Estonia

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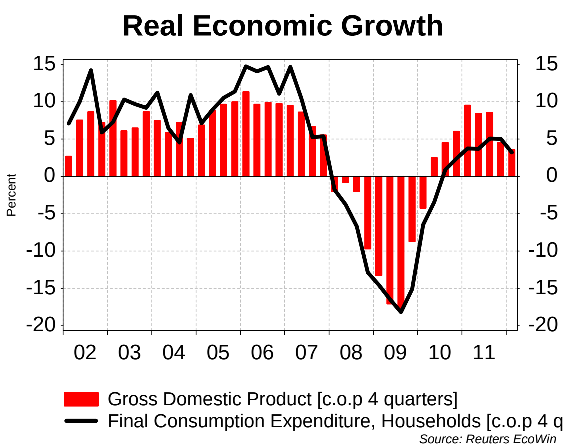
Country Risk Factors: Estonia

Strengths	Weaknesses
• Strong growth potential	• Low income per capita
• Healthy public finances	• Small economy susceptible to shocks
• Large net FDI inflow	• Somewhat high inflation & wage pressure
• Small current account surplus	• Declining population & emigration
• Euro membership	• High external debt service
• Good governance record / low corruption	• Lingering banking sector weakness

Summary: *Estonia's handling of the crisis following the bursting of its credit and construction bubbles is in many respects a paragon of success. Real GDP rebounded by a robust 7.5% in 2011. The fiscal accounts remain healthy with government debt reaching only 11% of GDP in 2012 (driven by commitments to the European Stability Mechanism). Exports jumped by more than 30% in both 2010 and 2011, and unemployment (ILO) fell to 11.5% in Q1 2012 from 19.8% in Q1 2010. Registrations of new limited companies have also surged, a sign of Estonia's strong governance record and relatively low corruption. Nevertheless, as a small open economy reliant on electronics exports, the next year or two will be challenging. Exports plunged by 7.2% y/y in April 2012. Competitiveness is being pressured by high inflation, low productivity growth, rising wage expectations, and emigration.*

Country Risk Analysis

Estonia has won widespread plaudits for its handling of the 2007-2009 economic crisis and the subsequent economic recovery, with real GDP expanding by 2.3% in 2010 and 7.5% in 2011. Growth — driven by government spending on infrastructure development — slowed to 3.6% y/y in the first quarter of 2012, due to flagging external demand, and looks set to average 1.5% for the year as a whole. However, this forecast is subject to



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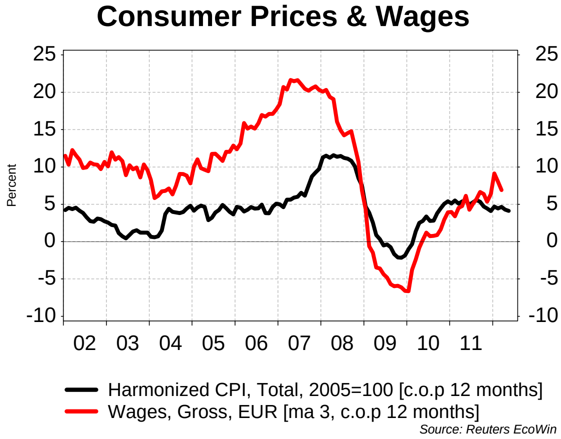
considerable uncertainty, due to the ongoing crisis in the euro zone, which could hurt Estonia if Germany and the Nordic countries (Estonia's main trading partners) slow more than anticipated.

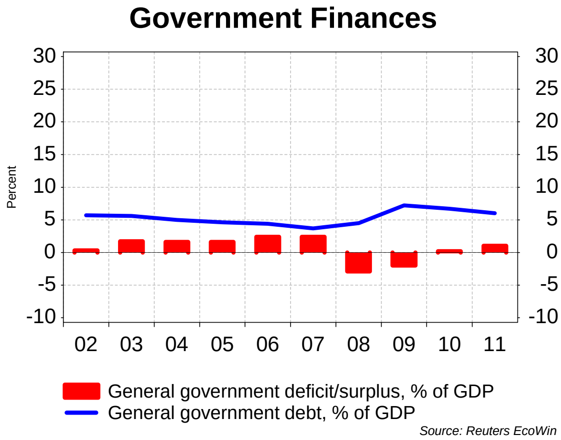
The underlying growth potential of the country is strong as a result of a high investment level of almost 22% of GDP in 2011 and high-quality institutions governing the macroeconomic and political environment. Estonia scores consistently in the top 25th percentile in both the World Bank's Governance Indicators and the World Economic Forum's Global Competitiveness Report.



