

# Estonian Economy

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## ESTONIAN ECONOMIC POLICY

- **According to Prime Minister Andrus Ansip, the economic situation of the Estonian state is very good and it is certainly not possible to speak about a crisis.** Ansip said there had been rumours already in the previous year that Estonia had come to an unexpectedly deep crisis. According to Ansip, there was considerable intake into the state budget above the target and the financial situation of the country was very strong. The prime minister also said that he had to sadden those people who expected poor results at the beginning of this year. The revenue intake of the budget is good beyond expectations. Concerning a new labor contract bill, which makes layoff simpler, Ansip said that it would incite people to learn more. He said that reproaches by various foreign organizations to Estonia that there was too little qualified labor in the country and that the labor market was inflexible, were true.
- **Addressing a forum of Estonian employers, President Toomas Hendrik Ilves admitted the necessity of labor market changes but underlined that the functioning of the market must be governed by all parties' agreement rather than the dictates of law.** Speaking about changes planned in a controversial employment contract bill, Ilves said employers do not have a monopoly on the flexibility of the labor market and employees, on security. In a balanced labor market, both sides need to have a common understanding of principles. The president named Denmark as an example of a flexible labor market with which Estonia does not stand comparison as yet. He pointed out that everybody -- the state, employers and employees -- participates in the Danish model either directly or through trade unions. This model takes into consideration the main thing: that entrepreneurs need workers and workers need jobs.
- **The Estonian Finance Ministry is planning to establish a wide-based think tank for the discussion of economic policy issues and wants to bring in numerous experts from outside public institutions.** As the aim of the think tank is to discuss wider economic policy issues, Estonia will try to involve as many experts and specialists as possible from outside the public sector.
- **Many economists view big current account deficits, high inflation and fixed exchange rates as a lethal combination but the example of the Baltic states does not bear this out, The Economist says.** After a scary year, the countries that looked most likely to tumble seem to be heading for a softish landing. In Estonia, growth has dropped from double digits to a mere 4%. In Latvia retail sales, rising by as much as 25% last summer, are growing by only 1%. The foreign banks that own most of the financial system in both countries have tightened lending. Even if some housing borrowers default, the pain is manageable.
- **The Estonian government will discuss a draft regulation that would no longer list Georgia and Singapore as low-tax countries.** In practice this means that the taxpayer will in the future have no obligation to prove to the tax administrator that a legal person residing in one of these countries actually conducts economic activity and its income is sufficiently taxed there.

## MAJOR ECONOMIC INDICATORS

- **The Estonian consumer price index has risen by 11% compared to January 2007. In December consumer prices were up by 9.6% year-on-year.** Goods were in January 10.2% more expensive than in the same month a year before. Food prices climbed by 14.3% and those of manufactured goods, by 6%. The prices of services increased by 12.%. Administratively regulated prices of goods and services soared by 21.1% and non-administered prices grew by 8.2% in annual comparison. The inflation was mainly powered by an increase in food prices, rising housing costs and a jump in the price of motor fuel. Expenses on food and non-alcoholic beverages climbed by 16.1% and housing costs, by 15.8% compared to January 2007. Dining out and accommodation were 14.8% more expensive and transport expenditures rose by 14.3%.
- **The January rise in Estonian consumer prices was in line with analysts' expectations.** The rising cost of transport, food, expenditures on housing and alcohol and tobacco contributed the most towards the overall price rise as was expected. Thus, a very large part of the price rise was tied to administrative impacts.
- **A flash estimate by the Bank of Estonia puts the shortfall of the current account of balance of payments in December 2007 at 3.582 billion kroons (EUR 228.88 mln).** In November, the deficit was slightly above three billion kroons and in December 2006 the gap was 2.833 billion kroons. The deficit in the fourth quarter of 2007 added up to more than 10 billion kroons or 15.5% of the anticipated GDP.

