

## Key developments and challenges

The scale of the economic recession has resulted in a rapid increase in the fiscal deficit, unemployment and deterioration in credit quality. Further efforts are required to ensure fiscal sustainability, while financial stability can be improved by intensifying cooperation with foreign financial regulatory authorities.

Progress has been made in securing future energy supply with the agreement between the Baltic states on the creation of a common electricity market by 2013. Decisive steps to carry out these plans will be needed, while there also needs to be more emphasis on developing renewables and improving energy efficiency.

Measures to increase innovation, develop human capital and support investor confidence will be crucial to Estonia's effort to promote the tradeable sector in the coming years when domestic demand is expected to be more subdued.

### Country data

Population (in millions)	1.3
Area ('000 sq km)	45.2
GDP (in billion US\$, 2008)	23.5
Average transition score (scale: 1 to 4.33)	3.93

## Progress in structural reform

### Business environment and competition

The Estonian economy's flexibility and resilience are being tested by the rapid change in economic conditions. The business environment in Estonia has long been considered to be well advanced, with low levels of corruption. Estonia was ranked 24th globally in the World Bank's *Doing Business 2010* survey, the highest ranking among all the central Europe and the Baltic states countries. However, on a few indicators, relating to employing workers, protecting investors and closing a business, Estonia ranks relatively low. In addition, persistent regional differences in employment and skill mismatches also point to barriers to mobility, which are of concern at a time of rising unemployment. The new Employment Act, which took effect on 1 July 2009, aims to make hiring and firing easier and cheaper for employers, while also increasing unemployment benefits.

### Infrastructure

Securing sustainable supplies of energy and developing sources of renewable energy are becoming increasingly pressing in Estonia. This reflects the growing reliance on fossil fuels (and the costs linked to buying carbon dioxide emission allowances), the high energy intensity of production and the closure of the Ignalina nuclear power plant in Lithuania at the end of 2009. Eesti Energia's Aulepa wind park development began operations in 2009 and is expected to supply 1.3 per cent of Estonia's electricity consumption. This development is part of Eesti Energia's long-term strategy of decreasing carbon dioxide emissions, while increasing generation capacity by 2016 when the oil shale-fired power plants of AS Narva Elektriijaamad will be closed or reconstructed. In April 2009 the prime ministers of the three Baltic states agreed on the creation of a common electricity market by 2013, guided by the Scandinavian Nord Pool market, and to build power interconnections under the Baltic Sea to Sweden and Finland. For Estonia, the implementation of the Estlink-2 project, a 800 MW interconnection to Finland, is of particular importance. In addition, Estonia remains favourable to the idea of building a nuclear power plant in Lithuania, although delays have put it off until 2018 at the earliest.

Unbundling of Eesti Energia remains a challenge and Estonia has decided to open 35 per cent of the market by the end of 2009, with full liberalisation by 2013, although restrictions may be lifted earlier. Private sector participation in generation and distribution is growing, but effective competition is limited by the dominant position of Eesti Energia and the small size of the market.

### Financial sector

As the recession has deepened, there has been a rapid deterioration in credit quality, forcing a number of the main Nordic parent banks to raise provisioning and new capital. Non-performing loans (defined as loans overdue by over 60 days) have increased from 2 per cent of the total loan portfolio in August 2008 to 6.1 per cent in August 2009. Credit growth to the private sector has continued to decelerate, from an annual rate of over 60 per cent in early 2007 to -1.3 per cent in July 2009. The presence of foreign banks continues to be a positive factor, in particular as government support measures to the banking sectors in home countries have not carried any restrictions in access to capital for foreign subsidiaries and branches and all major parent banks have confirmed their commitment to remaining in the Baltic region. In recent years, banks have built up sizeable capital buffers, also by retaining profits, and in April 2009 the capital adequacy ratio stood at over two times the 10 per cent minimum required in Estonia. Bank of Estonia has assessed that up to 6 per cent of the total portfolio could be written off while still remaining within the regulatory requirement. As the global financial crisis deepened in late 2008 and early 2009, a precautionary swap arrangement to provide foreign exchange liquidity was made with the Swedish central bank in February 2009 (allowing for access to Sk 10 billion (€0.92 billion) in exchange for Estonian kroons) in order to secure financial stability and promote confidence in financial markets. In Estonia, over 80 per cent of all loans are in foreign currency, mainly in euro.