Inflationary pressure remains a concern. Consumer price inflation has trended downward after peaking at 5.6% (EU harmonised rate) in August 2011, hitting 4.1% in May 2012. Price increases have been driven by high energy and food costs, which together with weakness in the euro will likely keep inflation close to 4% in 2012. Removal of electricity subsidies and deregulation of the electricity market in January 2013 look likely to keep inflation elevated next year. Inflation is unlikely to fall sharply also because of rising wage pressure arising from skills mismatches in the labour force and pent up demand from households.

Registered unemployment has come down sharply to 6.6% in May 2012, after peaking at 14.7% in March 2010. Nevertheless, long-term, or structural unemployment may become an increasing problem, unless the government can stimulate education and vocational training.

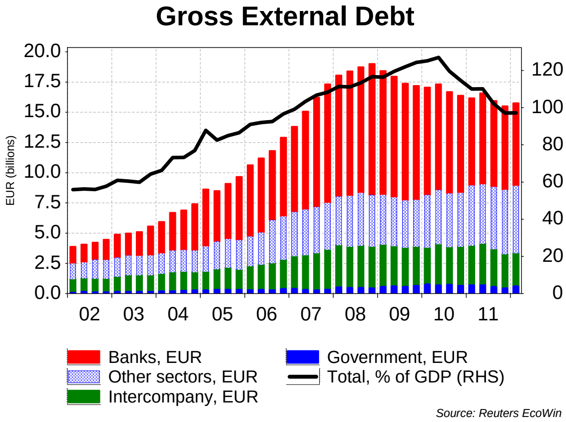
A long-term challenge is the declining and ageing population. The population has shrunk by 8.5% since 1998. The finance ministry estimates that emigration has reduced the potential workforce by 5%-10%, which in the short term may relieve the unemployment problem, but in the longer term may make Estonia less attractive for investors as young, flexible, and educated workers move to Finland, Sweden, and the UK.



Public finances stand out as an area of strength in Estonia's risk profile. The government has managed to keep its budget deficit within 3% of GDP since 1999 (when, after the Russian crisis, it reached 3.5% of GDP), posting a surplus of 1% of GDP in 2011. The government is forecasting a moderate deficit of 2.6% of GDP in 2012, as one off revenues from selling carbon dioxide emission quotas under the Kyoto protocol in 2011 fall out of the budget and investment spending (in infrastructure and energy projects) are implemented. In addition, a resumption of payments into the pension scheme will also weigh on the budget. As a small and open economy sensitive to swings in external demand, the government is aiming to return to a structural budget surplus by 2013 to rebuild its rainy day funds currently standing at 3% of GDP (or 9.9%, according to the government's definition).

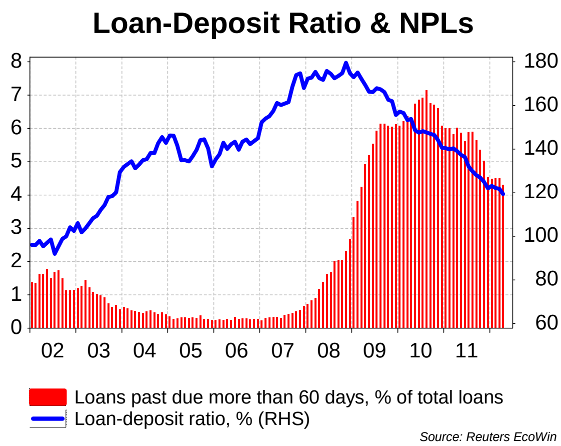
Gross government debt is low at 6% of GDP. Although it will likely jump to roughly 11% of GDP, primarily as a result of Estonia's contribution to EFSF and ESM, it remains low compared to peers. The ESM is controversial in Estonia, with both government representatives — the Estonian Chancellor of Justice argues that emergency voting provisions in the ESM are in conflict with the Estonian constitution — and the public bristling at the prospect of bailing out richer countries.

