

Full Rating Report

Estonia

Ratings

Foreign Currency	
Long-Term IDR	A+
Short-Term IDR	F1
Local Currency	
Long-Term IDR	A+
Country Ceiling	AAA

Outlooks

Foreign-Currency Long-Term Rating	Stable
Local-Currency Long-Term Rating	Stable

Financial Data

Estonia	
USDbn	2010
GDP	19.2
GDP per head (USD 000)	14.3
Population (m)	1.3
International reserves	2.6
Net external debt (% GDP)	25.4
Central government total debt	3.2
CG foreign-currency debt	0
CG domestically issued debt (EURbn)	0.1

Analysts

Michele Napolitano
+44 203 530 1000
michele.napolitano@fitchratings.com

Douglas Renwick
+44 20 3530 1045
douglas.renwick@fitchratings.com

Related Research

Applicable Criteria

- [Sovereign Rating Methodology](#)

Other Research

- [Macro-Prudential Risk Monitor \(June 2011\)](#)
- [Sovereign review and outlook \(June 2011\)](#)
- [Global Economic Outlook: Soft Patch in Global Recovery \(June 2011\)](#)
- [Estonia's Euro Upgrade: Why the Single Currency Has Boosted its Ratings \(July 2010\)](#)

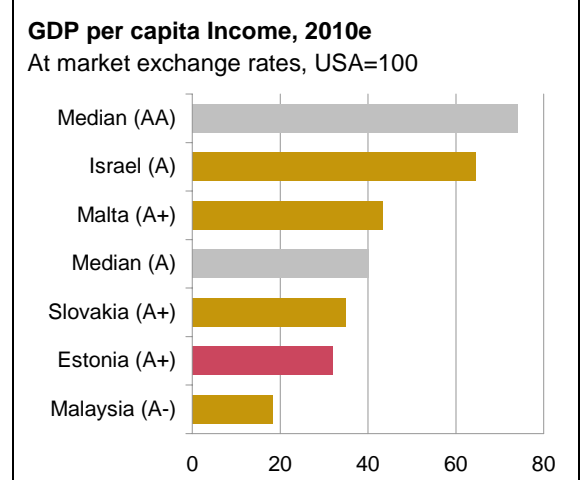
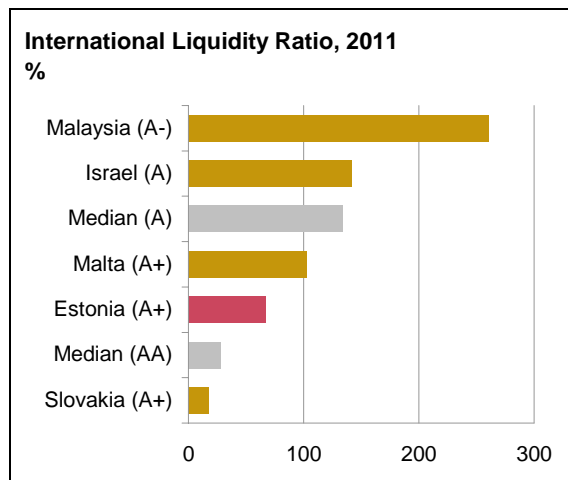
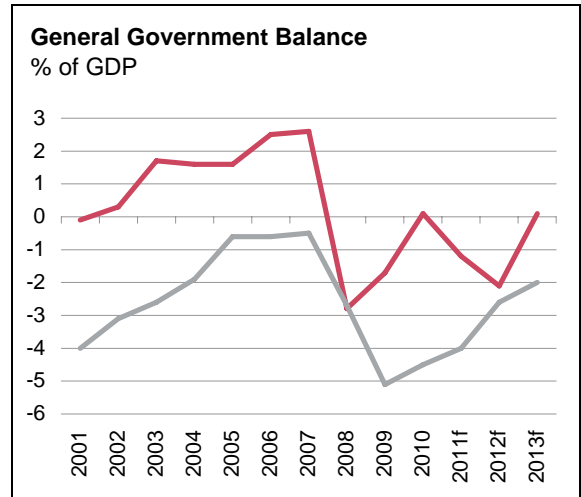
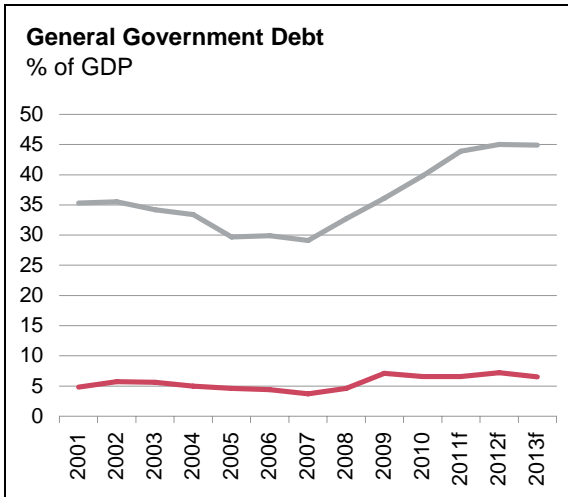
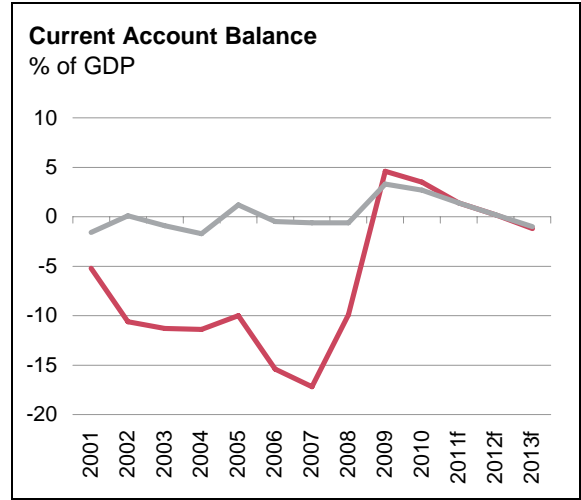
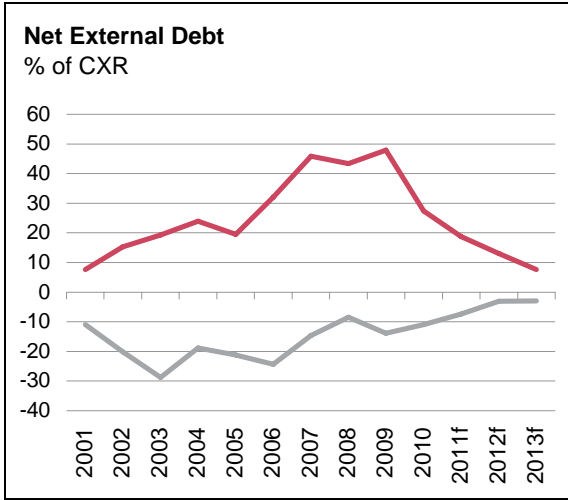
Rating Rationale

