Estonia
Credit Analysis

Republic of Estonia

Ratings

	Current Ratings
Foreign Currency	
Long-Term IDR	A
Short-Term IDR	F1
Local Currency	
Long-Term IDR	A+
Country Ceiling	AA

Outlook

Foreign Long-Term IDR	Negative
Local Long-Term IDR	Negative

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Related Research

- *Emerging Europe's Current Account Deficits: Mind the Gap!*
- *Risks Rising in the Baltic States?*

Rating Rationale

- Estonia's ratings are supported by its consistent budget surpluses, very low public debt levels and strong growth rates, which have delivered per capita income levels that were equivalent to 36% of the EU15 median in 2007, up from 24% in 2003. Sustained fiscal conservatism has brought Estonia's public debt stock down to just 2.7% of GDP, the lowest in the EU and the third-lowest of any sovereign rated by Fitch (after San Marino and Hong Kong). The sovereign was a net domestic and foreign creditor in 2007.
- However, Estonia's rating dynamics have deteriorated, weakened by a large current account deficit (16% of GDP in 2007) against the backdrop of a more challenging financing environment following the global credit shock, coupled with other signs of an overheating economy — rising inflation, a tightening labour market and rapid credit growth. Fitch Ratings considers that the Estonian economy has become more vulnerable to an abrupt stop to capital and financial flows, a sharp slowdown in economic growth and a stalling of the convergence process — a "hard landing" scenario. The agency revised the Outlooks on Estonia's Long-Term IDRs to Negative from Stable in January 2008.
- Driven mostly by financial flows from foreign parent banks to their Estonian subsidiaries, Estonia's gross external debt stock stood at 98% of GDP at end-2007, compared to the 'A' range median of 50%. Estonia's near-term external position is significantly weaker than the 'A' range median: Fitch estimates Estonia's liquidity ratio at 73% in 2008, below the 'A' range median of 131% while short-term external debt was equivalent to 215% of official reserves in 2007. Estonia's price stability has also deteriorated: the 12-month Harmonised Index of Consumer Prices (HICP) inflation rate rose to 11.5% in February 2008 from 5.1% at end-2006, partly due to rapid wage growth and strong domestic demand. Fitch does not expect euro adoption until at least 2012 for Estonia.
- Although inflation is continuing to rise, an adjustment to a more sustainable growth rate has clearly started in Estonia. GDP growth has slowed quarter on quarter in 2007 and was 4.5% in Q407, from 10.1% in Q107, as consumption and investment slowed. After growing at an average of almost 40% over 2005-2006, the pace of credit growth to the private sector started to decline in 2007, falling to under 35% at end-2007. Property prices have begun to fall, while there are some indications that the pace of wage growth peaked in Q207.

What Could Trigger a Downgrade?

- Although the Estonian economy has clearly started to slow, it is too early to be confident that the economy is certain to experience an orderly unwinding of its macroeconomic imbalances — a "soft landing" scenario. The slowdown is from an extended starting point and it will take time for slower demand to feed through to the current account deficit, inflation, wages and debt dynamics.
- While not Fitch's central scenario, a hard landing for the Estonian economy — particularly if it involved the abandonment of the currency board arrangement (CBA) — would put negative pressure on the rating, as would an extended period of stagnant growth which stalls the convergence process, coupled with continued high inflation.
- Further evidence that Estonia is certainly attaining a soft landing is likely to result in a revision of the Outlook back to Stable.

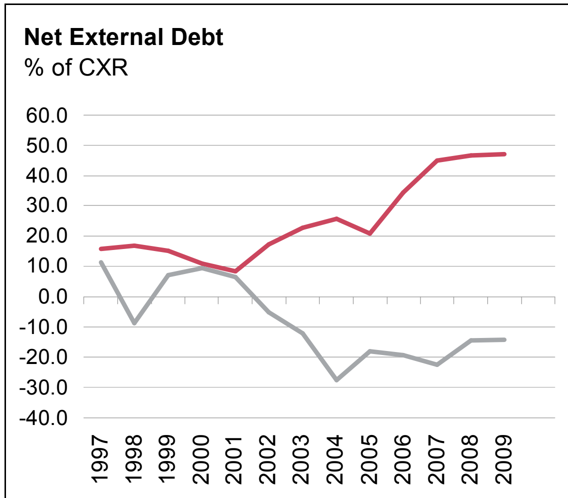
Key Indicators for Estonia

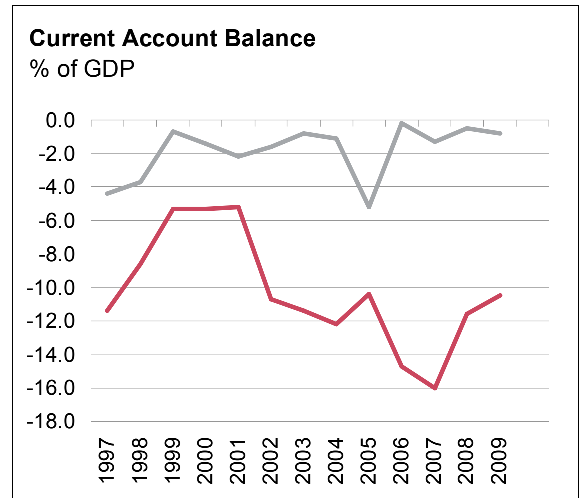
Population (2007e): 1.3m
Population Growth Rate (2002-2007e): -0.7% p.a.
GDP (2007e): USD21.1bn
GDP per Head at Market Exchange Rates (2007e): USD16,106
GNI Per Head at Purchasing Power Parity (2006): USD17,530 (= 40% of USA level)
Modern Sovereign Rescheduling History: None

