

Estonia

Deep recession but worst may be over

‘The Estonian recession is deep. Real GDP will shrink by 14.8% in 2009, and 2.8% the year after. Domestic demand has plummeted while exports have been hit by the global slowdown.’

‘The export markets will drive the recovery while investment encourages employment and spending growth in the domestic economy.’

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



Key business prospects

RECENT TRENDS	Real GDP fell by 3.4% in 2009q2, -16.1% year-on-year.
BUSINESS PLANNING ASSUMPTIONS	Monetary policy is dictated by a currency board. Eurozone entry is one of the governments key aims but the date of accession is uncertain.
2-YEAR OUTLOOK	Deep domestic downturn. Recovery led by trade and foreign investment. Key risk: Deflation, low confidence and a growing fiscal deficit that limits government stimuli.
LONGER-TERM OUTLOOK	Economic growth around 4.2% per annum. Key risk: Eurozone accession delayed, with negative impact on foreign direct investment.
CONSUMER	Consumption picks up from 2011 but does not reach the same pace as the previous decade. Key risk: Sluggish job creation keeps unemployment high while credit unavailability limits consumption.
TRADE	Current account surplus in short term and small and sustainable deficit in the long-run. Key risk: Doubts over currency peg.
INFLATION	Deflation in short term and more moderate inflation in the long-term. Key risk: Strong wage growth and bounce back sees inflation prevent euro-entry until 2015. Or deflation in the short-term delays recovery
LABOUR MARKETS	Sharp rise in unemployment but population dynamics ensure long-term prospects are good. Key risk: Emigration keeps labour market tight, driving wages up and competitiveness down.
GOVERNMENT	Perilous position currently but surpluses return from 2012. Key risk: Government debt spirals.

Estonia	08	09	10	11	12-16
National accounts (% change, real terms)					Avg
GDP	-3.6	-14.8	-2.8	2.6	4.2
Consumer spending	-3.8	-13.1	-5.8	1.4	4.1
Investment	-10.4	-25.0	-8.0	3.8	5.4
Government	4.4	-8.1	-4.7	0.9	1.3
Exports	-1.1	-17.1	-1.9	5.6	6.5
Imports	-7.9	-18.4	-6.4	4.4	6.0
Other indicators					
Employment (% change)	0.0	-8.0	-3.0	0.5	0.9
Unemployment (% workforce)	5.5	15.0	14.4	10.0	5.3
Consumer prices (% change)	10.6	-0.5	0.3	1.8	3.3
Fiscal balance (% GDP)	-3.0	-3.4	-3.7	-2.8	1.5
Current account balance (% GDP)	-9.1	0.5	1.8	-1.2	-1.8
3 m Talibor (% p.a.)	6.7	5.8	4.5	4.0	4.5
10 yr bond yield (% p.a.)	8.2	8.3	7.8	7.3	7.4
Exchange rate (EEK per €)	15.65	15.65	15.65	15.65	15.65

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Forecast closing date: **May 31st 2009**

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 eurozone rates being slashed and the credit crunch gradually easing, rates in Estonia have fallen from over 6.6% to near 5.6% so far in 2009. We expect rates to fall further.

KEY RISK: Inter-bank lending rates stay high despite low European Central Bank rates.



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: If Latvia devalue there will be increased pressure to follow suit

Forecasts

	Dec 08	Dec 09	Dec 10	Dec 13
3m TALIBOR	6.24	5.15	4.25	4.80

Forecasts

	2008	2009	2010	2013
EEK per € (y/e)	15.65	15.65	15.65	15.65
EEK per US\$ (y/e)	10.63	11.42	11.68	11.59

