RATING AGENCIES' ASSESSMENTS OF ESTONIA AND OTHER ACCEDING STATES

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Sovereign rating is an assessment by a rating agency of a government's capacity and willingness to meet its debt obligations. Sovereign rating should not be confused with other international comparisons measuring a country's competitive position or economic development. **As a rule, sovereign rating is the ceiling for corporate ratings and determines the cost of their borrowing.** Rating agencies evaluate separately the ability of the state to meet its obligations in foreign exchange and national currency[1]. Local currency rating is often higher than foreign currency rating as one can presume that it will be easier for a country to meet its local currency liabilities by raising taxes or printing more money. However, in the international context it is the foreign currency rating that is considered more important and is usually referred to when talking about sovereign ratings.

In assessing a country, rating agencies take into consideration both the evaluation of quantitative economic variables and qualitative assessment of the creditworthiness of the country. Among economic indicators economic growth, income per capita, fiscal balance, government and private sector debt burden, current account deficit, the ratio of import to external reserves, various financial sector stability variables, etc are significant. Qualitative assessment involves evaluation of overall and economic policy stability, relations with neighbouring states and trade partners, etc.

Qualitatively, in the case of Estonia, the rating agencies have always closely followed the progress in EU accession and related institutional, legal and economic policy developments. The accession perspective has upgraded our rating faster than most traditionally comparable economic variables would have allowed[2].

The following is an overview of recent changes in the methodology of the rating agencies regarding acceding countries and an analysis of potential implications of EU accession and joining of EMU to the rating of the acceding countries.

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[1] Both foreign currency and local currency have short- and long-term ratings. For example, in the longer term, the country and its economy can often be threatened by various external shocks, although in the short term it has serviced debts in a timely manner and achieved sufficient credibility.
[2] In the series of Working Papers of Eesti Pank, a longer analysis of determinants influencing Estonia's sovereign rating, has been published in English. See Andres Vesilind, Ingrid Toming and Raoul Lättemäe, Determinants of Estonian Sovereign Credit Rating. Working Papers of Eesti Pank, No 3, 2001, Tallinn, (http://www.bankofestonia.info)

Estonia's Sovereign Rating

Since 1997 Estonia has regularly been rated by three recognised international agencies – FitchRatings, Standard & Poor's and Moody's Investors Service. **In 2002, all three rating agencies assigned Estonia a rating in a comparable rating class. While in 2001, two rating agencies (Standard & Poor's and Fitch) had upgraded Estonia to the so-called category A of high credit quality, in November 2002 the third agency – Moody's – followed** (see Table 1). However, currently Estonia is on the lower levels of the category A, which indicates Estonia's ability to generally meet its obligations whereas in case of major economic shocks payment difficulties may arise. Among the euro area countries, Greece has a rating in the same category as Estonia; Portugal has a rating in the next AA class. Among the acceding states, Cyprus, Malta and Slovenia have ratings higher than Estonia. The higher ratings of A category (AA and AAA) indicate a high or very high credit quality. Most of the EU Member States are rated AAA.

Table 1. Credit rating assigned to Estonia by rating agencies

	Moody's		Standard & Poor's		FitchRatings	
	Foreign currency rating	Kroon rating	Foreign currency rating	Kroon rating	Foreign currency rating	Kroon rating
11.09.1997	Baa1	A1			BBB	A
10.12.1997			BBB+	A-		
28.09.2000					BBB+	A
30.08.2001					A-	A+
20.11.2001			A-	A-		
12.11.2002	A1	A1				

Sources: www.moodys.com, www.standardandpoors.com, www.fitchratings.com

In 2002, all rating agencies underlined low government debt and a strong banking system as strengths of Estonia. Estonia's conservative fiscal policy, which is very important in case of a currency-board-based monetary system, has always been considered a very important factor in assessing the country's creditworthiness. Successful structural reforms are another advantage why the rating agencies have singled Estonia out from among accession states. Confidence in Estonia's upcoming accession to the EU is gradually increasing whereas importance of Russia as a potential economic threat is decreasing.