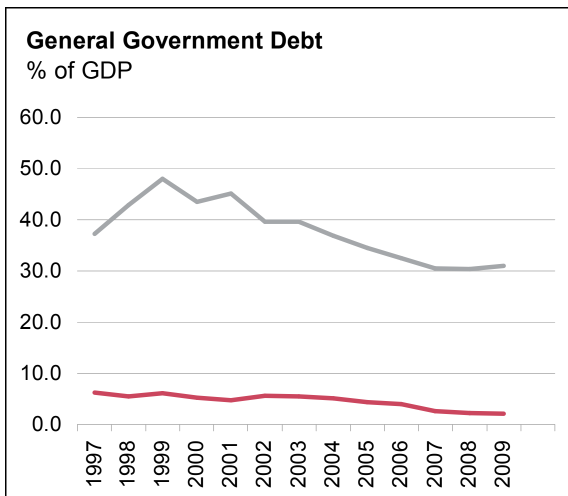
	2003	2004	2005	2006	2007e	2008f	2009f
Domestic economy and finance							
Real GDP growth (%)	7.2	8.3	10.2	11.2	7.1	4.3	5.7
Unemployment (% of labour force)	10.0	9.7	7.9	5.9	4.4	5.5	5.7
Consumer prices (annual average % change)	1.3	3.0	4.1	4.4	6.7	8.6	5.6
Gross domestic savings (% of GDP)	25.7	27.0	29.4	29.6	28.3	28.1	28.7
Gross domestic investment (% of GDP)	33.2	35.0	35.7	38.5	38.4	37.5	36.3
Short-term interest rate (%)[a]	2.9	2.5	2.4	3.2	4.1	4.5	4.5
Broad money (% change Dec to Dec)	10.9	15.8	41.9	28.2	13.3	10.0	12.0
EEK per USD (annual average)	13.86	12.60	12.58	12.47	11.43	10.49	10.46
REER (CPI, 2,000=100)	105.7	107.1	108.2	108.6	111.8	116.7	118.6
REER: % change (+ = appreciation)	1.7	1.3	1.1	0.4	2.9	4.4	1.6
Public finances							
General government balance (% of GDP)	1.9	1.8	1.9	3.6	2.6	1.0	1.0
General government debt (% of GDP)	5.5	5.1	4.4	4.0	2.7	2.3	2.1
General government debt maturities (% of GDP)[b]	2.8	2.6	3.3	2.9	3.2	2.2	2.0
General government debt/revenue (%)	15.2	14.2	12.4	11.0	7.3	6.0	5.4
Interest payments/revenue (%)	0.6	0.6	0.5	0.3	0.3	0.3	0.3
Balance of payments							
Current account balance (USDm)	-1,115	-1,458	-1,445	-2,446	-3,376	-3,012	-3,022
Current account balance (% of GDP)	-11.4	-12.2	-10.4	-14.7	-16.0	-11.6	-10.5
Current account balance plus net FDI (USDm)	-353	-754	943	-1,885	-2,556	-2,112	-2,022
Current account balance plus net FDI (% of GDP)	-3.6	-6.3	6.8	-11.3	-12.1	-8.2	-7.0
Gross financing requirement (% of official reserves)[c]	214.7	188.6	167.5	265.3	219.8	188.0	185.4
Current external receipts CXR (USDm)	7,336	9,673	12,106	14,581	17,375	18,697	21,240
Current external receipts CXR (annual % change)	32.3	31.9	25.1	20.4	19.2	7.6	13.6
Current external payments CXP (USDm)	8,452	11,131	13,551	17,027	20,751	21,709	24,261
Current external payments CXP (annual % change)	33.7	31.7	21.7	25.7	21.9	4.6	11.8
External assets and liabilities							
Gross external debt (USDm)	7,065	10,017	11,253	16,080	20,745	23,534	27,022
Gross external debt (% of GDP)	72.0	84.2	80.7	96.8	98.2	91.0	93.8
Gross external debt (% of CXR)	96.3	103.6	93.0	110.3	119.4	125.9	127.2
Net external debt (USDm)	1,665	2,483	2,534	5,023	7,810	8,728	10,004
Net external debt (% of GDP)	17.0	20.9	18.2	30.2	37.0	33.8	34.7
Net external debt (% of CXR)	22.7	25.7	20.9	34.4	44.9	46.7	47.1
Public external debt (USDm)	352	396	301	323	254	244	231
Public external debt (% of GDP)	3.6	3.3	2.2	1.9	1.2	0.9	0.8
Net public external debt (% of CXR)	-14.0	-14.4	-13.6	-16.9	-17.3	-17.7	-17.4
Public FC denominated & FC indexed debt (USDm)	352	396	301	323	254	244	231
Short-term external debt (% of gross external debt)	33.6	28.8	34.6	35.0	33.7	33.7	33.7
External debt service (% of CXR)	16.3	13.8	15.0	20.7	17.5	18.3	17.8
External interest service (% of CXR)	2.1	2.1	2.2	2.1	1.7	1.6	0.9
Liquidity ratio (%)[d]	79.4	74.1	89.0	76.0	72.4	73.3	77.0
Official international reserves including gold (USDm)	1,377	1,792	1,947	2,786	3,261	3,562	3,937
Official international reserves in months of CXP cover	2.0	1.9	1.7	2.0	1.9	2.0	1.9
Official international reserves (% of broad money)	34.0	35.3	31.1	31.2	29.1	28.2	27.8

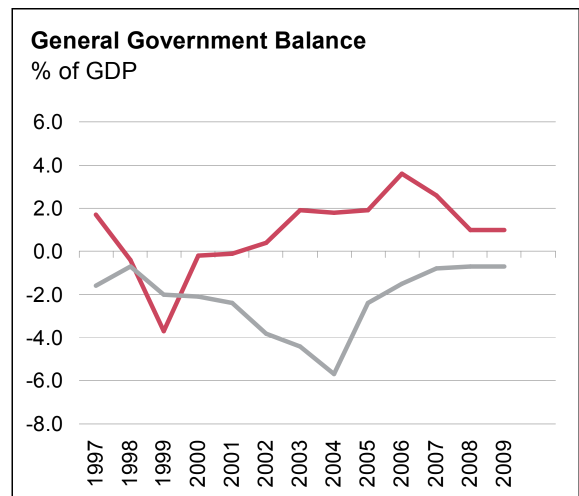
[a] Short-term EEK interbank interest rate (annual average)
[b] Maturities of medium- and long-term debt during year plus short-term debt outstanding at the beginning of the year
[c] Current account balance plus amortisation of medium- and long-term debt, over official international reserves
[d] Official reserves incl. gold plus banks' foreign assets/debt service plus liquid external liabilities

