Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF FINLAND	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:	28-10-2016 15-07-2022 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 15 July 2022

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.

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Key Rating Drivers

1. After the Finnish economy showed robust growth in 2021, coming on the heels of a moderate pandemic-induced recession, its economic expansion is set to decelerate considerably this year and next; we expect Russia's invasion of Ukraine to dampen export growth and domestic demand, driven by relatively close trade ties with Russia, as well as surging prices, exacerbated supply-side bottlenecks, and weakening private sector sentiment
2. While Finland's economy is characterized by a high degree of wealth and diversification, medium- to long-term growth prospects remain rather dim, as unfavorable demographics, coupled with low productivity growth and labor market mismatches, are set to translate into modest underlying growth; policy-makers have adopted a raft of structural reforms tackling the economy's pivotal challenges
3. Finland features extraordinarily sound institutional conditions, remaining one of the global front-runners in terms of good governance; we see high-quality government effectiveness underscored by ongoing health and social services reform as well as various structural reform initiatives; whilst its membership in the EU and EMU entail substantial advantages, the geopolitical situation prompted the sovereign to abandon its neutrality, prospectively joining NATO;
4. Following a marked improvement of the sovereign's public finances in 2021, we expect Finland's moderate public debt ratio to edge up gradually over the medium term, reflecting fiscal costs pertaining to Russia's military aggression against Ukraine and the government's measures to achieve its key economic policy objectives;
5. Fiscal risks are manifold, mainly relating to the geopolitical situation, sizable contingent liabilities, and age-related spending; however, we do not believe that the debt trend will derail, as key credit strengths remain in place, namely transparent and credible fiscal policy-making, sound debt management, significant government assets and high debt affordability

6. Despite close trade ties to Russia and the MFI's large external exposure, we deem external risks as contained, expecting Finland's current account to record only modest deficits this year and next, while its net international investment position (NIIP) is only slightly negative

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

We continue to view the sovereign's macroeconomic performance profile as a key support to its credit ratings, mainly reflecting very high GDP per capita and a moderate, but stable economic growth trend. The Finnish economy has witnessed less pronounced swings in economic performance in the wake of Covid-19 thanks to swift policy action, the economic structure displaying a high degree of diversification and tele-workability, as well as a comparatively low population density. New economic and societal challenges are engendered by Russia's war against Ukraine. Although the further geopolitical development is shrouded by uncertainty, we believe that medium-term growth will remain broadly robust. Replacing Russian trading partners as well as raw materials will take some time, but has already begun, and we assume that Finland's corporate and energy sector will progress in this respect going forward. Employment will presumably prevent more adverse economic effects. Although supply-chain disruptions coming on the back of the pandemic and the Russian invasion of Ukraine have put a break on the imminent improving trend, policies geared towards tackling Finland's loss of cost-competitiveness have borne some fruit by now, whilst we perceive non-cost competitiveness as a strength. More generally, structural challenges associated with anemic productivity growth and Finland's shrinking and aging work-force remain in place. We will closely follow the raft of structural reforms addressing the economy's pivotal challenges, which have been adopted by policy-makers but will take time to show their full effect.

First and foremost, Finland's wealthy and productive economy continues to buttress the sovereign's rating. At the latest count, GDP per capita totaled USD 53,757 in 2021 (IMF data, PPP terms), up from USD 50,041 a year before. Thus, the Finnish per capita income represents the 23rd highest reading world-wide and is broadly in line with GDP p.c. of AA-rates peers, standing below the Austrian (USD 59,692) and Belgian (USD 57,036) level, but well above the UK (USD 50,388) and France (USD 51,364). Nominal labor productivity per person posts 7.6% above the EU27 total (2021, PPS, Eurostat).

The strong growth in GDP per capita was backed by a robust and swift recovery in last year's real GDP growth. The pandemic-related contraction in total output was one of the smallest in Europe, as Finland's real GDP declined by only 2.2% in 2020 as compared to 6.3% in the euro area (EA) overall, and was followed by solid growth of 3.0% in 2021 (EA: 5.4%). Indeed, Finland managed to recoup the output losses already by mid- 2021, surpassing the pre-pandemic level of Q4-19 by 0.4% in Q2-21.

The solid growth performance was mainly due to a strong rebound in household spending, reflecting the easing of Covid-19 restrictions and upbeat sentiment. Private consumption grew at q-o-q rates of 1.9% (Q2) and 1.3% (Q3) in the summer, increasing by 3.6% in 2021 overall (2020:

[1] This rating update takes into account information available until 08 July 2022.

