

# Estonia

## Recession over but far from rosy

*'The recession has officially ended but growth of 2.6% q-on-q in 2009q4 was largely due to a one-off boost from stockbuilding.'*

*'Real GDP will grow by 1.1% in 2010 but domestic demand will not grow until the year after when the recovery will begin to kick in and GDP will rise by 4%.'*

*'Over the long term, the economy will grow at a robust but more moderate pace than during the previous decade.'*



## A corner turned

- The world economy started expanding again in August 2009, according to surveys of purchasing managers in manufacturing and services. This was backed up by national accounts data that showed most of the developed world returning to growth in 2009q3. Unprecedented monetary and fiscal stimulus across the globe has gone a long way to arresting the decline in output and fomenting a recovery in business and consumer sentiment.
- The eurozone as a whole exited recession in 2009q3, posting growth for the first time since 2008q1. While PMIs show eurozone manufacturing in expansionary territory, the recovery has lagged well behind its counterparts in the US and Asia. Services are more of a mixed bag, and both sectors continue to shed jobs. With car scrappage schemes and other fiscal measures coming to an end, eurozone growth slowed significantly in 2009q4, to just 0.1%
- The US also started growing again in 2009q3, and activity accelerated strongly in 2009q4. The \$800bn fiscal stimulus package is starting to kick in, with the US economy now expected to expand by more than 2.5% in 2010.
- While the US recovery bodes well for the world economy, emerging Asia played an important role in putting a floor under the global downturn. China has led the way, with authorities there channelling massive amounts of bank lending into export-led sectors while bringing forward large-scale infrastructure projects. This has helped to lift the fortunes of regional economies and capital goods exporters in Europe and Japan.

## Key risks

- Much of the rise in global activity of late has been in response to inventory building in the wake of the massive destocking that occurred in late 2008 and early 2009. With stimulus packages coming to an end, it remains to be seen whether the recovery has legs of its own. The risk of stagnation in the short term is on the rise, as seen in recent eurozone data.
- China has shown signs again of overheating, with asset bubbles building up in response to loose monetary and fiscal policy. The authorities are reining in stimulus, raising the risk that a sharp slowdown in China could undermine growth everywhere.

## Key business prospects

<b>RECENT TRENDS</b>	Real GDP grew by 2.6% in 2009q4, which was still down 9.4% on a year earlier.
<b>BUSINESS PLANNING ASSUMPTIONS</b>	Monetary policy is dictated by a currency board. Eurozone entry is one of the government's key aims but the date of accession is uncertain.
<b>2-YEAR OUTLOOK</b>	Worst looks to be past. Recovery from deep downturn led by trade and later, investment. <b>Key risk:</b> Consumers squeezed while investors stay away.
<b>LONGER-TERM OUTLOOK</b>	Economic growth around 4.5% per annum. <b>Key risk:</b> Eurozone accession delayed, with negative impact on foreign direct investment.
<b>CONSUMER</b>	Consumption picks up from 2012 but does not reach the same pace as the previous decade. <b>Key risk:</b> Unemployment remains high and credit unavailable while inflation rises.
<b>TRADE</b>	Current account surplus in short term and small and sustainable deficit in the long run. <b>Key risk:</b> Inflation undermines competitiveness.
<b>INFLATION</b>	Moderate wage-inflation spiral in the long-term. <b>Key risk:</b> Rising energy costs.
<b>LABOUR MARKETS</b>	Unemployment continues to rise in short term but population dynamics ensure long-term prospects are good. <b>Key risk:</b> Emigration keeps labour market tight, driving wages up and competitiveness down.
<b>GOVERNMENT</b>	Relatively good position after decisive government action. Small deficit turns to surplus. <b>Key risk:</b> Low receipts sees debt build up.

