Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF ESTONIA	Assigned Ratings/Outlook: **AA- /stable**	Type: Monitoring, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	23-12-2016 21-08-2020 “Sovereign Ratings” “Rating Criteria and Definitions”

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Rating Action

Neuss, 21 August 2020

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “AA-” for the Republic of Estonia. Creditreform Rating has also affirmed Estonia’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “AA-”. The outlook is stable.

Key Rating Drivers

1. Recent strong and robust economic growth translating into ongoing income convergence; diversified economy with highly-skilled labor force and favorable business environment, somewhat balanced by elevated degree of macro-financial volatility and slowly diminishing cost competitiveness

2. Near-term outlook significantly dampened by Covid-19-induced economic downturn, although GDP growth rebound in 2021 remains main scenario; uncertainty around these assumptions remains extremely high, and vulnerabilities associated with a small open economy call for caution

3. Strong and stable institutional set-up characterized by sound and forward-looking policy-making; significant benefits from EU/EA membership further enhanced by recent deal on MFF 2021-27 and NGEU-related funding; NATO membership beneficial with a view to persistent geopolitical risks

4. Despite significant – and assumed temporary - deterioration in public finances due to the corona pandemic and related aid measures, debt level to remain low; convincing track record of prudent fiscal policies and highly affordable debt add to assessment of relatively low risk in terms of fiscal sustainability; despite delayed rectification of related policies, limited AML-impact on financial stability and fiscal sustainability so far

5. Sustained current account surpluses and a further improving, mildly negative, net NIIP with benign composition reflect significant risk buffers

Reasons for the Rating Decision

The sovereign's very high creditworthiness mirrors its exceptionally strong public finances and the high quality of its institutional framework, as well as the macroeconomic and external risks typically associated with a small open economy advancing in its convergence process.

Macroeconomic Performance

The recent track record of strong and robust economic growth fostering ongoing income convergence, as well as a very favorable business environment, constitute major pillars supporting the sovereign's macroeconomic performance profile. By contrast, a continued elevated degree of macro-financial volatility and slowly diminishing cost competitiveness present some constraining factors to the medium-term outlook. While the corona pandemic and the related temporary confinement measures are provoking a sharp decline in economic output this year, we assume that this will be a transitory development and expect a rebound for the coming year. Lifted restrictions and the strong response from the government and relevant EU institutions, including the recent agreement among the EU countries on the Multiannual Financial Framework 2021-27 (MFF 2021-27) and joint funding programs summarized under Next Generation EU (NGEU), have set the stage for a recovery from the second half of this year. The shape thereof is difficult to predict at present, not least due to ongoing high uncertainty over the further evolution of the pandemic and the recently rising infection rate, while effective vaccines are not yet available. However, given its relatively strong starting point, we think that the Estonian economy should be in a position to adequately cope with the challenges.

Estonia's real GDP growth has outperformed euro area growth and that of the EU-27 respectively since 2016, as well as that of its fellow Baltic states. In 2019, real economic output expanded by 4.3%, only slightly decreasing compared to the preceding year (4.8%) and far exceeding euro area and EU GDP growth (EA: 1.3%, EU-27: 1.5%). Domestic demand contributed more than external demand last year, in particular on the back of strong impulses from gross fixed capital formation, which surged by 13.2% (2018: 1.7%) and, to a lesser extent, from private consumption, which grew by 3.1% (2018: 4.3%). The very dynamic investment activity was broad-based, with strong expansion of capital expenditure in construction (13.2%, 2018: -3.0%), machinery and equipment (12.9%, 2018: 9.3%) as well as intellectual property (14.4%, 2018: 2.9%). At the same time, household expenditure remained supported by ongoing job creation and rising real income in a tight labor market. Statistics Estonia data show that average monthly gross wages (salaries) rose by 7.4% in 2019. By contrast, the volatile inventory component posed a drag on GDP growth, taking 2.0 p.p. off. Export growth even accelerated slightly, to 4.9% (2018: 4.3%), although this was entirely owing to a strong start into the year, for in the course of 2019 quarterly export growth almost stalled, posting a decline in Q4-19. Import growth decelerated to 3.7% (2018: 5.7%), leaving net trade to add 1.0 p.p. to the overall result, its first positive contribution since 2015.

