Republic of Estonia

Rating Report

AA- STABLE OUTLOOK

Credit strengths

- Prudent fiscal management, low public debt
- Sound institutions, effective macroeconomic policymaking, EU and euro area memberships
- Solid medium-run growth prospects

Credit challenges

- Adverse demographics
- Exposure to external shocks

Rating rationale:

Estonia's AA- rating is underpinned by the following credit strengths: i) a track record of prudent fiscal management anchoring low public debt; ii) strong, transparent and accountable economic institutions and a commitment to a favourable investment environment, underpinned by EU and euro area memberships; and iii) strengthened resilience of the Estonian economy, supported by effective structural reform and robust absorption of EU structural and recovery funding.

Challenges relate to: i) an ageing population and skilled-labour shortages, alongside still lower per-capita income relative to the euro-area average; and ii) a large export sector relative to the size of the economy, which exposes Estonia to external shocks.

Estonia's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a-		-1/3	
Public Finance Risk		25%	aa+		0	
External Economic Risk		10%	bbb		-2/3	
Financial Stability Risk		10%	aaa		0	AA-
ESG Risk	Environmental Risk	5%	aa+		-1/3	
	Social Risk	5%	bbb+		0	
	Governance Risk	10%	aaa		0	
Overall outcome		**aa-**		**+1**	**-1**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket.
For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings

Outlook and rating triggers

The Stable Outlook represents Scope's view that Estonia will be able to weather the economic fallout from the Russia-Ukraine war without any significant deterioration in credit fundamentals.

Positive rating-change drivers

- Further improvement in structural indicators, supporting further income convergence
- Sustained improvement in medium-run fiscal outlook
- Sustained reduction in external vulnerabilities

Negative rating-change drivers

- Significantly higher debt/GDP, due to looser fiscal policy, lower growth
- Substantial deterioration in external accounts
- Sustained labour shortages worsening inflationary and growth outlooks
- External shock or heightened geopolitical risk undermining macro-economic stability

Ratings and Outlook

Local and foreign currency

Long-term issuer rating	AA-/Stable
Senior unsecured debt	AA-/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: RESP SCOP

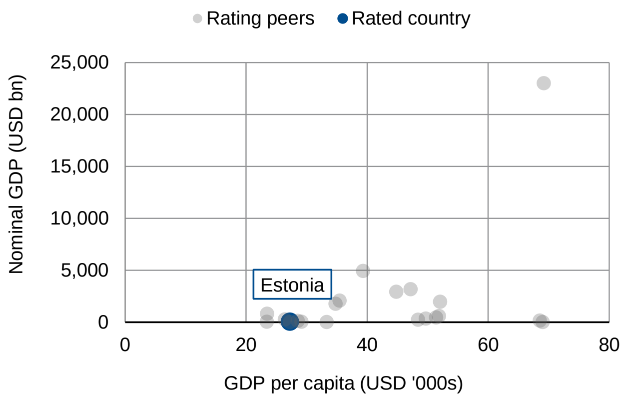
Domestic Economic Risks

- **Growth outlook:** Estonia's rating benefits from improved resilience of its economy against external shocks. This is helped by the authorities' prudent and predictable macroeconomic policymaking and effective structural reform, underpinned by the country's EU and euro-area memberships. After a relatively mild contraction of 2.6% during the pandemic crisis in 2020, the economy rebounded strongly in 2021, posting an 8.2% growth. At the same time, the Russia-Ukraine war is exerting considerable downward pressure on Estonia's small, open economy via higher inflationary pressures, lower confidence and foreign trade and supply chain disruptions, all of which pose downside risks to the near-term growth. Scope has revised down its growth projection for 2022 to 1.2% (previous review: 4.3%). Scope estimates Estonia's medium-term potential growth at around 3% annually. This is supported by the implementation of strategic public-infrastructure investment projects, including in renewable energy, on the back of Estonia's prudent absorption of EU funds.
- **Inflation and monetary policy:** Higher global commodity prices were fueling strong inflationary pressures already in H2 2021. Headline inflation surged to 19.1% yoy in April 2022, the fastest in over 25 years. Core inflation (excluding the prices of energy and unprocessed food) was also elevated, at 10.4% yoy in April. Scope expects average yearly headline inflation above double-digit area in 2022, at 12%. Russia-Ukraine conflict will add to inflationary pressures in the short-term, via higher prices for energy, commodities and food. Inflation is forecast to decline to 4% in 2023.
- **Labour market:** Scope does not see major risks to the labour market from the Russia-Ukraine war, with labour market indicators having recovered to their pre-pandemic levels. Unemployment rate reached 5.4% in March 2022, around the levels seen at start-2020. However, skilled-labour shortages and unfavourable demographics constrain longer-term growth prospects.

