MORNINGSTAR | DBRS

Date of Release: September 3, 2021

DBRS Morningstar Confirms Republic of Estonia at AA (low), Stable Trend

Industry Group: Public Finance – Sovereigns
Region: Europe

DBRS Ratings GmbH (DBRS Morningstar) confirmed the Republic of Estonia's Long-Term Foreign and Local Currency – Issuer Ratings at AA (low). At the same time, DBRS Morningstar confirmed the Republic of Estonia's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (middle). The trends on all ratings are Stable.

KEY RATING CONSIDERATIONS

The confirmation of the Stable trends reflect DBRS Morningstar's assessment that the risks to the ratings remain broadly balanced, even when confronted with the current crisis. The economy contracted in 2020, although by less than most other EU countries. Estonia's stable macroeconomic policy framework allowed the government to support businesses and households. The policy measures to mitigate the impact of the pandemic resulted in a significant deterioration in public finances. However, Estonia entered the crisis with a sound fiscal position and the lowest public debt burden in the euro area. This allows for additional public support to the economy if necessary.

The ratings are also underpinned by Estonia's membership of the European Union (EU) and the Euro area, and its strong institutions. The economy is supported by the free movement of goods and services offered by the single market that helped the economy grow by nearly 4% each year on average from 2011 to 2019, while maintaining balanced fiscal outcomes. The Estonian economy will also benefit in the years to come from generous spending at the EU level. Conversely, the ratings are constrained by structural challenges that existed prior to the pandemic. Income per capita in Estonia adjusted for purchasing power parity remains around three-quarters of the Euro area average.

RATING DRIVERS

The ratings could be upgraded if there is evidence of increased resilience to economic volatility inherent to Estonia's small and open economy, or successful implementation of measures that improve income and productivity.

The ratings could be downgraded if the current external shock causes lasting material macroeconomic underperformance and permanent relaxing of fiscal discipline that over time significantly weakens Estonia's public debt position; or if a return of excessive credit growth leads to private sector over-indebtedness and financial sector instability.

RATING RATIONALE

After Moderate GDP Contraction in 2020, Recovery Is Underway

The economic contraction in Estonia was less pronounced than initially anticipated and one of the lowest in Europe. Real GDP contracted by 2.9% in 2020 compared to a 6.4% drop in the euro area. High value added sectors such as information and communications technology (ICT) continued to perform well. Various service sectors such as travel and accommodation remained in negative territory. The restrictions introduced this year had a milder impact on economic activity than restrictions imposed last year, evident by strong 4.1% recovery in the first quarter of 2021 compared to a year earlier. Data from the second quarter of 2021 point to 12.9% growth year-over year.

The outlook for domestic and external demand should continue to improve due to the success of the vaccination rollout domestically as well as among its key trading partners, pent up demand and high private sector savings, and health investment prospects. The Estonian economy has already reached its pre-pandemic GDP level. The European Commission (EC) in its Summer 2021 forecast expects 4.9% real GDP growth this year and 3.8% in 2022, however, the strong performance in the first half of the year suggests growth this year could be much stronger. Large investments into Estonia by a Volkswagen subsidiary and support to households via reform to pillar-two pensions, represent economic windfalls. Looking ahead, the EU's Multiannual Financial Framework (MFF) 2021-2027 and the Next Generation EU recovery plan constitute additional upside risk for the Estonian economy. Taken together, the transfers amount to EUR 6.8 billion, or 2.5% of GDP.

After years of surpluses, Estonia's current account turned to a small deficit of 0.9% of GDP in 2020, mainly due to the large import of computer software from the Volkswagen investment in the last quarter of 2020. Strong recovery of exports is expected to return the current account back to surplus this year. The current account surpluses each year since 2009 helped lower external debt and narrow the net liability international investment position, which improved from -80.0% of GDP in 2009 to -22% in Q1 2021.

Extraordinary Measures Weigh on Public Finances, But Debt Remains Modest

The Estonian government implemented various measures to respond to the COVID-19 shock, including direct spending on healthcare, tax reductions for businesses and the self-employed, the reduction of excise duties on fuel and electricity, support to the unemployment insurance fund, a worker compensation programme, and a temporary suspension of second pillar pension payments. The general government budget deficit amounted to -4.9% of GDP in 2020. The aid package also included liquidity support measures estimated at around 1.5% of GDP, although these have no immediate impact on the budget. The State Budget Strategy 2022-2025 expects a 6.0% deficit in 2021, before improving to 3.8% in 2022. DBRS Morningstar expects that because of the country's historically conservative fiscal policy and improved growth prospects, Estonia could overperform current projections.