While the Covid-19 pandemic hit at a time at which Estonia's economic performance was still relatively robust, the outbreak and spread of the coronavirus will result in a sharp decline in total output this year. To contain the pandemic, Estonian authorities introduced restrictions on public life amid the declaration of a state of emergency in mid-March, which ended on 17 May. Judging by the stringency index compiled by Blavatnik School of Government, the lockdown seemed less strict both in terms of severity and duration than in a number of other European countries: For instance, while public gatherings including cultural and sports events were forbidden and shopping malls were closed, cafes and other shops were allowed to remain open subject to social distancing. However, Estonia pursued a relatively strict border policy early on.

In this year's first quarter, real GDP fell by 3.7% against the preceding quarter, broadly in line with the contraction recorded for the euro area as a whole (-3.6%) and with gross fixed capital formation posting the strongest decline (-6.7% quarter-on-quarter). Owing to the relatively mild lockdown and possibly also to an extent to Estonia's advanced stage as regards digitization of the economy and public services, the fall in private consumption (-0.5% q-o-q) compares as quite tame with the contraction in private consumption registered for the euro area overall (-4.6%). Factors related to the pandemic certainly played a role here, but we have to point out that the weak Q1-performance was mainly due to influences that had been at play prior to the Covid-19 outbreak, i.e. climate policy-induced effects on fuel stockbuilding, easing international trade, and labor shortages. Generally, our Pandemic Vulnerability Index suggests that the country seems comparatively well-equipped structurally to deal with a pandemic such as the current one.

Having said that, as the main phase of the lockdown occurred in April and May, real GDP should see a steep fall in Q2. According to Statistics Estonia, nominal exports in Q2-20 were 15% below the level of the same quarter one year prior, although at least in June the previous year's level of export was reached again, thus suggesting some recovery of economic activity going into the third quarter. The fact that Finland, Sweden, Latvia, and Germany - four countries that appear to be economically less hard hit by the pandemic - are main export destinations may help here. Industrial production data in June increased by 7.6% compared to the previous month (Statistics Estonia), following declines by 9.6% and 8.5% in March and April, and stagnation in May, thus also pointing to some recovery towards the end of the second quarter. The volume of retail sales seems to follow a similar path, with June registering a monthly increase of about 5%.

Looking ahead, we would expect the Estonian economy to record a pronounced decline to the tune of about 8.5% for the whole of 2020. Based on a recovery from the second half of this year which will be assisted by extensive support measures on the national and European level, including monetary policy support, we cautiously estimate real GDP to bounce back by about 7.4% in 2021, thus presumably not yet making up for lost output incurred in the first half of 2020 due to Covid-19. We fully acknowledge that uncertainty surrounding these estimates remains extremely high.

While sentiment indicators have generally tended to improve through June/July, thus backing assumptions of a recovery, they also seem to caution against enthusiasm at this stage. Industrial confidence, which had been on the decline pre-corona and which displayed a steep fall in April, has climbed back to levels seen in January. Although construction investment could constitute a stabilizing element, we expect a decline in gross fixed capital formation this year, as business investment will be weighed down by very high uncertainty. In the same vein, industrial new orders have fallen to their lowest level since 2009 (Q3: -37.7, Eurostat data), and capacity utilization stood at 66.0% in Q3-20, up from 63.3% in Q2, but well below its long-term average (2000-19: 72.3%).

While expectations pertaining to export orders have recovered somewhat, they still point to a deterioration with a view to the next three months. Given the adverse development in the first half of the year and more or less steep GDP declines among the main trading partners, coupled with severely disrupted supply chains, we expect both imports and exports to contract this year, with net external trade contributing negatively to real GDP growth. This is all the more since tourism is an important element in Estonia, both as a contributor to growth and employment (7.8% of GDP and 4.3% of employment, 2018 OECD data).

We note that the consumer confidence indicator compiled by the Estonian Institute of Economic Research in July remained at a very low level, despite brightening up somewhat following a slump in April. With this, the indicator suggests that consumer confidence may take longer to recover in the face of tremendous uncertainty, possibly slowing a recovery in private consumption in the second half of the year. An inevitably rising number of insolvencies should eventually lead to a higher number of job losses at some point.