Overview of Scope's qualitative assessments for *Domestic Economic Risks*

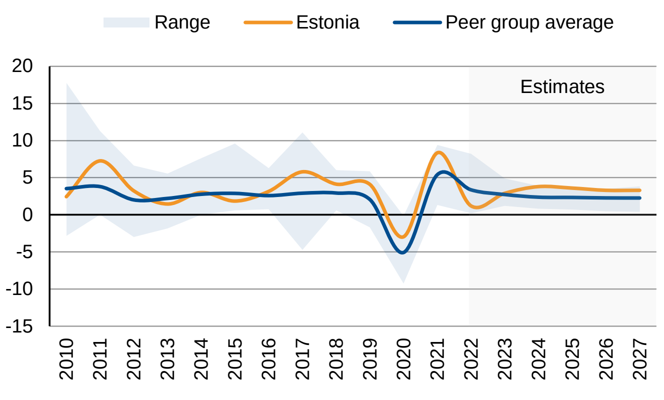
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Neutral	0	Medium-run growth potential faces challenges from adverse demographics; improvement in migration flows in recent years
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank; effective policy framework and transmission over the cycle
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings

Real GDP growth, %



Source: IMF, Scope Ratings

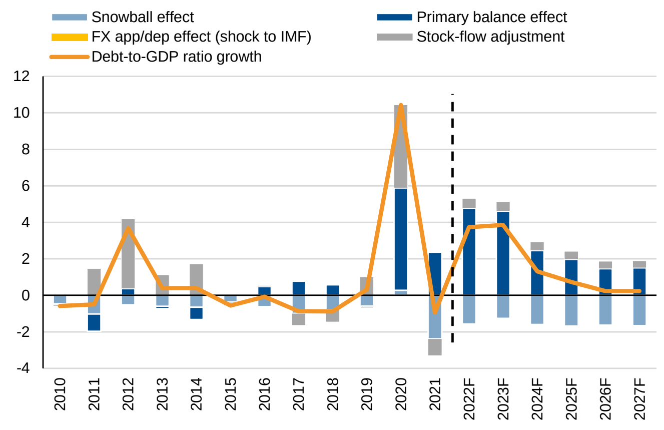
Public Finance Risks

- **Fiscal outlook:** Estonia's rating benefits from the country's sound fiscal space, underpinned by its strong fiscal management. We expect Estonia to remain committed to fiscal prudence despite increasing budgetary pressures from decelerated near-term growth and the need to provide fiscal support to the private sector to address inflation. We project the general government deficit to widen to 4.5% of GDP this year, from 2.4% of GDP in 2021. The deficit is expected to decline to 3.5% of GDP by 2023 and 2.5% of GDP by 2024, supported by economic recovery and budgetary consolidation. In the long term, the ageing population and relatively low levels of pensions, which might not be socially viable, pose budgetary pressures.
- **Debt trajectory:** As a result of deficit developments, general government gross debt is forecast to increase to 21% of GDP this year (from 18.1% of GDP in 2021) and further to 23% of GDP by 2023. At the same time, the debt ratio is expected to remain the lowest among the Central and Eastern European members of the EU.
- **Market access:** Of the EUR 5.5bn public debt stock at end-2021, almost 30% (EUR 1.6bn in total) reflects long-term loans from EIB, NIB, CEB and the EC's SURE programme. In June 2020, Estonia re-entered debt capital markets, issuing for the first time since 2002 a long-term bond: EUR 1.5bn with a maturity of 10 years and coupon of 0.125%. Estonia's ability to issue on favourable terms despite infrequent issues, access to the ECB's facilities and a stable investor base support its rating.

