Republic of Estonia
Rating Report

AA- NEGATIVE OUTLOOK

Credit strengths

- Sound institutional set-up underpinned by EU, euro area and NATO memberships
- Improved economic resilience and solid medium-run growth prospects
- Low public debt

Credit challenges

- 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 in the region caused by Russia's war in Ukraine.

Solid growth prospects: The country's solid economic growth and improved resilience have supported its convergence to euro area income levels. The Estonian economy, however, is particularly exposed to the ongoing cost-of-living crisis, with contractions of 1.3% in 2022 and 1.0% (expected) also this year. We estimate a robust medium-run growth potential for Estonia at 2.2%.

Low public debt: Prudent fiscal policies have resulted in Estonia having one of the lowest debt-to-GDP ratios globally, at 18.4% by end-2022, 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 labour shortages that are constraining the medium-term growth outlook and are likely to exacerbate fiscal pressures.

Estonia's sovereign rating drivers

Risk pillars		Quantitative: Weight	Quantitative: Indicative rating	Reserve currency: Notches	Qualitative: Notches	Final rating
Domestic Economic Risk		35%	bb+		+1/3	
Public Finance Risk		20%	aa		+1/3	
External Economic Risk		10%	b+	EUR [+1]	+2/3	
Financial Stability Risk		10%	aaa		+2/3	
ESG Risk	Environmental Factors	5%	a		-1/3	AA-
	Social Factors	7.5%	b+		0	
	Governance Factors	12.5%	aaa		0	
Indicative outcome		**a**			**+2**	
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 Negative Outlook reflects our view that risks to the ratings are tilted to the downside.

Positive rating-change drivers

- Geopolitical risks in the region declining
- Improving fiscal outlook, supported by the rebalancing of government finances
- Solid growth and income convergence continuing through reform and investment
- External vulnerabilities declining

Negative rating-change drivers

- Weaker fiscal fundamentals preventing stabilisation of debt-to-GDP
- Increased macroeconomic imbalances weakening medium-run growth prospects
- External and financial sector vulnerabilities increasing significantly
- Higher geopolitical risks undermining macroeconomic stability

Ratings and Outlook

Foreign currency

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

Local currency

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

Lead Analyst

Giulia Branz, CFA
+49 69 6677389-43
g.branz@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

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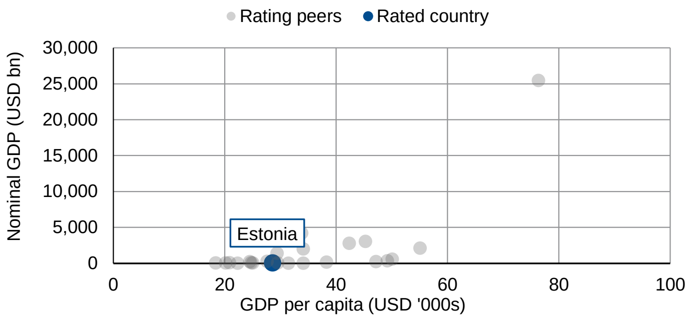
Domestic Economic Risks

