Estonia

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Following a long period of high economic growth, a gradual slowdown is in progress. The external and fiscal positions have grown increasingly strong. Labour market conditions remain tight but risks to overall competitiveness posed by high wage increases have so far not materialized. Some policy uncertainty has been introduced following the new government.

Country Risk Analysis

Recent economic developments

Economic activity cooling. Growth slowed in 2018 but remained at a healthy pace compared to other countries in the region. Strong household spending, supported by high real income growth, and bouyant construction activity produced a real GDP expansion of 3.9% (down from 4.9%). For 2019 we forecast a continued slowdown in growth to 2.8%. Average growth since the financial crisis of 3.6% is high by historical standards. It is slightly higher than what has been seen in other economies in Central and Eastern Europe and more than double the rate in the EU. High growth has come without creating any significant macro imbalances, and has helped push GDP per capita a tad higher. However, in nominal USD terms, per capita incomes are still low compared to similarly rated economies. This weighs on country risk. Adjusted for purchasing power parity (PPP), levels are better in line with the average for similarly rated economies and slightly below 80% of euro area average.

Inflation heading lower. Higher than average economic growth has come hand in hand with higher than average inflation rates. Rising global energy prices and higher excise tax lifted inflation to an average of 3.4% in 2018, the highest in the euro area. In the past months inflation has moderated in line with developments in the euro area, and is expected to average about 2.3% in 2019.

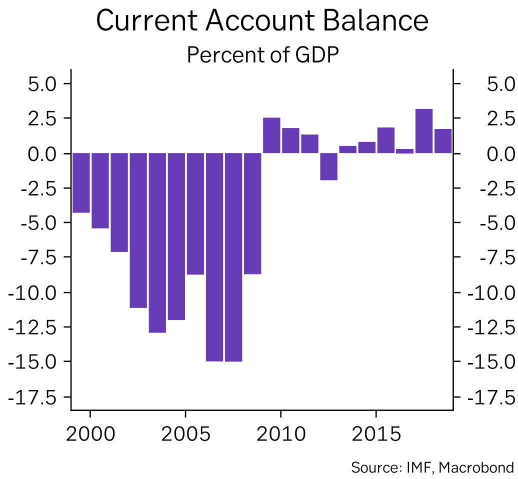
High growth puts pressure on labour market. Most estimates indicate that the economy is growing above its potential rate. As a consequence, the labour market has tightened further, with unemployment declining to 5.4%. Furthermore, the employment rate reached new highs (and the highest level among EU countries) last year helped by the multi-year "work-ability" reform introduced in 2016. These developments come despite relatively large inflows of foreign labour, mainly from Ukraine.

Wage costs rising at a high rate. The labour market is efficient by most measures, including a significant two-way flexibility of wages which has worked as a buffer against shocks. Still, an increasingly tight labour market in combination with a challenging demographic situation led to continued rapid wage hikes in 2018. Average wages rose by 7.3%, which is a slightly slower pace than in 2017 but still higher than average in the region. More importantly, it is higher than productivity growth, although measured as productivity per hours worked, the gap improved towards the end of 2018.

Long-standing threat to competitiveness remains mostly a threat... Estonia's small and very open economy makes it vulnerable to shifts in external demand and global sentiment. It also makes it vulnerable to a potential loss of competitiveness, due for example to rising wage costs. For several years Estonia's high wage growth has produced higher growth in unit labour costs than most of its competitors. While this poses threats to competitiveness, there is so far little evidence in data of exports suffering. Export growth accelerated in 2018 and, by most aggregate measures, global export shares increased.

…partly thanks to shifts in trade and production. The steady trade performance may signal that other factors than price matters for external competitiveness. A move higher up in the export value chain, including by a rising share of services exports, and a high and rising integration in the Nordic and Baltic supply chain have been highlighted as factors that help maintain competitiveness. In other words, a high degree of non-price competitiveness may be compensating for higher costs. A reflection of its competitiveness is its 32nd ranking of 137 countries in the World Economic Forum's (WEF) global competitiveness ranking. In addition, in contrast to for example Latvia and Lithuania, the WEF characterises Estonia as an innovation driven economy.

