of Eesti Pank's main objectives.

To this end, it is necessary to develop an appropriate financial stability framework, which involves relevant legal environment and financial sector policy, efficient supervision and reliable information about the financial sector.

THE ROLE OF EESTI PANK IN THE FINANCIAL STABILITY FRAMEWORK

Financial stability stands for a situation where the financial system is not interrupted or disturbed to the extent or duration which would considerably hinder economic activity or prevent the achievement of the central bank's primary goal – price stability. The efficiency of a monetary policy transmission mechanism largely depends on the functioning of important financial institutions and infrastructure. For safeguarding financial stability Eesti Pank mainly focuses on securing a smooth integrated performance of the financial system and minimising the threat of a systemic crisis.

Forming its financial policy, Eesti Pank relies on continuous monitoring and expert analysis. The output of financial sector analysis and stability assessments is the Financial Stability Review which also includes recommendations on financial sector policy. In order to assess the performance of the financial sector, overseer's assessments on the essential parts of the financial infrastructure – payment and settlement systems – are highly important. Pursuant to the division of tasks within Estonia Eesti Pank is also the banking sector regulator, i.e. its decrees establish norms, procedures and reporting requirements that other banks are to follow. Recently the development of a financial system safety net and ensuring its smooth functioning have gained in importance.

In regard to the international structure of the Estonian financial sector and domestic division of tasks, cooperation at both the national and international level with other state institutions is extremely important for safeguarding financial stability.

FINANCIAL POLICY AND FINANCIAL ENVIRONMENT IN 2005

Eesti Pank's financial sector policy is influenced by the development of the entire sector (especially the banking sector), cross-border integration, the changing economic environment and developments in the European and Estonian financial regulations.

Cross-border integration

Entry into the market by banking market participants from the Nordic countries has characterised Estonian banking from the mid-1990s. This is accompanied by **cross-border integration** which shows in a relatively great dependency of liquidity and risk management on the Nordic parent banks. In 2005, Swedbank obtained 100% of Hansapank's shares through the takeover bid. Consequently, 99% of the banks in Estonia belong to Nordic banking groups today. The future development of the Estonian banking market is affected by the operations and objectives of foreign banking groups. This is an important prerequisite for the implementation of the financial policy. On the other hand, increasing integration is definitely positive for financing economy.

Expansive economic environment and loan growth

The year 2005 saw very fast economic growth and high domestic demand, which were strongly supported by (along with exports) record levels of housing loans. Residential property prices increased rapidly and the risks related to unjustified expectations as to the continuation of present trends aggravated. For the financial stability banks should retain a conservative approach to assessing the future solvency of borrowers as well as the market value of collaterals (incl. residential property prices) despite the tightening competition. Today cross-border integration in the banking sector means that the growth rate of loans mainly depends on the decisions of Nordic financial groups. However, in order to safeguard financial stability it would be safer if taking risks were in line with maintaining their



buffers. Thus, the additional risks accompanying the rapid growth of loan portfolios of banks operating in Estonia should also invite proportionally larger liquidity and capital buffers here.

Regulatory environment

As regards banking regulations, the most important event in 2005 was the introduction of the new Basel II framework based Capital Adequacy Directive in the European Union. Accordingly, the entire package of prudential ratios which forms the basis for banking supervision, in particular capital adequacy regulation, needs to be reviewed.

The most prominent change in the domestic legal framework of the financial sector was the adoption of the Electronic Money Institutions Act by the Riigikogu.

SAFEGUARDING FINANCIAL SECTOR POLICY AND FINANCIAL STABILITY

Development of banking regulations in Estonia

The development of banking regulations has been characterised by the reorganisation of the system of acts and regulations through better integrated solutions on the one hand, and the need for updating provisions arising from the development of the banking market on the other.

The most significant amendment in the banking regulation in 2005 was the increase of the risk weighting of housing loans from 50% to 100% in calculating capital adequacy. Consequently, banks need to increase the share of own funds (i.e. financing by owners) in housing loan activities. Given the impact of the close cross-border relations of the Estonian banking system on the domestic loan market, a proposal was made to institutions that supervise foreign banks with branches in Estonia and relevant central banks in other countries to consider the application of 100% risk weighting in regard to housing loans issued to Estonian residents.

Another amendment related to updating was the exclusion of the exchange rate mechanism ERM II currencies from the prudential ratios that establish limitations to foreign currency open positions. For currency risk Estonia has double regulations: first, the prudential ratios which set limitations to foreign currency open positions, and second, the requirement for additional own funds, which depends on the size of the open currency position, included in the capital adequacy calculation. As the two regulations imply different calculation on consolidated basis, some distortions in the currency risk calculation occurred for large banking groups. Since the problems mainly concerned the national currencies participating in ERM II for which the currency risk is limited by an agreed fluctuation band, it was decided to exclude them from the prudential ratio calculation setting the limitation.

Financial sector analysis

Since autumn 2003 Eesti Pank publishes a biannual Financial Stability Review, which reflects developments affecting Estonian financial sector stability. The review includes assessments and projections of financial sector developments, being an important input for Eesti Pank's economic policy analyses.

In 2005, the key topics of the financial stability analysis were an **increasing growth in household debt** and a **rise in residential property prices**. The issues of loan demand, loan servicing ability and overpricing of housing deserved the most attention. The increased role of foreign capital in the Estonian banking market after Hansapank's takeover in summer 2005 gave an extra impetus for the **analysis of the impact of financial sector integration**. The issues of loan demand and international integration will be holding an outstanding position in financial stability analyses in 2006 as well.

Together with the other EU central banks and supervisory authorities, Eesti Pank participates in the analyses and assessments of the financial stability and the financial sector's structure of the EU. In 2005, the major common outputs were **regular**

reviews of European financial stability and banking sector structures. Special issues, more significant to Estonia, included the differences in the banking sector structures of the new Member States, financial stability implications of the new International Financial Reporting Standards (IFRS), and issuance of housing loans in EU countries.

From 2003, Eesti Pank has been participating in the **cooperation network of Nordic and Baltic central banks** which is used to exchange information and assessments on financial stability of the area on a regular basis. In 2005, the idea of analysis networks was adopted also at the EU level by other central banks and supervision authorities.

Cross-border cooperation and other issues of EU financial policy

The increasing integration of financial markets is inevitable. It is accompanied by new challenges in the formation of the EU financial stability framework. Operational and efficient solutions should be found concerning the scope of regulation, harmonisation of supervision standards and management of potential financial crises. In 2005, the European Commission published the **Green Paper on Financial Services Policy 2005–2010** which also covers the above issues.

Eesti Pank has outlined in the discussions on the EU financial services that an essential prerequisite for successful financial integration is advances in integration also in other fields of economy. Eesti Pank favours balanced approach in the financial policy: on the one hand, it should be borne in mind that efforts to minimise potential risks should not inhibit the integration of financial markets; on the other, we must prevent the situation where financial integration becomes a goal per se, which then begins to obstruct innovative solutions (for instance on the retail services market) through excessive regulation.

For the development of legal framework the main objectives of the EU financial services policy include the reorganisation of legislative drafting in financial

intermediation, achievement of 'better regulation' and prevention of over-regulation. Eesti Pank emphasises the need to pay more attention to the implementation of the current legislation apart from preparing new amendments. Another important field that deserves more attention in forming the EU financial services policy is the **convergence of the infrastructures of securities transactions and settlements.** This would strengthen competitiveness of the European markets and facilitate economic growth.

Given the structure of our banking sector, Estonia is very much interested in what the **EU policy on cross-border banking** will be like. The discrepancy between the rights, obligations and responsibilities of financial stability institutions in a home country and a host country comes to the fore in regard to the financial safety net and above all the framework for financial crisis management (see page 33).

The harmonisation of supervision practices was one of the EU priorities for the implementation of consolidated supervision principles. In the discussions over the development of the common European financial supervision framework, Eesti Pank has supported the approach which motivates **supervision authorities to more extensive cooperation and exchange of information** in both direction between the home country and the host country. Through commissions and committees at various levels of the European Union (including ECOFIN, EFC, CEBS, GenC, BSC), Eesti Pank has also brought out the need to pay more attention to the issues of sharing responsibility between the home country and the host country.

Problems of cross-border financial stability for the host country and their acknowledgement at an international scale and in developing the EU financial policy are currently of primary importance for Eesti Pank. Last year economists of Eesti Pank treated the financial stability issues related to cross-border banking also in the quarterly Kroon and Economy and in the Financial Stability Review.



Financial safety net

In 2005, the development of the **framework for financial crisis management** was more active than in the previous years. Advances were made both at national and international level.

International cooperation has improved which shows in the **enactment of the EU memorandum of understanding (MoU)** on cooperation in financial crisis situations **on 1 July 2005**. The objective of the MoU between the central banks, supervision authorities and ministries of finance of the EU Member States is to ensure timely and adequate implementation of national crisis management measures through effective information exchange. In addition to the minimum requirements of information exchange defined in the MoU, the drafting of guidelines and instructions specifying the content of cooperation agreements started. Eesti Pank participated in the preparation of the recommendations and best practices for crisis management in the task force formed from the representatives of banking supervision authorities and central banks.

The best way to develop a relevant crisis management framework is to test the functioning of the effective agreements in **crisis simulation exercises**. EFC is planning an extensive crisis simulation exercise in spring 2006, which involves all parties of the EU financial crisis management, and in which representatives of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance will take part in.

The national inter-agency discussion on the development of financial crisis management principles also moved further. In cooperation with the experts from the Financial Supervision Authority and the Ministry of Finance a draft national cooperation agreement was prepared on financial crisis management. Before the agreement will come into force, its applicability will be tested in the national crisis simulation exercise in 2006.

Another important part in the Estonian financial safety net is the **deposit guarantee schemes**.

Deposit insurance is mandatory for banks operating in Estonia since 1998, and from July 2002 it is managed by the Guarantee Fund. In 2005, the upper limit of compensation for deposits was 100,000 kroons per depositor, from 2006 on it is 200,000 kroons, and by end-2007 it will reach the level provided for in the EU directive (20,000 euros, i.e. 313,000 kroons). The role of Eesti Pank is to provide analytical support to the Guarantee Fund in determining the amount of appropriate contribution for guaranteed deposits. Apart from the Deposit Guarantee Sectoral Fund, the Guarantee Fund comprises the Investor Protection Sectoral Fund and Pension Protection Sectoral Fund, which are financed according to the principles of ex ante schemes.

Several discussions were held at the EU level in 2005 in terms of making amendments to the directive on deposit insurance. The main topics of discussion on the draft directive were the level of coverage provided by the directive, the definitions of deposits, "topping-up" arrangements, financing principles of deposit guarantee schemes, and agreements and procedures for cross-border information exchange.

DEVELOPMENTS IN STATISTICS

Over the years, Eesti Pank has created a well-functioning, modern, flexible, cost-effective, and internationally compatible system of collecting, processing, and disseminating financial sector and balance of payments statistics.

The comprehensive and regularly updated statistics page on Eesti Pank's web site reveals the extensive work done. This page contains about 400 tables of various statistical data.

In 2005, Eesti Pank's statistics-related activities entailed active participation in various committees and working groups of the ECB and the European Commission (Eurostat). The experts of Eesti Pank took part in the preparation of the **"ECB Report on the statistical preparedness of non-euro area EU Member States – 4th Progress Report"**. The progress report evaluated the compliance of non-euro area EU Member States' statistics with the Economic and Monetary Union (EMU) requirements. Eesti Pank already today meets the statistics requirements of EMU. Some shortcomings have occurred in general economic statistics compiled by the Statistical Office, but these are expected to be overcome by the time of acceding to the Economic and Monetary Union. Moreover, preparations were made to draw up another key document, the **ECB Convergence Report 2006**. As before, the report evaluates the convergence process of 11 non-euro Member States, including Estonia. The contribution of the statistics departments of Eesti Pank lies in providing the relevant statistics.

In addition to expanding relationships with the European Commission and the European Central Bank, regular data dissemination and cooperation continues with the International Monetary Fund (IMF) and the Bank for International Settlements (BIS).

Banking and other financial statistics

The most outstanding event in 2005 in the field of banking and other financial statistics was the **gradual integration in the ECB's system of**

data collection. Since January 2005, Eesti Pank submits MFI balance sheet statistics and monthly interest rate statistics prepared in compliance with the EMU requirements. In November, the submission of respective quarterly MFI balance sheet data was also started.

In 2005, further preparations were made to improve the accessibility and quality of **statistics of other financial intermediaries** (i.e. data of financial institutions not included under the MFI category) with the aim to meet all the ECB statistics requirements in the near future. As in 2004 most of the resources were spent on the reconciliation of the MFI statistics with the appropriate ECB standards, in 2005 more attention was paid to other than MFI statistics, mainly on other financial intermediaries and securities, and to the compilation of national financial accounts.

In order to ensure the availability of **securities statistics**, cooperation with the Estonian CSD was carried on which resulted in higher accuracy and quality of data submitted by the central register to Eesti Pank. The technical solutions of data exchange were updated as well. For the smooth operation of data exchange between Eesti Pank and ECSD an agreement was concluded.

Essential changes occurred in reporting the data of leasing and insurance companies. Since June 2005, the data of three more leasing companies were added to the leasing statistics. Before that, only the data of the member companies of the Estonian Leasing Association were included. Thus, leasing statistics became even more extensive. Eesti Pank participated in the development and introduction of the electronic reporting system of insurance companies, an initiative of the Financial Supervision Authority. Eesti Pank contributed by providing support in creating a framework for electronic data exchange and database structuring. This resulted in making the data of insurance companies available via database queries from the second half of 2005.



The compilation system of the **national financial accounts**¹ was developed further. Accounts for the first to fourth quarters of 2004 and the first and second quarters of 2005 were completed. New data sources were put into use (e.g. improved data of ECSD, insurance database) and compilation methods were elaborated. While at the end of 2005 the ECB guideline on the compilation of financial accounts was amended, the present financial accounts compilation system was analysed in light of the updated guideline. Amendments to the guideline do not, however, have a significant impact on the current system.

Meeting Eesti Pank's objectives for statistics inevitably requires efficient cooperation with other institutions collecting financial sector data and data providers. Eesti Pank and the Financial Supervision Authority continued cooperation to improve the reporting and data collection system of credit institutions and other financial intermediaries (investment funds, insurance companies, etc.). Traditional and mutually useful meetings with credit institutions were carried on; the primary issues discussed were planned amendments to reporting.

The conclusion of two important cooperation agreements should be mentioned in addition to the above noted close work relations with the ESCD. An agreement in spring 2005 denoted the long-time and successful cooperation with savings and loan associations. This agreement also served as a basis for the publication of the consolidated balance sheet of savings and loan associations on Eesti Pank's web site since November 2005. The other cooperation agreement was signed in May 2005 and covered data exchange between Eesti Pank and the Statistical Office.

Balance of payments statistics

In 2005, Estonia's balance of payments statistics aimed at the methodological compliance of the output with international standards, and higher accuracy and reliability of statistics.

Collection of data was improved and the internationally compatible Estonian model of balance of payments statistics was developed.

The launch of the **state accounting system** contributed significantly to **improving the quality of data**. Moreover, the integration of the system with the data sources of balance of payments allowed to considerably enhance the quality of statistics of general government's external transactions, especially in terms of transfers. As the state accounting system includes all public sector agencies, it was examined whether information on the balance of payments statistics of such agencies could be requested directly from the system. This would reduce the reporting burden for agencies. The related activities will continue in 2006.

Negotiations were held with the Ministry of Justice Centre of Registers and the Land Board for better coverage of **immovable property transactions** carried out by non-residents in Estonia in the balance of payments. It was agreed with the Land Board that they would transmit data on immovable property, which has been bought or sold by non-residents, to Eesti Pank by countries from 2006 onwards.

Problems with the **quality of intra-EU trade data persisted** (Intrastat). They were partly resolved through close cooperation between Eesti Pank, the Customs Board and the Statistical Office.

¹ National financial accounts represent a system of accounts, recording the stocks of financial assets and liabilities and the transactions and non-transactions related changes of different institutional sectors by the type of financial instrument. Financial accounts are an essential tool for the assessment of risks and financial behaviour of different institutional sectors and their sub-sectors.

The EU accession affected also the **intra-Community travel statistics**, since internal border crossings by EU tourists are no longer registered. Previously this data had been used to compile travel services account for the balance of payments flash estimate. Together with the Statistical Office and the Ministry of Economic Affairs and Communications opportunities were sought to improve the border crossing statistics under new conditions, including the installation of mechanical counters of vehicles on Estonia's southern border (Eesti Pank as the provider of funding).

An important data source for balance of payments statistics is the media. To make better use of it, a special **database of external events** was created, where all the news concerning balance of payments are entered.

Possibilities to arrange **sample surveys** for the collection of balance of payments statistics were examined with the aim of reducing companies' reporting burden. It appeared that specific features of doing business in Estonia do not allow carrying out such sample surveys in the near future.

Pursuant to the IMF Data Quality Assessment Framework (DQAF) for balance of payments, and taking into consideration recommendations of international institutions, **Estonia's balance of payments system of quality indicators** was elaborated, considering the methodological compliance of the output with international standards, accuracy and reliability, serviceability and consistency. Balance of payment statistics was assessed twice in 2005, i.e. in each half-year. The extent of later adjustment of quarterly balance of payments has been decreasing, but the quality of monthly balance of payments has slightly dropped after the accession to the EU. This is because several data sources fell off (very late deadline for Intrastat data and changes in the framework for collecting data on tourists' border crossings).

To ensure methodological compliance of the balance of payments with international standards, the **accounting method of reinvested earnings** had to be altered. In calculating reinvested earnings, the All-Inclusive Concept (AIC), which concentrates on the net profit/loss, and the Current Operating Performance Concept (COPC), which includes operating profit/loss, are used. In the case of the AIC, retained profit, which constitutes the basis for calculating reinvested earnings, is formed including unrealised gains/losses from exchange rate differences and revaluation of financial assets, other extraordinary income/expenses, and uncollectible receivables (incl. loan provisions). All of the above-listed are excluded in the case of the COPC, which is preferred in the international standards². Collection of data required for the application of the COPC method is problematic for most countries. Therefore, the use of the AIC method is overwhelming (also in Estonia). In 2005, Eesti Pank started to use the COPC method and the data available allowed adjusting the data for 2003 and 2004 retroactively.

The **web-based reporting system** of balance of payments statistics initiated in 2004 was developed further. Abobase System conducted a detailed analysis of the project and in late 2005 an invitation to tender was issued to a number of IT companies for the elaboration of an e-reporting system. The e-reporting system will be launched in 2007.

The **reform of outputs of balance of payments statistics** was finalised in 2005. Meeting the EU statistics requirements and introducing the new information system of balance of payments statistics facilitates the collection of more detailed and extensive balance of payments statistics (distribution of partners, a more detailed distribution of services and income accounts, distribution of cash flows of loans granted, drawings and repayments). Time-series of more detailed statistics from 2003 onwards are available on the web site of Eesti Pank.

² IMF, Balance of Payments Manual 5th Edition; OECD, Benchmark Definition of Foreign Direct Investment Statistics



The experts of Eesti Pank participated in the European Commission's (Eurostat) project "Transfer from GDP to GNI", which aimed to analyse the **accuracy and reliability of the methodology for calculating the gross national income** of the new Member States. Statistical transition from GDP indicators to gross national income indicators occurs through the income account of balance of payments, therefore the main actor in the project was Eesti Pank. The indicator of gross national income forms the basis for EU budget allocations of the EU Member States.

Close cooperation continued with the ECB within phase two of the **Centralised Securities Database (CSDB) project**. The main objective of the project is to make the statistics on portfolio investment available through a common database, and to improve the quality of statistics. The second project phase will establish online connections with all national central banks of EU Member States and provide them access to the database. Eesti Pank has submitted all required data to the ECB and has been exchanging ideas with the ECB on raising the quality of information from commercial sources.

Eurostat initiated participation in the **Foreign Affiliates Statistics (FATS) pilot project**. Its objective is gaining an overview of the impact of international concerns in various countries. As in addition to the balance of payments statistics also other indicators regarding economic activities are collected within that project, the Statistical Office was a substantial cooperation partner in the project. Until then inward foreign affiliates statistics (FATS) was focused on, but in 2005 arrangements were made to collect outward FATS.

The preparation of the 6th edition of the Balance of Payments Manual was a priority in cooperation with the **International Monetary Fund**. The relevant Balance of Payments Technical Expert Group (BOPTTEG) also includes a representative from Eesti Pank. Opinions were formulated through consultancy in writing on various issues over the year (statistics of financial gold and fixed rate bond

instruments, travel services, etc.). Eesti Pank participated for the fourth time in the IMF Coordinated Portfolio Investment Survey (CPIS), which aims at enhancing quality in this area. Moreover, a Survey of Country Distribution of Long-Term Securities Held as Foreign Exchange Reserve Assets (SEFER) was compiled and submitted to the IMF.

General economic statistics

Close cooperation with the ECB continued in the area of **general economic statistics and national fiscal statistics**. The ECB considers national central banks as competent and independent bodies capable of evaluating the quality of **general government financial statistics** and providing (in cooperation with the Ministry of Finance and the Statistical Office) relevant statistical data to the ECB. Cooperation between Eesti Pank, the Statistical Office and the Ministry of Finance is efficient and required data were submitted to the ECB in time. The assessment of the quality of statistics was also on the agenda.

Another significant issue in cooperation with the ECB was the development of the Harmonised Index of Consumer Prices (HICP) in two directions: **harmonisation of the presentation of owner-occupied housing costs and administered prices in the consumer price index (CPI)**. For the old EU Member States the extent of presentation of owner-occupied housing costs in the CPI varies, whereas they are not included in the CPI of the new Member States. The aim is to identify a common approach. The discussion, which the ECB initiated in 2005, now involves the Eurostat as well, and will continue in 2006. The ECB conducted two surveys into administered prices. The first treated the definition of administered prices, and the second their extent in the Member States. The summary of the second survey revealed that the list of administered prices in the new Member States is shorter than in the old ones.

PAYMENT SYSTEMS AND MEANS OF PAYMENT

Modern economy requires the use of a payment system in order to conduct money transactions. Therefore, the efficiency of the state's financial system largely depends on the fluent and efficient operation of payment systems. A well-functioning financial system of a country is characterised by stability, efficient monetary policy and smooth currency circulation which, in their turn, ensure price stability through a reliable monetary system and currency in circulation. Various types of payment systems should meet the needs of the society as well as comply with the legal framework of the country; they should operate without any risks that might endanger the financial system.

DEVELOPMENT OF THE PAYMENT ENVIRONMENT

In 2005, the payment environment was enhanced further with the aim of ensuring effective operation of payment flows in the international environment. Development proceeded in two directions: first, preparations for joining the Trans-European Automated Real-Time Gross Settlement Express Transfers (TARGET) system continued; second, the Designated Time Net Settlement System (DNS) was developed further.

Joining the TARGET ensures the necessary infrastructure for the transactions related to the implementation of monetary policy when Estonia obtains full membership in the European Economic and Monetary Union, and provides an efficient and secure infrastructure for trans-European real-time settlements. The **improvement of the DNS** resulted in more efficient operation of the entire settlement system. In particular, it entails faster interbank settlements and longer operating time of the system. The settlement procedure changed and thus the name of the settlement system was changed as well: **DNS was replaced by the Settlement System of Ordinary Payments (ESTA)**.

The most **important international partner** for Eesti Pank in the field of payment systems is the

European Central Bank. Under the aegis of the ECB Committee on Payment and Settlement Systems and its sub-groups, Eesti Pank contributed to:

- Progress achieved in the TARGET 2 project;
- Preparations for the harmonised collection and publication of payment and securities settlements statistics;
- Assessment of payment and securities settlement systems operational in Estonia.

Representatives of Eesti Pank also attended the payment systems expert group of the European Commission. The main tasks of the group included the **analysis of the draft directive on payment services taking effect in the internal market and the resulting impact** and **drafting a regulation on information related to the payer submitted along with the transfer**. Through the payment system expert group contributions were made to the preparation of a report on the application of the regulation on cross-border payments in euro.

SETTLEMENT SYSTEM OF INTERBANK PAYMENTS

On 3 October 2005, a **renewed interbank Settlement System of Ordinary Payments (ESTA)** was launched, which replaced the Designated Time Net Settlement System (DNS) used so far. Hence the Estonian Settlement System of Interbank Payments contains two sub-systems: the Settlement System of Ordinary Payments (ESTA) and the Real-Time Gross Settlement (RTGS) System.

On average, **187 transactions a day** were settled in the **RTGS** system in 2005 (see Figure 1). The number of payments has increased 21%, year-on-year. The reason behind the rise in RTGS payments were customer payments which accounted for 76% of all real-time payments. The average daily value was **2.7 billion kroons**. Banks' "compulsory" payments (transactions related to the collateral account of the ESTA system) accounted for most of the value (57%). Year-on-year, the value of payments settled through the RTGS system grew 24%.



The average size of customer payments settled through the RTGS system was 2.3 million kroons. Compared to the previous year, the average size of payments initiated by bank customers grew 2%.

An average of **69,000 transactions a day** were settled in **ESTA** in 2005 (see Figure 2). The number of payments has risen 8% year-on-year. In ESTA, an average of **866 million kroons** were settled daily. The value of the system increased 28%, year-on-year.

The number as well as the value of payments settled through ESTA are on the increase. It is to be presumed that faster settlement options – payments are transmitted to the other bank every hour, i.e. nine times a day instead of three as previously – further boost the rise in the number of payments made through ESTA.

The growth tendency is also apparent for the average size of the ordinary payments – the average value of an ESTA payment is 12,500 kroons, having grown 19%, year-on-year.

