

CREDIT ANALYSIS

Estonia

Europe

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Estonia

	Foreign Currency	Local Currency
Government bond rating	A1 - Stable	A1 - Stable
Country ceiling	Aa1 – Stable	Aaa
Bank deposit ceiling	A1 - Stable	Aa1

[Moody's sovereign rating lists](#)

Summary

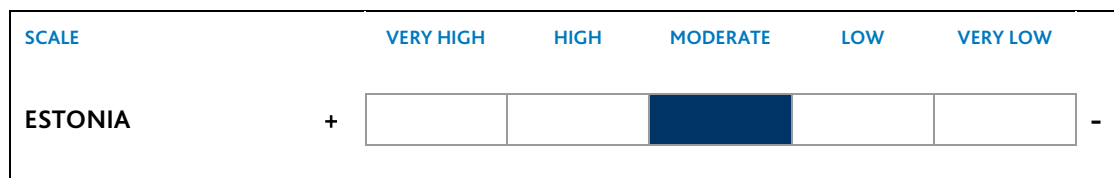
Moody's maintained Estonia's ratings at A1 throughout the global financial crisis, despite the deep recession. The stability of this rating was due to the government's low debt burden, strong fiscal performance and resilient Estonian banking system. We changed the outlook on Estonia's ratings to stable from negative in March 2010 as the economy and financial system stabilised. The outlook change was also prompted by the fact that Estonia will be admitted to the eurozone in January 2011, thereby effectively eliminating balance of payments and contagion risks.

Estonia is gradually beginning an economic recovery. Its small economy was severely pressured by the global financial crisis, but it retains some important structural strengths that should sustain above-average growth over the medium term. In our view, Estonia's institutions have demonstrated exceptional flexibility and determination over the past two years. The country's commitment to euro adoption is a good example of its institutional strength, particularly as it met the necessary targets under especially difficult circumstances.

The government's creditworthiness is boosted by very low debt ratios and a neutral debt trajectory, and we expect its prudent fiscal policy to constrain the budget deficit and limit the rise in debt ratios that is occurring in most EU countries. Susceptibility to event risk has declined substantially with the euro exit strategy for the currency board now secured, and improved stability in Latvia.

Small Economy With Some Structural Strengths

Factor 1 – Economic Strength: Moderate



The major determinants of a country's economic strength in Moody's methodology are incomes and wealth, the scale (size and diversity) of the economy, and the economy's long-term prospects. Moody's assesses Estonia's economic strength as moderate, based on middling wealth and a small, volatile economy, but good long-term growth prospects.

Estonia was on the threshold between what we typically consider an upper-middle income country and a high income country before the crisis. GDP per capita (measured in PPP¹ terms) increased by almost 2.5x between 1998 and 2008, reaching over \$20,000². However, Moody's estimates that Estonia's income per capita will decline by 15%-20% to around \$17,000 by the end of 2010. This would place Estonia's GDP per capita (PPP) around the 60th percentile in Moody's rating universe, slightly below such countries as Poland (rated A2/stable outlook) and Hungary (Baa1/negative), and above Russia (Baa1/stable), Mexico (Baa1/stable), Chile (A1/positive) and Malaysia (A3/stable).

We estimate that Estonia's nominal GDP will be approximately US\$18 billion in 2010, placing it in the bottom quartile of Moody's rating universe³. Other economies that are a similar size include Bosnia-Herzegovina (B2/stable), Bahrain (A2/negative), Bolivia (B2/stable) and Botswana (A2/negative). The economy's small scale means that it is not very diversified compared with larger EU countries, but it is well diversified relative to other countries that are around the same size. The economy underwent a major transformation before EU entry in 2004, moving from a relatively weak transition economy into one of the more prosperous and free-market new EU members. Higher value-added goods and services, such as high-tech manufacturing, software and shipping became more important, while foreign trade re-oriented towards the EU (from the CIS region). Companies tend to be small, making them more vulnerable to changes in their external environment, but also more flexible, and average productivity per person employed is around 60% of that in the Nordic countries.

