

GENERAL DEVELOPMENT OF ESTONIA'S BALANCE OF PAYMENTS IN 1992–2006

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During the history of the balance of payments of the newly independent Estonia – that is starting from 1992 – the **current account** has been in surplus only in the first couple of years, and even then to a limited extent (see Figure 1 and Tables 1–2). Later on, the current account has been in deficit, which has been constantly growing. In 2007, it reached nearly 8 billion kroons (11.4% of GDP). After the stock exchange crash in 1997 and the Russian crisis in 1998, the deficit narrowed slightly and stabilised. However, it soared again in 2002, reaching almost 13 billion kroons. Strong investment activity and domestic demand boosted the current account deficit to a record 32 billion kroons in 2006; that is 15.5% of GDP and twice as much as in the previous year.

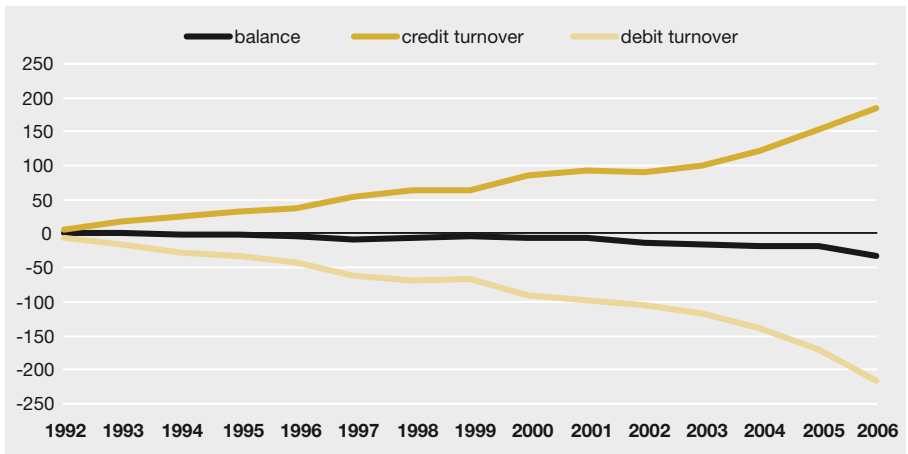


Figure 1. Current account turnover and balance (EEK bn)

As a ratio to gross domestic product, Estonia's current account deficit is one of the largest among the new EU members. In the years from 1992 to 2006, the credit turnover on the current account increased by 33 and the debit turnover by 41 times. Estonia has been a very open economy during the entire period of newly regained independence. In 1993, the current account turnover exceeded GDP by 1.5 times. The openness of the economy was further facilitated by Estonia's accession to the European Union: in 2006, the current account turnover was already twice the volume of GDP.

Thus, Estonia's foreign economic relations are primarily related to the European Union. In 2006, EU member states accounted for 69% of the credit turnover and 77% of the debit turnover.¹ The current account recorded a deficit with the EU as well as the CIS and a surplus

¹ Estonia's balance of payments items are available by countries and fields of activity since 2003. Regarding earlier periods, data on goods are available by countries and data on direct investment by countries and fields of activity.

Table 1. Annual growth of current account (%)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Current account														
credit	-11.5	-869.0	-15.6	165.5	62.5	-13.4	-46.6	43.5	9.0	128.7	19.4	19.4	-5.0	83.6
debit	202.8	44.4	29.3	19.6	41.5	17.1	0.4	35.1	7.7	-0.5	10.4	20.3	25.4	20.8
Goods														
credit	346.3	139.8	65.0	61.4	27.4	0.5	-23.1	10.5	1.3	36.3	16.6	18.5	-5.7	52.7
debit	190.9	47.1	22.7	12.4	45.9	18.7	-2.1	51.7	4.8	-1.4	9.5	18.5	30.3	22.7
Services														
credit	207.1	61.1	32.3	26.2	39.2	12.7	-8.3	41.5	4.1	5.6	11.2	18.5	21.2	28.6
debit	190.2	36.7	217.8	44.2	31.8	-2.2	3.6	22.3	10.7	-12.4	16.0	18.2	-4.4	-2.1
Income														
credit	213.4	50.1	50.6	33.2	37.5	13.3	5.5	15.1	11.4	0.1	8.9	16.4	12.6	7.9
debit	220.8	54.0	7.5	24.9	42.6	25.9	6.7	10.6	11.8	8.5	5.1	15.3	23.0	12.7
Income														
credit	121.5	103.9	-107.5	-7.1	-7,773.7	-42.1	29.4	129.7	41.6	10.1	34.3	9.5	-9.1	30.7
debit	7,306.3	35.7	50.8	85.9	17.9	17.4	4.9	3.5	48.7	11.6	6.3	53.4	54.1	59.2
Current transfers														
credit	511.2	59.1	-18.7	89.6	171.8	-15.8	14.3	58.2	44.2	10.6	23.5	24.0	16.7	46.1
debit	186.2	6.7	-2.6	-16.3	33.9	28.4	-20.5	-12.4	3.7	-30.3	78.4	-22.1	-45.0	69.3
Current transfers														
credit	193.1	8.6	-1.1	-8.7	33.5	29.1	-6.9	-13.9	3.7	2.4	63.7	55.3	12.2	21.6
debit	1,274.2	71.6	29.1	108.2	30.9	33.8	75.5	-17.9	3.6	98.1	48.5	151.1	34.1	14.0

Table 2. Estonia's balance of payments (EEK m)