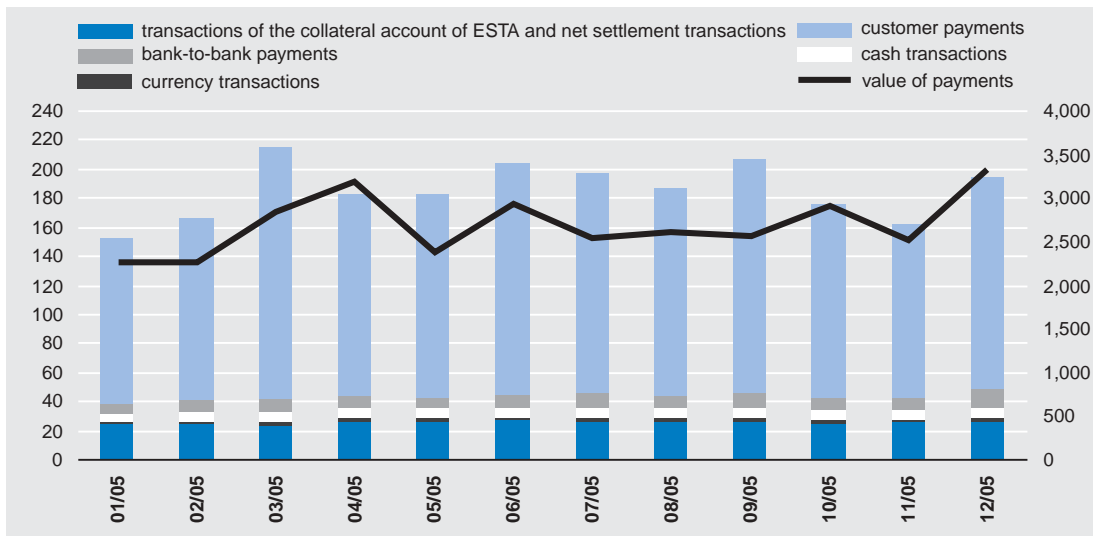


Figure 1. Number of payments settled through RTGS system by transaction types (pieces; left scale) and value (EEK m; right scale) as daily average in 2005

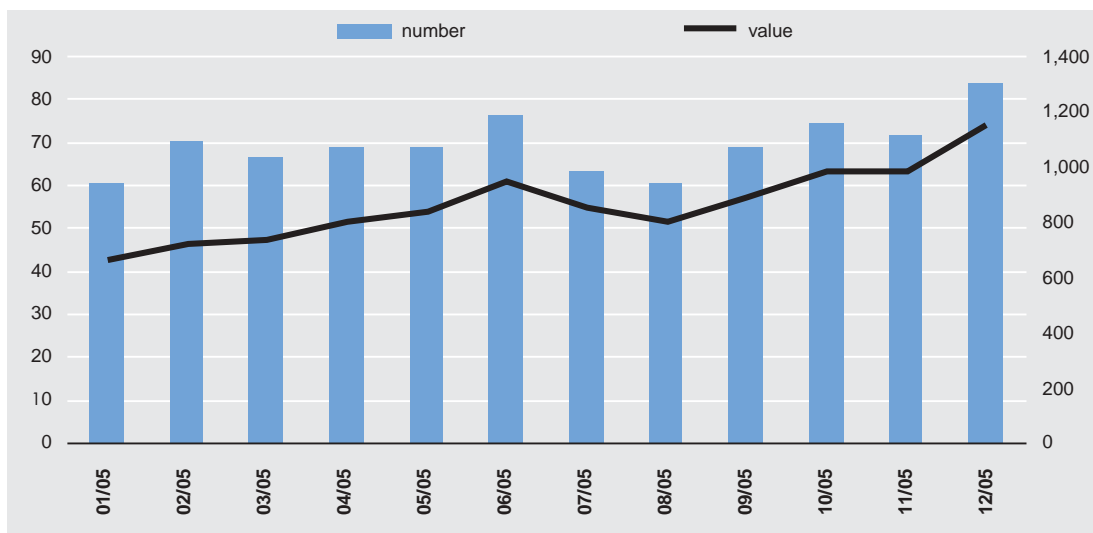


Figure 2. Number (thousands; left scale) and value (EEK m; right scale) of payments settled through ESTA as daily average in 2005

PAYMENT METHODS

The value of payments grew remarkably in 2005, by over 1 trillion kroons in a year (total value exceeded 3 trillion kroons). Nationwide growth in income and rapid development of the real estate sector must be mentioned as background factors of such tendencies.

The number of payments initiated in cash and their value continued to decrease, although at a slower pace. Cash payments constituted 0.3% of the number of payments settled through banks, and 0.5% of the value. Such trends comply with the objectives of the Strategic Development Plan of Eesti Pank for 2004–2006 aiming at reduction of the importance of cash in payment intermediation and fostering the use of more efficient payment methods.

The more efficient payment methods are non-cash payments which allow faster (electronic) money transfers and involve less risk. The structure of non-cash payments has not changed considerably. In 2005, card payments, the Internet bank,

the telephone bank and direct debits were used the most, accounting for 51%, 24%, 14% and 7% respectively out of the total number of non-cash payments. In terms of money, the value of card payments accounted for 0.7%, the value of both the Internet and telephone bank for 17% and that of direct debit for just 0.2% of the value of non-cash payments (see Table 1).

As expected, in 2005 the number and value of paper-based credit orders increased faster than in previous years, boosted by the very active real estate market. The growth rate of the value of paper-based credit orders rose from 8% to 64%.

The total number of payments in 2005 was five times and the total value three times higher than in 1998 (see Figure 3). The highest rise over eight years, namely 122 times, has occurred in the number of payments initiated by direct debits; the number of card payments has grown 19 times. The number of cash payments and paper-based credit orders decreased four times in eight years.

By the end of 2005, credit institutions operating in



Table 1. Payments by payment methods in 2005

	Value (EEK m)	Number of payments (thousands)	Average value (EEK thousand)
Total	3,299,506.68	165,972.32	19.9
Cash payments*	1,757.87	610.11	2.9
Non-cash payments	3,297,748.81	165,362.20	19.9
Checks	221.77	24.16	9.2
Traveller's cheques	13.43	2.04	6.6
Other cheques	208.34	22.12	9.4
Card payments	22,954.25	85,008.17	0.3
Direct debits	5,783.47	12,308.83	0.5
Other debit orders**	1,394.45	131.94	10.6
Mobile payments at POS	0.42	5.95	0.1
Credit orders	3,267,394.46	67,883.16	48.1
Standing orders	29,180.59	1,741.39	16.8
Paper-based credit orders	390,988.80	2,504.38	156.1
Telebank credit orders	571,324.77	23,383.27	24.4
Telephone bank credit orders	4,615.73	159.25	29.0
Internet bank credit orders	590,510.49	39,983.14	14.8
Mobile credit orders	19.41	85.11	0.2
Other credit orders***	5,266.25	3.13	1,680.9
SWIFT	1,675,488.41	23.50	71,309.5
Unidentified	0.00	0.00	0.0

* Cash payments include payments initiated with the downpayment of cash or a cash card payment. Card transaction with cash function is cash payment to the account or receiving cash from the account.

** Other debit orders include all debit orders not reflected under any other specific type of debit order (e.g. payments made on the basis of decisions subject to compulsory execution, such as court judgments and rulings, precepts of tax authority to collect tax arrears, etc).

*** Other credit orders include all credit orders not reflected under any other specific type of credit order (e.g. conditional credit orders).

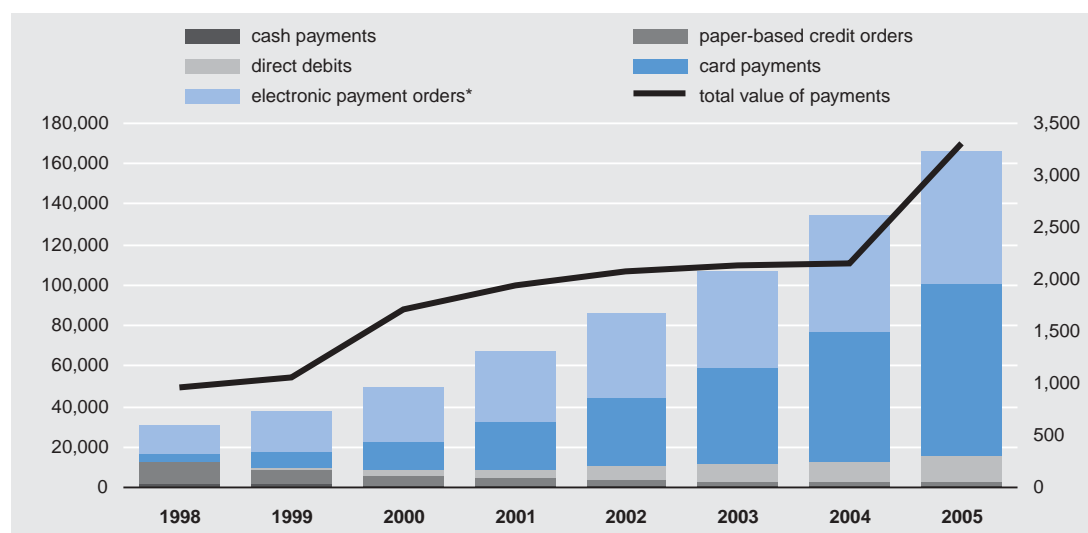


Figure 3. Number of payments (thousand; left scale) and value (EEK billion ; right scale) by payment method

* Electronic credit orders include direct debits, telebank, telephone bank, Internet bank SWIFT and mobile credit orders.

Estonia had issued 1.4 million payment cards in total, which is 9% more than in 2004 (see Table 2). Debit cards accounted for 81% of all payment cards issued (1.2 million) and credit cards for 19% (over 265,000). 22% of all payment cards were passive (i.e. no payments were made during a quarter). At the end of 2005, every Estonian resident had a payment card, an average of 86% of people had a debit card, and every fifth held a credit card.

In 2005, 62 ATMs were installed which is twice the number of 2004 (see Table 3). At the end of December, there were 841 ATMs in Estonia, 84% of which allowed cross-usage¹. The growth in the number of points of sale (POS) accepting payment cards has slowed down over the last three years and has declined from 25% to 15%. At the end of December, there were 12,730 POS accepting payment cards, which is 1,617 more than in 2004.

Table 2. Number of payment cards issued in Estonia (thousand)

	1998	1999	2000	2001	2002	2003	2004	2005
Payments cards (total)	697.6	770.8	858.4	987.2	1,119.6	1,197.9	1,303.6	1,419.7
Debit cards (total)	678.5	749.5	815.1	877.0	964.5	1,011.6	1,071.0	1,154.2
Local debit cards	292.3	59.5	13.4	8.8	8.8	8.5	10.1	11.7
debit cards with cash function	50.9	15.1	4.5	4.9	7.5	8.3	10.1	11.7
cards with credit/debit function	241.5	44.3	9.0	3.9	1.3	0.2		
International debit cards	386.1	690.0	801.7	868.2	955.7	1,003.2	1,060.9	1,142.5
Credit cards (total)	19.2	21.3	43.3	110.1	155.1	186.3	232.6	265.5
Revolving credit cards*							45.0	53.9
Charge cards*							39.8	47.1
Instalment cards*							103.2	110.9
Other credit cards*							44.6	53.7

* Statistics gathered since 2004.

Table 3. ATMs and POS accepting payment cards

	1998	1999	2000	2001	2002	2003	2004	2005
Automated Teller Machines (ATM; total)	490	591	630	680	719	747	779	841
ATMs with cash downpayment function	8	9	10	10	6	6	38	45
ATMs in cross-usage	433	530	564	600	638	646	649	707
ATMs with cash function	307	203	203	210	252	271	276	303
ATMs with cash and payment function	126	327	361	390	386	375	401	439
ATMs with payment function	57	61	66	80	81	101	102	99
Points of sale (POS; total)	2,586	3,267	4,084	5,260	7,353	9,184	11,113	12,730
Card payment POS*							9,515	10,904
Mobile payment POS*							1,236	1,311
Card and mobile payment POS*							362	515

* Statistics gathered since 2004.

¹ Bank-operated ATM where payment cards of the operating as well as other banks can be used.



PAYMENT SYSTEMS OVERSIGHT

Infrastructures of the Estonian financial sector – payment and securities settlement systems – meet the needs of the financial sector and the developing economy and their operation has not endangered financial sector stability. The summary of the assessment issued by the overseer of the payment systems which was published in the autumn of 2005 also confirmed that there had been no events or failures that could have put financial stability at risk.

The launch of the interbank Settlement System of Ordinary Payments (ESTA) can be regarded as the most significant change in the **systemically important settlement systems**, i.e. systems managed by Eesti Pank. ESTA allows faster interbank settlements, longer operating time of the system and greater efficiency without an increase in the risks to financial stability. Moreover, the settlement system developments contribute to enhancing competition in the banking market since they expand the opportunities of small banks. The interbank direct debiting service, which the central bank and commercial banks are now working on, will further tighten competition.

Even though various risks are minimised through the functionality and operating principles of the interbank systems (RTGS and ESTA), managed by Eesti Pank, malfunctioning cannot be entirely avoided. The size and length of some failures in the settlement systems in the past year have not influenced financial stability².

Similar to changes in the settlement systems operated by Eesti Pank, new developments in **important settlement systems** (the securities settlement system and the card payment system) aim at improving their efficiency and security.

In 2005, links were established between the Estonian Central Register of Securities and Lithuania's securities depository. Links between the Estonian Central Register of Securities and the Finnish securities depository for the **cross-border acquisition of securities** were renewed.³ As a result, the Baltic States can more or less be regarded as a single securities market and this has substantially simplified the entrance of Estonian investors to Latvian and Lithuanian securities markets. This facilitates wider integration of the financial environment of the region and increases investment opportunities. Finnish investors may obtain securities registered in Estonia through the link between the Estonian Central Register of Securities and the Finnish securities depository, but not vice versa, and thus there is room for further development. The expansion of the links between the Baltic depositories in the Nordic direction would mean further deepening of financial integration which in turn would create a single Nordic and Baltic investment environment.

At the **initiative of Pankade Kaardikeskus** (Card Centre of Banks) nearly all POS terminals⁴ were brought in line with the EMV standard. As a result, transactions with smart cards have become considerably safer (copying card information has become more complicated).

² A more detailed overview of settlement system failures is available in the Financial Stability Review, November 2005, pp 76.

³ The Estonian Central Register of Securities established a similar link with Latvia's securities depository in 1997.

⁴ Terminal capable of retrieving data from the memory chip on the card necessary for making a card payment.

MEETING CASH DEMAND

Banknotes and coins in circulation and their structure

As at 31 December 2005, the total amount of currency in circulation was 10,101.7 million kroons (see Table 4). 13.4% of that (1,354.6 million kroons) was in the vaults of credit institutions and savings and loan associations operating in Estonia, and 86.6% (8,747.1 million kroons) was in circulation outside the credit institutions or savings and loan associations.

Compared to 2004, when the amount of currency in circulation grew by 6.4%, the growth rate of 2005 was considerably faster, reaching 13.6%. The growth in circulation has accelerated in case of all banknotes and coins, except the 5-kroon coin.

The number of 2-kroon and 500-kroon banknotes in circulation rose the most (see Table 4). The amount of banknotes in circulation has increased fast as well due to the rise in the number of 500-kroon notes.

The number of coins in circulation exceeded 357 million, which means that there is an average of over 265 coins in circulation per resident. Only the number of 5-sent coins decreased, since Eesti Pank no longer issues them. The number of 20-sent coins increased the most, whereas the number of 50-sent coins showed the fastest growth compared to 2004.

The average value of a banknote in circulation grew by 4 kroons, compared to 2004, and stood at 136.5 kroons at the end of 2005. The average value of a coin in circulation was 32 sents, i.e. 0.4 sents higher than in 2004.

Currency circulation

Eesti Pank issued 10,445.0 million kroons to credit institutions and 9,237.8 million kroons were returned to Eesti Pank in 2005 (see Table 5).

In terms of amount, 105.8 million banknotes and 31.7 million coins were issued. 99.0 million banknotes and 0.6 million coins were returned. The amount of banknotes and coins issued or returned has significantly increased, compared to 2004.

Table 4. Banknotes and coins in circulation as at year-end

Nominal value	Total amount (EEK m)				Number (m)			
	31/12/02	31/12/03	31/12/04	31/12/05	31/12/02	31/12/03	31/12/04	31/12/05
1 kroon	4.8	4.7	4.6	4.6	4.8	4.7	4.6	4.6
2 krooni	22.3	23.9	26.0	29.6	11.1	11.9	13.0	14.8
5 krooni	35.6	36.7	38.8	43.1	7.1	7.3	7.8	8.6
10 krooni	65.1	66.8	70.6	77.5	6.5	6.7	7.1	7.7
25 krooni	174.7	179.6	187.4	207.1	7.0	7.2	7.5	8.3
50 krooni	51.5	49.5	45.4	46.6	1.0	1.0	0.9	0.9
100 krooni	1,020.9	1,068.6	1,076.1	1,122.4	10.2	10.7	10.8	11.2
500 krooni	6,648.3	6,796.8	7,337.8	8,450.3	13.3	13.6	14.7	16.9
Banknotes (total)	8,023.1	8,226.6	8,786.7	9,981.2	61.1	63.1	66.3	73.1
5 senti	2.2	2.2	2.1	2.1	43.1	43.0	42.4	42.0
10 senti	9.7	10.5	11.4	12.3	97.0	104.9	113.7	123.2
20 senti	14.6	16.2	17.7	19.8	72.9	80.8	88.7	99.2
50 senti	12.9	14.5	16.4	19.1	25.9	29.0	32.9	38.2
1 kroon	37.3	41.3	46.6	52.9	37.3	41.3	46.6	52.9
5 krooni	7.8	7.6	8.1	8.3	1.6	1.5	1.6	1.7
Coins (total)	84.5	92.2	102.4	114.6	277.8	300.5	326.0	357.1
Commemorative coins	5.3	5.4	5.9	6.0	0.1	0.1	0.1	0.1
Banknotes and coins	8,113.0	8,324.1	8,895.1	10,101.7				



All banknotes returned to Eesti Pank are sorted. Banknotes unfit for circulation are destroyed and the rest are returned to circulation. In 2005, 5.6 million banknotes with the total amount of 864.7 million kroons were withdrawn from circulation (see Table 6). The value of cash destroyed increased compared to the previous year and accounted for 106.5% of the value in 2004. Since 500-kroon notes were most often destroyed, the number of destroyed banknotes actually decreased (96.5 % of 2004).

Expert analysis of cash

One of the main tasks of Eesti Pank is to **conduct expert analyses of cash, primarily banknotes**. 2,546 banknotes were submitted for analysis in 2005 (15,238 in 2004). 91% of those examined were damaged and worn-out.

In December 2005, Eesti Pank discontinued carrying out expert analyses for credit institutions on suspicious notes. This task was transferred to relevant police authorities. The expert analysis of other currencies was also stopped. Eesti Pank will continue to examine damaged and worn-out Estonian kroon cash to estimate the possibilities to replace them.

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

Table 5. Movement of currency between Eesti Pank and credit institutions

Year	Total amount (EEK m)		Number (m)			
			Issued by central bank		Received by central bank	
	Issued by central bank	Received by central bank	banknotes	coins	banknotes	coins
2002	9,849.7	9,799.4	95.1	24.8	93.9	1.8
2003	8,495.8	8,282.8	88.9	23.1	86.8	0.5
2004	8,881.7	8,306.0	93.7	26.1	90.5	0.7
2005	10,445.0	9,237.8	105.8	31.7	99.0	0.6

Table 6. Banknotes unfit for and withdrawn from circulation as at year-end

Nominal value	Total amount (EEK m)				Number (m)			
	2002	2003	2004	2005	2002	2003	2004	2004
1 kroon	0.4	0.1	0.0	0.0	0.4	0.1	0.0	0.0
2 krooni	6.2	3.2	0.3	0.4	3.1	1.6	0.2	0.2
5 krooni	16.9	8.6	10.0	9.3	3.4	1.7	2.0	1.9
10 krooni	28.8	13.8	5.0	5.3	2.9	1.4	0.5	0.5
25 krooni	109.9	75.3	14.4	13.5	4.4	3.0	0.6	0.5
50 krooni	27.5	31.7	27.2	10.6	0.6	0.6	0.5	0.2
100 krooni	383.3	245.5	74.0	74.7	3.8	2.5	0.7	0.7
500 krooni	770.4	631.2	701.6	751.0	1.5	1.3	1.4	1.5
Total	1,343.4	1,009.4	832.6	864.7	20.1	12.2	6.0	5.6

PREPARATIONS FOR THE EURO CASH CHANGEOVER

In 2005, Eesti Pank continued preparations for the euro cash changeover. Experts of the central bank took part in various working groups at the ECB and the European Commission as well as in relevant working groups established in Estonia.

An important international cooperation body is the **Banknote Committee** (BANCO) of the European System of Central Banks. This committee deals with all the issues concerning euro banknotes. Experts of Eesti Pank participated also in the work of the security working group within the BANCO, and also in the sub-committee of the euro coins of the Economic and Financial Committee and the working group of directors of the European mints. Eesti Pank is represented in the working group on counterfeits and the working group of the euro cash information system.

For resolving practical issues related to the euro cash changeover, the **cash working group** was formed from the representatives of Eesti Pank, credit institutions and the Cash Centre. Moreover, there is a separate ATMs working group and a security issues working group.

An international adjudication was carried out in 2005 to find a mint for minting Estonian euro coins. Suomen Rahapaja (Finnish Mint) was the winner among the participating mints producing euro coins.

Along with the preparations for euro cash changeover, Eesti Pank started to update its technologies. One of the important events was the purchase of a new fully automatic banknotes sorting machine CPS 1800 from De La Rue Ltd. This machine may be used to sort both the euro and kroon banknotes.

PREPARATIONS FOR FULL MEMBERSHIP IN THE EUROPEAN ECONOMIC AND MONETARY UNION (CHANGEOVER TO THE EURO)

The Estonian Government and Eesti Pank have established the goal to introduce the euro **as soon as Estonia meets all the necessary requirements.**

At the Cabinet meeting on 9 December 2004, the Government decided to set up an **expert committee** to coordinate preparations for the changeover to the euro. The committee is chaired by the Secretary General of the Ministry of Finance. The committee comprises a Deputy Governor of Eesti Pank, the Secretary General of the Ministry of Justice, the Secretary General of the Ministry of Economic Affairs and Communications, the Secretary General of the Ministry of Internal Affairs, and the Director for Coordination of European Affairs in Estonia under the State Chancellery. Once a quarter the expert committee submits to the Government a progress review on the preparations.

Six working groups have been set up to elaborate technical solutions for the changeover – a working group between Eesti Pank and credit institutions, business environment working group, public sector working group, consumer protection working group, legal issues working group, and communications working group. Eesti Pank chairs the first group and participates in all the others, except for the public sector working group.

PRINCIPAL FEATURES OF ESTONIAN ECONOMIC POLICY IN LIGHT OF THE UPCOMING ACCESSION TO THE EURO AREA

Similarly to all the countries that joined the European Union in 2004, Estonia faces the adoption of the euro, i.e. becoming a full member of the European Economic and Monetary Union in the coming years. Joining the euro area is necessary for the Estonian economy to secure a favourable investment climate, improve our competitiveness and maintain a strong basis for long-term balanced economic growth and a rise in income levels.

When estimating the timetable and the strategy suitable for the euro changeover, it should be taken into account that EMU membership is above all

beneficial to a country whose economy is closely enough integrated with other Member States. For Estonia, it is important to have EU Member States as the main trading partners. Moreover, the majority of foreign investment into Estonia originates from EU Member States – as direct investment and also as through the financial sector. Besides, the Estonian kroon is pegged to the euro and the monetary policy transmission mechanisms in Estonia's economy are similar to these of the euro area. This makes Estonia "almost a member of the euro area" already today. Thus, the accession to the monetary union is a logical continuation of the monetary policy that Estonia has pursued so far.

Prerequisites for membership in the euro area

In order to become a member of the euro area the country must meet the **Maastricht criteria** in a sustainable manner (see Table 1).

Estonia joined **ERM II** on 28 June 2004, taking a unilateral commitment to maintain both the currency board arrangement as well as the fixed exchange rate of the kroon against the euro.

Estonia's strict and balance-oriented fiscal policy has established a strong starting position for meeting the Maastricht criteria on **budget balance and public debt**. As of 2000, the general government budget has been posting a surplus, public debt has decreased while central government's foreign assets have increased. In the medium-term perspective, the government is aiming at a balanced budget or a surplus. Also the year 2006 is expected to end with a surplus (according to the Ministry of Finance, a surplus as high as up to 1.8% is forecasted).

The Maastricht **interest rate criterion** indicates whether a country seeking to join the euro area is capable of maintaining balanced economic development also in the longer term. If it seems to international financial markets and investors that there are signs of possible problems in the long term, it is very likely that the country will have difficulties in fulfilling the inflation criterion. Arising from



Table 1. Maastricht criteria

Public finance	The general government deficit must be below 3% of GDP. The public debt must be below 60% of GDP or approaching it at a satisfactory rate.
Exchange rate	The country must participate in the exchange rate mechanism, ERM II, for at least two years and keep its exchange rate stable against the euro.
Price stability	The country's inflation rate must not exceed the average of the three best-performing countries by more than 1.5 percentage points.
Interest rates	The country's long-term interest rate must not exceed the average of the three best-performing countries in terms of price stability by more than 2 percentage points.

the credibility of the economic policy and market mechanisms, Estonia's interest rate level today is very close to that of the euro area, and thus there should not be any problems with meeting the interest rate criterion.

The most complicated task Estonia faces is fulfilling the **inflation criterion**. Being a small and open economy, Estonia is a price-taker also regarding consumer prices. Meanwhile, arising from the lower income level in Estonia, the share of the most volatile components in the consumer basket – food, fuel and energy – is relatively high. Namely because of rising oil prices in the global market, the annual consumer price growth in Estonia stood at more than 4% at the end of 2005. However, the expected decline in the inflation rate in the near future may be too slow from the perspective of meeting the inflation criterion.