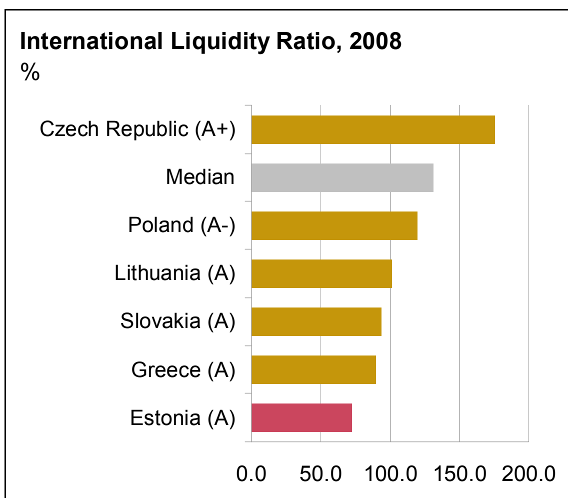
Peer Comparison

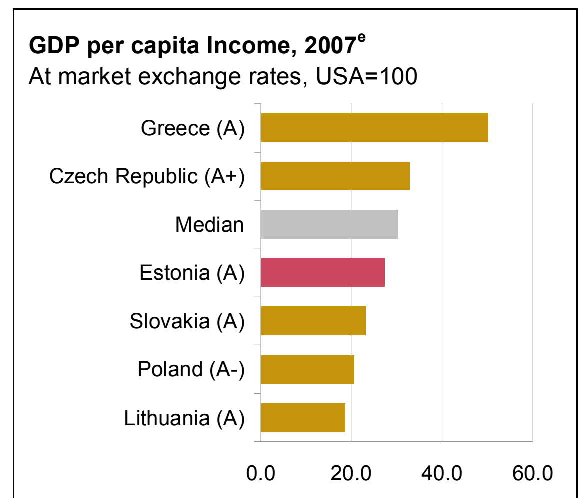












Estonia — A Median

Peer Group

Rating	Country
A+	China
	Czech Republic
	Iceland
	Korea
	Malta
	Saudi Arabia
	Taiwan
A	**Estonia**
	Bahrain
	Chile
	Greece
	Israel
	Lithuania
	Slovakia
A-	Malaysia
	Poland

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
7 Jul 2004	A	A+
30 Aug 2001	A-	A+
28 Sep 2000	BBB+	A
11 Sep 1997	BBB	A

Rationale

Estonia's ratings are supported by its consistent budget surpluses, very low public debt levels and strong growth rates, which have delivered per capita income levels that are comparable to the EU median. Estonia's real GDP growth rate averaged 9.5% over the five years to 2007. The broad policy consensus in favour of strong fiscal policy has led to budget surpluses since 2002. Estonia's government delivered a budget surplus of 2.6% of GDP in 2007 (the 'A' range median was a 0.7% of GDP deficit). Sustained fiscal conservatism has brought Estonia's public debt stock down to just 2.7% of GDP, the lowest in the EU and the third-lowest of any sovereign rated by Fitch (after San Marino and Hong Kong). Furthermore, the public sector has been a net external creditor since the country's independence. Estonia had a sovereign net foreign asset position of 20% of GDP in 2007. Estonia's flexible labour and product markets (it ranked 17th out of 178 countries for ease of doing business in 2008[1]), and its strong and almost entirely foreign-owned banking system are also rating strengths.

However, Estonia's rating dynamics have deteriorated, weakened by a large current account deficit (16% of GDP in 2007) against the backdrop of a more challenging financing environment following the global credit shock, coupled with other signs of an overheating economy — rising inflation, a tightening labour market and rapid credit growth. Fitch considers that the Estonian economy has become more vulnerable to an abrupt stop to capital and financial flows, a sharp slowdown in economic growth and a stalling of the convergence process — a "hard landing" scenario. The agency revised the Outlooks on Estonia's Long-Term IDRs to Negative from Stable in January 2008.

Strong economic growth and labour migration have reduced the unemployment rate by over 5pp in the five years to 2007, pushing up labour costs. Rising disposable incomes and low real interest rates have fuelled a credit boom, with lending to the private sector growing at over 40% in 2006 and H107. Estonia's credit boom (and current account deficit) has mostly been funded by financial flows from foreign parent banks to their Estonian subsidiaries, which has also led to the build-up of a large private-sector debt burden: Estonia's gross external debt stock stood at 98% of GDP at end-2007, compared to the 'A' range median of 50%. Furthermore, Estonia's near-term external position is significantly weaker than the 'A' range median: Fitch estimates Estonia's liquidity ratio at 73% in 2008, below the 'A' range median of 131% while short-term external debt was equivalent to 215% of official reserves in 2007.

Estonia's large GXD burden is significant in the context of the delay in euro adoption. Joining the euro zone would render transfer and convertibility risk and the threat of balance-of-payments crises negligible, shelter Estonia from the risk of self-fulfilling currency crises, and reduce risks associated with foreign currency bank lending (79% of outstanding loans were denominated in foreign currency in 2007). The delay to Estonia's adoption of the euro is due to rising inflation: Estonia's 12-month HICP inflation rate rose to 11.5% in February 2008 from 5.1% at end-2006, partly due to rapid wage growth and strong domestic demand. Fitch does not expect euro adoption until at least 2012 for Estonia.

Although inflation is continuing to rise, an adjustment to a more sustainable growth rate has clearly started in Estonia. GDP growth slowed quarter on quarter in 2007 and was 4.5% in Q407, down from 10.1% in Q107, as consumption and investment slowed. After growing at an average of almost 40% over 2005-2006, the pace of credit growth to the private sector started to decline in 2007, falling to under 35% at end-2007. Property prices have begun to fall, while there are some indications that the pace of wage growth peaked in Q207.

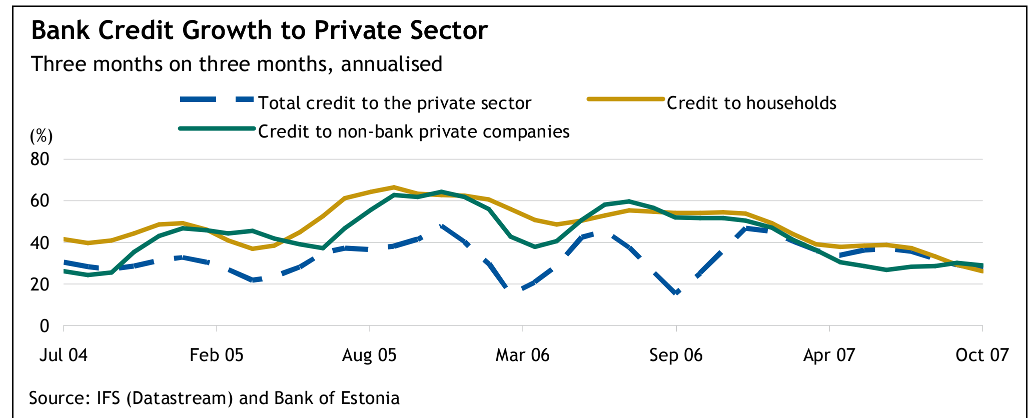
[1] World Bank Doing Business Survey 2008.

