Country report **ESTONIA**

Summary

Estonia made a swift recovery from the crisis that hit the economy in 2008 and 2009. Last year, the economy grew by 7.5%, on the back of increased exports and recovering domestic demand. However, unemployment remains high at 12.4% in 2011 and is unlikely to come down rapidly. For 2012, with the ongoing debt crisis in the eurozone, we expect export demand to fall, resulting in a lower expected growth rate of below 2%. Meanwhile, the government indicated it seeks to consolidate its budget in the coming years, as the budget balance is expected to move into deficit in 2012. Still, with public debt at 5.8% of GDP end-2011, we do not see any reason for concern. More worrisome is Estonia's high external debt, which currently stands at 112% of GDP. We do, however, obtain comfort from the fact that a large percentage of this debt is held in euro's and Estonia became a eurozone member in 2011.

Things to watch:

- Eurozone debt crisis and demand for Estonian exports
- External debt level

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Estonia

National facts		
Type of government	Republic	
Capital	Tallinnn	
Surface area (thousand sq km)	45,226	
Population (millions)	1.3	
Main languages	Estonian (official)	
	Russian	
Main religions	Evangelical Lutheran (13.6%)	
	Orthodox (12.8%)	
	Other/ unaffiliated (73.6%)	
Head of State (president)	Toomas Hendrik Ilves	
Head of Government (prime-minister)	Andrus Ansip	
Monetary unit	euro (EUR)	
Economy (2010)		
Economic size	*bn USD*	*% world total*
Nominal GDP	22	0.03
Nominal GDP at PPP	27	0.03
Export value of goods and services	22	0.10
IMF quotum (in mln SDR)	65	0.03
Economic structure	*2007*	*5-year av.*
Real GDP growth	7.5	0.4
Agriculture (% of GDP)	4	4
Industry (% of GDP)	31	27
Services (% of GDP)	66	60
Standards of living	*USD*	*% world av.*
Nominal GDP per head	16831	156
Nominal GDP per head at PPP	20147	163
Real GDP per head	11201	138

Social and governance indicators	rank / total
Human Development Index (rank)	34 / 187
Ease of doing business (rank)	24 / 183
Economic freedom index (rank)	16 / 179
Corruption perceptions index (rank)	29 / 183
Press freedom index (rank)	3 / 178
Gini index (income distribution)	36
Population below $1.25 per day (PPP)	0

Foreign trade (2010)			
Main export partners (%)		*Main import partners (%)*	
Finland	17	Finland	15
Sweden	16	Latvia	11
Russia	10	Germany	11
Latvia	9	Lithuania	8

Main export products (%)	
Machinery & Equipment	23
Mineral products	16
Timber products	12
Non-precious metals and metal products	9
Main import products (%)	
Machinery & Equipment	23
Mineral products	17
Foodstuffs	11
Chemicals	14
Openness of the economy	
Export value of G&S (% of GDP)	99
Import value of G&S (% of GDP)	92
Inward FDI (% of GDP)	6.2

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

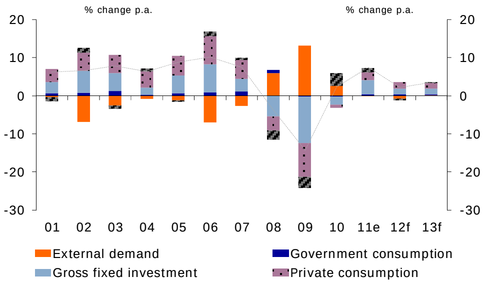
Estonia has made a swift recovery from the crisis that hit the economy in 2008 and 2009, on the back of a bursting housing bubble in an overheating economy and the global financial crisis. This caused the economy to contract by 3.7% and 14.3% respectively. In addition, unemployment rose to over 16% in 2010 (from 5.5% in 2008). The recovery in 2010 and 2011, when the economy grew by 2.3% and 7.5% respectively, was driven by increased external demand (especially for manufacturing exports), investment growth and recovering domestic demand. Nonetheless, for 2012, growth is expected to slow to below 2%, as the continued crisis in the eurozone will adversely affect demand for Estonian products. Already in the last quarter of 2011, slowing external demand led to a fall in the production of electronics. Still, as Estonia's main export markets consist of northern European countries and Russia, the impact of the eurozone crisis is expected to be less severe than for other Central and Eastern European countries. In the long-term, Estonia's favorable business-climate and tax regime will guarantee high growth rates and help it to further converge to European standards.