Estonia	09	10	11	12	13-17
<b>National accounts (% change, real terms)</b>					Avg
<b>GDP</b>	-14.0	1.1	4.0	4.4	4.5
<b>Consumer spending</b>	-16.0	-2.1	1.7	3.2	4.1
<b>Investment</b>	-33.5	-2.0	4.5	8.3	5.4
<b>Government</b>	-0.5	-0.1	0.7	0.8	1.3
<b>Exports</b>	-14.0	-0.4	5.5	8.3	6.4
<b>Imports</b>	-25.0	-2.2	4.3	8.7	6.0
<b>Other indicators</b>					
<b>Employment (% change)</b>	-8.0	-2.0	2.8	3.0	1.5
<b>Unemployment (% workforce)</b>	15.0	15.5	11.0	8.0	5.6
<b>Consumer prices (% change)</b>	-0.1	1.9	2.5	2.5	2.4
<b>Fiscal balance (% GDP)</b>	-2.6	-2.2	-2.0	0.4	1.5
<b>Current account balance (% GDP)</b>	5.0	1.8	-1.2	-2.5	-1.8
<b>3 m Talibor (% p.a.)</b>	5.9	3.5	4.0	6.5	7.2
<b>10 yr bond yield (% p.a.)</b>	7.4	5.5	6.5	7.4	7.4
<b>Exchange rate (EEK per €)</b>	15.65	15.65	15.65	15.65	15.65

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Forecast closing date: March 2<sup>nd</sup> 2010

## Business planning assumptions

### Interest rates



The Bank of Estonia has committed to a currency board arrangement, pegging the kroon to the euro. As such monetary policy is dedicated to preserving the value of the kroon and in effect is determined by market forces. With the threat of devaluation all but gone, rates in Estonia have fallen from nearly 7.9% to 3% at the end of 2009.

**KEY RISK:** Risk premium rises if EU finance ministers reject Estonia for euro-entry on June 8<sup>th</sup>.

### Exchange rates



The Estonian kroon is pegged against the euro at a rate of 15.6466 as part of a currency board. This is also the rate at which the kroon entered into ERM 2, the EU's exchange rate mechanism.

**KEY RISK:** Inflation soars during recovery and the peg means the kroon becomes over-valued and pressurised by speculators in the run-up to euro-entry.

### Forecasts

	Dec 09	Dec 10	Dec 11	Dec 14
3m TALIBOR	3.10	3.75	5.00	4.25

### Forecasts

	2009	2010	2011	2014
EEK per €(y/e)	15.65	15.65	15.65	15.65
EEK per US\$ (y/e)	11.23	11.26	11.42	11.68

## Signs of recovery, but still a long ways to go yet

### RECENT DEVELOPMENTS

#### GDP



The latest official data show that the Estonian economy grew by 2.6% in the final three months of 2009 following seven consecutive quarters of decline. Overall, the economy shrank by 14% in 2009. The strength of the bounce-back in q4 is slightly misleading as it was heavily influenced by a one-off surge in stockbuilding ahead of the January rise in excise duty rise on tobacco, alcohol and motor fuels.

#### Surveys



The latest monthly surveys suggest that underlying demand has been more sluggish. Retail sales were still down 10% year-on-year in January while industrial production was up just 0.3%.

#### Consumer



The consumer is still suffering. LFS unemployment rose to 15.5% in the 2009q4, slightly up on the previous quarter, while the number of employed fell to 581,000. Deflation was a necessary consequence of maintaining the exchange rate peg while achieving an internal devaluation. However prices only fell by an average of just 0.1% a month in 2009 and have risen in the first two months of this year, taking the price level to just 0.2% lower than in February 2009.

#### 2-YEAR OUTLOOK



Our baseline forecast for 2010 is for GDP to grow by 1.1%. Consumer spending will be undermined by long-term unemployment and rising prices while domestic investors will struggle to find credit. Indeed, we expect domestic demand to contract by 0.4%. The main source of growth will be net exports, although the initial boost will be more from the lack of imports. In 2011 we expect growth of around 4% and a positive contribution from all components.

#### CHANGES

The forecast has been revised up slightly but it is the impact of the 2.6% rise in 2009q4 which has had a larger effect on the 2010 headline number. In our view there is a slightly more positive outlook for investment with the government proving itself capable of fiscal restraint and differentiating itself from the other Baltic states. Eurozone entry approval this year is an increasing possibility.