## Macroeconomic performance

GDP growth fell by 3.6 per cent in 2008 following an eight-year period when growth averaged 8.4 per cent per year. The slow-down had begun in the domestic sector in 2007 and was further aggravated by the global financial turmoil in late 2008. Real GDP declined by nearly 16 per cent in the first half of 2009 (year on year) with the construction and real estate sectors particularly affected. From a record low of 4 per cent in the second quarter of 2008, unemployment has risen rapidly to 13.3 per cent in the second quarter of 2009.

In response, inflation has decelerated rapidly since the end of 2008. From an average of 10.4 per cent in 2008, the annual inflation rate fell to -0.9 per cent in August 2009. Annual wage growth has also slowed, from over 20 per cent in 2007, to -4.4 per cent in the second quarter of 2009.

The economic slow-down has led to a rapid external adjustment, with the current account turning into a surplus of 4.9 per cent of GDP in the second quarter of 2009, compared with a deficit of close to 18 per cent in 2007.

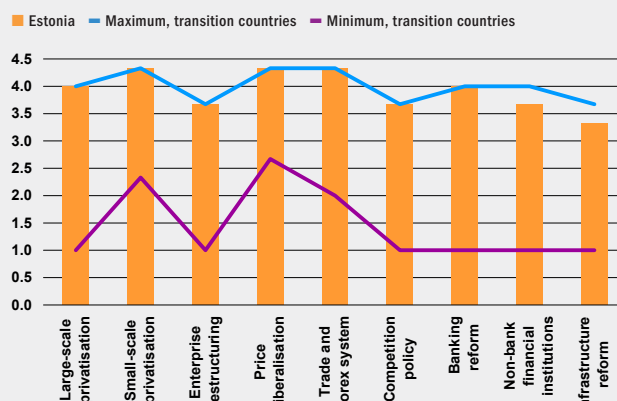
From a surplus in 2007, the general government balance moved into a deficit of 2.7 per cent of GDP in 2008. The weak economy has resulted in a rapid deterioration in budget revenues, forcing the government to implement emergency spending cuts and additional expenditure adjustments to halt the increase in the deficit. The past years of prudent fiscal policy have provided Estonia with a buffer of fiscal reserves, which have been helpful during the financial crisis.

## Outlook and risks

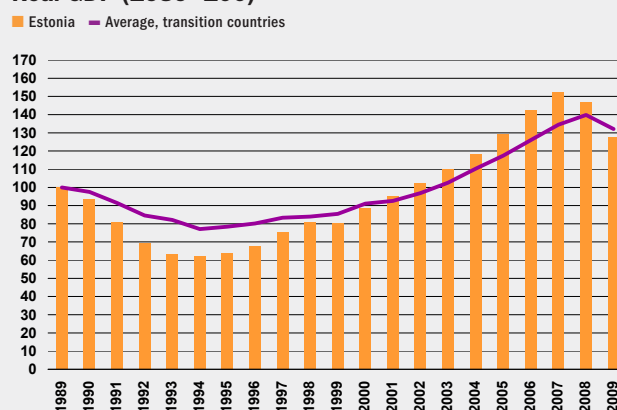
Real GDP is expected to contract by 13.2 per cent in 2009, with any recovery beyond that largely dependent on external demand conditions as domestic demand is likely to take longer to recover. So far, the flexibility of the Estonian economy has been impressive – a key condition for maintaining competitiveness and a successful currency peg. With a strong fiscal position at the outset of the crisis, no International Monetary Fund (IMF) support package has been required. The main challenges in the short term include addressing the rapid increase in unemployment and the deterioration in non-performing loans, while easing financing constraints to avoid any further weakening of growth.

