Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF FINLAND	Assigned Ratings/Outlook: **AA+ /stable**	Type: Monitoring, unsolicited
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:	28-09-2016 26-07-2019 “Sovereign Ratings” “Rating Criteria and Definitions”

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Rating Action

Neuss, 26 July 2019

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

Key Rating Drivers

1. High level of prosperity; economic growth likely to moderate gradually, with easing domestic demand and not much impetus from net external trade; medium-term growth prospects have brightened, but preserving cost competitiveness and coping with rapidly ageing population remain key challenges
2. Long-standing track record of sound policy-making, one of the strongest institutional frameworks worldwide, and EU/EMU membership; although responsiveness to structural challenges should remain high and broad policy continuity given, governing has not become easier in view of increasing political fragmentation
3. Downward-sloping debt trend, favorable affordability metrics, as well as strong net asset position and a large stock of liquid assets, balanced by sustainability risks entailed by high public guarantees and an ageing population
4. Public debt ratio should continue to fall, albeit at a slowing pace; expectation of sound fiscal policies, but incoming government’s fiscal policy stance should become somewhat more expansionary
5. Limited risks on the external front – current account should post moderate deficits going forward, while balanced NIIP masks sectoral vulnerabilities entailed by large external MFI liabilities

Reasons for the Rating Decision

The Republic of Finland’s very high creditworthiness mainly reflects the outstandingly high quality of its institutional conditions, the favorable credit profile regarding macroeconomic performance and fiscal sustainability, as well as broadly contained external risks.

Macroeconomic Performance

Our assessment continues to reflect the economy's strong macroeconomic performance profile, backed by high per capita incomes, moderate but stable economic growth, as well as a very favorable business environment buttressing the sovereign's economic resilience and flexibility, somewhat balanced by the need to sustain its cost competitiveness.

Similar to other Scandinavian countries, the Finnish population has a high level of wealth, alongside very low income inequality as compared to most European countries. Latest IMF estimates document the prosperity of the Finnish economy, with GDP per capita totaling USD 46,430 in 2018 (PPP terms). Hence, Finnish per capita income levels posted slightly above the median of AA-rated countries (USD 46,102), but remained somewhat lower than in Austria (USD 52,137) or Belgium (USD 48,245). Moreover, Finland features a system of taxes and social benefits which appears to be relatively effective in terms of wealth redistribution. As indicated by a Gini coefficient of equivalized disposable income of 48.8, income inequality in Finland was broadly on par with the euro area average (50.8) in 2017. After taking into account social transfers, however, Finland's Gini coefficient drops to 25.3, corresponding to the third lowest reading in the euro area. More generally, Finish citizens continue to enjoy very high living standards. According to the most recent edition of the United Nations Human Development Index (HDI), Finland was ranked 15th out of 188 countries, with only three euro area members receiving higher scores. The country's decent performance on the UN's HDI reflects a long life expectancy, a well-educated workforce, and high levels of prosperity.

Regarding its growth performance, we note that Finland's track record of economic growth gives a rather mixed picture. Due to losses in cost competitiveness, trade sanctions against Russia, and the decline of key industries (electronics and wood), real GDP growth averaged at 0.1% in 2011-15 before a strong recovery with growth rates of 2.8 and 3.0% was observed in 2016/17. Even though the Finnish economy was not able to sustain this momentum in 2018, the recovery has gone into its fourth consecutive year, with real GDP increasing by a still solid 1.7% (EA-19: 1.9%).

Slower growth came on the back of notably weaker net exports in 2018. In contrast to 2017, when net exports had boosted GDP growth by 1.4 p.p., the growth contribution of net external trade turned negative last year (-1.3 p.p.), as robust import dynamics coincided with a sharply decelerating external demand. The weaker macroeconomic backdrop in the global economy, intensifying trade tensions, and negative base effects took a toll on Finnish exports last year. After hitting a ten-year high at 7.6% in 2017, partly mirroring new production facilities put into operation in the automotive and forestry industries, export growth fell off sharply and expanded by a lackluster 1.1% in 2018. As indicated by Tulli data, growth in export of goods (in nominal terms) softened across all major industries and main trading partners as compared to 2017. While exports to Russia contracted by 2.6% (2017: +14.8%), external demand from Finland's Nordic neighbors (+8.0%), Germany (+13.8%) and the Netherlands (+4.3%) decelerated considerably.