-4.1%). Benefiting from strong wage and employment growth (see below), households thus contributed 1.9 p.p. to last year's real GDP growth. Largely driven by ongoing Covid-19 aid measures, government consumption also boosted the 2021 growth outturn (+0.6 p.p.). Fixed investment recovered moderately, expanding by 1.1% following its declines in 2019/20, thanks to investment in residential property (+5.8%) as well as in equipment (+4.0%). Net foreign trade was flat, as the rebound in exports was met by strong import growth, facilitated by brisk domestic demand.

As the Finnish economy weathered the Omicron wave quite well and confidence among households and corporates continued to improve at the turn of the year, the outlook was for a continued solid economic expansion. However, the Russian invasion of Ukraine has changed perspectives, dampening economic prospects and raising uncertainty substantially. Despite the positive surprise in Q1-22 in which total output rose by 0.5% q-o-q, we expect real GDP growth to ease significantly, falling to 1.2% in 2022 and 0.9% in 2023.

We note that uncertainty around this forecast is unusually high. A brief recession cannot be ruled out entirely, with risks to economic growth mounting as Russia's war drags on. The armed conflict weighs on export growth and suppresses domestic demand via rising economic uncertainty, soaring prices for energy, food, and raw materials, as well as supply-side bottlenecks.

Apart from its geographical proximity, Finland's economy is closely linked to Russia's via the goods trade channel. Russia was Finland's fifth largest export market in 2021, standing for roughly 5.4% of total goods exports, and second-largest import partner (11.7% of total imports in 2021, UN Comtrade data). Drawing on OECD TiVA data, the Bank of Finland (BoF) gauges the affected Finnish value added of goods exports to Russia to total approx. EUR 2.7bn or 1.1% of GDP.

As a corollary, we assume that sanctions and counter-sanctions will have considerable adverse effects on growth in goods exports directly via bilateral trade ties as trade with Russia plummets, and indirectly on the back of softening economic growth in Finland's European trading partners. As a case in point, we have seen exports plunge by 10.6% q-o-q in this year's first quarter, although base effects due to the strong Q4-21 outturn were also likely at play.

Whilst net foreign trade should act as a drag on economic growth this year, reflecting imports outgrowing exports, we assume that its contribution will turn mildly positive in 2023 as the roughly 2,200 businesses with trading links to Russia (BoF data) increasingly succeed in diverting trade to alternative export markets. Still, the re-orientation of trade flows will ultimately be a rather gradual process.

The recovery of consumer demand in the wake of the pandemic came to a halt in Q1-22 (-0.3% q-o-q) and we expect private consumption to suffer from adverse effects and rising uncertainty entailed by the geopolitical situation going forward. Surging inflation, in particular fuel, energy, and food prices, as well as prospectively rising interest rates, will act as headwinds to household spending growth, eating into households' purchasing power. In fact, consumer sentiment has taken a severe hit.

However, we see a good chance that confidence will quickly recover, as the deterioration seems largely driven by households' assessment of the general economic situation over the next 12 months, while their assessment of their financial situation going forward was significantly less affected. This said, inflation will likely remain elevated next year, thereby curtailing real disposable income.

To some extent, adverse effects on real disposable income should be mitigated by the government's aid package to cushion the effects of rising prices and accumulated savings. As households could increasingly resort to loans to maintain spending, the relatively moderate savings rate (1.2% of disposable income, Statistics Finland) may well turn negative in 2022/23. Moreover, consumption will be sustained by the overall robust labor market development

Favorable labor market developments are reflected by the harmonized monthly unemployment rate, which dwindled from a pandemic peak of 8.8% in Aug-20 to 6.2% in May-22 (May-21: 8.2%), posting somewhat below the euro area average of 6.6%. The declining unemployment rate came on the back of vivid employment growth that climbed to a new record high in this year's first quarter, seeing 2.77mn people employed, having risen by yearly rates of 4.1% or more over the last four quarters. Furthermore, Finland's pre-pandemic participation rate was swiftly restored, standing at an above EA19 average of 74.1% in Q1-22 (15-64y, EA: 69.4%), up from 71.7% a year before.

We think that the Finnish labor market will be able to absorb the exogenous shock, but expect somewhat softer labor demand going forward, mirroring weakening economic activity. In addition, Finland's labor market is becoming increasingly tight, with its vacancy rate rising to record high 3.9% (Q1-22, NACE sections B-S). At the same time, there are growing reports of labor market mismatches, mainly due to skilled labor shortages.