Overview of Scope's qualitative assessments for *Public Finance Risks*

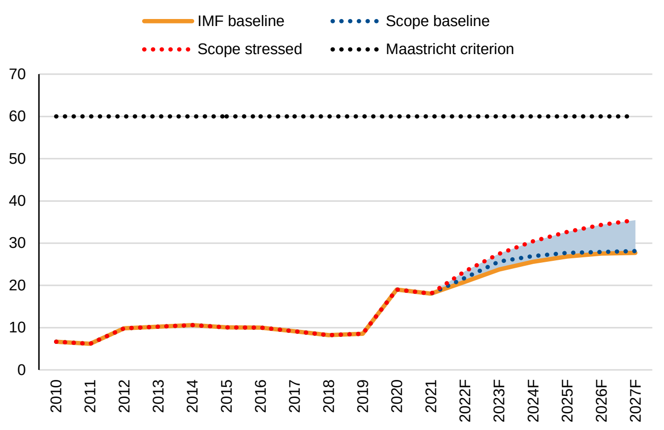
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Fiscal policy framework	Neutral	0	Record of robust fiscal policies, but still-sizeable shadow economy
	Debt sustainability	Neutral	0	Low but rising debt in the medium run
	Debt profile and market access	Neutral	0	Favourable debt structure, return to long-term debt capital markets in 2020 for the first time since 2002

Contributions to change in debt levels, pps of GDP



Source: Scope Ratings

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings

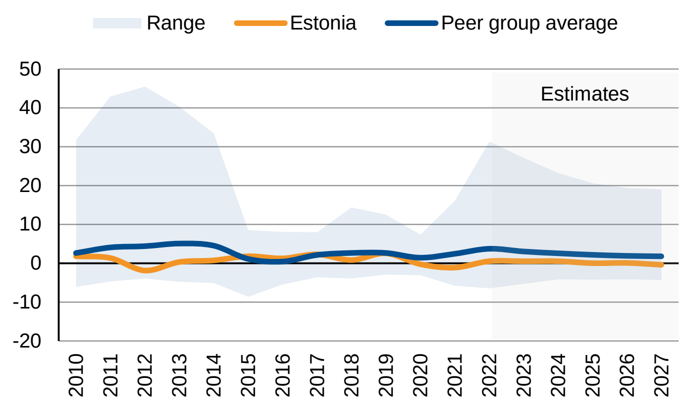
External Economic Risks

- **Current account:** We expect Estonia to continue diversifying its import and export markets and reducing energy imports from Russia. As a result of reduced imports of mineral fuels, Estonia's re-exports and exports of linked products, such as refined fuels, are expected to decrease. At the same time, we expect higher-value-added services exports, such as of telecommunications, computer, information and financial services, to keep a robust pace of growth, enabling Estonia to maintain a balanced current account this year and in the medium run.
- **External position:** Estonia's net international investment position (external financial assets minus liabilities) improved to -12.2% of GDP in Q4 2021, from -21.5% of GDP in Q4 2020. The structure of Estonia's gross external liabilities compares favourably with those of CEE peers, with foreign direct investment comprising 64% of total liabilities, a source of inward investment that is less prone to flight in times of market volatility than portfolio flows.
- **Resilience to shocks:** Estonia's small, open economy remains vulnerable to external shocks, including to a period of subdued growth in Europe because of the war in Ukraine. Total exports of goods and services of Estonia amounted to 81% of its GDP in 2021. At the same time, Scope does not expect the war to have a more substantial or permanent impact on the economy. This is due to continued improvement in Estonia's energy security and sustainability. The connection of Baltic states' and continental Europe's electricity networks is planned to be completed by 2025, with a possibility of earlier synchronisation, while the Estonian as well as Baltic natural gas transmission systems have already been connected with the Polish and EU systems.

Overview of Scope's qualitative assessments for *External Economic Risks*

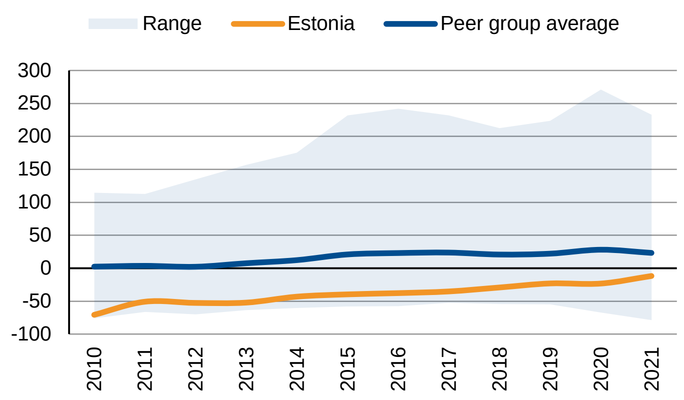
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Weak	-1/3	Limited export diversification
	External debt structure	Neutral	0	Substantial share of FDI in total external liabilities
	Resilience to short-term shocks	Weak	-1/3	Very small-open economy