- **Growth outlook:** The Estonian economy was remarkably resilient during Covid-19, experiencing a narrow contraction in 2020 (0.6%). This was followed by an exceptional rebound in 2021 with real GDP growing by 8.0%, also driven by one-off withdrawals of pension savings. Russia's war in Ukraine is affecting the outlook via high inflation, trade disruptions and weaker confidence. Last year GDP shrank by 1.3%, driven by weak investment and net exports, though this was also a consequence of growth above potential in 2021. This year we expect some recovery in economic activity, though it will be restrained by lasting effects of high inflation and the cost-of living crisis. GDP will likely contract by 1.0% in 2023 and then moderately rebound by 2.8% in 2024. In the medium run, we estimate a solid growth potential of 2.2% for Estonia, supported by ample access to EU funds amounting to close to 20% of (2021) GDP over 2021-27 (aggregate funding from the Recovery and Resilience Facility, Cohesion Fund and Common Agricultural Policy). In addition, the economy benefits from an attractive business environment and a highly digitalised public administration supporting continued advancements in productivity.
- **Inflation and monetary policy:** Estonia is heavily affected by exceptional inflationary pressures. The ramifications of the conflict were rapidly felt due to the large share of energy and food items in its consumption basket on top of deregulated gas and electricity markets. Inflation is however declining rapidly from the peak in August 2022 of 25.2% (harmonised rate, YoY), and reached 15.6% in March 2023. Declining energy prices, a subdued economic outlook and the ECB's rapid tightening of monetary policy, with rate hikes totalling 375 bps since July 2022, suggest price pressures will continue declining over the coming months. Core inflation, however, remains very high, above 12%, and is declining only at a moderate pace. We expect inflation to moderate to about 8.5% in 2023 and 3.0% in 2024, from 19.4% in 2022.
- **Labour market:** The labour market is moderately affected by the crisis, providing support to the economic outlook. Employment was record high at the end of last year counting over 680,000 workers, also driven by the inflow of war refugees, which is offsetting some pressures from unfavourable demographic dynamics in Estonia. In fact, the working-age population grew by 1.8% last year. Employment and participation rates are very high, at 77% and 82%, respectively, while the unemployment rate is low, though moderately increasing, at 5.4% in March 2023. We expect the unemployment rate to rise in the coming months, however, to an average above 6% in 2023, from 5.6% in 2022, and reach 6.5% in 2024-25. Despite flexibility and wide participation, the labour market suffers from labour and skill shortages, which are exacerbating wage pressures, representing a risk for sustained growth and competitiveness.

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

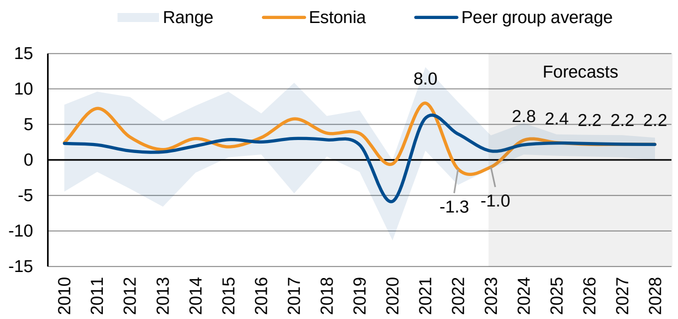
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Growth potential of the economy	Strong	+1/3	Robust economic prospects in the medium run supported by EU funds, although adverse demographic trends are a challenge
	Monetary policy framework	Neutral	0	ECB is a credible and effective central bank over the cycle
	Macroeconomic stability and sustainability	Neutral	0	Improved macroeconomic resilience and flexible labour market, but labour shortages and small economy with limited diversification