	1992	1993	1994	1995	1996	1997
Current account	315.1	279.0	-2,145.6	-1,810.6	-4,806.9	-7,810.2
Goods and services	-87.7	-927.9	-3,253.2	-3,285.2	-6,043.2	-7,420.1
Goods	-431.3	-1,925	-4,615.9	-7,615.5	-12,288.2	-15,652.8
credit (f.o.b.)	3,700.3	10,762.7	15,828.5	19,428.2	21,833.4	31,846.5
debit (f.o.b.)	-4,131.6	-12,687.7	-20,444.4	-27,043.7	-34,121.6	-47,499.3
Services	343.6	997.1	1,362.7	4,330.3	6,245.0	8,232.7
credit	1,414.9	4,434.3	6,657.0	10,022.9	13,352.8	18,366.7
debit	-1,071.3	-3,437.2	-5,294.3	-5,692.6	-7,107.8	-10,134.0
Income	-83.7	-185.4	-378.0	28.2	26.2	-2,010.5
credit	4.8	355.5	482.5	727.7	1,352.5	1,594.1
debit	-88.5	-540.9	-860.5	-699.5	-1,326.3	-3,604.6
Transfers	486.5	1,392.3	1,485.6	1,446.4	1,210.1	1,620.4
credit	489.6	1,434.9	1,558.7	1,540.8	1,406.6	1,877.7
debit	-3.1	-42.6	-73.1	-94.4	-196.5	-257.3
Capital and financial account (reserve assets excluded)	406.5	2,908.5	2,221.4	2,836.1	6,396.4	10,953.3
Capital account	213.4	0	-8.1	-9.1	-7.8	-2.0
Financial account	193.1	2,908.5	2,229.5	2,845.2	6,404.2	10,955.3
Direct investment	660.7	2,070.8	2,789.4	2,283.8	1,329.9	1,781.2
Abroad	-23.2	-82.1	-29.8	-29.1	-484.5	-1,912.9
In Estonia	683.9	2,152.9	2,819.2	2,312.9	1,814.4	3,694.1
Portfolio investment	0	-3	-183.4	-255.1	1,784.4	3,655.1
Assets	0	-5.4	-288.2	-382.3	-628.4	-2,319.3
Equity securities	0	-5.2	-187.7	58.0	-181.0	-1,238.5
Debt securities	0	-0.2	-100.5	-440.3	-447.4	-1,080.8
Liabilities	0	2.4	104.8	127.2	2,412.8	5,974.4
Equity securities	0	1.3	104.6	113.7	2,093.8	1,763.6
Debt securities	0	1.1	0.2	13.5	319	4,210.8
Financial derivatives	0	0	0	0	0	0
Assets	0	0	0	0	0	0
Liabilities	0	0	0	0	0	0
Other investment	-467.6	840.7	-376.5	816.5	3,289.9	5,519.0
Assets	-380.8	-1,909.7	-1,860.9	-1,118.8	-107.6	-4,635.5
Long-term	0	-9.8	-37	-221.9	-17.5	-1063
Short-term	-380.8	-1,899.9	-1,823.9	-896.9	-90.1	-3,572.5
Liabilities	-86.8	2,750.4	1,484.4	1,935.3	3,397.5	10,154.5
Long-term	320.4	1,687.5	113	1,046	1,783	4,604.9
Short-term	-407.2	1,062.9	1,371.4	889.3	1,614.5	5,549.6
Errors and omissions	1,088.6	-611.8	319.8	174.9	-361.1	-371.8
Overall balance	1,810.2	2,575.7	395.6	1,200.4	1,228.4	2,771.3
Reserve assets	-1,810.2	-2,575.7	-395.6	-1,200.4	-1,228.4	-2,771.3

