Credit Rating Announcement

21 February 2020

Scope upgrades Estonia's credit rating to AA-; Outlook Stable

Robust growth, prudent fiscal management as well as improved external resilience drive the rating upgrade. Wage-productivity growth imbalances, labour shortages and risks in the banking sector remain challenges.

For the rating action annex, click **here**.

Rating action

Scope Ratings GmbH has today upgraded the Republic of Estonia's long-term issuer and senior unsecured local- and foreign-currency ratings to AA- from A+ with a Stable Outlook. The short-term issuer rating has been affirmed at S-1+ in both local and foreign currency with a Stable Outlook.

Summary and Outlook

The drivers for the upgrade of Estonia's long-term ratings to AA- are: i) sustained real growth averaging 4.8% over 2017-19, driven by effective structural reforms, strong private consumption, and investment; ii) prudent fiscal management with very low public debt at 9.2% of GDP as of Q3 2019 and a broadly balanced budget; and iii) improved resilience against external shocks, with falling levels of net external liabilities. Under Scope's sovereign rating methodology, the upgrade reflects improvements in the 'domestic economic risk', 'public finance risk' and 'external economic risk' categories of Scope's assessment.

Estonia's ratings are furthermore supported by the country's euro area membership, strong governance, and a commitment to a favourable business environment, which Scope expects to continue under the current coalition government. However, still moderate per capita income levels relative to those of euro area peers, productivity growth below wage growth, unfavourable demographic trends, risks within the banking sector and a large export sector relative to the small size of the economy remain challenges.

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months. The rating/Outlook could be upgraded if, individually or collectively: i) a continued implementation of structural reforms, such as in the labour market, research and development, and infrastructure, drives a stronger growth outlook; and/or ii) there is a further sustained reduction in external vulnerabilities.

Alternatively, the rating/Outlook could be downgraded if, individually or collectively: i) a loosening of the commitment to fiscal discipline results in materially higher-than-projected fiscal deficits; ii) risks in the financial sector escalate, increasing financial stability concerns; iii) elevated wage-productivity growth imbalances weigh significantly on external competitiveness; and/or iv) an external shock or heightened geopolitical risks undermine Estonia’s growth outlook.

Rating rationale

The first driver underpinning the rating upgrade to AA- is Estonia’s robust economic performance. Estonia’s real GDP growth was higher than expected in 2019, estimated at 3.8%, remaining above its potential rate of growth, and above euro area growth of 1.2%. In 2020, Scope expects growth to ease towards 2.4%, due to weaker external demand, but supported nonetheless by ongoing public infrastructure projects, including the construction of Rail Baltica that connects the Baltic states to the European rail network (to be completed by 2026). As a result of past strong growth, Estonia’s per capita income increased to 60.5% of the euro area average as of Q3 2019, from 57.4% in Q3 2018. Growth has been supported by private consumption, due to the tight labour market: the employment rate (15-64) was 75.3% as of Q3 2019, the highest in Central and Eastern Europe (CEE), and the unemployment rate was at a near-historic low of 4.3% in December with wages rising briskly. Investment has been a key contributor to growth, supported by Estonia’s high absorption rate of EU structural funds. Importantly, sturdy economic growth has not been accompanied by an increase in private sector indebtedness: non-financial corporations have continued to deleverage, with outstanding debt amounting to 121% of GDP in Q3 2019, down from 142% in Q3 2017, while household debt remains at a moderate 38.5% of GDP.

The second driver of the upgrade to AA- is Estonia’s sound fiscal position, underpinned by prudent debt management. Public debt amounted to just 9.2% of GDP as of Q3 2019, by far the lowest among EU members and largely unchanged since 2012, while net debt after accounting for liquid fiscal reserves is zero. In addition, of the EUR 2.5bn public debt stock, around one-third (EUR 765mn) reflects loans from the European Investment Bank (AAA/Stable) to the central government. Given Estonia’s substantial fiscal space, Scope views positively government policies that enhance investment in areas key to raising long-term growth potential (i.e. infrastructure, the labour market and innovation, including increasing spending on research and development to 0.6% of GDP over the medium term), whilst maintaining a strong commitment to fiscal discipline. The fiscal deficit has fallen from 0.6% of GDP in 2018 to an estimated 0.2% in 2019; Scope expects the budget to remain broadly balanced at close to -0.2% of GDP in 2020. Strong fiscal developments are supported by the sturdy labour market with high and increasing employment, supported by effective government structural reforms, including the Work Ability Reform introduced in 2016 aimed at bringing people with reduced working abilities back to the labour market. Going forward, the planned introduction of spending reviews and performance-based budgeting in 2020 will support more efficient governmental spending.