Nominal GDP and GDP per capita, USD



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

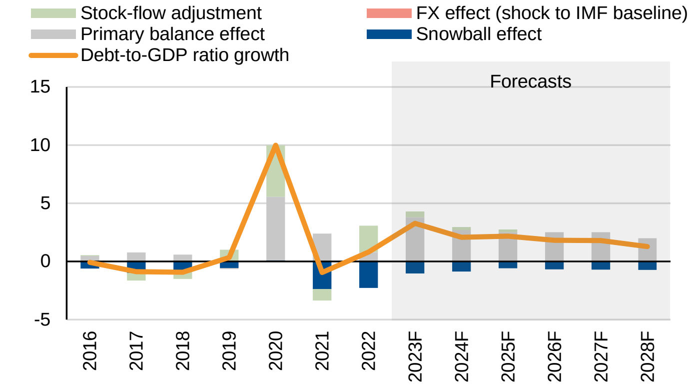
Public Finance Risks

- **Fiscal outlook:** Estonian authorities' fiscal prudence is reflected in broadly balanced government budgets in the 10 years prior to the Covid-19 crisis. However, structural budgetary pressures, exacerbated by the geopolitical and cost-of-living crises, are challenging the fiscal outlook. The fiscal deficit narrowed to 0.9% of GDP last year, after 2.4% and 5.5% in 2021 and 2020, thanks to buoyant nominal GDP growth boosting revenue. For 2023 we expect the deficit to widen to 4% of GDP, driven by lagged effects of inflation on social spending and public wages and the weak economic outlook, amplifying the impact of a looser fiscal policy stance than before the pandemic. The new government aims at increasing military spending and social benefits in the coming years, though it remains committed to safeguarding government finances, deciding to hike taxes, including VAT and the income tax, from 2024 onwards. This should help reduce the deficit to 3.0% of GDP next year, as targeted by the government. We expect the deficit to remain at similar levels until 2027, as further consolidation measures are likely to be challenging in a weak economic context. By 2028, the deficit should further decline owing to lower defence investments, though likely not sufficiently to stabilise debt-to-GDP.
- **Debt trajectory:** We expect general government debt to remain on an upward trajectory over the next five years to above 30% of GDP by 2028, up from 18.4% in 2022. According to our current economic and fiscal assumptions, a stabilisation of the trajectory is not likely even at the end of the forecasting horizon though the pace of debt increase should moderate. The debt ratio would nevertheless remain among the lowest in the euro area (around 85% in 2028). Estonia will also retain an interest burden much lower than that of peers, although significantly higher than before the crises, which supports strong debt affordability. Implicit liabilities from ageing-related expenditures over the next 30 years are low according to IMF and European Commission estimates. However, the currently low spending on healthcare and pensions, especially in the context of high inflation, signals downside risks on these estimates.
- **Debt profile and market access:** Estonia's ratings benefit from a low-risk debt profile, moderate funding needs and prudent liquidity management. There is no foreign currency exposure and a long average debt maturity of over seven years. The central government debt portfolio comprises EUR 1.65bn in long-term amortising loans from international financial institutions and EUR 2.85bn in securities, as Estonia is becoming a more frequent issuer on bond capital markets. Estonia maintains prudent liquidity management, holding an ample financial reserve of EUR 1.3bn as of March 2023.

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

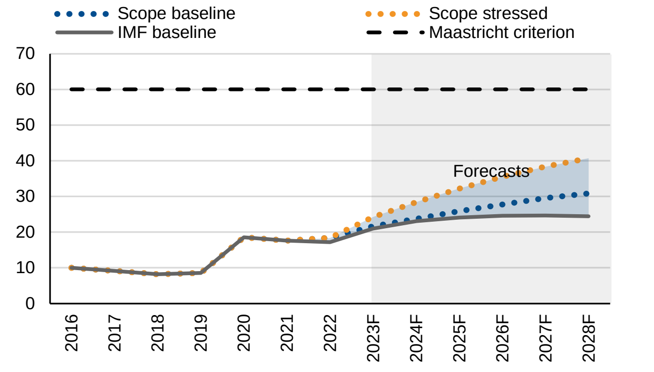
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy before Covid-19, but fiscal outlook challenged by the costs of the war and the energy crisis
	Debt sustainability	Strong	+1/3	Rising debt trajectory but debt burden set to remain much lower than that of peers
	Debt profile and market access	Neutral	0	Moderate funding needs and prudent liquidity management; favourable funding conditions despite infrequent issuance