Tremendous uncertainty created by the geopolitical situation should prompt businesses to push back plans to invest in machinery and equipment, whilst re-intensifying supply-side bottlenecks will likely stifle industrial production to some degree, or make it somewhat more expensive at least, as Finnish business have begun to revert to alternative suppliers of primary and intermediary inputs.

We forecast equipment investment to grow, partly due to solid demand for services, but at a significantly slower pace than previously expected. Capacity utilization dipped below the long-term average in Q2-22 (80.2% vs. 81.0%), new orders have tailed off and sentiment has deteriorated. Fixed investment will presumably be fostered by public investment, while construction investment should weaken beyond 2022, inter alia suggested by building permits which declined in Q4-21 and Q1-22.

Further afield, our underlying assumption is that economic growth converges towards its potential growth rate which the European Commission (EC) estimates at 1.5% and 1.4% in 2022 and 2023, respectively. That said, we have to reiterate our concerns about medium- to longer-term potential growth which, all else being equal, will likely be obstructed by Finland's structural challenges, essentially its rapidly aging and shrinking workforce.

As elaborated in our last review, Finland's old-age dependency ratio is high. In fact, the ratio (1st variant) increased from 36.0 to 36.8 in 2020-21, well above the readings of Nordic peers Sweden and Denmark and represents the second-highest level in the EU (avg. 32.5). We thus take the view that labor input will constrain rather than lift potential growth going forward. Concurrently, growth in labor productivity per hour worked has been sluggish over the last decade, with the annual average in 2012-21 coming in at only 0.6% as compared to 0.9% in the EU27 and 1.1% and 1.3% in Sweden and Denmark respectively.

On the other hand, we have to highlight that the government continues to pursue its key policy objective of significantly raising Finland's employment rate, i.e. by a minimum of 60,000 people by end-25 and by 80,000 workers by the end of the decade, and has seized measures to facilitate

the development of skills and mitigate the gradual decline in research, development, and innovation (see below). Finland appears to be on track with regard to its employment rate target, which amounted to a record-high 73.8% as of Apr-22 (15-64y), up from 71.5% in Apr-21 and 68.3% in Apr-17. Moreover, underlying growth should be boosted by investments aimed at the development of new technologies, in particular in sectors which are essential for promoting the twin transition (green and digital).

We note that these reforms will take time to yield meaningful results, but are also likely to increase Finland's competitiveness, mainly via its policies addressing challenges pertaining to the green and digital transformation, as well as R&D. Cost-competitiveness, as measured by real unit labor costs, has been largely preserved throughout the corona crisis. As real labor productivity moved broadly in tandem with real compensation, real unit labor costs were kept stable in 2021 (+0.2%, AMECO data) as well over a three-year horizon (2018-21: -0.1%). Between 2012 and 2021, real unit labor costs evolved significantly more favorably than in the euro area as a whole (-7.3% vs. -0.7%) and in key trading partners such as Germany (+2.6%).

Against this background, we will closely follow wage developments going forward, as the inflationary environment, as well as labor shortages, may induce marked pay increases, implying a wage-price spiral which would eventually prove detrimental to the recent successes in aligning productivity and wage growth. According to BoF intelligence, pay rises related to collective bargaining rounds have been moderate so far, but pressure for higher agreement increases in 2023 are growing.

Judging by one of our preferred measures for competitiveness, the global export market share, Finland was broadly able to retain its competitiveness, with its share of goods and services exports coming in at 0.42% in 2021, having edged down from 0.44% in 2020. While we still await an update to the World Economic Forum's Global Competitiveness ranking, in the 2019 assessment Finland stood at rank 11/141 economies worldwide, with Finland at 8th place out of 63 economies in the IMD World Competitiveness Yearbook ranking (2022, 2021: rank 11).

Institutional Structure

The Republic of Finland remains a global leader with a view to good governance and the authorities' perceived capacities to effectively formulate and implement prudent policies. We regard the extraordinarily high quality of Finland's institutional framework as a cornerstone of its very high creditworthiness. Our assessment also reflects the sovereign's membership in the European Union and the European Monetary Union, as well as broadly synchronized movements in HICP inflation, MFI interest rates and wages with the euro area. In light of the geopolitical developments, Finland decided to become part of the NATO alliance, in our view enhancing Finland's security, ultimately reducing Finland's country risk. We think that hallmark decisions such as the Competitiveness Pact (2016) or the Health and social service reform (SOTE, 2021) pay testament to the government's farsighted, prudent, and responsive policies. In the same vein, authorities recently decided to reformulate their climate policies as well as defense, cyber and border security policies.

