1 March 2021

THE MINISTRY OF FINANCE OF ESTONIA

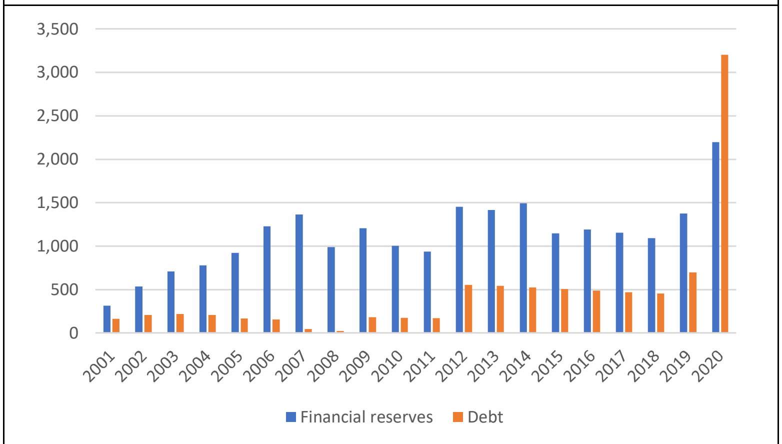
Estonian Government Borrowing and Debt in 2020

Overview of the Year 2020

Introduction

At the end of 2019, the government financial reserves (the Liquidity Reserve and the Stabilisation Reserve Fund) were two times larger than the amount of the Ministry of Finance's (MoF) outstanding debt obligations, which comprised of two loans from the European Investment Bank (EIB) and one outstanding Treasury bill issue. Figure 1 illustrates the development of government financial reserves and debt over time.

Figure 1. Central government financial reserves and debt in million euros



Covid-19 impact on the government borrowing need in 2020

The initial budgeted funding need for 2020 was EUR 414 million, which was planned to be met by reducing the Liquidity Reserve and increasing T-bill issuance. However, due to the outbreak of the coronavirus pandemic in March 2020, the government took steps to tackle the spread of the virus and to develop measures to support the economy going forward, by introducing the 2020 Supplementary Budget in April 2020. This was intended: (i) to cover direct expenditures for the health care system and other areas stemming from COVID-19; (ii) to preserve income for citizens; (iii) to support SMEs and large businesses; and (iv) to provide an economic stimulus. The 2020 Supplementary Budget included measures totalling EUR 2.8 billion (10.3% of GDP).

The updated funding requirement for 2020 pursuant to the 2020 Supplementary Budget was estimated to be EUR 3.8 billion while the general government deficit for 2020 was predicted to be EUR

2.62 billion (around 10% of GDP). However, the actual budget outturn was better than the April’20 forecast with the general government budget deficit for 2020 being EUR 1.46 billion (5.5% of GDP) based on the preliminary estimates in February 2021.

During 2020, the MoF’s debt obligations increased from EUR 700 million (2.5% of GDP) as of end-2019 to EUR 3 200 million (11.8% of GDP) as of end-2020, while the financial reserves[1] increased from EUR 1.4 billion (4.9% of GDP) to EUR 2.2 billion (8.1% of GDP) (see Figure 1 above).

Borrowing activities in 2020

In 2020, the MoF’s debt obligations increased by EUR 2.5 billion (9.2% of GDP) as follows:

- Net issuance of T-bills of EUR 325 million;
- EUR 750 million 15-year loan from the Nordic Investment Bank (NIB) signed in March 2020;
- EUR 1 500 million Eurobond issue due June 2030 issued in June 2020 (ESTONI).

In addition, the MoF signed a EUR 200 million loan agreement with the Council of Europe Development Bank (CEB) in May 2020, which is planned to be taken into use in 2021.

Increase in the size of the T-bill programme

The MoF increased its Treasury Bill programme amount from EUR 400 million to EUR 1 billion in March and subsequently to EUR 2.5 billion in November 2020. During the year, OP Corporate Bank, Erste Group Bank and Nordea Bank Abp joined as dealers regarding the primary offering of Estonian Treasury Bills. At the end of 2020, there were in total 7 banks in the T-bills dealership.

Overview of the Eurobond issue

In 2020, the government of Estonia returned to the international capital market for the first time since 2002[2]. The Eurobond issue was successful - there was very high demand from investors for Estonia’s (rated A1/AA-/AA-) issue of 10-year government bonds. The final order book stood at above EUR 7.7 billion with orders from nearly 280 institutional investors from all over the world. Given this high level of interest, the MoF decided to increase the size of the bond issue from EUR 1 billion to EUR 1.5 billion. The bond’s yield to maturity is 0.235%, which equated to mid-swap +30 bsp at the time of transaction.

This issue of a benchmark-sized government bond was also an important step in the development of Estonian capital markets. Estonia had been the only Eurozone member without a government bond issue outstanding. With this issue, there is now a clear pricing reference point for Estonian banks and companies considering their own bond issuance.

Composition of the Debt Portfolio

Historically, the MoF has mainly borrowed from IFIs (e.g., EIB) due to its limited borrowing needs. IFI loans typically have flexible and favourable terms and conditions. The MoF established its T-bill programme in April 2019 for managing short-term funding gaps due to the seasonality of budgetary cash flows. However, the start of the coronavirus pandemic in March 2020 led to a significant increase in borrowing. Table 1 illustrates the composition of the MoF’s debt portfolio at the end 2019 and 2020.