Private consumption took over from net exports as the main growth driver, contributing 1.1 p.p. to economic expansion. Following a relatively weak 2017, when consumer spending

expanded by 1.2%, private consumption gathered some steam, edging up by 2.0%. Above all, consumer spending benefited from further improving labor market metrics. Both employment and real wages exhibited positive growth last year. A slight increase in HICP inflation from 0.8 (2017) to 1.2% (2018), mainly due to higher food prices and some tax hikes, was more than offset by rising nominal wages. After having stalled in 2017 (+0.2%), wage growth picked up to 1.7% last year. As a result, real wage growth turned positive again, posting a moderate increase of 0.6% in 2018 (2017: -0.5%).

Gross fixed capital formation added another 0.7 p.p. to growth. Overall, investment activity was less vigorous than in 2016/17 (+8.6%; 5.2%), but still robust, as indicated by an annual growth rate of 3.1%. Both machinery and equipment and construction investment were unable to retain their 2017 growth rates. While spending on machinery and equipment and weapon systems dropped from 6.1 to 1.6% y-o-y, construction investment decelerated moderately from 5.8 to 4.2%. Construction activities thus continued to be supported by strong dwellings investment, which rose by 5.4% (2017: +6.5%), as the number of completed dwellings leapt to a record-high 42,562 units (2017: 35,696; 2016: 30,236). As a result, spending on residential construction climbed from 6.4 to 6.8% of GDP, the second highest level in the EU-28. The multi-year decline in intellectual property investment appears to have come to a halt. After a 20.3 p.p. drop between 2010 and 2017, growth resumed and spending on intellectual assets expanded by 2.2% in 2018.

We anticipate a gradual moderation in economic growth to 1.5 and 1.3% in 2019 and 2020 respectively, as domestic demand should pull back somewhat over the coming two years. Reflecting slowing import demand and a moderate recovery in exports due to one-offs related to the sale of cruise ships and strengthening growth in key trading partners, external trade should no longer weigh on economic expansion, but it seems unlikely that it will provide a significant impetus to economic growth.

To be sure, we expect that economic activity will pick up somewhat over the coming quarters. After economic activity had slowed down significantly from 1.8% y-o-y in Q3-18 to 0.8% in the fourth quarter of 2018 (Q4-17: 3.4%), growth remained muted at the beginning of the year. According to latest national accounts data, real output expanded by 0.9% on the year in the first quarter, mainly due to disappointing consumer spending, which contracted by 0.4% y-o-y in Q1-19.

At the current juncture, we believe that private consumption will emerge from its soft patch during the remainder of the year. On an annual basis, we anticipate household spending to grow at a similar pace as seen in 2018, fostered by rising household income and moderate HICP inflation. Apart from enduring job creation, accelerating wage growth in the private sector should be conducive to households' purchasing power. Drawing on Ministry of Finance estimates, negotiated wages may increase in the order of 2% this year, up from 1.2% in 2017, mirroring tightening labor market conditions (see below).