Current account does not indicate loss of competitiveness. In the years following the global financial crisis, the country's current account went through a structural shift. Following a long period of double digit deficits, improved competitiveness in combination with reduced import demand shifted the current account into surplus. In 2018, imports grew more rapidly than exports, thus reducing the surplus to 1.7% of GDP. We expect the current account to show a smaller surplus in the coming years. Foreign direct investment (FDI) as a share of GDP declined slightly in 2018.



External position is increasingly strong. The rebalancing that took place after the financial crisis also involved a significant deleveraging from the private sector. Hence, gross external debt as a percent of GDP has been on a declining trajectory ever since. In 2018, the ratio edged down below 80% reflecting, among other factors, some deleveraging in the banking sector. The banking sector stands for about one third of the debt. A stable share of the external debt, about 40%, is short term. In net terms, Estonia has become a growing creditor to the rest of the world, in 2018 to the tune of 18% of GDP. Furthermore, the deleveraging together with the current account surplus improved Estonia's net international investment position further in 2018. Estonia's external liabilities exceeded external assets by the equivalent of 27% of GDP. This stands in contrast to roughly 80% in 2009.

Economic policies

Small fiscal deficits. A long track record of strong public finances remains a key supporting factor for country risk. This is much due to a strong fiscal framework which increases transparency and predictability. In the past three years the headline budget balance has been in marginal deficit, however. Strong economic growth helped lift tax revenues in 2018 but higher than expected expenditures produced an increase in the deficit to an estimated -0.5% of GDP, slightly higher than budgeted.

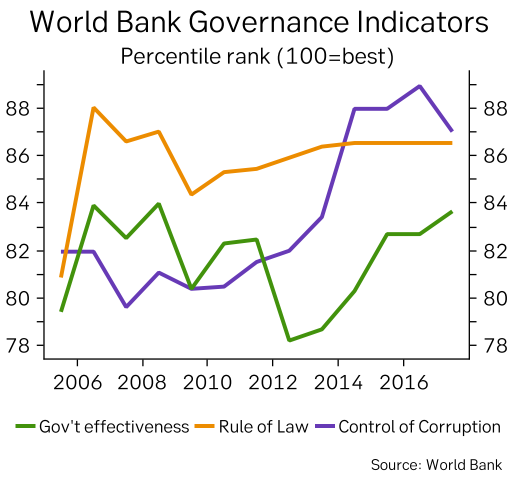
Very low government debt provides ample room for manoeuvre. Gross government debt edged down to 8.4% in 2018 of GDP, according to Eurostat. This is among the lowest of all countries that we cover. The central government has no bonds outstanding. The main share of the debt is due to the European Investment Bank. Expectations are for a continued gradual decline in the debt to GDP ratio. The government's fiscal strategy targets a debt ratio of 5-6% of GDP by 2022.

Fiscal reserves can be used to pay down debt. The government holds liquid financial assets in various fiscal reserve funds such as a general government reserve. These reserves amounted to about 9% of GDP in 2018 but are expected to decrease gradually in the next few years as the government intends to pay down existing debt.

Banking sector is stable. Most aggregate financial soundness indicators reflect a strong banking sector, with high capitalization and low share of non-performing loans. The past year's money laundering related irregularities have had limited effects on the general public's confidence in the overall banking system. Deposit growth has been steady. The central bank like most other observers, see negative spill-over effects from the Nordic economies and parent banks as the main risk to the banking sector. Deposits from non-residents, which to a greater extent risk being subject to money laundering than those of residents, have declined to 5% of total deposits. 0.3% of total bank deposits originate from clients not registered in the EU.

Economic structures

Governance indicators are strong. Strong and credible institutions are crucial factors reducing country risk in Estonia. Governance indicators are generally strong, in particular those relating to the rule of law and corruption, and have been broadly stable over the past decade or so. Moreover, the country ranks 16th among 190 countries in the World Bank's Doing Business index. This is a small drop compared to the previous year but an improvement since 2015 and superior to most country risk peers.



Rating agency upgraded sovereign rating. One of the major sovereign credit rating agencies improved the sovereign rating of Estonia in late 2018. They argued that the external position had strengthened thanks to years' of current account surpluses and deleveraging in the private sector. They also noted that competitiveness has been preserved despite the increase in labour costs. We broadly share these views and note that they contribute positively to country risk too.