Estonia's financial sector was also impacted by the crisis, which brought to light underlying vulnerabilities and reduced asset quality. However, the banks weathered the crisis relatively well, aided by their Nordic parent banks. In this respect, the recent deleveraging by eurozone banks is cause for some concern, but so far has not resulted in the withdrawal of funds by parent banks.

Political and social situation

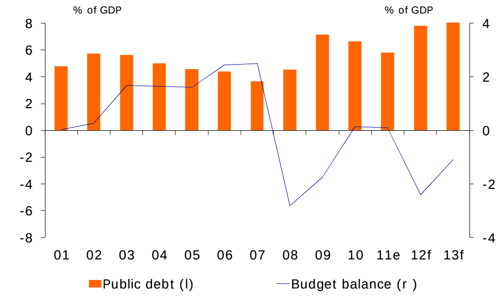
The current central-right coalition was re-elected in March 2011 and consists of the Pro Patria-Res Publica Union (IRL) and the Reform Party. The coalition currently holds 56 out of 101 parliamentary seats, which is an improvement from the 49 seats it held before its re-election. Nonetheless, the government's policy of fiscal consolidation is likely to receive criticism from labor unions and society at large (especially in light of Estonia's high unemployment rate), which could undermine the government's popularity. At the same time, we do not expect the possible strikes and protests to severely destabilize the economy. In the international sphere, Estonia is expected to continue to back Germany in finding solutions for the eurozone crisis.

Figure 1: GDP growth



Source: EIU

Figure 2: Public finances



Source: EIU

Economic policy

With a public debt to GDP ratio of 5.8% in 2011, Estonia is definitely the odd one out in the eurozone. The low debt ratio is the result of sound economic policy and allows the government to maintain a favorable tax system. In 2011, Estonia reported a budget surplus of 0.1% of GDP, but for 2012 we expect a budget deficit of 2.4% of GDP (still below the 3% of GDP requirement), on account of reduced revenues and increased investments in the energy sector.

Since Estonia adopted the euro in January 2011, the European Central Bank (ECB) dictates monetary and exchange rate policy. The 5.1% inflation rate in 2011 was largely the result of high food and energy prices. Slowing domestic demand, but elevated oil prices will translate into an inflation rate of roughly 3% in 2012.

Balance of payments

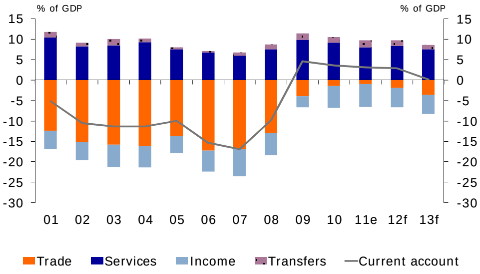
Estonia has a very open economy and the adoption of the euro last year allowed it to further trade relations with other eurozone members. However, its openness and further integration in the region also meant Estonia has felt and will continue to feel the impact of slowing demand in the eurozone. Still, despite slowing exports of goods, Estonia reported a surplus of 3.1% of GDP on the current account balance in 2011, which was largely the result of large surpluses on the services and transfer balances. The income balance did report an increasing deficit, which was caused by increasing debt payments on foreign debt. For 2012, increasing (fuel) import prices and recovering domestic demand are expected to result in a smaller current account surplus of a little under 3% of GDP.

Meanwhile, foreign direct investment inflows are expected to remain strong at roughly 6% of GDP. Estonia's low foreign exchange (FX) reserve level is explained by the fact that, as a eurozone member, it holds most reserves with the ECB.

External position

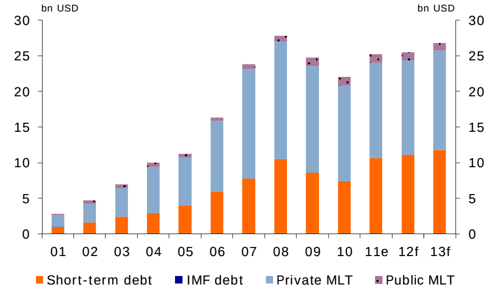
The greatest weakness of the Estonian economy is the high external debt level, which amounted to 112% of GDP in 2011. Roughly 40% of all foreign debt is short term debt and, as a result, total debt service due in 2012 (including short term debt) equals roughly USD 13bn (over 55% of GDP). Nonetheless, as Estonia belongs to the eurozone, banks can obtain financing with the ECB, which should help them roll-over their debt. Roughly 60% of all foreign liabilities are issued by Estonian credit institutions, with a large part of the debt held by their foreign parent companies. Although the debt level is high, the fact that most external debt is either held in euro or in Swedish krona is comforting.