On the other hand, the near-term outlook for investment has become more challenging. Most importantly, early indicators suggest subsiding tailwinds from construction investment in 2019. Following brisk residential construction over the last three years, the residential property market is showing signs of saturation. Building permits for dwellings,

which had been on the rise since 2014, were down by 11.9% y-o-y in 2018, pointing to lower construction activity this year. In addition, we expect firms to be rather cautious on machinery and equipment investment in view of persisting external uncertainties and easing capacity pressures. Capacity utilization in the manufacturing sector has steadily declined since Q3-18 (84.7%) and posted at 80.8% in Q2-19, somewhat below its long-term average (1993-2018: 82.3%). Improving profitability in Finland's non-financial corporate sector and favorable financing conditions should still provide some support to investment. While the profit rate of Finnish NFCs continued to improve throughout 2018 and reached its highest level since Q3-08 (34.5%) at the beginning of 2019 (31.7%), the average annualized agreed rate on new NFC loans posted at a moderate 2.0% in April 2019. We expect the current low interest environment to remain in place over our forecast horizon. Mirroring mounting external uncertainties and a more cautious economic outlook, the ECB decided to put monetary policy normalization on hold, and keep the refinancing rate at its present level at least through the first half of 2020.

Medium-term growth prospects have brightened notably in recent years. According to EU commission estimates, Finland's potential growth increased from 0.4% to 1.4% in 2015-18. At this level, it is aligned with both the euro area average and the median of AA-rated sovereigns. Hence, reforms enacted to increase labor market participation and to regain cost competitiveness seem to be paying off. Measures to decentralize wage bargaining and the implementation of the 2016 Competitiveness Pact, which included e.g. an extension of annual working hours and a wage freeze, helped to contain labor costs. Partly driven by a 2.6% drop in real compensation, Finland's real ULC edged down by 6.6% between 2013 and 2018. This compares favorably to ULC dynamics in the country's main trading partners over the same period. In Sweden and the Netherlands real ULCs fell by a moderate 2.3% and 2.8% respectively, while Germany recorded an increase of 0.8% in 2013-18. Looking ahead, however, the trajectory of unit labor costs warrants close monitoring in view of the anticipated acceleration in wage growth. Preserving cost competitiveness appears particularly important, given that the composition of Finnish exports has increasingly shifted away from high-tech towards more price-sensitive medium-tech goods over the recent years. As indicated by Eurostat data, the share of high-tech goods in Finland's total exports has more than halved over the last decade, declining from 13.9 to 6.1%.

Notwithstanding the implementation of growth-friendly structural reforms, the economy's medium-term growth potential remains restrained by a further decline in the working-age population and weak productivity growth. Despite the fact that total factor productivity has been recovering since 2014, it remains 4.3% below its pre-crisis level in 2007 (EA-19: +1.9%). Lackluster productivity dynamics are particularly challenging against the background of a shrinking workforce. Demographic change certainly is a common challenge to industrialized economies, but Finland's working-age population (15-64y) is the second lowest in the EU-28, having already decreased from 66.5% of total population in 2009 to 62.4% in 2018. According to the EU's 2018 Ageing Report, unfavorable demographic trends are here to stay as the population share of people at working-age is projected to fall by another 3.1 p.p. to 59.3% by 2030.

Meanwhile, Finland's labor market should continue to tighten, as indicated by a rising number of job vacancies. In this year's first quarter the vacancy rate stood at 2.4%, up from 2.1% in Q1-18. Given the still high demand for labor, we assume continuing job growth, albeit at a somewhat slower pace than seen in the previous year. In 2018, employment growth spiked to 2.7%, following growth rates of 1.2 and 0.6% in 2016 and 2017. Monthly LFS data signals slackening employment growth, with annual growth rates having gradually diminished from 3.1% in June 2018 via 2.1% last December to 1.3% in May.

Unemployment declined further, decreasing from 8.6 to 7.4% in 2017-18, and was accompanied by rising participation rates. In this context, the 2017 pension reform appears to have achieved its purpose, namely strengthening working incentives for the elderly. While the participation rate of elderly workers (55-64y) climbed from 67.8 to 70.3%, the overall participation rate experienced more muted growth, edging up from 77.7 (2017) to 77.9% in 2018. Accordingly, Finland is still trailing its Nordic peers Sweden and Denmark, as well as top-performing labor markets in Germany and the Netherlands.

