25 November 2022

Sovereign and Public Sector

Republic of Estonia
Rating Report

SCOPE AA- STABLE OUTLOOK

Credit strengths	Credit challenges
• Sound institutional set-up underpinned by EU, euro area and NATO memberships • Improved economic resilience and solid medium-run growth prospects • Low public debt	• Moderate income levels • Exposure to external shocks • Adverse demographics and skill shortages weighing on labour market prospects

Rating rationale:

Sound institutions: Estonia's effective policymaking is underpinned by its euro area membership, which provides a robust framework for fiscal policy, economic policy and banking supervision. Its NATO membership strongly mitigates external security risks, which have risen amid the heightened geopolitical tensions.

Solid growth prospects: the country's solid economic growth and improved macroeconomic resilience have accelerated its convergence to euro area income levels. Despite a significant hit from the current energy crisis, we expect growth of 0.4% and 0.8% in this year and the next. We estimate Estonia's medium-run growth potential at 2.2%.

Low public debt: Prudent fiscal policies have resulted in Estonia gaining one of the lowest debt-to-GDP ratios globally, at 17.6% by end-2021, further backed by high financial reserves.

Rating challenges include: i) still moderate per-capita income relative to the euro-area average, which, together with the economy's high exposure to external shocks, increases Estonia's vulnerability to the current inflationary pressures; and ii) an ageing population and skilled-labour shortages that are constraining the medium-term growth outlook.

Estonia's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb	EUR [+1]	0	AA-
Public Finance Risk		20%	aaa		0	
External Economic Risk		10%	bb		-1/3	
Financial Stability Risk		10%	aaa		+1/3	
ESG Risk	Environmental Factors	5%	a		-1/3	
	Social Factors	7.5%	b+		0	
	Governance Factors	12.5%	aaa		0	
Indicative outcome		**aa-**			**0**	
Additional considerations					**0**	

Notes: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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 reflects our view that risks to the ratings are balanced.

Positive rating-change drivers	Negative rating-change drivers
• Continued implementation of structural reforms and investment in sustained solid growth and further income convergence • Improvement in fiscal outlook, supported by a rapid rebalancing of government finances • External vulnerabilities significantly reduced further	• Weaker fiscal fundamentals leading to a significant increase in debt-to-GDP • Increased macroeconomic imbalances weakening medium-run growth prospects • Substantially increased external and financial sector vulnerabilities • Higher geopolitical risks undermining macroeconomic stability