Our assessment of Finland's institutional quality mainly factors in the World Bank's Worldwide Governance Indicators (WGIs). The latest vintage of WGIs show that the sovereign continues to achieve exceptionally good results. Finland has persistently been among the leaders in the respective league tables, not only from a European angle, but also on a global scale. In our view,

this underscores its long-standing track record of very sound and predictable policies which are based on a high degree of cross-party consensus.

Overall, the sovereign is listed in the top-3 across all WGIs we consider, and we have spotted no notable changes as compared to the year before. Regarding the perceived quality of policy formation and implementation, Finland ranks at 3 out of 209 economies. With a few exceptions, the sovereign was placed among the top-3 for most of the last two decades (except 2007, rank 6, and 2015, rank 5), highlighting the stellar quality of public services. Finland scores extremely high when it comes to the WGIs voice and accountability as well as control of corruption, respectively, achieving a 2nd rank, tantamount with a very high degree of personal freedoms, e.g. expression and association, whereas the extent to which private power is exercised for private gain is perceived as very low. Additionally, Finland continues to feature the best-performing justice system in the world, with a relative rank 1/209 on the WGI rule of law signaling an extremely high perceived quality of judicial independence and effectiveness, contract enforcement, and property rights.

The quality of the sovereign's justice system is confirmed by the EC's assessment in the context of its latest Rule of Law Report (20-Jul-21). According to the EC, the National Courts Administration established in 2020 facilitates the courts' operations considerably, whilst the recently implemented single National Prosecution Authority has enhanced the efficiency of the justice system. Concerning regulation of lobbying, we understand that implementation of a transparency register is underway. We gather that individuals and organizations involved in lobbying will be required to be entered into an electronic register and report their respective activities from 2024.

We continue to view the sovereign's policy-making as very forward-looking and responsive. Since our last review, Finland has pushed ahead with further reforms to achieve its key economic policy objective of lifting the employment rate to 75% and 80% by 2025 and 2030, respectively. Additional labor market reforms geared towards enhancing the functioning of the Finnish labor market and removing disincentives to work have thus been decided more recently.

The set of measures includes most notably the conversion towards the Nordic employment services model from May-22, foreseeing a personal job search obligation and closer extensive consultation support, with unemployment security attached to the number of applications for job opportunities, whilst municipalities take on a greater role and receive more funding to that end. Furthermore, the additional days of unemployment security available until the age of 65y is to be phased out, public employment services are to become more digitalized, and a new agency specialized on facilitating the employability of persons with partial work ability will be established.

Besides improving labor market outcomes, policy-makers have tabled various reform initiatives aimed at raising the economy's productivity growth and advancing Finland's competitive edge, inter alia by significantly shoring up investment in R&D and increasing high-speed broadband connectivity. An integral part of the government's strategy is the goal of addressing the digital transition and achieving carbon neutrality. Regarding the former, Finland seems to come from a favorable starting position, being ranked 2nd in the EU 27 concerning the EC's Digital Economy and Society Index.

In light of the green transition being perceived as a pressing issue, authorities agreed that the current policy set-up would not be sufficient to reach Finland's climate goals and reformed the

2015 Climate Change Act. The new Climate Change Policy Plan entered into force in July 2022 and provides for reaching carbon neutrality by 2035, in which case Finland would be the world's first fossil-free society. In presenting the General Government Fiscal Plan 2023-26, it was announced that the government would implement several measures to forge ahead in withdrawing from fossil energy and promoting new green technologies. Meanwhile, the amended Land Use and Building Act is planned to become effective as of January 2024, placing more weight on the energy efficiency of buildings.

We deem Finland as a leading economy in terms of sustainable development and environmental policy-making, performing very well on the EC's eco-innovation index and on the UN SDGs more generally. To be sure, Finnish greenhouse gas emissions still post well above the EU27 average (2020: 7.5 tons p.c.) and the levels observed in Nordic peers (Denmark: 7.3 tons, Sweden: 4.6 tons), but have declined markedly from 10.0 tons p.c. to 8.8 tons in 2019-20. At the same time, Finland ranks second in the EU27 as regards the overall share of energy from renewable sources (2020: 43.8%, EU 22.1%).

We note that the Russian war against Ukraine has motivated Finland's decision-makers to review its security policies, resulting in its application for NATO membership. The request was granted, prospectively strengthening Finland's national security. The ratification process was brought under way, as the respective accession protocol for Finland was signed by NATO ambassadors on 05 July 2022.