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

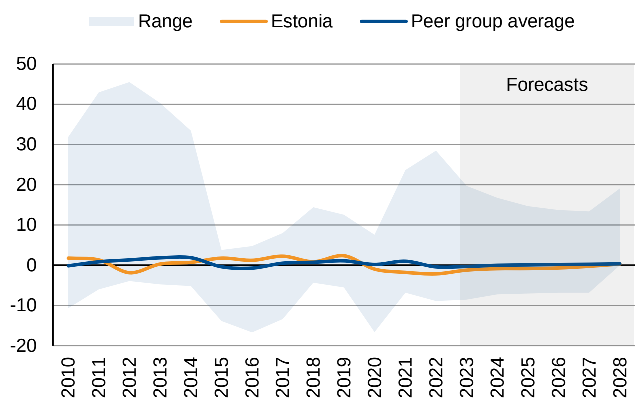
External Economic Risks

- **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 as a jump in imports related to corporate subsidiaries. The current account deficit further widened last year, to 2.2% of GDP, despite the recovery in the service balance, as the deficit in the goods account worsened, driven by the energy and commodity price shock aggravated by the war. Trade links with Russia were already declining before the war, which limits the exposure to trade sanctions prompted by the war in Ukraine, though the lower availability of raw materials at favourable prices will have some structural effects on good exports. We expect the current account balance to improve in the coming years, supported by growing, high-value-added export sectors such as ICT and financial services, though it is likely to remain in deficit near term. Structural adverse pressures on 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 -39.5% of GDP in 2016 to -20.5% in 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. Higher geopolitical risks related to the war have not yet translated into a reduction in foreign direct investments. Estonia's external debt is comparatively moderate, at 84.4% of GDP in Q4 2022, and broadly stable relative to historical averages. Most external debt is owed by the Estonian financial sector (58% of total), followed by the government (21%). Short and long-term external debt are divided equally as a percentage of total debt.
- **Resilience to shocks:** Estonia's small, open economy remains vulnerable to external shocks in view of its large export and import sectors, each representing over 85% of GDP. The Russia-Ukraine war is having significant direct and indirect negative impacts on the country's economy. At the same time, the economic scarring caused by the conflict is significantly mitigated by the continued improvement in Estonia's energy security, allowing a rapid and full substitution of energy imports from Russia. 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. Estonia benefits from the euro's status as an international reserve currency, significantly mitigating risk from currency sell-off and sudden stops of capital flows.

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

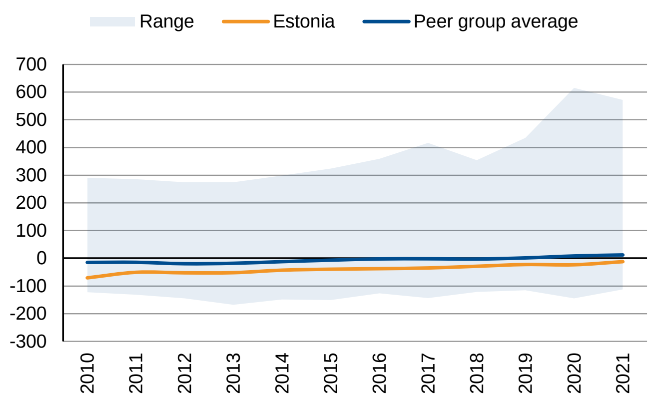
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Current account resilience	Strong	+1/3	Improved export competitiveness and focus on value-added segments
	External debt structure	Strong	+1/3	Declining net external debtor position, large share of foreign direct investment in net external liabilities reducing exposure to shocks
	Resilience to short-term external shocks	Neutral	0	Small-size and open economy, euro-area membership mitigates exposure to international markets