Ratings and Outlook

Foreign currency

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

Local 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

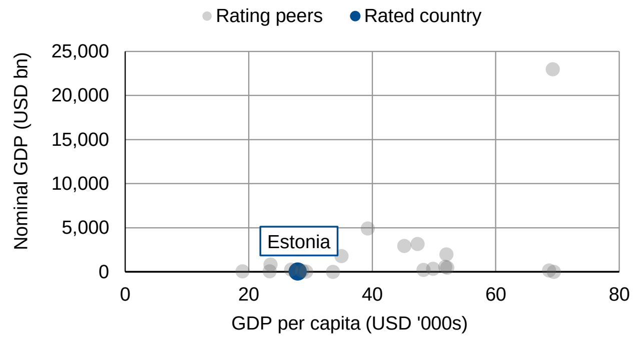
Domestic Economic Risks

- **Growth outlook:** The economy proved resilient to the Covid-19 crisis with the contraction in GDP contained to 0.6% in 2020. Last year's GDP rebound was exceptional at 8%. This benefited from consumption boosted by pension withdrawals after a reform allowed a switch to voluntary participation in the second pillar. Robust exports and investment growth also contributed to the strong rebound. However, the Russia-Ukraine war has affected the outlook via high inflation, supply-chain disruptions and weaker trade. Confidence also took a hit despite Estonia's ability to rapidly substitute energy imports from Russia. The impact was visible in H1 2022, including a contraction in Q2. We expect moderate GDP growth of 0.4% and 0.8% in 2022 and 2023 respectively, followed by a rebound to 3.2% in 2024. In the medium term, we estimate a growth potential of 2.2%, supported by Estonia's ample access to EU funds, at close to 20% of (2021) GDP over 2021-27, which include the Recovery and Resilience Facility, Cohesion Policy and Common Agricultural Policy. In addition, the economy benefits from an attractive business environment and a highly digitalised public administration supporting continued advancements in income and productivity.
- **Inflation and monetary policy:** Along with the other Baltic states, Estonia is heavily affected by the very high inflation. Its economy was already at risk of overheating before the full-scale invasion of Ukraine, given its tight labour market and loose monetary policy. A large share of energy and food items in its consumption basket on top of deregulated gas and electricity markets makes Estonia heavily exposed to the current supply-side price shocks. Inflation reached 22.5% in October, and we expect 19% for 2022 and a still elevated 7% in 2023. The ECB is rapidly normalising monetary policy, with rate increases totalling 200 bp so far this year on top of the halt of net asset purchases under quantitative easing. The tighter financing conditions will contribute to an economic slowdown in 2023.
- **Labour markets:** Employment was high as of Q2 2022 and back to pre-Covid levels, at over 670,000 people. Participation is also excellent, at above 80% of the labour force, while unemployment is low at 5.7% as of September. However, we expect unemployment to rise in the coming months as the rate is already close to its structural level and the economic outlook is weakening, to an average of 6% in 2022 and 6.5% in 2023-24. Despite labour flexibility and wide participation, the labour market still faces labour and skill shortages, exacerbated by unfavourable demographic trends only partially mitigated by a recent reversal in net migration. This hinders growth and has been fuelling double-digit wage growth in recent quarters.

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

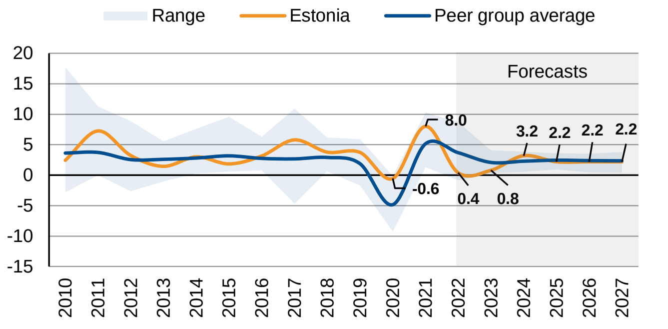
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Robust economic prospects supported by EU funds, although adverse demographic trends are a challenge
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank over the cycle
	Macro-economic stability and sustainability	Neutral	0	Improved macroeconomic resilience and flexible labour market, but labour shortages, overheating risks and large regional disparities

