Estonia

Thoughts turn to recovery

‘The recession has been deep. Real GDP will shrink by 14.8% in 2009, and 1.2% the year after. Domestic demand has plummeted while exports have been hit by the global slowdown.’

‘However, the latest quarter of national accounts data and more up-to-date survey evidence suggest the economy will begin expanding in 2010.’

‘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.’

Global Futures
Country Report

Q4 2009

Key business prospects

RECENT TRENDS	Real GDP fell by 2.8% in 2009q3, -15.3% year on year.
BUSINESS PLANNING ASSUMPTIONS	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.
2-YEAR OUTLOOK	Worst looks to be past. Recovery from deep downturn led by trade and investment. **Key risk:** Low confidence and a growing fiscal deficit that limits government stimuli.
LONGER-TERM OUTLOOK	Economic growth around 4.4% 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**: Unemployment remains high while credit unavailability limits consumption.
TRADE	Current account surplus in short term and small and sustainable deficit in the long run. **Key risk**: Productivity does not match wage growth, undermining competitiveness.
INFLATION	Deflation in short term and more moderate inflation in the long-term. **Key risk**: Deflationary expectations in the short term delay 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	Relatively good position after decisive government action. Small deficit turns to surplus. **Key risk**: Low receipts sees debt build up.

Estonia	08	09	10	11	12-16
National accounts (% change, real terms)					Avg
GDP	-3.6	-14.8	-1.2	3.7	4.4
Consumer spending	-3.8	-13.1	-4.0	1.7	4.1
Investment	-10.4	-25.0	-8.0	3.8	5.4
Government	4.4	-8.1	-4.9	0.9	1.3
Exports	-1.1	-16.0	-1.0	5.9	6.5
Imports	-7.9	-22.5	-5.0	4.2	6.0
Other indicators					
Employment (% change)	0.2	-8.0	-2.0	2.8	1.5
Unemployment (% workforce)	5.5	15.0	15.5	11.0	5.6
Consumer prices (% change)	10.6	-0.5	0.3	2.1	2.9
Fiscal balance (% GDP)	-2.7	-3.4	-3.0	-2.8	1.5
Current account balance (% GDP)	-9.5	3.6	1.8	-1.2	-1.8
3 m Talibor (% p.a.)	6.7	5.4	3.5	4.0	7.2
10 yr bond yield (% p.a.)	8.2	7.5	5.5	6.5	7.4
Exchange rate (EEK per €)	15.65	15.65	15.65	15.65	15.65

Forecast closing date: December 2nd 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 the threat of devaluation fading rates in Estonia have fallen from over 6.6% to just below 4% so far in 2009. We expect rates to fall further, before rising again in response to tightening by the major central banks.

KEY RISK: Inter-bank lending rates rise rapidly again

Forecasts

	Dec 08	Dec 09	Dec 10	Dec 13
3m TALIBOR	6.24	3.50	3.75	4.50

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 devalues there will be increased pressure to follow suit

Forecasts

	2008	2009	2010	2013
EEK per € (y/e)	15.65	15.65	15.65	15.65
EEK per US$ (y/e)	10.63	10.79	10.87	11.10

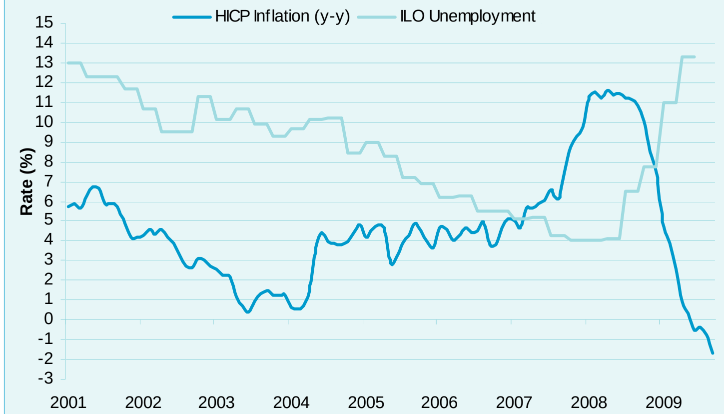
Turning the corner but a long way to go

- The economy has endured seven quarters of contraction following the implosion of a foreign-financed credit bubble. Real GDP fell 15.3% year on year in 2009q3 and domestic demand is still weak. The contraction in financial intermediation and wholesale & retail trade deepened while activity in the construction sector fell by 31%. However, the downturn has started to ease in the external sector. Imports fell by 2% compared with 2009q2 and exports declined by just 1%. Quarter on quarter, GDP shrunk by 2.8%, compared with falls of 6% and 3.4% in the preceding two quarters.