1998	1999	2000	2001	2002	2003	2004	2005	2006
-6,760.2	-3,607.7	-5,178.1	-5,643.6	-12,908.0	-15,418.2	-18,412.6	-17,485.5	-32,095.0
-7,676.2	-3,755.4	-3,167.6	-2,247.6	-8,564.6	-10,046.8	-11,937.6	-11,077.0	-24,025.4
-15,725.5	-12,096.9	-13,371.4	-13,542.4	-18,455.3	-21,522.3	-25,499.0	-24,044.8	-36,723.3
37,786.3	36,995.2	56,118.1	58,798.5	57,948.7	63,443.7	75,199.5	97,971.4	120,166.4
-53,511.8	-49,092.1	-69,489.5	-72,340.9	-76,404.0	-84,966.0	-100,698.5	-122,016.2	-156,889.8
8,049.3	8,341.5	10,203.8	11,294.8	9,890.7	11,475.5	13,561.4	12,967.7	12,697.9
20,804.0	21,951.9	25,263.4	28,135.4	28,164.3	30,674.0	35,703.4	40,200.7	43,391.7
-12,754.7	-13,610.4	-15,059.6	-16,840.6	-18,273.6	-19,198.5	-22,142.0	-27,233.0	-30,693.8
-1,164.0	-1,505.8	-3,458.9	-4,898.6	-5,391.1	-7,240.7	-7,931.4	-7,209.1	-9,424.8
1,871.8	1,964.3	2,032.5	3,022.2	3,371.3	3,584.1	5,496.5	8,467.8	13,483.4
-3,035.8	-3,470.1	-5,491.4	-7,920.8	-8,762.4	-10,824.8	-13,427.8	-15,676.9	-22,908.3
2,080.0	1,653.5	1,448.4	1,502.6	1,047.7	1,869.4	1,456.3	800.6	1,355.2
2,424.2	2,257.5	1,944.2	2,016.4	2,065.6	3,380.8	5,252.0	5,892.2	7,162.2
-344.2	-604.0	-495.8	-513.8	-1,017.9	-1,511.5	-3,795.6	-5,091.6	-5,806.9
6,869.8	5,916.6	7,433.8	5,026.3	13,055.3	18,552.9	21,454.4	21,457.9	39,235.7
25.2	17.8	439.1	253.2	636.4	977.8	1,149.8	1,240.3	4,682.6
6,844.6	5,898.8	6,994.7	4,773.1	12,418.9	17,575.1	20,304.6	20,217.6	34,553.1
7,989.7	3,208.2	5,601.4	5,901.3	2,611.8	10,716.0	8,739.4	27,335.5	7,274.7
-81.7	-1,239.8	-1,043.1	-3,528.3	-2,188.4	-2,149.2	-3,388.6	-7,939.6	-13,707.1
8,071.4	4,448.0	6,644.5	9,429.6	4,800.2	12,865.2	12,128.1	35,275.1	20,981.8
-23.4	156.0	1,417.5	-665.0	2,442.4	2,431.6	9,027.1	-27,559.2	-16,829.7
-127.9	-1,894.9	153.1	-2,100.2	-3,182.9	-5,351.6	-4,851.0	-10,675.0	-15,569.9
500.8	187.0	53.3	236.5	9.1	-1,028.9	-2,893.5	-4,848.9	-4,583.9
-628.7	-2,081.9	99.8	-2,336.7	-3,192.0	-4,322.7	-1,957.5	-5,826.1	-10,986.0
104.5	2,050.9	1,264.4	1,435.2	5,625.3	7,783.2	13,878.1	-16,884.3	-1,259.8
401.1	3,292.3	-538.8	568.4	912.2	1,526.9	2,205.2	-16,352.2	3,738.1
-296.6	-1,241.4	1,803.2	866.8	4,713.1	6,256.2	11,673.0	-532.0	-4,997.9
0	0	17.5	-34.7	-63.7	-19.2	-8.3	-97.6	78.5
0	0	-77.8	-0.3	-43.2	-139.2	-35.1	13.5	-180.9
0	0	95.3	-34.4	-20.5	120.0	26.8	-111.0	259.3
-1,121.7	2,534.6	-41.7	-428.5	7,428.4	4,446.8	2,546.4	20,538.9	44,029.7
-2,480.2	-1,651.2	-2,638.3	-3,716.7	695.1	-2,284.6	-11,168.8	-10,373.4	334.6
-786.5	421.8	-1108.7	-322.7	-1083.0	-565.7	-6052.6	5636.5	-3054.0
-1,693.7	-2,073.0	-1,529.6	-3,394.0	1,778.1	-1,718.9	-5,116.1	-16,009.9	3,388.6
1,358.5	4,185.8	2,596.6	3,288.2	6,733.3	6,731.4	13,715.1	30,912.4	43,695.1
1,258.4	1,691.5	-549.9	1,814.4	1,829.0	4,309.0	3,740.5	15,396.8	17,991.5
100.1	2,494.3	3,146.5	1,473.8	4,904.3	2,422.3	9,974.6	15,515.6	25,703.6
16.8	-511.3	14.8	-112.9	779.5	-822.7	383.6	911.6	383.2
126.4	1,797.6	2,270.5	-730.2	926.8	2,312.1	3,425.4	4,883.9	7,523.9
-126.4	-1,797.6	-2,270.5	730.2	-926.8	-2,312.1	-3,425.4	-4,883.9	-7,523.9

with other countries. Estonia's current account deficit was the biggest with Germany, whereas the highest surplus was registered with the United States.

Foreign trade constitutes the largest share in the **structure of the current account turnover**. During the period under review, it has been close to 60% of the credit turnover and 75% of the debit turnover. Neither of the two indicators has shown a clear upward or downward trend. Services form the second largest component in the structure: their credit turnover has been around a third and the debit turnover about a fifth of the current account turnover.

However, recent years have witnessed a slight decrease in the share of services. In 2006, services exports accounted for 24% of the total credit turnover and imports for 14% of the total debit turnover. The share of income, on the other hand, has been gradually growing. This particularly applies to the outflow but in the last three years also the inflow of income. In 1992, income inflow composed only 0.1% of the credit turnover, whereas in 2006 it comprised as much as 7.3%. The respective outflow figures were 1.7% and 10.6%.

Regarding current transfers, incoming transfers (mainly external aid) formed a rather large share in the current account turnover at the beginning of the period of newly regained independence, but declined gradually later on. During the period of EU accession, however, this ratio has gone up again. Until the accession, the percentage of outgoing transfers was low, whereas in the last three years their share has been increasing. The rising share of current transfers can be primarily attributed to transfers from EU structural funds, refunds of VAT and other such things. When analysing the transfers, also capital transfers recorded on the capital and financial account should be taken into account. These include, among other things, EU subsidies to Estonia for the development of infrastructure. Such subsidies have been rather substantial in recent years.

The main component of the **current account deficit** during the entire period under review has been the goods account (see Table 3 and Figure 2). The income account has contributed as well, since the outflow of income has been constantly bigger than the inflow. The services account, on the other hand, has always been in surplus: Estonia has sold far more services to non-residents than purchased from them. Moreover, also current transfers have recorded surpluses, but in recent years their surplus has been decreasing as a ratio of GDP. The same also applies to the surplus on services. The total deficit on goods and services, which are the direct components of GDP, accounted for 3–8% of GDP in the period from 2000 to 2005 and almost 12% in 2006. In absolute terms, the turnover of the current account components has generally increased.