#### FISCAL POLICY

- **According to a preliminary estimate by the Statistical Office, the Estonian economy grew in the fourth quarter of 2007 by 4.5% compared to the same period of 2006.** The Q4 growth figure was the lowest in the last 8 years. The preliminary estimate showed a year-on-year drop in value added in the real estate, renting and leasing, and in the transport, warehousing and communications segments. Value added continued growing at a fast pace in financial intermediation. Seasonally adjusted GDP at constant prices increased by 0.6% in the fourth quarter compared to the previous quarter.
- **The international ratings agency Standard & Poor's (S&P) has estimated in a survey of the Estonian economy that Estonia will be able to accede to the euro in 2013 at the earliest.** An earlier switch is prevented by inflationary pressure, which according to S&P is a side-effect of rapid income convergence in a small open economy having a fixed currency rate. The Bank of Estonia has estimated that introduction of the common European currency in Estonia could be possible starting from 2012. S&P estimates inflation in Estonia to hit 7.5% this year, dropping to 4.8% in 2010. Estonia's economy is set to grow at annual rates of 4.3 to 4.5% over the next 3 years. At the beginning of the year S&P reaffirmed Estonia's credit ratings at their previous levels but changed the outlook from stable to negative.
- **According to the Estonian Finance Ministry, it is not necessary to change the tax system to fight value added tax fraud but raise the efficiency of cooperation among member states' tax authorities.** More concrete measures against fraud should be devised rather than the whole tax system changed. While the suggested measures can be applied to combat carousel fraud they spell a major overhaul of the tax system and create opportunities for new fraudulent schemes. The present system of taxation of trade between EU member states is taken advantage of to swindle national tax authorities' out of non-existent input VAT.

#### GDP

- **Analysts predict very modest growth for the Estonian economy this year and estimate last year's average growth at around 7%.** The Estonian economy will continue cooling in 2008 mostly due to quickening inflation, real estate crunch and deteriorating external economic situation.

#### LABOUR MARKET

- **Data of the Tax and Customs Board show that although the number of workers whose gross monthly salary exceeds 12,000 kroons (EUR 767) increased last year by around 50,000 from 2006, three-fourths of employees in Estonia still receive smaller wages.** In 2006 employees earning between 12,000 and 20,000 kroons a month numbered more than 83,000. According to the tax authority's figures, last year the number of such people was already 130,736. The number of wage earners receiving 12,000-20,000 kroons and more than 20,000 kroons has grown significantly. The share of people earning average wages has changed the least in recent years. In 2004 around one-quarter of wage earners had salaries of 5,000-8,000 kroons and their number is the same at present.
- **The Estonian Statistical Office said the gross average monthly wages in Q4 2007 stood at 12,270 kroons (EUR 784), 20.1% higher than in the last quarter of 2006.** The gross average wages in October were 11,564 kroons, in November 12,120 kroons and in December 13,174 kroons. In Q1 2007 the gross average wages were 10,322 kroons, in Q2 11,549 kroons and in Q3 10,899 kroons. The average for 2006 was 9,407 kroons. In the last quarter of 2007 the employer's average cost per employee was 16,518 kroons monthly. On year the average cost of labor per month increased by 20%.

- **The Estonian Foreign Ministry said in a comment on the average wages in Q4 2007 that on the background of the slowing economic growth labor productivity grew by only 4% per employee in Q4.** This means that real wages are growing at double the labor productivity rate. Due to the rising inflation curve, the real growth in average wages fell to 10.2% in the last quarter of 2007. If in earlier years growth in companies' profits has been higher than labor costs then this year distribution of added value has been moving in a significantly favorable direction for employees, as a result of which companies are paying workers higher wages at the expense of their profits. Such activity cannot last long, as it wears away the entrepreneurs' profits.
- **Unemployed people registered with the Estonian Labor Market Board numbered 40,247 in 2007, a drop of 16.4% from 2006.** The number of registered jobless any one day averaged 13,459, making up 2.1% of the working-age population from age 16 to pension age. The corresponding figure in 2006 was 15,421. The share of young unemployed, or people aged from 16 to 24, was 13.8% of the number of registered jobless in 2007, compared to 13.6% in 2006. People over 50 years of age made up 29.7% of registered jobless in 2007 and 29.5% in 2006. New job offers during last year numbered 22,806, down from 30,263 in 2006.