Fiscal Sustainability

The sovereign's public finances continue to be a supportive factor to its credit ratings. Fiscal metrics improved after the weaker outturn related to the corona crisis, and we expect government finances to strengthen in the near term. At the same time, we expect the sovereign's debt-to-GDP ratio to edge up gradually over the medium term, reflecting multiple fiscal pressures, inter alia the economic and social fallout from the Russian invasion of Ukraine, spending on security and defense, initiatives related to boosting the economy's potential output (e.g. ramped-up spending on R&D and education), as well as the green and digital transformation. That said, we expect Finland's public debt ratio to remain at manageable levels. Despite the incipient monetary tightening of the ECB, funding costs will presumably remain favorable for the sovereign. Further fiscal risks pertaining to contingent liabilities, the large and concentrated, albeit sound banking sector, as well as to demographics are here to stay, but are balanced by sound and transparent fiscal policy-making, prudent debt-management, and by significant government assets.

The corona crisis had resulted in a marked decline in economic growth and substantial government measures to mitigate the economic and social fallout from the pandemic. Accordingly, 2020 saw a significant deterioration in Finland's fiscal metrics, which nevertheless remained in better shape than in the euro area overall. The headline deficit widened significantly to -5.5% of GDP in 2020, following moderate deficits in 2015-19, averaging at -1.3% of GDP per year. Last year's solid growth rebound and lower outlays related to the pandemic led to considerably strengthening government finances. Drawing on Statistics Finland data, the deficit halved to approx. EUR 6.8bn or -2.7% of GDP in 2021.

The improvement was due to strong general government revenue growth which came in at 8.0% in 2021. Tax receipts benefited from the significant economic recovery, with income, property and other direct taxes jolting by 10.7%, and taxes on production and imports rising by 4.8%.

What is more, social security contributions grew markedly by 12.5%. Meanwhile, total government expenditure dropped to 55.5% of GDP in 2021, rising by 2.5% y-o-y on the general government level and thus slower than last year's nominal GDP. While the public wage bill increased by 4.7%, expenditure was kept in check by decreasing fixed investment (-9.0%), subsidies (-9.5%), and interest outlays (-20.4%).

Looking forward, we believe that government finances will ultimately remain healthy, strengthening in the current and the following year. We have to emphasize, however, that the sovereign's fiscal consolidation will be impeded by the current geopolitical events. Thus, benign effects entailed by receding expenditure associated with the Covid-19 pandemic will be thwarted by additional costs coming on the back of the Russian war against Ukraine and concomitant adverse reverberations regarding Finland's economic activity and price pressures.

We would tentatively expect the headline deficit to inch down to 2.4% of GDP this year and narrow further to 2.2% of GDP in 2023, mainly on account of discontinued Covid-19 measures and solid tax receipts backed by robust employment growth and a relatively favorable financial situation for companies. We have to caution that these forecasts are subject to unusually high uncertainty, being dependent on the further development and duration of Russia's war against Ukraine. Additionally, re-surfacing challenges related to the Covid-19 pandemic and new virus variants cannot be ruled out, although we have not incorporated significant budgetary effects at this stage.

In this vein, Covid-19-related support will ebb. Discretionary expenditure with respect to the pandemic will amount to roughly EUR 0.6bn or 0.2% of our estimated 2022 GDP, substantially below the approx. EUR 6bn budgeted for 2021. We note that the government had presented an increase of somewhat more than EUR 300mn via its first supplementary budget in February, reflecting the epidemiological situation due to the Omicron strain.

By contrast, the Russian invasion will translate into a significant burden for the sovereign's public finances. Apart from somewhat softer tax revenue growth due to decelerating economic growth, the geopolitical context engenders a variety of fiscal pressures. On the one hand, policy-makers decided to implement a package to aid severely hit businesses and ease the effects of soaring prices, mainly targeting vulnerable persons, inter alia by adjusting pension and unemployment benefits as well as social assistance. Moreover, the government will deploy significant funds for the procurement of defense material and operating expenditure for border control in a bid to strengthen national security. Seeking to reduce risks to cyber security, additional funding will be earmarked for related measures.

The Finnish parliament approved a second supplementary budget in June which provides for roughly EUR 2bn (0.7% of GDP) in additional spending related to Russia's military aggression. Overall, the adopted supplementary budgets have raised net borrowing requirements by approx. EUR 1.85bn to EUR 8.9bn, according to information provided by the Ministry of Finance (MoF).