Institutional Structure

In our view, one of the world-strongest institutional frameworks and the long-standing track record of prudent, efficient, and transparent policy-making remain a key support to Finland's credit ratings. The sovereign's institutional conditions are further backed by the European Central Bank's monetary policy. HICP inflation and MFI interest rates in Finland are broadly aligned with the euro area averages. In general, we think that the Finnish economy continues to draw extensive benefits from its membership in the European Union and the euro area, which involves free movement of labor and capital, as well as broader and deeper capital markets and advantages related to the euro as a reserve currency.

The extraordinarily and consistently high quality of the sovereign's institutional conditions is essentially reflected by our preferred measure of good governance, the World Bank's Worldwide Governance Indicators (WGIs). All WGIs we consider show that Finland not only achieves scores that lie well above the respective euro area and the AA median, but also performs above the AAA median. The sovereign is thus attested to be highly effective in formulating and implementing policies, being placed at rank 5 out of 209 economies worldwide, and recouped the top spot on the WGI rule of law, being the sovereign with the highest quality of contract enforcement, property rights, and courts. Also, Finland is one of the countries with the lowest levels of corruption (rank 3/209 economies). It has to be pointed out that Finland is the best-performing EU-28 member on the WGIs government effectiveness, rule of law, and control of corruption. Concerning voice and accountability, measuring freedom of expression and association as well as free media, the sovereign is third behind Sweden and the Netherlands (6/204 economies worldwide).

Having said this, repeated failure to implement the regional government, health, and social services reform (SOTE) raises concerns about the sovereign's effectiveness in implementing reform measures. The SOTE reform was envisaged to come into effect in 2021, initially being foreseen for the year 2019. After the SOTE reform had been repeatedly delayed, the Finnish government unexpectedly resigned over the social and health care reform this March, just a few weeks before the parliamentary election.

We believe that reform measures on social and health care are important in a context of rising needs of a rapidly ageing population and medium- to long-term fiscal sustainability challenges. In view of the outcome of the parliamentary elections of April 2019, however, achieving parliamentary consensus and advancing far-reaching reforms has not become easier. Reflecting the Europe-wide trend, political fragmentation has thus increased further. For the first time ever, no party received more than 20% of the popular vote. The Social Democrats became the strongest party, albeit by a very thin margin, gathering a mere 17.7% of the vote, or 40 seats – just 0.2 p.p. ahead of the right-wing Finns Party, which only won one mandate less. While the National Coalition Party came closely behind (38 seats), the Center Party, which led the former government, had to accept heavy losses, losing 7.3 p.p. as compared to the last election (2019: 13.8%, 31 seats). The new government took office in June, after coalition talks had eventually resulted in a Social Democrats-led five-party center-left-wing coalition, including the Center Party and the Swedish People's Party, as well as the Greens and the Left Alliance (117/200 seats in total).

We think that responsiveness to structural challenges will be warranted, buttressed by a tradition of consensus-oriented decision-making underlying Finnish politics. In fact, coalitions with four parties and more, covering a broad political spectrum, are not unprecedented in Finland. We expect broad policy continuity to be given, as the newly formed government has expressed its commitment to sustainable public finances and improving labor market conditions. Restructuring health and social services remains among the priorities of the incoming government. In this vein, the government plans to build on the work done of the outgoing government, but design, scope, and time-scale remain unclear. Yet, the coalition agreement implies a greater focus on inclusive and sustainable growth, away from economic competitiveness and spending restraint. We note that the government intends to become carbon neutral by 2035 and step up public spending (see in more detail below).

Over the legislative term, policy-makers' stated key objective is raising Finland's employment rate to 75% by 2023. So far, not many new measures have been implemented. More recently, the Ministry of Social Affairs declared that the so-called activation model shall be abolished. The activation model entered into force at the beginning of 2018 and is targeted towards activating unemployed Fins via tighter eligibility criteria for receiving unemployment benefits, but has delivered inconclusive results as of yet. While facing stiff opposition right from the start, organizational issues at the TE offices and uncertainties related to the criteria for cutting benefits caused implementation problems.