Table 3. Components of current account as a percentage of GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Current account	1.2	-6.8	-4.2	-8.6	-11.4	-8.7	-4.4	-5.4	-5.2	-10.6	-11.3	-12.3	-10.0	-15.5
Goods	-8.4	-14.7	-17.7	-22.0	-22.8	-20.2	-14.8	-14.0	-12.5	-15.2	-15.8	-17.0	-13.7	-17.7
Services	4.4	4.3	10.1	11.2	12.0	10.3	10.2	10.7	10.4	8.1	8.4	9.0	7.4	6.1
Income	-0.8	-1.2	0.1	0.0	-2.9	-1.5	-1.8	-3.6	-4.5	-4.4	-5.3	-5.3	-4.1	-4.6
Current transfers	6.1	4.7	3.4	2.2	2.4	2.7	2.0	1.5	1.4	0.9	1.4	1.0	0.5	0.7
Goods and services	-4.1	-10.4	-7.6	-10.8	-10.8	-9.8	-4.6	-3.3	-2.1	-7.1	-7.4	-8.0	-6.3	-11.6
Current account without reinvested earnings	2.8	-5.1	-3.8	-8.5	-9.6	-8.2	-3.7	-3.6	-1.9	-8.4	-7.2	-7.6	-6.4	-10.9

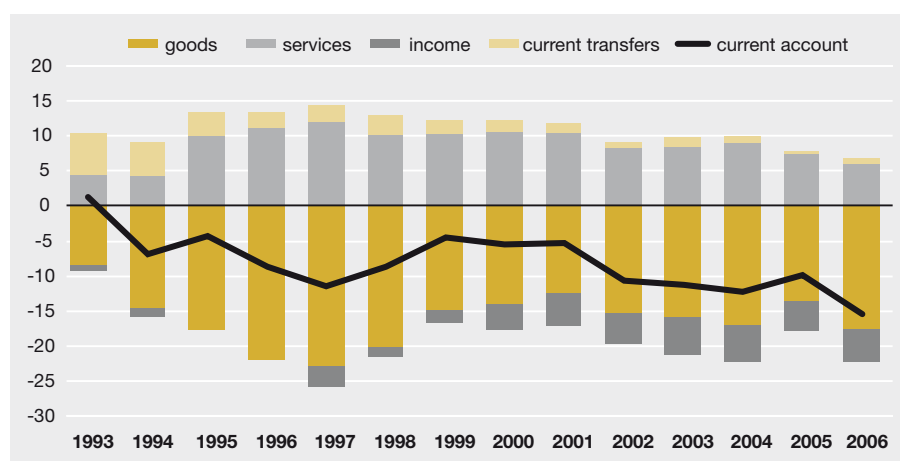


Figure 2. Components of current account as a percentage of GDP

The exports of **goods** grew by 33 and imports by 38 times during 1992–2006. The robust growth of foreign trade turnover lasted from 1992 to 1997 (see Figure 3). The double customs duties imposed by Russia on Estonia in 1997 and the Russian crisis in 1998 had a significant impact on Estonia’s foreign trade development. Namely, both exports and imports decreased in Estonia 1999. The new period of rapid economic expansion took off in 2004 when Estonia joined the European Union. The so-called Rotterdam effect² has also a role to play: part of the EU exports going through Estonia and imports channelled from third countries to the EU is reflected in Estonia’s exports and imports. Foreign trade deficit increased until 1996 and re-

² Called so after Rotterdam, which is well known as a transit port.

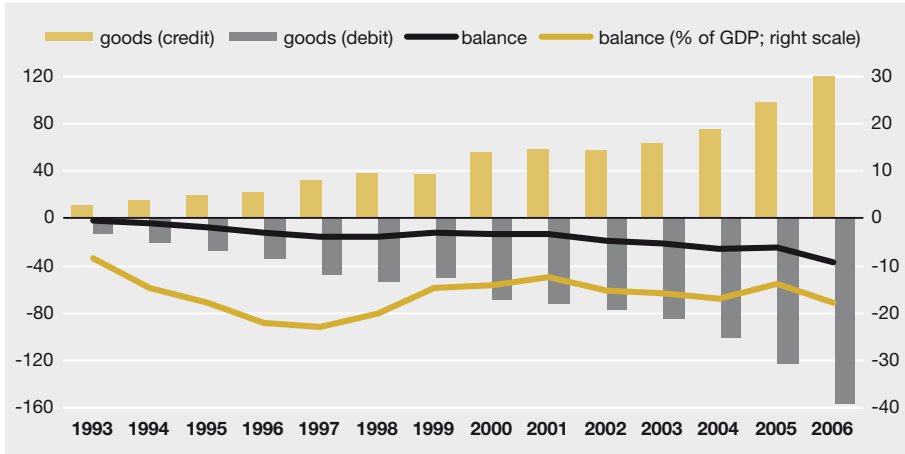


Figure 3. Foreign trade in Estonia's balance of payments (EEK bn)

mained stable at 12–15 billion kroons until 2002. After that, the deficit surged further. In 2006, Estonia's goods exports totalled 120 billion kroons (3.7 bn in 1992) and imports 157 billion kroons (4.1 bn in 1992). Imports exceeded exports by 37 billion kroons.

While in 1994 food³ was the largest export article, then in 2006 machinery and equipment prevailed. Machinery and equipment has also been the largest goods group in imports – during the entire period under review. The share of processing machinery and equipment is quite significant in Estonia's case. In 1994, approximately 25% of Estonia's exports went to Russia, whereas in 2006 only 8% was channelled there (even less in the interim years). Finland has been Estonia's main trade partner, but its share has decreased by two times: from 36% in 1994 to 18% in 2006. It is noteworthy that the current 27 EU member states accounted for 65% of Estonia's exports and for 74% of imports in 1994 as well as in 2006.