It will be necessary to further expand the tradeable sector and increase exports of higher value-added products. Measures to control the deterioration in public finances, improve innovation and human capital, as well as developing key sectors for future growth will be important for investor confidence and for attracting foreign investment. Moreover, finding sustainable solutions in the energy sector will be a key challenge. With macroeconomic imbalances being reduced, Estonia is again approaching a situation where adoption of the euro may be possible. Focus on fiscal sustainability will, in this regard, be crucial for a successful participation in the euro.

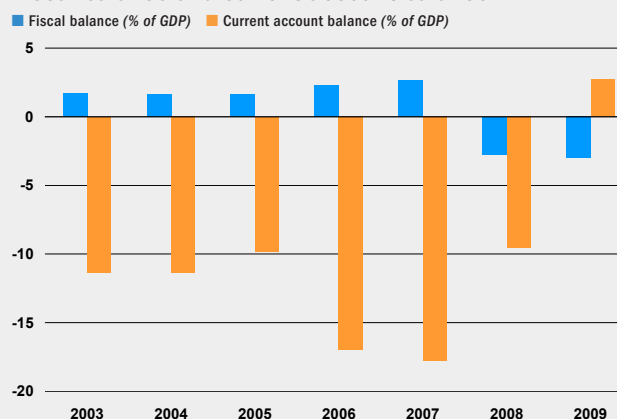
## Transition indicators 2009



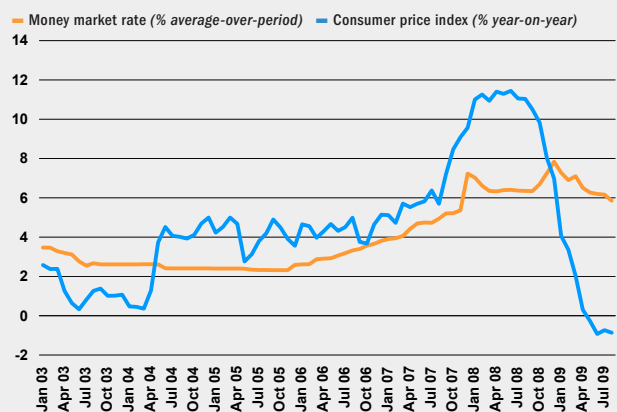
## Real GDP (1989=100)



## Fiscal balance and current account balance



## Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility - full	Competition office - yes	Telecoms regulatory assessment compliance - full	Capital adequacy ratio - 10 per cent	Share of population living in poverty - <2.0 per cent (2004)
Controls on inward direct investment - no	Quality of insolvency law - high	Independence of the electricity regulator - full	Deposit insurance system - yes	Government expenditure on health - 4.0 per cent of GDP (2005)
Interest rate liberalisation - full	Secured transactions law - inefficient	Separation of railway infrastructure from operations - full	Private pension funds - yes	Government expenditure on education - 6.0 per cent of GDP (2005)
Exchange rate regime - currency board in ERM II		Independence of the road directorate - partial		Household expenditure on power and water - 6.1 per cent
Wage regulation - no				
Tradeability of land - full except foreigners				

### Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
<b>Enterprises</b>							
Privatisation revenues (cumulative, in per cent of GDP)	7.1	7.2	na	na	na	na	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	73.7	74.5	75.5	74.8	75.9	76.3	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	2.1	2.3	2.2	2.4	2.6	na
Share of industry in total employment (in per cent)	25.2	27.0	26.0	23.8	22.9	23.4	na
Change in labour productivity in industry (in per cent)	4.3	1.5	14.6	14.2	11.1	-7.1	na
Investment/GDP (in per cent)	33.1	33.1	33.8	38.7	40.2	29.7	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<b>Markets and trade</b>							
Share of administered prices in CPI (in per cent) <sup>1</sup>	24.9	26.9	26.7	24.7	23.3	21.6	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	2.0	2.0	2.0	na
Share of trade with non-transition countries (in per cent)	71.6	72.4	71.8	67.5	65.9	64.1	na
Share of trade in GDP (in per cent)	109.2	114.8	125.0	135.7	121.6	118.6	na
Tariff revenues (in per cent of imports)	0.1	0.2	0.3	0.3	0.3	0.3	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.3	3.3	3.7	3.7	3.7	3.7
<b>Financial sector</b>							
Number of banks (foreign-owned)	7 (4)	9 (6)	13 (10)	14 (12)	15 (13)	17 (15)	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	97.5	98.0	99.4	99.1	98.8	98.2	na
Non-performing loans (in per cent of total loans)	0.5	0.3	0.2	0.2	0.5	1.9	na
Domestic credit to private sector (in per cent of GDP)	30.6	39.6	56.6	77.5	87.2	91.9	na
Domestic credit to households (in per cent of GDP)	14.3	19.7	28.1	38.2	43.3	46.9	na
- Of which mortgage lending (in per cent of GDP)	9.5	14.6	22.6	33.0	37.7	41.0	na
Stock market capitalisation (in per cent of GDP)	38.3	46.9	25.0	34.2	26.3	8.6	na
Stock trading volume (in per cent of market capitalisation)	18.3	17.5	51.1	20.5	34.9	25.4	na
Eurobond issuance (in per cent of GDP)	5.8	8.1	2.5	0.0	0.2	0.0	na
<i>EBRD index of banking sector reform</i>	3.7	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of reform of non-bank financial institutions</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.1 (77.6)	32.9 (93.1)	32.8 (107.3)	33.6 (123.4)	36.9 (147.6)	37.1 (188.2)	na
Internet users (per 100 inhabitants)	45.3	49.5	58.3	60.1	63.6	63.6	na
Railway labour productivity (1989=100)	256.5	294.4	359.7	348.0	285.2	208.2	na
Residential electricity tariffs (USc kWh)	6.5	8.1	9.2	10.1	10.2	11.5	na
Average collection rate, electricity (in per cent)	99	99	99	99	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.6	3.8	4.4	na	na	na	na
<i>EBRD index of infrastructure reform</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
- Electric power	3.0	3.0	3.0	3.3	3.3	3.3	3.3
- Railways	4.3	4.3	4.3	4.3	4.0	4.0	4.0
- Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
- Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	4.0
- Water and wastewater	4.0	4.0	4.0	4.0	4.0	4.0	4.0

<sup>1</sup> The high share is explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the Statistical Office.