- On 5 July 2011 Fitch Ratings upgraded Estonia's Foreign-Currency and Local-Currency Long-Term IDRs to 'A+' from 'A'. The Outlooks are Stable. The upgrade reflects strong economic recovery driven by solid export and investment performance, continued fiscal discipline, declining external debt ratios and an easing in banking sector risks. The agency has also affirmed the Short-term foreign currency IDR at 'F1' and the Country Ceiling at 'AAA'.
- Public finances are Estonia's key rating strength and euro area membership increases the significance of fiscal policy in the rating profile. Estonia's public debt is the lowest in the EU (6.6% of GDP in 2010) and is more than offset by liquid assets. The government reached a budget surplus of 0.1% in 2010. The country has never been placed under the Excessive Deficit Procedure.
- The country is experiencing a strong "V"-shaped recovery, albeit after a severe recession. GDP grew by 8.5% yoy in the first quarter of 2011, mainly driven by strong export growth. Fitch forecasts growth of 4.8% and 4.2% in 2011 and 2012, driven by exports and a recovery in investment.
- The recent rebound in economic growth is not driven by inflows of foreign capital in the non-tradable sector. This is a key difference from the pre-crisis growth model, and increases confidence that the country can grow robustly without generating macroeconomic imbalances.
- Wages and prices proved flexible during the crisis and competitiveness was regained. Such flexibility is an important asset for a small country in a currency union, enabling it to adjust after a loss of competitiveness.
- Estonia's economic volatility is a rating weakness. After average growth of 8.4% in 2000-2007, output fell by 3.6% in 2008 and 14.1% in 2009. The economy grew by 3.1% in 2010. Inflation has also been fairly high and volatile.
- The banking sector's risks are declining. Funding dynamics and capital adequacy ratios improved in 2010, while asset quality seems to have stabilised. Foreign (mainly Nordic) bank ownership significantly limits the sovereign's exposure to the sector.
- Euro area membership has markedly reduced the risks of a balance-of-payment crisis as the large-currency mismatches in banks' loan portfolios have now been neutralised. Nevertheless, Estonia's gross and net external debt ratios to both GDP and current account receipts are above the 10-year 'A' category medians. However, they are declining, and a large share of banks' external debt is to foreign parents, which entails much lower refinancing risk than market debt.
- Estonia's ratings are supported by underlying political and institutional strengths underpinned by its EU membership.

Key Rating Drivers

- A further track record of strong economic growth without significant macroeconomic imbalances could lead to an upgrade, particularly if combined with a continued decline in external debt ratios.
- Significant macroeconomic or financial instability (or signs of overheating) – for example arising from inflation or balance of payment imbalances – could put downward pressure on the rating.

Peer Comparison



— Estonia

— Medians

Rating Factors

Summary: Strengths and Weaknesses

Rating Factor	Macroeconomic	Public Finances	External Finances	Structural Issues
Status	Weakness	Strength	Neutral	Strength
Trend	Positive	Stable	Stable	Stable

Note: Relative to 'A' category (sovereigns rated 'A+', 'A' and 'A-')

Strengths

- The rating is supported by the country's institutional strengths. On measures of governance and corruption, Estonia is in line with 'A' and 'AA' peers. Estonia outperforms both the 'A' and 'AA' range median in the World Bank's Ease of Doing Business index.
- Estonia's public finances are exceptionally strong. The government reached a budget surplus of 0.1% and public debt was the lowest in the euro area (6.6% of GDP) in 2010.
- The recent track record of fiscal adjustment boosted the government's fiscal credibility and supports Estonia's rating. This is particularly important in light of the current euro area sovereign crisis.
- Wages and prices proved flexible during the crisis and competitiveness was regained.
- Current economic growth dynamics are driven by exports and investment. Unlike pre-crisis growth, it is not fuelled by excessive credit growth.
- Foreign bank ownership limits the sovereign's contingent liabilities through the provision of liquidity and capital support to the domestic banking system.

Weaknesses

- Estonia's external debt ratios are high. Gross and net external debt ratios to both GDP and current account receipts are above the 10-year 'A' range medians. However, they are declining, and a large proportion of banks' external debt is to foreign parents, which entails much lower refinancing risk than market debt.
- The unemployment rate is well above the 'A' median. Evidence suggests the existence of skill mismatches in the labour market.
- Estonia's economic volatility is a rating weakness. After average growth of 8.4% in 2000-2007, output fell by 3.6% in 2008 and 14.1% in 2009. The economy grew by 3.1% in 2010. Inflation has also been fairly high and volatile.

Local Currency Rating

For rated euro area sovereigns Fitch sets equal Local-and- Foreign-Currency ratings. For Estonia both ratings are 'A'. This reflects the lack of independent monetary policy and the potential to monetise its domestic debt stock, and lack of preferential access to domestic capital markets. As an EMU member, Estonia also benefits from low currency risk. Operating largely in euros means there is little difference in the sovereign's ability to service foreign- or local-currency debt.

Country Ceiling

Fitch assigns a single 'AAA' ceiling to all 17 euro area members because euro area sovereigns do not have preferential access to foreign exchange. The risk that a resident entity will be unable to transfer funds to a non-resident creditor due to an inability to convert euro into foreign currency – transfer and convertibility risk – is considered independent of the host's sovereign default risk. The 'AAA' ceiling reflects this (very low) euro-area-wide transfer and convertibility risk.

Peer Group

Rating	Country
AA-	Italy
	Saudi Arabia
A+	Estonia
	Chile
	China
	Czech Republic
	Korea
	Malta
	Slovakia
Taiwan	
A	Israel
	San Marino

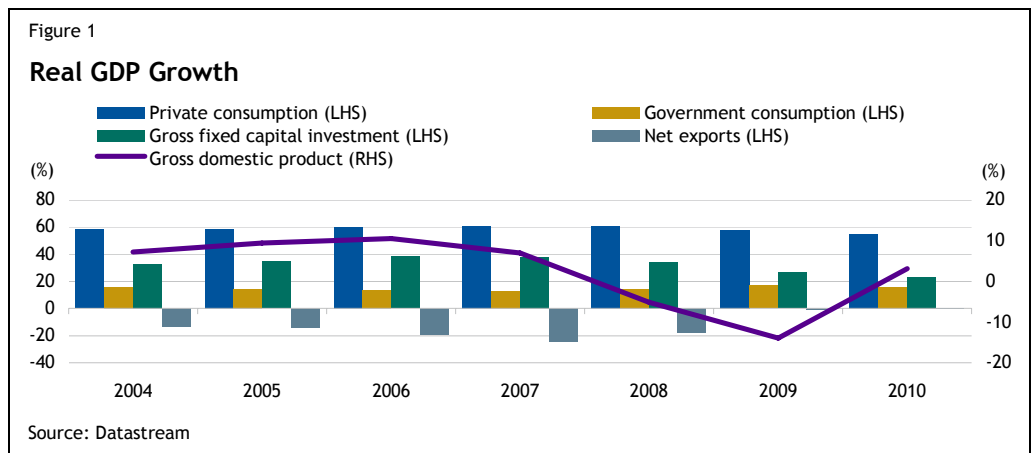
Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
19 Jul 10	A	A
08 Apr 09	BBB+	A-
03 Oct 08	A-	A+
07 Jul 04	A	A+
30 Aug 01	A-	A+
28 Sep 00	BBB+	A
11 Sep 97	BBB	A

Outlook and Key Issues

Exports Drive the Recovery

Estonia suffered a cumulative real GDP contraction of 19% in 2008-2009 due to a collapse in gross fixed investment coupled with a slowdown in external demand. After nine consecutive quarters of negative economic growth, real GDP turned positive in Q210. Driven by strong external demand from its main trading partners, the Estonian economy grew by 3.1% throughout 2010. Exports of goods and services (measured at 2000 prices, not seasonally adjusted) rose by 21.7%; exports of goods alone grew by 32.7%, exceeding pre-crisis growth rates. However, domestic demand remained weak (0.9%). The strong export-driven recovery indicates that the process of “internal devaluation” during 2009-2010 has allowed the economy to gain external competitiveness while maintaining the currency board.