The public debt-to-GDP ratio has increased in 2020, due to the extraordinary measures to manage the COVID-19 shock. The ratio nonetheless remains the lowest in the euro area. The government expects in its 2021 Stability Programme debt to increase to 21.4% this year and remain above 20% over the medium term. To cover the increased financing needs, the government returned to the capital markets for the first time since 2002 and also secured loans from European supranational institutions. In addition, Estonia's two reserve funds worth 8.1% of GDP in 2020, serve as a liquidity cushion in the current crisis.

Risks to Financial Stability are Contained

The recovery of the economy along with the strong capital position of the Estonian banking sector mitigate the risks from the COVID-19 crisis. The common equity tier 1 (CET1) capital ratio of the sector was 29.1% in Q4 2020. Bank asset quality is likely to deteriorate if the recovery is delayed. Sectors most affected by the crisis include accommodation, catering, and leisure. However, the overall impact appears limited. At the end of 2020, payment holidays covered only 3% of the corporate loan book and 2% of the household portfolio. As the majority of the banking sector is foreign owned, risks to financial stability are associated with spill overs from Nordic economies. These risks are broadly mitigated by the strong asset quality, deposit funding, and capitalisation of banks operating in Estonia.

The New Estonian Government is Expected to Maintain Policy Continuity

Estonia benefits from a sound political and institutional framework, which is also reflected in its strong performance in the World Bank Governance indicators. Kaja Kallas, leader of the Reform Party, was appointed as Prime Minister in January 2021. The new government has committed to responding to the COVID-19 crisis, strengthening the health care system, increasing R&D spending, and prioritizing green energy transition policies. Estonia is also one of the most digitally advanced countries in the world, allowing the smooth operation of the public services during the COVID-19 crisis. According to EC's Digital Economy and Society Index (DESI) Estonia ranks first among all EU countries in Digital Public Services.

ESG CONSIDERATIONS

Human Rights and Human Capital (S) subfactors were among the key ESG drivers behind this rating action. Estonia's per capita GDP is relatively low at $23,330 in 2020 compared with its euro system peers. This factor has been taken into account within the "Economic Structure and Performance" building block.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at https://www.dbrsmorningstar.com/research/373262.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments.

EURO AREA RISK CATEGORY: LOW

Notes:

For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: https://www.dbrsmorningstar.com/research/357883.

All figures are in EUR unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments (July 9, 2021) https://www.dbrsmorningstar.com/research/381451/global-methodology-for-rating-sovereign-governments. Other applicable methodologies include DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (February 3, 2021) https://www.dbrsmorningstar.com/research/373262/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings

The sources of information used for this rating include Ministry of Finance (State Budget Strategy 2022-2025 Stability Programme 2021), Bank of Estonia (Estonian Economy and Monetary Policy 2/2021, Financial Stability Review), Statistical Office of Estonia, European Commission (European Economic Forecast Summer 2021, Statistical office of the European Communities, International Monetary Fund, World Bank, United Nations Development Programme, Bank for International Settlements, Johns Hopkins University Coronavirus Resource Center, European Centre for Disease Prevention and Control, Social Progress Imperative, Global Carbon Project, Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

With respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, this is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: NO
With Access to Management: NO

DBRS Morningstar does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

Generally, the conditions that lead to the assignment of a Negative or Positive trend are resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are under regular surveillance.

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. DBRS Morningstar understands further information on DBRS Morningstar historical default rates may be published by the Financial Conduct Authority (FCA) on its webpage: https://www.fca.org.uk/firms/credit-rating-agencies.

The sensitivity analysis of the relevant key rating assumptions can be found at: https://www.dbrsmorningstar.com/research/384024.

This rating is endorsed by DBRS Ratings Limited for use in the United Kingdom.

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Initial Rating Date: July 14, 2017
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Issuer	**Debt Rated**	**Rating Action**	**Rating**	**Trend**
Republic of Estonia	Long-Term Foreign Currency – Issuer Rating	Confirmed	AA (low)	Stable
Republic of Estonia	Long-Term Local Currency – Issuer Rating	Confirmed	AA (low)	Stable
Republic of Estonia	Short-Term Foreign Currency – Issuer Rating	Confirmed	R-1 (middle)	Stable
Republic of Estonia	Short-Term Local Currency – Issuer Rating	Confirmed	R-1 (middle)	Stable