#### CONSUMER



The consumer has endured a difficult two years. A rapid rise in unemployment and taxes and a drop in earnings, as well as a massive depreciation in housing wealth, led to a collapse in spending. With unemployment staying high and prices beginning to rise we forecast consumer spending to pickup only gradually in 2010. It will be key how quickly the export markets recover, as well as the rise in credit worthiness, increasing the chances of finding employment and securing personal loans. It will be around 2015 before spending reaches its post recession levels.

#### INFLATION



Prices rose by 6.7% and 10.6% in 2007 and 2008. Even before the credit bubble burst, the consensus was that inflation was too high, threatening its competitiveness, euro-entry and the credibility of monetary policy. With domestic demand unable to lead a recovery, the export market is vital and a premature return to inflation could cause significant damage to competitiveness and therefore the recovery and euro-entry. Worryingly, prices rose by 0.6% over January and February.

#### LABOUR



The unemployment rate reached 15.5% in 2009q4 while real wages were down 4.6%. The number of long-term unemployed now accounts for nearly a third of the total. This means that the unemployment rate could stay high for some time after the rehiring has begun.

### RISKS

#### FINANCIAL



Standard & Poor's upgraded Estonia's outlook rating from negative to stable in February, citing an increasing likelihood of meeting the euro-criteria. However, the investment grade is still the fourth-lowest, A-

#### FORECAST



Deflation has not gone far enough and structural distortions allow the EU to reject Estonia on the basis that the country does not have credible medium-term budget plans and sustainable price performance.

## Slower but more sustainable over the long term

### LONG-TERM GROWTH TRENDS

Over time, confidence will begin to rise and credit markets will loosen. Estonia will regain its attractiveness to investors looking to take advantage of a productive workforce with wages that are still well below western levels. However, with tighter credit rules and a less rapid wage-price spiral, we do not expect a return to double-digit growth. More moderate domestic demand will result in sustainable real GDP growth, averaging around 4.4% per annum over the period 2012-16. Once the government has weathered the current storm, the fiscal balance should move back into surplus. However, if it fails to meet the criteria for euro entry, a bounce in inflation as the recovery takes off could delay entry until around 2015-16.

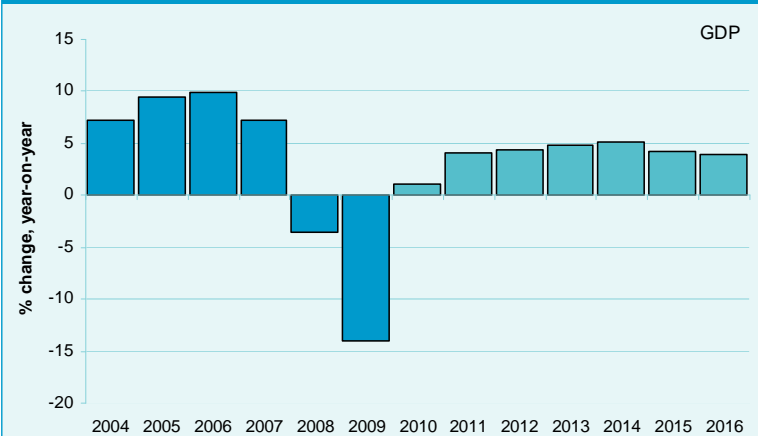
### LABOUR MARKET

With cuts in income tax and employer contributions encouraging more people into work and a shrinking population reducing the workforce, unemployment will edge down and stay low over the long run despite unimpressive job creation.

### HOUSEHOLDS

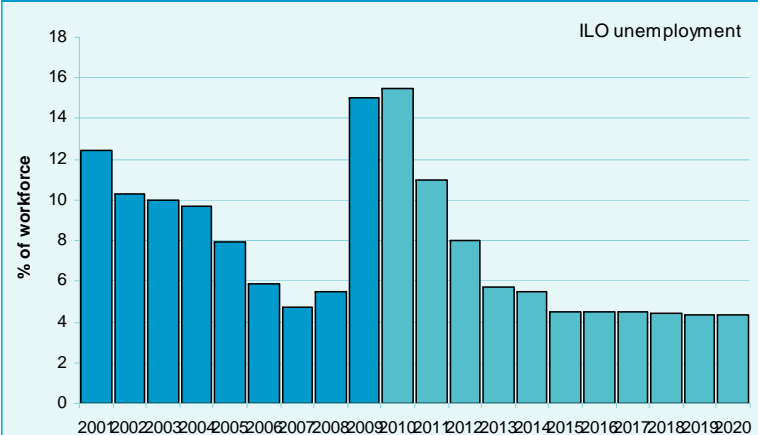
With low unemployment and a slower wage-price spiral we expect spending to grow at around 3.6% a year. House-prices will regain their value, boosting property wealth and a developing international integration will lead to higher skilled and higher-income profile to consumers, particularly in the capital Tallinn.