However, it is too early to be confident that the economy is certain to experience a smooth and orderly unwinding of its macroeconomic imbalances — a “soft landing” scenario. The slowdown is from an extended starting point and it will take time for slower demand to feed through to the current account deficit, inflation, wages and external debt dynamics. The resolution of the Negative Outlook on Estonia’s rating is expected to depend mainly on the rebalancing of the economy in the context of the prevailing financing environment. Further evidence that Estonia is certainly attaining a soft landing is likely to result in a revision of the Outlook back to Stable.

A non-central scenario of a hard landing for the Estonian economy — particularly if it involved the abandonment of the CBA — would entail significant economic costs and put negative pressure on the rating. In addition, an extended period of stagnant growth which stalls the convergence process, coupled with continued high inflation, would also put downwards pressure on the rating. Fitch notes that Estonia’s strong public finances, flexible economy, trade openness and foreign bank ownership could ease the costs of adjustment in the event of a hard landing but that the high level of euroisation is a vulnerability, as it would adversely affect balance sheets and debt service capacity in the event of an abandonment of the CBA.

Bank Credit Growth to Private Sector

Three months on three months, annualised



Source: IFS (Datastream) and Bank of Estonia

Local Currency Rating and Country Ceiling

Estonia’s Local Currency IDR is ‘A+’, one notch above the FCIDR. Estonia’s external imbalances weigh less on the Local Currency Rating. However, it is impossible to completely isolate the risks in the external finances from the Local Currency credit profile because a balance-of-payments crisis would have severe consequences for the domestic economy and fiscal position.

As a member of the European Union with robust institutions and high levels of trade and financial integration, Estonia’s Country Ceiling is three notches above the Foreign Currency IDR at ‘A+’ In Fitch’s opinion, the free movement of capital embodied in EU and national law as well as institutional and political constraints materially reduce (though do not wholly eliminate) the risk of exchange controls being imposed by a member of the European Union.

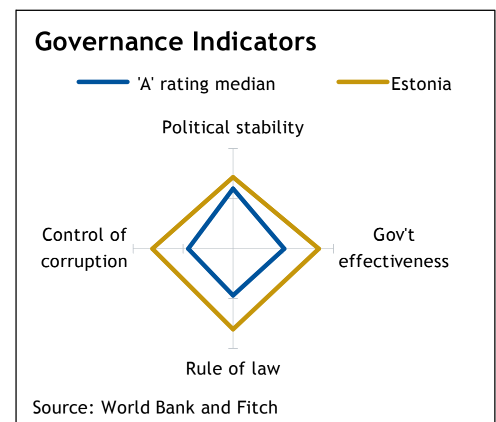
Political and Social Situation

Estonia’s three-party coalition government, led by Prime Minister Andrus Ansip’s Reform Party, took power following parliamentary elections in March 2007. The centre-right Reform Party is in coalition with the conservative Pro Patria and Res Publica Union (IRL) and the Social Democrats. Its former coalition partner, the Centre Party, which is perceived as representing the interests of Estonia’s 300,000-strong Russian-speaking minority (and also those who would benefit from higher social welfare provisions, such as pensioners), took second place in the elections and now leads the opposition.

Fitch considers the Estonian government's current coalition partners to be ideologically more compatible than their predecessors and believes the government is well-placed to remain in office for its full term. Although no Estonian government has served its full term since the country's independence in 1992, the broad cross-party consensus on fiscal conservatism and an investor-friendly business environment serve to allay concerns arising from frequent changes of government.

A quarter of Estonia's population is made up of ethnic Russians, around a third of whom are Estonian citizens. Another third hold Russian citizenship, while the remaining third are resident in Estonia but are officially stateless.[2] Non-Estonians have the right to vote in municipal but not parliamentary elections and the Centre Party has done well at municipal level, taking control of Estonia's most important municipality, Tallinn. As this gives it a stake in many important government issues, Fitch expects municipal elections in 2009 to be closely contested as the government tries to wrest control of Tallinn from the Centre Party.

Estonia's relations with Russia remain strained. The removal of a statue of a Red Army soldier from central Tallinn in April 2007 led to rioting amongst Estonia's ethnic Russians. The dispute also triggered a sharp fall in Russian fuel exports via Estonia while the Estonian public sector and some commercial banks suffered "cyber-attacks" on their websites, temporarily disrupting banking and internet services. The linguistic and citizenship rights of Estonia's Russian minority have also been a long-standing source of tension in Estonia's relations with Russia. Estonia still does not have a border treaty with Russia (Russia has stated that it does not recognise the border treaty ratified by the Estonian parliament). Nevertheless, Estonia's national security is bolstered by its membership of the EU and NATO (since 2004).



Source: World Bank and Fitch

Estonia compares well to its rating peers on governance indicators. It was ranked 28th out of 179 countries in Transparency International's Corruption Perceptions Index in 2007, the second highest ranking out of the ten countries that joined the EU in 2004 (after Slovenia, which is ranked 27th).

Financial Sector

The strength of the Estonian banking system is reflected by its 'B' rating on Fitch's Banking System Indicator, where a 'B' rating indicates a high-quality banking system. Furthermore, Estonia has no state-owned banks and 97% of banking system assets are foreign-owned, so the system does not represent a direct contingent liability to the sovereign. The system is dominated by the subsidiaries of two Swedish banks — Swedbank subsidiary Hansapank owned 52% of banking-sector assets at end-2007 and SEB held 23%.

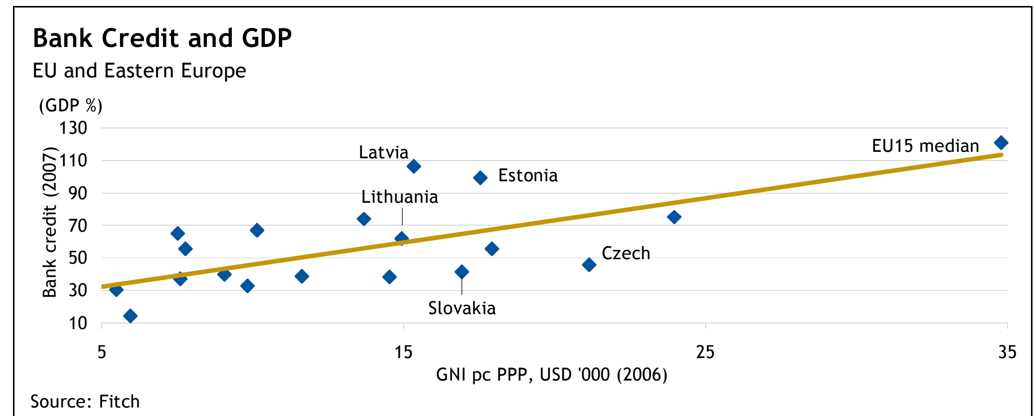
Key Facts

Banking system	2007
M2 (% GDP)	50.0
NPL ratio (%)	0.5
Capital adequacy ratio (%)	14.8
Public ownership, % of assets	0
Foreign ownership, % of assets	97
Fitch banking system indicator	B
Fitch macro-prudential indicator (MPI)	2

Source: Bank of Estonia and Fitch

[2] Estonian Citizenship and Migration Board and Amnesty International, December 2006.