Whilst indirect taxes, e.g. on tobacco, alcohol and fuels will be raised and cost effectiveness of the healthcare sector tackled by the health and social services reform, public finances will presumably remain in deficit over the medium term. Spending pressure stems from higher spending limits for defense and border security, outlays for the Air Force fighter project 2023-26 amounting to EUR 4.8bn, as well as immigration, to which authorities allocate EUR 0.3 to 0.8bn per year as per General Government Fiscal Plan 2023-26. The reformed earned income taxation

for low- and middle-income earners tends to act so as to decrease revenue. The green and digital transformation will remain a key determinant for additional spending needs, with only part of the extensive set of measures financed by the EU's Recovery and Resilience Facility. Also, authorities have envisaged to ramp up R&D expenditure to 4% of GDP by 2030.

Hence, we forecast general government debt to trend slightly upwards over the medium term. Still, in our view, government debt should remain sustainable and remain at manageable levels. Drawing on Eurostat data based on Finland's spring notification, Finnish general government debt dropped from 69.0% of GDP in 2020 to 65.8% of GDP last year. On that count, we expect debt-to-GDP to fall to 65.0% in 2022 before increasing to 66.2% next year, with moderate deficit levels cushioned by strong nominal GDP growth and low debt servicing costs.

We take note of Statistics Finland's methodological changes to the calculation of general government debt and will factor in these alterations starting with the GFS 2022 autumn notification. Considering revised national accounts data (22 June), as well as the exceptional revision in EDP debt statistics (28 June), debt-to-GDP stood at 72.3% of GDP at the end of 2021, also well below the euro area average of 95.6% of GDP.

High debt affordability remains a key balancing factor mitigating fiscal risks. Interest costs have diminished over recent years, declining from 0.8% of GDP to 0.6% of GDP in 2020-2021. Set against total consolidated income, interest outlays fell from 1.5% to 1.1%, corresponding to one of the lowest readings in the EU27. The average weighted maturity has been increasing over the last years, reaching 7.62y in May-22 (May-19: 6.39y, ECB data).

We think that the sovereign will be able to meet financing needs, inter alia by taking up debt at comparatively low rates. Towards the end of June, Finland's 10-year government bond yields continued to increase, posting at their highest level since March 2014 (24-Jun-22: 1,848%, weekly quote). Having said this, Finnish yields move in tandem with German Bunds, and spreads are still relatively low (24-Jun-22: 24bp).

To be sure, we expect that the interest rate environment is set to become increasingly less benign, mirroring the turning tides with regard to key policy rates amid rapidly rising prices. Following its June monetary policy meeting, the ECB Governing Council announced in a much anticipated step that the ECB intends to begin normalizing its monetary policy. The ECB thus envisaged ending its net asset purchases under the Asset Purchase Program (APP) in Jul-22 and to hike its key interest rates by 25bp, with a further 50bp rise likely to take place in Sep-22.

Principal payments from maturing securities purchased under the APP will be reinvested for an extended period of time, whilst principal payments purchased under the PEPP are to be reinvested until at least end-24. Cumulative net purchases under the APP (Apr-22 data) and the PEPP (Mar-22 data) combined make up for approx. 42% of Finland's general government gross debt, among the highest levels in the euro area.

Alongside aging costs, which BoF projects to remain very high at 30.4% of GDP in 2030 (2020: 30.4% of GDP), we continue to view sizable contingent liabilities as a potential source of vulnerability in terms of fiscal sustainability. As illustrated by MoF data, central government guarantees rose further in nominal terms, with the outstanding stock more than doubling to EUR 64.2bn over the last decade (2020: EUR 61.7bn). Totaling 25.5% of GDP, contingent liabilities are among the highest in the EU.

In the same vein, we continue to monitor the banking sector, which not only ranks among the largest in the EU (Q4-21: 346.2% of GDP), but also exhibits a very high degree of concentration and regional interconnectedness. Risks to financial stability cannot be discounted, with Finnish banks being largely dependent on investor confidence and wholesale finance, for instance reflected by a still high loan-deposit-ratio (Q1-22: 147.2), and risks in the real estate market building up. This is all the more, as the resilience of households is tested amid the current geopolitical turmoil.

Household debt, most of which takes the form of loans for house purchases, has increased steadily over recent years, having mounted to 120.9% of disposable income in Q4-21 (Q4-20: 117.8%), one of the highest readings in the EU. At the current juncture, we would deem the housing market as broadly stable, although we have to point out that residential property prices have evolved relatively dynamically since the onset of the corona crisis as demand was not in line with the supply of homes. House prices grew by 4.3% y-o-y in Q1-22 and Q4-22, respectively, as opposed to a quarterly average of 1.0% in 2015-19 (Eurostat data). BoF analyses indicates that borrowers should be prepared for debt-related risks, as the size of housing loans has increased in nominal terms as well as relative to borrowers' net income, and repayment periods tended to become longer, whilst new housing loans are mainly tied to Euribor rates.

