Republic of Estonia

Rating Report

SCOPE **AA-** STABLE OUTLOOK

Credit strengths

- Prudent fiscal management, low public debt
- Strong institutions, EU and euro area memberships
- Commitment to structural reform

Credit challenges

- Adverse demographics
- Exposure to external shocks
- Banking spill-over risks

Rating rationale:

Estonia's AA- rating is underpinned by i) a track record of prudent fiscal management anchoring low public debt; ii) strong institutions and commitment to a favourable business environment, underpinned by EU and euro area memberships; and iii) strengthened resilience of the Estonian economy, supported by effective structural reform, reducing the country's underlying vulnerability to shocks.

Challenges relate to i) an ageing population and skilled-labour shortages, alongside still moderate per-capita income relative to the euro-area average; ii) limited economic diversification, together with a large export sector relative to the size of the economy, which exposes Estonia to external shocks; and iii) risks in the banking sector related to the dependence on large Nordic banks.

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%	aaa		0	
External Economic Risk		10%	bb-		-2/3	
Financial Stability Risk		10%	aaa		-1/3	AA-
ESG Risk	Environmental Risk	5%	aa+		-1/3	
	Social Risk	5%	bbb+		0	
	Governance Risk	10%	aaa		0	
Overall outcome		**aa**		**+1**	**-2**	

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 GmbH

Outlook and rating triggers

The Stable Outlook reflects our view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Higher growth potential, supported by continued implementation of reform
- Further sustained reduction in external vulnerabilities

Negative rating-change drivers

- Material deterioration in public-finance outlook
- Escalation in financial sector risks
- Substantial deterioration in external finances
- 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

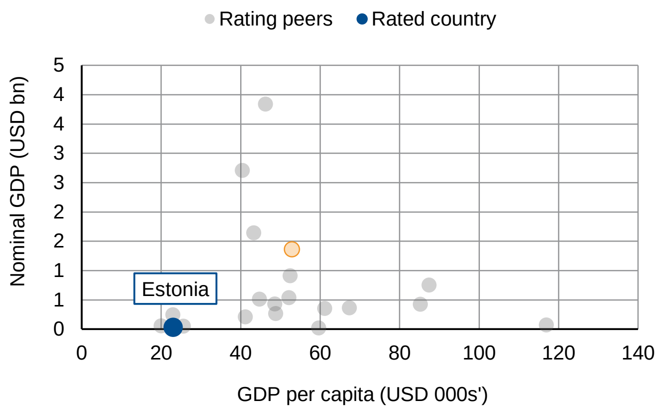
Domestic Economic Risks

- **Growth outlook:** Estonia's ratings benefit from robust economic recovery prospects and improved resilience against external shocks. This is helped by the government's prudent and predictable macroeconomic policy making and effective structural reform, underpinned by the country's EU and euro-area memberships. Scope projects Estonia's output to grow 9% this year, and 4.3% in 2022 supported by a strong private consumption and investment, and further driven by Estonia's prudent absorption of EU funds. Scope estimates Estonia's medium-term potential growth at around 3% annually. This is supported by the implementation of strategic public-infrastructure investment projects co-financed by the EU, including the construction of Rail Baltica connecting the Baltic region with the European rail network (planned to be completed by 2026).
- **Inflation and monetary policy:** Higher energy prices and rising production costs due to shortages of intermediary goods are expected to raise inflation to around 3.9% in 2021 and 4.4% in 2022. These factors are expected to slowly fade in the second half of 2022 and cause inflation to fall towards the 2% target in 2023. While some central banks have started tapering their asset purchase programmes or indicated interest rate rises in the near term, the ECB has signalled that it will maintain its accommodative monetary policy in the near term.
- **Labour market:** Labour market has been improving with a continuing economic recovery. The unemployment rate declined to 5.7% as of October, below the EU averages, but remains above the pre-crisis level of 4.6% in December 2019.