Consumers suffering amid recession

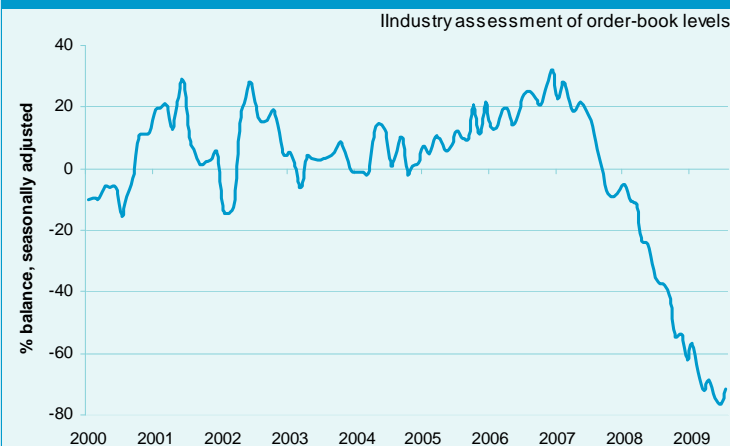
- The economy has endured 6 quarters of contraction. The end of the foreign-financed credit bubble left consumers, investors and exporters with no confidence or liquidity.
- Compared to a year earlier activity was down 16.1% in 09q2 but quarter-on-quarter the contraction was less severe (-3.4% compared to -6.1% in q1). All sectors have suffered from weak domestic demand and a poor external environment. Value-added in manufacturing and construction shrunk by 31%.
- The latest surveys have been slightly more positive but the index of production still shows activity down 28% y-o-y. Retail sales were down 3% in July compared to June (-16% y-o-y), as a 5% fall in manufactured goods outweighed the +4% in grocery stores.
- By the end of the second quarter, ILO unemployment had reached 17% (up from 9.7% in January) and gross wages had fallen by 4.4% y-o-y having declined for the first time since 1993 in the first quarter. Activity has also slowed sharply in the housing market. The number of transactions fell by a third year-on-year and the value of those by 58%. The only positive for the consumer has been falling prices but this could prolong the downturn if deflation is built into expectations.
- The government still hopes to adopt the euro from January 2011 and is slashing spending in an attempt to avoid exceeding a fiscal deficit of more than 3% of GDP.