Recent labor market measures taken by the outgoing government consist of the new Act on Early Childhood Education and Care (September 2018), including amendments to enhance quality and quantity of early childhood education and care staff. In December 2018, Finnish parliament approved a modified version of the controversial dismissal law. While the draft bill would have allowed firms with fewer than 20 employees to strip workers of protection from summary dismissals, the adopted bill does not mention any employee numbers, but calls for the number of a firm's employees to determine the relevance and number of redundancies implemented. In March 2019, parliament passed amendments on the working hours act. The law will provide for more flexible working time models and the introduction of a statutory working hours bank. Also, changes to the Unemployment

Security Act have already come into effect (April 2019), in an attempt to reduce delays in the payment of unemployment benefits and make partial employment a more attractive alternative.

What is more, authorities have established the Incomes Register information system, which contains encompassing real-time wage data at the individual level. The system was introduced in 2019 and will comprise data on pension and benefits paid as of January 2020. Whilst data is controlled by the Finnish Tax Administration, it shall also be made available to several stake-holders such as related Ministries, Statistics Finland, Kela, and the Unemployment Insurance Fund, potentially helping shape future policy measures, not only in the realm of tax administration.

Fiscal Sustainability

Fiscal risks are increasingly less of a drag on the sovereign's credit assessment, mainly reflecting favorable affordability metrics and continued fiscal consolidation efforts, resulting in a downward-sloping debt trend – somewhat balanced by sustainability risks entailed by high public guarantees and a fast-ageing population.

The government's budgetary position has steadily improved since 2015, being characterized by recurrent but decreasing deficits. On the general government level, Finland ran a headline deficit of 0.7% of GDP, slightly below the previous year's level (0.8% of GDP) and almost hitting the target envisaged in the 2018 Stability Program (0.6% of GDP).

As in 2017, the ongoing implementation of fiscal measures under the Competitiveness Pact continued to weigh on the revenue side of the budget. In accordance with the pact, social security contributions were partly shifted from employers to employees to lower labor costs and stimulate job growth. At the same time, taxation of earned income was eased as a partial compensation to employees for their increased contributions. Mirroring the implementation of these policies, current taxes on income and wealth stagnated at 2017 levels, inching up by 0.4% (PIT receipts: +1.1%, CIT: -3.1%), and employers' actual social contributions increased by a lackluster 1.3% on the year. Meanwhile, social security contributions from households', as well as VAT revenues posted healthy growth rates of 4.8 and 4.6% y-o-y respectively, reflecting strong employment growth and robust domestic demand. As a whole, general government revenues expanded by 2.6%, slightly faster than in 2017 (+2.1%).

Government outlays edged up significantly from 0.4 to 2.3% in 2017-18, but lagged revenue growth for the fourth consecutive year. Apart from further declining debt service costs (-8.2%), savings arose in particular from lower intermediate consumption and social transfers, which were not adjusted to the increase in the consumer price index. Aided by saving measures and improving labor market conditions, spending on social benefits fell from 21.9 to 21.4% of GDP last year. Furthermore, earlier measures to curb wage growth in the public sector, such as a 30% cut in holiday bonuses, remained in place in 2018. Although spending on the public wage bill, which accounts for almost a quarter of total government expenditures, increased moderately in absolute terms (+2.6%) for the first time since 2014, it remained broadly stable as measured by GDP (2018: 12.4%).

We expect the incoming government's fiscal policy stance should become somewhat more expansionary going forward, judging by the coalition agreement set out in June. The government pledged to end austerity, intending to step up public spending considerably. Yet, sound fiscal policies should remain in place. We note that Finland's new government has expressed its commitment to maintaining long-term fiscal sustainability.