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

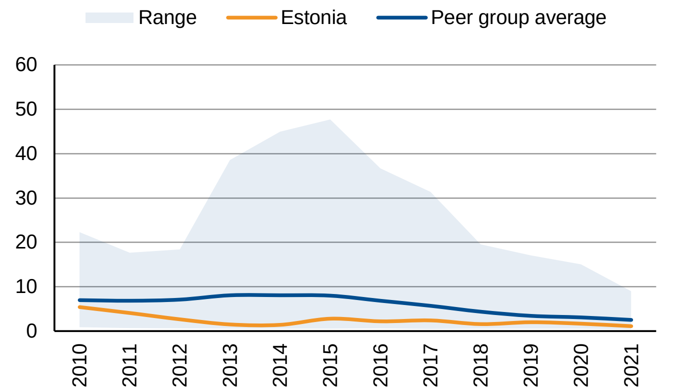
Financial Stability Risks

- **Banking sector:** Estonia's banking sector presents low contingent liability risk to the government and is well placed to absorb the current economic shock. The sector's resilience is underpinned by its high capitalisation levels – among the highest in the EU with an aggregate CET1 ratio of 21.9% as of Q4 2022 – and by its comfortable profitability with an aggregate return on equity of 10.7% as reported by the EBA. Strong asset quality, with a non-performing loan ratio of 0.6%, a lower cost-to-income ratio than peers and rising lending rates will support profitability over the coming years, although the weaker economic outlook and rising uncertainties in the global banking sector following monetary policy normalisation represent risks. According to the Bank of Estonia, overdue loans will increase from 0.3% in February 2023 to 0.6% this year, but Estonian banks are well prepared to cope with related possible loan losses. Banks' direct exposure to counterparties in Russia is negligible.
- **Private debt:** A buoyant housing market has fuelled robust growth in mortgage loans in recent years, although the growth rate has remained broadly in line with nominal GDP growth. The trend is now decelerating, following the rapid increase in interest rates, which is leading to a decline in real estate transactions and decelerating housing price growth. Debt of households and non-financial corporates is moderate, although above that in the other Baltic economies, and stood at 37% and 72% of GDP as of Q4 2022, below pre-pandemic levels. Robust credit standards, underpinned by the debt service and loan-to-value requirements of the Bank of Estonia, and low leverage partially mitigate risks resulting from a widespread use of variable-rate loans, representing on average 83% of new loans since 2015.
- **Financial imbalances:** Estonia is exposed to spillover risk from the Swedish financial sector and housing market as Swedish financial groups' market share of local deposits and loans exceeds 60%. Additionally, the Estonian banking sector is highly concentrated, with the top five credit institutions accounting for more than 90% of sector assets. Capital flight and cross-border money-laundering risks are however mitigated by the steady improvement in the financial sector's funding profile following strong growth in resident deposits, and by anti-money laundering oversight. The share of non-resident deposits is stable at 13% of total.

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

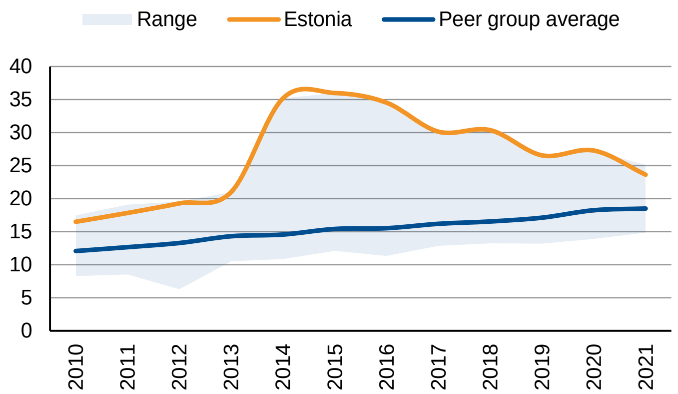
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	Highly capitalised and profitable banking sector
	Banking sector oversight	Neutral	0	Oversight under the Bank of Estonia and the ECB as part of European Banking Union
	Financial imbalances	Strong	+1/3	Concentration and spillover 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