Now that Estonia has adopted the euro, maintaining competitiveness is crucial for achieving sustained and balanced economic growth. The economy proved flexible during and after the global financial crisis of 2008-2009: labour productivity increased and unit labour costs dropped further in 2010¹. According to the EU Commission, wage and working-time adjustment have helped Estonia regain competitiveness. IMF calculations² support the Commission's view as they suggest that the real exchange rate is undervalued by around 2%-4%. Furthermore, the IMF suggests that the country's export market share has remained broadly stable, indicating that technological competitiveness has improved – export composition is shifting towards higher-value added products.

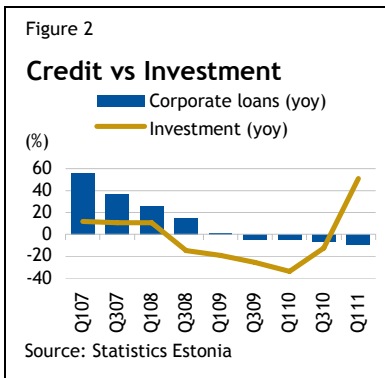
Investment Will Underpin Growth Alongside Exports

Recent data suggest that GDP growth appears to have momentum. Real GDP rose by 8.5% yoy in the first quarter of 2011. Exports of goods and services continued to grow strongly (39% yoy), but domestic demand has also started to recover. In Q410 gross fixed capital formation made a positive contribution to growth after having contracted for 13 consecutive months. In Q111 gross fixed investment rose by 12% yoy and private consumption also grew by 5% yoy, bringing domestic demand growth to 12.7%. Retail sales grew by 5% yoy in April 2011; this was the third consecutive yearly increase in retail sales volume, suggesting that deleveraging among households may be coming to an end.

Fitch forecasts real GDP growth of 4.8% for 2011 and 4.2% in 2012. In H111 exports will continue to be the main driver of growth, although they will slow in H211, mainly as a result of a weaker base effect. However, investments will pick up more

¹ Quarterly Report on the Euro Area, Section III.2

² IMF Staff Report Article IV Consultation February 2011



decisively: evidence suggests that capacity utilisation is full and that private enterprises are now willing and able to invest in new machinery and equipment.

In Q111 investment in fixed tangible assets increased by 51% (see Figure 2). With credit growth still subdued, corporate profitability is the current driver of investment: in Q111 enterprises' profits more than doubled relative to a year earlier. Increased corporate profitability, allocation of EU co-funded infrastructure projects, planned investments in the energy sector and government obligations to reinvest revenue from carbon credit trade underpin the outlook for gross fixed investment in 2011-2012.

Is Growth Dynamics sustainable?

A key issue is whether the country can achieve balanced economic growth to raise living standards without generating inflation or macroeconomic imbalances that threaten financial stability. Estonia's track record indicates that inflation has been fairly high and volatile, while GDP growth has been dependent on capital flows that have generated large current account deficits before a shock caused the boom to end in a recession.

A contributing factor behind the exaggerated credit cycle in Estonia was the inappropriately loose monetary stance imported from the European Central Bank. As a peripheral member of the euro area (accounting for just 0.2% of total GDP), monetary policy will continue to be inappropriate some (or perhaps most) of the time. This increases the chance that Estonia's real output will be volatile.

Nevertheless, the recent rebound in economic growth is not driven by inflows of foreign capital in the non-tradable sector, a key difference from the pre-crisis growth model (see Figure 3). The sources of current growth are more benign: positive development in trading partners and increased profitability in the corporate sector are driving growth in the export-oriented manufacturing sector.

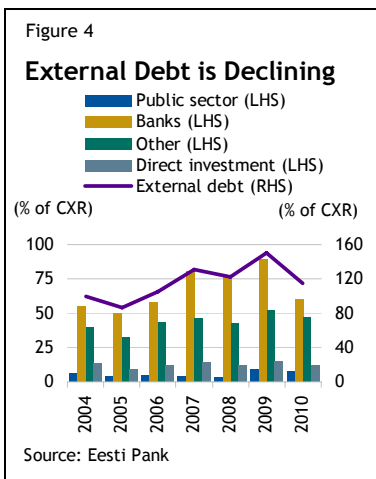
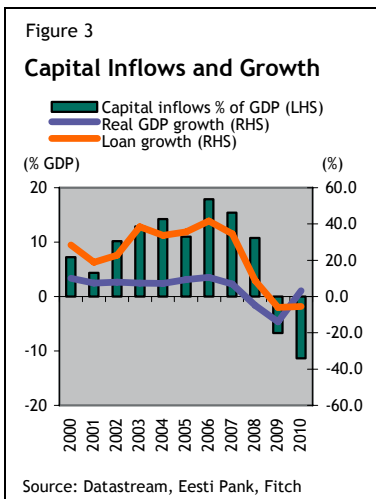
Estonia proved able to weather the global financial crisis while maintaining a fixed exchange rate and a low fiscal deficit, which suggests the economy is sufficiently flexible to cope with the volatile nature of convergence with the rest of the union. Wages and prices have been able to adjust rapidly and the country compares favourably with euro peers on OECD measures of product and labour market flexibility. Being able to undertake such internal devaluation is a key strength for a small country in a currency union, enabling it to adjust after a loss of competitiveness.

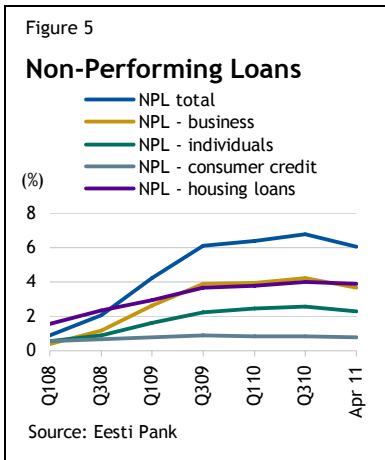
Banking System Risks Have Eased

The recession exerted severe pressure on the Estonian banking system, which experienced a marked deterioration in asset quality and large losses. Nevertheless, the sector weathered the crisis in 2008-2009 owing to the Nordic parent banks' support for their subsidiaries.

Liquidity risks eased over 2010, mainly as a result of improved funding dynamics. The volume of deposits rose by 4.6% in 2010 and continued to increase in Q111. This was accompanied by a reduction in the loan portfolio. Estonian banks have used the resulting excess liquidity to repay back loans from the parent banks. Furthermore, the reduction in the reserve requirement to euro area levels (from 15% to 2%) has reduced banks' liquid assets, as they can access the euro system's liquidity facilities. External private sector debt has therefore declined, with banks' liabilities to parent banks dropping to EUR6bn (41% of GDP) in Q111 from EUR9bn (56% of GDP) before the financial crisis (see Figure 4).