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

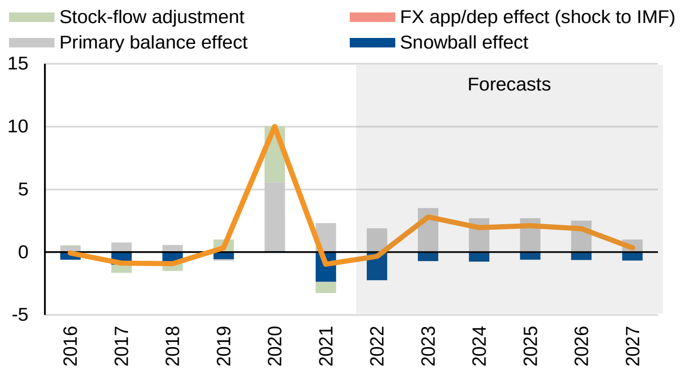
Public Finance Risks

- **Fiscal outlook:** Estonian authorities have shown fiscal prudence, reflected in a broadly balanced government budget in the 10 years prior to the Covid-19 crisis. Fiscal measures to cope with the pandemic caused government finances to deteriorate significantly: the fiscal deficit reached 5.5% of GDP in 2020, though it rapidly recovered to 2.4% in 2021. Despite measures to address the cost-of-living shock, on top of the need to strengthen energy and external security and support Ukrainian refugees, the deficit is likely to further decline this year to about 2.0% thanks to strong revenue growth and spending delays. However, we expect the deficit to eventually increase to about 3.0% in 2024-26, after a peak of 3.8% in 2023, accounting for further support to households and businesses. By 2027, the deficit should markedly decline as defence investment catches up. However, a failure to rebalance government finances in the medium run while economic growth is less buoyant than in the past could worsen the debt trajectory.
- **Debt trajectory:** We expect general government debt to remain on a slightly upward trajectory over the next five years before stabilising to about 26% of GDP by 2027. In comparison, we forecast 17.3% this year and 20.0% in 2023. The debt ratio is thus expected to remain among the lowest in the EU despite being twice today's level in absolute terms. Implicit liabilities from rising ageing-related expenditures over the next 30 years are low according to IMF and EC estimates. However, the currently low spending on healthcare and pensions also come with downside risks.
- **Debt profile and market access:** Estonia's ratings benefit from low-risk debt, moderate funding needs and prudent liquidity management. The country has no foreign currency exposure and a long average debt maturity of close to eight years, smoothing out redemption timing. The central government debt portfolio comprises EUR 1.7bn (close to 40% of total debt) in long-term amortising loans from international financial institutions including the EIB and the EC. Estonia also re-entered debt capital markets in 2020, issuing for the first time since 2002 a long-term bond for EUR 1.5bn followed by a EUR 1bn issuance in 2022, which attracted considerable investors and market demand despite the volatile market. The central government's very ample financial reserves of above EUR 2bn can cover several years of redemptions, strongly reducing refinancing risks.

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

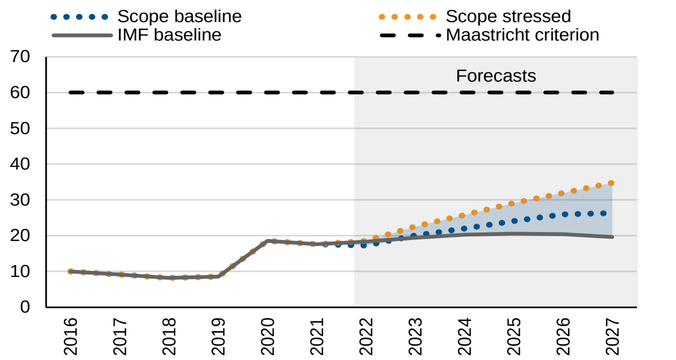
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy and conservative budgeting; fiscal balance set to weaken due to the costs of the war and the energy crisis
	Debt sustainability	Neutral	0	Low debt burden, anchored to moderate levels in the medium run
	Debt profile and market access	Neutral	0	Low-risk debt structure, moderate funding needs and prudent liquidity management; ability to issue at favourable terms despite infrequent issues