The exports of **services** grew by 31 and imports by 29 times during 1992–2006 (see Figure 4). The growth was particularly strong from 1992 to 1997 and again from 2004. The majority of the services turnover is made up of three types of services: transport, travel and other business services. Their share in the exports of services has been rather stable, comprising around 90%. Regarding imports, however, their share has fluctuated from 60% to 90%, standing at 84% for the last five years.

Finland has also been Estonia's major partner in terms of services: during 2003–2006 a third of services was exported to Finland and a fourth was imported from there. EU-27 captures

³ Foreign trade data are available by goods and countries since 1994.

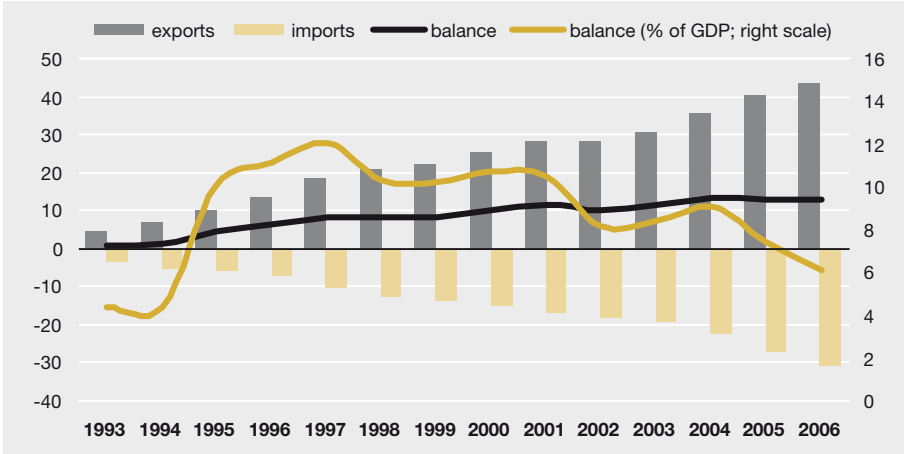


Figure 4. Services account (EEK bn)

the majority of the services trade: Estonia exported 72% of services to the EU and imported 75% from there.

The **income account** on Estonia's balance of payments has almost always recorded considerably bigger outflow compared to inflow, except in the first couple of years (see Figure 5). This can largely be attributed to non-residents' profitable direct investment in Estonia. The income account posted a modest turnover at the beginning of the period analysed, but surged in 1996 and 1997 when the Tallinn Stock Exchange posted record highs.

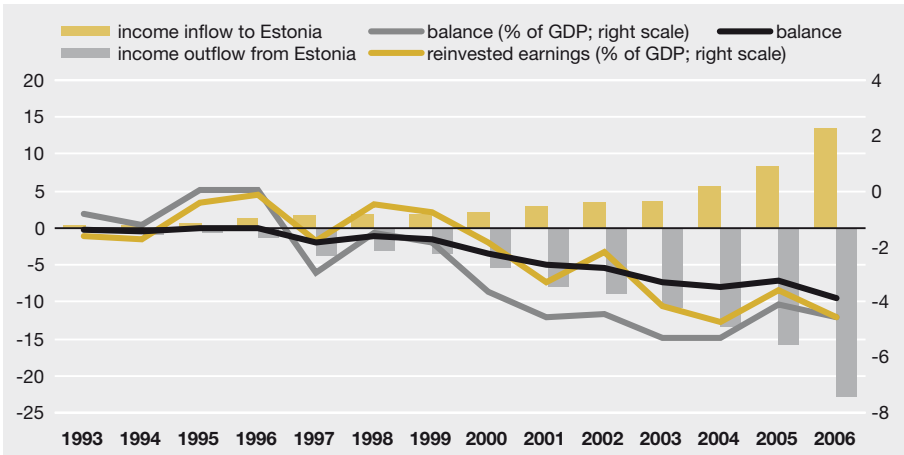


Figure 5. Income account (EEK bn)

This was followed by a crash in the stock exchange and the Russian crisis and a few years of moderate growth. Since 2001, the turnover of the income account – inflow in particular – has been rapidly growing. This indicates also higher returns of Estonian investors' investment abroad. The turnover of the income account has been largely affected by an Act that entered into force in 2001 and that provides for income tax exemption for reinvested earnings of companies operating in Estonia. Since then, the percentage of reinvested earnings in the income account structure has been considerably higher – a distinctive characteristic of Estonia's balance of payments.

As can be seen from Table 4, reinvested earnings do not play such a great role in the current accounts of the other new Member States who joined the EU together with Estonia. The percentage of reinvested earnings is especially high in income outflow: from 2003 to 2006 it formed 60% of the debit turnover of income. Excluding reinvested earnings from the current account calculation, as these do not involve any actual movement of funds, Estonia's current account deficit has been 4–5 percentage points and in the first two quarters of 2007 as much as 7–8 percentage points lower. Nearly 90% of both the inflow and outflow of income is related to EU-27, with financial intermediation being the primary field of activity.