The banking sector had a strong capital adequacy ratio (CAR) of 23.4% in April 2011 (22.2% at end-2009), resulting primarily from a reduction in the loan portfolio combined with growth in liquid assets. The structure of banks' balance sheets improved as a result of the contraction in the loan portfolio and a rise in the

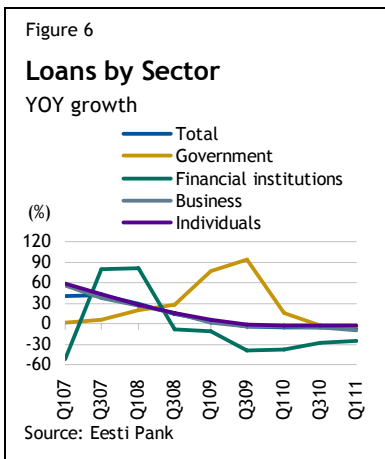




proportion of liquid assets, resulting in a reduction in risk-weighted assets. Moreover, the banking sector posted a net profit of EUR70.5m at end-2010, driven by a decline in loan loss provisions, wider spread between interest rates on loans and deposits and reduced dependence on (more expensive) wholesale funding. Estonian banks did not require recapitalisation from shareholders during the crisis, unlike Latvian and Lithuanian peers.

Problem loans reached their peak in mid-2010 and have slightly improved since then (see Figure 5). Loans more than 60 days overdue stood at 6% in April 2011, down from 6.3% a year earlier. However, this figure may understate the scale of the problem, as there are no published data on distressed loan restructuring. Most loans outstanding are floating rate³ and in euros. Although the currency risk has now been neutralised by euro adoption, borrowers still face exposures to interest rate rises. Although mortgage lending (41% of loan portfolio) tends to be concentrated in the wealthiest quartile of the household sector, banks' exposure to real-estate-related enterprises is high (19%).

The financial position of the household and corporate sector improved over 2010⁴, and the slight decrease in problem loans reflects this. Unemployment remains high (14.4% in Q111), and households and corporate sector have a backlog of debt in the context of rising interest rates: these factors are constraining a more marked improvement in asset quality. However, further deterioration is unlikely and Fitch expects gradual improvement in asset quality. The macroeconomic outlook and improved balance sheets of individuals and enterprises are supportive of a gradual decline in overdue loans. Nevertheless, credit demand will be muted: amortisation of the loan portfolio will exceed new lending, resulting in credit contraction.



Euro Entry Eases External Financing Risks

The euro has provided an ideal exit strategy for Estonia's currency board arrangement. Before euro adoption, most domestic lending was euro denominated – a currency mismatch that has now been neutralised. Relatively shallow domestic capital markets and low and volatile income levels reduce debt tolerance. However, although the stock of domestic and external private sector debt remains large, the risk is now one of gradual deleveraging in the medium term with potential downside effects to economic growth, rather than of a balance-of-payment crisis.

In 2010 the current account was in surplus for the second consecutive year. The adjustment was driven by a massive swing in the trade account and a reversal in the income balance, mainly due to bank losses in Nordic subsidiaries. Fitch expects the current account surplus to narrow to 1.4% of GDP in 2011, as stronger domestic demand and industrial production will fuel import growth. The profitability of foreign-owned companies is also likely to put downward pressure on the income account. Transfers from the EU will support the balance of payments in the medium term.

³ According to Eesti Pank's most recent Financial Stability Report, more than 90% of household loan agreements are floating rate.

⁴ Financial accounts data indicate that the household and corporate sectors' net financial assets rose by 8.1% and 5.8%, respectively, in 2010, driven by a substantial decrease in debt liabilities.

Figure 7

External Finances: Sources and Uses (USDbn)

	2009	2010	2011f	2012f
Uses	1.7	2.1	2.0	2.1
Current account balance	-0.9	-0.7	-0.3	-0.1
MLT amortisation	2.6	2.8	2.3	2.1
Sovereign	0.0	0.0	0.0	0.0
Non-sovereign	2.6	2.8	2.3	2.1
Sources	1.7	2.1	2.0	2.1
Gross MLT borrowing	0.7	1.2	1.0	0.9
Sovereign	0.6	0.2	-0.1	-0.1
Non-sovereign	0.1	1.0	1.1	1.0
Other debt inflows	-0.1	-1.6	0.2	0.3
Net equity inflows	0.7	0.9	1.1	1.0
FDI	0.9	1.3	1.3	1.2
Portfolio	-0.2	-0.4	-0.2	-0.2
Capital transfers	0.5	0.6	0.3	0.3
Errors and omissions	-0.1	-0.1	0.0	0.0
Decrease in reserves	0.0	1.1	-0.6	-0.4

Source: Fitch

Public Finances are a Key Rating Strength

Estonia has stronger public finances than any other euro area member. General government debt was 6.6% of GDP and the general government balance reached a surplus of 0.1% of GDP in 2011. In addition, the European Commission projects long-term ageing-related expenditure increases to be minimal. Furthermore, the minimal impact that the severe economic crisis had on the government debt stock indicates the fiscal discipline of the authorities. However, fiscal financing flexibility is low in light of the small size of the economy and the shallowness of domestic capital markets.

Figure 8

Public Finances: Sources and Uses (% GDP)

	2009	2010	2011f	2012f
Uses	3.5	0.4	1.5	2.7
Budget balance	1.7	-0.1	1.2	2.3
Amortisation (by place of issue)	1.8	0.5	0.3	0.4
Domestic	0.9	0.2	0.0	0.1
Foreign	0.8	0.3	0.3	0.3
Sources	3.5	0.4	1.5	2.7
Gross borrowing (by place of issue)	3.5	0.2	0.0	0.0
Domestic	0.0	-0.4	0.0	0.0
Foreign	3.6	0.7	0.0	0.0
Privatisation	2.4	-0.8	0.0	0.0
Other	-2.5	1.0	1.5	2.6

Source: Fitch

The 2010 budget surplus, which exceeded government's original plans, was significantly affected by sales of "Kyoto units" (emissions trading credits), equivalent to 1% of GDP. Nevertheless, it reflects stronger-than-expected GDP growth and a tight rein on government spending. The surplus was also influenced by delays in implementation of planned government investments, including some related to EU structural funds.

The government targets budget deficits of 1.2% of GDP in 2011 and 2.1% in 2012. This is affected by the decision to reverse gradually some consolidation measures that were temporarily introduced during the crisis. Furthermore, sales of "Kyoto units" and the related obligations to carry out "low-carbon" investments will also affect the public finances over 2011-2012. However, deficits will still be below the 3% Maastricht criteria.

The parliamentary elections held on 6 March 2011 indicated wide support for the centre-right governing coalition, led by Prime Minister Andrus Ansip (Reform Party), in spite of the tough austerity measures introduced during the recession. The new coalition government has agreed strict fiscal rules including the achievement of a budgetary surplus by 2013. Other measures include the requirement not to increase the debt burden and a commitment to restore the tax burden to pre-crisis levels.