Growth prospects are improving

Estonia experienced unbalanced and credit-fuelled growth during 2003-07⁴ that left its economy particularly vulnerable to the global credit crunch that began in mid-2007. As a small, open economy, Estonia also suffered from the collapse in global trade and deep recessions in its major trading partners. The economy contracted by approximately 19% in real terms from its peak in Q4 2007 to Q1 2010. Industrial production declined by one-third, and retail sales by approximately one-quarter, while unemployment rose to 19.8% in Q1 2010 from 5% in 2007. In addition, property prices declined by 50%.

¹ Purchasing power parity.

² Source: World Bank. 2008 is latest available data.

³ It is also the second smallest economy in the EU, after Malta.

⁴ Domestic credit/GDP increased from 51% in 2003 to 95% at end-2007, while external debt/GDP rose from 65% to 112% over the same period.

There are now signs, however, that the recession is coming to an end. Industrial production and exports are growing, and registered unemployment appears to be peaking. Economic sentiment surveys show a strong rebound in confidence across most sectors and EU funded spending could reach 7% of GDP in 2010,⁵ helping support public investment and economic growth. Foreign investment and consumer and business confidence should also be boosted by the upcoming euro adoption, which is scheduled for January 2011. Moody's assumes that the economy will start to grow again around the middle of 2010, and we are forecasting real GDP growth of approximately 1% for the year, accelerating to almost 4% in 2011.

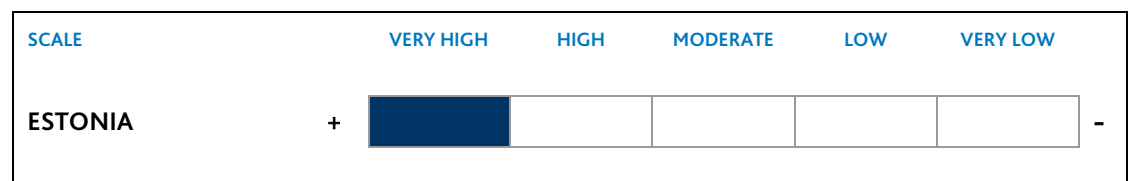
Moody's expects the medium-term recovery to be relatively muted, especially compared with the growth rates before the crisis. This is because economic growth is typically slow following financial crises because de-leveraging and re-balancing depress domestic demand. The sectors that contributed most to the boom – real estate, construction, financial services, domestic trade – are unlikely to bounce back quickly. In addition to this, the outstanding loan stock continues to shrink as bankers and borrowers remain cautious and government plans to gradually tighten its fiscal policy will also cause some drag on growth, albeit much less than in most other EU countries.

Beyond the immediate horizon, Estonia's growth prospects are improving. Moody's assumes that real economic convergence with the surrounding Nordic region should resume, even if the pace of convergence has diminished. Labour costs in Estonia are still 25%-50%⁶ of those in Finland and Sweden, suggesting considerable scope for an increase in productivity. Elevated investment rates should allow long-term potential GDP growth to be around 2-3 percentage points per year above the Nordic average, so that real income convergence will likely take another 20-30 years.⁷

If the Estonian economy returns to a sustainable path of robust, balanced growth, accompanied by a relatively stable macroeconomic environment, then Moody's would consider shading – and eventually moving – economic strength to “high”. This would lift Estonia's indicative rating range to Aa1-Aa3 from Aa3-Aa2 currently.

EMU Accession Demonstrates Flexibility And Determination

Factor 2 – Institutional Strength: Very High



Moody's classifies Estonia's institutions as very strong, based on the flexible policy environment and a prudent and transparent culture. The World Bank Government Effectiveness Index assigned Estonia a normalised score of 1.15 in 2008, which is the highest position in Central and Eastern Europe and places the country in the 75th percentile in Moody's rated universe. This compares with a GDP per capita (PPP) in the 60th percentile, indicating that Estonia's institutions are relatively strong for a

⁵ Budgeted amount. Actual amount will likely be less due to limited capacity to initiate and implement suitable projects.