At the same time, financial stability metrics hint at enduring banking sector soundness, with the CET 1 ratio edging down to 17.5% in Q1-22 (Q1-21: 18.1%), but remaining above the EU average of 15.2% (EBA data). Asset quality is high, as suggested by a low NPL ratio of 1.1% at the end of Q1-22 (EU average 1.9%). Furthermore, MoF tabled a proposal on new macro-prudential tools, e.g. limiting the maturity of mortgages and the share of housing company loans in new construction, as well as the obligation to analyze default risks in consumer lending.

Foreign Exposure

We think that external risks related to Finland remain limited, although the geopolitical situation could lead to a somewhat weaker external position, partly due to direct and indirect trade effects linked to Russia and to a somewhat diminished cost-competitiveness as a consequence of potential second-round effects of rising inflation. However, we expect only moderate current account deficits in 2022/23. The slightly negative NIIP continues to mirror the financial sector's large external liabilities balanced by sizable external assets on behalf of social security funds and NFCs.

Finland continued to run a current account surplus in 2021, coming in at 0.9% of GDP, after 2020 (0.6% of GDP) marked the first year in almost a decade of the Finnish economy posting a surplus (2010-19 average -1.1% of GDP). Robust services export growth, which outstripped that of services imports, translated into an improvement of the deficit in the services balance (-1.1% of GDP to -0.9% of GDP in 2020-21). The robust primary income surplus was maintained, standing at 1.8% of GDP, up from 1.7% of GDP in 2020 (2010-19 average: -1.1% of GDP) – lifted by declining dividend earnings of non-residents.

We expect moderate current account deficits in 2022 and 2023, respectively. The current account's assumed shift into negative territory will be mainly due to compressed exports, which should decline stronger than imports, and a narrowing primary income surplus. The four-quarter moving sum of the current account already appears to mirror the adverse impact of the Russian invasion, as the current account dropped sharply from 0.9% of GDP in Q4-21 to 0.1% of GDP this year's first quarter. The decline was largely driven by the falling goods surplus, which

halved from 1.2 of GDP to 0.6% of GDP, as well as by the deteriorating services balance (0.9% of GDP to -1.2% of GDP).

Given our expectation of only modest current account deficits, Finland's NIIP should remain close to balance in the near term. As of the first quarter of 2022, the NIIP equated to 4.2% of GDP, up from -3.2% of GDP in Q1-21. At this level, the NIIP signals no imminent external sustainability risks. However, we have to reiterate that risks related to the financial sector's still sizable external liabilities. The stock of external liabilities of other MFIs as measured by GDP fell from 113.5% of GDP in Q4-20 to a still high 104.5% of GDP in Q4-21 (Statistics Finland data).

Rating Outlook and Sensitivity

Our rating outlook on Finland's long-term credit ratings is stable, as we expect that the geopolitical situation and the related adverse impact on Finland's economy and public finances will ultimately remain limited. In any case, we believe that related risks, in particular with a view to the medium term, will essentially be mitigated by exceptionally high institutional quality and prudent policy formulation. That being said, we have to emphasize that the assessment and interpretation of economic developments remains subject to unusually high uncertainty in light of the recent accumulation of crises, as is the case for other indicators, essentially from the fiscal realm.

We could contemplate upgrading the outlook or the rating if medium-term economic growth comes in significantly higher than currently assumed in our baseline scenario, which may be due to a less severe economic impact of the Russian invasion in Ukraine, Finnish corporates adapting their business models or finding new trading partners more swiftly than currently assumed, and/or investment activity expanding more robustly, e.g. on the back of pull factors associated with the green and digital transition. Moreover, we could consider a positive rating action if the government's structural reforms foster the economy's potential growth or if the debt trend reversed on a sustainable basis.

On the other hand, the sovereign's outlook or rating could come under pressure if the geopolitical situation has a significantly greater adverse impact on Finland's economic activity and labor market than we currently assume, as well as on the sovereign's fiscal metrics, i.e. its public debt ratio would increase substantially and over a longer period of time. Likewise, we could consider a negative rating action if contingent liability risks materialize, which is not our base case at present.

Analysts

Primary Analyst
Fabienne Riefer
Senior Analyst Public Finance
f.riefer@creditreform-rating.de
+49 2131 109 1462

Chairperson
Dr Benjamin Mohr
Head of Public Finance
b.mohr@creditreform-rating.de
+49 2131 109 5172

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

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 the following, we explain how and to what 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 to 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.