Fitch believes that medium-term fiscal targets are credible and achievable. The budget is based on a growth forecast of 4% for 2011 and 2012: such assumptions are relatively conservative relative to those of Fitch (4.8% and 4.2%), June Consensus Economics poll of forecasters (5.4% and 4.2%) and Eesti Pank (6.3% and 4.2%). The target of balancing the budget by 2013 could be complicated by the government's decision to restore second-pillar pension payments and by potential spending pressures arising from public sector demands for wage increases in line with inflation expectations.

State payments into the pension fund were suspended for 18 months from June 2009 as a one-off fiscal consolidation measure. State contributions will resume at half of pre-2009 contribution rates in 2011 and the system will be restored fully in 2012. The Ministry of Finance estimates that resumption of payments to the second pillar be equivalent to EUR 72m (0.5% of GDP) and EUR 161m (1% of GDP) in 2011 and 2012 respectively.

However, the coalition government won the election on a programme of fiscal discipline, which entails keeping expenditure under control and rebuilding a fiscal buffer to pre-crisis levels, thereby enhancing confidence that the fiscal goals will be met.

Forecast Summary

	2006	2007	2008	2009	2010	2011f	2012f
Macroeconomic indicators and policy							
Real GDP growth (%)	10.6	6.9	-5.1	-13.9	3.1	4.8	4.2
Unemployment (%)	5.9	4.7	5.5	13.8	16.9	13.5	11.5
Consumer prices (annual average % change)	4.4	6.6	10.4	-0.1	3.0	4.5	3.5
Short-term interest rate (%) ^a	3.2	4.9	6.7	5.9	1.6	1.3	1.7
General government balance (% of GDP)	2.5	2.6	-2.8	-1.7	0.1	-1.2	-2.1
General government debt (% of GDP)	4.4	3.7	4.6	7.1	6.6	6.6	7.2
EUR per USD (annual average)	0.8	0.7	0.7	0.7	0.8	0.7	0.7
Real effective exchange rate (2000 = 100)	125.0	142.6	157.4	156.4	151.7	148.7	148.7
External finance							
Current account balance (USDbn)	-2.6	-3.7	-2.3	0.9	0.7	0.3	0.1
Current account balance (% of GDP)	-15.4	-17.2	-9.9	4.6	3.5	1.4	0.2
Current account balance plus net FDI (% of GDP)	-11.4	-12.6	-7.3	5.6	9.7	6.7	5.2
Net external debt (USDbn)	4.8	8.2	8.8	7.3	4.9	3.8	2.8
Net external debt (% of GDP)	28.6	37.9	37.2	37.8	25.4	16.8	11.5
Net external debt (% of CXR)	32.0	45.8	43.4	47.9	27.4	18.7	13.0
Official international reserves including gold (USDbn)	2.8	3.3	4.0	4.0	2.6	3.2	3.6
Official international reserves (months of CXP cover)	1.9	1.8	2.1	3.3	1.8	1.9	2.0
External interest service (% of CXR)	2.6	4.1	5.6	4.1	2.3	4.1	3.5
Gross external financing requirement (% int. reserves)	240.2	193.6	107.4	44.1	53.2	77.1	64.8
Memo: Global forecast summary							
Real GDP growth (%)							
US	2.7	1.9	0.0	-2.6	2.9	2.6	2.8
Japan	2.0	2.4	-1.2	-6.3	4.0	0.5	2.7
Euro area	3.1	2.7	0.4	-4.1	0.9	1.5	2.0
World	3.8	3.7	1.4	-2.5	3.1	2.9	2.7
Commodities							
Oil (USD/barrel)	65.4	72.7	97.7	61.9	79.6	110.0	100.0

^a Money Market Rate
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

Estonia

	2010						
	Malta 'A+'	Slovakia 'A+'	Estonia 'A+'	Israel 'A'	Malaysia 'A-'	'A' median	'AA' median
Real GDP (5yr average % change)	2.6	4.8	0.3	4.1	4.5	3.8	1.1
Volatility of GDP (10yr rolling SD)	2.1	4.0	7.7	2.4	2.9	2.4	2.5
Consumer prices (5yr average)	1.9	2.3	4.9	2.6	2.7	2.7	2.8
Volatility of CPI (10yr rolling SD)	0.7	2.8	2.9	1.9	1.4	1.5	1.1
Years since double-digit inflation	29.0	10.0	2.0	14.0	36.0	n.a.	n.a.
Unemployment rate	6.7	14.4	16.9	6.6	3.2	6.6	6.5
Type of exchange rate regime	EMU	EMU	EMU	Free float	Managed float	n.a.	n.a.
Dollarisation ratio	-	2.4	38.1	23.0	4.7	8.4	10.6
REER volatility (10yr rolling SD)	2.7	5.1	5.3	5.9	3.7	5.1	2.8

Source: Fitch

Strengths

- Current economic growth is driven by exports and investment. Unlike pre-crisis growth, it is not fuelled by excessive credit growth.
- The ability of the economy to cope with internal devaluation reflects the flexibility of wages and prices.
- Estonia's small size and flexible economy make the country well suited to a currency union.

Weaknesses

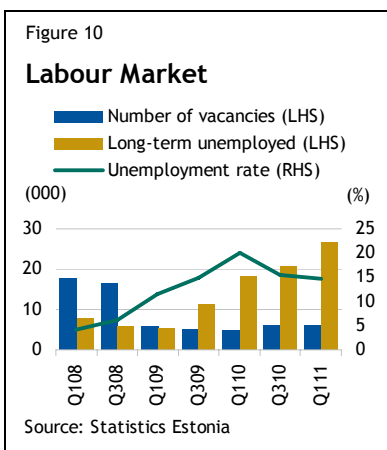
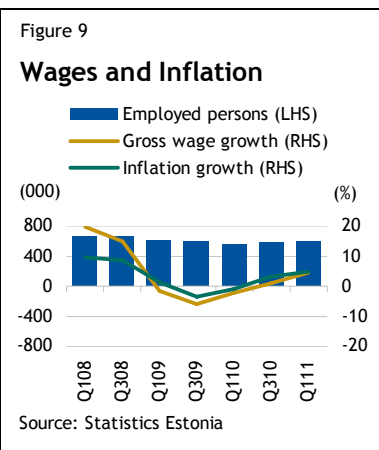
- The unemployment rate is well above the peer group median.
- GDP growth is more volatile than that of its rating peers. This is true not only in terms of 10-year standard deviations (see the comparative table above) but also the current cycle.
- Consumer price inflation has been higher (five-year average) relative to peers and more volatile (10-year standard deviation) than the 'A' median.

Commentary

The most significant downside risk to the economic outlook is external. Financial and economic links with Greece, Portugal and Ireland are limited; nevertheless further deepening of the euro area sovereign crisis will have spill-over effects to Estonia's main trading partners, affecting the export sector. Other risks lie in labour market developments and inflation. Eesti Pank notes that rising inflation may result in wage growth exceeding productivity growth, hampering competitiveness. A third risk relates to skill mismatches in the labour market that increase the risk of a permanent increase in structural unemployment.