The **capital and financial account** (excl. reserves) has posted surpluses during the entire period of regained independence, whereas these surpluses have been higher than current ac-

Table 4. Selected balance of payments indicators by selected countries (USD m)

Country	Year	Current account as % of GDP	Reinvested ear- nings as % of GDP	Direct investment per capita (USD)	
				In home country	Abroad
Czech Republic	2000	-4.7	-1.7	2,118	72
	2001	-5.3	-2.4	2,653	111
	2002	-5.7	-2.7	3,791	144
	2003	-6.3	-2.2	4,440	224
	2004	-6.0	-2.4	5,619	369
	2005	-2.0	-2.5	5,835	416
Estonia	2000	-5.3	-1.8	1,930	189
	2001	-5.2	-3.3	2,323	325
	2002	-10.7	-2.2	3,108	497
	2003	-11.4	-4.2	5,187	762
	2004	-12.2	-4.8	7,455	1,051
	2005	-10.4	-4.5	9,493	1,474
Hungary	2000	-8.4	-2.0	2,240	125
	2001	-6.0	-2.6	2,690	153
	2002	-7.0	-2.7	3,565	213
	2003	-8.6	-2.3	4,767	346
	2004	-8.5	-2.2	6,200	596
	2005	-7.3	-1.9	6,050	648

Country	Year	Current account as % of GDP	Reinvested ear- nings as % of GDP	Direct investment per capita (USD)	
				In home country	Abroad
Latvia	2000	-4.7	-0.8	876	10
	2001	-7.5	-0.4	986	17
	2002	-6.7	-0.3	1,171	25
	2003	-7.4	-0.7	1,406	49
	2004	-12.9	-2.3	1,947	101
	2005	-12.5	-2.1	2,171	123
Lithuania	2000	-5.9	-0.8	667	8
	2001	-4.7	-0.7	766	14
	2002	-5.1	-0.5	1,147	17
	2003	-6.9	-1.2	1,438	35
	2004	-7.7	-1.8	1,857	123
	2005	-6.9	-1.1	1,884	207
Poland	2000	-5.8	0.2	891	26
	2001	-2.8	0.6	1,075	30
	2002	-2.5	0.6	1,260	38
	2003	-2.1	0.0	1,512	56
	2004	-4.2	-2.5	2,258	84
	2005	-1.7	-1.2	2,348	169
Slovakia	2000			836	68
	2001			1,036	83
	2002			1,583	90
	2003			2,205	117
	2004				
	2005				
Slovenia	2000	-2.8	-0.2	1,461	388
	2001	0.2	0.1	1,304	497
	2002	1.1	-0.6	2,066	756
	2003	-0.8	-0.7	3,170	1,181
	2004	-2.7	-1.0	3,795	1,513
	2005	-1.9	-0.7	3,539	1,757
Bulgaria	2000	-5.6	-0.5	282	11
	2001	-5.9	-0.0	347	12
	2002	-2.0	-0.5	464	16
	2003	-5.1	-1.2	797	13
	2004	-5.9	-2.2	1,184	-15
	2005	-11.5	-1.0	1,475	23
Romania	2000	-3.7		314	6
	2001	-5.5		379	5
	2002	-3.3		356	7
	2003	-5.6		558	10
	2004	-8.5		944	14
	2005	-8.3		1,100	11

Sources: balances of payments and international investment positions – IMF Balance of Payments Statistics Year-book (2006); exchange rate (annual average) and GDP – IMF International Financial Statistics (Oct. 2007)

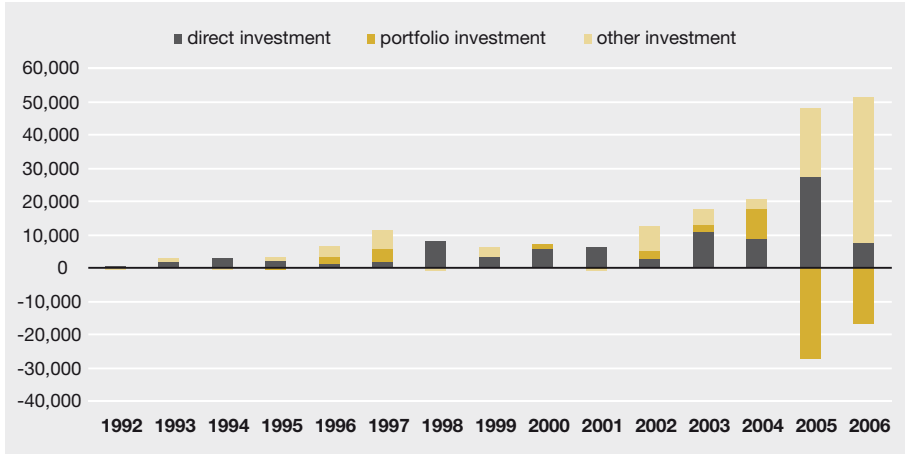


Figure 6. Sub-accounts of the capital and financial accounts in 1992–2006 (EEK bn)

count deficits every year except 2001 (see Table 1 and Figure 6). Moreover, also the balance of payments reserves have been constantly growing, amounting to 33 billion kroons at the end of 2006.

Direct investment has played an important role in the formation capital and financial account surpluses. Estonia’s investment climate has attracted many foreign investors who have supplied more and more direct investment in Estonia every year (see Figure 7). The last couple of years under consideration witnessed especially large direct investment: in 2005 in relation to