In autumn 2006, the European Central Bank and the European Commission will draw up **regular convergence reports** on all the countries that are not members of the euro area. The objective is to assess compliance with the Maastricht criteria and issue recommendations as to which Member States are ready to join the euro area, or in other words, regarding which countries the EMU membership derogation can be abrogated. Countries have the option to request drawing up a special convergence report, which Slovenia and Lithuania used in March 2006. The suitability of these countries for joining the euro area will be evaluated in summer 2006.

TECHNICAL PREPARATIONS FOR FULL EMU MEMBERSHIP

Legal framework

The draft act on the adoption of the euro will be prepared by the Ministry of Finance in cooperation with other ministries and Eesti Pank. The draft will regulate the exchange of Estonian kroons into euro, the withdrawal of kroons from circulation, the parallel circulation of the euro and the kroon, as well as provide for the amendments necessary for the changeover. However, the draft act on the adoption of the euro will not include amendments to the acts that are to undergo more comprehensive amendments in relation to the changeover to the euro. A separate legislative proceeding of amendments to the Eesti Pank Act and the Commercial Code is foreseen and also the State Fees Act will be redrafted.

The changeover to the euro also calls for **amendments to the Eesti Pank Act** so as to bring it in line with the requirements arising to the central bank of a full EMU member from the Treaty on European Union and the Statute of the European System of Central Banks. In the first half of 2005, Eesti Pank prepared a draft law amending the Eesti Pank Act. The Supervisory Board of Eesti Pank approved it at its session on 30 August 2005 and on 12 September 2005 Members of the Supervisory Board of Eesti Pank, Mrs Liina Tõnisson and Mr Mart Opmann, submitted the draft law to the Riigikogu for legislative proceeding. In the following months, the act underwent a



consultation procedure in the European Central Bank and two readings in the Riigikogu.

On 25 January 2006, the Riigikogu passed a resolution to apply for the position of the Supreme Court regarding the matter as to whether § 111 of the Constitution of the Republic of Estonia can in conjunction with the Act on Amendments to the Constitution of the Republic of Estonia and the *acquis communautaire* be interpreted so that:

- 1) Eesti Pank, being a full member of the Economic and Monetary Union, shall maintain the sole right to issue Estonian currency;
- 2) Eesti Pank, being a full member of the Economic and Monetary Union shall maintain the right to issue Estonian currency .

Legislative proceeding of the draft act to amend the Eesti Pank Act will continue after the Supreme Court delivers its position.

Payment and currency circulation

Technical preparations for the changeover to the euro in the field of **account money and cash** are coordinated and led by Eesti Pank, who has also engaged all Estonian credit institutions as well as the Estonian Banking Association. For more comprehensive work on single subjects working groups dealing e.g. with ATMs, the coin-collection campaign, technical aspects of account money and other issues have been set up.

The main positions and frameworks agreed upon so far have been covered in Section "Central Bank and Credit Institutions" of the National Changeover Plan which has been regularly updated on a current basis.

The discussions of the working groups have resulted in an agreement that in order to facilitate putting the euro cash into circulation credit institutions will exchange kroons for euros one month before and six months after the so-called €-day at the central rate (i.e. the rate indicated in the daily fixings of Eesti Pank) without a service fee and will continue the

exchange under the same conditions for at least six months, but then only in a limited network of bank offices. Thereafter, Eesti Pank will be exchanging kroons for euros at the central rate for an unlimited period of time and without a service fee.

Since 2003, Eesti Pank has been preparing to secure the introduction, storing and handling of euro cash and that storing, counting and destruction of the kroons withdrawn from circulation would proceed efficiently and safely. In 2005, a detailed cash exchange plan was developed, indicating the details of obtaining, frontloading and sub-frontloading of euro cash, and withdrawal of kroon cash. In order to guarantee safety upon the transportation of cash, Eesti Pank concluded a cooperation agreement with the Police Board in autumn 2005.

In 2006, the elaboration of the cash exchange logistics plan will continue, and the possibilities of involving Eesti Post (Estonian Post) into the cash exchange will be considered along with preparing the coin collection campaign. Besides, Eesti Pank is planning to carry out a series of training sessions for cash handlers.

As for account money, the changeover to the euro will take place without a transitional period. Eesti Pank's settlement systems will be converted into euro on the night of the €-day. This means that from the €-day on, the settlement systems of Eesti Pank will settle payments only in euro.

Prior to the accession to the euro area, Eesti Pank will prepare for joining the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) system.

Internal preparations for the changeover to the euro in Eesti Pank

Full membership of the ESCB sets additional requirements on financial accounting and reporting by Eesti Pank. By the time of the accession to the euro area compliance with the accounting and reporting requirements of the ECB must be secured.

Also IT systems, operations regarding statistics, reserve management, monitoring and analysis activities and several other areas require supplementation.

Public communication related to the euro changeover

A smooth changeover to the euro requires extensive public communication of different aspects related to the exchange. Besides the communications working group set up by the expert committee, also an internal working group has been operating in Eesti Pank since autumn 2005. The objective is to introduce the principles of the euro changeover in cooperation with other government agencies as well as the European Commission, the European Central Bank and several non-profit and professional associations to as many target groups as possible. Even though active communications activity started in autumn 2005, Eesti Pank's employees held presentations at more than 30 information events, introducing the euro in various Estonian counties throughout the year. During the first three months of 2006, another 15 events were added. At the end of January 2006, the euro web site was launched at www.euro.eesti.ee.

ROLE OF EESTI PANK IN ESCB TODAY AND AFTER THE ADOPTION OF THE EURO

European System of Central Banks

The objective and tasks of the **European System of Central Banks (ESCB)**, comprising the European Central Bank and the national central banks (NCB) of all EU Member States, have been provided in Title VII "Economic and Monetary Policy" of the Treaty Establishing the European Community and Protocol No 18 on the Statute of the European System of Central Banks and of the European Central Bank annexed to the Treaty Establishing the European Community.

The primary objective of the ESCB is to maintain price stability. Without prejudice to the objec-

tive of price stability, the ESCB supports the general economic policies in the Community.

According to Article 105(2) of the Treaty Establishing the European Community, the basic tasks are as follows:

- To define and implement the monetary policy for the euro area;
- To conduct foreign exchange operations;
- To hold and manage the official foreign reserves of the euro area countries, and
- To promote the smooth operation of payment systems.

Through its activities, the ESCB also supports financial supervision authorities and contributes to maintaining financial stability in the European Union. Besides, the ESCB organises gathering statistics required for performing its duties.

The ESCB does not have legal personality or separate decision-making bodies. Its tasks are implemented through the NCBs. The ECB and NCBs perform these tasks through a **central decision-making mechanism, but under the principle of distributed implementation**. The ESCB is managed by the decision-making bodies of the ECB: monetary and financial policy decisions are made by the Governing Council and Executive Board of the ECB. The ECB consults with the NCBs when preparing decisions and these decisions are then carried out by the NCBs.

Tasks of Eesti Pank as a central bank of a country within the euro area

After Estonia's accession to the euro area the tasks of Eesti Pank may be divided into three areas:

- Tasks of Eesti Pank as an independent central bank within the euro area;
- Tasks of Eesti Pank within the framework of European Union economic policy cooperation;
- Tasks of Eesti Pank regarding matters not directly within the sphere of competence of the European Union.



Tasks of Eesti Pank as an independent central bank within the euro area

Eesti Pank will be participating in **developing the single monetary policy and the policy-making in different areas within the competence of the ESCB**; after Estonia's accession to the euro area the Governor of Eesti Pank will be participating in the work of the **ECB Governing Council** and through that also in shaping the common policy of the ESCB on the top level. Eesti Pank's employees will be attending the committees and working groups of the ESCB where all the most important decisions and outputs of the governing bodies of the ECB are prepared.

As the central bank of the Republic of Estonia, Eesti Pank will be **implementing ESCB's decisions** regarding monetary policy and other areas according to the principles of the Treaty Establishing the European Community. To this end, Eesti Pank will do the following:

- Upon implementing the single euro area monetary policy, conduct **refinancing operations** with Estonian credit institutions on the basis of guidelines from the ESCB and implements the **credit institutions' minimum reserve system** in Estonia;
- **Manage a certain part of the ECB reserves** while complying with the single ESCB framework; conduct **currency interventions** together with the ECB and the central banks of other Member States, if necessary;
- **Regulate euro cash circulation in Estonia**, including daily issuing of currency to Estonian residents and companies through credit institutions operating in Estonia;
- **Secure smooth operation of the payment systems** in two ways – as manager and as overseer of payment systems;
- Participate in drawing up the **economic forecast for the euro area** and in broader **analytic cooperation** between the ESCB and the central banks belonging to the Eurosystem;

- Participate together with other NCBs and supervisory authorities in the **activities supporting the stability of the European Union financial sector**;
- **Collect and process economic and financial statistics, required for fulfilling the tasks of the ESCB, and deliver it to the ECB.** Since the central banks that are members of the Eurosystem are required to collect and forward more exhaustive and detailed data for operating the single monetary system, the duties of Eesti Pank in the field of statistics will increase after joining the Eurosystem.

Tasks of Eesti Pank in the European Union economic policy cooperation

Besides the matters within the competence of the ESCB, Eesti Pank also participates in **developing the general economic and financial policy of the European Union**. In particular, it involves participation in the committees and working groups of the Council of the European Union and of the European Commission. These working groups and committees coordinate the EU economic policy and conduct cooperation between the agencies of the European Union and the Member States regarding the legal framework and supervision of the financial sector.

Eesti Pank together with the Ministry of Finance participates in the **Economic and Financial Committee (EFC)** of the European Union. The EFC prepares the most important points on macroeconomics and the financial sector to be discussed and decided at the meetings of the Council of the European Union. Eesti Pank is also represented in EFC sub-committees that deal with the issues concerning euro coins as well as with the coordination of the common positions of the European Union regarding the activities of the International Monetary Fund (IMF).

In addition, Eesti Pank together with other Estonian government agencies has been, through commit-

tees and working groups set up by the Council of the European Union and the European Committee, involved in **shaping the financial sector policy and financial supervision of the European Union**. The task of the Committee of European Banking Supervisors (CEBS) is to support the implementation of the EU banking legislation in the Member States and facilitate the harmonisation of the daily activities of banking supervision institutions in the common financial market. Eesti Pank also participates in different financial supervision projects organized by the EFC and the European Commission.

Moreover, Eesti Pank represents Estonia in the committees and working groups of Eurostat involved in coordinating the collection of **European Union balance of payments and financial system statistics** and preparing legislation.

Tasks of Eesti Pank in areas not directly within the competence of the European Union

Like in other areas, the competence of the European Union in developing and implementing common principles and frameworks involving all Member States is significant also in central banking, which is why a considerable part of Eesti Pank's tasks and resources is taken up by the activities related to the ESCB in Frankfurt and by participation in shaping the European Union's economic and financial sector policy in Brussels. Drawing a line between the competence of the EU and that of a national central bank is somewhat artificial. Nevertheless, there is still a range of **central banking policy issues that will not directly fall under the EU competence** but will remain within that of Eesti Pank also after the accession to the euro area.

- An important objective of Eesti Pank as the central bank of the Republic of Estonia is to **secure the stability of the Estonian banking sector and the financial system** in cooperation with the Ministry of Finance and the Financial Supervision Authority, an agency operating at Eesti Pank. It is and will remain the duty of Eesti Pank

to regulate the banking sector, and to conduct integrated analysis of the financial system in order to prevent events and shocks affecting the reliability of the system.

- The tasks of Eesti Pank include **high-level analysis of Estonia's economy along with drawing up the country's economic forecast**. This helps to assess the impact of different economic processes on price and financial stability.
- Eesti Pank **advises the government and the public at large in various economic policy matters**, particularly in areas affecting price stability and the credibility of the Estonian financial system.
- Eesti Pank will be **holding Estonia's official foreign reserves** also after the adoption of the euro.
- **Developing the policy concerning Estonia's payment environment** will remain a task of Eesti Pank.
- Participation in the Eurosystem and additional tasks arising from that will not reduce Eesti Pank's **responsibility for collecting and publishing statistics on Estonia's economy and the financial sector**; Eesti Pank is inter alia responsible for drawing up Estonia's **balance of payments** as well as for collecting and publishing banking system statistics.
- **Representing Estonia in international cooperation outside the European Union** will also remain an important function of the central bank. Eesti Pank represents Estonia in the International Monetary Fund, participates in the activities of the Bank for International Settlements (BIS), and pursues cooperation with central banks of third countries.

ORGANISATION AND COOPERATION

INTERNATIONAL COOPERATION

Organisation of the central bank's international cooperation proceeds from the premise that what is happening in Estonia with its small and open economy is usually closely connected with processes outside Estonia. International cooperation claims a very significant place in the work of Eesti Pank. All principal fields of activity and most of the staff are involved in that. Meanwhile, it is important that the central bank's international communication be reasoned and coordinated. To this end, a separate framework has been set up, which includes e.g. regular surveys of different countries and regions, management working meetings every two weeks on handling international communication matters and an international communication database. Prior to sessions of committees and higher-level bodies, briefings are held where experts from different departments discuss relevant points and speech proposals with representatives of Eesti Pank.

Knowing one's foreign partners and the external environment establishes a foundation for efficient cooperation and, therefore, Eesti Pank pays quite a lot of attention to monitoring the economic policies

of other countries, especially the European Union Members States.

The central banks of the neighbouring countries – the Nordic and Baltic States – have had a special place among the communication partners of Eesti Pank now for more than ten years. Traditional cooperation seminars and bilateral meetings continue also in 2006. Meanwhile, relations with different European institutions have had increasingly more weight in recent years.

Regular cooperation within the European Union structures

Eesti Pank's representatives participate altogether in around seventy committees and working groups set up by the European System of Central Banks, the Council of Ministers and the European Commission (see also Table 1). In 2005, Eesti Pank's management and experts participated in about 300 EU committee and working group meetings. Extensive work in committees and working groups is necessary and as seen from current experience also an efficient way to take into consideration the expert and political opinion of all Member States.

Table 1. Eesti Pank's participation in the work of European Union councils and committees

Cooperation Bodies of the European System of Central Banks	<ul style="list-style-type: none"> • General Council of the European Central Bank • Accounting and Monetary Income Committee • Banking Supervision Committee • Banknote Committee • External Communications Committee • Information Technology Committee • Internal Auditors Committee • International Relations Committee • Legal Committee • Market Operations Committee • Monetary Policy Committee • Payment and Settlement Systems Committee • Statistics Committee
Cooperation Bodies of the Council of the European Union	<ul style="list-style-type: none"> • Informal Council of Economics and Finance Ministers • Economic and Financial Committee
Cooperation Bodies of the European Commission	<ul style="list-style-type: none"> • Banking Advisory Committee • Committee of European Banking Supervisors • Committee on Monetary, Financial and Balance of Payments Statistics • Balance of Payments Committee • Money Laundering Contact Committee



European Central Bank

The European Central Bank (ECB) is Eesti Pank's most significant cooperation partner in the European Union. As of Estonia's accession to the European Union, Eesti Pank has been a full member of the European System of Central Banks. Together with other governors of EU national central banks, the Governor of Eesti Pank is a member of the ECB General Council, which discusses EU economic policy, monetary policy of the non-euro area countries, preparations for the enlargement of the euro area as well as other economic and financial policy matters.

Daily cooperation proceeds in ECB committees, preparing the work for ECB decision-making bodies and other ECB output.

Through the ECB Eesti Pank has the possibility to make its contribution to handling various international economic and financial policy issues.

Council of the European Union and its substructures

Besides participation in the cooperation bodies of the European System of Central Banks, Eesti Pank's representatives also participate in committees and working groups set up by the **Council of the European Union**, i.e. the Council of Ministers. The Governor of Eesti Pank took part in informal meetings of the Council of Economic and Financial Ministers (ECOFIN) held in May and September 2005. The topics discussed included international economic environment and responding to the challenges posed by globalisation; cooperation in financial crisis management between central banks, supervisory authorities and ministries of finance; an overview of the stability of the financial system in the European Union as well as reforming the Stability and Growth Pact and developing common EU positions for the annual meeting of the International Monetary Fund.

Eesti Pank's specialists advise the officials of the Ministry of Finance participating in monthly ECOFIN meetings in matters within the competence of Eesti Pank. In 2005, such matters were e.g. the com-

mittee's proposals to establish common rules for designing the national sides of the new euro coins and to change the common side so that the European map depicted on the coins would correspond to the enlarged euro area. Also covered were the requirements set to the Member States for checking the authenticity of coins and the procedure for the withdrawal of coins unfit for circulation. In the area of financial stability, the common subjects were the committee's proposal to change the article in the banking directive that covers the acquisition and increase of qualified holdings in credit institutions, and the committee's strategic plan for 2005–2010 for financial sector regulation.

The most important cooperation body is the **Economic and Financial Committee (EFC)** and its working groups.

European Commission

Representatives of Eesti Pank participate in the committees and working groups set up by the European Commission covering statistics, economic forecasting, payment systems, banking issues, coin issuance and counterfeiting as well as fight against money laundering.

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

In addition, there was constant information exchange between the European Commission and the experts of Eesti Pank throughout 2005 in order to draw up an assessment of Estonia's Convergence Programme and assessments of the current state of technical preparations for the changeover to the euro.

Cooperation with the International Monetary Fund

The International Monetary Fund (IMF) is a very important institution of economic policy cooperation



involving most of the countries in the world (more precisely, 184 countries). The central objectives of the IMF are ensuring the stability of the international monetary system, supporting the development of international trade and stable sustainable economic growth, and avoiding financial and balance of payments crises.

A major part of the activities of the IMF is related to **the surveillance of the economic policies** of its member countries. As a result of such monitoring, the IMF provides the countries with economic policy suggestions. The methods for monitoring are continuously improved. Crisis prevention is another important field for the IMF. Since all crises cannot be fully prevented, **readiness for solving financial crises and providing financial assistance** in cases of temporary underfinancing are equally important. Also noteworthy is the IMF's role as a provider of **technical assistance**, particularly in the developing countries with insufficient economic policy know-how. All member countries can express their opinion in all these fields of IMF activities.

The Governor of Eesti Pank (a member of the highest decision-making body of the IMF, the **Board of Governors**) and the Secretary General of the Ministry of Finance (the alternate member) attend the IMF Annual Meeting every year. The **International Monetary and Financial Committee**, the advisory board to the Board of Governors, meets twice a year. In 2005, the main topics under discussion at the Board and the Committee meetings were global economic imbalances and oil price developments, reducing the debt burden of poor countries, and the development of IMF surveillance and credit lines.

In July 2005, regular economic **policy consultations were held under Article IV of the IMF Articles of Agreement**. After the approval by the Executive Board of the IMF, the main report on the Estonian economy based on these consultations was published on the web sites of both the IMF and Eesti Pank.

Day-to-day cooperation with the IMF is conducted through the **Nordic-Baltic Constituency** representing Estonia. The constituency includes eight countries (Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden) that elect a common representative to the Executive Board of the IMF. In 2005, the Constituency was represented by Jon Solheim; as of January 2006 the position of the Director of the Constituency has been held by Tuomas Saarenheimo. To participate in the daily decision-making process of the IMF, the Constituency coordinates the position of the eight countries on the issues handled in the Executive Board. The democratic working principles of the Nordic-Baltic Constituency have for a long time been a benchmark for organising the work of other constituencies (totalling 24).

The 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 Ministry of Finance and of the central bank. The experts daily involved in coordinating the work of the Constituency, i.e. the coordinators, meet once a year.

COOPERATION WITHIN ESTONIA

The experts of Eesti Pank participate in different cooperation bodies outside the bank when necessary. Also in 2005, Eesti Pank was represented in the **Research And Development Strategy Working Group** and in the **Development Council as well as in the Social and Economic Council** operating by the Ministry of Social Affairs and consulting upon tripartite negotiations.

Apart from the existing forms of cooperation, in 2005 Eesti Pank's experts participated in the so-called **Lisbon Working Group** drafting a long-term development plan targeted at raising economic competitiveness, which last year prepared an action plan for increasing employment.

The regular four-partite working meetings initiated by Eesti Pank where high-ranking officials of the central bank, the Ministry of Finance, the Ministry of Economic Affairs and Communications, and the Prime Minister's Office discuss topical issues, serve as a noteworthy example of high-level internal cooperation. The agenda of the meetings always includes an overview of the Estonian economy.

The coordination of the EU-related activities must ensure efficient and smooth participation for Estonia in the EU decision-making process. To this end, it is necessary to coordinate the views and positions of different agencies with the country's long-term interests and the government's programme. In January and June 2005, in connection with the new European Union Presidency, Estonia's political priorities were defined for the new presidency period along with the short-term objectives for the implementation of these priorities. One of such objectives is to prepare for the adoption of the euro.

In March 2005, the **European Union Coordination Council** was set up for the domestic coordination of participation in the EU decision-making process. All ministries and Eesti Pank participate in the work of the council, which has the following tasks: the coordination of domestic legislative proceeding of European Union draft legislation; the coordination and monitoring of the transposition of European Union legislation; the discussion and coordination of EU-related positions submitted to the Cabinet meeting, and the exchange of information regarding matters related to the European Union. The council meets every week and has proved to be a very necessary and efficient unit coordinating the exchange of information regarding the European Union and domestic activities.

PUBLIC RELATIONS AND COMMUNICATIONS

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

- To ensure public understanding of and sufficient

support to the monetary policy pursued by the central bank;

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

Central bank's public relations target groups and user surveys

Besides the general public and the media, a large group of local and foreign financial specialists along with local and international business circles and various international institutions are interested in the publications and informational materials issued by Eesti Pank. More than half of the users of Eesti Pank's web site and subscribers to its publications come from outside Estonia. The materials published on Eesti Pank's web site are distributed by large business information agencies (e.g. Reuters) while economic studies and surveys conducted by Eesti Pank are indexed for international business databases.

Given the diversity of the central bank's communication target groups, it is important to know the preferences for obtaining information that various target groups have as well as to find out their opinion of Eesti Pank's publications. This helps to tailor our output to the expectations of the users. To identify the data needs, quantitative opinion polls and qualitative studies are conducted. For example, based on a study that mapped the interests of potential users, the web site www.euro.eesti.ee on the euro currency was compiled.

In 2005, a user study of the two principal outputs of the central bank, namely the *Monetary Policy Survey* and the *Financial Stability Review* – was prepared to be carried out in 2006. In addition to the



findings of the studies, requests for information sent to the bank along with the statistics on the use of different materials and other feedback are taken into consideration when designing the content and form of the information output of the central bank.

Media relations and public appearances

Approximately 2,400 articles, news texts, radio and TV news etc. reflecting the activities of Eesti Pank and its economic policy stand were published in the Estonian media in 2005. The main topics included the adoption of the euro, the loan market and interest rates, as well as various economic comments. The central bank representatives held presentations at more than thirty conferences and events, particularly handling the issues of the euro changeover and Estonia's economic situation.

In 2005, Eesti Pank held five press conferences and issued 64 press releases.

Eesti Pank Museum

The Eesti Pank Museum was opened to the visitors under the auspices of the events dedicated to the 5th anniversary of the Estonian kroon on 12 June 1997. The mission of the museum is to introduce to the public the functions of Eesti Pank as the central bank of the Republic of Estonia and of a European Union Member State, record the history of Eesti Pank and collect, preserve and introduce the means of payment that have circulated in the Republic of Estonia from 1918 until today. The museum also sells collector coins, banknotes and publications issued by Eesti Pank. In 2005, the museum hosted more than 6,400 visitors and the sales turnover amounted to 1.3 million kroons.

Besides the permanent exhibition, the museum held several special exhibitions in 2005. The exhibition "Birth of Euro Coins" presented in cooperation

between Eesti Pank and the European Commission gave an overview of how the design of the common side of the euro coin was chosen and how different European countries found their motifs for the national sides of the coins. The exhibition attracted more than 1,500 visitors.

In spring 2004, the badges of honour that belonged to General Laidoner were returned to Estonia and were exhibited at the Eesti Pank Museum. The exhibition was such a success that on 24th February 2005, the Anniversary of the Republic of Estonia, the badges were exhibited for one more day.

In April-May 2005, an exhibition dedicated to the 10th anniversary of the Order of the Cross of Terra Mariana "Cross of Terra Mariana and Other New Estonian Decorations" was held.

On 1st June, the Child Protection Day, an exhibition "Savings Boxes" was opened, which was the first exhibition of the museum targeted at children.

GOVERNANCE, ORGANISATION AND PERSONNEL POLICY

Eesti Pank's governing bodies and decision-making processes

Supervisory Board of Eesti Pank

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

- Making a proposal to the President of the Republic for appointment of the Governor of Eesti Pank;

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 Minister of Finance is the Chairman of the Supervisory Board. 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.

- Appointment to office and release of Deputy Governors, members of the Executive Board and the chief accountant of Eesti Pank and the heads of the independent divisions and representative offices of Eesti Pank, and the appointment and removal of the two members of the Supervisory Board of the Financial Supervision Authority¹ appointed by Eesti Pank on the proposal of the Governor of Eesti Pank;
- Approval of the statute of Eesti Pank and the statutes of the independent divisions and representative offices of Eesti Pank;
- Supervision of the implementation of the budget of Eesti Pank;
- Appointment of internal auditors of Eesti Pank, approval of work schedules for internal audits and making of decisions on the basis of the results of internal audits;
- Appointment of independent auditors of Eesti Pank;
- Approval of Eesti Pank's annual report on the proposal of the Governor;
- Making of decisions concerning the denomination and design of new banknotes and coins;
- Deciding, on the proposal of the Governor of Eesti Pank, on the establishment, reorganisation and liquidation of independent divisions of Eesti Pank;
- Review and approval of written proposals and other documents submitted to the Riigikogu in the name of Eesti Pank.