Following a peak of 20.1% in the first quarter of 2010, the unemployment rate dropped fairly rapidly to 13.6% in Q410. The marked improvement was due to strong growth in export-oriented manufacturing sectors and to the high flexibility of Estonia's labour market. Nevertheless, although the number of vacancies rose by 24.7% yoy during the first quarter of 2011, the unemployment rate edged up to 14.4% and the number of long-term (over 24 months) unemployed rose by 45% yoy, pointing to the existence of skill mismatches in the labour market.

The consequences are twofold: despite high rates of economic growth unemployment may remain high for some time and wages may rise too rapidly in some specific areas that experience more severe skill shortages. Fitch expects unemployment to decline to 13.5% in 2011 due to employment growth in the manufacturing sector.

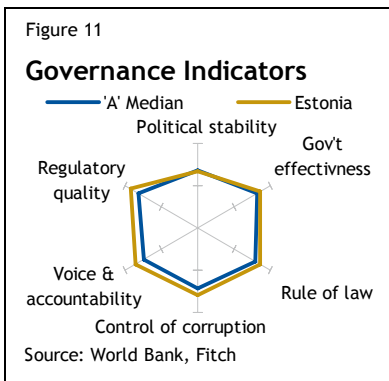


Comparative Analysis: Structural Features

Estonia

	2010						
	Malta 'A+'	Slovakia 'A+'	Estonia 'A+'	Israel 'A'	Malaysia 'A-'	'A' median	'AA' median
GNI per capita PPP (USD, latest)	22,640	21,600	18,890	27,110	13,710	21,600	32,675
GDP per capita (USD, mkt exchange rates)	20,034	16,139	14,324	29,805	8,504	18,451	34,170
Human Development Index (percentile, latest)	80.9	82.1	80.3	91.6	66.6	80.3	88.3
Ease of Doing Business (percentile, latest)	n.a.	78.1	91.3	84.7	89.1	80.3	88.8
Trade openness (CXR and CXP % GDP)	135.0	90.6	91.0	42.5	96.5	75.2	49.6
Gross domestic savings (% GDP)	19.4	23.2	29.8	17.5	39.2	29.6	24.6
Gross national savings (% GNP)	12.6	19.1	29.4	19.2	33.0	21.9	22.6
Gross domestic investment (% GDP)	16.0	22.4	23.1	15.6	20.1	21.8	21.1
Private credit (% GDP)	131.7	48.1	99.3	86.4	123.2	101.1	125.4
BSR Indicators	C2	C1	D1	C1	C1	n.a.	n.a.
Bank system CAR	15.0	12.7	22.1	13.6	14.8	13.9	16.7
Foreign bank ownership (% assets)	n.a.	99.0	98.0	6.4	20.1	41.3	37.1
Public bank ownership (% assets)	0.0	1.0	0.0	6.8	47.0	22.0	20.1
Default record (year cured)	None	None	None	None	None	n.a.	n.a.

Source: Fitch and World Bank



Strengths

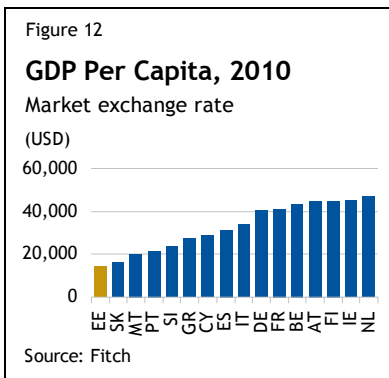
- Estonia outperforms both the 'A' and 'AA' medians in the World Bank's Ease of Doing Business index. This increases the likelihood of continued FDI inflows over the medium and long term.
- On measures of governance and corruption, Estonia is in line with 'A' and 'AA' peers. Political stability is a rating strength. The austerity measures in 2009 were approved with relatively little political difficulty.
- Estonia fares better than peers in terms of trade openness, making it easier to generate exports to service external debt.
- Foreign ownership of the banking system is a key support to the rating. The willingness of the parent banks (and their home-country authorities) to support the system through the crisis has been demonstrated and Fitch believes support will continue to be forthcoming over the medium term.

Weaknesses

- Although convergence with the euro area over the past decade has been strong, income per capita levels are the lowest in the euro area at USD18,890 on a purchasing power parity basis, behind Slovakia and Malta (both rated 'A+').
- Overall loan quality is improving but remains poor. This is a legacy of breakneck credit growth (which averaged 23.8% a year over 2000-2008), which fuelled an asset price bubble.
- The absence of a corporate bond market increases the dominant position of the banks in the Estonian financial markets. Deeper domestic financial markets would reduce dependence on foreign borrowing, increasing debt tolerance.

Commentary

Fitch's Banking System Indicator (BSI) for Estonia has improved and now scores 'D' (from 'E', the lowest system financial strength). The BSI is a summary measure of intrinsic banking system quality, which excludes potential support from shareholders or governments. The banking sector was profitable by end-2010. Moreover, asset quality has been stronger relative to the country's Baltic neighbours. The improvement is also influenced by euro adoption, which has neutralised foreign-currency risk and by the marked lending contraction over 2009-2010.

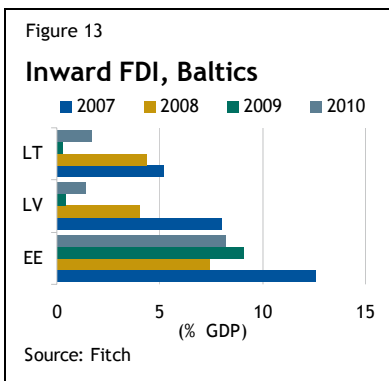


Comparative Analysis: External Finances

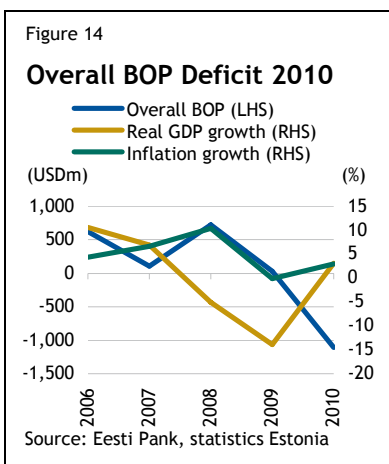
Estonia

	2010					Last 10 years	
	Malta 'A+'	Slovakia 'A+'	Estonia 'A+'	Israel 'A'	Malaysia 'A-'	'A' median	'AA' median
GXD (% CXR)	399.5	67.2	115.0	109.6	29.9	86.7	271.4
GXD (% GDP)	530.5	59.6	106.7	48.3	30.6	48.2	129.0
NXD (% CXR)	-19.5	6.2	27.4	-62.3	-29.3	-18.7	30.3
NXD (% GDP)	-25.9	5.5	25.4	-27.5	-30.1	-12.9	20.7
GSXD (% GXD)	4.3	63.3	6.5	38.4	35.4	17.9	12.0
NSXD (% CXR)	-3.9	10.8	-15.0	-31.9	-33.6	-25.1	-3.9
NSXD (% GDP)	-5.2	9.6	-13.9	-14.1	-34.4	-16.2	-1.7
SNFA (USDbn)	0.6	-8.4	2.7	93.3	81.8	5.3	0.5
SNFA (% GDP)	7.7	-10.3	13.9	42.9	34.4	15.5	2.1
Ext. debt service ratio (% CXR)	35.1	7.3	18.0	11.9	2.3	11.4	26.4
Ext. interest service ratio (% CXR)	17.7	1.3	2.3	4.4	1.1	2.6	8.7
Liquidity ratio (2011)	102.9	17.4	67.3	142.0	260.5	128.0	41.3
Current account balance (% GDP)	-4.4	-3.6	3.5	3.1	11.8	0.6	1.1
CAB plus net FDI (% GDP)	6.6	-3.3	9.7	1.9	9.9	2.2	-0.2
Commodity dependence (% CXR, latest)	2.0	11.9	22.6	3.6	23.9	12.1	13.5
Sovereign net FX debt (% GDP)	16.4	5.1	-6.5	-21.9	-34.0	-11.9	-5.3