[1] The Liquidity Reserve and the Stabilisation Reserve Fund

[2] In 2002, Estonia launched EUR 100 million 5-year transaction

Table 1. The composition of the MoF debt portfolio as of end-2019 and end-2020

Instrument	Dec 2019 (in EUR million)	% of total	Dec 2020 (in EUR million)	% of total
T-bills	100	14%	425	13%
IFI loans	597	86%	1 275	40%
Eurobond	-		1 500	47%
Total	**697**	**100%**	**3 200**	**100%**
Average interest cost	**-0.03%**		**0.08%**	
Average term to maturity	**4.1 years**		**7.4 years**	

Financial risk management

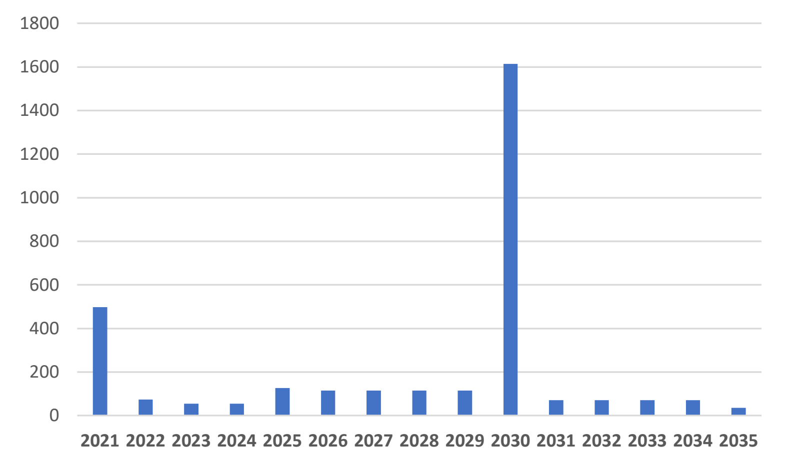
Management of refinancing risk

According to the MoF's financial risk management policy for managing refinancing risk:

- outstanding short-term debt (maturity under 1 year) cannot exceed 25% of the State's budgeted expenditures (total of costs and investments).
- the repayments of long-term debt obligations (final maturity greater than 1 year) in a year should be spread out so that the annual repayments of debt are not more than 5% of the forecasted GDP each year.

The repayment profile of debt as at 31 December 2020 is shown in Figure 2.

Figure 2. Central government debt repayments in million euros



Interest rate risk management

<u>*Interest rate risk management principles during 2014 and May 2020*</u>

From 2014 to May 2020, the interest rate risk of financial assets (meaning the Liquidity Reserve and on-lending portfolio) and outstanding debt was measured using modified duration. The duration of the financial assets could not exceed 0.45 years. The outstanding debt's duration could not exceed 0.5 years. This limit was set based on ALM principles, taking into account that the Liquidity Reserve was larger than the debt portfolio (see Figure 1 above). By maintaining a similar duration of financial assets and liabilities, the overall impact of changes in interest rate levels for the government was minimized.

Interest rate risk management principles since June 2020

During the second quarter of 2020, the level of government debt increased significantly due to the government response to tackle the spread of COVID-19 and to support the economy. This meant that the size of the debt portfolio substantially exceeded the size of the Liquidity Reserve, a situation that is expected to continue for the foreseeable future, so that the previous policy, based on an ALM approach where financial assets exceeded liabilities, was no longer appropriate.

In June 2020, the government therefore revised the principles of interest rate risk management. According to the new principles, the interest rate risk management of financial assets is no longer fully combined with interest rate risk management of liabilities under an ALM approach.
The principles for interest rate risk management of the financial assets (the Liquidity Reserve and the on-lending portfolio) remains unchanged – the modified duration of these financial assets must not exceed 0.5 years.

The risk management principles for the liabilities (the outstanding debt) were however updated – from June 2020, the interest rate risk of the outstanding debt is now measured using the average interest rate re-fixing period method. Two separate limits are in place: (i) the average interest re-fixing period of any outstanding debt up to EUR 600 million cannot exceed 0.5 years (i.e., a continuation of the ALM-principle as discussed above) and (ii) the average interest re-fixing period of any outstanding debt over EUR 600 million must exceed 3 years, with the maximum interest re-fixing period set periodically by the Minister of Finance based on the government's long-term risk-bearing capacity. As of end-2020, the weighted average interest re-fixing period of the total debt portfolio was 4.6 years (2019: 0.1 years). Table 2 provides an overview of average interest rates and financial risk indicators of the MoF's debt portfolio during the last 11 years.

Table 2. Overview of the MoF's debt portfolio's average interest rate, term to maturity and duration from 2010 to 2020

Year	Average interest rate, percent p.a.	Average term to maturity, in years	Average duration, in years
2010	1.66%	7.3	0.5
2011	2.03%	6.4	0.5
2012	1.16%	7.7	0.2
2013	1.12%	6.8	0.2
2014	1.07%	6.0	0.2
2015	0.99%	5.2	0.1
2016	0.78%	4.9	0.1
2017	0.01%	4.1	0.1
2018	0.01%	3.2	0.1
2019	-0.03%	4.1	0.1
2020	0.08%	7.4	4.5

Currency risk management

There is no currency risk related to the MoF's debt obligations since all obligations are denominated in euros.