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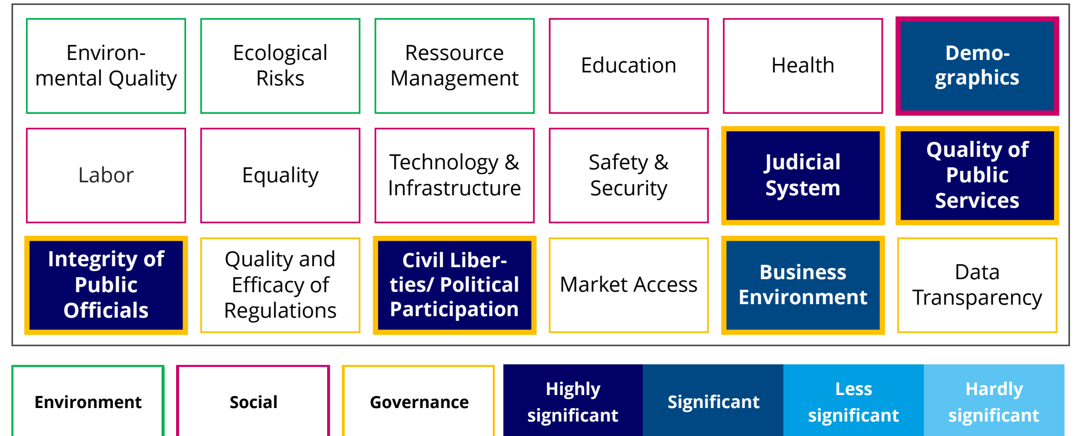
ESG Factor Box



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.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor 'Demographics' as significant since it has a bearing on the economy's potential growth as well as medium-term fiscal prospects.

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.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021	2022e
Macroeconomic Performance							
Real GDP growth	2.8	3.2	1.1	1.2	-2.2	3.0	1.2
GDP per capita (PPP, USD)	44,995	47,622	49,228	50,676	50,041	53,757	58,010
Credit to the private sector/GDP	95.7	94.7	95.9	97.3	102.1	100.6	n/a
Unemployment rate	8.9	8.7	7.5	6.8	7.7	7.7	n/a
Real unit labor costs (index 2015=100)	98.5	94.6	95.2	95.6	94.9	95.1	n/a
World Competitiveness Ranking (rank)	20	15	16	15	13	11	8
Life expectancy at birth (years)	81.5	81.7	81.8	82.1	82.0	82.0	n/a
Institutional Structure							
WGI Rule of Law (score)	2.0	2.1	2.1	2.1	2.1	n/a	n/a
WGI Control of Corruption (score)	2.2	2.2	2.2	2.2	2.2	n/a	n/a
WGI Voice and Accountability (score)	1.5	1.6	1.6	1.6	1.6	n/a	n/a
WGI Government Effectiveness (score)	1.9	2.0	2.1	2.0	1.9	n/a	n/a
HICP inflation rate, y-o-y change	0.4	0.8	1.2	1.1	0.4	2.1	6.0
GHG emissions (tons of CO2 equivalent p.c.)	10.9	10.4	10.6	10.0	8.8	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-1.7	-0.7	-0.9	-0.9	-5.5	-2.7	-2.4
General government gross debt/GDP	63.2	61.2	59.8	59.6	69.0	65.8	65.0
Interest/revenue	2.0	1.9	1.7	1.6	1.3	0.9	n/a
Debt/revenue	117.1	115.5	113.9	113.9	133.7	125.7	n/a
Total residual maturity of debt securities (years)	6.1	6.2	6.3	6.4	6.4	7.2	n/a
Foreign exposure							
Current account balance/GDP	-2.0	-0.8	-1.8	-0.3	0.6	0.9	n/a
International reserves/imports	0.2	0.1	0.1	0.2	0.2	0.2	n/a
NIIP/GDP	5.5	1.2	-5.6	4.0	-5.0	-3.5	n/a
External debt/GDP	194.7	181.0	218.3	224.4	222.7	205.9	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Statistics Finland, IMD Business School, 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
Monitoring	24.07.2020	AA+ /stable
Monitoring	16.07.2021	AA+ /stable
Monitoring	15.07.2022	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. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The State Treasury Finland participated in the credit rating process as it provided additional information. Creditreform Rating AG had no

access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

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, World Economic Forum, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Bank of Finland, Statistics Finland, Republic of Finland – Ministry of Finance, Tulli, Finland Financial Supervisory Authority (FIN-FSA), National Audit Office.

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.

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Creditreform Rating AG

Creditreform Rating

Creditreform Rating AG
Europadamm 2-6
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Michael Bruns
HRB 10522, Amtsgericht Neuss