Source: Fitch



Source: Fitch



Source: Eesti Pank, statistics Estonia

Strengths

- Euro area membership has neutralised large currency mismatches in private external debt. Although the level of gross external debt (GXD) is still high, it no longer poses the same threat to the rating, as Fitch considers the risk of a euro currency crisis low.
- The current account deficit has been eliminated in a very short time. This has been mainly driven by a massive swing in the trade account.
- The sovereign external principal repayments are negligible.
- Inflows of foreign direct investment held up well throughout the crisis, falling from USD2.7bn (12.6% of GDP) in 2007 to USD1.5bn (8.2% of GDP) at end-2010.

Weaknesses

- Relative to current receipts, external debt in Estonia is higher relative to the 'A' median (115% of CXR compared with a median of 86.7%) but lower than for most euro peers (median of 461% of CXR). Nevertheless it declined to 115% of CXR from 150% a year earlier.
- Net external debt was 27.4% of CXR in 2010, well above the 'A' median but broadly in line with the 'AA' median, mainly owing to the external assets of firms and the government.

Commentary

The country experienced a net capital outflow in 2010, with the balance-of-payments deficit reaching USD1.1bn (5.8% of GDP). The outflows were due to subsidiaries of foreign banks repatriating part of their profits and to the marked decline in minimum reserve requirements (see *Banking System Risks Have Eased* above). Fitch does not see this as a change in the commitment of Nordic parent banks towards the Estonian market. Subsidiaries are now posting profits and expectations for loan portfolio growth are weak. After significant capital support from parent banks during the crisis, capital needs from Baltic subsidiaries subsided in 2010. Parent banks have therefore tailored their exposure accordingly.

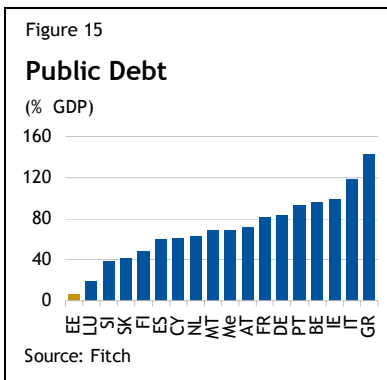
Comparative Analysis: Public Finances

Estonia

	2010					Last 10 years	
	Malta 'A+'	Slovakia 'A+'	Estonia 'A+'	Israel 'A'	Malaysia 'A-'	'A' median	'AA' median
Budget balance (% GDP)	-3.7	-7.9	0.1	-5.3	-5.7	-2.4	-0.5
Primary balance (% GDP)	-0.6	-6.6	0.3	-0.2	-3.7	-0.2	1.5
Revenue and grants (% GDP)	38.8	33.1	40.1	38.7	20.5	35.2	41.4
Volatility of revenue/GDP ratio	4.3	5.8	7.0	6.3	4.2	7.3	3.7
Interest payments (% revenue)	7.7	4.0	0.4	13.2	10.1	5.4	4.7
Debt (% revenue)	174.9	123.9	16.4	197.9	259.4	130.1	83.2
Debt (% GDP)	68.0	41.0	6.6	76.6	53.1	34.2	33.8
Net debt (% GDP)	61.0	39.0	1.5	69.4	42.5	28.9	26.7
FC debt (% total debt)	33.8	18.4	100.0	13.9	20.4	24.4	4.2
CG debt maturities (% GDP)	8.8	5.3	0.6	8.5	4.6	5.6	10.2
Average duration of CG debt (years)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

^a GG if not otherwise specified

Source: Fitch



Strengths

- Estonia’s public debt is the lowest in the EU (6.6% of GDP in 2011) and is more than offset by liquid assets.
- Estonia’s fiscal track record is strong. The government had a budget surplus of 0.1% in 2010. The country has never been placed under the Excessive Deficit Procedure.
- The government had built up reserves of EUR1.1bn (8.1% of GDP) by end-2009 through years of privatisation and fiscal surpluses during 2002-2007.
- The fiscal consolidation carried out over 2009-2010 boosted the government’s fiscal credibility. This is particularly important in light of the current euro area sovereign crisis.
- The volatility of government revenue is somewhat lower than for rating peers.
- The European Commission projects long-term ageing-related expenditure increases to be minimal.

Weaknesses

- Fiscal financing flexibility is low, due to the small size of the economy and shallowness of domestic capital markets. The government is reliant on asset drawdown for deficit funding.

Commentary

The government medium-term fiscal strategy sets ambitious goals. It aims to achieve a nominal budget surplus from 2013 and increase government reserves from 2015, to avoid any increase in public debt and to restore the tax burden to pre-crisis levels. Fitch believes that medium-term fiscal targets are achievable.

The consolidation carried out over 2009-2010 has boosted the government’s fiscal credibility. The key issue for the Estonian authorities will be to avoid pro-cyclical policies in the event of revenue over-performance. Nevertheless, the government has introduced a fiscal rule that prevents the adoption of positive supplementary budgets. This enhances confidence that fiscal discipline will be maintained even when revenue is over-performing.

Figure 16
Fiscal Accounts Summary

(% of GDP)	2008	2008	2009	2010	2011f	2012f
General government						
Revenue	37.0	43.2	40.1	37.7	36.8	36.5
Expenditure	39.8	44.9	40.0	38.9	38.9	36.4
O/w interest payments	0.2	0.3	0.1	0.1	0.2	0.1
Primary balance	-2.5	-1.4	0.3	-1.1	-1.9	0.2
Overall balance	-2.8	-1.7	0.1	-1.2	-2.1	0.1
General government debt	4.6	7.1	6.6	6.6	7.2	6.5
% of general government revenue	12.4	16.5	16.4	17.4	19.4	17.9
General government deposits	2.2	4.8	5.1	4.3	3.5	2.7
Net general government debt	2.4	2.4	1.5	2.2	3.6	3.8
Central government						
Revenue	26.9	32.1	29.2	26.7	24.8	23.2
O/w grants	1.6	3.3	3.3	2.4	2.2	2.1
Expenditure and net lending	29.3	32.7	29.8	29.0	27.0	25.2
O/w current expenditure and transfers	24.7	28.8	26.2	25.5	23.7	22.2
- Interest	0.1	0.2	0.1	0.1	0.1	0.1
O/w capital expenditure	4.6	3.7	2.0	1.9	1.8	1.7
Current balance	2.3	3.3	3.0	1.2	1.1	1.0
Primary balance	-2.3	-0.4	-0.6	-2.3	-2.1	-1.9
Overall balance	-2.4	-0.6	-0.6	-2.3	-2.2	-2.0
Central government debt	1.8	3.6	3.2	3.2	3.5	3.2
% of central government revenues	6.5	11.1	11.1	12.1	14.2	13.8
Central government debt (EURbn)	0.3	0.5	0.5	0.5	0.6	0.6
By residency of holder						
Domestic	0.2	0.2	0.1	0.1	0.2	0.1
Foreign	0.1	0.3	0.3	0.4	0.4	0.5
By place of issue						
Domestic	0.2	0.2	0.1	0.1	0.2	0.1
Foreign	0.1	0.3	0.3	0.4	0.4	0.5
By currency denomination						
Local currency	0.0	0.0	0.0	0.5	0.6	0.6
Foreign currency	0.3	0.5	0.4	0.0	0.0	0.0
in USD equivalent (eop exchange rate)	0.0	0.0	0.0	0.0	0.0	0.0
By maturity						
Less than 12 months (residual maturity)	0.1	0.3	0.1	0.1	0.1	0.1