After growing at an average of almost 40% over 2005-2006, the pace of credit growth to the private sector started to decline in 2007, falling to under 35% at end-2007. The largest Swedish-owned banks re-assessed their exposure to segments of the Estonian credit market — in particular to the real estate development sector, which made up 17% of the total loan portfolio in 2007 — following market volatility in Latvia in February 2007, which led to a fall in their share prices. However, Fitch understands that the demand for credit has also fallen, particularly in the household sector, as interest rates have risen, economic growth has slowed and property prices have begun to fall.[3]



Estonia scores '2' on Fitch's Macro-Prudential Indicator, reflecting moderate vulnerability to potential systemic stress as a result of above-trend credit growth coupled with asset price bubbles. In the past, Fitch's concerns have been mitigated by rapid credit growth coming from a low base, but this no longer applies, as bank credit was 96% of GDP in 2007, which is quite high relative to GDP per capita even though it is still below the median in the EU15 of 121%.

Many indicators of the Estonian banking sector, such as profitability, non-performing loan ratios (NPLs) and capital adequacy ratios look sound, although Fitch recognises that these are typically pro-cyclical and can be a lagging indicator of current risks. Furthermore, as almost three-quarters of all loans have property as collateral, a sharp reversal in property prices would threaten the contribution that secured lending makes to mitigating credit risk. Fitch also notes that the level of foreign-currency lending in Estonia remains high. Spurred by a stable currency regime and anticipation of euro adoption, much of the lending has been in euros: 79% of outstanding loans were denominated in foreign currency in 2007. Foreign-currency loans to unhedged borrowers (for instance, the household sector) expose banks to market-risk-related credit risk.

Nevertheless, the volume of NPLs in the banking system remains very low (0.5% of total loans were more than 90 days overdue at end-2007, up from 0.3% at end-2006). The Bank of Estonia estimates the volume of loans overdue for longer than 60 days will rise to only 1.3% at end-2009 from around 0.7% at end-2007. Furthermore, stress tests conducted by the Financial Supervision Authority suggest the system is reasonably resilient: a 25% drop in household disposable income or a 35-40% decrease in profits for corporates would result in only one bank's capital adequacy ratio falling below the 10% regulatory minimum. Rapid wage growth has also increased households' debt-servicing capability. The ratio of interest payments to disposable income was 4.4% of at Q307, comparable to the level in Nordic countries.

[3] The median price of apartments in Tallinn fell around 8% in H207 (Estonian Land Board and Central Bank of Estonia).

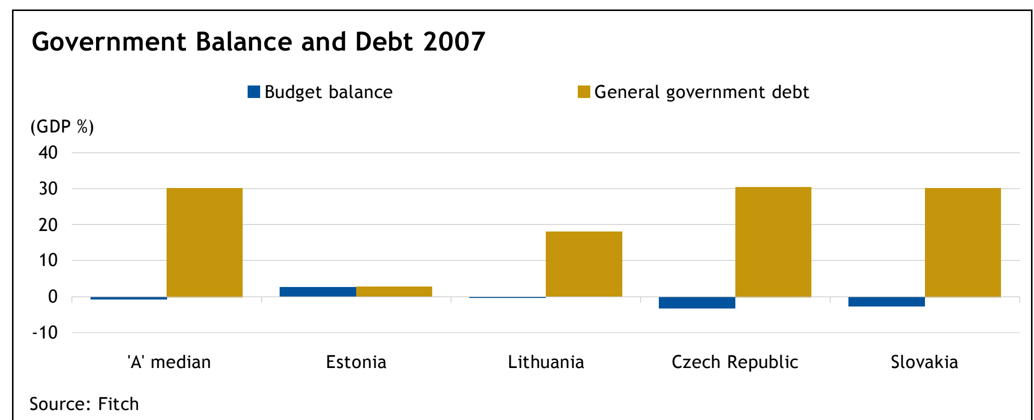
Public Finance

Estonia's low government debt and prudent fiscal policy (the general government budget has been in surplus every year since 2002) are key rating strengths. Its largest budget deficit since independence was still under 4% of GDP (in 1999, following the Russian crisis, after which it returned to balance in 2000, demonstrating the resilience of the budget to economic shocks). The government recorded a budget surplus of 2.6% of GDP in 2007. This is higher than the government's targeted 1.9% of GDP due to delays in commencing major investment projects.

The government has adopted a budget with a 1.3% surplus target for 2008. Although the budget was prepared using a growth forecast of over 7% (Fitch forecasts real GDP growth in 2008 to be around 4%) the authorities believe that higher-than-expected inflation will ensure that the nominal revenue targets will be met, despite the reduction in the income tax rate — the government is reducing the flat income tax by 1pp every year to 18% in 2011 (the first reduction, from 22% to 21% was implemented in January 2008). Furthermore, revenues will be boosted by an increase in excise taxes.

The 2008 budget plans a 20% rise in nominal spending although Fitch believes this could be higher as investment projects delayed from 2007 are carried over. Ministries are allowed to spend revenues earmarked for investment projects from the previous year and Fitch believes a slowdown in wage growth could encourage the implementation of projects. The agency is forecasting a budget surplus of 1% of GDP in 2008, slightly lower than the government's own estimate. The government is committed to delivering a budget surplus for each of its four years in office (2008-2011) and is targeting a 1% of GDP surplus in 2009.