#### STATE BUDGET

- **According to the Bank of Estonia, the government must be prepared to cutting budgetary expenditures if less revenue than projected is paid into the state budget.** According to the budget passed last year, the sum total of the state budget revenues should be 96.3 billion kroons (EUR 6.15 b). Members of the government have denied the need to revise the budgetary forecast, but Finance Minister Ivari Padar said that preparations for certain major public sector projects should be frozen because of below-target revenue intake. The Estonian economy had been generally moving in the direction forecast in the fall, but the further outlook has become somewhat more unfavorable. Continuing confusion on the world financial markets and the expected slowdown of economic growth in the US could rein in economic development of the EU, thus affecting also Estonia. In the opinion of the Bank of Estonia it is likely that economic growth slows down more than forecast this year. Slower growth, however, means higher prices and faster lowering of the foreign trade deficit. Price rise should slow down significantly in the second half of the year.
- **Finance Minister Ivari Padar said that a review of Estonia's budget strategy will start after the spring economic forecast of the Finance Ministry is ready and the state budget for next year will be "one taking into account the possibilities" and "with cutbacks."** There will be cutbacks in both the budget strategy and the state budget for 2009. The cutbacks will affect public spending and investments by the state. Padar added that the budget for 2009 will be in every way reasonable and take into account the present situation of the economy. The spring forecast of the Finance Ministry is due to be ready by the beginning of April. After that work with the budget strategy will start, and the strategy is expected to be completed by the end of May.

#### FOREIGN ECONOMIC RELATIONS

- **The EU has taken infringement proceedings against Germany and Estonia over tax regulation according to which dividends paid to foreign countries' pension funds can be taxed at a higher rate than dividends paid to local funds.** The Commission also sent an official letter to the Czech Republic in connection with tax regulation permitting taxation of dividends paid to foreign companies at a higher tax rate than dividends paid to domestic companies. Germany, Estonia and the Czech Republic are requested to answer to the inquiry within 2 months. Dividends paid to Estonian pension funds by Estonian companies are not taxed in Estonia while 22% is deducted from the dividends paid to foreign countries' pension funds. Estonia is preparing to amend its taxation law in order to bring it into line with the mother companies and subsidiaries directive in force in the EU. The main issue of the amendments will be dividends paid to foreign owners.
- **Minister of Economy Juhan Parts said that Estonia supports setting up an energy link between Lithuania and Poland as soon as possible, since that would create the prerequisites for the emergence of a genuine electricity market.** The companies will in July at the latest present to their ministers of economy draft agreements for the establishment of the power plant. All the countries have offered an overview of the developments on their respective energy markets. The ministers discussed the creation of new energy links between different countries and matters related to the construction of the new Lithuanian N-plant.
- **The Estonian investment bank GILD and the Azerbaijan Investment Company (AIC) have signed a memorandum of understanding regarding the creation of a joint investment fund.** The fund will be a joint venture fund of GILD, AIC and the Estonian Caspian Group. Under the memorandum, the sides will cooperate in the creation of the fund and attracting assets to it, raising investments, defining the projects to be financed, and investment into other investors' funds. The regulation, presentation and marketing aspects of the

fund will be looked after by GILD. The memorandum was signed in the framework of a visit of an Azerbaijani governmental delegation to Estonia.

- **To ensure full effect of the Convention of the OECD, the Estonian Justice Ministry has circulated a bill on amendements to the Penal and Criminal Proceeding Codes.** Estonia is a member of the OECD Convention already since 2005. The Convention is directed against graft to foreign countries' officials in international business relations. As a result of an evaluation visit by an OECD working group it appeared that some provisions of the Estonian penal and criminal proceeding law could make it difficult to fight against bribery to foreign countries' officials. Removal of the shortcomings and ensurance of full application of the Convention was the condition for Estonia's accession to OECD.
- **Being a small country, Estonia possesses an advantage in the EU's internal market as far as equal opportunities are concerned.** It is difficult to find the best regulations for the arrangement of the EU internal market because of the complex political compromises between member states that are always required. Small countries like Estonia and Ireland, have the possibility to react to changes rapidly, which provides them with an advantage on Europe's internal market. For Estonia it is very important that an internal market developed within the EU where all member states are equal and free movement of goods and people really works.