Current account balance, % of GDP



Source: IMF, Scope Ratings

Net international investment position, % of GDP



Source: IMF, Scope Ratings

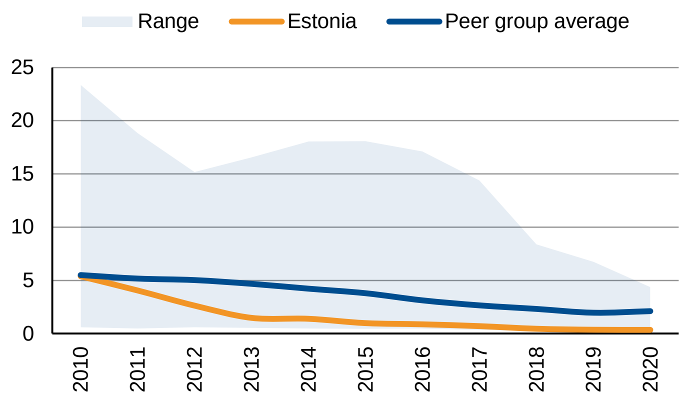
Financial Stability Risks

- **Banking sector:** Estonia's Nordic-dominated banking sector presents limited contingent liability risk to the sovereign balance sheet and is in a good position to absorb the current economic shock. As of Q4 2021, the system-wide Tier 1 capital amounted to 25.9% of risk-weighted assets, the highest in the euro area, and the non-performing loan ratio was a low 0.8% for the same quarter. The financial system's available buffers provide a sizeable cushion in adverse scenarios involving the Ukraine crisis.
- **Private debt:** The Covid-19 crisis has not caused exceptional macroeconomic imbalances with private sector (non-financial corporations and households) debt amounting to 116% of GDP as of end-2021, down from a pre-Covid-19 level of 125% of GDP as of end-2020.
- **Financial imbalances:** Estonia is exposed to spill-over risks from possible changes in market conditions in Sweden, as Swedish banking groups hold a dominant share in Estonia's financial system. As an example, Swedbank accounts for around one-third of the total banking sector assets in Estonia. Capital flight and cross-border money-laundering risks are further mitigated by a moderate share of non-resident deposits, at 12.9% of total deposits as of March, below that of Latvia (15%), but meaningfully above that of Lithuania (6.3%), as well as by an increased share of EU residents.

Overview of Scope's qualitative assessments for *Financial Stability Risks*

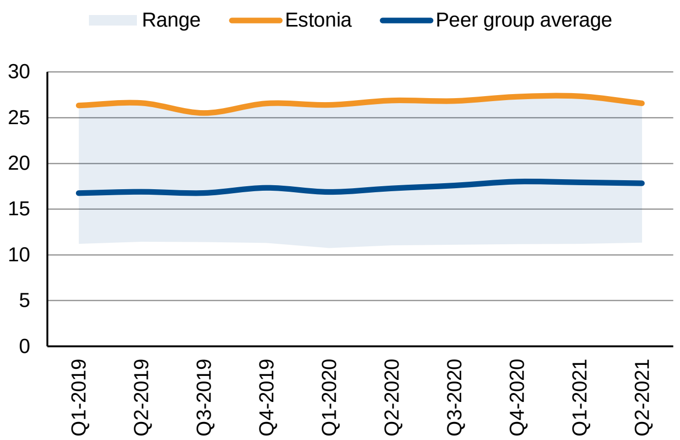
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	1/3	Largely Nordic-owned banking sector, which has a high level of capitalisation and low NPL ratio
	Banking sector oversight	Neutral	0	Oversight under the Bank of Estonia and the ECB as part of Banking Union
	Financial imbalances	Weak	-1/3	Concentration and spill-over risks in the banking system from dominant Nordic banking groups