⁶ Source: Eurostat, Moody's.

⁷ Prior to the crisis, Moody's expected that real economic convergence would take 10-15 years.

country at its income level. Other international surveys⁸ also rate Estonia highly compared with other transition countries.

The EU accession process benefited Estonia's institutions in several ways. As with all other new EU members, the adoption and implementation of the *acquis communautaire*, technical assistance and funding for public sector reform facilitated a radical overhaul of the country's institutions. Structural reform is also well advanced; privatisation and enterprise restructuring were mostly complete by 2001 and the economy is generally liberalised. According to the European Bank for Restructuring and Development's (EBRD) Transition Indicators, the only area where transition is substantially incomplete is infrastructure, specifically roads.⁹

The European Commission's recommendation that Estonia should adopt the euro in January 2011 is a good example of the country's institutional flexibility and macro-policy focus. As the recent Convergence Reports made clear, meeting all of the Maastricht criteria is incredibly difficult, and fulfilling the budget deficit criterion during the recent economic crisis is especially remarkable.¹⁰

Estonia's fiscal policy was relatively prudent during the boom years, and therefore the budgetary impact of the economic crisis was not nearly as severe as in other countries (e.g. in Latvia and Lithuania, who experienced similar drops in output)¹¹. However, the government tightened its fiscal policy several times in 2008 and 2009 – despite the severe recession – to ensure that the budget deficit was below the 3% of the GDP Maastricht criterion. There was relatively limited public or political opposition to the adjustments as euro adoption has been viewed as a worthwhile objective.

The labour market has also shown flexibility during the crisis. Private sector wages are estimated to be down 5%-10%¹² from their peak, and average public sector wages were 7.5% lower in 2009 compared with 2008 (although they are still 7% higher than they were in 2007). New measures took effect in July 2009 that increased the flexibility of the labour market by reducing the costs to companies of hiring and firing workers (similar to a Danish-style "flexi-curity" labour regime). It is notable that the measures were still introduced despite unemployment reaching 13.5% in Q2 2009, up from 4% in 2007. The changes probably led to higher unemployment during the recession, but may also make firms more willing to hire during the recovery.

Potential test in 2011-12

Estonia's institutional strength could be tested in 2011-12. Parliamentary elections in March 2011 will likely act as a partial referendum on the economic policy package of the past three years. Euro adoption is popular with the electorate, and – so far – this has dampened the painful impact of tight fiscal policy through the recession. Nevertheless, there is a possibility that Estonians could demand more tangible benefits from the government, particularly if economic growth is sluggish and unemployment remains high. In this case, the government may be tempted to loosen the fiscal strings and slow down the pace of reform. These actions could have positive short-term social and economic impact, but would probably slow the pace of convergence over the longer term. This scenario is not consistent with Estonia's track record, but is a plausible risk to Moody's central scenario.

⁸ Such as eStandards Forum's *Business Indicators*, Transparency International's *Global Perceptions Index* and the World Economic Forum's *Global Competitiveness Index*.

⁹ The indicators also suggest that the transition is not entirely complete in enterprise restructuring and competition policy.

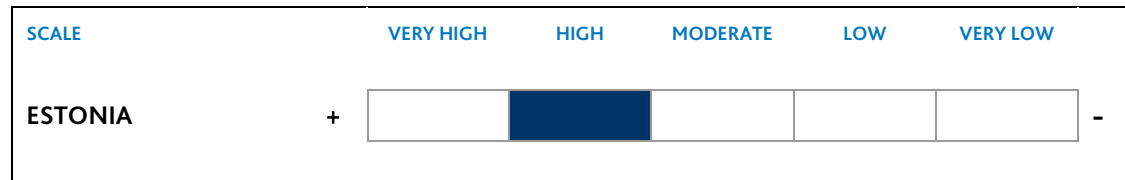
¹⁰ Estonia was the only country out of the nine assessed that met all of the Maastricht economic criteria.

