

Estonia Business Forecast Report Q3 2014

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Abstracts

Core Views

We believe Estonia is on a sustainable growth trajectory following the deep recession brought on by the eurozone debt crisis, with economic growth to average 3.1% from 2015-2017 before gradually settling towards long-term trend growth of 2.7%. Domestic demand will be the main driver of growth over the medium term, as sluggish regional economic activity hinders faster export growth. Estonia's external accounts pose few risks to macroeconomic stability.

Low current account deficits in the coming years will be comfortably financed, and will not be associated with an unsustainable build up of short-term foreign liabilities, as in the pre-financial crisis era. We maintain a positive view towards Estonia's fiscal trajectory, with total public debt to remain the lowest in Europe by a comfortable margin.

Major Forecast Changes

We have revised down our 2014 growth forecast, from 2.8% to 2.0%, as a sluggish recovery in external demand is weighing on the short-term growth outlook. However, we continue to expect a more robust recovery in 2015, as economic recoveries in the eurozone and Nordics gain traction and begin to spur higher regional trade volumes.

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CHAPTER 1: POLITICAL OUTLOOK

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BMI Political Risk Ratings
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Russia Threat To Spook Investors

Russia will not intervene militarily in Estonia, but Moscow is likely to use economic threats to increase political pressure on its Baltic neighbour. The implied threat to gas supplies and trade throughput alone is sufficient to hurt investor sentiment towards Estonia. That said, we do not expect a significant escalation in tensions among Estonia's large ethnic Russian population.

TABLE: Politics Table

Long-Term Political Outlook

Few Risks To Structural Stability Over Long Term

Estonia is among the most structurally stable countries in emerging markets, as reflected in its very high 84.8 (out of 100) BMI long-term political risk rating. Having fully converged to all major multilateral European institutions (European Union, European Monetary Union and Schengen Agreement), Estonia will continue to benefit from a strong policy anchor and high degree of institutional capacity over the long run. The country's often fractious relationship with neighbouring Russia, undermined by domestic divisions between ethnic Estonian and ethnic Russians, presents the one key risk to stability.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis
BMI Economic Risk Ratings
Economic Activity
Stronger Recovery Hinges On External Demand

Real GDP in Estonia will expand by 2.0% in 2014, well below its long-run potential. A sluggish recovery in export volumes will continue to weigh on the short-term growth outlook, with strong private consumption propping up economic activity as external

demand stages a gradual recovery. As such, we are more optimistic for 2015, when we forecast real GDP growth to accelerate to 3.3%.

TABLE: GDP BY EXPENDITURE

Balance Of Payments

External Account Stability Limits Macro Risks

Estonia's balance of payments in the coming years will be characterised by small current account deficits and stable, long-term external financing that imply few risks to macroeconomic stability. Our optimistic outlook for Estonia's export potential implies a return to current account surplus over a longer term time horizon.

TABLE: BALANCE OF PAYMENTS (Euro)

Fiscal Policy

Fiscal Stance To Remain Robust Amid Coalition Shakeup

Despite a shake-up of Estonia's governing coalition in March, we expect conservative fiscal policy to remain high on the agenda in 2014 and 2015. While we now forecast moderately higher expenditures, deficit and debt levels are set to remain among the lowest in the eurozone by a comfortable margin. Beyond 2015, we highlight the potential for a shift away from Estonia's flat income tax towards a more progressive system.

TABLE: FISCAL POLICY

Regional Monetary Policy

Food Prices No Threat To Policy Trajectory

Food price deflation has been a key driver of falling consumer price growth across emerging Europe. However, with our Commodities team forecasting a return of modest price growth in key food items, and domestic demand growth accelerating, inflationary pressures are set to rise once again in H214.

Regional Investment Climate

Macro Implications Of Ukraine Crisis

Even without an escalation of tensions, the Ukraine crisis will have significant macro and investment implications for Emerging Europe. Russia's investment profile and growth potential will be the hardest hit, followed by the Baltic economies which rely heavily on Russian import demand. From a sector perspective, the crisis will speed up the search for alternative sources of energy among Russia's western neighbours, although some Russian exporters may benefit.

FX Forecast

EUR: Monetary Policy Decoupling Will Weaken The Euro

We expect euro strength against the dollar and on a trade-weighted basis to persist in H114. However, we continue to argue that the economic and monetary policy cycles in the eurozone are lagging further behind peers in the US and UK, which will trigger a re-pricing of the euro towards the end of 2014. Indeed, we believe that weak eurozone

economic growth and lingering deflationary risks will spur the European Central Bank into loosen monetary policy further.

TABLE: BMI Euro zone Currency Forecast

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The Estonian Economy to 2023

Trend Growth To Average Much Less In 2017-2023

Trend average growth in Estonia is forecast to average 2.7% between 2017-2023, well below the 7.6% from 2001-2007. That said, we stress that the worst effects of the 2008-2010 recession are now passed and the economy is well positioned for sustainable long-term growth.

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