## Macroeconomic indicators

	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
<b>Output and expenditure</b>	<i>(Percentage change in real terms)</i>						
GDP	7.6	7.2	9.4	10.0	7.2	-3.6	-13.2
– Private consumption	8.6	9.6	9.9	13.0	9.1	-4.8	na
– Public consumption	0.8	2.0	-0.2	3.5	3.7	4.1	na
– Gross fixed capital formation	18.6	5.2	15.4	18.5	9.0	-12.1	na
– Exports of goods and services	7.4	14.6	18.6	14.0	0.0	-0.7	na
– Imports of goods and services	10.1	14.4	17.5	22.9	4.7	-8.7	na
Industrial gross output	8.4	8.9	12.5	11.4	8.1	-4.8	na
Agricultural gross output	3.7	-9.3	-3.2	-4.0	6.5	0.2	na
<b>Employment</b>	<i>(Percentage change)</i>						
Labour force (annual average)	1.2	-0.2	0.1	4.1	0.1	1.1	na
Employment (annual average)	1.5	0.2	2.0	6.4	1.4	0.2	na
Unemployment (annual average)	<i>(In per cent of labour force)</i>						
	10.0	9.6	7.9	5.9	4.7	5.5	na
<b>Prices and wages</b>	<i>(Percentage change)</i>						
Consumer prices (annual average)	1.3	3.0	4.1	4.4	6.6	10.4	0.3
Consumer prices (end-year)	1.1	5.0	3.6	5.1	9.6	7.0	-0.8
Producer prices (annual average)	0.2	2.9	2.1	4.5	8.3	7.1	na
Producer prices (end-year)	0.3	3.9	2.2	5.9	8.7	5.2	na
Gross average monthly earnings in economy (annual average)	9.4	8.4	10.8	16.5	20.5	13.9	na
<b>Government sector</b>	<i>(In per cent of GDP)</i>						
General government balance	1.7	1.6	1.6	2.3	2.6	-2.7	-3.0
General government expenditure	34.8	34.0	33.6	34.0	34.8	39.9	na
General government debt	5.6	5.0	4.6	4.5	3.8	4.6	na
<b>Monetary sector</b>	<i>(Percentage change)</i>						
Broad money (M2, end-year)	10.9	15.8	42.0	28.2	13.4	5.5	na
Domestic credit (end-year)	28.7	29.2	32.1	41.9	34.2	8.1	na
Broad money (M2, end-year)	<i>(In per cent of GDP)</i>						
	36.8	38.4	47.2	51.2	49.1	50.4	na
<b>Interest and exchange rates</b>	<i>(In per cent per annum, end-year)</i>						
Deposit rate (over 12 months)	2.4	2.1	3.0	4.1	5.6	6.0	na
Lending rate (over 12 months)	5.1	6.2	9.2	7.7	9.7	11.1	na
Exchange rate (end-year)	<i>(Kroons per US dollar)</i>						
	12.4	11.5	12.5	11.9	10.6	11.1	na
Exchange rate (annual average)	13.9	12.6	12.4	12.5	11.4	10.7	na
<b>External sector</b>	<i>(In millions of US dollars)</i>						
Current account	-1,116.3	-1,369.5	-1,386.8	-2,816.0	-3,803.8	-2,245.4	517.9
Trade balance	-1,556.7	-1,947.7	-1,920.4	-3,010.9	-3,816.0	-2,763.8	-750.1
– Merchandise exports	4,595.8	5,929.5	7,879.1	9,755.6	11,089.4	12,568.4	8,939.9
– Merchandise imports	6,152.5	7,877.2	9,799.5	12,766.5	14,905.4	15,332.2	9,690.0
Foreign direct investment, net	762.7	697.8	2,255.1	675.8	999.5	875.8	-50.0
Gross reserves, excluding gold (end-year)	1,373.4	1,792.5	1,945.1	2,855.9	3,330.0	3,913.0	na
External debt stock <sup>1</sup>	7,064.7	10,173.6	11,446.7	16,992.4	25,502.8	26,843.3	na
Gross reserves, excluding gold (end-year)	<i>(In months of imports of goods and services)</i>						
	2.2	2.2	1.9	2.2	2.2	2.5	na
Debt service	<i>(In per cent of exports of goods and services)</i>						
	20.5	26.2	27.0	30.4	38.1	39.0	na
<b>Memorandum items</b>	<i>(Denominations as indicated)</i>						
Population (end-year, million)	1.4	1.4	1.3	1.3	1.3	1.3	na
GDP (in billions of kroons)	136.4	151.5	175.0	207.0	244.5	251.5	219.0
GDP per capita (in US dollars)	7,258.5	8,903.8	10,495.7	12,340.5	15,930.7	16,686.9	na
Share of industry in gross value added (in per cent)	25.4	24.7	25.3	25.7	26.2	25.9	na
Share of agriculture in gross value added (in per cent)	3.6	3.4	3.1	2.8	2.9	2.5	na
Current account/GDP (in per cent)	-11.3	-11.4	-9.8	-17.0	-17.8	-9.5	2.7
External debt – reserves (in US\$ million)	5,691.3	8,381.1	9,501.6	14,136.5	22,172.8	22,930.3	na
External debt/GDP (in per cent)	71.8	84.6	80.9	102.4	119.3	114.1	na
External debt/exports of goods and services (in per cent)	103.6	115.9	102.9	128.1	164.7	151.2	na

<sup>1</sup> Data from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.