### GDP more modest in the long-term



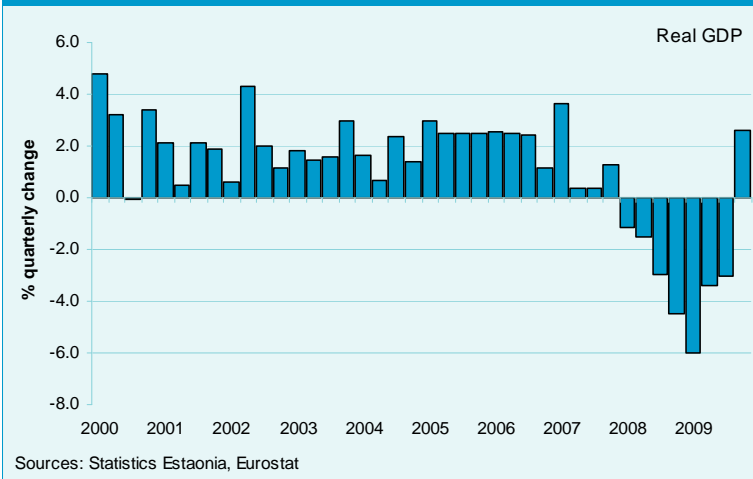
Sources: Statistics Estonia, Eurostat, Experian

### Unemployment remains low due to small labour force

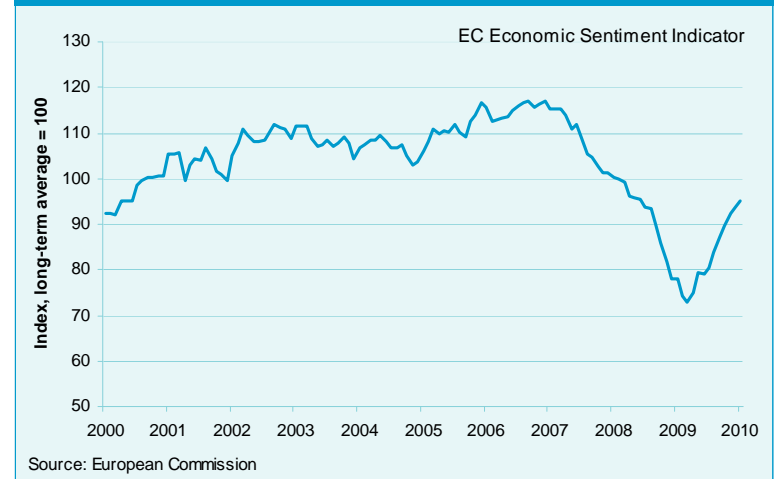


Sources: Statistics Estonia, Eurostat, Experian

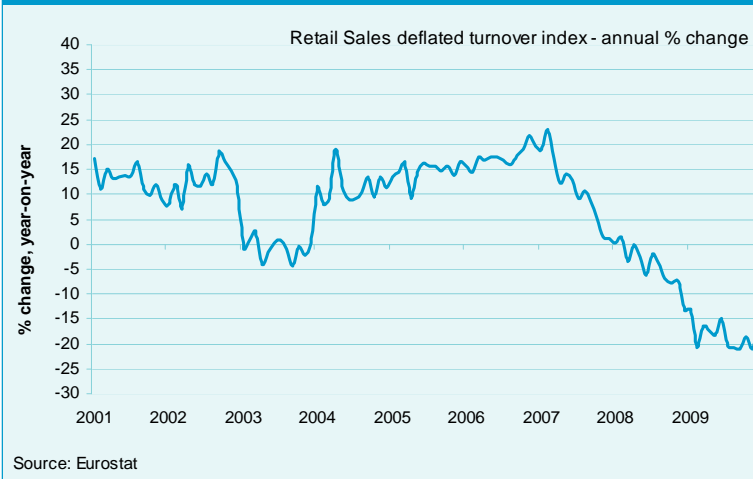
**Strong rebound skewed by one-off stockbuilding**