We expect unemployment to rise strongly, with the downside risk that it could translate into longer-term unemployment to some extent later on. However, the labor market was in a very strong position when the corona crisis broke out. Estonia's unemployment rate has followed a firm downward path over recent years, dropping to 4.4% in 2019 (2018: 5.4%). At that level, the rate continues to post significantly below the euro area level (7.5%) and that of its Baltic neighbors (LT: 6.3% and LV: 6.3%). Furthermore, Estonia's labor participation rate is markedly higher than in the euro area, at 78.9% in 2019 (EA: 73.7%). Employment also continued to grow solidly, by 1.3% last year (2018: 1.2%), roughly in line with the pace of job creation observed in the euro area and stronger than that in the other Baltic states (LV: -0.1% and LT: 0.5%).

Labor market conditions have already deteriorated, as unemployment jolted from 4.1% in Q4-19 via 5.0% in Q1 to 7.1% in this year's second quarter (Statistics Estonia), which would tie in with the notion of flexible labor markets. Strong wage increases as seen in 2019 are thus unlikely to be repeated. Due to the weak first half of the year, we expect private consumption to post a pronounced decline this year, although the Unemployment Insurance Fund should act as a cushion.

More generally, the Estonian government has implemented a number of aid measures to mitigate the damage inflicted on the economy through Covid-19 and the related restrictions to contain its spread, including increased spending on healthcare, a wage supplement scheme and targeted support to specific sectors such as shipping. Liquidity and loan measures include tax deferrals and loan guarantees for bank loans.

What is more, the economic recovery should also be supported by the ECB's stepped-up purchasing programs (Asset Purchase Program, APP, and Pandemic Emergency Purchase Program, PEPP), along with extensive measures to ensure uninterrupted liquidity to the banking sector and a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area. Relaxed macro-prudential measures by Eesti Pank (EP) should lend further support to the financial and the private sectors.

Combined with Estonia’s favorable business environment, this strengthens our expectation of stronger resuming activity once uncertainty starts to fade. While according to the latest World Bank's Doing Business Report Estonia has slipped from 16th place to 18th out of 190 economies, this still corresponds to the second-highest position achieved by a euro area member and puts the country in a better position than the majority of its AA-rated peers in our rating universe. While the report highlights registering property (rank 6), enforcing contracts (8) and paying taxes (12) as some of the strengths, it also suggests room to improve as regards getting electricity (53), resolving insolvency (54) and protecting minority investors (79).

The latest vintage of the World Economic Forum's Global Competitiveness Report, to our mind, underscores our assumption of reasonably positive medium-term growth prospects, echoing a relatively favorable stance as regards its non-cost competitiveness. The sovereign managed to slightly improve its position to rank 31 out of 144 economies, outperforming its Baltic neighbors (LV: 41 rank; LT: 39 rank), but lagging clearly behind most of its AA peers. Perceived strengths in particular relate to skills, ICT adoption, institutions and business dynamism. Especially ICT adoption seems to play out as a much needed feature in the face of the current crisis, as it adds to resilience under these circumstances. And while the Estonian economy overall shows a good degree of diversification with a relation of gross valued added (GVA) of services to industry of 2.7 (EA: 3.0), we continue to see Estonia as relatively well-placed given a GVA share of information and communication that markedly exceeds that of the euro area overall (Q1-20: 8.4% vs. EA 5.0%) and which has increased by 1.8 p.p. compared to the prior year. While business services account for a smaller share of GVA than in the euro area (9.7% vs. EA 11.6%), their share has increased in the year to Q1-20, narrowing the gap.

Prospects for the medium term in our view have been decisively bolstered by the recovery plan NGEU recently agreed among the EU countries, of which the Recovery and Resilience Facility (RRF) represents the largest chunk. Payments (loans and grants) will start in 2021, amounting to about EUR 1.5bn in Estonia’s case, thus constituting some tailwinds for the growth outlook. Financial transfers from the EU via structural and cohesion funds under the new Multiannual Financial Framework will add to this. Estonia will be able to draw on funds worth roughly EUR 6.8bn from the MFF 21–27. Compared to the current MFF, additional EU funds would amount to close to EUR 2.17bn.

Although the developments associated with Covid-19 currently present sizable downside risks, we thus expect Estonia to resume its convergence path after experiencing an assumed temporary setback due to the pandemic. The recent track record of steady and relatively high economic growth had the sovereign progress further towards EU income levels. According to available IMF data, Estonia’s GDP per capita is estimated to have totaled

USD 35,853 in 2019 (PPP terms). With that, per capita GDP is broadly on par with Lithuania (USD 36,701) and well above Latvia's GDP per capita (USD 31,402). We note that Estonia still displays a considerable gap towards the median of our AA-rated universe (USD 47,223).