¹¹ Latvia and Lithuania posted budget deficits of 9% of GDP in 2009. The relative magnitude of declines in government revenues also suggests that revenue collection and administration are likely stronger in Estonia.

¹² Based on anecdotal reports. Some sectors, such as construction, report much larger declines.

Lowest Government Debt Ratios in the EU

Factor 3 – Government Financial Strength: High



We classify the government's financial strength as high due to its solid balance sheet and prudent fiscal policy. The government has no bonds or commercial debt outstanding and a limited amount of other debt, all owed to multilateral development banks.

The government entered the economic downturn from a strong position: before 2008, the general government budget was in surplus for six years in a row. The government twice revised the 2009 budget to keep the deficit below the 3% of GDP Maastricht threshold¹³. Although part of the adjustment was due to non-recurring items,¹⁴ the end result was budget deficit well below the Maastricht limit, and one of the lowest in Moody's investment-grade universe.¹⁵

The government plans to continue gradually tightening its fiscal policy over the next few years. The medium-term budget strategy calls for budget surpluses to resume in 2013 to rebuild financial reserves that were depleted during the recession. Successful implementation of the plan relies on a rebound in domestic demand, as export-biased growth typically does not have a large impact on government revenues. Alternatively, the government may need to replace some of the temporary budget adjustment measures enacted in 2009 with permanent reforms.

The European Commission has assessed Estonia as being one of countries in the EU that is best positioned for the fiscal impact of ageing. The Commission's 2009 Sustainability Report estimated that Estonia needs to permanently reduce its structural primary deficit by only 1% of GDP to put public finances on a sustainable path, compared with the average EU required adjustment of 6.5% of GDP.¹⁶ However, this assessment assumes no change to the current conservative pension parameters, which we believe may not be politically sustainable.

We forecast Estonia's gross debt/GDP and debt/revenue ratios to be 9% and 21%, respectively, at the end of 2010. This compares with median debt ratios of 36% and 115% for the Moody's Sovereign A1 to A3 rating category, and 40% and 102% for the CEE-10.¹⁷ At less than 1%, the government's interest payments/revenue ratio is also well below the A rating category median and CEE-10 mean, both at 5%.

The central government holds financial assets in various reserve funds amounting to approximately 7%¹⁸ of GDP that it can use in the event of emergencies, unexpected budget shortfalls and for structural reform. An additional 2.5% of GDP is earmarked for health and social security spending.

¹³ Expenditures were cut by around 11% (4.5% of GDP) from the initial budget; revenues were increased by around 3% of GDP.

¹⁴ Such as land sales and special dividends from state-owned companies.

¹⁵ European sovereigns with stronger budget balances in 2009 were Switzerland, Sweden and Norway. New Zealand, Singapore, Hong Kong and the Gulf States also had stronger budgetary positions.

¹⁶ http://ec.europa.eu/economy_finance/publications/publication15998_en.pdf

¹⁷ Poland, Czech Republic, Slovakia, Slovenia, Hungary, Estonia, Latvia, Lithuania, Romania and Bulgaria.

¹⁸ As of 31 March 2010.

The reserve funds are an important source of emergency liquidity and meant that the Estonian government was not impacted by the extremely difficult funding conditions for many emerging markets during the global financial crisis in 2008-09. The reserve funds have declined by around half since 2007, but we understand that the government plans to rebuild them over the long term.

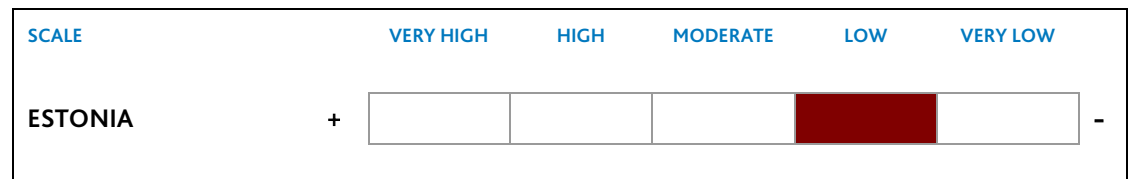
There is a low probability that the government could be forced to assume certain contingent liabilities, but the scale of these liabilities is modest outside of the banking sector. Debt associated with the various municipalities is equivalent to several percentage points of GDP, and their financial position has weakened during the crisis. The largest public sector company, Eesti Energia, has debt outstanding equal to approximately 2% of GDP, although we rate it investment-grade on a standalone basis. The banking sector is currently under stress (see discussion under Factor 4 below), but Moody's believes that it is highly unlikely that the government would need to bail-out banks, as almost all the banks are foreign owned and well capitalised¹⁹.