A high need for external financing reflects relatively high private sector external debt. S&P estimates that gross external payment needs (imports, dividends, and interest payments, as well as short-term external debt, maturing long-term debt, and non-resident deposits) will exceed external income and reserves by roughly 30%. Assuming a gradual, or even a weak economic recovery in the euro zone and the Nordic countries, the shortfall should not pose a problem as it would be covered partly by capital support from parent banks' primarily in Sweden in addition to foreign direct investment (FDI). Estonia has received a healthy net inflow of FDI (7.7% of GDP in 2011) since the crisis.



The correction in the current account from a deficit of 16% of GDP in 2007 to a surplus of 3% in 2011 is positive. However, the current account surplus is narrowing and exports are falling (by 7.2% y/y in April 2012). We expect FDI to support export growth in the coming years, which should keep the current account deficit manageable. However, if inflation remains above the rest of the euro zone and productivity growth falters, the current account may deteriorate further. A key test of Estonia's economic rebalancing since the crisis will be how the current account develops when growth picks up in 2013 and 2014.

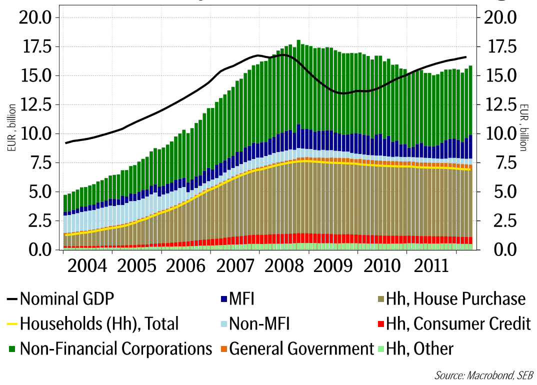
The banking sector is strengthening, but remains reliant on parent bank funding. Swedish banks own roughly 90% of the Estonian banking system. Banks have made significant progress on repairing their balance sheets. Non-performing loans (more than 60 days overdue) were 4.3% of total loans (down from a peak of 7.1% in August 2010), while provisions were 80%, in April 2012. With house prices having stabilised and even increased somewhat after falling by around 45% between 2007 and 2009, the downward trend in



NPLs looks likely to continue. The capital adequacy ratio is very high at more than 20%, up from 10% in 2006.

Nevertheless, S&P estimates contingent liabilities to be high at 35% of GDP resulting from lingering weaknesses including a relatively high share of commercial real estate and mortgage lending, which account for a high 60% of banks' loan portfolios. Total household borrowing accounts for almost 45% of total lending, while loans to (non-financial) corporations account for 38%.

Estonia: Monetary Financial Institutions Lending



In addition, total lending has fallen to 100% of GDP from around 110% in 2008. The loan-deposit ratio has come down to 120% in April 2012 from almost 180% in November 2008, but remains high. While Swedish parent banks remain relatively healthy, a deepening of the crisis in the euro zone (implying a Europe-wide interbank credit freeze) and/or a sharp fall in housing prices in Sweden could squeeze funding and availability of capital for Estonian banks.