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

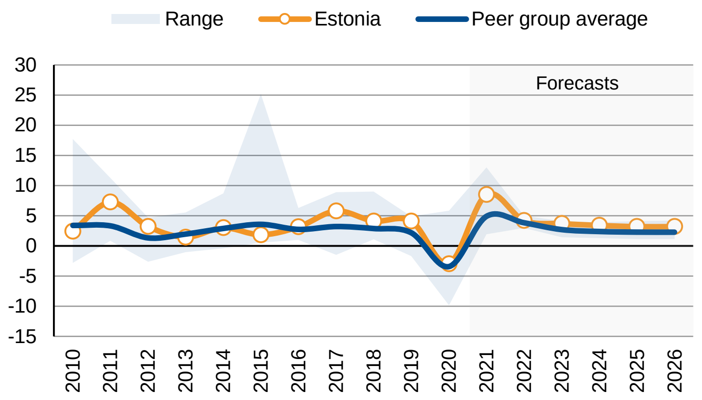
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Neutral	0	Medium-run growth potential faces challenges from adverse demographics
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; appropriate central bank response to the pandemic crisis
	Macro-economic stability and sustainability	Weak	-1/3	Limited economic diversification

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

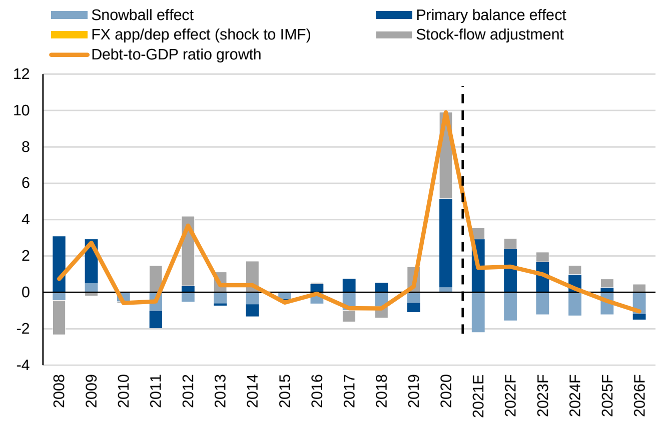
Public Finance Risks

- **Fiscal outlook:** Estonia's ratings benefit from the country's sound fiscal position, underpinned by its prudent debt management. Scope projects the general government deficit to decline to 2.5% of GDP in 2022 and 2% of GDP in 2023, from an estimated 3.1% of GDP in 2021.
- **Debt trajectory:** General government debt at an estimated 19% of GDP in 2021 is the lowest among the Central and Eastern European members of the EU. Scope projects debt to remain below 25% of GDP in the medium-term, supported by solid growth in nominal GDP and narrowing fiscal deficits in the medium-term.
- **Market access:** Of the EUR 5.5bn public debt stock, almost 30% (EUR 1.6bn in total) reflects long-term loans from EIB, NIB, CEB and the European Commission's SURE programme. In June 2020, Estonia re-entered debt capital markets, issuing for the first time since 2002 a long-term bond: a EUR 1.5bn security with a maturity of 10 years and coupon of 0.125%. Estonia's favourable financing costs and stable investor base support credit ratings.

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

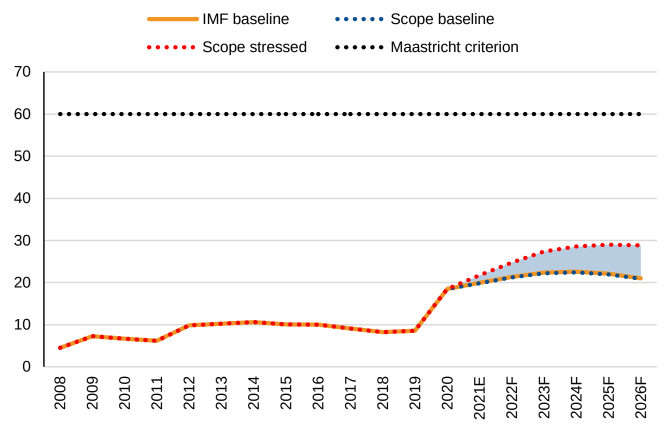
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Record of robust fiscal policies, but still-sizeable shadow economy
	Debt sustainability	Neutral	0	Low debt levels to remain in the medium-term
	Debt profile and market access	Neutral	0	Strong 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 GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