Government financial strength is capped at high because of Moody's assessment of Estonia's debt "finance-ability": the potential market for local-currency-denominated government debt is limited. This assessment is likely to change when the country adopts the euro in 2011, if fiscal policy remains prudent. Raising Estonia's government financial strength to "very high" would lift the indicative rating range to Aa2-A1 from the current Aa3-A2.

Euro Adoption Eliminates Currency and Contagion Risks

Regional and financial risks subside

Factor 4 – Susceptibility to Event Risk: Low



Moody's changed its assessment of Estonia's susceptibility to event risk to "low" from "moderate" when we changed the outlook on the rating to stable in March 2010.

Moody's was previously concerned about the possibility of financial contagion sparked by a worsening of the problems in Latvia or another country in the region. The three Baltic countries are often viewed collectively by outside observers, and there are many similarities in their economic and financial profiles.²⁰ Although it was not our base case, there was a plausible scenario in which a severe crisis in Latvia had a negative impact on Estonian economic confidence, and/or impacted economic performance through more direct channels, such as trade and investment.

¹⁹ The largest banks are owned by Swedish banks that have demonstrated support for their Estonian branches and subsidiaries. The Swedish banks are *de facto* supported by the Swedish government.

²⁰ For example, all three countries have high external debt ratios and all three experienced a major economic boom based on domestic demand, which is now deflating. The same Nordic banks are dominant in all three countries.

However, Moody's believes that the risk posed by financial contagion has substantially declined for four reasons:

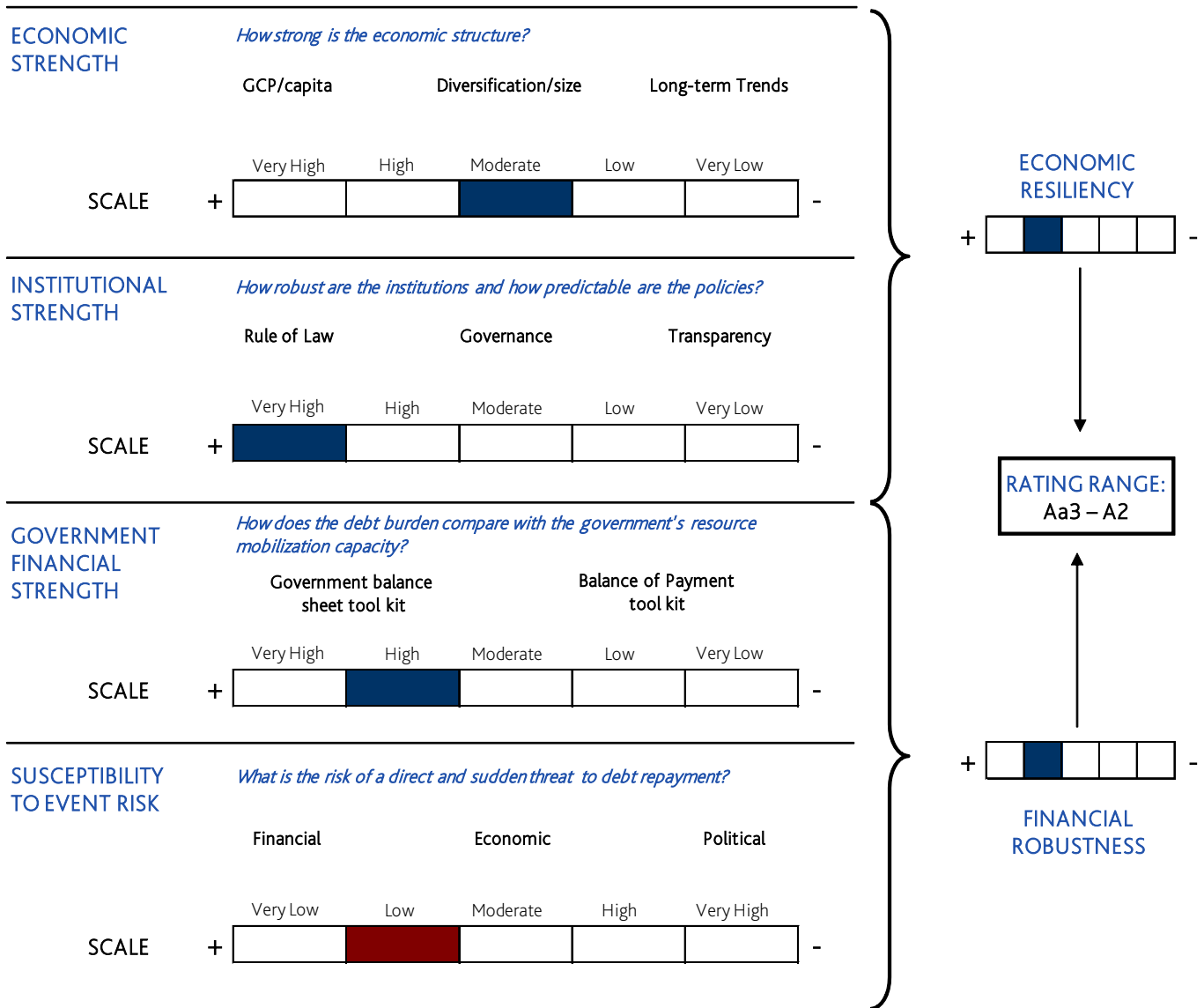
1. Euro adoption will eliminate currency and balance of payments risks. The European Commission confirmed that Estonia met all of the Maastricht criteria in May 2010 and recommended that Estonia adopt the euro in January 2011. ECOFIN²¹ should confirm this in July. Euro adoption will also differentiate Estonia from Latvia and Lithuania in the eyes of investors. However, it is important to emphasise that euro adoption is not a panacea for all Estonia's problems. In particular, it will not eliminate the painful adjustments necessary to achieve macroeconomic sustainability following the bursting of the domestic demand boom. These adjustments are likely to take many years to complete.
2. The Latvian economy and financial regime have stabilised. The probability of a disorderly currency devaluation in Latvia is now very low. The Latvian central bank and government hold large foreign currency reserves after receiving significant loans from the EU and IMF. Financial stress, as indicated by short-term interest rates, has declined markedly from mid-2009, and the current account is in surplus.
3. The Estonian banking sector is performing better than we had previously expected, given the severity of the downturn. The system is 99% foreign owned and has clearly benefited from its strong connections to Nordic banks. The Swedish banks demonstrated their commitment to the region by providing significant liquidity assistance to their Baltic operations during the worst stage of the crisis in October 2008.
4. Estonian asset quality has performed remarkably well in the economic recession. Nonperforming loans were 6.7%²² of outstanding loans in April 2010, compared to 18.3% in Latvia²³, and the Estonian ratio has been relatively stable since Q3 2009. Moody's assumes that parent banks will convert deposits or loans in their subsidiaries to capital if renewed deterioration in asset quality pressures solvency ratios.

²¹ Finance ministers of the eurozone countries.

²² Overdue at least 60 days.

²³ Overdue at least 90 days.