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

On 17 February 2004, the Riigikogu appointed to office the current **Supervisory Board of Eesti Pank**, comprising Professor **Mart Sõrg** (Chairman of the Board, appointed to office on 12 June 2003),

Faculty of Economics of the University of Tartu; Professor **Raul Eamets**, Faculty of Economics of the University of Tartu; Governor **Andres Lipstok** (by virtue of office as of 7 June 2005; until then **Vahur Kraft**); Professor **Enn Listra**, Dean of the Faculty of Economics of the Tallinn University of Technology; **Mart Opmann**, Member of the Riigikogu; **Tõnis Palts**, politician and businessman; Professor **Jüri Sepp**, Faculty of Economics of the University of Tartu; and **Liina Tõnisson**, Member of the Riigikogu. After Andres Lipstok assumed the office of Governor of Eesti Pank on 7 June 2005, one position in the Supervisory Board remained vacant until 24 January 2006 when **Harri Õunapuu** was nominated as an alternate member.

Governor of Eesti Pank

On 10 May 2005, the Supervisory Board of Eesti Pank elected Andres Lipstok² as candidate for the position of Governor of Eesti Pank and made a proposal to the President of the Republic of Estonia to nominate Andres Lipstok as Governor of Eesti Pank. The President appointed Andres Lipstok to office on 18 May 2005; the new Governor of Eesti Pank commenced his duties on 7 June 2005.

Executive Board of Eesti Pank

Pursuant to the Eesti Pank Act, the Executive Board of Eesti Pank is responsible for planning and organising Eesti Pank's activities. The Chairman of the Executive Board by virtue of office is the Governor of Eesti Pank. In 2005, the Executive Board comprised Governor **Andres Lipstok** (until 6 June **Vahur Kraft**) and Deputy Governors **Rein Minka**, **Märten Ross** and **Andres Sutt**.

Governor Andres Lipstok is in charge of the overall governance of the activities of Eesti Pank. His exclusive competence involves organising the

² Until that time Andres Lipstok was an ordinary member of the Supervisory Board of Eesti Pank.



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

The Governor of Eesti Pank controls the work of Deputy Governors and is responsible for supervising management mechanisms.

Deputy Governor Rein Minka is responsible for coordinating the activities related to currency circulation; safety of the working environment; reliable, cost-efficient and integrated development of the

settlement system of Eesti Pank; development of the information technology working environment and legal environment, as well as personnel management.

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

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

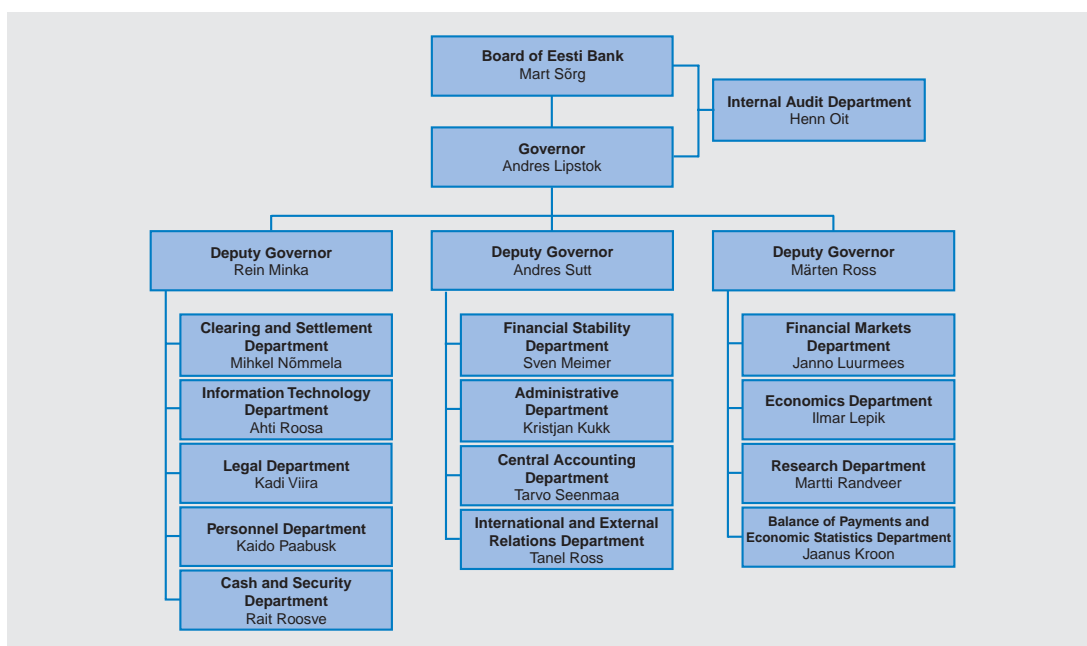


Figure 1. Organisational chart of Eesti Pank as at 1 April 2006

Monetary Policy Committee

In order to develop positions on monetary, economic and financial policies and coordinate the activities of Eesti Pank, a standing Monetary Policy Committee was established at Eesti Pank.

In 2005, the **Monetary Policy Committee of Eesti Pank** included the members of the Executive Board Governor **Andres Lipstok** (until 6 June **Vahur Kraft**), Deputy Governors **Rein Minka**, **Märten Ross** and **Andres Sutt** as well as **Janno Luurmees**, Head of the Financial Markets Department, **Ilmar Lepik**, Head of Economics Department, **Tanel Ross**, Head of the International and External Relations Department (until 1 September 2005 **Martin Pöder**), **Rait Roosve**, Head of the Cash and Security Department, and **Sven Meimer**, Head of the Financial Stability Department.

In order to prepare for the participation of Eesti Pank's experts in external working groups and discussions of interest to the public, intra-bank seminars and brainstorming sessions are held. For instance, at the spring seminar held in 2005 in Kuressaare problems regarding the competitiveness of the Estonian economy were analysed; at the autumn seminar held at Roosta one of the topics was global economic imbalances and possible future scenarios. There have also been meetings with representatives of the health care sector to discuss health care financing.

Governance framework

Strategic management

Eesti Pank followed the strategic management development path opted for in 2001, which involves description of the bank's development priorities and regular tasks in a three-year perspective and more precise planning of human and financial resources. The development of the bank's management sys-

tem has contributed to more precise planning of required labour.

In 2005, the Executive Board approved Eesti Pank's management system that associates different management activities, defines the relations between these activities as well as the persons responsible for these activities.

A lengthy seminar on governance organised in February 2005 in cooperation between Eesti Pank and the Bank of England also served the objective of developing the management system.

Financial and management accounting was developed further. In 2005, the focus was on preparing the accounting systems for the adoption of the euro. For that purpose the financial assets accounting module was introduced and by the beginning of 2006 the financial accounting and reporting standards obligatory for the central banks of the Eurosystem were applied. In order to improve bank's process-centred cost accounting model and make the results more comparable, the experience and methods of the ESCB central banks were applied.

For the fifth consecutive year, the bank conducted appraisal interviews with the purpose of reviewing and planning work and development tasks in cooperation between the executives and the staff as well as receiving proposals from the personnel regarding bank's strategic directions and organisation of work.

In November 2005, a regular staff satisfaction survey was carried out in the bank, traditionally asking for feedback regarding management quality, and structural and human capital. For the first time, the survey was combined with a staff commitment study. The survey provided the Executive Board with feedback from the employees and enabled to define potential problems.



According to the survey, the commitment of the staff of Eesti Pank is slightly above average, compared to the Estonian public sector as well as in global comparison³. Across the four major areas mapped, the employees gave the highest satisfaction ratings to managers and the lowest ratings to structural capital components. The findings in the fields of resources, reputation and human capital, which were included in the survey for the first time, remained at a medium level. The ratings were relatively similar to those of 2003, whereas the ratings in 2001 had been at a lower level on average.

The feedback received in the course of appraisal interviews coupled with the findings of the survey comprise the staff's contribution to better planning and organisation of work in the bank.

Process management

At the beginning of 2005, the Executive Board of Eesti Pank approved the list of bank's processes. Bank's processes were linked to process descriptions (previously drawn up by the departments) in the bank's management system. Bank's processes, regular reviews and updates are a natural part of the bank's strategic annual management cycle.

During the audit Bureau Veritas Eesti OÜ validated the ISO 9001:2000 Quality Certificate issued to the Cash and Security Department in 2002. The certificate serves as a proof that cash handling and security processes at Eesti Pank are compliant with the standard's requirements.

Risk management

Eesti Pank's Risk Assessment Working Group conducted an assessment of all risks related to the bank's main functions. As a result, the risk profile of the bank's key processes was mapped, i.e. its vulnerability to different risks.

Since the bank is involved in investing currency reserves (nearly 26 billion), its highest risks are quite expectedly related to financial markets (currency risk, price risk, etc.). Also a high level of operational and reputation risks is inherent to the central bank. On the other hand, it is natural that the level of accounting risk is low since the area is largely automated, strongly regulated both within Estonia as well as at the ESCB level and under multiple supervision (internal audit, external audit, ESCB audits). The high risk level of the monetary policy process stems above all from function-related image risks. As regards ensuring the currency circulation and security functions, force majeure and operating risks (contact with cash) are determinative.

When the assessment process has been completed and assessments have subsequently been specified, risk-handling under a two-level management scheme where roles have been distributed according to agreed principles will commence. The latter have been pooled into the so-called "risk management framework" and foresee different tasks for the Supervisory Board of Eesti Pank, the Executive Board, heads of departments or departments' risk managers. Such risk management process is passed once a year in synchrony with the strategic planning cycle.

e-Eesti Pank

Proceeding from the possibilities offered by information technology and the changing needs that Eesti Pank has in light of Estonia's integration with the European Union, the Executive Board approved the development strategy for document and information management in 2003. The first development stage ended in 2005.

The aim of e-EP is a stage-by-stage changeover to e-administration and building up a document creation and document management system compliant

³ A global comparison based on surveys conducted by TNS covers approximately 1.4 million employees from various public and private sector organisations.

with the best international experience in a common integrated environment. Moreover, e-EP offers modern possibilities for managing and monitoring work processes. In the first project stage an analysis of Eesti Pank's activities was completed, necessary information assets were defined, methods described, and a glossary of metadata compiled.

The following management information system elements have been implemented:

- Use of group work (project) facilities (e.g. in case of development activities and drafting the budget);
- Several document creation and processing workflows (e.g. orders, invoices, Executive Board decisions);
- Joint calendars (e.g. working groups, Executive Board, executive officer and the secretary);
- Task lists (e.g. work schedules).

The implementation of e-EP will facilitate more efficient document and information management along with better administrative capability, and administrative risks will be reduced as well.

Eesti Pank's personnel policy

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

Employees

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

Staff remuneration derives from the need to recruit and retain highly competent staff and motivate them to work effectively and contribute to the good reputation of the bank. The average compensation in the bank should be competitive in the labour market where the bank competes for employees. Generally, it means the financial sector labour market in Tallinn (Harju County). In order to determine the competitiveness of the pay, the indicators of the wage market in the past period are compared against current wages.

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

In 2005, total remuneration (basic wages and additional remuneration) paid to the top management of Eesti Pank (to members of the Supervisory and Executive Boards) amounted to 7,598,357 kroons.

Non-managerial positions have been assessed on the basis of the Hay method. Depending on the assessment results, all posts have been divided into wage groups listed in the classification of central bank posts. Eesti Pank has implemented a wage scale comprising all wage grades. The employees (except for the members of the Executive Board) receive remuneration on the basis of their wage grade, comparable by groups of similar work within as well as outside the bank.

At the beginning of 2005, the bank had contracts of employment with 259 employees (231 of them were actually at work and contracts with 28 employees



had been suspended) while at the end of the year the respective figure was 255 (233 of them were actually at work and contracts with 22 employees had been suspended). The principal 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 2005 was 41 years. The bank employed 107 men (42%) and 149 women (58%).

Development and training

In 2005, a range of **internal training projects and seminars** were carried out. The resources planned for training accounted for about 4.3% of the payroll and the **training costs** stood at **4% of the payroll** at the end of the year. The training cost per employee was 15,729 kroons. In 2005, 182 employees attended training, which amounts to 77% of all the staff. Training totalled 11,827 hours, an average of **six days of training per employee**.

The main training topics in 2005 were defined in the bank's internal training plan. Departments were independent in deciding internal training needs.

All in all, the bank staff participated in **214 training events** and nearly a half of the events were held outside the bank. There were 29 internal training courses, including 26 in associated areas (information technology, law, management, and communication) and three in core areas (financial stability, central banking, and economic theory and policy). In 2005, altogether 20 open seminars were held; at nine events lecturers came from abroad while at 11 events the bank's own research works were presented.

The key training topics included **management and communication aspects, economic theory and policy** and **financial stability**. Language training remained popular as well.

45 employees were engaged in **academic studies** in 2005; about half of them were acquiring the Master's degree (23), a third the Doctor's degree (15), and the rest the Bachelor's degree. During the year one staff member of Eesti Pank participated in a traineeship programme in the European Central Bank and one employee was a trainee at the Finnish central bank. Two employees from the Ministry of Finance were trainees at Eesti Pank for two months.

Hobbies and traditions of the staff

At the end of 2005, Eesti Pank's **Sports Club** had 214 members. Basketball, aerobics, swimming, bowling and volleyball were among the most popular fields of sport. The staff also practices cycling, skiing, chess, sailing, and orienteering.

Chamber choir. The association of chamber music enthusiasts comprised of the employees of Eesti Pank and the Financial Supervision Authority first gathered on 15 May 1998. The choir is conducted by Peeter Perens. The activities of the choir are coordinated by the board elected every year.

E E S T I - P A N K



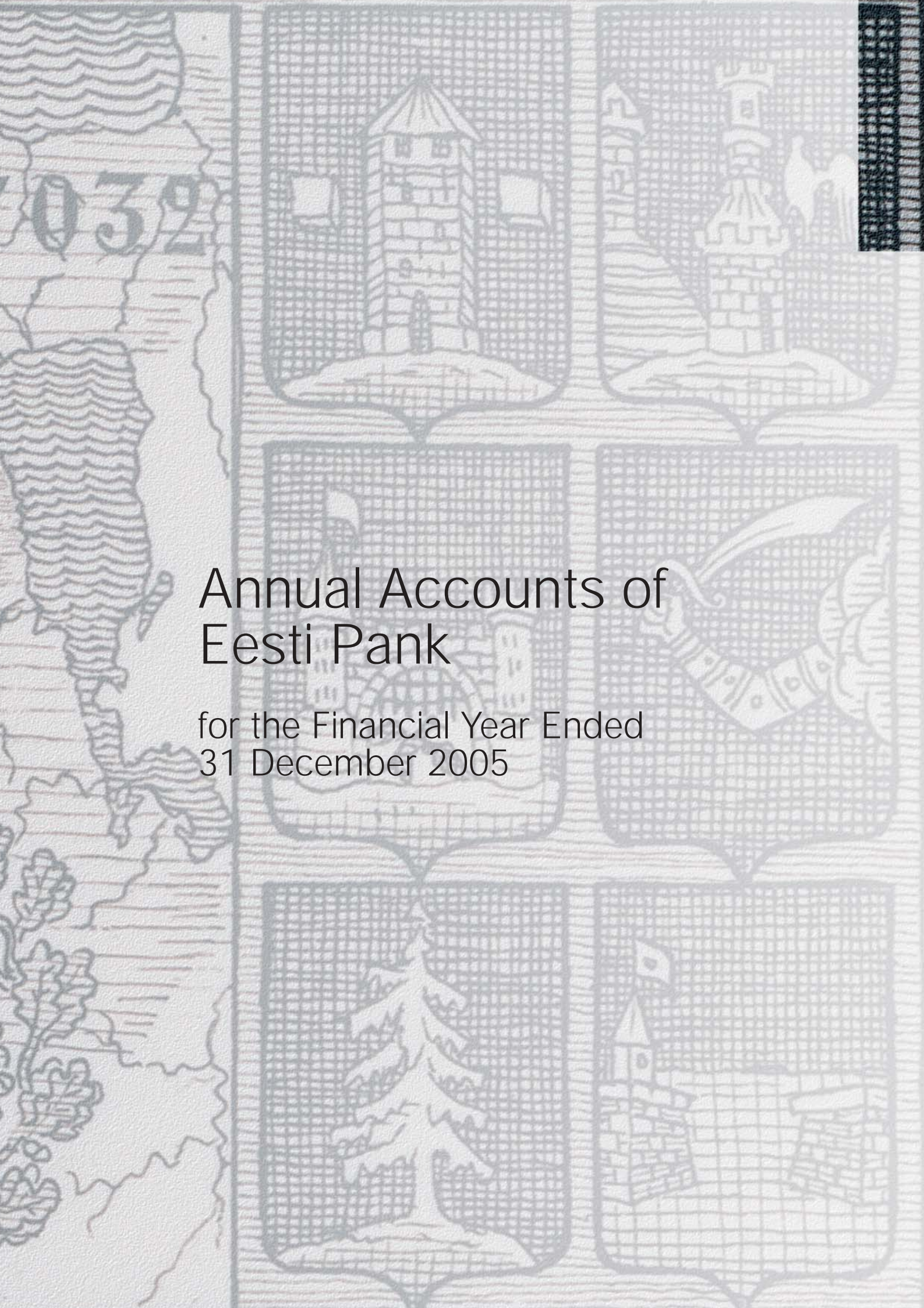
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Annual Accounts of Eesti Pank

for the Financial Year Ended
31 December 2005



**APPROVAL OF THE ANNUAL ACCOUNTS FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2005
BY THE EXECUTIVE BOARD OF EESTI PANK**

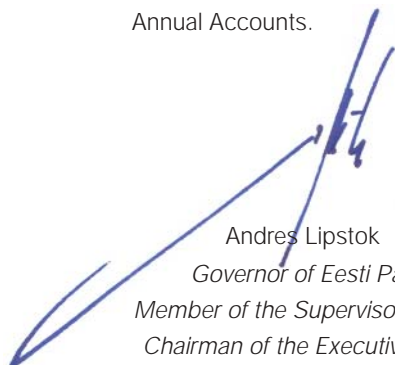
The Executive Board acknowledges its responsibility for the Annual Accounts of Eesti Pank for the financial year ended 31 December 2005, consisting of the balance sheet, profit and loss account, statement of changes in equity and the respective appendices.

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

Preparing the Annual Accounts in conformity with generally accepted accounting principles requires the Executive Board to provide estimates affecting the assets and liabilities of Eesti Pank as at the accounting date and income and expenses during the accounting period. These estimates are based on the information available about Eesti Pank, its intentions and risks as at the date of preparation of the Annual Accounts. The final outcome of the economic transactions reflected in the Annual Accounts may differ from the estimates of the Executive Board.

The Annual Accounts disclose significant events that occurred until the date of preparation of the Annual Accounts, i.e. 15 March 2006, and that affected the valuation of assets and liabilities.

On 27 March 2006, all members belonging to the Executive Board of Eesti Pank on that day signed the Annual Accounts.




Andres Lipstok
*Governor of Eesti Pank,
Member of the Supervisory Board,
Chairman of the Executive Board*



Rein Minka
*Member of the Executive Board,
Deputy Governor*



Märten Ross
*Member of the Executive Board,
Deputy Governor*



Andres Sutt
*Member of the Executive Board,
Deputy Governor*

BALANCE SHEET AS AT 31 DECEMBER 2005 AND 2004 (EEK thousand)

	Item	31/12/2005	31/12/2004
ASSETS			
Foreign assets		27,026,925	21,787,426
Gold	1	56,017	41,400
Convertible foreign currency	2	25,715,967	20,562,047
SDR account with the IMF	3	1,037	953
Participation in the IMF	3	1,231,491	1,161,271
Other claims on the IMF	3	11,540	10,882
Participation in the ECB	4	10,873	10,873
Domestic assets		346,919	284,890
Loans and other claims	5	45,546	53,520
Shares	6	3,441	73
Other assets	7	54,815	17,070
Fixed assets	8	243,117	214,227
Total assets		27,373,844	22,072,316
LIABILITIES AND EQUITY CAPITAL			
Foreign liabilities		1,291,347	1,672,277
Foreign debt	2	56,117	506,705
IMF kroon accounts	3	1,231,399	1,161,184
Non-residents' accounts	9	3,831	4,388
Domestic liabilities		22,221,378	16,713,513
Banknotes and coins in circulation		10,101,716	8,895,053
Accounts of credit institutions and other current liabilities	10	12,069,166	7,776,968
accounts of credit institutions		11,984,644	7,701,894
other		84,522	75,074
Liabilities in foreign currency	3	5,178	4,883
Other liabilities	11	45,318	36,609
Equity capital		3,861,119	3,686,526
Capital and reserves	12	3,623,724	3,435,323
Profit		237,395	251,203
Total liabilities and equity capital		27,373,844	22,072,316

The notes on pages 70–86 form an integral part of the Annual Accounts.

PROFIT AND LOSS ACCOUNT FOR THE YEARS 2005 AND 2004 (EEK thousand)

	Items	2005	2004
Net interest income and other net income on foreign assets and liabilities	13	502,330	477,502
Net interest cost and other net cost on domestic assets and liabilities	14	-88,665	-56,801
Interest and other income		12,421	11,829
Interest and other expenses		-101,086	-68,630
Other operating income	15	10,959	20,043
Operating expenses	16	-186,953	-189,489
Personnel expenses		-84,957	-78,805
Banknote and coin production costs		-3,716	-15,405
General administration expenses		-73,593	-69,546
Depreciation of fixed assets		-24,687	-25,733
Profit before write-downs		237,671	251,255
Net change of write-downs	17	-276	-52
Profit	18	237,395	251,203

The notes on pages 70–86 form an integral part of the Annual Accounts.



STATEMENT OF CHANGES IN EQUITY (EEK thousand)

	Fixed capital	Reserve capital	Special reserve	Profit	Total
Balance as at the end of 2003	100,000	500,000	2,628,509	275,751	3,504,260
Distribution of the 2003 profit	-	-	206,813	-206,813	-
Provisions into the state budget	-	-	-	-68,938	-68,938
Profit of 2004	-	-	-	251,203	251,203
Balance as at the end of 2004	100,000	500,000	2,835,323	251,203	3,686,526
Distribution of the 2004 profit	-	-	188,401	-188,401	-
Provisions into the state budget	-	-	-	-62,802	-62,802
Profit of 2005	-	-	-	237,395	237,395
Balance as at the end of 2005	100,000	500,000	3,023,724	237,395	3,861,119

The notes on pages 70–86 form an integral part of the Annual Accounts.

NOTES TO 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 guidelines. As regards issues not covered by the above-mentioned regulations, international financial reporting standards are applied.

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

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

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

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

Recording of transactions in a foreign currency

Transactions in a foreign currency are recorded on the basis of the official daily fixings of Eesti Pank as quoted by Eesti Pank at the transaction date. Assets and liabilities denominated in foreign currencies are translated into Estonian kroons at the official daily fixings effective on the balance sheet date. All gains and losses arising from translation are recognised in the Profit and Loss Account as income and expenses of the accounting period.

The official daily fixings applied on 31 December 2005 and 2004 were as follows:

	2005	2004
USD	13.2206	11.4711
SDR	18.8879	17.8109
EUR	15.6466	15.6466

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.

The Balance Sheet of Eesti Pank has been structured so that financial assets and liabilities as well as related gains and losses are presented separately according to residency (domestic and foreign). Such Bal-



ance Sheet structure allows monitoring the backing of the Estonian kroon by gold and convertible foreign currency. Foreign exchange transactions are primarily related to foreign exchange reserves management. Transactions in Estonian kroons are mainly related to currency circulation, market operations, and the daily operating activities of Eesti Pank.

Financial assets and liabilities are initially recorded at their acquisition cost, which is the fair value of the amount paid or received for a financial asset or liability. Financial assets sold or purchased under normal market conditions are entered on the delivery date. Further accounting of financial assets and liabilities is based on the fair value, the acquisition cost or the adjusted acquisition cost depending on the type of a respective asset or liability.

Fair value is the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction. If the fair value of financial assets and liabilities differs significantly from their book value, these differences have been shown separately in the Notes to the Annual Accounts.

Financial instruments recorded at fair value are revalued on every balance sheet date. Changes in fair value are recognised in the Profit and Loss Account of the reporting period.

There were no significant differences between the fair value and book value of the financial assets and liabilities of Eesti Pank as at 31 December 2005 and 31 December 2004.

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. Changes in the market value of gold at the end of the accounting period compared to the beginning of the period are recognised in the Profit and Loss Account under the item "Net Interest Income and Other Net Income on Foreign Assets and Liabilities".

Investments in convertible foreign currency

Foreign debt instruments and other quoted securities denominated in convertible foreign currencies are recorded at their year-end fair value. Gains and losses from changes in the fair value of securities are recognised in the Profit and Loss Account under the item "Net Interest Income and Other Net Income on Foreign Assets and Liabilities".

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 of Eesti Pank and the repurchase sum as a liability. The fair value has been estimated on the basis of the discounted cash flow method. The change in the fair value is recorded on an accrual basis in the Profit and Loss Account under the item "Net Interest Income and Other Net Income on Foreign Assets and Liabilities".

Reverse repurchase transactions (purchase/resale transactions) are recorded as collateralised loans granted at their fair value. The fair value has been estimated on the basis of the discounted cash flow method. The change in the fair value is recorded on an accrual basis in the Profit and Loss Account under the item "Net Interest Income and Other Net Income on Foreign Assets and Liabilities". Securities used as collateral for reverse repurchase transactions are not recorded on the Balance Sheet of Eesti Pank.

