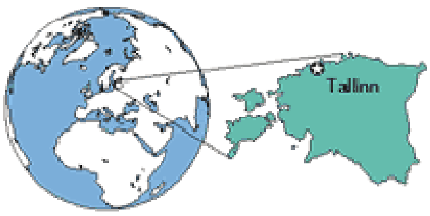
COUNTRY REVIEW

Estonia



14 March 2011

ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: AA

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 systemic political risk
- Good regional and international relations (except with Russia), EU membership
- One of the most open and liberal economies in the world
- Euro zone membership provides for low transfer and convertibility risk
- Strong business environment, supported by stable institutions and an independent judiciary

Weaknesses

- Rapid unwinding of previously large macroeconomic imbalances is socially painful
- The refinancing of private sector debt payments falling due will remain difficult, such that there is still a risk of disruptions in the corporate sector
- Some vulnerabilities in the banking sector

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Tallinn
Population:	1.34 mn (2009)
GDP:	USD 19260 mn (2009)
Currency:	Euro (EUR)
Form of state:	Parliamentary republic
Head of government:	Prime Minister Andrus ANSIP (since April 2005)
Next elections:	Presidential: September 2011 / Legislative: March 2015

Major Industries (% of GDP at market prices, 2009)	
Services	71.0%
Industry	26.5%
Agriculture	2.5%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr)	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	80	110

* Major economies

Main Exports (% of total, 2009)	
Machinery & equipment	19.5%
Mineral products	17.0%
Timber products	12.0%
Non-precious metals & metal produc	8.5%

Main Imports (% of total, 2009)	
Mineral products	20.0%
Machinery & equipment	19.0%
Chemicals	15.0%
Foodstuffs	12.5%

Lead Export Markets (% of total exports, 2010)	
EU-27	69.0%
Finland	17.0%
Sweden	15.6%
Latvia	9.0%
Russia	9.7%

Lead Import Markets (% of total imports, 2010)	
EU-27	80.0%
Finland	14.9%
Germany	11.3%
Latvia	10.9%
Russia	8.3%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	21,666	23,575	19,261	19,498	20,673
Population (mn)	1.34	1.34	1.34	1.33	1.33
GDP per capita (USD)	16,145	17,554	14,374	14,627	15,532
Real GDP growth (% yr/yr)	6.9	-5.1	-13.9	3.1	3.9
Inflation (HICP; %, eop)	9.7	7.5	-1.9	5.4	2.6
Fiscal balance (ESA 95;% of GDP)	2.5	-2.8	-1.7	-1.0	-2.2
Public debt / GDP (%)	3.7	4.6	7.2	8.0	10.0
Current account balance (% of GDP)	-17.6	-9.5	4.7	3.8	1.0
External debt/GDP (%)	117.8	113.8	130.0	128.2	133.0
Net external debt / GDP (%)	38.5	37.4	37.7	31.2	36.6
External debt/Exports of goods & services (%)	164.8	151.1	185.5	154.6	154.5
Debt-service ratio (%)	56.5	76.5	55.6	45.5	41.4
Foreign exchange reserves (EUR mn)	2,234	2,819	2,691	1,832	*
Import cover (months)	2.0	2.7	3.6	2.0	*
Exchange rate assumption, EUR:USD (av)	0.73	0.68	0.72	0.75	0.77

f: CRU central forecast

* Estonia adopted the EUR in January 2011 and has since access to pooled foreign exchange reserves of the ECB.

Sources: National figures, IMF, ECB, European Commission, Eurostat, IHS Global Insight, Euler Hermes

Political Stability

The political system in Estonia is stable and risk-free for business activities. 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. Moreover, Estonia became a member of the OECD in December 2010 and joined the euro zone at the beginning of 2011. Only relations between Estonia and Russia have remained tense, mainly owing to allegations of discriminatory treatment of the ethnic Russian minority in Estonia, who account for over 25% of the population, speak Russian and half of whom do not have Estonian citizenship. Relations have deteriorated further since the Estonian government relocated a Soviet-era war memorial from Tallinn in April 2007, which sparked violent riots by local Russian speakers and protests from Moscow. While Estonia's NATO membership should neutralise any residual threat to its national security, Russia has retained punitive import tariffs against some Estonian goods and continues to threaten economic sanctions.