Downside risks stemming from Estonia's eroding cost competitiveness, partly a consequence of the tight labor market and shortages of skilled labor that push up wages, have at least not resulted in a loss of export market share so far. Rather, the latter has been broadly stable over the last few years, standing at 0.09% as regards goods and services exports in 2019. Real unit labor costs (ULC) have been rising steadily since 2012, with increases in real compensation per employee continuously exceeding gains in real labor productivity per person (AMECO data). Compared to Estonia's main European key trading partners, this left the sovereign in a somewhat weaker spot, although it has to be stressed that higher wages are essential to retain higher-skilled workers or even draw in skilled workers from abroad, thus fostering the growth potential in the longer run. The trend continued in 2019 when real ULC rose by 1.3% compared to the prior year, still exceeding developments in the euro area as a whole by far (0.3%). However, with the labor market set to weaken, wage developments should moderate in the near future.

Further downside risks, especially in the current context, relate to Estonia being a small, open economy, which typically tend to display a higher degree of macro-financial volatility. With a nominal GDP of EUR 28.03bn in 2019, Estonia is one of the smallest economies in the EU-27, and exports of goods and services account for a significant, albeit decreasing, share of the economy (72.6% of GDP). While this causes vulnerabilities to adverse developments regarding its main trading partners, we would reiterate, as mentioned further above, that its four biggest European trading partners seem structurally well-positioned to get through this crisis comparatively well. Having said that, uncertainty surrounding these expectations is extremely high, and the risks need to be carefully monitored. While Estonia's dependence on capital flows from European structural financial support may hamper predictability of macro-financial indicators, we would currently above all emphasize the continuation of such funds as a positive and stabilizing element for the medium-term growth outlook. Current estimates for the country's potential growth (AMECO) remain favorable, as projected growth rates of 2.5% in 2020 and 3.4% in 2021 are among the highest in the EU. Although net migration continued to evolve favorably (2019: +5,458), longer-term demographic challenges remain in place as indicated by the EU Commission's Ageing Report 2018, thus stressing the need to stay on a path of embracing new technology, upskilling, and enhancing investment in R&D. At 1.4% of GDP (2018), Estonian R&D investment is still significantly lagging behind euro area and EU averages (2.2%).

Institutional Structure

The sovereign boasts a strong institutional framework, which continues to buttress our credit assessment. Significant advantages it can draw from its integration into EU, the euro area, and NATO are adding to this, as demonstrated not least by the recent EU-level agreement on the MFF 2021-27 and NGEU (see above). Through access to the large EU common market, the small open economy is presented with ample trade opportunities, illustrated among other things by a comparatively large share of intra-EU exports in goods of 73.1%, and of intra-EU exports in services of 70.8% in 2019.

Our view of the overall high quality of Estonian institutions is backed by the World Bank's Worldwide Governance Indicators (WGI), with regard to which the sovereign scores better than its CEE peers across the board. Furthermore, Estonia is broadly on par with the median of our AA-rated universe as regards the indicator gauging perceived control of corruption (rank 22, AA median: 21), while not too far off the AA-median pertaining to government effectiveness (33, AA median: 26), rule of law (29, AA median: 24) and voice and accountability (22, AA median: 15). As to the perception of the degree to which public power is exercised for private gain (WGI control of corruption), we would positively highlight that Estonia has made notable progress over time, narrowing the gap to global leader Finland in this respect.

Efforts to seek active participation of and feedback from the population as regards the long-term strategy ‘Estonia 2035’, to ensure a high degree of acceptance, further highlights Estonia’s institutional quality. Estonia 2035 aims, among other things, to integrate sustainability aspects into the government's strategic development plans and formulate policy guidelines for the coming years that will affect society, economy, environment and governance – underlining the sound and forward-looking approach to Estonian policy-making.

We continue to assess favorably the government’s high responsiveness to emerging challenges, which is corroborated by an excellent first place on the OECD’s Responsiveness Rate. In this vein, mention should be made of the government’s plan to reform its pension system. We note, however, that the current version of the pension reform is not uncontentious. The reform is to change mandatory participation in the second pillar (a statutory funded pension scheme) into voluntary contributions. While the reform was ultimately passed by Parliament earlier this year but not promulgated by the Estonian president due to doubts over conformity with the constitution, the matter currently sits with the Supreme Court. Reportedly, a final ruling of the Court is not expected before October this year. We are aware that EP has also raised concern over the current reform version, suggesting that the second pillar pension is important if the Estonian population declines more dramatically than expected and Estonian economic growth falls short of forecasts. In this event, voluntary contributions may not be able to keep pace, resulting in pressure to raise taxes in the future.