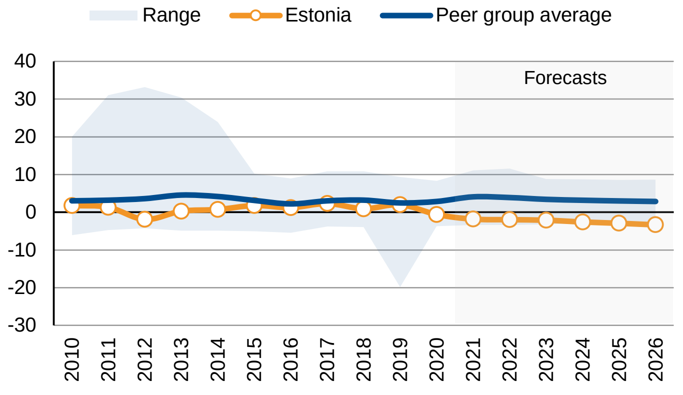
External Economic Risks

- **Current account:** Estonia's current account balance turned into a deficit of 3.8% of GDP for the first three quarters of 2021, after several years of surpluses (average of 1.3% of GDP over the last five years). Looking ahead we expect the current account to narrow but remain in deficit.
- **External position:** The structure of Estonia's external liabilities compares favourably with those of CEE peers, with foreign direct investment comprising 63% 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, which is highly integrated in global value chains, remains vulnerable to external shocks, including to a prolonged period of subdued growth in western Europe. Total exports of goods and services of Estonia amount to 75% of its GDP. Regarding energy sources, Estonia continues to reduce its remaining exposures to Russia and diversify its domestic sources with the help of EU financial support: several short-to-medium-term projects are underway, including the connection of the Baltic states' and continental Europe's electricity and gas networks alongside investments in renewable energy infrastructure.

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

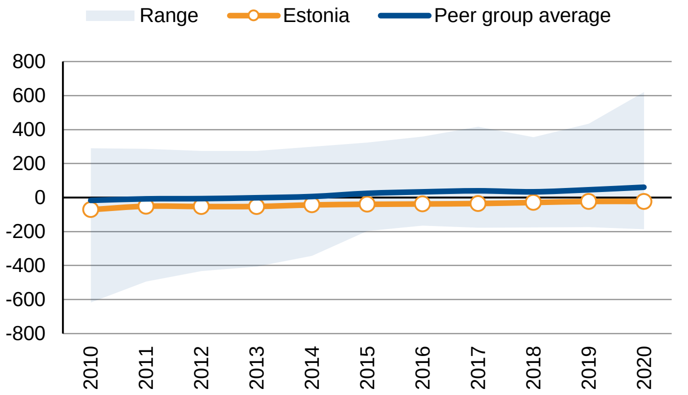
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Current account resilience	Weak	-1/3	Limited export diversification
	External debt structure	Neutral	0	Substantial share of FDI in total external liabilities
	Resilience to short-term shocks	Weak	-1/3	Very small-open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

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

Net international investment position, % of GDP



Source: IMF, Scope Ratings GmbH

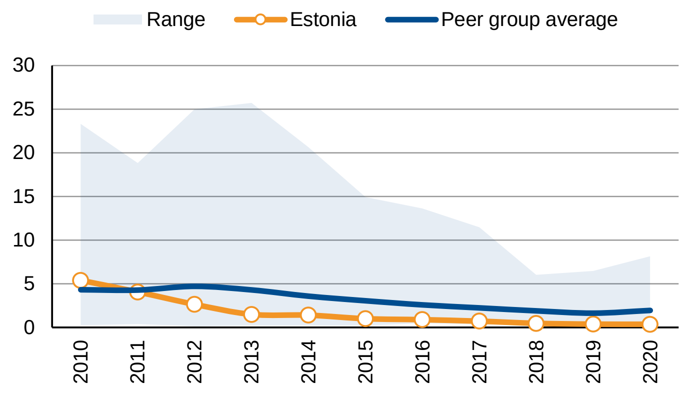
Financial Stability Risks

- **Banking sector:** Estonia's ratings are supported by its largely Nordic-owned banking sector, which remains sound with a high level of capitalisation and asset quality. As of Q2 2021, the system-wide Tier 1 ratio amounted to 29.3% of risk-weighted assets, the highest in the euro area, and the non-performing loan ratio was a low 1.1% for the same quarter. The financial system's available buffers provide a sizeable cushion in adverse scenarios involving the Covid-19 crisis.
- **Private debt:** The Covid-19 crisis has not caused exceptional macroeconomic imbalances with private sector (non-financial corporations and households) debt amounting to 104.4% of GDP as of end-2020, virtually unchanged compared with pre-Covid levels.
- **Financial imbalances:** Estonia is exposed to spill-over risks from high household debt and to changes in market conditions in Sweden especially, 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 mitigated by the moderate share of non-resident deposits, at 15.1% of total deposits as of October, compared to that of Latvia (16.2%), but meaningfully above that of Lithuania (3.6%).