Sovereign Rating Mechanics: Estonia²⁴



²⁴ Link to our [Sovereign Bond Rating Methodology](#)

Rating History

Estonia								
	FOREIGN CURRENCY CEILINGS				GOVERNMENT BONDS			
	BONDS & NOTES		BANK DEPOSIT		FOREIGN CURRENCY	LOCAL CURRENCY	OUTLOOK	DATE
	LONG-TERM	SHORT-TERM	LONG-TERM	SHORT-TERM				
Outlook Changed	--	--	A1	--	A1	A1	Stable	March-10
Rating Confirmed	--	--	A1	P-1	A1	A1	Negative	April-09
Review for Downgrade	--	--	A1	--	A1	A1	--	February-09
Outlook Changed	--	--	A1	--	A1	A1	Negative	November-08
Outlook Changed	Aa1	--	A1	--	A1	A1	Stable	September-07
Rating Raised	Aa1	--	--	--	--	--	Positive	May-06
Outlook Changed	--	--	A1	--	A1	A1	Positive	March-06
Rating Raised	A1	P-1	A1	P-1	A1	--	Stable	November-02
Rating Assigned	--	--	--	--	Baa1	--	--	July-99
Rating Assigned	--	--	--	--	--	A1	--	February-99
Rating Assigned	Baa1	P-2	Baa1	P-2	--	--	Stable	September-97

Annual Statistics

Estonia							
	2005	2006	2007	2008	2009	2010F	2011F
Economic Structure and Performance							
Nominal GDP (US\$ Bil.)	13.9	16.6	21.4	23.5	19.1	18.2	18.9
Population (Mil.)	1.3	1.3	1.3	1.3	1.3	1.3	1.3
GDP per capita (US\$)	10,329	12,359	15,938	17,541	14,284	13,652	14,207
GDP per capita (PPP basis, US\$)	16,413	18,535	20,361	20,662	--	--	--
Nominal GDP (% change, local currency)	15.5	18.3	18.1	2.9	-14.6	-0.1	5.7
Real GDP (% change)	9.4	10.0	7.2	-3.6	-14.1	0.9	3.8
Inflation Rate (CPI, % change Dec/Dec)	3.6	5.1	9.6	7.0	-1.7	1.3	2.0
Gross Investment/GDP	33.8	38.7	40.2	29.7	19.4	16.8	19.6
Gross Domestic Saving/GDP	27.3	27.9	27.9	24.7	24.9	28.1	29.3
Nominal Exports of Goods and Services (% change, US\$ basis)	22.9	23.2	16.9	14.3	-24.3	4.4	6.0
Nominal Imports of Goods and Services (% change, US\$ basis)	21.5	30.4	17.8	4.4	-33.7	1.8	6.1
Openness of the Economy (%) [1]	161.9	172.1	156.8	155.4	135.8	146.9	149.9
Government Effectiveness [2]	1.1	1.2	1.1	1.2	--	--	--
Government Finance							
Gen. Gov. Revenue/GDP	35.2	36.5	37.4	37.1	43.6	45.7	44.0
Gen. Gov. Expenditure/GDP	33.6	34.0	34.8	39.9	45.4	47.9	46.0
Gen. Gov. Financial Balance/GDP	1.6	2.5	2.6	-2.8	-1.7	-2.2	-2.0
Gen. Gov. Primary Balance/GDP	1.8	2.7	2.8	-2.6	-1.4	-1.9	-1.7
Gen. Gov. Debt (US\$ Bil.) [3]	0.6	0.8	0.9	1.0	1.4	1.7	2.1
Gen. Gov. Debt/GDP [3]	4.6	4.5	3.8	4.6	7.2	9.4	10.9
Gen. Gov. Debt/Gen. Gov. Revenue [3]	13.0	12.2	10.1	12.4	16.5	20.6	24.7
Gen. Gov. Interest Payment/Gen. Gov. Revenue	0.6	0.5	0.5	0.5	0.7	0.7	0.7
Gen. Gov. Foreign Currency & FC-Indexed Debt/Gen. Gov. Debt [4]	58.5	58.5	37.2	66.1	63.3	65.0	65.0
Gen. Gov. Guaranteed Debt (US\$ Bil.)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gen. Gov. Direct Debt Owed to Non-residents/Gen. Gov. Direct Debt	58.5	58.5	37.2	66.1	63.3	65.0	65.0
Total Gen. Gov. Direct & Guaranteed Debt (US\$ Bil.)	0.6	0.8	0.9	1.1	1.4	1.7	2.1
Total Gen. Gov. Direct & Guaranteed Debt/GDP	4.7	4.5	3.8	4.7	7.3	9.5	10.9
Total Gen. Gov. Direct & Guaranteed Debt/Gen. Gov. Revenue	13.4	12.4	10.3	12.5	16.6	20.7	24.8
External Payments and Debt							
Nominal Exchange Rate (local currency per US\$, Dec)	13.2	11.9	10.6	11.1	10.9	11.8	12.0
Real Eff. Exchange Rate (% change) [5]	1.1	0.4	2.9	4.7	1.6	--	--
Current Account Balance (US\$ Bil.)	-1.4	-2.8	-3.8	-2.2	0.9	0.6	0.3
Current Account Balance/GDP	-10.0	-17.0	-17.8	-9.5	4.7	3.4	1.5
External Debt (US\$ Bil.)	11.3	16.9	25.2	26.8	25.1	22.7	20.7
Public Sector External Debt/Total External Debt [6]	3.1	2.7	1.3	2.6	4.8	4.9	6.5
Short-term External Debt/Total External Debt	34.9	35.7	30.5	37.5	36.2	35.4	34.6
External Debt/GDP	85.4	96.8	109.8	118.5	126.8	124.6	109.4
External Debt/CA Receipts	96.5	107.9	131.7	138.3	159.5	138.5	123.3
Interest Paid on External Debt (US\$ Bil.)	0.2	0.2	0.5	0.4	0.7	0.6	0.6
Amortisation Paid on External Debt (US\$ Bil.)	1.1	2.1	1.8	1.2	1.4	1.6	1.6

