



## Flash report

### **CURRENT ACCOUNT DEFICIT IN ESTONIA: HOW WILL IT ADJUST IN TURBULENT TIMES?**

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**The Estonian economy has been enjoying steady foreign direct investment (FDI) and bank financing inflows over the last decade, underpinned by rapid economic restructuring, strong demand for new capital and excellent investment opportunities.** The resulting build-up of FDI stock is among the largest in the new member states of the EU, accounting for 75% of GDP at the end of 2007. However, large capital inflows have been accompanied by widening current account deficit, as external financing has supplemented to domestic savings in order to meet new investment needs. Moreover, Estonia's gross external indebtedness increased to 114% of GDP, with intra-group borrowing by banks and non-financial corporations accounting for about two thirds of that. Net external debt is lower, standing at 35% of GDP. Although investment-driven external deficits are regarded natural in rapidly catching-up economies, they nevertheless reflect risks to growth.

**A marked improvement in external balance is now underway, as the current account deficit (CAD) is expected to decline to around 6% of GDP in 2009.** After peaking at around 18% at the beginning of 2007 the current account deficit to GDP ratio narrowed to about 10% in the second quarter of 2008. The substantial adjustment of external accounts is driven by a significant correction in domestic demand and still solid export performance.

**Equally important are the changes in the composition of the current account, where trade and services deficit will fall below 3% of GDP in 2009. The rest of CAD mostly comprises "outflows" of investment income on FDI, most of which are reinvested in Estonia.** Although the dynamics of the current account are mainly shaped by the trade balance, the large contribution of imputed investment income outflows deserves special attention. In 2008, the average current account deficit equals to around 10% of GDP, with net investment income outflows accounting for two-thirds of that. The majority of these outflows reflect undistributed profits on foreign direct investment, which foreign-owned companies choose to reinvest in Estonia.

**The accrual-based income outflow should be regarded as an issue related to the long-term sustainability of the external balance, not as a factor increasing the vulnerability associated with high external financing needs in the short run.** Indeed, as the economy matures, profits on FDI will gradually converge to average EU levels. This will lead to an automatic decline in CAD as the investment income outflow will decrease relative to GDP along with lower profits. The same applies to lower profitability in the short run, as falling profits will inevitably result in lower CAD.

**Most importantly, the combined net cash flows from the EU budget will nearly offset the trade and services balance in 2008 and exceed it in 2009.** When assessing short-term external financing needs, especially in light of the current financial turmoil, one should:

- (a) define "external financing needs" as "borrowing needs";
- (b) concentrate on the balance of trade and services (trade balance);
- (c) evaluate the volume of trade balance against the cash flows in the form of current transfers and EU funding (mainly recorded on the capital account).

The above assessment shows that in the first half of 2008 both the trade deficit and financing needs have decreased considerably and are expected to decline even further (see Tables 1 and 2). Thus, actual residual net financing needs comprise 4.6% of GDP in 2008 and 2.5% of GDP in 2009 (net external interest payments will remain around 2% of GDP). Of course, the administrative capacity to use the opportunities arising from EU membership must be on track and further improved.

**With the economy starting to pick up in late 2009, CAD is expected to be around 7% of GDP in 2010, as the investment to GDP ratio will be high even during the ongoing economic slowdown and Estonia's exports will remain competitive.** However, it should be noted that the pace of capital formation in the next couple of years could well be lower in the context of the current financial turmoil. In that case, CAD will decline further. Moreover, due to lower credit demand the growth rate of deposits has exceeded the rate of credit growth in recent months. Therefore, the increased domestic savings have "covered" the new loans in recent months.

**Table 1. Trade deficit has declined considerably in 2008**

		Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
Current account / GDP (%)	1	-10.7	-17.3	-16.2	-14.7	-18.7	-23.9	-15.8	-16.8	-16.4	-13.3	-10.0
Trade balance / GDP (%)	2	-7.9	-11.4	-11.4	-10.6	-13.7	-14.3	-10.7	-10.2	-10.3	-6.8	-3.4
Income balance / GDP (%)	3*	-2.3	-4.6	-4.2	-3.5	-3.9	-7.9	-4.7	-5.8	-5.0	-6.2	-5.9
Transfers balance / GDP (%)	4	0.3	-0.4	0.7	0.6	0.3	-0.3	1.2	1.0	1.0	2.1	1.5
Capital account / GDP (%)	5	1.7	2.7	1.4	2.3	2.1	0.9	0.9	0.9	1.7	2.1	0.8
Financing needs / GDP (%)	6**	-6.7	-10.1	-10.6	-8.8	-12.7	-15.1	-10.3	-10.1	-9.6	-5.0	-3.4

\*) Defined as net of interest payments.

\*\*\*)  $6 = 1 - 3 + 5$

**Table 2. External balance is expected to improve further**

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Current account / GDP (%)	1	-5.4	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-11.1	-6.3	-7.1
Trade balance / GDP (%)	2	-3.3	-2.1	-7.1	-7.4	-7.4	-6.4	-11.8	-11.3	-5.6	-2.8	-3.4
Income balance / GDP (%)	3*	-2.7	-3.4	-3.5	-4.6	-4.3	-3.1	-3.7	-4.8	-4.5	-2.0	-2.2
Transfers balance / GDP (%)	4	1.5	1.4	0.9	1.4	1.0	0.5	0.3	0.7	2.1	1.5	1.4
Capital account / GDP (%)	5	0.5	0.2	0.5	0.7	0.7	0.8	2.1	1.1	2.0	1.8	3.3
Financing needs / GDP (%)	6**	-2.3	-1.6	-6.6	-6.0	-6.7	-6.2	-10.9	-12.1	-4.6	-2.5	-1.6

\*) Defined as net of interest payments.

\*\*\*)  $6 = 1 - 3 + 5$