Estonia

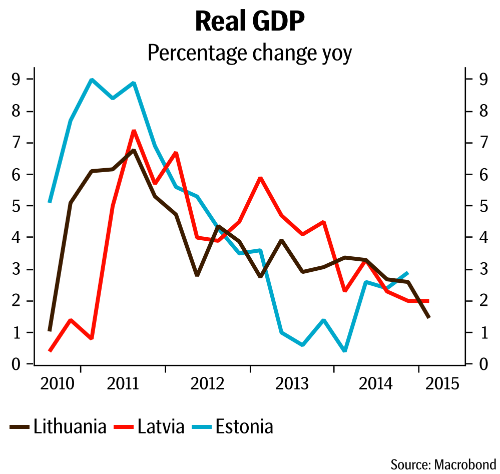
SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS May 18, 2015

Analyst: Martin Carlens. Tel : +46 8 763 9605. E-mail : martin.carlens@seb.se

The economy gathered pace in 2014 despite weaknesses among the country's main trading partners as domestic demand was firm. Fiscal and external accounts are more or less balanced and the political situation relatively stable. The shrinking labour force contributes to relatively high wage increases which may pose a risk to longer-term competitiveness.

Country Risk Analysis

Gradual growth acceleration in 2014. Following an acceleration in the second half of the year, economic in 2014 surprised most observers on the upside contrary to the weaker than expected performance in 2013. Household consumption was a steady driver of growth on the back of healthy increases in real wages and low interest rates. However, weak foreign demand and falling public investment limited the expansion of real GDP to 2.1%, up from 1.6% in 2013. While overall exports were as weak as in 2013, the fall in exports to Russia on the back of the trade embargo and weaker demand was offset by rising exports to the EU. The soft patch in growth should extend through a large part of 2015.



Tight labour market. Wage growth has been solid in the past two years as the labour market has been tightening. A continued decline in the working age population contributes to creating supply shortages. While increases in nominal wages slowed in 2014, real wages jumped almost 6% yoy in the final quarter of 2014. As productivity growth has been moderate, unit labour costs have risen rapidly and by far have surpassed pre-crisis levels. Meanwhile, unemployment fell to 7.4%.

Low inflation. Despite tight labour market conditions, inflation has trended downwards, following euro area price developments which are held back by lower food and fuel prices. Harmonized CPI averaged 0.5% last year. In the first months of 2015, price rises have been picking-up in line with Eurozone developments, and headline inflation reached 0.4% in April. House prices have stabilized in the past six months but conditions are very much in place for a re-acceleration in price increases.

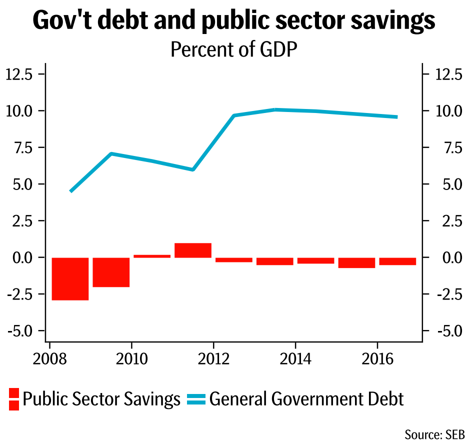
Current account broadly in balance. After the crisis, the current account balance turned into a solid surplus. However, that has gradually shrunk and since 2012 turned into a deficit of 1-2% of GDP. In 2014, the value of total exports and imports hardly grew at all. This left a small but stable trade deficit. An increase in the services surplus helped bring the current account broadly into balance. Looking ahead, exports are likely to be capped by weak demand in Estonia's main markets Russia and Finland while domestic demand should continue to be robust, thereby producing a current account deficit close to 1% this year.

External debt has declined but remains high. Since the crisis, external debt as a percent of GDP has come down significantly. A small rise in 2014 puts the debt at just below 100% of GDP which is high compared to rating peers. Less than one tenth is debt owed by the government. Roughly one half is on short term and mostly owed foreign parent banks with little motivation to put their subsidiaries under pressure.