The coalition parties announced to increase permanent general government expenditure by EUR 1.23bn over the government's term, equating to approx. 0.5% of 2018 GDP. Sizeable funds will be directed towards measures which aim to promote social cohesion and to reduce poverty and inequality – with the largest items being the reform of social security (EUR 300m), the reform of health and social services (270m), and the promotion of education, culture, and innovation (EUR 201.5m). An additional EUR 3.05bn (1.3% of 2018 GDP) was earmarked for non-recurrent expenditures, primarily for investment projects. These funds should help to accelerate Finland's transition towards a carbon neutral economy by 2035 and in the areas of transport and education.

The plan is to partly counter-finance the ramped-up permanent expenditure through tax hikes with a net impact of EUR 730m (mainly higher excise and environmental duties), and EUR 200m from reallocated on-budget revenue and expenditure. In addition, the one-off program of future-oriented investment is envisaged to have no impact on the sovereign's debt burden, as it is planned to be largely funded through the state's direct shareholdings (EUR 2.5bn) and other asset sales (EUR 0.5bn).

As the raft of expenditure-increasing measures has to be fleshed out in detail, it is more likely that these will become effective as of 2020 and beyond. The 2020 budget will be presented in October. Indeed, policy-makers recently agreed on raising the national and guarantee pension by EUR 31 and 50 respectively, reportedly submitting the draft for the vote by Parliament this autumn. Hence, we expect public finances to further improve this year, with the headline deficit falling to 0.5% of GDP. Primary expenditures should continue to evolve less dynamically than GDP, driven by expenditure containment pertaining to intermediate consumption, social benefits and public sector wages. Also, the budgetary outcome should benefit from somewhat lower capital spending due to the expiration of some large-scale investment projects.

Further out, we see minor but persistent headline deficits, mainly due to the proposed measures tabled in the coalition agreement, expiring Competitiveness Pact measures (e.g. cut in holiday bonuses), rising ageing costs (see below), the procurement of fighter aircraft (2021-23: EUR 1.5bn p.a.), and slower economic activity translating into somewhat lower tax receipts. Mirroring the envisaged fiscal easing, the authorities pushed back the outgoing administration's target of reaching a balanced budget by 2020 to the year 2023.

The government places much emphasis on the improvement of the employment rate, with the 75% goal playing a pivotal role in this respect. Awaiting new labor market policies, we view the 75% goal as rather ambitious in light of slowing economic and employment growth (see above). That said, we acknowledge that the government made clear that its spending plans are contingent on the health of the economy, and that it could cut back on its expenditure targets if this seems appropriate to keep public finances in check.

Coupled with solid GDP growth, the steadily improving budget balance has contributed to a significant reduction in Finland's public debt ratio in recent years, whilst still growing in nominal terms. Having almost doubled within eight years, the government's debt-to-GDP ratio peaked at 63.4% in 2015 before it entered a downward trajectory. Last year, public debt dropped from 61.3 (2017) to 59.5%. At the current level, Finland's debt-GDP-ratio compares well to the euro area as a whole (85.1% of GDP), but also to most AA-rated peers.

Although at a slowing pace, we assume that deleveraging will continue, supported by sustained economic growth, recurring primary surpluses, and favorable refinancing conditions. Given the ECB's latest forward guidance, monetary policy should remain highly accommodative over the next years. Against this backdrop, Finnish bond yields are likely to remain depressed. Down from an already low 0.52% at the beginning of 2019 (04-01-19, weekly readings), the 10y bond yield fell into negative territory at the end of June 2019. Furthermore, interest expenditure is likely to remain supportive, accounting for 1.67% of general government revenue in 2018 (2017: 1.87%), one of the lowest readings in the EU.

In the absence of a major policy shift, fiscal sustainability risks appear moderate at present. Nevertheless, it is worth pointing out two risks which could potentially result in a reversal of the debt-to-GDP ratio in the medium term.

Firstly, spending pressure from an ageing population is set to intensify over the coming decade. As we highlighted in our last review, the EU Ageing Report projects Finland to become the EU-28 member with the highest level of age-related expenditure by the year 2030. Ageing costs are gauged to climb from an already very high 29.8% of GDP in 2016 to 32.0% of GDP in 2030, largely driven by dynamically increasing spending on pensions and long-term care (2016-30: +1.4 and 0.8 p.p. respectively).