On the domestic front, government instability is an issue, as no government has managed to serve its full term. The 13th government—a predominantly right-of-centre coalition under prime minister Andrus Ansip, comprising the liberal Reform Party (RP), the conservative Res Publica-Pro Patria Union (IRL) and the Social Democratic Party (SDP), that took office in April 2007—broke up in May 2009 as the SDP departed the coalition over a dispute over unemployment benefits. But the other two parties continued as a minority government and successfully went on with an austerity programme that was rewarded with EU approval of euro-zone membership in 2011. Moreover, the RP and the IRL increased their share of parliamentary seats in the election on 6 March 2011 and will now enjoy a majority, assuming they agree to continue the coalition.

Economic Stability

The World Bank classifies Estonia as a high income country, with GNI per capita of USD14,060 in 2009. The economy is quite advanced, with services accounting for about 70% of GDP, industry 27% and agriculture 3%. However, the export structure is somewhat unfavourable. In 2010, Russia accounted for almost 10% of Estonia's merchandise exports, Latvia 9%, Lithuania 5% and all fellow members of the EU-27 together for 69%, making the economy vulnerable to the business cycles of these economies. Real GDP grew by an average annual 8.3% in 2000-2007, however, in large part this was due to overheating of the economy, which was reflected in mounting macroeconomic imbalances, such as an excessive credit boom that fuelled domestic demand and caused a housing bubble, elevated inflation and unsustainably high current account deficits. In the wake of the global financial and economic crisis, this growth model collapsed and the economy fell into deep recession, with a cumulative output decline of more than 18% in 2008-2009.

Real GDP continued to contract by 2.6% yr/yr in Q1 2010, but has returned to annual growth since Q2 and increased by an estimated 6.7% in Q4 2010. The rebound was largely export led while domestic demand was fairly subdued in 2010 as a whole. However, private consumption and investment improved over the course of the year and returned to annual growth in Q3 and Q4, respectively. The strong performance in Q4 2010—which took full year 2010 growth to 3.1%—was supported by increases in private consumption (2.6% yr/yr) and investment (11.9%) as well as by a positive contribution of net external trade as the expansion of exports (36.5%) outpaced import growth (30%). Government consumption continued to decline by 1.4% yr/yr. We expect the recovery to be sustained through 2011 and annual growth of about 4%.

Monetary policy until end-2010 was limited by the currency board arrangement that withstood the pressures from the global financial crisis remarkably well. 'Internal devaluation', i.e. massive real wage cuts and sharp fiscal tightening, helped to reduce inflation rapidly from a peak of 11.6% yr/yr (on the EU's HICP) in April 2008 and, combined with the sharp decline in domestic demand, shifted it to modest deflation from June 2009 to February 2010. Since then annual inflation has risen to 5.5% in February 2011, driven by higher food and oil prices as well as some base effects. As the latter will gradually wane, we expect annual average inflation of about 4% in 2011. The real effective exchange rate overvaluation (as compared to the previous 60 months) decreased from a peak of 9.2% in early 2009 to a low of 0.9% in June 2010 and stood at a modest 2% at end-2010. Annual private sector credit has been contracting since Q2 2009, a necessary adjustment which, however, has affected economic recovery.

Estonia has had a long-lasting commitment to budgetary prudence, reflected in many years of large fiscal surpluses. But in the wake of the economic downturn in 2008 the fiscal account shifted into a deficit of 2.7% of GDP. With sharp fiscal tightening, the government achieved a remarkably low 1.7% of GDP fiscal deficit in 2009, despite the steep 13.9% contraction of GDP which eroded the tax base. Thanks to sizeable sales of so-called "Kyoto units" (representing an allowance to emit greenhouse gases), the fiscal deficit declined further to an estimated 1% of GDP in 2010. However, environmental investments funded by these revenues are likely to increase the deficit to 2-3% of GDP in 2011 and 2012. Gross public debt has remained very low at around 8% of GDP at end-2010 and the government was also a net external creditor.