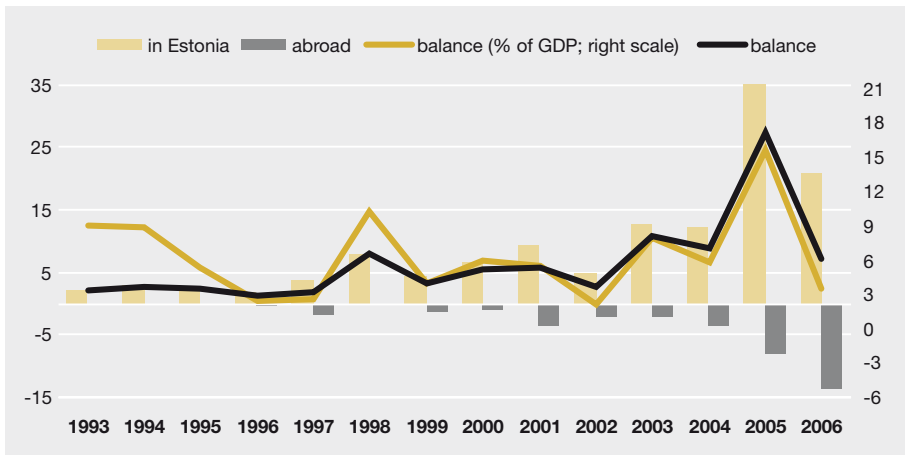


Figure 7. Direct investment (EEK bn)

the takeover of Hansapank and in 2006, as a result of a robust increase in reinvested earnings.

Estonia's direct investment abroad was quite modest in the first years but started to increase in 1999, and even doubled every year in the last three years under analysis. In terms of direct investment per capita, Estonia ranked first among the ten Eastern European countries and second after Slovenia for foreign direct investment abroad (see Table 4 and Figures 8–9).

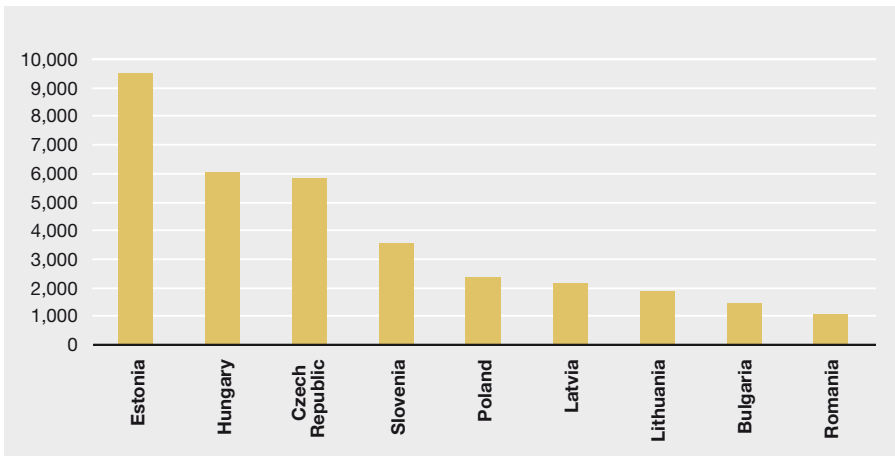


Figure 8. Direct investment per capita in selected countries as at 31 December 2005 (inflow; USD)

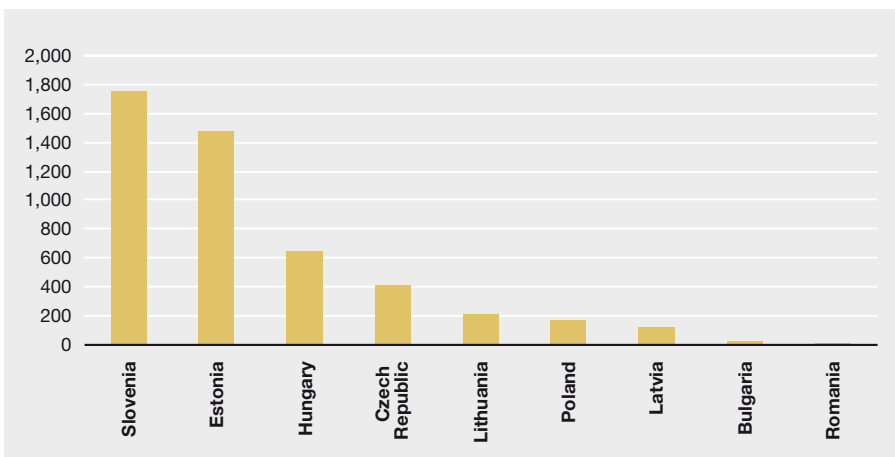


Figure 9. Direct investment per capita in selected countries as at 31 December 2005 (outflow; USD)

In the first half of the period under review, the majority of direct investment in Estonia consisted of equity investment. Since 2001, the share of reinvested earnings has grown considerably owing to the above-mentioned tax exemption, and has reached 70% of the total direct investment in Estonia in several years. Estonia's direct investment abroad, on the other hand, has mainly comprised direct equity investment. However, the percentage of reinvested earnings in residents' foreign direct investment has risen and has comprised a third during the past five years.

Foreign direct investment in Estonia has primarily come from the north: from Sweden (40%) and Finland (26%). The most preferred fields of activity have been real estate, renting and business activities, financial intermediation and manufacturing. Estonia has channelled its investment mainly to the south: to Latvia (34%) and Lithuania (32%). The most active foreign direct investors have been engaged in financial intermediation and real estate, renting and business activities.

The turnover of **portfolio investment** was low in early-1990s but picked up in 1996–1997 as a result of the robust growth of the securities market, when residents assumed considerable debt and equity security liabilities from credit institutions and other sectors (see Figure 10). The turnover decreased significantly after the stock exchange crash but picked up later again. In the years 2004 to 2006, it reached considerable levels: in 2005, the net outflow of portfolio investment was over 27 billion and in 2006 nearly 17 billion kroons. The strong outflow in 2005 was largely related to the takeover of Hansapank (which brought along a decrease in the equity security liabilities of credit institutions). In 2005 and 2006, also other sectors and the general government increased their equity and debt security assets.