Derivative instruments

Derivative instruments are used to manage foreign exchange risks and interest rate risks and they include foreign exchange forwards, swaps, and futures. Derivative instruments are recorded on the Balance Sheet at their fair value on the transaction date under "Convertible Foreign Currencies" (contracts with positive value) and "Foreign Debt" (contracts with negative value). The change in the fair value is recorded on an accrual basis under the item "Net Interest Income and Other Net Income on Foreign Assets and Liabilities" in the Profit and Loss Account. Eesti Pank does not apply hedge accounting to derivative instruments.

Investments in shares

Investments in shares are recorded at their fair value if their value can be reliably assessed. The assessment of the fair value of shares is not reliable if they are not actively traded and there are no alternative methods to assess their value in a reliable way. In this case shares are recorded at their adjusted acquisition cost (initial acquisition cost less provision for any impairment in value other than temporary below balance sheet value). Profits and losses on the sale of shares are recorded in the Profit and Loss Account after all conditions of sale are met. Dividend income is recorded as income for the period.

Fixed assets

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

	2005	2004
Buildings	3%	3%
Utility systems of buildings	20%	20%
Hardware	33%	33%
Software	20–50%	20–50%
Other fixed assets	20%	20%

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

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

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



Allowance for loans and other claims

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

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

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

Asset impairment

An assessment is carried out on every balance sheet date to identify possible signs of an impairment of financial assets recorded at acquisition cost or adjusted acquisition cost or tangible fixed assets recorded at acquisition cost.

The impairment of significant financial assets is assessed for each object separately. The impairment of financial assets that are not individually significant and that are not known to have impaired is assessed for all assets together. Write-downs of financial assets is recognised as expenses in the income statement for the accounting period.

The recoverable amount of an asset is identified during testing the value of tangible fixed assets recorded at acquisition cost. If it is not possible to identify the value of a single asset (object) through testing, the value is tested across the smallest possible group of assets. The recoverable amount is equal either to the net selling price or the value in use of an asset, depending on which of the two is higher. The value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. In calculating the present value the discount factor is the expected profitability of investments with similar risk-level. If the recoverable amount of an asset is smaller than its carrying amount, the asset is written down. The write-down is recognised in the Profit and Loss Account as an expense of the accounting period on an accrual basis.

Liabilities

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

Banknotes and coins in circulation

Banknotes and coins in circulation are banknotes and coins issued by Eesti Pank at their nominal value and reflected on the Balance Sheet as a liability to the holder of banknotes and coins. Production costs of banknotes and coins are recorded in the Profit and Loss Account when the bank's payment obligation to the supplier arises.

Claims and liabilities to the Financial Supervision Authority

The Balance Sheet of Eesti Pank contains a claim to the Financial Supervision Authority in relation to services provided by Eesti Pank and acquisition of current assets (see Item 7) and a liability in relation to the settlement account of the Financial Supervision Authority held with Eesti Pank (see Item 10).

Income and expenses

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

Estimates

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



ITEM 1 – GOLD

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

	Amount (ounces)	Market price (EEK per ounce)	Market value (EEK thousand)
Balance at the end of 2004	8,250.171	5,018.0400	41,400
Revaluation	-	-	14,617
Balance at the end of 2005	8,250.171	6,789.7800	56,017

ITEM 2 – CONVERTIBLE FOREIGN CURRENCY ASSETS, FOREIGN CURRENCY LIABILITIES

This item comprises Eesti Pank's foreign exchange reserves and liabilities related to reserve management in convertible foreign currency. The following financial instruments are used to manage the foreign exchange reserves: demand and time deposits, bonds, spot transactions, derivatives (futures, forwards, and swaps), repurchase and reverse repurchase transactions.

EEK thousand

	Balance at the end of 2004	Structure of remaining maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
Convertible foreign currency	20,562,047	14,272,032	2,543,989	1,913,911	752,223	1,079,892
Cash and current accounts	391,732	391,732	-	-	-	-
Time deposits	-	-	-	-	-	-
Debt securities	17,191,651	10,902,096	2,543,900	1,913,911	751,852	1,079,892
Reverse repurchase agreements	2,926,978	2,926,978	-	-	-	-
Fair value of derivatives	51,686	51,226	89	-	371	-
	Balance at the end of 2005	Structure of remaining maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
Convertible foreign currency	25,715,967	14,808,752	5,842,146	2,265,445	1,209,089	1,590,535
Cash and current accounts	426,290	426,290	-	-	-	-
Time deposits	998,082	998,082	-	-	-	-
Debt securities	21,900,002	11,006,305	5,840,940	2,265,445	1,200,457	1,586,855
Reverse repurchase agreements	2,362,413	2,362,413	-	-	-	-
Fair value of derivatives	29,180	15,662	1,206	-	8,632	3,680

	Balance at the end of 2004	Structure of remaining maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
External debt	506,705	506,705	-	-	-	-
Repurchase agreements	489,728	489,728	-	-	-	-
Fair value of derivatives	12,630	12,630	-	-	-	-
Other liabilities	4,347	4,347	-	-	-	-
	Balance at the end of 2005	Structure of remaining maturity				
		up to 3 months	3–12 months	1–3 years	3–5 years	over 5 years
External debt	56,117	25,454	893	-	4,468	25,302
Repurchase agreements	-	-	-	-	-	-
Fair value of derivatives	43,477	12,814	893	-	4,468	25,302
Other liabilities	12,640	12,640	-	-	-	-

In 2005, Eesti Pank's net foreign exchange reserves increased by 5.6 billion kroons.

During 2005 the amount of Estonian kroons purchased from Eesti Pank for foreign currency was 62.3 billion, while the amount of Estonian kroons sold to Eesti Pank for foreign currency totalled 57.1 billion. The net gain of 5.2 billion kroons on transactions in line with the principles of the currency board arrangement was additionally channelled into circulation. Foreign exchange reserves increased due to growth in the volume of Estonian kroons in circulation and in the fair value of the reserves.

Eesti Pank's foreign exchange reserves are required to back up banknotes and coins in circulation, funds in the accounts of credit institutions with Eesti Pank, and other Balance Sheet liabilities of Eesti Pank. Therefore, conservative risk limits established to the assets backing the Estonian kroon are followed, which prioritise maintaining the assets and their liquidity while earning investment income.

At the end of 2005, financial instruments denominated in euros accounted for 93% of the total foreign exchange reserves. Adding also the currency positions from foreign exchange swaps and forwards, the share of the euro in Eesti Pank's foreign exchange reserves was nearly 100%.

EEK thousand

	Balance at the end of 2005		Balance at the end of 2004	
	Convertible foreign currency	Structure	Convertible foreign currency	Structure
Total	25,715,967	100%	20,562,047	100%
EUR	23,865,365	93%	18,862,308	92%
USD	1,754,921	7%	1,678,725	8%
Other currencies	95,681	0%	21,014	0%

	Balance at the end of 2005		Balance at the end of 2004	
	External debt	Structure	External debt	Structure
Total	-56,117	100%	-506,705	100%
EUR	-22,317	40%	-4,241	1%
USD	-8,607	15%	-495,010	98%
Other currencies	-25,193	45%	-7,454	1%

Off-balance-sheet net position

Total	-1,739,174	100%	-1,202,368	100%
USD	-1,665,767	96%	-1,393,670	116%
Other currencies	-73,407	4%	191,302	-16%

The guidelines for managing Eesti Pank's foreign exchange reserves allow only transactions with highly rated international banks and financial institutions and limit any credit risk the bank can take in managing its foreign assets. The issuer risk is allowed for the following minimum credit ratings assigned by international rating agencies (S&P/Moody's): A-1 or P-1 for bonds with the maturity of up to one year and AA- or Aa3 for bonds with the maturity of over one year. In 2005, Eesti Pank's foreign exchange reserves were mainly placed in the markets of low-risk government bonds of leading industrial countries of the euro area and the United States with an average maturity of slightly above one year.



ITEM 3 – RELATIONS WITH THE INTERNATIONAL MONETARY FUND (IMF)

Special Drawing Rights (SDR)

Each IMF member has an SDR account of IMF which is used for settling loan transactions and various other similar operations between the member state and the IMF. The following table reflects the dynamics in the account the Republic of Estonia holds with the IMF.

EEK thousand

	2005	2004
SDR account in the IMF		
Balance at the beginning of the year	953	969
Interest and other income	51	35
Exchange rate differences	33	-51
Balance at the end of the year	1,037	953

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 2005, the quota of the Republic of Estonia was 65,200,000 SDRs (1,231,491,080 kroons).

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

EEK thousand

	2005	2004
Participation in the IMF (assets)		
Balance at the beginning of the year	1,161,271	1,202,326
Exchange rate differences	70,220	-41,055
Balance at the end of the year	1,231,491	1,161,271
IMF kroon accounts (liabilities)		
Balance at the beginning of the year	1,161,184	1,202,237
Exchange rate differences	70,215	-41,053
Balance at the end of the year	1,231,399	1,161,184

Other claims on 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 of the Stand-by Arrangement (SBA) and the Systemic Transformation Facility (STF).

EEK thousand

	2005	2004
Other claims on the IMF		
Balance at the beginning of the year	10,882	11,267
Exchange rate differences	658	-385
Balance at the end of the year	11,540	10,882
Eesti Pank, SBA loan-related receivable	6,362	5,999
Government, STF loan-related receivable	5,178	4,883
Total	11,540	10,882

Liabilities in foreign currency

The item reflects the Republic of Estonia's claim on the IMF, which is recognised 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). In previous years, the item included also demand deposits of the Republic of Estonia with Eesti Pank.

EEK thousand

	2005	2004
Liabilities in foreign currency		
Balance at the beginning of the year	4,883	5,056
Exchange rate differences	295	-173
Balance at the end of the year	5,178	4,883

ITEM 4 – PARTICIPATION IN THE EUROPEAN CENTRAL BANK

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

On 1 May 2004, the Republic of Estonia joined the European Union and consequently Eesti Pank became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the ECB, Eesti Pank became a subscriber of the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the Statute of the ESCB and which must be adjusted every five years. The share of the Republic of Estonia in the ECB's capital is 0.1784%. It was calculated in accordance with Article 29 of the Statute of the ESCB on the basis of population and GDP data provided by the European Commission. As the Republic of Estonia does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Consequently, Eesti Pank was required to pay up a minimal contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB on 1 May 2004. The respective contribution amounted to 694,916 euros (10.9 million kroons). Eesti Pank is obliged to pay the remaining 93% upon Estonia's accession to the Economic and Monetary Union.

ITEM 5 – LOANS AND OTHER CLAIMS

The following is a more detailed overview of changes in loans and other claims in 2005 followed by additional explanations.

EEK thousand

	Balance at the end of 2005	Increase	Decrease	Change in write-down	Balance at the end of 2004
Total	45,546	7,060	-14,758	-276	53,520
Guarantee Fund	178	657	-626	-	147
Loans	45,368	6,403	-14,132	-276	53,373
to employees of Eesti Pank	45,188	4,703	-12,430	-276	53,191
Accrued interest	180	1,700	-1,702	-	182



Guarantee Fund

In 2002, Eesti Pank entered into an asset management agreement with the Guarantee Fund under which the Guarantee Fund pays a service fee to Eesti Pank for the Fund's asset placement. The item records the service charge for the fourth quarter of 2005, which the Guarantee Fund paid in 2006.

Loans to the employees of Eesti Pank

Housing loans secured by real estate have been granted to employees of Eesti Pank for a maximum of 25 years and consumption loans for up to two years. The Supervisory Board of Eesti Pank establishes the interest rate on consumption loans for every fiscal year. The interest rate on consumption loans is comparable to the interest rate charged by Estonian credit institutions under similar conditions. The interest rate on housing loans is based on the reserves' interest rate Eesti Pank pays to credit institutions plus a risk margin. The reserves' interest rate equals ECB deposit interest rate, which remained within 1.0–1.25% in 2005. In addition, study loans were granted for a maximum of ten years and with a 5% interest rate. Additional information on write-downs of loans is provided under Item 17.

ITEM 6 – SHARES

Shares held by Eesti Pank:

	Balance at the end of 2005		Balance at the end of 2004	
	Holding (%)	EEK thousand	Holding (%)	EEK thousand
Total		3,441		73
Bank for International Settlements (BIS)				
214 shares (200 voting shares)	N/A	3,397	N/A	2
Tallinna Börs (Tallinn Stock Exchange)				
29 shares with nominal value à 10,000 kroons	1.1	44	1.1	71

N/A – not available

Tallinn Stock Exchange

Arising from the resolution of the annual general meeting of the shareholders of the Tallinn Stock Exchange to repurchase 10% of shares and to increase the share capital, Eesti Pank resold three shares to the Tallinn Stock Exchange in 2005. As a result of increasing the share capital, Eesti Pank holds 29 shares on the Tallinn Stock Exchange, amounting to a 1.1% holding.

Bank for International Settlements (BIS)

Arising from the resolution of the Board of Directors of the Bank for International Settlements of 10 January 2005, the Bank for International Settlements sold 35,933 non-voting shares to shareholders (member central banks) in the course of redistributing shares. Eesti Pank purchased 14 non-voting shares from the BIS, paying 23,978 Swiss francs per share. Eesti Pank maintains its present status and rights in the Bank for International Settlements, holding 200 voting and 14 non-voting shares.

ITEM 7 – OTHER ASSETS

This item includes various prepayments for services and goods to be provided in 2006, the liability of the Financial Supervision Authority to Eesti Pank for services provided, as well as stocks and other current assets.

ITEM 8 – FIXED ASSETS

As of the beginning of 2005, the limit of the acquisition cost of fixed assets is 50,000 kroons (previously 5,000 kroons).

Arising from the change in the limit of the acquisition cost of fixed assets, information technology costs (repair and maintenance of hardware) in the Profit and Loss Account increased by 1.5 million kroons and the administrative expenses of real estate increased by 1.2 million kroons in 2005, compared to 2004. Depreciation costs of fixed assets decreased by 800,000 kroons.

Changes in fixed assets in 2005:

EEK thousand

	Buildings	Hardware	Furniture and fixtures	Software	Total
Acquisition cost					
Balance at the end of 2004	205,453	66,960	82,776	46,498	401,687
Acquired	4,976	4,075	2,924	3,594	15,569
Disposals	0	-6,594	-5,469	-206	-12,269
Balance at the end of 2005	210,429	64,441	80,231	49,886	404,987
Accumulated depreciation					
Balance at the end of 2004	33,531	56,746	67,797	32,566	190,640
Acquired	7,392	6,716	4,206	6,434	24,748
Disposals	-	-6,594	-5,214	-206	-12,014
Balance at the end of 2005	40,923	56,868	66,789	38,794	203,374
Residual value					
At the end of 2004	171,922	10,214	14,979	13,932	211,047
At the end of 2005	169,506	7,573	13,442	11,092	201,613
Advance payments for fixed assets					
Balance at the end of 2004	3,180	-	-	-	3,180
Balance at the end of 2005	15,250	17	20,811	5,426	41,504
Total fixed assets					
At the end of 2004	175,102	10,214	14,979	13,932	214,227
At the end of 2005	184,756	7,590	34,253	16,518	243,117

The cost of fixed assets acquired in 2005 amounted to 15.6 million kroons. Majority of the procurement of buildings accounted for the improvement of the building of Eesti Pank at Estonia pst 13, Tallinn. Hardware procurement included computers, servers, printers, and various accessories. Purchases of furniture and fittings mainly included security devices and business machines. Software purchases included mostly system software and additional user licences for existing software.

As at the end of 2005, prepayments for fixed assets had been made primarily for software, inventory, security devices, and the construction works of the building of Eesti Pank at Sakala 6, Tallinn.



ITEM 9 – ACCOUNTS OF NON-RESIDENTS

This item includes non-interest-bearing demand deposit accounts held with Eesti Pank by the World Bank and the Nordic Investment Bank and used for intermediating foreign loans from the above organisations to the Republic of Estonia.

ITEM 10 – ACCOUNTS OF CREDIT INSTITUTIONS AND OTHER CURRENT LIABILITIES

This item includes the settlement accounts of credit institutions with Eesti Pank. The deposits of credit institutions increased by 4.3 billion kroons in 2005. 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 2005, the deposit interest rate of the ECB increased from 1.0% to 1.25% (see Item 14). The interest rate is calculated on the basis of the monthly average balance of the settlement account.

Since 2002, this item reflects also the funds in the account of the Financial Supervision Authority held with Eesti Pank, which subjects of financial supervision pay as supervision fees. Interest has been paid on the funds in the Financial Supervision Authority's account since 2004.

ITEM 11 – OTHER LIABILITIES

This item includes liabilities for miscellaneous expenses for settlements related to economic activities in 2005 with payments due in 2006. The majority are liabilities related to payments and liabilities to suppliers.

ITEM 12 – CAPITAL AND RESERVES

Changes in capital and reserves in 2005:

EEK thousand

	Balance at the end of 2005	Distribution of 2004 profit	Balance at the end of 2004
Total	3,623,724	188,401	3,435,323
Fixed capital	100,000	-	100,000
Reserve capital	500,000	-	500,000
Special reserve	3,023,724	188,401	2,835,323

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 profits may be used, pursuant to a decision of the Supervisory Board of Eesti Pank, to establish and augment the foundation capital and funds for specific purposes. Any remaining profits are transferred to the state budget.

ITEM 13 – NET INTEREST INCOME AND OTHER NET INCOME ON FOREIGN ASSETS AND LIABILITIES

This item reflects net income from transactions with government debt instruments gained in managing Eesti Pank's foreign exchange reserves, including reverse repurchase transactions, gains arising from fluctuations

in exchange rates and gold price, interest income from time deposits, income from currency exchange transactions, and dividends.

In 2005, the rate of return of net foreign exchange reserves was 2.17%, which was 0.43% less than expected. The main reason was the faster than expected rise of interest rates in the United States. As the volume of reserves grew faster than expected in 2005, investment income exceeded the forecast (490 million kroons) by 12 million kroons.

EEK thousand

	2005	2004
Total	502,330	477,502
Income		
Time deposits	13,947	8,635
Debt securities	429,178	401,060
Reverse repurchase agreements	71,910	57,557
Dividends (BIS shares)	890	849
Foreign currency derivatives	-	14,659
Exchange rate gains	4,562	-
Other income	2,087	2,936
Expenses		
Repurchase agreements	-10,363	-3,673
Foreign currency futures transactions	-7,155	-
Exchange rate losses	-	-4,519
Other expenses	-2,726	-2

ITEM 14 – NET INTEREST COST AND OTHER NET COST ON DOMESTIC ASSETS AND LIABILITIES

This item includes mostly interests paid for funds in the settlement accounts of credit institutions and income from servicing credit institutions' settlement accounts. The item reflects also interest income on loans to the employees of Eesti Pank.

EEK thousand

	2005	2004
Total	-88,665	-56,801
Interest income	1,700	1,916
Interest expenses	-517	-468
Remuneration of credit institutions' deposits and other fees		
Interest expenses	-100,112	-67,924
Income on settlement services	9,821	8,941
Other income	899	971
Other expenses	-456	-237

In 2005, net interest cost and other net cost increased by 31.9 million kroons compared to 2004. This resulted mainly from the growth of interests paid on the settlement accounts of credit institutions, as the latter have increased their deposits (see Item 10). The income from settlement services remained at the level of 2004.



ITEM 15 – OTHER OPERATING INCOME

Most of other operating income comprises income for services provided to the Financial Supervision Authority in the amount of 7.8 million kroons. Pursuant to the cooperation protocol between the Financial Supervision Authority and Eesti Pank, the Financial Supervision Authority reimbursed, in monthly payments, 100% of the cost of the support services provided by Eesti Pank in 2004 and 2005. Eesti Pank provides the following services to the Financial Supervision Authority: information technology, accounting, real estate, and administration services.

In 2005, income from the sale of numismatic-bonistic products amounted to 2.2 million kroons. Products made in 2004 accounted for most of that.

Rental income comprises income from the rent of the training centres of Eesti Pank. Income from the sale of assets reflects income from the sale of fixed assets and stocks unnecessary for Eesti Pank.

Most of other income in 2005 comprises revenue from the sales of publications of Eesti Pank. Other income declined as a caterer operates the canteen of Eesti Pank since 2004.

EEK thousand

	2005	2004
Operating income	10,959	20,043
Expenses compensated by financial supervision	7,826	7,956
Income from the sale of collector coins and numismatic-bonistic products	2,154	10,465
Rental income	703	700
Income from the sale of assets	223	304
Other income	53	618

ITEM 16 – OPERATING EXPENSES

Compared to 2004, operating expenses declined 1% in 2005. Personnel expenses and general administrative expenses increased, whereas the production costs of banknotes and coins and the depreciation of fixed assets decreased.

EEK thousand

	2005	2004
Staff costs	-84,957	-78,805
Wages	-62,191	-57,589
Compensation and benefits	-1,653	-1,694
Social tax	-20,826	-19,245
Unemployment insurance	-287	-277

In 2005, staff costs increased 8% compared to 2004. Staff costs include mainly wage costs, including taxes. Wage costs grew owing to a general wage increase as well as a wage increase arising from the career and individual development of employees. Moreover, one-off remunerations related to the change of the Governor of Eesti Pank contributed to the growth of wage costs.

Compensations and benefits include single benefits, pension insurance compensations, and the tax expenses of fringe benefits related to the interest rates on housing loans. The expenditure on compensations and benefits was somewhat lower in 2005, year-on-year, as the lower interest rate imposed by the Minister of Finance reduced the fringe benefits calculated on loans to employees as well as taxes paid on them.

Eesti Pank had 233 staff members at the end of 2005 (231 at the end of 2004).

In 2005, Eesti Pank participated in the voluntary pension investments of its staff and members of the Supervisory Board of Eesti Pank, contributing the total of 0.7 million kroons. In addition, Eesti Pank pays a special merit pension to two individuals in recognition of their special merits in the development of the Estonian monetary and banking system. The special merit pension amounts to 1.6 times the Estonian average monthly wages. In 2005, the costs of the special merit pension stood at 0.3 million kroons.

The production costs of banknotes and coins have decreased by 11.7 million kroons in 2005 compared to 2004. The production costs of banknotes and coins amounted to 1.9 million kroons and the production costs of numismatic-bonistic products stood at 0.2 million kroons. In 2005, 20-cent coins were minted and payments were made for the preparation costs related to issuing a silver collector coin dedicated to the Torino Winter Olympics and a silver collector coin dedicated to the national flag of Estonia. No banknotes were printed in 2005.

General administrative expenses have increased by 4.0 million kroons compared to 2004, mostly due to an increase in IT maintenance costs and financial assets management expenses.

Compared to 2004, IT maintenance costs increased by about 3.2 million kroons mainly owing to higher hardware and data communication costs and software maintenance costs. As a result of raising the limit of the acquisition cost, hardware maintenance costs (PC and equipment purchases) grew by 1.5 million kroons. Software maintenance costs increased by 0.6 million kroons stemming from the maintenance of new software modules and a price rise in maintenance costs. Data communication costs grew arising from the ECB Governing Council's decision on payment of core network maintenance costs. In 2005, Eesti Pank reimbursed the core network maintenance costs to the ECB for the full year, i.e. 1.1 million kroons more.

Financial assets management expenses increased by 1.3 million kroons compared to 2004. Hiring another external manager increased the costs of foreign reserves maintenance. Commissions and settlement costs grew as well because of a larger volume of foreign settlements.

Compared to 2004, training and travel expenses increased by 0.9 million kroons, whereas training expenses grew by 1.0 million and travel expenses declined by 0.1 million kroons.

Business travel expenses are the travel expenses incurred by the officials on assignment, accommodation expenses, daily allowances, and conference or seminar participation fees. Travel expenses, arising from participating in different committees and working groups of the European System of Central Banks and the European Union, remained close to the level of 2004. In 2005, 83 employees were sent to altogether 241 EU-related assignments. Business travel expenses reached 4.0 million kroons.



The main cost items among other expenses were office expenses totalling 3.8 million kroons, and the cost of seminars and events organised by the bank totalling 3.7 million kroons.

EEK thousand

	2005	2004
General administrative expenses	-73,593	-69,546
Property renovation and administration expenses	-13,103	-13,875
Information technology maintenance costs	-16,558	-13,406
Communications and transportation expenses	-3,361	-2,826
Public relations and publications	-6,311	-6,597
Legal and arbitration expenses	-770	-954
Training and business travel expenses	-10,995	-10,052
Financial assets management expenses	-11,446	-10,157
Other expenses	-11,049	-11,679

ITEM 17 – NET CHANGES IN WRITE-DOWNS

This item includes income and expenses arising from the establishment of provisions and write-downs of loans.

EEK thousand

	2005	2004
Net change of write-downs	-276	-52
Net change of loan portfolio write-downs	-276	-52
Income on the write-down of Eesti Pank's loan portfolio	99	63
Expenditure on the write-down of Eesti Pank's loan portfolio	-375	-115

The write-down of the loan portfolio of Eesti Pank is made in accordance with generally accepted accounting principles and in order to reflect the loans issued by Eesti Pank as fairly and objectively as possible. Due to the decline in the risk rates of study and consumption loans in 2005, income on the write-down totalled 99,000 kroons. As the risk rates of housing loans increased, the expenditure on the write-down was 375,000 kroons. The write-down of the loan portfolio delivered 276,000 kroons in net expenses in 2005.

ITEM 18 – PROFIT DISTRIBUTION

The Profit Distribution Strategy of Eesti Pank is based on the principle of avoiding too rapid decrease of Eesti Pank's own capital and net foreign exchange reserves against main economic indicators before joining the Economic and Monetary Union.

Having evaluated the Profit Distribution Strategy in April 2005, the Supervisory Board of Eesti Pank decided to continue with the strategy and transfer 62.8 million kroons from the profit of 2004 to the state budget and 188.4 million kroons to the special reserve fund.