Thanks to retention of favourable fiscal indicators as well as to low inflation and exchange rate stability, Estonia was able to join the euro zone at the start of 2011. While monetary policy is now conducted by the European Central Bank (ECB), membership of the euro zone provides for low transfer and convertibility risk (as long as the euro zone remains intact) and has substantially decreased external vulnerabilities related to exchange rate risk.

The current account swung from a deficit of 9.5% of GDP in 2008 to a 4.7% surplus in 2009, as imports (in line with domestic demand) contracted even sharper than exports. The surplus narrowed to 3.8% in 2010 and is forecast to decline further to 1% or so in 2011, as imports are likely to expand somewhat stronger than exports.

Gross external debt is relatively high in relation to GDP (approximately 128% at end-2010) and export earnings (155%). However, around 75% of gross external liabilities are balanced by gross external assets such that net external debt stood at about 31% of GDP at end-2010. While this ratio is more favourable, it should be noted that it is significantly higher than in 2005 (17%). Around 37% of gross external debt is short-term, which together with principal repayments due in 2011 is estimated at about EUR8.3bn. The forecast debt-service ratio of more than 40% in 2011 reflects that the refinancing of maturing private sector external debt payments falling due will remain difficult as long as domestic and external lending continues to be tight. Disruptions in the corporate sector cannot be ruled out entirely.

Structural Business Environment

The Structural Business Environment is overall very strong. Estonia ranks 28th out of 212 economies in our assessment overall, just behind Switzerland and ahead of France and Germany. Thanks to the ambitious reform-oriented and liberal free-trade policy of Estonian governments, the country is today one of the most open and liberalised economies in the world. 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 the pre-crisis years combined with the global financial crisis increased the risks of banking illiquidity and a domestic banking crisis sharply. The latter has been avoided so far, but the ongoing contraction of private sector credit reflects that Estonian banks still face difficulties in attracting financing from their foreign parents. With doubts about the European banking system overall not yet fully cleared, there also remains a risk of contagion in the event of a banking crisis elsewhere.

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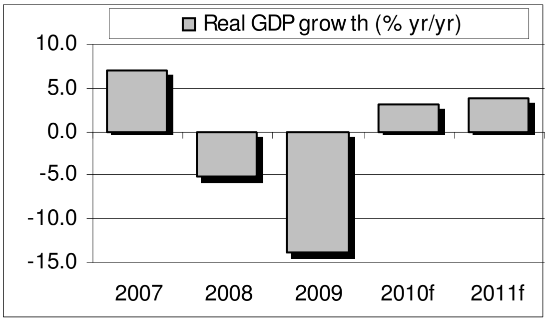
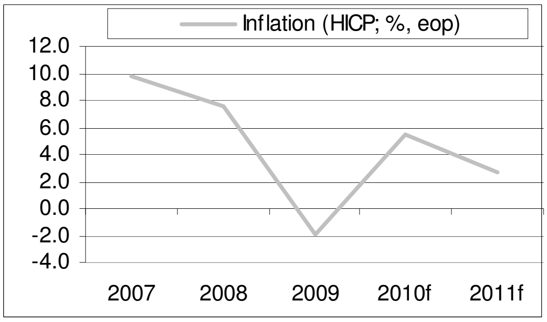
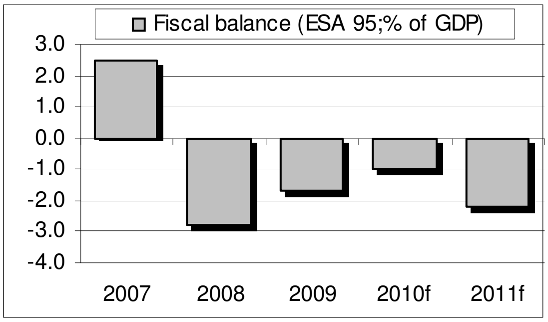
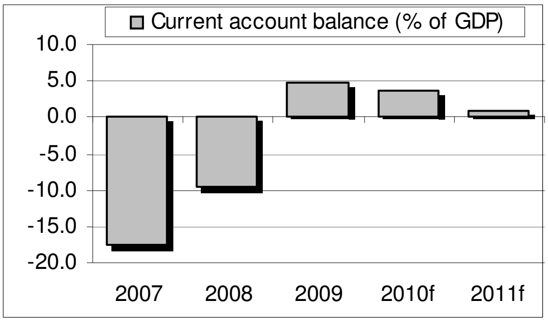
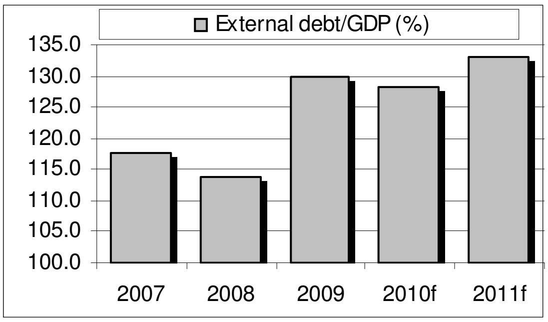
Charts