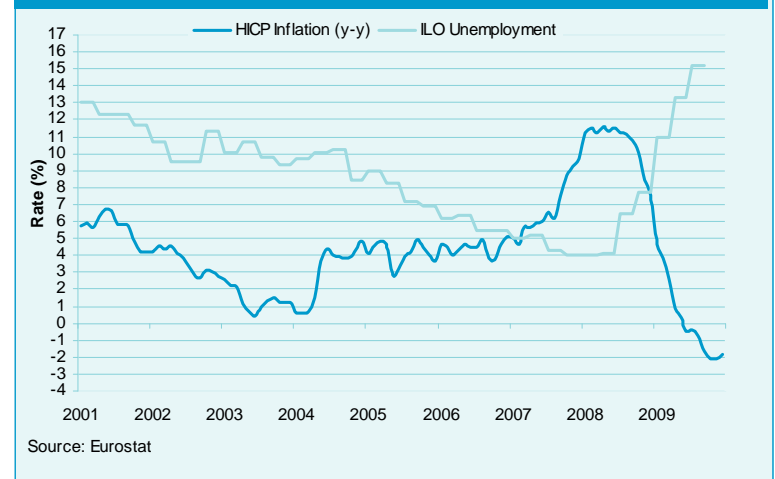
**Economic Sentiment improving but still low**



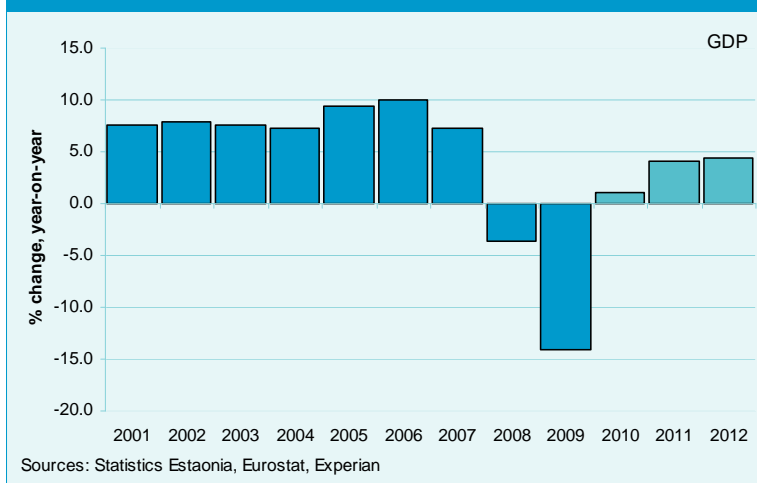
**Retail Sales yet to show any improvement**



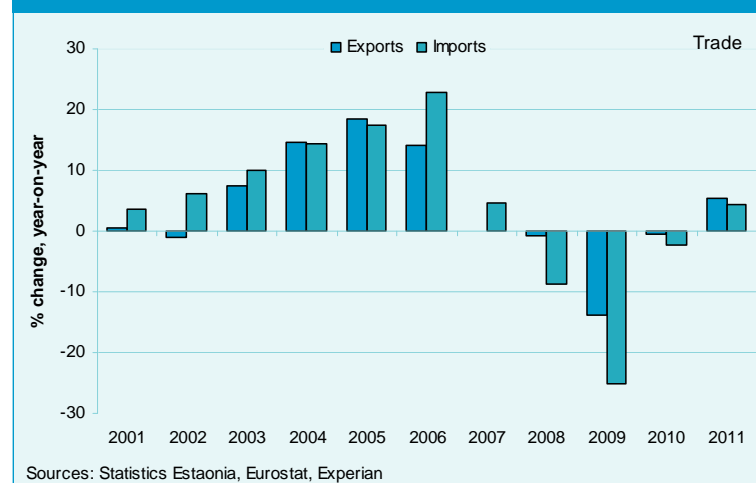
**Unemployment still rising. Deflation eases**