Economic policies

Fiscal deficit is still contained. Following two straight years of small deficits, preliminary 2014 data put the general government budget surplus at 0.6% of GDP. This favourable result provides space for a possible loosening of fiscal policy in 2015. Indeed the 2015 budget plans for a modest budget gap of 0.5% of GDP, partly due to reductions in personal income tax rates and higher pensions. We expect a marginally higher deficit.

Despite last year's budget surplus, government debt rose marginally. Estonia's gross government debt has been relatively stable in the past two years, and at 10.6% it is still the lowest among rating peers. The low public sector debt ratio combined with reserves stored in various reserve funds ensures that the government would have no problems financing a moderate budget deficit. The general government holds financial assets in reserve funds that amount to roughly 9% of GDP which can be tapped in case of unexpected budget shortfalls.



Banking sector health is improving. Most of the banking sector is foreign owned with the bulk of financing coming from Swedish parent banks. Estonian banks remain well capitalized and have a low and falling level of non-performing loans. By mid-2014 it hit 1.7%, down from nearly 8% during the global financial crisis. Profitability is rising, with return on assets having returned to pre-crisis levels. Meanwhile, private credit growth in the economy is slowly accelerating, coming from low levels in 2014.

Indebtedness of corporates and households has fallen to moderate levels. Nevertheless, the central bank pushed through a series of new requirements for housing loans that became effective in January 2015. These requirements include a loan-to-value ratio for new loans of 85% and a debt service-to-income limit for new and existing loans of 50%. The new requirements will generally not be binding at this time, but should reduce the risk of an excessive acceleration in household indebtedness.

Political developments

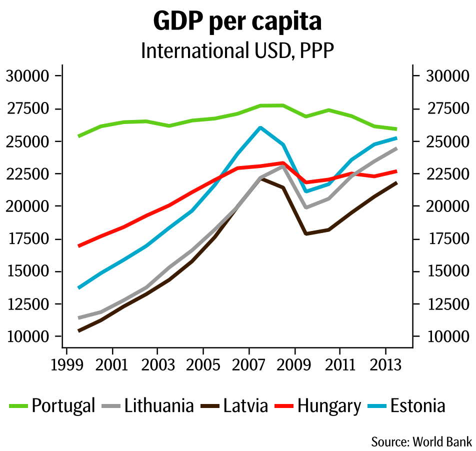
New coalition government. Following elections in March 2015, the ruling Reform Party which gained the most seats in parliament formed a new coalition government with the Social Democratic Party and Pro Patria and Res Publica Union. This centre-right coalition will largely maintain the previous government's political course, focusing on various EU commitments, maintaining a business friendly climate and pursuing prudent fiscal policies. In political terms, Estonia is considered as relatively stable. It scores 64 out of 100 on the World Bank's political stability scale which is strong in view of the country's short track record since independence.

High security uncertainty. Among all NATO members, Estonia is the one closest to Russia and with the longest border relative to its small size. About a fifth of its population is of Russian origin. About a third of them are still stateless having failed or not enlisted to pass naturalization tests including the Estonian language. That has triggered speculations that Russia might exploit the situation of these people to foment unrest and opposition against Tallinn.

Outlook

In the near-term, economic growth is set for a gradual pick-up, supported by continued strong domestic demand and by some recovery in the Eurozone and in Finland. We expect GDP to expand by 2.2% in 2015. Risks to this scenario mainly relates to a weaker than expected economic performance in Russia and Finland. Moreover, increased geopolitical uncertainty coming from an escalation of the Russian-Ukrainian conflict could weigh on sentiment and depress investment, domestic as well as foreign. In the medium-term, we also see upside risks to our inflation forecast as unemployment is below NAIRU since last year.