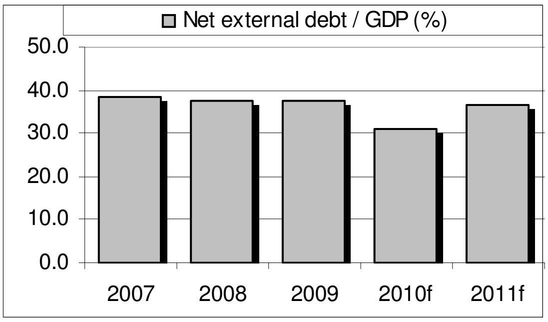

Real GDP growth (% yr/yr)
10.0
5.0
0.0
-5.0
-10.0
-15.0
2007
2008
2009
2010f
2011f

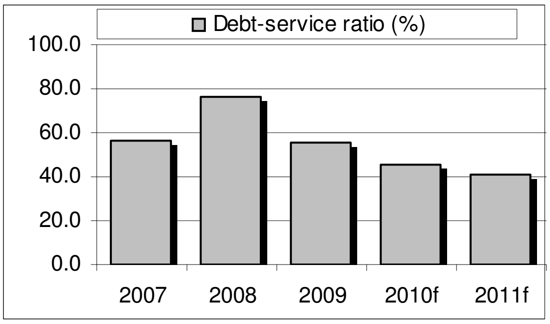

Inflation (HICP; %, eop)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
2007
2008
2009
2010f
2011f

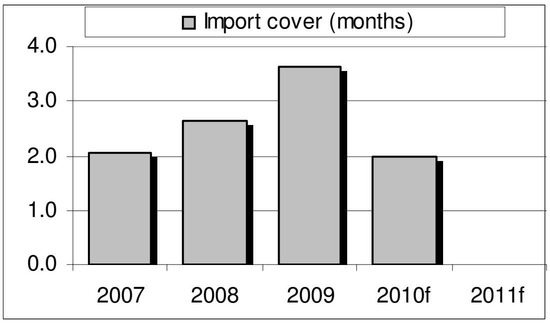

Fiscal balance (ESA 95;% of GDP)
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
10.0
5.0
0.0
-5.0
-10.0
-15.0
-20.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
135.0
130.0
125.0
120.0
115.0
110.0
105.0
100.0
2007
2008
2009
2010f
2011f


Net external debt / GDP (%)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
100.0
80.0
60.0
40.0
20.0
0.0
2007
2008
2009
2010f
2011f


Import cover (months)
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f