Estonia

OUTLOOK

Estonia has developed amazingly well over the past years. GDP at constant prices is now almost 60 % higher than 5 years ago, profits have more than doubled and real wages are up by over 50 %. Inflation nevertheless remained below 5 % until late 2006. However, since 2006 signs of overheating have emerged, price pressures have strengthened and profits probably peaked in 2006. Export growth has begun to slow. Substantial corporate and household indebtedness suggest that a period of consolidation might lie ahead in Estonia as interest rates rise. The asset quality of banks has remained high, but will likely deteriorate somewhat over the coming months. This will prompt banks to lend more cautiously, thus reducing credit growth, the main reason for the overheating of the Estonian economy. Some economic turbulence may occur, but the sound banking system should combine with the relatively comfortable fiscal situation to limit risks.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (AUG) N.A.
A1/Stable	A/Negative	A/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	11.2	13.2	15.5	17.4	19.5
Per capita GDP (EUR)	8,320	9,840	11,510	13,030	14,630
Real GDP yoy (%)	10.5	11.4	8.0	6.7	6.4
Inflation (CPI), yoy, eop. (%)	3.6	5.1	6.5	7.1	4.6
Inflation (CPI), yoy, avg. (%)	4.1	4.4	6.0	7.0	5.3
Unemployment rate LFS (%)	7.9	5.9	5.3	4.7	4.0
Exchange rate EEK/EUR, avg./eop.	15.65	15.65	15.65	15.65	15.65
Interest rate eop. (3m Talibor)	2.59	3.81	5.20	5.08	5.05
Interest rate avg. (3m Talibor)	2.38	3.16	4.90	5.14	5.07
Current account balance/GDP (%)	–10.3	–14.7	–16.8	–16.0	–14.6
FDI/GDP (%)	20.9	9.6	12.2	9.5	8.9
Budget balance/GDP (%)	2.3	3.8	3.4	1.5	1.0
Public debt/GDP (%)	4.5	4.1	2.8	2.5	2.1
Total external debt/GDP (%)[1]	84.8	94.7	106.2	111.8	115.5

1) More than one–half is trade credits.
Sources: Ministry of Finance of Estonia, Bank of Estonia, Statistics Estonia, UniCredit New Europe Research Network.

MAIN TOPICS

- GDP growth slowed slightly in Q2 2007. Real GDP increased by 7.6 % yoy compared with 10.1 % yoy in Q1. GDP grew 0.9 % qoq in seasonally adjusted terms in Q2 compared with 2.1 % in Q1.
- Price pressures continue to build. Consumer prices were 5.7 % higher in August 2007 than in August 2006. Hikes in administered prices amounted to 3.4 % yoy, increase in non-regulated prices to 6.5 % yoy.
- Credit growth slowed, but is still high: the stock of outstanding loans to households was 50.5 % higher at the end of July 2007 than the year before, the stock of outstanding loans to companies was 44.4 %.
- Interest rates have been rising since October 2006 and their increase has gained speed since the global credit crunch emerged. Average interest rates on kroon loans amounted to 8.44 % p.a., according to central bank statistics in July, up from 6.73 % in October 2006. Given the high debt stock of companies and individuals, this will be felt.
- The current account deficit widened to EUR 1,197 mn in January-June from EUR 972 mn the year before, despite gains in terms of trade. We expect a CA deficit of 17 % of GDP in 2007 as a whole.
- In politics, relations with the Russian minority are still taking centre stage.

At a turning point

Growth cooling somewhat

Real GDP growth cooled further in Q2 2007 due to easing domestic demand pressures and weaker export growth. Real GDP growth amounted to 7.6 % yoy, compared with a revised 10.1 % yoy in Q1. Mainly because of lower expenditures on food, beverages and tobacco, clothes and footwear, private consumption grew by "only" 12 % yoy in Q2, the lowest figure in 7 quarters. Fixed capital formation accelerated to 21.8 % yoy from 15 % yoy in Q1, but this was thanks to the low basis in Q2 2006. Exports of goods and services increased by 3.3 % yoy in Q2, with exports of goods alone increasing by a meagre 0.5 % yoy. Imports of goods and services grew by 3.5 %.