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

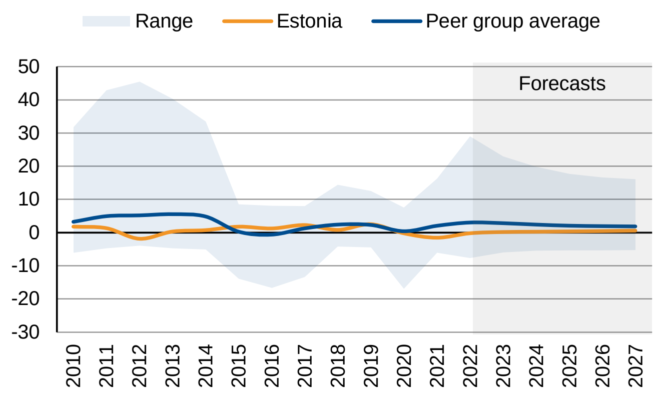
External Economic Risks

- **Current account:** Following a period of steady surpluses averaging 1.1% of GDP over 2010-19, Estonia's current account balance turned negative in 2020 (-0.3%) and 2021 (-1.6%), reflecting weaker exports as well a jump in imports related to corporate subsidiaries. The dissipation of this one-off effect combined with robust export growth and a lower deficit in primary income drove a recovery in the current account, which returned to surplus in the year to Q2 2022 (1.6% of GDP), notwithstanding the high energy and commodity prices. Trade links with Russia also primarily consists of re-exports, which limits the exposure to trade sanctions prompted by the Ukraine war. We expect the current account to continue posting small surpluses, supported by growing, high-value-added export sectors such as ICT and financial services, and despite the weakening of the economic outlook for Estonia's main Baltic and Nordic trading partners. Long-term challenges to the external balance relate to rapid wage growth, which could weigh on cost-competitiveness.
- **External position:** Estonia's net international investment position has improved steadily, from -40% of GDP in 2016 to -21% in Q2 2022. Around two-thirds of external liabilities relate to inward foreign direct investment, curbing risks related to sudden capital flows in times of market stress. Estonia's external debt is comparatively moderate, at 87% of GDP, and broadly stable relative to historical averages. Most external debt is owed by the Estonian financial sector (52% of total), followed by the government (17%). A significant 51% of external debt is short-term, albeit remaining low relative to euro area peers as a share of GDP (35%).
- **Resilience to shocks:** Estonia's small, open economy remains vulnerable to external shocks in view of its large export and import sectors, each representing around 78% of GDP. The Russia-Ukraine war is having significant direct and indirect negative impacts on the country's economy, primarily due to shortages in raw materials and weaker growth among key trading partners. At the same time, we do not expect the conflict to cause permanent scarring of the country's growth potential. This is due in part to Estonia's lower dependency on energy imports than peers thanks to its sizeable domestic oil shale production. The connection of Baltic states to mainland Europe's electricity networks is due to be completed by 2025 and synchronisation during emergencies is already possible.

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

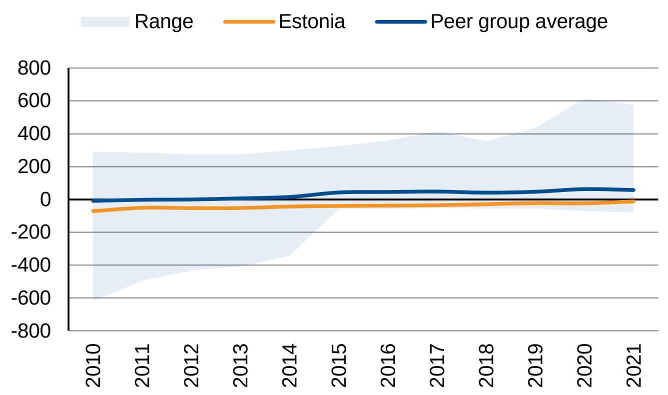
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Current account resilience	Neutral	0	Improved export competitiveness and focus on value-added segments
	External debt structure	Neutral	0	Declining net external debtor position, large share of foreign direct investment in net external liabilities reducing exposure to shocks
	Resilience to short-term external shocks	Weak	-1/3	Small-size and open economy, affected by external developments