ITEM 19 – DERIVATIVE INSTRUMENTS

EEK thousand

	Contractual value	Market value	
		Assets	Liabilities
Derivatives			
Total as at 31 Dec 2004	4,145,056	51,686	-12,630
Foreign currency forward transactions	675,972	19,041	-11,978
Foreign currency swap transactions	3,460,919	30,988	-413
Futures transactions	8,165	1,657	-239
Total as at 31 Dec 2005	10,389,426	29,180	-43,477
Foreign currency forward transactions	1,431,171	9,508	-10,134
Foreign currency swap transactions	1,323,749	4,721	-2,462
Interest rate swap transactions	836,496	12,311	-29,769
Futures transactions	6,798,010	2,640	-1,112

The contract value of outstanding foreign exchange swaps used for risk hedging in managing the foreign exchange reserves amounted to 1.3 billion kroons at the end of 2005. The contract value of forwards stood at 1.4 billion kroons. The contract value of futures totalled 6.8 billion kroons and that of interest swaps was 836.5 million kroons at the end of 2005. The transactions matured in early 2006.

ITEM 20 – CONTINGENT LIABILITIES

EEK thousand

	Balance at the end of 2005	Balance at the end of 2004
Contingent liabilities	160,082	154,408
Uncalled share capital (75%) of BIS	8,352	8,352
Uncalled share (93%) of ECB participation	144,456	144,456
Contractual obligations to produce banknotes and coins	7,274	1,600

Bank for International Settlements (BIS)

Since 1930, Eesti Pank has a contingent liability to the Bank for International Settlements. This liability is the uncalled part of the share capital (75%) of BIS denominated in Swiss gold francs, totalling 8.4 million kroons on the balance sheet date (see Item 6).

European Central Bank (ECB)

Arising from Estonia's accession to the European Union and Eesti Pank becoming a member of the European System of Central Banks, Eesti Pank became a subscriber of the capital of the ECB. Eesti Pank paid up a minimal contribution of 7% of its subscribed capital to the ECB amounting to 694,916 euros (10.9 million kroons; see Item 4). Eesti Pank is obliged to pay the remaining 93% amounting to 9.2 million euros (144 million kroons) upon Estonia's accession to the Economic and Monetary Union.

Printing of Banknotes and Minting of Coins

At the end of 2005, the contractual liabilities of Eesti Pank for printing banknotes and minting coins in 2006 amounted to 7.3 million kroons. Majority of that arises from the highest possible costs of preparations for minting euro coins.

INDEPENDENT AUDITORS' REPORT

To the Board of Eesti Pank:

We have audited the annual accounts of Eesti Pank ("the Bank") for the year ended 31 December 2005. These annual accounts are the responsibility of the Bank's Management. Our responsibility is to express an opinion on these annual accounts based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the annual accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the annual accounts. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall presentation of the annual accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the annual accounts of the Bank present fairly, in all material respects, the financial position of the Bank as at 31 December 2005 and the result of its operations for the year then ended, in accordance with the Law of the Central Bank of the Republic of Estonia and the accounting principles stated in the "Accounting Policies used in the Annual Accounts".



Veiko Hintsov
Certified auditor



Villu Vaino
Certified auditor



AS Deloitte Audit Eesti
27 March 2006



VARRANG



ANNEXES

GLOBAL ECONOMY IN 2005

Global economic activity followed the trend in 2005 and a rather similar growth trend is expected in the near future. According to the International Monetary Fund, the GDP of industrialised countries increased 2.7% in 2005 (3.3% in 2004; see Table 1)¹. In 2006, GDP growth is expected to accelerate up to 2.9%.

Economic growth varied quite substantially across regions. It held up high in the emerging Asian economies. China's economic growth reached 9.9% in 2005 and with the adjusted data on economic growth over previous years, China is now the world's sixth economic area in terms of GDP. As to advanced economies, the growth rate slightly slowed down in the US (annual growth 3.5%) but was still faster than in the euro area (1.3%) and Japan (2.7%). Compared to the forecasts made earlier in the year², real economic growth in the US turned out to be 0.1 and in the euro area 0.4 percentage points below the target and in Japan 1.7 percentage points above the target.

Global economic growth was most affected by extremely volatile oil prices, which reached record highs repeatedly (a barrel of oil rose from 40–45

US dollars at the beginning of the year to over 65 dollars in late August and fell again to 55–60 dollars by the end of the year). Other influential factors included the extensive and consistent imbalances in several economic areas (especially the consistently growing current account deficit in the US), and a normalisation process in monetary policy in the US, the euro area, Canada, Sweden, Norway, and other advanced economies. Price increase picked up in major economic areas in the third quarter, mostly owing to a rise in oil prices. The inflation rate decreased again later in the year. Residential property price increase accelerated to record levels in several areas; a similar trend was observed for precious metals (e.g. gold, silver). According to labour statistics, the unemployment rate decreased in all major economic areas.

UNITED STATES AND JAPAN

The United States maintained its role as a driving force of global economic growth in 2005. The US economic growth exceeded that of the other developed countries by far. As in 2004, growth in 2005 was primarily driven by private consumption.

Table 1. Economic indicators of advanced economies

	GDP growth (%)		Annual average CPI growth (%)		Annual average unemployment rate (%)		State budget surplus or deficit (% of GDP)		Current account balance (% of GDP)	
	2004	2005*	2004	2005*	2004	2005*	2004	2005*	2004	2005*
World	5.3	4.8								
Advanced economies	3.3	2.7								
United States	4.2	3.5	2.7	3.4	5.5	5.1	-4.7	-4.1	-5.7	-6.4
Japan	2.3	2.7		-0.3	4.7	4.4	-6.6	-5.8	3.8	3.6
Euro area	2.1	1.3	2.1	2.2	8.8	8.5	-2.7	-2.5	0.8	0.2
Germany	1.6	0.9	1.8	1.9	9.2	9.1	-3.7	-3.5	3.8	4.6
France	2.1	1.5	2.3	1.9	9.5	9.6	-3.7	-3.0	-0.4	-1.4
Finland	3.6	1.9	0.1	0.9	8.8	8.3	2.3	2.6	5.1	2.8
Other EU Member States										
United Kingdom	3.2	1.8	1.3	2.1	4.8	4.8	-3.2	-3.0	-2.0	-2.2
Sweden	3.7	2.7	1.1	0.8	5.5	5.6	1.8	2.9	6.8	6.6

* Data for 2005 are preliminary.

Sources: IMF World Economic Outlook (March 2006); Eurostat (March 2006)

¹ International Monetary Fund, World Economic Outlook, March 2006.

² Consensus Forecasts, January 2005.



Investments also made a major contribution. External trade showed poor performance; the current account deficit rose to over 6% of GDP. The US fiscal policy remained expansive, however, the deficit in the 2004/2005 fiscal year (368.9 billion dollars, i.e. nearly 2.5% of GDP) was below the previous year's level. Both current account and budget deficits were covered by a record high capital inflow into the US, mainly in the form of bonds.

The US economic growth slowed by the end of the year to hit the low in the fourth quarter – mainly as a result of hurricane damages. Considering the trend growth and the inflation risk stemming from high oil prices, the Federal Reserve started the normalisation of the stimulative monetary policy: the key interest rate was raised eight times a year by 25 basis points – from 2.25% to 4.25%.

Inflation, which stood at 3.0% in the US in early 2005, rose to 4.7% by September due to increased oil prices and returned to 3.4% by the end of the year. Unemployment decreased from 5.2% in January to 4.7% by the end of 2005 (the lowest in four and a half years), whereas employment growth showed marginal acceleration.

Japanese economic growth picked up over the year and reached 4.0% in the fourth quarter. Industrial output increased the most (annual growth in December was 3.7%) supported by a fast growth in export demand (annual growth in exports was 17.5% in December). Fixed investment expanded considerably. Private consumption remained weaker – annual growth was just 1.3% in December. The annual GDP increased 2.8%. Although consumer prices, which had been declining for five years, began rising again in late 2004 and the rise was positive over three months, the consumer price growth remained negative in 2005. Unlike in other major economic areas, even oil price growth did not accelerate inflation. The unemployment rate in Japan decreased from 4.5% at the beginning of the year to 4.4% at year-end (last time it was that low seven years ago).

EURO AREA

The economic growth of the euro area countries accelerated in 2005 but still remained below the 2004 level (1.3% and 2.1%, respectively). Economic growth was steady in terms of components: private consumption, private investment, the general government and net exports all contributed to growth. However, the contribution of net exports decreased towards the end of the year, and the surplus of goods and services account was replaced by a deficit in the fourth quarter.

The inflation dynamics of the euro area very much resembled that of the US: price pressures stemming from the oil price rise took the annual consumer price growth to 2.6% in September, but inflation fell back to 2.2% at year-end. The core consumer price inflation decreased from 1.6% in January to 1.4% in December. The unemployment rate of the euro area kept declining throughout the year from 8.8% in January to 8.4% in December.

Considering the steady trend growth and inflationary pressures arising from increasing oil prices, the European Central Bank also started to normalise the key interest rate, raising it by 25 basis points to 2.25% on one occasion. The budget deficits of several larger euro area countries remained above the 3% limit set in the Stability and Growth Pact for the third or fourth year.

The economic outlook of the euro area for 2006 is positive and economic growth is expected to reach 2.1%.

INTERNATIONAL FINANCIAL AND COMMODITY MARKETS

The upward trend continued on the major **stock markets** in 2005 in the setting of a sustained global economic revival, being even faster than the year before. The rise was especially remarkable in the second half-year. Even the historically high oil prices could not slow it down. Prices grew the most in

Japan's stock market with Nikkei 225 index rising to 40.2%, indicating investors' improved interest in Japan's economy. The euro area economic outlook was considerably better as shown by 21.8% growth in the FTSE Eurobloc 300 index. The US stock market looked rather bleak in comparison, since the S&P 500 index increased only 3%.

In **bond markets**, the dynamics of short-term interest rates reflected countries' monetary policy developments, which varied greatly across regions. The US Federal Reserve continued increasing monetary policy rates in light of the reviving economy. The key interest rate was raised eight times over the year from 2.25% to 4.25%. In the euro area, however, it was raised only once – in December. The key interest rate that had remained unchanged since June 2003 was then raised by 0.25 percentage point to 2.25%. Despite the economic achievements, Japan was not able to overcome the deflation that had started a few years ago, and thus the Japanese central bank retained its zero interest rate policy. Changes in long-term interest rates were quite volatile during the year and differed considerably across regions as well. The interest rates on 10-year government bonds rose in the US by 17 and fell in Japan by 4 basis points, whereas in the euro area they declined by 37 basis points.

Currency markets saw a turn in the dollar trend. The US dollar has kept depreciating in the recent years but at the beginning of 2005 it began appreciating against the other main currencies. The growth in the dollar rate was facilitated by positive figures of the US economy and rising interest rates which improved the dollar's attractiveness as a carry currency (currency with an interest rate higher than those of other currencies). In 2004, currency market participants raised concerns about the high current account deficit of the US but in 2005 it was apparent that the US will be able to retain its leadership among the G3 countries and can finance the deficit by continuous capital inflow. Year-on-year, the dollar appreciated by 12.6% against the euro (to 1.1849) and by 14.7% against the yen (to 117.75).

In **commodity markets**, the oil price increase remained in the limelight. It peaked in early September when US oil production areas were hit by hurricanes shooting the crude oil price to 70 dollars per barrel. Year-on-year, oil prices increased 40% to 61 dollars per barrel. The oil price growth brought about a similar rise in inflation pressures and encouraged a rise in the gold price as well. At the end of the year, an ounce of gold cost 517 dollars (annual growth 18%). The 500-dollar level was last exceeded in 1983. The CRB index reflecting the prices of major commodities increased almost as much as in the previous year (by 3.4%).

ESTONIAN ECONOMY IN 2005

NON-FINANCIAL SECTOR

Monetary Policy Environment

Contrary to market participants' expectations, the ECB raised the monetary policy rates only in December 2005. Due to a decrease in the spread between monetary policy rates, the interest rates on housing loans issued by Estonian banks kept falling until summer. At the end of the year, the rise in EURIBOR started to show some influence in Estonia and the long-term downward trend of the interest rates turned upward.

The nominal exchange rate of the Estonian kroon appreciated by 0.3% on annual average, compared to 2004. It was the lowest figure over the last five years and in the last quarter of 2005 the exchange rate even depreciated by 0.6%. The kroon slightly appreciated against the currencies of most partner states outside the euro area with the exception of the Swedish krona.

The environment was favourable for a rapid rise in the exports of goods. Low interest rates, however, also facilitated growth in domestic demand based on bank loans.

External and domestic demand

The growth in demand on Estonia's major export markets was the fastest of the last years. High investment activity in recent years has strengthened the growth potential. Therefore, there were no supply-side constraints and the export sector could take advantage of the improved external environment. Contrary to expectations, the growth of goods and services exports did not decline but even accelerated. The growth of goods exports increased nearly 29%.

The growth was broad based and included nearly all fields of activity and manufacturing sub-sectors (see Table 1). The employment growth was one of the fastest over the last years and the number of the employed grew 2% as an annual average. Jobs were created faster than the average in the services sector, where nearly 16,000 jobs were added. The unemployment rate fell from 9.7% to 7.9% on 2004; the number of the long-term unemployed declined significantly. The labour participation rate remained unchanged over the first three quarters but increased considerably in the fourth quarter.

Table 1. Changes in gross domestic product by fields of activity in 2003–2005

	2003	2004	Q1–Q3 2005
Agriculture and hunting	2.0%	6.2%	-1.9%
Forestry	-7.5%	-4.7%	-7.2%
Fishery	-34.4%	-3.8%	-3.3%
Mining	10.3%	-7.5%	6.0%
Manufacturing	10.5%	10.7%	11.9%
Energy, water and gas supply	9.1%	1.3%	4.4%
Construction	6.3%	10.5%	13.2%
Wholesale and retail trade	9.2%	5.4%	11.8%
Hotels and restaurants	5.1%	14.1%	19.7%
Transport, storage and communications	9.4%	7.2%	9.9%
Real estate, renting and business activities	1.5%	5.5%	5.2%
Financial intermediation	20.7%	29.3%	26.6%
Public administration and national defence	2.4%	0.1%	2.7%
Education	0.6%	1.4%	1.3%
Health and social care	-3.4%	5.0%	2.8%
Other	2.5%	7.1%	9.7%
Total GDP	6.7%	7.8%	9.3%

The increasing domestic demand also fuelled economic growth (see Figure 1). Private consumption growth picked up, even though it remained slower than the income growth, resulting in increased household savings. Low loan interest rates and tight competition in the banking market favoured loan supply, which together with increased savings boosted residential construction.

Expanding residential construction and real estate development combined gave an impetus to the growth of the gross domestic product to 9.8%, which exceeds the potential level. Supply-side constraints as well as related increased production costs were clearly noticeable in construction. That along with an accelerating loan growth brought about a 30% rise in residential property prices.

The level of investment remained high due to active residential construction, and thus the external balance did not improve as much as the increased household savings might have implied. The current account and GDP ratio improved by about 2 percentage points in 2005 compared to the previous year and fell to nearly 10.5% (see Figure 2). Domestic savings and foreign direct investment were not sufficient to cover persistently high investment needs, and therefore almost

half of the required instruments had to be borrowed from abroad. Estonia's foreign debt increased to 89.9% of GDP by the end of the year.

General government

The fiscal year started by lowering the corporate income tax and the personal income tax rates from 26% to 24%. Due to the impact of tax harmonization measures taken at the time of the EU accession and a modest increase in the excise duty rates of tobacco and alcohol in 2005, the overall tax burden did not change. The plan is to lower the personal income tax to 20% by 2009.

The third-quarter economic growth exceeded expectations, and this meant windfall revenue for the government. Like in earlier times, the extra revenue was used to pass a supplementary budget. The supplementary budget increased the state expenditure, although some of the extra revenue was used to increase the government reserves.

A rapid growth in tax revenues continued in the last months of the year and the fiscal year ended with surplus revenue for the fifth year in succession. It accounted for 1.6% of GDP and was somewhat larger compared to 2004. The government savings

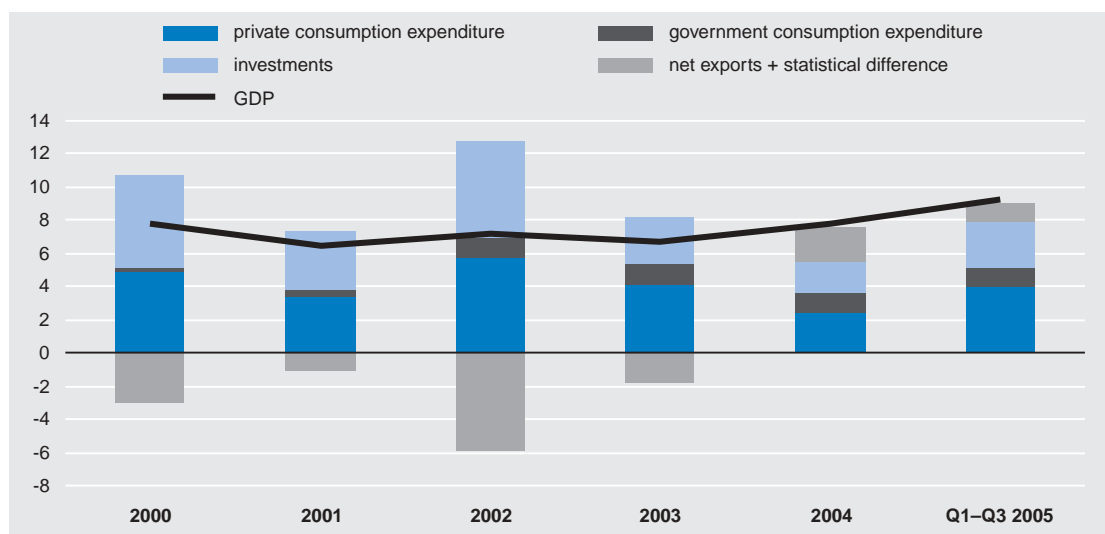


Figure 1. Contribution of GDP consumption components to economic growth (percentage points)

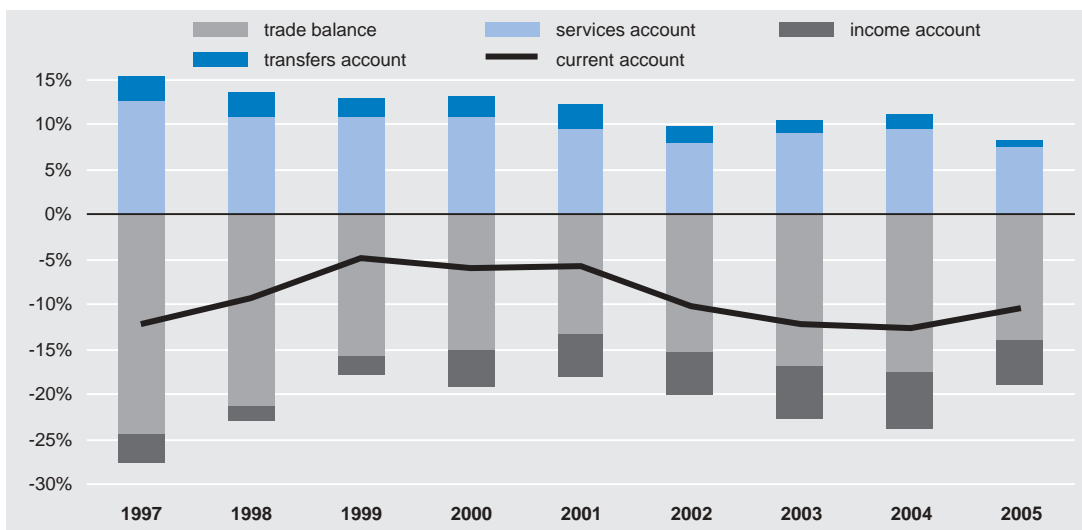


Figure 2. Current account balance and balance of payments accounts (% of GDP)

supported the improvement of the external balance. The government debt burden decreased to 4.8% of GDP by the end of the year.

At the beginning of December, the Riigikogu adopted the 2006 state budget aiming at moderate surplus.

Inflation

While 2004 saw an increase in food prices following the implementation of the EU common agricultural policy, in 2005 fuel and energy prices affected consumer prices the most.

The rise in electricity price planned for the beginning of March was followed by an expected decrease in inflation, which came to a halt in June as oil prices increased in the world market. Persistent growth in motor fuel prices transferred into transport services prices and was followed by a rise in heating oil prices at the beginning of the heating season. Thus, consumer price growth was volatile and the average annual inflation rate was 4.1% (see Figures 3 and 4).

Fuel-related goods and services account for a larger share in the Estonian households' consumer basket

than the EU average due to lower income level. Thus, the impact of the oil price rise on inflation was more distinct in Estonia. The difference in inflation rates between Estonia and the euro area countries increased to about 2 percentage points. Given that productivity in Estonia increases faster than in the European Union on average and the convergence of income levels and prices continues, the above difference in inflation rates is quite expected, even without the oil price hike in 2005.

In 2005, there were few signs indicating domestic inflationary pressures, except for in the construction and real estate sectors. Although nominal wage growth picked up to almost 11%, it was balanced by rising productivity and unit labour costs calculated at constant prices decreased for the second successive year. Therefore, core inflation increased modestly and did not exceed 2% as annual average (see Figure 5).

The real exchange rate of the Estonian kroon appreciated by 32% against the currencies of the industrial countries over the year, but considerably less against the currencies of other major trade partners, since inflation was rather slow in Estonia (see Figure 6).

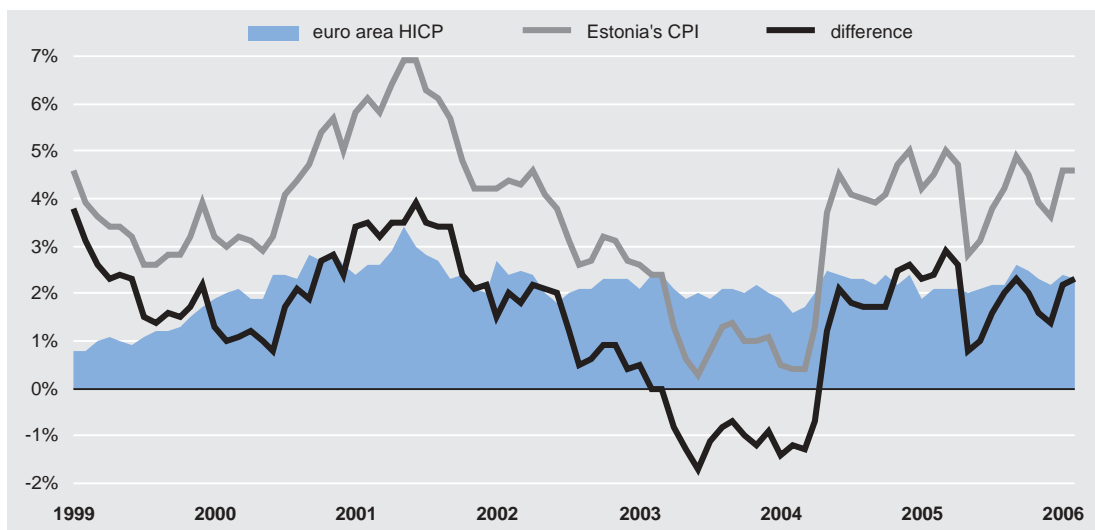


Figure 3. 12-month consumer price growth in Estonia and in the euro area

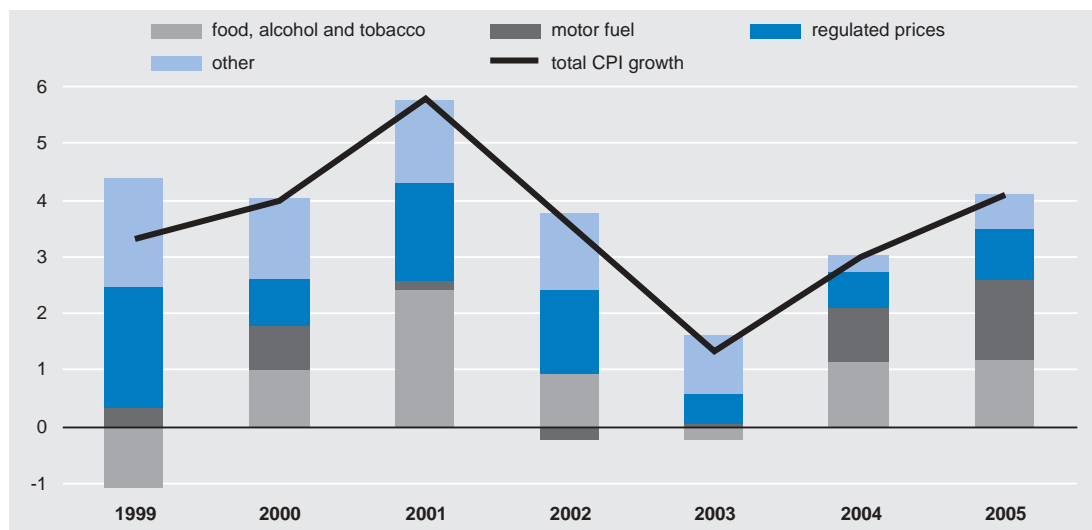


Figure 4. Consumer price growth by components (percentage points)