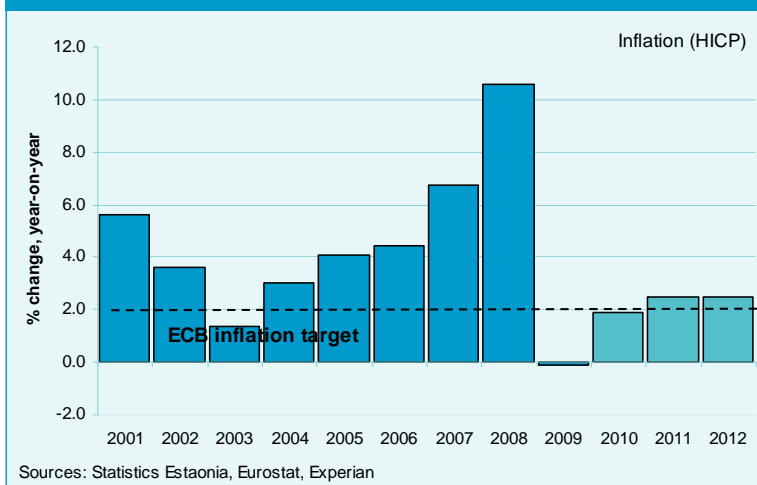
Recovery gathers pace only in 2011



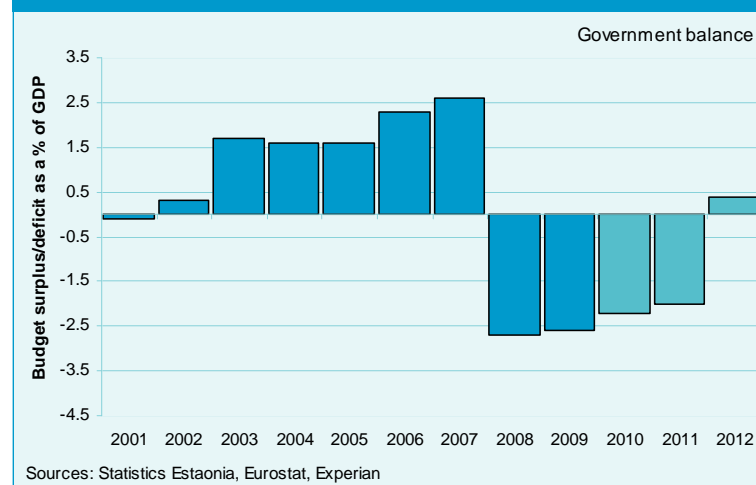
Positive net exports thanks to weak imports