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

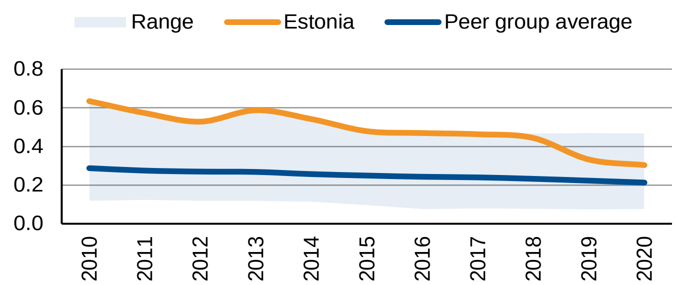
ESG Risks

- **Environment:** Estonia has progressed in fostering energy efficiency: its share of renewable energy in gross final energy consumption was 30.1% in 2020, above the EU average of 22.1%, with plans for further investment in renewable energy. However, Estonia's highly carbon-intensive oil shale industry remains economically important, making the transition to meet EU carbon-neutrality objectives challenging. The industry produced 40% of electricity in 2020, albeit down from 76% in 2018.
- **Social:** Estonia's performance across key social factors is mixed. This is reflected in a moderate rate of unemployment, income inequality around the EU-average and slightly higher poverty levels (with 22.8% of the population at risk of poverty or social exclusion in 2020, compared to 21.5% for the EU-27). The EC's Digital Economy and Society Index 2021, which assesses digital competitiveness in the EU, ranks Estonia seventh. Importantly, immigration to Estonia has exceeded emigration since 2015, mitigating labour shortages in some sectors. However, adverse demographics are a key credit challenge.
- **Governance:** Estonia's performance is stronger compared with that of CEE sovereign peers as assessed under the World Bank's WGI. In general, policymaking in Estonia has been effective and has enjoyed continuity. Estonia's EU and euro-area memberships enhance the quality of macroeconomic policymaking and the macroprudential framework. In our view, external security risks for Estonia, which has a border with Russia, have increased since the escalation of Ukraine war. However, we believe that Estonia's and other Baltic states' NATO memberships (since 2004) limit the risk that the conflict could expand beyond Ukraine's borders, including into the Baltic region. Estonia's security guarantees are underpinned by NATO's Article 5, which states that if one member of the Alliance is subject to an armed attack, other members will consider this as an armed attack against all members and will provide necessary support. Both NATO and Estonia have continually confirmed their commitments to Article 5

Overview of Scope's qualitative assessments for *ESG Risks*

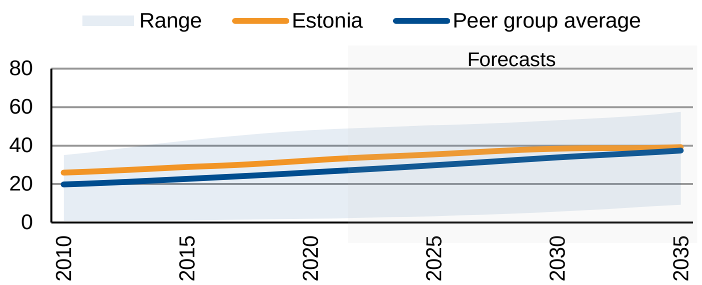
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Environmental risks	Weak	-1/3	Higher exposure to transition risks due to economically important oil shale industry
	Social risks	Neutral	0	High rates of employment, net immigration since 2015, income inequality levels around the EU average, but adverse demographics
	Institutional and political risks	Neutral	0	Record of effective policymaking and strong governance supported by EU and euro area memberships; risen external security risks mitigated by NATO membership

