Date of Release: March 5, 2021

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

Industry Group: Public Finance – Sovereigns

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 reflects DBRS Morningstar's assessment that the risks to the ratings remain broadly balanced, even when confronted with the current crisis. Estonia entered the COVID-19 crisis with a stable macroeconomic policy framework that allowed the government to implement various expansionary measures to support the economy during the shock. The disruption in economic activity resulted in a sharp output contraction last year, although less pronounced than in most other EU countries. The policy measures to mitigate the impact of the pandemic will result in a significant deterioration to public finances. However, Estonia's prudent fiscal stance and the lowest public debt burden in the euro area provides space for additional 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 increased evidence of a persistent reduction in 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

New Estonian Government is Expected to Maintain Policy Continuity

Kaja Kallas, leader of the Reform Party, was appointed as Prime Minister in January 2021. This follows the resignation of Juri Ratas over charges of corruption within the Center Party (KESK). The center-left KESK remains in the new coalition government along with the center-right Reform Party (ER), the largest party in the Estonia Parliament. The Conservative People's Party (EKRE) was left out of the coalition.

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. While COVID case counts have increased dramatically to start the year, Estonia has broadly avoided the more severe health outcomes seen in many countries in Europe. This is partly due to lower population density and less cross-border transit, but also as a result of Estonia's strong public institutions. Estonia is a strong performer on the World Bank Governance Indicators.

Moderate GDP Contraction in 2020, But the Outlook is Tightly Linked to Domestic and External Health conditions

As the infections started to fall in May, most restrictions eased, leading to the smooth reopening of the economy. GDP contracted by 2.9% in 2020, considerably less than European peers. Various service sectors, such as transport and travel and accommodation were affected the hardest, while high value added sectors such as information and communications technology (ICT) services were more resilient. The new restrictions introduced in March 2021 are expected to have a milder impact on economic activity than restrictions imposed last year.

The control of new outbreaks and the success of the vaccination rollout domestically as well as among key trading partners will determine the outlook for the Estonian economy in 2021. The EC in its Winter 2021 forecast expects a 2.6% real GDP growth this year and 3.8% in 2022. The impact of EU's Multiannual Financial Framework (MFF) 2021-2027 and the Next Generation EU recovery plan are not incorporated into the forecast and constitute upside risk for the Estonian economy. Taken together, the transfers amount to roughly 3.6% of GDP. Policy measures that were implemented to support employment and limit damage to companies prevented sharp increases in unemployment and business closures. The recovery now depends on ample public sector consumption, the capacity of the labour market to reabsorb employment, and the degree to which the private sector can recover from the economic damage.

Despite the crisis, external accounts are broadly balanced. Preliminary Central Bank results for 2020 show the current account in a small 0.9% of GDP deficit in 2020. After years of current account surpluses, Estonia's external position has strengthened significantly, mitigating the impact of the COVID-19 disease shock. 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 -19.5% in September 2020.

Economic Support Measures will Result in a Large Increase in the Fiscal Deficit and Public Debt

The majority of measures to respond to the COVID-19 shock included direct spending for additional health funding, 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 support package also includes public loan guarantees that may have less impact on fiscal accounts. The government estimates that the general government budget deficit amounted to -6.6% of GDP in 2020 and is forecast at -6.7% next year before starting to improve gradually. DBRS Morningstar expects that because of the country's historically conservative fiscal policy, Estonia is likely to overperform current projections.

Public debt-to-GDP is estimated to have increased to 18.2% last year from 8.4% in 2019 due to the extraordinary measures to manage the COVID-19 shock and the contraction of the economy. The government expects in its State Budget Strategy for 2021-2024 the ratio to remain above 20% over the medium term. Despite the increase in the debt level and the funding needs, Estonia's debt ratio remains the lowest in the euro area. To cover the increased financing needs, the government returned to the capital markets for the first time since 2002 by issuing a 10-year bond in June 2020 and also secured loans from European supranational institutions. In addition, Estonia's two reserve funds worth 8.3% of GDP in 2020, serve as a liquidity cushion to the current crisis.