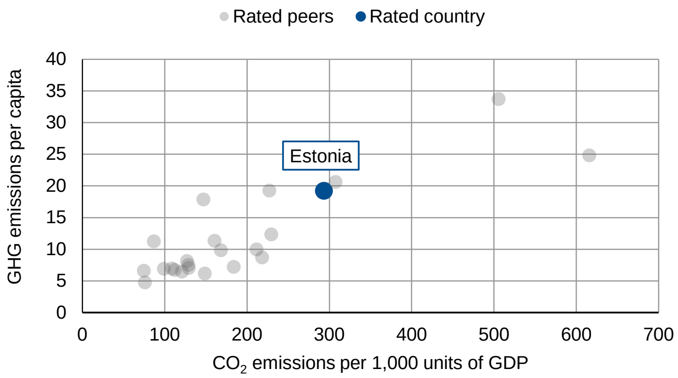
ESG Risks

- **Environment:** Estonia has made significant progress in the development of renewable energy. The share of renewables in the energy mix stood at 31% in 2021, above the EU average of 19% and up from 17% in 2005. However, the Estonian economy is still one of the most carbon-intensive in the EU, with fossil fuels covering 62% of energy consumption, primarily owing to its dependence on domestic oil shale. To reduce dependency from Russian energy imports, Estonia slowed down its plans to phase out shale oil power plants but remains committed to end production by 2040. This transition will however come with challenges, given the systemic relevance of the sector in the economy. 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). Income inequality and poverty risks are slightly above the EU average but have significantly declined in 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 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 government took office in April 2023, after swift negotiations following general elections in March. Kaja Kallas was confirmed as prime minister, leading a coalition consisting of her pro-European liberal Reform party together with the centrist Estonia 200 and the centre-left Social Democrats, which underpins our expectations of broad policy continuity. 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.

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

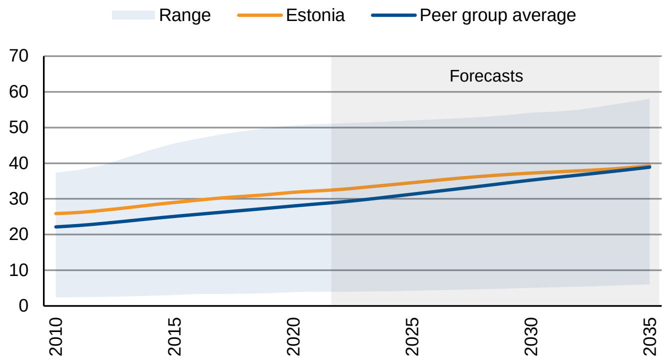
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental factors	Weak	-1/3	High exposure to transition risks due to economically important oil shale industry
	Social factors	Neutral	0	Inclusive labour markets, balanced inequality and poverty risks, adverse demographic 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, $mtCO_2e$



