FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Estonia at 'AA-'; Outlook Stable

Fri 03 Sep, 2021 - 17:02 ET

Fitch Ratings - Frankfurt am Main - 03 Sep 2021: Fitch Ratings has affirmed Estonia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA-' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Estonia's 'AA-' ratings reflect strong governance standards and institutions underpinned by EU and eurozone membership, a record of sound fiscal policies that have resulted in low public debt, and a net external creditor position. These are balanced by lower income per capita relative to peers and the economy's small size, which exposes the country to shocks.

We forecast Estonia's gross general government debt (GGGD)-to-GDP to increase to 19.6% in 2021 as a result of wider fiscal deficits associated with the coronavirus shock, but well below the forecast 'AA' median of 43.6%. On a net basis, general government debt is even lower, at 8.5% of GDP given the large accumulation of deposits that increased further during the crisis. Estonia entered the pandemic with one of the lowest GGGD ratios across Fitch-rated sovereigns, at just 8.4% of GDP in 2019 and its economy has weathered the shock much better than peers. The government's record of small and stable deficits prior to the pandemic supports our view that the debt ratio will decline over the medium term, after peaking at just below 20% of GDP in 2021-2022, according to our baseline projections.

Public debt sustainability is further underpinned by Estonia's favourable financing costs. Interest payments relative to revenue stood at only 0.1% in 2020, which compares favourably with the 'AA' median at 2.2%. Moreover, the favourable cost of debt servicing has been locked in for a longer period, with the average maturity increasing to 7.4 years from 4.1 years in 2019.

We forecast the fiscal deficit to narrow to 3.5% of GDP in 2021 from 4.9% in 2020, much better than our previous projection of 4.2% of GDP and the government's forecast of 6.0% of GDP. Tax receipts are strong as job losses have been concentrated mainly among low-wage sectors of the economy, such as trade, accommodation & food services and the wage dynamic was strong overall. Fiscal revenues will be additionally boosted in 2021 by the one-off effects of the pension reform (EUR330 million or 1.1% of GDP) as withdrawals from the second pillar are subject to 20% tax.

On the expenditure side, only 37% of the budgeted amount under the supplementary budget had been used as of end-1H21, pointing to likely under execution for the whole of 2021. We expect the fiscal deficit to narrow to 2.1% of GDP in 2022 and 0.6% in 2023 as the health crisis subsides and support measures are gradually unwound.

We have revised our real GDP growth forecast to 9.7% this year, followed by 4.8% and 5.1% in 2022 and 2023, respectively (last review: 3.8% in 2021 and 4.3% in 2022). The revision reflects the base effects from the very strong 1H21 and our expectation for a continued recovery of the sectors most affected by the pandemic. In 1H21, the economy grew at record speed (4.8% and 4.3% quarter-on-quarter in 1Q21 and 2Q21, respectively), reflecting continued expansion of Estonia's high value-added sectors, such as information and communication technologies, but also the recovery of sectors most hit by the pandemic, such as manufacturing, transportation & storage and accommodation.

The effect of the pension reform and an expected pick-up in EU fund absorption should provide a substantial uplift to growth in 2022 and 2023. Around EUR1.3 billion (24% of total funds or 3.4% of GDP after tax) in second-pillar pension funds will be withdrawn in September, which we expect to have a significant impact on household consumption and real estate investment. At the same time, the EU fund absorption is set to accelerate as the current financing cycle under multi-annual financial framework (MFF) 2014-2020 approaches its end in 2023 and the Next Generation EU (NGEU) fund comes on stream.

According to the authorities' projections, the inflow of EU funds will increase by around 1% of GDP to EUR1.2 billion (3.8% of GDP) in 2021 and peak at EUR1.6 billion (4.3% of GDP) in 2023. Finally, the build-up of household deposits during the pandemic (around EUR1 billion, equal to 3.3% of GDP) is likely to translate into pent-up demand, providing an additional boost to growth.

Risks stemming from the coronavirus have diminished, given the vaccine implementation and the proven resilience of the economy to social distancing measures. In Fitch's view, the balance of risks to growth is now tilted to the upside amid the positive effect of the investments and structural reforms under the NGEU on Estonia's growth potential. The recent investments by Volkswagen AG (BBB+/Positive) in Estonia also create upside potential for growth, although this is likely to have limited positive spill-over effects to the broader economy, due to the nature of the investment (intellectual property products). Downside risks relate to economic overheating, especially in the construction sector, as multiple large-scale infrastructure projects will come on stream at the same time.