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Estonia

Scorecard Indicators | Source | Current Scorecard Input

Fiscal Management and Policy	2015	2016	2017	2018	2019	2020	2021	2022	2023	Source		Current Scorecard Input
Overall Fiscal Balance (% of GDP)	0.1%	-0.3%	-0.4%	-0.5%	0.0%	-5.4%	-7.1%	-6.3%	-5.2%	IMF WEO	13 year average	-1.8%
Government Effectiveness (Percentile Rank)	82.7	82.7	82.7	84.6	85.6	-	-	-	-	World Bank	5 year average	83.7
Debt and Liquidity	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
General Government Gross Debt (% of GDP)	10.0%	9.9%	9.1%	8.2%	8.4%	18.5%	25.1%	30.3%	34.4%	IMF WEO	5 year projection	39.5%
Interest Costs (% of GDP)	-0.1%	-0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	IMF WEO	5 year average	0.0%
Economic Structure and Performance	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
GDP per Capita (USD thousands)	17.5	18.4	20.5	23.2	23.7	23.3	26.5	28.8	30.6	IMF WEO	10 year average	20.1
Output Volatility (%)	5.6%	5.6%	5.5%	5.5%	5.4%	5.2%	5.2%	5.1%	-	IMF WEO	Latest	5.2%
Economic Size (USD billions)	23	24	27	31	31	31	35	38	41	IMF WEO	5 year average	29
Monetary Policy and Financial Stability	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Rate of Inflation (%, EOP)	-0.2%	2.4%	3.8%	3.3%	1.8%	-0.9%	1.8%	2.5%	2.1%	IMF WEO	13 year average	2.0%
Total Domestic Savings (% of GDP)	141%	150%	156%	157%	163%	183%	-	-	-	ECB/IMF	Latest[1]	183%
Change in Domestic Credit (% of GDP)	-2.6%	-2.6%	-4.8%	-2.8%	-0.8%	7.3%	-	-	-	BIS/IMF	7 year average[1]	-0.8%
Net Non-Performing Loans (% of Capital)	5.7%	4.6%	3.5%	1.9%	1.0%	1.1%	-	-	-	IMF IFS	Latest[1]	1.1%
Change in Property Price/GDP Index (%)	3.8%	-0.7%	-3.0%	-2.6%	-1.3%	9.7%	-	-	-	Statistics Estonia/IMF	7 year average[1]	1.9%
Balance of Payments	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Current Account Balance (% of GDP)	1.8%	1.2%	2.3%	0.9%	2.0%	-1.0%	0.4%	-0.5%	-0.5%	IMF WEO	8 year average	0.6%
International Investment Position (% of GDP)	-39.9%	-39.1%	-33.1%	-29.6%	-21.4%	-20.8%	-	-	-	IMF	5 year average[1]	-28.8%
Share of Global Foreign Exchange Turnover (Ratio)	201.4%	194.7%	200.5%	199.0%	206.4%	208.2%	-	-	-	BIS/IMF	Latest	208.2%
Exchange Rate Classification (see footnote)	5	5	5	5	5	5	-	-	-	IMF	Latest	5
Political Environment	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Voice and Accountability (Percentile Rank)	87.2	89.2	89.7	89.2	88.7	-	-	-	-	World Bank	5 year average	88.8
Rule of Law (Percentile Rank)	86.5	86.5	86.5	86.5	87.0	-	-	-	-	World Bank	5 year average	86.6

See DBRS Morningstar's Global Methodology for Rating Sovereign Governments for additional details on the methodology behind the scorecard indicators and associated scoring thresholds. Exchange Rate Classifications: Freely floating exchange rate = 1; Float = 2; Crawls, banded pegs, and other managed = 3; Stabilized = 4; Pegs, currency unions and dollarized arrangements = 5.

[1] Scores for 2020 have been computed using the most recent data when year-end data is not available.

Rating Committee Date: 31-Aug-2021

Estonia

Building Block Assessments and Rating Committee Summary

31-Aug-2021

Building Blocks	Scorecard Result	Quantitative Assessment	Net Impact of Qualitative Factors	Building Block Assessment
Fiscal Management and Policy	17.60	Strong	N/A	Strong
Debt and Liquidity	19.37	Very Strong	N/A	Very Strong
Economic Structure and Performance	3.61	Weak/Poor	N/A	Weak/Poor
Monetary Policy and Financial Stability	17.81	Strong	N/A	Strong
Balance of Payments	11.56	Good/Moderate	N/A	Good/Moderate
Political Environment	20.00	Very Strong	N/A	Very Strong

Overall Assessment	Composite Scorecard Result	Scorecard Rating Range	Composite Building Block Assessment	Indicative Rating Range
	75.0	AA (high) - AA (low)	75.0	AA (high) - AA (low)

Estonia's Long-Term Foreign Currency - Issuer Rating AA (low)

Main topics discussed in the Rating Committee include: the economic and fiscal impact from COVID-19, the economic recovery, and developments in political environment. For additional details on DBRS Morningstar analysis and opinions, please see the accompanying rating report.