Estonia							
	2005	2006	2007	2008	2009	2010F	2011F
Net Foreign Direct Investment/GDP	16.2	4.1	4.7	3.7	1.3	2.7	3.2
Official Foreign Exchange Reserves (US\$ Bil.)	1.9	2.8	3.3	4.0	3.9	3.5	3.6
Net Foreign Assets of Domestic Banks (US\$ Bil.)	-1.0	-3.4	-6.8	-8.1	-7.6	--	--
Monetary, Vulnerability and Liquidity Indicators							
M2 (% change, Dec/Dec)	41.7	27.8	13.6	6.0	-0.8	--	--
Short-Term Nominal Interest Rate (% per annum. Dec. 31)	2.5	3.8	7.1	7.1	2.7	--	--
Domestic Credit (% change, Dec/Dec)	30.9	42.3	33.6	7.7	-3.0	--	--
Domestic Credit/GDP	68.3	82.1	92.9	97.3	110.5	--	--
M2/Official Forex Reserves (X)	3.3	3.2	3.5	2.9	3.0	--	--
Total External Debt/Foreign Exchange Reserves	581.9	606.2	773.8	676.9	647.0	648.8	579.8
Debt Service Ratio [7]	10.4	15.8	13.3	7.9	13.6	13.2	13.1
External Vulnerability Indicator [8]	429.1	363.6	358.4	272.0	258.4	263.9	269.8
Liquidity Ratio [9]	277.4	317.0	151.2	169.3	262.5	--	--
Total Liabilities due BIS Banks/Total Assets Held in BIS Banks	510.5	699.5	533.5	624.2	856.5	--	--

Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP (%)

[2] Composite Index with Values from -2.50 to 2.50, higher absolute Numbers suggest better Level of Maturity and responsiveness of Government Institutions

[3] Eurostat and Moody's

[4] Official National Source and Moody's

[5] Central Bank of Estonia

[6] General government only

[7] (Interest + Current-Year Repayment of Principal)/Current Account Receipts (%)

[8] (Short-term External Debt + Currently Maturing long-term Debt + Total Nonresident Deposits over one Year)/Official Foreign Exchange Reserves

[9] Liabilities to BIS Banks Falling Due within one Year/Total Assets Held in BIS Banks (%)

 Report Number: 125265

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