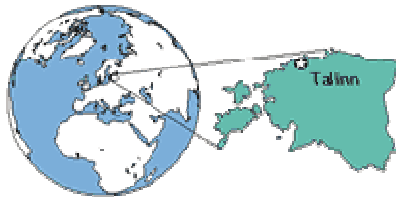


# COUNTRY REVIEW

## Estonia



7 July 2009

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**EULER HERMES COUNTRY RISK GRADE: C**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- Low risk of systemic political instability
- Good regional and international relations (except with Russia), EU and NATO membership
- One of the most open and liberal economies in the world
- Very strong business environment, supported by stable institutions and an independent judiciary

## Weaknesses

- After overheating, the economy has hard-landed and entered a deep, prolonged recession
- A currency board has largely neutralised monetary policy, leaving fiscal policy as the major tool to steer the economy
- Rapid unwinding of previously large macroeconomic imbalances is socially painful
- Property market “bubble”
- Very high external debt (projected 130% of GDP in 2009, about 40% of which is short-term)
- Low FX reserves relative to imports and annual external debt payments
- Difficulty in refinancing of short-term debt in tighter conditions of global financial crisis, which risk disruptions in the banking and corporate sectors are
- Banking sector

## KEY RISKS

- **Deep, prolonged recession in 2009-2010, with the number of insolvencies to rise sharply**
- **Difficulty in refinancing large amounts of maturing external debt, potentially resulting in insolvencies or debt restructurings of banks and companies**
- **Exchange rate risk (significant probability that the currency board collapses)**
- **Transfer risk (in the event that the currency board collapses)**

## Country Risk Assessment

Ratings	Estonia		Median Grade C	Median Grade B	Peers	
	Latest	Previous			Bulgaria	Hungary
<b>Systemic Political Risk:</b>	<b>P1</b>	<b>P1</b>	<b>P3+</b>	<b>P2-</b>	<b>P2+</b>	<b>P2+</b>
<b>Systemic Economic Risk:</b>	<b>E5</b>	<b>E4</b>	<b>E5</b>	<b>E4</b>	<b>E5</b>	<b>E5</b>
ME rating:	ME5	ME4	ME5	ME4	ME5	ME5
<i>Structure</i>	2.6	1.6	5.9	4.8	3.3	1.6
<i>Policy</i>	4.2	2.8	5.2	3.7	5.2	5.8
<i>Solvency</i>	4.2	3.2	2.8	2.8	3.8	4.6
<i>External Liquidity</i>	6.0	6.0	4.3	4.0	6.0	6.0
SBE rating:	SBE1	SBE1	SBE4	SBE3	SBE3	SBE2
<b>COUNTRY GRADE:</b>	<b>C</b>	<b>B</b>			<b>C</b>	<b>C</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

## ECONOMIC STRUCTURE

### Country Profile

Capital city:	Tallinn
Population:	1.34 mn (2008)
GDP:	USD 23213 mn (2008)
Currency:	Estonian kroon (EEK)
Form of state:	Parliamentary republic
Head of government:	Prime Minister Andrus ANSIP (since April 2005)
Next elections:	Legislative and presidential: 2011

Major Industries (% of GDP at market prices, 2008)		Global Assumptions		2008	2009
Services	68.5%	Real GDP grth (% yr/yr) *	1.0		-0.6
Industry	29.0%	Inflation (% av) *	3.4		1.5
Agriculture	2.5%	Dated Brent (USD/b)	98		55
* Major economies					

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Machinery & equipment	22.0%	Machinery & equipment	21.5%
Fuels & mineral products	12.0%	Fuels & mineral products	16.0%
Metals & metal products	12.0%	Chemicals	12.5%
Timber products	11.5%	Transport equipment	11.0%
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
Finland	18.5%	Finland	14.0%
Sweden	14.0%	Germany	13.5%
Russia	10.5%	Sweden	10.0%
Latvia	10.0%	Latvia	9.0%

## Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	16,443	20,904	23,213	18,387	17,923
Population (mn)	1.35	1.34	1.34	1.34	1.34
GDP per capita (USD)	12,180	15,600	17,323	13,722	13,376
Real GDP growth (% yr/yr)	10.4	6.3	-3.6	-13.0	0.0
Inflation (% eop)	5.1	9.6	7.0	-0.6	0.1
Fiscal balance (ESA 95;% of GDP)	2.9	2.7	-3.0	-4.5	-4.0
Current account balance (% of GDP)	-16.8	-18.0	-9.4	-0.7	0.0
External debt/GDP (%)	103.3	122.0	115.5	130.5	139.5
External debt/Exports of goods & services (%)	128.1	164.8	151.2	203.4	206.9
Debt-service ratio (%)	30.4	38.1	39.0	44.0	44.0
Foreign exchange reserves (EUR mn)	2,115	2,234	2,819	2,500	2,500
Import cover (months)	2.1	2.1	2.7	3.3	3.3
Exchange rate assumption, EEK:USD (av)	12.5	11.4	10.7	11.8	12.0
Exchange rate assumption, EEK:EUR (av)	15.6	15.6	15.6	15.6	15.6
f: CRU central forecast					

Sources: Eesti Pank, Statistics Estonia, Ministry of Finance, IMF, ECB, European Commission, Euler Hermes CRU

## Political Stability

The political system is stable. After regaining independence from the Soviet Union in 1991, Estonia soon established a parliamentary democracy and became a leader among transition economies in structural and institutional reforms. Its impressive political and economic transition and sound economic performance culminated in NATO and EU membership in 2004, underscoring generally good regional and international relations. Only relations between Estonia and Russia have remained tense, mainly owing to the allegedly discriminatory treatment of the relatively large Russian minority in Estonia—over 25% of the population—half of whom do not have Estonian citizenship. The relations have deteriorated further since the Estonian government re-located a Soviet-era war memorial from Tallinn in April 2007, sparking violent rioting by local Russian speakers and drawing protests from Moscow. The riots revealed the continuing deep social divisions between the two ethnic groups. In September 2007, Estonia's rejection of a Russian request to survey the seabed off the Estonian coast in preparation for building an underwater pipeline further strained relations. While Estonia's NATO membership should neutralise any residual threat to national security, Russia has retained punitive import tariffs against some Estonian goods and continues to threaten economic sanctions.

On the domestic front, frequent changes of government are an issue and no government has managed to serve its full term. The 13th government—a predominantly right-of-centre coalition under PM Andrus Ansip, comprising the liberal Reform Party (RP), the conservative Res Publica-Pro Patria Union (IRL) and the Social Democratic Party (SDP), which took office in April 2007—broke up in May 2009 as the SDP departed the coalition over a dispute over unemployment benefits. The RP and the IRL are now attempting to rule in a minority government, but the new administration is unlikely to survive for long. In particular, it will face growing popular opposition to fiscal austerity measures that it has already implemented or plans to introduce in order to pave the way for euro adoption as soon as possible. There is a risk that, if this administration falls, a new government could change strategy and opt for fiscal loosening, which in turn could endanger the currency board.

## Economic Stability

The economy has developed broadly along a pattern similar to that of several other countries in Emerging Europe in recent years. A credit boom largely funded by large-scale foreign borrowing of domestic banks from foreign parent banks fuelled domestic demand (private consumption and investment) and thus boosted real GDP growth. However, much of the credit was denominated in foreign currency and directed towards real estate, causing exchange rate risk and a housing bubble. Moreover, the booming economy involved soaring wage growth, well above productivity increases (partly owing to labour shortages caused by emigration) and pushed inflation to double-digits. Furthermore, imports increasingly exceeded exports, resulting in unsustainably high current account deficits, which had to be financed by new credit, driving up (short-term) external debt. The result of all this was an overheated economy with severe macroeconomic imbalances and an ever-larger external financing requirement. The latter has become an acute problem amid the ongoing global financial crisis as the sudden global liquidity shortage caused problems in refinancing short-term debt and may result in a domestic banking crisis and/or exchange rate crisis.