Convergence towards EU levels of wealth has been quick in the past years, not least since developments in other EU economies have been disappointing. This process will continue in the medium-term but will progress more slowly as the scope for catching-up is lower and as investment from EU's structural funds are set to decline. Nevertheless, long-run potential GDP growth is 3-4% according to most estimates.



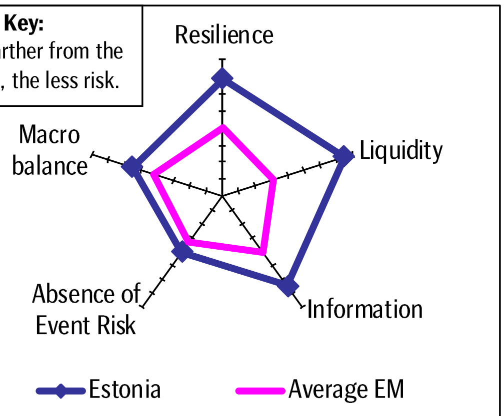
In the longer term, Estonia faces the same problems as peers in the EU as seen in a rising dependency ratio. Forecasts point to a decline in the working age population by around 15% by 2040. Higher than expected outward migration would risk reducing the country's growth potential. Adverse demographics will also soon put pressure on government finances as a pay-as-you-go system would eventually put pressure on the country's pension and social security systems.

Finally, we note that Estonia's macroeconomic imbalances declined significantly in the aftermath of the financial crisis and competitiveness has improved. However, maintaining the level of competitiveness by preventing a return to excessive credit growth and monitoring that wage increases do not continue to surpass productivity growth for an extended period will be a key challenge going forward.

Estonia: Risk Profile

Key Indicators	2015
Population (millions)	1.3
GDP/capita (USD)	14 081
Real GDP (% chg)	2.2
Inflation (%)	0.5
Current Account Balance (% of GDP)	-0.8
Reserves/imports (months)	1.3
Budget balance (% of GDP)	-0.6
Government debt (% of GDP)	10

Chart Key: The farther from the centre, the less risk.



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

Peers:
Latvia
Lithuania
Poland

Graph: Estonia outperforms the average score of our emerging market economies on all counts.