Government Balance and Debt 2007



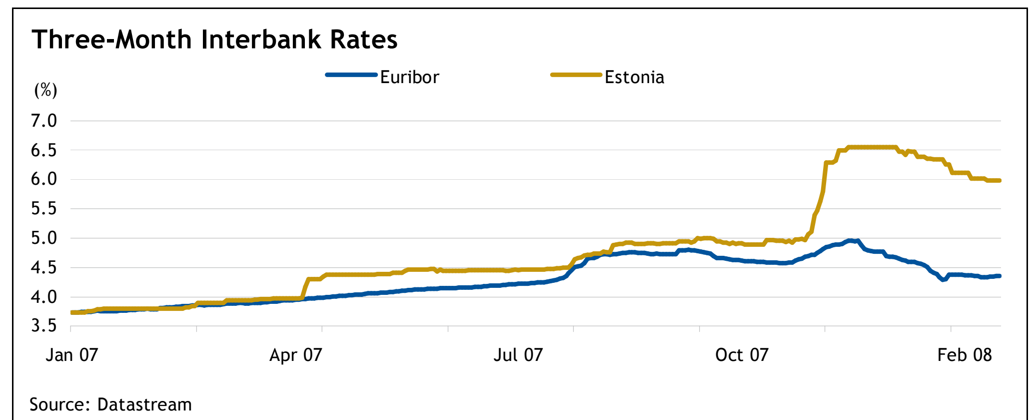
Source: Fitch

Estonia's government debt burden was just 2.7% of GDP in 2007, the lowest in the EU and among 'A' range credits. Around two-thirds of the debt is owed by local governments. The Estonian government has built up both domestic and external financial assets from successive budget surpluses, privatisation revenues and EU funds. While part of these reserves is for liquidity management purposes, the government's stabilisation reserve, which held the equivalent of 2.7% of GDP at end-2007, was created to decrease the potential impact of economic shocks. The fund's assets are invested conservatively and it has been accessed only once since its creation in 1997 (to compensate the depositors of a bank which went bankrupt in 1998). Estonia's five-year EUR100m, eurobond matured in mid-2007 and was paid out of the reserves the government has built up from successive budget surpluses.

Fitch believes Estonia's strong and flexible public finances are a key contributor to the economy's resilience to a hard-landing scenario. The government's low debt allows it scope for fiscal loosening if necessary, while its fiscal reserves also provide an additional buffer to ease the costs of adjustment in the event of a hard landing.

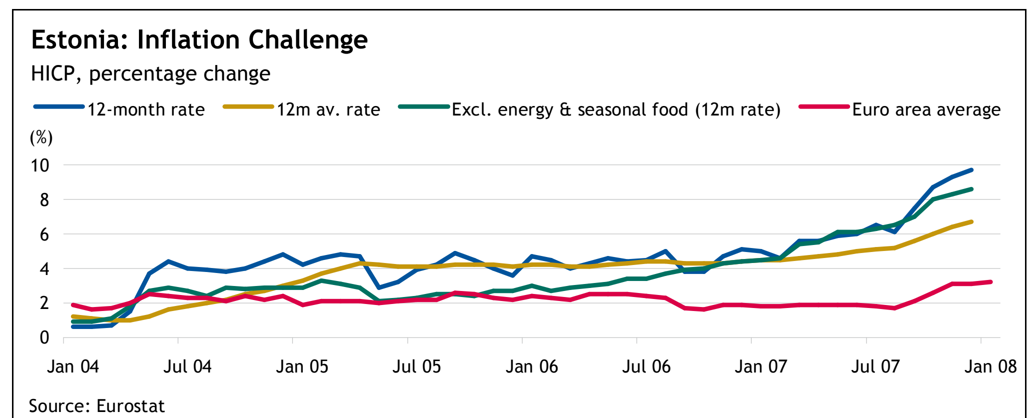
Monetary and Exchange Rate Policy

Estonia has successfully maintained its CBA since 1992 and joined the European Exchange Rate Mechanism (ERMII) in June 2004 at a central parity equal to its CBA fixed rate of EUR1/EEK15.6466. The Estonian government has not announced a new target date for euro adoption. In 2006 the authorities were forced to abandon the revised target date of January 2008 as it became clear that Estonia would not be able to meet the Maastricht inflation criterion.



Market pressures in Latvia highlighted the risks to countries which suffer from large external imbalances and signs of overheating. There was some pressure on the EEK towards the end of 2007, firstly on account of rumours of an imminent devaluation of the kroon over a weekend, and secondly due to some foreign companies closing EEK positions at the end of the year. The pressure on the EEK was reflected in a rise in interbank lending rates. Despite pressure on the currency, Fitch thinks a devaluation of the EEK is currently very unlikely. There are few local-currency assets to sell or liquid investments to short-sell, while the level of public debt, and the volume of local-currency debt held by foreigners, is low. Furthermore, Estonia's CBA ensures the monetary base is fully backed with foreign-exchange reserves (although Fitch recognises that a loss of depositor confidence in the currency and the banking system would put severe pressure on the EEK). Given the central role of the CBA in the macroeconomic framework, the level of foreign-currency debt and the economic and political cost of abandoning the CBA, Fitch believes that the authorities would be prepared to endure high interest rates to defend it.

Estonia's 12-month Harmonised Index of Consumer Prices (HICP) inflation rate rose to 11.3% in January 2008 from 5.1% at end-2006. While rapid wage growth and strong domestic demand caused the core inflation rate to accelerate, in H207 higher food and energy prices also contributed to the rise in headline inflation, especially as their weight in Estonia's CPI basket is greater than the EU average.

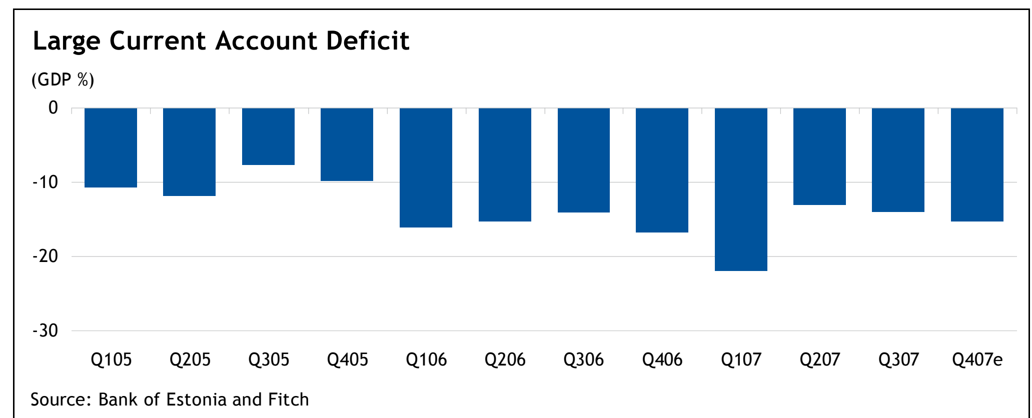


Fitch expects Estonia's core inflation rate to moderate in 2008 as domestic demand and wage growth slow (there were signs that it was beginning to moderate in Q407). Nevertheless, the headline inflation rate will continue to rise due to higher food prices as well as the effect of regulated price increases. The Estonian government will implement by mid-2008 all the excise tax increases (on tobacco, alcohol and energy products) which the country is obliged to undertake before 2010 to comply with EU directives — a strategy which it hopes will improve Estonia's chances of meeting the Maastricht inflation criterion in 2010. The excise tax rises will raise the headline inflation rate by 1.6% in 2008 and 0.9% in 2009 (as part of the impact of the excise tax on the inflation rate will emerge with a lag). Fitch expects Estonia's 12-month average inflation rate to rise to 8.6% in 2008 and then decline in 2009. However, a continuation in rapid wage growth would lead to a higher inflation rate.