Figure 3: Current account



Source: EIU

Figure 4: Foreign debt



Source: EIU

Estonia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	7.5	-3.7	-14.3	2.3	7.5	2.2	3.5
Consumer prices (average % change pa)	6.6	10.4	-0.1	3.0	5.0	3.2	3.0
Current account balance (% of GDP)	-16.9	-9.8	4.6	3.6	3.1	2.9	0.1
Total foreign exchange reserves (mln USD)	3263	3965	3972	2556	398	420	440
Economic growth							
GDP (% real change pa)	7.5	-3.7	-14.3	2.3	7.5	2.2	3.5
Gross fixed investment (% real change pa)	9.3	-15.1	-38.0	-9.0	17.5	6.0	6.0
Private consumption (% real change pa)	8.8	-6.4	-16.1	-1.8	4.0	3.3	3.0
Government consumption (% real change pa)	6.6	5.0	-1.6	-1.1	2.0	2.0	1.5
Exports of G&S (% real change pa)	3.7	0.6	-18.6	22.5	25.8	2.5	4.3
Imports of G&S (% real change pa)	6.3	-6.3	-32.4	20.6	28.5	3.5	4.5
Economic policy							
Budget balance (% of GDP)	2.5	-2.8	-1.8	0.1	0.1	-2.4	-1.1
Public debt (% of GDP)	4	5	7	7	6	8	9
Money market interest rate (%)	4.9	6.7	5.9	1.6	2.0	2.2	2.5
M2 growth (% change pa)	12	6	2	4	3	4	7
Consumer prices (average % change pa)	6.6	10.4	-0.1	3.0	5.0	3.2	3.0
Exchange rate LCU to USD (average)	0.7	0.7	0.7	0.8	0.7	0.8	0.8
Recorded unemployment (%)	4.7	5.5	13.8	16.9	12.4	11.7	11.6
Balance of payments (mln USD)							
Current account balance	-3720	-2340	893	678	697	620	20
Trade balance	-3741	-3128	-778	-284	-232	-410	-830
Export value of goods and services	11164	12571	9125	11656	16797	17390	17960
Import value of goods and services	14904	15699	9903	11940	17029	17800	18790
Services balance	1303	1801	1882	1724	1779	1790	1680
Income balance	-1445	-1287	-529	-1025	-1250	-1050	-1050
Transfer balance	162	274	318	263	400	300	230
Net direct investment flows	986	615	182	1193	400	300	350
Net portfolio investment flows	-495	700	-2078	-549	100	150	180
Net debt flows	6423	4723	-3557	-1751	3399	1030	1470
Other capital flows (negative is flight)	-2712	-2996	4569	-985	-6755	-2090	-2000
Change in international reserves	483	702	9	-1414	-2159	20	20
External position (mln USD)							
Total foreign debt	23819	27832	24762	22035	25232	25520	26820
Short-term debt	7800	10500	8600	7449	10673	11160	11780
Total debt service due, incl. short-term debt	8344	10805	13838	11052	9944	13260	13610
Total foreign exchange reserves	3263	3965	3972	2556	398	420	440
International investment position	-17029	-17573	-16342	-13917	n.a.	n.a.	n.a.
Total assets	23065	21880	21711	21749	n.a.	n.a.	n.a.
Total liabilities	40094	39453	38052	35666	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-17.0	-13.0	-4.0	-1.5	-1.0	-1.9	-3.7
Current account balance (% of GDP)	-16.9	-9.8	4.6	3.6	3.1	2.9	0.1
Inward FDI (% of GDP)	12.4	7.3	9.1	8.3	6.2	6.0	6.7
Foreign debt (% of GDP)	108	116	128	116	112	118	119
Foreign debt (% of XGSIT)	133	138	163	124	103	102	104
International investment position (% of GDP)	-77.3	-73.3	-84.8	-73.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	47	53	91	62	41	53	53
Interest service ratio incl. arrears (% of XGSIT)	5	7	5	3	2	2	2
FX-reserves import cover (months)	2.6	3.0	4.8	2.6	0.3	0.3	0.3
FX-reserves debt service cover (%)	39	37	29	23	4	3	3
Liquidity ratio	93	93	91	94	93	86	85

Source: EIU