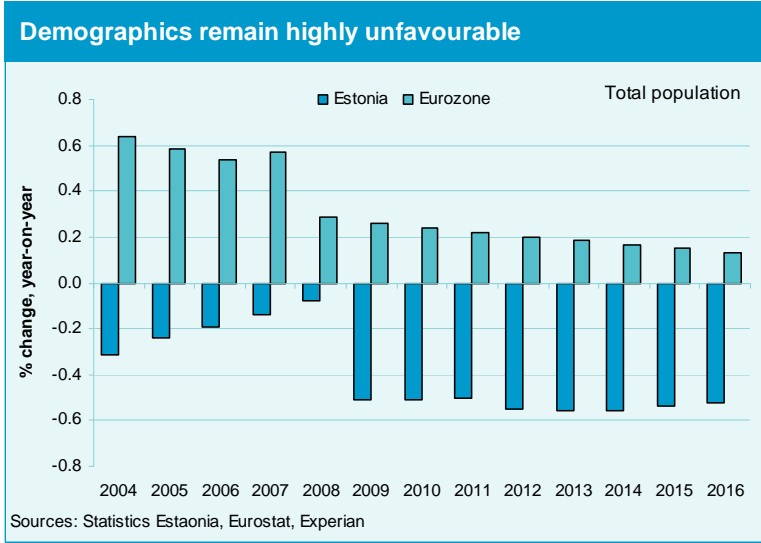
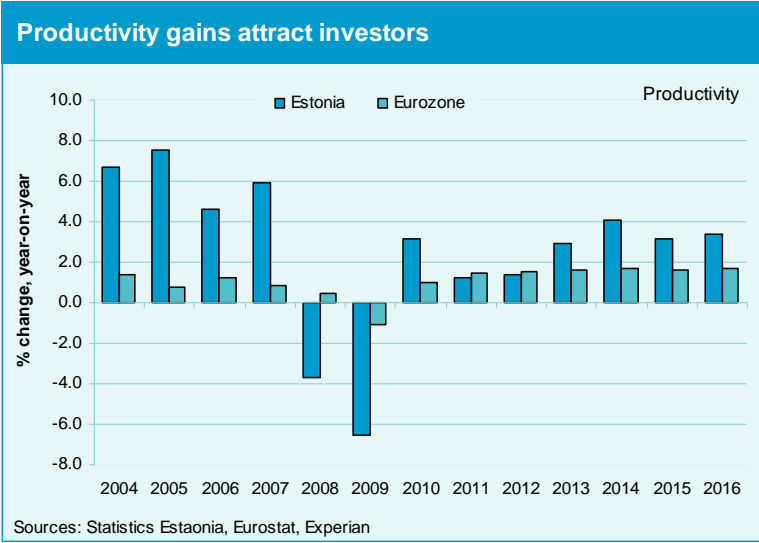
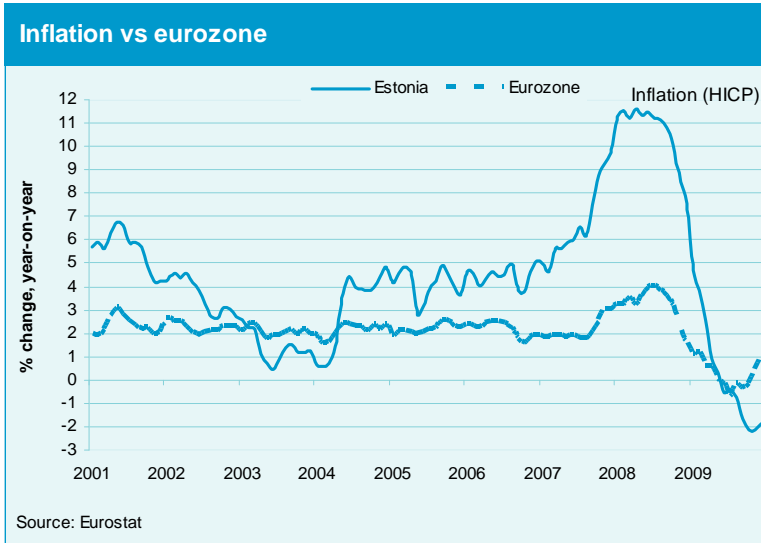
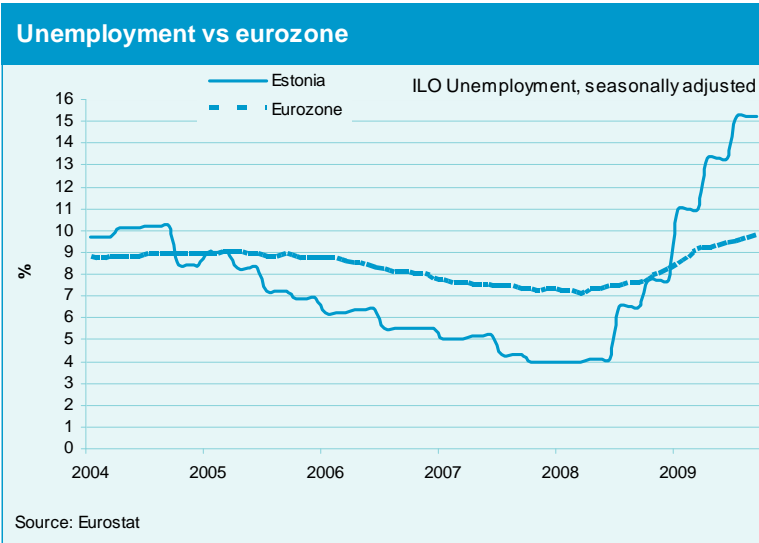


One year of deflation after years of rapid inflation



Government restraint to keep deficit below 3% of GDP





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