Ongoing tensions with neighboring Russia constitute, to some extent, a constraining element in our otherwise positive assessment of the sovereign’s institutional structure, not least as EU sanctions against Russia have been extended by another six months as of this June. While we do not expect any escalation at this stage, Estonia remains exposed to shocks in this respect. Another case in point would be Belarus, where political unrest has resurfaced. We would argue along a similar line as regards any potential aggression on the part of Russia, against which Estonia’s NATO membership represents a deterring factor. As a possibly more immediate risk we would reiterate that Estonia displays a certain degree of vulnerability to cyber attacks, given that the country can be seen as a frontrunner in terms of digitization of its economy and public services.

We gather that, in a bid to further reduce the level of dependence on Russian energy supply and to enhance the competitiveness of producers within the Baltic countries, the third electricity interconnection between Estonia and Latvia is expected to be completed by the end of 2020.

Fiscal Sustainability

Estonia's very low debt level, the lowest in the EU, prudent fiscal execution, and high debt affordability underscore relatively low risks to fiscal sustainability. While fiscal metrics are very likely to deteriorate substantially due to Covid-19 and the considerable economic and social damage it has caused, there nevertheless should be sizable fiscal leeway to counter these negative effects in the near to medium term.

Estonia's general government balance inched closer to a balanced position last year, narrowing from a minor deficit of 0.6% of GDP in 2018 to 0.3% of GDP. Total expenditure growth moderated somewhat to 7.4% (2018: 8.9%), mainly as social benefits increased to a lesser extent than in the preceding year (8.5%, 2018: 10.8%), whereas spending on public sector wages even accelerated somewhat (9.8%, 2018: 9.4%). Amid a slightly reduced pace of economic activity and, among other things, personal income tax cuts for low- and medium-income earners, total general government revenues also grew more slowly than in the previous year. With an expansion of 8.1% (2018: 9.4%), however, revenue still rose more strongly than total outlays. Both current taxes on income and wealth and net social contributions increased less vigorously than in the preceding year (5.8% and 9.4%, 2018: 12.8% and 12.1%).

Had it not been for the Covid-19 pandemic, the general government could have been expected to remain close to or even reach a balanced budget. The unfolding corona crisis will lead to a significant deterioration of public finances. Falling revenues due to the lockdown phase and some disruptions to production and supply chains, together with the emergency support to mitigate the negative consequences thereof, will send the deficit soaring this year and will lift the debt-to-GDP ratio considerably, although from a very low level.

Seeking to combat the crisis and minimize the damage to the economy, the Estonian government put forward the April Supplementary Budget 2020 totaling approx. EUR 2.8bn, comprising a number of aid measures including additional expenditure on health, local government and sectors especially hard hit by corona exceeding EUR 600mn. In order to support SME and large businesses, direct lending via Kredex is boosted by EUR 550mn, among other things. We would follow along the lines of the Ministry of Finance, which estimates the fiscal impact to add up to about 4.4% of GDP. Already in March, Nordic Investment Bank had signed a loan agreement for EUR 750mn with the Estonian state. On top of that, the Estonian government secured a EUR 200mn financing facility loan from the Council of Europe Development Bank.

In light of falling revenues due to substantially reduced economic activity and amid the aid package and operating automatic stabilizers, we expect the headline deficit to surge to about 9.4% of GDP this year. The assumed GDP growth rebound for 2021 should result in a marked deficit reduction, assuming there is no further broad-based wave of infections that would require a nationwide lockdown. Risks seem skewed to the downside here, not least in the face of the rising number of confirmed infections recently.

The leaping headline deficit in combination with a strongly falling GDP will at least temporarily cause Estonia's very low debt level to rise substantially. Posting at a very low 10-year-average of 8.8% of GDP in 2009-18, its general government debt-to-GDP ratio stayed put at 8.4% last year, representing the lowest debt ratio by far in the EU and one of the lowest readings worldwide. We estimate that the government debt ratio will rise to some 21% of GDP this year, followed by a modest increase in 2021. Uncertainties around these estimates, to which materialization of public guarantees contribute, remain high.