Secondly, the materialization of high and rising contingent liabilities may lead to a notable weakening of public finances. Central government guarantees have leapt from 19.1 to 24.2% of GDP over the last five years (Stability Program 2019), with the bulk of guarantees concentrated in the state-owned export credit agency Finnvera and government funds (mainly the Housing Fund of Finland). As illustrated by Eurostat data, Finland's public guarantees are higher than in any other EU-28 member, also diverting from the common observation of downward-trending guarantees in Europe. Admittedly, risks associated with contingent liabilities are somewhat mitigated by the sovereign's strong asset position. On the general government level, assets totaled at 125.2% of GDP at the end of 2018, the highest level observed in the EU-28. More importantly, we regard the sovereign's assets as relatively liquid. Alongside cash deposits and gold (7.7% of GDP), the Finnish state is holding significant equity stakes. In 2018, equity and investment fund shares accounted for 82.1% of GDP. We believe that a large proportion of these assets could be swiftly liquidated to cushion a potential contingent liability shock.

Fiscal risks stemming from the very large and highly concentrated banking sector appear limited as the moment, even though these have in fact risen somewhat since our last review. Following Nordea's decision to relocate its headquarters from Sweden to Finland in last October, Finland's banking sector has become one of the largest in the EU-28, with total banking sector assets jumping sharply from 195.7% of GDP in Q3-18 to 344.8% of GDP in

the fourth quarter of 2018. Adding to the risks related to size and concentration, it has to be mentioned that the Finnish banking sector is highly interconnected within the Nordic financial system and real estate markets, and takes a key role in financing the Finnish real economy. Moreover, Finnish banks remain exposed to elevated funding risks, as mirrored by the still very high loan-to-deposit ratio, amounting to 159.3% in Q1-19 (Q1-18: 159.4%), the third highest reading in the EU-28.

At the same time, credit growth in certain segments should be monitored, while the residential property market at the national level does not present a cause for concern as of yet. In particular, lending to housing corporations continues to increase rapidly, showing double-digit annual growth rates over the last decade (May-19: +11.3%), standing roughly 190% above the outstanding credit volume seen ten years ago. Consumer and other lending is also expanding steadily, growing in the 3-4% (y-o-y) range since August 2017. Against this background, the growing importance of non-bank lending has to be stressed. According to Bank of Finland data, peer-to-peer lending volumes totaled EUR 150.1m at the end of 2018, up by approx. 40% on the year, after a plus of 67% in 2017. Including this and other forms of lending outside the banking sector (e.g. foreign cross-border, small-loan companies), the total household consumer loan volume was just short of EUR 22bn as compared to some 16bn granted by deposit-taking institutions alone.

Increasing consumer lending has been accompanied by constantly rising household debt, which is climbing from one historical high to the next, albeit at moderate pace. In the first quarter of 2019, household debt accounted for an elevated 116.2% of disposable income, up from 114.6% a year before.

Risks are balanced by the good shape of the banking sector, which exhibits an NPL-ratio considerably below the EU-28 average (Q1-19: 1.6 vs. 3.1%), and a sufficient degree of capitalization, although the CET 1 ratio has dropped sharply from 21.1% in Q1-18 to 16.4% at the beginning of the year, mainly due to onboarding Nordea (EU-28: 14.7%). On top of this, we note that authorities are well aware of the challenges at hand. To gain deeper insight into consumers' underlying credit risks, the government envisaged establishing a positive credit register. Furthermore, FIN-FSA has ramped up staff and seized additional macroprudential measures, such as tightening the maximum LTC ratio, and introducing a bank-specific systemic risk buffer requirement.

Foreign Exposure

Although Finland's external position slightly deteriorated in 2018, we continue to see limited risks on the external front, with some vulnerabilities entailed by large external MFI liabilities.