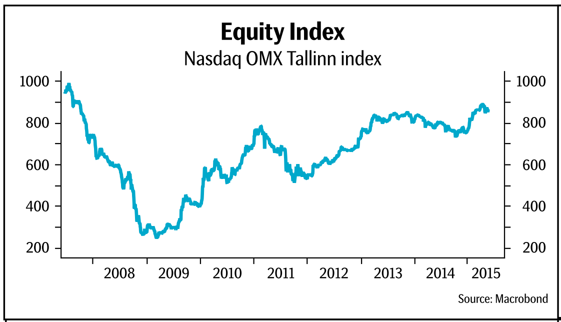
Estonia: Key Economic Indicators

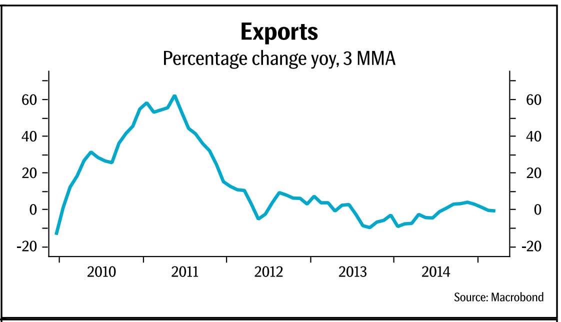
Macroeconomic	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (USD bn)	11.1	11.8	13.7	14.1	14.4	18.5	20.6	21.8	22.9
GDP/capita (USD)	8344	8893	10398	10700	10955	14081	15650	16627	17512
GDP (change)	2.5%	8.3%	4.7%	1.6%	2.1%	2.2%	2.8%	3.5%	4.0%
Investments/GDP	21%	26%	28%	28%	27%	27%	28%	28%	29%
Government Finances									
Budget balance/GDP	0.2%	1.0%	-0.3%	-0.5%	-0.5%	-0.6%	-0.4%	-0.1%	0.1%
Govt debt/GDP	7%	6%	10%	11%	11%	10%	10%	0%	0%
Money & Prices									
CPI inflation (%)	2.7	5.1	4.2	3.2	0.5	0.5	2.1	2.5	2.5
Money, M2 (yoy change)	3%	7%	7%	7%	2%	3%	5%	6%	7%
Stock prices (yoy change)	73%	-24%	38%	11%	-8%	9%	7%	6%	6%
Interest rates, short-term	2%	1%	1%	0.2%	0.2%	0.0%	0.0%	0.0%	0.1%
Exchange Rate (EUR/USD)	1.3	1.4	1.3	1.3	1.3	1.1	1.0	1.0	1.0
Oil price (USD/barrel, Brent)	80	111	112	109	99	61	70	74	78
Balance of payments (USD, bn)									
Exports of goods	14.6	18.3	19.4	19.9	20.2	20.9	22.4	24.3	26.1
Imports of goods	13.4	17.0	19.0	19.6	20.0	20.9	22.4	24.3	26.2
Current account	0.4	0.1	-0.4	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3
as % of GDP	1.7	1.4	-2.4	-0.4	-0.1	-0.8	-1.5	-1.6	-1.5
FDI	1.5	1.8	0.3	0.6	0.6	0.5	0.5	0.5	0.6
Loan repayments	-2.5	-2.2	-2.6	-2.5	-2.4	-2.9	-3.0	-3.1	-3.0
Net other capital	0.3	-2.9	-1.1	-1.5	-0.1	4.1	5.2	6.3	7.1
Balance of payments	-0.3	-3.2	-3.8	-3.7	-2.1	1.5	2.4	3.4	4.3
Reserves	2.5	0.1	0.2	0.2	0.3	1.6	2.6	3.6	4.6
Total debt	22.0	20.1	21.9	22.1	21.0	20.2	20.3	20.5	20.7
o/w short term debt	8.9	8.4	9.8	9.7	9.2	8.9	8.9	9.0	9.1

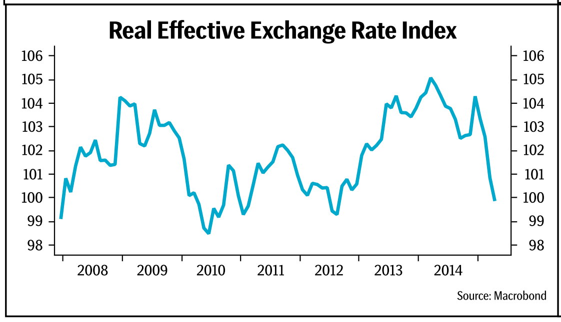
Sources: Oxford Economics and SEB estimates

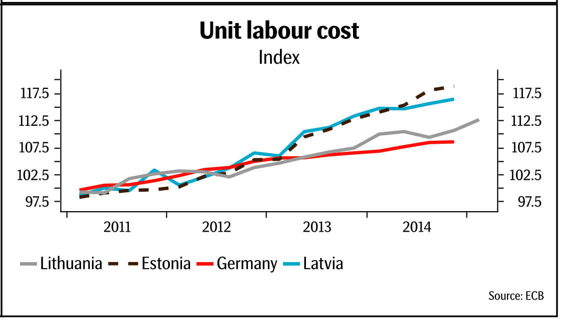
Rating history (eoy)					
Fitch	A	A+	A+	A+	A+
Moody's	A1	A1	A1	A1	A1

Type of government:	Parliamentary democracy
Next elections	Parliamentary 2019, Presidential 2016
Other:	
Latest PC deal	None
Latest IMF arrangements	2000, SBA









Disclaimer

Confidentiality Notice

The information in this document has been compiled by SEB Merchant Banking, a division within Skandinaviska Enskilda Banken AB (publ) ("SEB").

Opinions contained in this report represent the bank's present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.