Notwithstanding the material increase in the debt ratio, we consider that risks to fiscal sustainability are broadly contained, given the still comparatively low debt level, the sovereign's track record of prudent fiscal policies, and ongoing high debt affordability. The latter should also remain supported by the ECB's ongoing accommodative monetary policy. Total interest payments in 2019 amounted to only EUR 10.2mn or 0.1% of total revenue. Moreover, EP announced that it would allocate three quarters of its 2019 profits, equivalent to EUR 18.9mn, and the maximum amount possible to support the state budget in the wake of the corona crisis. What is more, as of Q1-20 Estonia is still one of only two countries in the EU to boast a positive net debt position.

We note that Estonia returned to the capital market for the first time since 2002 on 5 June, issuing a 10-year Eurobond over EUR 1.5bn to cover negative cash flow caused by the corona crisis, thus more than the initially envisaged EUR 1bn as orders had amounted to EUR 7.7bn, at a coupon of 0.125% and a yield to maturity of 0.235%. The finance ministry envisages the issuance of one or two further benchmark bonds in 2020-2021. The average term-to-maturity of the debt portfolio of just over 4 years at the end of 2019 is thus set to rise to at least 7 years, according to Ministry of Finance estimates.

We view contingent liability risks entailed by the medium-sized banking sector (134.1% of GDP in Q4-19) as rather muted, although Estonia's banking sector remains vulnerable to economic woes in the Nordic and Baltic states. Judging by relevant metrics regarding asset quality and capitalization, the sector was in a very strong position when the corona pandemic struck, suggesting that banks command over significant buffers should rising numbers of insolvencies lead to difficulties in servicing loans, or to loan defaults more generally. The ratio of non-performing loans (NPL) decreased further to 1.5% in Q1-20 (Q1-19: 2.0%), thus remaining significantly below the EU average of 3.0%. At 26.9% in Q1-20, the CET1 ratio is the largest in the EU and almost twice as high as the EU average (14.6%). Profitability may be deemed comparatively high, as mirrored by banks' return on assets at 1.1% (EU: 0.1%), and a low cost-to-income ratio (46.1%, EU: 71.7%) in Q1-20, adding to the impression of a healthy banking sector.

Recent money laundering scandals have again emphasized some reputational risks for Estonia's banking sector, bearing in mind allegations against the Danske Bank Estonia Branch which has been in liquidation since Oct-19 after the Estonian Financial Supervision Authority (FSA) issued a precept prohibiting Danske Bank from operating in Estonia in Feb-19. In March this year, cooperating Estonian and Swedish financial supervision authorities came to the conclusion that Swedbank AB had serious shortcomings in the management of money laundering risks in its operations in the Baltic States. The Estonian FSA had conducted a parallel investigation into Swedbank AB's Estonian subsidiary, Swedbank AS, with similar conclusions. We gather that the Estonian Prosecutor's Office has taken over this case, investigating whether money laundering or other criminal acts have taken place at the bank. Moreover, in June 2020, FSA imposed a fine on AS SEB Pank for violating anti-money laundering and anti-terrorist financing regulations. As a response to such incidents, Estonia will be reassessed by Moneyval in the fall of 2021. Thus, there is a potential risk that Estonia could be included in the list of countries under enhanced supervision in the prevention of money laundering, which would cause reputational harm. We would monitor further developments here, although we have to mention that we have not observed a significant impact on economic and fiscal performance or negative repercussions on banking sector soundness so far.

At the same time, we are aware that policy-makers are adept at taking measures to work towards preventing such cases. In June this year, the Estonian parliament approved the amendments to the Money Laundering and Terrorist Financing Prevention Act, which, among other things, gives whistleblowers a higher protection rating and creates a legal basis for establishing a database of bank accounts based on the electronic arrest system, which should facilitate detection of money laundering processes. Passing this law is seen as the last step to fully transpose the latest EU directive (AMLD V) on this issue, and it is also thought to rectify deficiencies pointed out by the European Commission regarding the transposition of AMLD IV, on which Estonia had been issued with a formal notice to undertake amendments.

Foreign Exposure

We assess risks related to Estonia's external position as limited given that no significant imbalances prevail. Rather, a continued and upward-trending current account surplus since the year 2013 seems to point to a further moderation of external risks.