DBRS Morningstar Scorecard: Scoring Ranges and Associated Assessment Categories

Lower Bound	0.00	1.00	3.00	5.00	7.00	9.00	11.00	13.00	15.00	17.00	19.00
Upper Bound	0.99	2.99	4.99	6.99	8.99	10.99	12.99	14.99	16.99	18.99	20.00
Assessment Category	Very Weak	Weak	Weak/ Poor	Poor	Poor/ Moderate	Moderate	Good/ Moderate	Good	Strong/ Good	Strong	Very Strong

Estonia, Republic of

ESG Checklist

ESG Factor		ESG Credit Consideration Applicable to the Credit Analysis:	Y/N	Extent of the Effect on the ESG Factor on the Credit Analysis: Relevant (R) or Significant (S)*
Environmental		Overall:	N	N
	Emissions, Effluents, & Waste	Do the costs or risks result in changes to a government's financial standing or relationship with other governments, and does this affect the assessment of credit risk?	N	N
	Carbon and GHG Costs	Does a government face coordinated pressure from a higher-tier government or from numerous foreign governments as a result of its GHG emissions policies, and does this affect the assessment of credit risk?	N	N
		Will recent regulatory changes have an impact on economic resilience or public finances?	N	N
		Carbon and GHG Costs:	N	N
	Resource and Energy Management	Does the scarcity of key resources impose high costs on the public sector or make the private sector less competitive?	N	N
		Is the economy reliant on industries that are vulnerable to import or export price shocks?	N	N
		Resource and Energy Management:	N	N
	Land Impact and Biodiversity	Is there a risk to a government's economic or tax base for failing to effectively regulate land impact and biodiversity activities?	N	N
	Climate and Weather Risks	Will climate change and adverse weather events potentially destroy a material portion of national wealth, weaken the financial system, or disrupt the economy?	N	N
Social		Overall:	Y	S
	Human Capital and Human Rights	Compared with regional or global peers, is the domestic labour force more or less competitive, flexible, and productive?	Y	S
		Are labour or social conflicts a key source of economic volatility?	N	N
		Are individual and human rights insufficiently respected or failing to meet the population's expectations?	N	N
		Is the government exposed to heavy, coordinated international pressure as a result of its respect for fundamental human rights?	N	N
		Human Capital and Human Rights:	Y	S
	Access to Basic Services	Does a failure to provide adequate basic services deter investment, migration, and income growth within the economy?	N	N
Governance		Overall:	N	N
	Bribery, Corruption, and Political Risks	Does widespread evidence of official corruption and other weaknesses in the rule of law deter investment and contribute to fiscal or financial challenges?	N	N
	Institutional Strength, Governance, and Transparency	Compared with other governments, do institutional arrangements provide a higher or lesser degree of accountability, transparency, and effectiveness?	N	N
		Are regulatory and oversight bodies insufficiently protected from inappropriate political influence?	N	N
		Are government officials insufficiently exposed to public scrutiny or held to insufficiently high ethical standards of conduct?	N	N
		Institutional Strength, Governance, and Transparency:	N	N
	Peace and Security	Is the government likely to initiate or respond to hostilities with neighboring governments?	N	N
		Is the government's authority over certain regions contested by domestic or foreign militias?	N	N
		Is the risk of terrorism or violence sufficient to deter investment or to create contingent liabilities for the government?	N	N
		Peace and Security:	N	N
		Consolidated ESG Criteria Output:	Y	S

* A **Relevant Effect** means that the impact of the applicable ESG risk factor has not changed the rating or rating trend on the issuer.

A **Significant Effect** means that the impact of the applicable ESG risk factor has changed the rating or trend on the issuer.

Estonia, Republic of: ESG Considerations

September 3, 2021

Environmental

This factor does not affect the ratings assigned to Estonia. From a credit perspective, policies relating to each subfactor are generally sound, and the fiscal cost of new investments is managed effectively within the context of Estonia's budgetary framework. According to the National Energy and Climate Plan, Estonia aims to reduce GHG emissions by 80% by 2050 compared to 1990 levels. The Global Carbon Project estimated that Estonia released 14 metric tons of carbon dioxide equivalent in 2019, down from 17 in 2005. DBRS Morningstar will continue to assess the credit impact of new regulatory and policy measures.

Social

This factor, the Human Capital and Human Rights subfactor in particular, affects the ratings assigned. Estonia's GDP per capita of $23,330 in 2020 is relatively low compared with its euro system peers. Respect for human rights is high, and there is widespread access to quality healthcare and other basic services. Estonia ranks 24 among the 163 countries assessed in the 2020 Social Progress Index.

Governance

This factor does not affect the rating assigned. Estonia has independent and transparent institutions, providing a strong environment for investment and limited scope for corruption. Estonia institutions demonstrate a high degree of transparency and accountability. Estonia is a strong performer in the World Bank's Worldwide Governance Indicators, with percentile rank scores of 88.7 for Voice and Accountability and 87.0 for Rule of Law in 2019. The country is also a strong performer on safety and security measures.