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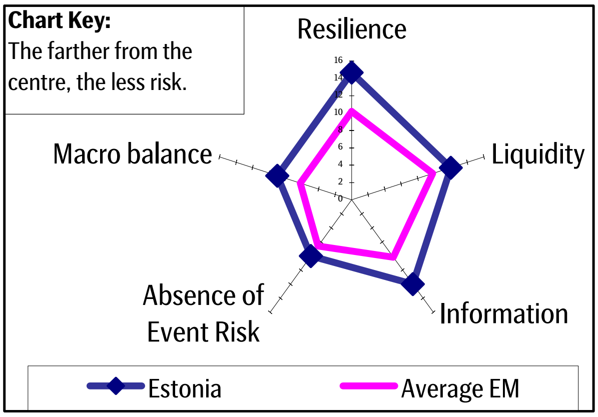
Estonia: Risk Profile

Key Figures	**2012**
Population (millions)	1.3
GDP/capita ($)	16,416
Real GDP (% chg)	1.5%
Inflation (%)	3.8%
Curr.Acc. Balance (% of GDP)	1.2%
Reserves/imports (months)	0.7
Budget balance (% of GDP)	-2.7%
Government debt (% of GDP)	7.6%

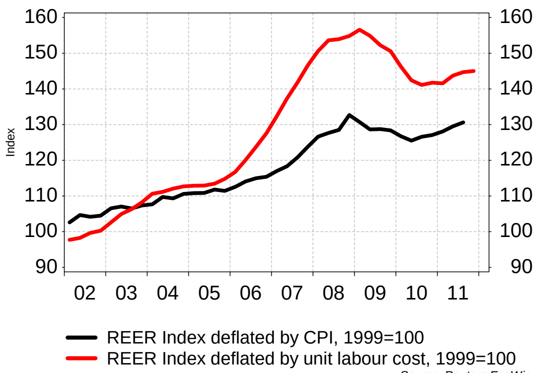


External ratings:
Fitch: A+ / Stable
Moody's: A1 / Stable
S&P: AA- / Negative

Peers:
Latvia
Lithuania
Poland

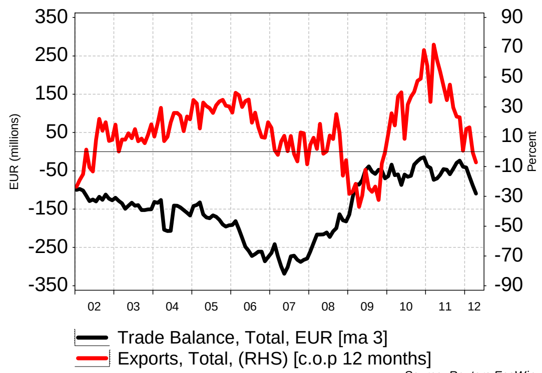
Graph: Estonia outperforms the average score of our emerging market economies on all counts. The relatively poor scoring on event risk reflects the small economy and resulting potential volatility.

Real Effective Exchange Rate



Source: Reuters EcoWin

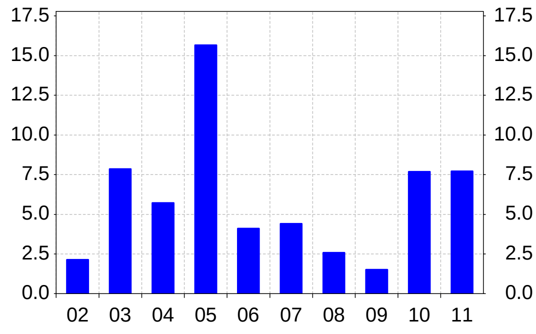
Exports & Trade Balance



Source: Reuters EcoWin

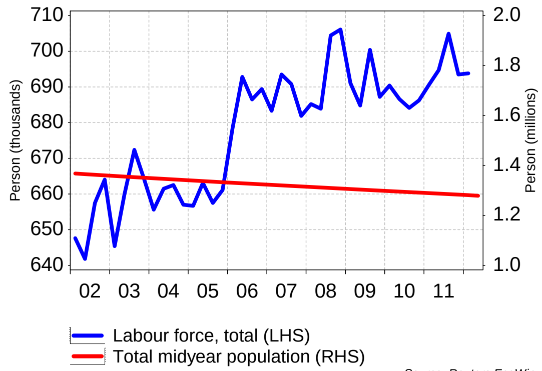
Net Foreign Direct Investment

(Percent of GDP)