The Estonian government hopes to meet the Maastricht criteria in 2010 and join the euro zone in January 2011. Fitch believes that in the absence of a positive price shock, the 12-month inflation rate is unlikely to fall sufficiently from its peak in 2008 to be able to meet the Maastricht inflation criterion before 2011. Fitch's opinion is that 2012 is the earliest date that Estonia could join the euro zone.

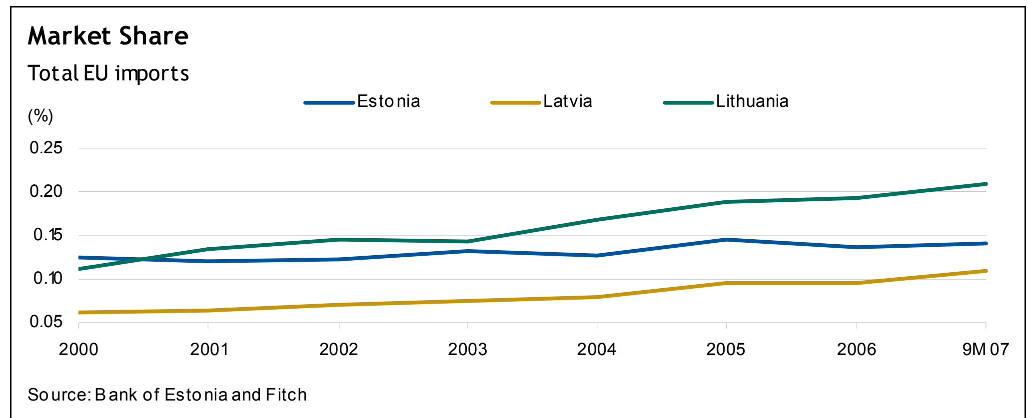
External Finance

Estonia's current account deficit widened to 16% of GDP in 2007 (2006: 14.7%) due to a two-thirds increase in income debits as foreign companies repatriated high profits in Q107. The current account widened despite an improvement of approximately 1pp of GDP in Estonia's trade deficit as import growth declined due to weaker domestic demand and the decline of transit flows from Russia. Fitch expects Estonia's current account deficit to decline to 11.6% in 2008 and 10.5% in 2009 as the trade balance improves further (as a % of GDP).



The pace of growth of Estonia's exports declined in 2007 as the transit flow from Russia — mainly oil products — fell due to a political backlash over the events of April 2007. Russia has begun to re-direct its export flows and will continue to channel transit trade away from Estonia as it completes the development of its own ports. Export growth has remained strong in other sectors. Furthermore, Estonia's exports to Russia have also continued to grow.

Wage growth above productivity growth in the tradables sector (relative to trading partners) has the potential to worsen external competitiveness. Indicators of Estonia's external competitiveness present a mixed picture. Estonia's market share of EU imports appears to have stalled, although profitability remains high. Strong economic growth and labour migration have reduced the unemployment rate by over 5pp in the five years to 2007, pushing up labour costs. Wages grew around 20% year on year in 9M07 and real wage growth has surpassed real gains in productivity since H205. However, Fitch expects the economic slowdown to moderate wage growth in 2008 as the unemployment rate rises. The pace of wage growth appears to have peaked in Q207.



Estonia's large current account deficit appears to be driven partly by substantial capital inflows to banks from their foreign parents, which has funded rapid credit growth in Estonia, and can be partly justified by Estonia's high investment rate. Fitch estimates gross domestic investment was 38% of GDP in 2007 — the highest among 'A'-rated sovereigns with the exception of China — although the agency notes that investment is not necessarily channelled to the tradables sector and that investment in residential housing does not boost the country's export capacity. Capital inflows to banks amounted to over 21% of GDP in 2007, much higher than the 12% in 2006, although around a third of the flows were re-directed abroad to fund the purchase of investment assets. Fitch believes these flows will slow in the medium-term as credit demand weakens, also leading to a decline in the investment rate. Capital inflows to the non-bank private sector slowed to under 2% of GDP in 2007 (2006: 9%).

Estonia receives large foreign direct investment (FDI) inflows, amounting to over 11% of GDP in 2007. Around two-thirds of Estonia's FDI inflows are in the form of re-invested earnings, of which 40% is to Estonian credit institutions. However, large investments abroad mean net FDI flows to Estonia were just 3.9% of GDP in 2007, covering only a quarter of the current account deficit.

External Debt

Estonia's external debt burden and the high volume of short-term external debt are key rating weaknesses, particularly as euro adoption has been delayed. Fitch estimates Estonia's GXD burden was equivalent to 98% of GDP at end-2007, above the 'A' range median of 50%. Fitch estimates Estonia's liquidity ratio at just 73% in 2008, below the 'A' range median of 131%. Around a third of Estonia's GXD is short-term debt. Furthermore, its external financing need (current account balance plus amortisation of medium- and long-term debt) was 220% of official reserves in 2007, the third-highest in the 'A' range after Greece and Iceland.

The most important mitigating factor for Estonia's creditworthiness is the strong external position of the sovereign. The sovereign has been a net external creditor since independence and Fitch estimates sovereign net foreign assets were equivalent to 20% of GDP in 2007. Furthermore, most of the external debt of the banking sector (which accounts for around 60% of Estonia's GXD burden) is in the form of loans from foreign parent banks to their subsidiaries and therefore does not involve as high re-financing risk as market debt.