- Survey evidence suggests that activity is still depressed, although conditions are improving. The index of production was down 30% y-on-y in September but against August the decline was 2%. Retail sales volumes fell by 2% q-on-q in September (-17% y-on-y), but deflation pushed values down 7% (-23% y-on-y).

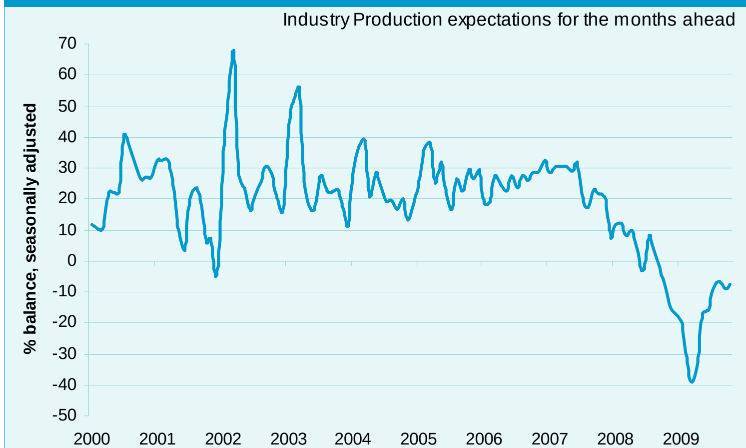
- ILO unemployment has hit 14.6%. However, despite minimal activity in most industries, employment increased by 0.9% over the three months to September. At the two extremes, gross wages in utilities rose by 2.7% while in construction they fell by 13.8%. Real estate transactions were down 2% and average prices were 36% lower than in 2008. Prices elsewhere have also been falling and the HCIP measure showed inflation at -2.2% in October. An extended period of deflation could prolong the downturn if it is built into expectations. However, deflation is a necessary consequence of maintaining the exchange rate peg.

Unemployment still rising. Deflation continues



Source: Eurostat

Confidence beginning to return



Source: European Commission

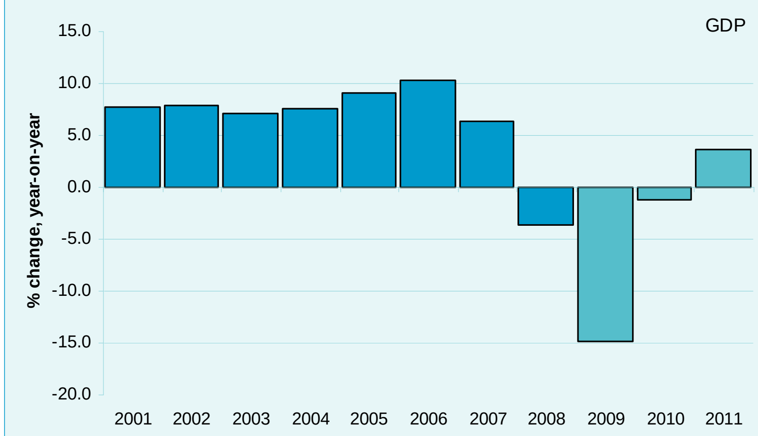
Exports will lead a slow recovery

- Despite a slight pickup over the last few months, the latest surveys are still in negative territory. We expect the economy to continue to shrink for the rest of 2009, albeit at a more modest rate. For the year as a whole, GDP will contract by 14.8% with investment falling by 25%, consumer spending by 13% and exports by 16%.

- With global conditions brightening and a period of deflation bolstering competitiveness, some of Estonia's main trading partners, notably Russia, the Nordics and Germany will help exporters lead the recovery. Domestic demand will be sluggish, falling by a further 4.4% in 2010, as unemployment remains high and wage growth depressed. We expect real GDP to contract by 1.2% in 2010. Thereafter, investor confidence begins to return and, together with exports drive GDP growth of 3.7% in 2011.