Source: Ministry of Finance and Fitch estimates and forecasts

Figure 17

External Debt and Assets

(USDbn)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross external debt	3.1	4.4	6.6	9.5	10.7	15.8	23.3	24.6	22.8	20.5
% of GDP	49.9	60.6	67.2	79.3	76.8	93.8	107.7	104.4	118.3	106.7
% of CXR	59.2	80.2	90.4	99.1	86.7	105.0	130.3	121.7	150.0	115.0
By maturity										
Medium- and long-term	2.4	3.6	5.3	8.2	6.8	9.8	15.6	14.7	14.0	11.5
Short -term	0.7	0.8	1.3	1.4	3.9	6.0	7.7	9.9	8.8	9.0
% of total debt	21.8	18.7	20.0	14.5	36.5	38.0	33.2	40.2	38.6	44.0
By debtor										
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.1
General government	0.2	0.2	0.4	0.6	0.5	0.7	0.7	0.7	1.3	1.3
O/w central government	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	1.1	1.7	3.0	5.2	6.2	8.6	14.4	15.3	13.6	10.7
Other sectors	1.8	2.5	3.3	3.7	4.0	6.5	8.2	8.5	7.9	8.4
Gross external assets (non-equity)	2.7	3.6	5.2	7.3	8.3	11.0	15.1	15.8	15.5	15.6
International reserves, incl. gold	0.8	1.0	1.4	1.8	1.9	2.8	3.3	4.0	4.0	2.6
Other sovereign assets nes	0.2	0.4	0.9	1.1	1.1	1.6	2.2	1.8	1.7	1.4
Deposit money banks' foreign assets	0.9	1.1	1.4	2.5	3.5	3.7	5.9	5.5	5.7	5.6
Other sector foreign assets	0.9	1.2	1.8	2.3	2.5	3.9	5.2	5.8	6.3	7.9
Net external debt	0.4	0.8	1.4	2.3	2.4	4.8	8.2	8.8	7.3	4.9
% of GDP	6.4	11.6	14.3	19.1	17.3	28.6	37.9	37.2	37.8	25.4
% of CXR	7.6	15.3	19.3	23.9	19.5	32.0	45.8	43.4	47.9	27.4
Net sovereign external debt	-0.9	-1.2	-1.9	-2.3	-2.5	-3.8	-4.8	-5.1	-4.3	-2.7
% of GDP	-13.8	-16.2	-19.4	-19.2	-18.3	-22.4	-22.0	-21.5	-22.5	-13.9
Net bank external debt	0.4	0.8	1.8	3.2	3.4	5.9	9.9	11.1	10.0	7.0
Net other external debt	0.9	1.3	1.5	1.4	1.5	2.6	3.1	2.7	1.6	0.5
Net international investment position	-3.0	-4.4	-7.2	-11.4	-11.3	-13.0	-17.1	-17.8	-16.1	-14.2
% of GDP	-47.8	-60.1	-73.5	-94.9	-81.2	-77.5	-79.0	-75.7	-83.7	-74.0
Sovereign net foreign assets	0.9	1.2	1.9	2.3	2.6	3.8	4.8	5.1	4.4	2.7
% of GDP	13.8	16.2	19.4	19.3	18.4	22.5	22.2	21.6	22.6	13.9
Debt service (principal & interest)	0.8	0.8	0.9	0.8	1.3	2.5	2.4	2.3	3.3	3.2
Debt service (% of CXR)	14.9	15.1	12.1	8.8	10.5	16.5	13.5	11.4	21.5	18.0
Interest (% of CXR)	2.7	2.5	2.1	2.1	2.1	2.6	4.1	5.6	4.1	2.3
Liquidity ratio (%)	107.9	112.0	122.8	126.8	160.1	84.9	76.7	91.4	72.1	80.4
Net sovereign FX debt (% of GDP)	-10.5	-10.4	-10.4	-10.2	-10.5	-12.6	-11.9	-13.8	-13.8	-6.5
Memo										
Nominal GDP	6.2	7.3	9.9	12.0	13.9	16.8	21.7	23.6	19.3	19.2
Gross sovereign external debt										
Inter-company loans	0.7	0.8	1.2	1.3	1.1	1.8	2.5	2.5	2.2	2.1

Sources: NBP, IMF, World Bank and Fitch estimates and forecasts

Figure 19
Balance of Payments

(USDbn)	2007	2008	2009	2010	2011f	2012f
Current account balance	-3.7	-2.3	0.9	0.7	0.3	0.1
% of GDP	-17.2	-9.9	4.6	3.5	1.4	0.2
% of CXR	-20.8	-11.6	5.9	3.8	1.6	0.3
Trade balance	-3.7	-3.1	-0.8	-0.3	-0.5	-0.9
Exports, fob	11.2	12.6	9.1	11.7	13.2	14.3
Imports, fob	14.9	15.7	9.9	11.9	13.7	15.2
Services, net	1.3	1.8	1.9	1.7	1.9	2.0
Services, credit	4.4	5.2	4.4	4.5	5.1	5.5
Services, debit	3.1	3.4	2.5	2.8	3.2	3.5
Income, net	-1.4	-1.3	-0.5	-1.0	-1.3	-1.2
Income, credit	1.7	1.7	0.9	1.0	0.9	0.8
Income, debit	3.1	3.0	1.5	2.0	2.2	2.0
O/w: Interest payments	0.7	1.1	0.6	0.4	0.8	0.8
Current transfers, net	0.2	0.3	0.3	0.3	0.2	0.2
Memo						
Non-debt-creating inflows (net)	0.8	1.5	1.3	1.5	1.4	1.3
O/w equity FDI	0.9	1.2	0.9	1.3	1.3	1.2
O/w portfolio equity	-0.4	0.1	-0.2	-0.4	-0.2	-0.2
O/w other	0.2	0.2	0.5	0.6	0.3	0.3
Change in reserves (-= increase)	-0.1	-0.7	0.0	1.1	-0.6	-0.4
Gross external financing requirement	5.4	3.5	1.7	2.1	2.0	2.1
Stock of international reserves, incl. gold	3.3	4.0	4.0	2.6	3.2	3.6

Sources: IMF and Fitch estimates and forecasts

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2011 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.