The third driver of the rating upgrade is Estonia’s improved external resilience. The economy’s external financial liabilities in net terms (its net international investment position) declined by 15pp between Q3 2017 and Q3 2019 to 20.4% of GDP. Moderate current account surpluses averaging 2.2% of GDP over this period contributed to this improvement. Furthermore, the structure of Estonia’s external liabilities compares favourably with those of CEE peers, with foreign direct investment comprising around 60% of liabilities, a source of inward investment that is less prone to flight in times of market volatility than portfolio flows. 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.

In addition, 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 Q3 2019, the system-wide common equity tier 1 (CET1) capital ratio amounted to 27.5% of risk-weighted assets, the highest in the euro area, and the non-performing loan ratio was a low 1.8% for the same quarter. In Scope’s view, the financial system’s available buffers provide a sizeable cushion in adverse scenarios involving the money laundering investigations, potential fines and impacts on the operations of Nordic banks in Estonia. Scope moreover views positively Estonia's strengthened AML framework, including stricter penalties for AML breaches and more on-site inspections, as well as the enhanced cooperation between Nordic and Baltic financial supervisors regarding AML and counter-terrorism financing.

Despite these credit strengths, Estonia still faces a number of challenges. Estonia's medium-to-long-term growth prospects are hindered by adverse demographics that constrain labour market supply. According to European Commission (EC) projections, the old-age dependency ratio (those aged 65 years and over as a percentage of those aged 15-64) will increase to 37.8% by 2030, from 31% in 2018. This change will also weigh on productivity growth. In addition, the government plans to make the mandatory second pillar of the pension system voluntary from 2021 onwards, which has savings of 15% of GDP. Positively, this change could enhance private consumption over the short term, and will increase individual investment choices and flexibility. People can choose to i) continue with the second pillar contributions; ii) suspend further payments and withdraw savings; or iii) invest in other funds of their choice. However, allowing people to exit the system and withdraw their savings could also pose budgetary pressures over the long term given the ageing population and low levels of pensions, which may not be socially viable – Estonia's pre-retirement income replacement rate through pensions was at 47% in 2018. Importantly, immigration to Estonia has exceeded emigration since 2015, mitigating labour shortages in some sectors.

Next, Estonia's small, open economy, which is highly integrated in global value chains, remains vulnerable to external shocks, including to any intensification of trade tensions and a prolonged period of subdued growth in western Europe, with total exports of goods & services amounting to 73% of GDP. Furthermore, 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.

Despite research and innovation strategies adopted over 2014-20, productivity growth in Estonia remains moderate. One reason is the limited expenditure on research and development, partly due to the small scale of firms, with just 1.4% of GDP spent in 2018 across all sectors, significantly lower than the euro area average of 2.2%. Real wage growth, on the other hand, has been very strong, averaging 5.2% year-on-year between Q1 2019 and Q3 2019 – materially exceeding productivity growth rate of 3.1% YoY over the same period. A prolongation of this divergence could affect the external competitiveness of Estonia's export-dependent economy.

Estonia is a major beneficiary of EU Structural and Investment Funds (ESIF) and has the highest absorption rate among CEE economies, supporting strategic infrastructure projects, amongst other areas. The economy's ESIF allocation during 2014-18 amounted to 2.7% of GDP annually, or half of public investment. For 2021-27, however, the EC proposed to reduce Estonia's financing allocation, by around 20% compared to 2014-20 levels. The proposal accounts for Brexit, Estonia's ongoing income convergence to the EU average, and proposed new criteria for EU fund allocations. However, Scope expects the proposal to be amended in ongoing negotiations between the European Council and the European Parliament, which could result in a meaningful change in Estonia's fund allocation.