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**Further information is available:**

<http://www.eestipank.info/pub/en/dokumendid/statistika/>

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## DEVELOPMENT BY SECTORS

### AGRICULTURE

- **The government confirmed the Estonian positions on planned changes in the agricultural policy of the EU.** The key standpoint concerns tying the amount of a direct subsidy to the number of hectares of farming land in actual use rather than the volume of production. Estonia is also in favor of harmonizing support levels of EU member countries and setting ceilings for support levels. In addition, Estonia backs as speedy as possible elimination of the milk quota system and the development of an agricultural sector less in need of support.

### BANKING

- **In a recent overview of the Estonian banking sector, the international Moody's rating agency has assessed the outlook of the Estonian banking sector as negative.** Moody's finds that this reflects the growing risk of a decline in the asset quality and liquidity in light of the rapid growth in loans in recent years. The outlook applies also to Hansapank, while the outlook for Sampo Bank and Balti Investeeringute Grupi Pank remain stable. Nordic banks dominate the Estonian market. The 4 largest banks are owned by Nordic financial groups and have an aggregate market share of 95% measured by total amount of loans and leases. Foreign banks' branches or subsidiaries control close to 100% of total assets in the banking system. Moody's primary concern is rapid loan growth mainly in the mortgage and real estate sectors. As a good sign Moody's noted that the lending growth was now slowing and this could contribute to the stabilization of the banking system.
- **A continuing increase in the amount of vacant real estate in the Baltic states is putting the real estate markets of these countries under pressure, and on the overheated Estonian market Swedbank and SEB are feeling particular squeeze.** Fresh internal reports at Swedbank show that the amount of vacant office space is growing at a high speed. According to Hansabank, the overall area of vacant office space in Tallinn is expected to increase by 45% over the next year. Thus far tenants have been found for only a small proportion of the new office space. In the event of a major slowdown of the Estonian economy large quantities of office space will become vacant and finding tenants may prove more difficult. Such a development may put the builders and their financers, mainly Swedish banks, under serious pressure.

### ENERGY

- **The Estonian government finds that 1990, not 2005 as suggested in the present version of the EU's climate measure package, should be taken as the basis in the calculation of carbon dioxide emissions.** Estonia's energy supply security must not contract as a result of the climate and energy package, and neither

must the competitiveness of our economy deteriorate," Economic Affairs Minister Juhan Parts said. The government endorsed Estonian positions concerning 6 European Commission bills making up the renewable energy and climate package. One of Estonia's most important positions is that energy produced from oil shale must partly be brought out from under the CO<sub>2</sub> quota. This is because Estonia's energy security will depend on oil shale energy in the foreseeable future. At the same time money from the sale of quota must only be channelled into energy sphere investments.

- **If the EU's energy and climate package for the years 2013-2020 is implemented in its present form, further reconstruction of oil shale fueled generating units at Estonia's Narva power plants will be in serious jeopardy.** In the light of things as they are now it makes no sense for Eesti Energia to proceed with the plan. The government may decide, however, that the new generating units are needed for Estonia to ensure security of supply, and decide in favor of the corresponding investments. Together with the opening of the EU's energy market in 2013 also the market for CO<sub>2</sub> emission quotas will open. As a result, companies will have to buy quota for themselves on the market. Electricity generated using oil shale will after 2013 remain a competitor on the Nordic energy market, where the share of CO<sub>2</sub> emissions in power generating is significantly smaller than in Estonia. Thus investments into new generating units in northeastern Estonia also depend on the price level on the Nordic energy exchange Nordpool. The possibility also remains that in an open market, cheap electricity from Russia will start arriving in Estonia via third countries, the price of which does not contain expenditure for carbon emission rights.
- **Eesti Energia will not be able to introduce higher prices for electricity from June 1 as originally planned due to a delay in regulatory approval.** The Competition Board has made it clear that the new prices won't be approved at a level 23% above the present prices as sought by Eesti Energia. Yet it has given no details. The law requires that consumers be notified of changes in the price of electricity at least 3 months in advance.
- **Economy Minister Juhan Parts promised that debates involving the public will start soon on the future of the Estonian energy sector, including on the prospect of building a nuclear power plant.** The first public forum should take place on March 12. The discussions will be held within the framework of the drafting of Estonia's energy sector strategy. The strategy paper should be ready by the end of this year and it would have to be ultimately endorsed by the parliament. The purpose of the strategy paper is to set out what Estonia's energy portfolio should consist of in the event of different scenarios, and it also should contain a decision in principle on whether and how to proceed with the matter of nuclear energy.