Prices falling as demand side pressures weaken



Source: Eurostat

Order-book levels offer scant hope of quick recovery

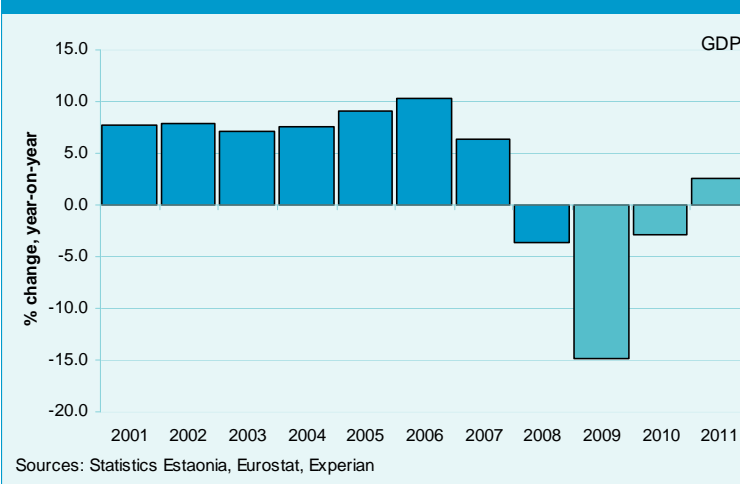


Source: European Commission

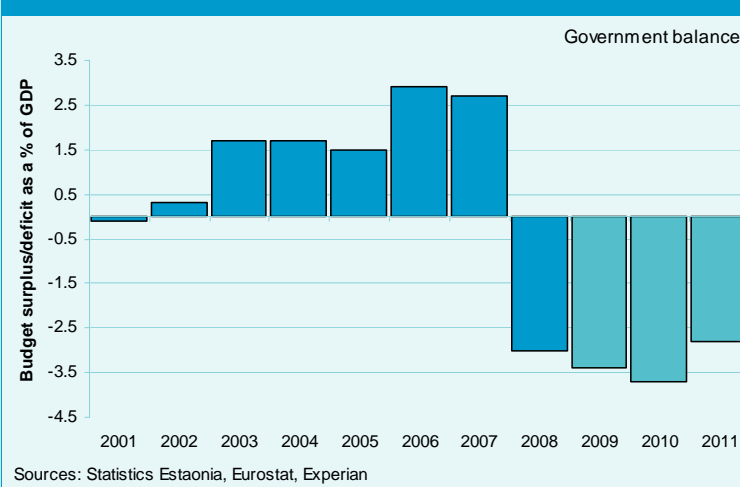
Exports will lead a slow recovery

- Extremely weak business and consumer confidence portray the grim situation, despite a slight pickup over the last few months. We expect the economy to continue shrinking albeit at a more modest rate. For 2009 as a whole, GDP will shrink by 14.8% with investment contracting by 25%, consumer spending by 13% and exports by 17%.
- With global conditions brightening and a period of low inflation bolstering competitiveness, some of Estonia's main trading partners, notably [Russia](#), [Scandinavia](#) and [Germany](#) (*check that its consistent with other GF forecasts*) will help exporters lead the recovery. Domestic demand will be more sluggish, falling by a further 6.3%, as unemployment remains high and investor confidence low. We expect real GDP to contract by 2.8% in 2010. Thereafter, confidence begins to return, but slow job creation and subdued wage growth limit consumer spending. Modest growth of 2.6% will return in 2011.
- In order to keep the budget deficit in check, fiscal spending will fall sharply. With benefits rising sharply and tax revenues plummeting, the €550m loan from the EIB will provide a useful stimulus. One positive to emerge from the recession will be the correction on the current account. With a two-year period of low inflation boosting exports and import demand shrinking, Estonia will record a current account surplus for the first time since 1993.

Recovery will be slow



Government accounts under pressure



'Silicon Valley' on the Baltic

- One of the fastest growing economies in Europe until 2008, Estonia took advantage of strong financial links to Scandinavia and its proximity to Finland in particular. Ports that are ice-free year round have also made Tallinn an important entrepôt for trade with Russia.
- Manufacturing is key, employing over 20% of the workforce and accounting for 17.8% of output in 2008. It's linguistic ties with Finland make it a good destination for 'nearshoring' and acting as a back office for other Nordics. This is more than just call centres, however, with foreign companies setting up research & development facilities. For instance, Estonian software engineers were instrumental in the development of Skype, the online telephony software.
- In terms of employment, distribution & retail and construction both employ more than 10% of the workforce, with the latter benefitting from a building boom in recent years. Transport & communications is also important given Estonia's role in transiting goods between Russia and western Europe.
- During the recession these sectors have been suffering the most, as exports and investment collapse. Business services will also fare badly as international inflows dry-up. However, from 2011 we expect a return to trend with services gradually gaining share from a manufacturing sector gradually converting to higher value-added goods.