Fiscal Accounts Summary[a]

(% of GDP)	2003	2004	2005	2006	2007e	2008f	2009f
Revenue & grants (excl. priv'n)	36.4	35.9	35.4	36.6	37.9	38.8	38.4
Expenditure & net lending	34.5	34.1	33.4	33.0	35.3	37.8	37.4
Interest payments	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Primary balance (excl. interest)	2.1	2.0	2.1	3.7	2.7	1.1	1.1
Overall balance	1.9	1.8	1.9	3.6	2.6	1.0	1.0
Financing							
Privatisation	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic borrowing	0.3	-0.2	0.0	-0.1	-0.1	-0.1	0.0
Net external borrowing	0.3	0.2	0.0	0.4	-0.6	0.0	0.0
Other (includes net deposits/assets)	-2.5	-1.8	-2.0	-3.9	-1.9	-0.9	-1.0
Public debt[a]	5.5	5.1	4.4	4.0	2.7	2.3	2.1
External	2.8	2.7	2.3	2.3	1.4	1.2	1.0
Domestic	2.7	2.4	2.1	1.7	1.4	1.2	1.1
Public debt (% of revenue)	15.2	14.2	12.4	11.0	7.3	6.0	5.4
Net general government debt	3.7	2.3	0.8	0.6	-2.2	-2.8	-3.5
Memo							
Interest service (% of revenue)	0.6	0.6	0.5	0.3	0.3	0.3	0.3

[a] All figures refer to the consolidated general government and include the cost of pension reform
Source: Ministry of Finance, Fitch estimates and forecasts

Central Government Amortisation Projections

(EEKm)	2008	2009	2010	2011	2012+
Principal	160	155	117	89	222

Source: Ministry of Finance and Fitch projections

Balance of Payments

(USDm)	2003	2004	2005	2006	2007e	2008f	2009f
Current account balance	-1,115	-1,458	-1,445	-2,446	-3,376	-3,012	-3,022
(% of GDP)	-11.4	-12.2	-10.4	-14.7	-16.0	-11.6	-10.5
(% of CXR)	-15.2	-15.1	-11.9	-16.8	-19.4	-16.1	-14.2
Trade balance	-1,567	-2,019	-1,845	-2,739	-3,256	-3,537	-3,872
Exports fob	4,597	5,983	7,783	9,635	11,015	12,447	14,190
(Annual % change)	31.0	30.1	30.1	23.8	14.3	13.0	14.0
Imports fob	6,164	8,002	9,628	12,374	14,271	15,984	18,061
(Annual % change)	33.3	29.8	20.3	28.5	15.3	12.0	13.0
Services, net	831	1,074	1,000	1,033	1,211	1,200	1,300
Services, credit	2,224	2,830	3,156	3,493	4,344	4,200	4,800
Services, debit	1,393	1,756	2,156	2,460	3,133	3,000	3,500
Income, net	-536	-637	-700	-751	-1,416	-750	-600
Income, credit	249	436	669	979	1,427	1,450	1,500
Income, debit	785	1,073	1,369	1,730	2,843	2,200	2,100
O/w: interest payments							
Current transfers, net	157	124	100	11	85	75	150
Capital & financial account	1,324	1,715	1,842	3,143	3,906	3,312	3,397
Capital account	50	93	140	412	332	500	500
Non-debt-creating flows, net	514	364	3,481	-354	487	430	480
Direct investment, net	700	773	2,520	446	800	880	980
Portfolio equity investment, net	-186	-409	962	-800	-313	-450	-500
External borrowing, net	952	2,024	2,429	2,850	4,685	2,810	3,507
Net lending abroad	-473	-1,049	-1,371	-727	-2,132	-700	-700
Capital nes, net	282	283	-2,838	962	534	272	-390
Net errors and omissions	-39	14	-11	-78	-56	0	0
Overall balance = change in reserves	169	271	386	620	474	300	375
Memo							
Gross borrowing (incl. short-term)	3,451	5,539	6,865	9,468	13,062	12,928	15,029
Gross external financing requirement	768	1,445	2,154	2,597	3,000	5,165	6,125
Stock of international reserves, excl. gold	820	1,000	1,373	1,788	1,943	2,781	3,255

Source: Bank of Estonia and Fitch estimates and forecasts

External Debt & Liquidity

(USDm)	2003	2004	2005	2006	2007e	2008f	2009f
Gross external debt	7,065	10,017	11,253	16,080	20,745	23,534	27,022
(% of GDP)	72.0	84.2	80.7	96.8	98.2	91.0	93.8
(% of CXR)	96.3	103.6	93.0	110.3	119.4	125.9	127.2
By maturity	7,065	10,017	11,253	16,080	20,745	23,534	27,022
Medium- and long-term	4,689	7,137	7,354	10,452	13,745	15,593	17,904
Short-term	2,376	2,880	3,899	5,628	7,000	7,941	9,118
Total debt (%)	33.6	28.8	34.6	35.0	33.7	33.7	33.7
By debtor	7,065	10,017	11,253	16,080	20,745	23,534	27,022
Public sector	352	396	301	323	254	244	231
Non-bank private sector	3,725	4,397	4,709	7,750	7,998	8,548	9,348
Banks	2,988	5,225	6,243	8,008	12,493	14,743	17,443
Gross external assets	5,399	7,534	8,718	11,058	12,935	14,807	17,017
International reserves, incl. gold	1,377	1,792	1,947	2,786	3,261	3,562	3,937
General government overseas funds	867	1,010	995	1,078	1,237	1,308	1,331
Banks	1,376	2,388	3,312	3,497	4,371	5,464	6,830
Net external debt	1,665	2,483	2,534	5,023	7,810	8,728	10,004
(% of GDP)	17.0	20.9	18.2	30.2	37.0	33.8	34.7
(% of CXR)	22.7	25.7	20.9	34.4	44.9	46.7	47.1
Net sovereign external debt	-1,025	-1,396	-1,647	-2,464	-3,007	-3,318	-3,706
(% of GDP)	-10.4	-11.7	-11.8	-14.8	-14.2	-12.8	-12.9
(% of CXR)	-13.7	-14.0	-14.4	-13.6	-16.9	-17.3	-17.7
Sovereign net foreign assets	1,907	2,421	2,643	3,913	4,268	4,650	5,061
(% of GDP)	19.4	20.3	19.0	23.6	20.2	18.0	17.6
(% of CXR)	26.0	25.0	21.8	26.8	24.6	24.9	23.8
Debt service (principal & interest)	1,193	1,340	1,817	3,019	3,049	3,419	3,781
(% of CXR)	14.1	12.0	13.4	17.7	14.7	15.7	15.6
Liquidity ratio (%)	79.4	74.1	89.0	76.0	72.4	73.3	77.0
Excl. banks' foreign assets	37.8	37.1	38.1	28.1	32.4	31.6	30.7
Sovereign net FX indicator (%)	-74.4	-77.9	-84.6	-88.4	-92.2	-93.2	-94.1
Memo							
Public foreign currency & indexed debt	351.9	395.7	300.8	322.8	254.4	243.9	231.0

Source: Bank of Estonia and Fitch estimates and forecasts

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