The rating agencies consider the external vulnerability of Estonia as a small open economy problematic. The agencies become especially alert vis-à-vis external balance when the share of FDI in financing current account deficit shrinks and the share of debt-creating borrowing expands. This negative trend has been underlined also in the assessments of the year 2002. Rating agencies mention that a significant test for Estonia is strengthening of the administrative capacity upon accession to the European Union and the capacity to cover accession costs from the national budget.

Changes in the Rating Methodology Regarding Acceding Countries

In December 2002, the Copenhagen European Council announced the enlargement and ten candidate countries received an invitation – Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Two of the EU candidate countries – Bulgaria and Romania – were excluded from the first enlargement round. However, they could get an invitation as early as in 2006. Also Croatia and Turkey are interested in the accession to the European Union and, therefore, they are included in the below table of rating comparison (see Table 2).

Table 2. Long-term foreign currency and domestic currency ratings of EU candidate countries as of 31 March 2003

	Moody's		Standard & Poor's		FitchRatings	
	Foreign currency	Local currency	Foreign currency	Local currency	Foreign currency	Local currency
Cyprus	A2	A2	A	AA-	A+	AA
Czech Republic	A1	A1	A-	A+	BBB+	A
Estonia	A1	A1	A-	A-	A-	A+
Hungary	A1	A1	A-	A	A-	A+
Latvia	A2	A2	BBB+	A-	BBB	A
Lithuania	Baa1	Baa1	BBB	A-	BBB	A-
Malta	A3	A3	A	AA-	A	AA-
Poland	A2	A2	BBB+	A	BBB+	A+
Slovakia	A3	A3	BBB	A-	BBB	A-
Slovenia	Aa3	Aa3	A+	AA	A	AA
Bulgaria	B1	B1	BB	BB+	BB	BB+
Croatia	Baa3	Baa1	BBB-	BBB+	BBB-	BBB+
Romania	B1	B1	BB-	BB	BB-	BB
Turkey	B1	B3	B-	B-	B-	B-

Sources: www.moodys.com, www.standardandpoors.com, www.fitchratings.com

The success of twelve acceding countries preparing for the EU accession has made the rating agencies to change their attitude towards these states. It is particularly significant for the agencies that all acceding countries will eventually have to join EMU and adopt the single currency euro. **Considering that all major trade partners of the accession countries are either EU Member States or accession countries, the external vulnerability of the accession countries with large current account deficits will decrease upon the introduction of the euro.** The rating agencies consider fiscal policy (except the Baltic States) and government agencies' capacity of the accession states to meet EU membership commitments problematic.

Standard & Poor's was the first rating agency to assign an equal rating to Estonia's kroon and foreign currency liabilities in November 2001 (previously, Estonia's foreign currency liabilities rating was a notch lower). **Estonia was the first state, which was assigned the rating in compliance with S&P's new methodology[3] that candidate countries' foreign currency ratings would gradually converge with the local currency ratings.** According to the agency, this will be their policy towards all states that will be potential euro area members in the medium term. General convergence of ratings will begin once the timetable for EMU will be clear.

In November 2002, Moody's announced upgrading of long-term foreign currency ratings of eight EU accession countries to long-term local currency ratings[4]. This was a change in the rating policy, which similar to Standard & Poor's takes into consideration potential EMU membership of the accession states. Moody's upgrading was significant as ratings of all accession countries were upgraded simultaneously and in some cases, eg Estonia, sovereign foreign currency rating was upgraded by three notches. Besides, Moody's stressed that the economic and financial integration of the accession countries with the EU was irreversible and the likelihood of a foreign currency crisis has shrunk.

FitchRatings continues a country-by-country approach and will take rating decisions also step-by-step. Currently Fitch has rated accession countries' local currency liabilities higher than foreign currency liabilities. Similar to other agencies, also Fitch considers euro area membership a premise of a significant change in the rating. Upon joining the euro area, sovereign rating will focus more on fiscal policy aspects. The general strong foreign position of the euro area and the access to the internal market savings will make financing of the current account deficit as a vulnerability measure less significant[5].

Potential Impact of EU Referendums on Accession Countries

After the EU accession referendum in Malta[6], Standard & Poor's issued a press release, confirming Malta's long- and short-term foreign currency liabilities ratings at A/A-1[7]. Standard & Poor's will issue press releases also after other accession referendums. Although a yes-vote at the referendum will not upgrade the rating, a no-vote could slow down the reform process and could lead to a downward rating in the longer term. Currently the ratings assigned to the accession countries already reflect their rapid accession to the European Union.