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

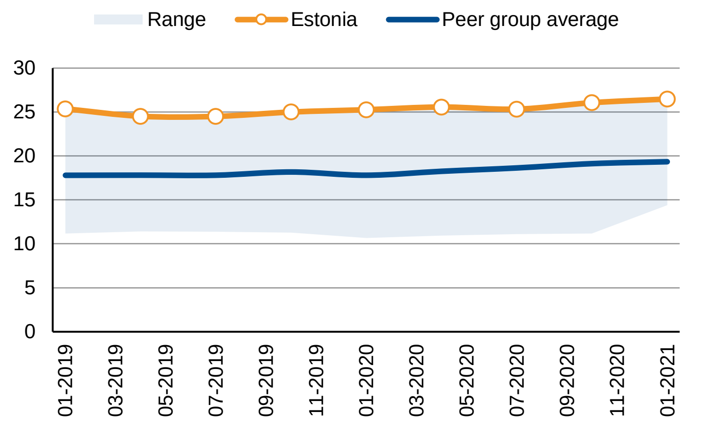
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Largely Nordic-owned banking sector, which has a high level of capitalisation and low NPL ratio
	Banking sector oversight	Neutral	0	Oversight under the Bank of Estonia and the ECB 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 GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

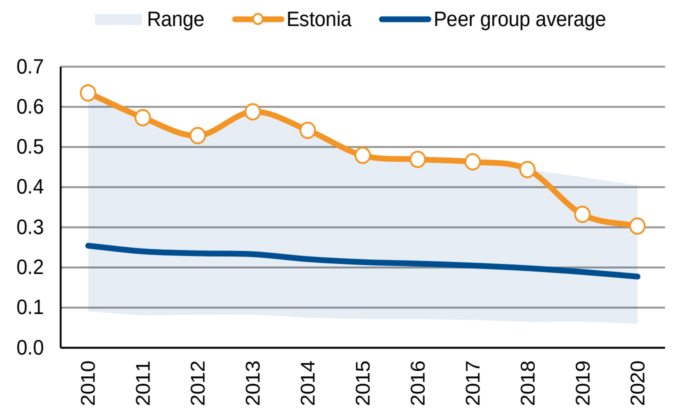
ESG Risks

- **Environment:** Estonia has progressed in fostering energy efficiency: its share of renewable energy in total energy consumption was 26% in 2020, above the EU average of 21.3%, 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:** Social factors are reflected in Estonia's moderate rates of unemployment (5.7% in October), income inequality levels around the EU-average and slightly higher poverty levels than the EU average (with 23.3% of the population at risk of poverty or social exclusion in 2020, compared to 22% for the EU-27). The EC's Digital Economy and Society Index 2021, which assesses digital competitiveness in the EU, ranks Estonia seventh. Estonia's demographics are more adverse than that of its peers.
- **Governance:** Under governance-related factors, Estonia's performance is stronger compared with that of central and eastern European sovereign peers as assessed under the World Bank's Worldwide Governance Indicators. In general, policymaking in Estonia has been effective and has enjoyed continuity. Estonia's EU and euro-area memberships enhance the quality of macroeconomic policy making and the macroprudential framework.

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

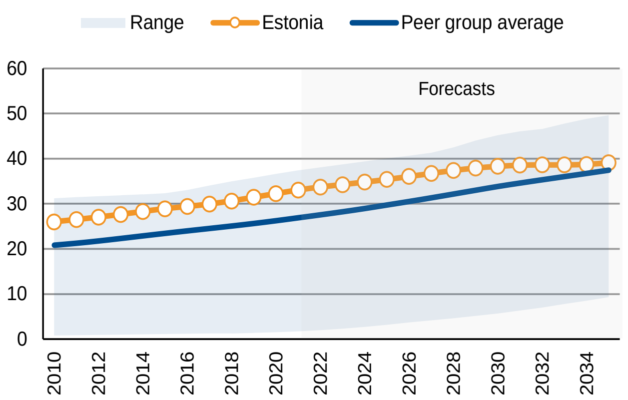
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Environmental risks	Weak	-1/3	Effective action against elevated exposure to transition risks (economically important oil shale industry)
	Social risks	Neutral	0	High rates of employment, net immigration since 2015, income inequality levels around the EU average
	Institutional and political risks	Neutral	0	Record of effective policymaking and strong governance performance