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

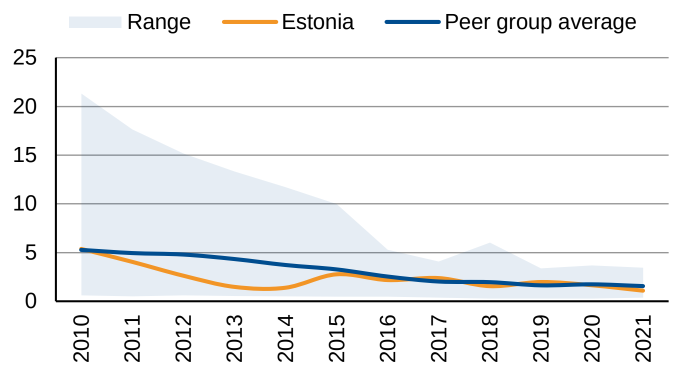
Financial Stability Risks

- **Banking sector:** Estonia's Nordic-dominated banking sector presents low contingent liability risk to the sovereign balance sheet and is well placed to absorb the current economic shock. The sector's resilience is underpinned by its exceptional capitalisation levels – among the highest in the EU with an aggregate CET1 ratio of 24.4% as of Q2 2022 – and by its comfortable profitability with an aggregate return on equity of 8.7% as reported by the EBA. Strong asset quality, with a non-performing loan ratio of 0.7%, a lower cost-to-income ratio than peers and rising lending rates will support profitability over the medium term despite the deteriorating economic outlook. The countercyclical capital buffer base rate will increase to 1% from December 2022 in response to rapid growth in private sector borrowing and real estate prices.
- **Private debt:** A buoyant housing market has fuelled robust growth in mortgage loans in recent years, although the rate has remained broadly in line with nominal GDP growth. Debt of households and non-financial corporates stood at 37% and 73% of GDP as of Q2 2022, both below pre-pandemic levels. Robust credit standards, in part underpinned by the debt service and loan-to-value requirements of the Bank of Estonia, and low leverage partially mitigate risks resulting from a high share of variable-rate mortgage loans.
- **Financial imbalances:** Estonia is exposed to spill-over risk from any changes in the Swedish market as Swedish financial groups hold above 60% of local banking sector assets. Additionally, the Estonian banking sector is one of the most concentrated in the EU, with the top five credit institutions accounting for more than 90% of sector assets. Capital flight and cross-border money-laundering risks are mitigated by the steady improvement in the financial sector's funding profile over recent years following strong growth in resident deposits. The share of non-resident deposits is moderate at 14% as of September 2022.

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

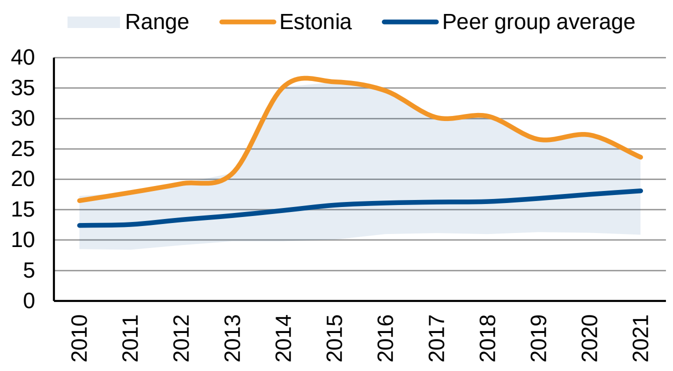
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	Highly capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Oversight under the Bank of Estonia and the ECB as part of European Banking Union
	Financial imbalances	Neutral	0	Concentration and spill-over risks in the banking system from dominant Nordic banking groups; low private indebtedness and foreign deposits