The particular situation and outlook for Estonia is as follows:

- Private-sector credit growth was excessive until end-2007, when it stood at 32% yr/yr. Since then, however, credit expansion has declined to just 7% at end-2008 and 1.5% in May 2009 and since Q2 2008, has been below the median of around 150 emerging economies. The rapid decline already points to an abrupt cooling of the economy.
- Indeed, annual real GDP growth decelerated from 10.4% in 2006 to 6.3% in 2007 and -3.6% in 2008. On a quarterly basis, real GDP growth steadily declined from 9.8% yr/yr in Q4 2006 to 4.4% in Q4 2007 and just 0.2% in Q1 2008. Since Q2 2008 GDP has contracted, 1.1% yr/yr in Q2, 3.5% in Q3, 9.7% in Q4 and a hefty 15.1% in Q1 2009. Industrial production plummeted by more than 30% yr/yr in January-May 2009, with April-May being worse than Q1. The once overheated economy has hard-landed and is now in the midst of a deep and protracted recession. While still base effects are still likely from Q3 onwards, we expect real GDP to shrink by about 13% in 2009 as a whole, followed by no growth for calendar 2010.
- Estonia has had a currency board arrangement in place since 1992, under which the local currency, the kroon (EEK) is pegged to the EUR at a rate of 15.65 EEK/EUR within the EU's Exchange Rate Mechanism II (ERM-II, a 2-year waiting room prior to entry to the European Monetary Union—the euro zone). Although the currency board helped to achieve investor confidence and strong economic growth in previous years and entry in ERM-II in 2004, it also left

the Eesti Pank (EP, the central bank) with few effective measures with which to curb credit growth and inflationary pressures since monetary policy is primarily determined externally. Hence the currency board also contributed to the previous overheating of the economy and the mounting macroeconomic imbalances.

The currency board arrangement requires that the monetary base is fully backed by the foreign exchange (FX) reserves of the EP. This requirement has not been tested so far, and at end-May 2009 FX reserves covered 117% of the monetary base. Further, analysis of the real effective exchange rate suggests that in May 2009 the EEK was just about 6% overvalued as compared to the average of the previous 60 months, down from a peak of 9.2% in January-February 2009. Although the rapid unwinding of the macroeconomic imbalances amid the ongoing sharp economic downturn has put considerable pressure on the fixed exchange rate, it appears that this pressure is waning. It seems that the Estonian authorities, who have remained committed to the currency board, are on track to restore competitiveness through 'internal devaluation', i.e. through massive real wage cuts and sharp fiscal tightening.

Nevertheless, the currency board continues to face several risks. Contagion from the collapse of another currency peg in the region currently appears to be the major threat. A devaluation of the Latvian lat and/or the Lithuanian litas might trigger fears of a devaluation of the EEK as well and lead to a period of EEK selling and capital outflows which the currency board might not survive. Moreover, continued fiscal restraint is at risk following the reduction of the ruling coalition to a minority government in May 2009 (see Political Stability section). In particular, policymakers could at some point of time consider a EEK devaluation as a policy option to restore competitiveness if further wage cutbacks, rising unemployment and fiscal tightening were to become politically unsustainable.

- After a peak of 11.4% in June 2008, year-on-year inflation gradually eased to 9.8% in October 2008, before falling more quickly and shifting into deflation of 0.3% in May 2009. In June prices fell further by 0.9%. The rapid decline reflects lower world oil and food prices and sharply weaker domestic demand pressures. Though base effects and an increase of VAT from 18% to 20% in July 2009 will moderate the downtrend, we expect deflation to persist until well into 2010.
- Since the currency board has largely neutralised monetary policy, fiscal policy is the major tool with which to steer the economy. Estonia has a long-lasting commitment to fiscal prudence, reflected in many years of large fiscal surpluses (2.9% of GDP in 2006, 2.7% in 2007). But in the wake of the economic downturn in 2008 the fiscal account shifted into a deficit of 3% of GDP. The government is targeting 3% deficits in 2009 and 2010 as well, in order to meet the Maastricht criterion for euro adoption in 2012. However, in view of the very steep contraction of GDP it is unlikely to meet its objectives. If needed the government has room to take on more debt as gross public debt is very low (4.8% of GDP at end-2008) and indeed in Q1 2009 Estonia was still a net external creditor.
- The current account deficit widened to 18% of GDP in 2007, but narrowed to 9.4% in 2008 and shifted into a small surplus in the first four months of 2009. Both exports and imports have been shrinking rapidly since Q4 2008. For 2009 as a whole, we expect a small current account deficit of less than 1% of GDP.
- Official FX reserves have been fairly stable, albeit somewhat volatile, around an average of EUR2.6bn since early 2008. Although reserves have remained sufficient to cover the monetary base which is needed to maintain Estonia's currency board arrangement (see above), they have been traditionally low in relation to imports (just over two months cover) and coverage of external debt payments due (see below). Moreover, in the event of a currency collapse, a rush to convert savings into EUR would be likely and there would be an increased risk of imposition of (temporary) currency controls.
- The external debt burden remains high. Gross external debt reached a peak of USD29.2bn in Q2 2008 and fell to USD24.4bn in Q1 2009. We expect a further decline to about USD24bn by the end of 2009. However, the external debt burden in relation to GDP (export earnings) will continue to increase from 116% (151%) in 2008 to about 130% (200%) this year.