Finally, recent money laundering allegations continue to pose significant reputational risks to Estonia's banking sector, and ongoing investigations have resulted in higher costs for banks. Swedbank, which accounts for 28.6% of total banking-system assets in Estonia, is under investigation by Estonian and Swedish financial supervisory authorities (jointly) as well as by US authorities regarding large amounts of alleged 'high-risk, non-resident' money that flowed through its Estonian branch, mostly from Russia. The bank's total costs increased by 19% in 2019, affected by higher consulting expenses to address investigations. These risks are mitigated by the bank's sound capitalisation, with a CET1 ratio of 17% in 2019, up from 16.3% in 2018.

The impact on financial stability from Danske Bank's exit from Estonia, as required by Estonia's Financial

Supervision Authority following money laundering revelations, has been contained. The bank accounted for 4.6% of the total market in terms of assets and 0.5% of deposits as of 2018. Overall, the share of non-resident deposits in total deposits in Estonia has fallen to 9% in 2019 from 19% in 2014, potentially lowering future risk to Estonia's banking sector relating to non-resident money flows.

Core Variable Scorecard (CVS) and Qualitative Scorecard (QS)

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative 'AA' ('aa') rating range for the Republic of Estonia. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on qualitative analysis.

For Estonia, the following relative credit strength is identified: i) debt sustainability. The following relative credit weaknesses are identified: i) growth potential of the economy; ii) macro-economic stability and sustainability; iii) vulnerability to short-term external shocks; iv) geopolitical risk; and v) financial imbalances and financial fragility.

The combined relative credit strength and weaknesses generate a one-notch downward adjustment and indicate a sovereign rating of AA- for Estonia.

A rating committee has discussed and confirmed these results.

Factoring of Environment, Social and Governance (ESG)

Scope considers sustainability issues during the rating process as reflected in its sovereign methodology. Governance factors are explicitly captured in Scope's assessment of 'institutional and political risk' under its methodology, under which Estonia has the strongest performance among CEE countries as assessed by World Bank's Worldwide Governance Indicators. In general, policymaking in Estonia has been effective and has enjoyed continuity. Furthermore, Estonia is among the top performers in the United Nations' E-Government Survey 2018, which measures effectiveness in the delivery of public services using information and communication technologies.

According to the EC, Estonia performs relatively well on most indicators along a social dimension but needs further investment in education to reduce labour market skills mismatches. Social factors are reflected in Estonia's very low rates of unemployment (4.3% in December 2019), income inequality levels around the EU-average and slightly higher poverty levels than the EU average (with 24.4% of the population at risk of poverty or social exclusion in 2018, compared to 21.6% for the EU-27). The EC's Digital Economy and Society Index 2019, which assesses digital competitiveness in the EU, ranks Estonia eighth after Ireland.

Estonia has progressed in fostering energy efficiency: its share of renewable energy in total energy consumption increased to 30% in 2018, above the EU average of 18%, with plans for further investment in renewable energy. However, Estonia's highly carbon-intensive oil shale industry remains economically important, accounting for 70% of energy consumption and 4% of GDP, meaning the implementation of the EU's long-term target of carbon-neutrality could negatively impact the country's economic activities during the transition period.

Rating committee

The main points discussed by the rating committee were: i) Estonia's growth outlook; ii) labour market and demographics; iii) wage and productivity growth; iv) banking sector developments; v) external sector developments; vi) fiscal performance; vii) geo-politics; and viii) peers.

Methodology

The methodology used for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.
Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.
The rating outlook indicates the most likely direction in which a rating may change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rating was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.
The following material sources of information were used to prepare the credit rating: public domain. Key sources of information for the rating include: Statistics Estonia, Bank of Estonia (Eesti Pank), Ministry of Finance of Estonia, the European Commission, the European Central Bank (ECB), the Statistical Office of the European Communities (Eurostat), the IMF, the OECD, the BIS and Haver Analytics.
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Prior to the issuance of the rating, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.
Lead analyst: Levon Kameryan, Analyst
Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director
The ratings/outlook were first assigned by Scope in January 2003. The ratings/outlooks were last updated on 5 April 2019.

Potential conflicts

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About Scope Ratings GmbH

Scope Ratings GmbH is part of the Scope Group with headquarters in Berlin and offices in Frankfurt, London, Madrid, Milan, Oslo and Paris. As the leading European credit rating agency, the company specialises in the analysis and ratings of financial institutions, corporates, structured finance, project finance and public finance. Scope Ratings offers a credit risk analysis that is opinion-driven, forward-looking and non-mechanistic, an approach which adds to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with ECAI status.

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