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

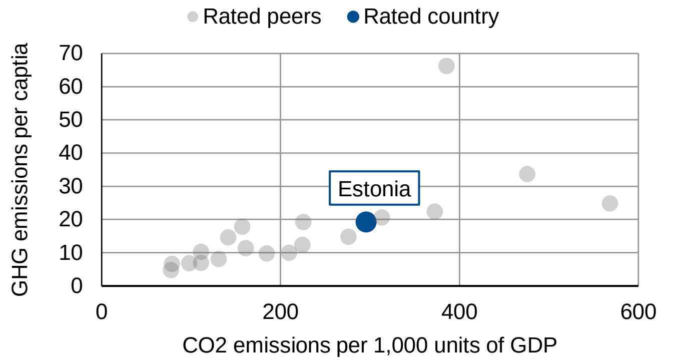
ESG Risks

- **Environment:** Estonia has made significant progress in the development of renewable energy. The share of renewables in gross final energy consumption stood at 30% in 2020, above the EU average of 22% and up from 17% in 2005. However, the Estonian economy is still one of the most carbon-intensive in the EU, primarily owing to its dependence on oil shale (60% of total energy consumption). The government aims to have renewable resources cover all its electricity needs by 2030, reduce CO_2 emissions by 70% relative to 1990 levels and reach carbon neutrality by 2050. Estonia has earmarked 41.5% of its Recovery and Resilience Plan to climate objectives, with projects aimed at expanding renewable energy production and improving the energy efficiency of the economy, particularly of the transport sector.
- **Social:** Estonia's performance across key social factors is balanced. The country's labour market is inclusive, as reflected in the high participation (80% of labour force) and the low gender employment gap (3.7% vs 10.8% in the EU). Income inequality and poverty risks are slightly above the EU average, with significant improvements over recent years. The EC's Digital Economy and Society Index 2022, which assesses digital competitiveness in the EU, ranks Estonia seventh. A key social challenge for the ratings is posed by adverse demographic trends. Over the next 20 years, Estonia's working-age population is projected to decline by over 12%, while the old-age dependency ratio is projected to exceed 40. These risks are in part mitigated by net migration having turned positive in Estonia since 2015.
- **Governance:** Policymaking has been effective and enjoyed broad continuity despite the multi-party system that requires coalition agreements. EU and euro area memberships also enhance the quality of Estonia's macroeconomic policies and macroprudential framework. A new ruling coalition was formed in July under the confirmed leadership of Prime Minister Kaja Kallas. Her previous government resigned due to internal disagreements over spending and welfare. She is expected to remain in office until the next elections, scheduled in March 2023. External security risks for Estonia have increased since the war in Ukraine escalated. However, Estonia's NATO membership strongly limits the risk that the conflict will expand into the Baltic region. Both NATO and Estonia have continually confirmed their commitment to Article 5, which states that an armed attack on one member will be considered an armed attack against all other members.

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

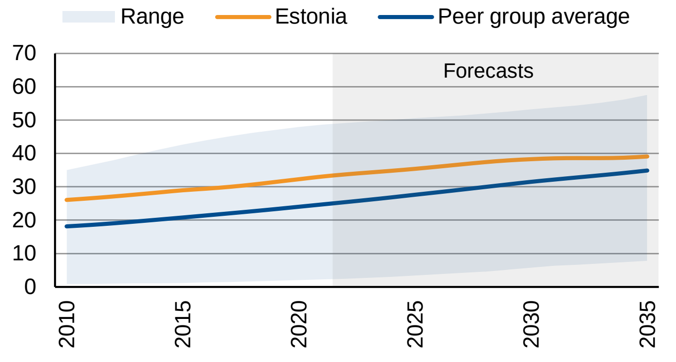
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental factors	Weak	-1/3	High exposure to transition risks due to economically important oil shale industry
	Social factors	Neutral	0	Inclusive labour markets, balanced inequality and poverty risks, adverse demographic trends
	Governance factors	Neutral	0	Effective policymaking and governance supported by euro area memberships; external security risks mitigated by NATO membership