CO2 emissions per GDP, mtCO2e



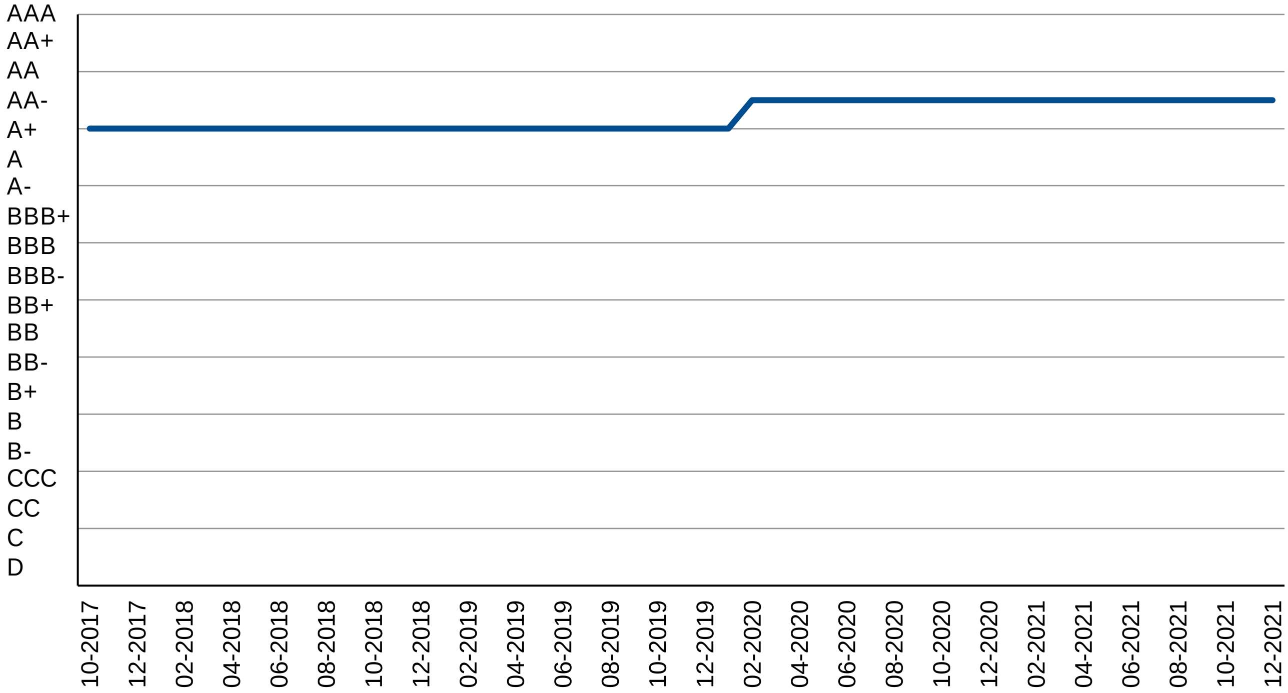
Source: European Commission, Scope Ratings GmbH

Old Age Dependency ratio, %



Source: United Nations, Scope Ratings GmbH

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
Austria
Belgium
Czech Republic
Denmark
Estonia
Finland
Germany
Ireland
Lithuania
Luxembourg
Netherlands
Norway
Slovenia
Sweden
Switzerland

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

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

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	18.3	20.4	23.1	23.4	23.0	27.1	29.7
Nominal GDP, USD bn	24.1	26.9	30.5	31.0	30.6	36.0	39.5
Real growth, %[1]	3.2	5.8	4.1	4.1	-3.0	9.0	4.3
CPI inflation, %	0.8	3.7	3.4	2.3	-0.6	3.9	4.4
Unemployment rate, %[1]	6.8	5.8	5.4	4.4	6.8	6.2	5.5
Public debt, % of GDP[1]	10.0	9.1	8.2	8.6	19.0	19	20
Interest payment, % of government revenue	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0
Primary balance, % of GDP[1]	-0.5	-0.8	-0.5	0.5	-4.9	-2.9	-2.4
External Economic Risk							
Current account balance, % of GDP	1.2	2.3	0.8	2.5	-0.3	-4.0	-1.5
Total reserves, months of imports	0.2	0.2	0.4	0.7	1.0	-	-
NIIP, % of GDP	-39.5	-33.0	-30.0	-22.8	-21.5	-	-
Financial Stability Risk							
NPL ratio, % of total loans	1.3	1.7	1.2	1.5	1.1	-	-
Tier 1 ratio, % of risk weighted assets	35.8	30.9	31.6	27.0	28.1		-
Credit to private sector, % of GDP	69.8	64.1	62.2	59.8	64.8	-	-
ESG Risk							
CO² per EUR 1,000 of GDP, mtCO²e	469.4	463.1	443.8	332.0	302.9	-	-
Income quintile share ratio (S80/S20), x	5.0	4.7	4.7	-	-	-	-
Labour force participation rate, %	77.6	78.9	79.1	78.9	-	-	-
Old age dependency ratio, %	29.4	30.0	30.7	31.5	32.3	33.1	33.7
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, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 17 December 2021	70

[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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