## IT

- **In addition to its Tallinn and Tartu offices, the Estonian software developing company Webmedia opened a new development center at the Keres Center in Narva.** Webmedia's Narva development center has 13 and by the end of the year 30 employees. The company currently employs over 200 people. Besides Estonia, the Webmedia Group has offices also in Lithuania, Finland, Romania, Serbia and Denmark.

## MEDIA. TELECOMMUNICATIONS

- **Elion, the fixed-line and broadband subsidiary of the listed Eesti Telekom group, saw the number of customers of its digital television service double during 2007 to 57,725 at the end of the year.** Elion was the fastest growing provider of digital television on the market. Elion estimates its market share to be 55.6% in permanent Internet connections for private customers, whereas in fixed-line call minutes it estimates its market share to stand at 8%, compared with 83% in December 2006.

## RETAIL

- **Trade figures for December show that the sped-up growth in Estonia's exports in the preceding months was a passing phenomenon as compared with the increase in imports.** Given the tendency of cooling of the world economy and the US economic decline's being carried over to Europe, the picture as regards Estonia's foreign trade in the whole of last year is not pleasing at all. If the Estonian export growth figures are put side by side with EU economic growth figures, Estonia's export looks powerless in an absolutely unjustifiable manner.

## TOURISM

- **TEZ Tour, one of the largest travel agencies in eastern Europe, aims to take 30% of the market here.** The investment in the Estonian operation totals 3.2 million kroons (EUR 0.2 mln). Estonians will be offered holiday trips to Greece, Turkey, Spain, Egypt and Thailand. The company intends to work closely with all travel agencies in Estonia, with consumers able to buy tours of TEZ Tour from all travel agencies. TEZ Tour is active in 18 countries, including in Latvia and Lithuania.

- **Last year 962,771 residents of Estonia stayed at accommodation establishments in this country, an increase of 16% from 2006.** All told, accommodation establishments received 2.34 million tourists in 2007 of whom 41% were Estonian residents. Foreign tourists using the services of Estonian accommodation establishments numbered 1.38 million, a drop of 3% year-on-year. The number of foreign tourists increased slightly in the first 4 months of the year, but in the high season of tourism and in the fall months the number decreased primarily due to the diminishing interest of Finnish tourists in Estonia, Finland being Estonia's main partner in tourism. Slightly more than half, or 51% of accommodated foreign tourists came from Finland. Compared to 2006, the number of tourists from Sweden, Germany, Britain and Russia also decreased considerably.

## TRANSPORT

- **The supervisory board of the state-owned company Tallinna Sadam decided in favor of an investment of 355 million kroons (EUR 22.7 mln) in the Paldiski South Harbour for the construction of new quays.** It also approved an investment of 25 million kroons in the Old City Harbor of Tallinn for the improvement of new ships calls. In the South Harbor of Paldiski, an 8 quayline is about to be built with a length of 160.1 meters and a ninth quayline with a length of 247.5 meters. The quaylines will be built in the sea with a depth of up to 13 meters and the area between the new quayline and the existing quay filled and covered. Works in Paldiski are expected to start at the beginning of 2009 and end in late May in the same year.
- **The volume of domestic freight carriage on Eesti Raudtee track increased by 88% against last January, amounting to over half a million tons.** The volume of export freight carriage increased by 14% to 80,000 tons this January against the same month last year. Of the commodities, oil and oil products was the biggest group of freight in January amounting to 1.75 million tons. But against the same month last year that volume was 31% lower.
- **Compared with the biggest ports on the east coast of the Baltic Sea Tallinna Sadam still held the third place after Russia's Primorsk and St. Petersburg ports in terms of freight turnover.** If the large Russian ports managed to increase their freight turnover by respectively 12 and 11% to 74 and 60 million tons, then the freight turnover of Tallinna Sadam fell by 9% to 36 million tons. Ventspils, Klaipeda and Riga with respectively 31, 27 and 26 million tons followed.