Last year, Estonia's current account surplus amounted to 2.8% of GDP (2018: 2.0% of GDP), surpassed only by Slovenia among our AA-rated sovereigns. Main drivers behind the increase were a narrowing deficit in goods trade (-3.0% of GDP, 2018: -3.8% of GDP) as well as the primary income balance. Available data relating to Q1-20 (four-quarter moving sum) show that the surplus in Estonia's current account climbed further to 3.2% of GDP, boosted mainly by a more positive balance in services trade.

While difficult to gauge at this juncture, we deem it possible that the current account surplus could prove stable in 2020 as compared to the preceding year. The Estonian surplus may even continue to rise somewhat, as exports may be less strongly affected than imports by the corona crisis, considering that exports of IT-related services, as well as business services, may help to slow down the expected decline in overall exports, and as falling energy prices should compensate for the shortfall in tourism-related services exports.

The sustained current account surplus has also supported further diminishing of Estonia's position as an international net borrower. From -69.4% of GDP in 2010, the negative net international investment position (NIIP) has shrunk to -20.9% of GDP in 2019 (2018: -27.7% of GDP), suggesting receding vulnerabilities as regards foreign exposure. We continue to see remaining risks as further mitigated by the composition of the NIIP; measured against GDP; net foreign direct investment amounted to -56.7% of GDP last year, a broadly stable ratio compared to 2018.

Rating Outlook and Sensitivity

Our rating outlook for Estonia's long-term credit ratings is stable, as we see risks related to significantly weaker economic and fiscal prospects prompted by the corona crisis as broadly balanced by the abovementioned factors concerning fiscal risks in the short to medium term, and supported by our assumption of a deep but short recession. We note, however, that the assessment and interpretation of economic developments is subject to a substantially higher degree of uncertainty than usual, given the still considerable uncertainty in the economy and financial markets, and the constantly evolving news flow surrounding Covid-19 and its impact.

We could downgrade Estonia's credit ratings or the outlook if we observe that the economic recovery is facing delays, e.g. in the event of a second broad-based Covid-19 infection wave, resulting in weaker-than-expected medium-term growth, in turn translating into a more protracted setback in income convergence. Downward pressure on the rating or outlook could also arise if the erosion of cost competitiveness becomes more entrenched, possibly as wage growth remains detached from productivity gains, resulting in falling export market shares. We might also consider a negative rating action if tensions between the EU and the Russian Federation escalate.

Although relatively unlikely at this stage, we could raise Estonia's ratings or outlook if income convergence towards Western European levels resumes earlier than expected, which could be the case if the Covid-19-related setback turns out to be less severe than expected and economic recovery is stronger than assumed in our baseline scenario. Upward pressure could also be triggered if productivity is further enhanced and moves more in line with wages, thereby bolstering the economy's export market share.

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Ratings*

Long-term sovereign rating	AA- /stable
Foreign currency senior unsecured long-term debt	AA- /stable
Local currency senior unsecured long-term debt	AA- /stable

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	3.0	1.8	2.6	5.7	4.8	4.3	-8.5
GDP per capita (PPP, USD)	27,752	28,557	29,603	31,856	34,157	35,853	n.a.
HICP inflation rate, y-o-y change	0.5	0.1	0.8	3.7	3.4	2.3	0.2
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	77.4	78.0	78.0	78.4	78.5	n.a.	n.a.
Fiscal balance/GDP	0.7	0.1	-0.5	-0.8	-0.6	-0.3	-9.4
Current account balance/GDP	0.7	1.8	1.7	2.7	2.0	2.8	n.a.
External debt/GDP	94.3	92.2	88.5	83.1	76.4	73.8	n.a.

Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In what follows, we explain how and to which degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	**Business Environment**	Data Transparency

Environment	**Social**	**Governance**	**Highly significant**	**Significant**	**Less significant**	**Hardly significant**

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	23.12.2016	AA- /stable
Monitoring	27.10.2017	AA- /stable
Monitoring	31.08.2018	AA- /stable
Monitoring	30.08.2019	AA- /stable
Monitoring	21.08.2020	AA- /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Ministry of Finance (MoF) participated in the credit rating process as MoF commented on a draft version of the rating report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of MoF during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, European Stability Mechanism (ESM), World Economic Forum, European Investment Bank, Blavatnik School of Government, Estonian Ministry of Finance, Eesti Pank, Statistics Estonia, Estonian Fiscal Council (Eelarvenoukogu).

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

Disclaimer

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When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

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