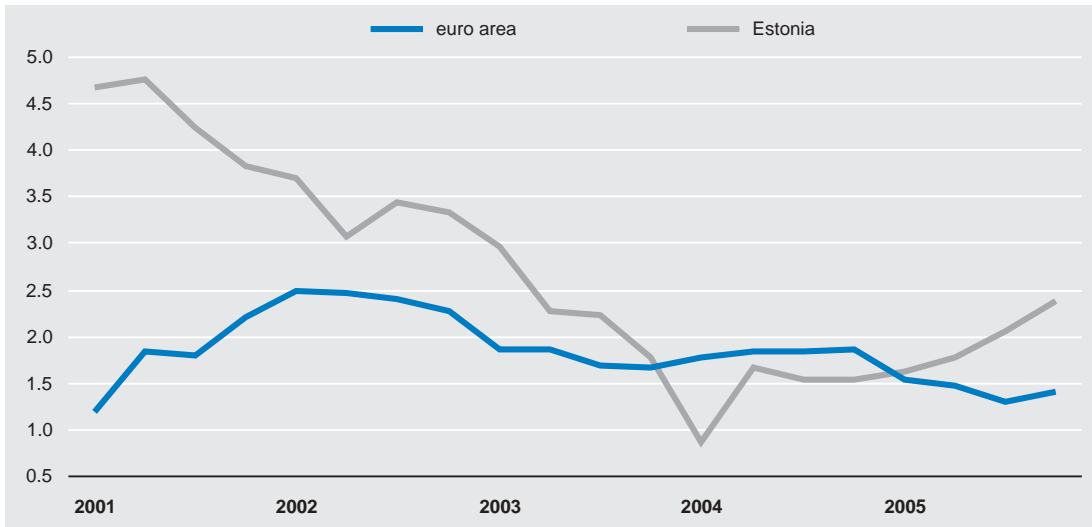


Figure 5. HICP growth (energy, food, alcohol and tobacco prices excluded; %)

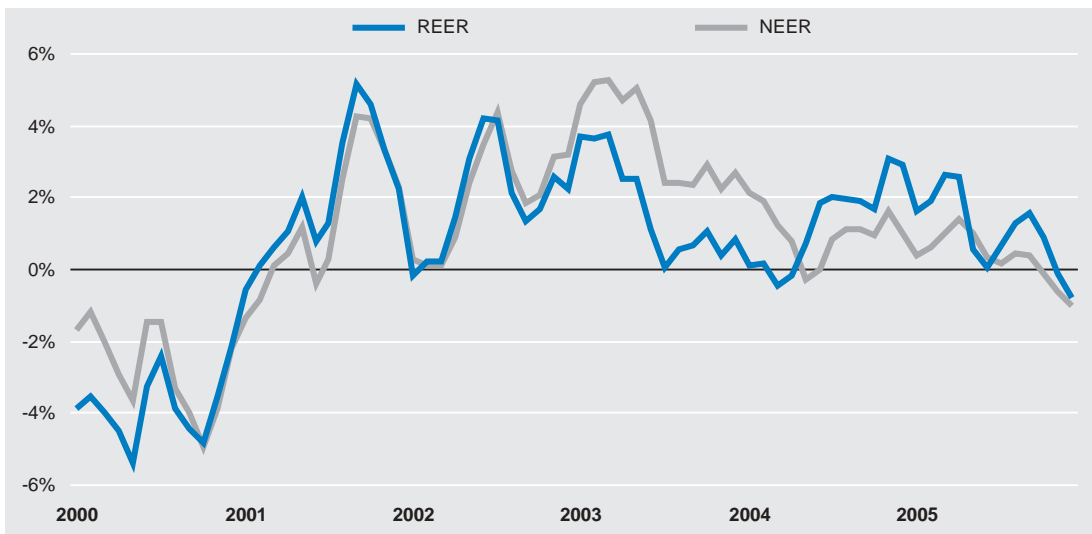


Figure 6. 12-month changes in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

FINANCIAL SECTOR

Key developments in the financial sector in 2005

Rapid economic development and stable external credibility offered opportunities for all financial sector segments to flourish in 2005 (see Figure 7). The increased demand for loans and leasing brought along a rise in banks' assets as well as in their profitability. Similarly to 2004, the stock of loans and leasing related to residential property increased fast. Under intense economic activity companies required financing for expanding their activities, and savings of economic agents needed to be invested. This resulted in more frequent issuances along with increased secondary market turnovers in the securities markets. The volume of investment and pension funds grew due to a rise in investments and in their market value. The growth in pension savings reflected in an increase in pension fund assets and partly also in premiums collected by life insurance companies over the year.

Banking

Institutional development

The fast growth of finance portfolios and an increasingly tough competition remained characteristic of the Estonian banking market also in 2005. Apart from the **credit institutions** already operating in Estonia (Hansapank, SEB Eesti Ühispank, Sampo Pank, Eesti Krediidipank, Tallinn Business Bank, and SBM Bank) and **branches** of Nordea Bank Finland Plc, Parex Banka and Bayerische Hypo- und Vereinsbank, the Baltic Investment Group Bank obtained a credit institution licence in 2005 and started to operate in Estonia. Branches were also opened by NORD/LB Latvija, Scania Finans AB, Svenska Handelbanken AB, and Siemens Financial Services AB (see Figure 8). On 31 December 2005, four foreign credit institutions had a **representative office** in Estonia: AP Anlage & Privatbank AG, HSH Nordbank AG, OKO Bank, and Rietumu Banka. The number of applications for providing

cross-border banking services submitted to the Financial Supervision Authority has more than doubled in a year (nearly 100 at the end of 2005).

The Estonian banking market witnessed a robust growth in loan volumes during 2005. The favourable economic environment facilitated strong loan demand. Although the European Central Bank increased the key interest rate in the second half of the year, loan demand has been further fuelled by a continued decrease in loan interest margins. Favourable loan terms and conditions have enabled companies to increase borrowing from the domestic banking sector. Households use loan resources increasingly to purchase or renovate housing.

The estimates of international rating agencies on the Estonian banking sector remained stable or even increased in 2005 (see Table 2).

Table 2. Ratings assigned to Estonian commercial banks by Moody's Investors Service as at end-2005

Moody's	Hansapank	Ühispank	Sampo Pank
Long-term deposits	A 1	A 1	A 2
Short-term deposits	Prime 1	Prime 1	Prime 1
Financial strength	C+	C-	D+

Assets and liabilities of banks

Given the strong loan demand, banks' assets grew by almost 52 billion kroons, i.e. 39%, on an aggregate basis in 2005, reaching 185 billion kroons at the end of the year (see Figure 9). Corporate debt to the domestic banking sector increased 49% over the year, and thus the total volume of the finance portfolios of banks and leasing companies approached 134 billion kroons at the end of December. The growth in banks' securities portfolios remained modest in 2005. The rise in claims on foreign credit institutions in the structure of the consolidated balance sheet mainly reflects

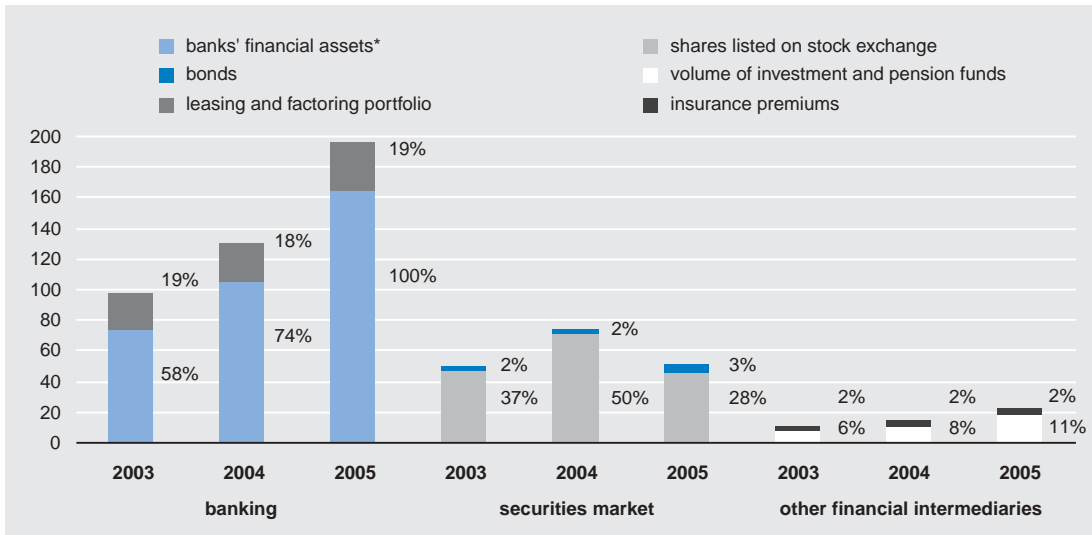


Figure 7. Structure of Estonian financial intermediaries (EEK bn and % of GDP)

* except loans to financial institutions

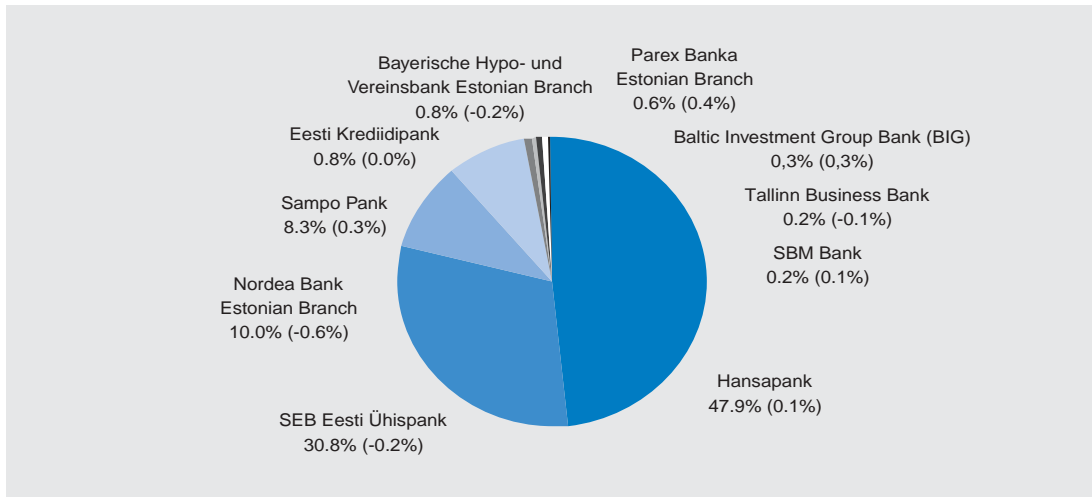


Figure 8. Market shares of banking groups in Estonia by volume of non-financial and public sector financing (bank loans, leasing and factoring) as at end-2005 (in brackets annual change compared to 2004)

the change in the intra-group funding scheme of the activities of subsidiaries.

The strong growth in housing and commercial real estate loans continued in 2005 at an even higher rate (see Figure 10). The stock of housing loans and leasing granted to households in 2005 increased over 60%, reaching 42 billion kroons at the end of the year. The growth rate of other liabilities of

households was somewhat slower than the growth in housing loans: the share of other loans and leasing of households in the total household debt to the domestic banking sector decreased to 22% by the end of 2005.

The development of the domestic property market played a key role in more than 30% annual growth in the corporate domestic debt. The loan stock of

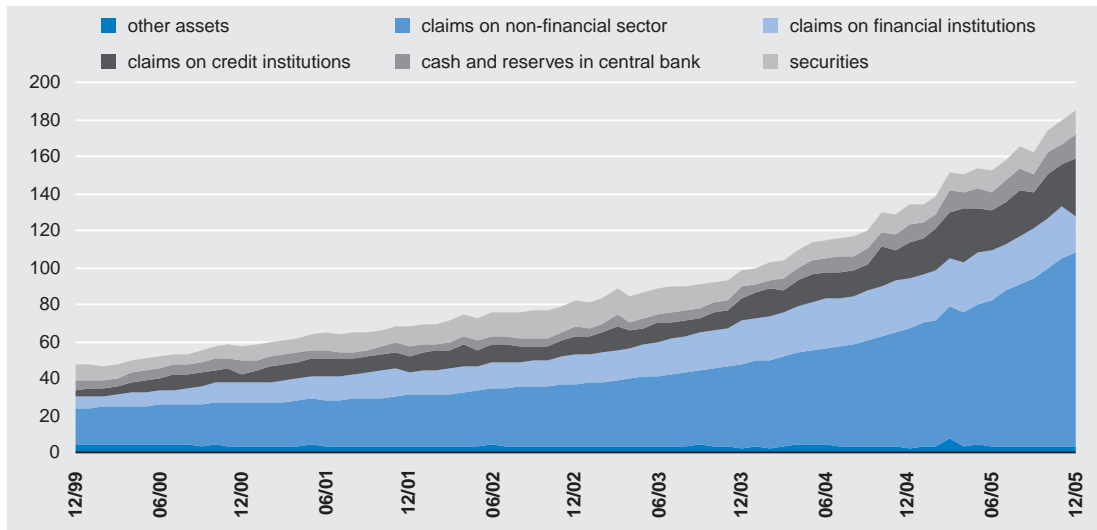


Figure 9. Structure of banks' aggregate assets (EEK bn)

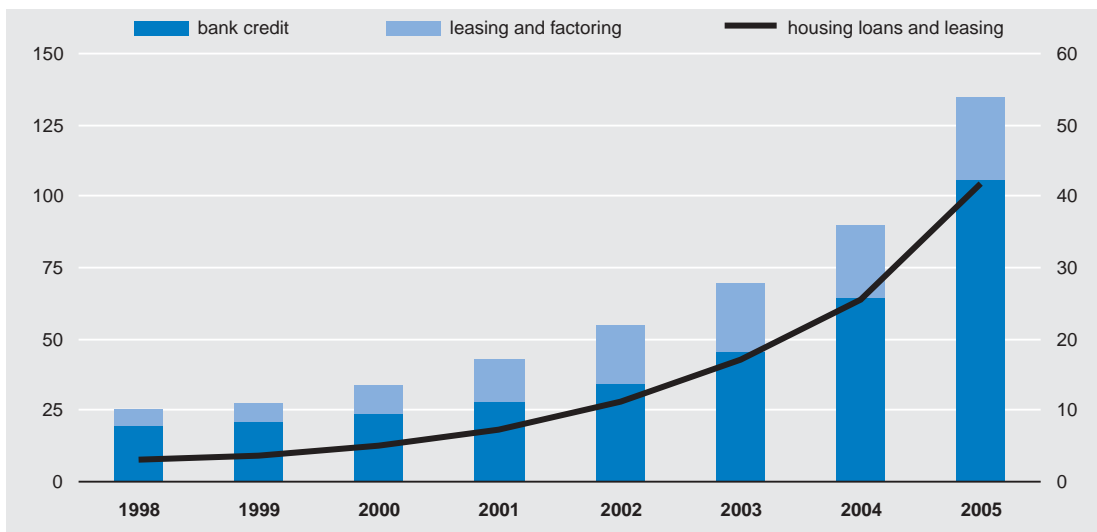


Figure 10. Public and non-financial sector financing (EEK bn)



commercial real estate companies increased by 7.6 billion kroons in 2005. The loan stock of business service companies has also grown fast (by nearly 4 billion kroons). The 30% annual growth in the loans of tradable sector companies is partly caused by replacing funds previously obtained from abroad by finances borrowed from the domestic banking market. With respect to the tradable sector, the financing of transport, communications and manufacturing companies grew the most (by 3 and 2 billion kroons, respectively).

Growth in savings was rapid in 2005. Savings increased 46%, i.e. nearly 95 billion kroons (21% in 2004). Regardless of that, banks attracted additional funds in the amount of almost 16 billion kroons from non-residential institutional investors in order to satisfy the high loan demand (see Figure 11). The share of institutional foreign borrowing in the total liabilities of the banking sector in 2005 remained slightly below the respective indicator in 2004 (39%), partly owing to changes in the financing schemes of banks' subsidiaries. In previous years, banks obtained foreign funding through parent banks or directly from international markets by issuing bonds, whereas in 2005 the role of market-based resources

in institutional foreign borrowing decreased and that of funds received from foreign banks increased.

Profitability

Rapid economic growth and persistently strong loan demand brought about a rise in the banking sector profitability. Even though the income base increased fast, the share of net interest income in total income kept declining; however, more slowly than in 2004. Above all, this was caused by growing interest expenses (see Figure 12). The growth in interest expenses and the fall in interest income regarding interest-earning assets also resulted in a steady decline in the spread: from 2.3% in 2004 to 1.9% in 2005. While the demand for loans and other banking services kept rising, the share of fee and commission income increased even further. All in all, the fee and commission income accounted for over a half of the net interest income of the banking sector in 2005.

Given the vigorous expansion of the business volume and high cost efficiency in comparison to the EU, banks find it increasingly more difficult to decrease costs in ratio to income. The cost-income

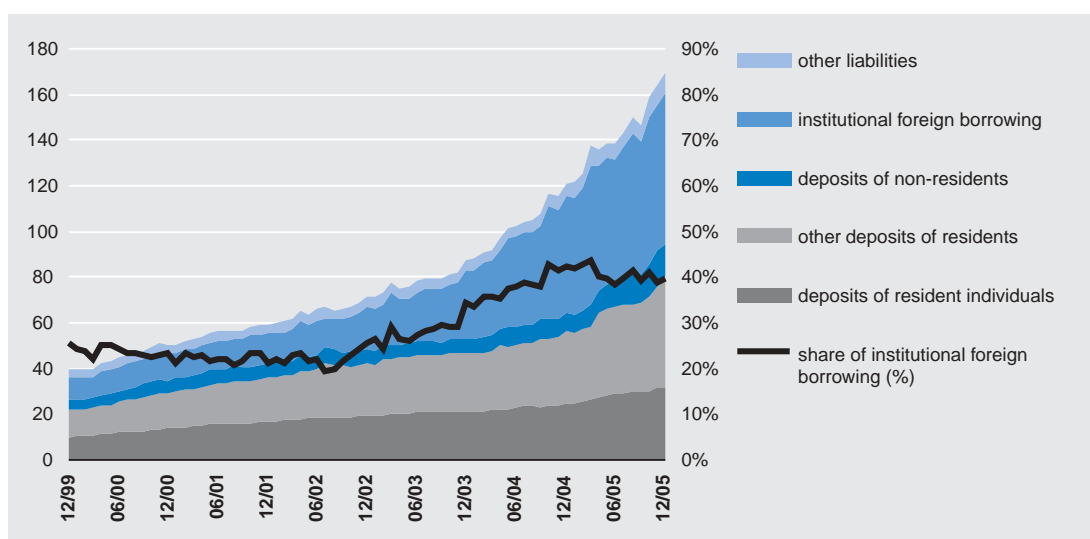


Figure 11. Structure of banks' resources (EEK bn; left scale) and share of foreign borrowing (right scale)

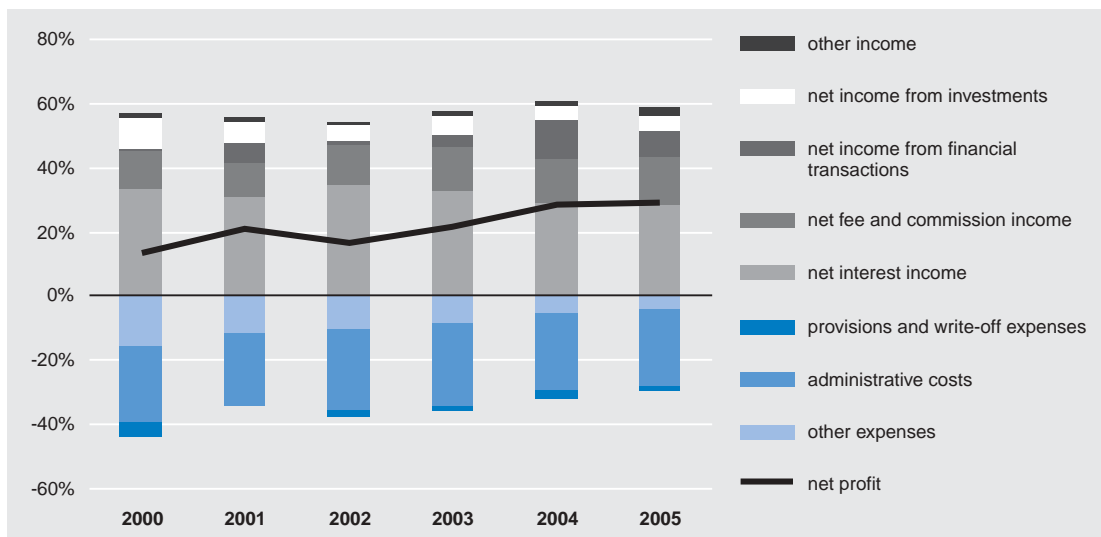


Figure 12. Banks' income and expenses (% of total income)

ratio declined from 45.8% in 2004 to just 45.6% in 2005. The profitability growth was also backed by a fall in the cost of allowances for uncollectible claims in ratio to total income. On the one hand, this was possible thanks to satisfactory loan quality, and on the other hand, owing to changes to the principles for the formation of provisions arising from the implementation of the International Financial Reporting Standards (IFRS/IAS). These factors combined caused a rise in the return on equity of the banking sector from 20.0% in 2004 to 21.0% in 2005. The consolidated return on equity of banking groups was primarily shaped by similar trends, thus raising the indicator from 22.8% in 2004 to 24.4% in 2005.

Capital adequacy and risks

Although several banks decided not to pay dividends in 2005 and retain audited profits of the previous year in their own funds, banks' capital adequacy indicators declined in 2005 due to a strong growth in risk-weighted assets. Banks' risk-weighted assets increased by a third on an aggregate basis in 2005, whereas the growth in own funds remained below 17%. Thus,

the banks' aggregate capital adequacy ratio on a solo basis was 11.7% at end-December 2005 and 10.7% on a consolidated basis (see Figure 13).

The loan servicing ability of banking customers has been quite strong under favourable economic conditions. The share of loans overdue for more than 60 days in the total loan portfolio fell to below 0.3% by the end of 2005. The share of such loans was the highest (1.3%) among household consumer credit (see Figure 14). The share of loans overdue for more than 60 days in all other sectors has decreased, compared to 2004.

Securities market

Debt securities market

The debt securities market witnessed a more active primary market and a significant rise in the turnover of the secondary market in 2005 (see Figure 15). Securities market capitalisation, which had picked up again in 2004, grew by 57%, i.e. over 4.8 billion kroons in 2005. The growth in capitalisation stemmed from a 17% rise in the volume of resident companies' debt securities' issues.

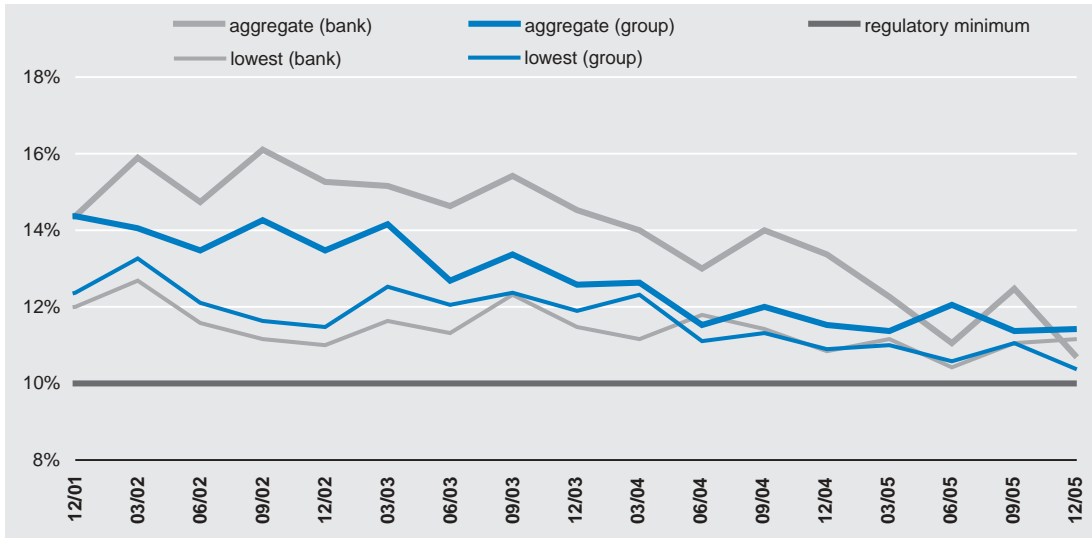


Figure 13. Banks' capital adequacy on a solo and consolidated basis

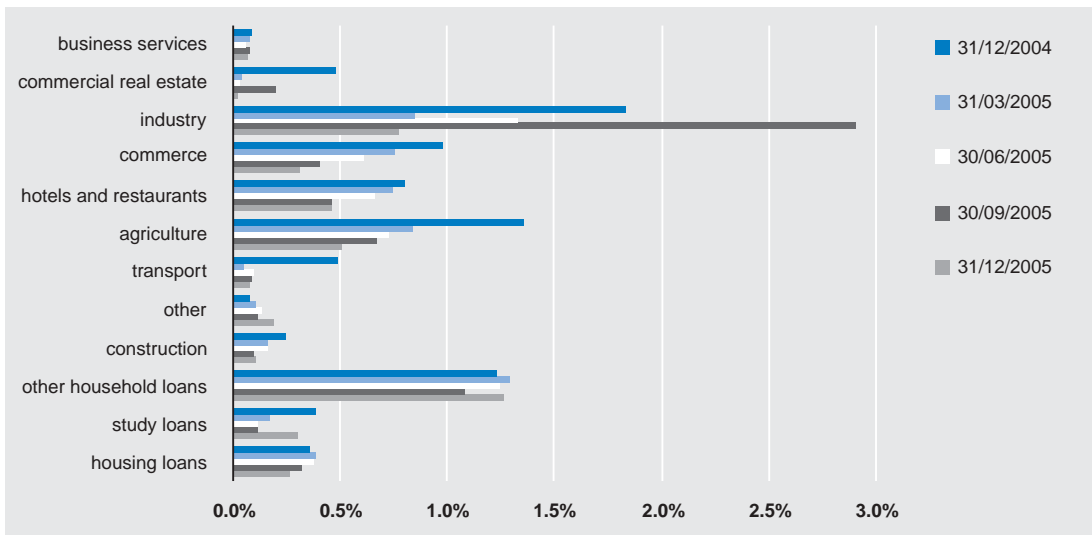


Figure 14. Share of loans overdue for more than 60 days in total loan portfolio by fields of activity

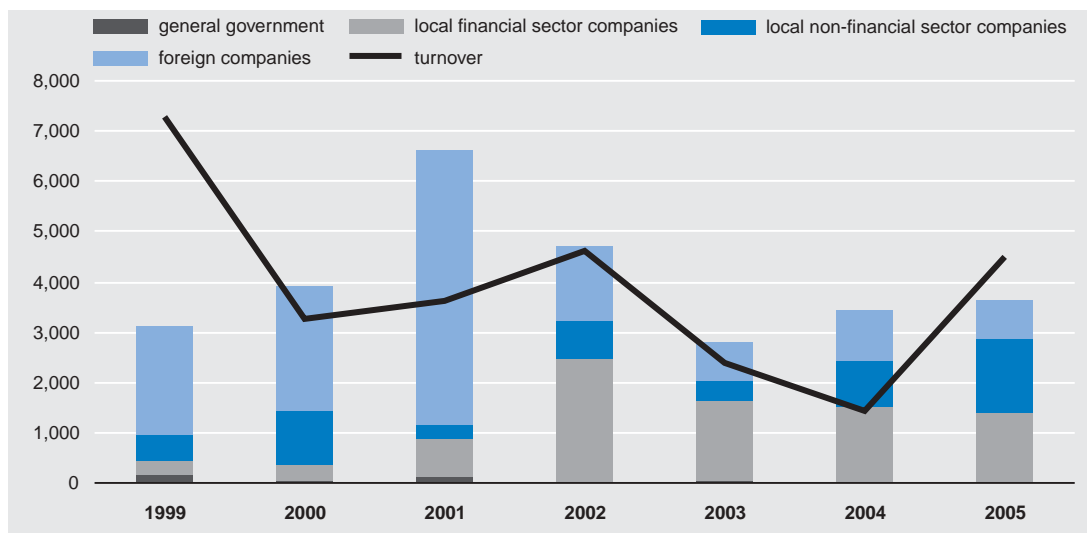


Figure 15. Volume of debt securities by issuers (EEK m; left scale) and secondary market turnover (EEK m; right scale)

In 2005, almost 80% of new debt securities were issued by domestic non-financial and financial sector companies, and nearly half of these were funds obtained by banks from the debt securities market.