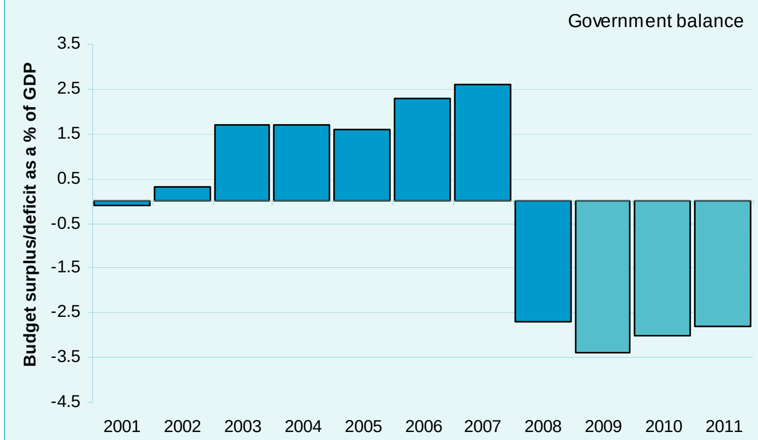
- In order to keep the budget deficit in check, fiscal spending has fallen sharply with temporary and permanent measures. The public sector has been subjected to wage cuts, changes to pensions and job cuts. With lower revenues, indirect and direct taxes have both been raised and could be increased again over the next few years. The €550m loan from the EIB will provide a useful stimulus. One positive to emerge from the recession has been the correction on the current account and Estonia will record a current account surplus in 2009 and 2010, for the first time since 1993.

Recovery gathers pace only in 2011



Sources: Statistics Estaonia, Eurostat, Experian

Government accounts under pressure



Sources: Statistics Estaonia, Eurostat, Experian

‘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

Euro-entry the main aim

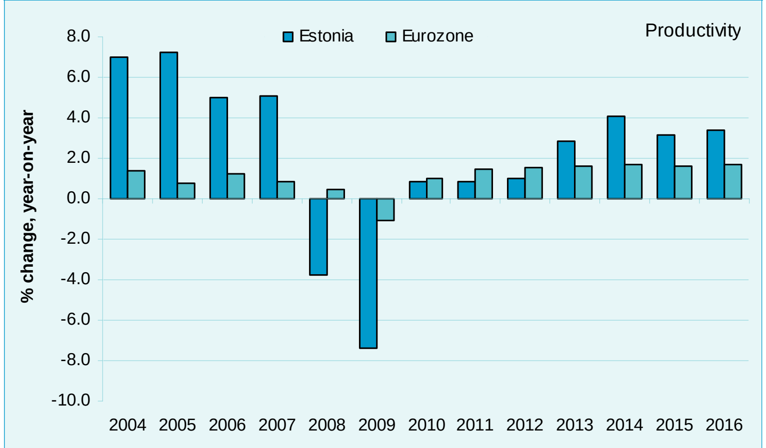
- After a sluggish start to the recovery, confidence will begin to rise, credit markets will loosen and export markets thrive. Estonia will regain its attractiveness to investors looking to take advantage of a productive workforce with wages that are still below western levels.

- 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.

- 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.

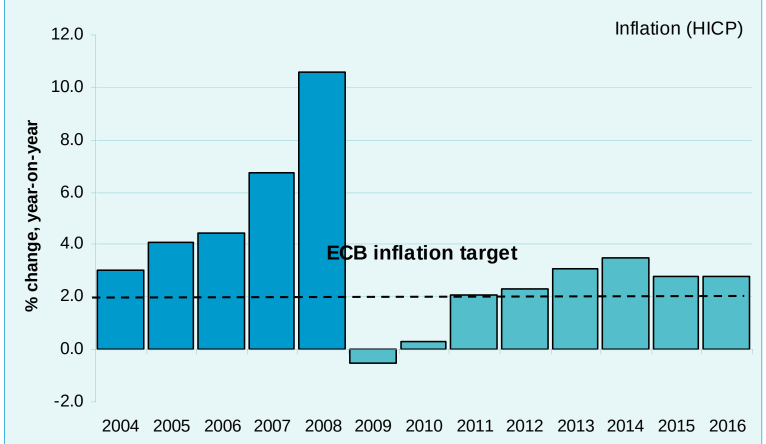
- Once the government has weathered the current storm, the fiscal balance should move back into surplus with the government wary of jeopardising eurozone entry by exceeding a deficit of 3% of GDP. The government's stated aim is eurozone entry in January 2011. However, if it fails to meet the criteria, of which the budget deficit is the main concern at present, a bounce in inflation as the recovery takes off could delay entry until around 2015-16.

Productivity gains attract investors



Sources: Statistics Estaonia, Eurostat, Experian

Inflation bounces with domestic recovery



Sources: Statistics Estaonia, Eurostat, Experian

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