Around 35-40% of gross external debt is short-term, which together with principal repayments due in 2009 is estimated to be about five times the level of current FX reserves. The refinancing of debt payments due this year is particularly difficult given the global financial crisis, such that there is a high risk of disruptions in the banking and corporate sectors.

Even taking into account the considerable assets held abroad by Estonian institutions, the debt position now appears critical. Net external debt has risen from a manageable 17% of GDP in 2005 to 38% in 2008 and may reach a worrisome 44% this year and probably 50% in 2010.

However, net short-term external debt is still relatively low, standing at USD1bn in Q1 2009.

External debt-servicing has become more difficult, as upwardly revised data show an increase from 27% of export earnings in 2005 to 39% in 2008 and forecast 44% in 2009.

- Banking sector risk has increased. Although the Scandinavian banks that have funded much of Estonia's external imbalance would be reluctant to choke off financing suddenly, they might be forced to do so at some point, as their position has weakened over the past months, mainly because of their exposure to their Baltic subsidiaries. Thus Estonian banks may face increasing difficulties in attracting financing from their foreign parents. There is also a risk of banking system contagion in the event of a banking crisis in a neighbouring country. The foreign-currency exposure of Estonian borrowers is high as about 85% of bank loans are denominated in FX (mostly EUR).

**Summary:** After the economy overheated, the downtrend in Estonia began before the global financial crisis intensified in September 2008— and earlier than in all other overheating economies in Emerging Europe, because the authorities initiated the necessary economic adjustments quite promptly. Major sources of concern, such as the large current account deficit, high inflation and excessive credit growth have already diminished. However, as the authorities have opted for maintaining the existing currency board system and for economic adjustment through internal devaluation (wage cuts, fiscal restraint), the economy is in severe recession, exacerbated by much tighter lending conditions in the wake of the global financial crisis. In this environment, the private sector's ability to repay or refinance large amounts of maturing external debt remains a key risk. We expect the number of insolvencies to rise sharply. As some 85% of total bank loans are denominated in foreign currencies, these risks would further increase if Estonia's currency board were to collapse. Although macroeconomic devaluation pressures on the Estonian kroon (EEK) are moderate— the kroon is currently estimated to be about 6% overvalued and official foreign exchange reserves have been roughly stable since early 2008, backing the currency board—contagion from a potential currency devaluation in neighbouring Latvia in the near future is a serious concern. Overall, country risk has increased and is now assessed as high.

## Structural Business Environment

The Structural Business Environment overall is very strong. Estonia ranks 17th out of 210 economies in our assessment overall, just behind Norway and ahead of Belgium. Thanks to the ambitious reform-oriented and liberal free-trade policy of successive governments, Estonia is one of the most open and liberalised economies. The degree of regulation and bureaucracy is low and corruption is moderate. The judiciary is regarded as independent and property rights enjoy a high level of protection. Only the banking sector poses a weakness. Although largely owned by fairly strong foreign banks, the unsustainable credit boom in recent years combined with the global financial crisis has increased the risks of banking illiquidity and a domestic banking crisis (see Economic Stability section).

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**Charts**