[3] Standard & Poor's, A Ratings Roadmap for EU Candidate Countries, 19 November 2002.
[4] Moody's Investors Service, Moody's Upgrades Foreign Currency Ratings of Eight EU Accession Countries, 12 November 2002. Ratings of Malta and Cyprus remained unchanged as their local currency and foreign currency ratings had already converged.
[5] FitchRatings, Special Report 'EU Enlargement – Its Impact on the Accession Countries' – amended, 26 September 2002. See http://www.fitchratings.com
[6] In Malta the EU accession referendum took place on 8 March 2003 and it was the first accession referendum held in the accession countries. Also in Slovenia the referendum was held in March. The referendum in Estonia will be on 14 September 2003.
[7] Standard & Poor's, Prospects for Accession Country Sovereign Ratings, 18 March 2003. See http://www.ratingsdirect.com

Impact of Changed Rating Methodology on Company Ratings

While previously sovereign foreign currency liabilities rating was automatically the ceiling of corporate ratings[8], abolition of capital controls and integration of international financial markets has made agencies to change their rating methodology. **Now strong international corporations and companies with sound investor base can be assigned also a rating above that of their country of residence.** Thus, sovereign rating does not theoretically limit ratings assigned to the entities of the accession countries, although in fact there are really very few financial institutions and other undertakings in Central and Eastern Europe with a rating above the sovereign rating.

In Estonia only major banks (Hansapank, Eesti Ühispank and Sampo Pank) and Estonian Energy have commissioned a credit rating. Until November 2002 Moody's rating to Hansapank was higher than to foreign liabilities of Estonia – Hansapank's credit rating was equal to Estonian kroon liabilities

Slower growth rates of the world economy since 2001 have made downgrading of entities in large states quite common. This is well evident in telecommunication (mainly in Europe) and insurance sectors (the USA, also UK and Switzerland). Corporate governance scandals in major US companies (primarily Enron) have slashed share prices in the energy sector (primarily in energy selling entities) elsewhere as well. Company ratings in emerging markets have declined also, although this does not apply equally to all the states. While government debt and financial crises in Argentina, Turkey, Brazil and Uruguay have had a negative impact on the ratings of their entities (especially of financial institutions), entities in the accession countries have rather been improving their ratings. Primarily due to the revision of its rating policy by Moody's, also ratings assigned to entities in Central and Eastern Europe improved in 2002. Although mainly financial institutions gained from upgraded sovereign rating, several of the region's real sector entities have got a higher rating as well.

Will EU and EMU Membership Secure Higher Ratings?

As mentioned above, the rating agencies have already taken into consideration Estonia's upcoming accession in assigning the current ratings. It is assumed that the accession will commit Estonia to economic and institutional integration and maintenance of political values in compliance with common EU principles. The upcoming membership has definitely set off risks arising from the small size and vulnerability of Estonian economy. Should accession to the European Union and EMU unexpectedly be delayed, variables like large current account deficit could be assigned a different category risk assessment in case of Estonia.

[8] However, until now the rating of most entities has been below or corresponded to sovereign external liabilities rating because in deteriorating economy or in case of a financial crisis the state can impose capital controls.

Nevertheless, the EU membership will not automatically secure enhanced creditworthiness. A significant leap forward could occur when Estonia joins EMU and introduces the euro and thus the foreign currency risk would be eliminated. However, it is difficult to draw far-reaching conclusions. Some rating agencies, eg Moody's, assign the highest rating – Aaa – to all EMU member states. However, the case of Greece proves that this is not an exclusive attitude. Besides, some agencies have warned that if the EU Member States will not tackle fiscal issues arising from aging population, even the most creditworthy ratings could be revised. However, accession to the euro area should be a strong impetus to upgrade sovereign ratings of Estonia and other Baltic States. In Estonia, Latvia and Lithuania the fiscal position is relatively strong and the level of government debt low. External balance remains a major problem, however, this variable would play a decreasing role in the rating assessment once in the EMU.