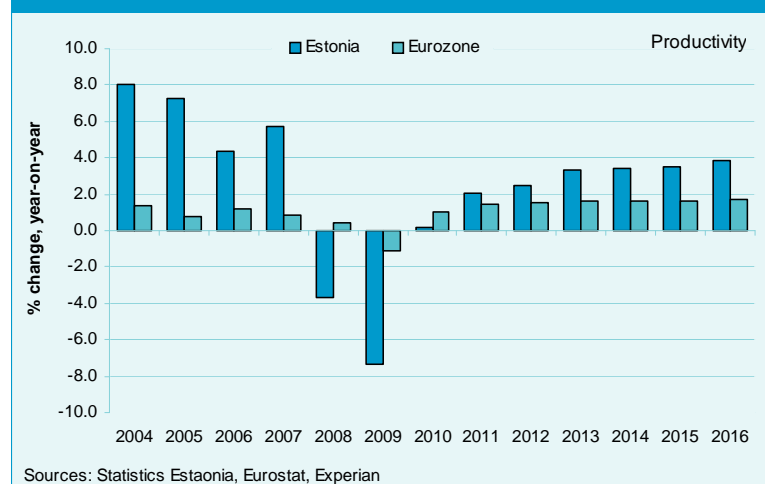
Estonia	Structure		Growth		
	08	08	09	10	12-16
Employment					Avg
Agriculture	4.1	-12.8	-9.2	-1.4	-3.7
Mining & Utilities	2.3	7.3	-8.4	-5.2	-1.2
Manufacturing	20.8	3.1	-20.2	-2.7	0.7
Construction	11.0	-2.5	-16.2	-2.8	1.0
Distribution & retail	13.5	-0.1	-4.8	-2.6	1.1
Hotels & catering	3.4	-0.8	-3.2	-2.8	1.3
Transport & communications	8.9	1.7	-2.7	-3.5	2.6
Financial services	1.3	-0.5	-3.6	-3.5	3.5
Business services	7.8	-1.6	-7.0	-3.5	2.6
Other services	5.7	0.4	-1.9	-5.4	0.7
Public administration	6.3	0.2	-0.7	-0.7	-1.6
Education	9.0	-0.3	1.1	-4.6	1.0
Health	5.8	1.8	3.6	-1.7	0.7
Total	100.0	0.0	-8.0	-3.0	0.9
Gross Value Added					
Agriculture	2.9	6.3	-5.3	-0.2	1.7
Mining & Utilities	3.8	-7.4	-11.8	-4.4	1.7
Manufacturing	17.8	-4.0	-24.8	-5.5	4.2
Construction	8.0	-6.0	-16.3	-3.0	3.2
Distribution & retail	15.0	-8.0	-17.3	-3.4	4.7
Hotels & catering	1.7	-4.5	-9.1	-3.5	5.8
Transport & communications	11.5	-5.7	-9.5	-2.1	6.4
Financial services	4.7	-3.6	-10.8	-2.2	6.5
Business services	18.3	-0.5	-17.8	-2.3	4.6
Other services	3.5	1.5	-8.5	-1.6	4.0
Public administration	5.3	6.7	-4.6	-1.2	1.7
Education	4.3	1.4	-5.6	-2.1	2.3
Health	3.1	0.2	-3.3	-0.2	2.0
Total	100.0	-3.2	-14.8	-2.8	4.2

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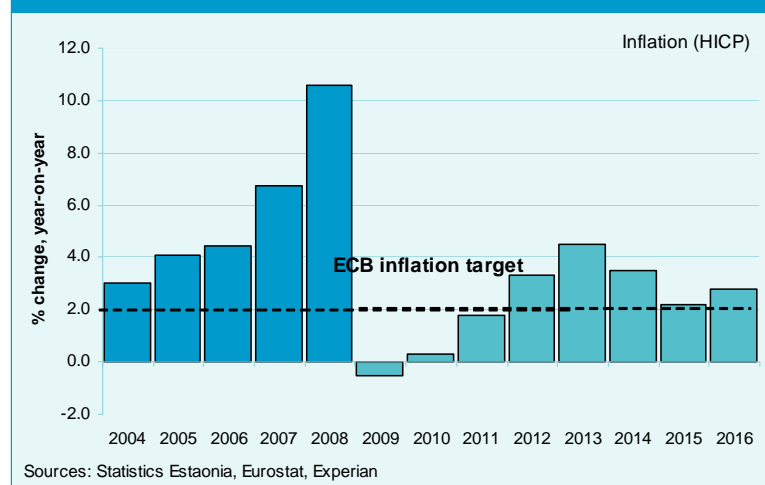
Euro-entry the ambitious aim

- After a sluggish start to the recovery, output will pick up from 2011. With confidence rising, credit markets loosening and export markets growing, Estonia will regain its attractiveness to investors looking to take advantage of a productive workforce with wages that are still below western levels.
- With investment and global trade leading the recovery, job creation will resume and spending will pick up. 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 4.2% per annum over the period 2012-16.
- 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.
- Once the government has weathered the current storm, the fiscal balance should move back into surplus over the long run with the government wary of jeopardising eurozone entry by exceeding a deficit of 3% of GDP. The other concern is a bounce in inflation as the recovery takes off, forcing Estonia to wait until around 2015-16 for euro-entry.

Productivity gains attract investors



Inflation bounce delays eurozone entry



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