Financial Sector Risks from Nordic Parent Banks Appear Contained

The strong capitalisation and the good profitability of the Estonian banking sector along with the gradual recovery of the economy mitigate the risks from the COVID-19 crisis. The common equity tier 1 (CET1) capital ratio of the sector was 28.8% in Q2 2020. Bank asset quality is likely to deteriorate, especially from sectors most affected by the crisis, including accommodation, catering, and leisure. However, loans to these sectors account for a small share of the loan portfolio under moratoria. As the majority of the banking sector is foreign owned, risks to financial stability are associated with spill overs from Nordic economies. The global COVID-19 economic shock could reduce capital flows from the Nordic region into Estonia, and affect the income of Estonian exporters and their ability to service loans. These risks are broadly mitigated by the strong asset quality, deposit funding, and capitalisation of banks operating in Estonia.

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 $22,986 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 27, 2020) https://www.dbrsmorningstar.com/research/364527/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 Budgetary Strategy 2021-2024), Bank of Estonia (Estonian Economy and Monetary Policy 4/2020), Statistical Office of Estonia, European Commission (European Economic Forecast Winter 2021 (Interim)), 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.

This is an unsolicited 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/374841.

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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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

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

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%	-0.4%	-6.8%	-4.9%	-4.5%	-3.8%	IMF WEO	13 year average	-1.5%
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)	9.8%	9.1%	9.1%	8.3%	8.4%	18.7%	22.4%	25.6%	28.0%	IMF WEO	5 year projection	31.9%
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	23.8	23.0	26.4	28.2	29.9	IMF WEO	10 year average	20.1
Output Volatility (%)	5.6%	5.6%	5.6%	5.6%	5.6%	5.4%	5.3%	-	-	IMF WEO	Latest	5.4%
Economic Size (USD billions)	23	24	27	31	31	30	35	37	40	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%	0.2%	1.4%	2.2%	2.1%	IMF WEO	13 year average	2.1%
Total Domestic Savings (% of GDP)	139%	148%	154%	156%	152%	168%	-	-	-	ECB/IMF	Latest[1]	168%
Change in Domestic Credit (% of GDP)	-2.6%	-2.6%	-4.8%	-5.6%	-3.3%	3.8%	-	-	-	ECB/IMF	7 year average[1]	-2.0%
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%	6.0%	-	-	-	SE/IMF	7 year average[1]	1.3%
Balance of Payments	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Current Account Balance (% of GDP)	1.8%	1.6%	2.7%	2.0%	2.6%	4.0%	2.0%	1.0%	-0.1%	IMF WEO	8 year average	2.0%
International Investment Position (% of GDP)	-39.9%	-39.1%	-33.1%	-29.6%	-21.4%	-19.2%	-	-	-	IMF	5 year average[1]	-28.5%
Share of Global Foreign Exchange Turnover (Ratio)	201.1%	194.4%	200.2%	198.6%	206.3%	208.7%	-	-	-	BIS/IMF	Latest	208.7%
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: 2-Mar-2021

Estonia

Building Block Assessments and Rating Committee Summary

2-Mar-2021

Building Blocks	Scorecard Result	Quantitative Assessment	Net Impact of Qualitative Factors	Building Block Assessment
Fiscal Management and Policy	17.85	Strong	N/A	Strong
Debt and Liquidity	19.87	Very Strong	N/A	Very Strong
Economic Structure and Performance	3.41	Weak/Poor	N/A	Weak/Poor
Monetary Policy and Financial Stability	18.52	Strong	N/A	Strong
Balance of Payments	11.63	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**
	76.1	AA (high) - AA (low)	76.1	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, developments in the banking sector and 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

March 5, 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. The government in its "General Principles of Climate Policy until 2050" attempts to actively address climate change by committing 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 metric tons 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 $22,986 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's 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.