In line with the more active primary market, the daily turnover in the secondary market rose from 6 million kroons in 2004 to 17 million kroons in 2005. Like in 2004, 75% of the bond investors were residents as at the end of 2005, most of them being private companies (incl. credit institutions and investment funds).

Stock market

The trends on the Tallinn Stock Exchange in 2005 were affected by contradictory factors.

The market enlivened significantly in spring due to trading with Hansapank's shares, as its strategic owner Swedbank made a takeover bid. This

resulted in the leading company with the highest capitalisation leaving the Tallinn Stock Exchange at the end of June. Although the shares of Hansapank were delisted from the exchange, this was counter-balanced by the initial public offers of shares that took place on the Tallinn Stock Exchange again over several years. As of 1 June 2005, the main list of the stock exchange includes the shares of Tallinna Vesi, a public utility company, at market value of 4.2 billion kroons; as of 28 June the shares of Starman, a telecommunications company, at market value of 0.8 billion kroons, and as of 9 December the shares of Tallink Grupp, a shipping company, at market value of 10.6 billion kroons.

The stock index OMXT¹ reached its record level on 4 October 2005 at 700 points (see Table 3 and Figure 16) owing to the takeover bid for Hansapank and listing of shares of new companies on the Tallinn Stock Exchange. The annual growth of the index,

¹ As of 3 October 2005, OMX harmonised the index name structure for all OMX exchanges, including in Tallinn. The new name of the Tallinn Stock Exchange index (TALSE) is OMX Tallinn (OMXT).



Table 3. Aggregate indicators of securities market (EEK bn)

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

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

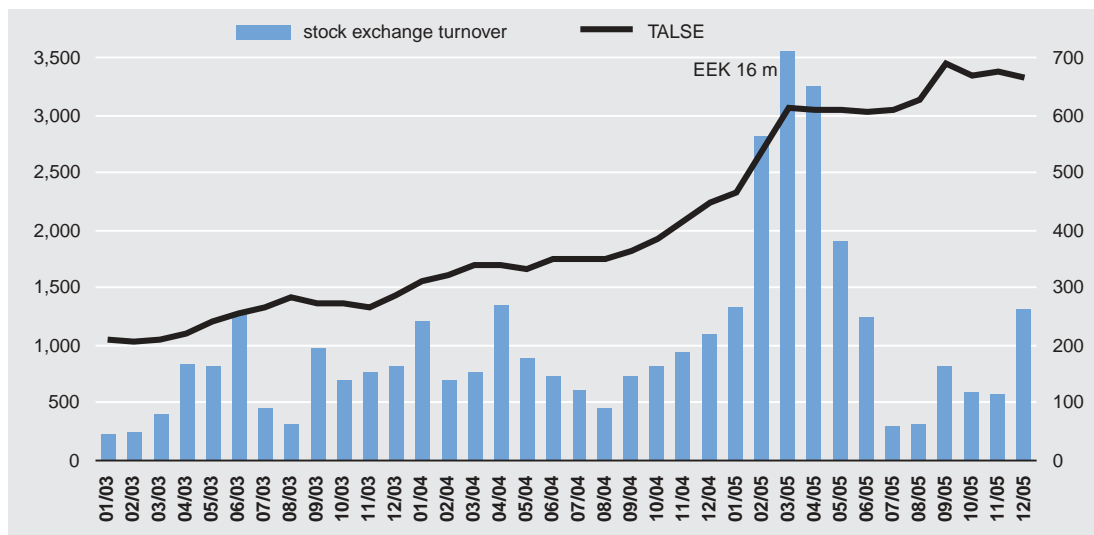


Figure 16. Monthly turnovers of Tallinn Stock Exchange (EEK m; left scale) and index TALSE as at end of month (points; right scale)

which had been on the fall from early October, declined to 48% by late December (growth peaked at 90% at the end of the third quarter).

After the transactions related to Hansapank's takeover bid and new listings, the average daily turnover of stock exchange transactions reached 118 million kroons in 2005, outpacing the previous year's level more than three times.

Other financial intermediaries

Investment and pension funds

The growth in the volume of investment funds picked up in 2005, as a result of a strong growth in emerging markets. The volume of investment funds increased by 7.4 billion kroons to over 18 billion kroons over the year. Investment in equity funds and in mandatory pension funds contributed the most to the growth (see Figure 17). Boosted by a rise in Central and Eastern European and Russian stock exchanges, the volume of stock funds increased almost 2.2 times to 7.8 billion kroons, year-on-year. Low key interest rates meant low yields for the money market and interest funds,

and thus the volume of these funds did not change much, compared to the end of 2004.

By 31 October 2005, the deadline for starting collecting savings as of the beginning of 2006, the number of subscribers to the second pillar of the pension system rose to about 475,400 people, accounting for 78% of the employed. The volume of the second pillar funds grew 1.9 times to 4.7 billion kroons over the year. At the end of 2005, the number of subscribers to the third pillar of the pension system reached nearly 90,000, constituting 14.6% of the labour force. By the end of 2005, savings in the voluntary pension system, including pension funds and insurance, totalled over 1.5 billion kroons, the value of funds accounting for about 30%.

Insurance

The growth of the life insurance market accelerated for the fifth successive year in 2005 and 57% more gross premiums were collected in 2005, compared to 2004. The volume of gross premiums collected by life insurance companies in 2005 was about 1.3 billion kroons, with gross premiums for unit-linked life insurance and

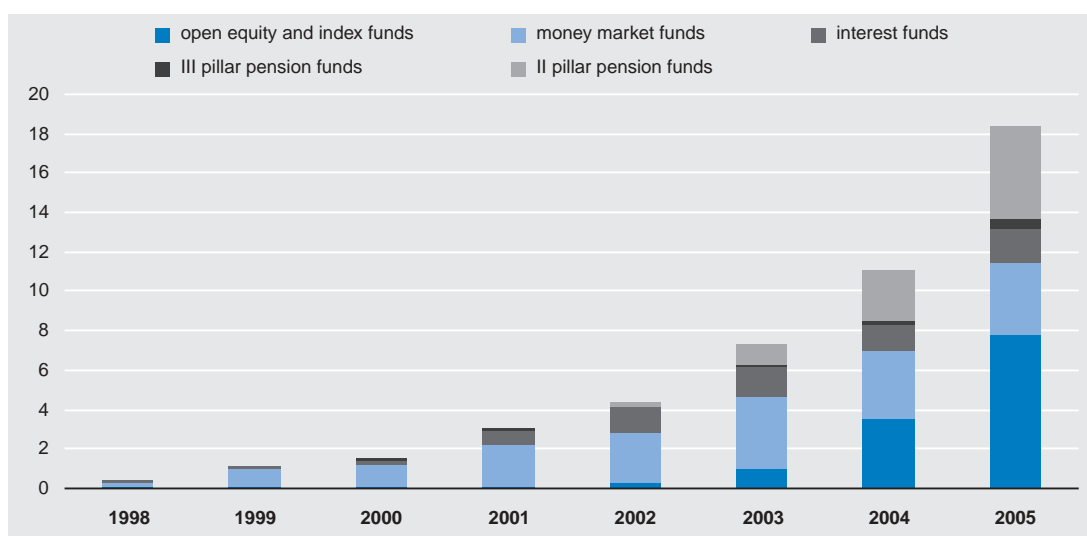


Figure 17. Total volume of investment funds as at year-end (EEK bn)



capital saving insurance accounting for the major share (see Figure 18). The gross premiums of unit-linked life insurance increased primarily because of residents' interest in the pension products of the third pillar.

Gross premiums collected by non-life insurance companies grew by 15.2% in 2005, which is comparable to the 2004 level when the growth rate was 15.7%. Most of the gross premiums of non-life insurance companies are collected for motor vehicle, property and motor third party liability insurance. Other non-life insurance accounts

for just about 10% of gross premiums collected and its share is consistently declining. The gross premiums for motor third party liability insurance have risen the fastest in recent years.

The institutional structure of the life insurance market has stabilized over recent years but the structure of the non-life insurance market is still going through restructuring. As of 20 April 2005, the new business name of Nordicum Kindlustuse Eesti AS is QBE Kindlustuse Eesti AS, which QBE Insurance Group, the largest Australian insurance and reinsurance company, purchased from Tryg Vesta.

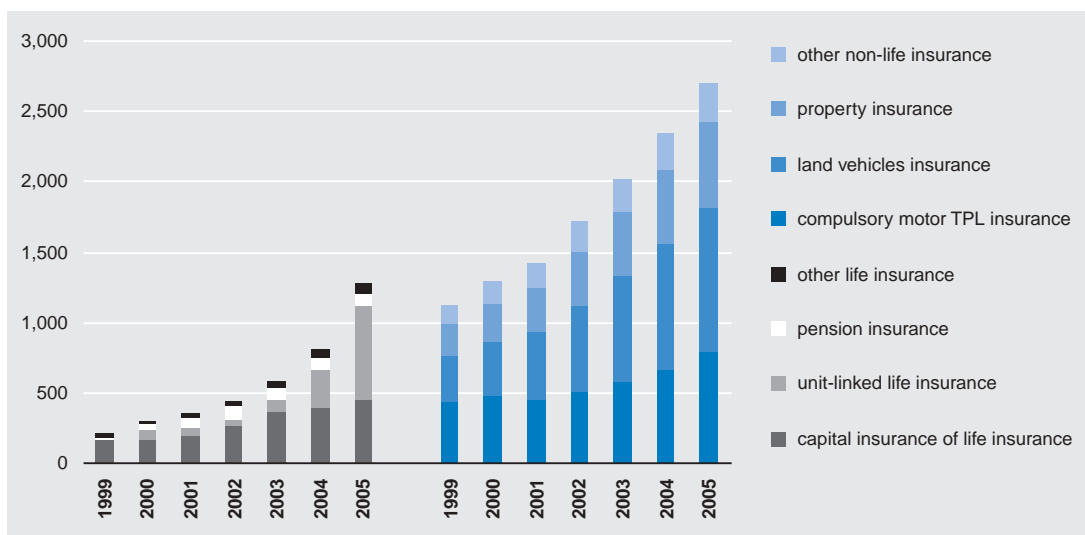


Figure 18. Gross premiums collected by insurance companies (EEK m)

KEY POINTS OF ECONOMIC FORECASTS OF EESTI PANK FOR 2005

The global growth outlook will be favourable in the coming years. Although the global economic growth is projected to decline to approximately 4%, the growth rate will still remain at the potential level in the long term. Several national central banks consistently increased their key interest rates in the first half of 2005. Despite the above, the level of nominal and real interest rates is still relatively low. The second half of 2005 saw several indications of an expected recovery of economic activity in the euro area, although regarding the persistent structural bottlenecks (above all the high level of unemployment), several international forecasting centres had downgraded the growth outlook. The economic development in the Nordic countries (boosted by domestic demand) is expected to outpace that in the euro area or in Europe on average. The economic growth in 2006–2007 is expected to be rather fast also in the new EU Member States.

Estonia has experienced fast economic growth in recent years. Although the rapid growth has been partly achieved on account of the growing debt burden, Estonia's economic outlook for the coming years is still positive. As regards domestic demand, the growth outlook is supported by further rapid income growth, excessive credit supply, and optimistic expectations of economic agents. On the other hand, the gradually improving external environment and the impact of dynamic integration into the EU trade market will ensure sufficient export demand growth.

Among the export-oriented branches, the electronics, metal and timber industries will foster growth, but the share of the non-tradable sector (incl. residential property) in growth will remain large. Construction, real estate, retail and wholesale, and financial intermediation will also make a strong contribution. The success looming for the real estate sector is expected to continue, which makes the non-tradable sector a significant driving force behind economic growth for the years ahead.

The autumn forecast pointed to **longer-term risks on the supply side of the economy, which has**

to be ready for moving up in the value added chain. This means a transition to more knowledge-based products and services. However, the lack of qualified labour force sets limits here. Moreover, Estonia's demographic situation is anything but favourable; the shortage in the labour force may create serious problems in the longer term.

The share of private consumption in GDP decreased over the last year, and households preferred to invest a great deal of their savings in real estate. The real estate boom continued in 2005 and therefore the domestic demand growth stayed fast as well. According to the autumn forecast, household income will increase faster than private consumption expenditure in the coming years. Such expectations are based on personal income tax cuts along with an expected rise in interest rates, which should specifically limit the consumption growth.

The increased income of households would have allowed them to consume considerably more than they actually did in 2005. Thus, it may be concluded that households have started to save more. Presumably, such trends will continue and mainly due to rapid growth in housing investment. In addition, saving is fostered by mandatory saving in pension funds, as well as by the increased supply of saving and investment products provided by the financial sector.

Private consumption risks related to the economy as a whole lie in the **potential changes in households' saving behaviour**, as perceived in autumn 2005. Should the risks stemming from the labour market materialize, wage growth might accelerate to such extent that households would be able to spend considerably more.

In 2002–2004, the share of investment in GDP remained at a relatively high level – more than 30%. Following the autumn estimates, the share of investment in GDP in the following years will be nearly 29%, which is lower than the last three years' average, but still stands out among Central and Eastern European countries. The growth in investment in



2005 was mainly driven by household investment, which has increased much faster than corporate fixed investment. Taking into account the continuously favourable interest environment and good demand conditions, the macroeconomic environment should favour investment activity during the entire forecast period.

As regards risks, the **further growth of export-oriented investment is important for Estonia**. If the recent developments continue and investment increases mainly on account of real estate investment, economic growth will slow down and the competitiveness of Estonian enterprises will decline after a certain period of time.

Employment growth has been accelerating since the early 2005 – the **demand for labour as a production input has considerably grown against the background of increased economic activity**. As a result, wage growth has been picking up since the beginning of 2005. Employment also increased fast in 2005. The autumn forecast expects a decline in the employment growth in 2006–2007.

Labour market is showing more and more signs of turning into an “employee market”, as the demand for labour force is outpacing the supply and pressures for wage growth surpassing labour productivity are increasing. **It is important to link productivity and wage growth in wage negotiations** in order to ensure more effective allocation of production resources. The increase in real wages is expected to be in line with the rise in productivity in the coming years. The labour market related risk lies in too fast wage growth, which arises from a wide gap between labour supply and demand.

As the developments of the first half of 2005 turned out more favourable than expected, it allowed to be more optimistic in autumn concerning the further improvement of the external balance than in spring 2005. Estonia's exports have maintained a rapid growth rate, which allows forecasting a decline in the current account deficit over a longer period of time. Such development presumes continuously

high external demand on the one hand and a slow-down in domestic demand on the other.

The external balance will improve mainly with the support of the goods and services account in the next years. The negative balance of the income account will increase further: it may reach 7.1% of GDP by 2007. The growth in the income account deficit arises from the high share of foreign ownership and sound corporate revenues, which foster the outflow of profits. According to the forecast, the transfers account balance will remain modest at below 2% of GDP. The surplus of the transfers account is ensured by capital flows from the EU structural funds.

In previous years, the **financing need of the private sector has been large** and it has grown, year by year. In order to cover the need, credit institutions have attracted plenty of external resources. Taking into account additional financing through other channels and the share of foreign direct investment, the gross external debt of 2005 constituted approximately 89.9% of GDP (as at the end of 2005) and it will increase to around 100% by 2007.

Inflation was considerably faster than expected in 2005. The main reason was the rise in oil prices, which caused upward adjustments of the inflation indicators in the autumn forecast. Considering the price of crude oil futures, it is likely that oil prices will not decline very fast. This means that in addition to oil, the prices of other types of energy will also stabilize at a level higher than before the shock. In Estonia, the prices of transport services have risen rather quickly after the rise in oil prices, and other types of energy (e.g. firewood, shale oil) have witnessed a price increase as well. According to the autumn forecast, the increase in food prices should slightly slow down. As regards risks associated with food prices, primarily the pressures accompanying the growth in export demand should be taken into account. In 2006, the main administrative action will be a rise in thermal energy prices, which will bring about upward price pressures. The background factor is the price growth of major production in-

puts, primarily shale oil. Changes in core inflation should move in line with the growth in domestic prices, which will pick up following the autumn outlook. The main reason here is the fast convergence of income levels.

The source of additional inflationary pressures is the further rise in oil prices in the world market. Consumer price growth may decelerate, though, should core inflation remain below the expected level. This will happen if the price rise of transport services stops, the competition in the telecommunications sector remains strong, the competition in the clothing and footwear sector becomes tighter, and household goods cheapen due to the further reorientation of imports to the Asian market.

DECREES OF THE GOVERNOR OF EESTI PANK IN 2005

No 1, 25 January

Establishment of report on the balance of claims of a credit institution's consolidating group, report on interest-rate risk, and report on the movement of claims written off from the balance sheet

No 2, 16 February

Amendments to Eesti Pank Governor's Decree No 12 of 2 July 2002 "Prudential ratios of credit institutions"

No 3, 22 February

Repeal of Eesti Pank Governor's Decree No 2 of 2 February 2004 "Report on the residency of the owners of investment fund units"

No 4, 7 March

Supplementary reports of credit institutions' balance sheet

No 5, 26 April

Approval of the list of data recorded in the list of representative offices of foreign credit institutions

No 6, 26 April

Repeal of Eesti Pank Governor's Decree No 19 of 6 July 1999 "Procedure for applying for and granting of the licence to credit institutions and branches of foreign credit institutions and list of documents submitted on applying for the licence", Decree No 23 of 15 October 1999 "Acquisition of the qualifying holding in a bank" and Decree No 23 of 3 October 1997 "Requirements on regulating the information technology in credit institutions"

No 7, 26 April

Establishment of the procedure and conditions for opening, closing, or changing the address of a credit institution's representation abroad

No 8, 2 May

Amendments to Eesti Pank Governor's Decree No 12 of 2 July 2002 "Prudential ratios of credit institutions"

No 9, 16 May

Balance of payments reports of credit institutions

No 10, 17 May

Amendments to Appendix to Eesti Pank Governor's Decree No 9 of 27 June 2000 "Minimum requirements of loan servicing and procedure for entering uncollectible claims in expenses" and Appendix 1 to Decree No 9 of 9 October 2003 "Report on payments"; rewording of Decree No 1 of 25 January 2005; repeal of Decree No 15 of 22 November 2004 "Amendments to Supplementary Reports of Credit Institutions' Balance Sheet"

No 11, 15 June

Amendments to the Eesti Pank Governor's Decree No 20 of 13 December 2002 "The rules on fixing daily exchange rates of the Estonian kroon"

No 12, 19 September

Amendments to Eesti Pank Governor's Decree No 1 of 10 January 2002 "Approval of Documentation of Payment Systems of Eesti Pank" and Decree No 10 of 13 May 2004 "Establishment of General Terms and Conditions and Price List of Account Management"

No 13, 22 September

Amendments to the Eesti Pank Governor's Decree No 20 of 13 December 2002 "The rules on fixing daily exchange rates of the Estonian kroon"

No 14, 7 October

Repeal of Eesti Pank Governor's Decree No 20 of 9 July 1999 "Procedure on internal security measures of credit institutions for the prevention of money laundering and list of suspicious and unusual transactions"

No 15, 4 November

Procedure for sending banknotes and coins to Eesti Pank

PUBLICATIONS OF EESTI PANK IN 2005

The **web site of Eesti Pank** is at www.bankofestonia.info.

The web site includes information on Eesti Pank and its activities, as well as on **Estonian monetary system, economy and financial environment**. The web site also displays **banking legislation**, information on **Estonian banknotes and coins** (including guidelines for collectors) and on the **European Union** and the **euro**, as well as **publications and press releases of Eesti Pank**. Moreover, the site includes a comprehensive **statistics database** and the **daily fixings of currencies**. In addition, there is a **virtual library** (in Estonian only), which links to other economic libraries.

Quarterly Comment of Eesti Pank

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

Annual Report

The Annual Report includes the annual analysis of the monetary and economic policy environment of a calendar year, a survey of changes taking place in the financial and non-financial sectors and the central bank, an overview of bank's international cooperation, the annual accounts of the central bank, etc.

Monetary Developments & Policy Survey

The Monetary Developments & Policy Survey is a periodical publication of Eesti Pank, analysing changes in Estonian financial and non-financial sectors.

Financial Stability Review

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

Estonian Balance of Payments Yearbook¹

The yearbook provides a survey of Estonia's foreign economic activities, including the international investment position and the external debt of the country. It contains a lot of statistical data. The yearbook is published only electronically. On request the subscribers can have it sent to their e-mail addresses.

Kroon&Economy

Kroon&Economy is published quarterly. It includes surveys and analyses on topical economic issues, comments, translated articles, statistics, etc. In 2005, the following articles were published:

Year 2004 in Estonia's economy (Ilmar Lepik)

The Economics of Taxation – a Brief Survey (Karsten Staehr)

Price Rise, Perception of a Price Rise and Respective Fears (Kaja Kell)

Estonian Population and Employment – Projection for the Next Half-Century (Orsolya Soosaar)

Price Rise Fears in the Euro Area in Light of the Euro Changeover and the Potential Realisation of Such Fears in Estonia (Raoul Lättemäe)

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



Management of Financial Crisis in the Case of Cross-Border Banking Groups (Jana Kask)
Seminar Introducing Researches on Financial Markets (Lenno Uusküla)
Estonia's Preparations for Joining the Euro Area (Raoul Lättemäe)
Maastricht Criteria Compliance Prospects in Latvia (Helmūts Ancāns)
Risks in Fulfilling Maastricht Convergence Criteria: Lithuania's Perspective (Raimondas Kuodis)
Financial Environment and Economic Growth in Light of Globalisation (Vahur Kraft)
Integration of Securities Market Infrastructures in Europe (Kadri Martin)
Share of Cross-Border Financial Groups and Banks in the European, Nordic and Baltic Banking Sectors (Ulla Tischler)

Working Papers of Eesti Pank

Each Working Paper is a short summary of a particular economic study. It is published in Estonian (Eesti Panga toimetised) or in English (Working Papers of Eesti Pank). In 2005, the following papers were published:

Tööjõupakkumine Eestis (Labour Supply in Estonia – Janika Alloja)
Estimating the Equilibrium Exchange Rate of the Estonian Kroon (Marit Hinnosaar, Hannes Kaadu, Lenno Uusküla)
Critical Levels of Debt? (Lenno Uusküla, Peeter Luikmel, Jana Kask)
Short-term Effects of Foreign Bank Entry on Bank Performance in Selected CEE Countries (Janek Uiboupin)
Hooverism, Hyperstabilisation or Halfway-House? (Rasmus Kattai, John Lewis)
Application of Investment Models in Foreign Exchange Reserve Management in Eesti Pank (Andres Vesilind, Toivo Kuus)
Money and Prices in Estonia (Aurelijus Dabusinskas)
Investigating the Early Signals of Banking Sector Vulnerabilities in Central and Eastern European Emerging Markets (Kadri Männasoo, David G. Mayes)
Does an Increase in Unemployment Income Lead to Longer Unemployment Spells? (Ott-Siim Toomet)
The Effect of Financial Depth on Monetary Transmission (Danny Pitzel, Lenno Uusküla)
Which Firms Benefit More From Inward Foreign Direct Investment? (Priit Vahter)
EMMA – a Quarterly Model of the Estonian Economy (Rasmus Kattai)
Home versus Host Country Effects of FDI: Searching for New Evidence of Productivity Spillovers (Priit Vahter, Jaan Masso)

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

Public information

Phone: **+372 668 0719**

E-mail: **info@epbe.ee**

Subscription for publications of Eesti Pank

Phone: **+372 668 0998**

E-mail: **publications@epbe.ee**