Emissions per GDP and per capita, $mtCO_2e$



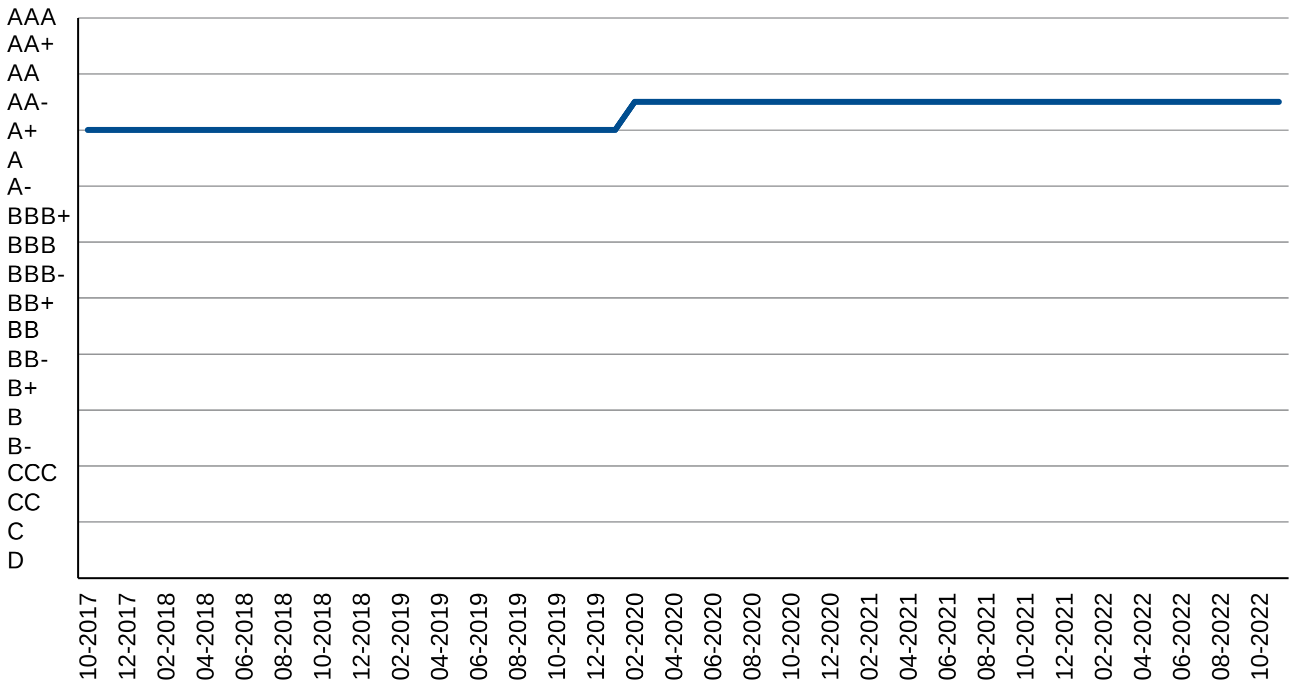
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Belgium
Czech Republic
France
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

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	20,431	23,176	23,427	23,576	27,962
	Nominal GDP, USD bn	IMF	26.9	30.6	31.1	31.3	37.2
	Real growth, %	IMF	5.8	3.8	3.7	-0.6	8.0
	CPI inflation, %	IMF	3.7	3.4	2.3	-0.6	4.5
	Unemployment rate, %	WB	5.8	5.4	4.5	6.8	6.3
Public Finance	**Public debt, % of GDP**	IMF	9.1	8.2	8.5	18.6	17.6
	Interest payments, % of revenue	IMF	-0.1	-0.1	0.0	0.0	0.0
	Primary balance, % of GDP	IMF	-0.8	-0.6	0.1	-5.5	-2.3
External Economic	**Current account balance, % of GDP**	IMF	2.3	0.8	2.5	-0.3	-1.6
	Total reserves, months of imports	IMF	0.2	0.4	0.7	1.0	0.9
	NIIP, % of GDP	IMF	-35.0	-28.9	-22.7	-23.6	-12.4
Financial Stability	**NPL ratio, % of total loans**	IMF	2.4	1.6	2.0	1.6	1.1
	Tier 1 ratio, % of RWA	IMF	36.3	31.3	26.3	26.4	27.3
	Credit to private sector, % of GDP	WB	64.1	62.2	59.8	64.8	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	474.0	466.4	311.5	295.7	293.5
	Income share of bottom 50%, %	WID	17.9	17.9	18.3	18.2	18.2
	Labour-force participation rate, %	WB	78.9	79.1	78.9	-	-
	Old-age dependency ratio, %	UN	30.0	30.7	31.5	32.3	33.1
	Composite governance indicators*	WB	1.2	1.2	1.2	1.3	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps)	127

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