Volkswagen's investments have not yet affected headline GDP figures, as the fixed capital formation was offset by the import component. However, it contributed to turning Estonia's current account balance into a deficit at 4.7% of GDP in 1Q21 after several years of surpluses (average 1.1% of GDP over the last five years). We assume this trend will continue, which is reflected in our expectation for a small current account deficit over the forecast horizon. Estonia's external position remains favourable, as reflected in the net external creditor position forecast at 20.5% of GDP in 2021 ('AA' median at -0.9% of GDP).

Inflation accelerated in 2Q21 to 4.9% year-on-year in June (HICP), the highest in the EU. The increase was mostly driven by soaring electricity and motor fuel prices as the increased production cost of electricity was passed on to the consumer and global commodity prices recover. We expect these effects to be transitory, but forecast inflation to remain elevated this and next year given the upcoming increase in gas prices by 50% in September, robust wage growth (7.3% year-on-year in 2Q21) and increasing public spending.

Under our baseline scenario, inflation will average 3.4% this year and 3.8% next year, before easing to 2.8% in 2023. However, we note the injection of second-pillar funds into the economy at a time of strong economic activity could lead to overheating that would manifest itself in high inflation levels over a longer horizon, especially if fiscal policy fails to counterbalance these pressures.

Estonian banks remain well positioned to absorb higher loan losses caused by the pandemic. Capital ratios remain the highest in the EU, with the common equity Tier 1 ratio at 26.5% at end-1Q21. Profitability held up and remains very high in the international comparison (return on equity rose to 9.6% in1Q21 from 8.8% in 2020). Non-performing loans were very low at 0.6% of total loans at end-1Q21, and the declining share of loans under debt moratoria means risks to asset quality from the coronavirus pandemic are abating. In March 2021, only 2.1% of loans were subject to loan holidays, down from a peak at 11.3% in June 2020. However, the non-performing loan ratio could gradually increase due to the renewed restrictions and the expiry of debt moratoria and some government support measures.

ESG - Governance: Estonia has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Estonia has a high WBGI ranking at 85th percentile, reflecting its long record of stable and peaceful political transitions, well-established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Public Finances: Significantly higher government debt relative to GDP reflecting persistently loose fiscal policy.

- Macro: Severe persistent economic overheating leading to the creation of macro-financial imbalances.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Structural Features: Further improvement in structural indicators, including a significant narrowing of the differential in GDP per capita to rated peers.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Estonia a score equivalent to a rating of 'AA-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

KEY ASSUMPTIONS

The global economy performs broadly in line with Fitch's latest Global Economic Outlook published on 15 June 2021. We estimate eurozone real GDP at 5.0% in 2021, 4.5% in 2022 and 2.2% in 2023.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Estonia has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's Sovereign Rating Model and are therefore highly relevant to the rating and a key rating driver. As Estonia has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

Estonia has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's Sovereign Rating Model and are therefore highly relevant to the rating and a key rating driver. As Estonia has a percentile rank above 50 for the respective governance indicators, this has a positive impact on the credit profile.

Estonia has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as World Bank Governance Indicators have the highest weight in Fitch's Sovereign Rating Model and are therefore relevant to the rating and a rating driver. As Estonia has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

Estonia has an ESG Relevance Score of '4[+]' for Creditors Rights as willingness to service and repay debt is relevant to the rating and a rating driver. As Estonia has a record of 20+ years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

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Estonia	LT IDR	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+
•	LC LT IDR	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
•	LC ST IDR	F1+	Affirmed	F1+
•	Country	AAA	Affirmed	AAA

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Estonia	EU Issued, UK Endorsed

UNSOLICITED ISSUERS

Estonia (Unsolicited)

With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	Yes

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ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Estonia	-	Long Term Issuer Default Rating	Unsolicited
Estonia	-	Short Term Issuer Default Rating	Unsolicited
Estonia	-	Country Ceiling	Unsolicited
Estonia	-	Local Currency Long Term Issuer Default Rating	Unsolicited
Estonia	-	Local Currency Short Term Issuer Default Rating	Unsolicited

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Sovereigns Europe Estonia