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### Research Update:

# Sovereign Ratings On Estonia Raised To 'AA-/A-1+' On Strong Growth And Improved External Position; Outlook Stable

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## Research Update:

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## Overview

- We believe Estonia will be able to sustain strong economic growth while maintaining a close-to-balanced government budget and an improved external position over the medium term.
- We are therefore raising the long-term sovereign credit rating on Estonia to 'AA-' from 'A'.
- The upgrade reflects our view on Estonia's track record of predictable, fiscally-prudent, and growth-supportive policymaking.

## Rating Action

On Aug. 9, 2011, Standard & Poor's Ratings Services raised the long-term sovereign credit rating on the Republic of Estonia to 'AA-' from 'A'. At the same time, we raised the 'A-1' short-term ratings to 'A-1+'. The outlook is stable.

The transfer and convertibility assessment is 'AAA', the same as is applied to all European Monetary Union (EMU) members, given our view of the extremely low likelihood that the European Central Bank would constrain access to foreign exchange needed for debt service.

## Rationale

The upgrade reflects what we view as Estonia's consensus-driven policy framework, economic flexibility, transparent and productive public sector, sound fiscal management, and strong economic growth prospects. We expect policy to remain predictable, prudent, and supportive of growth over the ratings horizon.

Estonia's commitment to conservative public financial management in the context of a rigid monetary framework was demonstrated, we believe, between 2008 and 2010. Despite a cumulative contraction in real GDP of nearly 20% during the two years ending 2009, in tandem with sharply declining nominal wages and rising unemployment, Estonia's fiscal deficit did not exceed 3% of GDP between 2008 and 2010 as the government quickly implemented measures (such as civil service wage cuts and VAT hikes) to consolidate public finances. We expect Estonia's new coalition government (elected March 2011) will implement the previous administration's 2011 budget, with net general government debt remaining below 2% of GDP, among the lowest in the European Union.

For 2011 as a whole, net exports are likely to contribute between one and two percentage points to overall GDP growth. We expect the greatest GDP growth driver over the next few years will be investment, associated with sizeable inflows of European Structural and Cohesion Funds coming primarily via the capital account, alongside a recovery in private consumption. A severe slowdown in Estonia's trading partners, in particular Finland and Sweden, would likely present the most material risk to Estonia's medium-term growth prospects.

We anticipate Estonia's external finances will strengthen on the back of three consecutive years of current account surpluses (2009-2011). By end-2011, we estimate narrow net external debt at just over 60% of current account receipts, down from 84% two years ago. The expected reduction in the external debt burden is partly related to the current account surpluses and partly to the lowering of central bank reserve requirements to EMU levels, which has allowed foreign banks to repatriate some of their funding. It also reflects--in the denominator--an improvement in Estonia's capacity to generate foreign currency receipts. By the end of 2011, we expect Estonian current account receipts to hit an all-time high of just under €23 billion, or 145% of GDP, as a result of two consecutive years of above 20% volume export growth.

Our view is that the direct risk posed by the financial sector's contingent liabilities is mitigated by the dominance of supportive Nordic parent banks. These banks injected capital into their subsidiaries of over 5% of GDP between 2008 and 2010.

Although we expect Estonia's GDP per capita to rise to \$20,000 by 2014, this would still be below the 'A' median of \$24,500. We therefore view Estonia's wealth levels as a rating weakness. Similarly, despite the improvement in Estonia's external position, net external liabilities remain relatively large, acting as a further ratings constraint.

## Outlook

The stable outlook reflects our view of the balance of risks to the government's creditworthiness at the 'AA-' level. Should Estonia continue to post sustained growth without generating internal, primarily fiscal, or external imbalances, we could consider raising the rating over the next several years. On the other hand, we could lower the rating in the case of a return to excess reliance on external debt inflows or an unexpected widening of the fiscal gap.

## Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

## Ratings List

### Ratings Affirmed

Estonia (Republic of)

Sovereign Credit Rating	AA-/Stable/A-1+	A/Positive/A-1
Transfer & Convertibility Assessment	AAA	

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