According to revised balance of payment data, Finland displayed a stable current account deficit of 0.7% of GDP from 2015 to 2017, only half of the annual average of 1.4% of GDP seen in the years 2010-14. Last year, the current account deficit widened to 1.6% of GDP, mainly due to intensifying trade tensions, slower growth in Finland's main trading partners,

and weakening international trade more generally. Thus, its trade in goods balance narrowed from 0.7 to 0.3% of GDP in 2017-18, while the trade in services balance worsened to -1.0% of GDP after having improved from -2.7 to -0.6% of GDP in 2012-17.

We expect the current account to improve slightly, posting moderate deficits going forward. Due to sustained competitiveness gains and prospectively robust euro area growth, the trade balances are likely to improve somewhat. This year, net exports may be transitorily inflated by cruise ship exports. However, a negative secondary income and trade in services balances should sustain Finland's current account deficit. Hence, the net international investment position (NIIP) will presumably remain close to balance over the medium term. Finland's NIIP fell back into negative territory in 2018, standing at -0.4% of GDP, down from 1.4% of GDP in 2017.

It has to be highlighted that the balanced NIIP, which averaged at 5.8% of GDP over the last ten years, masks sectoral vulnerabilities to some extent. Large and positive NIIPs on the account of social security funds (Q4-18: 60.4% of GDP), the Bank of Finland (22.7% of GDP), and collective investment schemes (21.9% of GDP), compensate for the significant negative positions posted by NFCs (-36.3% of GDP) and, in particular, MFIs (-44.4% of GDP). In this vein, Nordea's relocation is worth mentioning. Whilst the effect on the economy's net position was not significant as compared to fluctuations in recent years, the underlying gross positions have moved up sharply, with the MFIs external assets and liabilities leaping from 35.8 and 99.7% of GDP in Q3-18 to 99.2 and 143.5% of GDP in the last quarter of 2018 respectively.

Rating Outlook and Sensitivity

Our Rating outlook on Finland's sovereign ratings is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the next twelve months.

Downward pressure on the ratings or the related outlook may result from significantly weaker economic growth, which could stem from weaker-than-expected growth in the euro area and/or China, further escalating trade tensions, or a disorderly Brexit. We could also consider a negative rating action if authorities fail to implement meaningful reforms, reflecting a deterioration in the government's ability to address structural challenges, if the wage development decouple from productivity growth, threatening the economy's cost competitiveness, or if the debt trend reversed, possibly in the event of significant weakening of medium-term growth or materializing contingent liability risks.

By contrast, a reinvigorated reform momentum, which may eventually lead to higher productivity growth or mitigated fiscal sustainability risks entailed by demographics, could trigger an upgrade. In the same vein, we could raise Finland's rating if we observe a faster-than-expected reduction in government debt, or a sustainable improvement in the economy's external position or cost competitiveness.

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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

	2013	2014	2015	2016	2017	2018	2019e
Real GDP growth	-0.8	-0.6	0.5	2.8	3.0	1.7	1.5
GDP per capita (PPP, USD)	40,576	40,897	41,235	42,598	44,492	46,430	48,006
HICP inflation rate, y-o-y change	2.2	1.2	-0.2	0.4	0.8	1.2	1.3
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.1	81.3	81.6	81.5	81.7	n.a.	n.a.
Fiscal balance/GDP	-2.6	-3.2	-2.8	-1.7	-0.8	-0.7	-0.5
Current account balance/GDP	-2.2	-1.8	-0.7	-0.7	-0.7	-1.6	n.a.
External debt/GDP	207.7	218.7	213.7	195.0	181.9	208.3	n.a.

Source: International Monetary Fund, Eurostat, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	AA+ /stable
Monitoring	01.09.2017	AA+ /stable
Monitoring	27.07.2018	AA+ /stable
Monitoring	26.07.2019	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.

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The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used 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, Bank of Finland, Statistics Finland, Republic of Finland – Ministry of Finance, Tulli.

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".

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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.

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