CO2 emissions per GDP, mtCO2e



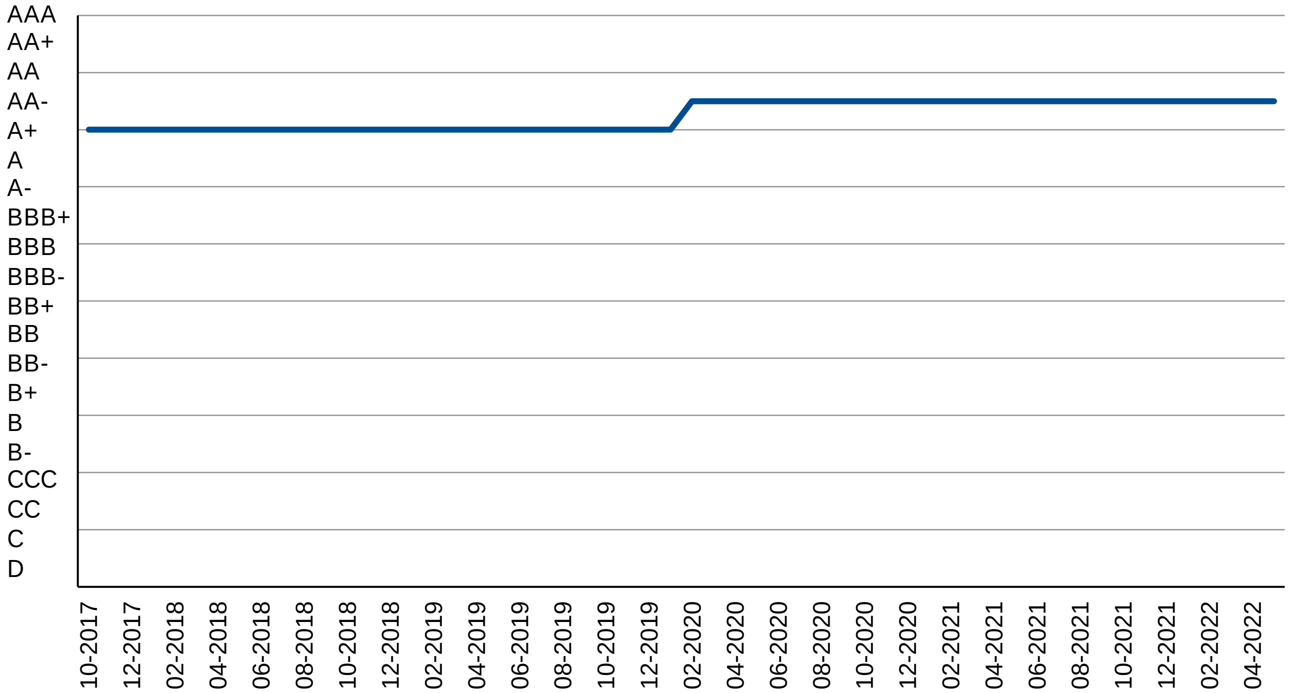
Source: European Commission, Scope Ratings

Old Age Dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per our Core Variable Scorecard (CVS).

Peer group*
Belgium
Czech Republic
France
Italy
Japan
Lithuania
Malta
Slovenia
United Kingdom
United States

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators[1]

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	18.3	20.4	23.1	23.4	23.0	27.3	28.0	30.2
Nominal GDP, USD bn	24.1	26.9	30.5	31.0	30.6	36.3	37.2	40.1
Real growth, %[1]	3.1	5.5	4.1	4.0	-2.6	8.2	1.2	2.7
HICP inflation, %	0.8	3.7	3.4	2.3	-0.6	4.5	12.0	4.0
Unemployment rate, %[1]	6.8	5.8	5.4	4.4	6.8	6.2	6.9	6.8
Public Finance Risk								
Public debt, % of GDP[1]	10.0	9.1	8.2	8.6	19.0	18.1	21.0	23.0
Interest payment, % of government revenue	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Primary balance, % of GDP[1]	-0.5	-0.8	-0.6	0.1	-5.6	-2.4	-4.2	-3.6
External Economic Risk								
Current account balance, % of GDP	1.2	2.3	0.8	2.5	-0.3	-1.1	0.0	0.0
Total reserves, months of imports	0.2	0.2	0.4	0.7	1.0	0.9	-	-
NIIP, % of GDP	-39.5	-33.0	-30.0	-22.9	-21.5	-12.2	-	-
Financial Stability Risk								
NPL ratio, % of total loans	1.3	1.7	1.2	1.5	1.1	0.8	-	-
Tier 1 ratio, % of risk-weighted assets	35.8	30.9	31.6	27.0	28.1	25.9	-	-
Credit to private sector, % of GDP	69.8	64.1	62.2	59.8	64.8	-	-	-
ESG Risk								
CO_2 per USD 1,000 of GDP	469.4	463.1	443.8	332.0	302.9	-	-	-
Income quintile share ratio (S80/S20)	5.0	4.7	4.7	4.8	-	-	-	-
Labour-force participation rate, %	77.6	78.9	79.1	78.9	-	-	-	-
Old-age dependency ratio, %	30.0	30.6	31.0	31.5	32.2	-	-	-
Composite governance indicator[2]	1.2	1.2	1.2	1.2	1.3	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, National statistical office and central bank, Scope Ratings

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 10 June 2022	76

[1] This table presents a selection of the indicators (24 out of 29) used in our quantitative model, the Core Variable Scorecard.

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