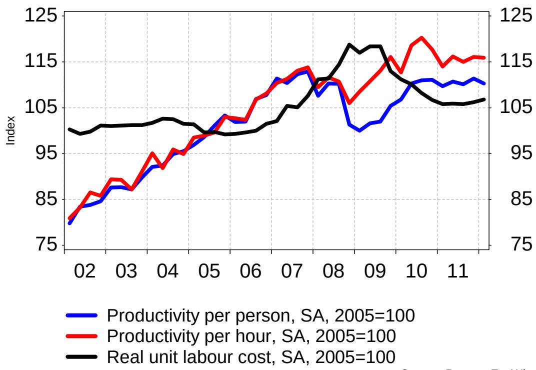
Source: Reuters EcoWin

Population & Labour Force



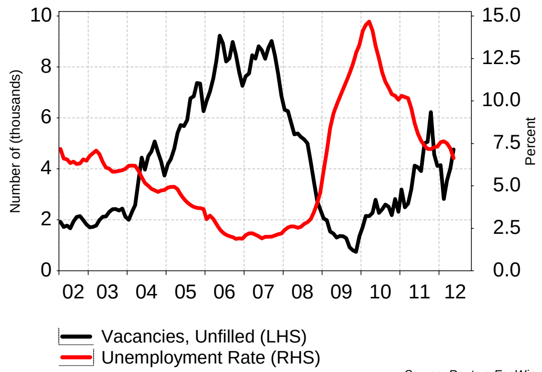
Source: Reuters EcoWin

Labour Productivity & Cost



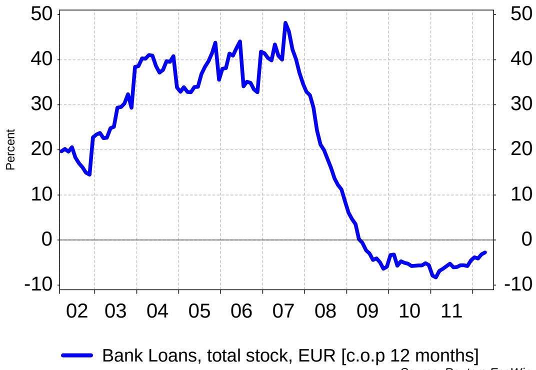
Source: Reuters EcoWin

Unemployment & Vacancies



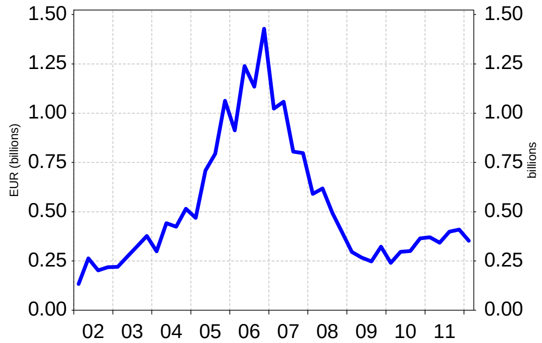
Source: Reuters EcoWin

Bank Lending Growth



Source: Reuters EcoWin

Value of Real Estate Sale Contracts



Source: Reuters EcoWin

ESTONIA: ECONOMIC INDICATORS*

Table I: Macroeconomic	2008	2009	2010	2011	2012	2013	2014
Real GDP Growth (%)	-3.7	-14.3	2.3	7.6	1.5	3.5	4.8
GDP, nominal (US$; Bil.; SA)	23.9	19.2	19.0	22.2	21.9	23.3	24.2
Population, total (mil)	1.3	1.3	1.3	1.3	1.3	1.3	1.3
GDP per capita at PPP (2005 US$)	19,046	16,334	16,703	18,006	18,302	18,969	19,906
GDP, per capita, nominal (US$; SA)	17,796	14,354	14,145	16,616	16,416	17,466	18,197
Labour productivity growth (%)	3.5	6.0	-3.9	-5.5	6.7	0.9	1.0
Unemployment rate (%)	5.5	13.8	16.9	12.5	11.4	9.9	8.2
Total fixed investment (% of GDP)	29.7	21.5	18.8	21.5	22.2	22.9	23.6
National savings (% of GDP)	21.6	23.2	23.9	25.3	24.5	23.5	23.3