Political developments

New government coalition raises political risk. Following general elections in 2019 a new three-party coalition is governing the country. The coalition is headed by the Centre party leader, and Prime Minister since 2016, Jüri Ratas and also includes conservative Isamaa and the far-right Conservative People's Party (EKRE). We assume continued prudent economic policies, with broadly balanced government budgets. There could be some downside risk to this assumption, however, as some representatives of the new coalition have declared increased tolerance towards budget deficits and public debt. For example, a planned pension reform could imply financing pressures in the longer-term as government support for the country's aging population may have to increase. This being said, a potential rise in the budget deficit to slightly above our forecast and a stabilization of government debt would not be alarming given the healthy starting point.

Outlook

Economic growth set to moderate further. A slight slowdown in real GDP growth is expected in 2019 and 2020 as household spending slows (from high levels) and demand from the euro area cools further. Our forecasts of 2.8 and 2.5% are broadly in line with those of the central bank. Labour markets will be tight also going ahead, but we expect slightly lower wage growth in 2019.

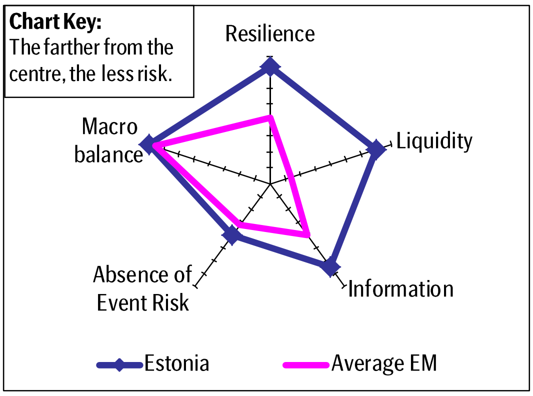
Risks to our main scenario are mainly external. Downside risks to our macro scenario include the ongoing slowdown in the euro area which includes Estonia's largest trading partners. Weaker than expected demand in the region would lead to lower exports and slower than forecasted GDP growth in Estonia, and could reduce the current account surplus further.

Geopolitical risks continue to weigh on country risk. Another important external risk is the geopolitical tail risk given Estonia's proximity to Russia and its large ethnical Russian population. Security tensions in the region could rise to such levels that they affect sentiment and economic activity negatively. This being said, Estonia has proven resilient to a range of political and economic developments in Russia, and a military invasion in the Baltic region appears highly unlikely.

Domestic risks: Labour supply constraints and loss of competitiveness. The past two years provided a welcome halt in the negative population trend due to chiefly positive net migration since 2015. Although the working age population has continued to decline, albeit at a slightly slower pace than before, forecasts still point to a decline by nearly 1% annually for the coming decade. The currently record high employment rate could mean that there is limited scope to boost the labour supply though policy measures. Consequently, there is a risk that the government fails in addressing this challenge and that the limited supply of labour holds back the country's growth potential to a greater extent than expected. In addition, a rising dependency ratio is set to pressure health and pension systems. A related and important risk going forward is that wage increases surpass productivity growth for an extended period. Such a diverging trend could lead to a loss of competitiveness, and hence pose risks to economic growth and to the current account balances.

Estonia: Risk Profile

Key Indicators	**2019**
Population (millions)	1.3
GDP/capita (USD)	17 269
Real GDP (% chg)	3.0
Inflation (%)	2.5
Current Account Balance (% of GDP)	-0.4
Reserves/imports (months)	0.4
Budget balance (% of GDP)	-0.4
Government debt (% of GDP)	7.6