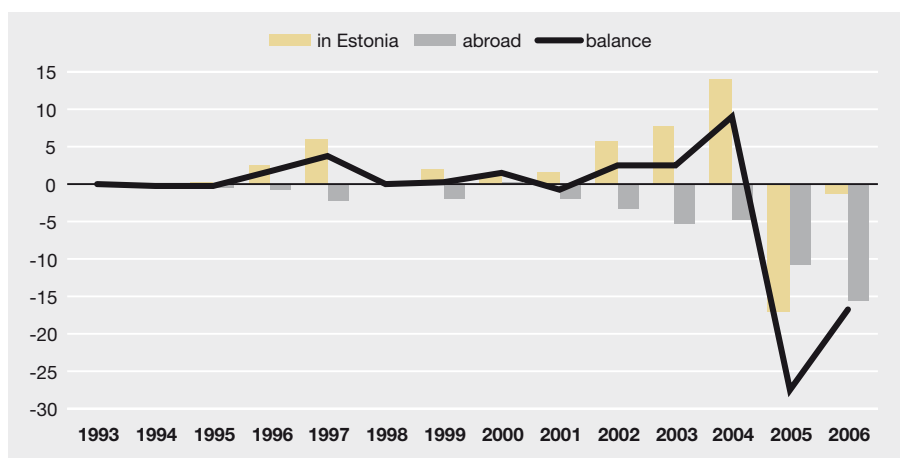


Figure 10. Portfolio investment (EEK bn)

The majority of portfolio investment turnover is related to EU-27. At the end of 2006, 82% of the assets and 90% of the liabilities of portfolio investment were related to this group of countries.

The dynamics of **other investment**, that is trade credit, loans and deposits, have been rather similar to portfolio investment, except for the higher turnover of the former (see Figure 11). At the start of the analysed period, the turnover of other investment was modest, recording net inflows in some years and net outflows in others. During 1996–1997, there was substantial inflow of other capital, which could be mostly attributed to credit institutions. Further developments were slightly more moderate, posting net inflows in some years and net outflows in others.

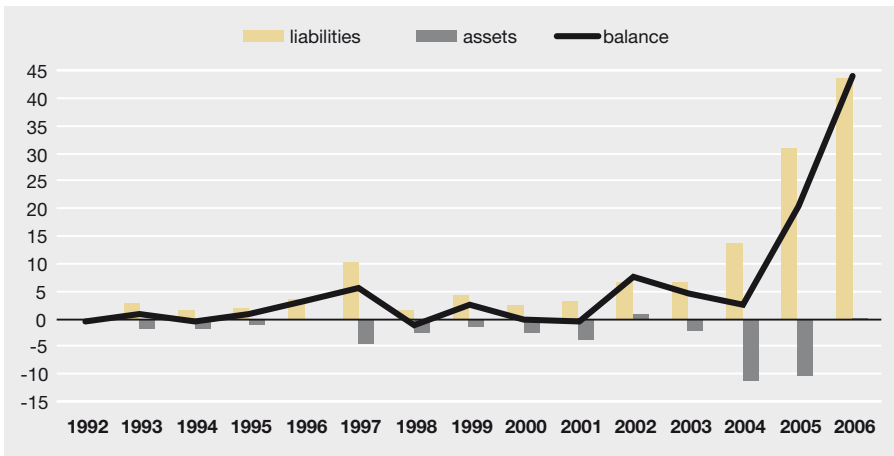


Figure 11. Other investment (EEK bn)

Since 2002, the inflow of other investment capital has constantly exceeded the outflow, especially in the last couple of years. In 2005, the inflow stood at 21 and in 2006, at 44 billion kroons, being thus the primary source of capital inflow in 2006. Estonia's rapid economic expansion, strong domestic demand and favourable real estate market created high demand for loan capital. Credit institutions then brought cheap loan money from foreign parent banks to meet that demand.

At the end of 2006, 62% of the assets and 80% of the liabilities of other investment were related to EU-27.

Estonia's gross **external debt** as at 31 December 2006 totalled approximately 200 billion kroons (96% of GDP). The debt of general government accounted for only 2% of the gross debt, whereas 51% belonged to credit institutions, 28% to other sectors and the rest was intercompany lending of direct investment companies. Excluding these from the calculation of gross external debt,⁴ long-term debt formed 56% of the gross debt. Estonia's net external debt (assets less liabilities) was 56 billion kroons (27% of GDP).

CONCLUSION

Three stages can be distinguished in the history of Estonia's balance of payments during 1992–2006:

- rapid expansion until 1997;
- a setback during 1998–1999 and a relatively slower development until accession to the EU;
- strong growth during the EU membership.

Estonia has been a very open economy (current account turnover is double the volume of GDP) with favourable investment climate. This has boosted the turnover of the current account: from 1992 to 2006, the credit turnover increased by 33 and the debit turnover by 41 times.

The current account has recorded deficits practically throughout the entire period under review (in 2006 as much as 15% of GDP) owing to strong domestic demand and investment activity.

Estonia's investment environment has attracted numerous foreign direct investors. Estonia ranks first among the ten new EU Member States in terms of direct investment per capita and second in terms of foreign direct investment abroad.

Profitable foreign direct investment and income tax exemption for reinvested earnings in the second half of the period have substantially contributed to the growth of reinvested earnings.

Cheap loan money and the construction boom brought along strong inflow of loan capital during 2005–2006. Consequently, Estonia's external debt increased rapidly and was almost equal to GDP at the end of 2006. The general government debt was marginal, as over half of the external debt consisted of the liabilities of credit institutions.

⁴ The statistics on the intercompany lending of direct investment companies does not include information on its distribution into short-term and long-term liabilities.