Table II: Money & Prices	2008	2009	2010	2011	2012	2013	2014
Consumer price index (% y/y)	10.4	-0.1	3.0	5.0	3.8	2.6	2.2
Money supply, M2, Growth (%)	6.2	0.8	3.0	6.9	5.4	6.2	7.1
Private sector credit growth (%)	--	--	--	--	--	--	--
Interest rate, short-term (%)	6.7	5.9	1.6	1.5	0.8	0.9	1.9
Minimum bid rate ECB (%)	3.7	1.1	1.0	1.2	1.0	1.0	1.6
Exchange rate, average (US$ per euro)	1.5	1.4	1.3	1.4	1.3	1.3	1.3
Real exchange rate index vs US$ ('90=100)	213.4	198.6	189.2	201.9	192.4	192.7	187.5
Share price index (% chg)	-63.0	47.2	72.6	-23.9	9.6	10.7	11.3

Table III: Government Finances	2008	2009	2010	2011	2012	2013	2014
Gross government debt (% of GDP)	4.5	7.2	6.7	5.2	7.6	8.8	8.5
Gen. government debt (% of revenue)	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Government budget balance (% of GDP)	-2.9	-2.0	0.3	0.8	-2.7	-1.6	-0.3
Government expenditure (% of GDP)	39.5	45.2	40.6	37.8	38.4	37.7	36.3
Interest expendit (% of Govt revenue)	4.1	7.5	7.6	7.1	7.7	7.5	7.0
10-Year Govt Bond Yield (%)	--	--	--	--	--	--	--

Table IV: Balance of Payments (US$; Bil.)	2008	2009	2010	2011	2012	2013	2014
Current account (% of GDP; SA)	-9.7	3.7	3.6	3.2	1.2	-0.3	-0.4
Current account	-2.3	0.7	0.7	0.7	0.3	-0.1	-0.1
Merchandise trade balance	-3.1	-0.8	-0.3	-0.3	-0.6	-1.0	-1.2
Exports, goods, nominal	12.6	9.1	11.6	16.8	19.4	21.1	23.4
Imports, goods, nominal	15.7	9.9	12.0	17.1	20.1	22.1	24.7
Services trade balance	1.8	1.9	1.7	1.7	1.8	2.0	2.2
Transfers, net	0.3	0.3	0.3	0.4	0.3	0.2	0.2
Interest, profit, and dividends, net	-1.3	-0.7	-1.1	-1.2	-1.2	-1.2	-1.2
Capital account	2.6	-1.3	-2.2	-1.3	1.0	1.4	1.5
Foreign direct investment, net	0.6	0.3	1.4	1.7	1.6	1.7	1.8
Foreign direct investment, inward	1.7	1.9	1.5	1.8	1.8	1.9	2.0
Non-FDI net capital flow	1.9	-1.6	-3.6	-3.0	-0.6	-0.3	-0.3

Table V: External Debt & Liquidity	2008	2009	2010	2011	2012	2013	2014
External debt, total (% of GDP)	111.4	129.7	116.1	91.1	90.5	85.6	82.7
External debt, total (% of exports)	157.3	200.4	146.2	98.3	85.0	79.3	71.8
External debt, total (US$; Bil.)	26.6	25.0	22.0	20.3	19.9	19.9	20.1
External debt, short-term (US$; Bil.)	9.4	8.9	7.8	7.2	7.1	7.1	7.1
External debt, government (US$; Bil.)	--	--	--	--	--	--	--
External debt, private (US$; Bil.)	--	--	--	--	--	--	--
Debt service requirement (% of exports)	32.0	40.6	29.5	19.8	17.1	15.9	14.4
Foreign debt repayments (US$; Bil.)	5.4	5.1	4.4	4.1	4.0	4.0	4.0
Reserves, excl. gold (US$; Bil.)	4.0	4.0	2.6	0.2	2.7	5.4	8.1
Reserves (months of import cover)	3.0	4.7	2.5	0.1	0.8	1.5	2.0

** Source: Oxford Economics, Global Economic Model, May 2012, unless otherwise indicated.*

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