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

Peers:
South Korea
Chile
Czech Republic

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

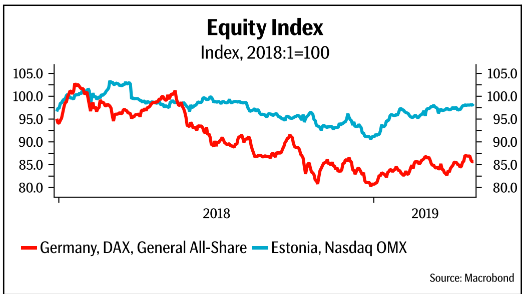
Estonia: Key Economic Indicators

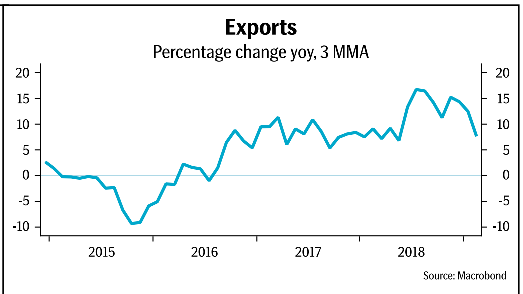
Macroeconomic	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP (USD bn)	18.6	19.6	20.9	21.7	22.7	23.0	23.1	23.9
GDP/capita (USD)	14144	14894	15884	16499	17269	17474	17575	18195
GDP (change)	1.9%	3.5%	4.9%	3.5%	3.0%	2.7%	2.3%	2.4%
Investments/GDP	24%	24%	26%	26%	27%	27%	27%	27%
Government Finances								
Budget balance/GDP	0.1%	-0.3%	-0.3%	-0.3%	-0.4%	0.3%	0.5%	0.6%
Govt debt/GDP	9.7%	9.5%	9.2%	8.4%	7.6%	7.2%	6.8%	6.8%
Money & Prices								
CPI inflation (%)	0.1	0.8	3.7	3.4	2.5	2.4	2.2	2.1
Money, M2 (yoy change)	50%	53%	51%	57%	44%	36%	30%	29%
Interest rates, short-term	0%	0%	0%	0%	0%	0%	0%	1%
Exchange Rate (EUR/USD)	1.1	1.1	1.1	1.2	1.1	1.2	1.2	1.3
Oil price (USD/barrel, Brent)	52	44	54	71	61	66	67	69
Balance of payments (USD, bn)								
Exports of goods	17.7	18.6	19.3	20.1	20.8	21.5	22.5	23.6
Imports of goods	16.8	17.7	18.4	19.5	20.1	20.9	21.8	22.8
Current account	0.4	0.5	0.9	0.5	0.4	0.3	0.3	0.3
as % of GDP	2.3	1.9	3.3	2.4	-0.4	-0.4	-0.4	1.2
FDI	-0.1	0.5	1.0	1.3	1.0	1.1	1.2	1.3
Loan repayments	-2.6	-2.6	-2.6	-2.5	-2.6	-2.5	-2.5	-2.5
Net other capital	-0.6	-2.1	-2.9	-1.2	1.8	1.6	1.6	1.4
Balance of payments	-3.0	-3.7	-3.6	-1.8	0.6	0.5	0.6	0.5
Reserves	0.3	0.2	0.2	0.7	0.7	0.7	0.8	0.8
Total debt	19.3	19.4	19.6	19.8	19.9	20.2	20.5	20.9
o/w short term debt	8.5	8.5	8.6	8.7	8.7	8.8	9.0	9.2

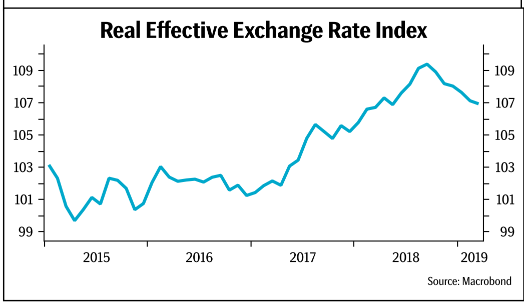
Sources: Oxford Economics, IMF and SEB estimates

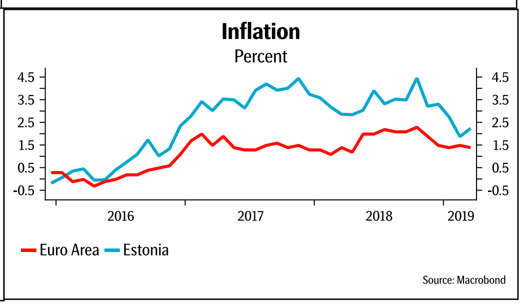
Rating history (eoy)				
Fitch	A+	A+	A+	AA-
Moody's	A1	A1	A1	A1

Type of government:	Parliamentary democracy
Next elections	Parliamentary 2023, Presidential 2020
Other:	
Latest PC deal	None
Latest IMF arrangements	2000, SBA









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