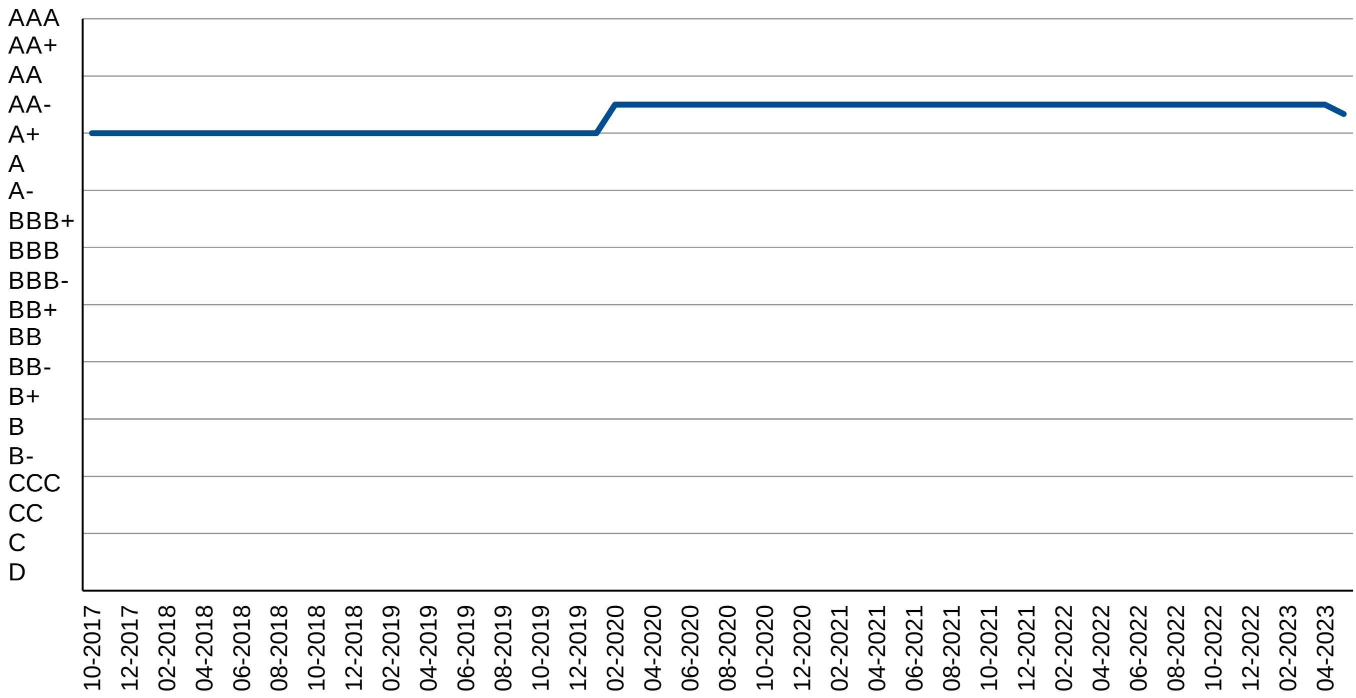
Source: European Commission, Scope Ratings

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
Croatia
Cyprus
Czech Republic
France
Italy
Japan
Latvia
Lithuania
Malta
Portugal
Slovakia
Slovenia
Spain
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	2018	2019	2020	2021	2022	2023
Domestic Economic	**GDP per capita, USD '000s**	IMF	23.2	23.4	23.6	28.0	28.6	31.2
	Nominal GDP, USD bn	IMF	30.6	31.1	31.3	37.2	38.1	41.6
	Real growth, %	IMF	3.8	3.7	-0.6	8.0	-1.3	-1.2
	CPI inflation, %	IMF	3.4	2.3	-0.6	4.5	19.4	9.7
	Unemployment rate, %	WB	5.4	4.5	7.0	6.2	-	-
Public Finance	**Public debt, % of GDP**	IMF	8.2	8.5	18.5	17.6	17.2	21.0
	Interest payment, % of revenue	IMF	-0.1	0.0	0.0	0.0	0.1	0.7
	Primary balance, % of GDP	IMF	-0.6	0.1	-5.5	-2.3	-1.1	-4.5
External Economic	**Current account balance, % of GDP**	IMF	0.9	2.4	-1.0	-1.8	-2.2	-1.2
	Total reserves, months of imports	IMF	0.4	0.7	1.0	0.9	-	-
	NIIP, % of GDP	IMF	-28.9	-22.7	-23.6	-12.4	-20.8	-
Financial Stability	**NPL ratio, % of total loans**	IMF	1.6	2.0	1.6	1.1	-	-
	Tier 1 ratio, % of risk-weighted assets	IMF	31.3	26.3	26.4	27.4	23.8	-
	Credit to private sector, % of GDP	WB	62.0	59.7	63.4	-	-	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	466.4	311.5	295.7	293.5	-	-
	Income share of bottom 50%, %	WID	17.9	18.3	18.2	18.2	-	-
	Labour-force participation rate, %	WB	79.1	78.9	-	-	-	-
	Old-age dependency ratio, %	UN	30.8	31.3	31.9	32.3	32.7	33.3
	Composite governance indicators*	WB	1.2	1.2	1.3	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)	78

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891-0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

10 avenue de Messine
F-75008 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30 31 58 14

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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