Some uncertainty remains about the accuracy of the data as the statistical discrepancy shaves 5 percentage points off yoy GDP growth. However, some cooling does appear to be credible and is also revealed by other indicators such as retail sales and construction output.

Weaker exports

In euro terms, exports increased by 4.9 % yoy in Jan–June 2007 and imports by 7.3 % yoy according to data from Statistics Estonia. Exports of "electrical machinery and equipment and parts thereof", which includes mobile phones and parts, declined by 30 %, as did imports. This is worrisome as it is accompanied by a partial relocation of production by globally operating companies to countries which are now more cost effective, especially in Asia. Estonia is also being affected by cuts in Russian oil supply and transit: exports of mineral fuels fell by 15 % and imports by 13 %. Increases in exports were observed in chemicals, wood and metals. On the import side, the demand for cars increased particularly strongly.

Slight fall in FX reserves

The current account deficit widened from EUR 972 mn in Jan–June 2006 to EUR 1197 mn in Jan–June 2007 due to the worsening foreign trade performance. We expect a CA deficit equivalent to 17 % of GDP for 2007 as whole. Net inward foreign direct investment amounted to EUR 1170 mn, more than EUR 400 mn higher than the year before, but outward FDI also increased to EUR 684 mn. As a result of the wider CA deficit and lower net capital inflows, mainly due to net outflows of short-term capital, official reserves fell slightly by EUR 43 mn. Under the currency board arrangement, declining reserves reduce central bank money and thus tighten monetary conditions.

Price and wage pressures

The strong growth in GDP has increasingly exceeded potential output growth, adding to price pressures. Consumer prices were 5.7 % higher in August 2007 than in August 2006, with administered prices up by 3.4 % and non-administered prices by 6.5 %. The August figure was lower than the one in July, but inflation will increase again: in September and October 2006, motor fuel prices fell considerably. The low base will translate into faster yoy inflation late this year. Energy price hikes early next year could accelerate inflation to an average 7 % in 2008.

Gross wages and salaries were 21.2 % higher in Q2 than a year earlier and almost double as high as in Q2 2003. With the exchange rate pegged to the euro, this has begun to erode competitiveness.

Profits peak, corporate debt high

Corporate profits were 69 % higher in Q1 2007 than two years earlier at constant prices, but will likely begin to decline now as markets become more difficult and labour costs and cost of capital are on the rise. The number of enterprise start-ups has begun to fall, while the number of bankruptcies has risen since the second half of 2006. Corporate indebtedness had grown to 71 % of GDP by the end of 2006 (compared to 69 % of GDP in the euro zone) and has since further increased. Growth in corporate loans slowed but still amounted to 43 % yoy in July 07.

In 2006, also the net financial position of households began to worsen, and this has gained speed in 2007.

Asset quality good for now

Despite higher interest rates, debt-servicing has remained disciplined until now. Loans overdue accounted for only 0.4 % of the loan portfolio as of 31 July 2007. The ratio of non-performing loans to loan loss provisions amounted to less than 88 %. However, the share of overdue loans will likely increase over the coming months.

Growth to slow, some restructuring required

Estonia's economy is set to cool, with prospects for a soft landing intact. Some corporate restructuring will be needed, however. The exploitation of current growth drivers such as low wages and taxes has reached its limits to some extent. Now decisive movements towards higher-end products are needed, which will take some time to engineer.

What 2008 and 2009 will bring

For 2008 we forecast real GDP growth of "only" 6.7 %, for 2009 6.4 % because of lower credit growth and weaker exports, and only after some restructuring a renewed acceleration of growth beginning in 2010. Inflation will accelerate to 7 % in 2008 due to higher food and energy prices. The risk premium over Eurozone interest rates will decline only marginally in 2008 and 2009 as loan quality particularly of loans to companies will deteriorate and the perception by foreign lenders might strengthen that the currency board arrangement is at risk. We expect however that the fx-rate to the Euro can be preserved unless the Scandinavian banks would be severely hit by the current global liquidity crisis.

Event	Date	Reading
GDP Q3 estimate	13 November 2007	Should provide further evidence about the cooling of the economy